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INSIGHTS

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EDITORS' NOTE

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

- **Changes Announced to Dutch Entity Classification Rules and Tax Regimes for Funds.** In the Netherlands, the third Tuesday in September, known as Princes' Day, marks the opening of the new parliamentary year. The budget for the coming year is announced, including an accompanying Tax Plan. The 2024 Tax Plan was presented by the sitting Dutch government, which is merely a caretaker until a new coalition is formed in November. This year, the Tax Plan contains provisions that will have a significant impact on businesses and financial institutions, particularly in relation to Dutch investment institutions. One major goal is to simplify the tax characterization of various entities to eliminate the opportunity of planning through hybrid entities. The distinction between open and closed C.V.'s is eliminated. The possibility of planning for an F.G.R. to be opaque or transparent is mostly eliminated, but for those F.G.R.'s that adopt the redemption method as the exclusive means of disinvesting in a fund. Where transparent, an F.G.R. will not be eligible to benefit from the V.B.I. regime for collective investment vehicles and its 0% rate of tax. Paul Kraan, a tax partner at Van Campen Liem in Amsterdam, explains all, and advises that the general consensus in the Netherlands is that the legislative process should continue, having been subject to public consultation previously.

- **British Virgin Islands Economic Substance Requirements.** Just as water flows downhill, action to prevent aggressive tax planning flows from (i) the O.E.C.D. in its B.E.P.S. Action Plan, especially Action 5 applicable to no or nominal tax jurisdictions ("N.T.J.'s") to (ii) the E.U. Code of Conduct Group ("C.O.C.G."), in its scoping paper identifying nine relevant activities and economic substance criteria for N.T.J.'s to avoid the E.U. blacklist, to (iii) the N.T.J.'s, themselves, in steps taken to police economic substance requirements of local law. The B.V.I. heard the message and has implemented a robust information reporting system for relevant entities. In their article, Joshua Mangeot, a partner in the B.V.I. office of Harneys and Kiril Pehlivanov, a member of the investment funds and regulatory team in the B.V.I office of Harneys, explain the effect of the B.V.I. economic substance regime on companies and limited partnerships registered in the B.V.I. and provide practical guidance for compliance and reporting.

- **Singapore: Tax on Disposal of Foreign Assets.** During the summer, the Singapore Ministry of Finance released a proposal calling for the imposition of tax on the receipt in Singapore of proceeds of gains arising from the sale or disposal of foreign assets. When effective in 2024, the proposal will align Singapore law to guidance on economic substance prepared by the E.U. C.O.C.G. Unless prescribed or excepted, the proposal applies to all companies and limited liability partnerships resident in Singapore. In his article, Sanjay Iyer, the founder of Silicon Advisers, based in Singapore, explains the workings of the tax, including (i) entities that are within scope, (ii) entities that are not within scope, (iii) the definition of foreign assets, (iv) the circumstances in which proceeds are considered to be received in Singapore, and (vi) the ability to use losses from the sale of foreign assets to reduce the amount of foreign gain that is taxed on remittance to Singapore.

- **Regulating the Issuance of A.P.A.'s in Greece.** Advance Pricing Agreements ("A.P.A.'s") regarding intercompany transactions have been issued in Greece for several years. In late July, the Independent Authority for Public Revenue introduced new procedural and timeline-related modifications, aligning the A.P.A. procedure in Greece with global standards. In her article, Natalia Skoulidou, a partner of the Iason Skouzos Law Firm, Athens, addresses new rules for (i) pre-submission consultations, (ii) procedures to be followed when applying for an A.P.A., (iii) the content of the information that must be submitted, (iv) the taxpayer's A.P.A. history in other countries, (iv) the disclosure of key assumptions on which the proposed pricing method is based, (v) the ability to roll back the methodology to open years, and (vi) revisions, revocation, or cancellation of the A.P.A.

- **Too Bad to be True – Code §§267A and 894(C) Signal the End for Cross Border Hybrids in the U.S**. If you are a tax professional, you know your client is in a pickle if a provision under U.S. tax law disallows a deduction for the payor of an expense and another provision subjects the corresponding income of a foreign counterparty to U.S. tax, notwithstanding its residence in a treaty partner jurisdiction. That is the predicament that is faced when Code §§267A and 894(c) apply to outbound payments of deductible items to hybrid entities. In their article, Stanley C. Ruchelman and Neha Rastogi explain the death knell of what had been a common planning technique for U.S. tax advisers. They point out that, in certain circumstances involving payments to a reverse hybrid entity, relief might be provided by resort to competent authority proceedings.

- **Is it Safe to Use S.A.F.E.?** In 2013 a new investment scheme was introduced to the world. A Simple Agreement for Future Equity ("S.A.F.E.") allows a company to receive funds in exchange for an obligation to issue shares in the future at favorable conversion rates for an investor at the happening of a fundraising round, a liquidity event, or an I.P.O. The S.A.F.E. is popular among start-up tech companies because of its simplicity. However, it does not properly fit into any of the usual categories of investment vehicles, such as debt or equity, and there is much ambiguity as to the proper characterization of a S.A.F.E. for U.S. tax purposes. Stanley C. Ruchelman and Daniela Shani take a deep dive into the tax issues that surround the character of a S.A.F.E. Should it be treated as debt, equity, a warrant, a prepaid variable forward contract? None of the above? While the I.R.S. was asked by the A.I.C.P.A. to provide guidance on the character of a S.A.F.E. arrangement, the I.R.S. declined to include the matter in its 2023-2024 list of regulatory priorities.

- **Code §367 and Unassuming Outbound Transfers.** U.S. tax law provides for the deferral of taxation for a person transferring assets in connection with certain tax-free corporate reorganizations or transactions. However, the same may not be true when the reorganization or transaction involves a U.S. person who transfers shares to a foreign corporation. In these situations, the Code causes gain to be triggered for the U.S. person unless the transferred assets consist solely of shares of stock of a target corporation and certain arrangements are made by the U.S. transferor to grant the I.R.S. the right to collect deferred tax on a retroactive basis in the event of a future (i) retransfer of those shares by the foreign corporation or (ii) a transfer by the target corporation of its underlying assets. These rules appear in Code §367(a) – which imposes tax – and I.R.S. regulations related to a gain recognition agreement ("G.R.A.") – which allows tax deferral for the original transfer. Not all transfers that are subject to the rules of Code §367(a) are obvious. To illustrate, a U.S. person that is a passive investor in a foreign partnership may face U.S. tax immediately by reason of Code §367(a) when that partnership transfers shares of stock to a foreign corporation in return for shares of that corporation in a transaction that ordinarily is tax-free under Code §351 or 368(a)(1)(B). While the transaction is effected between two foreign entities, the transferor foreign partnership is tax transparent in the U.S., meaning that the partner is deemed to have made an indirect transfer of assets. In his article, Michael Bennett describes the tax issue and explains how a G.R.A. is a simple way to obtain the benefit of deferral.

- **I.R.S. Issues Proposed Regulations on Information Reporting for Digital Assets.** Digital assets are considered to be a form of intangible property and exchanges of digital assets or transfers for cash are taxable events under U.S. tax law. Compliance with income tax rules on income recognition from the disposal of digital assets is viewed to be low. As part of the move to enforce compliance, the I.R.S. recently issued the first of several sets of proposed regulations intended to provide greater clarity on information reporting rules that are designed to enhance compliance. The list of transactions that must be reported by brokers has been expanded to include dispositions of digital assets in exchange for cash, other digital assets, stored-value cards, broker services, or other property subject to reporting under Code §6045. In his article, Wooyoung Lee explains (i) the proposed definition of a digital asset for reporting purposes, (ii) persons considered to be brokers covered by the reporting obligations, (iii) the definition of a sale in a digital asset transaction, and (iv) the scope of information that must be reported.

- **U.S. Income Tax Treaty Update.** The past 12 months or so have seen an uptick in matters related to the network of U.S. income tax treaties. Perhaps most interesting is a legislative proposal to amend the Internal Revenue Code so that it adopts rules applicable to qualified residents of Taiwan that mirror income tax treaty benefits. The rules would go into effect when the Administration reports to Congress that Taiwan has adopted equivalent rules applicable to U.S. persons investing or working in Taiwan. Other recent events related to U.S. income tax treaties include (i) Senate approval of an income tax treaty with Chile, subject to certain reservations regarding the taxation of direct investment dividends and the imposition of the B.E.A.T. provisions of Code §59A, (ii) the signing of an income tax treaty with Croatia that will require the addition of similar language to the reservation in the treaty with Chile, (iii) announcements that signed income tax treaties with Poland and Vietnam that await Senate action will need to be revised related to double tax relief and B.E.A.T., (iv) the termination of the income tax treaty with Hungary, (v) the start of negotiations of a new income tax treaty with Israel, and (vi) and the completion of treaty negotiations with Romania and Norway, also subject to reservations regarding double tax relief for direct investment dividends and the B.E.A.T. provisions. Nina Krauthamer and Wooyoung Lee tell all.

We hope you enjoy this issue.

- The Editors

CHANGES ANNOUNCED TO DUTCH ENTITY CLASSIFICATION RULES AND TAX REGIMES FOR FUNDS

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F.B.I.
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V.B.I.

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INTRODUCTION

In the Netherlands, traditionally the third Tuesday in September, which is known as Princes' Day, marks the opening of the new parliamentary year. At this occasion, the budget for the next year is also presented to parliament, including a "Tax Plan" (*Belastingplan*) containing fiscal measures.

The 2024 Tax Plan was presented on September 19, 2023, by the sitting Dutch government, which is merely a caretaker cabinet, which remains in office until a new coalition has been formed after the November general elections. Nonetheless, the Tax Plan comprises a number of legislative proposals that, if adopted by parliament, will have a significant impact on businesses and financial institutions, particularly in relation to Dutch investment institutions. The general consensus is that the legislative process should continue, since most of the proposals were subject to public consultation previously and some are long overdue.

The latter applies particularly to the measures concerning fundamental changes to Dutch entity classification rules, notably those applicable to a Dutch limited partnership (*commanditaire vennootschap* commonly referred to as a "C.V.") or a foreign partnership, as well as a Dutch fund for joint account (*fonds voor gemene rekening* or "F.G.R.").

Since existing Dutch entity classification rules substantially deviate from those applied in most other jurisdictions, the rationale for introducing entirely new rules is to reduce the number of hybrid mismatches. Following the implementation of the second iteration of the E.U. Anti-Tax Avoidance Directive ("A.T.A.D'.), such mismatches typically cause undesirable complexity. Therefore, the Dutch tax authorities are now prepared to abandon the entity classification rules that traditionally applied in the Netherlands.

Initially, the intention was to change Dutch entity classification rules that were in effect from January 1, 2022, which coincides with the implementation of A.T.A.D.2. However, due to severe criticism received from market parties during the public consultation at the time, the process was delayed. Most of the criticism came from Dutch financial institutions, claiming they would be adversely impacted by the originally proposed changes to the classification rules for a Dutch F.G.R. Although this is reflected in the current proposed legislation, these rules are removed from the new rules for classifying a Dutch C.V., and laid down in a separate legislative proposal.

The 2024 Tax Plan includes a proposal to amend the two specific Dutch tax regimes for funds, *i.e.*, the criteria to qualify as an exempt investment institution (*vrijgestelde beleggingsinstelling*) or a fiscal investment institution (*fiscale beleggingsinstelling*). In order to allow taxpayers sufficient time to adapt their structures accordingly, it is proposed that all of these measures will enter into force as of January 1, 2025.

In this article, the main contours of the above legislative proposals and their implications for investment in or via the Netherlands are discussed.

PARTNERSHIPS

General Partnership

In the Netherlands a general partnership is fiscally transparent by default. Obviously such classification is not affected by the 2024 Tax Plan. However, at present, an exception to this rule still applies to a Dutch partnership with a capital divided into shares (*personenvennootschap waarvan het kapitaal geheel of gedeeltelijk in aandelen is verdeeld*). While that type of partnership currently is treated as opaque for Dutch tax purposes, under the new rules it will also become fiscally transparent.

C.V.

In comparison to a general partnership, a limited partnership such as a Dutch C.V. has two different types of partners: a general partner with unlimited liability and one or more limited partners, each having liability capped at the amount of capital contributed. Due to the combination of limited liability and legal flexibility, the legal form of a limited partnership is often used for structuring investment funds, particularly real estate ventures and private equity funds.

However, the existing Dutch entity classification rules are rather complex for a C.V., since a Dutch limited partnership or a comparable foreign limited partnership may either qualify as opaque – meaning it is subject to Dutch corporate income tax for its own account – or fiscally transparent. The former is known as an open C.V./L.P., while the latter is commonly referred to as a closed C.V./L.P.

Under current law, fiscal transparency based on closed C.V. status requires a limited partnership to meet certain stringent restrictions regarding the admission of new partners, as well as the transfer of a limited partnership interest. In a nutshell, both require the written prior approval of all partners. Although this principle stems from the notion that forming a partnership has a personal character, that approach has become rather obsolete, particularly within the context of an investment fund. Moreover, applying these restrictions is generally perceived to have an adverse commercial effect.

For this reason, as well as to align Dutch entity classification rules with common international standards, the proposed new entity classification rules completely abandon the criterion of consent, which represents a significant shift in the Dutch fiscal framework. Instead, the proposed new rules entail that, going forward, all Dutch and foreign limited partnerships will be treated as fiscally transparent, *i.e.*, regardless of any further criteria and without exception.

Foreign Entity Without a Dutch Equivalent

In addition to partnerships, certain entities exist under foreign law in a legal form which does not have an equivalent under Dutch law. Where such entity is a non-resident taxpayer, it is proposed that going forward the Netherlands will simply follow the fiscal classification in the relevant foreign jurisdiction. This rule would apply in case such foreign entity must recognize taxable income in the Netherlands (*e.g.*, from real estate or a permanent establishment), holds an interest in a Dutch entity, or vice versa.

By contrast, where such noncomparable foreign entity is considered to be a tax resident in the Netherlands, it will be treated as a taxable entity in the Netherlands, and thus opaque for Dutch tax purposes, regardless of its fiscal qualification in the jurisdiction under which laws it exists.

Transitional Law

Since all limited partnerships will be treated as fiscally transparent going forward, the phenomenon of the taxable open C.V. will cease to exist once the new rules enter into force. As a result, an open limited partnership will be deemed to transfer its assets and liabilities in return for fair market value consideration immediately prior to that moment, which may lead to recognition of unrealized taxable profits such as goodwill and hidden reserves. Concomitantly, the limited partners in an open C.V. will be deemed to acquire their *pro rata* share in the partnership's assets and liabilities, meaning they will be entitled to a corresponding step-up in base.

To mitigate the effects of gain recognition without the receipt of cash consideration, transitional legislation has been proposed. Although the wording of such legislation might suggest that its scope is restricted to an open C.V. and its participants, the explanatory notes seem to indicate that it extends to any foreign limited partnership that is subject to tax in the Netherlands under current law.

"Since all limited partnerships will be treated as fiscally transparent going forward, the phenomenon of the taxable open C.V. will cease to exist once the new rules enter into force."

In any case, the relevant transitional law stipulates that, provided certain conditions are met, a limited partner may contribute its limited partnership interest into another Dutch taxable entity in a tax neutral way, *i.e.*, through a share-for-share merger. Should the assets of the partnership comprise real estate situated in the Netherlands, an exemption from real estate transfer tax may apply in such case.

In addition, the proposed transitional legislation facilitates rollover relief for latent capital gains on interests held in a limited partnership, which might otherwise need to be recognized at the moment the new rules enter into force.

As a last resort, corporate taxpayers may request payment deferral over a period of up to ten years in relation to any Dutch tax due as a result of the disappearance of the open C.V.

FUND FOR JOINT ACCOUNT

Unlike a C.V., which has its specific legal basis in the Dutch Civil Code, the legal form of an F.G.R. is purely a contractual arrangement. As such, in the Netherlands an F.G.R. is commonly used for collective investment. Although in principle an F.G.R. may be used for a wide range of asset classes, including private equity and real estate, in practice it is mostly used for structuring hedge funds and collective investments in transferable securities.

As is the case for a C.V. or comparable foreign limited partnership, the entity classification rules that currently apply in the Netherlands to a Dutch F.G.R. or a comparable mutual fund established under foreign law are quite complex. They may be classified either as opaque, and for that reason, subject to Dutch corporate income tax or fiscally transparent. Similar to a C.V., the former is known as an open F.G.R. and the latter is commonly referred to as a closed F.G.R.

Under current law, in order to create fiscal transparency, participations in the F.G.R. may not be considered as freely tradable. That result is commonly achieved in one of two ways. The first is to apply the same restrictions to a transfer of participations in the F.G.R. that apply in case of a closed C.V. Consequently, this implies that a transfer of participations in a closed F.G.R requires written prior approval from all other participants. The second is to provide restrictions in the constituent documents that participations can be transferred only to the F.G.R,. itself. This is commonly known as the redemption model. Any other form of transfer is null and void. Either way, the participations in the fund are not considered to be freely tradable.

Going forward, the requirement of consent will no longer play a role in determining whether an F.G.R. or a comparable fund under foreign law should be treated as a partnership. By contrast, restricting free transferability of participations through mandatory use of the redemption model will largely survive the changes to Dutch entity classification rules.

Under the 2024 Tax Plan, any F.G.R. that is not regulated by definition qualifies as a closed F.G.R. Only a U.C.I.T.S. (*instelling voor collectieve belegging in effecten*) or other investment institution (*beagginginstelling*) as defined in the Financial Supervision Act (*Wet op het financieel toezicht*) may qualify as an open F.G.R. This implies that going forward, family funds and other relatively small ventures will be treated as fiscally transparent, unless they change the structure to fall within the definition of a U.C.I.T.S. or other investment institution and thus to accept regulation.

Typically, regulated funds are eligible for the two special Dutch tax regimes for investment institutions, meaning that fiscal transparency may not be desired in all cases. However, during the public consultation it became clear that many regulated investment institutions in the Netherlands still prefer fiscal transparency over application of either of the two special regimes. For this reason, following the consultation an exception was added to the Tax Plan, which essentially means that the redemption model remains in existence. On that basis, as before, a regulated F.G.R. can still qualify as fiscally transparent by virtue of the fact that its participations are not considered freely tradable.

Transitional Law

Since any F.G.R. that is not regulated will be treated as fiscally transparent under the new rules, an existing open F.G.R. which is not in scope of the Financial Supervision Act will cease to be a taxable entity once these rules enter into force. Consequently, an open F.G.R. will be deemed to transfer its assets in return for fair market value consideration immediately prior to becoming fiscally transparent, thereby triggering recognition of all unrealized capital gains for Dutch tax purposes. At the same time, participants in an open F.G.R. will be deemed to acquire their *pro rata* shares in the fund's assets at fair market value, meaning that in principle they will be entitled to a corresponding step-up in basis.

To mitigate the effects of the above, transitional legislation is proposed for an open F.G.R. First, to the extent the investors in the F.G.R. are subject to Dutch corporate income tax, an election for rollover relief can be made, meaning that such investors continue the fiscal book value of their *pro rata* share in the fund's assets. In that case, the investors forego a step-up in basis and the F.G.R. does not recognize any unrealized capital gains.

Another possibility is to defer payment of the corporate income tax due on capital gains recognized upon the deemed asset transfer. Gain would be recognized over 10 years.

Finally, the transitional law offers a participant the possibility to contribute its participation into another Dutch taxable entity in a tax neutral way by participating in a share-for-share merger, provided certain conditions are met. Should the fund's assets comprise real estate situated in the Netherlands, an exemption from real estate transfer tax may apply, as well.

EXEMPT INVESTMENT INSTITUTION ("V.B.I.") REGIME

As discussed above, under the proposed new entity classification rules, a regulated F.G.R., other than one that applies the redemption model to achieve fiscal transparency, qualifies as an open F.G.R., which implies that it is subject to Dutch corporate income tax. However, this does not necessarily imply that the F.G.R. actually pays tax in the Netherlands, since it may well be eligible for one of the two special Dutch tax regimes for investment institutions.

One of these regimes is the exempt investment institution regime (*vrijgestelde beleggingsinstelling*, commonly referred to as a "V.B.I. regime"). In a nutshell, the V.B.I. regime entails that the investment institution is exempt from Dutch corporate income tax and not obliged to withhold Dutch dividend tax on its profit distributions. To qualify for the V.B.I. regime, the investment institution must meet several criteria, notably that it invests only in financial instruments as defined in the Financial Supervision Act and within that context applies a policy of diversification in assets as a means of risk spreading.

The V.B.I. regime aims to facilitate collective investment in financial instruments by retail and institutional investors in the Netherlands. In line with this purpose, only a public limited liability company (N.V.) or an open F.G.R. can avail itself of the V.B.I. regime. Nonetheless, the V.B.I. regime is frequently used by nonregulated entities.

The proposed new entity classification rules already prevent such unintended use in the case of an F.G.R. in that, if not regulated, an F.G.R. is fiscally transparent by default, and hence not eligible for the V.B.I. regime. However, without further measures, an N.V. could still benefit from the V.B.I. regime, despite being unregulated. Therefore, it is proposed that the V.B.I. regime will be amended in such a way that, going forward, it will only be available to U.C.I.T.S. and investment institutions as defined in the Financial Supervision Act, meaning that unregulated structures will be entirely excluded.

DUTCH FISCAL INVESTMENT INSTITUTION REGIME

In addition to the V.B.I. regime, a public limited liability company in the form of a Dutch N.V. or an open F.G.R. may also seek to apply the other special Dutch tax regime for investment institutions, known as the fiscal investment institution (*fiscale beleggingsinstelling* or "F.B.I." In principle, the F.B.I. regime may also be applied by a private limited liability company such as a Dutch B.V.

As with the V.B.I. regime, the *raison d'être* of the F.B.I. regime is to facilitate collective investment in such a way that the tax burden does not exceed the level that would exist for an individual investment. In a nutshell, the F.B.I. regime entails that the relevant investment institution is subject to Dutch corporate income tax at a 0% statutory rate, which technically is not an exemption, although the tax results are economically the same. However, the F.B.I. regime does entail an obligation to withhold Dutch dividend tax at the statutory rate of 15% on annual profit distributions. Other criteria include detailed anti-concentration provisions, as well as a restriction on the use of leverage.

In comparison to the V.B.I. regime, application of the F.B.I. regime is not restricted to financial instruments as defined in the Financial Supervision Act or any other specific asset category. Instead, a qualifying investment can be any asset that is held as a passive portfolio investment. Consequently, the F.B.I. regime currently is often used for investments in real estate. This will change on a go-forward basis. The 2024 Tax Plan introduces a new restriction, pursuant to which the F.B.I. regime no longer applies to direct investments in real estate situated in the Netherlands. This is already the case for the V.B.I. regime, for which real estate does not qualify as a financial instrument.

Those investment institutions that currently invest in Dutch real estate may benefit from proposed transitional measures, including exemptions from Dutch real estate transfer tax that would be due upon a restructuring.

BRITISH VIRGIN ISLANDS ECONOMIC SUBSTANCE REQUIREMENTS

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P.E.H.E.
Tax Reform

INTRODUCTION

Every B.V.I. company and limited partnership has some obligations in respect of the economic substance regime and must take the following steps:

- It must have adequate systems and controls to ensure compliance with this regime.
- During each compliance period, it must determine whether it carries on or receives gross income from any of the nine relevant activities. If so, it must determine whether it qualifies for exemption due to its tax status.
- It must file an economic substance at required intervals, generally on an annual basis, even if the entity is not subject to any economic substance requirements.

This article summarizes the B.V.I. economic substance regime and provides practical guidance for compliance and reporting.

BACKGROUND

The 15-point Base Erosion and Profit Shifting ("B.E.P.S.") Action Plan of 2015 developed by the Organization for Economic Cooperation and Development (the "O.E.C.D.")' marked a watershed moment for international tax advisers.

B.E.P.S. Action 5 requires that no or only nominal tax jurisdictions ("N.T.J.'s")) adopt substantial activities requirements proposed by the O.E.C.D.'s Forum on Harmful Tax Practices ("F.H.T.P."). In addition, the European Union ("E.U.") Code of Conduct Group ("C.O.C.G.") evaluates whether countries require economic substance as a precondition for the allowance of tax advantages linked to certain geographically mobile activities. On June 22, 2018, the C.O.C.G. published a scoping paper identifying nine relevant activities and economic substance criteria, which it expected N.T.J.'s to adopt by 2019. Failure to comply with E.U. requirements carries the threat of being placed on Annex I of the E.U.'s list of noncooperative jurisdictions for tax purposes (the "E.U. Blacklist").

Twelve N.T.J.'s were identified – Anguilla, Bahamas, Bahrain, Barbados, Bermuda, the B.V.I., the Cayman Islands, Guernsey, Isle of Man, Jersey, the Turks and Caicos Islands and the United Arab Emirates.[1]

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[1] The United Arab Emirates has subsequently adopted a corporate income tax system effective from June 1, 2023.

The B.V.I.'s economic substance requirements were implemented via the Economic Substance (Companies and Limited Partnerships) Act 2018 (the "Economic Substance Act"), which came into force on January 1, 2019, with a six-month transitional period for companies and limited partnerships with separate legal personality and that were registered in the B.V.I. before that date. Of such entities, the vast majority were companies incorporated under the B.V.I. Business Companies Act (the "B.C. Act"). As a result, by default, the key commencement date was June 30, 2019, for most B.V.I. companies registered prior to 2019.

In October 2019, the O.E.C.D. released guidance on its framework for the spontaneous exchange of economic substance information by N.T.J.'s. As a result, economic substance reporting requirements were introduced via various amendments to the Beneficial Ownership Secure Search System Act 2017 (the "B.O.S.S. Act") between 2019 and 2021. N.T.J.'s exchange certain information under the O.E.C.D. standard, thereby enabling recipient tax administrations to conduct risk assessments and apply anti-B.E.P.S. provisions under their domestic laws.

Limited partnerships without separate legal personality ("Relevant Partnerships") were added to the regime effective July 1, 2021, with a six-month transitional period for those formed prior to such date.[2]

Owing to the tight timeframes for implementation and the high-level nature of the C.O.C.G.'s scoping paper, many key concepts and requirements are not defined in detail in the Economic Substance Act, itself. The scoping paper uses many defined terms and concepts that are not in common use in the B.V.I. or common law and which are untested before a B.V.I. court. Further guidance appeared in economic substance rules and explanatory notes (the "Economic Substance Rules") published by the B.V.I. International Tax Authority ("I.T.A."), which is the regulator for the regime. The Economic Substance Rules were most recently updated as version 3 on 24 February 2023.[3]

The I.T.A. is now investigating and taking enforcement action where appropriate against certain entities in respect of the first compliance periods that commenced in 2019. The I.T.A. has broad powers under the Economic Substance Act and, in June 2022, its powers were increased via amendments to the International Tax Authority Act (the "I.T.A. Act") and related regulations. Under that Act, all companies and limited partnerships registered in the B.V.I. are required to have adequate systems and controls in place to ensure compliance with the Economic Substance Regime.

As part of their monitoring of compliance and enforcement by the N.T.J.'s, the C.O.C.G. and F.H.T.P. regularly review the I.T.A. and the I.T.A. generally has up to six years from the end of the relevant period to determine noncompliance. Directors or general partners of relevant B.V.I. entities and their advisors should therefore continue to monitor B.V.I. entities to ensure compliance.

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2 As most Entities are companies incorporated under the BC Act, we focus on companies in this article. Limited partnerships should consider the specific guidance in Part 16 of the Rules.

3 At the time of writing, version 3 of the Rules is available here. Subsequent references to a "Rule" or "Explanatory Note" are to the corresponding Rule or Explanatory Note in that version.

HOW IS THIS RELEVANT TO EACH B.V.I. ENTITY?

Whether domestic or foreign, every company and limited partnership registered in the B.V.I. (an "Entity") has some obligations under the regime – even if merely to file nil returns via its registered agent.

Economic Substance Act Requirements

The key obligation under the Economic Substance Act is for an Entity that carries on any relevant activity during any financial period to comply with economic substance requirements in relation to each such activity.

Under Rule 1, an Entity will be deemed to carry on relevant activity during any financial period in which it receives gross income from that activity. Our interpretation of Explanatory Notes 2.2 and 6.4 is that an activity must generate gross income, or be expected to generate gross income at some point to be a relevant activity of the Entity. Subject to Rule 1, the absence of any gross income during any specific financial period generally is not determinative.[4]

Relevant Activities and Investment Funds Exemption

The Economic Substance Act defines nine relevant activities, and detailed guidance on each definition appears in Part 5 of the Rules. The relevant activities are the following:

- Banking business
- Insurance business
- Fund management business
- Finance and leasing business
- Headquarters business
- Distribution and service center business
- Shipping business
- Holding business
- Intellectual property ("I.P.") business

Investment fund business (as defined) is expressly excluded from being a relevant activity.[5] However, as mentioned above, fund management business is included.[6]

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4 Gross income is defined by Rule 20 and purposively we do not think 'income' has its narrow accounting sense (*i.e.*, it should include capital gains or other gains on sale).

5 This means the business of operating an investment fund, which means an entity whose principal business is the issuance of investment interests to raise funds or pool investor funds with the aim of enabling a holder of such an investment interest to benefit from the profits or gains from the entity's acquisition, holding, management, or disposal of investments and which includes any entity through which an investment fund directly or indirectly invests or operates (but not an entity that is itself the ultimate investment held. It does not include a person licensed under the Banks and Trust Companies Act, 1990 or the Insurance Act, 2008, or a person registered under the Cooperatives Societies Act 1979 or the Friendly Societies Act 1928.

6 Fund management business is activity requiring a license under category 3 of Schedule 3 of the Securities and Investment Business Act 2010.

In practice, we are finding that persons not familiar with the Economic Substance Regime are most frequently caught out by the breadth of the finance and leasing business definition. There are no carveouts for intragroup debt.

The definitions of (i) the distribution and service center business and (ii) the headquarters business are specifically aimed at intragroup sales of goods and provision of services.

The intellectual property business regime is particularly fearsome so any Entity holding any form of intellectual property rights should ensure it has considered this topic.

The concept of relevant activity is also misleading in that the passive receipt of income may be sufficient to bring an Entity into scope by virtue of Rule 1.

Financial Periods

Compliance with the economic substance and related reporting requirements is assessed for each financial period. A financial period cannot cover more than 12 months.

Part 10 of the Rules prescribes default financial periods determined by the Entity's date of registration in the B.V.I. In broad terms, the default financial periods are as follows:

Registration Date	Start of First Financial Period	End of First Financial Period
Company / limited partnership with separate legal personality registered **before** January 1, 2019	June 30, 2019 by default	June 29, 2020
Company / limited partnership with separate legal personality registered **from** January 1, 2019 onwards	Date of incorporation	12 months from date of incorporation
Relevant Partnership that is registered **before** July 1, 2021	January 1, 2022 by default	December 31, 2022
Relevant Partnership that is registered **on or after** July 1, 2021	Date of formation	12 months **from** date of formation

There are various mechanisms to alter these default financial periods, by filing an election or application with the I.T.A. The financial period need not coincide with the Entity's financial year for accounting or tax purposes. Of crucial importance is the need to refer to individual, non-consolidated company financial statements because intra-group balances can influence the Entity's classification and reporting information.

In many cases, it will be simplest to align the financial period with the Entity's financial year – particularly in view of the new annual return requirement applicable to companies under the B.C. Act from 2024 onwards.

Nonresident Entities for Tax Purposes

Broadly speaking, a legal entity that is nonresident for tax purposes in the B.V.I. is not treated as an Entity. To be considered a nonresident, the entity must be resident for tax purposes in a jurisdiction that is not on the E.U. Blacklist. Part 4 of the Rules expands the traditional concept of residence to include certain transparent Entities and Entities all of whose income from relevant activities is subject to tax, other than withholding tax.

Special provisions dealing with entities claiming residence in another N.T.J. are provided under Rules 5 and 5A.

“In practice, the nonresident tests can be complex to apply.”

An Entity must claim nonresident status in its report for the financial period and either (i) provide evidence complying with Rule 3 (or 5A, if applicable) or (ii) submit a provisional nonresidence application under Rules 6-10, and if its application is accepted, provide evidence of residence in a country that is not on the E.U. Blacklist within the timeframe allowed by the I.T.A.

In practice, the nonresident tests can be complex to apply. The determination depends in large part on questions of law in other jurisdictions and whether the other jurisdiction is on the E.U. Blacklist. Entities may need to seek advice from their B.V.I. and tax advisors to help when preparing reports and supporting evidence.

Broadly, a nonresident claim will result in spontaneous exchanges of all information regarding the Entity on the B.O.S.S. registered agent database with the overseas competent authority in each relevant overseas jurisdiction as described in Part 14 of the Rules. If a beneficial owner or legal owner as defined for purposes of the B.O.S.S. Act of the Entity is resident in an E.U. Member State, information will also be exchanged spontaneously with the competent authority in the Member State in which the beneficial owner or legal owner resides.

Reporting Obligations

Broadly, every Entity must identify if it carries on any of nine relevant activities during the financial period, and if so, the specific relevant activities carried on. Unless it is an “exempt person” for the purposes of the B.O.S.S. Act that does not carry on any relevant activity, the Entity must ascertain and report certain prescribed economic substance information to the I.T.A. via its registered agent. The precise information depends on the activities and ownership of the Entity and whether it claims to be nonresident.[7]

The reporting deadline is six months following the end of the relevant financial period. The I.T.A. has the power to impose penalties for late filing.

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[7] From October 1, 2019, exempt persons that were previously exempt from beneficial ownership reporting obligations under the B.O.S.S. Act are no longer exempt if they carry on any relevant activity. Broadly, the exempt person definition includes (i) certain licensees and regulated persons under B.V.I. financial services legislation, (ii) entities whose securities are listed on a recognized exchange, and (iii) subsidiaries of entities within (i) or (ii).

WHAT ARE THE ECONOMIC SUBSTANCE REQUIREMENTS FOR EACH RELEVANT ACTIVITY?

The Pure Equity Holding Entity Definition

Holding business is defined as the business of being a pure equity holding entity (a "P.E.H.E.") that only holds equity participations in other entities and only earns dividends and capital gains. This is a narrowly defined term of art and should not automatically be equated with being a holding company in the commercial sense.

Except as provided below, if an Entity has non-equity assets or sources of gross income other than dividends or gains on equity assets, it will generally not be a P.E.H.E. Consequently, it will need to consider whether it carries on any of the other eight relevant activities.

Viewed purposively, we do not think that having a bank account to receive dividends and pay expenses or physical premises used in the holding business should take an Entity outside the narrow P.E.H.E. definition.

Economic Substance Requirements for a Holding Business

An Entity meets the economic substance requirements for holding business if two conditions are met. First, it must comply with its statutory obligations under the B.C. Act or the Limited Partnership Act, as applicable. Second, it must have adequate employees and premises in the B.V.I. for holding or managing its equity participations. The Economic Substance Rules acknowledge that holding of equity participations may be entirely passive in nature. In reality, no employees or premises may be required during a financial period. In such cases, the industry expectation is that having a B.V.I. registered office may be adequate.

I.P. Business

Broadly, an Entity will be considered to carry on I.P. business if it holds I.P. rights in intangible assets from which identifiable income or gains accrue (that are separately identifiable from any income generated from any tangible asset in which the right subsists).

In addition to the general economic substance requirements outlined below, Entities involved in I.P. businesses are subject to particularly burdensome economic substance requirements as I.P. was identified by the C.O.C.G. and F.H.T.P. as giving rise to increased B.E.P.S. risks. To illustrate, a requirement exists for any specialist equipment used in the I.P. business to be located in the B.V.I.

Certain presumptions of noncompliance with economic substance requirements may also apply as set out in Part 9 of the Rules. In practice, compliance for most I.P. businesses is extremely difficult and any Entity holding I.P. rights should ensure it has considered economic substance requirements carefully.

Other Relevant Activities

Entities carrying on any of the other seven relevant activities comply where all of the following requirements are met:

- The relevant activity is directed and managed in the B.V.I.
- Having regard to the nature and scale of the relevant activity:
  - An adequate number of suitably qualified employees are physically present in the B.V.I., even if employed by another entity.
  - Adequate expenditures for the relevant activity are incurred in the B.V.I.
  - The Entity has physical offices or premises in the B.V.I. as appropriate for its core-income generating activities ("C.I.G.A.").
- The entity conducts C.I.G.A. in the B.V.I.
- In the case of income-generating activity carried out for the Entity by another entity, no C.I.G.A. is carried on outside the B.V.I. and the arrangements comply with certain other anti-avoidance provisions relevant to outsourcing.

The holding business regime is quite straightforward and the most common relevant activity encountered in practice. For Entities carrying on any of the other relevant activities, there is no one-size-fits-all solution. Professional advice is usually required to review the structure carefully and make necessary changes as the potential consequences of non-compliance are significant.

PATH FORWARD

Every Entity is required by law to ensure that it has adequate systems and controls in place to meet its obligations under the Economic Substance Regime.

In particular, every director or general partner of a B.V.I. Entity may find it prudent to ensure the following:

- He or she knows the Entity's financial period and has considered if the financial period should be altered to match the financial or fiscal year.
- On a continuing basis, he or she identifies whether the Entity may be carrying on or receiving gross income from a relevant activity.
- If the Entity carries on a relevant activity or receives gross income from any relevant activity, he or she determines the following:
  - Whether the Entity qualifies for exemption from the economic substance requirements because it is a tax nonresident.
  - If the Entity qualifies in principle as a tax nonresident, the steps and deadlines for filing a provisional claim and then marshaling evidence in support of that claim, including sufficient evidence of residence in a jurisdiction that is not on the E.U. Blacklist.

- ○ A fallback plan exists to allow in compliance with the economic substance requirements applicable to the Entity's relevant business. As discussed above, those requirements range from a simplified regime for holding businesses to very onerous requirements for I.P. businesses.

- He or she fully understands the reporting requirements that apply to the Entity, which depend on the foregoing points.

Part 12 of the Economic Substance Rules sets out the prescribed economic substance information which every Entity needs to consider.[8] The required information for financial periods commencing on or after January 1, 2022, has increased significantly, particularly for Entities carrying on relevant activity and not claiming to be nonresident. Entities affected by these changes will be well advised to allow longer than usual to prepare reports on a timely basis, leaving enough time for a thorough review by local counsel.

In view of the I.T.A. Act requirements, it may be prudent to record that the directors or general partners have considered these points in minutes or resolutions and, if the Entity carries on relevant activity, to document the steps taken to ensure compliance.

[8] Entities considering the reporting requirements for financial periods commencing prior to January 1, 2022 should refer to version 2 of the Rules.

SINGAPORE: TAX ON DISPOSAL OF FOREIGN ASSETS

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Tags
Capital Gains
C.O.C.G. Guidance
P.E.H.E.
Section 10L
Section 10(25)
Singapore

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INTRODUCTION

On June 6, 2023, the Singapore Ministry of Finance ("M.O.F.") released for public consultation 33 proposed legislative amendments to the Income Tax Act 1947 ("S.I.T.A.").

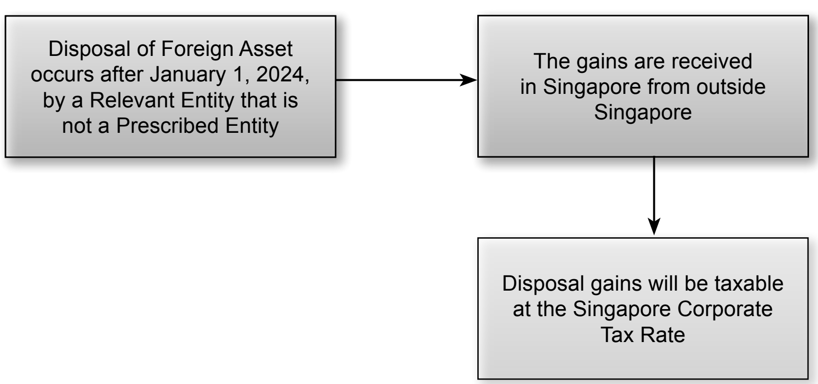
Under the Proposed Section 10L, the proceeds of gains arising from the sale or disposal of a Foreign Asset received in Singapore from outside of Singapore by a Relevant Entity will be treated as income chargeable to tax under Section 10(1)(g) of the S.I.T.A. In addition, the Inland Revenue Authority of Singapore ("I.R.A.S.") will have the power to adjust the disposal gains where the consideration is not at market value. The change in law will be effective from January 1, 2024. It will override anything to the contrary in the S.I.T.A. except for certain Prescribed Entities.

On September 8, 2023, the M.O.F. issued feedback to comments it received in regard to Section 10L. This article explains the context of Section 10L and the I.R.A.S. feedback to comments received.

PURPOSE OF SECTION 10L

Section 10L was introduced to align the treatment of disposal gains from the sale of foreign assets to the E.U. Code of Conduct Group Guidance ("C.O.C.G. Guidance"). In December 2022, updated Guidance on Foreign-Sourced Income Exemption Regimes ((F.S.I.E. Regimes") was introduced to explicitly require capital gains, as a general class of income covered by an F.S.I.E. Regime, to be subject to an economic substance requirement.

OPERATION OF SECTION 10L



SCOPE OF SECTION 10L

The scope of Section 10L is wide. It overrides all other provisions in the S.I.T.A. that would provide a contrary result, such as treating gains as not taxable or exempt under the S.I.T.A. Hence, the provisions of Section 10L would override Section 13W, which exempts gains or profits from the disposal of ordinary shares under certain constraints.

DEFINITION OF A RELEVANT ENTITY

A Relevant Entity is any entity having financial results that are included in a set of consolidated financial statements prepared by the parent entity of the group, provided that at least one member of the group has a place of business outside Singapore. The term Entity is defined as any legal person, including a limited liability partnership. It does not include an individual, a general partnership, a limited partnership, or a trust.

Based on the above, individually owned businesses, individuals, and foreign businesses that are not operating in or from Singapore are not subject to Section 10L.

DEFINITION OF A PRESCRIBED ENTITY

Section 10L only applies to Relevant Entities that are not specifically excluded. Entities that are specifically excluded are known as Prescribed Entities, and include

- financial institutions defined in the Financial Services and Markets Act 2022;
- entities generating income that is exempt from tax or is taxed at a concessionary rate under the specified provisions of the law related to specific substantive business activities in Singapore. An example is an entity that qualifies for benefits under the global trader program. Examples of entities that will continue to be Relevant Entities are Singapore funds and family offices that benefit from incentives; and
- Excluded Entities, as defined below.

DEFINITION OF AN EXCLUDED ENTITY

An Excluded Entity is a Prescribed Entity that does not qualify as an Entity described in the first two bullets in the preceding paragraph, but meets certain economic substance requirements in Singapore.

Depending on whether the "Excluded Entity" is a Pure Equity-Holding Entity ("P.E.H.E.") or an entity that is not a ("Non-P.E.H.E."), prescribed economic substance requirements will need to be met.

P.E.H.E.

This is an entity whose main function is to hold shares or equity interests and derives only (i) dividends, (ii) disposal gains, and (ii) incidental income. The entity will need to comply with various obligations imposed under Singapore law and have its operations managed and performed in Singapore by employees or other persons that operate through local outsourcing arrangements.

Non-P.E.H.E.

This is an entity that is not a PEHE. The entity will need to have its operations managed and performed in Singapore and have reasonable economic substance in Singapore in terms of employees or other persons who perform services in Singapore under local outsourcing arrangements.

Reasonable economic substance will be determined based on the following factors:

- The number of employees or magnitude of outsourcing arrangements
- The experience and qualifications of the employees or individuals involved in the outsourcing arrangement
- The amount of business expenditure incurred inside and outside of Singapore relative to the entity's income
- Whether key business decisions are made by persons in Singapore

In the M.O.F. feedback, the M.O.F. agreed that a Non-P.E.H.E. need not carry on a trade, business, or profession in Singapore. The requirement will be removed in the final wording of Section 10L.

Economic Substance

During the consultation period, comments were received asking the M.O.F. to legislatively prescribe bright-line tests that would establish whether economic substance requirements have been met. Minimum thresholds would be an example of the requests received. The purpose of this would be to reduce uncertainty for taxpayers in determining if disposal gains are subject to tax.

The M.O.F. did not accept this request, commenting that it would not be practical to prescribe minimum thresholds in legislation because business models and scale of operations vary even within the same sector. However, the I.R.A.S. stated it would provide further guidance through an e-Tax Guide, including examples for certain sectors.

The I.R.A.S. will require Entities to maintain all records reasonably required to ascertain (i) the circumstances in which disposal gains would be considered to have been received in Singapore, (ii) the computation of the taxable gains, and (iii) the relevant economic substance requirements have been met.

It is not clear yet whether the I.R.A.S. will implement an advanced ruling process for Entities regarding sufficient substance. In comparison, Hong Kong an implemented an advanced ruling system to provide certainty to taxpayers.

THE DEFINITION OF A FOREIGN ASSET

The I.R.A.S. will use certain determining factors to assess where an asset is situated. Section 10L describes the appropriate factor for most types of assets:

- For shares, it is where the disposed entity is incorporated.
- For immovable property, it is where the property is located.
- For a ship or aircraft, it is where the owner is resident.
- For intangible movable property, it is where the ownership rights would be primarily enforceable.
- For secured or unsecured debt, it is where the creditor is resident.
- For tangible movable property not covered elsewhere, it is where the property is located.

GAINS RECEIVED IN SINGAPORE

Section 10L applies only in cases where the proceeds of gains arising from the sale of assets located outside Singapore are received in Singapore. The statute defines transactions where the consideration or proceeds of gain are received in Singapore:

- Any amount of the consideration or proceeds is remitted to, transmitted to, or physically brought into Singapore.
- Any amount of the consideration or proceeds is applied towards the satisfaction of any debt incurred in respect of a trade or business carried on in Singapore.
- Any amount of the consideration or proceeds is applied to the purchase of movable property that is brought into Singapore.

"Section 10L applies only in cases where the proceeds of gains arising from the sale of assets located outside Singapore are received in Singapore."

The above definition is almost identical to the wording under Section 10(25) of the S.I.T.A.:

> To avoid doubt, it is declared that the amounts described in the following paragraphs are income received in Singapore from outside Singapore whether or not the source from which the income is derived has ceased:
>
> a) any amount from any income derived from outside Singapore which is remitted to, transmitted or brought into, Singapore;
>
> b) any amount from any income derived from outside Singapore which is applied in or towards satisfaction of any debt incurred in respect of a trade or business carried on in Singapore; and
>
> c) any amount from any income derived from outside Singapore which is applied to purchase any movable property which is brought into Singapore.

It is widely expected that the principles of existing I.R.A.S. guidance under Section 10 (25) will apply to Section 10L. Here are several examples.

Re-investment of Proceeds Outside of Singapore

With respect to Section 10(25), the I.R.A.S. has clarified that proceeds of foreign source income reinvested overseas without repatriation to Singapore should not be considered to have been received in Singapore as a result of reinvestment overseas. Taxation continues to be deferred.

Payment of Overseas Dividend

Similarly, with respect to Section 10(25), the I.R.A.S. has clarified that foreign source income should not be considered to be received in Singapore under Section 10(25) where such income is utilized to pay a single tier, tax exempt dividend directly into a shareholder's offshore bank account and does not involve a physical remittance, transmission, or bringing of funds into Singapore.

Satisfaction of Trade Debts

It is unclear whether the use of foreign income to satisfy debts incurred by a Relevant Entity that is an investment holding company not conducting a trade, business, or operation and not having economic substance in Singapore would be considered as having been received or deemed received under Section 10(25)(b), in light of the Section 10L provisions which emphasize economic substance. Section 10(25)(b) may not provide guidance as the I.R.A.S. position in the context of Section 10(25) is that a passive investment holding company is not considered to be carrying on a trade or business in Singapore.

TAXATION OF DISPOSAL GAINS UNDER SECTION 10L

Given the above provisions, gains arising from the sale of foreign assets that fall within the scope of Section 10L, but are not considered to be received in Singapore, are not subject to tax in Singapore until received or deemed received in Singapore. At that time, the Entity will be taxable on the disposal proceeds, reduced by any expenditure incurred to acquire, protect, preserve, create, or improve the foreign asset or to sell or dispose of the foreign asset.

To the extent that the sales price is determined to be less than the open-market price, the I.R.A.S. is able to adjust the sales price to the open market price.

The M.O.F. feedback also confirmed that it will allow foreign source disposal losses to be set off against foreign source disposal gains that are subject to tax. The set-off will be restricted to foreign source disposal losses that would have otherwise been brought to tax if they were gains. In addition, unutilized foreign source disposal losses may be carried forward indefinitely for setoff against foreign sourced disposal gains in future years.

HONG KONG

Effective January 1, 2023, Hong Kong implemented similar rules to tax foreign-sourced income ("F.S.I.E."), such as dividends, interest, royalties, and capital gains. As a result of the C.O.C.G. Guidance, Hong Kong will make some adjustments to its F.S.I.E. Regime, effective January 1, 2024.

CONCLUSION

The Proposed Section 10L will impose tax on gains derived from the disposal of foreign assets by non-Prescribed Entities that are considered Relevant Entities where the disposal proceeds are received in Singapore. Multinational groups that use Singapore as a holding jurisdiction for regional assets should revisit their holding structures to ensure that the Singapore Entities have adequate economic substance in Singapore. Without such substance, gains realized from the disposal of assets located outside Singapore tax in Singapore could be taxed in Singapore beginning January 1, 2024, if the resulting proceeds that are received in Singapore.

REGULATING THE ISSUANCE OF A.P.A.'S IN GREECE

Author
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Tags
A.P.A.
Greece
Pre-submission Conference
Key Assumptions
Rollback

INTRODUCTION

Advance Pricing Agreements ("A.P.A.'s") regarding intercompany transfer pricing have been issued in Greece for several years.[1] The procedure for obtaining an A.P.A. was set forth in Circular POL.1284/2013. In late July, Decision A.1107/2023 of the Independent Authority for Public Revenue ("A.A.D.E.") introduced new procedural and timeline-related modifications.[2] The Decision is effective July 28, 2023.

Thies article provides a comprehensive outline of the updated process for the issuance of A.P.A.'s in Greece.

OBJECT OF THE A.P.A.

The object of the A.P.A. is to establish intercompany transfer prices that will be accepted by Greek tax authorities over a fixed time period. The A.P.A addresses acceptable methodology, comparative data, relevant adjustments, key assumptions about future conditions, and other special matters that relate to intercompany transfer pricing. An A.P.A. application may be submitted by a Greek parent of a multinational group, a Greek company maintaining permanent establishments abroad, a Greek subsidiary of a foreign parent company, or a permanent establishment maintained in Greece by a foreign corporation.

COMPETENT AUTHORITY

The competent authority for issuing an A.P.A. is the Directorate of Operational Planning of Audits of the General Directorate of Tax Operations of the A.A.D.E.

PRELIMINARY CONSULTATION

Natalia Skoulidou is a partner of Iason Skouzos Law Firm, Athens, where her practice focuses on Greek and E.U. V.A.T. and customs duties, taxation of international transactions, corporate taxation, and private clients.

Pre-submission consultation is available so that prospective applicants may assess the likelihood of obtaining a successful result. At the pre-submission conference, a taxpayer may submit documentation that may help the competent authority in reaching an informed assessment that is acceptable to the applicant. At a minimum, it must include descriptions of business risks and functions of group members, the intercompany transactions involved, the proposed methodology, the time period covered by the A.P.A., and the countries in which counterparties are resident for tax purposes.

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1 Article 22 of the Greek Code of Tax Procedures (L. 4987/2022).

2 Government Gazette B' 4806/28.07.2023.

During this stage, the taxpayer and the competent authority discuss the documentation to be included in the A.P.A. application and the competent authority may highlight any points of concern and make proposals regarding the content of the application.

Upon completion of the preliminary consultation stage, the competent authority issues a formal letter in which its preliminary views regarding the outcome of the assessment and the chance of success of the A.P.A. application. This is a modification compared to the previous regime, where any such notification by the competent authority to the taxpayer was verbal and informal.

It is noted that the discussions held during this stage and the written notification of the competent authority do not have a binding effect for any of the parties involved or any impact on the process following the filing of the official A.P.A. application. Moreover, all information and data provided are covered by the tax secrecy provisions. Nonetheless, the written notice ensures that examiners have a roadmap to follow based on information gathered in the pre-submission consultation.

FILING OF THE A.P.A. APPLICATION

The A.P.A. application is submitted to the competent authority. In case of bilateral or multilateral A.P.A.'s involving States with which Greece has concluded income tax treaties, the A.P.A. application and any accompanying or subsequent documentation must be submitted to the competent tax authority of the treaty partner jurisdiction on a simultaneous basis.

The application and relevant documentation may be submitted in English or any other accepted language, except for any documentation that the competent authority deems necessary to be submitted in the Greek language and specifically requests so.

The 30-day deadline for filing the A.P.A. application following the preliminary consultation stage no longer applies.

CONTENT OF THE A.P.A. APPLICATION

The A.P.A. application should include all information necessary for the competent authority to assess the application and form an opinion on the methodology to be used for the determination of the intercompany transfer prices based on the arm's length principle.

The A.P.A. application must contain at least the following items:

- The data of the applicant
- The data of all the involved related parties and permanent establishments
- The group structure
- The description of the intercompany transactions for which the A.P.A. is requested, and where applicable, an additional short justification for not including all intercompany transactions in the requested A.P.A.
- The proposed methodology for the intercompany transfer prices
- The key assumptions on which the A.P.A. is based

- The time period covered by the A.P.A.
- Where applicable, a justification for requesting a unilateral A.P.A.

The A.P.A. application no longer is required to justify why the applicant deems the proposed transfer pricing methodology to be arm's length beyond the economic analysis.

"The A.P.A. application must state the assumptions on which the proposed methodology is based."

In addition, the taxpayer may file supplementary information, that address the following items:

- An analysis of industry and market trends that are expected to affect the business activities, commercial exploitation studies, or economic studies of the business activities
- A brief description of the current and business strategy and potential changes to that strategy
- An analysis of functions performed and risks taken on by all entities involved in the A.P.A. application
- Detailed information on the proposed methodology and its compliance with the arm's length principle
- A list of all A.P.A.'s that have been concluded by related persons involved in the A.P.A. application that concern the same or similar transactions, either in Greece or abroad
- Detailed financial data of the last three years for all group members involved in the A.P.A. application
- A list of relevant contracts
- Any other information deemed appropriate by the taxpayer in support of the correctness of the transfer pricing

KEY ASSUMPTIONS

The A.P.A. application must state the assumptions on which the proposed methodology is based. Key assumptions consist of (a) the functional, legal, and economic features of the taxpayer, or a specific industry or business activity and (b) the anticipated general economic conditions that are a prerequisite for the implementation of the A.P.A.

In addition, key assumptions must be based on verifiable, reliable, and independent data, to the extent possible. In addition, they must be determined according to the particular circumstances of the taxpayer, the commercial environment, and the transfer pricing methodology of the intercompany transactions. Finally, key assumptions should not be too narrowly defined. Rather, they should be based on a sufficient range of data so as to avoid making it difficult for the taxpayer to comply with the A.P.A..

ASSESSMENT OF THE A.P.A. APPLICATION

The competent authority examines the provided information and assesses the A.P.A. application with the assistance of the Directorate of Direct Taxation, where applicable. If an applicant is requested to provide additional information or clarifications, a response must be submitted within two months from the date of the request. Previously, information simply needed to be provided within a reasonable period of time.

The competent authority is not limited in seeking information from the taxpayer, only. It may request information from foreign tax authorities using the information exchange procedure provided for by international conventions. In bilateral or multilateral A.P.A.'s, the competent authorities may conduct consultations with each other pursuant to the exchange of information provisions of the applicable income tax treaty. Exchanges of views or information can be effected through formal position papers, video conferences, and physical meetings.

The competent authority may carry out on-site inspections of the taxpayer's premises and interviews with the employees of an applicant.

FORMAL POSITION PAPER

Upon completion of the assessment stage, the competent authority issues a Formal Position Paper stating its conclusion and proposals, which is communicated to the taxpayer. In case of a bilateral or multilateral A.P.A., the taxpayer is notified of the final Formal Position Paper which is agreed following the completion of the consultations with the foreign tax authorities.

The Formal Position Paper must address the following:

- The conclusion of the competent authority or authorities, accompanied by a brief justification for the proposed methodology and the reason for its selection
- The reasons for any rejection or modification of the initially proposed methodology
- The actual facts on which the conclusion of the competent authority is based
- Details of the key assumptions on which the A.P.A. will be based
- A plan for monitoring the implementation of the A.P.A. and reasons for its revision, revoking, or cancellation
- The time period covered by the A.P.A.

It is expected that the position paper will address the above in cursory fashion.

FINAL MEETING

The Formal Position Paper, together with a written invitation for a final meeting, is communicated to the taxpayer at least twenty days in advance. The applicant is entitled to a copy of the minutes of the A.P.A. approval or rejection.

ISSUANCE OF THE A.P.A.

The A.P.A. is issued within 30 days from the date of the final meeting. Previously, the A.P.A. was issued with a 20-day timeframe.

In case of a unilateral A.P.A., a decision generally must be reached with 18 months from the date on which the application was filed. However, the competent authority may be given an extension by the Governor of the A.A.D.E. The extension may not exceed 36 months.

The A.P.A. includes the following:

- The details of the taxpayer
- The details of the related counterparties
- A description of the intercompany transactions that are covered
- The duration and date of commencement of the A.P.A.'s validity
- Detailed information regarding the agreed transfer pricing methodology for the concerned intercompany transactions
- The key assumptions for the implementation, and if deemed necessary, an acceptable margin of deviation
- Possible events or circumstances that will necessitate revision or early termination.

The A.P.A. is valid for a maximum of four years.

- ROLLBACK CLAUSE IN BILATERAL/MULTILATERAL A.P.A.'S

In case of a bilateral or multilateral A.P.A., the taxpayer may request the inclusion of a rollback clause, namely a request for the A.P.A. to have a retroactive effect for previous tax years, provided that the facts of the A.P.A. and the facts of the rollback years are substantially comparable. In order for a rollback to be granted, the tax administration must have the right to carry out an examination for the tax years in the rollback period. This means the rollback year must not be time-barred under a statute of limitations. In addition, a rollback year must not be under examination by the tax authorities.

If a rollback is requested, an applicant must submit all the necessary information that will enable the competent authority to validate the similarity of facts in the rollback period. Once factual similarity is validated, the rollback clause is included in the A.P.A. for the years that are not barred for reasons addressed above.

OBLIGATIONS OF THE TAXPAYER FOLLOWING THE ISSUANCE OF THE A.P.A.

Once an A.P.A. is issued, a taxpayer must submit an Annual Report of Compliance with the terms and conditions of the A.P.A. The report must be filed not later than 90 days from the deadline for filing tax returns for the tax year. Failure to timely filing the report results in the termination of the A.P.A. beginning with the year of non-compliance. If the A.P.A. has rollback effect, the taxpayer must submit the relevant Annual Compliance Report for each previous tax year covered by the A.P.A. within 90 days from the issuance of the A.P.A. Failure to timely filing the report results in the termination of the A.P.A. for the rollback period.

Any amended tax returns that are required to be filed for previous tax years are considered as timely if filed within 30 days from the issuance of the A.P.A..

REVISION, REVOCATION, OR CANCELLATION OF THE A.P.A.

The A.P.A. may be revised upon the request by the taxpayer or by the Governor of A.A.D.E. under the same process that applied to its issuance.

Under specific circumstances, the A.P.A. may be revoked or cancelled. In such case, a Special Position Paper is issued by the competent authority, notifying the taxpayer of the proposed cancellation or revocation. The taxpayer may protest such action in a written submission. The submission is followed by an opportunity to meet not earlier than ten days following the written protest. A final decision must be issued within 30 days from meeting.

In case of a revocation, the A.P.A. is considered as having never been issued, whereas in case of a cancellation the A.P.A. ceases to apply as of a specified time onwards.

ADMINISTRATIVE FEES

The following administrative fees are imposed:

- €1,000 upon filing of a Preliminary Consultation request
- €5,000 upon filing of an A.P.A. request or an A.P.A. revision request
- €10,000 for each involved State upon filing of a bilateral or multilateral A.P.A. request

TOO BAD TO BE TRUE – CODE §§267A AND 894(C) SIGNAL THE END FOR CROSS BORDER HYBRIDS

Authors
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Tags
Anti-hybrid Rules
Code §267A
Cod3 §894(c)
Cross Border
Fiscal Transparency
Hybrid Entities

INTRODUCTION

If you are a tax professional, you know your client is in a pickle if a tax provision disallows a deduction and another provision subjects the corresponding income to U.S. tax. If you are the client, read on to avoid a situation which can prove to be a nightmare if not addressed at the time of structuring the business.

This article focuses on the potential issues of operating a group financing function through a fiscally transparent entity to cater to the financial needs of operating U.S. subsidiaries of a foreign multinational group. Fact patterns that result in a deduction/no inclusion scenario are identified, the scope of the problems explained, possible solutions are proposed. Good-bye to the reverse hybrid entity.

BACKGROUND

The following fact pattern is used to describe the tax issue.

- A parent corporation ("Parent") is tax resident in the fictional country of Fredonia.[1]
- Parent is the sole shareholder of a subsidiary in the U.S. ("U.S. Co") and a subsidiary in Fredonia ("FREDCO").
- Parent and FREDCO are members of an L.L.C. in the U.S. ("L.L.C.") to serve as a group financing entity in the U.S.
- L.L.C. raises funds from Parent and lends those funds to U.S. Co and related corporations it owns in the U.S.
- L.L.C. is treated as a partnership for U.S. tax purposes.
- L.L.C. is treated as a foreign corporation for Fredonian tax purposes.
- Dividends received by a Fredonian corporation from a foreign subsidiary enjoy from a dividends received deduction ("D.R.D.") where the Fredonian corporation owns at least 10% of the shares of the corporation paying the dividend.
- The anti-deferral rules in Fredonia for C.F.C.'s apply only when the C.F.C. is resident in a country with which Fredonia does not have a comprehensive income tax treaty in effect.

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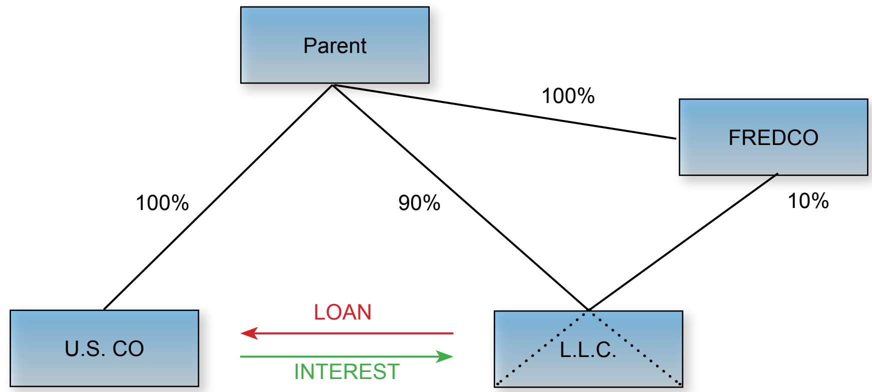
[1] In the 1933 movie "Duck Soup," Fredonia was a mythical country and Groucho Marx portrayed its president.

The facts are illustrated in the following diagram where the subsidiaries of U.S. CO are ignored:



U.S. ANTI-HYBRID RULES

In General

Generally, interest expense is allowed as a deduction when computing U.S. taxable income when and as it accrues, subject to various limitations.[2] For a taxpayer that reports income on the accrual basis, actual payment generally is irrelevant. However, when the lender is a related foreign entity, interest expense is deductible only when included in the gross income of the recipient.[3] For interest income received by a foreign corporation, income is recognized when and as paid.[4] Stated otherwise, the interest expense is allowed as a deduction to the payor in the year in which it is paid.[5]

The Anti-Hybrid Rules Restrict the Ability of a U.S. Person to Deduct Interest Expense When Paid to a Related Reverse Hybrid Entity if Certain Conditions Exist

An entity that is treated as fiscally transparent in the country of organization but not fiscally transparent under the tax law of the country of residence of an investor is classified as a reverse hybrid entity for purposes of the anti-hybrid rules.[6]

L.L.C. is treated as a fiscally transparent entity for U.S. tax purposes in the absence of an election under U.S. tax law commonly known as a "check-the box-election."[7] It

[2] Code §163(j) limits the deduction to 30% of E.B.I.T. for most businesses. Code §263A requires construction period interest to be capitalized.

[3] Code §267(a)(2).

[4] Code §§881(a)(1) and 1441(a) and (b).

[5] Code §267.

[6] Treas. Reg. §§1.267A-2(d)(2); 1.267A-1(b)(1). Note the definition the term "reverse hybrid" is different for purposes of Code §894(c).

[7] Treas. Reg. §301.7701-3(b)(1)(i).

is classified as a partnership because it is a domestic eligible entity[8] that has more than one member.[9] However, it is treated as a corporation for purposes of Fredonian tax law, the tax law of the country of residence of the investor in the L.L.C. Therefore, (a) L.L.C. is a reverse hybrid entity for purposes of the anti-hybrid rules and (b) the deductibility of any interest payment made by a related U.S. payor to L.L.C. will be subject to the anti-hybrid rules of Code §267A.

The Anti-Hybrid Rules Under Code §267A Disallow a Deduction of the Interest Payments by U.S. Operating Companies to a Reverse Hybrid Entity if the Interest Payments are not Currently Distributed to Parent

The anti-hybrid rules are designed to disallow – not defer – a deduction for interest expense paid to a reverse hybrid entity when certain conditions exist. In general, the anti-hybrid rules aim to prevent a current tax benefit in the U.S. by disallowing a deduction for a payment to a related reverse hybrid entity if the corresponding income is not subject to tax in the same year in the foreign country of residence of the investor. The problem is typically referred to as a "deduction/no inclusion" scenario.

Under the anti-hybrid rules, an interest payment made to a reverse hybrid entity is disallowed if the following four conditions are satisfied:[10]

First, the U.S. payor and the reverse hybrid entity are related to each other. That will occur if the reverse hybrid entity and the U.S. payor are controlled by the same person.[11] Control is defined to mean the direct or indirect ownership of more than 50% of a corporation's stock, by vote or by attribution from other related persons.

Second, the investor's country of residence treats the reverse hybrid as a taxpayer in its own right, meaning it is not fiscally transparent. Under a no-harm, no-foul rule, the second condition is not met if an anti-deferral regime in the country of residence requires the investor to include in its taxable income the interest payment made to the reverse hybrid entity. For no-harm, no-foul rule to apply, the anti-deferral regime must tax the included income at the full marginal rate imposed on ordinary income and the amount must not be reduced or offset by any relief particular to the amount.[12]

Third, a "no-inclusion" event occurs. This means the investor does not include the payment in income in its country of residence in the same year the interest is paid to the reverse hybrid. Under an ameliorative rule, an investor is treated as if it timely included the interest payment in income if it actually does so in a taxable year that ends within 36 months following the close of the payor's tax year in which a deduction would otherwise be allowed.

For the ameliorative rule to apply, the amount distributed to the foreign investor must be taxed at the full marginal rate imposed on ordinary income in its country of

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8 Treas. Reg. §301.7701-3(a). It is eligible because it is not required to be treated as a corporation under Treas. Reg. §301.7701-2(b)(1).

9 *Id.*

10 Treas. Reg. §1.267A-2(d)(1).

11 Code §§ 267A(b)(2), 954(d)(3).

12 Treas. Reg. §1.267A-6(c), Example 5(iii).

residence or, if different, the full marginal rate imposed on interest income. Moreover, the tax base cannot be reduced or offset indirectly by an exemption, exclusion, deduction, credit, or similar relief. Examples include the following:

- A participation exemption
- A dividend received deduction
- An indirect foreign tax credit for corporate income taxes paid by the corporation from which a distribution is received
- A rule calling for the recovery of basis in shares before dividend income is recognized
- A rule calling for the recovery of principal with respect to indebtedness so that principal is recovered in its entirely before interest income is taxed.

Generally applicable deductions such as net operating losses or depreciation are acceptable and do not defeat the exception. When an indirect reduction reduces 90% or more of the payment, it is considered to reduce 100% of the payment. On the other hand, if it reduces or offsets 10% or less of the payment, it is considered to reduce or offset none of the payment.[13]

Fourth, the investor's no-inclusion result is directly connected to the payment made to the reverse hybrid entity. The investor's no-inclusion event is considered to be directly connected if the interest is not included in the income of the investor because the reverse hybrid entity is treated as an opaque entity under the tax law of the country of residence of the investor.

The 36-month Exception is not Available With Respect to Payments Made to a Reverse Hybrid; Rather the Anti-Hybrid Rules Call for a More Restrictive Condition Requiring a Current Distribution by the Reverse Hybrid Entity of the Interest Payments to its Investor to Allow a Deduction

A more restrictive and specific rule is applicable to reverse hybrids, which makes any subsequent distributions by the reverse hybrid irrelevant when determining deductibility.[14] Under the more restrictive rule, the reverse hybrid must distribute all its income for the taxable year during the year. To the extent an investor includes in income one or more current-year distributions from the reverse hybrid, the investor is treated as including in income all or a portion of interest payments made to the reverse hybrid during the year. As a result of the investor's income inclusion, the U.S. payor is allowed a deduction when computing U.S. taxable income.[15]

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13 Treas. Reg. §1.267A-3(a)(5).

14 Treas. Reg. §1.267A-3(a)(3).

15 *Id.*

U.S. F.D.A.P.[16] **Withholding Tax Imposed on the Investor in a Reverse Hybrid is not Relevant in Determining Whether a Distribution Triggers Full Tax for the Investor**

The preamble to regulations issued under Code §267A provides that the determination of whether a deduction of interest payment is disallowed under Code §267A is made without regard to the collection of U.S. withholding tax imposed on F.D.A.P. income.[17] The Preamble explains that the purpose of U.S. withholding taxes is generally not to address mismatches in tax outcomes, but rather to allow the source jurisdiction to retain its right to tax a payment.[18]

APPLICATION OF THE ANTI-HYBRID RULE TO HYPOTHETICAL FACT PATTERN

In the hypothetical, U.S. CO and L.L.C. are related to each other within the meaning of the anti-hybrid rules. Parent controls both U.S. CO and L.L.C., a reverse hybrid. Consequently, interest payments made by U.S. CO to L.L.C. will be deductible only if the conditions explained above are met. In the hypothetical, those conditions are not met:

- Parent and FREDCO are members of L.L.C. In the language of the regulations, each is the investor in the L.L.C.
- Fredonian tax law treats L.L.C. as an opaque entity that is not resident in Fredonia.
- L.L.C. is not taxed in Fredonia as a resident under concepts of management and control.
- Fredonian anti-deferral rules for C.F.C.'s are not applicable.
- When and as income is received by L.L.C., Parent and FREDCO are not required to treat that income as taxable for Fredonian tax purposes.
- U.S. CO will not be allowed a deduction for the interest payments made to L.L.C. even if L.L.C. distributes all of its income to Parent and FREDCO. Fredonian tax law allows Parent and FREDCO to claim a D.R.D. that reduces the tax base in Fredonia. Consequently, the distribution is not subject to the general rate of income tax in Fredonia.

"The Preamble explains that the purpose of U.S. withholding taxes is generally not to address mismatches in tax outcomes, but rather to allow the source jurisdiction to retain its right to tax a payment."

CODE §894(C) – ADDING INSULT TO INJURY

Until this point, the article focused on the anti-hybrid rules of Code §267A and its adverse effect on deductions claimed by U.S. Co for interest paid to L.L.C., a related party and a pass-through entity for U.S. income tax purposes, but not for Fredonian purposes. Assuming that an income tax treaty between the U.S. and Fredonia is in effect and the treaty does not address the status of hybrid entities, the problem

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[16] Fixed and determinable, annual and period income, such as interest, dividends, and royalties.

[17] Code §§1441 in general and 1442 in particular.

[18] TD 9896 (April 7, 2020) Section II, B, 3.

grows for the members of Parent's group. The interest payment to L.L.C. that flows through to Parent and FREDCO will not benefit from the reduced rates of withholding tax that provided by the income tax treaty between Fredonia and the U.S. A 30% withholding tax must be collected from the payments of F.D.A.P. income to which Parent and FREDCO are entitled. The adverse consequences stem from Code §894(c) and Treasury Department regulations issued in furtherance of that provision. The result of no deduction as a result of Code §267A and income inclusion due to the application of Code §897 result in consequences that are too bad to be true.

Fiscal Transparency

Code §894(a) provides that income of any kind will not be included in gross income and will be exempt from tax in the U.S., to the extent required by any treaty obligation of the U.S. Eligibility for treaty benefits is limited under Code §894(c) when income is derived through an entity that is treated as transparent under U.S. tax law, but as the beneficial owner under the tax laws of the treaty country.

The U.S. tax regulations[19] that address the effect of income tax treaties on U.S. domestic tax law were designed to clarify the circumstances when a payment of U.S. source income to a fiscally transparent entity such as a partnership are entitled to reduced tax by reason of an income tax treaty. Under these rules, eligibility for benefits depends on whether a payment received by a fiscally transparent entity is derived by a resident of the other Contracting State – either the tax transparent entity such as partnership or its members.[20] Since the L.L.C. is a U.S. entity, the focus is on the taxation of the members of the L.L.C. under the laws of the jurisdictions in which members of the L.L.C. are tax resident.

Under the applicable provision in the regulations, for an entity to be treated as fiscally transparent by the jurisdiction in which a member resides, the tax law in that jurisdiction must require that the member to take into account separately its share of the various items of income of the entity on a current basis and to determine the character and source of the items as if they were realized directly from the source.[21] Thus, the rules applicable under the laws of the jurisdiction in which the member is resident must be analogous to the U.S. rules applicable to entities that are treated as partnerships. Where such treatment exists under the laws of that jurisdiction, the entity is treated as transparent. Current inclusion under tax regimes similar to Subpart F of the Code, or as a result of current distributions, is not sufficient to meet this requirement.[22]

Because foreign laws are not often identical to provisions of U.S. tax law, the regulations provide an alternative test to determine fiscal transparency. Under the alternative, an entity will be fiscally transparent with respect to an item of income even if the item of income is not separately taken into account by the interest holder when the tax liability of the member is unaffected by the character or source of the

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19 Treas. Reg. §1.894-1(d)(1).

20 The regulations address only the treatment of U.S.-source F.D.A.P. income that is not E.C.I.

21 Treas. Reg. §1.894-1(d)(3)(ii).

22 Treas. Reg. §1.894-1(d)(5), Examples 6 and 9.

income. For this alternative to apply, the item of income, if separately taken into account, must not result in an income tax liability that is different from the liability which would result if the interest holder did not take the item into account separately. In addition, the interest holder must be required to take into account on a current basis the interest holder's share of all such non-separately stated items of income paid to the entity, whether or not distributed. Simply stated, this means that a bottom line inclusion of a share of all income to the member may be acceptable if there is no difference in tax for the member as a result of separate inclusions on an item-by-item basis or one inclusion of a bottom line amount.[23] This view is confirmed in the preamble to the Treasury Decision[24] that adopted the alternative provision of the regulations addressing fiscal transparency.

If an entity that is owned by one or more residents of a treaty partner jurisdiction is not treated as fiscally transparent where the members reside, the payment to that entity will not qualify for treaty benefits based on the income tax treaty between the U.S. and the jurisdiction of tax residence.

Based on the foregoing discussion, the entity (L.L.C.) deriving the income is a U.S. entity, its members (Parent and Fredco) are foreign, and since the members are not reporting the distributive share of the entity's income in the tax returns of jurisdiction in which they reside, the ordinary domestic rules for the collection of income tax by U.S. partnerships will apply. Withholding tax will be collected at the statutory rate of 30% for F.D.A.P. income. Withholding tax must be collected and paid over to the I.R.S. at the time distributions are made. If a foreign partner's distributive share of income subject to withholding is not actually distributed, the U.S. partnership must withhold on the foreign partner's distributive share of the income on the earlier of the date that a Schedule K-1 to Form 1065 is furnished or mailed to the partner or the due date for furnishing that schedule.[25]

Application of Fiscal Transparency Requirement to Parent and FREDCO

The regulations discussed above apply to all income tax treaties that are in force between the U.S. and foreign jurisdictions.[26] Consequently, the regulations apply to the income tax treaty between the U.S. and Fredonia. Because Fredonia does not treat L.L.C. as fiscally transparent, no treaty relief will be granted to interest income that is paid by U.S. CO to L.L.C. As a result, L.L.C. has an obligation to collect 30% withholding tax from the respective shares of Parent and FREDCO of F.D.A.P.

23 Treas. Reg. § 1.702-1 requires that each partner of a U.S. domestic partnership is required to take into account separately the partner's distributive share, whether or not distributed, of each class or item of partnership income, gain, loss, deduction, or credit that could affect the computation of income on the partner's tax return. This rule is intended to ensure that specific items of the partnership income, gain, deduction, or loss are taken into account when the partner's tax return is computed; the partnership cannot be used as a vehicle to avoid limitations at the partner level. However, if the partnership reports income, gain, loss, or expense that are not subject to special rules or limitations, the opportunity for abusive tax planning is absent. The policy for this rule is the basis for the alternative relating to fiscal transparency in Treas. Reg. §1.894-1(d)(3)(ii).

24 T.D. 8889, Income affected by treaty – U.S. source payments to entities, Code Sec. 894, 7/03/2000.

25 Treas. Reg. § 1.1441-5(b)(2)(i)(A).

26 Treas. Reg. 1.894-1(d)(4).

income it receives from U.S. CO. Withholding tax imposed at the rate of 30% will be due and payable at the time specified above.

Path Forward

One last path forward exists to solve the problem faced by U.S. CO, L.L.C., Parent, and FREDCO – a request for competent authority relief under the income tax treaty between Fredonia and the U.S.

As mentioned above, the income tax regulations defining fiscal transparency state that the competent authorities of the U.S. and its treaty partner may agree to modify the position in competent authority proceedings under a relevant income tax treaty. Specifically, the regulations state:

> * * [T]he competent authorities may agree on a mutual basis to depart from the rules contained in this paragraph (d) in appropriate circumstances. However, a reduced rate under a tax treaty for an item of U.S. source income paid will not be available irrespective of the provisions in this paragraph (d) to the extent that the applicable treaty jurisdiction would not grant a reduced rate under the tax treaty to a U.S. resident in similar circumstances, as evidenced by a mutual agreement between the relevant competent authorities or by a public notice of the treaty jurisdiction. The Internal Revenue Service shall announce the terms of any such mutual agreement or public notice of the treaty jurisdiction. Any denial of tax treaty benefits as a consequence of such a mutual agreement or notice shall affect only payment of U.S. source items of income made after announcement of the terms of the agreement or of the notice.

Precedent exists for that type of relief in the form of a competent authority agreement between the U.S. and France that was reached in 2019 relating to the ability of a U.S. citizen residing in France to claim a foreign tax credit on a U.S. tax return for French social security charges (C.S.G. and C.R.D.S.). The I.R.S. regularly challenged the creditable nature of those taxes under provisions of U.S. tax law that deny foreign tax credits for foreign social security taxes that are covered by a Social Security Totalization Agreement between the U.S. and a foreign country. The agreement followed a decision of a U.S. Court of Appeals that reversed an I.R.S. victory in U.S. Tax Court.[27]

SOMETIMES ALL IT TAKES IS CHECKING A BOX

The balance of the article looks to ways by which Parent, L.L.C., and U.S. CO can adopt a plan of self-help in neutralizing the adverse effects of a deduction/no inclusion plan in a post B.E.P.S. world. The basic premise is for L.L.C. to elect to be treated as a corporation for U.S. tax purposes combined with a normalization of the structure between a foreign parent and its U.S. subsidiaries. Self-help entails a simple check-the-box election under which L.L.C. check the box on Form 8832 (Entity Classification Election) to be treated as a corporation for U.S. tax purposes. It would be accompanied by a contribution of the U.S. CO shares to L.L.C.

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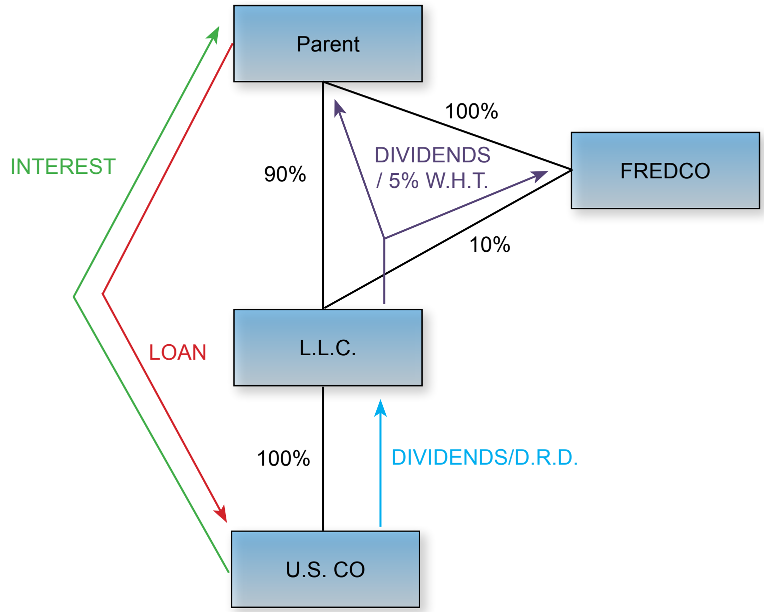
[27] *Eshel v. Commr.,* 831 F.3d 512 (D.C. Cir. 2016) revg. 142 T.C. 197 (2014).



D.R.D. Available to L.L.C. in Relation to Dividends Received from U.S. Subsidiaries

The U.S. allows a D.R.D. to a domestic corporate shareholder that receives a dividend from a domestic subsidiary. The D.R.D. is applied at different rates depending on the percentage of ownership that is maintained in the corporation distributing the dividend.

A corporate shareholder is allowed to deduct the following percentages of a dividend received from a domestic corporation:[28]

- 50%, if it owns less than 20% of the paying corporation's stock, measured by vote or by value
- 65%, if it owns 20% or more of the paying corporation's stock, measured by vote or by value
- 100%, in case of qualifying dividends

A dividend constitutes a qualifying dividend if certain requirements are met:[29] The first requirement is that, at the close of the day on which the dividend is received, the recipient and the corporation making the distribution[30] are members of the same affiliated group of corporations. For this purpose, the term "affiliated group" includes a group of corporations in which one corporation, the common parent, directly owns 80% of the voting power and value of the stock of at least one other member of the group and 80% of the stock (measured by vote and value) of the other members is held in the aggregate directly by one or more corporations within the group.[31]

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28 Code §243(a).

29 Code §243(b).

30 Code §1504(b)(3). Each corporation must be a U.S. corporation.

31 Code §1504(a)(1).

The balance of the requirements are (a) the common parent of the group files an election to which all members consent (a wholly owned subsidiary is deemed to consent),[32] (b) qualifying dividends are paid from the earnings and profits accumulated during the period of affiliation, and (c) both the distributing and receiving corporations have been members of the affiliated group for each day of the year in order for the earnings of the year to be taken into account.[33]

Application of the D.R.D. Provisions to L.L.C. and U.S. CO

If L.L.C. were treated as a corporation for U.S. tax purposes, L.L.C. and U.S. CO would be entitled to a 100% D.R.D. with respect to intragroup dividends. L.L.C. (as a corporation) and U.S. CO would be treated as members of the same affiliated group of companies. L.L.C. would be the common parent since it would directly own at least 80% of voting power and value of the stock of the U.S. CO. If more companies are added, 100% of the stock (measured by vote and value) of all members other than L.L.C. would be held directly by the one or more members. L.L.C. would make an election for application of the D.R.D. to which all members would consent (a wholly owned subsidiary is deemed to consent).[34] The election would be made by filing a statement with the I.R.S.

If the group elects to file a consolidated income tax return,[35] losses in one company can be used to offset profits in other companies that are members of the group.[36]

"If the group elects to file a consolidated income tax return, losses in one company can be used to offset profits in other companies that are members of the group."

No Disallowance Under The Anti-Hybrid Rules

Because L.L.C. elects to be treated as a corporation for U.S. tax purposes, the anti-hybrid rules become inapplicable. U.S. CO can borrow directly from Parent. Although Parent may be taxable in Fredonia on interest income received from U.S. CO, that tax exposure is offset against the deduction that is now allowed in the U.S. to U.S. CO, at least to the extent the deduction is not capped by limitations.[37]

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32 Treas. Reg. §1.243-4(c). A wholly owned subsidiary is deemed to consent.

33 *Id.*

34 Treas. Reg. §1.243-4(c).

35 Form 1122 (Authorization and Consent of Subsidiary Corporation To Be Included in a Consolidated Income Tax Return) is the form on which a subsidiary authorizes the common parent to file a consolidated tax return. Form 851 (Affiliations Schedule) is the form on which the common parent corporation and each member of the affiliated group is identified, the amount of overpayment credits, estimated tax payments, and tax deposits attributable to each corporation are reported, and each subsidiary corporation determines whether it qualifies as a member of the affiliated group.

36 The consolidated tax return rules appear in Code §§1501 to 1563. The treasury regulations that implement the Code provides the detail. A discussion of those provisions is beyond the scope of this article.

37 For instance, Code §163(j) which limits the ability of a corporation to claim an interest deduction to 30% of earnings before interest and tax.

Entitlement of Treaty Relief to Reduce U.S. Withholding Tax on Dividend Distribution From U.S. CO to Parent

If L.L.C. is treated as a corporation for U.S. tax purposes and Parent meets one of the tests of the limitation on benefits article, dividend distributions made by L.L.C. to Parent should qualify for treaty benefits, typically 5% of the amount distributed rather than 30%, the rate provided under U.S. domestic law on F.D.A.P. income.

CONCLUSION

The enactment of Code §267A attacking tax benefits for hybrid entities and hybrid payments combined with the Treasury regulations issued under Code §894 effectively put an end to cross border tax planning based on different treatment of entities and transactions. As illustrated above, use of hybrid plans can result in a loss of deductions by a U.S. entity combined with a loss of access to treaty benefits for the recipient of payments. While some pundits may complain that the U.S. is an outlier as to the O.E.C.D. pillars, the U.S. is at the top of the class with regard to putting an end to abusive hybrid arrangements.

IS IT SAFE TO USE A S.A.F.E.?

Authors
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Tags
C.L.E.
Contract
Convertible Debt
Debt vs. Equity
Forward Contract
O.I.D.
Original Issue Discount
Prepaid Variable Forward
Q.S.B.S.
S.A.F.E.
Secuirty
Warrant
Y Combinator

INTRODUCTION

In 2013 a new investment scheme was introduced to the world by Y Combinator, a well-established start-up companies accelerator. A Simple Agreement for Future Equity ("S.A.F.E.") allows a company to receive funds in exchange for an obligation to issue shares in the future, if and when a fundraising round, a liquidity event, or an I.P.O. occurs. Due to its the relatively simple nature for capital-raising, the S.A.F.E. became very popular among start-up tech companies.

The S.A.F.E. does not properly fit into any of the usual categories of investment vehicles, such as debt or equity, and there is much ambiguity as to the proper characterization of A S.A.F.E. for U.S. tax purposes.

Earlier this year, the Israeli Tax Authority ("I.T.A.") published its position on taxing a S.A.F.E. The I.T.A.'s position is not the main focus of this article, but it evoked the interesting question of how should a S.A.F.E. be characterized for U.S. Federal income tax purposes. Interestingly enough, the I.R.S. has not yet published any guidance on point.

THE MECHANICS OF A S.A.F.E.

A S.A.F.E. typically refers to a financing arrangement under which an investor tenders an agreed amount to a company, in exchange for the company's obligation to issue stock (typically preferred stock) at a later time. At the signing of the S.A.F.E., the specific date on which shares will be issued and the price per share at time of issuance are unknown. Instead, the parties typically agree on the following mechanics:

- Shares will be issued upon a future financing round, a change in control, an initial public offering, or a dissolution (a "Triggering Event").
- The price-per-share will be determined based on the company's valuation on the Triggering Event date, subject to a valuation cap or a specified discount.

If the parties agree on a valuation cap, the stock value at the time of conversion is limited to a maximum amount.[1] This mechanism protects the investor's rights by

[1] To illustrate, the investor invests $200,000 in a company under the S.A.F.E. and the parties agree that the value of the company will be capped at $2 million. This means that the investor will receive 10% of the company's stock at the time of a Triggering Event, even if the Triggering Event takes place when the company is evaluated at $4 million. Without the cap on value for conversion purposes, the investor would have received shares reflecting 5% of the company.

ensuring that the investor's price per share does not rise too high causing the number of shares issued to fall below an acceptable amount. The alternative mechanism designed to protect the investor's rights is granting the investor a pre-determined discount for the future shares.[2] The discount alternative imposes no limitation on the investor's future price per share, but it ensures that such a price will be a better price relative to the price in the next financing round.

The S.A.F.E. is relatively straightforward to create and implement. The parties do not need to evaluate the company's stock, negotiate interest payments, or subject the agreement to certain conditions or restrictions that typically apply to debt instruments. This presents a significant benefit to the company because it is able to raise additional funds quickly and easily in the future. The investor derives its own advantages, mainly the opportunity to benefit from an upside of the company's shares after the time the S.A.F.E. is signed.

Nonetheless, a S.A.F.E. presents its own set of disadvantages, as well. The Triggering Event might never occur, and the investor might lose the entire investment. Repayment rights typically kick in only upon the company's dissolution and, in any event, they are junior to the rights of creditors. The S.A.F.E. investor might also incur losses if a Triggering Event occurs, but the company's valuation is lower than was expected at the time of funding the S.A.F.E. These are typical risks of equity owners.

Another significant disadvantage is the lack of clear taxing rules, thereby creating a level of uncertainty for both parties to the S.A.F.E. arrangement. In the absence of specific taxation rules, a common approach to quantifying expected tax consequences is to equate a new instrument such as the S.A.F.E. to a type of instrument that it resembles most, and for which established taxing rules exist.

This raises the main question that remains unanswered, except perhaps, to a limited extent, in Israel. In what category does the S.A.F.E. fit? The possible alternatives include debt, stock, warrants and forward contracts. Below is a short discussion on each of these alternatives.

DEBT?

There is a large body of case law identifying several key factors that point to the status of an instrument as debt, rather than equity, based on common law principles.[3] Those factors include, *inter alia*,

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2 For example, if the parties agree on a 20% discount and the price per share at the closing of the Triggering Event is $10, the price per share offered to the S.A.F.E. investor is only $8. As a result, a S.A.F.E. investor who invested $200,000, and should have received 20,000 shares based on a price of $10, will receive 25,000 shares (200,000 ÷ 8 = 25,000).

3 See, for example, *Indmar Products Co. v. Commr.*, 444 F.3d 771, (6th Cir. 2006); *Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625 (6th Cir. 1986), *affg*. T.C. Memo 1985-58; *Estate of Mixon v. U.S.*, 464 F.2d 394 (5th Cir. 1972)); *Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968); and *Laidlaw Transp., Inc. v. Commr.*, T.C. Memo 1998-232.

- the borrower's repayment obligations, typically with a schedule of payments;
- a fixed maturity date;[4]
- stated interest payments;
- the borrower's preferred rights on dissolution
- credit worthiness of the borrower, measured for example based on the debt-equity ratio;
- no rights of conversion into equity are granted to the borrower;
- documentation and the title of the instrument refer to a debt instrument; and
- the parties' intent to treat the instrument as debt.

"The S.A.F.E. does not meet the above factors and therefore lacks the essential indicia of a debt."

The weight given to any factor varies from case to case, indicating that the answer depends on all the facts and circumstances that are present.[5]

The S.A.F.E. does not meet the above factors and therefore lacks the essential indicia of a debt. The company is not obligated to repay the S.A.F.E. amount and there is no maturity date. There is also no obligation to pay any interest. The S.A.F.E. holder's rights are usually junior to those of any creditor and the legal documents typically clarify that the parties did not intend to create a debt instrument. Therefore, the common view is that a S.A.F.E. should not be treated as a debt instrument for tax purposes.[6]

Convertible loan agreements ("C.L.E.s") are debt instruments that give the holder the right to convert the debt instrument into an equity security. Despite their hybrid nature, they are typically treated as debt for U.S. tax purposes until converted to stock.[7] It follows that, since a S.A.F.E. should not be treated as debt, a S.A.F.E. should not be treated as a C.L.E. In fact, the S.A.F.E. was originally designed by Y Combinator to avoid having C.L.E. characteristics.[8]

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4 See *Farley Realty Corp v. Commr.*, 279 F.2d 70 (2nd Cir. 1960): "Numerous cases have held that the absence of a fixed maturity date is a crucial factor weighing against a corporate taxpayer's claim that a debtor-creditor relationship existed between it and its payee." *Laidlaw Transp., Inc. v. Commr., supra, (*citing *Estate of Mixon v. U.S., supra).*

5 *John Kelley Co. v. Commr.*, 326 U.S. 521 (1946); Notice 94-47, 1994-1 C.B. 357.

6 See, *e.g.*, Damsky, *Pigeonholing the 'S.A.F.E.' and 'KISS,'* Tax Notes, May 7, 2018, p. 831; L.P. Adamo, Tax Treatment of S.A.F.E.s, Lowenstein Sandler Client Alert..

7 See, for example P.L.R. 201517003, cross-refencing to H.R. Rep. No. 105-220, at 524 (1997): "This appears to indicate a Congressional preference for treating convertible debt instruments as valid debt in most cases." However, where it is substantially certain that the holder will receive stock, the instrument is presumed to be equity and interest deduction will not be allowed. See also Code §163(l). The conversion of the debt into equity is also not a taxable event because it is a mere exercise of rights embedded in the security under its own terms. Treas. Reg. §§1.1272-1(e) and, 1.1275-4(a)(4).

8 See here.

Interestingly, the I.T.A. did not preclude the possibility of characterizing a S.A.F.E. as a debt instrument in its announcement. The I.T.A. clarified that, unless certain specified conditions are met, a S.A.F.E. may be categorized as debt and the discount given to the investor upon conversion of the S.A.F.E. into stock, may be treated as taxable interest income, similar to the concept of original issue discount ("O.I.D.") under Code §1272.[9] The I.R.S. is not expected to adopt a similar approach because the S.A.F.E. does not meet any of the factors that serve as an indication of debt. Even if S.A.F.E. could be viewed as debt, no taxable O.I.D. would exist under Code §1272 because an option to convert debt into equity is ignored for purposes of determining O.I.D. income.[10]

EQUITY?

Based on the debt vs. equity analysis that has been developed by the courts, an instrument that is disqualified as debt is typically recharacterized as equity. Under certain circumstances, instruments may be classified as equity even if labelled by the parties as debt when the likelihood of conversion is very high at the time of issuance.[11] For example, in one Technical Advice Memorandum ("T.A.M.") published by the I.R.S. discussing subordinated loan agreements,[12] a company issued non-interest-bearing notes with no maturity date. The investor had no right to force any repayment, and his repayment rights on a dissolution of the company were subordinated to the creditors' rights. In addition, the lender was the only shareholder of the company and the company was thinly capitalized. In the circumstances, the notes were found to be equity for income tax purposes. In addition, "deep in the money" stock options have been traditionally treated as equity.[13]

Hybrid Nature

The S.A.F.E. resembles equity in several aspects. Like some of the instruments discussed in the cases mentioned above, a S.A.F.E. is signed with the view that it will be converted into stock. It bears no interest and has no maturity date. The S.A.F.E. investor has no right to force repayment and his repayment rights upon dissolution are junior to the creditors' rights. Lastly, the S.A.F.E. investor is not required to pay any strike price, which causes the conversion option to be viewed as deep in the money.

In addition, a S.A.F.E. investor's gain or loss is subject to the company's success and profits, much like the holder of an equity instrument.[14] If the company's value goes up and it undergoes a successful financing round, the investor will gain significantly on the conversion of the S.A.F.E. by receiving discounted shares. However,

9 Any S.A.F.E. arrangement that will not meet the conditions outlined by the I.T.A. will be examined and its classification for Israeli tax purpose will be determined based on all facts and circumstances.

10 Treas. Reg. §1.1272-1(e).

11 See, for example, Rev. Rul. 83-98. There, the parties agreed that the debt would be converted into equity unless the stock price dropped by more than 40%. See also Bozkurt and Bauer, A Bridge Between Debt and Equity: Taxation of Bridge Convertibles.

12 T.A.M. 2004180008.

13 Rev. Rul. 82-150.

14 *U.S. v. Title Guarantee & Trust Co.*, 133 F2d 990, 993 (6th Cir. 1943).

if the company is unsuccessful and fails in raising any funds, the investor might end up losing the investment without receiving any stock or any other compensation.

Based on the above, it is not improbable that a S.A.F.E. will be classified by the I.R.S. as equity (more accurately, preferred stock). Some practitioners have already expressed their views that the S.A.F.E. is a type of equity instrument.[15]

On the other hand, equity generally reflects an ownership interest in a corporation. Some commentators explained that ownership concepts for tax purposes are not coterminous with concepts of legal ownership. Rather, tax ownership is based on the three attributes:

- Legal ownership
- Possession (including the right to use the property or to derive any current income from the property)
- The right to derive any appreciation and to suffer any depreciation in the value of the property[16]

A S.A.F.E. holder does not fully meet any of these attributes. First, the S.A.F.E. investor does not legally own any shares in the company. Secondly, the S.A.F.E. investor has no possession or any right to use the corporation's property (no voting rights) and has no right to derive any current income from the property (no dividend rights). Finally, a S.A.F.E. investor may derive only limited appreciation or depreciation in the value of the company.[17] In comparison, holders of traded options on shares or commodities enjoy the right to appreciation and suffer the burden of losses in value, but are not considered to own the underlying shares or commodities. If such rights and risks were determinative, all equity swaps, options, forward contracts, and other derivatives would effect an immediate transfer of tax ownership because they all shift the risk of appreciation or loss in value.[18]

Again, with reference to the stated position of the I.T.A., a S.A.F.E. is viewed in Israel as a mere upfront payment for future issuance of the company's stock, provided

15 In an American Bar Association Section of Taxation letter to the I.R.S. dated June 9, 2023, on identified issues to be addressed in the I.R.S. 2023-2024 priority guidance plan, one commentator asked guidance concerning the classification of a S.A.F.E. as a second class of stock for purposes of Code §1361(b)(1)(D) regarding S-Corporations that are a form of pass-through entities for U.S. individuals.

16 Dolan, Dabrowski, Massed & Tretiak, U.S. Taxation of International Mergers, Acquisitions, and Joint Ventures (Thomson Reuters/Tax & Accounting, 1995, with updates through May 2023) (online version accessed on Checkpoint (www.checkpoint.riag.com)) para 23.03[1].

17 If the corporation's value appreciates, the S.A.F.E. investor may benefit from a limited and predetermined discount on issuance of future shares. Similarly, if the value depreciates, the S.A.F.E. investor is not exposed to unlimited risks. In case of dissolution, the S.A.F.E. investor will have priority over the common stockholders. In that respect, see B. Bittker & J.S. Eustice, Federal Income Taxation of Corporations and Shareholders, (Thomson Reuters/Tax & Accounting, 7th ed. 2015 with updates through July 2023) para. 4.05[1][a], explaining that equity is the " * * *unlimited claim to the residual benefits of ownership and an equally unlimited subjection to the burdens thereof."

18 Dolan, Dabrowski, Tretiak & Massed, *supra*, n.16, para 23.03[1].

that certain criteria specified in the I.T.A.'s announcement are met. If the I.R.S. were to adopt a similar approach, the S.A.F.E. would be considered an executory contract that is completed only on the passage of the legal title in the shares at the time of closing the transaction.[19] These types of contracts, where the buyer is paying an upfront amount for property to be delivered at a future settlement date, are typically referred to as forward contracts. Forward contracts are discussed in greater detail, below.

Tax Implications

If the S.A.F.E. is treated as stock, no taxable event is expected to be recognized by the investor[20] or the company[21] at the time the S.A.F.E. is signed and funds are advanced to the company. The conversion of the S.A.F.E. into stock might trigger gain unless the conversion meets the requirements of Code §1036 (regarding stock-for-stock exchanges of shares of the same corporation) or Code §368(a)(1)(E) (regarding recapitalizations) and nonrecognition treatment applies.[22]

If the S.A.F.E. is treated as stock, and nonrecognition treatment applies to the conversion of the S.A.F.E. into company stock, the investor's holding period in the stock would relate back to the date the investor purchased the S.A.F.E. This may become relevant in two respects:

- If the investor sells the shares of stock acquired in connection with the conversion of the S.A.F.E., the holding period would relate back to the date the S.A.F.E. transaction was entered. The starting date would not begin with the conversion, and for that reason, favorable tax rates for long-term capital gains could be achieved without having to wait an additional 12 months.[23]
- If the investor seeks to have the stock qualified small business stock ("Q.S.B.S.") allowing an exemption from taxation on gain under Code §1202 when the stock is sold,[24] the Q.S.B.S. must have been held for at least five years prior to the sale. Where the Q.S.B.S. in a corporation is acquired solely

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19 In determining whether a sales contract is executory, some courts have focused on whether legal title to the underlying goods passes. (*Commr. v. Segall*, 114 F.2d 706 (6th Cir. 1940). Executory contracts are open transactions that are taxed only upon closing, at the time when an unconditional liability of the buyer is created. See, *Lucas v. North Tex. Lumber*, 281U.S. 11 (1930).

20 At the time the investment is made, no realization is expected on the part of the investor.

21 Code §1032(a).

22 For more detail on the proposition that conversion of a S.A.F.E. into stock may be treated as recapitalization under Code §368(a)(1)(E), see Damsky, *Pigeonholing the 'S.A.F.E.' and 'KISS,' supra* note 6., at page 833.

23 The tax rate that applies to long-term capital gains is 20%. See Code §1(h)(1)(D). In contrast, short term capital gains are subject to the same tax rates that apply to ordinary income and may reach 37%. In both cases, Net Investment Income Tax (N.I.I.T.") of 3.8% would be imposed. See Code §1411.

24 Code section 1202 provides for a tax exemption on a sale of certain corporate stock received in an original issuance from a qualified small business. The exemption is capped at the greater of (i) gain not exceeding $10 million and (ii) 10 times the aggregate adjusted bases of Q.S.B.S. issued by such corporation and disposed of by the taxpayer during the taxable year. A business is considered "small" if the gross assets of such corporation do not exceed $50 million any time prior to or immediately after the issuance of stock.

through the conversion of other stock in the same corporation, the holding period for the other stock is taken into account in determining the start of the five-year holding period.[25] This is commonly known as "tacking" of holding periods.

A WARRANT?

Very broadly, a warrant is a noncompensatory option, which is an option issued not in consideration for the performance of services. A S.A.F.E. is similar to warrant, except that a S.A.F.E. does not include a price per share, it has no strike price, and it does not provide an option on whether to exercise or not.

In light of these differences, it is unlikely that the S.A.F.E. will be categorized as an option, mostly because the I.R.S. and the courts have narrowly construed the meaning of an option for tax purposes. Most significantly, where the investor's ability to exercise an option is contingent on the occurrence of events outside the investor's control, an option status is typically not available.[26] Since a S.A.F.E. is contingent on the occurrence of a future financing event, it will not be surprising if the I.R.S. position is that the S.A.F.E. not treated as a warrant. Moreover, a S.A.F.E. does not require payment of an exercise price, which means that it is deep in the money. There is authority that deep in the money options should be treated as either stock[27] or a forward contact.[28]

Tax Implications of a Warrant

If the S.A.F.E. is categorized as a warrant, the company issuing the warrant will have no taxable income on the receipt of the initial payment, which will be treated as an option premium[29] or prepaid exercise price.[30] Issuance of the stock upon conversion of the S.A.F.E. should also not be a taxable event.[31]

The investor's holding period in the stock is expected to start on the date of exercise. The shares of stock must be held for 12 months and one day in order for an investor to benefit from long-term capital gains treatment when the underlying stock is sold.[32] This is also true for purposes of the Q.S.B.S. exemption.[33] As a result, the treatment of a S.A.F.E. as a warrant may be significantly less favorable to the treatment as shares, which was discussed above.

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25 Code §1202(f).

26 See, Damsky, *Pigeonholing the 'S.A.F.E.' and 'KISS'*, Tax Notes, *supra* note 6, and the cross-references made there to Rev. Rul. 68-801; P.L.R. 8936016; M.A. Stevens, The Tax Treatment of Contingent Options, Tax Notes, January 27, 2004; *Saviano v. Commr.*, 80 T.C. 955 (1983).

27 Rev. Rul. 82-150; P.L.R. 9747021.

28 Rev. Rul. 80-238; *Progressive Corp. and Subsidiaries v. U.S.*, 970 F.2d 188 (1992); FSA 956.

29 *Virgina Iron Coal & Coke Co. v. Commr.*, 37 B.T.A. 195 (1938).

30 Code §1032.

31 Rev. Rul. 78-182.

32 Rev. Rul. 88-31; *Helvering v. San Joaquin Fruit & Investment Co.*, 297 U.S. 496 (1936).

33 H.R. Rep. No. 103-111, 1993-3 CB 163 (July 1993).

A FORWARD CONTRACT?

Forward Contract

The Code defines a forward contract as a "contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price."[34] In simple words, a forward contract is typically an agreement to sell agreed property for an agreed price at an agreed date in the future.[35]

The S.A.F.E. does not fit into the foregoing definition of a forward contract because neither requirement is met. The number of shares to be issued is unknown as is the price and the date.

Prepaid Variable Forward Contract

A Prepaid Variable Forward Contract ("P.V.F.C.") is a special type of a forward contract, under which the investor pays a purchase price to the seller at the time the agreement is entered into, in exchange for the seller's obligation to deliver a variable quantity of stock at the closing of the contract.

"There is no bright line demarcation between a P.V.F.C. and a stock purchase agreement."

A P.V.F.C. is an attractive arrangement because it allows stock owners to manage equity risk by providing protection against price decreases and get up-front liquidity with no current tax liability, while also allowing them to profit to some extent from price increases.

The S.A.F.E. resembles the P.V.F.C. in that in both arrangements, the investor is making a prepayment at the signing in exchange for a variable amount of shares at the closing. The main difference between the P.V.F.C. and the S.A.F.E. is that a P.V.F.C. typically has an agreed-upon settlement date, whereas the settlement date for the S.A.F.E. will occur only upon a future financing event. Nevertheless, such a distinction should not preclude a S.A.F.E from being treated as a type of P.V.F.C., especially in light of a recent Tax Court case that suggests that an uncertain settlement date might not invalidate forward contract status. In *McKelvey v. Commr.,* [36] the court held that an amendment of the delivery date under the P.V.F.C. was not a taxable event. In comparison, the I.R.S. has treated a significant option extension as a taxable event.[37]

There is no bright line demarcation between a P.V.F.C. and a stock purchase agreement. In Rev. Rul. 2003-7, the I.R.S. ruled that an agreement made by a shareholder to deliver a variable amount of shares on an agreed-upon future date, will be respected as a V.P.F.C. rather than a stock sale where the execution of the agreement does not effect a sale of the underlying shares. The shareholder-seller pledged the underlying shares to the buyer by placing them with a third-party trustee, but the shareholder retained the right to vote the shares, receive dividends, and substitute cash or other shares for the pledged shares on the delivery date. The I.R.S. further noted that the result might have been different had greater limitations been placed on the rights retained by the shareholder in the pledged shares.

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34 Code §1259.

35 See, the Joint Committee on Taxation, *Present Law and Analysis Relating to the Tax Treatment of Derivatives* (JCX-21-08), Mar. 4, 2008, at 6-7.

36 148 T.C. 13 (2017).

37 T.A.M. 9129002.

A different conclusion was reached in *Anschutz Co. v. Commr.*[38] There, the Court found that a prepaid forward contract that was accompanied by share-lending agreements and a master stock purchase agreement, resulted in a current taxable sale of the underlying shares because the overall effect of the transactions amounted to a sale of the pledged shares. On the facts presented, the benefits and burdens of ownership were transferred when the P.V.F.C. was agreed to. The decision was based on the answers to the following questions:

- **Did legal title pass?** Yes. No restrictions were placed on the counterparty's rights to immediately sell, assign, or otherwise transfer the shares.
- **How did the parties treat the transaction?** While the agreement treated the agreement as an executory contract to be performed at a later date, it was understood that the counterparty would sell the pledged shares to pay off amounts that were previously borrowed in order to fund amounts payable to the taxpayer.
- **Did the purchaser acquire equity in the property?** Yes. The forward seller in the agreement effectively exchanged its ownership rights in the pledged stock for an upfront cash payment equal to 75% of the pledged stock's then-existing market value. It retained the potential of benefitting to a limited degree if the pledged stock increased in value over the life of the transactions. It eliminated all risk of loss of value in the pledged property. The counterparty obtained the right to use the pledged stock as it saw fit, and used most of the pledged stock to repay its borrowings from pre-transaction short sales. In this manner, the counterparty acquired an equity interest in the pledged shares.
- **Did the contract create a present obligation on the seller to execute and deliver shares and a present obligation on the purchaser to make payments?** Yes. Under the terms of the agreement, the forward seller had an obligation to give the pledged shares to the counterparty, which had an obligation to pay the forward seller the requisite prepaid lending fee. Considered together, these obligations bore substantial similarity to a sale of the pledged stock.
- **Was the right of possession vested in the purchaser?** Yes. Although the forward seller had the right to recall the property lent to the counterparty, the counterparty retained possession of the pledged shares or the proceeds of sales of those shares.
- **Which party bore the risk of loss?** The forward seller was protected against a fall in the price of the property.
- **Which party had the opportunity for gain?** The forward seller capped its opportunity for gain at 50%, which ultimately translated into relinquishment of the next 20% to 40% of the appreciation over the following 10 years.
- **Which party held the voting rights?** The counterparty retained the right to vote the shares.
- **Which party had the right to receive dividends?** Although the forward seller retained a modified right to dividends from the pledged shares, restrictions

[38] 664 F.3d 313, (10th Cir. 2011), affg., 135 T.C. 78 (2010).

were placed on that right to protect the counterparty if the value of the pledged shares dropped below a specified level at maturity. No dividends would accrue to the forward seller until the share value was known at maturity.

Application to a S.A.F.E.

Rev. Rul. 2003-7 and *Anschutz Co*. establish the parameters by which a transaction results in (i) a prepaid variable forward contract or (ii) an immediate sale. In the former, no immediate sale of the shares was deemed to occur because of the limited rights enjoyed on a current basis by the forward seller. In the latter, the majority of the benefits and burdens of ownership were transferred to the counterparty immediately.

A typical S.A.F.E. would resemble the P.V.F.C. discussed in Revenue Ruling 2003-7 more than the agreement in *Anschutz Co*. Under a typical S.A.F.E., the investor receives no legal title in the underlying stock, no voting rights, and no rights for dividends. On the other hand, the investor would have an interest in appreciation of company shares, but those shares remain unissued until the safe is converted into shares. In the circumstances, it appears more likely than not correct to conclude that that the S.A.F.E. will be treated as a P.V.F.C. for tax purposes.

TAX IMPLICATIONS OF A PREPAID VARIABLE FORWARD CONTRACT

The V.P.F.C. characterization is generally desirable for the parties because the transaction is not considered closed until the property is delivered.[39] Accordingly, similar to the tax treatment of an option,[40] the company has no taxable income on the receipt of the investor's funds. Such payment is treated as an advance deposit, without immediate tax consequences. In addition, when the SAFE is converted into stock of the company, there is no taxable event for the company[41] and for the investor.[42]

If the S.A.F.E. is viewed as a P.V.F.C., the holding period in the underlying stock will only start upon the conversion of the S.A.F.E. into stock.[43] As a result, the holding period in the S.A.F.E. prior to its conversion into stock will not be taken into account,

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39 *Lucas v. North Tex. Lumber*, 281U.S. 11 (1930); *Virginia Iron Coal & Coke Co. v. Commr.*, 37 B.T.A. 195 (1938).

40 Rev. Rul. 78-182; Rev. Rul. 58-234.

41 Code §1032.

42 Settlement of a forward contract generally should be treated for tax purposes in the same manner as a sale of the underlying assets. C.C.A. 201025047, P.L.R. 200450016, P.L.R. 200518062. A sale of shares by the issuing company to a shareholder involves not realization for the buyer and thus it is generally not a taxable event for the buyer. In addition, it is not a taxable event for the issuing company. See, section 1032.

43 L.P. Adamo, *Tax Treatment of S.A.F.E.s*, *supra*, note 6; E. Zimmerman and B.A. Silikovitz "Gimme Shelter: VC-Backed M&A Tax Strategies for QSBS/1202" *Forbes* (July 19, 2016). The Supreme Court has held that when a prepaid forward contract remains executory (that is, not yet fully performed or carried out), the receipt of the prepayment is not taxable income to the recipient until the contract is no longer executory. (*Lucas v. North Texas Lumber Co.,* 281 U.S. 11 (1930).

and a sale of such stock within one year from the date of issuance, will trigger short-term capital gain treatment and higher tax rates.[44] Similarly, the holding period in the S.A.F.E. will also not be taken into account for purposes of the five-year holding requirement that must be met to trigger the Q.S.B.S. exemption.

NONE OF THE ABOVE – SIMPLY A NEW TYPE OF SECURITY?

A S.A.F.E. is close in nature to stock, warrants, and prepaid variable forward contracts, but it does not really fall within the four walls of any of those categories. Instead of trying to fit the S.A.F.E. into one of the existing categories, perhaps it is more accurate to treat a S.A.F.E. as a security that differs from a stock, a note, a warrant, and a forward contract.

Under Tres, Reg. §1.354-1(e), the term "security" includes rights to acquire stock and such general definition seem to include a S.A.F.E.

". . . the term 'security' includes rights to acquire stock and such general definition seem to include a S.A.F.E."

If a S.A.F.E. is considered a new type of security, its issuance should not give rise to any taxable event, for the same reasons that issuance of stock, a warrant or a P.V.F.C. does not create taxable income for any of the parties.[45] Further, the conversion of the S.A.F.E. into stock should not be a taxable event if it is treated as a recapitalization under Code §368(A)(1)(E).[46]

As to the holding period, it makes sense that a S.A.F.E. security will have its own holding period and the underlying stock, being a separate asset, will have its own holding period as well. However, as explained above, some commentators[47] suggest that stock received in exchange for S.A.F.E. may benefit form a tacked holding period that includes the holding period in the S.A.F.E. itself. This argument is based on the premise that the conversion S.A.F.E. to stock should be treated as a section 368(A)(1)(E) recapitalization.[48] The fact that no additional investment is made, further supports the proposition that a tacked holding period should apply.[49]

The matter has not been resolved as of the date of publication of this article. It likely will not be resolved finally until all of the following events occur:

- A stout-hearted investor tacks the holding period of the S.A.F.E. onto the holding period of shares.
- The investor sells those shares within the following 12 months.

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44 The ordinary income tax rates of up to 37%, instead of lower tax rates of 20%. Whichever rate applies, the gain will be subject to an addition 3.8% N.I.I.T.

45 Issuance of such securities involves no realization for any of the parties.

46 For further discussion on this point, see Damsky, *Pigeonholing the 'S.A.F.E.' and 'KISS'*, *supra*, note 6, at page 833. Under this approach, the S.A.F.E. document should be viewed as the plan of reorganization.

47 Damsky, *Pigeonholing the 'S.A.F.E.' and 'KISS'*, *supra*, note 6, at page 833.

48 In general, stock received in exchange for a security in a section 368(A)(1)(E) recapitalization entitle the holder to benefit from a tacked holding period. The S.A.F.E. is a security.

49 Rev. Rul. 77-238.

- The investor claims long-term capital gain treatment based on the tacking of the holding period for the S.A.F.E. to the holding period of the shares.
- The extended holding period is challenged by the I.R.S.
- A final decision is rendered by a court.
- Congress does not amend the law to legislatively reverse the court decision on a prospective basis.

CONCLUSION

In the absence of specific guidance from the I.R.S. or the courts as to the proper characterization of S.A.F.E. for U.S. tax purposes, S.A.F.E. is expected to be treated as the instrument it resembles most, for which existing taking rules apply.

Characterizing the S.A.F.E. as an equity grant would generally be most desirable for the S.A.F.E. investor. Not only there will be no taxable income upon issuance of the S.A.F.E. or its conversion to stock, but also the holding period in the stock will relate back to the date the investor purchased the S.A.F.E. The longer the holding period is, the higher the investor's chances to benefit from reduced tax rates[50] or even an exemption[51] in case of a suture sale of the stock.

The second-best category, at least from the investor's point of view, is the P.V.F.C. Most commentators mentioned the V.P.F.C. characterization as the most probable one to be adopted by the I.R.S. in the future. If the S.A.F.E. will be viewed as a P.V.F.C., no income will be recognized on the issuance of the S.A.F.E. or its conversion. However, the holding period in the underlying stock will only start upon the conversion of the S.A.F.E. into stock.

In light of the above, practitioners can and should design the terms of a S.A.F.E. to fit better a plan to raise equity than a plan to borrow money. One commentator suggests that start-up entities seeking funding for operations through the issuance of a S.A.F.E., should take steps emphasizing the link between the funding through the S.A.F.E. and the next round of equity funding.[52]

Earlier this year, the I.R.S. invited the public to submit recommendations for items to be included on the 2023-2024 Priority Guidance Plan.[53] The American Institute of Certified Public Accounts responded to the invitation with 35 pages of suggested items that should be addressed. Item no. 11 that appears on page 2 of the

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[50] Long term capital gain rates are subject to a reduced rate of 20% and an additional Net Investments Income Tax of 3.8%.

[51] Under Code §1202, which allows for an exemption on the sales of a "qualified small business stock," under certain circumstances outlined in the Code and regulations.

[52] See, Adamo, *Tax Treatment of S.A.F.E.s*, *supra*, note 6. The commentator suggests that the more likely it is that the S.A.F.E. will convert into shares of stock based on the circumstances surrounding the S.A.F.E. issuance (for example if, at the time the S.A.F.E. is issued, an equity financing is substantially certain to occur), the stronger the support for treating the S.A.F.E. as an equity grant.

[53] The I.R.S. uses the Priority Guidance Plan to identify and prioritize the tax issues that should be addressed through regulations, revenue rulings, revenue procedures, notices, and other published administrative guidanc

submission is a request for guidance clarifying the tax characterization of Simple Agreement for Future Equity as a prepaid forward contract, a warrant, or equity.

While the I.R.S. may not address the characterization of S.A.F.E. in the 2023-2024 Priority Guidance Plan, sooner or later light will be shed on the characterization of S.A.F.E. for U.S. tax purposes, and it will then be safer to use a S.A.F.E.

CODE §367 AND UNASSUMING OUTBOUND TRANSFERS

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Code §351 Exchange
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Gain Recognition Agreement
Outbound Transfer
Triggering Event

INTRODUCTION

In purely domestic situations, the Internal Revenue Code (the "Code") provides for the deferral of taxation when certain corporate reorganizations or transactions take place and specific requirements are met. However, the same may not be true when the reorganization or transaction involves a U.S. person and a foreign corporation. In these situations, the Code may trigger gain for the U.S. person. For instance, if a U.S. person contributes shares in a U.S. corporation to another U.S. corporation in a qualifying Code §351 exchange, the U.S. person does not recognize gain on the transaction. However, if the same U.S. person were to contribute shares in a corporation to a foreign corporation, Code §367(a) requires the U.S. person to recognize gain unless certain exceptions apply. This is also the case if a U.S. person is deemed to transfer the shares indirectly, for example by way of a domestic or foreign partnership. An unwary taxpayer with a merely passive interest in the partnership may not realize that he or she has U.S. tax obligations since the transaction took place between foreign entities and their overall interests remain the same.

This article highlights the situation described above where a seemingly foreign transaction may result in U.S. tax consequences to a U.S. person under Code §367(a). While a number of reorganizations can give rise to implications under Code §367, this article will examine the consequences of a Code §351 exchange where a U.S. person directly or indirectly transfers shares in a foreign corporation to another foreign corporation.

SECTION 351 OVERVIEW

A Code §351 Exchange occurs when one or more persons transfer property to a corporation solely in exchange for stock of the transferee corporation and are in control of such corporation immediately after the exchange.[1] The phrase "one or more persons" includes individuals, trusts, estates, partnerships, associations, companies, or corporations.[2] Control is defined as ownership of at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock.[3] Where a transaction qualifies as a Code §351 Exchange, no gain or loss is recognized by either the transferor or

1 Code §351(a).

2 Treas. Reg. §1.351-1(a); Rev. Rul. 84-111.

3 Code §§351(a) and 368(c).

transferee corporation.[4] A carryover basis is taken in the shares received, thereby preserving the exposure to tax on a future sale of the shares received.[5]

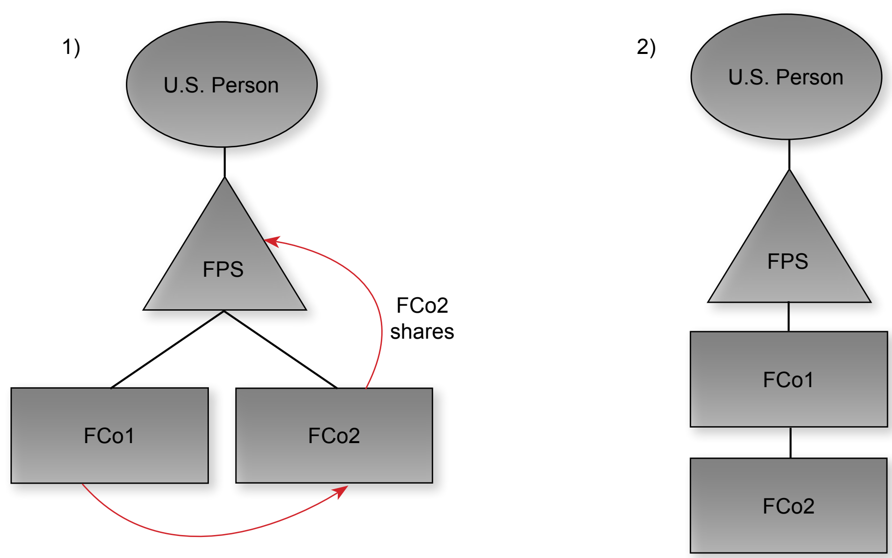
OPERATION OF 367(A)

Notwithstanding the nonrecognition provision under Code §351, Code §367(a) provides that if, in connection with certain exchanges, including Code §351 exchanges, a U.S. person transfers property to a foreign corporation (*i.e.*, an outbound transfer), such foreign corporation will not be considered a corporation for purposes of determining the extent to which gain is recognized. As a result, the nonrecognition treatment under Code §351 is shut off.

For these purposes, a U.S. person is defined in Code §7701(a)(30).[6] The Code defines a U.S. person to include a citizen or resident of the U.S., a domestic partnership, a domestic corporation, and any estate or trust other than a foreign estate or trust.

Moreover, if a domestic or foreign partnership transfers property to a foreign corporation, then a U.S. person that is a partner in the partnership will be treated as having transferred a proportionate share of the property for purposes of Code §367(a).[7]

To illustrate, assume a U.S. person holds a passive interest in a foreign partnership in jurisdiction X. The foreign partnership wholly owns two sister foreign corporations in jurisdiction X, FCo1 and FCo2. As part of a restructuring plan, the foreign partnership contributes shares in FCo1 to FCo2 in exchange for FCo2 shares in a §351 exchange. FCo2 becomes the parent of FCo1. The transaction takes place all within jurisdiction X and qualifies as a nonrecognition transaction under the tax laws of jurisdiction X. Notwithstanding the tax-free nature of the transaction under the tax law of jurisdiction X, Code §367(a) may treat the U.S. person as transferring property to a foreign corporation and deny nonrecognition treatment for U.S. tax purposes.



4 Code §§351(a) and1032(a).

5 Code §§351(h)(2), 358 and 362.

6 Treas. Reg. §1.367(a)-1(d)(1).

7 Treas. Reg. §1.367(a)-1T(c)(3)(i)(A).

Despite the general operation of section Code §367(a)(1) that restricts the application of the nonrecognition provisions on outbound transfers of property, an exception applies where the transferred property is stock or securities of a foreign corporation.[8] In that case, the regulations provide that the transaction will not be subject to Code §367(a)(1) in either of the following fact patterns:

- The U.S. transferor owns less than 5%[9] of both the total voting power and the total value of the stock of the transferee corporation immediately after the transfer.
- The U.S. person transferor enters into a five-year gain recognition agreement ("G.R.A.").[10] The relevant provisions about a G.R.A. are discussed below.

GAIN RECONITION AGREEMENT ("G.R.A.")

Definition

A G.R.A. is an agreement made by the U.S. transferor pursuant to regulations promulgated under Code §367. A G.R.A. extends the statute of limitations for the year of the transaction for a period of five years, ending at the close of the fifth tax year following the close of the tax year in which the exchange occurs (the "G.R.A. Period"). Under the G.R.A. provisions., the U.S. transferor is generally not required to recognize gain on an outbound transfer of stock in a foreign corporation but must certify that it will recognize gain if certain triggering events occur within the G.R.A. Period.[11] As explained in more detail below, a triggering event generally includes any subsequent disposition by the transferee foreign corporation of the transferred stock to an unrelated party. If a triggering event occurs during the G.R.A. Period, the transferor must report the deferred gain realized in the earlier transaction either on an amended tax return for the tax year of the initial exchange, or in the tax return for the tax year in which the triggering event occurs.[12] In either case, the taxpayer must pay interest on the deferred tax that is then deemed to be paid late, going back to the initial transfer year.[13]

"A G.R.A. extends the statute of limitations for the year of the transaction for a period of five years, ending at the close of the fifth tax year following the close of the tax year in which the exchange occurs . . ."

Triggering Event

A triggering event includes, *inter alia*,[14]

- a complete or partial disposition, directly or indirectly, of the transferred stock in the initial exchange by the initial foreign transferee;

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8 Code §367(a)(2).

9 Applying the attribution rules of Code §318 as modified by Code §958(b). These rules are outlined in greater detail in Section 2(A) below. Each U.S. person will be attributed stock owned by H.Q.H. and any intermediary entity. No other attribution rules outlined in the Code will apply here to increase a U.S. person's interest.

10 Treas. Reg. §1.367(a)-3(b)(1).

11 Treas. Reg. §1.367(a)-8(c)(1).

12 Treas. Reg. §1.367(a)-8(c)(1)(iii).

13 Treas. Reg. §1.367(a)-8(c)(1)(v).

14 Treas. Reg. §1.367(a)-8(j).

- a disposition in one or more related transactions of substantially all of the assets of the transferred corporation except for (i) inventory or property held for sale to customers in the ordinary course of business, (ii) an exchange of stock or securities pursuant to an asset reorganization, and (iii) an exchange of stock by a corporate distributee pursuant to a complete liquidation;
- a complete or partial disposition, directly or indirectly, of the stock of the transferee foreign corporation received by the U.S. transferor in the initial transfer. If the U.S. transferor is an individual, losing U.S. citizenship or ceasing to be a U.S. permanent resident, is treated as a disposition of all the stock of the transferee corporation;
- entering or leaving a consolidated group, in the case of a U.S. corporate transferor;
- the death of a U.S. transferor, or the termination of a trust or estate that was the transferor; and
- failing to comply with the G.R.A. requirements.

Exclusions

Certain dispositions of the transferred stock by the transferee are excluded from the triggering event rules, mainly dispositions that are part of nonrecognition transactions in which the transferor retains an interest, directly or indirectly, in the transferred stocks and securities or assets of the transferred corporation, and provided that the U.S. transferor enters into a new G.R.A. relating to the stock received in the exchange for the remaining term of the existing G.R.A ("New G.R.A.").[15]

Content of a G.R.A.

A G.R.A. includes information about the transferor and a description of the property and the gain that is subject to the agreement. It is signed under penalties of perjury and must be filed with the tax return of the U.S. transferor for the tax year in which the exchange occurs.[16] A G.R.A. is considered timely filed only if included with a timely filed return, and all relevant G.R.A. documents are complete in all material respects.

In connection with filing, the U.S. transferor must agree to extend the statute of limitations on assessments as it applies to the tax on the gain realized but not recognized as a result of the initial transfer through the close of the eighth full tax year following the tax year of the initial transfer.[17] This extension is made by filing Form 8838 (Consent to Extend the Time to Assess Tax Under Section 367—Gain Recognition Agreement) together with the G.R.A.[18] If a New G.R.A. is entered into by a U.S. transferor, the U.S. transferor must also extend the limitations on the initial transfer through the close of the eighth full tax year following the tax year of the

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15 Treas. Reg. §1.367(a)-8(k)(3).

16 Treas. Reg. §§1.367(a)-8(d)(1), (e)(1).

17 Treas. Reg. §1.367(a)-8(f)(1).

18 *Id.*

initial transfer, unless the U.S. transferor for the New G.R.A. is the U.S. transferor for the existing G.R.A.[19]

In addition, the U.S. transferor must include with its timely-filed tax return for each of the five full tax years following the year of the exchange, a certification that contains certain information, including whether any triggering events occurred during the year and the gain that was recognized under the G.R.A. by reason of that event.[20] If no gain recognition event occurred during the taxable year, an annual certificate should be filed confirming the absence of gain.

367(B) CONSIDERATIONS

Code §367(b) applies to exchanges described in Code §351 and to which Code §367(a) does not apply, including where Code §367(a) does not apply as a result of a G.R.A. Under Code §367(b), a foreign corporation generally will be considered as a corporation, thereby allowing nonrecognition treatment to apply, except to the extent provided in the regulations. Treas. Reg. §1.367(b)-4 applies to transactions in which a foreign corporation acquires the stock or assets of another foreign corporation in certain exchanges, including a Code §351 Exchange. Under the §367(b) regulations, income inclusion is required as a result of a transfer of foreign stock in three scenarios:[21]

- Loss of status as a "Code §1248 shareholder"
- Receipt of preferred shares or other stock that allows the transferor to disproportionally participate in the earnings of particular assets
- Certain recapitalizations.

In regard to the first scenario, a Code §1248 shareholder is a U.S. shareholder that owns directly or indirectly at least 10% of a foreign corporation's voting stock at any time during the five-year period ending on the date of the transaction, provided that such foreign corporation was a controlled foreign corporation ("C.F.C.") at the time when the shareholder owned 10% of its stock.[22] For an exchange to involve the loss of status as a Code §1248 shareholder and be taxable under the Code §367(b) regulations, the U.S. transferor must be a Code §1248 shareholder with respect to the acquired foreign corporation immediately before the transaction[23] and must no longer be a Code §1248 shareholder immediately after the transaction.[24] If the foreign corporation that issued the shares being transferred is not a C.F.C., a U.S. transferor cannot be considered a Code §1248 shareholder and income inclusion cannot result from this scenario under Code §367(b).

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19 Treas. Reg. § 1.367(a)-8(f)(2).

20 Treas. Reg. § 1.367(a)-8(g).

21 Additional scenarios become relevant for purposes of Code §367(b) where property is transferred from a foreign corporation to a U.S. person, *i.e.*, an "inbound transfer". See, Treas. Reg. §1.367(b)-3.

22 Treas. Reg. §1.367(b)-2(b), Code §1248(a)(2), 1248(c)(2).

23 Treas. Reg. §1.367(b)-4(b)(1)(i)(A).

24 Treas. Reg. §1.367(b)-4(b)(1)(i)(B).

In order for a transaction to fall within the second scenario, three tests must be met:[25]

- In the first test, the acquired foreign corporation and the acquiring foreign corporation are not part of the same affiliated group immediately before the transaction. An affiliated group includes corporations that have a common parent corporation that owns 80% or more of the total voting power and value of each.[26]
- In the second test, a U.S. corporation directly or indirectly owns 10% or more of the voting power or value of the transferee foreign corporation.
- In the third test, the exchanging shareholder receives preferred stock in consideration for common stock or preferred stock that is fully participating with respect to dividends, redemptions, and corporate stock.

Finally, the Code §367(b) regulations provide that income inclusion would occur in certain recapitalizations described in Code §368(a)(1)(E). A recapitalization generally refers to reshuffling of a capital structure, within the framework of an existing corporation.[27] In a recapitalization, the corporation itself does not ordinarily receive property other than its surrendered stock or securities.

REPORTING REQUIREMENTS

Code §6038B requires transfers subject to Code §367(a) to be reported on I.R.S. Form 926.[28] The U.S. transferor must attach the Form 926 and with attachments to such person's timely filed U.S. income tax return for the taxable year that includes the date of the transfer.[29] A U.S. person is not required to file Form 926 if the U.S. person owned less than 5% of the transferee corporation and the transfer qualified for nonrecognition treatment.[30] When a G.R.A. is filed, an exemption from filing may be available.

Failure to file Form 926 triggers a penalty equal to 10% of the fair market value of the transferred property at the time of the exchange, unless the U.S. person demonstrates the failure was due to reasonable cause and not to willful neglect.[31] The penalty will not exceed $100,000 unless the failure was due to intentional disregard.[32]

CONCLUSION

When a U.S. person is considered to transfer shares in a foreign corporation to another foreign corporation, especially indirectly through a partnership, he or she

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25 See, Treas. Reg. §1.367(b)-4(b)(2)(i).

26 Within its meaning in Code §1504(a) with certain modifications mentioned in Treas. Reg. §1.367(b)-4(b)(2)(i)(A).

27 *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194.

28 Treas. Reg. §1.6038B-1(b)(1)(i).

29 *Id.*

30 Treas. Reg. §1.6038B-1(b)(2)(i)(A).

31 Code §6038B(c).

32 Code §6038B(c)(3).

may not contemplate the U.S. tax consequences of a seemingly foreign transaction with no material effect on his or her holdings. As illustrated, though, the Code is not so generous. It will look to tax the U.S. person under Code §367(a) or (b) unless an exception applies. U.S. persons with direct or indirect foreign holdings should be cognizant of the decisions made by foreign corporations, as even a minor restructuring could result in U.S. tax liability and corresponding interest and penalties.

I.R.S. ISSUES PROPOSED REGULATIONS ON INFORMATION REPORTING FOR DIGITAL ASSETS

Author
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Tags
Digital Assets
Information Reporting

INTRODUCTION

The I.R.S. recently issued the first of a set of what is expected to be several sets of proposed regulations to provide greater clarity on the application of information-reporting rules.

EXISTING LAW

I.R.S. Notice 2014-21 provides guidance on reporting digital assets received as compensation. However, the notice is silent on reporting the sale or exchange of digital assets or the use of digital assets to purchase product or services. The Proposed Regulations aim to fill that gap.

As the preamble explains, "digital assets" are digital representations of value that use cryptography to secure transactions that are digitally recorded using distributed ledger technology such as blockchains. Individual units are sometimes called coins or tokens. Digital assets include cryptocurrency (also known as virtual currency). Owners of digital assets can access their digital assets and conduct transactions with them using what is known as a wallet.

The following provisions of the Code already apply to sales of digital assets:

- Code §1001 and §1012 set the basic income-tax rules for applying cost basis and calculating gain apply to sales.
- Code §6041 requires a person who makes payments of $600 in fixed or determinable income in the course of a trade or business to file information reports and furnish payee statements to the payee.
- Code §6045 requires brokers to file information returns and furnish payee statements for customers on whose behalf the broker sold shares of stock, certain commodities, options, regulated futures contracts, securities futures contracts, forward contracts, or debt instruments in exchange for cash.
- Code §6045A requires certain persons who transfer certain securities to a broker to furnish statements to the broker.
- Code §6045B requires certain securities issuers to provide reports to the I.R.S. and to shareholders regarding the effect on basis of certain organizational actions, such as stock splits, mergers, and acquisitions.
- Code §6050W requires banks and other entities to file information returns and furnish payee statements regarding certain payments in settlement of reportable payment transactions.

The Infrastructure Investment and Jobs Act

The Infrastructure Investment and Jobs Act of 2021 provided some guidance on the application of §6045 and §6045A:

- The term 'broker' specifically includes any person who regularly provides services effectuating transfers of digital assets on behalf of another person.
- "Specified securities" under §6045(g) (which requires that the information reported include basis and the character of the gain) explicitly include digital assets. The requirements under §6045(g) apply to digital assets acquired in 2023 or later.
- A "digital asset" is defined as any digital representation of value recorded on a cryptographically secured distributed ledger or any similar technology.
- Code §6045A specifically applies to digital assets and adds more reporting requirements for transfers of digital assets.
- These new provisions are not applicable for periods prior to the effective date of the new provisions.

NEW RULES

The proposed regulations are focused on Treas. Reg. §1.6045-1. Later rulemaking will focus on Code §6045A.

Expansion of Reporting Obligations

As it currently exists, Code §1.6045-1(a)(9) provides that Code §6045 comes into play only if the property disposed of is a security, commodity, option, regulated futures contract, securities futures contract, or forward contract in exchange for cash.

The proposed regulations add to this list a disposition of digital assets in exchange for cash, other digital assets, stored-value cards, broker services, or other property subject to Code §6045.

Defining Digital Assets

The proposed regulations use the same definition of "digital asset" as in the Infrastructure Investment and Jobs Act, underlining the importance of cryptography in the definition.[1] But an asset can be a digital asset even if not all transactions involving that asset are actually recorded on such ledgers. The example given in the preamble is a broker who carries out transactions between customers in its internal ledger and only uses the secured ledger to execute net purchases.

The definition is meant to capture traditional cryptocurrency as well as newer technologies, such as stablecoins or N.F.T.'s. However, the new rules do not cover tokens that can only be used in a computer game or digital representations of fiat currency (*e.g.*, U.S. dollars sitting in an online bank account).

The preamble explains that the classification of digital assets as securities is for the limited purpose of information reporting. A digital asset that might also be a

[1] Prop. Reg. §1.6045-1(a)(19)(i).

> *"Because digital assets are often exchanged for other digital assets instead of cash, the proposed regulations clarify that a sale includes a disposition of a digital asset for another digital asset."*

security or commodity is to be treated as only a digital asset for reporting purposes.[2] One area left unresolved is conventional broker transactions that are carried out on blockchain technology. The proposed regulations decline to carve out an exception because of uncertainty over the frequency of such transactions, but that may change with the final or future regulations.

Defining Brokers

The proposed regulations expand the circumstances in which a person is a broker. The definition now covers a person that provides facilitative services that effectuate sales of digital assets by customers in the course of its trade or business. Whether someone effects transactions in digital assets on behalf of others depends on whether the person is in a position to obtain identity information.[3] This phrasing reflects the fact that certain digital-asset trading platforms allow for a great deal of anonymity for its users. But the ability to modify the operation of a platform to obtain user information is treated as being in a position to know a user's information. This is designed to prevent operators of platforms from deliberately raising the level of anonymity in their platforms in order to avoid reporting obligations.

The regulations are not intended to cover persons engaged in the business of providing distributed ledger validation services, such as proof-of-work or proof-of-stake mechanisms. Such persons are conventionally known as miners. Because miners are typically not in a position to know the identity of transacting parties, engaging solely in mining is excluded from the definition of brokers.[4] For similar reasons, persons who are solely providers of wallet software are also excluded. But the exclusion is not available if the wallet software provides direct access to trading platforms from the wallet.

Defining Sales

Because digital assets are often exchanged for other digital assets instead of cash, the proposed regulations clarify that a sale includes a disposition of a digital asset for another digital asset.[5]

Required Information

Much of the information that a broker must report is similar to that for securities:[6]

- Customer's name, address, and tax I.D.
- Name or type of digital asset sold
- Number of units sold
- Date and time of sale

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2 Prop. Reg. §1.6045-1(c)(8)(i).

3 Prop. Reg. §1.6045-1(a)(10).

4 Prop. Reg. §1.6045-1(a)(21)(iii)(A).

5 Prop. Reg. §1.6045-1(a)(9)(ii).

6 Prop. Reg. §1.6045-1(d)(2)(i)(B).

- Gross proceeds of sale
- Any other information required by the form (*i.e.*, Form 1099-B)

Information specific to digital assets that must be reported is as follows:

- Transaction identification (transaction I.D. or hash)
- Digital asset address from which the digital asset was transferred, if any (*i.e.*, the wallet's identifying code composed of alphanumeric characters)
- The nature of the consideration (*e.g.*, cash)

If a broker sells a digital asset that was held in a wallet on behalf of a customer, and the asset was previously transferred into the wallet, the broker must also report information on the previous transfer. However, this is intended to be a temporary rule until regulations concerning such transfers are issued under Code §6045A.

<u>Gross Proceeds</u>

The rules for calculating proceeds and gains do not depart greatly from standard income tax principles. Gross proceeds from a sale of a digital asset are defined as:[7]

- The excess of
  - cash received,
  - fair market value of property received (or the issue price for debt instruments received), and
  - fair market value of services received, over
- transaction costs.

Transaction costs are generally fees charged by brokers; they also include applicable transfer taxes.[8] For administrative simplicity, transaction costs are allocated to the disposition of digital assets. With one exception, costs allocated to the receipt of property or services in exchange for the disposed-of digital asset) are not treated as reportable transactions costs.[9] Under the exception, if one digital asset is exchanged for a materially different digital asset, the transaction costs are allocated 50-50 to the disposition of the original digital asset and the acquisition of the materially different digital asset.

Initial basis is similarly defined as the cost to purchase a digital asset plus allocable transaction costs.[10]

<u>Basis Reporting</u>

As mentioned previously, Code §6045(g) requires brokers to report basis information for certain assets. Only brokers who acquired digital assets for a particular customer, provided hosted wallet services (*i.e.*, held them in a wallet on behalf of the

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7 Prop. Reg. §1.1001-7.

8 Prop. Reg. §1.6045-1(d)(5)(iv).

9 *Id.*

10 Prop. Reg. §1.1012-1(h).

customer), and held them until disposition are required to report basis.[11] In general, only these brokers have the information necessary to compute basis. This is contrasted with a customer who acquired the asset using another broker or a customer who mines digital assets on his or her own.

Basis reporting will likely become more extensive once regulations requiring reporting on transfers of digital assets under Code §6045A are issued, as that will give brokers the necessary information even if they did not acquire the digital assets themselves. In the meantime, brokers who can obtain basis information by other means can voluntarily report basis under the proposed regulations. The reward is a waiver from penalties under Code §6721 or Code §6722 for a failure to report such information correctly.[12]

Ordering Rules

If a customer has multiple units of the same digital asset with a broker, it is not always clear which units the customer wishes to sell off first. Under the proposed regulations, the customer is permitted to identify which units are being sold.[13] If the customer does not provide such information, then the rules adopt a F.I.F.O. method (first in, first out.)Under that method, the units bought or transferred to the broker at the earliest point in time are considered sold first.

International Application

As with other types of income, digital-asset transactions involving non-U.S. persons trigger special reporting requirements. One threshold question is the determination of the geographic location of a transaction. As digital assets are bought and sold entirely online, the existing rules do not adequately address the issue.

The proposed regulations first classify a broker as a U.S. digital asset broker, a C.F.C. digital asset broker, or a non-U.S. digital asset broker.[14] The latter two categories are further split into brokers that conduct activities as money services businesses ("M.S.B.") and those who do not. As the names for each category suggests, sales by U.S. brokers are considered to take place in the U.S., while sales by the other two categories of brokers are considered to take place outside of the U.S.

U.S. digital asset brokers include U.S. persons, U.S. branches of foreign entities, foreign partnerships with controlling U.S. partners, U.S. trades or businesses, and foreign persons for which at least 50% of its gross income is considered to be effectively connected with a U.S. trade or business.[15] While the rules for U.S. digital asset brokers are generally similar to existing rules for U.S. securities brokers, one difference is that securities brokers are allowed to accept and use evidence that a sale took place outside the U.S. The proposed regulations decline to adopt such a rule due to administrative complexity but invite comment on alternative approaches for distinguishing a U.S. digital asset broker's U.S. activities from its non-U.S. activities.

C.F.C. brokers that do not conduct M.S.B. activities are treated in the same way as

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[11] Prop. Reg. §1.6045-1(a)(15)(i)(J).

[12] Prop. Reg. §1.6045-1(d)(2)(iii)(A).

[13] Prop. Reg. §1.6045-1(d)(2)(ii)(B).

[14] Prop. Reg. §1.6045-1(g)(4).

[15] Prop. Reg. §1.6045-1(g)(4)(i)(A).

U.S. brokers are treated. In other words, they must generally report all sales. But in comparison to U.S. brokers, they can accept documentary evidence rather than a withholding certificate that a recipient is an exempt foreign person and therefore not subject to reporting. C.F.C. brokers are also not required to perform backup withholding unless they have actual knowledge that the customer is a U.S. person.

Sales by non-U.S. digital asset brokers are presumed to take place outside the U.S., unless documentary evidence indicates otherwise. As with C.F.C. brokers, non-U.S. digital asset brokers are not required to collect backup withholding tax.

An M.S.B. is generally defined by FinCEN as a person that is doing business wholly or in substantial part in the U.S. as (i) a dealer in foreign exchange, (ii) a check casher (iii) an issuer or seller of traveler's checks or money orders, (iv) an issuer, seller, or redeemer of stored value, or (v) a money transmitter.[16] Different rules apply for C.F.C. brokers and non-U.S. brokers that are M.S.B.'s because of FinCEN's greater concern about M.S.B.'s being used for money laundering. Accordingly, M.S.B. brokers are treated the same way as U.S. brokers – all sales are reportable and presumed to take place within the U.S.[17]

NEXT STEPS

Comments are requested by the end of October, with a public hearing to take place a week later. As mentioned previously, more proposed rules on reporting sales of digital assets are expected.

". . . more proposed rules on reporting sales of digital assets are expected."

[16] 31 C.F.R. §1010.100(ff).

[17] Pop. Reg. §1.6045-1(g)(4)(v).

U.S. INCOME TAX TREATY UPDATE

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Tags
894A
Chile
Croatia
Hungary
Income Tax Treaty
Israel
Norway
Poland
Romania
Taiwan
Vietnam

INTRODUCTION

A robust and extensive income tax treaty network has worked to the advantage of U.S. corporations and individuals. But for years, the tax treaty approval process of the U.S. Senate has been stymied by Senator Rand Paul. His opposition arises because of privacy concerns stemming from the Foreign Account Tax Compliance Act, also known as F.A.T.C.A., which was passed in 2010 and his concern that these treaties will lead to unchecked intergovernmental information sharing and snooping.

Historically, income tax treaties were ratified by unanimous consent. Senator Paul's decision not to permit ratification by unanimous consent was essentially a threat to filibuster income tax treaties brought to the floor of the Senate for a vote.

In the summer of 2019, Senate Majority Leader Mitch McConnell successfully brought treaties with Spain, Switzerland, Japan, and Luxembourg to the floor, just as the Senate was about to leave Washington for scheduled recess. Affirmative votes from two-thirds of the senators present are required for a treaty resolution to be approved.

This article addresses recent developments related to the income tax treaty network of the U.S.

TAIWAN

Early this year, Senate Foreign Relations Committee Chair Senator Robert Menendez and Senator Jim Risch proposed a bill that embodies the Taiwan Tax Agreement Act of 2023, the equivalent of a U.S.-Taiwan tax treaty. Given Taiwan's unique status with China, the United States and Taiwan cannot enter into a treaty, but this bill was designed to contain the key features of an income tax treaty. The bill would facilitate investment between the United States and Taiwan in key strategic industries such as semiconductors. On June 1, Senator Paul held up consideration of legislation by offering a reservation clause as an amendment. This was rejected by most of the other members of the Committee. The Senate Foreign Relations Committee finally approved the bill on July 13.[1]

In the meantime, on July 12, the leaders of the Senate Finance Committee and House Ways and Means Committee unveiled a bipartisan discussion draft of legislation aimed at reducing double taxation for employees and businesses involved in U.S. and Taiwan cross-border investment.[2] Again, the legislative proposal was intended to achieve the same goals as an income tax treaty. This legislation would

[1] See here.

[2] See here.

have bypassed the Senate Foreign Relations Committee to bring the legislation directly to the floor of the Senate. Senator Paul is a member of the Foreign Relations Committee, but not the Finance Committee.

The bill aims to significantly reduce withholding taxes on dividends, interest and royalties paid on cross-border investments, lower barriers for smaller businesses to make such investments, reduce complexity for dual residents, and unlock deeper economic cooperation with Taiwan. Nonetheless, the reduced rates of withholding tax would be significantly greater in several instances than rates on comparable categories of income that are in effect in recent income tax treaties of the U.S.

The legislation would add new Code §894A, having provisions fall into four primary categories.

Reduction of Withholding Taxes

A reduced rate of withholding tax would apply to certain income from U.S. sources – interest, dividends, royalties, and certain other comparable payments, such as dividend equivalent amounts – received by qualified residents of Taiwan. Instead of the 30% withholding tax generally imposed on U.S. source fixed and determinable, annual and periodic income received by nonresident, noncitizen individuals and foreign corporations, lower rates would apply. Interest and royalties would be subject to a 10% withholding tax. Dividends generally would be subject to a 15% withholding tax, which would be reduced to 10% for direct investment dividends where a corporation resident in one country owns at least 10% of the shares of stock in a corporation resident in the other country. The lower withholding tax rates on dividends would not apply in certain circumstances to dividends from a R.E.I.T., certain dividends from a R.E.M.I.C., amounts subject to F.I.R.P.T.A., and payments to or from inverted companies.[3]

Application of Permanent Establishment Rules

The threshold for imposing tax on the effectively connected income of a Taiwanese resident corporation will not be determined in accordance with Code §§864 and 882. Rather, the threshold will be raised to the permanent establishment standard in income tax treaties.

Income From Employment

No tax will be imposed on qualified wages paid to a qualified resident of Taiwan who either (i) is not a U.S. resident or (ii) is employed as a member of the regular component of a ship or aircraft operated in international traffic. Qualified wages are those wages, salaries, or similar remunerations with respect to employment involving the performance of personal services within the United States when the wages (a) are paid by, or on behalf of, any person other than a U.S. person and (b) are not borne by a U.S. permanent establishment of any person other than a U.S. person.

Several categories of qualified wages are not given favorable tax treatment. These include (i) directors' fees, (ii) income derived by entertainers or athletes from their performance of services as such in the U.S., (iii) income derived as a student or

[3] Joint Committee on Taxation, *Description of the Chairman's Mark of the "United States-Taiwan Expedited Double-Tax Relief Act,"* Sept 12, 2023, JCX-37-23.

trainee, (iv) pensions, or (v) amounts paid with respect to employment with the U.S., any State, or any U.S. possession.

Qualified Residents of Taiwan, Including Rules for Dual Residents

A qualified resident of Taiwan generally is any person who is liable for tax to Taiwan because of such person's domicile, residence, place of management, place of incorporation, or any similar criterion, and is not a U.S. person. For corporations, a qualified resident of Taiwan must also meet the limitation on benefits requirements to be a beneficiary of the provision.

The provision contains rules to determine whether certain dual resident individuals who are subject to residence based tax by both Taiwan and the U.S. are to be treated as qualified residents of Taiwan. The tie-breaker rules look to factors such as where a permanent home exists, where personal and economic relations are closer, and other factors.

All the above changes would become effective if and when Taiwan grants reciprocal benefits to U.S. persons, as determined by the Treasury Secretary, in consultation with the American Institute in Taiwan and the Taipei Economic and Cultural Representative Office in the United States.

The Senate Finance Committee approved the bill on September 14, 2023. The bill appears to have administration support.[4] The legislation builds on a trade bill with Taiwan that was enacted in August this year.[5]

The outlook for passage is complicated by the competing legislative bills in the Senate, reflecting a "turf war" between committees having jurisdiction over tax matters and other committees having jurisdiction over treaties. The leaders of the Senate Finance Committee and House Ways and Means Committee have asserted jurisdiction as their proposal constitutes tax legislation. However, it has been reported that the draft has rankled some members of the Senate Foreign Relations Committee, because the tax agreement is the equivalent an income tax treaty, which would be within the purview of their committee.[6]

CHILE

At the beginning of June, the Senate Foreign Relations Committee favorably reported out the Chile-U.S. Income Tax Treaty by a vote of 20 to 1. This was the fourth time the committee has approved the treaty over the last nine years. On June 22, 2023, the full Senate approved a resolution to advance the Chile-U.S. treaty by a vote of 95 to 2. This is only the third treaty with a Latin American country, Venezuela and Mexico being the other two countries. In addition, an income tax treaty exists with Barbados which is located off the coast of Venezuela.

Under the Constitution's supremacy clause (Article VI, section 2), a U.S. treaty enjoys equivalent legal standing to U.S. domestic law.[7] Code Section 894(a) provides

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4 See here.

5 See here.

6 See here.

7 *Foster v. Neilson*, 27 US (2 Pet.) 253, 314 (1829).

that the tax code shall be applied with "due regard" to the nation's treaty obligations. Code Section 7852(d)(1) assigns equal weight to these two sources of law, so that neither is presumed to control the other.

A later-in-time rule is applied to resolve any conflicts. The U.S. Supreme Court has ruled that in such cases, in general, effect should be given to the legislative enactment if it conflicts with an earlier treaty obligation, but to a treaty obligation if the treaty was ratified subsequent to the conflicting legislation, because "the last expression of sovereign will must control."[8] Treaty provisions can override previously enacted legislation, and the U.S. Congress can override treaty provisions by subsequent legislation. However, a number of courts have held that for legislation to override a treaty obligation, a clear expression of Congressional intent must be present.[9]

"There is some thought by tax professionals (not universally shared) that the new treaty might have the effect of overriding recent tax legislation."

There is some thought by tax professionals (not universally shared) that the new treaty might have the effect of overriding recent tax legislation. The Senate Foreign Relations Committee report on the Chile-U.S. treaty, however, contains two reservations, designed to implement the substantial changes made to the international provisions of the Internal Revenue Code by the Tax Cuts and Jobs Act in 2017 (the "2017 Legislation").

The first reservation clarifies that nothing in the agreement prevents the imposition of the Base Erosion and Anti-Abuse Tax ("B.E.A.T.") under Code Section 59A.

The second reservation changes Article 23 (Relief from Double Taxation) with a modified provision in order to account for the repeal of the indirect foreign tax credit rules of Code §902 and the implementation of the current dividends received deduction under Code §245A in its place. When addressing the effect of the repeal of the indirect foreign tax credit on provisions of existing income tax treaties, the Foreign Relations Committee Report declined to take a position, stating as follows:

> The terms of the reservation and this report are not intended to create any inferences regarding the interpretation of existing tax treaties to which the United States is a party.[10]

Chile approved the treaty as signed several years ago. It must now approve and ratify the reservations adopted by the U.S. Senate.

POLAND, VIETNAM, AND CROATIA

An income tax treaty with Croatia was signed on December 7, 2022 but has not been sent to the Senate for consideration. The same reservations described above in the case of the treaty with Chile were integrated into the language of the Croatia treaty.

Treasury Officials have stated that in the case of new treaties with Poland and Vietnam, targeted reservations must be drafted due to the passage of the 2017 Legislation after the proposed treaty was signed.[11]

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8 *Chae Chan Ping v. United States (The Chinese Exclusion Case),* 130 US 581 (1889).

9 *Cook v. United States*, 288 US 102, 120 (1933).

10 See here.

11 See here.

HUNGARY

On July 8, 2022, the United States notified Hungary of its termination of the Hungary-U.S. Income Tax Treaty, which was in force since 1979. Termination is effective as of January 8, 2023, six months from date of notification. The effect of the termination is as follows:

- Reduced withholding tax benefits will cease to have effect on January 1, 2024.
- In respect of other taxes, the Convention will cease to have effect with respect to taxable periods beginning on or after January 1, 2024.

It is widely thought that termination of the treaty resulted from Hungary's policy of attracting investment through a low-tax economic policy:

- Hungary opposed the E.U.'s adoption of the O.E.C.D. Pillar 2 global minimum tax rules and delayed its adoption by E.U. Member States.
- Hungarian domestic law does not contain provisions for the imposition of withholding tax on payments to nonresident corporate entities.
- The nominal rate of corporate tax in Hungary is below 10%.

A replacement treaty between the U.S. and Hungary was signed in 2010. Its fate is uncertain. Commentators have noted that in most cases, the termination of the treaty would not result in a significantly higher tax burden for US companies with investments in Hungary, although there would be exceptions.

FUTURE DEVELOPMENTS

Treasury officials have indicated that the U.S. is negotiating a new income tax treaty with Israel. Although negotiated in 1975, reflecting the peace accords between Egypt and Israel, the treaty did not come into effect until 1995, after protocols were signed in 1980 and 1993.

Negotiations on new income tax treaties with Romania and with Norway are complete, but await acceptable reservations as to the B.E.A.T. provisions and to the language of the avoidance of double taxation article.[12]

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[12] See here.

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