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International Tax for Asset Managers Update

A global focus on the investment management industry

In this issue

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United States: OECD releases the BEPS project 2014 deliverables

Background

On September 16, 2014, the Committee on Fiscal Affairs of the Organization for Economic Cooperation and Development (OECD) released the documents (the 2014 deliverables) that it had promised, in the 2013 Action Plan on base erosion and profit shifting (BEPS), to produce this year. The 2014 deliverables represent seven of the 15 actions of the BEPS project, a project undertaken by the 44 countries that are, or will soon be, members of the OECD or the G20 group of countries.

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Some of the 2014 deliverables provide draft recommendations, agreed to by negotiators for the 44 countries, to change domestic tax laws, treaties, and other measures so as to combat government concerns about tax BEPS in cases involving (among other things) "hybrid mismatch arrangements" and tax treaty abuse. Five of the seven documents were previously issued in draft form and the 2014 deliverables provide refinements to the recommendations in the earlier drafts; two of the seven documents are entirely new.

I. Action 2: Neutralizing the effects of hybrid mismatch arrangements

This deliverable (the "September Report," the "Report," or "Action 2") does two things: It recommends changes to countries' domestic tax laws (Part I) and recommends changes to the OECD Model Tax Convention and its Commentaries (Part II).

A. Part I—Recommended changes to domestic laws

The recommendations for changes to domestic laws in the September Report retain the basic design recommended in the discussion draft on the same topic that was released in March (the "Discussion Draft"). The following is a brief outline of the seven reports:

1. Basic framework

A. What is a hybrid mismatch arrangement?

Part I's proposed domestic legislation would apply in the case of hybrid mismatch arrangements, arrangements in which (1) there is a difference in the tax treatment of an entity or an instrument under the laws of two or more tax jurisdictions, such that a payment by or between parties to such an arrangement produces a mismatch in tax outcomes; and (2) the mismatch lowers the aggregate tax burden of the parties to the arrangement.

Action 2 identifies two basic types of mismatched tax outcomes: (1) a D/NI (abbreviation for "deduction/no inclusion") outcome is one in which the payment is deductible to the payer, but is not included in ordinary income by the payee or a related investor in the payee (i.e., is not income taxable at the full marginal rate without the benefit of any relief applicable to particular categories of payments); (2) a DD ("double deduction") outcome is one in which the payment is deductible under the laws of more than one jurisdiction.

B. Types of hybrid mismatch arrangements

Action 2 identifies five general types of hybrid arrangements.

- Two can give rise to D/NI outcomes: (i) *hybrid financial instruments* (including hybrid transfers, such as sale and repurchase agreements, or repos), where, for example, the payer/issuer on the instrument treats its payment as deductible interest and the payee/holder treats the payment as a tax-exempt dividend; and (ii) payments to reverse hybrid entities, meaning that the payee is fiscally transparent in the jurisdiction in which it was established, but not in its investor's jurisdiction.
- Another type of hybrid arrangement, involving payments by *hybrid entities* (hybrid payments), can give rise to D/NI or DD outcomes depending on the identity of the payee; here the term "hybrid" generally means that the payer is fiscally transparent under the law of the jurisdiction of its parent or investor, but not in its own jurisdiction.
- Payments by *dual residents* represent a fourth type of hybrid arrangement and can generate a DD outcome.
- Finally, by tacking a hybrid arrangement onto a non-hybrid arrangement (e.g., a party in one jurisdiction pays interest to a lender in another jurisdiction under a non-hybrid debt instrument and the lender is itself the issuer of a hybrid instrument to yet another party in a third jurisdiction), the three parties can achieve an indirect D/NI outcome in what Action 2 calls an *imported mismatch arrangement*, in that the mismatch is "imported" into the first jurisdiction.

2. Issues still to be resolved

The OECD and G20 will provide written guidance on the application of the recommendations in the form of a commentary to be published no later than September 2015. In addition, the negotiators have yet to reach consensus on certain concerns raised by countries and businesses, including:

- The application of the hybrid instrument rule to transactions, such as:
  - Intragroup hybrid regulatory capital
  - Certain on-market stock lending transactions
  - Sale and repurchase agreements
- The application of the hybrid mismatch rule to nonstructured transactions, such as treasury center operations
- Whether income subject to taxation in an investor's jurisdiction (e.g., under a controlled foreign corporation (CFC) regime) should be treated as included in ordinary income
- The extent to which the implementation of domestic law changes should be coordinated across jurisdictions, especially for noncontrolled entities
- Transitional rules establishing how the rules will apply where the dates of implementation differ among countries

The consultation period closes on February 11, 2015 and the intention is to introduce legislation from January 1, 2017 at the earliest.

B. Part II—Recommended changes to the OECD Model Tax Convention

The recommended changes to the OECD Model Tax Convention and Commentaries and other treaty material included in the Report are very similar to those included in the Discussion Draft of treaty issues that was released March 19, 2014. The item of greatest significance in this regard in Part II of Action 2 is the addition of a "fiscally transparent entity" provision to Article 1 (Persons Covered) that is similar in purpose to Article 1(6) of the US Model Income Tax Convention.

II. Action 6: Preventing the granting of treaty benefits in inappropriate circumstances

Action 6 proposes changes to the OECD Model Tax Convention to prevent treaty shopping. In contrast to one possible outcome suggested in the discussion draft of Action 6 released in March, the September version does not recommend incorporating both a US-style limitation on benefits (LOB) article and a general anti-abuse rule (referred to here as the principal purpose test or PPT) of the type commonly appearing in non-US treaties. Instead, the 2014 deliverable agrees that a disjunctive approach is sufficient, allowing the contracting states to choose either an LOB rule, supplemented by anti-conduit rules, or a PPT rule. "At a minimum," Action 6 reads.

- Countries should agree to include in their tax treaties an express statement "that their common intention is to eliminate double taxation without creating opportunities for nontaxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements"; and
- They should also implement that common intention through either:

- The "combined approach," of both the LOB rule and the PPT rule, or
- The inclusion of the PPT rule, or
- The inclusion of the LOB rule supplemented by a mechanism—whether in the treaty or domestic rules, including judicial doctrines—that would deal with conduit arrangements not already dealt with in tax treaties.

This appears to be a compromise accommodating both sides of the LOB versus PPT debate among the 44 countries.

With some exceptions, the proposed LOB rule is generally based on the US Model Income Tax Convention. Action 6 proposes that the Commentary on the LOB rule be substantially similar to the technical explanation of the LOB Article of the US Model.

Differences from the US Model include the addition of a derivative benefits provision and a provision for collective investment vehicles (CIVs). Both the derivative benefits and CIV provisions are bracketed in the report, as they are still under consideration. The status of the CIV provision reflects the ongoing debate on whether, and to what extent, countries should provide treaty benefits to CIVs and non-CIV funds.

III. Action 5: Countering harmful tax practices more effectively, taking into account transparency and substance

In general, this deliverable focuses exclusively on (1) measuring substantial activity when evaluating preferential tax treatment for certain income arising from qualifying intellectual property (e.g., a so-called IP box regime), and (2) developing a framework for compulsory spontaneous information exchange on taxpayer-specific rulings related to preferential regimes.

The action plan calls for the improvement of the transparency of preferential tax regimes, including the compulsory and spontaneous exchange of rulings related to preferential tax regimes. The report discusses, but does not fully develop, a process for such exchanges.

IV. Action 1: Addressing the tax challenges of the digital economy

With most BEPS risks of the digital economy still to be addressed in other deliverables, the digital report itself discusses, without resolving, broader tax policy challenges. These tax policy challenges are separated into those concerning (1) taxable nexus created by the mobility of intangibles, users, and business functions; (2) attribution stemming from the collection and use of data; and (3) characterization of payments in certain digital economy business models.

Moving forward, the Task Force on the Digital Economy (TFDE) is to act as industry experts tasked with ensuring that the action plan deliverables adequately address BEPS risks of the digital economy. Consequently, much of the TFDE's job is left to be completed.

V. Action 15: Developing a multilateral instrument to modify bilateral tax treaties

Like the 2014 deliverable for Action 5, the 2014 deliverable for Action 15 is an initial public release of a BEPS project paper. It covers "phase 1" of the issue of whether or how it would be feasible for 3,000+ tax treaties now in force to be revised to implement the BEPS project recommendations through a multilateral instrument. The paper concludes that it would be feasible, in particular with respect to treaty recommendations in Actions 2 and 6 (as well as possible later treaty recommendations in future deliverables) to implement them through a single multilateral instrument. The instrument contemplated in the paper would allow adopting countries to "tailor their commitment" to a core set of provisions to which countries can opt in or opt out. However, what that precisely means is unclear from the report. The report proposes that the G20 mandate an international conference to further explore implementing a multilateral instrument in 2015.

Conclusion

The BEPS project remains a work in progress and many of the most difficult questions have been deferred for later consideration. The 2014 deliverables provide a window into how the G20 and the member countries of the OECD may implement BEPS-related domestic tax law and treaty changes when the OECD's work is completed.

United States: PFIC reporting relief for mark-to-market investments

Background

On September 10, 2014, the Treasury released Notice 2014-51 announcing intent to amend its regulations under Section 1298(f) to provide relief for reporting on Form 8621 with respect to investments in a passive foreign investment company (PFIC) which is marked-to-market under any provision of the Internal Revenue Code.

On December 30, 2013, the Treasury released new temporary and proposed regulations (the "Temporary Regulations") under the PFIC rules of Code Sections 1291–1298 and withdrew corresponding portions of proposed regulations issued in 1992. The main impact of the Temporary Regulations was to implement Section 1298(f)'s requirement that a taxpayer file an annual report on Form 8621 with respect to an investment in a PFIC.

The Temporary Regulations generally impose Form 8621 reporting requirements on the lowest-tier US person in cases where there are tiers of US ownership in a PFIC. However, an upper-tier US person is required to file Form 8621 in the event they are subject to tax under Section 1291 on an excess distribution. Generally, an upper-tier US person is not required to make an annual filing with respect to a PFIC if the taxpayer is only subject to tax on the PFIC investment under the qualified electing fund (QEF) or Section 1296 mark-to-market regimes.

Notice 2014-51 announces that Treasury has determined to extend the relief afforded for PFIC investments marked-to-market under Section 1296 to PFIC investments marked-to-market under Section 475(f) or other provisions of the Code, except if in the first year of the mark-to-market election, the taxpayer's holding period includes a period during which the PFIC was not a QEF with respect to the taxpayer, or if the investment is not in fact marked-to-market (e.g., identified as held for investment or a hedge under Section 475). The notice provides that taxpayers may rely on it for taxable years ending on or after December 31, 2013.

United States: Treasury anti-inversion notice

On September 22, 2014, the US Treasury issued Notice 2014-52 (the "Notice"), which announces its intent to issue regulations that would (i) increase the effective tax rate to foreign acquirers of US targets by limiting the opportunities to achieve tax efficiencies in the course of integrating the operations, management, and financing of the businesses; and (ii) tighten the anti-inversion rules of Section 7874. This generally would directly increase US targets' tax costs and thereby reduce the after-tax returns for their foreign acquirers. The Notice announced the intent that future regulations issued thereunder apply to inversion transactions completed on or after September 22, 2014.

Regulations under Section 956 and 7701(l) only apply if the inversion transaction occurs on or after September 22, 2014, and the positions subject to those rules are also entered into or completed after that date.

Background

Generally, for Section 7874 to apply to a foreign acquisition of a US target, there must be a direct or indirect acquisition of substantially all the target's assets, ownership continuity of at least 60 percent of the acquirer's stock by reason of equity in the target (the ownership continuity test), and lack of substantial business activities by the foreign acquirer's worldwide group in the country where the acquirer is organized (more specifically, the expanded affiliated group (EAG)), which generally refers to the foreign acquirer and its direct and indirect greater-than-50 percent subsidiaries). If the ownership continuity test is satisfied at the 60-percent level, generally Section 7874 denies the use of tax attributes to reduce tax attributable to transfers of assets by the target to related foreign persons. If the ownership continuity test is satisfied at the 80-percent level, generally Section 7874 instead treats the foreign acquirer as a US corporation for US tax purposes.

Overview of notice

A focus of the announced regulations is addressing acquisitions that would otherwise conflict with Section 7874 (i.e., meeting the three requirements discussed below, which are generally an acquisition of a US target, ownership in the foreign acquirer by reason of equity in the US target at the 60-percent level, and lack of substantial business activities in the foreign acquirer's country). Thus, an impact of the regulations would be to generally limit the tax efficiencies that can be achieved in business-driven "mergers & acquisitions" transactions where owners of the US target acquire at least 60 percent of the equity in the foreign acquirer by reason of their equity in the US target. The Notice also alerts taxpayers that Treasury is considering tightening rules on otherwise-permissible leveraging of US subsidiaries of a foreign parent.

Analysis of notice

Anti-inversion standard and passive assets of foreign acquirer

In applying the ownership continuity test, Treas. Reg. §1.7874-4T generally disregards (in both the numerator and denominator) shares of the foreign acquirer issued for cash, cash equivalents, obligations of related persons, and property acquired with a principal purpose of avoidance (defined as nonqualified property). Using the broad authority to modify the anti-inversion rules under Section 7874(c)(6), the Notice announced that Treasury and the Internal Revenue Service (IRS) intend to issue regulations expanding the reach of Treas. Reg. §1.7874-4T in the case of acquisitions where over 50 percent of the foreign acquirer's EAG constitutes nonqualified property (i.e., so-called cash boxes) by reducing the denominator of the ownership continuity percentage's testing fraction; generally, the reduction is akin to reducing the denominator (equity in the foreign acquirer) by the fraction equal to the ratio of the group's nonqualified property to its total property.

Anti-inversion standard and distributions by US target

Pursuant to the broad anti-avoidance rule of Section 7874(c)(4), the Notice announced that Treasury and the IRS intend to issue regulations expanding the reach of Section 7874 by disregarding nonordinary course distributions by the US target during the 36-month period ending on the acquisition date, as well as cash or other property received by shareholders of the US target in connection with the acquisition. In other words, the regulations generally would change the application of the ownership continuity test by increasing the numerator and denominator of the ownership continuity's testing fraction. Nonordinary course distributions generally are those in excess of 110 percent of the average during the 36-month period preceding the year of the acquisition (The Notice also announced that a comparable look-back rule will be added to tighten the testing for substantiality for purposes of the limited exception to gain recognition under Treas. Reg. §1.367(a)-3(c)).

Anti-inversion standard and spin-offs

Generally, Treas. Reg. §1.7874-1 applies the ownership continuity test by disregarding shares of the foreign acquirer held by members of the EAG (the "EAG rule"), subject to two exceptions created by Treasury and the IRS. Generally, shares of the foreign acquirer held by an EAG member are included in the denominator, but not the numerator (i.e., diluting the testing fraction to facilitate business combinations without application of Section 7874) in (i) internal group restructurings where the common parent of the EAG owns at least 80 percent of the US target before the acquisition and at least 80 percent of the foreign acquirer afterward (the internal restructuring exception) and (ii) transactions where there is a loss of control (i.e., where the former owners of the US target do not hold in the aggregate, directly or indirectly, more than 50 percent of any member of the foreign acquirer's EAG).

The Notice announced that Treasury and the IRS intend to carve back the EAG rule and its internal group restructuring exception; generally, if stock of the foreign acquirer is retransferred in a transaction related to the acquisition, the stock is not treated as held by a member of the EAG (i.e., the transferred stock is included in the numerator and denominator of the ownership continuity testing fraction). The carve back does not apply in the case of a US parented group if (i) before and after the acquisition, the target shareholder is a member of the EAG; and (ii) after the acquisition and all related transfers of the foreign acquirer stock, the foreign acquirer and holder of the retransferred stock are members of the EAG. The carve back does not apply in the case of a foreign parented group if (i) before the acquisition, the target and transferor of the retransferred stock are members of the same EAG; and (ii) after the acquisition the retransferor is a member of the EAG or would be absent the transfer of stock in the foreign acquirer by a member of the EAG in a transaction related to the acquisition.

The carve back would have the effect of denying use of the EAG rule and internal group restructuring exception in situations where a US subsidiary of a US multinational transfers substantially all its assets to a new foreign subsidiary and the shares of the new foreign subsidiary are distributed to the public in a Section 368(a)(1)(D) reorganization and Section 355 spin-off. As a result, the new foreign acquirer would be treated as a US corporation by application of the general rules of Section 7874. Treasury alerted taxpayers that it was considering this treatment of divisive transactions in the preamble that accompanied Treas. Reg. §1.7874-4T and -5T in January 2014, as well as in the preamble to final regulations issued under Section 7874 in June 2012.

Inversions and use of offshore cash

Generally, Section 951(a)(1)(B) together with Section 956 cause a US shareholder of a CFC to have taxable income akin to a deemed dividend in respect of the US shareholder's pro rata share of the CFC's investment in US property (Generally, a US shareholder is a US person holding shares with at least 10 percent voting power in respect of a relevant foreign corporation; generally, a CFC is a foreign corporation whose stock is over 50 percent [by vote or value] held in the aggregate by US shareholders). Over time, Congress has passed various rules to define what constitutes US property in order to prevent repatriation of US earnings without US tax.

Using the authority under Section 956(e), the Notice announced that Treasury and the IRS intend to issue regulations to change the statutory definition of "US property" to include investments in stock or obligations of related foreign persons within the meaning of Section 7874(d)(3) (or pledges or guarantees in respect of obligations of such persons), but only for CFCs for which an expatriated entity is a US shareholder, and then only for the 10-year inversion gain period of Section 7874. For this purpose, a foreign-related person is a foreign person that is related to or under common control with a US target in an acquisition to which Section 7874 applies (or a US person related to said target). Generally, however, a foreign related person does not include an expatriated foreign subsidiary (i.e., a CFC with respect to which the US target or a related US person is a US shareholder), unless after the acquisition and related transactions the US target ceases to be a US shareholder with respect to that foreign subsidiary.

Section 956(e) authorizes regulations to prevent avoidance of Section 956; however, as noted, Section 956 also contains a specific list of investments over time decided by Congress to represent investments in US property. Thus, these regulations would represent an expansive reading of Congress' intent for anti-abuse regulations, so as to treat an investment in non-US property as "US property" without the need to trace a CFC's investment in such non-US property back to a US person (such as under a conduit arrangement).

Inversions and business integration

Generally, Section 367 and Section 1248 operate to allow for taxation of a CFC's untaxed earnings on various dispositions of shares in the CFC by a US shareholder. Using the authority under Section 7701(l) (which addresses multiple party financing transactions), the Notice announced that Treasury and the IRS intend to issue regulations to prevent avoidance of Sections 367 and 1248 by recharacterizing specified transactions. Generally, a specified transaction is one in which stock in an expatriated foreign subsidiary is transferred to a specified related person or a US target's share ownership in the expatriated foreign subsidiary is diluted. Again, an expatriated foreign subsidiary is defined as a CFC for which an expatriated entity is a US shareholder and then only for the 10-year inversion gain period of Section 7874. A specified related person generally is a foreign related person that is not a CFC of the US target, a US partnership that has one or more partners that is such a foreign person, or a US trust that has one or more beneficiaries that is such a foreign person.

Generally, a specified transaction is recast for all purposes of the Code such that the investment in stock of an expatriated foreign subsidiary by a specified related person is treated as having been transferred by that specified related person to the US shareholder(s) of the expatriated foreign subsidiary in exchange for stock issued by said US persons and those US persons are, in turn, treated as transferring that property to the expatriated foreign subsidiary for stock. Generally, a specified transaction does not include transactions where the specified stock was transferred by a shareholder of the expatriated foreign subsidiary and the US shareholder is required to recognize, and includes in income, proceeds as an actual or deemed gain or dividend. Further, generally, a specified transaction does not include a transaction where the expatriated foreign subsidiary is a CFC after it and all related transactions and the stock (by value) in the expatriated foreign subsidiary (and any lower tier expatriated foreign subsidiary) that is owned in aggregate by US shareholders does not decrease by more than 10 percent as a result of the specified transaction and any related transactions.

Congress enacted Section 7701(l) in the wake of arrangements where three parties engaged in a chain of financing transactions (e.g., back-to-back loans from a Cayman company to a company resident in a country with a tax treaty with the United States and turn to a US company, in hopes of obtaining treaty benefits for payments from the US company). Congress specified that it intended to prevent tax avoidance by intermediate or conduit entities (even if not involving back-to-back loans). Thus, these regulations would represent an expansive reading of Congress' intent for Section 7701(l), given their impact on the integration of business assets of a US target with a foreign acquirer (as opposed to shell intermediate companies), even when such arrangements do not include financing transactions.

The Notice also announced that Treasury and the IRS intend to issue regulations that would require an exchanging shareholder described in Treas. Reg. §1.367(b)-4(b)(1)(i)(A) (generally, a US person that is directly or indirectly a 10 percent shareholder by vote in respect of a foreign corporation that is exchanging said stock for stock in a foreign acquirer in an exchange as described in Section 351 or Section 354 or a foreign corporation that has such a US shareholder and makes such an exchange) to include as a deemed dividend the Section 1248 amount attributable to stock of an expatriated foreign subsidiary transferred in the exchange, even when the requirements for noninclusion under Treas. Reg. §1.367(b)-4(b) are otherwise satisfied. This would expand the reach of Treas. Reg. §1.367(b)-4. The Notice further announced that the future regulations will provide that the exceptions to Subpart F foreign personal holding income treatment under Treas. Reg. §1.367(b)-4(c)(1) and for related-party dividends under Section 954(c)(3)(A)(i) and 954(c)(6) would not apply to the resulting deemed dividend of the Section 1248 amount.

Section 304 deemed distributions

The Notice announced that Treasury and the IRS intend to issue regulations that would expand the scope of Section 304(b)(5)(B) (relating to a foreign corporation's acquisition of stock in a related corporation). Generally, the rule prevents the acquisition of stock in a Section 304 transaction resulting in a deemed dividend of the foreign acquirer corporation's earnings and profits of the transferor of the stock, unless over 50 percent of any deemed dividend resulting from the acquisition is subject to US tax or includible in the earnings of a CFC. Under the authority of Section 304(b)(5)(C), the Notice announced that future regulations will further enhance the Section 304(b)(5)(B) limitation by providing that none of the foreign acquirer corporation's earnings and profits will be taken into account, unless more than 50 percent of the Section 304 deemed dividend is (i) sourced out of the earnings and profits of that foreign acquirer corporation and (ii) otherwise subject to US tax or included in the earnings and profits of a CFC (i.e., the earnings and profits of the issuing corporation are not to be taken into account for purposes of this 50 percent test). If the foreign acquirer corporation's earnings and profits are not taken into account under this enhanced Section 304(b)(5)(B) limitation rule, the Section 304 deemed dividend will then be sourced solely out of the earnings and profits of the issuing corporation. This enhanced Section 304(b)(5)(B) limitation rule would apply to all Section 304 transactions, regardless of whether related to or subsequent to an inversion subject to Section 7874.

Given that Congress drafted Section 304(b)(5)(B) so as to test for application to the "dividend" under the Section 304(a) transaction "without regard to this subparagraph," these announced regulations represent an expansive reading of Congress' intent for regulations appropriate to carry out the purposes of Section 304(b)(5)(B).

Effective dates

The Notice announced the intent that future regulations issued thereunder apply to inversion transactions completed on or after September 22, 2014. However, the regulations under Section 956 and Section 7701(l) apply if the inversion transaction occurs on or after September 22, 2014, and the positions subject to those rules are also entered into or completed after that date.

Under the Notice, taxpayers may elect to apply to earlier periods the foreign-parented group exception for the carve back to the regulatory internal group restructuring exception.

Other matters for consideration: Earnings "stripping" and treaties

The Notice announced that Treasury and the IRS expect to issue additional guidance to limit inversion transactions contrary to the purposes of Section 7874 and the benefits thereof. In particular, the Notice requests comments on guidance on cross-border investment and acquisitions that inappropriately shift or "strip" US source earnings to lower-tax jurisdictions, including, but not limited to, intercompany debt. The Notice announced that such guidance will be prospective, except that for inverted groups such future guidance will apply to groups that completed inversion transactions on or after September 22, 2014. The authority to promulgate such possible regulations is unstated and unclear.

Finally, the Notice states that Treasury is "reviewing its tax treaty policy regarding inverted groups and the extent to which taxpayers inappropriately obtain treaty benefits that reduce US withholding taxes on US source income."

Treasury is "reviewing its tax treaty policy regarding inverted groups and the extent to which taxpayers inappropriately obtain treaty benefits that reduce US withholding taxes on US source income."

Modifying treaties with respect to inverted companies, especially through regulations, would represent an expansive reading of Congress' intent for anti-abuse regulations given that Congress is given constitutional power to ratify or refuse to ratify amendments to treaties or legislative overrides thereof.

France: New protocol to treaty with Luxembourg addresses taxation of gains on shares in real estate companies

Background

On September 5, 2014, France and Luxembourg signed a protocol to the tax treaty dating from 1958, as amended by several earlier protocols. The new protocol contains rules on the tax treatment of capital gains derived from the sale of shares in real estate-rich companies.

Under the existing treaty, and unlike the treatment under the OECD model, capital gains on the sale of shares in companies whose assets are composed mainly of real estate located in a contracting state are not taxable at all in the state where the property is located. For example, capital gains derived by a Luxembourg company from the disposal of shares held directly or indirectly in a company holding real estate located in France will be taxable only in Luxembourg. These gains generally will be exempt from taxation in Luxembourg if the requirements for application of Luxembourg's participation exemption regime are satisfied.

The protocol adds a new paragraph four to article 3 of the treaty to close the loophole under which it is possible for an investor in one country to avoid tax in the other country by selling shares in an entity holding property in that other country, rather than selling the property itself.

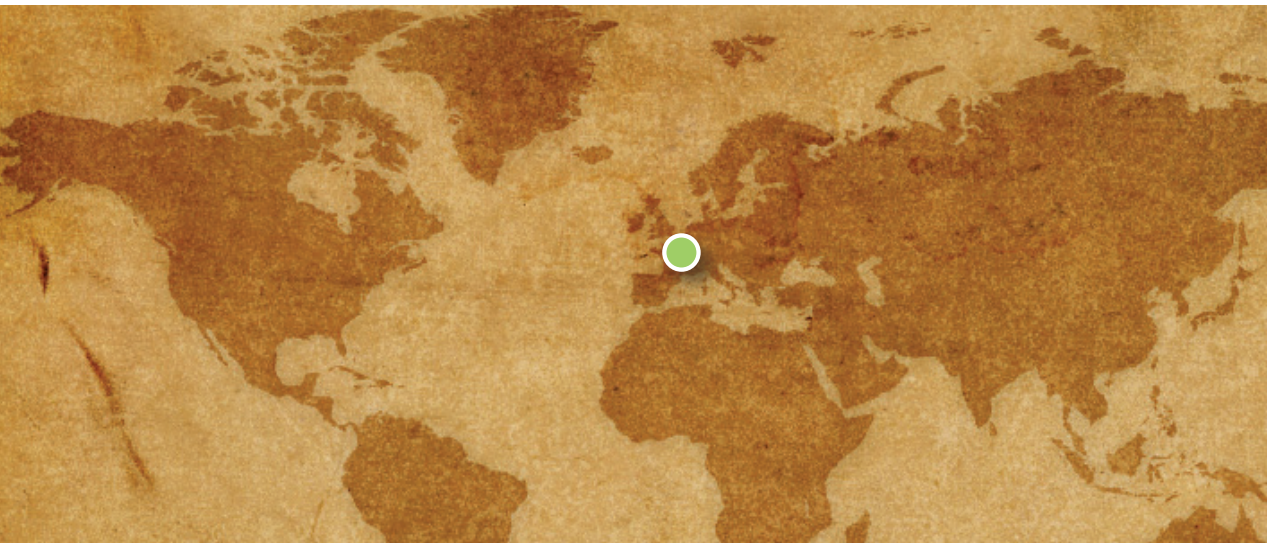
Under the protocol, a sale of shares (or an assignment of shares, stock, or similar rights) in a company deriving most of its value from real estate located in a contracting state no longer will be exempt from tax in the state where the property is located. New paragraph four provides that taxation rights on gains derived by a resident of a contracting state from the sale of shares or similar rights in an entity (including a company, trust, or other institution) whose assets or goods are composed of, or derive more than 50 percent of their value directly or indirectly from, immovable property located in the other contracting state will be granted to that other state. In applying this paragraph, immovable property allocated by such an entity to its own business activities will not be taken into account (e.g., where an entity owns a hotel property and also operates the hotel).

Under the new rule, the treaty no longer will pose an obstacle to the full application of French domestic tax law to capital gains derived from shares in companies predominantly holding real estate located in France.

The protocol will apply from the beginning of the financial year following the year in which it enters into force as a result of the exchange of notifications between the contracting states. The new rule will not apply retroactively. Assuming both countries complete their ratification procedures by the end of 2014, the protocol will apply as from January 1, 2015.

The protocol does not make changes to any other provisions of the treaty affecting the real estate industry, although the French and Luxembourg governments have expressed their intent to continue negotiations with a view to "modernizing" the treaty provisions.

A sale of shares in a company deriving most of its value from real estate located in a contracting state no longer will be exempt from tax in the state where the property is located.



Germany: Upper house of parliament proposes new anti-hybrid rule and other measures

Background

On November 7, 2014, Germany's upper house of parliament (*Bundesrat*) approved a draft tax bill that includes a new anti-hybrid rule and several other measures (*Law on the adaptation of the General Tax Code to the European customs codex and amendment of other tax provisions*). The draft is part of a legislative process initiated by the federal government in September, although the version approved by the upper house includes several new measures.

Although it is unclear whether the changes proposed by the upper house will be included in the final version of the draft law and whether this will take place before year-end, the changes do reflect the current political environment in Germany and it is likely that at least some of the proposals will make it into the final version.

The most important proposed changes affecting the investment management industry are the following:

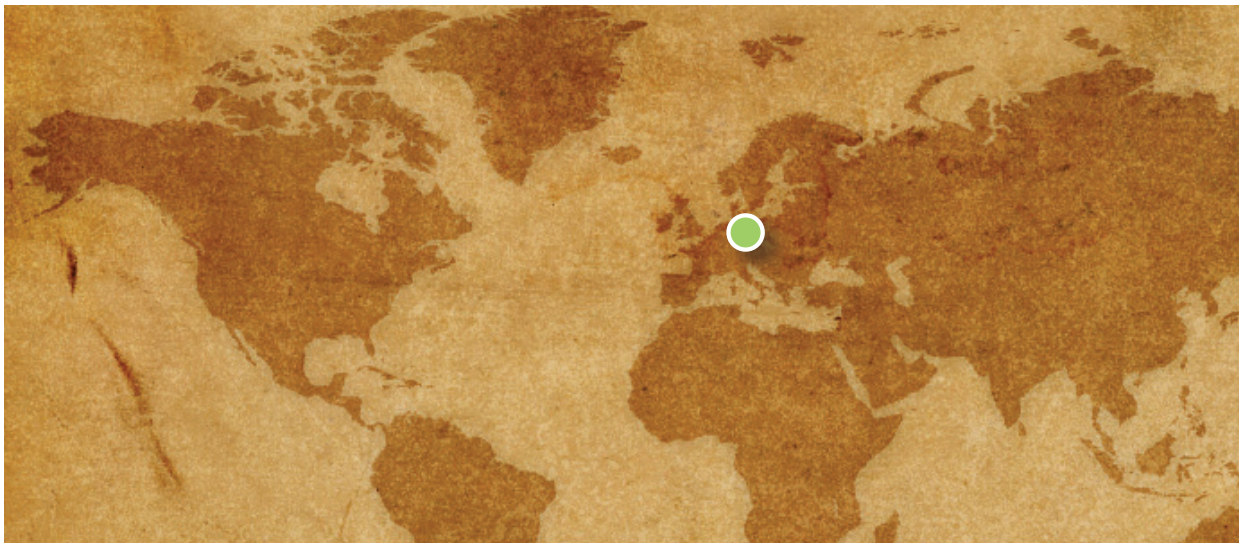
- In response to the OECD BEPS initiative, a deduction for business expenses would be disallowed to the extent there is no corresponding income inclusion (deduction/no-inclusion) or to the extent there is a reduction of the taxable income in another country for the same expenses (double deduction).
- A 10 percent minimum shareholding requirement would be introduced to qualify for the 95 percent participation exemption on gains from a sale of shares.
- Competency for certain withholding tax reclaims based on EU law would be centralized in the federal tax office.

The final vote on the draft tax law is expected in mid-December. Although it is unclear whether the changes proposed by the upper house will be included in the final version of the draft law and whether this will take place before year-end, the changes do reflect the current political environment in Germany and it is likely that at least some of the proposals will make it into the final version.

Details of proposed changes

Anti-hybrid and anti-double-dip rule: The proposed anti-hybrid rule would disallow a deduction of business expenses for German tax purposes in two situations:

1. To the extent the corresponding income is not included for tax purposes at the level of the direct or indirect recipient of the payment; or
2. To the extent the income is treated as being tax exempt at the level of the recipient.



In both cases, the noninclusion would have to be based on a mismatch relating to the underlying debt instrument, (e.g., in the case of a hybrid instrument that qualifies as debt at the level of the German borrower and as equity at the level of the foreign recipient).

In addition, a proposed "anti-double-dip rule" would disallow a deduction for German tax purposes to the extent there is a deduction for tax purposes for the same expenses in another jurisdiction.

The proposed rules would become effective for the fiscal year in which they are formally published. Should the law including this provision be enacted in 2014, the rule could become retroactively effective for 2014.

The proposals are based on the OECD BEPS Action 2 (hybrid mismatches), as described in the report published in March 2014. Interestingly, in its tax policy statement issued in November 2013, the German federal government took the position that unilateral measures resulting from the BEPS initiative should be taken only if no consensus could be reached at an international level after the final publication of the relevant OECD reports in 2015. Whether the government will revise this position during the legislative process remains to be seen.

It should be noted that the proposals of the upper house would not be limited to related-party transactions, but also would encompass transactions with unrelated third parties. This goes beyond the OECD recommendations and it is questionable whether (and how) a taxpayer would have to demonstrate how the income in a third-party transaction is treated at the level of the foreign recipient for local tax purposes. The introduction of the term "indirect recipient" raises even more questions. Based on the official explanations, the inclusion of indirect recipients should target back-to-back structures. It appears that this terminology (which previously has not been used in German tax law) is based on the D/NI outcome as described in Action 2 of the BEPS initiative.

Based on the wording of the anti-hybrid rule and the reference to Action 2 in the official explanations to the draft law, it is possible that the rule also would apply where the noninclusion at the level of the recipient is based on the fact that the underlying debt instrument is ignored for tax purposes by the country where the recipient is resident. This would target structures in which the payer is a subsidiary of the recipient and treated as a disregarded entity in the country of the recipient. As a result, the debt instrument would be ignored for purposes of the taxation of the recipient, which, under the new rules, would potentially result in the expenses on the instrument being nondeductible for German tax purposes.

With respect to anti-double-dip structures, the proposal specifically mentions structures involving German partnerships where, under the German tax accounting rules for partnerships, interest expenses may be deductible for German tax purposes at the level of the partnership and for foreign tax purposes at the level of the relevant partner at the same time. The proposal aims to shut down these frequently used structures in the future.

Capital gains from the sale of portfolio shareholdings would no longer qualify for the 95 percent participation exemption

The introduction of a 10 percent minimum shareholding for the application of the 95 percent tax exemption for capital gains from the sale of shares responds to the law change after the Court of Justice of the European Union ruled that Germany's withholding tax on outbound dividends violates EU law. As a result, a 10 percent minimum shareholding requirement for the application of the 95 percent participation exemption for dividends was introduced in 2013. Based on the official explanations provided by the upper house, the proposed law change would shut down tax planning opportunities resulting from the currently different treatment of capital gains and dividends. The upper house previously launched several initiatives to introduce the same treatment, but thus far has been unsuccessful.

Federal tax office to determine withholding tax reclaims based on EU law

For a number of years, many foreign corporate shareholders and investment funds have filed reclaims for withholding tax on dividends paid by German companies where an argument could be made that the withholding tax was levied in violation of EU law, namely the free movement of capital provisions. With the exception of EU-resident corporate shareholders, the competency for dealing with these reclaims has been unclear. According to German case law, the tax office where the most valuable part of the German assets of the claimant is situated is competent to address such reclaims. However, particularly in cases where the claimant owns more than one shareholding in German companies, it often is very difficult to determine the competent tax office, resulting in complex reclaim procedures where parallel reclaims are filed with many tax offices.

The proposal of the upper house includes an amendment to the technical provisions of the law on tax administration that would significantly affect these withholding tax reclaims. Under the revised rule, the federal tax office would be designated as the single competent tax office to address withholding tax reclaims of foreign corporate shareholders, regardless of the reason for the reclaims. Hence, the process would become significantly less burdensome for taxpayers and the tax administration.

Comments

The draft law approved by the upper house of parliament includes significant changes for foreign investors, especially investors from the United States. The introduction of the anti-hybrid rule and the anti-double-dip rule would exceed the recommendations of the OECD and would have a broad scope of application. Although the outcome of the proposals is still unclear, taxpayers should closely monitor the progress of the bill and any subsequent developments to avoid surprises.

Finland: Changes proposed to tax treatment of dividends received by foreign pension institutions

Background

The Finnish government has proposed changes to the withholding tax treatment of foreign pension funds (both EU/European Economic Area (EEA) and third country funds) that receive dividends from Finland. The proposal responds to the 2012 decision of the Court of Justice of the European Union (CJEU) in Commission v. Finland, in which the court held that the Finnish withholding tax levied on dividends paid to EU/EEA resident pension funds violated the free movement of capital principle. If approved, the proposed rules would apply as from January 1, 2015, and could create an opportunity for affected funds to request a refund for prior years.

Under current Finnish law, dividends received by an EU/EEA resident pension fund are subject to a 15 percent withholding tax on the gross amount (unless a lower rate is available under a tax treaty), whereas, in practice, a Finnish pension fund does not pay tax on dividend income. In principle, 75 percent of dividends is considered taxable income of a Finnish pension fund, but domestic tax law allows a domestic fund to take a notional tax deduction (e.g., based on amounts needed to cover future pension liabilities) that effectively reduces the taxable result to zero. Since Finnish pension funds are taxed on a net basis, dividends received effectively are exempt from tax. The CJEU ruled that nonresident pension funds are treated less favorably than domestic funds and that the different treatment could not be justified.

The government now has proposed that certain foreign pension funds be subject to the same treatment as Finnish pension funds.

The government now has proposed that certain foreign pension funds be subject to the same treatment as Finnish pension funds. Provided certain requirements are met, a foreign pension fund would be able to deduct as a cost an amount that corresponds to the portion the Finnish source gross dividends represent the turnover of the fund. The 15 percent tax then would be withheld on the net dividends. Primarily because of the way the amount of the deduction is calculated, in practice, the Finnish dividend payer would withhold the 15 percent tax on the gross amount and the foreign pension fund subsequently would have to file a refund claim with the Finnish tax administration.

An EU/EEA pension fund would be entitled to the new deduction on gross dividends if (1) it is comparable to a Finnish pension fund; and (2) the Finnish shares can be classified as "investment assets," as defined in Finnish law. A pension fund from outside the EU/EEA would need to meet these requirements, as well as the following:

- The direct participation in the Finnish dividend distributing entity is less than 10 percent; and
- The country in which the fund is resident has concluded a treaty on the exchange of tax information with Finland and the Finnish authorities are able to verify with the treaty partner information relating to the taxation of the pension fund, its activities, and its supervision.

EU/EEA and third-country pension funds also would have to produce sufficient information to enable the calculation of the amount of the new deduction.

If enacted, the proposed rules would apply to dividends paid to foreign pension funds on or after January 1, 2015. However, the proposal also would open up an opportunity to request the deduction for years before 2015 because the Finnish withholding tax rules violated the EU freedoms prior to 2015. Because Finland's statute of limitations is five years, a refund claim for tax withheld in 2009 would need to be submitted to the Finnish tax administration before December 31, 2014, at the latest, to preserve a foreign pension fund's rights.

India: Delhi High Court clarifies tax consequences of indirect share transfers

In a decision issued on August 14, 2014, Director of Income Tax (International tax) v. Copal Research Limited, Mauritius), the Delhi High Court examined the meaning of the term "substantially" in the amended version of the provisions of the Income Tax Act (ITA) dealing with indirect transfers. The court opined that the purpose of the amended rules is not to expand the scope of taxation to include income derived from transfers that do not have a territorial nexus with India. The court also ruled in favor of the taxpayer and stated that capital gains arising from a transfer of shares of a foreign company should not be liable to tax in India if such shares derive less than 50 percent of their value from underlying assets located in India. In other words, a threshold of 50 percent or more should be met before taxation of capital gains is triggered in India. The court upheld the applicability of the capital gains tax exemption under the India-Mauritius tax treaty.

While the Delhi High Court decision provides welcome clarification with respect to the interpretation of the term "substantially" that is used in the provisions of the ITA relating to indirect transfers, the fact that the court addressed the meaning of the term even though this issue was not specifically before it means that its interpretation may be considered nonbinding dicta that may have only persuasive value in other cases.

Background

Following India's Supreme Court decision in the Vodafone case in 2012, the Finance Act 2012 introduced a controversial and far-reaching amendment into the ITA that clarified that a nonresident would be subject to tax in India on a transfer of shares or an interest in a foreign entity if such shares/interest substantially derive their value from assets located in India. The fact that the word "substantially" is not defined in the amended rules has created considerable uncertainty regarding the application of the rules, particularly for foreign companies with business interests in India; such companies have faced ambiguity about the capital gains tax and withholding tax implications of certain share transfers overseas that result in the indirect transfer of an India business, as well as potential challenges by the India tax authorities.

...capital gains arising from a transfer of shares of a foreign company should not be liable to tax in India if such shares derive less than 50 percent of their value from underlying assets located in India.

Facts of the case

The Copal Group had undertaken the sale of shares of its companies to the Moody's Group via three transactions:

- Copal Research Limited, Mauritius (CRL) sold a wholly owned Indian subsidiary to Moody Cyprus (transaction 1);
- Copal Market Research Limited, Mauritius (CMRL) sold a wholly owned US subsidiary that, in turn, was the 100 percent owner of an Indian subsidiary to Moody USA (transaction 2); and
- One day after transactions 1 and 2, the Copal group shareholders holding 67 percent of the shares in Copal Partners Limited, Jersey (CPL), the ultimate holding company at the head of the Copal group, sold their shareholdings to Moody UK; the balance of 33 percent of shares in CPL continued to be held by banks and financial institutions (transaction 3).

The taxpayers claimed that transactions 1 and 2 were not taxable in India under the provisions of the India-Mauritius tax treaty and requested a ruling from India's Authority for Advance Rulings (AAR) on the capital gains and withholding tax implications of these transactions. The AAR determined that the capital gains resulting from the transfers were not taxable in India and, consequently, did not attract withholding tax.

The Indian tax authorities challenged the AAR's ruling, claiming that:

- Transactions 1 and 2 were carried out with the objective of avoiding tax and had no commercial substance. All three transactions should be viewed together as a transfer of the entire business of the Copal group to the Moody's group, which would have been taxable in India if transactions 1 and 2 had not been executed because the shares of CPL (involved in transaction 3) derived significant value from assets located in India. Effectively, all three transactions were part of a single, larger transaction.
- Management and control of the Copal group were carried out by a UK resident, and not in Mauritius; therefore,the companies involved in transactions 1 and 2 should not have been entitled to beneficial treatment under the India-Mauritius tax treaty.

Delhi High Court ruling

The Delhi High Court upheld the determination of the AAR, ruling that the sales of shares by the Mauritius companies were bona fide transactions with a commercial justification.

Specifically, the court held that transactions 1 and 2 were commercially justified and were not structured to avoid tax. Executing transactions 1 and 2 before transaction 3 allowed the Moody's group to acquire 100 percent of the Copal subsidiaries sold (rather than the 67 percent it would have acquired from a direct transfer of the shares in CPL) and allowed the Copal group to distribute the entire consideration from the sale of these subsidiaries to the Copal shareholders and the other 33 percent shareholders in CPL by way of a dividend.

Although it was not necessary for the high court to consider whether the sale of CPL would have been taxable in India if transactions 1 and 2 had not been respected, the court considered it appropriate to address the tax authorities' argument.

The Delhi High Court noted that, according to the amended law dealing with indirect transfers, income from a transfer of shares of a foreign company is deemed to be income from an asset located in India if the shares substantially derive their value from assets located in India. The court determined that the purpose of the amended rules is not to expand the scope of taxation to include income derived from transfers that do not have a territorial nexus with India. It opined that the term "substantially" should be interpreted to mean "principally," "mainly," or at least "a majority" and stated that capital gains arising from a transfer of shares of a foreign company should not be liable to tax in India if such shares derive less than 50 percent of their value from underlying assets located in India. In arriving at the 50 percent threshold, the court referred to relevant provisions of the proposed Direct Taxes Code (DTC) 2010 and the "Shome Committee" report (which recommended that the term be defined at a threshold of 50 percent of the total value being derived from assets located in India). The court also referred to the capital gains articles in the UN and OECD model treaties (which provide a threshold of 50 percent to determine whether shares derive their value "principally" from immovable property situated in the relevant contracting state).

The court considered the values of the consideration for transactions 1 and 2 (which involved the Indian subsidiaries) and for transaction 3, and concluded that only a fraction of the value of the shares in CPL (less than 50 percent) was derived indirectly from India. Accordingly, even if transactions 1 and 2 had been disregarded, the court concluded that the income from the sale of CPL would not have been taxable in India.

Although the court agreed with the AAR that a UK individual played a broader role than that of an agent with respect to the transactions, it concluded that this fact alone, in the absence of further evidence, was insufficient to conclude that CRL and CMRL were managed from the UK rather than by their Mauritius boards of directors. Accordingly, the court did not deny the benefits of the India-Mauritius treaty for transactions 1 and 2.

Comments

As noted above, the decision of the Delhi High Court provides much-anticipated clarification of the term "substantially" in the law relating to indirect transfers. However, the meaning of this term was not an issue specifically before the court; therefore, the court's interpretation is dicta that may have only persuasive value. More guidance also is awaited from the government.

It is relevant to note that the proposed DTC 2013 defines the term "substantial" to mean an interest of 20 percent or more (in the instant case, the Delhi High Court considered the earlier, 2010 version of the DTC). It would be interesting to see what the court's conclusion would have been if it had an opportunity to consider the DTC 2013.

Taxpayers should carefully review their cross-border sales and acquisitions of businesses, as well as intragroup restructurings, in light of this decision.

China: Official guidance on tax treatment for MMA/QFII/RQFII

The Ministry of Finance, the State Administration of Taxation, and the China Securities Regulatory Commission jointly issued two tax circulars, clarifying the income tax treatment for capital gains and business tax implication under mutual market access (MMA) scheme and the income tax treatment for capital gains for qualified foreign institutional investor (QFII) and renminbi qualified foreign institutional investor (RQFII) as follows:

Starting November 17, 2014, overseas investors trading securities in China under MMA scheme will be entitled to exemption of tax for capital gains and business tax exemption.

- Starting November 17, 2014, overseas investors trading securities in China under MMA scheme will be entitled to exemption of tax for capital gains and business tax exemption. However, stamp duty should still be payable for securities trading pursuant to the applicable regulations.
- QFII and RQFII will be temporarily exempted from tax for capital gains generated from its securities and other equity investment in China starting from November 17, 2014. However, capital gains received by QFII and RQFII before November 17, 2014, shall be subject to corporate income tax.

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