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International Tax for Asset Managers Update

A global focus on the investment management industry

In this issue

OECD releases final BEPS reports

On Monday, October 5, 2015 the Organization for Economic Cooperation and Development (OECD) released the 2015 Final Reports on the G20/OECD Base Erosion and Profit Shifting (BEPS) project.[1] These reports cover the seven topics that were the subjects of the "2014 Deliverables" approved last fall, and finalize subsequent discussion drafts on the remaining eight "actions."[2] The 2015 Final Reports recommend changes to domestic laws, the OECD Model Tax Convention (the "OECD Model"), and the OECD Transfer Pricing Guidelines (TPG). In addition, they propose to accelerate the incorporation of recommended treaty changes into existing bilateral treaties through a multilateral convention to be entered into by interested countries.

The 2015 Final Reports are to be presented to the G20 Leaders in Lima on Thursday, October 8.

Overview of the BEPS package

Putting aside Actions 8, 9, and 10 (recommending changes to the TPG), many of the recommendations in the 2015 Final Reports are consistent with the 2014 Deliverables, subsequent discussion drafts, and public statements by the BEPS negotiators. The recommendations include additional examples and resolve some open issues, leaving others for subsequent development.

The table below contains an overview of several key non-transfer pricing reports and highlights some of the significant changes from prior deliverables and discussion drafts.

Implementation

In General

The practical realities of achieving consensus among the countries that participated in the BEPS project are reflected in the fact that almost every recommendation generally reflects only one of three possible levels of endorsement; they are indicated by, in descending order, the terms "minimum standards," "common approaches," and "best practices." (One of the 2015 Final Reports (Action 7, regarding changes to the OECD Model definition of a permanent establishment ("PE")) lacks even one of these levels of consensus.) "Minimum standards" reflect commitments to consistent implementation of standards

[1] *The final reports are on the OECD website at http://www.oecd.org/tax/beps-2015-final-reports.htm.*

[2] *The BEPS Package also includes an Explanatory Statement that provides a useful, and very brief, introduction to the 1000-plus pages of the final reports.*

laid out in final reports, and agreements to be subject to monitoring by the OECD during and after implementation. "Common approaches" reflect agreement as to "general tax policy direction," with the aspiration that they will become "minimum standards" over time. "Best practices" are offered where the negotiators failed to reach a consensus that countries must adopt legislation on the particular topic in question.

European Union

The European Council may intend to implement these minimum standards and best practices across all of the EU's 28 member states in conjunction with the implementation plan outlined in the 2015 Final Reports.

United States

The US Congress has not been directly involved in the BEPS project, and to this point has shown little interest in implementing it. However, the 2015 Final Reports, and subsequent actions by other nations, may motivate Congressional action of some sort on international tax issues in the future.[3] Earlier this year, the chairmen of the House and Senate tax writing committees[4] sent two letters to Treasury Secretary Jack Lew, asking to be kept informed on the details of the BEPS project and voicing concerns about country-by-country reporting (agreed to by the BEPS negotiators in Action 13), including whether the Treasury has the authority to implement it without legislation. In addition, the BEPS negotiators' endorsement of the "substance" approach to preferential tax regimes (agreed to in Action 5) may have increased Congress's appetite for enacting an "innovation box" that would be intended to preserve US R&D jobs.[5]

Highlights of Final Reports

The following table provides a brief outline of some of the 2015 Final Reports, including an overview of significant changes from prior deliverables and discussion drafts as well as notes concerning agreement implementation of each final report:

[3] *The most recent effort by key taxwriters, including Ways and Means Committee Chairman Paul Ryan, R-Wis., and Senate Finance Committee member Charles Schumer, D-NY, to pair a rewrite of the U.S. international tax rules with legislation to provide additional funding for highway construction and repair, appears to have stalled, at least temporarily. But in a statement released October 5, Ryan said that the 2015 BEPS Final Reports "will only increase the pressure for American businesses to move overseas [and the solution] is to bring our tax code into the 21st century, allowing companies to bring back their earnings without penalty and making our tax rates more competitive with the rest of the world. There is never going to be a perfect time to fix the tax code, but stalling for so long got us into this problem. We can't afford to wait any longer."*

[4] *Paul Ryan and Senator Orrin Hatch, R-Utah.*

[5] *House Ways and Means Committee members Charles Boustany, R-La., and Richard Neal, D-Mass., released a discussion draft proposal for a so-called "innovation box" in July that, among other things, could theoretically reduce the corporate income tax rate to as low as roughly 10 percent on certain income associated with intellectual property such as patents, inventions, know-how, software and films. The Boustany-Neal proposal was expected to be part of broader legislation being developed by Chairman Ryan that would overhaul U.S. international tax rules and generate certain one-time revenue from the reform provisions to pay for a long-term extension of the Highway Trust Fund.*

Action	Overview	Significant Developments	Implementation
		Financing	
Neutralize effects of hybrid mismatch arrangements (Action 2)	• Domestic law and treaty provisions that deny a deduction or require an income inclusion with respect to arrangements involving hybrid instruments or entities	• Favorable treatment for income inclusions under CFC regimes • Treatment of stock loans and repos • Further detail and explanatory examples	• Common Approach
Limit base erosion via interest deductions (Action 4)	• Limits on deductions for related and unrelated party interest deductions	• Net interest deductions limited to a fixed ratio of EBITDA • Fixed ratio between 10-30% • Exception from fixed ratio test for individual members of more highly leveraged consolidated groups	• Common Approach • Additional work in 2016 on groups that are highly leveraged or in banking or insurance • Additional work in 2016 and 2017 on transfer pricing aspects of financial transactions
		Supply Chain	
Strengthen CFC rules (Action 3)	• Outlines "building blocks" for design of a CFC regime	• Largely unchanged	• Best Practices
Prevent treaty abuse (Action 6)	• Recommends changes to OECD Model to prevent treaty shopping	• Largely unchanged	• Minimum Standard • Insert into the Multilateral Instrument • The LOB will be updated to reflect the US Model Treaty revisions due to be finalized this fall. • Non-collective investment vehicles to be addressed in early 2016
Prevent artificial avoidance of PE status (Action 7)	• Recommends following changes to PE definition in OECD Model: – Expand types of sales agent activity that can give rise to a PE – Replace bright-line exceptions with subjective preparatory and auxiliary activity test – No longer test for PE status on a separate company basis.	• Adds the words "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise" to the description of a "dependent agent PE"	• Insert into the Multilateral Instrument • Follow-up work on attribution of profits; additional guidance planned before end of 2016

Action	Overview	Significant Developments	Implementation
Intellectual property			
Counter harmful tax practices (Action 5)	• Define substantial activity requirement for preferential IP regimes • Compulsory spontaneous exchange of rulings and APAs	• Agreed approach to tracking and tracing front-end R&D activities to back-end IP exploitation • Limit qualifying IP assets to include 3 categories: patents (broadly defined), copyrighted software, and other similar IP assets that meet specific conditions on company size and amount of benefited income • Rules to prevent IP assets (not already in a regime) from being shifted from one related party to another	• Minimum Standard • Disclosure of existing post-2009 rulings by end of 2016 • Disclosure of future rulings within 3 months, beginning April 2016 • Monitoring of preferential regimes
Tax challenges of digital economy (Action 1)	• Digital economy cannot be ring-fenced; BEPS risks addressed in other Actions are exacerbated by the digital economy	• Generally concludes that other parts of the BEPS Package addressing mobile income effectively address BEPS concerns in the digital economy • Does not adopt proposals discussed in 2014 Deliverable regarding Significant Economic Presence Test, Withholding Taxes, and Equalizing Levies	• Post-project monitoring process to be developed in 2016
Dispute resolution and multilateral instrument			
Make dispute resolution mechanisms more effective (Action 14)	• Recommendations for the effective and timely resolution of disputes through MAP	• General agreement on taxpayer access, timely resolution, and peer review of MAP process • Agreement by 20 countries (representing 90% of all MAP cases at end of 2013) to adopt mandatory binding arbitration in their bilateral tax treaties6	• Minimum Standard
Develop multilateral instrument (Action 15)	• Ad hoc group, open to all interested countries, began in May 2015 to develop multilateral instrument to implement the BEPS treaty-related measures and amend bilateral tax treaties	• See discussion of OECD Model changes above	• Negotiations underway with over 90 countries • Speculation that the United States may join • To be open for signature by end of 2016

Final and temporary rules issued on treatment of dividend equivalents under section 871(m)

On September 17, 2015, the US Treasury Department ("Treasury") and Internal Revenue Service (IRS) released final and temporary regulations under Internal Revenue Code section 871(m) (the "Final Regulations" and the "Temporary Regulations") which were published in the Federal Register on September 18, 2015[6]. The Final Regulations generally retain the framework set forth in the proposed regulations released on December 5, 2013 (the "2013 Proposed Regulations") by testing the "delta" of notional principal contracts (NPCs) and equity-linked instruments (ELIs) referencing US equities to determine whether such contracts are characterized as "specified NPCs" or "specified ELIs" that give rise to "dividend equivalent" payments subject to US gross basis tax and withholding tax under Chapters 3 (withholding) and 4 (FATCA) of the Internal Revenue Code. (For a discussion of the 2013 Proposed Regulations, see US International Tax alert dated December 6, 2013.)

Highlights of the Final Regulations include:

- Postponed effective date
- Delta standard increased from 0.7 to 0.8
- Delta tested only at issuance
- Division of contracts into "simple contracts" and "complex contracts" for purposes of delta testing
- Significant revisions to the definition of a qualified index, the rules for combined transactions, and the partnership look-through rule
- Reduction in the expected application of disqualified contingent interest treatment for debt issuances that reference actively traded property for purposes of portfolio interest treatment under section 871(h)(4)
- Update to timing of required withholding

The Temporary Regulations introduce a new Qualified Derivatives Dealer (QDD) regime to alleviate cascading gross basis tax and withholding tax on serial transactions. The QDD regime will replace the Qualified Securities Lender regime adopted in Notice 2010-46 and, for the first time, will coordinate securities lending and sale repurchase transactions with all equity-based transactions that are subject to section 871(m). The Temporary Regulations, when finalized, will limit relief from cascading gross basis tax to Qualified Intermediaries (QIs) who elect QDD status. Treasury and the IRS also announced they currently and preliminarily intend to eliminate the "Credit Forward" regime currently available to non-QIs and foreign persons who do not elect Qualified Securities Lender status with respect to their equity securities loans and sale repurchase transactions as defined under the 1997 final regulations. The IRS has requested comments on how a workable Credit Forward regime may be reliably implemented. The Temporary Regulations reserve on the Credit Forward regime and provide no proposed rule pending a final decision whether to adopt new rules or to abolish the Credit Forward regime altogether.

[6] 80 Fed. Reg. 56865 (September 18, 2015).

Observation: Unless a workable regime for implementing Credit Forward treatment in a chain of transactions is presented to the IRS in comments, non-QIs will be ineligible for relief from US withholding on US equity-based stock loans, sale repurchase transactions, specified NPCs and specified ELIs once the Temporary Regulations are finalized. Although the classes of transactions eligible for cascading relief will be expanded when the Temporary Regulations are finalized, the eligible foreign persons who may facilitate gross basis tax reduction will be significantly reduced.

Brief Background

Generally, dividends paid by a domestic corporation to a non-US person are subject to a 30 percent rate of US withholding tax, subject to rate reduction by treaty. Prior to the enactment of section 871(m), US withholding tax generally was not imposed on income earned by a non-US person on a swap or other derivative that referenced stock of a US issuer. On March 18, 2010, in response to concerns that non-US persons were able to avoid US withholding tax on dividends through the use of equity swaps, Congress enacted section 871(m).

Four statutory categories—The statutory provisions of section 871(m) treat dividend equivalent payments with respect to US equity-based NPCs as US-source dividend income subject to US gross basis and withholding tax by providing four categories of "Specified NPCs":

1. the long party transfers the underlying security to the short party in connection with entering into the NPC ("crossing-in");
2. the short party transfers the underlying security to the long party in connection with terminating the NPC ("crossing-out");
3. the underlying security is not readily tradable on an established securities market; or
4. in connection with entering into the NPC, the underlying security is posted as collateral to the long party.

The statute also provided regulatory authority to identify other NPCs as Specified NPCs.

2012 Proposed Regulations

Treasury and the IRS initially issued temporary and proposed regulations on January 19, 2012 (the "2012 Proposed Regulations"). The 2012 Temporary Regulations extended the expiration period for the four statutory conditions that provide specified NPC status. Absent such extension, all US equity-based NPCs would have been treated as specified NPCs and subject to gross basis tax as of September 14, 2012. In addition to the four statutory conditions that give rise to specified NPC status, the 2012 Proposed Regulations created seven categories of Specified NPCs and were proposed to apply to payments made on or after January 1, 2013. These were intended to replace the four statutory conditions (which were encompassed in the seven categories of the Proposed Regulations). Any contract that passed the tests of the 2012 Proposed Regulations would not be specified and would not be subject to dividend equivalent treatment. Hence, during that proposed period, only the four statutory categories provided specified NPC status. The Proposed Regulations also introduced rules for the treatment of ELIs that are not Notional Principal Contracts, and included rules for single payment and other non-NPC contracts that the IRS treated as bearing a substantial similarity to specified NPCs.

2013 Proposed Regulations

After a delayed effective date, the 2012 Proposed Regulations were withdrawn with the release of the 2013 Proposed Regulations. The four statutory categories were extended further during this new second proposed regulations period and remained the only identified conditions in effect for specified NPC status. The 2013 Proposed Regulations expanded the scope of section 871(m) to include ELIs and focused on an instrument's delta (as defined below) to determine if a contract was to be treated as "specified" and subject to the sourcing rule of section 871(m). Potential non-specified ELI treatment that was apparently granted in the 2012 Proposed Regulations pending their finalization (e.g. with respect to certain Single Stock Futures) was removed and subjected to more certain specified ELI treatment under the new delta test in the 2013 Proposed Regulations. Other equity derivatives such as certain options that might expire out of the money were also seemingly subjected to specified ELI status by the 2013 delta test. These problems gave rise to an extended notice and comment period that was due to expire at the

end of 2014 and was extended an additional year to the end of 2015. Notice 2014-14 was issued in March 2014 extending the announced effective date for ELIs issued 90 days after the regulations were published as final in the Federal Register. This effective date has not been followed in the new Final Regulations discussed below and has been postponed to a later alternative effective date depending on whether the ELI is issued in 2016 or in 2017 (or later).

New Final Regulations

As stated above, the Final Regulations generally retain the framework set forth in the 2013 Proposed Regulations, but with substantial revisions. In particular, any payment that references the payment of a dividend from an "underlying security" pursuant to an NPC or ELI with a delta of 0.8 or greater (a "Specified NPC" or "Specified ELI") is treated as a dividend from sources within the United States.

For this purpose, a payment is any US dividend payment that is included in calculating a net payment.[7] In addition, an "underlying security" is an interest in an entity that could give rise to a US-source dividend if a payment were made with respect to such interest. In addition, the Temporary Regulations (with corresponding proposed regulations) introduce new concepts where Treasury and the IRS have requested comments.

Effective Dates

The Final Regulations contain a staggered effective date provision:

- Transactions issued on or before December 31, 2015 are grandfathered from the Final Regulations.
- For transactions issued on or after January 1, 2016 and on or before December 31, 2016 (i.e., issued in 2016), the Final Regulations apply to payments made on or after January 1, 2018.
- For transactions issued on or after January 1, 2017, the Final Regulations apply to payments made on or after January 1, 2017.
- The four statutory conditions remain in force and apply to all payments on all current and future contracts. The effective dates discussed above apply to the new rules and provide supplemental rules to the four statutory categories for determining the specified NPC and specified ELI status of an instrument.

Accordingly, while the Final Regulations become fully effective in 2017, transactions entered into as early as January 1, 2016 and as late as December 31, 2016 may become subject to US withholding tax under section 871(m), albeit only with respect to payments in 2018 or later. Taxpayers thus need to consider the impact of the Final Regulations on long-dated contracts entered into in 2016 (i.e., with a term extending into 2018). Further, taxpayers will continue to remain subject to common-law assertions by the IRS that a non-US person is the owner of a US equity for tax purposes (and thus subject to US withholding tax on US-source dividends) notwithstanding the form of the transaction as a derivative on the underlying equity.

Observation: The factual conditions that most often are evaluated by the IRS for assigning tax ownership to a non-US person are also those that already give rise to specified NPC status under the four statutory conditions that will continue to apply as final regulations.[8]

Delta

While the Final Regulations retain the concept of "delta" from the 2013 Proposed Regulations, the Final Regulations provide a number of important changes in this regard. First, contracts are characterized as either simple contracts or complex contracts. Second, the delta for a potential section 871(m) transaction is determined only when the potential section 871(m) transaction is issued (as defined below), and is not recalculated in conjunction with a secondary market acquisition or dividend payment. Third, the delta standard was raised from 0.7 to 0.8 for purposes of determining whether a potential section 871(m) transaction is subject to section 871(m) (i.e., for purposes of determining if a contract is considered to be a Specified NPC or a Specified ELI).

Simple Contracts

Generally, a simple contract is a NPC or ELI that has payments calculated by reference to a single, fixed number of shares in an underlying security that can be determined at issuance and that has a single maturity or exercise date (including American-style options). As stated in the preamble, it is expected that most NPCs and ELIs will be

[7] Section 871(m)(5) defines a "payment" as including any gross amount that is used in computing any net amount that is transferred to or from the taxpayer.

[8] See LMSB Industry Directive on Total Return Swaps Used to Avoid Dividend Withholding Tax, January 10, 2010. LMSB Control No. LMSB-4-1209-044, Impacted I.R.M. 4.51.5. Section 871(m) was enacted in March 2010, soon after this LMSB Industry Directive was issued..

simple contracts. For simple contracts, "delta" is defined as the ratio of the change in fair market value of the contract to a "small change" in the fair market value of the underlying security referenced by the contract. Delta must be determined in a commercially-reasonable manner, and where delta is calculated for non-tax business purposes such calculation will generally be used for purposes of section 871(m). The Final Regulations implicitly retain the concept that contracts with a constant delta are in scope by providing detail on how to determine how many shares of an underlying security are provided for in the contract.

As stated above, delta is determined at the time of issuance of a contract. For this purpose, a contract is considered to be issued when it is entered into, purchased, or otherwise acquired at its inception or original issuance. A modification of an outstanding contract that results in a realization event under section 1001 for all parties would also result in a new issuance for purposes of section 871(m) and thus would require delta to be tested at such time.

Generally, delta is determined separately for each underlying security if the contract references more than one underlying security. To help simplify the delta calculation, the Final Regulations allow for a short party that hedges a basket of 10 or more underlying securities with an exchange-traded security that references substantially all of the securities in the contract to use such hedge security to determine the delta of the basket of securities (rather than calculating the delta of each underlying security referenced in the contract).

Observation: While the Final Regulations do not explicitly exclude convertible debt from section 871(m), the embedded option within a typical convertible debt instrument has a delta of less than 0.8 at issuance, thus effectively excluding typical convertible debt instruments from section 871(m), unless a modification of an outstanding debt instrument resulted in a deemed "new" issuance.

Observation: Because the purchase of a listed option is typically viewed as the issuance of a new option, it is likely that delta will need to be tested at the time of acquisition of a listed option. In such case, because stock price movements will affect delta, it is possible that if a taxpayer purchases listed options with identical terms on different days, one such listed option could be a Specified ELI because delta was greater than 0.8 on the date of acquisition, while the identical listed option purchased on a different day could be out of scope for purposes of section 871(m).

Complex Contracts

A complex contract is a NPC or ELI that is not a simple contract. A structured note with a formulaic return is an example of a complex contract. The Temporary Regulations set forth a "substantial equivalence" test to determine if a complex contract is a section 871(m) transaction. The substantial equivalence test is a mathematical formula designed to determine whether the complex contract substantially replicates the economic performance of the underlying security. Commenters on the 2013 Proposed Regulations suggested this test which compares the complex contract and its initial hedge to a comparable simple contract with a delta of 0.8 and its initial hedge. For this purpose, the initial hedge is the number of shares of the underlying security that the short party would need to fully hedge a NPC or ELI. A complex contract is a Specified NPC or Specified ELI if the expected change in value of the complex contract and its initial hedge is equal to or less than the expected change in value of the simple contract benchmark and its initial hedge, calculated at the time the complex contract is issued. The IRS and Treasury have requested comments on this test.

Dividend-Equivalent Payments

Generally, a "dividend equivalent" is any payment that references the payment of a dividend from an underlying security pursuant to (i) a securities lending or sale—repurchase transaction, (ii) a Specified NPC or Specified ELI, or (iii) any substantially similar payment, which is defined in the final regulations as a payment by the payor of the payee's gross basis tax on a dividend-equivalent payment that is treated as a grossed-up dividend. It remains unclear whether the term "substantially similar payment" may include determinations made by the Secretary on examination with respect to facts and circumstances not defined in the regulations, or whether the definition provided is the full scope of "substantially similar" treatment for purposes of section 871(m)(2)(C), from which the term is derived.

A dividend equivalent includes any amount that references an actual or estimated payment of a US-source dividend regardless of whether the reference is explicit or implicit. An implicit dividend includes a contract such as a forward or regulated future whose price is adjusted by reference to an estimated dividend amount, including a dividend amount that has not been declared at the time the contract is issued. Accordingly, even a price-only contract could result in a dividend equivalent payment. A dividend equivalent also includes any payment by a withholding agent made in satisfaction of a tax liability of the long party with respect to a dividend equivalent. The short party to a section 871(m) transaction is treated as paying an actual dividend amount per-share unless the short party identifies in writing a reasonable estimated dividend amount upon issuance of the transaction.

A dividend equivalent on a simple contract is equal to (i) the amount of the per-share dividend, multiplied by (ii) the number of shares referenced in the contract, multiplied by (iii) the applicable delta of the simple contract measured at issuance. A dividend equivalent on a complex contract equals (i) the amount of the per-share dividend, multiplied by (ii) the number of shares that make up the initial hedge of the complex contract. The amount of a dividend equivalent is determined on the earlier of the record date or the day prior to the ex-dividend date for the relevant dividend. In practice, with unusual exception generally only applicable to special dividend declarations or to due bills transactions, the day prior to the ex-dividend date for a relevant dividend will precede the dividend record date.

If a section 871(m) transaction references long positions in a basket of more than 25 underlying securities, the short party may treat all of the dividends on the basket as paid on the last day of the calendar quarter. Furthermore, if a section 871(m) transaction references the same underlying securities as an index or other security for which there is a publicly-available quarterly dividend yield, the per-share dividend amount for the section 871(m) transaction can be calculated by using the publicly-available dividend yield with an adjustment for any special dividends.

Observation: Because a dividend equivalent payment may occur even for implied dividends in a contract, the Final Regulations create the possibility of cashless withholding requirements. For example, US withholding tax could be required for a dividend equivalent payment with respect to a price-only contract where the offshore long party owes an amount to the short party (i.e., the stock price declined but dividends were paid during the term of the contract). As another example, US withholding tax could be required upon the lapse of a call option held by a non-US person. In this regard, we note that the short-term exception for contracts with a term of one year or less included in the 2013 Proposed Regulations (which would have prevented this result in many circumstances) was not included in the Final Regulations.

Timing for Withholding

A withholding agent is not obligated to withhold on a dividend equivalent payment until the later of (i) the date the amount of the dividend equivalent is determined (i.e., the earlier of the date that is the record date of the dividend or the day prior to the ex-dividend date with respect to the dividend), or (ii) the date a payment occurs on the Specified NPC or Specified ELI. For this purpose, a payment occurs if money or other property is paid to or by the long party, or the long party disposes of the Specified NPC or Specified ELI. This rule in the Final Regulations provides some relief as compared to the 2013 Proposed Regulations, which required withholding at the time a dividend equivalent was determined, regardless of whether a payment occurred at such time.

Observation: No guidance was provided for determining withholding on contracts where the cash is provided for the acquisition of the contract but the withholding agent would not ordinarily be in a position to know the estimated dividend that was assumed in the pricing of the contract. Contractual arrangements will likely need to be expanded so that long parties will be required to provide dividend estimates to their brokers who acquire contracts for undisclosed principals and for contracts that settle on regulated exchanges.

Qualified Index

As a safe harbor for potential section 871(m) transactions, a "qualified index" is not treated as an underlying security; therefore, a NPC or ELI that references a qualified index is not subject to section 871(m). The Final Regulations have updated the definition of a qualified index from the 2013 Proposed Regulations. Importantly, the determination of whether an index is a qualified index will be made on the first business day of each calendar year and applies to all potential section 871(m) transactions issued during that calendar year.

A qualified index is an index that:

1. references at least 25 component securities (including foreign securities);
2. contains only long positions (with a de minimis exception for up to five percent short positions, taking into account short positions held by the taxpayer or a related party);
3. references no single underlying security representing more than 15 percent of the index;
4. references no five or fewer component underlying securities that together represent more than 40 percent of the index;
5. is modified or rebalanced only according to publicly-stated, predefined criteria (which may require interpretation by the index provider);
6. did not provide an annual dividend yield in the preceding calendar year that is greater than 1.5 times the annual dividend yield of the S&P 500 index for the same period; and
7. is traded through futures or option contracts on an SEC-registered exchange, CFTC-designated domestic board of trade, or, in certain circumstances, a foreign board or exchange that is a "qualified board or exchange" pursuant to section 1256(g)(7)(C) or satisfies certain other criteria.

As a safe harbor provision to the qualified index rule, an index is a qualified index if the referenced component underlying securities in the aggregate comprise 10 percent or less of the weighting of the component securities in the index (i.e., the index provides 10 percent or less US equity exposure). Additionally, if a potential section 871(m) transaction references stock in an exchange-traded fund or other security that tracks a qualified index, the potential section 871(m) transaction will be treated as referencing a qualified index.

Combined Transactions

For purposes of section 871(m), two or more transactions referencing the same underlying security can be treated as a single transaction for purposes of calculating delta if they are entered into "in connection" with each other and if, when combined, they replicate the economics of a transaction which would be a section 871(m) transaction (i.e., satisfies the delta test). The Final Regulations provide two presumptions allowing short party brokers to presume that transactions were not entered into "in connection" with each other (absent actual knowledge): (i) the long party holds or reflects the transactions in separate accounts maintained by the short party, or (ii) the transactions are entered into two or more business days apart.

The Commissioner will presume that a long party did not enter into two or more transactions in connection with each other if such transactions are properly reflected on separate trading books, or such transactions are entered into two or more business days apart. However, the Commissioner may rebut these presumptions. On the other hand, the Commissioner will presume that transactions are entered into in connection with each other if the transactions are entered into less than two business days apart and reflected on the same trading book. In this case, the long party may rebut this presumption.

Partnership Look-Through Rule

Subject to the look-through rule set forth below that was expanded by the Final Regulations, a contract referencing a partnership interest will not be a section 871(m) transaction. The assets of a partnership will be treated as referenced by a potential section 871(m) contract referencing the partnership interest, however, if the partnership carries on a trade or business of dealing or trading in securities; the partnership holds "significant investments in securities;" or (iii) the partnership holds, directly or indirectly, an interest in a lower-tier partnership that satisfies one of the first two tests. For purposes of the second test, the phrase "significant investments in securities" means that either (i) 25 percent or more of the value of the partnership's assets consist of underlying securities or potential section 871(m) transactions, or (ii) the value of the underlying securities or potential section 871(m) transactions is equal to or greater than $25 million.

Observation: Consideration should be given to investments such as swaps on Master Limited Partnerships (MLPs) that utilize C corporation blockers. While such corporate holdings may represent a very small percentage

of the MLP's investments and activities, it is likely that such a blocker entity could have a value in excess of $25 million, thus creating a potential section 871(m) transaction.

Reporting Requirements

Generally, a broker or dealer that is a party to a potential section 871(m) transaction will have the obligation to determine and report delta at issuance of the transaction, as well as the timing and amount of any dividend equivalents. If both parties are brokers or dealers, or neither party is a broker or dealer, the short party will have the reporting obligations. The determination will generally be binding on the other relevant parties and requested information must be reported within a reasonable time, not to exceed 10 business days. The Final Regulations are intended to make clear that agents and intermediaries are considered parties to the transaction for this purpose.

Other Rules

The Final Regulations provide guidance on overlapping rules with other Code sections in two instances:

1. **Section 305 transactions—A** dividend equivalent under section 871(m) is reduced by any amount treated as a dividend pursuant to section 305 with respect to the same underlying security. In this instance, both the section 871(m) and 305 rules apply concurrently, with section 305 treatment taking precedence to common dividend treatment amounts.
2. **Contingent debt instruments**—The portfolio interest exemption under section 871(h)(4) does not apply to any portion of interest paid on a debt obligation if such payment is treated as a dividend equivalent. However, the final regulations will only apply to debt instruments whose interest is determined by reference to the performance of US equities where such debts have a delta of 0.80 or higher on the debt issuance date. While technically this could apply for the first time to contingent debt instruments that reference actively traded US stocks, Treasury and the IRS state in the preamble to the Final Regulations that they expect this rule to apply in limited circumstances. Still, offering documents for contingent debt issuances will likely require some detail about the delta on the issuance date to enhance marketability as qualified portfolio debt instruments.

Exceptions to 871(m) Treatment

The Final Regulations also provide relief from section 871(m) in certain other circumstances:

- Mergers & acquisitions: If one or more persons, including the long party, are required to acquire underlying securities representing more than 50 percent of the entity issuing the underlying securities, the transaction is not a section 871(m) transaction.
- Equity-based compensation: In general, equity-based compensation for services of a nonresident alien individual is not a dividend equivalent for section 871(m) purposes.
- Due bills: Payments made pursuant to a due bill are not dividend-equivalent payments for section 871(m) purposes.
- Annuities, endowments and domestic life insurance company contracts: The Temporary Regulations also provide that there is no dividend equivalent associated with a payment pursuant to the terms of an annuity, endowment, or life insurance contract issued by a domestic insurance company. The IRS and Treasury are still considering such contracts issued by foreign life insurance companies, but provide current relief from section 871(m).

Anti-Abuse Rule

The Final Regulations contain an anti-abuse provision that enables the Commissioner to treat any payment made with respect to a transaction as a dividend equivalent if the transaction was entered into with a principal purpose of avoiding withholding under section 871(m). The regulations provide no illustration of how this rule might apply, including whether the anti-abuse rule might apply where a delta is near, but not equal to or greater than, the 0.80 delta on the contract issuance date.

Qualified Derivatives Dealers

The Temporary Regulations under Reg. §1.1441-1T(e) set forth a new regime intended to prevent cascading withholding by reason of section 871(m) for "qualified derivatives dealers" (QDDs). The new regime would expand and replace the regime for qualified securities lenders (QSLs) set forth in Notice 2010-46. Currently, the QSL regime applies only to US-based stock loans defined in section 1058 (or any similar transaction) and equity sale repurchase transactions. The regime is currently available to (i) foreign banks, custodians, broker-dealers and clearing

organizations that are subject to regulatory supervision by a governmental authority in the jurisdiction in which they were created or organized, and (ii) where such entity is regularly engaged in a trade or business that includes borrowing the securities of domestic corporations from, and lending to, the entity's unrelated customers. The entity must be either a Qualified Intermediary (QI) or subject to tax under section 7602. Since Notice 2010-46 was issued, the IRS National Office has regularly explained that they intended the reference to section 7602 to be limited to US trades or businesses of foreign corporations and to CFCs of US parent corporations so that the summons power under section 7602 could be exercised over such foreign operations who are not already operating under a QI agreement. However, they have not enforced the reference to section 7602 on that basis and have acknowledged that such reference to section 7602 in the Notice was overbroad and in need of amendment. Foreign QIs were also enabled to include securities loans and sale repurchase transactions the entity transacted as principal, and were not limited only to those it already was eligible to handle in custody. Existing QI agreements were treated as amended by the Notice to accommodate this limited class of principal transactions.

To explain the changes made to QSLs in the forthcoming QDD regime that will replace it, a brief explanation of the scope of eligible taxpayers and limited transactions to which the QSL regime is available is provided below. A brief discussion of the current Credit Forward regime available to non-QSLs is also provided, followed by a comparison of the changes to the eligible taxpayers and eligible transactions the QDD regime will adopt.

QSL regime

The QSL regime, adopted on May 20, 2010 by Notice 2010-46, enabled the eligible foreign entity to elect to act as a primary withholding agent when the foreign entity regularly acted as a principal borrower from, and lender of US stocks to, unrelated customers. Accordingly, a US borrower of stocks could pay a substitute dividend to a foreign QSL and not withhold as it would if it were paying a QI. In turn, the QSL could make an offsetting substitute dividend payment to a lender and withhold based on the stock lender's gross basis rate of tax, if any, with the United States. Under the QSL regime, for the first time, a foreign hedge fund could borrow a US stock from a QSL without having to withhold on the substitute payment made to the QSL if the QSL was situated in a jurisdiction with a higher rate of tax than the hedge fund borrower. Notice 97-66 was repealed with the implementation of the QSL regime. As a result, taxpayers' arguments for claiming exemption under Notice 97-66 with respect to substitute payments to lenders in jurisdictions with the same rate as the borrower, were no longer available as of September 14, 2010 when the repeal of Notice 97-66 and the commencement of the Notice 2010-46 regime became effective. However, under Notice 2010-46, the QSL may borrow from a US person (including its US parent or affiliate broker dealer) and pay no withholding tax on its offsetting substitute payment. Accordingly, the QSL's offsetting transactions enable it to lend into the United States to a US person or US trade or business of a foreign person, and also to borrow from a US person (or US trade or business of a foreign person) without having any gross basis tax imposed on the substitute payment received. Such treatment was not previously available, even under Notice 97-66, which only applied to foreign-to-foreign stock loans and sale repurchase transactions.

The QSL regime is limited to transactions where the QSL obtains and/or transfers the physical US stock through a stock loan under section 1058 or a similar transaction and to a sale repurchase transaction. The QSL regime does not grant exemption from gross basis tax or withholding with respect to dividends on the actual stock owned by the QSL on the ex-dividend date, or any specified NPCs or specified ELIs.

"Credit Forward" treatment of non-QSLs

Foreign taxpayers that did not elect into the QSL regime either as a QI or a non-QI can avail themselves of an alternative "Credit Forward" regime to reduce and prevent cascading of excessive gross basis tax in accordance with the legislative goals of section 871(m)(6). It requires that the Credit Forward treatment apply only to dividends received and substitute payments received with respect to transactions in a series of stock loans or sale repurchase transactions. The Credit Forward regime is not available to prevent cascading of gross basis tax or withholding with respect to:

- dividend-equivalent payments received or paid by the non-QSL with respect to specified NPCs or specified ELIs; or
- dividend-equivalent payments received or paid by the non-QSL with respect to stock loans and sale repurchase transactions where the withholding in a series of transactions is not substantiated

The Credit Forward regime is not fully realized in Notice 2010-46 and does not, for instance, resolve the treatment of excess withholding to a foreign person who in turn

may pay a substitute dividend payment to another foreign person in a jurisdiction with a greater rate of tax. For instance, if a UK resident is eligible for a 15% rate of gross basis tax but is withheld 30% on a substitute dividend, the regime does not appear to prohibit the full 30% from being credited forward against another foreign lender in a non-treaty jurisdiction where the gross basis rate is 30%. This approach created problems of proving and timely reporting the eligible gross basis tax for a particular year after all refund claims are made by persons subject to a treaty-reduced tax rate, and then proving the scope of available withholding for offsetting transactions. For these reasons, among other problems of proving withholding in a series of transactions, Treasury and the IRS have proposed to eliminate the Credit Forward regime, but have solicited comments on how a workable regime could be implemented. If the Credit Forward regime is eliminated with finalization of the Temporary Regulations, the only eligible taxpayers who will be able to facilitate reduced cascading of gross basis tax will be QIs who are eligible entities and who make QDD elections under a revised QI agreement that will be effective for years ending after December 31, 2016.

The forthcoming QDD regime

Under the Temporary Regulations, only a QI may elect to be a QDD if it is (i) a dealer in securities subject to regulatory supervision in the jurisdiction where it is organized or operates; (ii) a bank subject to regulatory supervision in the jurisdiction in which it was organized or operates that issues potential section 871(m) transactions to customers and receives dividends or dividend equivalent payments; and (iii) wholly-owned affiliates of banks that are regulated in the jurisdiction where it is organized or operates. Custodians and clearing organizations are no longer eligible entities unless the IRS intends that they should be encompassed by the QI regime for acting solely in a non-beneficial owner capacity. It will then be expected that the QDD regime should also apply to transactions where the QI does not act as principal—but clarification should likely be sought during the regulations' notice and comment period. The reference to taxpayers that "are subject to audit under section 7602" is eliminated, and foreign entities with US branch operations and CFCs of US parents will no longer be eligible even if they are regulated banks or dealers in securities unless they also are QIs acting under the forthcoming Revenue Procedure that will be issued for all periods beginning after December 31, 2016.

Observation: The addition of affiliates of regulated banks as eligible entities does not appear to require that the affiliate be resident in the same jurisdiction as that in which the regulated bank or securities dealer is organized and subject to regulatory supervision. Therefore, as long as the affiliate is a QI where it does operate, its affiliation with a regulated bank or dealer in securities that is subject to regulatory supervision where it is organized or operates appears to qualify the entity for the QDD regime. Clarification should also be sought during the notice and comment period of the regulations concerning the scope of entities in a multinational group of companies that will be eligible for the QI regime, including whether, for instance, a foreign investment company may qualify to enter into a QI agreement so long as it is affiliated with the necessary regulated entity, and whether it must be organized in the same country or may be organized in another country.

Eligible transactions in the QDD regime

The QDD regime does expand the eligible transactions to include all transactions that may give rise to a dividend equivalent payment under section 871(m).

Accordingly, and for the first time, a foreign QI acting in a principal capacity may combine a stock borrowing with a specified equity derivative and avoid withholding. For instance, if a foreign securities dealer borrows a stock in a stock loan transaction to deliver in a short sale it entered into with a customer, and it hedges such short sale with a specified ELI such as an option or a single stock future, the foreign dealer that has a QDD election under a QI agreement in place with the IRS as of January 1, 2017 may have no gross basis tax or withholding imposed on the specified ELI, and should only have to withhold on its substitute payment with respect to its stock borrowing if the stock lender is a beneficial owner in a jurisdiction that has a gross basis rate of tax with the United States. If the stock lender is a US person, or a qualified exempt person, then the QDD regime should eliminate all gross basis tax for properly-documented payments on the series of transactions. In contrast, the QSL regime does not cover dividend equivalent payments with respect to specified ELIs, and cascading gross basis tax relief is not yet available for this type of transaction.[9]

[9] The proposed 2013 regulations provided a limited related-party broker dealer exception for hedge transactions, but this provision was not effective or integrated with transactions to which Notice 2010-46 applies.

Credit Forward regime

The Credit Forward regime is reserved in the Temporary Regulations and no rule is adopted in the accompanying proposed regulations issued with the Temporary rules. For the time being, the Credit Forward regime that is applicable only to stock loans and sale epurchase transactions and substantially similar transactions remains in place, but may be gone after January 1, 2017 unless some approach is adopted. No regulation has yet been written for the Credit Forward regime under section 871(m). The only understanding of its application is stated in Notice 2010-46 (which will be rescinded and replaced by the QDD regime). The problems identified by Treasury and the IRS in the preamble to the new regulations necessitate specific industry action to introduce a reliable and verifiable system that may be adopted in withholding and reporting regulations.

Observation: Even for eligible taxpayers that elect QDD status, withholding imposed on a QI might not be eligible for credit forward treatment with respect to offsetting dividend equivalent payments the QI must make, unless the forthcoming QI agreement so provides.

A public hearing is scheduled for January 15, 2016 at 10:00 a.m. in the IRS National Office auditorium in Washington, D.C. Anyone wishing to present at the hearing must submit an outline of topics by December 27, 2015.

Peru: Temporary tax exemption to apply to certain share sales

Peru's parliament approved a bill on September 3, 2015 that contains a measure designed to increase liquidity and promote the development of the domestic securities market by providing a three-year tax exemption for gains derived from the sale of certain shares (and other securities representing shares) through a centralized exchange in Peru (e.g. the Lima stock exchange or any equivalent exchange that may be established in the future).

The bill was introduced because Peru's capital gains tax on the sale of shares through the domestic stock exchange has been identified as one of the primary factors hindering the development of the domestic capital market, because other countries in the region exempt such transactions from capital gains tax. Additionally, as a result of the Latin American Integrated Market (MILA, a market integration project launched by Chile, Colombia and Peru), minimum standards must be achieved by the member countries.

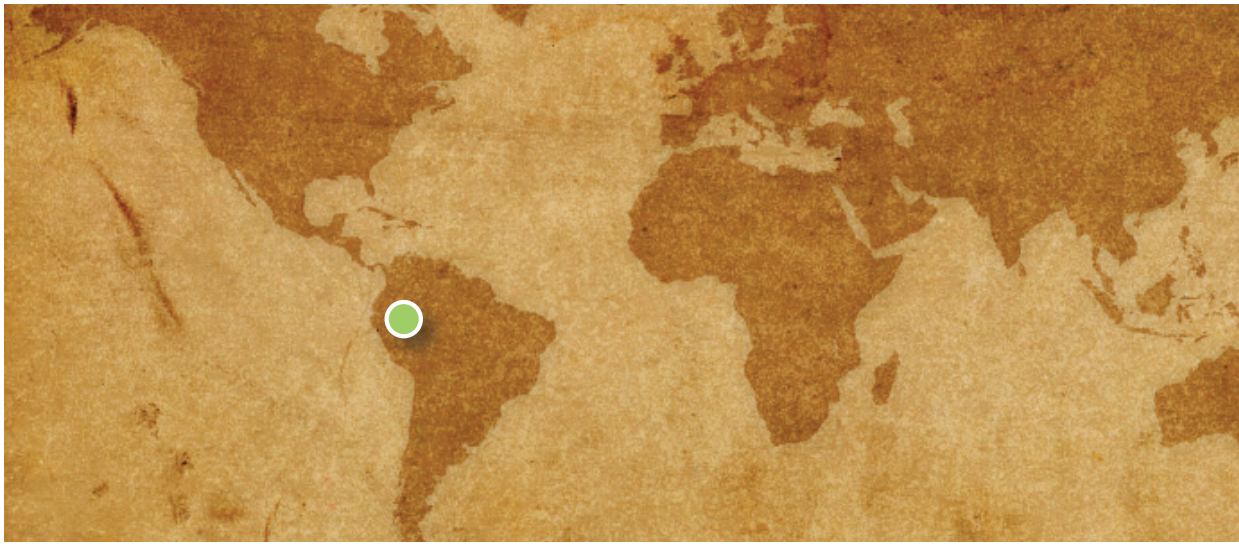
Peru's capital gains tax rules have undergone a number of changes in recent years. Capital gains derived by domestic or foreign investors (in the latter case, from the direct (and, in some cases, the indirect) sale of shares of a Peruvian corporation) currently are considered taxable income. Until December 31, 2009, gains derived by individuals and legal entities were exempt from Peruvian income tax (in the latter case, if the transaction was carried out on the Lima stock exchange), regardless of the residence status of the transferor. As from January 1, 2010, capital gains derived from the sale of shares through the Lima stock exchange are taxed based on a rules that vary depending on the nature and residence status of the taxpayer. Current rates on such transactions range from 5% to 28% (previously, up to 30% in the case of domestic corporate investors).

The bill aims to improve the liquidity and development of the Peruvian securities market, in line with other markets in the Pacific Alliance trade bloc (e.g. Chile, Colombia and Mexico), and the Latin America region in general, by introducing a tax exemption for gains from the sale of certain shares on a Peruvian stock exchange. If approved, the exemption would be effective for the three-year period from January 1, 2016 through December 31, 2018.

Current rules

Capital gains from the sale of shares through a Peruvian stock exchange currently are subject to specific rules, depending on the residence status of the transferor.

Sales made by resident taxpayers: Peruvian-resident taxpayers are subject to income tax on their worldwide income; therefore, any capital gains derived from the sale of shares negotiated through a Peruvian stock exchange fall within the tax net. Capital gains derived by a legal entity are treated as ordinary income and, therefore, are subject to the normal corporate income tax rate (currently 28%). Capital gains derived by an individual from the sale of shares are subject to a tax rate of 6.25%.



The Central Securities Depository (CAVALI) (or other clearing and settlement institutions, as established in the future) is required to act as a withholding agent on securities transactions settled on the Peruvian stock exchange, except where the transferor is a resident legal entity (those entities report and pay taxes directly, e.g. through monthly advance payments of corporate income tax). Where the transferor is a resident individual, a 5% withholding tax applies to the difference between the gross proceeds from the sale and the tax basis of the shares recorded in the ICVL's records.

A specific procedure applies to determine the amount of tax due, based on the capital losses reported in a given month. Tax withheld by the ICVL must be paid to the tax authorities by the (monthly) deadlines set out in the Peruvian Tax Code. These withholdings will be treated as advance payments of tax, with the individual taxpayer able to use the tax withheld as credits against his/her final tax liabilities for the fiscal year.

Sales made by nonresident taxpayers: Nonresident taxpayers are taxed only on Peruvian-source income. Capital gains from the direct or indirect sale of shares issued by a Peruvian legal entity are subject to a 5% withholding tax if the gains are from sales "within the country," (i.e., where the shares are recorded in the Public Securities Registry and the transfer is effected through a centralized exchange in Peru.)

The CAVALI is treated as a withholding agent on the sale of Peruvian shares on the Peruvian stock market. A 5% final withholding tax applies to the difference between the gross proceeds of the sale and the tax basis of the shares recorded with the ICVL. Under the capital gains tax rules, a domestic legal entity whose shares or participating interests are sold is jointly and severally liable with a nonresident transferor for the payment of any capital gains tax that may arise from a direct or an indirect transfer if the parties were economically related during the 12-month period preceding the sale. Joint and several tax liability continues to apply when an ICVL is acting as a withholding agent. (Where the transferor is a resident, these rules do not apply, since the tax authorities can direct an assessment for any unpaid capital gains tax to the resident transferor.)

Proposed exemption

According to the bill, capital gains derived by a resident or a nonresident from the sale of shares (and other securities representing shares that would be identified by future regulations) through a centralized exchange in Peru would be exempt from income tax if the following conditions are fulfilled:

- During the 12-month period preceding the sale, the taxpayer, or a party related to the taxpayer, does not transfer ownership of 10% or more of the total shares (or securities representing these shares) issued by the company whose shares are sold (the tax authorities would issue regulations that would determine which transactions would be taken into account in calculating whether the ownership threshold has been met); and
- The shares meet a liquidity threshold (to be established by future regulations). The parties in charge of operating a Peruvian stock exchange would be required to publicize (e.g. through their websites) the list of shares that comply with the liquidity threshold.

Compliance obligations for claiming the exemption: The bill seeks to clarify the withholding obligation of an ICVL, by providing that the ICVL (or other equivalent party incorporated in Peru) must withhold the capital gains tax at the time of the cash settlement, unless the taxpayer or an authorized third party has reported that the sale is exempt from tax (the reporting process and applicable deadlines would be established by future regulations). The bill also seeks to clarify that the joint and several tax liability of the ICVL for any unpaid taxes would be limited to the amount that should have been withheld based on the applicable capital gains tax provisions. Finally, under the proposed measure, a domestic legal entity whose shares are transferred would remain jointly and severally liable with a nonresident transferor for any unpaid tax, even when an ICVL is acting as a withholding agent.

Comments

As noted above, the goal is to make the Lima stock exchange more attractive to investors, align the tax rules governing sales on the stock exchange with the standards in other MILA countries and enhance the competitiveness of the domestic market with other exchanges in the region. Affected parties should start assessing the tax costs associated with current or future investments in a Peruvian stock exchange, as well as identifying the formal obligations that would apply to claim the exemption from Peru's capital gains tax. The bill (possibly with minor amendments) will be submitted to the executive for publication in the official gazette in the near future.

Netherlands: Supreme Court rules SICAV not entitled to refund of dividend withholding tax

The Netherlands Supreme Court issued a decision on July 10, 2015, concluding that a Luxembourg fund for collective investment (SICAV) is not entitled to a refund of Dutch dividend withholding tax because a SICAV is not comparable to a Dutch financial investment institution (FII). The court followed the March 19, 2015 opinion of the Netherlands Advocate General (AG).

Facts of the case

In 2007 and 2008, a Luxembourg SICAV received Dutch portfolio dividends, on which a 15% Dutch dividend withholding tax was levied. Since a SICAV is exempt from corporate income tax in Luxembourg, it was not able to credit the Dutch dividend withholding tax against its corporate income tax liability.

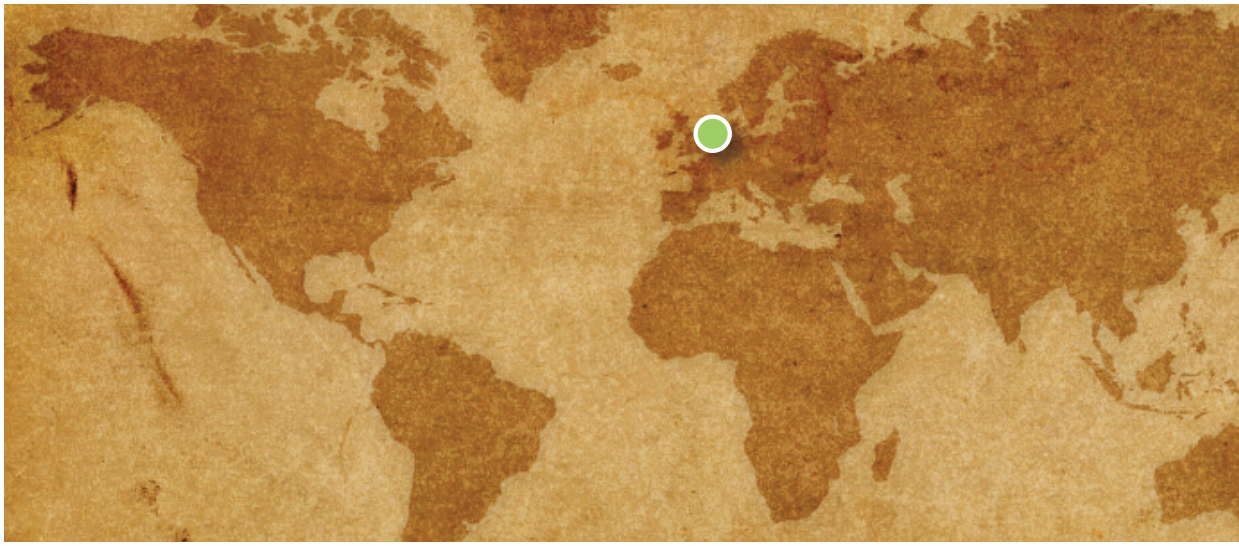
The SICAV requested a refund of the withholding tax from the Dutch tax authorities on the grounds that a SICAV was comparable to a Dutch FII. A Dutch FII would be subject to dividend withholding tax, but under the law applicable in the years at issue, an FII would be entitled to a refund of the tax; as a result, an FII effectively would not be subject to withholding tax in the Netherlands. The SICAV argued it should be subject to the same treatment, and that the different treatment of Luxembourg SICAVs and Dutch FIIs constitutes an infringement of the free movement of capital principle in the Treaty on the Functioning of the European Union. After the Dutch tax authorities denied the refund request and rejected the EU arguments raised by the SICAV, the SICAV filed an appeal with the Dutch courts, with the case eventually reaching the Supreme Court.

Supreme Court decision

In a briefly worded decision, the Supreme Court agreed with the opinion of the AG and held that the SICAV was not entitled to a refund of the Dutch dividend withholding tax because a SICAV is not comparable to a Dutch FII.

To ensure that investors participating in a collective investment vehicle, such as an FII, are subject to the same tax treatment as they would have been had they made the investment directly, a Dutch FII is subject to a 0% corporate income tax rate (provided certain conditions are fulfilled, including some distribution requirements) and the Dutch dividend withholding tax levied on dividends paid by a Dutch company to an FII is eliminated by a refund; however, tax is withheld when the FII itself pays out dividends to FII participants, so that only the participants bear a withholding tax burden.

Under Dutch law, a nonresident individual that invests in a Dutch resident entity is not entitled to a refund of dividend withholding tax, i.e. the tax levy is a final levy. When a nonresident individual invests in the Netherlands via an FII, the Dutch dividend withholding tax on the dividend distribution by the FII is considered a final levy. If a nonresident individual uses a nonresident investment fund (such as a SICAV) to invest in the Netherlands, the Dutch dividend withholding tax levied on the investment fund also is a final levy. Thus, the nonresidents are subject to the same withholding tax treatment whether they invest in a Dutch resident entity directly or through a resident or nonresident investment fund.



Comments

The consequences of the Supreme Court's decision could be far-reaching. If interpreted broadly, it would mean that nonresident investment institutions, such as SICAVs, never will be entitled to a Dutch dividend withholding tax refund. It is unfortunate that the Supreme Court did not refer the case to the Court of Justice of the European Union (CJEU) to request a ruling on the factors that should be taken into account in determining comparability, and whether the tax position of individual investors must be considered. In 2012, the CJEU ruled in the Santander case, which involved different withholding tax treatment of resident and nonresident investment vehicles (and which the CJEU held constituted a restriction of the free movement of capital), that the tax circumstances of individual investors in the investment vehicle (e.g. whether the investors were subject to tax on dividends received from the investment) are not relevant. The Dutch Supreme Court, however, did not refer to Santander in its decision.

The Supreme Court also did not refer to cases that are pending before the CJEU that involve the issue of comparability in a dividend withholding tax situation (e.g., Miljoen and Société Générale). In those cases, CJEU AG Jääskinen recently opined that the combined levy of dividend withholding tax and individual income tax in domestic situations should be compared to the dividend withholding tax as a final levy in cross-border situations (for prior coverage, see EU tax alert, June 29, 2015). In the case of a Dutch FII, the combined tax levy would be lower than the 15% dividend withholding tax on a distribution to a SICAV, thus potentially infringing EU law.

The Supreme Court's decision is disappointing, and could have an enormous impact on pending dividend withholding tax refund requests. The Dutch tax authorities likely will begin to reject refund requests on the basis of this decision.

India: Government issues clarification on minimum alternate tax

On September 24, 2015, the Indian government announced its decision to amend the minimum alternate tax (MAT) provisions in the tax law retroactively, with effect as from April 1, 2001, to provide relief from the MAT to foreign companies that are residents of a country that has concluded a tax treaty with India and that do not have a permanent establishment (PE) (as defined under the treaty) in India. The relief from the MAT also will be extended to foreign companies that are residents of nontreaty countries and that are not required to register under the relevant provision of the Indian company law (foreign companies without an office or PE in India are not required to register under the company law).

After the Indian government announced on September 1, 2015 that it would adopt the recommendations of the Shah Committee to clarify that the MAT provisions will not apply to foreign institutional investors (FIIs) or foreign portfolio investors (FPIs) for the period before April 1, 2015, the expectations of the foreign investor community had grown that similar relief also could be extended more broadly to foreign companies, as they stand on the same footing as FIIs/FPIs (i.e., similar to FIIs/FPIs, foreign companies that do not have an office or PE in India are not required to be registered under the relevant provisions of the company law and are not required to prepare their financial statements as prescribed under the Indian company law). Although the Shah Committee's terms of reference restricted its recommendations to FIIs/FPIs (foreign investors registered with the Securities Exchange Board of India that are permitted to purchase listed shares and convertible debentures issued by Indian companies), its findings suggested that its recommendations also could be applied to foreign companies in general, and that relief could be granted to them as well.

Background

India introduced the MAT to facilitate the taxation of "zero-tax companies"—companies that were paying marginal or no tax due to tax concessions and incentives, despite the fact that such companies reported high book profits. The MAT was intended to levy a minimum tax on such companies by deeming a certain percentage of their book profits to be their taxable income. The MAT is imposed at a rate of 18.5% (plus the applicable surcharge and cess) on the adjusted book profits of a company whose income tax liability is less than 18.5% of its book profits.

Whether the MAT applies to foreign companies has been the subject of considerable recent controversy in India, due to conflicting rulings of the Indian courts. The controversy shifted after the Indian tax authorities issued tax notices to FIIs/FPIs to levy and collect the MAT on the basis of the Authority for Advance Rulings (AAR) 2012 decision in the case of Castleton Investments Ltd. (for prior coverage, see World Tax Advisor, September 14, 2012). As discussed further below, in Castleton, the AAR departed from certain previous advance rulings and held that the MAT was applicable to foreign companies, even if they do not have a PE or place of business in India. The appeal in the Castleton case, which was pending before the Supreme

Court, has now been dismissed by the Supreme Court in light of the clarifications issued by the Indian government regarding the applicability of the MAT provisions to foreign companies.

To allay the concerns of the foreign investor community, and to clarify the relevant issues, the finance minister proposed to rationalize the MAT provisions and, accordingly, amended the relevant provisions through Finance Act 2015 (for prior coverage, see World Tax Advisor, June 12, 2015. The amendment clarifies that the MAT provisions will not apply to foreign companies (including FIIs/FPIs) in respect of capital gains, interest, royalties or fees for technical services if the tax payable on such income under the regular provisions of the Indian tax law is less than the rate prescribed for the MAT; however, this amendment was effective as from April 1, 2015, which created uncertainty as to whether the MAT would apply to foreign companies (including FIIs/FPIs) for the period before April 1, 2015. The amendment also failed to clarify whether the MAT provisions would apply to foreign companies that have an office or PE in India.

Key rulings

As mentioned above, there have been conflicting rulings from the Indian courts on the issue of the applicability of the MAT to foreign companies. As early as 1998, the AAR ruled (on Petition No. 14 of 1997) that the MAT was applicable to a foreign company; however, in another case from the same year (Niko Resources Ltd.), it ruled that the MAT was not applicable to a foreign company.

In the 2010 case of The Timken Company, the AAR distinguished its ruling on Petition No. 14 of 1997, on the grounds that the applicant in that case was carrying on business in India through a PE (for prior coverage, see World Tax Advisor, September 3, 2010). The AAR ruled that the MAT provisions were not applicable to Timken, since the company did not have a physical presence in India. The AAR took a similar view in the case of Praxair Pacific Limited, in which it relied on the Timken ruling (for prior coverage, see World Tax Advisor, August 20, 2010).

The AAR's position changed with the Castleton case, in which the AAR determined that the MAT applies to foreign companies, even if they do not have a PE or place of business in India. This was a clear departure from the AAR's conclusions in Timken and certain other cases. Based on the Castleton ruling, the Indian tax authorities began issuing tax notices to levy the MAT on FIIs/FPIs.

If the MAT were to apply to foreign companies, they would be liable for tax at a rate of 18.5% of their book profits, which effectively could render certain tax concessions under the Indian tax law meaningless (where the applicable tax rate is less than the 18.5% MAT rate, namely (1) the long-term capital gains exemption, and (2) the concessional tax rate of 15% applicable to short-term capital gains realized on the sale of Indian securities through a recognized stock exchange and on which securities transaction tax has been paid). Additionally, if the MAT provisions were applied to foreign companies regardless of exemptions or benefits potentially available under India's tax treaties, this effectively would render certain provisions of the treaties meaningless.

Committee's report

According to the findings of the Shah Committee (whose final report was submitted to the Indian government on August 25, 2015), the MAT provisions will not apply to foreign companies if they are not required to register under the Indian company law and, therefore, are not required to prepare their financial statements as prescribed under the Indian company law. FIIs/FPIs ordinarily do not have an office or PE in India, so they are not required to register under the Indian company law or prepare financial statements as prescribed under the Indian company law. As a result, the MAT provisions under the Indian tax law are not applicable to FIIs/FPIs.

The Shah Committee's report relied on the axiom that, if it is impossible to compute tax liability, the provisions that would impose tax cannot apply. Since there is no guidance available under the MAT provisions regarding the segregation of domestic and global accounts in the case of foreign companies without a PE or an office in India, it is impossible to compute their MAT liability and, therefore, the MAT provisions cannot be applied to these foreign companies. Accordingly, the Committee recommended that the government amend the income tax act to clarify that the MAT does not apply to FIIs/FPIs.

The Shah Committee's report also clarified that beneficial tax treaty provisions will override the MAT provisions. The committee concluded that the AAR's contrary interpretation in the Castleton ruling, based on the overriding clause contained in the MAT provisions, was incorrect.

Comments

The government's latest clarification on the applicability of MAT to foreign companies excludes those foreign companies that have an office or PE in India. The Shah Committee clearly indicated that its report did not express any view on whether a foreign company with an office or PE in India is covered by the MAT provisions, since this issue is squarely covered by the advance rulings in The Timken Company and Praxair Pacific. Thus, it is clear that the MAT will apply to foreign companies that have an office or PE in India. Foreign companies that do not have an office or PE in India, including FIIs/FPIs, will be exempt from the MAT. To give effect to its decision in relation to foreign companies, the government will carry out an amendment to the MAT provisions that will apply retroactively as from April 1, 2001.

Australia: Investment Manager Regime law enacted

On June 25, 2015, Australian legislation containing the third and final element of the Investment Manager Regime (IMR 3), including a number of last-minute changes, received Royal Assent and is now enacted law. The law generally applies as from the 2015-16 income year (the year ended June 30, 2016), although taxpayers may elect to apply certain provisions in prior years.

IMR 3, as enacted

The enactment of the IMR 3 is the culmination of a lengthy process commencing in December 2010. The first two elements of the IMR (IMR 1 and 2) were enacted in 2012. The IMR 3 legislation follows a bill that was introduced into parliament in May 2015 (for prior coverage, see Australia Tax Alert, May 28, 2015).

The stated objective of the IMR is to encourage particular kinds of investment made into or through Australia by certain nonresidents that have wide membership, or that use Australian fund managers. This is achieved by providing nonresidents with an Australian income tax exemption for income or gains in respect of the disposal of their investments that otherwise might be sourced in Australia and subject to Australian tax.

Between the introduction of the IMR 3 bill into parliament in May 2015 and final passage by parliament, a number of changes were made to improve the operation of the IMR, which are summarized below:

- In respect of indirect concessions involving an independent Australian fund manager, a sub-underwriting fee may qualify for the IMR concession under certain circumstances. This provision does not apply in the case of direct concessions.
- The revised explanatory memorandum for the law provides some clarification on the scope of eligible income.
- In applying the "widely held" tests, participation interests of fund managers that relate to entitlements to remuneration may be disregarded (subject to certain conditions), whether the fund manager is an independent Australian fund manager or an independent foreign fund manager.
- Certain aspects of the finalized IMR rules may be applied on an optional basis for periods up to June 30, 2011, covered by enacted IMR 1, to ensure that the IMR 1 rules operate as intended. (However, the indirect concession is not available for this period.) The concessional amendments dealing with the residence of a limited partnership also will apply for periods up to June 30, 2011.

Comments

The IMR should be welcomed by nonresidents, such as hedge funds investing in Australia and funds that engage independent Australian fund managers. Funds should

consider undertaking an IMR review to determine whether they qualify for the IMR concession for any year (including prior years) in which income or gains from investments otherwise might be subject to Australian tax. In addition, fund managers should consider whether funds should establish or make greater use of Australian fund managers, and whether any other operational aspects of the fund may need to be reviewed in light of the finalization of the IMR.

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