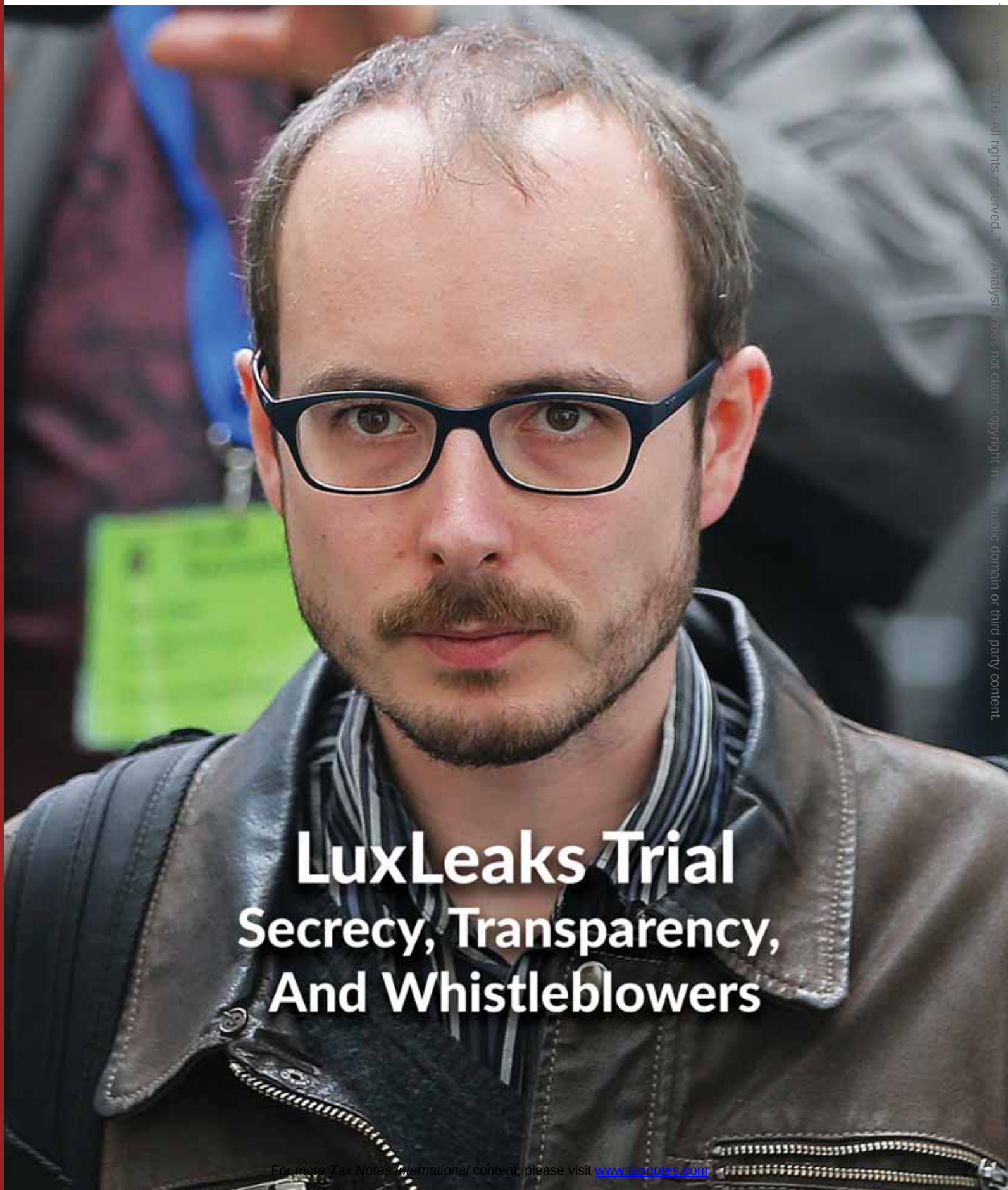
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Volume 82, Number 5 ■ May 2, 2016



LuxLeaks Trial
Secrecy, Transparency, And Whistleblowers

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FROM THE EDITOR

LuxLeaks on Trial: Whose 'Public Interest' Will Prevail?

by Stuart Gibson

Tax Analysts was founded 45 years ago to promote transparency and open government in tax policy and administration. For us the LuxLeaks trial that began last week may represent the quintessential battle between darkness and light, secrecy and openness. We are pleased to provide coverage from Tax Analysts' Teri Sprackland, who is reporting on the trial from inside the courtroom. (Coverage of the LuxLeaks trial begins on p. 411.)

On one side are the Luxembourg prosecutors, supported through the criminal investigation and at trial by global accounting firm PwC, whose records were taken and leaked to the press. They are trying to prove that former PwC employees Antoine Deltour and Raphaël Halet and journalist Edouard Perrin committed criminal violations of Luxembourg's strict business privacy laws.

On the other side are the defendants, their lawyers, and much of the public. Some prominent people have recently voiced their support for Deltour, who was awarded the 2015 European Citizen's Prize by the European Parliament. French Finance Minister Michel Sapin shortly before the start of the trial delivered an impassioned speech on the floor of the French legislature supporting the defendants (all of whom are French). Two German members of the European Parliament, Sven Giegold and Fabio De Masi, are testifying for the defense at trial.

There can be little doubt that the three defendants improperly took from PwC and made public copies of tax rulings issued by the Luxembourg finance ministry to about 340 multinational clients of PwC — that is a crime by almost anyone's standards. There is also little doubt that the accounting firm's computer systems were secured — if you can call it that — by the digital equivalent of a password consisting of the numbers 1234. Finally, it is almost certain that had these rulings become public when they were issued, calls for greater tax transparency would have echoed throughout Europe long ago, leading to greater openness and information exchange and less tax avoidance within the European Union.

At its core, the trial pits two views of the public interest against each other. On one side is the public interest in the people's right to be secure in their property, including digital property. Advocates of this view would argue that respect for private property represents a bedrock value of a democratic society, perhaps citing the Fourth Amendment to the U.S. Constitution. On the other side is the public interest in open government, and the people's right to know how their representatives develop and implement public policy. Supporters of this view would argue that it is critical to the public interest to protect whistleblowers who expose the secret inner workings of government to the public. They would cite Daniel Ellsberg's release of the Pentagon Papers as helping end the United States' involvement in the Vietnam War.

At the end of the trial the judges hearing the case will have to weigh these competing views, apply the laws of Luxembourg, and arrive at a decision. Whatever they decide, we hope they will acknowledge the importance of both sides, and not unduly punish individuals who were, at least in the view of many, doing the right thing.

Much has been written about the Panama Papers since the International Consortium of investigative Journalists (ICIJ) disclosed information about them last month. Expect more controversy when the ICIJ releases a searchable database of the documents on May 9. Mindy Herzfeld reviews the responses of the tax community to the leaks and cautions against knee-jerk responses that could backfire (p. 415).

♦ *Stuart Gibson is editor of Tax Notes International.*

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CORRESPONDENCE: Correspondence regarding editorial matters and submissions should be sent to the Editor, *State Tax Notes,* 400 S. Maple Ave., Suite 400, Falls Church, VA 22046 USA, or e-mailed to **tni@taxanalysts.org**.

SUBSCRIPTIONS, ADDRESS CHANGES: Change of address notices, subscriptions, and requests for back issues should be sent to the Customer Service Department, Tax Analysts, 400 S. Maple Ave., Suite 400, Falls Church, VA 22046 USA, or e-mailed to customer.service @taxanalysts.org.

REFUND POLICY: All Tax Analysts products and services are subject to a full money-back guarantee within the first 30 days after each initial purchase.

FREQUENCY: *Tax Notes International* is published 51 weeks of the year by Tax Analysts.

DELIVERY: *Tax Notes International* is delivered by first-class mail, hand delivery, or international air mail, without additional charge.

FORM OF CITATION: Articles appearing in *Tax Notes International* may be cited by reference to the date of the publication and page, thus: *Tax Notes Int'l,* Jan. 5, 2004, p. 25.

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LUXLEAKS TRIAL

LuxLeaks Trial Opens; PwC Data Breach in Spotlight

by Teri Sprackland

TNI reporter Teri Sprackland is in Luxembourg covering the LuxLeaks trial. Following are her daily dispatches. Sprackland's coverage of the trial will continue in the May 9 issue of *Tax Notes International*.

A Luxembourg district court on April 26 opened criminal proceedings for theft of corporate documents and other crimes under the Grand Duchy's strict professional secrecy laws against French whistleblower Antoine Deltour and two other French citizens: reporter Edouard Perrin and Raphaël Halet, a previously unnamed defendant who, like Deltour, is a former PwC employee.

According to PwC witness Anita Bouvy, the documents taken by Deltour were accessible through an oversight in computer systems management. The company did not know that scanned documents were easily accessible under its Microsoft software package. Halet was employed by PwC as a manager of a five-person team that provided clerical assistance in scanning documents and sending them to clients. No prior connection between Deltour and Halet has been alleged. Changes to corporate software security were made after the problems were uncovered as a result of the LuxLeaks press coverage.

Perrin has been accused of arranging, some months after receiving the original information from Deltour, an unrelated theft by Halet of rulings and actual tax statements of several large PwC clients. Information was exchanged through a Google account said to be called ''$100,0000inthesunshine.'' The Gmail account was used as a message drop with both Perrin and Halet using the draft features and thus avoiding actually transmitting the documents, according to information provided by PwC from information given to them by Halet. (A similar procedure was used by former CIA director General David Petraeus during his liaison with former military officer Paula Broadwell, according to news reports.) Many organizations have condemned the legal proceedings against Perrin as an attack on freedom of the press. (Prior coverage: *Tax Notes Int'l*, May 4, 2015, p. 434.)

Halet was persuaded to cooperate with PwC in disclosing the exact nature and extent of the documents taken after the company obtained a warrant from the court authorities in Metz, France, for a search of his home and after the PwC search team told him that the company was estimating the damages caused at €10 million. Defense attorneys sharply questioned the PwC witness on whether Halet had been intimidated into giving up the password for the Gmail account by threats of financial consequences. Halet made the agreement to cooperate with PwC only after a lawyer was present and the damages were reduced to €1, Bouvy confirmed. The cost was established on the basis of the ''hours and hours and hours of work'' by PwC staff to create the rulings and other papers, she said. Halet was fired at the end of a period during which he was on medical leave, she said. Halet has signed a nondisclosure agreement with PwC and kept his identity secret until now.

PwC has previously stated that its clients were not harmed by the data breach. (Prior coverage: *Tax Notes Int'l*, Dec. 21, 2015, p. 967.)

The original version of the search warrant has not been entered into court documents.

''We know it existed, and none of us have a copy,'' Judge Gilles Mathay said in response to requests by defense attorneys for a copy of the original complaint filed by PwC. No procedural details were available on the steps taken by PwC to acquire the search warrant outside Luxembourg.

PwC became aware of the documents' disappearance only after being contacted by journalists after Perrin's television program, *Cash Investigations*, aired its program in 2012, Bouvy said. At that point, the company began an internal investigation of who had had access to the extensive cache of private rulings between clients and the government of Luxembourg. Deltour was identified as the employee, who, on the eve of his last day of work as a PwC auditor, had accessed and

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copied the documents. The sequence of events on October 13, 2010, as described in court by the PwC witness, was previously confirmed by Deltour to Tax Analysts.

The airing of a BBC1 documentary on the LuxLeaks information, and another by *Private Eye*, a British satirical newspaper, led to PwC's conclusion, based on images from the TV programs, that the rulings had originated with PwC and not within the government of Luxembourg, Bouvy said.

Based on computer details, PwC identified three other occasions when Deltour had looked at some of the documents: in April, May, and June of 2010. During questioning by defense attorneys, Bouvy said it was not possible for PwC to determine if those accesses had been inadvertent or had involved a period of review or other activity such as copying. Deltour's defense said it was therefore possible that those earlier occurrences had been accidental.

Deltour himself provided a statistical analysis of the number of people who had accessed the private rulings during certain time periods, which amounted to hundreds, according to his defense. Deltour is currently a statistician employed in a government agency in Nancy, France.

Deltour left PwC voluntarily and told PwC during his exit interview that the workload on auditors was excessive and that he had concerns on that matter. His job performance was above average and entirely satisfactory to PwC, Bouvy said under questioning.

''So, he was a good employee right up until October 13,'' Mathay remarked.

Proceedings for the Twelfth Criminal Chamber of the District Court of Luxembourg are presided over by Mathay, with judges Marc Thill and Paul Lambert. The prosecution is represented by David Lentz. Each defendant is represented by his own defense team. Deltour is represented by outspoken French lawyer William Bourdon, who has represented other whistleblowers such as Hervé Falicani and Edward Snowden. His Luxembourg attorney is Philippe Penning.

Perrin is represented by Roland Michel and Olivier Chappuis. Halet, whose first name is listed in court documents as David, is represented by Emmanuel Hannotin and May Nalepa.

PwC is represented by Hervé Hansen.

March for Transparency

Braving the unseasonably cold and damp morning, Deltour's support committee was out in force in front of the courthouse. Transparency advocates wore T-shirts, waved signs, and acted out a game of hide-and-seek with blindfolded activists looking for hidden tax havens. Among those in attendance were members of Deltour's extended family who traveled from his hometown in northeastern France to be in the courtroom. Seats were parceled out among an international press, with an additional courtroom opened up for transmission of events to those who didn't get a spot in the main 100-person courtroom.

French Finance Minister Michel Sapin made a ringing statement of support for Deltour during regularly scheduled question time in the French legislature the first day of the trial.

''This morning, I asked the ambassador of France in Luxembourg and the Consulate General to be good enough to help if necessary, in this difficult period,'' Sapin said, noting that Deltour defended the general interest but is nonetheless standing trial in a criminal court. ''It is thanks to him that we were able to end this opacity that has prevented European countries from knowing the exact tax situation of a number of large companies in Luxembourg,'' Sapin said. Previously, Prime Minister Manuel Valls had told local news service Luxemburger Wort that the French government would take no action in what he termed an internal Luxembourg matter. (Prior coverage: *Tax Notes Int'l*, Apr. 25, 2016, p. 319.)

Sven Giegold and Fabio De Masi, German members of the European Parliament who are intensely involved in pushing for both tax transparency and whistleblower protection legislation, have agreed to appear as witnesses for the defense.

''Our Special Committee on Tax Rulings has used Mr. Deltour's testimony while drafting its conclusions and proposals — particularly on the legal protection for whistle-blowers — which was supported by the whole European Parliament in its resolution of 25 November 2015,'' said Alain Lamassoure, chair of the European Parliament's TAXE II committee in a statement. ''In fact, the case of Mr. Deltour prompted the European Parliament to recommend the adoption of a law on the protection of whistle-blowers. After all of our public and private exchanges I am convinced that Mr. Deltour acted selflessly, in the public interest and in the interests of justice by disclosing tax agreements, some of which have been deemed illegal under European law and the application of laws concerning state aid.''

The trial is expected to continue attracting extensive media attention as European and international governments struggle to regain their balance after the revelation of the Panama Papers, the third massive data leak distributed by the International Consortium of Investigative Journalists. The EU, headed by Luxembourg's former prime minister and finance minister, European Commission President Jean-Claude Juncker, has been seeking to get ahead of the rising public clamor for tax transparency with a series of commission proposals and European Parliament consultations. (Prior coverage: *Tax Notes Int'l*, Apr. 18, 2016, p. 236.)

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Day 2

Luxembourg Broke EU Law, Witness Says

Antoine Deltour's decision to disclose private rulings uncovered during his employment as an auditor at PwC proved that Luxembourg had broken a 1977 EU law calling for the exchange of tax rulings with other member states, said a member of the European Parliament who was called as a witness for the defense of the LuxLeaks whistleblower.

Luxembourg officials, PwC, and the multinational enterprises that benefited from private tax rulings providing steeply discounted rates have insisted that the rulings were legal under Luxembourg law and that Deltour broke Luxembourg's strict professional privacy laws.

Fabio De Masi, a German member of the European Parliament in the forefront of efforts to create a transparent tax system in the EU and establish whistleblower protections, said April 27 that Luxembourg had broken EU law and that Deltour's revelations of hundreds of private rulings were thus in the public interest of EU citizens. He described the disclosures as the driving force behind efforts undertaken by the EP's TAXE II special committee on tax rulings in the last year. (Prior coverage: *Tax Notes Int'l*, Apr. 25, 2016, p. 336.) De Masi said that as a result of Deltour's actions that gave rise to LuxLeaks, agreement has been reached on the automatic exchange of information on tax rulings.

De Masi, a member of the Confederal Group of the European United Left — Nordic Green Left, answered questions from the attorneys, the prosecutor, and the judges on the European Parliament's legislative efforts to crack down on tax avoidance by MNEs that play one EU country off against another.

After the court adjourned, De Masi told Tax Analysts that he was in contact with a significant number of whistleblowers, none of whom had been able to bring their concerns to authorities without suffering severe consequences from their employers.

''Antoine had no one he could go to to express his concerns; if he had, he would most certainly have been fired,'' De Masi said, adding that ''others have had that happen.'' He described Deltour as a quiet man who shunned the limelight in his dealings with the European Parliament. ''If Deltour is treated harshly, there will certainly be diplomatic repercussions for Luxembourg,'' he said.

De Masi also said he is exploring the possibility of setting up a cross-party European Parliament group that would support a decision to boycott any lobbying efforts by PwC if the LuxLeaks trial ends with serious consequences for the defendants.

Day 3

Police Investigation Orchestrated by PwC, Attorney Claims

The police investigation into the theft of PwC documents that form the basis of the LuxLeaks scandal was orchestrated and supervised from within the company's internal audit department, according to details that emerged April 27 in a Luxembourg district criminal court.

Charges of computer data theft, disclosure of business secrets, and violation of professional secrecy laws are among those leveled against former PwC employees Antoine Deltour and Raphaël Halet and journalist Edouard Perrin.

The execution of a search warrant for PwC premises was planned for and scheduled by the police and PwC for January 2, 2015, Roger Hayard, the Luxemburg police commissioner in charge of the criminal investigation, admitted under cross-examination by Olivier Chappuis, Perrin's lawyer. The warrant allowed into evidence folders and a thumb drive of emails between Perrin and Halet that were obtained during an earlier search of Halet's home in Metz, France.

Hayard said the efforts by Luxembourg police to obtain a search warrant for Perrin's home in Paris were frustrated by a lack of cooperation from the French police. A search warrant for Halet's home was obtained through judicial channels, according to testimony. However, a copy of the paperwork for that warrant has not been provided to the defense, according to defense attorneys.

''Did Mr. Halet receive the same advance warning when his home was searched?'' Chappuis asked Hayard. Presiding Judge Marc Thill cut short Hayard's response, saying that the advance notice was hardly unusual in Luxembourg.

The defense also raised questions about a privately arranged deal under which PwC agreed not to sue Halet for $10 million in exchange for his cooperation and the signing of a nondisclosure agreement prior to his termination. The agreement is not part of the trial documents and was discovered independently, Chappuis said. PwC agreed to not seize Halet's or his wife's personal property and to instead receive a symbolic €1 payment, according to defense attorneys.

Allegations that Perrin had contacted Halet and orchestrated his handing over of additional PwC documents, including corporate tax statements, were challenged by the defense, and testimony was given about the Gmail account that Halet and Perrin had used. According to Hayard and PwC witness Anita Bouvy, messages saved as drafts in the account do not show Perrin initiating contact.

According to Hayard's testimony, Perrin contacted Deltour after reading an Internet forum posting about tax rulings. After a meeting in Metz, the journalist

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asked for copies of the hundreds of rulings that Deltour had copied prior to his departure from PwC. Deltour has said that he provided the documents on assurances that PwC and its clients would remain anonymous.

Hayard said that Halet provided Perrin with 16 other documents published in late 2014 by the International Consortium of Investigative Journalists, confirming the testimony provided on April 26 by Bouvy, a PwC internal auditor. Bouvy said neither Deltour nor Halet had asked for or received financial compensation for providing the documents to Perrin. She also said the PwC investigation found that Deltour had acted alone.

''It was Mr. Halet who looked to make contact with Mr. Perrin,'' Hayard said. ''But it was Mr. Perrin who orchestrated the whole thing.''

In addition to calling Deltour an ''anti-capitalist,'' Hayard expressed his negative opinion of the three defendants for choosing to ''denounce tax procedures that may have been dubious, but were certainly legal.''

♦ *Teri Sprackland is a reporter with Tax Notes International. Email: teri.sprackland@taxanalysts.org*
J.P. Finet contributed to this article.

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HIGHLIGHTS

NEWS ANALYSIS

Cutting Through the Panama Rhetoric

by Mindy Herzfeld

Panama Papers is the information leak that launched a thousand campaigns against tax avoidance. Since highlights were revealed from 11.5 million documents showing how opaque entities were used for shady purposes, governments and international organizations have been falling all over each other to announce stronger anti-tax-evasion efforts. They have used the leak to emphasize the need to crack down on illicit offshore financing, to show that they are taking all necessary steps to do that, and to marginalize noncompliant jurisdictions.

While much of the rhetoric targets offshore tax havens, so far the reports describing individuals' use of entities and the substance of many government responses illustrate that this is not primarily a problem of tax avoidance, or even tax evasion. The term ''tax havens'' as used in the Panama Papers discussions refers primarily to jurisdictions that enable individuals to hide information about their assets through nontransparent entities, rather than a reference to favorable tax rates or laws. The larger issues posed by illicit offshore financing involve the use of secret financial systems by terrorist networks to support their stateless regimes, and by corrupt politicians, their associates, and celebrities to hide money.

But the conflation of illicit financing with tax avoidance has repercussions that may fall disproportionately on corporate multinationals. For example, the European Union's response to the Panama Papers was to expand proposals that had been in the works to require public reporting of country-by-country (CbC) information by multinational corporations.

At the same time, another undercurrent is building, highlighting the hypocrisies and negative effects of a global crackdown on tax havens. Though few, these voices counterbalance the rhetoric from international organizations and media outlets that worked with the International Consortium of Investigative Journalists — which distributed the Panama Papers — to emphasize the need for more transparency initiatives.

A summary of key post-Panama initiatives and proposals, as well as the longer term implications of the Panama fallout, follows.

OECD Report to the G-20

In conjunction with the IMF's spring meetings in Washington, the OECD on April 14 released a report to the G-20 on OECD initiatives and the progress countries have made to combat financial secrecy. (See http://goo.gl/IgbNeX.) In it, the OECD noted that the 132 members of the Global Forum on Transparency and Exchange of Information for Tax Purposes have committed to the tax transparency standard for exchange of information on request, and that 98 jurisdictions have committed to implementing automatic exchange systems via the common reporting standard (CRS) in 2017 or 2018. But the report adds that progress is still needed to ensure effective and global implementation, and includes recommendations for other actions the G-20 should take.

The message from the report is that the G-20 will set the standards for the rest of the world to follow and that the OECD will help implement and enforce them. One result from the Panama Papers scandal is to expand the OECD's mandate as international tax enforcer and the G-20's role as standard setter.

A focus of the report was Panama's noncompliance with the CRS. But another jurisdiction that has failed to commit to the CRS is the United States. U.S. noncompliance is excused in a footnote to the report:

> The United States has indicated that it is undertaking automatic information exchanges pursuant to FATCA from 2015 and has entered into intergovernmental agreements (IGAs) with other jurisdictions to do so. The Model 1A IGAs entered into by the United States acknowledge the need for the United States to achieve equivalent levels of reciprocal automatic information exchange with partner jurisdictions. They also include a political commitment to pursue the adoption of regulations and to advocate and support relevant legislation to achieve such equivalent levels of reciprocal automatic exchange.

In other words, the Obama administration wants to implement the standard, but its hands are tied by the legislative process. The report reaffirms the need for

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countries to commit to the standard as soon as possible, but it's unclear how the United States, a member of the G-20, could plausibly argue for others to commit to a standard while it hasn't.

G-5 Initiative

On April 14, in a letter to their G-20 counterparts, the finance ministers of the United Kingdom, France, Germany, Italy, and Spain committed to establishing, as soon as possible, mechanisms for the exchange of information on the beneficial owners of entities, and they called on other jurisdictions to join them. Those five countries want beneficial ownership information to be made available for tax administration and law enforcement authorities, and they asked the G-20 to call on the OECD in cooperation with the Financial Action Task Force (FATF) to draw up a new single global standard for that exchange.

So far, more than 30 countries have announced their intent to join the pilot program. (See https://goo.gl/LPkoIN.) The United States is not among them.

The EU Directive

In March the press reported on a leaked draft of a European Commission proposal to require large multinationals to publish CbC reports online. (Prior coverage: *Tax Notes Int'l*, Mar. 28, 2016, p. 1068.) The information that would be required was similar to what would be in the CbC reports mandated by action 13 of the OECD's base erosion and profit-shifting project.

The Panama Papers provided the impetus for the commission to officially release the proposal, which was largely similar to the draft, with one twist. Under the draft, companies would have to report country-specific information only for their EU operations and report information only in the aggregate for non-EU jurisdictions. Under the April 12 proposal, companies would also have to report separate CbC data for countries that ''do not respect international tax good governance standards'' or ''certain tax jurisdictions which pose particular challenges.'' (Prior coverage: *Tax Notes Int'l*, Apr. 18, 2016, p. 234.)

This would in effect create a tax haven blacklist, applying the following criteria to assess each jurisdiction:

- transparency and exchange of information, including information exchange on request and automatic exchange of financial account information;
- fair tax competition;
- standards set up by the G-20 or the OECD; and
- other relevant standards, including international standards set up by the FATF.

It is unclear how the United States, which isn't fully compliant with exchange of information requirements under the CRS or the FATF, would fare under this list.

JITSIC

Tax administrators are proceeding on their own separate post-Panama track. The Joint International Tax Shelter Information and Collaboration (JITSIC) network met in Paris on April 13 to discuss potential responses, including opportunities for obtaining data, cooperation, and information sharing. Although JITSIC operates under the OECD umbrella, it is separate from the OECD's tax policy arm. Instead, JITSIC is a forum for the tax administrators who get together to resolve issues under the Forum on Tax Administration.

JITSIC's efforts could prove as important as the policy initiatives being developed by government finance ministries because they represent practical steps by tax administrations to advance the goals of information sharing within the confines of current law.

Enforcing the Rules

Although the FATF, an intergovernmental organization tasked with combating terrorist financing and money laundering, hasn't yet played much of a visible role in tax evasion and tax avoidance discussions, that could change as crackdowns on tax evasion and illicit offshore financing become more closely intertwined. FATF has developed a series of measures that constitute the international standard for combating money laundering and terrorist financing, monitor its members' progress in implementing the measures, and promote the adoption and implementation of them globally. (See http://goo.gl/1mFTB1.)

Its recommendations regarding customer due diligence include the following:

- Financial institutions should be prohibited from keeping anonymous accounts or accounts in clearly fictitious names.
- Financial institutions should have to undertake customer due diligence measures when establishing business relations or carrying out significant transactions that could give rise to suspicion of money laundering or terrorist financing.
- Customer due diligence measures should include identifying the customer and verifying his identity using reliable, independent-source documents; identifying the beneficial owner; and taking reasonable measures to verify the identity of the beneficial owner.

In the most recent G-20 communiqué, finance ministers asked the FATF to work with relevant international organizations on identifying and tackling loopholes and weaknesses in the financial system, and to ensure that FATF standards are effective and fully implemented.

In its 2006 review, the FATF criticized the United States for failing to comply with the FATF standard on

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collecting beneficial ownership information, and urged the United States to correct this deficiency by July 2008. It has not.

The United States as Tax Haven

The Panama Papers publicity has shed more light on the United States' failure to comply with the transparency standards it imposes on the rest of the world. The IRS administers FATCA through IGAs signed with individual countries, but while the IRS obtains financial account information from other countries through the IGAs, it lacks statutory authority to collect and hand that information over to other countries. In contrast to the requirements imposed on foreign signatories to an IGA, U.S. financial institutions have no obligation to identify and report the beneficial owners of foreign entities. The IGAs generally provide that the United States will continue to cooperate with the other signatory to respond to requests under the bilateral tax treaty in effect, in order to collect and exchange information on accounts held in U.S. financial institutions by residents of the foreign government. For example, the Switzerland-U.S. IGA, which is typical, states:

> when and to the extent Switzerland seeks to collaborate with the United States to implement FATCA based on direct reporting by Swiss Financial Institutions to the Swiss Government followed by the transmission of such information to the United States, the United States is willing to negotiate such an agreement on a reciprocal basis on the same terms and conditions as similar agreements concluded with other Partner Jurisdictions, subject to both Parties having determined that the standards of confidentiality and other prerequisites for such cooperation are fulfilled.

In other words, the IGAs commit the United States only to negotiating with other signatories on what information it will provide.

In 2014 Treasury's Financial Crimes Enforcement Network issued proposed regulations to amend the Bank Secrecy Act to require financial institutions to obtain more information about the beneficial ownership of account holders (79 *Fed. Reg.* 45151 (Aug. 4, 2014)). The regulations would require financial institutions to identify any individual who owns 25 percent or more — directly or indirectly — of a legal entity, and any individual with significant responsibility to control, manage, or direct a legal entity customer.

Although the regulations were proposed by FinCEN and not the Treasury Office of Tax Policy, the preamble highlights tax compliance efforts under FATCA as one reason for tightening customer due diligence rules. The preamble says the proposed rules were necessary for ''advancing national commitments made to foreign counterparts in connection with'' FATCA, and it notes the commitments the United States has made under many IGAs to pursue reciprocity in collecting and reporting to the authorities of the FATCA partner information on the U.S. accounts of residents of that partner.

In a February letter responding to concerns expressed by Oregon Democratic Sen. Ron Wyden that the U.S. government's inability to obtain information on beneficial ownership was aiding terrorist financing, Treasury Assistant Secretary for Legislative Affairs Anne Wall said Treasury was working to finalize these regulations ''in the very near term.''

The Obama administration's recent budgets have included a proposal that would have required all entities formed in a U.S. state or territory to obtain an employer identification number to ensure that responsible-party information is provided for every U.S. entity. The proposal would also have authorized the Treasury secretary or a delegate to share responsible-party information with law enforcement and to impose obligations under the Anti-Money-Laundering and Counter Terrorism Financing Act on persons in the business of forming companies.

In February Democratic Sens. Sheldon Whitehouse of Rhode Island and Dianne Feinstein of California introduced a bill, the Incorporation Transparency and Law Enforcement Assistance Act (S. 2489), to obtain beneficial ownership information from persons who form corporations in the United States by requiring states to obtain that information under their incorporation systems. Similar bills have been introduced in the past but have gone nowhere. Unlike EU countries, U.S. states seem disinclined to change their regulations in light of the Panama Papers. (Prior analysis: *State Tax Notes*, Apr. 25, 2016, p. 271.)

Winners and Losers

A campaign against financial secrecy that is couched in anti-tax-avoidance rhetoric has several side effects. One is the harm done to countries whose financial centers are tainted by the tax haven label even though they may be fully compliant with the financial disclosure, bank secrecy, and exchange of information requirements imposed by other countries through the OECD.

A March 30 meeting of the Permanent Council of the Organization of American States (OAS) considered the topic of finance and banking service challenges to development in the Americas. The speakers' comments highlighted the concern of many Central American and Caribbean countries as a result of the ''de-risking'' activities taken by many global banks, which leave them without correspondent banking services, effectively cutting them off from the global financial system. (Watch the meeting at https://www.youtube.com/watch?v=NnD55NZ0GD0.)

Representatives from OAS argued that the campaign against tax havens has left their financial sectors under assault, complicating efforts to build their economies and alleviate poverty. They added that they have been labeled as tax havens and accused of lax regimes for

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money laundering and terrorist financing, even though they have invested heavily in costly software for detecting money laundering and terrorist financing (despite extremely scarce resources); adhered strictly to requirements of FATF and the Global Forum; and have tax exchange agreements for information exchange on request in place with every major country.

Those representatives introduced a resolution expressing concern over reductions in correspondent banking relationships, and their potential effect on ''financial inclusion, economic growth, and social development, especially of small economies'' (CP/doc.5178/16). The resolution failed when the U.S. and Canada objected, and it was then tabled for further consideration.

In an article published in *Tax Notes International* last year, Bruce Zagaris noted that a new District of Columbia law requiring worldwide combined reporting by entities doing business in designated tax havens ''unfairly targets small Caribbean jurisdictions even though many of them meet international transparency standards and spend disproportionate resources to help U.S. tax enforcement.'' He also noted the contrast between strict corporate transparency rules of the Caribbean jurisdictions that require disclosure of beneficial owners and updating of that information on the corporate registry, and U.S. state laws that do ''not require the registrar of companies or the formation agents to know and keep information on beneficial owners, let alone update it.'' (Prior analysis: *Tax Notes Int'l*, Nov. 16, 2015, p. 607.)

Others, such as Daniel Mitchell of the Cato Institute, have also noted that when smaller jurisdictions — whose economies depend on the financial services industry — see a cutback in banking services, that business is shifting to countries that aren't complying with the rules, including the United States. (See http://goo.gl/z8dCr5.) Mitchell and the Tax Justice Network seem to agree that the biggest winners in the global fight to increase transparency may be the international organizations seeking to exercise more authority. (See http://www.taxjustice.net/2016/04/19/oecd-had-bad-panama-papers.)

Finally, generally missing from the debate over the need for transparency and exchange of information are questions of the legitimacy of the governments that benefit from the information, and how automatic exchange of information to governments that deprive their citizens of basic rights enables them to strengthen their grip on power and further suppress dissent.

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NEWS ANALYSIS

Transfer Pricing Needs a Save Shot

by Lee A. Sheppard

A Martian visiting the United States would be forgiven for thinking that rock music was a British import. Rock has a race problem, so much so that some radio stations greeted Prince's death with cover versions of his songs played by white artists.

In the 1950s, rock music was denigrated as ''race music'' and parents tried to keep teenagers (just being identified by marketers as a separate age group) away from it. White fans watched from sections in the balcony of segregated clubs. As white Southerners and Brits picked up the music, record companies shoved African-American artists to the soul and R&B categories. Later the latter sued their record companies and Led Zeppelin for ripping them off.

Born to a biracial musical family, Prince Rogers Nelson defied and resisted categorization, but his most recent platinum album, *Musicology,* was R&B, the genre where he started. A prolific musical prodigy and pop genius, he had the talent that is often ascribed to the Beatles — whose most important member, producer George Martin, also died recently. Hum ''Little Red Corvette'' and then try to get it out of your head. That's what solid pop hooks do — they stick there.

Prince was more than a pop songwriter — he was a masterful guitarist, instrumentalist, producer, and synthesizer of myriad influences. His talents were both visual and musical. He wrote his first song at age 7, and joined a cousin's band as a teenager. He played all the instruments on his first album. Prince, his given name, was also the stage name of his father, who channeled his ambitions into him.

Prince died at the age of 57 under circumstances that are still being investigated. Six days after a forced landing to rectify an apparent Percocet overdose on the way home from an Atlanta show, he was found unresponsive in an elevator at Paisley Park, his huge concrete complex that could easily be mistaken for a commercial building. He was declared dead a half-hour later. He had been unable to sing at his last stage appearance. His Jehovah's Witnesses faith may have caused him to eschew treatment for what are believed to be complications from AIDS.

President Obama's comments said it best:

> Few artists have influenced the sound and trajectory of popular music more distinctly, or touched quite so many people with their talent. As one of the most gifted and prolific musicians of our time, Prince did it all. Funk. R&B. Rock and roll. He was a virtuoso instrumentalist, a brilliant bandleader, and an electrifying performer.

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Associated Press

Prince's purple reign. Transfer pricing regulations also need a save shot.

He might have been happier, although less wealthy, had he started his career after record companies and radio stations lost control of pop music. He had constant battles with them. He once wrote ''slave'' on his face to protest Warner Bros. ownership of his music. After recording a bunch of platinum albums in the 1980s, he made the music he wanted for the next two decades, resurfacing occasionally to perform his hits. He was one of the first artists to break away from the system, but later returned to Warner. He kept his music off file sharing and was even suspicious of computers.

Purple Rain, his biggest seller, was the soundtrack for a movie about rival bands. Loaded with over-the-top anthems, this 1984 album had a fairly conventional Led Zeppelin musical inspiration. Prince was adored by critics — who pronounced this backward-looking album important — which is unusual for so successful an act.

Prince adopted purple as his personal signature, painting his Minneapolis house purple and doing over a basketball player's $70,000-per-month rental in that color, paying the owner $1 million for repairs. Paisley Park, which he designed, had purple skylights, a recording studio, a dance rehearsal room, a soundstage, and a vault of his unreleased music. The fight over his assets is just beginning.

Prince did things that would have torpedoed the careers of lesser talents. He changed his name to a squiggle in 1993, making him the object of endless ''the artist formerly known as'' jokes. He justifiably refused to play Live Aid in 1985, when he was the biggest star in the world, and suffered commercially for it. He got around, but his wives and regular girlfriends were women of musical ability who looked like him. He wrote hit songs for other pop singers, with authorship often unacknowledged.

His explicit lyrics were the inspiration for Tipper Gore's insistence that her husband hold hearings about obscene rock lyrics. Her child had been listening to ''Darling Nikki,'' a song with a graphic reference. Prince was oversexed, and it infused his music. He did not appear at that hearing, which was dominated by Frank Zappa's intellectual demolition of the accusations.

Prince often seemed self-destructive, from both pharmacological and career perspectives. The government recently managed to do everything it could to demolish a sure thing in losing *Altera Corp. v. Commissioner*, 145 T.C. No. 3 (July 27, 2015). Around here, we'd like to be writing the obituary of separate company accounting and transfer pricing, but in the meantime, the IRS has to be able to put on a credible show of enforcement.

That means winning the occasional transfer pricing case against Silicon Valley, which is at war with the tax system. Just as the New Age business model doesn't admit to compliance with pesky impediments like labor and licensing laws, it apparently also excludes the tax code. What observers don't seem to notice about the OECD's base erosion and profit-shifting project and other debates about corporate income taxation is how few industries are really tax planning down to zero. Silicon Valley is Exhibit A. Apple Inc. co-founder Steve Wozniak recently criticized his company for not paying enough tax (BBC Radio 5, Apr. 22, 2016).

Why discuss *Altera* nearly a year after it was decided? Your correspondent's initial reaction to this reviewed decision was that the Tax Court judges didn't want to be reversed and were merely affirming the court's dreadful decision in *Xilinx Inc. v. Commissioner*, 125 T.C. 37 (2005), *aff'd*, 598 F.3d 1191 (9th Cir. 2010). It's still a mystery why 14 other judges signed this dubious opinion by their newly elected chief judge. Administrative law separates rulemaking process from the merits. *Xilinx*, after all, seemed manageable at the time.

Altera, in which the court granted the taxpayer's motion for partial summary judgment, invalidated a cost-sharing regulation issued to cure the problem. It backfired so badly that the government is now in a worse situation. *Altera* has been appealed to the Ninth Circuit,

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where it is likely to be affirmed. There is no schedule for filings. This article argues that the Ninth Circuit should reverse the Tax Court and uphold the regulation.

The decision was the subject of a lively debate between Michael Schler of Cravath, Swaine & Moore LLP and Richard Skillman of Caplin & Drysdale Chtd. at the April 20, 2016, International Tax Institute (ITI) luncheon in New York. Both have contributed articles to *Tax Notes* on the case. (Prior analysis: *Tax Notes*, Jan. 18, 2016, p. 347; and *Tax Notes*, Nov. 30, 2015, p. 1149.)

Incantations

Xilinx and *Altera* had the same basic facts. The U.S. parent and its tax haven subsidiary entered into a cost-sharing agreement for the improvement of existing technology supplied by the parent. The parent's employees did all the work in the United States. The parties shared all the costs of the research except for equity-based compensation of the employees, which, in *Xilinx*, was the largest cost of the project. The effect was a shift of future profits to the tax haven subsidiary, as Schler explained at ITI.

In *Xilinx*, the applicable regulation stated that all development costs must be shared in the same proportion as the reasonably anticipated benefits. The government argued that this meant equity-based compensation too, and the taxpayer countered that whatever unrelated parties do governs all cases. The Tax Court held that the contradiction between the general rule and the cost-sharing rule introduced an ambiguity and that the arm's-length method was controlled by the actions of unrelated parties.

The Ninth Circuit initially understood that section 482 is an antiabuse rule aimed at clear reflection of income. The court held that the IRS was not bound by recitations that the arm's-length method governs intragroup pricing adjustments when making section 482 regulations. The court concluded that cost-sharing agreements are a self-contained exception to the general rule of arm's-length pricing and the preferred methods.

The government enjoys broad discretion in its clear reflection power, and regulations made under it are rarely reversed as arbitrary and capricious. The Supreme Court has read the clear reflection power expansively (*Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979)).

But upon rehearing after a barracking by former government officials, the Ninth Circuit held that U.S. treaty obligations required the cost-sharing regulation to be interpreted to treat related parties the same as unrelated parties. The regulation at issue was not declared invalid. Silicon Valley was not satisfied, and vowed to knock out the 2003 cost-sharing regulation. *Altera* was the vehicle for that.

As Schler's special report explained, the government in *Altera* was hoist on its incantations that the cost-sharing regulation was consistent with the arm's-length method. Schler, an admitted transfer pricing neophyte, dissected every government squeak about the primacy of the arm's-length method and concluded that *Altera* was correctly decided under this rubric. Those incantations appeared in the related-party pricing regulations as early as 1936 and were reiterated in 2016 additions to the IRS training manual.

Many of these recitations about the sanctity of the arm's-length method are defensive. The United States protects its multinationals from the depredations of countries where they do business by insisting that the latter respect self-serving contracts and income-stripping transactions. Banging on about the arm's-length method as an international norm is a way of shaming and coercing countries that might otherwise think that it would be fairer to allocate income according to sales or might argue that the terms of trade between the nonresident taxpayer and its local affiliate were inappropriate.

''In the interest of avoiding extreme positions by other jurisdictions and minimizing the incidence of disputes over primary taxing jurisdiction in international transactions, the United States should continue to adhere to the arm's length standard,'' Treasury stated in a white paper on transfer pricing required by the Tax Reform Act of 1986 — the same law that installed the commensurate with income clause (Notice 88-123, 1988-2 C.B. 458). Ah, for that bygone, more innocent time when double taxation was perceived to be the problem!

Of course, no administration could admit in court — a public forum — that it was just putting on a show to placate treaty partners. It wouldn't be diplomatic, and it would also be unnecessary. Treaty partners are well aware that the United States uses the OECD as a vehicle to ascribe intellectual respectability to its positions about how multinationals should be taxed. The BEPS project was an attempt by European countries to get the OECD to work for them.

And why should Treasury even care that it is perceived as acting hypocritically? Why should the United States be any less hypocritical on taxation than it is on any other issue in its relationship with Europe? The Europeans are beginning to grasp that the United States was faking it on BEPS. (Prior coverage: *Tax Notes*, Apr. 25, 2016, p. 411.)

Schler pointed out that some of Treasury's statements in support of the authorized OECD approach to attribution of profits to permanent establishments were internally inconsistent. Yet the PE attribution approach is widely accepted, even if not always practicable. A PE is a branch; if it does not actually transact with its parent, transactions must be made up to determine

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what its income should be. Schler criticized the controversial BEPS report on actions 8, 9, and 10 for its focus on outcomes — which is also the focus of the commensurate with income clause.

What was Treasury doing when it rewrote the cost-sharing rule during the *Xilinx* litigation? On the face of it, it was trying to cure the inconsistency between its statement that the arm's-length method controls all and the cost-sharing requirement that all costs be shared. (In *Altera*, the tax years at issue were 2004-2007.)

The general rule states that ''in determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's-length with an uncontrolled taxpayer'' (reg. section 1.482-1(b)(1)). It recites that a cost-sharing agreement only meets the standard if it satisfies the administrative safe harbor (now reg. section 1.482-7A). Treasury specifically adopted a cost-sharing rule that variable equity-based compensation costs be shared (reg. section 1.482-7(d)(2)).

A regulation designed to achieve a particular result in litigation is a fighting regulation. The remedial regulation was proposed three years before *Xilinx* was decided. So it was not a fighting regulation, but may have been perceived as such by the Tax Court. Some judges respect prospective regulations to interpret prior law. Others — apparently including the Tax Court judges in *Altera* — find fighting regulations disrespectful. Judges do not like to be disrespected.

Let's put a more charitable interpretation on what Treasury might have been doing. Although evidence adduced by the taxpayers and seemingly the entirety of Silicon Valley in both cases showed that unrelated parties do not share the risk of each other's variable equity-based compensation costs, it is reasonable to expect related parties — for which parent equity is a common currency — to share them. That is, the reasonable expectation that these costs should be shared is an economically logical theoretical point.

''The arm's-length result is a platonic ideal,'' Skillman commented at ITI. ''Where Treasury failed in the preamble, I believe, was in pretending that this was the arm's-length standard as usual, rather than coming out and acknowledging that it was embracing a more expansive and theoretical view of the arm's length standard,'' Skillman elaborated later.

Indeed, it could be argued that Treasury was being cute and somewhat arrogant when it flatly declared that the cost-sharing rule was consistent with the arm's-length method (T.D. 9088). The preamble stated:

> Treasury and the IRS continue to believe that requiring stock-based compensation to be taken into account for purposes of QCSAs is consistent with the legislative intent underlying section 482 and with the arm's length standard (and therefore with the obligations of the United States under its income tax treaties and with the OECD transfer pricing guidelines). The legislative history of the Tax Reform Act of 1986 expressed Congress's intent to respect cost sharing arrangements as consistent with the commensurate with income standard, and therefore consistent with the arm's length standard, if and to the extent that the participants' shares of income ''reasonably reflect the actual economic activity undertaken by each.'' See H.R. Conf. Rep. No. 99-481, at II-638 (1986).

Xilinx demonstrated that Silicon Valley and its supporters in the tax bar had no patience with theoretical niceties. The arm's-length method is whatever unrelated parties do in those exceedingly rare circumstances when they share valuable technology, full stop. This is so even when it produces unwarranted, unintended tax avoidance results when related parties set up the same way (*Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001)). (''Baggage'' according to Jasper Cummings, Jr. in *Tax Notes Int'l*, Oct. 26, 2015, p. 349.)

In *Altera*, incoming Chief Judge L. Paige Marvel took Treasury at its word that the validity of the 2003 regulation depends on its consistency with the arm's-length method as interpreted in *Xilinx* to mean whatever unrelated parties would do. The government had not bothered to adduce evidence about what unrelated parties would do, while the taxpayer trooped in everyone in Silicon Valley and his lawyer to argue that unrelated parties do not share equity-based compensation.

''That's not quite true,'' said Skillman at ITI. He noted that parties could agree to share predictable costs of equity-based compensation or use book values.

The *Altera* court concluded that the regulation lacked a basis in fact and was contrary to the evidence before the IRS, so that the agency did not engage in rational decision-making. Marvel even said that the 2003 regulation was ''arbitrary and capricious in substance.'' And she stated that the rule ''epitomizes arbitrary and capricious decisionmaking.''

At ITI, Skillman mused that the court might have meant process rather than substance in this statement. ''It invalidated the regulation based on how it was explained by Treasury; nothing in the Tax Court's *Altera* decision suggests that the regulation would have been invalidated if Treasury hadn't maintained that it was consistent with the arm's-length standard,'' he wrote in his viewpoint.

Skillman, who could not predict how the Ninth Circuit would handle the case, argued that *Altera* would permit a taxpayer to have the benefit of the cost-sharing safe harbor while refusing to share the cost of equity-based compensation. In the BEPS context, *Altera* might mean that an island cash box would be allocated the residual extra-normal profit from valuable technology — the irony being that only a related party would allow an island cash box to have the residual.

In all its fictions, transfer pricing does at least understand that to treat a controlled subsidiary organized on an island with no employees as a separate independent

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economic actor, it has to have thinking capacity attributed to it. The OECD transfer pricing guidelines require that the ''options realistically available'' from the perspective of both parties be considered before making the deal. That is, would a rational technology owner transfer the bulk of the future income of a promising new technology to a passive investor? (See Example 29 in the OECD BEPS report on actions 8, 9, and 10.)

In *Altera*, the cash box was literally on an island — the taxpayer's subsidiary was in the Cayman Islands, removing treaty arguments from the case. Thus the treaty consistency argument about the 2003 regulation can wait for another day, in Skillman's view. But the *Altera* opinion may require a future court to interpret a U.S. treaty to require pricing according to the behavior of unrelated parties, regardless of generally accepted deviations contained in the OECD transfer pricing guidelines. Moreover, it doesn't matter whether the regulation is consistent with U.S. treaties because a U.S. resident taxpayer is allowed to choose treaty treatment over statute when it gives a better result.

Neither decision said that Treasury could not change the ''in every case'' incantation in the general rule, but it seems unlikely to do so. Treasury's position all along seems to have been that the arm's-length method means whatever the regulations say it means.

Rulemaking Authority

Prince, a Jehovah's Witness, couldn't abide swearing. But some readers must be wondering how the government screwed up — insert stronger word here — the *Altera* litigation. How did we get from the judicial deference to administrative rulemaking to this utter nonsense? The Tax Court purported to be applying Supreme Court precedent governing deference to administrative decisions (*Chevron USA Inc. v. Natural Resources Defense Council Inc.*, 467 U.S. 837 (1984)).

The *Chevron* test first asks whether Congress has directly addressed the issue at hand. If it has, all bets are off. Second, *Chevron* asks whether the rule is ambiguous. A court may need to dissect the statute to figure out whether it is unambiguous (*United States v. Home Concrete & Supply LLC,* 132 S. Ct. 1836 (2012)).

If the statute is ambiguous, *Chevron* holds that a court must not disturb the agency interpretation unless it is ''arbitrary or capricious in substance, or manifestly contrary to the statute.'' But *Chevron* does not demand the best, or the court's preferred, interpretation of an ambiguous statute.

''If a statute is ambiguous, and if the implementing agency's construction is reasonable, *Chevron* requires a federal court to accept the agency's construction of the statute, even if the agency's reading differs from what the court believes is the best statutory interpretation,'' Justice Clarence Thomas wrote for the majority in *National Cable & Telecommunications Association v. Brand X Internet Services*, 545 U.S. 967 (2005).

The *Altera* court held that the regulation had to be consistent with the stated rationale and that the preamble justification controls. ''We therefore need not decide whether Treasury would be free to modify or abandon the arm's-length standard because it has not done so here,'' the court stated, citing *Brand X*, which held that an agency cannot make a regulation to justify an interpretation that a court has held impermissible.

In the end, *Chevron* analysis is about reasonableness, as Steve R. Johnson of Florida State University College of Law frequently argues. (Prior coverage: *Tax Notes*, Mar. 28, 2011, p. 1547.)

There is a clear feeling in *Altera* that Treasury wasn't acting reasonably, whatever the substantive merits of its rule. ''The outcome in each arbitrary and capricious case ultimately turns on whether the judge, taking everything together, feels that the agency made a genuine, reasonable, good faith effort to 'get it right,''' according to Johnson.

''If that feeling emerges, the judge upholds the agency action, plugging in one or more of the 'excuse foot faults' precedents as needed to paper over procedural shortcomings,'' he said. ''If, however, the judge isn't left with that feeling, if instead she believes that the agency acted in lazy, cavalier, or biased fashion, the judge will leave those precedents on the shelf and will invalidate the agency's action.'' (See also *Dominion Resources Inc. v. United States*, 681 F.3d 1313 (Fed. Cir. 2012).)

Perhaps the best explanation for the Tax Court's opinion and the 14 other signatures may well be that the court thought that *Xilinx* foreclosed the question of what the IRS could require in a cost-sharing regulation, and *Brand X* established that previous unambiguous court interpretations are not to be disregarded.

The Supreme Court held that there is no different standard for tax law interpretations; it had previously been very deferential. The Court refused to differentiate general rulemaking authority from specific legislative grants of rulemaking authority (section 7805(a)). It recognized that ''in an area as complex as the tax system, the agency Congress vests with administrative responsibility must be able to exercise its authority to meet changing conditions and new problems'' (*Mayo Foundation for Medical Ed. and Research v. United States*, 131 S. Ct. 704 (2011)).

The *Altera* court relied on a decision in which the Supreme Court struck down a Bureau of Immigration Appeals determination that a resident alien, who had pleaded guilty to a couple of serious crimes committed while he was resident, could not appeal his deportation order (*Judulang v. Holder*, 132 S.Ct. 476 (2011)). The *Judulang* majority opinion was written by Justice Elena Kagan — a big believer in administrative power.

The Court second-guessed the agency's criteria for granting discretionary relief from deportation, concluding that those criteria were not rationally based and did not comport with the purpose of the immigration laws.

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Kagan likened the discretionary relief criteria to a coin flip. The majority divorced administrative process from the merits of the petitioners' case. Thus a court could refuse to defer to an agency whose evaluation of pertinent factors or failure in that regard was deemed wanting.

The case on which the *Altera* court relied for its decision about the substantive incorrectness of the 2003 regulation dealt with a weighty national concern much more sensitive than taxes — cars. It was an equally controversial dispute about the National Highway Traffic Safety Administration (NHTSA) rescission of a regulation requiring automatic seat belts in passenger cars (*Motor Vehicle Mfrs. Ass'n of the U.S. v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29 (1983)). The petitioners were the agency and the car companies' trade association, and the respondents were insurance companies and state insurance supervisors that liked the idea of idiot-proof seat belts.

The NHTSA was interpreting a federal law requiring it to set motor vehicle safety standards when technologically feasible, so that agency factual findings that proposed technologies would work were required. Restraint requirements bounced back and forth, seemingly turning on politics and the whim of whoever was transportation secretary. The Reagan administration finally spiked the rule after carmakers whined about the cost in the face of a business downturn. The NHTSA cited dubious safety benefits — that is, people could detach the automatic seat belts permanently.

The Supreme Court agreed with the D.C. Circuit that the rescission was arbitrary and capricious because the agency had not given sufficient consideration to airbags. Rescission, as the Court noted, is a big deal requiring a good explanation. The statute, in the Court's view, did not permit agency deference to car industry preferences. (Ironically, in *Chevron* itself, the industry and the agency also were on the same side.)

Moreover, *State Farm* dealt with the rescission of an existing regulation that had been on the books for nearly two decades when the case was decided. It is understandable that a court would be suspicious when the loudly deregulatory Reagan administration suddenly pulled a seat belt rule alleging that people weren't really safer.

In adopting the cost-sharing regulation, ''Treasury wasn't making an empirical judgment like that underlying the seatbelt regulation that was invalidated in *State Farm*,'' Skillman wrote in his viewpoint. Let's unpack that.

The traffic safety statute required the agency to make specific fact findings about feasibility and costs of passive restraints before it could require them in cars — obviously to delay the requirement until automakers were ready. The factual finding was a condition precedent to issuance of the regulation being evaluated. The Court noted that the car industry was at war with airbags despite evidence of their efficacy. The NHTSA argued for minimum rationality, while the D.C. Circuit noted that Congress voted for airbags (while threatening to defund for unpopular automatic seat belts).

There is no factual condition precedent to the adoption of any section 482 regulation. Neither section 482 nor the arm's-length mythology of the OECD requires the drafters of tax regulations to make specific factual findings to justify tax rules. Even *Xilinx* and *Altera* do not say that. *Xilinx* says that arm's length is always what unrelated parties do, so transfer pricing rules must adhere to that formulation if the standard applies ''in every case.'' *Altera* requires that regulations that purport to be consistent with the standard be governed by what unrelated parties would do.

Maybe there's hope for the Ninth Circuit. The Federal Circuit recently distinguished *State Farm* and *Altera* in a decision upholding a regulation denying a refund of FICA tax paid on deferred compensation that the earner never received because his employer went bankrupt (*Balestra v. United States*, No. 2014-5127 (Fed. Cir. Oct. 13, 2015)). The regulation contained a simplified method for calculating deferred amounts without adjustment for the payer's financial condition. The court said that Treasury's explanation fulfilled its purpose of achieving practicality and simplicity without contravening the governing statute.

Super Royalty

The IRS action underlying *Xilinx* and *Altera* is more similar to the congressional support for airbags than it is to the NHTSA's rescission of the automatic seat belt rule. The will of Congress was for passive restraints; the NHTSA flouted it and the Supreme Court scolded it. In the tax cases, the will of Congress was for technology transfers to be priced according to the income produced. The IRS clumsily fulfilled this requirement, but the Tax Court scolded it because Silicon Valley doesn't like taxes any more than once-powerful carmakers liked airbags.

If *Altera* had been properly handled, the 2003 regulation would have survived *Chevron* step two. The commensurate with income clause unambiguously says that the pricing of technology transfers has to be commensurate with income. It does not say techies have carte blanche to park technology in tax havens. It uses the word ''shall.'' The conference report on the change said that cost-sharing agreements should adhere to the new clause (H. Conf. Rep. 99-841).

Also known as the ''super royalty'' rule, the commensurate with income clause of section 482 states: ''In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.''

Congress was aware of what owners of valuable intangibles were doing when offshoring them, and didn't like it. Low royalties had become the industry

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norm, and courts accepted it. The legislative history states: ''In making this change, Congress intended to make it clear that industry norms or other unrelated party transactions do not provide a safe-harbor payment for related party intangibles transfers.'' (See H. Rept. 99-426, p. 414 (1985), 1986-23 C.B. (Vol. 2) 424.)

Cost-sharing agreements were clearly contemplated by Congress in enacting the commensurate with income clause in 1986. The legislative history indicates that cost-sharing agreements were an out — something that, if the IRS approved of them, would save the taxpayer the trouble of having to prove its prices. Bona fide cost-sharing arrangements were supposed to be an exception to the commensurate with income requirement, provided that the allocations under the agreement reflected economic reality, that is, the activity of each party. (See H.R. 99-841, pp. 637-638 (1986).)

For the Ninth Circuit, that leaves the question of the commensurate with income clause as an alternative ground for upholding the 2003 regulation. If a court can find another ground to uphold a regulation, does it have the obligation to do so? Yes. Indeed, the IRS would be disobeying a clear legislative command of the commensurate with income clause if it allowed techies to continue to do what they have been doing.

A federal court cannot rewrite the record for the agency. But it could uphold an agency action if there was some other ground for it. As Justice Byron White stated in *State Farm*, ''We will, however, 'uphold a decision of less than ideal clarity if the agency's path may reasonably be discerned.''' (See also *FCC v. Fox Television Stations Inc.*, 556 U.S. 502 (2009).)

The commensurate with income clause gives Treasury the clear power to make rules forcing related taxpayers to share all costs to qualify for the cost-sharing safe harbor. ''Because the 1986 legislative history provides ample basis to conclude that Congress authorized Treasury to adopt a cost-sharing regulation that was inconsistent with the arm's-length standard, Treasury's assertion of consistency with that standard is irrelevant to the regulation's validity under this view of the legal basis for the regulation,'' Skillman wrote in his viewpoint.

The statute's legislative history makes it abundantly clear that the commensurate with income clause is not a gloss on the arm's-length method. It is not a ''supplement'' as the Tax Court characterized it in *Xilinx*. It is an exception. Congress wasn't happy with what taxpayers and courts had characterized as arm's-length results.

At ITI, Schler noted that the *Altera* court gave Treasury leeway to depart from the arm's-length method, and this invitation was not taken up. Indeed, before the Ninth Circuit in *Xilinx*, the government refused to endorse that court's previous holding that cost-sharing is a safe harbor not governed by the arm's-length method. Instead the government argued that the commensurate with income clause is merely a backup rule for intangibles cases when there are no comparables.

''Although the preamble refers to the commensurate-with-income standard, we have already concluded that Treasury never indicated that it was prepared to independently rely on the commensurate-with-income standard — or any other reason — as a basis for adopting the final rule,'' Marvel stated in *Altera*. Instead the government argued that the rule was good policy, to which Marvel responded that the court's job was not to evaluate policy but rulemaking process.

Other Vulnerabilities

''If a regulation can be invalidated because of a flaw or gap in its preamble explanation, it will be open season, and in some cases easy pickings, to challenge the validity of many tax regulations that have gone unchallenged for years,'' Skillman wrote in his viewpoint.

Taxpayers and tax administrations like profit-split methods of transfer pricing. The OECD transfer pricing guidelines bless them (http://www.oecd.org/ctp/transfer-pricing/transfer-pricing-guidelines.htm). But they arguably violate the arm's-length standard. That regulation would be vulnerable, according to Skillman, even though unrelated parties can and do agree to profit splits. Thus the IRS might be deprived of the ability to impose a profit split.

Would other regulations that have the recitation of fealty but arguably deviate from the religion be vulnerable after *Altera*? The U.S. transfer pricing regulations and OECD guidance contain numerous examples of deviations from the sacrosanct arm's-length method that were adopted when theological purity was impractical.

Formulary apportionment methods blessed by the OECD and in regular use include the transactional net margin method (comparable profits method in reg. section 1.482-5); the profit-split method (reg. section 1.482-6); allocation of expenses to foreign income (reg. sections 1.861-8, 1.861-9); and the OECD recommendations for taxation of global trading operations (http://www.oecd.org/tax/transfer-pricing/2497694.pdf). The comparable profits method and the profit-split method would be vulnerable, according to Skillman.

Does *Altera* affect BEPS — leaving aside the lack of U.S. practical cooperation? Schler mentioned the tough and controversial draft version of the BEPS report on actions 8, 9, and 10 — which did not survive. It was specifically watered down at the behest of the United States to restore the tax administrator's obligation to honor self-serving intragroup contracts, shoving disregard of them off to extraordinary circumstances. It would allow island cash boxes to continue to exist in altered form.

A cash box may only be allocated a normal return — which in a zero-interest-rate-policy era is practically

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nothing — if it has the capacity to manage risk contractually assigned to them, that is, cash boxes with warm bodies in them. It's a double dare for taxpayers — to put enough bodies on islands to justify a greater-than-normal return allocated to them. The U.S. companies that are best positioned to abuse this rubric have all the money in the world because they are quasi monopolies that haven't been paying taxes.

The report says that the residual profit for uniquely valuable intangibles must be allocated to the place of value creation. Uh-huh. Value creation is the kind of nebulous language that everyone in the room could sign off on because everyone has his own interpretation of what that means. Tax administrators would be allowed to use hindsight in evaluating transfers of nascent technology.

This report will be formally incorporated into the OECD transfer pricing guidelines. It says nothing about cost-sharing agreements, which are conceptually approved by the OECD transfer pricing guidelines. Some countries are already following the report on audit, in the hope that it will enable them to extract income booked in tax havens.

As is becoming evident to treaty partners, the U.S. interpretation is that value is created in the United States, where the R&D is performed. Unless the owner of the intangible has a real foreign parent, in which case the U.S. interpretation is that a bunch of value was created in the U.S. market. And only if there is a perception that the U.S. base is being stripped does the U.S. government care.

Even though it may not follow this BEPS report, the U.S. government could usefully cite it on appeal to the Ninth Circuit in *Altera*, as evidence of the general acceptance of deviations from the idea that the arm's-length method always equals what unrelated parties choose to do. That is, the report shows that what is called ''the arm's-length standard'' has been institutionalized as a flexible doctrine for determination of transfer pricing cases to get to a sensible result for the countries involved.

Cases challenging administrative actions in tax and non-tax areas are on deck, according to Johnson. Florida bankers don't like the intrusion of deposit interest reporting rules into their South American tax haven business (*Florida Bankers Association v. U.S. Department of Treasury*, 779 F.3d 1065 (D.C. Cir. 2015)). They have asked the Supreme Court for certiorari (*Florida Bankers Association et al. v. U.S. Department of Treasury et al.*, No. 15-969). Amici have raised administrative authority questions.

The taxpayer's brief in the *Marvel Entertainment* appeal to the Second Circuit raises an alternative argument against the retroactive effect of a consolidated return regulation requiring reduction of net operating losses for COD income on a group basis rather than a separate-entity basis. It is clear that the government has broad power to make consolidated return regulations (*Marvel Entertainment LLC v. Commissioner,* 145 T.C. No. 2 (2015)).

In *Metlife Inc. v. FSOC*, 2016 WL 1391569 (D.D.C. Mar. 30, 2016), a federal district court scolded the Financial Stability Oversight Council for failure to consider costs of financial regulation. This case has been appealed to the DC Circuit. Although the tax administrator isn't strictly required to consider costs of compliance, this case again raises the question of agency failure to consider all factors the court deems pertinent. (See also *Michigan v. Environmental Protection Agency*, 135 S. Ct. 2699 (2015).)

There are similarities among the cases coming forward and *Altera*, *Judulang*, and *State Farm*. The legal issue in these cases is the propriety of the administrative process used to issue the objectionable regulation or administrative action. The subtext is the merits. Judulang didn't want to be deported. Auto companies didn't want to install airbags. Techies don't want to pay taxes. The procedural issue is being used to decide the merits. So we're being told that the IRS — which can barely get a regulation out the door — has to lay on yet more process to justify regulations that it clearly has the statutory authority to make. That is ridiculous, and one has to hope the Ninth Circuit sees a way out.

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NEWS ANALYSIS

Who's Afraid of Anti-Inversion Rules?

by Amanda Athanasiou

Swift and merciless. That was the apparent effect the U.S. Treasury's April 4 regulatory package had on what was poised to be the largest inversion in history. But several pending inversions have emerged relatively unscathed, and experts are predicting continued corporate exodus, raising questions about what exactly Treasury has accomplished.

On April 6 Pfizer Inc. announced the termination of its agreement to merge with Allergan PLC, making the failed tie-up the largest withdrawn mergers and acquisitions deal on record, according to financial markets platform Dealogic Ltd. (Prior coverage: *Tax Notes Int'l*, Apr. 11, 2016, p. 145.) Had it closed, the deal would have been the second largest on record, after Vodafone Airtouch's $172 billion acquisition of Mannesmann in 2000.

Treasury had bagged its trophy, it would seem. Friedemann Thomma of Venable LLP captured the sentiments of many observers over recent weeks when he told Tax Analysts he thought Treasury's latest round of anti-inversion rules were issued specifically to address the Pfizer deal (T.D. 9761, REG-135734-14, REG-108060-15). Thomma said he finds it disconcerting that the IRS and Treasury have effectively built rules around specific fact patterns. ''I'm not a fan of that,'' he said. ''Conceptually, we want to achieve certain goals, and the latest round of regulations was very much targeted.''

But Andrew Eisenberg of Jones Day, a former attorney-adviser in the IRS Office of Associate Chief Counsel (Corporate), pointed out that IRS and Treasury are most effective at writing rules when they have real facts in front of them. ''It's really hard to write rules in a vacuum,'' he said. ''When certain transactions are announced, the government does utilize those transactions in crafting its rules.''

Arguably as striking as the quick collapse of Pfizer's deal following the issuance of the new rules is the number of companies that remain undeterred.

During Johnson Controls' second-quarter earnings call April 21, CEO Alex Molinaroli said the company is proceeding with its merger with Tyco International PLC and expects $650 million in operational and tax synergies over the three years following the merger — just as it did before Treasury released the reg package. (Prior coverage: *Tax Notes Int'l*, Apr. 25, 2016, p. 356.) The new rules did cause the company to revisit its tax planning, Molinaroli said. It was also said during the call that the company is confident that tax synergies from the deal will be in the range anticipated before the new rules were released.

IHS Inc. and U.K.-based Markit Ltd. said April 5 that after reviewing the new rules, they don't expect their $13 billion merger-of-equals to be subject to IRC section 7874. When the companies announced their agreement in March, they projected a tax rate in the low to mid-twenties for the combined company. ''Treasury rule changes will not impact the combined company's adjusted effective tax rate guidance,'' the companies said after their review. (Prior coverage: *Tax Notes Int'l*, Mar. 28, 2016, p. 1104.)

Waste Connections Inc., which is planning to invert to Canada through its merger with Progressive Waste Solutions Ltd., said April 5 that Treasury's proposed regulations could have an impact of less than 3 percent of the combined company's expected year 1 adjusted free cash flow, ''excluding any additional structuring benefits that could offset such impact.'' The companies said in a release that they remain committed to the merger and expect the deal to close in the second quarter of 2016. (Prior coverage: *Tax Notes Int'l*, Jan. 25, 2016, p. 314.)

U.S.-incorporated fertilizer company CF Industries Holdings Inc. announced last August that it planned to combine with Netherlands-based OCI NV using a new holding company domiciled in the U.K. Shortly after the release of Notice 2015-79, 2015-49 IRB 775, which included the third-country rule, the company said the tax residency of the new holding company would be in the Netherlands, rather than the U.K. A CF Industries spokesperson told Tax Analysts that the company has no comment on the rules released April 4.

Without mentioning Treasury's new rules, Coca-Cola Enterprises announced April 11 that its combination with Coca-Cola Iberian Partners SAU and Coca-Cola Erfrischungsgetränke GmbH to form new U.K. corporation Coca-Cola European Partners Ltd. is on track to close by the end of the second quarter of 2016. (Prior analysis: *Tax Notes Int'l*, Aug. 17, 2015, p. 559.) The company did not respond to a request for comment by press time.

Connecticut-based industrial equipment maker Terex Corp. and Finnish competitor Konecranes PLC announced April 27 that they will proceed with their agreement to form new Finnish company Konecranes Terex PLC even though the Treasury regulations eliminated substantially all the tax synergies expected from the deal.

Other companies have chimed in about the noneffect Treasury's rules will have on their cross-border transactions. Shire PLC announced April 6 that it expects its $32 billion acquisition of Baxalta Inc. to proceed as announced in January. (Prior coverage: *Tax Notes Int'l*, Jan. 18, 2016, p. 234.) Medtronic PLC sought to reassure investors April 6 that the temporary and proposed regulations ''do not have a material financial impact on any transaction undertaken by the

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company.'' Medtronic Inc.'s acquisition of Ireland's Covidien closed in January 2015.

What Happened to Pfallergan?

Treasury's perceived attack on Pfizer might be fairly described as targeted, but it wasn't unexpected. Some observers were surprised by the company's April 6 termination announcement, given its presumed awareness that Notice 2015-79 wasn't Treasury's final word on inversions, the deal's compelling business rationales, and Pfizer's continued projections of confidence leading up to the release of the new rules.

''I would have expected Pfizer knew and believed the government would pull out all the stops,'' said Ira Gorsky, a strategist at Elevation LLC. The importance of the Allergan deal to Pfizer was clear, Pfizer CEO Ian Read had long pitched the deal as a priority, and Allergan is considered a well-run company, Gorsky said, adding, ''People had the perception that Pfizer was prepared to have a long, drawn-out fight against government overreach if it came to that.''

Gorsky and others agreed that regardless of whether Treasury is on firm legal footing, the practical barriers to challenging the regulations — for example, having to close a transformative transaction and wait for audit — are prohibitive. ''There's a big difference between saying something is unlawful or is government overreach and actually trying to roll it back,'' Gorsky said. He added that if Pfizer had proceeded with the deal with an intent to challenge the regulations, the resulting uncertainty in its books would have been significant.

Not many taxpayers will enter a transaction expecting specific tax results knowing that to realize those results they will have to go to court and win on the point that a regulation is invalid, Eisenberg said. ''It's likely that the only time somebody will challenge these rules is if they inadvertently fall into them,'' he said.

Still, companies were on notice that Treasury would take further action against inversions. When coupled with the uncertain fate of regulatory proposals in an election year and the improbability of a legislative response in the current administration, Gorsky said he thought Pfizer ''would have taken the chance that the next administration wouldn't have the same view as the current Treasury or that a different deal could be worked out. I thought it was their window to do something.''

Notably, the cost to Pfizer for walking away from the Allergan deal was relatively modest. While the companies had agreed to potential termination fees of up to $3.5 billion, Pfizer ended up owing only $150 million for reimbursement of Allergan's expenses, with the reason for the termination characterized as an ''adverse tax law change'' as defined in the merger agreement. The parties had planned for an inexpensive unwinding of the deal in the event of a change in law regarding section 7874. ''They had the contractual out, so they took it,'' Gorsky said.

Pfizer's Next Move

Now that Pfizer has abandoned the Allergan deal, it really doesn't have anything else, Gorsky said. ''I think the window is closed for Pfizer and that the shutdown was important for the government to secure as a signal that it will do everything fair and unfair to stop companies from doing this,'' he added. ''Pfizer isn't going to try again unless it gets a friendlier administration,'' he said.

While the company has said its decision to terminate the deal was driven by recent Treasury actions, Gorsky pointed out that the U.S. government is a customer of Pfizer's. ''You never know what kind of private pushback Pfizer could have gotten,'' he said. Recent statements indicated that the company was prepared for a Treasury challenge, so it either didn't want to deal with the uncertainty created by the new rules, ''or it was fearful of some other form of retribution,'' according to Gorsky. A Pfizer spokesperson told Tax Analysts the company has no comment.

Another complication for Pfizer is the ''post-Martin Shkreli environment where pharmaceutical companies have been tarred as bloodthirsty opportunists willing to raise prices so as to harm patients,'' so adding tax dodger to that image is too much for Pfizer to absorb from a reputational standpoint, Gorsky said.

Bret Wells, a tax law professor at the University of Houston Law Center, thinks Pfizer will probably be back, either with Allergan or another partner. ''If Pfizer agreed to pay a stock premium based on its expectation of a large, upfront interest-stripping benefit, then the current valuation and exchange ratios may not make sense now,'' Wells said. ''It doesn't mean the deal isn't a good deal at some stock price.''

Meanwhile, Allergan can take its $40 billion war chest from the sale of its Actavis Generics business to Teva Pharmaceutical Industries Ltd. and start buying up U.S. companies, said Gorsky. The sale to Teva is expected to close in June, according to an April 6 Allergan release.

Plus, under the 36-month lookback in the multiple domestic entity acquisition rule of Treasury's temporary regulations, Allergan will become a desirable large merger partner — even for potential inverters — not long from now, according to Edward D. Kleinbard of the University of Southern California Gould School of Law.

Some practitioners have speculated that with the lookback, Treasury has effectively instituted a cooling-off period and may have been signaling Congress that it has a few more years to act.

Future Trends

The cat-and-mouse nature of the new rules has created a sense of déjà vu in the tax community. With each new inversion Band-Aid comes renewed conviction that inversions and corporate flight won't be

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stopped by surgical administrative action. ''If you sic enough smart tax lawyers on a complicated set of rules, they're going to find a way to arbitrage them,'' said Eric Talley of Columbia Law School, summing up popular sentiment among those who spoke with Tax Analysts.

Several observers commented that Treasury's actions could lead to an environment in which global companies are generally not U.S.-parented. Some speculated that in the absence of U.S. tax reform, companies will continue to be drawn offshore to more competitive jurisdictions regardless of how hard Treasury makes it to do so without tripping the IRC section 7874 ownership thresholds.

''All that these new rules will do is create a permanent competitive advantage for foreign acquirers,'' Read wrote in an April 6 *Wall Street Journal* op-ed. ''There will be more foreign acquisitions of U.S. companies resulting in fewer jobs for American workers.'' He acknowledged that his company benefits from world-class academic institutions, a highly skilled labor force, and other U.S. advantages, but noted that Pfizer's foreign competitors do too — and ''pay significantly less for the privilege.''

The U.S. tax system disadvantages U.S. companies relative to their foreign competitors, and inversions eliminate that disadvantage, Wayne Winegarden of the Pacific Research Institute told Tax Analysts. ''It's not the best solution,'' which would be corporate tax reform, he said.

The answer isn't as simple as lowering the U.S. tax rate, Eisenberg said. ''Even if corporate tax rates go to 25 percent, there will always be a lower corporate tax rate available in an alternative country, which means there will always be incentive for U.S. companies to outbound their income-producing assets,'' he said.

It's possible that the wave of the future is a sharp decrease in the number of U.S. parents because U.S. corporate rates will always be greater than those of many other countries, Eisenberg said. Whatever the U.S. tax rate is, there will always be pressure to get earnings outside the United States, he said. ''Companies fight for their shareholders by doing what they can to increase company value — and tax is an expense that reduces that value.''

Talley said the proposed IRC section 385 rules might inspire companies that weren't even thinking of inverting to move offshore. ''One could make the argument that the section 385 rules are actually more injurious to companies that had no plans to invert,'' he said. Regulatory developments in other areas — securities law, for example — have already paved the way for companies to leave the United States, and the tax package could have a similar effect, Talley said. (Prior analysis: *Tax Notes Int'l*, June 15, 2015, p. 978.)

Thomma said he thought the proposed section 385 regulations were potentially more damaging to the cross-border M&A world than the serial acquisitions rule. Those rules ''will add another layer of complexity to debt-financed M&A transactions and could thus slow down or impede common structures like those placing debt financing on operating subsidiaries of a target,'' he said. Making an intercompany loan now requires running ''through the gauntlet of section 385, making sure there's no possibility of potential recharacterization, and complying with all documentation requirements,'' which are somewhat consistent with, but more onerous than, transfer pricing documentation rules, he said.

Thomma said the compliance burden is a real concern for clients. He said he won't be surprised if companies that have the opportunity to move their parent companies offshore and operate under a more efficient structure get nudged further in that direction by the new rules. ''Any related-party financing is an issue, any cash pooling will be affected, typical treasury management practices will be affected,'' he said, adding that emerging growth companies are the most likely to move offshore.

Proposed U.S. Treas. reg. section 1.385-2 (REG-108060-15), regarding documentation of related-party indebtedness, is intended to apply only to large taxpayer groups. Companies with up to $100 million in assets or up to $50 million in revenue ''will think quickly and seriously about getting out of the U.S. tax system,'' Thomma said. ''I think it's going to be harder for the more established companies to get out of these rules,'' he added.

Inversions will continue because there are still huge benefits to doing them, Wells said. ''The government has tinkered with the [section] 7874 rules consistently since 2004 and still hasn't stopped the problem because the financial savings are so compelling,'' he said. Left undiscussed are ''all the tools left in the earnings stripping toolbox that can be done post-inversion or by foreign-based multinationals,'' he added.

Wells predicted that intellectual property migration and the ability to do royalty stripping will become a larger benefit over time. ''The IRS can't deal with that under section 385 but it could under section 482 — and it should,'' he added.

Non-interest earnings stripping is difficult, Kleinbard said. But what Treasury has done with traditional interest stripping ''is both very complicated and more limited in scope than what Congress could have done in straightforward legislation,'' he said.

Investment bankers and lawyers will find the most efficient corporate structure for running combined businesses, and as long as there's an inversion benefit to be had, companies will continue to invert, Wells said. ''I don't want to say people will do tax-motivated deals; they won't,'' he said. ''They'll do deals that make economic sense.'' But inverting clearly brings synergies that are unrelated to nontax business combination efficiencies, and foreign acquirers have the ability to pay larger premiums than would be justified without the tax savings, Wells added.

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Mihir Desai, a professor at Harvard's law and business schools, said he doesn't think about the effects of the regulatory package as concerning inversions, per se. ''I think of this as a broad pattern of M&A that shifts the balance of power toward larger foreign firms — which are now the preferred buyers of U.S. corporate assets — in merger negotiations,'' he said.

Allergan, for example, has a preferential tax status and can pay higher prices for targets than U.S. competitors, Gorsky said. ''Treasury knows there's nothing it can do at the moment to prevent foreigners from buying U.S. companies, so everything it's trying to prevent is still going to occur,'' he said. ''It's just going to show up in a different form.''

The competitive disadvantage the U.S. tax system creates for domestic companies will lead either to foreign companies buying out U.S. companies or U.S. companies losing the ability to compete, said Winegarden. ''Either way, you're moving capital from the higher-tax, less-tax-efficient country to the more preferable tax country,'' he said. Inversions tend to result in keeping employees and facilities in the United States, which, from a U.S. economics perspective, is a better outcome than a foreign takeover that dismantles the U.S. headquarters and moves jobs offshore, he said.

Another consequence could be that U.S. companies downsize, said Desai. He cited Pfizer's announcement that it will decide whether to pursue a separation of its business by the end of the year, consistent with the time frame it contemplated for the decision before the announcement of the Allergan transaction. ''Either foreign firms win or U.S. firms get smaller so they can undertake the same transactions they were going to without running afoul of the regulations,'' Desai said, adding that neither result is in the interest of the United States.

Wells said Treasury should be more focused on the fundamental financial tax savings generated from inverting than its satisfaction with arbitrary strata of combined entity ownership percentages. The new section 385 regulations are just a first step, he said. ''It shouldn't matter whether the inbound investor is an inverted company or a foreign-based company, if they're stripping the U.S. tax base, that is an unfair competitive advantage,'' he added.

Macro-Level Effects

Treasury thinks it must address inversions, which are just one subset of the M&A market, ''but the alternative view is that you don't have to do something, and in fact you can make things worse by doing something,'' Desai said.

Several observers labeled Treasury's willingness to pursue pending deals a disturbing trend. One economist said that with merger arbitrage funds taking positions on the outcomes of deals, subjecting signed transactions to new regulations creates an unfortunate set of lobbying incentives.

''Now even when a deal is done, it's not done,'' which creates incentives for funds, competitors, or even estranged former partners from failed deals to lobby to change the rules, said Winegarden. Treasury's signal that the rules of the game might not be constant compromises one of the fundamentals of a solid economy, he said. He agreed with the premise that in the absence of tax reform, no action is preferable to the action taken.

For every horror story showing that retroactivity is unfair, there's a corresponding cautionary tale about why having only prospective rules is a bad idea, Talley said. He added that 2014 and 2015 were ''great years to be an M&A attorney, but they would have been even better if Treasury wasn't allowed to touch signed deals.''

Talley said he's ''not insensitive to the idea that people relied to their detriment on existing legal rules, but no one could have fairly expected that for the first time in human history we were living in a static regulatory environment.'' The way to strike the right balance between the costs posed by prospective-only rules and costs posed by retrospective-only rules might be for Treasury ''to avoid being utterly predictable, as if Secretary [Jacob] Lew were flipping a coin,'' he said.

Eisenberg agreed that the new rules create some business-related inefficiencies. ''There were combinations that could have taken place that were probably good from a nontax business perspective that can't happen now,'' he said. He added that U.S. companies will now have to combine with foreign or domestic companies that might not give them as favorable business synergies.

But maximizing synergies in M&A doesn't always equate to optimal economic efficiency, Talley said. When Pfizer walked away from Allergan, people who stood to gain from the synergies missed that opportunity, ''so that looks like a prima facie economic cost,'' he said. Despite an inefficiency at the company level, however, a deal breakup is not necessarily a social inefficiency ''when one takes into account that tax authorities around the world get shortchanged on some of these deals,'' Talley said.

If the tax benefits of some types of transactions, such as inversions, are too large, ''companies will decide to merge in ways that reinvent each other's wheels, which is inefficient'' said Talley. The companies don't get much in the way of operating or other synergies by combining, but the tax savings are significant enough that despite an efficiency loss to their productive capacities, they still gain overall. ''If that's the kind of thing being deterred by the regs, then Treasury just forestalled a decision that would have visited a social inefficiency on society,'' Talley said.

Further, because the name of the game in executing inversions is to be European and big — or become big by acquiring European, rather than U.S., entities — the industries represented are going to get more and more

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concentrated to the point where deals may be blocked by antitrust authorities — not to mention what would happen to drug prices if a global pharmaceutical company were to amass 60 percent of the market, Talley said. ''That would also be a social loss, so even though a merger might appear to be full of strategic synergies, it may essentially be leveraging anti-competitive market power,'' he added.

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NEWS ANALYSIS

Withholding on Conversion Ratio Adjustments

by Ajay Gupta

Nearly a half-century has passed since Congress directed Treasury to issue regulations defining events to be treated as stock distributions taxable as dividends under section 305(b). Now, more than four decades after those regulations were first released, Treasury has gone back and proposed additional regulations clarifying when changes to conversion ratios of convertible securities would constitute deemed distributions of the underlying securities, specifying how those deemed distributions would be valued, and requiring withholding of the resulting taxes for foreign investors. Those proposed new regulations, however, still leave many questions unanswered.

Decades of Neglect

Congress enacted section 305(c) mandating deemed distribution rules as part of the Tax Reform Act of 1969. In 1973 Treasury finalized regulations implementing that mandate. But Wall Street seems to have long concluded that when it comes to making changes to conversion ratios of convertible securities, those rules are more honored in the breach than the observance. The financial services industry's Hamlet-like disregard of how section 305(c) applies to convertible securities became painfully evident to Treasury as it sought to plug another hole in the withholding regime for foreign investors in U.S. securities — this one engineered by financial derivatives.

In Title V of the Hiring Incentives to Restore Employment Act of 2010 (which included the Foreign Account Tax Compliance Act) Congress added a new code provision, since redesignated as section 871(m). This section was designed to prevent foreign investors from circumventing the withholding tax requirement on dividend payments on U.S. equities by holding swaps or other derivatives designed to replicate their performance, including dividend payments. Section 871(m) treats a ''dividend-equivalent payment'' as U.S.-source income and therefore subject to a 30 percent withholding tax, unless reduced or eliminated by an applicable treaty.

In 2012 Treasury issued proposed regulations that applied a seven-factor approach to determine whether a derivative held by a foreign investor was a tax avoidance transaction that would trigger the application of section 871(m). The next year, however, Treasury withdrew the proposed regulations and issued new ones adopting a more objective approach, including applying

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a ''delta'' standard to determine whether payments under a derivative contract would be subject to withholding. Delta connotes the change in the value of the derivative as a proportion of the change in the value of the underlying equity instrument.

The 2013 proposed regulations cross-referenced section 305(c), excepting from section 871(m) payments on derivatives to the extent they constituted taxable dividends under the deemed distribution rules. The logic of that exception was impeccable — a deemed distribution under section 305(c) (subject to tax under section 305(b)) would not need to be picked up as a dividend equivalent payment under section 871(m).

But to paraphrase Justice Oliver Wendell Holmes, the life of this piece of tax law has not been logic, it has been experience. And that experience, as the New York State Bar Association Tax Section pointed out in a comment letter, was marked by wanton noncompliance with the section 305(c) deemed distribution rules for convertible securities. Concerned that the proposed section 871(m) regulations and the NYSBA comment letter would end up not just highlighting a history of neglect but also drive adoption of explicit withholding requirements in the future, industry groups sought to forestall such a move.

Now or Never

A hastily organized Coalition of Concerned Convertible Bondholders argued in 2015 against taxing deemed distributions arising from adjustments to conversion ratios, claiming valuation and other logistical difficulties. The U.S. Chamber of Commerce voiced similar fears. Rejecting those expressions of concern, the IRS Office of Chief Counsel pointed to how stable and predictable the law governing adjustment ratios of convertible securities has been over many years. It characterized section 305 and its regulations as ''one of the more static areas of corporate tax law,'' noting that Treasury issued the regulations more than 40 years ago and concluding that they remain the current law and reflect the IRS's position.

Although they heightened the delta threshold for dividend equivalent payments and made other taxpayer-friendly revisions to the proposed regulations, the final and temporary section 871(m) regulations issued in September 2015 gave no quarter on the taxability of and withholding for deemed distributions caused by changes to conversion ratios of convertible securities. Industry lost that battle for good when the proposed new section 305(c) regulations came out this month.

That Congress intended the deemed distribution rules of section 305(c) to apply to convertible preferred stock and debt is evident from the provision's legislative history. And though noncompliance would matter whether a convertible security is held by a domestic or foreign investor, the tax stakes in the case of domestic investors have been lowered considerably since 2003. The Jobs and Growth Tax Relief Reconciliation Act of 2003 reduced the tax rate on ''qualified dividends'' to the same as on long-term capital gains, a reduction made permanent by the American Taxpayer Relief Act of 2012.

As a result, a domestic investor who disregards a taxable adjustment to the conversion ratio of his convertible security merely obtains a timing advantage and not a rate gain. Eventual sale of the security, before or after conversion, will inevitably subject all resulting gains to taxes. Recognizing dividend income earlier, on adjustment of the conversion ratio, would have triggered a tax liability then. But it would have also added to the security's basis, in the amount of the recognized dividend income, thus offsetting an equal amount of gain on disposition.

In comparison, the tax stakes are dramatically higher for a foreign holder of convertible securities. While for a domestic investor, the issue is whether tax is due tax now or later, for a foreign investor, it is whether tax is due now or never. Dividends received from a domestic corporation are U.S.-source income, and when paid to a nonresident alien individual, foreign partnership, or foreign corporation, are subject to withholding under sections 1441(b) and 1442(a) as fixed or determinable annual or periodic income. But that is generally not the case for U.S.-source capital gains.

Other than section 1445, which requires the transferee to withhold a 10 percent tax when a foreign person disposes of a U.S. real property interest, withholding does not apply to a foreign investor's U.S.-source capital gains, even if the investor is an individual taxable on those gains under section 871(a)(2) (for having been present in the United States for 183 days or more in the year). So if withholding is not imposed on a conversion ratio adjustment as a deemed distribution taxable under section 305(b), that adjustment will forever escape the U.S. withholding net.

Expanded Definitions and Wider Reach

Section 305(d) provides that for all purposes of section 305, the term ''stock'' includes ''rights to acquire such stock,'' while for purposes of the taxable dividend rules of section 305(b) and the deemed distribution rules of section 305(c), the term ''shareholder'' includes ''a holder of rights or of convertible securities.'' Consistent with those statutory definitions, the current regulations (reg. section 1.305-1(d)(2)) specify that the term ''shareholder'' includes ''a holder of rights or warrants or a holder of convertible securities.''

The proposed new regulations would amplify and vastly expand the definition provision to separately define ''actual stock'' and ''a right to acquire stock.'' The latter term includes a conversion right, subscription right, stock right, or ''other option to acquire shares of stock of the corporation issuing the instrument.'' Similarly, the proposed new regulations distinguish between

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an ''actual shareholder'' and a ''deemed shareholder.'' Finally, in somewhat circular fashion, the proposed new regulations define a deemed distribution as ''a transaction or event, other than an actual distribution of cash or property, that constitutes a distribution under section 305(b) and (c).''

The expanded definitions in reg. section 1.305-1(d)(2) help bring greater analytical clarity to the proposed new regulations' discussion of the situations in which a constructive distribution may rise to the level of a taxable dividend under one of the four prongs of section 305(b). In addition to actual distributions implicating one of these prongs, section 305(c) tells us to consider various transactions (redemptions and recapitalizations) and events (redemption premiums and changes in stock acquisition and conversion rights). It is this last set — acquisition and conversion right changes — that the proposed new regulations address, by revising and restating reg. section 1.305-7.

That restated regulation now begins with a new defined term, ''applicable adjustment,'' spanning various acquisition and conversion right adjustments, including changes in number and price. Interestingly, an adjustment in the terms of a right to acquire stock includes ''an extension or reduction of the term during which a right to acquire stock may be exercised.''

That adjustment might implicate the disproportionate distribution rule of section 305(b)(3), under which a distribution of common stock to some common shareholders and preferred stock to other common shareholders is taxable. Section 305(b)(3) itself is an extension of section 305(b)(2), the paradigmatic taxable stock dividend consisting of a property distribution to some shareholders and an increase in the proportionate interest of other shareholders in the corporation's assets or earnings and profits. Because section 317(a) excludes stock from the definition of property, the companion distribution requirement of section 305(b)(2) remains unsatisfied in the situation envisaged by section 305(b)(3) — common to some common shareholders, preferred to others.

In addition to this straightforward case of actual distributions covered by section 305(b)(3), the current regulations under this provision also encompass distributions of convertible preferred stock to common shareholders that are likely to result in some common shareholders converting into additional common and others retaining the distributed preferred (reg. section 1.305-4(b), example 2).

The proposed new regulations' wide-ranging definition of applicable adjustment, embracing changes to the term during which a right to acquire stock may be exercised, suggests that extending the term during which existing convertible preferred stock held by common shareholders may be converted could be enough to construct a distribution that could then be taxable under section 305(b)(3), by increasing the likelihood of conversion for some common shareholders. Such a constructive distribution could also implicate the convertible preferred stock distribution rule of section 305(b)(5) by increasing the likelihood that some common shareholders would sell their convertible preferred stock.

Under the current regulations, section 305(c) is considered to construct distributions that are potentially taxable under the paradigmatic case of section 305(b)(2) and the distributions-on-preferred rule of section 305(b)(4). Despite existing language in reg. 1.305-7(a)(2) suggesting the possibility that section 305(c) could apply to any one of the four prongs of section 305(b), the discussion and examples in that and other regulation sections remain confined to section 305(b)(2) and (4). But as shown above, it seems that under the proposed new regulations, constructive distributions could also result in taxable dividends under section 305(b)(3) and (5), thus validating the assertion in proposed reg. 1.305-7(b)(1) that a deemed distribution would have ''the result described in section 305(b)(2), (3), (4), or (5).''

Permissible Anti-Dilution Protection

The proposed regulations clarify that applicable adjustments made to prevent dilution do not constitute constructive distributions under section 305(c), while applicable adjustments compensating for property distributions to other actual or deemed shareholders do. Although the distinction between anti-dilution and compensatory adjustments is evident in the current regulations, the cryptic and scattered discussion has sometimes prompted practitioners to claim regulatory inconsistency.

Reg. section 1.305-7(b), titled ''antidilution provisions,'' states that changes in the conversion ratio or price of convertible preferred stock (or securities), or in the exercise price of rights or warrants, ''made pursuant to a bona fide, reasonable, adjustment formula (including, but not limited to, either the so-called 'market price' or 'conversion price' type of formulas),'' having ''the effect of preventing dilution of the interest of the holders of such stock (or securities)'' will not be considered to result in a deemed distribution of stock. Further, ''an adjustment in the conversion ratio or price to compensate for cash or property distributions to other shareholders that are taxable'' will not be considered as made under a bona fide adjustment formula.

Commentators have sometimes argued that the difference between anti-dilutive and compensatory adjustments is simply rhetorical, suggesting that the regulations seem to be trying to distinguish between an anti-dilutive adjustment merely making the convertible holders whole for the temporary loss in value of their securities from one that overcompensates them and thus renders them taxable. (Prior analysis: *Tax Notes*, June 29, 2015, p. 1491.) These arguments have usually rested on the axiom that as an economic proposition, a dividend is a nullity. While that is certainly the case,

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the distinction made in the existing regulations and clarified in proposed regulations is more doctrinal than rhetorical.

The paradigmatic section 305(b)(2) taxable stock dividend reflects the concerns expressed in *Koshland v. Helvering*, 298 US 441 (1936), of leaving untaxed a shift in the proportionate equity holdings of distinct groups of shareholder groups resulting from two distributions — one stock, the other property. An adjustment preventing dilution, from a stock split or a stock sale below the conversion price, a so-called down-round of financing, does not implicate these concerns, for the simple reason that nothing is removed from corporate solution. But an adjustment to compensate for property distributed to other interest holders embodies these concerns. The distributed property is taxed on the grounds that it was extricated from corporate solution. That is reason enough to tax the compensating adjustment.

Proposed reg. section 1.305-7(c)(6) incorporates the single example of a permissible anti-dilution adjustment — a down-round of financing — currently contained in reg. section 1.305-7(b)(2). It proceeds to add two more: another permissible anti-dilution adjustment, a stock split; and an impermissible compensatory adjustment, a conversion ratio change in the convertible debt securities accompanying a cash dividend on the common stock. Perhaps just as helpful, proposed reg. section 1.305-7(c)(6) also calls attention to the two examples currently in reg. section 1.305-3(e) (examples 6 and 7) demonstrating compensatory conversion ratio changes that run afoul of section 305(b)(2).

Unfortunately, the proposed regulations don't discuss how an anti-dilution adjustment should be computed. Instead, the text limits itself to the current regulatory phrase, ''bona fide, reasonable, adjustment formula.'' Moreover, the proposed revisions would exclude the current parenthetical reference to the ''market price'' or ''conversion price'' type of formulas. Anti-dilution adjustments for additional issuances below the conversion price can run the gamut, from complete protection under a so-called full-ratchet adjustment to partial protection under a weighted average protection.

It is unclear whether every kind of anti-dilution protection is blessed by the proposed new regulations. Conversely, the failure to make a ''full'' adjustment can increase the other security holders' interests. A regularly paid cash distribution on the convertible securities, or, under reg. section 1.305-3(b)(4), even an irregular one that happens to be within a 36-month window of the less-than-full anti-dilution adjustment, would then potentially constitute a taxable dividend for the other security holders. They could thus be subject to taxes merely because the convertible security holders were not fully protected against dilution. These, along with valuing deemed distributions resulting from applicable adjustments, are issues for another day.

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Conversations: Marlies de Ruiter

by Stephanie Soong Johnston


Photo courtesy of Marlies de Ruiter

Marlies de Ruiter is a former head of the tax treaty, transfer pricing, and financial transactions division at the OECD's Centre for Tax Policy and Administration. A Dutch national, de Ruiter was appointed to the OECD in February 2012, after more than 15 years working with direct tax and international tax issues in the Dutch Ministry of Finance. In an interview with Tax Analysts just before she left the OECD, de Ruiter discusses the implementation phase of the OECD's base erosion and profit-shifting project and what's ahead for both her and her yet-to-be-appointed successor.

Tax Analysts: You have been at the OECD for over four years. In that time, what have you learned about where we are on transfer pricing and treaties?

Marlies de Ruiter: I think everyone learned a lot. If you see how the world has changed in the past four years, it's incredible. First of all, we had the BEPS project reset the rules, which is huge. But I think what has been as interesting, if not most interesting, is that when I came to the OECD, it was very much OECD countries only. In the past three years, we have worked with so many BEPS associate countries, all the non-OECD G-20 countries on an equal footing, and now we're expanding it even more. The interesting dynamic is that you're changing the standards, they are becoming much more global, and they are implemented in a more coherent way because of the attention for implementation.

TA: What advice would you give to your successor on BEPS project implementation?

de Ruiter: That there is a big difference between consensus language and real consensus. Before BEPS, we tried to find consensus language. Countries came in with domestic positions, and they said this is what we're doing and we want the language to capture that. We tried to find the common denominator. That has totally changed. We now have clear guidance that we need to change things. Countries are open to compromise and once they're open to compromise, you also get more convergence in the rules. So what I would advise my successor is to use the room that you have to get to that real consensus because that will facilitate global rules and better implementation.

TA: What qualities should your successor have?

de Ruiter: What I would hope is that it would be someone who really can help with transition from the guidance to implementation. So someone with broad experience, definitely also in transfer pricing and tax treaties. That would be good. Making the rules work is where the future is going to be. We'll need to make sure it works both for tax administrations and for taxpayers.

TA: What are the things you're most proud of and what do you think needs more work?

de Ruiter: I'm really proud we were able to deliver in the very short time frame that we had. And I'm also very proud in what we delivered within that time frame. It's real consensus, and it's better than some things we produced earlier when we didn't have the political commitment yet. That's what I'm most proud of. Of course, I would have liked things to move quicker. I would have also liked more clarity and more implementation guidance, so it would have been much clearer to business and tax administrations on how to implement this guidance, but I just don't think it was realistic to deal with it in that time frame. Therefore, it is good that all of these things are captured in the follow-up work that my successor will be working on.

TA: Do you think the work on mutual agreement procedures and dispute resolution will be a game changer?

de Ruiter: My past is very much about dispute resolution because I was chair of the subgroup that did the initial work in 2008, and at that time I was already proud of the work we produced. It was a great result, but it was never implemented; it was just paper. And I strongly believe what we have now with the peer review mechanism will mean that it will be implemented. That will be the game changer. The paper is not the game changer: Getting countries to do it is what will be the game changer; that's where the meat is.

TA: What do you hope to see happen with increased cooperation with the other international organizations, the World Bank, the U.N., and the IMF?

de Ruiter: What I hope to see come out of that increased cooperation is more interaction between standard setting and implementation. If you really want a global implementation where the demand is, you need to make sure it works for all countries, and you will need to make sure that it's appealing to do the same thing for all countries. International organizations working together can achieve that because together we can feed all our experiences into the high-level standard setting, which can be translated to manageable and administrable tools for developing countries without confusing them with mixed messages. And then we can also provide the capacity-building together — with the other international organizations doing the biggest part of it.

I think it's a huge opportunity to have these organizations now working together. What I also hope is

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from their vast experience with developing countries and transfer pricing, they will be providing input that will lead to the filling in of the discrepancies in the standard setting for developing countries. So that interaction is going to be very important between implementation and standard setting.

TA: As far as the remaining work that needs to be done on the BEPS project, such as profit splits, do you think countries will be as fast to move on these issues?

de Ruiter: Yes, I'm confident that the deadlines that have been set will be met, but the deadlines that were set were more relaxed than the BEPS deadlines. For transfer pricing, for example, we will be doing implementation guidance on hard-to-value intangibles and low-value-adding services. But the real meat will be in financial transactions and profit splits, and that will be delivered next year. So we will really have enough time to address these difficult issues.

TA: So what's next for you?

de Ruiter: I'm taking four months off, so my plan is to not plan anything. I'm indeed moving back to my home country, the Netherlands. My family moved back about a year ago because of personal reasons, and I'm going to be living with them again, which will be very nice. It was okay while they lived here, but I find the commuting quite hard. When they left, I agreed with [OECD tax director Pascal Saint-Amans] that I would stay until the BEPS project was finished and there was a reasonable transition. So this was in the planning for a long time.

TA: And after four months?

de Ruiter: I will need another job. I decided not to look for another job while I was still at the OECD because of potential conflicts. I will be trying to find out what to do in the next four months.

TA: Any final thoughts?

de Ruiter: It's an extremely interesting, challenging time to be at the OECD. I'm sorry I'm going to miss out, because the next four years are going to be as important as the past four years. I will be following with interest what will be happening. From the role where I am as of September, I definitely hope to contribute.

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Brexit Like Tax With No Benefit, OECD's Gurría Says

by Santhie Goundar

Following President Obama's controversial remarks on his state visit to the U.K., the OECD has waded into the U.K.'s debate on whether it should vote to leave the European Union in its referendum on June 23. Like Obama, OECD Secretary-General Angel Gurría's answer is an emphatic ''no.''

In a passionate speech accompanying the release of the OECD report ''The Economic Consequences of Brexit: A Taxing Decision'' on April 27 at the London School of Economics, Gurría argued that a British exit from the EU (Brexit) would work like a tax, hitting the well-being and pockets of U.K. citizens.

''Unlike most taxes, however, this one will not finance the provision of public services or close the fiscal gap,'' he said. ''The 'Brexit tax' would be a pure deadweight loss, a cost incurred with no economic benefit. And this tax would not be a one-off levy: Britons will be paying it for many years.''

According to the OECD report, it is estimated that the Brexit tax would cost each household an average of £2,200 by 2020, with British GDP shrinking by 3.3 percent. By 2030, the report states, British GDP would have shrunk by around 5 percent, meaning that the average household would be £3,200 worse off. In the worst-case scenario estimate for 2030, GDP would shrink by 7.7 percent, with the average household worse off by as much as £5,000. (The report was available at http://goo.gl/1Zlb2M as of April 27, 2016.) Gurría said he believes that the OECD's estimates are too cautious, focusing almost entirely on the future effects of Brexit. Those forecasts, however, are similar to other official estimates, such as those produced by the U.K. Treasury and the Confederation of British Industry, which show that ''quantitatively and qualitatively,'' Britain would be worse off as a result of Brexit.

Were Brexit to occur, Gurría added, the U.K. would have to negotiate new trading relationships because it would not only give up full, automatic, and unrestricted access to the European single market, it would also lose the benefit of preferential trade agreements covering 53 non-EU markets that the U.K. currently enjoys and helped to shape.

The OECD report considers several possible post-Brexit arrangements with the European Union, concluding that none clearly stand out, and that Britain would have to comply with a wide range of EU regulations with no say in how they are drafted — and that's assuming that it wouldn't take several years, even up to a decade — for the U.K. to renegotiate its trade agreements in the first place. Obama, at least, has already

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indicated that from the U.S. perspective, a post-Brexit U.K. would be ''back of the queue'' for negotiating agreements.

Gurría noted that since the U.K. joined the EU in 1973, its real GDP per capita has doubled, more than other major EU states (with the exception of Ireland, which joined at the same time as the U.K. and saw its GDP per capita quadruple in the same period) and more than other non-EU English-speaking countries.

''Supporters of Brexit argue that the U.K. would actually achieve a more liberal trade regime outside the EU than it enjoys now, but this is a delusion,'' Gurría said. ''Bilateral and regional trade agreements take years to negotiate and absorb substantial energy and resources [and] the U.K. would be starting from scratch.''

The first priority would likely be to negotiate with the rest of the European Union, which accounts for around 45 percent of U.K. exports. Facing an ''embittered, freshly rejected and much larger partner with an incentive to make exit costly is not a good basis for a favorable outcome,'' Gurría argued, especially with the EU looking to send a clear and firm message to any other members that might consider following Britain in leaving.

The report says the mere risk of Brexit, and the uncertainty it brings, are already having an effect months before the referendum takes place. Financial markets in the U.K. and the eurozone have been less buoyant than in the U.S. The pound sterling has depreciated since the fourth quarter of 2015, businesses have started to defer investment projects (U.K. business investment declined by 2 percent in the fourth quarter of 2015), and capital spending intentions and hiring decisions have fallen. In the event of a Brexit, foreign (and British) businesses that set up in the U.K. to access the European market could decide to relocate, and real exports would drop by 8 percent if the U.K. lost its preferential trade agreements. Gurría said the fallout from Britain's exit would be felt for years, both in Britain and throughout the EU.

''Our conclusion is unequivocal — the U.K. is much stronger as a part of Europe, and Europe is much stronger with the U.K. as a driving force,'' Gurría said. ''There is no upside for the U.K. in Brexit — only costs that can be avoided and advantages to be seized by remaining in Europe. No one should have to pay the Brexit tax.

''The best outcome under Brexit is still worse than remaining an EU member, while the worst outcomes are very bad indeed,'' Gurría added. ''The Brexit tax just gets bigger. Why spend so much effort trying to recover the benefits of membership in a club you don't have to leave?''

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TRANSFER PRICING ROUNDUP

Tax Analysts' Transfer Pricing Roundup reports on transfer pricing controversies disclosed in SEC filings and from other sources, foreign and domestic.

Cameco Corp.

Cameco Corp., a uranium company headquartered in Saskatoon, Canada, reported in an April Form 6-K that the Canada Revenue Agency has issued notices of reassessment for the company's 2003-2010 tax returns based on the transfer pricing method used for intercompany uranium sales and purchases. Cameco has recorded a cumulative tax provision of $50 million as a result. The company said it is confident that it will be successful in its case and that the resolution will not have a material effect on its financials.

Jurisdiction(s): Canada

Microsoft Corp.

Microsoft Corp., a multinational software company headquartered in Redmond, Washington, reported in an April Form 10-Q that tax contingencies and other income tax liabilities were $12.7 billion as of March 31, 2016, related primarily to intercompany transfer pricing adjustments, offset by a partial settlement of the company's IRS audit for tax years 2007-2009. Microsoft remains under examination for tax years 2004-2009.

Jurisdiction(s): United States

Trinity Industries Inc.

Trinity Industries Inc., a Dallas-based company that provides products and services to the industrial, energy, transportation, and construction sectors, reported in an April Form 10-Q that the 2007 tax year of one of its Mexican subsidiaries is still under review for transfer pricing and that its statute of limitations remains open through the later of the resolution or July 2018.

Jurisdiction(s): Mexico

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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
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COUNTRY DIGEST

Australia

Senate Panel Challenges International Transfer Pricing Regime

Australia should reassess — and possibly even revise — its transfer pricing rules, even if that means straying away from established international standards, according to a report by the Australian Senate's Standing Committee on Economics.

The committee's April 22 report, ''Corporate Tax Avoidance Part II: Gaming the System,'' offers a harsh assessment of multinationals' tax avoidance practices and the laws that fail to prevent them. ''The central concern is to what extent multinationals arrange their corporate structure and engage in practices deliberately intended to deny Australia its proper share of tax and whether they are held accountable for engaging in such practices,'' it says.

Along with excessive interest deductions, transfer pricing is one of the most glaring instances in which existing law is inadequate in countering aggressive avoidance, according to the report.

''While OECD transfer pricing principles may be the accepted practice, the evidence provided to the committee across a variety of industries confirms that the current transfer pricing regime does not serve Australia well from a tax revenue perspective,'' the report says.

In an exchange with Tony King, the managing director of Apple Australia, excerpted in the report, Sen. Christine Milne of the Australian Greens went so far as to describe the separate-entity approach and the arm's-length principle as ''ridiculous.''

''You are acting as if you are a separate entity and you are not a separate entity; you are part of a global structure, and you are fixing the prices around the world so you maximise your expenses here in this jurisdiction and then maximise your tax avoidance in a low-tax jurisdiction,'' she said, adding that ''it is ridiculous to regard you as a single entity when you are part of a global company which is avoiding tax.''

The report also describes an exchange during which Sanofi Managing Director Laurie McAllister attempted to explain to the committee that profit was determined using the transactional net margin method — a commonly used transfer pricing method sanctioned by both the OECD and the Australian Taxation Office (ATO) — as a refusal on McAllister's part to answer a question about product production costs.

The report notes the frustration with representatives of multinational companies for what the committee perceived to be vague and evasive answers to its questions, some of which it says ''stretched beyond credulity.''

''The audacity of certain multinationals in refusing to comply with legitimate and reasonable requests for information raises suspicions that they have something to hide. The unwillingness of many multinationals to discuss openly their tax arrangements underscores the need to establish mechanisms to increase transparency,'' it says.

The report recommends harsher penalties for Australian subsidiaries to maintain the type of documentation necessary to evaluate their tax positions. Stressing the critical importance of transparency, it also endorses public country-by-country (CbC) reporting. The European Commission issued a proposed directive mandating public CbC reporting this month. (Prior coverage: *Tax Notes Int'l*, Apr. 18, 2016, p. 234.)

The report came one day after the committee's most recent hearing on tax avoidance, during which the committee took testimony from the authors of an April 19 report published by GetUp! estimating that aggressive tax planning by the largest 76 companies has resulted in Australian revenue loss of AUD 5.4 billion ($4.2 billion) in 2013-2014. (Prior coverage: *Tax Notes Int'l*, Apr. 25, 2016, p. 333.) The report measures tax aggressiveness using the difference between a company's current tax expense and what its tax liability would have been had it paid tax at Australia's statutory tax rate of 30 percent.

While useful for risk assessment, it is important to consider the limitations of this approach, said Jeremy Hirschhorn, the ATO's deputy commissioner of public groups, at the committee's April 21 hearing.

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''When looking at any sort of effective tax rate of a large company, you have to look at not just how much cash tax was paid but what's the reason why the cash tax is way out of line with accounting profit,'' he said, adding that ''in many cases that's the result of explicit policy choices'' such as research and development credits, exemption of foreign income, and accelerated depreciation.

Hirschhorn also took issue with estimating profit attributable to an Australia entity using the group's global margin — which the committee report and GetUp! study both use — arguing that the approach ''captures profit which Australia does not have the right to tax.''

''Australia does not have the right under [its tax treaties] to tax the entire profit of an international organization from its sales in Australia. It gives away some of that right so that other countries won't tax Australian companies offshore on their profits,'' he said.

During the hearing, ATO Commissioner Chris Jordan announced that his office is working with the federal courts to develop a fast-track system to expedite ''strategic cases'' that would affect the outcome of other pending cases, in part to counter taxpayers' stalling techniques. The ATO is ''very much hardening [its] approach'' to such practices, he said.

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Taxpayer Alerts Address Emerging Profit-Shifting Schemes

Concerned that multinationals and other large companies operating in Australia are not paying the correct amount of tax, the Australian Taxation Office (ATO) released a series of taxpayer alerts as an early warning to taxpayers and their advisers about emerging profit-shifting arrangements that might lead to tax avoidance.

One of the alerts cautions against the use of interim arrangements that might run afoul of Australia's multinational antiavoidance legislation (MAAL), which took effect January 1. The MAAL, which applies to multinational groups with more than AUD 1 billion (about $773 million) in annual revenue, denies tax benefits arising after January 1 from certain types of ''artificial and contrived arrangements'' put in place to avoid the attribution of income to an Australian permanent establishment. (Prior coverage: *Tax Notes Int'l*, Jan. 25, 2016, p. 303.)

''Our view is that interim arrangements must reflect the economic and commercial reality of operating in Australia and we continue to engage with taxpayers and review these interim arrangements to ensure they do not themselves amount to tax avoidance schemes,'' Deputy Commissioner (International) Mark Konza said in a statement.

MAAL Avoidance May Backfire

The ATO said it is concerned that in an attempt to avoid the MAAL, some taxpayers are entering into artificial and contrived arrangements that might themselves be subject to the antiavoidance rules. The tax authority described one scheme under which foreign and Australian entities swap roles via contracts. ''These contracts purport to make the Australian entity the distributor of the products or services, and the foreign entity an agent of the Australian entity, collecting the sales revenue from customers on its behalf,'' the ATO said. ''This is despite no changes being made to the underlying functions performed by the entities.''

Under such an arrangement, the foreign entity purportedly makes no supply of goods or services to Australian customers and has the potential to become a PE of the Australian entity in the foreign entity's jurisdiction, the ATO said. That could lead to the argument that income from the Australian sales should continue to be declared in the foreign tax jurisdiction, it said.

The ATO said royalty payments — normally paid to a related party located offshore — that are made by the foreign entity supplying goods or services to Australian customers might be subject to Australian royalty withholding tax under the MAAL. In some cases, contrary to the previous arrangements between the parties, such payments have been recharacterized as distribution fees in an attempt to escape withholding tax, the tax authority said.

The ATO said companies should work with it on arrangements they are considering in order to avoid the MAAL. ''This will help ensure that their new arrangements reflect the substance of their activities in Australia, including appropriately reflecting the functions performed, assets used, and risk assumed in Australia,'' the ATO said. ''There should also be an appropriate consideration of any withholding tax obligations.''

It said taxpayers and advisers involved in MAAL avoidance arrangements will be subject to increased scrutiny and that it will initiate compliance activities, when necessary, that could result in the assessment of penalties of up to 120 percent of the tax that was avoided.

Valuation of 'Generic Material'

A second alert warns against the inappropriate recognition and revaluation of internally generated intangible assets for thin capitalization purposes. The ATO said it is focusing on the valuation of ''generic material,'' such as internal policies, internal meeting protocols, and procedures. It is also looking at what it described as ''the application of unsupportable or questionable management assumptions from an asset revaluation perspective,'' as well as the double counting

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of the same value across multiple intangibles. The tax authority is also reviewing entities that are not impairing assets when the fair value or the cash-generating unit has declined.

A third alert describes the use of related-party arrangements to inappropriately shift profits out of Australia. ''We've seen arrangements where the funding has been implemented in an excessively complex manner for Australian tax purposes, rather than in a simpler manner more appropriate in the circumstances,'' the ATO said.

The final alert addresses the use of cross-border leasing arrangements involving mobile assets to lower taxable profits reportable in Australia. The ATO said withholding tax might apply to such lease payments, with the head lessor liable if head lease payments are deemed to have an Australian source and either the sublessor has limited commercial activities or ''there are limited, sound commercial reasons for its position in the leasing arrangement.''

The alerts follow the publication of a report by three professors on April 19 that says the Australian government would have collected AUD 5.37 billion more in corporate tax from 76 large private sector firms during the 2013-2014 period if the companies had paid tax at statutory rates. (Prior coverage: *Tax Notes Int'l*, Apr. 25, 2016, p. 333.) On April 22, an Australian Senate committee issued a report saying that the government should reassess and possibly revise its transfer pricing rules, even if it means deviating from established international standards. The report is sharply critical of tax avoidance practices allegedly engaged in by multinational companies.

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Senate's Profit-Shifting Report At Odds With OECD

The interim report by the Australian Senate's Standing Committee on Economics on corporate tax avoidance shows that the committee and the OECD are far apart on transfer pricing, but some question whether the committee will be able to translate its conclusions into concrete legislative measures.

The committee's interim report on profit shifting by multinational enterprises, ''Corporate Tax Avoidance Part II: Gaming the System,'' rejects some of the basic principles underlying OECD and Australian guidance on transfer pricing. The April 22 report argues strongly that current rules have allowed MNEs to arbitrarily attribute income among countries to the detriment of Australian tax revenue, even portraying the term ''transfer pricing'' as a type of avoidance strategy rather than part of determining an MNE's income.

''The transfer pricing rules effectively allow multinationals to charge Australian consumers whatever the market will accept and then shift the profits out of the country through transfer pricing,'' it says.

But despite its strong objections to the principles and methods of the current transfer pricing regime, the report doesn't include any specific modifications to the rules or a more effective alternative regime.

''The committee appreciates that there are no easy solutions to reforming internationally accepted principles as they relate to transfer pricing. That said, the committee considers that the current transfer pricing principles need to be fully explored, and, where necessary, redrafted to ensure that transfer pricing cannot be manipulated to the detriment of Australian tax revenue,'' according to the report.

Local Revenue, Global Margins

The report repeatedly objects to foreign multinationals' approach to attributing taxable income to Australia, especially regarding what it describes as inappropriately low margins for domestic distributors determined using the transactional net margin method (TNMM). The TNMM determines the appropriate return in a related-party transaction based on the selected operating profitability ratio — described as ''only a fraction'' by the report — of functionally comparable independent enterprises. The report singled out Apple Australia's margins of between 2.5 and 4.5 percent over the 2010-2015 period as a prime example of a distributor that should have higher profits in Australia.

''Australian subsidiaries are remunerated only for, and pay corporate tax on, the value added in the role as a distributor and/or facilitator of goods and/or services to Australian consumers. Evidence provided to the committee indicated that the profits, and thus tax paid, from these distribution activities represent only a fraction of total Australian revenue,'' the report says.

This rejection of what may be the most commonly applied transfer pricing method is sharply at odds with international standards. For reference, the IRS reported in its 2015 advance pricing agreement report that the TNMM accounted for 78 percent of all tested tangible and intangible property transactions, and 85 percent for all tested services transactions. (Prior coverage: *Tax Notes Int'l*, Apr. 4, 2016, p. 59.)

Although the fixed distribution margin determined using the TNMM may be higher or lower depending on the functional profile of the tested entity, the approach often leaves the local entity with a lower margin than the multinational group's consolidated margin, especially if the group is highly profitable. This result is justified, under current principles, when the tested distributor doesn't own any of the group's core intangible property, perform any of the group's key management decisions, or bear any of the group's fundamental risks of success or failure.

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The report flatly rejects this justification, stating that ''the committee does not accept the argument that activities within Australia represent only a small proportion of overall value creation.'' It goes on to suggest that locally added value may be measured using the excess of the distributed product's market price in Australia over its price in other countries. It doesn't address whether lower prices in Australia would indicate negative value added, therefore justifying a tax loss.

The committee's conceptual approach is analogous to the one taken by many critics of HM Revenue & Customs' settlement with Google, which many argued resulted in an effective tax rate of 3 percent on the company's U.K. operations. This criticism became so widespread that HMRC went so far as to post a response on its website, noting that applying the global consolidated margin to local revenue ''does not reflect how tax law works.'' The margins of different group entities should and do deviate from the group's consolidated margin to reflect their different contributions, according to HMRC. (Prior coverage: *Tax Notes Int'l*, Feb. 29, 2016, p. 749.)

Exploration and Possible Redrafting

The report notes that exploration of the current transfer pricing principles is needed, and redrafting is a possibility. However, acknowledging the difficulty of developing and implementing an alternative transfer pricing framework, it declines to offer specifics regarding what legislative changes may be warranted. The decision not to take on the daunting task isn't surprising, according to Antony Ting, an associate professor with the University of Sydney Business School.

''This report highlights the problems of the current transfer pricing rules, especially the tension between the arm's-length principle [and separate-entity approach] and the modern highly integrated MNEs,'' he said. ''However, it does not make any specific recommendation to improve the regime, possibly due [partly to] lack of resource to do so, and partly the appreciation of the extreme difficulty to do so.''

''Therefore, it is unlikely that the government will act on this front as a result of this report,'' Ting added.

However, even if the transfer pricing rules themselves aren't changed, the committee's work may support efforts to enact other anti-base-erosion measures, according to Niv Tadmore of Clayton Utz.

''Australia's transfer pricing rules were reformed in 2013 and the new rules are as robust and comprehensive as one can get within an OECD-based framework, and Australia is unlikely to depart from that framework,'' he said. ''However, the report is likely to trigger specific new antiavoidance legislative measures, such as the recent measure targeting certain multinationals without a permanent establishment in Australia.''

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Austria

Austria Lobbying ECOFIN to Join Pilot Anti-VAT-Fraud Project

Austrian Finance Minister Hans Jörg Schelling asked the EU finance ministers assembled for an informal Economic and Financial Affairs Council meeting to make his country part of a pilot anti-fraud project by allowing it to implement a reverse-charge VAT system, according to a statement from the Austrian Ministry of Finance.

The Czech Republic is also seeking to participate in the anti-VAT-fraud pilot project, the MOF noted in its statement issued April 23 after the two-day meeting.

Austria has been pushing for VAT reform for more than 10 years, but the European Commission is only now presenting an action plan for combating VAT fraud that would allow individual countries to implement the reverse charge system, the MOF said in its statement. (Prior coverage: *Tax Notes Int'l*, Apr. 11, 2016, p. 153.) The reverse charge system requires the recipient of a good or service, rather than the supplier, to account for the VAT due.

''We need 10 days to draft a joint paper relating to the Panama Papers, but in 10 years we are unable to put together a solution for combating VAT fraud,'' said Schelling, as quoted in the statement. The MOF added that EU member states should seek a general solution to the issue of VAT fraud and not use a ''hotchpotch'' of different solutions to address the issue.

Addressing the issue during an April 23 press briefing following the ECOFIN meeting, European Commission Vice President Valdis Dombrovskis said the ministers discussed upgrading and linking the information technology systems of the member states. He said the upgrades would be an important step because they would allow tax authorities to receive critical information faster.

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Brazil

Prospects for Tax Reform Dim as President Faces Impeachment Trial

With Brazil's Federal Senate poised to put President Dilma Rousseff on trial after an impeachment referral from the Chamber of Deputies, tax professionals say it's unlikely that either the National Congress or the

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president — whoever that turns out to be — will push for meaningful tax reform until well after Rousseff's fate has been decided.

More than two-thirds of the Chamber of Deputies — the required majority — voted April 17 to impeach the president, who is accused of covering up a yawning budget deficit during the run-up to the national elections in 2014. Rousseff eked out a narrow victory in that runoff, picking up only 51.6 percent of the vote. The budget deficit, if disclosed, could have jeopardized her chances for a second term in office.

The case against Rousseff is now before the Senate, where a simple majority of its 81 members must vote in favor of a trial. If the trial is approved, the Senate is expected to vote by mid-May to suspend Rousseff and install Vice President Michel Temer in her place. A two-thirds majority of the Senate is needed for a conviction. If the required supermajority can't be achieved or the Senate fails to vote within 180 days, Rousseff will be reinstated.

Many pundits predict that the trial of the unpopular president will proceed. Dissatisfaction with Rousseff 's performance has spread as Brazil's recession drags on and the inflation and unemployment rates have increased against the backdrop of a widening political scandal. The country's GDP declined by 3.85 percent in 2015, with Brazil's Central Bank projecting a further contraction of 3.88 percent in 2016. The bad economic outlook is blamed on falling demand for exports of Brazilian commodities such as oil and iron ore, chronic budget deficits attributable to overspending by the governments of Rousseff and her predecessor, Luiz Inácio Lula da Silva, a complicated tax regime, and an overregulated private sector.

While the export issue is largely beyond Brazil's control, few of the country's other problems — especially those regarding taxes — are likely to be addressed until the uncertainty over Rousseff's future is cleared up. ''We don't expect any significant change in tax legislation during the impeachment process,'' said an analyst at an investment bank in São Paulo, who asked not to be identified.

Temer Says No to Tax Hike

At least one question about Brazil's taxes has been cleared up in recent days: They apparently won't be going up in the near term — assuming, that is, that Rousseff is put on trial and that Temer takes her place. After a six-hour meeting with Temer on April 24, Paulo Skaf, president of the Federation of Industries of the State of São Paulo (FIESP), told a press conference that the vice president agreed there is no need to raise taxes to balance the government's books. While an increase in government revenues will come naturally with the resumption of economic growth, Skaf said, an increase in the tax burden would further chill the economy.

''Nothing has been written in stone, but Temer has apparently reached some sort of compromise with FIESP,'' said Flavio Rubinstein of Vettori, Rubinstein & Foz Advogados. ''Whether they can do that, with the deficit where it is and no increase in taxes, isn't clear.''

Rubinstein said the government tried to raise taxes in 2015, only to see collections fall. ''Most economic agents reduced their investments, and [tax receipts] went backwards for a few months,'' he said. ''But it's an interesting idea not to raise taxes any further and [to] try to rebuild a relationship of trust with economic agents to get the economy to bounce back.''

Bank Transaction Tax Still Possible

One particularly thorny tax issue is whether to reintroduce a controversial bank transaction tax (CPMF). The CPMF was first implemented in 1996 at a rate of 0.38 percent. It remained in effect until 2007, when it was allowed to expire. The government has made a number of attempts to bring back the unpopular tax over the years. The National Congress included BRL 10.1 billion (around $2.7 billion) of CPMF revenue in the 2016 budget but didn't pass a law requiring that the tax be paid. (Prior coverage: *Tax Notes Int'l*, Jan. 11, 2016, p. 121.)

Resistance to the idea remains strong. According to reports in the Brazilian press, Skaf told a press conference after his meeting with Temer that ''under no circumstances'' would his organization support a revival of the CPMF and that necessary fiscal reforms could be accomplished through spending cuts. ''We know that it is possible to carry out fiscal adjustment — it is possible to normalize the government's accounts with respect to expenses — by reducing wasted expenditures in such a way as to [bring them into] balance,'' Skaf was quoted as saying.

''When the CPMF was first introduced, it was supposed to be a temporary measure, but it went on for many years,'' Rubinstein said. ''People could see it every time they went to the bank. When [the government] tried to reinstate it, there was a huge backlash.''

Despite the opposition, Rubinstein said, the prospects for bringing back the tax looked good until Temer's agreement with FIESP. ''Temer won't be taking that political battle on himself,'' Rubinstein said. ''But it's still on the table because it's one of the easiest revenue-raising strategies they could adopt.''

At least one observer, however, thinks the CPMF will be reintroduced during a Temer administration. ''We consider that, if he assumes the presidency, [there is] a 75 percent chance of approval in the Congress,'' the investment bank analyst said.

Ricardo Chamon of Pereira Neto Macedo Advogados said he expects Temer to focus on creating new sources of income and reducing public expenses. ''[But] I don't think he will have enough political support to work on major changes,'' Chamon said. ''From

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day one, he will be working on gathering support and prestige in order to be successful in the next election. After 2018, we may see bigger changes taking place in order to fix things here and put us back on track.''

Rousseff Lacks Political Support

If Rousseff is ousted from office, Temer will take over until the end of her elected term, which runs through December 31, 2018. However, even if Rousseff survives the impeachment process, there will probably not be any meaningful revisions to Brazil's tax regime before the end of her term. ''Rousseff won't be able to raise, reform, or rationalize taxes because she won't have any sort of political support,'' Rubinstein said. ''She might call for new elections. That would be the most likely scenario.''

Analysts say a Senate failure to convict Rousseff wouldn't necessarily end the uncertainty because other impeachment charges pending against the president could start the process anew. Brazil's bar association filed a petition on March 28, asking the National Congress to broaden its impeachment investigation to include a charge of obstruction of justice based on allegations that Rousseff appointed da Silva to be her chief of staff on March 16 to prevent him from facing federal charges for his alleged role in a bribery and influence-peddling scandal involving Petrobras, the government-controlled oil company.

Prosecutors say Petrobras paid inflated amounts for service and supply contracts, with a significant part of the overpayments being used to finance the political campaigns of key elected representatives. Despite having served as the chair of Petrobras's board of directors from 2003 to 2010, Rousseff has not been implicated in the scandal.

Under Brazilian law, many high-level officials can be tried only by the Supreme Court. A Supreme Court justice suspended da Silva's appointment, which is now being considered by the full Court. Da Silva and Rousseff have both compared the various impeachment efforts to a political coup d'état.

Even if Rousseff is forced from office, the impeachment machinery could quickly be put back into motion because Temer himself is also being investigated for his alleged role in the Petrobras scandal. Temer has denied any wrongdoing.

Tougher Enforcement Needed

Despite the corruption scandals, Rubinstein said, Brazil's existing rules against tax evasion and bribery are sufficiently tough. ''It's primarily a matter of enforcement,'' Rubinstein said. ''The normal penalty for underpayment of tax is 75 percent of the past-due amount, plus interest.'' Rubinstein pointed to what he said appears to be a successful offshore voluntary disclosure program. Under the program, which runs from April 4 through October 31, Brazilians with undisclosed offshore assets can resolve their legal situations by reporting the assets and paying a penalty equal to 30 percent of their value. (Prior coverage: *Tax Notes Int'l*, Jan. 18, 2016, p. 214.)

Before federal prosecutors started their investigation into influence peddling and bribery, little was done about bribery in Brazil, Rubinstein said. ''It frequently went under the radar or dragged on for a long time without any concrete action or important people going to jail,'' he said. ''That situation has obviously changed.''

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Estonia

Parliament Drafting Tax Framework Under 'Uber Law'

The Estonian Parliament is discussing amendments to the Public Transportation Law, also known as the ''Uber Law,'' to provide a regulatory framework, including taxation, for ''sharing-type'' taxi services.

Under the proposed new system, a customer would contact and make an ''agreement'' with a carrier (an individual or legal entity) via a digital device such as a smartphone or tablet. These agreements, which would be based on a web platform only, would include full information about the driver, his or her professional service record, the expected fare, and other relevant information.

The carrier would be required to provide full and direct access to its transaction records to the Estonian Tax and Customs Board (EMTA). Representatives from Uber and EMTA announced earlier that they have established a digital system to report every payment in real time to the EMTA. If the system is a success, it will be unique to global taxation.

Traditional taxi companies and drivers are protesting loudly and organizing various actions against the ''new pirate'' taxi service providers. However, until the amendments are officially adopted by Parliament, business goes on as usual.

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European Union

EU Court Tells France, Ireland, and Italy to Recover State Aid

France, Ireland, and Italy must recover excise taxes from three alumina producers that were granted exemptions in violation of EU state aid rules, the EU's General Court held April 22. The court's decision reverses two previous rulings it made in the same case.

Alumina, a derivative of bauxite, is used in smelters to produce aluminum and in some chemical applications. France, Ireland, and Italy granted Alcan Inc., Aughinish Alumina Ltd., and Eurallumina SpA, respectively, exemptions from excise duties due on mineral oils used for the production of alumina.

Case Background

The European Council had originally authorized the exemptions and later extended their use until December 31, 2006, but the European Commission determined that the tax breaks conferred a selective advantage on the recipients and distorted competition to a degree that affected the single market. In 2005 the commission said the exemptions constituted illegal state aid that had to be repaid. The commission ordered recovery of the aid starting from February 2, 2002, the date on which the decision to initiate a procedure to disallow the exemptions was published in the official gazette, saying that a requirement to repay earlier amounts would be ''contrary to the principles of legitimate expectation and legal certainty.''

The three countries appealed to the General Court, which in 2007 annulled the commission's decision on grounds that it had breached its obligation to provide reasons for its determination. The commission appealed to the Court of Justice of the European Union, which in 2009 set aside the General Court's decision, sending the case back to that court. In 2012 the General Court once again annulled the commission's determination, on grounds that it partially nullified the legal effects of the European Council's earlier decisions to authorize the exemptions. The commission appealed that decision to the CJEU, which agreed with the commission and returned the case to the lower court for further consideration.

On the third, and most recent, go around, the General Court agreed with the commission, ordering that the state aid be recovered for the period between February 3, 2002, and December 31, 2003. ''Council authorization decisions do not predetermine the effects of decisions adopted by the commission in the exercise of its powers in the area of state aid,'' the General Court said in its decision.

The court said the excise duty exemption on the mineral oils conferred an advantage on the companies involved, as compared with other undertakings that use mineral oils. ''In addition, the court takes the view that the commission clearly indicated the reasons why the exemptions at issue were liable to affect trade between member states and distort competition in the market by strengthening the competitive position of alumina producers established in Ireland, France, and Italy vis-a-vis other European alumina producers,'' the court said.

Even though the commission had not adopted its decision ''within a reasonable period,'' with 49 months elapsing between the initiation of the formal investigation and the adoption of a decision, the delay was not an exceptional circumstance that could have led to a legitimate expectation that the aid was lawful, the court said.

''On the one hand, the exemptions were granted after the commission's initiation of the formal investigation procedure and, on the other, the aid schemes had not been notified to the commission in any way,'' the court said. ''The undertakings in question therefore could not reasonably believe, despite the delay in the investigation procedure, that the commission's doubts no longer existed and that the exemptions at issue would encounter no objection.''

Representatives of the three countries could not be reached for comment by press time, so it is not yet clear whether they will appeal the General Court's latest decision to the CJEU.

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EU Study Targets Aggressive Tax Planning by MNEs

Countries seeking to curb tax avoidance by multinational enterprises and high-net-worth households need to reduce incentives for the promotion of aggressive tax planning schemes by financial institutions, according to a draft study released by the European Parliament's TAXE II special committee on tax rulings.

According to the study, aggressive tax planning schemes are only viable in jurisdictions that allow inconsistent tax treatment and don't participate in coordinated information exchanges.

The study, ''The Role of the Financial Sector in Tax Planning,'' prepared by the EU Directorate General for Internal Policies, says the symbiosis of financialization, globalization, and digitization is threatening the very concept of organized fiscal revenue bodies. The varying speed in which the tax and legal systems of countries have adapted to this new reality has created paths of least resistance that are easily identified by financial advisers, the study says.

Countries seeking to counter aggressive tax planning can do so by reducing the supply of providers of aggressive tax planning services through measures such

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as disallowing contingent fees based on tax savings, providing an enforceable code of conduct that does not rely on self-regulation, and requiring that banks and their employees report aggressive tax planning activities, the study says.

The study also examines how jurisdictions could work to reduce the incentives for aggressive tax planning within their financial sectors. One way to do that would be to emphasize that high-net-worth taxpayers and MNEs are ultimately responsible for their tax returns, it says. Another would be to attach conditions to tax credits or economic incentives that bar participation in tax avoidance schemes. The study points out that demand can be reduced by creating a stable and predictable fiscal environment that is not grounded on complex rules.

Finally, the study addresses the manner in which coordination between jurisdictions and the sharing of intelligence can deter aggressive tax planning. It suggests that countries in the EU, OECD, and G-20, as well as offshore banking centers, should unambiguously and consistently define beneficial ownership. It suggests establishing a worldwide comprehensive registry of ultimate beneficial ownership of financial holdings. The study also recommends discouraging treaty shopping.

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VAT Decision Addresses Valuation of Rights in Long-Term Lease

The value of a right to use land and the cost of completing a building on that land may be included in the taxable amount of a supply if the business holding that right has already paid the VAT on the value and costs but deducted the tax paid, the Court of Justice of the European Union has found.

In its April 28 decision in *Staatssecretaris van Financien v. Het Oudeland Beheer BV*, C-128/14 (CJEU 2016), the CJEU also found that if the land and the building under construction were acquired through a grant of the right to use immovable property, the value of that right must be considered when calculating the taxable amount of a supply. The value of that supply corresponds to the value of the amount to be paid in consideration each year during the remainder of the 20-year leasehold agreement, as corrected or capitalized according to the same method used to determine the value of the grant of the long leasehold, the Court said.

The case was before the CJEU following a request from the Supreme Court of the Netherlands to provide a preliminary ruling on the VAT issues related to the taxable amount of the supply. In proceedings before the Supreme Court, Het Oudeland Beheer BV asserted that only those costs incurred by the date of supply, such as annual rent payments on a property and the costs of completing an office building on that land, should be included in the taxable amount. Dutch tax authorities contended that the taxable amount of the value of the long leasehold should be based on the capitalized value of the ground rent as a whole and the costs of completing the building.

In March 2004 Oudeland finalized a 20-year lease agreement for a property and an office building that was being constructed on it that called for the company to make annual rent payments. Oudeland treated the lease of the office building as a supply of goods purchased in the course of business on its VAT return. The company calculated the taxable amount of the supply as the entire cost, excluding VAT, of completing the building, plus the annual ground rent that was due at the time.

The CJEU agreed, finding the Dutch government's claim that the full value of the leasehold should be taken into account at the time it is granted would ignore the fact that the value of a long leasehold generally decreases proportionally over time. It added that the annual rents do not represent the value of the leasehold at the time of its supply.

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Academic Urges Caution on EU Tax Reform Proposals

The European Commission and European Parliament have introduced a number of international tax reform proposals recently, but they may be moving too quickly and, in some cases, may not be going far enough, according to John Vella, a professor at the Oxford University Centre for Business Taxation.

Vella discussed several of the recent proposals at a workshop of the TAXE II special committee on tax rulings in Brussels April 28.

According to Vella, public country-by-country (CbC) reporting has benefits, but also has limitations that the commission should be aware of. ''The benefits include the fact that if we have this information, we can get a better general picture about what's going on. If we see tax havens with huge profits, taxable profits arising there, that tells us something. So we can get a better picture of what's going on at a country level,'' Vella said. ''But I think this proposal has a number of dangers. These figures can be sensationalized and they can be easily misunderstood. These figures may decrease the quality of the debate. Once these figures, based on misunderstanding, enter into the public debate, it is very hard to get rid of them, even if they are debunked.''

Vella also noted that simply making companies' tax information public will not fix a broken international

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tax system. ''The need to make information public is put forward as some sort of panacea. The only way we will get a tax system which gives us the results we want is actually undertaking effective reform of the tax system,'' he said. Nevertheless, Vella said he does not believe that those limitations are fatal to the CbC reporting proposal.

Another proposal to issue companies some sort of fair tax label is also problematic, Vella said. Companies should not be evaluated based on an arbitrary and subjective standard as to what constitutes a fair amount of tax, he said. ''To think that we should judge a company, not by the law but by some other criteria of fairness which is not very clear, doesn't sound like a good idea to me,'' Vella said. ''Who is going to judge the companies? The government? A private individual? I just don't see the sense behind this.''

Vella also told the committee that a fair tax label may not have the intended consequences and that the commission and the public need to rethink the concept of using a reputational mechanism to encourage companies to pay tax. Such mechanisms may create unforeseen and unwanted economic consequences, he said, adding that customer-facing retail businesses would be affected by the labels more than business-to-business industries.

Jeppe Kofod, rapporteur for the committee, questioned whether the fair tax label could be awarded based on the degree to which companies are open about their tax affairs, rather than being based on the amount of tax they pay. Kofod noted that this would be a less subjective standard than the one Vella described.

Vella also cautioned against the hasty adoption of patent box regimes. The guiding principle behind patent boxes is to tax profits where the economic activity actually occurs, he said. However, governments should be careful in adopting such tax regimes because they may force companies to move activities, creating real economic distortions, Vella said.

The commission and Parliament should also consider some options that are more radical than the common consolidated corporate tax base (CCCTB), Vella said. He said he does not see why other options — such as a residual profit split and a destination-based cash flow tax — have been taken off the table without any debate.

Nevertheless, ''I think the CCCTB has some clear benefits,'' Vella said. ''It would do away with transfer pricing problems among participant member states, so that is a huge benefit. Some criticism that is leveled at the CCCTB is unjustified. Some people argue it would lead to an arbitrary allocation of profits. I think the current allocation of profits is equally arbitrary, so I'm not sure we would be moving in a bad direction on that.''

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Value of Fiat and Starbucks State Aid Decisions Questioned

The European Commission issued its Fiat and Starbucks state aid decisions six months ago, but it is questionable whether they provide guidance for taxpayers or member states because their texts have still not been made public, Raymond Luja told members of the European Parliament's TAXE II special committee on tax rulings.

Luja, a tax law professor at Maastricht University, discussed the limits of state aid recovery as an anti-tax-avoidance measure during an April 28 workshop where studies requested by the TAXE II committee were presented. His state aid discussion centered on the October 2015 press release in which the commission said that Luxembourg and the Netherlands issued tax rulings that granted selective tax advantages to Fiat Finance and Trade Ltd. SA. and Starbucks, respectively, that violated EU state aid rules. (Prior coverage: *Tax Notes Int'l*, Oct. 26, 2015, p. 301.)

''To the extent that these cases can give us guidance, to me they mainly raise questions,'' Luja said, noting that the texts of the decisions have yet to be released even though the decisions have already been appealed.

One of the largest unanswered questions raised is what role the European courts will have in reviewing the commission's findings, Luja said. He observed that the decisions addressed a number of issues involving economic analysis and that the courts tend to only perform a limited review of the commission's economic actions. ''That's a major issue here because, when you are dealing with issues like transfer pricing, sometimes the economic details, the economic analysis, is at the very heart of the problem,'' he said.

Luja also observed that in the Starbucks and Fiat cases, the commission used a new tool to get market information from competitors all over Europe to analyze the transfer pricing determinations at issue. He said the press release was unclear as to how that information was used.

''So when we are doing an ex-post assessment based on information gathered from all over Europe, the very basic question we have to answer first is whether the information from other competitors was available to the tax authorities of the Netherlands or Luxembourg and to the companies that applied for certain rulings,'' Luja said. ''That's a very basic issue that you need to make clear: whether the information could have been available.''

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If it turns out that the information was not available to the parties at the time of the tax rulings, then the state aid recoveries may be reduced considerably, Luja said. ''We wouldn't be talking about recovering €20 to €30 million per company,'' he said. ''Maybe the amounts might be much lower.''

Exchange of Tax Rulings

Luja was skeptical that exchanges of cross-border tax rulings would be of much help in state aid investigations involving future tax rulings by member states. Council Directive 2011/16/EU established procedures for better cooperation between EU tax administrations, which included the exchange of tax decisions. In December 2015 the commission voted to adopt implementing regulations for the directive, which include provisions for the creation of a database for the exchange of information. (Prior coverage: *Tax Notes Int'l*, Dec. 21, 2015, p. 1008.)

Luja said that investigators will be able to examine tax rulings issued prior to the creation of the database, but that member states will be much more careful in the future about which tax rulings will appear in the database.

''We are going to get informal gentlemen's agreements,'' Luja explained. Such agreements would not be enforceable in court, but would strongly imply that a member state was not opposed to a taxpayer's actions, he said.

Luja added that tax rulings involving domestic companies that could be considered state aid will not appear in the database.

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France

Tax Authorities Take $338 Million Bite Out of McDonald's

French tax authorities reportedly notified McDonald's France that it owes $338 million in unpaid taxes on income that was allegedly funneled through Luxembourg.

According to an April 19 report by French business magazine *L'Expansion*, French authorities accused McDonald's of shifting profits from McDonald's France to McD Europe Franchising, a Luxembourg subsidiary, by billing the French subsidiary excessively for the use of the company brand and other services.

McDonald's France reportedly declined to comment, other than to say that McDonald's is one of the largest payers of corporate tax in France. According to McDonald's France, the company has paid €1.2 billion in tax in France since 2009, invested another €1 billion, and created approximately 10,000 jobs.

The McDonald's dispute with French tax authorities began in 2013. In January 2014 McDonald's confirmed that French tax authorities had carried out a ''request for information'' as part of a tax inspection at the McDonald's France headquarters in Guyancourt on October 15, 2013. At the time of the inspection, McDonald's firmly denied any wrongdoing or attempt to hide portions of its revenue from tax authorities. The investigation into McDonald's France continued, however, culminating in the $338 million tax bill served to the restaurant chain earlier this month.

McDonald's has also acknowledged that its European entities pay royalties for the use of intangible assets such as the McDonald's brand, McDonald's Group technological innovations, and other intellectual property. Those royalty payments appear to be the cause of the controversy.

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Germany

FX Loss From Liquidation of Foreign Partnership Nondeductible, Court Says

Expenses related to a foreign exchange (FX) loss from the liquidation of an overseas partnership are not deductible for trade tax purposes, according to the German Federal Fiscal Court.[1]

In the case at issue, a domestic limited partnership with a limited liability company had an investment of 25 percent in a limited partnership located in the United States (US LP). The US LP was liquidated and the domestic limited partnership deducted the foreign exchange loss resulting from the exchange rate difference between the time of investment and the date of liquidation from its German trade tax base. The German tax authorities argued that the loss related to the liquidation process was not deductible from trade tax because the positive income earned from the US LP was tax-exempt under the Germany-U.S. tax treaty. The U.S. income was only included in the progression proviso to calculate the German tax rate. This is also true for the taxation of capital gains and losses related to the U.S. investment.

[1]The judgment was issued on April 13, 2016, and can be found under case reference BFH-Urteil v. 2.12.2015 — I R 13/14.

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The court clarified that each partnership is treated as a separate entity for trade tax purposes. This means that the taxpayer is required to eliminate profits and losses from investments in other partnerships. According to section 8, paragraph 8, and section 9, paragraph 8, of the Trade Tax Act, this adjustment regulation includes domestic as well as foreign investments. Therefore, the FX loss may not be deducted in the profit and loss accounts of the domestic partnership, the court held.

It said its ruling also took into account the judgment of the Court of Justice of the European Union in *XAB v. Sweden*, C-686/13 (CJEU 2015). In that case, the Court ruled about the right of free establishment under article 49 of the Treaty on the Functioning of the European Union.

The German court concluded that the limitation on the deduction of FX losses violates neither the right of free establishment nor the right of free movement of capital under EU law. However, it remains to be seen whether this issue will be subject to future CJEU jurisdiction.

♦ *Michael Birk, German public auditor and tax adviser, Germany*

Greece

VAT Rate Increased to 24 Percent

The Greek government reached an agreement with a quartet of institutional creditors to increase Greece's standard VAT rate from 23 pecent to 24 percent, effective July 1.

The increase — recommended by the IMF, the European Central Bank, the European Stability Mechanism, and the European Commission — is expected to generate additional revenues of €400 million to €500 million, closing a gap in the 2017-2018 budget forecast. Greece has been receiving financial assistance from the creditors since 2010.

Greece has raised the standard VAT rate twice since 2010, when it was 19 percent. The standard rate applies to packaged foods, pet food, soft drinks, and public transportation and taxi service. The agreement with the creditors will not increase the VAT rates for domestic electricity, water, and private education.

The reduced 6 percent VAT rate applicable to books, magazines, and newspapers will be increased, but it is not yet clear by how much.

The creditors also recommended lower tax-free thresholds for pensioners and employees.

♦ *Slim Gargouri, chartered accountant, Sfax, Tunisia*

India

India's Panama Papers Investigations In Preliminary Stages

Although India has acted quickly to examine possible cases of tax dodging by Indian taxpayers based on information in the Panama Papers leak, investigations are still in the preliminary stages, a Ministry of Finance official said.

In written replies published on April 27 to questions posed in the Rajya Sabha, India's upper house of Parliament, Jayant Sinha, minister of state in the MOF, gave an update on the state of the government's special multiagency task force, which was created on April 4. The special unit includes officers from the investigation division and the foreign tax and tax research division of the Central Board of Direct Taxes, the Enforcement Directorate, the Financial Intelligence Unit, and the Reserve Bank of India, according to Sinha.

''The investigation team has been ordered to conduct a time bound inquiry into the allegations alleged in the Panama Papers leaks,'' Sinha said in a statement, adding that the team has been asked to report on its progress on a regular basis.

The International Consortium of Investigative Journalists (ICIJ) leaked millions of documents from Mossack Fonseca on April 3 showing how the Panamanian firm helped wealthy and powerful clients, including world leaders and celebrities, use shell companies to hide their assets, in some cases allegedly for illegal reasons, such as tax evasion. *The Indian Express* identified more than 500 Indians, including celebrities such as actress Aishwarya Rai Bachchan, as having connections to offshore companies, foundations, and trusts linked to Mossack Fonseca. (Prior coverage: *Tax Notes Int'l*, Apr. 11, 2016, p. 113.)

''The government has taken necessary measures for expeditious investigation in such cases including through enhanced international cooperation,'' Sinha said. He noted the ICIJ's caveat that it shouldn't be assumed that everyone named in the Panama Papers is involved in tax avoidance or evasion because there are legal reasons for creating a company in an offshore jurisdiction.

Sinha also said that the government's special investigation team on ''black money,'' which was established in May 2014, is looking into the Panama Papers as well.

''Determination of [the] total volume of money that has been evaded by Indian persons in violation of laws/applicable regulations is [the] subject matter of [the] investigation and other follow-up actions, which is an ongoing process,'' Sinha said in another statement. Such follow-up actions under India's direct tax laws include income assessments; levying of taxes, interest,

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and penalties; and filing prosecution complaints at criminal courts, when applicable, he said.

In general, the Indian government has adopted several measures to address the country's black money problem, in particular assets hidden offshore, Sinha said in another statement. Those include more effective enforcement actions, establishing ''robust legislative and administrative frameworks,'' and building up the government's data-mining abilities using information technology, he said.

Along with the creation of the special investigation team on black money, the government has also enacted the Undisclosed Foreign Income and Assets (Imposition of Tax) Bill, 2015, and is ''proactively engaging with foreign governments . . . to facilitate and enhance the exchange of information'' through double taxation avoidance agreements, tax information exchange agreements, and multilateral conventions, according to Sinha. (Prior coverage: *Tax Notes Int'l*, May 18, 2015, p. 591.)

For example, India has signed the OECD's multilateral competent authority agreement on automatic exchange of financial account information and has an intergovernmental agreement with the United States under the U.S. Foreign Account Tax Compliance Act, Sinha added. (Prior coverage: *Tax Notes Int'l*, June 8, 2015, p. 890.)

''There is no official estimation of the amount of black money present in the country and taken outside the country,'' he said. However, the government has commissioned a study to estimate how much income and wealth goes unaccounted for within and outside India, according to Sinha.

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Luxembourg

Revised Tax Package Includes Tax Fraud Law

Luxembourg will revise a package of previously announced tax measures to make aggravated tax fraud a criminal offense and to adjust personal allowances. A proposal to reduce the tax rate on certain real estate sales will be broken out as a separate bill.

Minister of Finance Pierre Gramegna told members of the finance and budget committee that the new crime of aggravated tax fraud will be added to the reform measures and that simple tax fraud would be decriminalized and made punishable by an administrative fine. (Prior coverage: *Tax Notes Int'l*, Mar. 7, 2016, p. 831.)

The government will leave untouched previous proposals, announced on February 29, to lower the basic income tax rate for corporations and restrict companies' ability to deduct loss carryforwards.

Fatima Chaouche, a research assistant at the University of Luxembourg, said the government also plans to increase the allowance thresholds for certain benefits to provide a greater degree of ''social justice.'' The current annual deduction of €3,480 per child, which is intended to cover education and maintenance costs paid by a non-custodial parent, would be increased to €4,020, Chaouche said. Another allowance for child care and home cleaning costs would go from €3,600 a year to €5,400, if the bill is approved, she said.

To ensure legal certainty, the government said, it broke out as a separate bill a previously announced measure to reduce the tax rate for gains resulting from sales of private real estate assets to one-fourth of the overall tax rate. The reduced rate, which would not apply to gains from speculative sales of real property, would remain in effect from July 1 through the end of 2017.

Chaouche said the decision to put that provision into a separate bill was motivated by the government's desire to have the measure, which is intended to stimulate the real estate market, enacted as soon as possible. The rest of the package is scheduled to go into effect on January 1, 2017, she said.

Chaouche said the government hasn't released any details as to what actions would qualify as aggravated tax fraud under the proposed measures. The penalties that could be imposed for violations of the new fraud statute are similarly unclear.

Gramegna estimated that the proposed tax measures would cost the state an additional €373 million in 2017, €502 million in 2018, and €524 million a year in 2019 and 2020. ''It should be noted that these are gross figures, which do not take into account dynamic effects induced by the reform,'' Gramegna told the legislators. ''Indeed, it is estimated that [the measures] will help accelerate growth, create new jobs, and increase competitiveness, which will generate new revenues.''

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Mexico

Energy Trust Rules Amended to Lure Additional Investment

Mexican authorities recently amended the rules for the new energy and infrastructure investment trusts (FIBRA E) to make the trusts even more attractive to investors and to clear up technical issues.

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FIBRA E is a special tax regime applicable to energy and infrastructure investment trusts. Intended to promote new investment structures by offering significant tax and economic advantages to the oil, gas, power, and infrastructure sector, the FIBRA E rules took effect in October 2015. Mexican authorities have said FIBRA E was inspired by the master limited partnership used in the United States to provide a tax-efficient vehicle for securing investments in energy and infrastructure projects. (Prior coverage: *Tax Notes Int'l*, Oct. 12, 2015, p. 171.) The 2016 federal budget removed the rule that venture capital trusts must not have a duration of more than 10 years to be eligible for tax incentives. Given the long-term nature of energy and infrastructure projects, the amendments will make those projects more suitable for investment.

Jorge Correa of Creel, García-Cuéllar, Aiza y Enríquez in Mexico City told Tax Analysts that one of the reasons for the April 1 rules change was that potential sponsors did not find the FIBRA E tax regime attractive enough. The trusts did not offer such benefits as tax-free rollups for the infrastructure industry, and the deferral of capital gains derived from the sale of shares issued by an operating company to a FIBRA E was not available, he said. Correa added that the definition of the term ''new assets'' in FIBRA E was viewed as being too restrictive. Finally, Correa said the changes clarified some technical issues with the rules.

Although the new rules took effect October 1, 2015, Correa said that no FIBRA E trusts have been issued. ''That being said, however, many sponsors and investment bankers have been looking into potential transactions since the issuance of the original FIBRA E regulations and those changes will, no doubt, help them to move faster,'' he said. Correa noted that it was early, but that he expected that FIBRA E will help channel funds from Mexican pension funds and other institutional investors into the energy and infrastructure industries.

The new rules became effective the day after their April 1 publication date, Correa said. He noted that the Mexican Congress did not need to approve the FIBRA E regulations since the regime was introduced through regulations issued by the commissioner, instead of through a change in the law. ''That being said, the FIBRA E tax regulations have their legal basis on the real estate FIBRA tax regime (akin to a U.S. REIT) that may be found in the Income Tax Law,'' Correa said. ''While some see this as a negative feature, we see it as an advantage that allows flexibility for a newly introduced asset class.''

Correa said tax practitioners involved in capital markets transactions had been aware of the FIBRA E amendments since mid-March when the Secretariat of Finance and Public Credit announced the changes as a result of feedback it had received from the business community. ''Unlike other areas of law in Mexico or tax law in other jurisdictions, changes to tax law in Mexico are not subject to public consultation,'' he said. ''However, since the issuance of the original FIBRA E tax regulations in September 2015, tax authorities have conducted an ongoing dialogue with business to improve the FIBRA E tax regime.''

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Multinational

More Than 20 Countries Join Information Exchange Pilot Program

The world is moving firmly in the direction of greater tax transparency, U.K. Chancellor of the Exchequer George Osborne declared after more than 20 European countries joined a pilot scheme for automatic exchange of information on beneficial ownership, launched by the G-5 European economies earlier this month.

Finance ministers from the U.K., Germany, France, Italy, and Spain wrote to their G-20 counterparts on April 14 to urge further progress toward global exchange of information. The initiative will give tax and other authorities ''vast'' amounts of information and help them to track ''the complex offshore trails used by criminals,'' they wrote. (Prior coverage: *Tax Notes Int'l*, Apr. 18, 2016, p. 238.)

Since that launch, 19 additional European countries — Belgium, Bulgaria, Croatia, Cyprus, the Czech Republic, Denmark, Estonia, Finland, Greece, Ireland, Latvia, Lithuania, Malta, the Netherlands, Portugal, Romania, Slovakia, Slovenia, and Sweden — have joined the pilot, HM Treasury announced on April 22. Gibraltar, the Isle of Man, and Montserrat have also joined. The Gibraltar government said it is ''fully expected by the G5 that further countries and territories outside the EU will begin to participate as from next week.''

Tax and law enforcement agencies will now exchange data on company beneficial ownership registers and new registers of trusts, enabling ''more effective investigation of financial wrongdoing and tax-dodging,'' HM Treasury said.

Osborne said, ''I welcome the early commitment made by Gibraltar, Isle of Man, and Montserrat to participate and call on all of the remaining overseas territories and crown dependencies to do likewise. It should be clear to all countries and tax jurisdictions that the world is moving firmly in the direction of greater tax transparency and the U.K. will continue to push for an internationally agreed blacklist for those that refuse to do the right thing.''

The announcement followed the U.K. government's publication on April 21 of correspondence with crown

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dependencies and overseas territories setting out new or revised arrangements for the sharing of beneficial ownership information. The participating governments recognize the importance of access to this information to prevent and detect ''corruption, money laundering, terrorism financing, financing of the proliferation of weapons of mass destruction and other serious and organised crime,'' the Cabinet Office said.

Transparency proponents have called for public access to registers of beneficial ownership. Responding to the G-5 initiative, the Tax Justice Network asked, ''Why no shared commitment to public registers? The Panama papers reveal the tremendous power of public access to the world's media and others. Closed registries risk putting the fox in charge of the chicken-house.''

Australia has now signaled that it will follow the U.K. and become the second major economy to create a public register of beneficial ownership, *The Guardian* reported on April 22.

U.K. Prime Minister David Cameron told the overseas territories in April 2014 that public access to a central register was ''vital to meeting the urgent challenges of illicit finance and tax evasion.'' But this month he accepted that those territories were ''not going as far'' as the U.K., which is introducing a public register of people with ''significant control.''

That register will show an individual's name, month and year of birth, nationality, and details of their interest in a company, according to guidance published by the Department for Business, Innovation & Skills. Some information may be suppressed when ''there is a serious risk of violence or intimidation,'' according to the department.

Agreements

The agreements reached with the Isle of Man and Jersey, signed on April 12 and 13, require the participants to maintain ''a central register, or equivalent system, containing accurate and current information on beneficial ownership for corporate and legal entities incorporated in their jurisdictions.'' Law enforcement authorities will have the automatic right to the provision, for law enforcement purposes, of ''unrestricted and timely (where urgently required, within one hour) beneficial ownership information held in the other jurisdiction,'' HM Treasury said.

The U.K. reached similar agreements with the overseas territories of Anguilla, Bermuda, the British Virgin Islands, the Cayman Islands, Gibraltar, and Turks and Caicos. Guernsey's chief minister, Jonathan Le Tocq, set out in a letter to Cameron earlier this month the bailiwick's ''active and practical commitment'' to the international anti-corruption agenda. The U.K. government plans to sign an exchange of notes and technical protocol when the new Guernsey government is in place, after the election of the States of Guernsey deputies on April 27. ''Timely exchange of information means within 24 hours, but from our perspective we consider that the target should be 30 minutes where the requesting authority considers it to be urgent,'' Le Tocq wrote.

Anti-Money-Laundering Plan

The U.K. government announced the start of a new action plan against money laundering on April 21, in the run-up to the Anti-Corruption Summit to be held in London on May 12. ''We will not stand for money laundering or the funding of terrorism through U.K. institutions,'' ministers declared.

The plan is intended to make the U.K. a ''more hostile place'' for those seeking to move, hide, or use the proceeds of crime or corruption, they said.

''The laundering of proceeds of crime through U.K. institutions is not only a financial crime, [but] it fuels political instability around the world, supports terrorists and extremism and poses a direct and immediate threat to our domestic security and our overseas interests,'' Home Secretary Theresa May said.

The plan includes new legal powers and extends the international reach of law enforcement agencies. The government is consulting on measures such as new ''unexplained wealth orders'' requiring people suspected of money laundering to explain the origin of assets, and ''fundamental'' reform of the suspicious activity reports regime. HM Treasury has invited views by June 2 on options for reform to address perceived weaknesses in the U.K.'s ''anti-money laundering and counter financing of terrorism'' supervisory regime.

The announcement followed creation of a cross-government task force to deal with the Panama Papers revelations. U.K. Financial Secretary to the Treasury David Gauke said in a parliamentary written answer that the task force will bring together ''some of the most sophisticated technology, experts and resources to tackle money laundering, tax evasion and wider forms of financial crime anywhere in the world.'' (Prior coverage: *Tax Notes Int'l*, Apr. 18, 2016, p. 252.)

♦ *Andrew Goodall, Staffordshire, U.K.*

Coalition Hopes to Use ISIL's Own Tax Regime Against It

Almost half of the Islamic State's income stream comes from tax revenue, and the governments working together to fight the militant group hope to use its tax regime against it, according to U.K. Air Vice-Marshal Edward Stringer, assistant chief of the Royal Air Force Defence Staff (operations).

''This is not just a terrorist organization that looks at normal forms of terrorist financing. This is a pseudo-state and we need to conduct economic warfare

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against it,'' Stringer said during testimony before Parliament's foreign affairs subcommittee on April 26. According to Stringer and Patrick Rarden, threat finance subject matter expert at the U.K. Ministry of Defence, ISIL, also known as ISIS — or Daesh, as Stringer and Rarden refer to the group — operates a far more advanced economy than terrorist organizations such as al-Qaida.

ISIL has implemented a somewhat progressive tax system, Stringer said. ''I think they made an attempt to build a hearts and minds tax base, built on concepts such as the CAT [commercial activity tax], to tax the less well-off not very much — essentially a progressive regime,'' he said. ''There are taxes on agriculture, there are taxes essentially on all productive elements of the economy.''

So far, ISIL has taxed activity that is relatively easy to monitor, Stringer said. ''Broadly, I would say look at any aspect of the economy and where it's easy to regulate or you can calculate, they have tax inspectors and they go out and they assess how much crop can come from a field,'' he said. ''So if you had an industry that was quite easy to observe, they were very good at taxing it.''

ISIL's income can be broken into three primary revenue streams, according to Stringer — 40 percent from taxes, 40 percent from the internal oil market, and 20 percent from illicit criminal activities. The estimates of ISIL's revenue from oil are unpredictable, with the vast majority of the oil it sells going to individuals or businesses within the territory it controls, Stringer said. However, as the U.S. and other coalition governments continue to attack ISIL's oil reserves and pumps, the group will rely more heavily on tax revenue, he said.

That will force ISIL to find new ways to tax individuals and businesses, and the taxes will ''become more arbitrary, looking more like fines, and therefore not as progressive and not as easy to sell to the population,'' Stringer said. It is hoped that this will further tarnish the ISIL brand in the area it controls, he said.

Rarden added that the U.S. Treasury has helped immensely in cracking down on ISIL's ability to generate income by working with the Iraqi Central Bank to keep ISIL-controlled banks out of the market for dollar auctions.

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Governments Urged to Use Transfer Pricing Values to Acquire IP

The U.S. and other countries could go a long way toward minimizing multinational enterprises' tax avoidance by using eminent domain to acquire intellectual property from the companies at the lowballed prices they often declare for transfer pricing purposes, according to a paper by the University of Maryland's Andrew Blair-Stanek.

In the U.S., the Fifth Amendment allows the government to acquire private property for public use as long as it pays fair compensation. There are variations on the concept in many other countries, where it is generally referred to as compulsory purchase, compulsory acquisition, or expropriation.

''Holders of valuable intellectual property — particularly drug companies — avoid tax on an epic scale by transferring their intellectual property . . . to subsidiaries in tax havens for low prices,'' Blair-Stanek says in a draft of the paper, ''Just Compensation for Intellectual Property,'' to be published in the *Arizona Law Review*. Immediately after taking the IP through eminent domain at the amount declared by the MNEs for transfer pricing purposes, the government can make the property free for anyone to use, he said. ''When the taken IP is a drug patent, the result would be immediately allowing generic versions of the drug, driving down prices, increasing access to medicines, and reducing healthcare expenditures,'' Blair-Stanek said. Acquisition through eminent domain would also deter tax avoidance, he added.

Blair-Stanek said his proposal avoids the problem posed by the ''huge informational advantage'' that MNEs enjoy over tax authorities: The companies have the best possible understanding of the properties and potential of the IP that they develop, as well as an intimate knowledge of the relevant markets for the products. That makes it difficult for a tax agency to convince a court that the price claimed by an MNE for transfer pricing purposes is below its actual value.

The proposal passes legal muster in the U.S., according to Blair-Stanek, because the IP owner must attest under penalty of perjury that the price used for such transfers meets a standard under the Internal Revenue Code that is identical to the takings clause used for determining fair compensation under the Fifth Amendment.

Dead Weight Losses

While the cost to the government would appear substantial, Blair-Stanek said it doesn't have to acquire all of the drug companies' patents for the plan to be cost-effective. As long as the government takes a lower percentage of all patents, selected randomly, than its marginal corporate tax rate, the country will likely come out ahead and the ''dead weight losses'' to society will be reduced, he said. (Dead weight losses occur when consumers are priced out of the market because of the higher prices typically charged by the holders of IP while their products are under patent protection, Blair-Stanek said.)

In the case of medications, Blair-Stanek said putting the patents into the public domain for use by manufacturers of generic drugs would sharply reduce what the

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federal government pays for healthcare, which is currently about 60 percent of all healthcare costs in the U.S.

''High drug costs often cause patients not to take drugs prescribed for them, causing expensive complications,'' he said. ''For example, a patient who is deterred from taking [an] antibiotic by its cost may have a severe infection that results in an expensive hospitalization. Combining these savings with the additional tax revenue from reducing tax avoidance would likely cover the full cost of paying just compensation for those drug patents taken.''

Blair-Stanek said drug patents alone have been estimated to create dead weight losses of at least $100 billion. ''These priced-out consumers lose by getting no access to the invention, yet the patent holder gets no corresponding gain since it receives zero money from priced-out consumers,'' he said.

Blair-Stanek said most other countries have concepts similar to the takings clause of the Fifth Amendment. A foreign country could eliminate its own dead weight losses if it were to use that authority to acquire IP at the values declared by MNEs for transfer pricing purposes when the property is transferred to an affiliate in another country, he said.

If foreign countries were to adopt his approach, the U.S. could also benefit if the IP acquired was based on technology developed in the U.S., Blair-Stanek said. He gave as an example a patent granted to Gilead Sciences, a U.S. company, for the exclusive rights to sell the company's Sovaldi medication in Japan. Blair-Stanek said the company almost certainly transferred the patent to a tax-haven subsidiary at a low transfer price. ''Suppose Japan adopted this proposal to take some Japanese patents that are transferred by U.S. companies to tax-haven subsidiaries,'' he said. ''Japan would obviously eliminate dead weight losses in Japan and reduce avoidance of Japanese taxes. But Japan would also be reducing U.S. companies' avoidance of U.S. taxes.''

While apparently simple, Blair-Stanek's proposal has attracted its share of criticism. Bin Zhou, an economist with the Brattle Group, said he doesn't agree that IP protection, in general, creates dead weight losses. ''The evidence listed in the paper is limited to the headline news of high drug prices,'' Zhou said in an email. ''How extensive/systematic is the evidence of welfare loss in a dynamic economy? I believe IP protection is, in general, welfare-improving.''

It's All in the Timing

Another possible problem with the idea involves the timing of the acquisitions. If the government waits until after the IP developer files its tax return, it could be a year or more before a determination can be made that the IP had been significantly underpriced. By that time, the IP would already have been transferred.

Blair-Stanek said the government can have much more timely access to information because U.S. companies are already required to maintain contemporaneous appraisal documentation to support transfer pricing valuations (26 U.S.C. section 6662(e)(3)(B) and 26 CFR section 1.6662-6(d)(2)(iii)).

Lorraine Eden of Texas A&M University is skeptical about the practicality of the idea. ''Yes, firms must maintain [contemporaneous documentation (CD)], but they typically do not expect to be asked to provide it by the IRS, so the quality often isn't all that great,'' she said in an email. ''CD is done more on the basis of a 'need to fulfill the reporting requirement.'''

''If the IRS doesn't think the MNE is declaring sufficient returns for the IP generated in the U.S. in line with the 'commensurate with income' sentence in IRC section 482, [which states that] the value of IP sold or transferred out of the USA should be commensurate with the income expected from exploitation of the IP, the IRS can revalue the IP proceeds,'' Eden said.

Blair-Stanek said a requirement that transfer pricing documentation be submitted at the time of transfer or even before would preclude any argument that the value of the IP increased between the point of transfer and the date of its taking through eminent domain. ''Waiting until the multinational files its tax return is too late,'' he told Tax Analysts.

Random Taking

In fact, Blair-Stanek said, the government should carry out blind acquisitions of only a fraction of transferred patents. ''The beauty of randomized taking of, say, 25 percent of the transferred patents is that the government need not even evaluate the calculations in order to improve the transfer pricing incentives of multinationals,'' he said. ''It suffices just to have a government official flip a coin twice and immediately take the patent with just compensation equal to its transfer price if the result is 'heads' and 'heads.'''

Random takings reduce the likelihood that MNEs will highball transfer prices, thereby generating windfall profits at the government's expense, Blair-Stanek said. ''The government could tailor the probability of taking a piece of IP to the size of the dead weight loss typically created by that class of IP,'' he said. ''The government could randomly take 30 percent of cardiac drugs, which tend to create high dead weight losses, while randomly taking only 10 percent of drugs in the classes of antibiotics that cause much lower dead weight losses.'' Blair-Stanek said the only restriction that should be applied to that approach is that the probability of the taking must always be lower than the corporate tax rate.

In support of that conclusion, he gave the example of a government that randomly takes 25 percent of all drug patents transferred to foreign affiliates. For every $100 in excess of the true arm's-length value of the IP that a company claims for transfer pricing purposes,

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the laws of probability suggest it would receive an additional $25 from the government. But if the corporate tax rate is set at the 35 percent stated in the Internal Revenue Code, each extra $100 of claimed value would cost the MNE an additional $35 in federal tax. If the government were to randomly take a higher percentage of IP than its marginal tax rate, it would be giving windfall profits to MNEs to the extent of the difference between the two rates.

Blair-Stanek emphasized that the probability of taking IP must be considerable for his approach to have any substantial impact on corporate tax avoidance. He said only five jurisdictions have ever used self-assessment valuation systems, none of them for transfer pricing purposes. The only one for which he said data are available is Taiwan's requirement from 1954 to 1977 that property owners determine the values of their real estate for property tax purposes. While the deterrent against abuse was that the government could buy the property at the values reported by the owners, Blair-Stanek said, undervaluation was widespread because the government took only an average of 0.04 percent of all real estate each year. ''The Taiwanese experience confirms the obvious,'' he said. ''The rate of randomized IP taking cannot be a trivially small number if the goal is to noticeably curtail companies' tax avoidance.''

Impact on Innovation

There is widespread concern about the impact of Blair-Stanek's proposal on innovation. ''The key issue of the proposal of compulsory acquisition seems to be that, if strictly implemented, it will likely kill off any incentive for MNEs to invest in research in the country,'' said Antony Ting of the University of Sydney.

Jean-Pierre Vidal, who teaches tax and accounting at HEC Montreal, agreed. ''If there is no way to recover the cost because the IP is automatically taken away and given to generics that do not incur any significant cost for research, research is simply going to stop,'' he said.

Blair-Stanek said he anticipated such criticism. ''The objection that this proposal reduces incentives for innovation boils down to objecting that it reduces the expected payoff from drug companies' tax-avoidance,'' he said in his article. ''This proposal would not cut into drug companies' profits from their core business of developing and selling patented lifesaving cures.''

However, in a follow-up interview, he agreed with a suggestion that a government might be able to defray some of the cost of acquiring IP through eminent domain by charging licensing fees to generic manufacturers instead of just putting the IP into the public domain for anyone to use.

Despite his claim that the combination of lower government spending on healthcare and reduced levels of tax avoidance would likely cover the full cost of paying fair compensation for drug patents acquired through eminent domain, Blair-Stanek appeared to hedge his position by saying that the data do not yet exist to back up his claim that his proposal would pay for itself. ''Out of fiscal prudence, this article's proposals should be phased in in stages,'' with drug patents being taken first because they offer the most in the way of savings,'' Blair-Stanek said.

He also appeared to contradict his earlier conclusion, based on Taiwan's experience, that the percentage of property taken must be non-trivial to have any substantial impact on tax avoidance. Blair-Stanek said the percentage of drug patents taken could ''start out low,'' at perhaps 2 percent. ''Assuming that the reduced tax-avoidance and lower drug expenditures indeed cover the cost of just compensation, the percentages taken can then be increased,'' he said.

Bundled Rights Blur Price

Peter Barnes of Caplin & Drysdale took issue with Blair-Stanek's proposal because he said it assumes that IP rights are singular and easily identified. ''In fact, most IP rights are bundled, even in the pharmaceutical world,'' Barnes said. ''In most cases, some IP is transferred at some point in time, and then additional research builds on that initial IP. The original valuation — which is often approved by the IRS in an advance pricing agreement — does not value the later-in-time developments.'' Barnes said it is unrealistic to assume there are tax valuations for specific IP that can be used when property is taken by eminent domain.

In his article, Blair-Stanek said MNEs might respond to a government's use of eminent domain ''by obfuscating their transfer pricing arrangements so that it is not clear precisely what transfer price they have assigned to a particular patent or copyright.'' To avoid uncertainty caused by the transfer of multiple patents for a lump sum or when the consideration is based on a complex formula contingent on future events, he said, MNEs should be required to specify as a single dollar amount the consideration to be paid for each separate IP right transferred.

William H. Byrnes of Texas A&M said he found Blair-Stanek's article provocative, but he questioned whether the proposal would work in the real world. He said pharmaceutical companies claim that about 90 percent of their expenditures are for research and development into medications that never pan out but which are necessary to come up with the 10 percent that do. ''If a government were to take a right of first refusal on the transfer of IP offshore at whatever the contemporaneous documentation price is, I definitely think the government would be a loser,'' Byrnes said. ''Since 90 percent of their research is a failure, if you expropriate the remaining 10 percent through eminent domain, we're back to the original problem that we haven't figured out as a society yet . . . how do we get R&D for new treatments.''

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Eden said there could also be complications with Blair-Stanek's proposal if it were found to interfere with rights protected under bilateral investment treaties. ''Bottom line is that I think it would be very hard for any government to expropriate . . . the IP of a foreign firm without provoking some sort of MNE-state dispute, whether through [the North American Free Trade Agreement] or [the International Centre for Settlement of Investment Disputes] or something else,'' Eden said in her email.

In the follow-up interview, Blair-Stanek agreed that the investment treaty ramifications of his proposal require further research, which he said he intends to do for the next draft of the article.

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Panama

Panama Papers Data to Be Released May 9

The International Consortium of Investigative Journalists (ICIJ) announced that it will unveil a searchable database containing information from Panamanian law firm Mossack Fonseca at 2 p.m. EDT May 9.

The database will include information about more than 200,000 offshore entities, including companies, trusts, foundations, and funds incorporated in 21 tax havens that are part of the Panama Papers investigations. It will also include information about more than 100,000 companies identified in a 2013 ICIJ Offshore Leaks investigation, according to the ICIJ announcement.

Rather than having to contend with a data dump of original documents, database users will be able to ''visualize the networks around thousands of offshore entities, including when possible, Mossack Fonseca's internal records of the company's true owners,'' according to the ICIJ.

What will not be released is ''personal data en masse'' — for example, bank account records, emails, passports, and telephone numbers, the ICIJ said. ''The selected and limited information is being published in the public interest,'' it added.

The ICIJ publicized the global investigation into over 11 million leaked files exposing the use of offshore companies to facilitate offenses ranging from drug trafficking to tax evasion on April 3. At that time, it published select details about the secret dealings of political figures, celebrities, and other prominent figures who had dealings with Mossack Fonseca but said it would not release a full list of the over 200,000 offshore entities incorporated by the firm and people connected to the companies until early May. (Prior coverage: *Tax Notes Int'l*, Apr. 11, 2016, p. 103.)

Since then, a number of government agencies have appealed to the ICIJ and its partner news organizations for access to the leaked information, some citing its value to national law enforcement investigations. (Prior coverage: *Tax Notes Int'l*, Apr. 25, 2016, p. 321.) Media organizations have generally remained aligned against such requests, although the Australian Taxation Office announced on April 4 that it received data containing the names of Australian residents associated with a Panamanian law firm.

The ICIJ database will be available May 9 at https://offshoreleaks.icij.org.

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Panama and U.S. Sign FATCA Agreement

Panama signed an intergovernmental agreement with the United States April 27 that will implement the information reporting and withholding tax provisions of the U.S. Foreign Account Tax Compliance Act, the U.S. Treasury Department has confirmed.

The two countries reached an agreement in substance for a Model 1A reciprocal agreement on May 1, 2014. Since that date, Panama has been treated as having an agreement ''in effect'' pending a formal signing, Treasury said.

News of the signing comes two weeks after the April 14 announcement by Panama's Ministry of Economy and Finance that the country is ''fully and immediately'' committed to implementing a system for the automatic exchange of tax information consistent with the goals of the OECD's common reporting standard. (Prior coverage: *Tax Notes Int'l*, Apr. 25, 2016, p. 322.)

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Thailand

Philip Morris Pleads Not Guilty to Tax Evasion Charges

Representatives from Philip Morris International's Thailand unit on April 25 reportedly pleaded not guilty to import tax evasion charges, rejecting allegations

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from Thai prosecutors that the tobacco giant had underdeclared the value of cigarettes imported from 2003 to 2006.

The defendants, including a Philip Morris (Thailand) Ltd. (PMTL) representative, appeared before a criminal court for a pretrial hearing focusing on ''preliminary procedural matters,'' the company said in a statement emailed to Tax Analysts. Issues covered included reviews of proposed witness lists and evidence to be presented during trial, the company added.

Thailand's Office of the Attorney General filed a criminal complaint against PMTL in January, alleging that the company underdeclared the price of 272 units of Marlboro and L&M brand cigarettes manufactured in the Philippines, according to media reports. The value of the imported cigarettes and duties is reportedly more than THB 20 billion (about $568.4 million). (Prior coverage: *Tax Notes Int'l*, Jan. 25, 2016, p. 310.)

The company said that the ''meritless and unjust'' charges contradict Thai law and directly violate Thailand obligations to comply with the WTO Customs Valuation Agreement.

''It is regrettable that this matter still went to court despite both Thai and World Trade Organization authorities having confirmed that our declared import prices comply with Thai and international customs laws,'' Alejandro Paschalides, managing director and PMTL branch manager, said in the statement.

''We hope to receive a fair review and justice going forward as the matter proceeds in court to end once and for all the unjust distress this case has caused our employees and former employees,'' he said.

The Thai public prosecutor had alleged that PMTL's declared import prices were too low compared to the purchase prices of duty-free cigarettes, but such a comparison is illegal according to Thai and international customs laws, the company said.

''We would like to encourage the Thai government to reconsider these meritless charges, which will harm Thailand's standing in the international trade community and ultimately cause damage to the Thai economy and thus the Thai people,'' Paschalides said, adding that the company will ''vigorously'' fight the charges.

The first witness hearing is reportedly scheduled for October 10.

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Ukraine

Guidance Addresses Effect of Tax Haven on Controlled Transaction

Ukraine's State Fiscal Service issued guidance clarifying that a business transaction is not considered to be controlled for transfer pricing purposes if the ownership title to the goods involved in the transaction passed to the buyer after its state of residence was removed from Ukraine's list of low-tax jurisdictions.

Guidance Letter 7861/6/99-99-19-02-02-15 (dated April 8) says transactions will be recognized as controlled for transfer pricing purposes if the conditions under which they are executed affect the taxation of the parties and the transactions involve nonresidents registered in a low-tax jurisdiction that is included on the government's list of low-tax jurisdictions.

Therefore, a purchase and sale transaction cannot be considered controlled for transfer pricing purposes if the advance payment for the forthcoming supply of goods was made at a time when the jurisdiction in which the buyer is registered was on the government's list of low-tax jurisdictions, but the ownership title to the goods passed to the buyer after the jurisdiction in which it resides was removed from the list of low-tax jurisdictions.

For transfer pricing purposes, Ukraine considers a low-tax jurisdiction to be:

- a country or territory with a corporate tax rate at least 5 percentage points lower than Ukraine's general corporate rate of 18 percent; or
- a country or territory that does not have an effective tax treaty with Ukraine that provides for the exchange of information on tax matters.

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United Kingdom

HMRC Claims Victories in 2 Tax Avoidance Cases

The U.K. tax authority has emerged victorious in two court decisions involving tax avoidance schemes, protecting millions of pounds of tax in each case, HM Revenue & Customs announced on April 22.

In the first case, *Fidex Ltd. v. HM Revenue & Customs*, [2016] EWCA Civ 385, the Court of Appeal (Civil Division) held in HMRC's favor against Fidex Ltd., a subsidiary of BNP Paribas banking group.

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The appeal involves Project Zephyr, a tax avoidance scheme whose goal was to create for Fidex a loss of about €84 million by ''taking advantage of different accounting standards covering the tax treatment of assets to create a tax benefit,'' according to an April 22 HMRC news release. The decision protects more than £17 million in tax, HMRC said.

The Court of Appeal's latest decision follows the November 13, 2014, decision from the Upper Tribunal (Tax and Chancery Chamber) holding in HMRC's favor in the case.

The decision is ''another important win against tax avoidance,'' Jim Harra, HMRC's director general of business tax, said.

''The scheme was being used by the subsidiary of a major bank to dodge tax, and the Court of Appeal has confirmed that it doesn't work,'' he added. ''HMRC will always take on schemes like these on behalf of the vast majority of taxpayers who play by the rules and pay their share.''

In the second case, *Clavis Liberty 1 LP v. HM Revenue & Customs* [2016] UKFTT 0253 (TC), the First-Tier Tribunal (Tax Chamber) held in HMRC's favor against the Clavis Liberty Fund 1 LP scheme, which involved a Jersey-registered limited partnership with 99 users. The users had contributed money, which was combined with a bank loan, to purchase rights to dividends declared by a company registered in the Cayman Islands, according to another April 22 HMRC news release.

The partnership claimed a deduction covering the cost of the dividend rights but tried to exclude the resulting dividend payments from its trading profits, which gave rise to an artificial tax loss, the tribunal found.

The decision in *Clavis* is notable because it was the first time the antiavoidance legislation under section 730 of the Income and Corporation Taxes Act 1988 had been tested in court. According to HMRC, £18 million in tax was at stake in the *Clavis* case, with an additional £347 million across similar cases.

Jennie Granger, HMRC's director general of enforcement and compliance, emphasized the significance of the decision, in both a monetary and symbolic sense, as it sends a ''powerful signal'' to those who are considering using offshore arrangements for tax avoidance purposes.

HMRC also noted that the two decisions come shortly after the U.K. Supreme Court refused on April 13 to hear an appeal from Eclipse Film Partners No. 35 LLP against an earlier England and Wales Court of Appeal decision that the partnership's film investment scheme was ineligible for film tax relief because it was an investment, not a trading venture. (Prior coverage: *Tax Notes Int'l*, Apr. 18, 2016, p. 252.)

''In the space of a week HMRC has secured three court victories, protecting more than £1 billion in tax and proving that tax avoidance doesn't pay,'' Granger said. ''It's time for people to get out of these schemes — they don't work and we will defeat them.''

According to Chas Roy-Chowdhury, head of taxation with the Association of Certified Chartered Accountants, these kinds of artificial schemes ''are very much in the cross hairs'' of HMRC, which has indicated that it would go ''all-out'' in attacking them. There will be a lot more victories claimed by HMRC, and those who have invested in these kinds of schemes must be aware they will not get the losses they thought they were going to get, he added.

Roy-Chowdhury noted that the tax community will also start to see the effects of the U.K.'s general antiabuse rule, which came into effect in 2013. ''Cases from that will start coming in this year as well,'' he said. ''There's going to be lots of different ways in which tax avoidance will be combatted by the U.K. government.''

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Report Forecasts Decline in Corporate Tax Revenues

The U.K. may experience a decline in corporate tax receipts as a proportion of national income by the end of the current Parliament due to shrinking receipts from North Sea oil operations, a decrease in bank profitability, and corporation tax rate cuts.

In a briefing note published on April 26 by the Institute for Fiscal Studies, researchers found that between the 2007-2008 and 2009-2010 periods, total government receipts had dropped by more than 9 percent in real terms and were 2 percent lower as a share of national income, mostly because of the global financial crisis and ensuing recession. The note predicted that government receipts would reach 37.2 percent of national income by the end of this decade, which is slightly lower than 2007-2008 levels but higher than 2009-2010 levels and higher than the average level over the 20 years before the recession hit.

While findings indicate that by 2020 to 2021, the U.K. will raise about the same proportion of national income in revenue as it did just before the crisis hit, the report notes that there have been significant changes in the composition of those receipts over recent years.

In general, HM Revenue & Customs is likely to raise more revenue from VAT but less from other indirect taxes, according to the note. While the tax authority is set to raise about the same amount of revenues from personal income taxes, more of those taxes will come from the highest earners, the note says. Moreover, the government can expect to rake in ''substantially less'' from corporate taxes, researchers found.

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For the report's purposes, corporation taxes include onshore and offshore corporation tax, oil royalties, windfall taxes levied on tobacco companies, petroleum revenue tax, the diverted profits tax, the bank surcharge, and the bank levy, which collectively contributed 2.5 percent of national income in 2015 to 2016. ''By the end of the parliament, these receipts as a proportion of national income are due to be a third lower than before the crisis,'' the report says.

Specifically, onshore corporate tax receipts as a proportion of national income are expected to be 26 percent lower than pre-crisis levels because of weak corporate profits and policy changes. North Sea oil revenues amounted to 0.5 percent of national income before the crisis, and are estimated to reach near 0 percent for 2015 to 2016, according to the report. In 2018 to 2019, the North Sea tax regime is projected to cost the U.K. government money because of continual weak profitability and relief for decommissioning costs.

''Given the underlying decline in North Sea resources . . . the associated tax revenues look unlikely to form a substantial part of the UK tax base in future,'' the report says.

Researchers also found that the financial sector, particularly banks, was once an important source of corporate tax receipts before the crisis, and has experienced the largest decrease compared with other kinds of tax receipts. Corporate tax on financial sector profits amounted to 0.7 percent of national income and 25.8 percent of total onshore corporation tax receipts in 2007 to 2008, and of that amount, more than 50 percent comprised receipts solely from bank profits, according to the report. However, corporate tax on financial sector profits are just 0.3 percent of national income and 15.2 percent of onshore corporation tax today, a change driven mostly by the decrease in corporate tax that banks pay, the report says.

''The recovery of the formerly tax-rich banking sector remains uncertain, in part because receipts from this sector are especially dependent on the profitability of a few very large banks,'' the report says, noting the introduction of the bank levy and the bank surcharge.

The bank levy, which took effect in 2011, is a charge on the worldwide balance sheets of banks operating in the U.K. and had been introduced as a way to encourage banks to reduce risk following the financial crisis. The bank surcharge, which took effect in January, is a new 8 percent corporate tax surcharge on banks' U.K. profits.

''These measures will be sufficient to roughly maintain the proportion of national income paid in taxes by banks between 2014-15 and 2020-21, but this proportion will still be considerably below the pre-crisis peak,'' the report says.

The additional taxes have ''produced a system of bank taxation that is substantially more complicated than before the crisis, and one that is not underpinned by a clear strategy,'' researchers wrote. ''This is not a coherent way to design a tax aimed at changing behaviour.''

Moreover, since 2010, there have been several changes to corporate tax, the report says, adding that the policy changes announced between 2010 and the 2016 budget have cost £10.8 billion annually in 2015-2016 terms.

Noting the government's plans to cut the corporate tax rate further to 17 percent by 2020 to 2021, the report points out that corporate tax rates in the developed world have decreased significantly since the 1970s as countries try to remain competitive for ''mobile activities and profits.'' Along with corporate tax rate cuts, the policy mix also includes other corporate tax changes since 2010. (Prior coverage: *Tax Notes Int'l*, Mar. 21, 2016, p. 1022.)

As a result of the policy changes, some companies, particularly highly profitable and mobile companies, stand to gain more than others from the lower corporate tax rates, although some may be hit with antiavoidance measures, such as new interest deduction restrictions, the report says. Companies with significant investment or losses and multinationals with high debt levels in the U.K. will benefit the least from lower rates, the report adds.

It is possible that corporate revenues will be higher than predicted because corporate tax rate cuts will increase corporate activity or because antiavoidance measures will be able to raise more revenues than expected, according to the report.

''However, in the longer run, there is also likely to be continued competitive pressure on corporate taxes,'' the report says.

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Lawmaker Notes Snag in HMRC's 'Making Tax Digital' Plan

HM Revenue & Customs' 'Making Tax Digital' (MTD) program could have a more significant negative impact on businesses than previously thought, Andrew Tyrie, chair of the House of Commons Treasury Committee, warned in an April 26 letter to Financial Secretary David Gauke.

According to Tyrie, HMRC recently clarified that businesses will have to submit the required quarterly information using a prescribed digital format. Tax professionals were under the impression that businesses would be able to use their choice of computer software for record keeping, as long as it is submitted in digital form, Tyrie said.

''This would entail the use of designated software packages. It would have an impact on large business

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([which] may not currently have accounting systems which are compatible with HMRC's requirements),'' Tyrie's letter says.

''This may affect the overwhelming majority of businesses. A survey published by the [Institute of Chartered Accountants in England and Wales (ICAEW)] recently suggested that 75 percent of all businesses and 82 percent of sole traders would have to change their recordkeeping systems to comply with the government's new proposals for 'Making Tax Digital,''' the letter says. ''If this sample is representative, and if [ICAEW's] fears are borne out, then it seems implausible that 'Making Tax Digital' could generate large savings to business — as the government is forecasting.'' (Prior coverage: *Tax Notes Int'l*, Apr. 18, 2016, p. 249.)

Chancellor of the Exchequer George Osborne previously claimed that the MTD would reduce business's compliance and administrative costs by £400 million, an estimate supported by Gauke.

Tyrie's letter asks that the government conduct an assessment of the potential increase in compliance costs for businesses before implementing the MTD. ''Before anything is done to implement these proposals, the government now needs to provide a comprehensive impact assessment. Full cooperation and consultation on it — with those most affected, and with Parliament — will be needed. An acceptable plan for its gradual introduction is also essential,'' Tyrie said.

There is ''no doubt [that] 'Making Tax Digital' is the future,'' he said. ''But businesses and their customers should not be expected to foot the bill for the transition.''

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U.K. Would Reopen Google Tax Settlement if New Evidence Arises

HM Treasury has accepted a recommendation from a parliamentary watchdog committee to reopen the tax authority's corporate tax settlement with Google if relevant new evidence surfaces that indicates more tax should have been paid.

In HM Treasury's latest minutes, published on April 28, the government responded to recommendations from several reports from the House of Commons Public Accounts Committee (PAC), including one on corporate tax settlements, released in February. In that report, PAC criticized HM Revenue & Customs' £130 million settlement with Google, which included interest and covered the 2005-2015 period. The controversial settlement, announced in January, drew sharp criticism as a ''sweetheart deal,'' with some members of Parliament, including Margaret Hodge, Labour MP and former PAC chair, saying the settlement was inadequate and nontransparent. (Prior coverage: *Tax Notes Int'l*, Feb. 29, 2016, p. 749; and *Tax Notes Int'l*, Feb. 1, 2016, p. 391.)

PAC's report followed its February 11 public hearing about the settlement, in which MPs grilled representatives from HMRC and Google, who in turn defended the arrangement.

PAC recommended that HMRC ''monitor the outcome of other tax authorities' investigations into Google, and re-open its settlement with Google if relevant new evidence becomes available.'' HMRC should also look to other countries' tax authorities to glean lessons if they are able to come to larger tax settlements with the Internet giant, according to the report.

In response, HM Treasury accepted and implemented PAC's recommendation, noting its track record in cooperating with other tax authorities through information exchange channels under international agreements.

HMRC also shares its experience and expertise with other countries through such forums as the Joint International Tax Shelter and Collaboration (JITSIC) network, a platform for tax administration officials to collaborate within the boundaries of bilateral and multilateral conventions and tax information exchange agreements to address common issues, such as tax evasion and avoidance, the government said in its minutes.

HMRC has also worked with five of its counterparts in other countries under the so-called E6 project, which began in August 2013, to map out the international affairs of multinational enterprises operating in the digital economy and exchange information to address tax avoidance, according to the minutes.

''The department will continue to collaborate with tax administrations in other countries to share any relevant information,'' the government said. ''Should further relevant information come to light that was not made available to the department during the course of the enquiry, the department would consider its tax impact and look again at the settlement if it appeared that further tax should be paid.''

The government also accepted PAC's recommendation that HMRC ''should consult widely, including with other tax authorities, on the case for changing the rules that protect corporate taxpayer confidentiality to make the tax affairs of multinational companies open to public scrutiny.''

The U.K. has taken the lead on country-by-country reporting measures, first by initiating work on the issue during its G-8 presidency in 2013 and by being the first to commit to implement the OECD model for country-by-country reporting in Finance Act 2015, the government said.

''The government remains in the vanguard; for example, in now pressing the case for agreement to public country-by-country reporting on a multilateral basis,'' HM Treasury said, adding that it will keep

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pushing for domestic transparency measures that complement international action while keeping taxpayer confidentiality secure.

The government also noted introduction of legislation in Finance Bill 2016 that would require all large companies to publish their U.K. tax strategies. HMRC had recently issued draft guidance on the new tax strategy disclosure requirement, which would apply to companies with turnover of more than £200 million or a relevant balance sheet total of more than £2 billion for the preceding financial year. (Prior coverage: *Tax Notes Int'l*, Apr. 4, 2016, p. 50.)

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United States

Panama Papers Raise Publicity for U.S. Tax Enforcement Efforts

The Panama Papers may reveal little new information about U.S. taxpayers using offshore accounts, but the publicity surrounding the leaked documents could help U.S. criminal tax enforcement efforts, according to a former head of the Justice Department's Tax Division.

Ever since the International Consortium of Investigative Journalists (ICIJ) broke the news that it had obtained millions of leaked documents, now known as the Panama Papers, from the files of Panamanian law firm Mossack Fonseca, there have been questions about just what the leak will mean for U.S. tax enforcement. The papers identified 214,000 offshore entities connected to people in more than 200 countries and territories and named numerous banks as connected with the firm's operations, including UBS, HSBC, Credit Suisse, and Deutsche Bank. (Prior coverage: *Tax Notes Int'l*, Apr. 11, 2016, p. 103.)

The ICIJ is refusing to hand over the Panama Papers to government enforcement agencies, but it plans to publicize a list of clients and entities named in the documents. (Prior coverage: *Tax Notes Int'l*, Apr. 25, 2016, p. 321.) News reports on the Panama Papers so far have mentioned few U.S.-related names. Ramon Fonseca, co-founder of Mossack Fonseca, told the Associated Press April 7, a few days after the first Panama Papers reports, that the firm simply prefers not to deal with U.S. clients and thus only had a handful.

Even for the few U.S. related clients Mossack Fonseca may have or have had, U.S. tax enforcement agencies may not learn much that is new, particularly if the only information is a list of names of clients and entities. The DOJ's Tax Division recently finished executing non-prosecution agreements (NPAs) with 80 Swiss banks, each of which requires the banks to disclose information about transfer of funds and to cooperate in future investigations. The United States is also on its third (or fourth, depending on the parsing of the streamlined disclosure procedures) offshore voluntary disclosure program.

Kathryn Keneally, former assistant attorney general for the DOJ's Tax Division and now with DLA Piper, was the author of the DOJ's Swiss bank program. She said that the DOJ has had avenues to get a wealth of information for a long time. ''The key purpose of the Swiss bank program was to get information about where did the money come from and where did the money go,'' she said, adding that the DOJ obtained a large amount of information on transfers involving countries other than Switzerland.

In addition to the Swiss bank program, the U.S. tax enforcement authorities have been getting information from the OVDP (and its previous incarnations), whistleblowers, cooperators, and treaty requests, Keneally said. ''From a law enforcement point of view, [the Panama Papers are] just one more piece of information in what's been a very effective ongoing enforcement effort over many years,'' she said.

Keneally emphasized the ongoing efforts in the context of the increased penalty under the OVDP for those with accounts at institutions that are under investigation or cooperating with the IRS or the Justice Department, or have been issued a John Doe summons. Anyone with an undisclosed offshore account or structure should consider coming forward as soon as possible, she said. ''What part of 'we raised the penalty to 50 percent once the bank got disclosed' did everybody miss?'' she asked.

Keneally said one new aspect of the Panama Papers is the general publicity of prominent Mossack Fonseca clients. ''The Panama Papers disclosure has had a public impact because of the startling nature of seeing account holders' names and prominent people publicly disclosed in that manner,'' she said.

Keneally contrasted the benefits of whistleblower information with leaked information, while noting that both can help tax enforcement efforts. One benefit of whistleblower information is that it can be kept confidential during an investigation, but ''on the other hand, you want a certain amount of disclosure out there, because from a tax system point of view you want people to come forward into voluntary compliance, get right with the government, and be good taxpayers going forward,'' she said.

Great Big Caveat

The publicity of the Panama Papers comes with a serious qualification: The use of shell companies is not inherently illegal and may be accompanied by full compliance with tax laws.

Caroline Ciraolo, acting assistant attorney general of the Tax Division, told Tax Analysts, ''Mere ownership

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of foreign accounts and the formation of offshore entities is not, in and of itself, illegal. However, it is a crime to willfully conceal foreign accounts and income, and to use offshore structures to hide such accounts and evade U.S. taxes.''

Keneally said, ''The fact that somebody was on the client list of that law firm doesn't mean they committed a crime.'' One downside to the publicity of leaked information is the potential to unjustifiably ruin the reputation of a law-abiding taxpayer, she said.

Nathan J. Hochman of Morgan, Lewis & Bockius LLP, another former assistant attorney general for the DOJ's Tax Division, said, ''Setting up an entity in and of itself is not illegal, it's only if that entity is used for an illegal purpose to evade tax that it becomes part of a criminal course of action warranting prosecutions.''

Should the U.S. government eventually gain access to the Panama Papers, it will have to face another issue specific to a leak from a law firm, namely, working through the attorney-client privilege and the work product doctrine protections that could render some of the documents inadmissible at trial.

Hochman said that privilege is ''an important issue that would have to be handled by the Department of Justice, most likely, by having a separate document 'taint' team go through the types of records they are receiving and determine whether or not these records fall within the scope of the attorney-client privilege or work product doctrine.'' Many documents might not contain communications between the attorneys and the clients or attorney work product, he said. Should a dispute arise over what is privileged or protected, the court will ultimately have to rule on the question, Hochman said.

What Practitioners Have Seen So Far

Bryan C. Skarlatos of Kostelanetz & Fink LLP said that he has not seen a flood of new clients since the ICIJ revealed its possession of the Panama Papers, attributing this lack of response to the success of the OVDP. Prior U.S. efforts such as the OVDP and the DOJ's Swiss bank program have ''already squeezed out most of the noncompliant taxpayers,'' he said. ''I am sure there will be some that are still revealed to be noncompliant, but I think a relatively small number.''

Further, an attempt to hide assets using a shell company will still most often place reportable assets in an account at a financial institution, raising the existing reporting pressures from the Foreign Account Tax Compliance Act, according to Skarlatos.

Other prominent criminal tax attorneys who have dealt with hundreds or thousands of previously undisclosed foreign accounts told Tax Analysts that they have seen other shell company facilitators dozens of times, but Mossack Fonseca only a couple of times, if at all.

Larry A. Campagna of Chamberlain, Hrdlicka, White, Williams & Aughtry said that Panamanian companies have been appearing in Swiss bank account matters for years. ''The release of these papers has heightened awareness that there really isn't anyplace left to hide in the world,'' he said.

''I would guess that [Mossack Fonseca] was a known facilitator as a result of the non-prosecution agreements and investigations in Switzerland,'' Campagna said. Many of the Swiss bank agreements mentioned not only Panamanian entities, but also entities in many other tax havens such as the British Virgin Islands, he said.

Campagna said that the DOJ and CI have already been looking to prosecute the lawyers, accountants, and bankers who help U.S. taxpayers hide their assets and income. ''The Panama Papers are just additional fuel for that fire; the fire is already burning,'' he said.

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Cash Pooling Viability Debated Following Related-Party Debt Regs

Practitioners debated the viability of cash pooling arrangements following the issuance of new proposed regulations that would recharacterize some related-party debt as equity.

''I don't see how clients maintain a cash pool arrangement that they have today with the rules as they are written,'' Marty Collins of PwC said at a meeting of the International Fiscal Association USA branch in Washington. ''These rules seem unworkable unless you go into a fully checked structure or you do away with the cash pool and you do third-party borrowing.''

The proposed regs (REG-108060-15) would generally treat related-party debt as equity unless it facilitates new net investment in the borrower's operations. Included in the regs is a bifurcation rule that enables the government to divide a purported debt instrument into part debt and part stock; documentation rules; transaction rules, which treat issuances of new debt among some related parties as equity; and the consolidated group rules. Under the transaction rules are two primary operating rules: a general rule and a funding rule. A debt instrument issued by a corporation to a group member is treated as stock if issued in a distribution. (Prior coverage: *Tax Notes Int'l*, Apr. 25, 2016, p. 354.)

The rules also ask for comment on ''whether special rules are warranted for cash pools, cash sweeps, and similar arrangements for managing cash of an expanded group.''

''When I think about 'cash pools,' I view that term as just a label, and I need to understand more of

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what's behind it,'' said Kevin Nichols, senior counsel, Treasury Office of International Tax Counsel. Nichols added that he had heard cash pools described as short-term liquidity vehicles that may be reversed within the same entity in a matter of a few days but that a party may also be an indefinite borrower from the cash pool. ''It would be helpful for us to delineate between what one may think of as short-term liquidity on one hand versus what one might think of as a substitute or economic equivalent of related-party borrowings that are addressed in these rules.''

Peter Blessing of KPMG LLP argued that a carve-out for cash pooling would not be irrational because it is not within the scope of targeted transactions. He argued that the business aspects of cash pooling would overwhelm any tax concerns.

Gretchen Sierra of Deloitte Tax LLP agreed. ''I can't see my clients not doing cash pooling,'' she said. ''They don't do it for tax. This is just CFO 101 tools to be able to manage cash.''

Sierra said there were concerns whether taxpayers could bring dividends back to the United States. And the simultaneous nature of cash pooling would make managing ordering rules under the regs difficult, she added. ''It would be incredibly difficult to figure out what you've got, in terms of what is matched to what, and on top of that, figuring out what your equity structure looks like afterward.''

E&P Exception Notional

Within the transaction rules is an exception for current-year earnings and profits. Under that exception, the aggregate amounts of distributions or acquisitions (under the general rule or the funding rule) are reduced by the issuer's current-year E&P.

Sierra said that limiting the exception to current-year E&P was ''somewhat notional'' without a significant, specific policy rationale behind it. She questioned whether previously taxed income of an entity should also be considered under the umbrella of an exception, since distributions of notes to the extent of that income would be legitimate.

Nichols argued that the definition of distribution was broad and not tied to taxability of an amount and the rule was constructed in ''an indifferent way'' regarding whether the distribution is taxed as a dividend. ''The E&P exception is the limited, potentially ordinary course distributions, to provide flexibility,'' he said.

Nichols noted that the exception applies to a distribution or acquisition leg of a transaction in the chronological order in which the transactions occurred. But Sierra questioned whether the ordering of a cash distribution and a note distribution should matter in determining whether that exception might first be exhausted by an initial cash distribution and thereby make a note subject to reclassification as equity, when it otherwise would not have been reclassified if issued first.

''I appreciate that there might be better tax planning to do one or the other, but if the policy is to just cover distributions that might be made in the ordinary course [of business], then that is sort of consistent with moving chronologically,'' Nichols said.

Affirmative Use

Daniel McCall, special counsel, IRS Office of Associate Chief Counsel (International), acknowledging that distributions could still be used in repatriation planning, argued that the potential recharacterization of note distributions under the regs was not intended to be a cure-all for such planning.

''What's important to note is that a lot of these notes that were distributed in the repatriation planning, to me, shines a spotlight on the lack of business purpose. This really is tax planning,'' McCall argued.

To prevent abuse, the rules prohibit affirmative use of the proposed regs to support a particular characterization. The rules do not apply to the extent a person enters into a transaction with the principal purpose of reducing the tax liability of a group member by disregarding the treatment of the debt instrument.

''That sort of raises, in my mind, one of the questions of whether these regulations are valid,'' Peter Daub of Morgan, Lewis & Bockius LLP said. Daub noted that section 385 enunciates numerous factors to be considered when making a determination of debt or equity. ''You question whether [section] 385 is really giving you the authority to write an antiabuse rule, which really these regulations are or is it simply providing authority to write neutral rules distinguishing debt from equity in a more uniform way than the courts have done over the last hundred years?''

McCall said that the government would take Daub's comment into consideration before the regs are finalized but that inclusion of an affirmative use rule is not unprecedented. He later cited the ''fast pay'' regs under section 7701(l) as one example when a ''no affirmative use'' rule is used.

''If you look at the statute just through the lens of some of the discussion in the legislative history, you might think that these rules are just to sort out whether we use 11 factors instead of 13 factors,'' McCall said. ''We just don't see the statute as being that limited. We decided, due to serious policy concerns, to exercise the broad authority of [section] 385.''

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Treasury Hasn't Ruled Out Inversion Regs Expansion

Treasury is keeping open the possibility of expanding its rules limiting post-inversion planning beyond the scope of inverters, including in the context of hopscotch loans and decontrolling controlled foreign corporations, a Treasury official said April 27.

''From a policy perspective, we chose to limit [these rules] to inverted companies,'' Brenda Zent, special adviser, Treasury Office of International Tax Counsel, said on a webcast sponsored by Penn State Law. ''We will continue to consider what we might do, including potentially extending these beyond inverted companies.'' Zent added that Treasury probably had the authority to go after such transactions beyond the inversion context, but that it ''hadn't made the call yet'' whether any action was needed. She said that while it was clear that the new hopscotch loan rule didn't apply beyond the inversion context, taxpayers still needed to consider other existing section 956 rules.

In a *Tax Notes* viewpoint, Stephen E. Shay, J. Clifton Fleming Jr., and Robert J. Peroni argued that Treasury ''can and should'' expand its decontrol rules beyond section 7874 inversions to include cases ''in which any foreign acquirer would achieve an advantage in relation to pre-effective-date earnings.'' The authors also argued that ''the rationale underlying Notice 2014-52's treatment of a loan to a non-CFC foreign affiliate is coherent in protecting the U.S. tax base, but it is not and should not be limited to inversions.'' Notice 2014-52, which was incorporated in the temporary regs, invoked the antiabuse provision of section 956 to prevent inverters from loaning around a U.S. parent to avoid taxes.

Although before the release of the new temporary regs (T.D. 9761) Treasury was noncommittal on the expansion of the hopscotch rule beyond the inversion context, following the release of the regs, a senior Treasury official, without specifically elaborating on what was being evaluated, said that the agency was looking at all the work being done in the academic community to help inform its judgments. (Prior coverage: *Tax Notes Int'l*, Feb. 29, 2016, p. 756; and *Tax Notes Int'l*, Apr. 11, 2016, p. 130.)

Signing Date

The temporary regs expand on earlier anti-inversion notices and impose some new rules, including a serial inverter rule, which disregards some foreign acquiring stock from the denominator of the ownership fraction when determining inversion thresholds. The serial inverter rule invokes a three-year lookback period, disregarding such ownership from transactions that occurred in the 36-month period ending on the signing date of the transaction in question. The rule does not depend on the transactions being completed together as part of a plan. (Prior coverage: *Tax Notes Int'l*, Apr. 25, 2016, p. 353.)

Zent said that signing date, rather than completion date, was chosen as the date to determine the appropriate lookback period in order to avoid having taxpayers simply wait long enough after inking the deal to avoid limitations.

''It has a little bit of a plan flavor to it though, doesn't it, if you are thinking somebody is going to be monitoring this?'' J. Brian Davis of Ivins, Phillips & Barker asked.

Zent said while that was a fair point, she didn't view it that way, since she saw it more as a matter of preventing circumvention of the rule.

''Maybe we just could have gone longer than 36 months,'' Zent said.

Minimum Standard for Documentation

Speaking on proposed regs (REG-108060-15) that would recharacterize some related-party debt as equity, Samuel C. Thompson Jr. of Penn State Law argued that documentation rules should provide an exception in order to avoid reclassification for a documentation failure in situations in which it was obvious from case law that a particular instrument was debt.

''For example, suppose [a U.S. subsidiary] was capitalized with 80 percent equity and 20 percent debt, but there was no documentation,'' Thompson posited. ''So you come in and say this 20 percent debt capital is not debt. That seems a little bit harsh to me.''

Under the requirements, documentation evidencing four essential characteristics — the legally binding obligation to pay, a creditor's rights to enforce, the reasonable expectation of repayment at the time of creation, and an ongoing relationship during the life of the interest consistent with arm's-length principles — is necessary for debt characterization, although the documentation is not dispositive evidence for establishing debt.

''I think that what you've described is part of the reason why these rules exist,'' said Kevin Nichols, senior counsel, Treasury Office of International Tax Counsel, who also acknowledged that Thompson's concern was a fair point. ''These rules set forth minimum standards and there are consequences.'' The preamble to the regs notes that the documentation rules are designed to ''impose discipline'' in a related-party context, similar to what occurs in a debt issuance between third parties. The documentation requirements also provide a reasonable cause exception for failures, under reg. section 1.385-2(c)(1).

But Thompson persisted, though he did not argue against Treasury's authority to write documentation requirements under section 385.

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''You shouldn't cut the guy's hand off because he walked across the street when he shouldn't have. I just think the regulations have that sort of potential,'' Thompson argued.

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Draft Qualified Intermediary Agreement on Horizon

Practitioners should ''keep their Blackberries on'' in anticipation of an upcoming notice containing a draft 2017 qualified intermediary agreement, an IRS official said April 27.

John Sweeney, branch 8 chief, IRS Office of Associate Chief Counsel (International), said there will be two major adjustments from the current QI agreement in the upcoming draft: It will address the qualified derivatives dealer regime implemented by the new section 871(m) regulations, and it will amend some of the compliance procedures from the current QI agreement, which was released in 2014.

The language of the draft agreement will be complex, Sweeney said. Appearing at the Tax Reporting and Withholding Conference in Arlington, Virginia, he urged practitioners to look at the draft and provide comments as soon as possible, given the approaching deadline for the revised agreement.

Sweeney also identified three guidance projects that he expects will be released by the end of the year. Two of the projects are ''cleanup'' regulations for chapters 3 and 4; some of the changes have been foreshadowed in a series of notices over the past few years, he said.

The third guidance project will be a set of proposed regs for the compliance requirements of sponsoring entities for foreign financial institutions and nonfinancial foreign entities.

Laurie Hatten-Boyd of KPMG LLP noted the high error rate by foreign entities filling out the Form W-8BEN-E, ''Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities).'' She said sophisticated investors are doing fine filling it out, but that for the average investor there are many mistakes, which raises the question of what level of due diligence the IRS expects from withholding agents.

Sweeney said what constitutes sufficient due diligence will be addressed in either the chapter 3 regulations or the form instructions to be released later this year.

The Form W-8BEN-E, released earlier this month, does not need to be used until November 1, 2016, Sweeney said. November 1 will mark six months after the form was released, though the IRS can change the timing of the form's applicability through regulation, he said.

Hatten-Boyd objected to a Foreign Account Tax Compliance Act rule under which the withholding agent is deemed not to have a permanent address for an account holder if the address on the form is subject to a ''hold mail'' instruction, resulting in the presumption rules being applied. She said this doesn't reflect how business is done — many account holders place hold mail instructions on their addresses for security reasons because they don't want mail arriving at their address from foreign financial institutions.

The IRS is aware of this issue and is considering addressing it in the chapter 3 and 4 regulations to be released later this year, Sweeney said.

Responding to a question from Chip Collins of UBS AG about how to apply the section 305(c) convertible bond deemed distribution regulations to prior-year withholdings, Sweeney said that while the regulations tell withholding agents the amount they should treat as the deemed distribution, practitioners should wait until the IRS foreign payments practice issues an update.

Penalties for Incorrect TINs

Earlier in April, the IRS issued a chief counsel memorandum (ILM 201615012) that said there should not be penalties assessed for incorrect taxpayer identification numbers on Form 1042-S, ''Foreign Person's U.S. Source Income Subject to Withholding,'' unless the withholding agent knew or had a reason to know that there was an incorrect TIN provided on the Form W-8BEN, ''Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals).''

Speaking on a panel April 26, Aureon Herron-Hinds of PwC said the memo was welcome because if the IRS imposes a penalty, the withholding agent can argue for an abatement by showing reasonable cause for the incorrect TIN.

Jon Lakritz of PwC said the memo demonstrates to withholding agents that the IRS is looking at TINs and considering applying penalties in the case of incorrect reporting.

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FATCA Constitutionality Challenge Dismissed for Lack of Standing

Finding that the plaintiffs failed to allege a violation of a legally protected interest or an irreparable injury, an Ohio federal judge has dismissed a lawsuit challenging the constitutionality of the U.S. Foreign Account

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Tax Compliance Act and other foreign bank account report requirements for lack of standing.

The April 26 ruling in *Crawford v. Treasury*, No. 3:15-cv-00250 (S.D. Ohio 2015), by Judge Thomas M. Rose of the U.S. District Court for the Southern District of Ohio dismissed the lawsuit, brought by 10 plaintiffs, including Sen. Rand Paul, R-Ky., which sought to enjoin the government from enforcing FATCA and FBAR requirements. Rose leaned heavily on his September 2015 decision rejecting the plaintiffs' request for an injunction barring the U.S. Treasury Department from enforcing the provisions because none of them had suffered, or was about to suffer, injury as a result of the FATCA withholding tax. (Prior coverage: *Tax Notes Int'l*, Oct. 5, 2015, p. 38.)

Although the plaintiffs filed a motion seeking leave to amend the action, Rose found that the proposed amendments still failed to overcome the government's motion to dismiss. ''No individual plaintiff has suffered an invasion of a legally protected interest, which is concrete and particularized, and actual or imminent, not conjectural or hypothetical,'' said Rose. ''Moreover, no alleged injury is fairly traceable to the actions of the defendants, but rather, the actions of an independent third party.'' Rose also found no indication that the claimed injuries would be redressed by a decision in the plaintiffs' favor.

Rose noted that Paul claimed legal standing in the case based on his role as a U.S. senator charged with the institutional task of providing advice and consent under the U.S. Constitution. According to Paul, the FATCA intergovernmental agreements exceeded the scope of executive branch power and should have been submitted to the Senate for approval.

In his preliminary injunction, Rose found that Paul's claims were insufficient to meet the requirements of standing because the alleged injury was not to himself as an individual, the institutional injury alleged was wholly abstract, and the timing of his attempt to litigate was contrary to ''historical experience.'' Paul claimed the deficiencies in his case were cured in the plaintiffs' amended complaint. Rose dismissed this argument, finding that the proposed amendment ''formulaically recites the elements for standing, while reasserting the same basis for standing that the court previously found insufficient.''

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Terex Merger Materially Affected by Anti-Inversion Rules

Substantially all of the advertised annual tax synergies expected from the merger of Connecticut-based industrial equipment maker Terex Corp. and Finnish competitor Konecranes PLC will be eliminated as a result of the new U.S. inversion rules, according to the companies.

The parties are still considering the extent of the regulations' effects and, in the meantime, will continue to pursue the merger with some adjusted expectations, according to a Konecranes statement, filed with the SEC on April 27, that estimated the potential lost tax and financial benefits to be €32 million.

If completed according to the companies' August 11, 2015, announcement of the deal, the all-stock merger would result in a Finland-incorporated combined company, approximately 60 percent of which would be owned by Terex shareholders. Konecranes said the deal is now expected to close midway through the second half of 2016, rather than in the first half of the year, and that the anticipated pretax operational synergies of the deal are not affected by the Treasury rules (T.D. 9761, REG-135734-14, REG-108060-15).

Although Treasury actions have had a significant impact on tax savings expected from the deal, ''the Terex board of directors has not changed its recommendation in support of the proposed combination with Konecranes,'' Terex CEO John Garrison said during an April 27 conference call to discuss financial results for the first quarter of 2016. The company is moving forward to obtain the antitrust, regulatory, and shareholder approvals required to complete the merger, he added.

Garrison declined to say whether the terms of the deal with Konecranes are being renegotiated to reflect the reduced synergies expected from the transaction, saying only that the two companies are working together to understand the full impact of the rules.

''We're learning. It's a very dense document, but our initial analysis is that there will be at least a $35 million reduction in the announced synergies at the time of the merger,'' Garrison said.

Terex is also in negotiations with China's Zoomlion Heavy Industry Science and Technology Co., which has made a conditional, nonbinding proposal to acquire all of the outstanding shares of Terex for $31 per share in cash.

''Until such time as [Terex's] existing agreement with Konecranes is terminated, Terex is prohibited from entering into an agreement with Zoomlion,'' Terex said in a March 23 press release announcing Zoomlion's most recent bid.

''We are holding discussions with Zoomlion to determine whether we can obtain a binding and fully financed proposal which provides for a high degree of closing certainty,'' Garrison said during the April 27 call.

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IRS Reports Significant Increase in MAP Resolutions

The IRS released its annual report on competent authority statistics, which shows a decline in the number of transfer-pricing-related mutual agreement procedure (MAP) requests received and an increase in the number of cases closed.

According to the April 28 report, the IRS advance pricing and mutual agreement program's inventory slightly increased, from 718 pending requests in 2014 to 755 in 2015. The treaty assistance and interpretation team (TAIT) maintained a stable inventory, with a small increase from 238 pending requests in 2014 to 243 at the end of 2015. (Prior coverage: *Tax Notes Int'l*, Apr. 20, 2015, p. 239.)

The number of cases the APMA program closed in 2015 increased by almost 45 percent over the previous year, from 133 in 2014 to 193 in 2015. Hareesh Dhawale, director of the APMA program in the IRS Large Business and International Division, told reporters that the increase was the result of the January 2015 framework agreement with the Indian competent authority, which cleared the significant backlog of Indian cases that existed at the end of 2014. Dhawale said the competent authority was able to close 93 Indian MAP cases thanks to the framework agreement. (Prior coverage: *Tax Notes Int'l*, Feb. 1, 2016, p. 428.)

Dhawale also said the framework agreement with the Indian competent authority may have skewed the average processing time for cases in 2015. Many of the cases solved as a result of the agreement were some of the oldest cases in the APMA program's inventory, according to Dhawale. The average processing time for cases increased from 21.4 months in 2014 to 32.1 months in 2015.

In terms of relief from double taxation for taxpayers, Dhawale said the competent authority's success rate has been fairly stable over the past few years. ''In 2015, about 94 percent of the closed cases involved full relief of double tax, either through complete withdrawal or full correlative relief, or a combination of partial correlative relief and partial withdrawal,'' Dhawale said. The competent authority has been effective in providing full double tax relief, which is good news from the taxpayer's perspective, Dhawale added.

Dhawale also noted that there was a decrease during 2015 in the number of cases in which the total adjustment was withdrawn by the initiating tax authority or full correlative relief was provided. During 2015 those cases represented only 27 percent of the total cases resolved, while in 2014 they represented almost 59 percent.

Jennifer Best, LB&I's acting director for treaty administration, told reporters that everything has remained steady at TAIT in terms of requests, case resolutions, and inventory. ''As you can tell from our report, the overall inventory on the treaty assistance and interpretation side is a smaller inventory,'' Best said. ''Our request received and cases resolved [numbers] both went down this year. But net-net, we're holding fairly stable from last year. The requests that came in were lower, the resolution numbers were lower, and we're stable from where we were last year.''

TAIT received 52 MAP requests in 2015, compared with 68 in 2014. TAIT resolved only 22 cases in 2015, compared with 52 in 2014. Best also said the increase in average processing time, from 19.8 months to 23.3 months, was attributable to the resolution of several cases that had been in TAIT's inventory for longer than usual.

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ATM Operator Cardtronics Seeks Friendlier Tax Regime in U.K.

Cardtronics Inc., a leading global ATM owner-operator, announced a plan to move its parent company's place of incorporation from Delaware to the U.K., using the rarely invoked substantial business activities test.

Rather than relying on a transaction with an unrelated foreign company to invert, the company said in a Form S-4 filed with the Securities and Exchange Commission on April 27 that it expects to meet the requirements of section 7874's substantial business activities test, which permits the redomiciliation of companies to countries where they have significant activities.

Cardtronics said it has ''significant operations in the U.K.'' and that it will merge with one of its subsidiaries, becoming an indirect, wholly owned subsidiary of Cardtronics Group Ltd., a newly formed English public limited company, which will be renamed Cardtronics Plc.

For the Cardtronics Plc expanded affiliated group to satisfy the substantial business activities test, at least 25 percent of the employees, assets, and income of the group must be located or derived in the U.K. The test has become stricter over time, and the definition of group income for purposes of the test was clarified in temporary regulations released by Treasury on April 4. (Prior coverage: *Tax Notes Int'l*, Apr. 11, 2016, p. 142.)

Approximately 60 percent of the company's global workforce is in the U.K., according to its April 27 press release, which states that the fastest growing segments of Cardtronics are in the U.K. and continental Europe.

Though the company's Form S-4 notes a risk that there could be changes to the tax code or regulations that could result in Cardtronics Plc being treated as a U.S. corporation, the company said that after a review of the recently issued Treasury regulations (T.D. 9761,

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REG-135734-14, REG-108060-15), ''we do not expect the anti-inversion regulations or the debt regulations to adversely impact our ability to effect the merger or the expected treatment of Cardtronics PLC as a foreign corporation for U.S. federal tax purposes.''

If finalized in their current form, however, the proposed section 385 regulations could compromise the company's ability to manage its capital structure and could reduce opportunities to introduce and maintain related-party debt, the company added.

While Cardtronics' press release didn't mention tax advantages, the Form S-4 did state that the merger will allow the company to benefit from a ''territorial (versus worldwide) taxation regime'' and an extensive treaty network.

Another stated reason for the move is that it will enable Cardtronics to more effectively compete for acquisitions on a global scale. This is reflective of a familiar refrain among experts who have blamed Treasury's actions against inversions for shifting the balance of power in the mergers and acquisitions market to large foreign acquirers.

The Cardtronics merger is subject to shareholder approval and conditional on a tax opinion from Baker & McKenzie LLP.

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Stack Calls for More MNE Engagement

Treasury and the IRS are working toward a solution to the ''gap year'' problem by allowing optional country-by-country (CbC) reporting for 2016, but U.S. multinationals can help their own cause by engaging more in the global debate over corporate tax avoidance, according to Robert Stack, Treasury deputy assistant secretary (international tax affairs).

Speaking at the April 28 University of San Diego School of Law's fourth annual transfer pricing symposium, Stack said that although Treasury is committed to resolving the gap year issue, more work is needed to ensure that allowing optional CbC reporting will be effective in shielding U.S. multinationals from local filing requirements.

''What everybody has to appreciate is there's no victory [in] accepting voluntary filings if the other countries that are our partners in country-by-country [reporting] are not going to accept them as good filings and therefore obviate the need for local filing,'' Stack said.

Under the OECD's final action 13 (transfer pricing documentation) report in its base erosion and profit-shifting project, CbC reporting is required by multinationals with more than €750 million in global revenue for years beginning on or after January 1, 2016. Although reporting is generally required only in the ultimate parent's country of residence, the countries in which its subsidiaries operate can require local filing if the parent's jurisdiction doesn't require CbC reporting, hasn't agreed to automatic exchange of reports, or isn't effectively exchanging reports. Because the U.S. CbC reporting regulations (REG-109822-15) won't be in effect for years beginning January 1, 2016, U.S. multinationals may face local filing requirements in 2016.

''We are fully appreciative and accepting of the fact that the gap year problem is real, and we feel we have the responsibility to try to help solve it. And we've been working to do that,'' Stack said.

Stack previously announced that the U.S. CbC reporting regs are expected to apply for years beginning on or after July 1, 2016. (Prior coverage: *Tax Notes Int'l*, Mar. 7, 2016, p. 848.)

Regarding U.S. multinationals' overall role in the BEPS project, Stack stressed the need to understand the political environment, particularly in the context of the U.S. deferral and the Panama Papers controversy. Global tax arbitrage and the mobility of intangible property have subjected the arm's-length principle and the separate entity approach to ''enormous pressure'' around the world, and in that context, drastic changes in tax policy may arise, he said. (Prior coverage: *Tax Notes Int'l*, Apr. 11, 2016, p. 103.) Even the term ''transfer pricing'' is often used as a pejorative, according to Stack.

''If you watch the speed at which country-by-country went from nowhere to government-to-government exchanges, to now a proposal in Europe to be made public by companies, you really ought to ask yourselves what similar things could happen in [transfer pricing],'' Stack said.

On the issue of arbitrage through special tax regimes like the U.K. patent box, Stack pointed out the tension between the political backlash in Europe and European countries' role in facilitating base erosion.

''Usually the villain in transfer pricing and in BEPS [is] the multinationals, and I use the [U.K.] patent box case because I remind the world that the multinationals — and certainly not the U.S. multinationals — were not the people that put the U.K. patent box in place,'' Stack said. ''And they were certainly not the people running around to the U.S. multinational community inviting them to come use their patent box so they could do the very thing they were condemning in the BEPS project.''

''I have a very, very strong conviction that the U.S. multinational community is not engaged enough with the multinational tax debate, that the nongovernmental

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organization community is fully engaged and sets the agenda in ways that [the] multinational community does not,'' Stack said.

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Practitioners, Officials Hash Out Earnings Stripping Regs

Several of the many questions raised about the recently issued earnings stripping regulations designed to recharacterize debt as equity in some situations were addressed by a panel of Treasury officials and practitioners on April 28.

The panel, speaking at the District of Columbia Bar Association Tax Section financial products committee luncheon, discussed the bifurcation and documentation rules under the proposed section 385 regs (REG-108060-15) released April 4.

The proposed regs would generally treat related-party debt as equity unless it facilitates new net investment in the borrower's operations. While the rules were issued at the same time as section 7874 anti-inversion guidance, including T.D. 9761, the section 385 regs can apply to transactions that have no connection at all to foreign acquisitions of U.S. companies, including transactions between two foreign companies with no U.S. entities anywhere in the ownership chain. (Prior analysis: *Tax Notes Int'l*, Apr. 18, 2016, p. 215.)

The regs have four main parts: the bifurcation rule of prop. reg. section 1.385-1(d), which enables the government to divide a purported debt instrument into part debt and part stock; the documentation rules of prop. reg. section 1.385-2; the transaction rules of prop. reg. section 1.385-3, which treat issuances of new debt among some related parties as equity; and the consolidated group rules of prop. reg. section 1.385-4.

Effective Date

The section 1.385-1 and -2 regulations apply for any instrument that is issued or deemed issued after the rules are finalized. ''Deemed issued'' raises the question whether the government was limiting it to a reg. section 1.1001-3 debt modification event, which is how ''deemed issued'' is often used, said Craig J. Gibian of Deloitte LLP.

''I think that [reg. section 1.1001-3] is the most common scenario you would find in a deemed issuance, but it is not the only one,'' said Karl Walli, senior counsel (financial products), Treasury Office of Tax Legislative Counsel. ''We didn't want to write the rule so it would be so exclusive that it would only apply to [reg. section 1.1001-3],'' he said. Brett York, attorney-adviser, Treasury Office of International Tax Counsel, added that an example of another deemed issuance would be when an intercompany obligation ceases to be held within the consolidated group under reg. section 1.1502-13(g)(3).

Bifurcation Rule

Prop. reg. section 1.385-1(d) provides the government the ability to treat an instrument that is debt in form as in-part debt and in-part stock if the instrument and parties meet specific conditions, including the debt capacity of the issuer.

York said that the bifurcation rule was intended as a solution to the all-or-nothing approach developed under case law. He said that analysis of an instrument should go beyond the borrower's ability to pay and look to the substance of the interest. ''When you think about the scope of the rules, it is intended to be a rule about the substance; we think it should apply in situations where the equity features are sufficient to treat it as in-part debt and in-part stock,'' he said.

Officials were hesitant to write a rule that would only bifurcate some instruments because they didn't believe they could develop an exhaustive list of products, Walli said. If people want to make comments to suggest that some instruments lend themselves to bifurcation and others do not, the government should listen to those suggestions, he said, adding, ''We don't want too narrow of a rule, but we also don't want to draw it too wide.''

The government is trying to finalize these regulations swiftly, York said, ''so comments will be appreciated as soon as possible.''

Section 163(l) disallows an interest deduction for debt that is payable in the equity of the issuer. Answering an audience question about how to balance section 163(l) concerns on bifurcated debt, Walli said that he understood that coordination would be helpful to taxpayers in this situation. He added, ''If there is going to be a debt piece, then treat it like debt, and treat the equity piece like stock.''

The panelists made it clear that an ordering rule would be appreciated for allocating payments on bifurcated debt. The regulations don't speak to how payments should be allocated after a bifurcation, Richard Larkins of EY explained.

Gibian offered the example of an instrument that is treated as 50 percent debt and 50 percent equity; the debtor then pays 60 percent of the coupon. Is there a payment ordering concept that debt should be given priority, meaning that it is treated as the interest being paid and the default is on the equity side of the instrument, he asked.

Walli said that the government will give consideration to the concept of an ordering rule and whether it will give taxpayers selectivity by the terms of the instrument.

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Applicable Instrument and 'In Form Debt'

An applicable instrument for purposes of the regulations is any interest issued or deemed issued that is in form a debt instrument. While the basic concept of an instrument being ''in form a debt instrument'' is clear for many instruments, there are others for which the concept is not as clear. An example is a repo transaction in which the taxpayer makes a sale followed by a repurchase with a difference in value representing the time value of money. The tax code treats this as debt in form under section 1275.

On the repo transaction, Walli said, ''I think you are over-thinking this. It is not in the form of debt, it is in the form of a sale and repurchase that has been treated as debt.'' Walli also said that embedded loans in notional principal contracts are also not ''in form debt.''

Gibian asked about how taxpayers should approach instruments that are debt under statute but may or may not be debt in form, such as real estate mortgage investment conduit regular interests. Larkins also pointed out that production payments under section 636 are treated as debt under the code but not in form.

Walli and York at first shrugged at the query. Walli then said, ''That's a good question,'' and conceded that with time and help from practitioners, Treasury will be able to develop a more complete definition of things that are debt in substance but not form. ''We could think of some and weren't sure we could think of them all, and frankly it didn't seem critical to the message we were trying to send,'' Walli said.

Documentation Rules

Prop. reg. section 1.385-2 sets forth the documentation rules, including the creation of a per se presumption that if documentation isn't provided to the IRS upon request, the instrument will be treated as equity. Larkins noted that there is not guidance on how long taxpayers have to respond to such requests.

Walli said the government spent time thinking about this issue and it isn't trying to keep taxpayers who are late turning over their documents from seeking remedies. But on the other hand, Walli said he doesn't think the idea is to allow taxpayers to drag their feet through the process and provide documentation at the end.

York said one of the main objectives of the documentation rule is to ensure that the appropriate documents are available to the IRS so the analysis can be performed under federal tax principles.

Accrued Interest

Section 267 limits the interest deduction to interest actually paid. That is, if interest is only accrued — for example, it has qualified stated interest — the issuer does not take an interest deduction. Larkins asked whether a payment made after a deemed exchange can be allocated to accrued interest limited by section 267. A deemed exchange under the regulations says that with respect to the principal, the holder of the debt does not have gain or loss and the issuer does not have cancellation of indebtedness income nor a deduction.

Walli said that a taxpayer may take the interest deduction up to the accrued amount for the period the instrument was treated as debt.

Dividend Received Deduction?

Rev. Rul. 94-28 says that a taxpayer can't get a dividend received deduction on equity that has creditor rights. So if an instrument gets flipped from debt to equity under a per se rule, the equity will be equity with creditor rights. Larkins asked if the government had given thought to this issue.

''That is a really good question,'' Walli said. ''I have not thought of that.'' He said that his initial thinking was that taxpayers would treat equity as equity for all purposes, which would entitle a taxpayer to the dividend received deduction. He said he will go back and review the revenue ruling for consideration.

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TREATY WATCH

Bahrain / Morocco

Bahrain, Morocco Sign Tax Treaty Protocol

Officials from Bahrain and Morocco signed a protocol to amend their countries' tax treaty on April 22 in Manama, according to local media reports.

The protocol, which is the first amendment to the treaty, was signed by Ahmed bin Mohammed Al Khalifa, Bahraini minister of finance, and Mohamed Boussaid, Moroccan minister of economy and finance. It will enter into force after the exchange of ratification instruments.

The treaty was signed April 7, 2000, in Rabat and has been in effect since January 1, 2002.

— Iurie Lungu, Graham & Levintsa, Chisinau

Chile / Czech Republic

Czech Senate Approves Tax Treaty With Chile

The Czech Senate on April 20 approved a law on the ratification of the pending tax treaty with Chile, according to information published on the Senate's website.

The treaty was signed in Santiago on December 2, 2015. It stipulates that dividends are taxable at a top rate of 15 percent. Interest derived from loans or credit granted by banks or insurance companies is taxable at a maximum rate of 5 percent. A 15 percent rate applies in other cases. Royalties paid for the use of, or the right to use, industrial, commercial, or scientific equipment are subject to a 5 percent tax rate; in other cases, a 10 percent rate applies. Both countries generally apply the credit method to eliminate double taxation.

This is the first tax treaty between the two countries. It will enter into force once the ratification instruments are exchanged. In Chile, its income tax provisions will apply from January 1 of the year following its entry into force. If Chile begins imposing taxes on capital, the treaty's capital tax provisions will also apply from that date; if not, they will apply from January 1 of the year in which capital taxes are introduced in Chile. In the Czech Republic, the treaty will apply from January 1 of the year following its entry into force.

In the case of Chile, information to which paragraph 5 of treaty article 26 (exchange of information) applies — to the extent that it is covered by Chile's Decree Law 707, article 1, and Decree Law 3, article 154 — will be available for bank transactions carried out beginning January 1, 2010.

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Colombia / Panama

Colombia, Panama Hold Eighth Round of Treaty Talks

Officials from Colombia and Panama held an eighth round of income tax treaty negotiations in Bogota on April 13, the Panamanian government has announced.

The countries agreed in October 2014 to negotiate a tax treaty that would include information exchange provisions in line with the OECD standard. Talks began in April 2015 and have continued for several months.

Despite making progress, the two sides are reportedly deadlocked over Panama's objection to the inclusion of provisions for the automatic exchange of information. They plan to continue talks in the coming weeks.

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Czech Republic / Iran

Iran Ratifies Tax Treaty With Czech Republic

Iranian President Hassan Rouhani on April 20 signed a law on the ratification of the income and capital tax treaty with the Czech Republic, according to a government news release. The law was passed by Iran's parliament in February and approved by the country's supervisory body, the Guardian Council, in March.

The treaty, signed April 30, 2015, in Prague, is the first agreement of its kind between the two countries. It stipulates that dividends and interest are taxable at a maximum rate of 5 percent, while royalties are subject to an 8 percent tax rate. Interest paid on the credit sale of merchandise or equipment, or on a loan or credit granted by a bank, is tax exempt. Both countries generally apply the credit method to eliminate double taxation.

The treaty will enter into force upon the exchange of ratification instruments and will apply from the first day of the calendar year following entry into force.

— Larissa Hoaglund, Tax Analysts.
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Ecuador / Hungary

Hungary Authorizes Tax Treaty With Ecuador

Hungarian Prime Minister Viktor Orbán issued a decree authorizing the minister of national economy to negotiate and sign an income tax treaty with Ecuador. The decree was published in the April 13 Hungarian official gazette.

The treaty would be the first agreement of its kind between the two countries. It must be signed and ratified by both sides before entering into force.

— Sarah Carpenter, Tax Analysts.
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Estonia / Kyrgyzstan

Estonia, Kyrgyzstan Initial Tax Treaty

Officials from Estonia and Kyrgyzstan initialed a tax treaty following a second round of negotiations in Bishkek April 18-20, the Kyrgyz Ministry of Economy has announced.

The treaty, which is expected to attract foreign direct investment to Kyrgyzstan, will reportedly include provisions for the exchange of information between the countries' competent authorities.

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.
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Ethiopia / Multinational

Ethiopia's Lower House Approves Tax Treaties With 3 Countries

Ethiopia's House of People's Representatives (lower chamber of Parliament) on April 19 approved the country's pending tax treaties with Ireland, the Netherlands, and the United Arab Emirates, according to information published by the official government news agency.

Ethiopia-Ireland Tax Treaty

The Ethiopia-Ireland tax treaty was signed in Addis Ababa on November 3, 2014. It stipulates that dividends, interest, and royalties are taxable at a top rate of 5 percent. However, interest arising in a contracting state will be exempt from tax in that state, if it is derived and beneficially owned by:

- the government, a political subdivision, or a local authority of the other contracting state; or
- for Ethiopia, the National Bank of Ethiopia; and
- for Ireland, the Central Bank of Ireland or the National Treasury Management Agency.

Both countries generally use the credit method to eliminate double taxation.

The treaty will enter into force upon the exchange of ratification instruments, and its provisions will apply in Ethiopia from July 8 following its entry into force and in Ireland from January 1 following its entry into force. Ireland ratified the treaty on October 13, 2015. Ethiopia will complete the ratification process

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when the law ratifying the treaty is approved by the upper chamber of Parliament and signed by the president.

Ethiopia-Netherlands Tax Treaty

The Ethiopia-Netherlands tax treaty and exchange of notes were signed on August 10, 2012, in Addis Ababa. The treaty provides that dividends are taxable at a maximum rate of 5 percent if the beneficial owner is a pension fund or a company (other than a partnership) that is a resident of the other state and directly holds at least 10 percent of the capital of the payer company. In other cases, if the payer company is a resident of Ethiopia, the maximum tax rate is 10 percent, and if the payer company is a resident of the Netherlands, the maximum tax rate is 15 percent. Interest and royalty payments are subject to a 5 percent rate. The notes to the treaty deal with entitlement of exempt investment institutions to benefits under the treaty.

The treaty and notes will enter into force on the first day of the second month following the exchange of ratification instruments. Their provisions will apply in Ethiopia from July 8 following entry into force and in the Netherlands from January 1 of the year following entry into force. The Netherlands ratified the treaty and notes on June 14, 2015. Ethiopia will complete the ratification process when the law ratifying the treaty is approved by the upper chamber of Parliament and signed by the president.

Ethiopia-U.A.E. Tax Treaty

The Ethiopia-U.A.E. tax treaty was signed April 12, 2015, in Abu Dhabi and is the first agreement of its kind between the two countries.

The treaty will enter into force after the exchange of ratification instruments. Ethiopia will complete the ratification process when the law ratifying the treaty is approved by the upper chamber of Parliament and signed by the president.

— Iurie Lungu, Graham & Levintsa, Chisinau

European Union / San Marino

EU Council Approves San Marino Tax Agreement

The Council of the European Union has approved an agreement with San Marino to automatically exchange financial account information starting in 2017, according to an April 21 release.

Finland / Germany

Finland Ratifies Tax Treaty With Germany

Finnish President Sauli Niinistö on April 22 ratified the pending income tax treaty with Germany, according to a Finnish government release.

The treaty was signed in Helsinki on February 19.

Interest and royalty payments are taxable only in the beneficial owner's state of residence. Finland uses the credit method for the elimination of double taxation, while Germany uses a modification of the credit and exemption methods.

The treaty will enter into force 30 days after the exchange of ratification instruments, and its provisions will apply from January 1 of the year following its entry into force. Once in force and effective, it will replace the countries' existing agreement, signed in Helsinki on July 5, 1979.

— Sarah Carpenter, Tax Analysts.
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Finland / Portugal

Finland, Portugal to Sign New Tax Treaty

Officials from Finland and Portugal have successfully concluded negotiations on a new income tax treaty between their countries, the Finnish Ministry of Finance announced April 23; once signed, in force, and effective, it will replace the 1970 Finland-Portugal treaty.

Finland / Uzbekistan

2016 Protocol to Finland-Uzbekistan Tax Treaty Available

Tax Analysts has obtained the English text of the protocol, signed March 8 in Helsinki, that amends the Finland-Uzbekistan income tax treaty.

The protocol replaces the article on exchange of information and adds a new article providing for assistance in tax collections. This is the first amendment to the treaty. It will enter into force 30 days after the exchange of ratification instruments, and its provisions will apply from January 1 of the year following entry into force.

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The provisions of article 25 (exchange of information) will apply from the date of entry into force. The protocol also stipulates that its provisions will apply to information that predates its entry into force.

France / United States

France-U.S. IGA Competent Authority Arrangement Available

The French and U.S. competent authorities have signed an arrangement under the two countries' 2013 intergovernmental agreement to implement the information reporting and withholding tax provisions of the U.S. Foreign Account Tax Compliance Act.

Germany / Netherlands

Germany Approves Protocol to Tax Treaty With Netherlands

Germany's Bundesrat (upper house of Parliament) on April 22 approved the pending protocol to the Germany-Netherlands income tax treaty, according to information published by the German government.

The protocol was signed on January 11 in Berlin.

This is the first amendment to the treaty, although a memorandum of understanding signed in The Hague on October 13, 2015, entered into force on December 1, 2015. The treaty was signed in Berlin on April 12, 2012, and has been in effect since January 1, 2016.

— Sarah Carpenter, Tax Analysts.
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India / Maldives

2016 India-Maldives TIEA Available

Tax Analysts has obtained the English text of the India-Maldives tax information exchange agreement signed in New Delhi on April 11.

This is the first TIEA between the two countries. It will enter into force once ratification instruments are exchanged, and its provisions will generally apply from that date.

2016 India-Maldives Air Transport Agreement Available

Tax Analysts has obtained the English text of the air transport agreement signed between India and Maldives on April 11 in New Delhi.

The agreement, which provides for the relief from double taxation of income from aircraft operations, will enter into force on the first day of the second month following the exchange of ratification instruments. Its provisions will apply in India from April 1 following entry into force and in Maldives from January 1 following entry into force.

Italy / Switzerland

Italy Approves EOI Protocol to Tax Treaty With Switzerland

The Italian Senate (upper chamber of Parliament) on April 20 approved for ratification the pending protocol to the Italy-Switzerland income and capital tax treaty, according to information published on the Senate's website.

The protocol, signed in Milan on February 23, 2015, updates article 27 (exchange of information) to bring the treaty in line with the OECD standard on information exchange and transparency.

The protocol will enter into force upon the exchange of ratification instruments and will apply to requests made on or after that date for information relating to February 23, 2015, or later. The Swiss parliament approved the protocol on January 26.

— Sarah Carpenter, Tax Analysts.
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Italy / Turkmenistan

2015 Italy-Turkmenistan TIEA Available

Tax Analysts has obtained the English text of the Italy-Turkmenistan tax information exchange agreement signed in Rome on May 4, 2015.

This is the first TIEA between the two countries. It will enter into force once ratification instruments are exchanged, and its provisions will generally apply from that date.

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Luxembourg / Russia

Russia Clarifies 'Other Income' Article in Luxembourg Treaty

Russia's Ministry of Finance has issued a guidance letter clarifying the application of article 21 (other income) of the Luxembourg-Russia tax treaty.

In Guidance Letter 03-08-05/21033 (dated April 13), the MOF held that under treaty article 21, paragraph 1, items of income of a resident of a contracting state, wherever arising, that are not dealt with in the preceding articles of the treaty will be taxable only in that state.

However, article 21, paragraph 3, introduced by the amending protocol to the treaty, provides that items of income of a resident of a contracting state that are not dealt with in the preceding articles of the treaty, and that arose in the other contracting state, may be taxed in that other state.

The MOF therefore held that if the national legislation of a contracting state that is the source of items of income not dealt with in articles 1 through 20 of the Luxembourg-Russia tax treaty provides for the taxation of that income, that source state will have the priority right of taxation.

— Iurie Lungu, Graham & Levintsa, Chisinau

Mauritius / Ghana / Ivory Coast

Mauritius to Sign Tax Treaties With Ghana, Ivory Coast

Mauritius plans to sign tax treaties with Ghana and the Ivory Coast soon, according to a recent release by the Mauritian government.

At an April 22 meeting in Accra, Xavier-Luc Duval, deputy prime minister and minister of tourism and external communications for Mauritius, met with Ghanaian officials and urged them to accelerate the process of signing a tax treaty between their countries. Negotiations have been ongoing since 2009.

After signing several economic cooperation agreements on April 21 in Abidjan, Ivory Coast, officials from the Ivory Coast and Mauritius expect to sign a bilateral tax treaty by the end of May.

These would be the first income tax treaties between Mauritius and the respective countries.

— Larissa Hoaglund, Tax Analysts.
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Netherlands / Norway

2016 Netherlands-Norway MOU on Exchange of Information Available

Tax Analysts has obtained the text of the Netherlands-Norway memorandum of understanding on exchange of information in tax matters signed April 6 in Oslo; the MOU entered into force April 6 and applies to information regarding calendar years beginning on or after January 1, 2014.

Netherlands / Uruguay

Corrective Notes to Netherlands-Uruguay TIEA Available

Dutch and Uruguayan officials, in an exchange of notes dated February 16, 2013, agreed on corrections to errors in the English, Dutch, and Spanish versions of the tax information exchange agreement signed October 4, 2012, in The Hague. The notes will enter into force on the same date as the TIEA.

Uruguay Ratifies TIEA With Netherlands

Uruguayan President Tabaré Vázquez on March 18 promulgated Law 19,375 on the ratification of the Netherlands-Uruguay tax information exchange agreement, and related corrective notes, according to information published on the parliament's website. Law 19,375 was approved by the Chamber of Senators on March 16.

The TIEA, signed on October 24, 2012, in The Hague, is the first agreement of its kind between the two countries. It provides for the mutual exchange of information on tax matters in accordance with the OECD standard. The exchange of notes, dated February 16, 2013, corrects errors in the English, Dutch, and Spanish versions of the TIEA.

The agreement will enter into force on the first day of the second month after the exchange of ratification instruments and will apply from that date. Uruguay has completed the ratification process.

— Iurie Lungu, Graham & Levintsa, Chisinau

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Paraguay / Spain

Paraguay, Spain Revising SSA

Officials from Paraguay and Spain are finalizing the details of a revised social security agreement (SSA) between the two countries, according to an April 14 Paraguayan government release.

The existing SSA was signed June 24, 1998, and has been in effect since March 1, 2006. The revised agreement is expected to include administrative procedures for handling the paperwork of temporarily displaced workers.

— Larissa Hoaglund, Tax Analysts.
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Romania / OECD

Romania Ratifies Multilateral AEOI Agreement

Romanian President Klaus Iohannis on April 22 signed a decree ratifying the pending multilateral competent authority agreement on the automatic exchange of financial account information, according to information published on the president's website.

Romania was part of the early adopter group that signed the agreement on October 29, 2014, in Berlin. The agreement implements the automatic exchange of information standard that was developed by the OECD and the G-20 countries and published in 2014.

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

Russia / Singapore

Russia Approves for Ratification Treaty Protocol With Singapore

The Russian government on April 21 approved for ratification the pending protocol amending the 2002 Russia-Singapore income tax treaty, according to information published on the government's website.

The protocol, signed in Moscow on November 17, 2015, is the first amendment to the treaty.

The protocol amends treaty articles 2 (taxes covered), 3 (general definitions), 5 (permanent establishment), 14 (independent personal services), 18 (pensions), and 24 (nondiscrimination), as well as provisions of the protocol signed with the 2002 treaty. It also replaces articles 22 (limitation of benefits) and 26 (exchange of information).

The protocol will enter into force after the exchange of ratification instruments, and its provisions will apply in Russia from January 1 of the year following entry into force. In Singapore, its withholding tax provisions will apply from January 1 of the year following entry into force, its other tax provisions will apply from January 1 of the second year following entry into force, and the provisions of article 26 will apply for requests made on or after the date of entry into force for information relating to tax periods beginning on or after January 1 of the year following entry into force. Russia will complete the ratification process when the law on ratification of the protocol is approved by the parliament and signed by the president.

— Iurie Lungu, Graham & Levintsa, Chisinau

Russia / Ukraine

Ukraine Clarifies Tax Treatment of Royalties Under Russian Treaty

Ukraine's State Fiscal Service (SFS) has issued Guidance Letter 6047/6/99-99-19-02-02-15 (dated March 21) clarifying the application of the Russia-Ukraine tax treaty to royalties paid to a Russian resident through an agent.

The SFS noted that a nonresident's Ukrainian-source income, which includes royalties, is generally subject to corporate tax, collectible at the source of payment in Ukraine, at the rate of 15 percent, unless an applicable tax treaty provides otherwise (Tax Code article 141.4).

Under article 12 of the Russia-Ukraine tax treaty, income from copyrights and licenses (royalties) arising in a contracting state and payable to a resident of the other contracting state may be taxed in that other state. However, that income may also be taxed in the contracting state in which it arises, according to the laws of that state, but the tax collected may not exceed 10 percent of the gross income amount.

Tax Code article 103.2 states that a tax agent may independently apply a tax exemption or a reduced tax rate 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.

A person (individual or company) is considered a beneficial owner for treaty purposes if it has the right to receive the income. However, a person does not qualify as the beneficial owner, even if it has the right

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to receive the income, if it simply acts as an agent, nominal holder, or intermediary for the income.

The SFS also held, with a reference to Decision of the Ukrainian Supreme Administrative Court K/800/52155/13 (dated March 24, 2014), that the term ''beneficial owner'' should not be construed in a narrow technical sense and that its meaning should be determined in line with the purposes and tasks of a tax treaty to prevent tax evasion and abuses. According to the court, a person may be considered a beneficial owner of the specific categories of income paid from Ukrainian sources if it is not only entitled to receive that income but is also allowed to determine the subsequent economic fate of that income.

In light of the foregoing, the SFS ruled that if royalties are paid to a Russian tax resident (which is the beneficial owner of such income) through an agent, the payments won't be subject to the provisions of article 12 of the Russia-Ukraine treaty. They will be taxed in accordance with the procedure, and subject to the rate, established by Tax Code article 141.4.

— Iurie Lungu, Graham & Levintsa, Chisinau

Slovakia / United States

Slovakia-U.S. IGA Competent Authority Arrangement Available

The Slovak and U.S. competent authorities have signed an arrangement under the two nations' 2015 intergovernmental agreement to implement the information reporting and withholding tax provisions of the U.S. Foreign Account Tax Compliance Act.

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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FEATURED PERSPECTIVE

The Secrets to the Success of the Dutch Innovation Box

by Willem Bongaerts and Ivo IJzerman


Willem Bongaerts


Ivo IJzerman

Willem Bongaerts is a tax partner with Bird & Bird LLP in The Hague, the Netherlands, and Luxembourg, and Ivo IJzerman is a tax lawyer with Bird & Bird in The Hague.

In this article, the authors examine the conclusions and findings of a recent report on the Dutch innovation box, which provides for an effective corporate income tax rate of only 5 percent on the profits from self-produced, qualifying intellectual property.

The Dutch Ministry of Finance requested a study on the effects of the Dutch innovation box, which provides for an effective corporate income tax rate of only 5 percent on the profits from self-produced, qualifying intellectual property. On February 19 Dutch State Secretary of Finance Eric Wiebes, presented to the Dutch parliament the most important observations from a recent evaluation report.[1]

The Dutch innovation box has two main objectives: enhancing the business climate in the Netherlands to attract innovative, high-end companies, and stimulating research and development expenditures. The report concludes that both objectives have been met, essentially declaring the Dutch innovation box a success.

This article discusses the letter and provides some observations on the report's conclusions and findings, which are of interest, given the international debate on IP boxes.

Enhancing Business Climate

The report concludes that the innovation box contributes to the overall business climate for (foreign) investors and causes an increase of R&D activities. However, when the Dutch innovation box was introduced in 2007 (under the name ''patent box''), only France and Hungary had patent box regimes in place. The report notes that many more jurisdictions now have similar regimes.

Because the Dutch innovation box must compete with more European IP box regimes, it might be less effective at attracting new foreign investments than when it was introduced. However, abolishing the innovation box would mean the Netherlands would become less attractive to (foreign) investors, compared with other countries.

Tables 1, 2, and 3 provide a brief overview of differences in patent box regimes in Europe. The overview shows the Netherlands allows relatively many types of income in the innovation box with a relatively low tax rate.

Stimulating R&D Expenditures

The report states that the innovation box and related R&D incentives stimulate R&D expenditures in the Netherlands. For every euro lost in tax revenue as a result of the innovation box, an additional €0.54 in R&D expenditures are produced. Therefore, more R&D activities have been performed because of the

[1]Dialogic/UNU-Merit, ''Evaluation Innovationbox 2010-2012'' (2015) (in Dutch).

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Table 1. Types of Qualifying Income for Different European Patent Box Regimes

	Nether-lands	Portu-gal	Belgium	Spain	Malta	U.K.	France	Cyprus	Hun-gary	Nidwalden (Switzerland)	Luxem-bourg	Liech-tenstein
Royalties	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Capital gains	✓	✓		✓*		✓	✓*	✓	✓*	✓	✓	✓
Sales	✓		✓			✓					✓*	✓
Notional royalties	✓		✓			✓					✓*	✓

Source: Dialogic/UNU-Merit, ''Evaluation Innovationbox 2010-2012'' (2015) (in Dutch); and Lisa Evers et al., ''Intellectual Property Box Regimes: Effective Tax Rates and Tax Policy Considerations,'' 22(3) *Int'l Tax & Public Fin.* 502-530 (June 2015).
* Conditions/exceptions apply (simplified by authors).

Table 2. Types of Qualifying Intellectual Property for Different European Patent Box Regimes

	Nether-lands	Portu-gal	Bel-gium	Spain	Malta	U.K.	France	Cyprus	Hun-gary	Nidwalden (Switzerland)	Luxem-bourg	Liech-tenstein
Patents	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Supplementary protection certificates	✓**		✓			✓	✓				✓	
Software	✓*				✓			✓	✓	✓	✓	✓
Other copyrights					✓			✓	✓	✓		✓
Trademarks					✓			✓	✓	✓	✓	✓
Designs and models		✓*		✓*				✓	✓*	✓	✓	✓
Utility models											✓	✓
Secret formulas and processes	✓*			✓				✓*	✓	✓		
Know-how								✓	✓	✓		

Source: Dialogic/UNU-Merit, ''Evaluation Innovationbox 2010-2012'' (2015) (in Dutch); and Lisa Evers et al., ''Intellectual Property Box Regimes: Effective Tax Rates and Tax Policy Considerations,'' 22(3) *Int'l Tax & Public Fin.* 502-530 (June 2015).
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** Added by authors.

benefit. The government could implement rules regulating the reinvestment of the tax savings; for example, requiring investing the savings in additional R&D activities.

Using the Innovation Box

It seems that large enterprises are overly represented among users of the Dutch innovation box. Approximately 80 percent of the tax savings go to large enterprises, while those enterprises account for only 59 percent of the total R&D expenditures in the Netherlands. That might be partly explained by the fact that small and medium-size enterprises benefit from a lower tax rate because the first €200,000 of profits are subject to a 20 percent corporate income tax instead of the 25 percent imposed over that amount. SMEs thus benefit less from the innovation box. That is different for other tax incentives for innovation, which SMEs use more often (see Table 4).

The innovation box has been used for different types of innovative activities. As shown in Figure 1, the focus of almost three-quarters of all users was on product innovation, with the remainder on process and services innovation.

One topic of discussion with the tax authorities is what part of a company's total profits should be attributed to the relevant IP that will benefit from the reduced tax rate of the innovation box. One method is the per-asset method, applied in approximately 9 percent of the cases examined in the report. That method is often easy to use when selling the self-developed IP. In 25 percent of the cases, the cost-plus method, often used if R&D is not a core function of the company

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Table 3. European Patent Box Regimes (2014)

	Year of Implementation	Patent Box Tax Rate	Corporate Income Tax Rate	Treatment of Current R&D Expenditures	Treatment of Production Costs
Malta	2010	0%	35%	Nondeductible	Patent box does not apply to patent box income if R&D expenditures were deducted
Cyprus	2012	2.5%	12.5%	Net	Capitalization of production costs
Liechtenstein	2011	2.5%	12.5%	Net	Compensation
The Netherlands	2007	5%	25%	Net	Compensation
Luxembourg	2008	5.84%	29.22%	Net	Capitalization of production costs
Belgium	2007	6.8%	33.99%	Gross	No compensation
Nidwalden (Switzerland)	2011	8.8%	12.66%	Net	No compensation
Hungary	2003	9.5%	19%	Gross	No compensation
United Kingdom	2013	10%	21%	Net	Allocated to patent income
Spain	2008	12%	30%	Net	No compensation
Portugal	2014	15%	30%	Gross	Capitalization of production costs
France	2000	16.76%	35.41%	Net	No compensation

Source: Dialogic/UNU-Merit, ''Evaluation Innovationbox 2010-2012'' (2015) (in Dutch); and Lisa Evers et al., ''Intellectual Property Box Regimes: Effective Tax Rates and Tax Policy Considerations,'' 22(3) *Int'l Tax & Public Fin.* 502-530 (June 2015).

Table 4. SMEs' Share in Tax Incentives and R&D Expenditures

	WBSO/RDA Budget (2014)	Innovation Box Benefits	Total Tax Incentives Related to Innovation	Total R&D Expenditures (2013)
Total (in € millions)	1,035	742	1,777	7,095
Share of SMEs	67%	17%	46%	41%

Source: Letter from State Secretary of Finance Eric Wiebes to Dutch parliament (Feb. 19, 2016).

involved, was used. If the R&D is a core function, the specific allocation or peeling method is used. In that method, the earnings before interest and taxes (EBIT) will be allocated to the specific functions in the company (peeling the EBIT, so to speak), leaving the residual profits to the R&D (see Figure 2).

Entry Ticket

To benefit from the Dutch innovation box, taxpayers must have either a patent (including plant breeder's rights) or an R&D certificate. In addition to providing access to the innovation box, the R&D certificate provides reduced wage tax benefits. In short, the R&D certificate was available for four types of projects in the evaluation period (2010-2012):

a) development of new technical products, processes, or software;

b) technical scientific research;

c) an analysis of the technical feasibility of the company's own R&D project; and

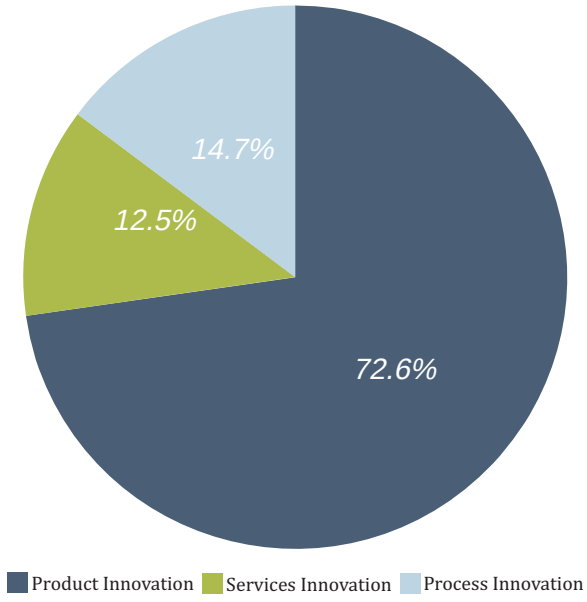
d) technical research intended to improve physical production process or software used by the company.

As of January 1, 2016, the R&D certificate is no longer available for the types of products mentioned in items c) and d).

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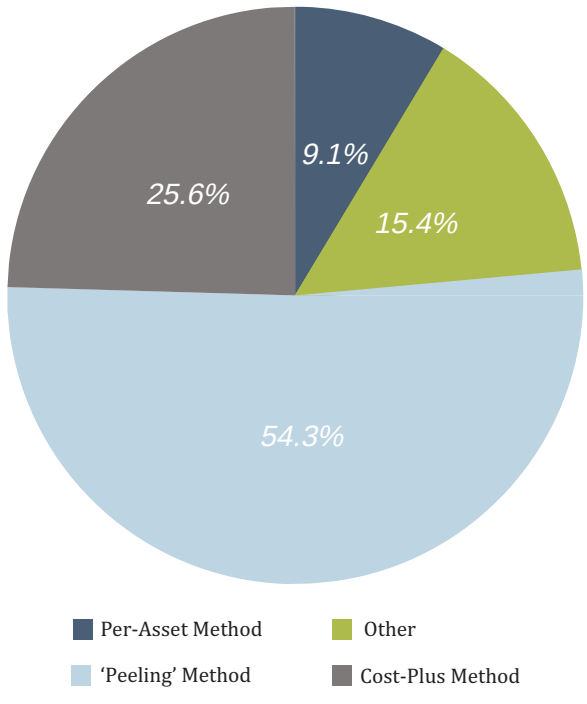
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Figure 1. Innovation-Related Activities by Innovation Box Users



Source: Dialogic/UNU-Merit, "Evaluation Innovationbox 2010-2012" (2015) (in Dutch).

Figure 2. Calculation Methods — Innovation Box

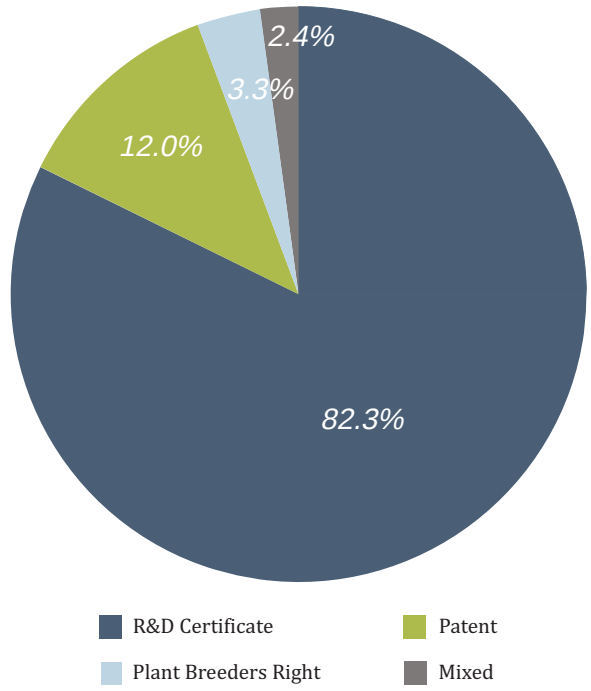


Source: Dialogic/UNU-Merit, "Evaluation Innovationbox 2010-2012" (2015) (in Dutch).

A Dutch company can apply for an R&D certificate only if it organizes and implements the R&D activities itself, the technological development is new to that organization, there are technical bottlenecks in the development, and the R&D work will take place in the future.

Remarkably, 82.3 percent of taxpayers benefiting from the innovation box predominantly use an R&D certificate as a ''ticket'' into the box, and only 12 percent predominantly use patents (see Figure 3).

Figure 3. Basis for Innovation Box as Percentage of Total (2010-2012)



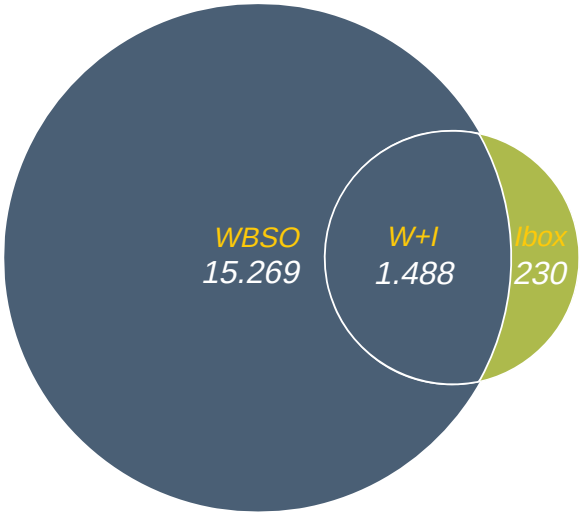
Source: Dialogic/UNU-Merit, "Evaluation Innovationbox 2010-2012" (2015) (in Dutch).

The report also explains the size of the use of R&D certificates as a way into the innovation box. The researchers interviewed taxpayers benefiting from the innovation box, with 58 percent of respondents saying they used the R&D certificate because it covers activities for which no patent can be obtained. Thirty-one percent said patents are not a desirable means of protecting IP (for example, because the knowledge concerned would become public or the application process is too expensive). Approximately 80 percent of respondents, regardless of the size of their respective companies, expect the tax savings stemming from use of the innovation box will decline if the R&D certificate would no longer grant access to the box (see Figure 4).

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Figure 4. Interaction Between the Use of Innovation Box and R&D Certificates With Entrepreneurial Groups



Source: Dialogic/UNU-Merit, "Evaluation Innovationbox 2010-2012" (2015) (in Dutch); and Dialogic research based on 2012 data from the Dutch Central Bureau for Statistics (2015).

The interaction between the use of R&D certificates and the innovation box is depicted in the above overview. A small number of companies uses only the innovation box and a somewhat larger group combines the innovation box with R&D certificates. The 230 companies that use only the innovation box are mostly smaller companies (53 percent have 0-5 full-time equivalent employees). Most taxpayers, however, use only R&D certificates.

Future Implications

Because the R&D certificate is widely used by taxpayers as a ticket to the innovation box and because some taxpayers cannot or do not want to obtain a patent (which would be the alternative), the report recommends maintaining the R&D certificate as a ticket to the box as much as possible. We agree, because we fail to see why R&D resulting in a patent would be eligible for the innovation box and R&D from an R&D certificate would not. It could be claimed that the R&D certificate focuses more on the actual R&D work and effort put into the IP than the patent does (which mainly considers the output).

However, in action 5 of its base erosion and profit-shifting project, the OECD agreed that certificates similar to the R&D certificate can grant innovation box access only to companies that are part of a group with a maximum global groupwide turnover of €50 million that do not themselves earn more than €7.5 million annually in gross revenues from all IP assets (using a five-year average for both calculations). Because larger companies also use the R&D certificate as a ticket to the innovation box, the box will likely become less available for those companies.

We are pleased that for at least some entities the R&D certificate will still provide access to the innovation box. In our view, however, action 5 should not have limited the use to SMEs. Wiebes acknowledged that the BEPS rules have that limitation, saying he intends to hold a consultation in the second quarter of 2016 to discuss the implementation of the agreements following from the BEPS project regarding the innovation box.

Patents and software would still be eligible for the innovation box under the BEPS agreements, for both large and smaller companies. In the Netherlands, the innovation box is open only to corporate entities. It may well be that the new proposals will include the same benefits for private individuals with an innovative enterprise. That may further boost the application of the innovation box and R&D-related activity.

A second recommendation made in the report is to regulate the spending of tax savings related to the innovation box. For example, taxpayers could be required to reinvest the savings in R&D-related activities. The report points out, however, that measures will be difficult to implement, because the innovation box is tied to R&D proceeds rather than costs.

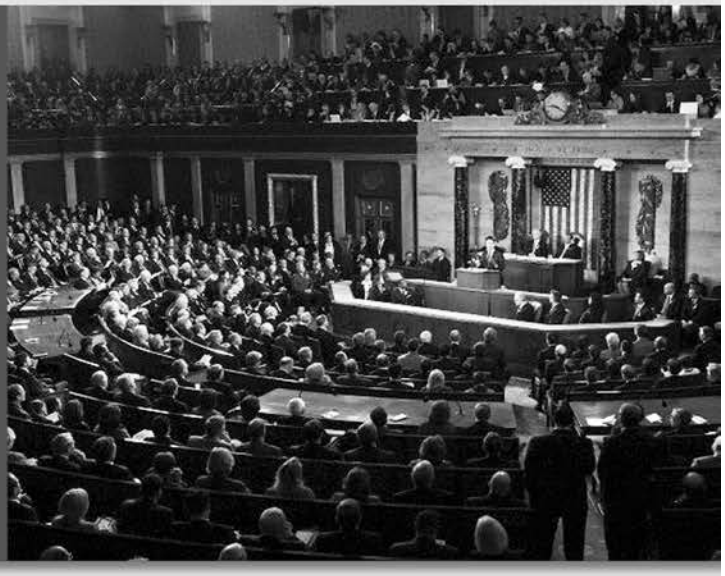
Other recommendations relate to reducing complexity of and enhancing the administration of the use of the innovation box. Although the tax authorities are accessible and helpful and information is generally well stored, there are more improvements that can be achieved. We welcome amendments in that direction.

On September 20 — budget day — at the latest, the Dutch government will announce its proposals to amend the innovation box. The Dutch Association of Tax Advisors (de Nederlandse Orde van Belastingadviseurs) has already commented on this topic. In a March 15 letter, the association suggested that it would be better to have clarity before budget day. It said it is in favor of announcing the Dutch position before June 30, when BEPS action 5 enters into force. We agree with the advisers. ◆

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FEATURED PERSPECTIVE

Examining the Proposed U.S. Country-by-Country Reporting Regs

by Lewis J. Greenwald and Lucas Giardelli


Lewis J. Greenwald


Lucas Giardelli

Lewis J. Greenwald is a partner and Lucas Giardelli is an associate with Mayer Brown LLP in New York.

In this article, the authors provide an overview of the proposed country-by-country reporting regulations and discuss some potential problems that its implementation could present for U.S. taxpayers.

In February 2013 the OECD released a report identifying the need for a comprehensive global action plan to address base erosion and profit shifting by multinational enterprises. Less than three years later, on December 23, 2015, the U.S. Treasury proposed the first set of BEPS-related regulations (REG-109822-15) on country-by-country (CbC) reporting.

This article reviews the OECD's recommendations on CbC reporting, then provides an overview of the proposed U.S. regulations, discussing questions and potential problems that their implementation might present for U.S. taxpayers.

Background: BEPS Action 13

In July 2013 the OECD and G-20 countries released a 15-point action plan to address BEPS. The plan called for a reexamination of transfer pricing documentation (action 13). More specifically, action 13 called for the development of:

> Rules regarding transfer pricing documentation to enhance transparency for tax administrations, taking into consideration the compliance cost for business. The rules to be developed will include a requirement that MNEs provide all relevant governments with needed information on their global allocation of income, economic activity and taxes paid among countries according to a common template.

On October 5, 2015, the OECD issued its final report on action 13.[1] The report contains a complete rewrite of Chapter V of the OECD transfer pricing guidelines addressing documentation, with three objectives for transfer pricing documentation:

- to ensure that taxpayers give appropriate consideration to transfer pricing requirements in establishing prices and other conditions for transactions between associated enterprises and in reporting the income derived from those transactions in their tax returns;
- to provide tax administrations with the information necessary to conduct an informed transfer pricing risk assessment; and
- to provide tax administrations with information useful in conducting an appropriately thorough audit of the transfer pricing practices of entities subject to tax in their jurisdiction — although it might be necessary to supplement that documentation as the audit progresses.

[1]The OECD also released an interim report (Sept. 16, 2014).

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To meet those objectives, new Chapter V provides that countries should adopt a standardized approach to transfer pricing documentation — a three-tiered structure consisting of:

- A master file containing standardized information relevant to all MNE group members (the master file generally includes disclosure of the group's organizational structure, a description of the business and a brief functional analysis, a description of intangible and financing arrangements, the consolidated financial statements of the group, and a list of existing tax rulings and advance pricing arrangements).
- A local file referring specifically to material transactions by the local taxpayer.
- A CbC report containing information regarding the global allocation of the MNE's income and taxes together with specific indicators of the location of economic activity within the MNE group. The CbC report also requires a listing of all the constituent entities (defined below) for which financial information is reported, including the tax jurisdiction of incorporation if different than the tax jurisdiction of residence, as well as the nature of the main business activities carried out by that constituent entity.[2]

Annex III to Chapter V contains the model template for the CbC report, shown in the figure.

The Proposed Regulations

In response to the final action 13 report, the U.S. Treasury issued the proposed regulations to require annual CbC reporting by U.S. persons that are the ultimate parent entity of an MNE group. Given that the IRS is still developing the form for CbC reporting, this form has yet to be officially numbered and is referred to in the proposed regulations as ''Form XXXX.''

According to the preamble to the proposed regulations, Treasury determined it was appropriate to use the OECD's model template as a guide for Form XXXX because the template had been created ''taking into account extensive consultations with stakeholders, including in particular U.S. MNE groups, in order to appropriately balance the benefits to tax administrations of collecting the information about an MNE group's global operations against the compliance costs and burdens imposed on MNE groups.'' The preamble also notes that Treasury believes the model template reflects an agreed international standard for reporting by MNE groups that will promote consistency in reporting obligations across tax jurisdictions and reduce the risk of other countries imposing inconsistent and overlapping reporting obligations on U.S. MNE groups. In fact, Form XXXX is an exact replica of the template proposed by the OECD in its final action 13 report.

Proposed Effective Date

Under the proposed regulations, the new CbC reporting obligations would apply to tax years of parents of U.S. MNE groups that begin on or after the date of publication of the final regulations and that include annual accounting periods of all foreign constituent entities and tax years of all domestic constituent entities beginning on or after that date.[3] This is one of the most controversial aspects of the proposed regulations.

Even if the proposed regulations are finalized by June 30, 2016,[4] the 2017 tax year will be the first filing year for U.S. MNEs. As such, the first U.S. CbC reports will have to be filed on or before September 17, 2018.

The OECD recommended that countries impose CbC reporting effective for tax years beginning on or after January 1, 2016, and, indeed, several foreign jurisdictions have implemented CbC reporting effective as of that date. Further, many of those foreign CbC reporting regimes include the OECD-recommended secondary reporting rule under which a subsidiary might have an obligation to file a CbC report when the ultimate parent company is not required to file in its jurisdiction. Under the OECD recommendation, that secondary rule could be accompanied by the possibility to appoint a surrogate parent entity to prevent the need for widespread filing in multiple jurisdictions (although some countries may choose not to legislate the option for surrogate filing, or to legislate surrogate filing in a manner that differs from the OECD recommendations).

As a result of that timing mismatch, a U.S. MNE group may be required to file a CbC report for tax year 2016 in the jurisdictions of one or more of its subsidiaries by reason of not being required to file for that year in the United States, the jurisdiction of the ultimate parent. At a minimum, this means that U.S. MNE groups must engage in the costly exercise of examining the applicable CbC reporting requirements in each country where they operate. Further, U.S. MNE groups will need to ensure that any CbC report they are required to file for tax year 2016 in a foreign jurisdiction complies with local legislation, which could

[2]Annex IV to Chapter V also contains a CbC reporting implementation package, which includes:

- model legislation that can be used by countries to require the ultimate parent entity of an MNE group to file the CbC report in its jurisdiction of residence, including backup filing requirements; and
- three model competent authority agreements that are to be used to facilitate implementation of the exchange of CbC reports.

[3]Prop. U.S. Treas. reg. section 1.6038-4(i).

[4]*See* Ryan Finley, ''Treasury Expects to Finalize CbC Regs by June 30,'' *Tax Notes Int'l*, Mar. 7, 2016, p. 848.

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Model Template for CbC Report

Name of the MNE group:
Fiscal year concerned:
Currency used:

Tax Jurisdiction	Revenues			Profit (Loss) before Income Tax	Income Tax Paid (on Cash Basis)	Income Tax Accrued — Current Year	Stated Capital	Accumulated Earnings	Number of Employees	Tangible Assets other than Cash and Cash Equivalents
	Unrelated Party	Related Party	Total							

Name of the MNE group:
Fiscal year concerned:

Tax Jurisdiction	Constituent Entities Resident in the Tax Jurisdiction	Tax Jurisdiction of Organization or Incorporation if Different from Tax Jurisdiction of Residence	Main Business Activity(ies)												
			Research and Development	Holding or Managing Intellectual Property	Purchasing or Procurement	Manufacturing or Production	Sales, Marketing or Distribution	Administrative, Management of Support Services	Provision of Services to Unrelated Parties	Internal Group Finance	Regulated Financial Services	Insurance	Holding Shares or Other Equity Instruments	Dormant	Other[1]
	1.														
	2.														
	3.														
	1.														
	2.														
	3.														

Source: OECD/G-20 Base Erosion and Profit Shifting Project, "Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 — 2015 Final Report" (2015).

result in the need to prepare different reports (for example, to account for differences in currencies or definitions). Finally, there is some concern that the filing by a U.S. MNE group in the jurisdiction of one of its subsidiaries for tax year 2016 could set a precedent that results in the group being required to file in that same jurisdiction in subsequent tax years, even after the proposed regulations come into force.

The concern with U.S. MNE groups being required to file their CbC reports in their subsidiaries' jurisdictions goes well beyond the mere administrative inconvenience. Importantly, when filing CbC reports in foreign jurisdictions, U.S. MNE groups run the risk of forgoing the confidentiality guaranteed under U.S. exchange of information agreements, as discussed below.

It is reasonable to assume that the OECD's secondary reporting rule was not intended to apply when, as in the case of the United States, the parent's jurisdiction has merely taken longer to implement the requirement than the OECD's recommended timeline. Indeed, jurisdictions such as Australia have already indicated that they will grant an exemption for the first year of reporting if a parent jurisdiction is still in the process of implementing its CbC reporting regime.[5] However, other jurisdictions may not provide similar exemptions.

[5]"Delay in Country-by-Country Reporting Rules Incites Backlash," BNA *Daily Tax Report*, 09 DTR G-5.

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For example, it has been reported that France will not provide relief to address the timing gap.[6]

U.S. MNE groups had hoped Treasury would allow taxpayers to make an election to file CbC reports with the IRS for the 2016 gap year to safeguard against filing requirements from their subsidiaries' jurisdictions. Although Treasury initially indicated it was considering that possibility, the IRS seems to have ruled it out, noting that the government does not have the technical capability to begin transmitting reports in time.[7]

U.S. Persons Required to File Form XXXX

In general, the proposed regulations require every U.S. person that is the ''ultimate parent entity of a U.S. MNE group'' to make an annual return on Form XXXX for each annual accounting period.

That said, prop. U.S. Treas. reg. section 1.6038-4(h) provides that a U.S. person that is an ultimate parent entity of a U.S. MNE group is not required to file Form XXXX if the group's annual revenue for the preceding annual accounting period was less than $850 million. The OECD set the reporting threshold at €750 million in overall annual revenue, and the United States, as well as many other jurisdictions that have implemented CbC rules, translated that figure into its own currency. That could present an issue because currency markets fluctuate, possibly resulting in corporations that are close to the threshold to be required to file in some jurisdictions but not others.

In general, an ultimate parent of a U.S. MNE group is a U.S. business entity that controls a group of business entities (at least one of which is organized or tax resident outside the United States), that are required to consolidate their accounts for financial reporting purposes under U.S. generally accepted accounting principles, or that would be required to do so if equity interests in the U.S. business entity were publicly traded on a U.S. securities exchange.[8]

The preamble to the proposed regulations requests comments regarding the procedures a taxpayer should follow to demonstrate a national security reason to be excepted from filing some or all of the information required by the CbC report. The OECD guidance did not contemplate any exception for national security reasons. That statement in the preamble refers to concerns raised by some U.S. MNEs that CbC reports would put into the hands of foreign nations information regarding the location of the facilities, operations, and personnel of U.S. defense contractors.[9]

Information Required by Form XXXX

Form XXXX requires that specific information be provided for each constituent entity, defined as any separate business entity of a U.S. MNE group. The term does not include a foreign corporation or partnership for which the ultimate parent entity is not required to furnish information under IRC section 6038(a) or any permanent establishment of that foreign partnership or corporation. In general, that means information will be required for each legal entity (or, in some cases, PE) the U.S. parent controls.

The following information for each constituent entity of the group must be reported on Form XXXX:

- the jurisdiction, if any, in which the constituent entity is resident for tax purposes;[10]
- the jurisdiction in which the constituent entity is organized or incorporated (if different from the tax jurisdiction of residence);
- the tax identification number, if any, used for the constituent entity by the tax administration of the entity's tax jurisdiction of residence; and
- the constituent entity's main business activity or activities.

Form XXXX also requires the reporting of specific financial and employee information for each tax jurisdiction in which at least one constituent entity is resident (to be reported on an aggregate basis, per tax jurisdiction)[11]:

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[6]''France: No Deadline Break on Reporting by U.S. Companies,'' BNA *Daily Tax Report*, 19 DTR I-1.

[7]*Supra* note 4.

[8]*See* prop. reg. section 1.6038-4(b)(1)-(2).

The preamble acknowledges that the definition may need refinement. Guidance should be provided to address situations in which U.S. GAAP or securities exchange regulations may require consolidation for reasons other than majority ownership and when they may permit separate financial accounting for a majority-owned company.

The regs define a business entity as a person that is not an individual and includes any entity that has a single owner and is disregarded as a separate entity from its owner. The term also includes a business establishment treated as a permanent establishment under an income tax convention to which the jurisdiction where it is located is a party, or that would be treated as a PE under the 2014 OECD Model Tax Convention on Income and on Capital and that prepares financial statements separate from those of its owner for financial reporting, regulatory, tax reporting, or internal management control purposes.

[9]*See* letter from Remy Nathan of the Aerospace Industries Association expressing concerns regarding CbC reporting (Aug. 5, 2015).

[10]A business entity is considered resident in a tax jurisdiction if, under the laws of that jurisdiction, it is liable to tax there based on its place of management or organization, or other similar criterion. However, a business entity will not be considered resident in a tax jurisdiction if it is liable to tax there solely on income from sources there or capital situated there. The proposed regulations also provide rules for determining the tax jurisdiction of a business entity that is resident in more than one jurisdiction or that is a PE. *See* prop. reg. section 1.6038-4(b)(6).

[11]This information must also be provided, in the aggregate, for any constituent entity or entities that have no tax jurisdiction of residence.

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- revenue[12] generated from transactions with other constituent entities;
- revenue not generated from transactions from constituent entities;
- profit or loss before income tax;
- total income tax paid on a cash basis to all tax jurisdictions, and any taxes withheld on payments received by the constituent entities;
- total accrued tax expense recorded on taxable profits or losses, reflecting only operations in the relevant annual accounting period and excluding deferred taxes or provisions for uncertain tax liabilities;
- stated capital of all the constituent entities, except that the stated capital of a PE must be reported by the legal entity of which it is a PE unless there is a defined capital requirement in the PE tax jurisdiction for regulatory purposes;
- total accumulated earnings, except that accumulated earnings of a PE must be reported by the legal entity of which it is a PE;
- total number of employees on a full-time equivalent basis[13] in the relevant tax jurisdiction; and
- net book value of tangible assets other than cash or cash equivalents.

All of those amounts must be expressed in U.S. dollars and should be based on applicable financial statements, books, and records maintained for the constituent entity, or records used for tax reporting purposes.[14]

Although U.S. taxpayers must already report much of the information required by Form XXXX (for example, on IRS forms 5471, 8858, and 8865), that is not true for every item of information listed above. As such, U.S. MNEs will need to update their systems and processes to ensure they are able to gather, compile, and aggregate the information required by the proposed regulations.

For example, under the proposed regulations, Form XXXX requires taxpayers to specify for each constituent entity the tax residency jurisdiction (even if different from its jurisdiction of incorporation) and the amount of income tax paid on a cash basis to all jurisdictions (including via withholding on payments received). That information is not required by existing IRS forms. Likewise, the CbC report requires that taxpayers inform the number of employees of each constituent entity, information also not currently reported to the IRS. Finally, even though taxpayers generally report their revenue from transactions with related parties under Schedule M of forms 5471 and 8858 and Schedule N of Form 8865, the CbC report may require accounting for some transactions that are otherwise not reported on those schedules (for example, transactions between a disregarded entity and its regarded owner).

Reporting of Fiscally Transparent Entities

As noted above, because the proposed regulations provide CbC reporting for business entities, entities that are disregarded for U.S. tax purposes must be separately identified. However, for entities treated as fiscally transparent in their residence jurisdiction, the financial items of the CbC report (for example, revenues, profits before taxes, and taxes) flow through to its owners or partners and are reported at their level (even if the entity is treated as a corporation for U.S. tax purposes).[15]

Employees of the transparent entity are not necessarily allocated to its owners or partners. Instead, it appears that employees should still be reported in the jurisdiction in which they perform their services (which may be the jurisdiction of organization of the fiscally transparent entity). Various other questions remain regarding partnership reporting — for example, should cash remittances from a partnership be excluded from the partner's reported revenue?

Time and Manner for Filing; Records Maintenance

The OECD recommended that companies be given a year after the end of their fiscal year to file their CbC reports. The proposed regulations provide, however, that Form XXXX will be filed with the ultimate parent's income tax return for the tax year on or before the due date (including extensions) for filing that person's income tax return. As such, for a calendar-year taxpayer, the CbC report would need to be filed by mid-September at the latest, rather than December 31, as recommended by the OECD. That poses a practical

[12]For this purpose, the term ''revenue'' includes all revenue, including from sales of inventory and property, services, royalties, interest, and premiums. It does not include payments received from other constituent entities that are treated as dividends in the payer's tax jurisdiction of residence. *See* prop. reg. section 1.6038-4(d)(3)(ii).

[13]The number of employees on a full-time basis may be reported as of the end of the accounting period, on the basis of average employment levels for the annual accounting period, or on any other reasonable basis consistently applied across tax jurisdictions and from year to year. Independent contractors participating in the ordinary operating activities of a constituent entity may be reported as employees of that entity. Reasonable rounding or approximation of the number of employees is permissible, provided that that rounding or approximation does not materially distort the relative distribution of employees across the various tax jurisdictions. *See* prop. reg. section 1.6038-4(d)(3)(iii).

[14]The proposed regs define an applicable financial statement as a certified audited financial statement accompanied by a report of an independent CPA or similarly qualified independent professional that is used for purposes of reporting to shareholders, partners, or similar persons; for purposes of reporting to creditors in connection with securing or maintaining financing; or for any other substantial nontax purpose.

[15]That said, the preamble questions whether a different rule is needed for entities that are not fiscally transparent in the owner's residence jurisdiction but are fiscally transparent in the entity's country of organization — that is, reverse hybrid entities.

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problem for companies intending to use their statutory accounts to prepare the CbC report, which will likely not be available nine months after the close of the tax year. Ultimately, if the proposed regulations are finalized in their current form, most U.S. MNE groups will be forced to use consolidated financial data instead of their statutory accounts as the OECD intended.

Taxpayers filing Form XXXX must maintain records to support the information on the form. However, the proposed regulations clarify that taxpayers are not required to maintain records that reconcile the amounts reported on Form XXXX with tax returns of any tax jurisdiction or applicable financial statements.

Penalty and Potential Limitations Extension

The proposed regulations do not impose penalties for a taxpayer's failure to report. However, because the rules will be promulgated under section 6038, the IRS will likely impose the penalty of that section on taxpayers that fail to file a CbC report in accordance with the regulations.

Further, the failure to file a CbC report will likely extend the statute of limitations for the assessment of taxes under section 6501(c)(8), which provides that the statute remains open when a taxpayer fails to file any information under section 6038 (subject to the reasonable cause exception).

No Master File Requirement

The proposed regulations do not require the master file described in the final action 13 report. However, if the U.S. MNE group is required to file a master file with a foreign jurisdiction, it is expected that the IRS might require that file in an audit.

Confidentiality

The information required by the proposed regulations constitutes return information under section 6103. Section 6103(k)(4) allows the IRS to exchange return information with a competent tax authority to the extent provided in, and subject to the terms and conditions of, an information exchange agreement. The U.S. competent authority is expected to enter into competent authority arrangements for the automatic exchange of CbC reports under the authority of information exchange agreements to which the United States is a party. Information exchange agreements contain several safeguards to protect confidentiality (for example, foreign tax jurisdictions are not permitted to further disclose the information received under the agreement or use it for any nontax purpose).

Conclusion

CbC reporting will certainly not be the death knell for aggressive international tax planning. Further, existing U.S. reporting obligations already require U.S. taxpayers to report most of the information that would be included on the new CbC form. That said, Form XXXX will provide the IRS with information on an aggregate, jurisdiction-by-jurisdiction basis, together with other key information that is not currently readily available or apparent (for example, number of employees in each jurisdiction and tax residence of the subsidiaries). As such, it is expected that CbC reporting, coupled with the automatic exchange of information with other jurisdictions, will make MNEs' international tax planning strategies more visible to tax authorities. ◆

Crossword Puzzle Solution



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DATELINE: DEUTSCHLAND

Germany's 3 Great Tax Reforms

by Manfred Mössner

Manfred Mössner is a tax consultant at PwC and was formerly the director of the Institute of Finance and Tax Law at the University of Osnabrück.

In this article, the author discusses Germany's efforts to reform its inheritance tax, modernize its tax assessment system, and overhaul the taxation of investment funds.

Recent discussions in Germany have been dominated by the refugee crisis. But beyond that controversial debate, there are important developments in the tax field. The federal government has begun the legislative process on three major reforms.

First is the reform of the inheritance tax. (Prior coverage: *Tax Notes Int'l*, Sept. 14, 2015, p. 949.) After the restrictive proposal of Finance Minister Wolfgang Schäuble, the government decided to provide more generous tax advantages to the heirs of enterprises, which led to further deliberation in the Bundestag (lower house of parliament). During those deliberations, lobbyists pushed for further changes. Finally, a group of the three parties forming the government was established to find a solution.

After several months a compromise was reportedly found, but it is still unknown to the public. Even the ''Big Four'' accounting firms — normally well informed — have no access to the document. Surprisingly, the Bavarian state government, though part of the group that brokered the compromise, declared it unacceptable. One may assume that it wants more exceptions of taxation for the heirs of enterprises. The Federal Constitutional Court (Bundesverfassungsgericht, or BVerfG) set a deadline of June 30, 2016, for the legislature to enact a new law. If the new law is not in force before that date, it is unclear what will happen. There are three possibilities:

- Nothing will happen, and the old law will remain in force.
- The old law will be in force except for the sections containing the advantages for enterprises, so the heirs of enterprises would be taxed without any tax advantage.
- There will be no inheritance tax after that date. Since the BVerfG found the old law unconstitutional because of its advantages for the heirs of enterprises, the legislature must reduce those advantages or provide similar advantages to all heirs. Many German scholars predict the only possible outcome is that there will be no law on inheritance tax after June 2016.

Perhaps it is the goal of the Bavarian government to reach such a solution. Looking at the timetable of the legislative process with the involvement of the Bundestag and Bundesrat (upper house of parliament), it takes at least eight weeks to bring a new law into force. That means that any final decision must be made by early May.

Tax Assessment Modernization

The second project is the modernization of the tax assessment. Germany has no system of self-assessment — except a rudimentary form in turnover taxes. Normally the taxpayer files a declaration, which is controlled by the tax administrators, and a rescript of taxation (Steuerbescheid) is issued by the tax administration.

The plan is that taxpayers will file an electronic document that will be assessed according to risk management programs. It is hoped that more than 90 percent of tax assessments will be finalized electronically without any human intervention — and less than 10 percent handled by tax administrators. The goal is to use personnel resources more efficiently. This is a reaction to the fact that the costs of assessment are too high and the general population is decreasing.

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Fundamental principles of the tax procedures will need to be changed, and there are still many questions. For example: How to guarantee that the person who sends the electronic declaration is really the taxpayer? Is the electronic program compatible with the principle of legality and equality? The tax administration needs all information in the new system from employers, banks, and social security agencies. How can protection of data be guaranteed? What is the legal nature of an electronic administrative act?

To secure the working of the new system, the government proposes severe punishment if taxpayers fail to file. Some years ago the tax administration introduced the electronic tax declaration (Elektronische Steuererklärung, or ELSTER). There were many technical problems early on, and it took some years to solve them. It is still not possible to correspond with the tax administration via email.

Investment Funds

The third project concerns a complete change to the taxation of investment funds. The current law treats an investment fund as a transparent entity. It is in principle not the funds but the investor in the funds who is the taxable person. This gave rise to many problems involving tax avoidance structures and aggressive tax planning. Moreover, the Court of Justice of the European Union in *Rita van Caster and Patrick van Caster v. Germany*, C-326/12 (CJEU 2014), held that Germany's treatment of investment funds was incompatible with EU law as far as cross-border investment is concerned. A reform is, therefore, unavoidable.

On December 16, 2015, the Ministry of Finance published a draft reform for public discussion. The main new approach would treat investment funds as ''semitransparent.'' As long as the income of the funds is not distributed to the investors, the investors would not be taxed. The fund itself must only tax income derived from dividends, interest, and rental activities. The subject is highly complicated. Funds in Germany total more than €2 trillion. Later this year, the MOF plans to evaluate all points in the discussion, and the government's decision will follow. A final draft could be published in October.

Other Items on the Agenda

Regarding the OECD's base erosion and profit-shifting project, Germany must evaluate its tax laws for whether tax system changes are necessary. As far as controlled foreign corporation rules, hybrid financial instruments, transfer pricing, and interest deductions are concerned, it is largely agreed that Germany need not do anything because it is already in compliance with OECD demands. Only the country-by-country (CbC) reports require action by the legislature, which is discussing whether enterprises beyond a given threshold should publish their CbC reports on the Internet. It is hoped that a first draft will be available before the parliament's summer holidays.

In recent months, the Federal Tax Court (Bundesfinanzhof, of BFH) has published some interesting and important judgments. Perhaps the most important concerns the deductibility of interest. When the CJEU declared the former thin capitalization rule incompatible with EU law (*Lankhorst-Hohorst*, C-324/00 (CJEU 2002)), Germany began limiting interest deductions. Interest is deductible only to the extent that the taxpayer receives interest from investments and up to 30 percent of earnings before interest, taxes, depreciations, and amortization. If the interest paid by the taxpayer is lower than €3 million per year, the interest is fully deductible.

The BFH now finds that these rules are unconstitutional and referred the case to the BVerfG (I R 20/15, Oct. 14, 2015). Whether or not it is a constitutional principle, income taxation is based on the taxation of net income. The nondeductibility of interest paid for business purposes violates this fundamental rule of income taxation and must be justified under the equality principle of the constitution (article 3 of the German Constitution). The court discusses several possible justifications, but none is — according to the court — able to justify the exception of the principle of taxation of the net income.

The interest deduction limitation was introduced when the tax rates declined. But that is not a justification for the limitation, because less than 1 percent of the enterprises are touched by the limitation, and the lower tax rates apply to all enterprises. It seems that the court would have accepted if a limitation for all enterprises corresponded to the lower tax rates. The main purpose of the limitation could be seen in the prevention of abusive constructions in cross-border financial arrangements. But the limitation also relates to purely domestic cases and does not concern financial arrangements with interest paid of less than €3 million, which surely are abusive. It is now up to the BVerfG to decide whether the interest deduction limitation is constitutional. This decision — to be expected within two or three years — is of special importance because the OECD in BEPS action 4 and the European Commission (article 4 of the draft anti-tax-avoidance directive, COM(2016) 26 final (Jan. 28, 2016)) propose the same rule of limiting interest deductions. What will happen if the BVerfG decides that the German rules are not compatible with the German Constitution? Action against hybrid financing is one of the central points of BEPS.

Treaty Overrides

On January 10, 2012, the BFH referred a case to the BVerfG concerning treaty overrides. According to article 59 of the German Constitution, Germany's international treaties need the consent of the legislative bodies by an act of legislation. The traditional interpretation of this article is that international treaties have

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the same position as the other acts of parliament within the hierarchy of sources of law. This means that the legislature may overrule a given stipulation of the treaty in force by a later internal legislative act, which results in a treaty override.

The tax administration requested the legislature in recent years to make more use of the treaty override when finding that the rule of a double tax agreement does not fit into German tax policy. Klaus Vogel, the famous late tax professor, argued that the German Constitution made a decision for international cooperation and that treaty overrides violate this fundamental decision. This started a discussion among scholars. A majority followed Vogel finally.

One of the arguments is that a treaty is a law-creating process, involving at least two states and their legislatures. It is the cooperation of these legislatures that creates the treaty law. Therefore, a single legislature has no power to cancel or modify the treaty law with effect to domestic law. The BVerfG on December 15, 2015 (published in February 2016), did not follow this new approach but applied a very traditional view on the matter. (Prior coverage: *Tax Notes Int'l*, Feb. 22, 2016, p. 648.) The legislature may not change unilaterally the treaty itself with an international effect. The treaty itself remains unaltered when treaty override takes place by the national legislature. Domestic law in this case contradicts the international obligations of Germany, but under domestic law, the later treaty override is the law in force. One dissenting vote argued why the court should have made a judicial development of the constitutional law. But the majority did not have the courage to make this step into the future.

The case, however, was a special one. A German resident worked temporarily in Turkey. According to the Germany-Turkey double taxation agreement, Turkey (article 15, paragraph 2 of the OECD model) had the right to tax the salary, and Germany was obliged to exempt the salary from taxation. Under German income tax law (section 50d, paragraph 8 of the Einkommensteuergesetz, or EStG), exemption as stipulated in the tax treaty is given only if the taxpayer can prove he paid taxes in the other country. Obviously the taxpayer did not pay taxes in Turkey. As a result, no exemption was allowed. The BFH decided that section 50d, paragraph 8 of the EStG contains a treaty override. Under the treaty, Germany should have informed Turkey that its resident worked in Turkey, but it did not, so it was a participant in the tax fraud committed by the taxpayer. According to the Tax Court, Germany does not have ''clean hands'' and thus has no right to tax the income earned in Turkey by its resident and should allow an exemption. The Tax Court has meanwhile referred other sections of the EStG containing treaty overrides to the BVerfG. After this decision, one might expect that the BVerfG will confirm its decision. But that will not end the discussion among scholars. ◆

COMING ATTRACTIONS

A look ahead at upcoming commentary and analysis.

Interest deductibility in Canada: The *TDL Group Co.* decisions (*Tax Notes International*)

Héléna Gagné and Dov Whitman examine the conclusions reached by the Tax Court of Canada and the Federal Court of Appeal in *TDL Group Co.* in an effort to identify a more unified theory on the proper approach to interest deductibility in Canada.

Privacy rights in an age of transparency: A European perspective (*Tax Notes International*)

Philip Baker addresses taxpayer privacy and data protection issues in Europe, examining how automatic exchange of taxpayer information could infringe upon rights to confidentiality and privacy.

Mr. California retires (*State Tax Notes*)

State Tax Notes will look back at the career of Prentiss Willson, who worked on a dozen U.S. Supreme Court cases and was for decades California's preeminent state tax practitioner. Willson quietly retired from state tax work at the end of February.

Litigating a New York tax case, volume 3: The administrative appeals process (*State Tax Notes*)

Timothy P. Noonan and Ariele R. Doolittle continue their four-part series on litigating a New York tax case with a discussion on the administrative appeals process within the New York State Division of Tax Appeals and the Tax Appeals Tribunal.

Section 355: Breaking up is hard to do (*Tax Notes*)

Andrew F. Gordon and Mark J. Silverman explore the permissible continuing relationship between distributing and controlled corporations after a distribution under section 355.

ASU 2015-17 adoption: Potential impacts of reclassifying current deferred taxes (*Tax Notes*)

Nancy B. Nichols, Charles P. Baril, and Irana J. Scott discuss how adopting the Financial Accounting Standard Board's recent accounting standards update on the balance sheet classification of deferred taxes will affect companies' financial ratios and emphasize that the effect on companies and financial statement users will be far-reaching.

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PRACTITIONERS' CORNER

Corporate Tax Considerations for U.S.-Canadian Cross-Border Planning

by Patrick Tchiengang


Patrick Tchiengang

Patrick Tchiengang is a U.S. and Canadian CPA based in Montreal. His practice focuses on U.S. and Canadian cross-border income taxes and international tax rules, as well as cross-border transactions.

This article provides an overview of the U.S and Canadian tax provisions relevant in cross-border corporate transactions.

In light of the increasing number of transactions being structured between the United States and Canada, this article takes a closer look at several tax provisions that can be of relevance in a cross-border context. The typical cross-border deal involves Canadian and U.S. tax advisers working together to design a structure satisfying for the buyer and seller, on both sides of the border. In that environment, it can be only of benefit for those tax advisers to further their understanding of select aspects of the other country's tax legislation. The goal of this article is neither to identify all legislative differences nor to go in-depth into any particular provision; rather, the objective is to summarize the above-mentioned provisions in both tax systems and examine how they can affect a cross-border corporate transaction.

I. Domestic Regimes

A. Rollover Provisions

1. Canada

Section 85 of the Income Tax Act is one of the provisions most used by Canadian tax practitioners. It allows Canadian taxpayers to transfer eligible properties to taxable Canadian corporations on a tax-deferred basis. By making a section 85 election, the transferor and transferee agree on an elected price between the tax cost and the fair market value of the property transferred. As consideration for a property received, the transferee corporation must issue shares (common, preferred, or a combination) to the transferor and might also issue nonshare consideration, or boot, which cannot exceed the elected amount.

2. United States

Section 351(a) of the Internal Revenue Code provides that no gain or loss is recognized if property is transferred to a corporation by at least one person solely in exchange for stock if the transferors control the corporation immediately after the exchange. Section 368(c) defines control as at least 80 percent ownership of the total combined voting power of all classes of voting stock and at least 80 percent of the total number of shares of all other classes of stock. IRC section 351(a) applies solely to the exchange of property for stock, and under section 351(b), the receipt of any boot triggers the recognition of a gain (but not a loss) on the exchange. Nonqualified preferred stock received, which is essentially akin to debt, does not

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qualify for a tax-deferred exchange and is treated as boot under section 351(g)(2).

B. Thin Capitalization Rules

1. Canada

Generally, a business may deduct interest paid on debt.[1] ITA subsections 18(4)-(8) highlight Canadian thin capitalization rules, under which deductibility of interest incurred by specified nonresidents is limited by forcing the Canadian subsidiary to abide by a debt-to-equity ratio of 1.5 to 1.

2. United States

IRC section 163(a) permits a deduction of interest paid or accrued in a tax year. However, section 163(j) limits a corporation's interest deduction on related-party indebtedness if the corporation's debt-to-equity[2] ratio at the end of the year exceeds 1.5 to 1. The disqualified interest is the excess of the corporation's net interest expense over 50 percent of the corporation's adjusted taxable income (ATI).

II. Mergers: Amalgamation and Windup

A. Canada

1. Amalgamation

A shareholder may want to amalgamate two or more companies he owns to offset losses in one company with the taxable income in the other, or to simplify his corporate structure. ITA section 87 provides for a tax-deferred amalgamation of corporations. The amalgamation might be vertical or horizontal. Under ITA subsection 87(4), the predecessor shareholders are deemed to dispose of their old shares at their adjusted cost bases and to acquire the amalgamated shares at the same value. As a result of the amalgamation, the tax attributes of the merged companies flow through to the new amalgamated entity.

A merger can also be achieved by way of a triangular amalgamation under ITA subsection 87(9), assuming the following conditions are met:

- the merger is of taxable Canadian corporations;
- the new amalgamated corporation is controlled by the parent (a taxable Canadian corporation); or
- the shares of the parent are issued to the shareholders of the predecessor entities.[3]

2. Windup

Another alternative for two entities to combine their operations is by way of a windup. Under ITA subsection 88(1), a tax-deferred windup requires the parent to own 90 percent of the issued shares of each class of the subsidiary's capital stock immediately before the windup. In this instance, the tax attributes of the subsidiary flow through to the parent. As a general rule, the shares of the subsidiary's capital stock owned by the parent are deemed disposed of by the parent for the greater of:

- the lesser of the paid-up capital of the shares and the tax cost of the subsidiary's net assets; and
- the adjusted cost base to the parent of the shares immediately before the windup.

Under ITA subsection 88(2), a taxable windup occurs when the conditions for a tax-deferred windup are not met, and all or substantially all of the property owned by the corporation immediately before that time is distributed to the shareholders of the corporation. That taxable liquidation might result in a deemed dividend and capital gain for the shareholders.

3. Tax Bump

The ITA allows a corporation to bump the tax cost of non-depreciable capital property of a subsidiary corporation when it winds up the subsidiary corporation or amalgamates with a wholly owned subsidiary.[4] The tax cost bump allows a Canadian corporate bidder who has acquired control of a Canadian corporate target to wind up or vertically amalgamate the target into the bidder and push down the high adjusted cost base of the disappearing target shares onto non-depreciable capital properties owned continuously by the target from the time the bidder acquired control until the distribution on the winding-up or vertical amalgamation.[5] However, the ITA contains bump denial rules[6] that can deny the availability of the bump.

B. United States

1. Corporate Acquisitions and Mergers

A corporation deciding to acquire a business operated by another corporation can acquire the targeted corporation's assets or stocks, and can do so as a taxable or a tax-deferred transaction. Structuring a merger as a taxable transaction can result in immediate adverse tax consequences for the selling party.

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[1]ITA para. 20(1)(c).

[2]IRC section 385 states, ''The Secretary is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for this purpose as stock or indebtedness (or as in part stock and in part indebtedness).'' Proposed regulations under section 385 that can have a significant impact on debt or equity classification are not addressed herein.

[3]L. David Fox, ''Takeovers and Tax Issues,'' 17th Taxation of Corporate Reorganization presentation (Jan. 23, 2013).

[4]Brian R. Carr and Julie A. Colden, ''The Bump Denial Rules Revisited,'' 62:1 *Canadian Tax J.* 273 (2014).

[5]Geoffrey S. Turner, ''Use of the Tax Cost Bump in an Acquisition'' (Nov. 2011).

[6]ITA subpara. 88(1)(c)(vi). As a result of recent legislative changes, in limited circumstances the bump might be available when shares of a non-Canadian corporation are issued to shareholders in consideration for the acquisition of a Canadian target.

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IRC section 368 defines seven types of corporate reorganizations, which are labeled by reference to the subparagraph describing them. Only the first three of those reorganizations involve the acquisition of a target corporation's assets or stock by another corporation.[7] The seven types of reorganization are:

- A type A reorganization must be structured as a merger or consolidation of two corporations.[8] In a merger, the acquiring corporation is the surviving legal entity. In a consolidation, the acquiring and the target combine to form a new legal entity. The receipt of boot triggers the recognition of gain (but not loss) up to the FMV of the boot.[9] An acquiring corporation can also structure a merger as a forward triangular merger in which the target is merged into a subsidiary of the acquiring corporation, leaving the subsidiary as the surviving entity.[10] Similarly, in a reverse triangular merger, a subsidiary of the acquirer is merged into the target, leaving the target as the surviving entity and a subsidiary of the acquirer.[11]
- A stock acquisition is tax-deferred if it qualifies as a type B reorganization, in which the acquirer uses only voting stock to pay for the target stock.[12] Immediately after the stock-for-stock exchange, the acquirer must own at least 80 percent voting control of the target and 80 percent of any nonvoting class of target stock.
- In a type C reorganization, the acquirer must obtain substantially all the target's assets solely for voting stock.[13] The target corporation must also liquidate after exchanging its assets for the acquirer stocks.
- A type D reorganization involves the transfer by a target corporation of all or part of its assets to another acquiring corporation if, immediately after the transfer, the transferor corporation or at least one of its shareholders controls the corporation to which the assets were transferred.[14] In a D reorganization, control means 50 percent of the stock of the transferee by vote or by value.[15] While the distribution requirement would seem to literally require the target's shareholders to receive at least some equity in the acquiring company, the law has developed a nominal share concept. If there is identical ownership of Target and Acquiring, the transfer of Target's assets to Acquiring solely for cash will satisfy the distribution requirement. As such, in case of 100 percent common ownership, it is possible to undertake a D reorganization in exchange for all cash consideration.[16]
- A corporation could have a business reason to modify its capital structure by issuing new stock to its shareholders in exchange of their original stock; that recapitalization is a type E reorganization.[17]
- A type F reorganization is merely a change of identity.[18]
- A type G reorganization is a capital restructuring resulting from a bankruptcy.[19]

The above provisions allow for nonrecognition only if under a plan of reorganization, and if business-related requirements are met.

2. Corporate Liquidations

Liquidation is the process in which the corporation ceases to operate and disposes of all its assets. The corporation recognizes gains and losses on the liquidation as if it had sold assets at their FMV.[20] Under IRC section 331, shareholders receiving the liquidating distribution can treat the distribution as payment for their stock, which can result in capital gain recognition from the distribution.

When the parent owns at least 80 percent of a controlled subsidiary's total voting power and value of the stock, the parent doesn't recognize a gain or loss on the receipt of property from the subsidiary.[21] Further, the subsidiary's basis in the distributed assets carries over to become the parent's basis.[22] For minority shareholders, a corporation's distribution of assets in an IRC section 332 liquidation triggers a gain (but not a loss) to the corporation.[23]

3. Tax Bump

Under certain conditions, in a taxable purchase of target stock, an election can be made to treat the purchase of stock as a purchase of the target's assets. As such, the acquirer can make a unilateral IRC section 338(g) election, or if available, a joint section 338(h)(10) election (with the common parent of the consolidated group of which the target is a member or

[7]Sally M. Jones and Shelley C. Rhoades-Catanach, *Principles of Taxation: Advanced Strategies* (2004 ed.).

[8]IRC section 368(a)(1)(A).

[9]IRC section 356(a)(1).

[10]IRC section 368(a)(2)(D).

[11]IRC section 368(a)(2)(E).

[12]IRC section 368(a)(1)(B).

[13]IRC section 368(a)(1)(C).

[14]IRC section 368(a)(1)(D).

[15]IRC section 368(a)(2)(H).

[16]William R. Skinner, *A Primer on the Use of IRC Section 304 Transactions and Cash D Reorganizations to Effect Cross-Border Restructurings* (2015).

[17]IRC section 368(a)(1)(E).

[18]IRC section 368(a)(1)(F).

[19]IRC section 368(a)(1)(G).

[20]IRC section 336(a).

[21]IRC section 332.

[22]IRC section 334(b).

[23]IRC section 336(d)(3).

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with shareholders of a target S corporation).[24] From a cross-border perspective, that election provides the opportunity for any Canadian company investing in the United States to do so by acquiring shares of a subsidiary in a U.S. consolidated group, agreeing with the vendor for an election, and stepping up the tax basis of the assets for U.S. tax purposes. No step-up will be available for Canadian tax purposes. Also, the notional deduction arising from the election can require adjustments to compute the subsidiary earnings for Canadian surplus purposes (an overview of Canadian surplus pools follows[25]).

IRC section 336(e) permits a U.S. corporation to elect to treat some dispositions of stocks representing at least 80 percent, by vote or value, of another U.S. corporation as a deemed asset sale for federal income tax purposes.

III. Divisive Reorganizations

A. Canada

In Canada, tax practitioners often refer to divisive reorganizations as butterfly reorganizations. Depending on the facts, a tax-deferred reorganization can be completed as a related-party butterfly[26] or an unrelated-party butterfly.[27] Butterfly rules are essentially an exception to the antiavoidance rules in ITA subsection 55(2), which when applicable, effectively convert into capital gains dividends resulting from the implementation of the butterfly steps.

A related-party butterfly involves a divisive reorganization within a related group of persons. ITA paragraph 55(3)(a) imposes several technical tests regarding unrelated persons,[28] all of which must be met in order for the exception to subsection 55(2) to be applicable.[29]

The unrelated-party butterfly provision allows a corporation to distribute its assets among its shareholders, with the requirement that each shareholder receives its proportional share of each type of property of the corporation.

The following scenarios illustrate how a butterfly reorganization can be implemented.

1. Split-Up

Assume Opco is 50 percent owned by Holdco X and Holdco Y, and both holdcos are wholly owned by Mr. X. and Mr. Y. The shareholders decided to split the corporation between them and part ways. The butterfly steps would be implemented as follows:

- Opco will transfer 50 percent of its assets to Holdco X on a rollover basis. As consideration, Holdco X will assume 50 percent of Opco's liabilities and issue preferred shares with a redemption value equal to the difference between the FMV of the assets transferred and the liabilities assumed.
- Holdco X would redeem[30] its preferred shares held by Opco while issuing a promissory note to Opco as consideration.
- Opco would purchase for cancellation[31] its shares held by Holdco X, while issuing a promissory note to Holdco X as considerations.
- The two promissory notes would be set off against one another.
- Holdco Y would repeat similar steps as the ones mentioned above.
- At the end of the process, Holdco X and Holdco Y would each receive half of Opco's assets while Opco would cease to exist.

2. Spinoff

Assume Opco has a Keep business and a Spin business. The shareholders want to structure a spinoff reorganization to transfer the Spin business to a Newco. The butterfly steps would be implemented as follows:

- Newco is incorporated. (The shareholders of Opco are related to Opco and Newco.)
- The shareholders of Opco transfer on a tax-deferred basis some of their common shares of Opco to Newco in consideration for common shares of Newco. The FMV of the Opco shares transferred is equal to the FMV of the Spin business.
- Opco transfers the Sell business to Newco in consideration for preferred shares of Newco under ITA section 85.
- Newco redeems its shares held by Opco in consideration for a promissory note.
- Opco purchases for cancellation its common shares held by Newco.
- The notes are set off and canceled.

3. Conclusion

The 2015 budget proposed some changes to the butterfly rules, which can significantly affect how those reorganizations are implemented. Given the uncertainty regarding how the new rules are to be applied and administrated, butterfly reorganizations ought to

[24]KPMG International, *Taxation of Cross-Border Mergers and Acquisitions* (2014).

[25]*See* CRA 2013-0499141I7.

[26]ITA para. 55(3)(a).

[27]ITA para. 55(3)(b).

[28]As defined under ITA paragraph 55(3.01)(a). Paragraph 55(5)(e) sets out deeming rules for determining whether persons are related for purposes of section 55, including paragraph 55(3)(a).

[29]David Louis et al., *Tax and Family Business Succession Planning* (3rd ed.).

[30]ITA subsection 84(3).

[31]*Id.*

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be implemented with great caution until the tax authorities release more guidance.

B. United States

Under the U.S. tax system, divisive reorganizations can be undertaken as follows.

1. Spinoff

The shareholders of a parent-subsidiary can restructure their ownership by having the parent corporation distribute subsidiary stock proportionally to the parent shareholders. After the distribution, the shareholders directly own the stock of both corporations. If the reorganization cannot be completed on a tax-deferred basis, the parent would potentially be taxed under IRC section 311 on the accrued gain on the subsidiary's stock, while the shareholders would be taxed under IRC section 301 on receipt of the stock as dividend.

2. Split-Off

A parent-subsidiary group's shareholders could decide that one set of shareholders should retain ownership of the parent and a different set should acquire ownership of the subsidiary. That would be achieved by the parent distributing subsidiary stock to one set of shareholders in exchange for their parent stock. If the split-off fails to be implemented on a tax-deferred basis, the parent corporation would be taxed under IRC section 311 on the FMV (in excess of basis) of the subsidiary stock distributed in redemption of the shareholder's stock in the parent, and the shareholder receiving the subsidiary stock would be taxed under section 302 on the redemption of his stock in the parent.

3. Split-Up

This involves a nonoperating parent corporation that functions as a holding company for multiple operating subsidiaries. The shareholders could eliminate the holding company via the parent liquidating by distributing the stock of its subsidiaries to its shareholders. After the liquidation, the shareholders directly own the subsidiaries. In the absence of tax-deferred reorganization, the parent would be taxed under IRC section 336 as if it has sold the subsidiaries at FMV, and the shareholders would be taxed under IRC section 331 on the receipt of the stock.

If all the required statutory and nonstatutory requirements are met, IRC section 355 allows for the preceding reorganizations to be undertaken on a tax-deferred basis.

4. Conclusion

As illustrated by the foregoing, the mechanics of a Canadian and U.S. divisive reorganization are different. A Canadian butterfly is implemented by having a shareholder roll over his shares in the distributing corporation to a new holding corporation, then having the distributing corporation roll over the distributed assets to the holding corporation, followed by the use of cross redemptions to unwind the structure.

In the United States, the divisive reorganization could be effected by simply distributing the subsidiary where the assets are held directly to the distributing corporation, having the distributing corporation ''incorporate'' the distributed assets into a subsidiary, and then distributing the shares of the subsidiary to the transferee shareholder.[32]

The Canada Revenue Agency has said that a cross-border butterfly may be successfully implemented on a tax-deferred basis while respecting both IRC section 355 and section 55 requirements.[33]

IV. International Regimes

A. Canada

Under ITA section 126, Canadian corporations are allowed to use foreign taxes paid on business and nonbusiness income as credit against their Canadian tax payable.

The Canadian foreign taxation regime is centered on foreign affiliates (FAs) and controlled foreign affiliates (CFAs). Under ITA subsection 95(1), an FA is a nonresident corporation in which the Canadian taxpayer has an equity interest of at least 1 percent, and the Canadian resident or a group related to the Canadian resident own at least 10 percent of the corporation shares.

ITA subsection 95(1) defines a CFA of a Canadian taxpayer as an FA of the taxpayer that is controlled by the taxpayer or would be controlled by the taxpayer if it owned the shares owned by the taxpayer and some other persons:

- not more than four other persons resident in Canada (relevant Canadian shareholders); or
- persons non-arm's-length to the taxpayer or to other relevant Canadian shareholders.

The aforementioned classification and the type of income generated (active or passive) will determine the tax implications for the Canadian taxpayer.

1. Passive Income: FAPI

Only CFAs as defined above are affected by foreign accrual property income rules.[34] FAPI simply represents the passive-type income of the CFA. The primary intent of the rules is to prevent the deferral of passive-type income earned by CFA. Broadly speaking, FAPI includes net income from property, net income from a business other than an active business, and net income

[32]Michael N. Kandev and Abraham Leitner, ''Through the Looking Glass: Dividing up a Family Business in a Canada-US Cross-Border Context,'' 59 *Canadian Tax J.* 899 (2011).

[33]Rick McLean, ''Cross-Border Butterfly Redux,'' 22 *Canadian Tax Highlights* (May 2014).

[34]Defined in ITA subsection 95(1).

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from a nonqualifying business.[35] The Canadian shareholder must recognize FAPI when earned, not on distribution.[36] However, ITA subsection 91(4) allows compensation for foreign taxes paid on FAPI and on a subsequent FAPI distribution, because the related dividend is included in the taxpayer's income, ITA subsection 91(5) provides for a deduction mechanism to reflect that the dividend may have already been taxed as FAPI.

2. Surplus Regime

The intent of the surplus regime is to provide relief from double taxation on income earned by an FA of a Canadian taxpayer by granting either an exemption from Canadian tax (for exempt surplus dividends) or an effective credit against Canadian tax (for taxable and hybrid surplus dividends) on the payment of dividends from foreign FAs. That is achieved by tracking surplus pools to allocate various types of income[37]:

- *Exempt surplus pool*[38]: In general terms, this pool tracks active business income earned by an FA if the FA is resident in a designated treaty country.[39] ITA paragraph 113(1)(a) provides a 100 percent deduction for dividends paid out of exempt surplus.
- *Hybrid surplus pool*[40]: This pool mainly tracks the amount of capital gains realized by an FA from the disposition of shares in certain FAs and partnership interests. Dividends paid out of hybrid surplus are included in the recipient's shareholder's income with a corresponding deduction equal to half of the dividend income, and additional deductions based on the hybrid underlying tax available and withholding tax incurred.[41]
- *Taxable surplus pool*[42]: This includes FAPI and other income earned by an FA, such as business income earned in a non-treaty country. ITA paragraph 113(1)(b) provides a deduction of foreign income taxes paid on amounts included in the taxable surplus and from which dividends are being paid, while paragraph 113(1)(c) allows for a deduction for any foreign withholding taxes incurred on a dividend paid from taxable surplus.
- *Pre-acquisition surplus*: After the preceding surplus pools have been exhausted, any other dividend paid by an FA is notionally paid out of this surplus.[43]

Although the normal ordering required for dividends to be paid is exempt surplus, hybrid surplus, taxable surplus, and finally pre-acquisition surplus, various provisions in the ITA alter the ordering, with various consequences:

- qualifying return of capital election under ITA subsection 90(3) to treat legal returns of capital as cost base reduction;
- pre-acquisition surplus dividend election under ITA regulation 5901(2)(b) to treat a dividend as paid immediately out of the pre-acquisition surplus;
- regulation 5901(1.1) to treat dividend as coming from taxable surplus ahead of hybrid surplus; and
- regulation 5900(2), which treats a dividend paid from exempt surplus as if paid from taxable surplus.[44]

From a cross-border perspective, of relevance are the various recharacterization rules[45] available in the ITA that recharacterize interest income earned by an FA as active business income being added to its exempt pool, which can effectively be repatriated tax free in Canada. Canadian tax practitioners rely on those clauses in structuring some well-known financing structures.[46]

3. FA Reorganizations

There are several relevant FA reorganization provisions.[47] ITA subsection 85.1(3) allows a Canadian resident taxpayer to transfer ownership of shares of an existing FA to any corporation that is an FA or that becomes one as a result of the transfer on a deferred or partially tax-deferred basis.

ITA paragraph 95(2)(c) allows for a taxpayer's FA to transfer shares of another FA that was immediately after the transfer of an FA on a fully or partially tax-deferred basis.

Subsections 88(3)-(3.5) provides rules for determining the tax implications of liquidating FAs held directly

[35]Drew Morier and Raj Juneja, ''Foreign Affiliates: An Updated Primer,'' in *Report of Proceedings of the Annual Tax Conference* 40:1-40:48 (2006).

[36]ITA subsection 91(1).

[37]Brian J. Arnold and James Wilson, ''Aggressive International Tax Planning by Multinational Corporations: The Canadian Context and Possible Responses,'' University of Calgary SSP Research Paper 7.29 (Sept. 2014).

[38]ITA regulation 5907(1).

[39]As defined in ITA regulation 5907(11).

[40]ITA regulation 5907(1).

[41]See ITA para. 113(1)(a.1).

[42]ITA regulation 5907(1).

[43]ITA para. 113(1)(d).

[44]Mark Coleman and Liza Mathew, ''International and Foreign Affiliate Taxation 101,'' Calgary Young Practitioners Group Meeting presentation (Feb. 25, 2014).

[45]ITA clauses 95(2)(a)(ii)(B) and (D).

[46]Some of which are outlined in Julie Bouthillier, ''Structure de Financement à L'ètranger,'' Canadian Tax Foundation (Mar. 20, 2014).

[47]Ken J. Buttenham, ''Foreign Affiliate Reorganizations: Where Are We Now?'' in Canadian Tax Foundation report on its 65th tax conference (2014).

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by a Canadian corporation. The liquidation can be undertaken on a tax-deferred basis under a qualifying liquidation and dissolution, with suppression elections being made.

Paragraph 95(2)(e) provides rules for determining the income tax implications of a liquidation of an FA held by another FA. The liquidation can be made on a tax-deferred basis as a designated liquidation and dissolution.

One of the key features of Canadian foreign reorganization rules is the ability to consolidate surplus balances in a given chain of FAs. ITA regulations 5905(7.1)-(7.7) contain the fill-the-hole surplus adjustment and related basis adjustment rules to be considered on the windup of an upper-tier affiliate.[48] In simple terms, the rules push up any exempt surplus in an underlying FA in which a liquidating affiliate with exempt deficit has an equity percentage. It represents an effective way of netting a blocking exempt deficit in an upper-tier affiliate against lower-tier exempt surplus.

One benefit of making the regulation 5901(2)(b) election is the potential to move exempt surplus of lower-tier affiliates.[49] As such, the election will result in an automatic 93(1) election[50] that arises after the adjusted cost base in the top-tier FA shares is fully depleted and a capital gain of the Canadian parent is triggered by subsection 40(3). This combined with regulation 5902 will determine the notional surplus balances of the top-tier FA.[51]

Finally, for any inbound investments to Canada, considerations must be given to the ITA section 212.3 foreign affiliate dumping rules, which can apply when a corporation resident in Canada that is controlled by a nonresident invests in a corporation that is, or becomes, an FA. Those circumstances would result in a deemed dividend being paid by the corporation resident in Canada to the foreign parent.

B. United States

1. Foreign Tax Credit

U.S. citizens and individual residents and domestic corporations are taxed on their worldwide income. To prevent the double taxation that could result on income derived from foreign sources, the United States allows a credit for foreign taxes paid or accrued.[52] The credit is elective, but if elected, the taxpayer thereby waives any deductibility for the taxes under IRC section 275(a)(4).

However, the foreign tax credit must be computed for separate categories of income referred to as baskets.[53] The intent of the separate basket designation is to restrict the ability of U.S. taxpayers to average foreign-source income subject to high foreign tax rates with foreign-source income subject to low foreign tax rates to maximize the available FTC.

A domestic corporation that owns at least 10 percent of the voting stock of a corporation is entitled under section 902 to claim a deemed paid FTC for the foreign income tax paid by the foreign corporation on its accumulated profits in the year in which the domestic corporation receives a dividend from the foreign corporation. Similar to the double taxation relief provided domestically at the corporate level by the dividend received deduction under section 243, section 902 alleviates and eliminates double international taxation of earnings at the corporate level if a foreign corporation is involved.

A U.S. corporate parent cannot claim an indirect FTC for the foreign income tax of a seventh- or lower-tier subsidiary.[54] If a foreign corporate structure has more than six underlying corporations, it is usually recommended that those entities elect to be disregarded under check-the-box rules.[55]

2. Subpart F Income of CFCs

Income considered subpart F income is constructively repatriated and subject to U.S. tax as it is earned by a controlled foreign corporation. In simplified terms, a CFC is a foreign corporation in which U.S. shareholders own more than 50 percent of the total voting power or value of the corporate stock.[56] A U.S. shareholder includes any U.S. individual or corporation owning at least 10 percent of the foreign corporation's voting stock. Subpart F income includes most types of passive income from foreign sources. Under IRC section 959(a), subsequent actual distributions from subpart F income are not taxed at distribution. When a CFC earns both subpart F income and non-subpart F income, it must separately track the earnings and profits[57] from subpart F sources. Distributions are deemed to be made first from the subpart E&P pool,

[48]Penny Woolford and Francis Favre, ''The Latest Foreign Affiliate Proposals: Selected Aspects,'' 58 *Canadian Tax J.* 791 (2010).

[49]Turner, ''Upending the Surplus Ordering Rules: Implications of the New Regulation 5901(2)(b) Election,'' 2079 *Tax Topics* 2 (Jan 12, 2012).

[50]That election deems a portion or all of the proceeds of a disposition to be dividend paid by the FA.

[51]That is essentially the tax-free surplus balance of the top-tier FA as defined in regulation 5905(5.5).

[52]IRC sections 27, 901, and 903.

[53]IRC section 904(d).

[54]IRC section 902(b)(2)(B).

[55]IRC section 7701; Mathieu Ouellette, ''International Tax Planning? US Owner-Managed Enterprises Conducting Business in Canada: An Integrated Approach,'' 2 *Canadian Tax J.* 421 (2012).

[56]IRC section 951(a).

[57]Earnings and profits measures a corporation's financial capacity to pay a return on invested capital without returning the capital itself. Section 312 lists the effects of specific transactions on E&P.

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and not taxable. Distributions in excess of subpart F E&P are not taxed when earned and are taxable to the U.S. corporation.

3. PFIC

In simplified terms, a corporation qualifies as a passive foreign investment company if 75 percent of its gross income is passive or 50 percent of its assets are held for the production of passive income.[58]

IRC section 1291 hits the U.S. shareholder of a PFIC with an interest charge on the value of the deferral privilege when he disposes of his PFIC stock. However, if the shareholder makes a qualifying electing fund (QEF) election under section 1295, he is taxed currently under section 1293 on the undistributed earnings of the PFIC.

Alternatively, a mark-to-market election is available for shareholders of a publicly traded PFIC.[59] If the PFIC shareholder elects into the regime, year-end gains are ordinary income, as are losses (but losses are allowed only to the extent of previously included gains), and basis is adjusted to reflect those gains and losses. Once in IRC section 1296, however, the shareholder is no longer subject to the interest charge regime of section 1291.[60]

4. Foreign Reorganization

IRC section 1248 requires the gain realized by some U.S. persons on the sale, exchange, or redemption of stock or on the liquidation of a foreign corporation to be treated as a dividend to the extent of the E&P accumulated when the shareholder held his stock. In determining the amount of E&P under section 1248, amounts previously included as income under section 951 are excluded.[61]

Section 1248 was originally enacted as an antiavoidance measure as part of the subpart regime. When capital gain rates are lower than those for dividends, it prevents U.S. shareholders from accumulating earnings in a foreign corporation and converting the ordinary income into capital gains. Section 902 credits are available as if the earnings had been distributed. If a U.S. person sells stock in a CFC, the E&P included in the section 1248 dividend also includes the E&P of some lower-tier foreign corporations. A CFC selling stock in a lower-tier CFC triggers the application of section 1248 rules by virtue of section 964(e).

Also of relevance in a cross-border restructuring context are section 304 transactions and their cousin, cash D reorganizations, as a means to realign entities in a foreign corporate structure and to repatriate cash in an effective manner.

In a sibling section 304 transaction, a corporation's stock is sold to another corporation, and both the acquiring corporation and the target corporation are under common control. The net effect of a section 304 transaction is a section 302 redemption by the acquiring corporation that is sourced first from the E&P pool of the acquiring corporation and then from the E&P of the issuing corporation. If the issuing and acquiring corporations are CFCs or other section 902 corporations, the deemed dividend under section 304 carries a section 902 indirect credit along with the E&P deemed distributed.

In a cash D reorganization, a target corporation transfers all its assets to an acquiring in a tax-free transfer under section 361 for cash and the nominal share. That is effected by a sale of stock in Target, followed by an integrated liquidation of Target into Acquiring using a check-the-box election. Section 361(b)(1) assumes that all the cash received is distributed to the shareholders as part of the plan of reorganization. Also, the shareholder's receipt of the boot is governed by section 356, rather than section 301. The deemed dividend is limited to the gain realized by the shareholder. Contrast that to section 304, which results in a deemed dividend to the extent of the issuing and acquiring combined pools.

If a U.S. corporation liquidates into a foreign corporation in what would otherwise qualify as section 332 liquidation, section 367 generally requires a liquidating domestic corporation to recognize gain on the distribution of its assets. The domestic corporation may avoid gain recognition, however, on the distribution of U.S. real property interests and some U.S. trade or business assets.[62] The logic is that the United States generally can tax gain recognized later by the foreign parent corporation.[63]

If a foreign corporation liquidates into a U.S. parent corporation in what would otherwise qualify as a section 332 liquidation, the U.S. parent is taxed on all E&P of the liquidated corporation.[64] Under section 334(b), if there is an aggregate built-in loss in the assets, the U.S. parent must take an FMV basis in the assets. ◆

[58]IRC section 1297(a).

[59]IRC section 1296.

[60]Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations & Shareholders*.

[61]*Id.*

[62]IRC section 897(c)(1).

[63]Joel D. Kuntz and Robert J. Peroni, *U.S. International Taxation* (1991).

[64]Treas. reg. 1.367(b)-3.

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SPECIAL REPORT

The Post-BEPS World of Permanent Establishment

by Kevin Cunningham



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The author would like to thank Tom Zollo and Grant Wardell-Johnson for their helpful comments on this article. This article represents the views of the author only, and does not necessarily represent the views or professional advice of KPMG LLP. The information herein is of a general nature and based on authorities that are subject to change.

In this article, the author discusses how the OECD's final base erosion and profit-shifting report on action 7 (artificial avoidance of PE status) would change the definition of permanent establishment and the effect that change could have on multinational enterprises.

How to allocate tax rights between a source and residence country is an important role of tax treaties. That question requires delineating between when a company is selling to a country and when it is selling within a country. It also requires a determination of when an enterprise's physical presence in a country, through an office or other fixed place of business, extends beyond activities that are merely preparatory or auxiliary and therefore warrants source-country taxation.

As part of its overall effort regarding base erosion and profit shifting, the OECD in July 2013 issued an action plan that identified 15 actions to address BEPS in a comprehensive manner, including action 7 on preventing the artificial avoidance of permanent establishment status.

The OECD issued two action 7 discussion drafts on October 31, 2014, and May 15, 2015, and its final report on October 5, 2015. In the final report, the OECD recommended changes to the definition of PE identified as necessary to prevent tax avoidance strategies that can be used to circumvent the existing PE definition.

Action 7 would change the standard in article 5 of the OECD model convention regarding what circumstances would cause a seller to be viewed as selling within a country and thus having a taxable presence there. It would narrow the scope of the specific activity exemptions by which some activities are characterized as preparatory and auxiliary and viewed as automatically not giving rise to a PE. It would also prevent those enterprises from fragmenting two or more activities among different related parties so that each related party could rely on the exception for the activity it conducts.

The OECD groups its recommendations into three categories:

- artificial avoidance of PE status through commissionnaire arrangements and similar strategies;
- artificial avoidance of PE status through the specific (activity) exemptions in article 5(4); and
- other strategies for the artificial avoidance of PE status (for example, fragmenting two or more activities among different related parties).

Because those measures would change the PE standards in current treaties, their implementation will depend on the willingness of countries to embrace the new PE standard either by incorporating it into their

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future treaties or adopting the multilateral treaty instrument in action 15 of the OECD action plan.

The OECD action plan indicated that action 7 would address profit attribution issues. As stated in the first discussion draft, ''The question of attribution of profits must be a key consideration in determining which changes should be made to the definition of PE.'' Indeed, because some observers have argued that some source countries are asserting a broader definition of PE to address what should be properly viewed as transfer pricing questions, it would seem appropriate to address attribution issues as part of action 7 as well.[1] Otherwise, changes to the definition of PE might be made, increasing compliance costs and complexity to taxpayers with little revenue effect. The second discussion draft noted that many comments suggested that PEs resulting from the various options would generate little or no additional profits, but because of the broader definition of PE, some countries might be tempted to tax profits that were not really attributable to the PE, which would create risks of double taxation and increase cross-border disputes.

But despite the original emphasis on attribution of profits, the OECD determined in that same discussion draft that because of the complexity associated with profit attribution, the work on it would not be completed before the end of 2016. And because the negotiation of the multilateral instrument — which would incorporate the definition of PE from action 7 — would occur before that, it would not be possible to address profit attribution as part of action 7.

As such, action 7 proposes changes to the definition of PE without identifying the relevant profits that would result from the proposed changes. Thus, it is fair to question the extent to which the changes address abuses that practically speaking are likely to result in a significant loss of revenue for source states. As discussed herein, it is hard to have a principled conversation about what should and should not constitute a PE absent a basic understanding of the revenue implications in that respect. Because many of the proposed changes to the definition of PE eliminate reasonably clear limits on what constitutes a PE, the changes proposed in the final report make it much harder for nonresident taxpayers to structure their affairs to avoid source-country taxation.

Commissionnaires and Similar Strategies

A commissionnaire, which is recognized only in civil law countries such as France or Italy, is a person in a country who sells products on behalf of a nonresident located outside the country. The sale is not ''in the name of'' the nonresident. The commissionnaire receives a commission for the sale that is taxable in the customer's country, but the residual profit (or loss) is taxable in the nonresident's country.

Although tax authorities have tried to challenge commissionnaire structures by using substance-over-form principles in their local countries, they have not always been successful.[2] The proposed changes to article 5(5) would extend the contracts that can create a taxable presence, if other conditions are met, to those that are not only ''in the name of the enterprise'' but also to those that are ''for the transfer of, or the right to use, property that the enterprise owns or has the right to use'' or ''for the provision of services by the enterprise.''

Article 5(5) would read as follows (the new language is in italics):

> 5. Notwithstanding the provisions of paragraphs 1 and 2 *but subject to the provisions of paragraph 6,* where a person is acting *in a Contracting State* on behalf of an enterprise and, in doing so, *habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are*
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> a) in the name of the enterprise*, or*
>
> *b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise, or that the enterprise has the right to use, or*
>
> *c) for the provision of services by that enterprise,*
>
> that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4, which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

As an initial observation, the paragraph 5 changes are — consistent with action 7's intent to prevent an artificial avoidance of PE — intended to ensure that substance-over-form principles apply. That is, they are designed to prevent a nonresident taxpayer from organizing its affairs in a manner that permits it to conduct significant business operations in a source state without giving rise to a PE.

There are three significant changes to paragraph 5. First, the authority to conclude contracts language has been broadened, ostensibly to address rubber-stamp approvals from the resident country. After the changes, a PE would result not only if an enterprise ''habitually concludes contracts,'' the previous standard for PE, but

[1] *See* Lee A. Sheppard, ''Limited Future for the OECD Model?'' *Tax Notes Int'l*, Sept. 22, 2008, p. 1002.

[2] *See Société Zimmer Ltd.*, Nos. 304715, 308525 (Conseil d'État 2010) (commissionnaire not a dependent agent because it could not legally bind the principal).

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also if it ''plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise.'' The scope of the phrase ''habitually concludes contracts'' was arguably always broad enough to cover the activities of a person that negotiated the material elements of a contract.[3] However, the standard was thought to be too limiting on the basis that a party in a country might do all the groundwork for a fee or for a return based on its costs with the final conclusion of the contract with the nonresident who takes the profit in its home country. The changes above make it clear that those activities will be covered.

Second, clause (b) has been added to include commissionnaire structures in the definition of PE. The changes would cover commissionnaire arrangements by including in the definition of PE the conclusion of contracts for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use. Under prior versions of article 5, a contract would be covered only if it was concluded ''in the name of the enterprise.''[4] That language created exceptions for commissionnaires, which are a primary focus of the report and were mentioned in the OECD action plan.[5]

Third, clause (c) has been added to address contracts concluded in the source country on behalf of a service provider resident outside that state.

In the first discussion draft, the OECD provided four alternatives to change the standard for a dependent agent PE in article 5(5). Two of the alternatives provided language that was eventually adopted into article 5 — that is, a PE would result if a person is acting on behalf of an enterprise and habitually concludes contracts:

- in the name of the enterprise;
- for the transfer of ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use; or
- for the provision of services by that enterprise.

As discussed above, the new language in those two alternatives would create a dependent agent PE in connection with a commissionnaire structure because the commissionnaire generally would conclude contracts for the ''transfer of ownership of property owned by the enterprise.'' As such, the language in those alternatives was adopted into article 5(5) described above.

Even so, the OECD's intent was to address more than commissionnaire structures; it indicated that it would address the ''artificial avoidance of PE status through commissionnaire arrangements and similar strategies.'' Although it is unclear what a ''similar strategy'' is, presumably the OECD means arrangements by which a nonresident taxpayer would — as is the case with commissionnaires — adopt a business form that subverts the substance of the arrangement, which is the conducting of significant operations in the source state. The commentary to action 7 indicates that a limited risk distributor acting under a buy-sell arrangement would not be considered a similar strategy for that purpose.[6] Even so, the OECD provided two alternatives that would address so-called rubber-stamp strategies, in which the most significant economic activities were performed in the source state but the resident state merely approves the substance of what has already been done.

Most commentators expressed an aversion to the first alternative because it was imprecise; to wit, it would have replaced the words ''concludes contracts'' with the phrase ''engages with specific persons in a way that results in the conclusion of contracts.''[7] As such, although commentators also identified several problems with both alternatives, the second alternative would have replaced the words ''concludes contracts'' with ''concludes contracts, or negotiates the material elements of contracts,'' which is more targeted. As a result, almost all commentators expressed a preference for that alternative, and it seemed as if it would be adopted in the final report.

The second discussion draft then provided an example that arguably suggested that a service organization that merely promotes products or services in the source country might be viewed as having negotiated the material elements of contracts and thus be considered as having concluded contracts. After numerous comments noting the ambiguity, the OECD changed the language of paragraph 5 in the final report, replacing ''concludes contracts, or negotiates the material elements of contracts'' with ''concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise.'' It then clarified the example to indicate that promoting products and services can result in a PE but only if the promotion of the products and services is ''the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise.''

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[3] *See* Stephen R.A. Bates et al., ''U.S. Tax Planning for Providers of Cross-Border Services,'' *Tax Notes Int'l,* Apr. 11, 2005, p. 151 (''Eurotest should take care not to 'rubber stamp' or automatically approve contracts procured by the check-the-box branches'').

[4] The U.S. model treaty uses the phrase ''that are binding on the enterprise,'' which the U.S. Treasury Department views as merely clarifying that it includes undisclosed principals.

[5] *See Société Zimmer Ltd.*, Nos. 304715, 308525.

[6] *See* para. 32.12 of commentary to para. 5 in the final report.

[7] *See, e.g.*, letter from Thomas Zollo of KPMG to Marlies de Ruiter, OECD head of tax treaties, transfer pricing, and financial transactions division (Jan. 9, 2015).

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In the example, source-country employees solicit customers for the sale of products and services concluded with a resident-country enterprise through a contract with several standard terms that the source-country employees cannot modify. Because the employees play the principal role leading to the conclusion of contracts and the resident-country enterprise routinely concludes them without material modification, the source-country employees are considered a dependent agent PE of the resident enterprise.

By way of contrast, the commentary indicates that if promotion activity does not directly result in the conclusion of contracts, there would be no dependent agent PE. For example, the commentary indicates that pharmaceutical representatives who actively promote drugs produced by an enterprise by contacting doctors who subsequently prescribe the drug do not directly result in the conclusion of contracts even though the sales of the drugs might significantly increase as a result of the marketing activity.

At the request of various commentators,[8] the commentary was amended to make clear that the changes to paragraph 5 regarding service providers — covering contract conclusion activities — do not apply to cause a PE in connection with a mere contractor-subcontractor arrangement in which a resident service enterprise subcontracts some of those services to a person in the source country.[9]

Despite that, the new standard might cause sellers of goods and services with marketing or negotiating teams in a country to have a taxable presence where they did not before. That change is likely to give rise to new disputes as the lines are redrawn, putting pressure on dispute resolution procedures. Many companies will want to seek security in advance because those disputes can give rise to double taxation, at least in the short term.

Paragraph 6, addressing independent agents, would be removed and replaced with:

> 6. a. Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise in the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.
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> b. For the purposes of this Article, a person is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or enterprises. In any case, a person shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50 percent of the beneficial interest in the other (or, in the case of a company, more than 50 percent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person possesses directly or indirectly more than 50 percent of the beneficial interest (or, in the case of a company, more than 50 percent of the aggregate vote and value of the company's shares or the beneficial equity interest in the company) in the person and the enterprise.

By contrast, existing paragraph 6 provides:

> An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on a business in that State through a broker, general commission agent, or any other agent of an independent status, provided that such person is acting in the ordinary course of its business.

The changes to paragraph 6 basically provide that a person will not be considered an independent agent if it acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related. In that regard, a person might act on behalf of many enterprises — an automobile company might, for example, own hundreds of dealerships on whose behalf a person exclusively acts — but as long as the enterprises on whose behalf it acts are each related to the person, it will be viewed as acting exclusively on behalf of a single enterprise and not be considered independent. Also, it is not obvious what it means to act almost exclusively on behalf of a single enterprise. In that regard, the commentary to article 5(6) in the final report indicates that an agent will be viewed as acting almost exclusively on behalf of a single enterprise if its sales to unrelated persons do not represent a significant part of its sales. The commentary also indicates that if the person derives only 10 percent of its sales from unrelated persons, it will be viewed as acting almost exclusively on behalf of a single enterprise. In any event, the closely related test seems to be an improvement over the associated enterprise and connected enterprise tests in the earlier discussion drafts.

Avoiding PE Status

The second change resulting from the action plan affects the specific activity exemption in article 5(4) and would limit the extent to which activities can be viewed as preparatory and auxiliary and thus exempt from PE status. The final report recommends the following changes to article 5(4) (changes to the text are in italics, and deletions are italicized in brackets):

[8] *Id.*

[9] *See* para. 32.12 of commentary to para. 5 in final report.

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4. Notwithstanding the preceding provisions of this Article, the term ''permanent establishment shall be deemed not to include:

a) the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise;

b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

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

f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) through e), [*provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory and auxiliary character*] *provided that such activity or, in the case of subparagraph f) the overall activity of the fixed place of business, is of a preparatory or auxiliary character*.

As an initial matter, unlike the commissionnaire and rubber-stamp arrangement, it is not as clear that there is an abuse, or an artificial avoidance of a PE, that must be addressed in article 5(4). The specific activity exemptions might permit a nonresident taxpayer to conduct activities in a source state that are economically significant without a resulting PE. Even so, those activities will often be preparatory and auxiliary, and the intended purpose of subparagraphs (a) through (d) is presumably to create a safe harbor by which specific activities, which are often preparatory and auxiliary, could be conducted without needing to resort to the highly factual question of whether they are in fact preparatory and auxiliary. In other words, the specific activity exemptions could be viewed as having been based on a conclusion that the administrative benefits of clear exemptions outweighed the potential revenue loss of a more ambiguous facts-and-circumstances approach.

The recommended change to paragraph 4 might reflect a conclusion that the specific activity exemptions create a greater potential for revenue loss under modern business models than was previously the case. Perhaps most significant, the ability of some technology enterprises to conduct economically significant operations in a state without a significant physical presence there appears to have influenced the recommendation to eliminate any bright-line exemptions. For example, an Internet search provider might operate a server in a source country to gather relevant information about a user and rely on the exception in subparagraph (d) — the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or collecting information, for the enterprise. An Internet retailer, on the other hand, could operate a warehouse in a source country to deliver goods to customers and rely on the exception in subparagraph (a) — the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise. Because those businesses have a relatively small physical presence, there is less nexus in general, and states obviously don't like it when the limited physical activities they do undertake in their state avoid a taxable nexus.

Under article 5(4), the exceptions in subparagraphs (a) through (d) are available to an enterprise regardless of whether the activity was viewed as preparatory and auxiliary. If the enterprise were to undertake a combination of activities, including an activity described in subparagraphs (a) through (d), the combination of activities would need to be described in subparagraph (f) — the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), but it would also be required to satisfy the condition that the overall activity of the fixed place of business resulting from that combination be preparatory and auxiliary. As such, it could no longer conduct the activities described in subparagraphs (a) through (d) without creating a PE unless those activities were still preparatory and auxiliary.

It seems meaningless to separately describe the activities set out in subparagraphs (a) through (d) in paragraph 4 if they are still subject to the requirement that they be preparatory and auxiliary or, at a minimum, aren't subject to some sort of favorable presumption that those activities are not preparatory and auxiliary. Stated another way, subparagraphs (a) through (d) provided certainty by enumerating a list of activities that by definition are not considered preparatory and auxiliary. If those activities now need to be preparatory and auxiliary, why separately state them at all? In other words, wouldn't it be easier to merely amend subparagraph (e) — the maintenance of fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity — by striking the word ''other,'' in which case the activities described in subparagraphs (a) through (d) would be subsumed within subparagraph (e)?

Many comments on the discussion drafts noted a loss of clarity regarding how the activities in subparagraphs (a) though (d) would be viewed and suggested that they be subject to some sort of presumption that they are in fact preparatory and auxiliary.[10] However,

[10]*Supra* note 7.

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the commentary to paragraph 5(4) in the final report does not go that far, instead providing:

> The wording of this subparagraph [e)] makes it unnecessary to provide an exhaustive list of the activities to which the paragraph may apply, the examples listed in subparagraphs a) to d) being merely common examples of activities that are covered by the paragraph because they often have a preparatory and auxiliary character.[11]

The commentary then acknowledges that some states might choose to keep subparagraphs (a) through (d) as safe harbors and not create a preparatory and auxiliary requirement:

> Some States consider that some of the activities referred to in paragraph 4 are intrinsically preparatory and auxiliary and, in order to provide more certainty to tax administrators and taxpayers, take the view that these activities should not be subject to the condition that they be of a preparatory and auxiliary character, any concern about the inappropriate use of these exceptions being addressed through the provisions of paragraph 4.1 [fragmentation of activities]. States that share that view are free to amend paragraph 4 as follows [providing for existing language] (and may also agree to delete some of the activities listed in subparagraphs a) through d) below if they consider that these activities should be subject to the preparatory and auxiliary condition in subparagraph e).[12]

In the final analysis, keeping the preparatory and auxiliary safe harbor probably would not have been acceptable to developing countries (for example, India and China) that are dissatisfied with the definition of PE in the model OECD treaties. As such, the OECD apparently needed to modify the definition of PE to accommodate those nations but still leave the door open for the definition of PE where the contracting states so agree. The definition of PE, and whether to keep any of the preparatory and auxiliary safe harbors, will likely be one of the most difficult questions in the acceptance of the multilateral instrument.

The treaties that adopt the language from the final report and eliminate the safe harbor will have far less certainty regarding what constitutes a PE. The PE analysis was always factual by nature and after those changes will become even more factual. The commentary is likely to become more important in determining what a PE is. The proposed commentary in the final report provides new language with examples addressing what activities should be considered preparatory or auxiliary in connection with each of the activities in subparagraphs (a) through (d). Also, the commentary in the final report provides guidance regarding what type of activities are in fact preparatory and auxiliary:

> As a general rule, an activity that has a preparatory character is one that is carried on in contemplation of the carrying on of what constitutes the essential and significant part of the activity of the enterprise as a whole. Since a preparatory activity precedes another activity, it will often be carried on during a relatively short period, the duration of that period being determined by the nature of the core activities of the enterprise. This, however, will not always be the case as it is possible to carry on an activity at a given place for a substantial period of time in preparation for activities that take place somewhere else. Where, for example, a construction enterprise trains its employees at one place before these employees are sent to remote work sites located in other countries, the training that takes place at the first location constitutes a preparatory activity for that enterprise. An activity that has an auxiliary character, on the other hand, generally corresponds to an activity that is carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a whole. It is unlikely that an activity that requires a significant portion of the assets or employees of the enterprise could be considered as having an auxiliary character.[13]

If the final report's new PE standard is adopted, language such as the above will become important in determining whether an activity is a PE. Under the existing standard, the relevant inquiry is whether an activity is described in the safe harbors, and only if it's not so described it is necessary to discuss the often thorny question of whether it qualifies as preparatory and auxiliary. Under that new standard, taxpayers will need to go directly to the second inquiry, and without an overarching safe harbor to rely on, they must consider whether their activities are economically significant enough to create a PE in the source state.

In addition to the changes to paragraph 4, the OECD has proposed adding paragraph 4.1, relating to fragmentation of activities:

> Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and
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> > a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or

[11] *See* para. 23 of commentary to para. 4 in final report.

[12] *See id.* at para. 30.1.

[13] *See id.* at para. 21.2.

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b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory and auxiliary character

provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise and closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.

Paragraph 4.1 will be less important in treaties that modify paragraph 4 to eliminate the preparatory and auxiliary safe harbor. Under old paragraph 4, as discussed above, the safe harbor applied only if there was no combination of activities that needed to be tested under subparagraph (f). If, however, the enterprise undertook multiple activities in the source jurisdiction, those multiple activities, including any activities that would qualify for exemption under the safe harbor, needed to be tested under subparagraph (f), which would require that the overall activity of the fixed place of business resulting from the multiple activities be of a preparatory and auxiliary character. Thus, there is arguably some incentive to fragment what might be an economically significant activity that qualifies for the safe harbor, such as warehousing in a source jurisdiction for resale to customers, from an activity that is not significant to ensure that the economically significant activity continues to qualify for the safe harbor under subparagraph (a) and is not tested under the combination rule under subparagraph (f).

In new paragraph 4, only preparatory and auxiliary activities can qualify for the exception of paragraph 4; there is no safe harbor. As such, the incentives to fragment what must be many economically insignificant activities into separate enterprises to prevent them from being analyzed under the combination rule of subparagraph (f) is likely to be much lower. Thus, paragraph 4, when viewed in combination with paragraph 4.1, is probably unnecessary.

Further, paragraph 4.1 is especially problematic because it does not merely operate to combine branch activities of various related enterprises in the source state; it can combine residence-based activities as well. The operation of paragraph 4.1 in that manner is confirmed by an example to the commentary of paragraph 4.1 in which RCo, an enterprise resident of State R, conducts warehousing activities in State S that by themselves are viewed as preparatory and auxiliary. However, RCo also has an affiliate that is a tax resident in S and that acts as its buy-sell distributor. According to the example, ''paragraph 4.1 prevents the application of the exceptions of paragraph 4 to the warehouse and it will not be necessary, therefore, to determine whether paragraph 4, and in particular subparagraph 4 a) applies to the warehouse.''[14]

The importance of combining certain residence-based activities of closely related enterprises cannot be overstated. Many multinational enterprises have affiliates in countries all over the world that conduct activities that would constitute a PE but for the fact that they are a tax resident in the source country. Those activities are usually economically significant and the MNE has usually chosen to conduct them through a tax resident rather than, say, a branch for that very reason. If those activities are to be combined — as paragraph 4.1 apparently requires — with the otherwise preparatory and auxiliary activities in the source country conducted by affiliates that are not tax resident in the source country, that affiliate's activities will always fail to be preparatory and auxiliary, and the affiliate will always have a PE.

In other words, the difficult factual analysis in paragraph 4 described above that requires an analysis of whether activities are in fact preparatory and auxiliary will become easy. Because paragraph 4.1 requires that those activities be combined with the economically significant activities undertaken by affiliates that are tax resident in the source country, the combined activities will almost never be preparatory and auxiliary. Thus, for larger enterprises, paragraph 4.1 has reversed the presumption by which paragraph 4 operates. Previously, there was a safe harbor by which some activities could always qualify as preparatory and auxiliary even if they were not economically significant, but after paragraph 4.1, activities of those larger enterprises will often not be preparatory and auxiliary even if they are economically insignificant.

Other Strategies

The last item addressed relates to the possibility of splitting up a contract for a construction or installation project that has a term of more than one year into at least two shorter contracts, each with a term of under a year. In that case, each shorter contract might qualify for the exception in article 5(3) that provides that a building site or construction or installation project constitutes a PE only if it lasts more than 12 months.

Initially, the discussion drafts proposed automatically combining activities of related enterprises conducted at the same site for a period of 12 months or less into a single activity conducted for a period of more than 12 months and, therefore, not eligible for the 12-month exception of article 5(3).

The final report did not adopt that approach. That decision might have been motivated by the fact that it

[14] *See* para. 30.4 of commentary to para. 4.1 in the final report.

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is unclear to what extent, if any, MNEs separate projects into component parts with a duration of less than 12 months to avoid a PE. Moreover, that combination rule does not apply for purposes of attributing profits to an enterprise and, absent that, the revenue effects are likely to be small. For example, if one enterprise conducted an activity at a site in the source state for 11 months, and a related enterprise undertook activities at the same site for two months, the two activities could be combined into a single activity lasting 13 months and resulting in a PE. Yet the revenues implications are likely to be limited, especially for the enterprise that conducts the activity at the site for only two months. Thus, it is questionable whether it is necessary to adopt a complicated rule with substantial compliance burdens when the revenue effect could be small.

As an alternative, the final report recommends that treaties rely on general antiabuse provisions that deny treaty benefits if a principal purpose of an arrangement or transaction is to obtain the benefits of the treaty. That approach is more reasonable and avoids creating detailed compliance obligations to address what is likely a relatively limited abuse. Of course, there will be a problem with relying on that type of provision in connection with U.S. income tax treaties because the United States has expressed an unwillingness to ratify a treaty that contains a general antiabuse provision of that nature.[15] In those cases, the final report suggests it would be appropriate to adopt an automatic rule that combines activities similar to the one described above.

Conclusion

The effect of the new definition of PE is likely to be significant. The new standard is broader and — just as troubling — ''grayer,'' in that it will be far less certain when an enterprise will be considered to have a PE. The real risk of the new standard is that countries will interpret the rules differently, leading to a proliferation of disputes and putting greater pressure on dispute resolution procedures.

The post-BEPS world could be relevant, at least under some treaties, from as early as 2017 or 2018, depending when the work on the multilateral instrument is completed or countries adopt the new standards into new treaties. It is therefore important that MNEs consider reorganizing their affairs now to ensure their business structures can accommodate the new rules when they are finally adopted. ◆

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[15] *See* U.S. National Foreign Trade Council, ''Introducing Main Purpose Test in U.S. Tax Treaties Will Cause Uncertainty'' (June 28, 2000); and Joint Committee on Taxation, ''Testimony of the Staff of the Joint Committee on Taxation Before the Senate Committee on Foreign Relations Hearing on Tax Treaties and Protocols With Eight Countries,'' JCX-76-99 (Oct. 28, 1999) (discussing main purpose clause in Slovenia and Italy treaties).

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TAX CALENDAR

May 3

Foreign Tax Changes and U.S. Businesses — Washington. The Urban-Brookings Tax Policy Center will hold a symposium on how foreign tax changes affect U.S. businesses. Topics to be discussed include how foreign tax incentives like patent boxes affect the U.S. corporate tax base and efforts by the OECD's base erosion and profit-shifting project to target tax havens.

- Email: events@brookings.edu
- Website: http://goo.gl/hvVFHl

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

U.S. Global Competitiveness — Washington. The Bipartisan Policy Center will host a morning discussion on global company decision-making and U.S. competitiveness. This event will examine a range of issues, including the prospects for U.S. tax reform and international tax trends.

- Tel: (202) 204-2400
- Website: http://bipartisanpolicy.org/events

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

Tax Policy at the Crossroads — Washington. The National Tax Association and the American Tax Policy Institute will jointly host their 46th Annual Spring Symposium on the future of tax policy. This two-day event will cover issues including various tax reform proposals, Affordable Care Act taxes, the OECD's base erosion and profit-shifting project, and the role of the private sector in tax administration.

- Tel: (202) 737-3325
- Website: http://www.ntanet.org/events.html

D.C. Bar 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 five of a six-part series of luncheons on international tax issues and will focus on the Treasury Department's recently released anti-inversion regulations.

- Tel: (202) 626-3463
- Website: https://goo.gl/Bt8yHK

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.

The calendar is available online as *Doc 2016-8884*.

Submissions to the Tax Calendar may be sent by fax to (703) 533-4646 or by email to tni@taxanalysts.org.

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- 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

May 18

Offshore Voluntary Disclosures — Webcast. This webcast from Networking Seminars will provide tax professionals with a practical understanding of available programs for the voluntary disclosure of unreported foreign accounts and income.

- Email: info@networkingseminars.com
- Website: http://www.networkingseminars.com/tax-calendar/ovdwebinar

May 19

Global Tax Compliance Reporting — Webcast. Deloitte Tax LLP has scheduled a program on the evolution of global tax compliance and reporting operating models. This webcast will examine how multinational companies are using new methods and processes for meeting compliance and reporting requirements.

- Website: http://goo.gl/C3sx3w

May 24

Cost Contribution Arrangements — Webcast. Deloitte Tax LLP will host a webcast that will discuss requirements in regard to ''control,'' particularly in the context if cash box participants in cost contribution arrangements (CCAs); valuation of contributions; and the application of the OECD's new rules on CCAs.

- Website: http://www2.deloitte.com/global/en/pages/about-deloitte/articles/asia-pacific-tax-date.html

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

Tax Function of the Future — Webcast. PwC has scheduled a webcast on the tax functions of multinational organizations that will examine the growing responsibilities these organizations face and what steps they need to take to increase automation, improve data integration and processes, and take advantage of new tax technology.

- Website: https://goo.gl/mxa0GA

May 26

China Tax Cases — Webcast. Deloitte Tax LLP will host a webcast that will discuss a dozen representative China tax cases that cover areas such as indirect transfers, beneficial ownership, controlled foreign corporations, and advance rulings.

- Website: http://www2.deloitte.com/global/en/pages/about-deloitte/articles/asia-pacific-tax-date.html

May 31

Tax Considerations of Restructuring — Webcast. Deloitte Tax LLP will host a webcast that will discuss local tax law and regulations relevant to corporate restructuring in a deal context with focus on Australia, Korea, and Southeast Asia; best practices in managing tax liabilities and risks from both the seller's and buyer's perspectives; and practical case studies.

- Website: http://www2.deloitte.com/global/en/pages/about-deloitte/articles/asia-pacific-tax-date.html

June 2

U.S. Tax Reform and Policy — Villanova, Pennsylvania. The Villanova University Graduate Tax Program will host its annual tax policy symposium, ''Fundamental Tax Reform and Tax Policy Issues in Election Year 2016.'' This one-day event will discuss the state of the current U.S. tax regime, proposals to tax carried interests, and international tax policy issues and prospects for future tax law changes that will impact multinational corporations and businesses. Contact: Kate Johnston.

- Tel: (610) 519-8333
- Email: kate.johnston@villanova.edu
- Website: http://www1.villanova.edu/villanova/law/newsroom/webstories/2016/0412.html

Australia Tax Update — Webcast. Deloitte Tax LLP will host a webcast that will discuss multinational antiavoidance law implementation in Australia, the Australia Taxation Office's success in recent cases on international tax matters, and the country's initiatives on tax transparency.

- Website: http://www2.deloitte.com/global/en/pages/about-deloitte/articles/asia-pacific-tax-date.html

June 6

OECD International Tax — Washington. The Organisation for Economic Cooperation and Development will co-sponsor a two-day conference that will provide a unique opportunity for the U.S. business community to interact with key representatives from the OECD and senior U.S. tax officials and key countries involved in the OECD/G-20 BEPS project. Contact: Erin Breitenbucher.

- Tel: (202) 682-7465
- Website: http://www.uscib.org/oecd-tax-conference-ud-3647

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

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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 14

Tax Planning and Compliance — Webcast. Deloitte Tax LLP will host a webcast that will provide an overview of data analytics concepts and components and discuss three areas of value creation through tax data analytics, including improving tax operations, impacting tax liabilities, and providing strategic tax insights for decision-making across the business.

- Website: http://www2.deloitte.com/global/en/pages/about-deloitte/articles/asia-pacific-tax-date.html

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

June 23

NYU Tax Controversy Forum — New York. The New York University School of Professional Studies will host its annual Tax Controversy Forum. This event will examine a broad range of issues concerning tax audits and tax litigation and will feature a panel of IRS and Justice Department officials providing an update on their latest tax enforcement efforts. Contact: Kathleen Costello.

- Tel: (212) 992-3320
- Website: http://goo.gl/Y1RGHP

August 8

Intellectual Property Taxation — San Francisco. This program from Networking Seminars will provide a technical update on the taxation of intellectual property. This two-day event will also cover the latest techniques for maximizing the value of IP assets through effective tax planning strategies.

- Email: info@networkingseminars.com
- Website: http://www.networkingseminars.com/tax-calendar/taxip-sf

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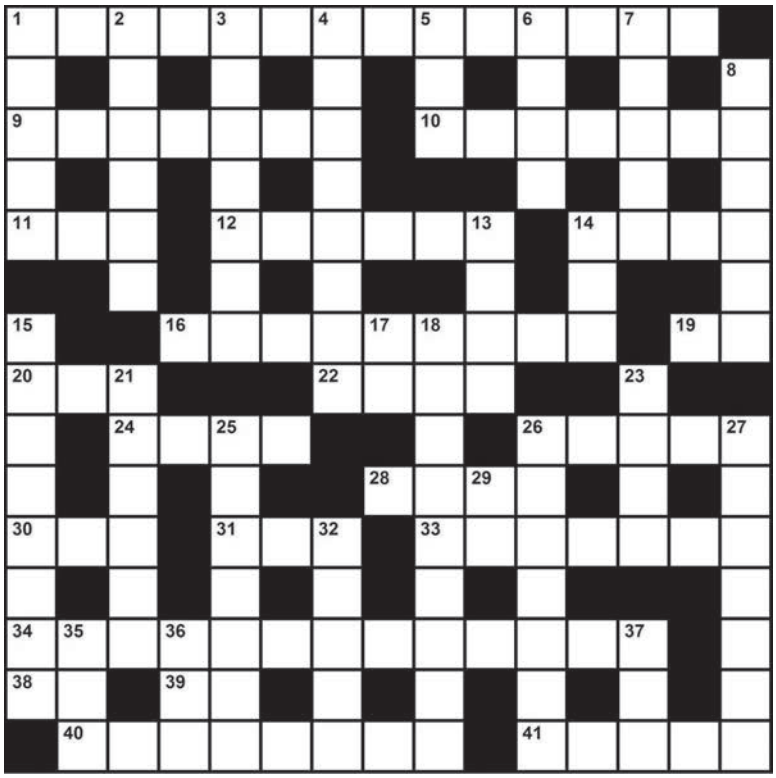
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CROSSWORD PUZZLE

May Tax Crossword Puzzle

by Myles Mellor



Across

1 They allow inverted companies to avoid taxes on dividends by loaning to a foreign parent, 2 words
9 One of the founders of the Panamanian law firm now under the spotlight in relation to offshore transactions
10 ''Clean'' dirty money
11 It might be twisted to get cooperation
12 Earn a lot of money, 2 words
14 Word with iron or lock
16 Difficult-to-track company used in hiding money flows
19 Work time covered by labor laws, abbr.
20 Revenge phrase ending
22 Understand
24 Illegally enter a computer network
26 What a prosecutor does first
28 Not resilient
30 Investigator's question word
31 Fix at a particular level
33 Caught in a sting
34 Preventing U.S. companies relocating HQ offshore to lower taxes, 2 words
38 Bismarck locale
39 Thousandth of a volt
40 Went to a higher court
41 Return

Down

1 1992 Nicholson title role — and a union boss who vanished
2 Nation under the microscope due to a leak of financial documents
3 Oil company under extensive audit relating to its tax relationship with its Australia branch
4 Following
5 Rogue computer of filmdom
6 Obligation
7 Consumer crusader
8 Start to Suisse
13 Secluded spot
14 Empty talk
15 Someone used as a cover for questionable activity, 2 words
17 365 days, abbr.
18 Supervised
21 See 23 down
23 Covert informant, goes with 21 down
25 Insurance companies established to cover the parent company's risk
26 Lucidity's opposite
27 Subject to a burden
29 Goes with Mrs.
32 Judge's mallet
35 Confidentiality agreement, abbr.
36 Tiny troublemaker
37 Compass direction

(See p. 490 for solution.)

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Sfax, Tunisia

Guy Katz
Herzog Fox and Neeman
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Peter Surtees
Norton Rose South Africa
Cape Town

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White & Case
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Frederick Burke
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