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Editorial

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> *If a jurisdiction chooses to adopt these Rules it must implement them consistently with the OECD guidance*

In October 2021, the OECD/G-20 nations agreed to make radical changes to global taxation. The countries adopted a two-pillar solution to address the tax challenges arising from the digitalisation of the economy. Pillar 2 comprises two measures: the GloBE Rules (Global anti-Base Erosion Rules) and STTR (Subject to Tax Rules). The GloBE rules were released in December 2021. Pursuant to the issuance of these Rules, in March 2022 the OECD released technical guidance on the 15% global minimum tax (GloBE) rules under Pillar Two. The guidance, in the form of a commentary, gives examples of how the Rules have to be implemented.

It is important to understand that the Rules seek to achieve a minimum tax rate of 15% in each jurisdiction and as such the Rules adopt a concept of jurisdictional blending, which is different from entity-level and global blending approaches. The Rules would apply if the effective tax rate of a jurisdiction, computed by clubbing results of all group entities located in that jurisdiction, is lower than the minimum tax rate of 15%. Any such undercharging would result in top-up tax liability at the jurisdictional level.

GloBE Rules are to be introduced by way of amendment to domestic tax laws. It needs to be understood that these Rules must be implemented as a 'common approach', which means that they are non-mandatory. A jurisdiction is not *required* to adopt these Rules but, if it chooses to do so, it must implement them in a manner consistent with the guidance given by the OECD.

These Rules apply only if the group is a MNE and the annual consolidated revenue of the group in the consolidated financial statements (CFS) was more than €750 million in at least two of the four preceding fiscal years. A MNE consists of entities located in more than one jurisdiction which are related through ownership/control so that their assets, liabilities, incomes, expenses and cashflows are consolidated on a line-by-line basis in the CFS. Under jurisdictional blending, the effective tax rate is determined by aggregating income and tax expense of all entities within the group in a particular jurisdiction.

So that the tax in each jurisdiction is at least 15%, a set of interlocking rules consisting of Domestic Minimum Top-up Tax rules (DMTT), an Income Inclusion Rule (IIR) and an Under-Taxed Payment Rule (UTPR) is designed to be coordinated by an agreed rule order. The OECD has set an ambitious target: part of these Rules must be implemented by December 2023 and the balance by 2024. While that may not be achieved, the world is slowly but surely heading for this unified taxation approach.

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Will our company soon have to declare whether it is an empty shell?

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Developments at European level in the fight against tax avoidance and evasion – what do you need to know?

The European Commission has repeatedly stated that it wants to focus more on *"fair taxation"* within the European Union. At the end of last year, various initiatives were taken from this perspective in the form of proposals for directives.

On one hand, the Commission initiated effective minimum taxation of 15% for multi-nationals in each country in which they operate (according to the OECD's draft "GloBE" – "Global Anti Base Erosion" – Rules). This will only affect large corporate groups with a consolidated group turnover of at least €750 million. Those same large multi-nationals will also have to disclose certain information to the general public (possibly from mid-2024).

On the other hand, the Commission's proposals also include a directive to tackle the improper use or abuse of *"shell companies"* (*"ATAD 3"*). This directive would apply to all companies, regardless of their size. The Directive on Shell Companies is explained as below:

"Shell companies"

The European Commission is of the opinion that, corporate groups often use "shell companies" to shift income, profits or immovable property for (purely) tax reasons. This view stems from empty shell companies that in reality do not exercise an economic activity and that are established in a state where the applicable tax burden is non-existent, very low or exceptionally favourable.

The proposal for a directive prescribes a *"substance test"* to counteract this practice. It also imposes additional tax reporting obligations, provides for sanctions and extends the scope of the automatic exchange of information between the tax authorities of the different member states.

Companies will have to evaluate three determining criteria on their own account:

- Does the *"passive income"* exceed 75% of the income earned during the two previous years? (Passive income: interest, royalties, dividends, financial income from crypto assets, rental income etc.)
- Does the entity engage in cross-border activities, whereby:
  - more than 60% of the book value of certain assets is located outside the state of establishment (*"asset test"*)?
  - more than 60% of the passive income is of foreign origin (*"income test"*)?
- Does it outsource all or part of the management of daily operations and decision making with regard to important functions to independent professional, third-party, service providers?

If all these questions are answered in the affirmative, an additional reporting obligation applies in the tax return of the entity concerned. In particular, the entity will have to prove that material *"substance indicators"* are present. These constitute (cumulatively) the presence of (1) own business premises in the state of establishment; (2) at least one active bank account in the European Union; and (3) at least one (active) director, or at least half of the employees, is/are established in the vicinity of the entity and can be considered as residents in this state of establishment for tax purposes.

If the entity cannot demonstrate any of these substance indicators, the entity is presumed to be operating as a "shell

> *The ground-breaking aspect of this proposal, but at the same time the administrative burden for your company, lies in the required reporting obligations and the related exchange of data between the administrations of the European Member States*

company". However, this presumption is rebuttable where the entity in question can prove that it *either* performs a genuine economic activity in the state of establishment *or* does not enjoy any tax benefit or favourable regime in that state.

Where a company does not rebut the presumption, sanctions will apply. In particular, the entity will not be able to claim the tax benefits from double tax treaties and from the European Parent–Subsidiary and Interest–Royalty Directives. In addition, the entity will be treated as fiscally transparent, and those underlying shareholders resident in the EU will therefore be taxed on the income and assets of the shell company.

Automatic exchange of information between EU Member States will have to ensure that the envisaged transparency and rapid detection of shell companies are realised. This exchange of information will take place regardless of whether the company is a shell company. Indeed, information will also be exchanged where the substance indicators are effectively available. In addition, this proposal grants a Member State the right to request another Member State to conduct a tax audit of a suspicious entity (i.e. a company that is deemed not to be in compliance with its obligations under this directive) and to communicate the outcome of the audit to the requesting Member State within a reasonable period of time.

Is this really so ground-breaking? Yes, it is!

Is this initiative more effective or efficient than existing anti-abuse provisions (e.g. in the Parent–Subsidiary, Interest–Royalty Directives or double tax treaties)would be presence of certain economic substance? For example, think of the impact of the existing *"principal purpose test"* on dividend payments from the Netherlands to Belgian holding companies since the entry into force of the multi-lateral instrument between the two countries. The big difference, however, is that they do not prescribe any concrete substance test or indicators.

Moreover, in principle the current international tax rules already assign profits to the country where the company performs its value-creating functions. Thus, companies with limited substance normally are not entitled to large (operational) profits. In practice, however, these principles are not always effectively applied. Also, the proposed regulation particularly targets passive income.

The ground-breaking aspect of this proposal, but at the same time the administrative burden for your company, lies in the required reporting obligations and the related exchange of data between the administrations of the European Member States. It is noteworthy that a company will be required to proactively prove certain matters in its tax return. If it fails to do so, or does so inadequately, it automatically loses tax benefits and the underlying shareholders are taxed on the company's income.

Certain bona fide situations will, also be (unintentionally) targeted because of this new legislation. Consider, for example, a group that historically, e.g. through acquisitions, consists of several holding companies that do not actively manage their participations. Or a group in which a company with ample cash provides loans, but does not actively monitor the loan portfolio.

It is therefore necessary to proactively analyse the possible impact on European activities and to check whether the requested information is readily available for reporting.

The EU Member States must unanimously agree to harmonise direct tax matters. If adopted, Member States will have to implement the Directive in their domestic law by 30 June 2023, after which the regulation will effectively come into force on 1 January 2024.

The Texas Supreme Court ruling multi-state businesses need to know about

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The district court decided in favour of Sirius XM on the basis that the apportionment factors used by Sirius XM on the originally filed returns reflected the fair value of the services that are rendered in Texas

On March 25, 2022, the Texas Supreme Court, in a much-anticipated opinion ruled in favour of Sirius XM and rejected the Comptroller's use of the *"receipt-producing, end-product act"* test to determine where a service is *"performed."* The Texas Supreme Court's decision in Sirius XM v. Hegar upheld the State's statutory language that requires receipts from services to be sourced to Texas if the services are performed in Texas, and a service is considered "performed" in Texas when a taxpayer's employees are or equipment is physically doing work in Texas for customers.

Background

Texas revenue sourcing rules provide that revenue from performing a service is attributed to the location where the service is performed. When services are performed both within Texas and other states, then the service receipts sourced to Texas are *"the fair value of the services that are rendered in Texas."*

Sirius XM provides satellite radio programming to subscribers for a fee. They held that the services they provide to Texas subscribers are:

- the production of radio shows and
- transmission of a radio signal.

Because Sirius hosts a majority of its staff and equipment outside of Texas, these two activities take place nearly entirely out of Texas, so in Sirius's view very little of the subscription revenue received from subscribers should be sourced to Texas.

However, under audit the Comptroller argued that the service being provided was the *"unscrambling [of] a radio signal"* rather than satellite radio programming and that the *"receipt-producing, end-product act"* took place at the location of the radio receiver (i.e. the customer's location). It attributed all subscription revenue from Texas-based subscribers to Texas.

Multiple lower court decisions

Upon the Comptroller's decision and after paying the assessment, Sirius XM filed a refund suit with the Texas district court. The district court decided in favour of Sirius XM on the basis that the apportionment factors used by Sirius XM on the originally filed returns reflected the fair value of the services that are rendered in Texas.

The Comptroller then appealed to the Texas appellate court (Court of Appeal, Third District). The appeals court upon review of the facts viewed the "receipt-producing, end-product act" as occurring when Sirius XM activated or deactivated the customer's satellite-enabled radio and the act was therefore performed where the radio was located, which could reasonably be presumed to be where Sirius XM's customers resided. This decision resulted in a sourcing method consistent with the Comptroller's and overturned the district court's decision.

Sirius XM then petitioned the Texas Supreme Court for review with key non-profit trade associations filing briefs in favour of Sirius XM and urging the Court to review the case.

Texas Supreme Court's decision

The Texas Supreme Court (the Court) rejected the Comptroller's "receipt-producing, end-product act" test, overturning the Court of Appeal's decision. It pointed out that no such test exists in the state's statutes and there was no reason to depart from the *"straightforward understandings of the everyday words"* that the apportionment statute uses. As such, a “service” is considered “performed” in Texas if the *“labor for the benefit of another is done in Texas”* (i.e. where employees do their work). Additionally, when technology performs the useful act, the Court noted that services are considered performed at the location of that equipment.

The Court also noted that in this case *“customers want to listen to radio content. They do not want decryption.”* This is consistent with Sirius XM’s position that the service they provide is radio broadcasting, not signal decryption, and the revenue is generated from subscriptions to access the radio content, not from the sale, lease, or activation of radio sets.

What it means for taxpayers

With the Court upholding the existing legislation and its rejection of the Comptroller’s “receipt-producing, end-product act” test, many tax professionals see this as a significant victory for service providers located outside of Texas. The Court’s decision is especially relevant to out-of-state taxpayers providing services electronically such as Software as a Service (SaaS) providers that often have customers/users all over the U.S.A. but few or no employees outside the state where headquartered. For now, the focus remains where a service provider’s equipment and personnel are located and not where services are received.

This ruling shows that the courts are sticking to what the state’s tax statutes say and rejecting reinterpretations. Comptrollers and tax departments will not be able to reinterpret the meaning of tax statutes without actually changing the statutes. However, rules can be changed quickly, and state tax departments are getting more and more aggressive. For now, taxpayers doing business in Texas should continue to focus on where they’re performing their services and remain alert for any future changes.

Belgian transfer pricing audit wave 2022 – forewarned is forearmed

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The demand for companies to be transparent about their international operations and where they pay taxes is increasing on a global scale. This also goes for Belgian companies belonging to a multi-national group. Since the introduction of transfer pricing documentation requirements in 2016, numerous Belgian companies are required to effectively submit their transfer pricing documentation to the Belgian tax authorities on a yearly basis. Consequently, the number of transfer pricing audits has intensified over the years as Belgian tax officials have got better and better acquainted with this field of expertise.

In Belgium, the tax administration starts its transfer pricing audits at the beginning of February. In recent years, it has become increasingly clear that these audits are gaining in importance. This translates, among other things, into an ever-increasing expansion of the inspection team: the number of transfer pricing inspectors has almost doubled in the past five years. Moreover, the Special Tax Inspectorate and the Large Corporations Department have also begun to focus more on transfer pricing issues through coordination and contacts with the Transfer Pricing Cell. In addition to the increase in staff, the team has more resources and advanced technologies available to intensify the number of audits. Furthermore, the Belgian Minister of Finance recently announced a significant additional increase to the budget.

So there is no getting around it: a correct and substantiated transfer pricing policy is crucial to survive the audit waves. For 2022, these audits look (slightly) different from previous years. In this article, we outline the most important changes.

Selection procedure for a transfer pricing audit

The selection of companies for a transfer pricing audit is based on an internal data mining process founded on a risk assessment analysis. Although the risk indicators are confidential, practice shows that criteria such as strong profit fluctuations, restructurings and structural loss-making positions are possible triggers for a transfer pricing audit.

In its selection, the administration also takes into account compliance with Belgian transfer pricing documentation requirements. Incorrect, late, incomplete or inconsiderate completion of the local file, master file and/or country-by-country reporting significantly increases the likelihood of a transfer pricing audit. In addition to an increased risk of audit, non-compliance with Belgian transfer pricing documentation requirements can result in a fine between €1,250 and €25,000.

It is strongly recommended, therefore, that a Belgian company belonging to a multi-national group verifies that it has complied with all relevant transfer pricing documentation requirements and met all compliance obligations. That being said, the tax authorities can also target companies that do not exceed the *"documentation thresholds"* for a transfer pricing audit.

Course of an audit: the most important changes and points of interest

Personalised questionnaire

Compared to the audits of previous years, there are significant changes in audit procedure. Personalised questionnaires

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(instead of standardised questionnaires) are being used more often in this year's audits. These are adapted to the specifics of the company and pay particular attention to certain transfer pricing transactions, such as intra-group financing, acquisitions, restructurings and so on.

In the past, auditors sent personalised questionnaires during transfer pricing audits of large multi-national companies, but as of 2022 this approach will be applied more widely. As a result, smaller groups operating internationally can also expect to receive a personalised questionnaire.

The wide application of the personalised questionnaire seems to be a consequence of the increased number of auditors and the greater resources within the Transfer Pricing Cell of the Belgian tax administration. The administration can thoroughly analyse the annual local file and master file forms first, then prepare a customised questionnaire. A company that prepares these forms in a well-thought-out and consistent manner can thereby increase the chance that the questionnaire will remain limited.

Taxpayers are required to respond to the questionnaire within 30 days from the third business day after the letter is sent. In exceptional cases, you may be granted an extension of this deadline.

Pre-audit meeting

"Pre-audit meetings" have becoming increasingly important in this year's transfer pricing audit wave. In the past, it was often the taxpayer who requested a pre-audit meeting with the tax authorities in order to proactively describe its business and possible intra-group transactions. This offered the chance to get a better sense of the information the tax authorities were looking for, which often resulted in a reduction of the audit's duration.

It is now more common for the tax administration to request a pre-audit meeting. The purpose of these meetings is to give the tax administration a better idea of how the Belgian entity operates within the group. It is often only after a pre-audit meeting that the tax authorities issue a personalised questionnaire to the taxpayer. This questionnaire will then be partly based on the answers given in the meeting. Good preparation for the pre-audit meeting is therefore of great importance.

Scope

The scope of transfer pricing audits also appears to have broadened. Whereas in the past a single entity was usually audited, the current audits focus on several (or even all) Belgian entities of the group.

Tax correction

As a conclusion to the audit, the administration could make an adjustment to the company's taxable base. This will happen when the tax administration believes that intra-group transactions were not made at arm's length and that an additional profit is attributable to the audited company. It is important to note that in most cases such adjustment will consist of a minimum taxable base that automatically results in an effective tax "cash out" or sometimes even international double taxation. Indeed, no tax deductions (e.g. losses) can be offset against an attributed increase in profits stemming from a tax audit when a 10% tax increase is also imposed (which, in practice, is almost always done).

Whereas in the past transfer pricing audits were usually settled on the basis of negotiations with the taxpayer, today's audits are increasingly being concluded without agreement. Specifically, this means that the tax administration sticks to the proposed tax adjustment, which is often the start of an administrative appeal procedure.

Conclusion

The evolution of transfer pricing audits, both in number and in structure, combined with the increasingly assertive attitude of the tax administration, means that companies must be better prepared for these audits. Thus, it is extremely important to have a well-thought-out transfer pricing policy that is applied consistently and that is supported by the necessary documentation.

New check-the-box opportunity for partnerships in Germany

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Introduction

As in many other countries, partnerships and corporations are taxed differently in Germany. While corporations, as separate tax subjects, are subject to corporate income tax and trade tax at rates of approx. 30% and the shareholder is only taxed at a flat rate of 25% when profits are distributed, taxation of a fiscally transparent partnership takes place directly with the respective shareholder. If the partner is a natural person, the profit is subject to the full progressive income tax of up to 45%. On the other hand, tax losses can be used directly by the partner, whereas this is not possible for a corporation.

Thus, the choice of the legal form under civil law has a decisive influence on the taxation of the income generated by a company. The legal form of a corporation regularly offers tax advantages, particularly to high-yield companies where long-term retention of profits may be possible. In order to change from transparent taxation to non-transparent taxation, it was previously necessary to also change the legal form under civil law. With the introduction of section 1a German Corporation Tax Act (CITA – KStG), however, the German legislator has now created an opportunity for partnerships to benefit from the advantages of non-transparent taxation without changing their legal form under civil law, and to switch to the taxation regime of a corporation.

General information

As of 1 January 2022, commercial partnerships (*Personenhandelsgesellschaften*, e.g. OHG and KG) have the opportunity to switch into the taxation regime of a corporation by filing an application under section 1a German CITA. This also applies if the company has a form, under a foreign state's laws, that is comparable to the German partnerships mentioned within section 1a German CITA or is a partnership without a registered office and place of management in Germany.

The application that needs to be filed in order to switch to the taxation regime of a corporation is irrevocable, requires a majority shareholder resolution (if the articles of association so provide, carrying at least 75% of the votes cast; if they do not, unanimity) and must be submitted to the responsible tax authority one month before the start of the financial year from which taxation as a corporation will apply (no retroactive effect possible). Additionally, please note that section 1a German CITA affects income tax but no other types of tax (e.g. real estate transfer tax or inheritance tax).

After the option has been exercised, in general all tax regulations for corporations apply to the former partnership. This leads – *inter alia* – to the following consequences:

- The income of the opting partnership is directly taxed at company level, and the tax rate will be approximately 30%, including corporate income tax, solidarity surcharge and trade tax.
- Any income a shareholder derives from any activity for the opting partnership (e.g. interest, royalty or salary income) needs to be re-qualified for his personal taxation as this income is no longer considered part of the distribution of profits as would be the case with partnerships (this is known as *Sondervergütungen*).
- Any transaction between a shareholder and the opting partnership must be at arm's length to avoid hidden dividend distributions or hidden contributions.

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> *While a tax-neutral option is possible for any German partnership with German shareholders there may be differing consequences in cross-border situations*

- Any gain from the transfer of the shares in the opting partnership will be taxed as capital gain.

If the option is being exercised, this is treated for taxation as a change of legal form (*Formwechsel*) under section 1, paragraph 3, number 3 German TTL (Transformation Tax Law). This generally represents a profit-realising, exchange-like process which – however – can be suspended if the principles of a tax-neutral conversion apply, as regulated by section 20, paragraph 2 German TTL.

Where a tax-neutral conversion takes place, the fictional new shares in the opting company that have been issued are treated as vesting in the shareholder over seven years. Thus, any transfer of the shares within this period will trigger retroactive taxation of the shareholder on the hidden reserves in the partnership shares at the date the option was exercised (called "contribution gain", Einbringungsgewinn). This contribution gain is reduced by 1/7 for each year that has elapsed since the first application of the option, so after seven years any transfer of the shares will have no retroactive effect at the shareholder's level.

Application in cross-border situations

While a tax-neutral option is possible for any German partnership with German shareholders there may be differing consequences in cross-border situations.

A partnership is generally eligible to file an application under section 1a German CITA. To be tax-neutral the special provisions of the German TTL must apply. This means the opting partnership must be:

- a company under article 54 of the Treaty on the Functioning of the European Union (TFEU) or article 34 of the European Economic Area (EEA) Agreement
- that was established under the legal provisions of an EU/EEA state and
- has a registered office and place of management located within the sovereign territory of one of these states (triple EU/EEA-criterion).

Furthermore, the direct or indirect shareholders of the opting partnership must be

- either natural persons who are resident in an EU/EEA state
- or corporations that fulfil the triple EU/EEA criterion just mentioned.

In consequence, a tax-neutral option is not available for any non-EU/EEA partnership or any shareholder of an EU/EEA partnership not resident in an EU/EEA state.

Example:

A German partnership AB-KG is established by the Austrian A-GmbH (50%) and the American B-Ltd (50%). If an application is filed under section 1a German CITA for AB-KG, the special regulations of the German TTL generally apply to the shares held by A-GmbH and thus to the fictitious change of legal form that results. In contrast, the American B-Ltd does not meet the triple EU/EEA criterion, so is not eligible for the special regulations of the German TTL. Consequently, the shares in AB-KG held by B-Ltd will be deemed to have been sold at fair market value.

Another result of the option being exercised is that Germany treats the opting company as entitled to the regulations of the various double tax treaties (DTT) currently in force, regardless of whether its place of management is located in Germany or a foreign contracting state.

Dividend payments to foreign shareholders

As any profits of the opting company will now be paid to the shareholders by way of dividend distributions, which are generally subject to German withholding tax (25% plus solidarity surcharge), and owing to the fact that, under various DTT, Germany's taxation right (as the sourcing state) is usually limited to a percentage of the dividend distribution, Germany is regularly obliged to reduce the withholding tax it applies. Likewise, where shares in the opting company are sold, from a German perspective the right to tax under the DTT would lie with the state in which the shareholder resides and the profit would thus be tax-exempt in Germany.

In cases where the foreign contracting state treats the opting company differently (transparently, not non-transparently), we need to consider a new treaty override under section 50d, paragraph 14 German ITA (Income Tax Act). According to this regulation, which has been established to prevent non-taxation (or lower taxation) of income arising from different national treatment, any reduction of the withholding tax under DTT will not be granted and a transfer of shares will not be tax-free in Germany.

Example:

C-Ltd, which is domiciled in another EU country, holds an interest in GmbH & Co. KG, which operates in Germany. In 2023, GmbH & Co. KG opts for taxation as a corporation.

Where GmbH & Co. KG distributes a profit, taxation in Germany depends on how C-Ltd's state of residence treats the option GmbH & Co. KG has exercised.

If the overseas state considers GmbH & Co. KG as fiscally transparent and does not tax the dividend, the dividend is subject to full withholding tax in Germany. No reduction under the DTT is possible.

If the foreign country taxes GmbH & Co. KG as a corporation and the profit distribution as dividend payment, a reduction of the German withholding tax under the DTT is possible. However, according to the German tax authorities, the benefits of the Parent–Subsidiary Directive do not apply, so the maximum withholding is based on DTT regulations.

Option by foreign partnerships

The option under section 1a German CITA is also available to foreign companies without a registered office and place of management in Germany as long as the legal form of the company is comparable to the German partnerships mentioned in section 1a German CITA. In the case of a foreign partnership, however, the option is only possible if the partnership is also subject to tax on a basis comparable to German corporate income tax in its country of residence. Thus, a foreign partnership can only exercise the option if its country of residence will also tax the partnership like a corporation after the option has been exercised.

Example:

D, a resident of Germany, holds an interest in EF LP, registered and having a place of management within the EU, which also generates income subject to German taxation. In principle, an option by EF LP is possible. For D, however, the option is only tax-neutral if EF LP is subject to corporate income tax in its country of domicile.

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Summary

The new regulation offers certain partnerships the opportunity to benefit from the taxation system of a corporation without changing the legal form of the company and without facing the disadvantages that apply to this type of company (e.g. German publication rules). However, the comprehensive direct and indirect tax consequences – both at company level and for the shareholders – must be analysed in detail.

In cross-border constellations, the tax consequences depend on the domicile of the shareholders and the tax treatment of the company abroad. Sometimes the option triggers different tax consequences for the individual shareholders and thus could lead to significant tax disadvantages.

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Securitisation in Luxembourg: even more flexible and attractive than before

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In the highly attractive but also fast-moving Luxembourg securitisation landscape, and against the backdrop of developments in the global market, it seemed inevitable that the securitisation law would be developed and modernised

Luxembourg is a country widely preferred for the domiciling of securitisation vehicles in Europe. The Luxembourg Securitisation Law of 22 March 2004 (the "Securitisation Law") has been very successful since it has been able to balance a great deal of freedom in the types of assets that can be securitised with a degree of legal certainty for investors. Thus, the law has created a flexible and very efficient legal and tax framework for securitisation transactions.

An important feature distinguishing Luxembourg securitisation from the definition in EU Regulation 2017/2402 is the broad interpretation of the term. The Luxembourg definition allows the securitisation of all types of risk (not just credit risk), as well as the issuance of securities that are not tranched. Well-known features of the securitisation law include the rules protecting investors through subordination, those governing recourse and attachment protection clauses. The option to set up separate compartments, the wide range of eligible assets, the VAT exemption for management services and the ease of communication with the regulator have been among Luxembourg's greatest competitive advantages since 2004.

In the highly attractive but also fast-moving Luxembourg securitisation landscape, and against the backdrop of developments in the global market, it seemed inevitable that the securitisation law would be developed and modernised. The Luxembourg Parliament voted to do so in February 2022. The primary objective is to adapt to changing requirements through increased flexibility and to further clarify the legal framework by deleting some restrictive aspects, spelling out individual provisions and adding several options. On 25 February 2022 these adjustments were incorporated into the Securitisation Act and entered into force on 8 March 2022.

Six significant changes accompany the February 2022 modernisation

Financing through financial instruments

One necessity was to open up further financing possibilities for securitisation vehicles or to reduce ambiguities in this context. The inclusion or scope of other means of financing was often controversial in practice. Accordingly, securitisation vehicles will no longer be limited to issuing securities for their financing: other forms of financing can now be used, e.g. financing through bank loans. Past discussions as to whether promissory notes qualify as a permissible security should thus become obsolete.

Active management

In the past, securitisation vehicles were limited to passive management of their assets, while active management, e.g. trading or actively exchanging assets in the collateral pool, was not easy to implement. This often raised legal issues in practice for securitisation structures that require active management of the collateral pool, such as collateralised loan obligations (CLOs) or collateralised debt obligations (CDOs). To allow active management of the collateral pool and thus gain significant market share, it was important for Luxembourg to allow active risk management in these structures. While active management remains excluded in principle, a loan portfolio in CDOs or CLOs can now be actively managed by legal definition as long as it issues no financial instruments to the public. This is expected to open up the market for actively managed securitisation portfolios in Luxembourg.

Regulatory criteria

Currently, the vast majority of Luxembourg securitisation vehicles are not regulated.

However, under certain circumstances a few securitisation vehicles are regulated by the Commission de Surveillance du Secteur Financier (CSSF). The 2022 law defines the criteria for regulation, which are essentially based on the existing CSSF guidelines for continuous issuance to the public. The definition of *"regular"* continues to include more than three issues per calendar year. In addition, the term *"public"* refers to three cumulative criteria:

- the issuance of financial instruments to non-professional clients
- not exceeding €100,000 in total and
- not distributed as a private placement.

Authorised legal forms

Securitisation vehicles were formerly limited to four forms: a public limited company (*société anonyme*), a limited liability company (*société à responsabilité limitée*), a partnership limited by shares (*société en commandite par actions*) or a cooperative organised as a public limited company. The 2022 Securitisation Act introduces four new, additional legal forms for establishing securitisation vehicles: a general partnership (*sociétés en nom collectif*), a limited partnership (société en commandite simple), a special limited partnership (*société en commandite spéciale*) and a simplified joint stock company (*sociétés par actions simplifiées*) can be used from now on. This brings additional flexibility in structuring, since, among other things, Luxembourg partnerships can now use subfunds for the first time. It also makes securitisation more attractive for investors such as private equity houses or family offices, which already make extensive use of partnership structures in Luxembourg.

Guarantees/warranties in favour of third parties

Prior to the 2022 Law, a securitisation vehicle could only provide collateral/guarantees for its securitised assets to its investors. Third parties, e.g. banks and other involved parties, could not enjoy such guarantees, which made the structuring of the transaction unnecessarily complex or even impossible. The 2022 law allows for collateral/guarantees to be provided to third parties while maintaining a high level of protection for investors, which increases flexibility in structuring.

"Governance" for equity-financed subassets

Securitisation vehicles can issue either debt or equity securities. The Securitisation Law previously did not contain any requirements on the "governance" rules for equity-financed securitisation vehicles. The modernised law now clarifies that the annual financial statements of equity-financed compartments must be approved only by the shareholders of those compartments and that decisions on the allocation of the legal reserve must also be taken at the level of the compartment concerned. This eliminates uncertainty in equity-financed securitisation vehicles with multiple compartments.

Conclusion

Overall, the very successful and flexible securitisation law has been modernised in numerous areas that can be considered important and relevant for arrangers. This modernisation provides more flexibility in structuring than before, while maintaining the reliability and investor protection that have distinguished this securitisation law in the past.

Real estate tax reform

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Overall, the procedure is being updated, but should not generate additional revenue for the municipalities. The new property tax is complicated by the existence of different procedures by which it can be assessed

Real estate tax – an introduction

Real estate tax is one of the oldest taxes and can be traced back to the year 2000 bce. It is currently being reformed in Germany.

In Germany, real estate tax is charged on real estate located in the country. The amount of tax is based on the value of the estate. The nature (legal personality) of the owner, however, does not play a role. Accordingly, foreign property owners are also liable to pay tax on real estate located in Germany. The revenue from property tax accrues to the local communities and is one of their most important sources of income. In 2020, real estate tax revenues amounted to approximately €14 billion.

Assessment of the "old" real estate tax

Until now, real estate tax has been assessed in two steps. First, the local tax office calculated the "unit value" (*Einheitswert*) of the property. Using this, it determined the "property tax assessment amount" (*Grundsteuermessbetrag*), which it communicated to the municipality in which the property is located. The municipality calculated the real estate tax by multiplying the property tax assessment amount by its assessment rate and then assessed the tax against the property owner. Because the local authority can determine its own assessment rate, in Germany the real estate tax burden for similar properties can vary.

Why the reform?

Because unit values have remained unchanged, in the former West German states since 1 January 1964 and in the former East German states since 1 January 1935 (!), the Federal Constitutional Court declared the real estate tax assessment system to be incompatible with the German constitution and required the German legislature to establish new rules. These will enter into effect as from 1 January 2025. Accordingly, as from 1 July 2022 approximately 36 million property owners in Germany will be requested to submit a real estate tax return to the local tax office in electronic form via the ELSTER online tax platform. Currently the submission deadline for the tax returns is 31 October 2022. We believe it makes sense to inform clients who own properties in Germany *now* about what will change with regard to real estate tax.

Assessment of the "new" real estate tax

As before, the new real estate tax will be calculated in two steps. The base amount for determining the property tax is once again the value of the property (*Grundsteuerwert*), to which the municipality's property tax rate (*Grundsteuermesszahl*) and assessment rate (*Hebesatz*) are applied. However, in the new form, the value of the property will be calculated as of 1 January 2022 and then updated every seven years (at latest). Overall, the procedure is being updated, but should not generate additional revenue for the municipalities. The new property tax is complicated by the existence of different procedures by which it can be assessed. An opening clause allows individual German states to apply procedures different from the "federal model" used by most German states.

All models distinguish between unbuilt and built-up sites. Unbuilt sites are sites with no usable buildings. The value of undeveloped sites is usually calculated by multiplying the size of the site by a "standard land value" (*Bodenrichtwert*), which is determined by the administration and publicly announced.

In the case of built-up sites, a distinction must essentially be made between residential and non-residential sites. Residential properties contain one or more flats. They are valued using the "capitalised earnings value" method, which is based on the market rent. For residential sites, for example, the following information must be declared in the owner's tax return:

- location of the real estate
- size of the real estate (in hectares)
- standard land value
- type of the building (a one-flat building or building containing more than one flat)
- size of the living space (in square metres)
- year the building was constructed.

Non-residential properties, on the other hand, are valued using the "asset value" method, where the construction cost of the building determines the value. For this type of building other information is required for the tax return. Both procedures are relatively complicated, and a detailed description would exceed the scope of this article.

Summary and outlook

There is no doubt that it is necessary to reform the real estate tax and adjust it to current values. It is fairly typically German that this is being done in a relatively complicated procedure in which both individual municipalities (via their assessment rate) and different German states have the opportunity to determine the amount of the property tax via the procedure. Whether the new real estate tax will actually be revenue-neutral is open to doubt, because it is predictable that individual municipalities, faced with empty treasuries, will be tempted to raise revenue. In any case, we are ready to advise and support domestic and foreign clients on the best approaches to the real estate tax.

Internationally traded IP right and VAT planning – Taiwan, Japan and OECD perspectives

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Transferring foreign-registered intellectual property (IP) right

Both company T ("T Co.") and company J ("J Co.") are incorporated and tax-resident in Taiwan. In 2022, J Co. accepted T Co.'s offer to transfer the right to its patent, which is registered in Japan ("Japanese patent right"), to T Co. for a price of US$1 million. After the patent transfer, T Co. will license that patent right to its Vietnamese subsidiary, company V ("V Co."), which will use it in manufacturing consumer products in Vietnam.

Tax issues

- Will the sale of the Japanese patent right incur value added tax ("VAT") liabilities? If so, in which country?
- If there is potential risk of VAT double taxation, what can T Co. and J Co. do to minimise this risk?

Taiwan's tax ruling requires VAT filing in Taiwan

According to the Taiwan Finance Ministry (MOF)'s 2014 Tax Ruling No. 10304022020,[1] in a case where two local enterprises purchase and transfer an intellectual property right ("IP right") registered in another country, the seller is obliged to file for a VAT taxable service, because provision of intangible property is deemed a service and it is being provided and consumed in Taiwan. The sale of a foreign-registered IP right will be considered neither as trading foreign property nor as export-related services, which are VAT-exempt. Accordingly, J Co. is required to file a VAT return and pay VAT to the Taiwanese tax authorities. It seems that the Taiwan MOF ruling adopts a subjective test that VAT taxation depends on the residency of seller and buyer. Taiwan's eligible VAT rate is 5%.

Japanese VAT laws tax IP rights at the registered jurisdiction

Unlike the Taiwanese regulation, Article 6, paragraph 1, no. 5 of the Enforcement Rules under the Japanese Consumption Tax Law (i.e. VAT Law) stipulates that registered IP rights, such as patents, trademarks and (here) integrated circuit layouts, are deemed to be property located in the jurisdiction where they are registered.[2] If the IP rights are registered in Japan, transferring their ownership is subject to Japanese VAT taxation. In other words, IP rights registered in other jurisdictions are considered overseas assets and transactions in them are exempted from Japanese VAT. Japan's eligible VAT rate is now 10%.

OECD VAT Guidelines also have different rules

Not only do Taiwan and Japan have different rules on the same transaction, but the Organisation for Economic Co-operation and Development (OECD)'s International VAT/GST Guidelines also indicate different VAT treatment when interpreting the "*destination principle*".[3] According to Guidelines 3.2 and 3.3, internationally traded intangibles will generally be taxed in the jurisdiction where the buyer is resident, which should be named in the contract. However, if the buyer satisfies the conditions to be regarded a "*multiple location entity*", then the jurisdiction in which that intangible is "actually used" will have the VAT taxing right. The term "*actually used*" covers usage, delivery and sharing of costs. However, the OECD guidelines are only reference material; they are not directly binding on Member States. So, taxability would depend more on the VAT regulations of the countries related to the transaction.

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How to avoid double VAT taxation by contract arrangement

To sum up, this analysis shows very possible double VAT taxation in this case because Taiwan and Japan, and even the OECD, have adopted different rules on VAT relating to internationally traded intangibles. In this case, J Co. would be liable to charge T Co. 10% VAT in Japan, and 5% VAT in Taiwan, with filings in both countries. This double taxation is an unnecessary cost that would follow from failing to make proper contractual arrangements in advance.

A possible option to avoid this unwelcome double taxation is for the contract subject/seller to be J Co.'s Japanese branch, which would file a VAT return in Japan; then for T Co. to charge costs to V Co. for using this patent right in Vietnam. This arrangement will then satisfy Taiwan, Japan and the OECD VAT guidelines.

This analysis shows very possible double VAT taxation in this case because Taiwan and Japan, and even the OECD, have adopted different rules on VAT relating to internationally traded intangibles

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Medingo Ltd v. Tax assessor Afula – Civil Appeal Number 53528-01-16 (08/05/2022)

Facts of the case

Medingo was established in November 2005 by the appellant under the control of Elron Electronic Industry Ltd ("Elron") and operated from its offices in Israel. It is an Israeli company that has developed a unique wireless insulin pump for diabetics called "Solo".

On 13 April 2010 F. Hoffmann-La Roche Ltd, an entity from the Roche Group, acquired the full share capital of the appellant in exchange for approximately US$160 million, plus a payment of US$19 million under agreed milestones, not all of which were completed ("purchase of shares" or "exit"). The purchase of shares was completed on 28 May 2010.

About six months after the acquisition of the shares, four agreements with retroactive applicability were signed between the appellant and Roche Diagnostic International Ltd, another member of the Roche Group ("RDI"):

- An agreement for research and development services ("R&D agreement"), signed on 9 November 2010. Medingo agreed to provide R&D services from 1 June 2010 to 31 December 2013 based on a cost + 5% pricing model. Under the agreement, all the intellectual property that would be developed from the date of the agreement ("new IP") is fully and exclusively owned by Roche.
- An agreement for services (the "services agreement"), signed on 9 November 2010 for the period 1 June 2010–31 December 2013. The appellant agreed to provide Roche with additional services in the areas of marketing, technical support and administration as well as advice and support regarding the use of patents, based on a cost + 5% pricing model.
- An agreement to provide production services ("production agreement"), signed on 15 November 2010 for the period 1 June 2010–31 December 2013, under which the appellant would provide Roche with manufacturing and packaging services for Solo, based on a cost + 5% pricing model.
- A licence agreement ("licence agreement"). In the framework of this agreement, signed on 22 December 2010 for the period 28 May 2010–31 December 2013, the appellant granted Roche a licence to use the intellectual property developed up to that point ("old IP"), which allows Roche, among other things, to produce, use, sell, exploit commercially and continue to develop related products, and to grant sub-licences to related entities in the Roche Group. In return, Roche would pay the appellant royalties of 2% of net sales of products incorporating the appellant's patents.

In January 2012, the appellant's employees were notified that the work in Israel would be stopped no later than 31 December 2013, as Roche planned to reduce activity sites. The appellant's business activity did indeed discontinue during 2013.

On 1 November 2013, an agreement was signed between the appellant and several companies from the Roche Group for the sale of the old IP ("IP sale agreement"). Under the agreement, the appellant sold to Roche all her rights and obligations, including patents, trademarks, registration rights, etc. for CHF42.9 million.

The contention of the taxpayer

According to the appellant, these are separate, unrelated transactions. In 2010 Medingo's shares were sold (exit) and after a number of years a result of a collaboration with Roche was a change in the appellant's business model, which in 2013 led to it selling its intellectual property and ceasing activities.

According to the appellant, the old IP remained in the hands of Medingo at the time of the exit, and since she did not separate it from Medingo's activities and assets, the transaction should not be treated as if it had been a sale of functions, assets and risks (FAR) in 2010 by Medingo (before 2013).

The appellant claimed that she had, in fact, changed the business model which was reflected in the cessation of her business activity in its current form in 2013 and as a result of which she sold her intellectual property in 2013 and closed Medingo's activity three years after the exit.

The appellant reported to the respondent (Tax Assessing Officer, Afula) that she sold her intellectual property for the sum of NIS166,070,190 in 2013.

Contentions of the Tax Assessing Officer

However, the respondent did not accept the appellant's contention that the intellectual property was sold in 2013 under the IP sale agreement.

In its view the old IP cannot be separated from the new IP and, consequently, the old IP was transferred to Roche within the framework of the share purchase agreements and the appellant transferred most of the FAR related to its activity in the tax year 2010; this transfer constituted a taxable capital gain transaction by Medingo.

The Tax Assessing Officer argued that in fact the appellant and Roche had agreed that the activity would be transferred to Roche, but they did so gradually through the licence agreement in order to avoid tax on the sale of the activity at the time of purchase (in 2010), and by 2013 the value of the old IP had been eroded.

According to the respondent, the sale in 2010 and the "*change in business model*" of Medingo should be seen as a sale of the company's activity, which entails a charge to capital gains tax that should apply to the company in 2010.

Moreover, since this was a transaction between related parties, the value of the FAR can be deducted from the consideration paid to Elron in the 2010 share purchase, after various adjustments. Accordingly, the respondent held that the appellant owed income tax on a total of NIS481,354,600 and that Medingo would be liable to pay tax of NIS119,962,719 (principal) for the capital gain from the FAR transaction (about NIS170 million in current value).

Hence the appeal.

The Court decision

The court noted that, since the four agreements constitute a transaction between related parties, in the light of the OECD Guidelines, it should examine whether the very fact that the parties were involved influenced the characterisation and pricing of the transaction; and as a separate question, whether the agreements would constitute in essence a sale of the appellant's activities even if they had been made between unrelated parties and even if there was no defect in the agreements *per se* and the consideration stipulated in them.

Accordingly, the judge noted that two questions needed to be answered:

- whether the share purchase agreements *per se*, taking no account of the appellant's connection to Roche, constituted a sale of the activity;

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According to the court, the patents developed within the framework of the old IP, which are the main part of the IP, were registered and remain in the name of the appellant, while only the new patents were registered in Roche's name.

- and even if the agreements did not constitute a sale of the activity, whether the fact that the parties are related influenced the characterisation of the agreements so that, in practice, the agreements should be regarded as a sale of the activity between the parties.

The court ruled that the answer to the first question was negative. The evidence presented to the judge shows that the activity in Medingo continued and, more to the point, accorded with what was stated in the agreements. Thus, looking for example at functions, the appellant's representatives had testified that the appellant continued its activities, including the R&D functions, production, marketing and management, and there was no dispute that the appellant continued to carry out the R&D activities, and was paid cost + 5%. The court said that the respondent had not examined the factual circumstances of the case at all, and had determined solely from the agreements that the functions were actually transferred by way of sale.

According to the court, the patents developed within the framework of the old IP, which are the main part of the IP, were registered and remain in the name of the appellant, while only the new patents were registered in Roche's name.

Finally, the judge noted that there is no dispute that after the agreements there was a change in the appellant's activity and business model. This, the judge says, happens in any agreement that redistributes risks and opportunities, even between unrelated parties. However, this does not indicate that the appellant transferred or sold most of her activities to Roche. In the judge's view, this is a question of re-estimating the value of the service transaction between related parties and not a question of re-classifying the nature of the transaction

Further to that, the judge examined whether the agreements and the change in the business structure would not have come into being had Roche and Medingo not been related parties.

The judge noted that the OECD guidelines indicate that in a transaction between related parties, two different issues must be examined at arm's length: the characterisation of the transaction and its pricing. The characterisation of the transaction must be examined first, and in particular whether it would have been made if the parties had been unrelated. If this examination reveals that even unrelated parties would have entered into a transaction in the same situation, then an assessor should go on to examine whether the price paid for the assets was consistent with current market conditions.

The judge found no defect in the characterisation of the transaction in this case, and ruled that this was a completely different case from those mentioned in the guidelines. She then stated that it has been proved that transactions of a similar character can and do take place even between unrelated parties.

In addition, the judge ruled that an examination of the respondent reveals that the issue underlying the components of its case is the price of the transaction between related parties; but the respondent had not referred to the pricing of the transaction and did not argue in this matter. Therefore, after rejecting the respondent's claim for reclassification of the transaction, the court ruled that the appellant's position should be accepted.

Changes to trust registration: what you need to know

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Trusts that are not considered to be express trusts may still need to register through the TRS if they have a UK tax liability

Her Majesty's Revenue & Customs (HMRC) have announced many updates to the trust registration service over the last few years, in line with European money laundering directives, which are summarised here: What is the Trust Registration Service (TRS)?

Until recently, people still registered trusts manually, by completing a paper form (form 41G). The data that was captured included information around the names and addresses of the trustees and any professional services acting on behalf of the trust. HMRC were clear that, if there was no income arising from the trust and no likelihood of income or gains in the future, a form did not need completing. But recent updates have meant that some of these trusts may now need to be registered with HMRC or risk facing penalties.

Which trusts need to register through the TRS?

Since 26 June 2017, trustees and representatives of complex estates are required to comply with the registration obligations under the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017. The following trusts are required to register with the TRS:

- all UK "*express trusts*" where the trustees have incurred a tax liability during the tax year
- all non-UK express trusts which receive a UK-sourced income, or have UK assets on which the trustees have incurred a UK tax liability, during the tax year.

What is an express trust?

An express trust is the most common type of trust and is one that has been created deliberately by a settlor, usually in the form of a written document or declaration of trust. Examples include declarations of trust for co-owners of property, discretionary trusts and trusts established on death under a will.

Other types of trust include a statutory, implied, or constructive trust, which can be set up because of legislation or a legal arrangement.

Important: Trusts that are not considered to be express trusts may still need to register through the TRS if they have a UK tax liability. Examples of tax liability can include liability to income tax, capital gains tax, inheritance tax (IHT) and/or stamp duty land tax.

Who is responsible for registering a trust?

The trustees are legally responsible for registering their trust, and updating the registration. If there are multiple trustees, they must appoint a "lead" and main point of contact for HMRC. It is acceptable for trustees to appoint an agent to complete the registration, which can often help to ensure that it is completed correctly and within the required time frame.

What changes and deadlines do you need to be aware of?

Under the latest update in the changes to trust registration, the most important point to remember is that most trusts now need to be registered. Even if your trust is not liable to tax, it may still need registering.

Take note of the following deadlines:

- Non-taxable trusts created *after 1 September 2022* must be registered within the first 90 days of creation
- From 1 September 2022, changes to the trust details and/or circumstances must be notified within 90 days of the change.

If you registered a trust before 1 May 2021, you will need to update the information in TRS and confirm whether your trust is

- a non-UK trust (that has a business relationship or land and property situated in the UK).
- the trust has purchased any UK land or property
- the trust has a controlling interest in a company based outside the European Economic Area (EEA).

Under new guidance, if you fail to register or update your registration within whichever of the 90-day time frames applies you may receive a £100 penalty.

Could you be affected?

Type of trust	Express trust	Taxable trust
Bare trust	Yes.	No. The beneficiary is taxed on income and gains, not the trustees.
Bereaved minor trust and 18–25 trusts	No.	Yes. If there is a UK tax liability.
Charitable trust	No.	No.
Disabled persons trust	No.	Yes. If there is a UK tax liability.
Discounted gift trust	Yes.	Yes. If there is a UK tax liability (this would typically occur if there was a chargeable gain on any bond or IHT periodic or exit charges).
Discretionary trust	Generally discretionary trusts will need to register. However, there are no reporting requirements for the first two years *if it is a will trust*. No reporting is required where a discretionary trust holds life assurance policies (whole of life/term assurance etc.)	Yes, if there is a UK tax liability
Interest-in-possession (IIP) trust	Generally, IIP trusts will need to register. However, there are no reporting requirements for first two years *if it is a will trust*. No reporting is required where a discretionary trust holds protection policies (such as whole of life/term assurance etc.)	Yes, if there is a UK tax liability.

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Type of trust	Express trust	Taxable trust
Loan trust	Yes.	Yes, if there is a UK tax liability (typically this would occur if there was a chargeable gain on any bond or IHT periodic or exit charges).
Non-UK resident trust	No – unless they hold UK land/property.	Yes, if there is a UK tax liability.
Pension scheme	UK pension schemes registered with HMRC under Part 4 Finance Act 2004 *do not need to register* under TRS.	Provided details on the Manage & Register Pension Scheme service are up to date, HMRC considers that the trustees have met their TRS obligations.
Personal injury trust	No.	Depends on the type of trust created. Bare trusts will not need to register. All other trusts *will need to register* if they have a UK tax liability.
Pilot trust	*Set up before 6 October 2020* Pilot trusts which hold less than £100 do not need to register. *Set up before 6 October 2020* Pilot trusts will need to register, as will any pre-6 October 2020 pilot trust where its value passes £100 (e.g. where pension death benefits have been added to it).	Yes, if a UK tax liability existed both before and from 6 October 2020. However, in many cases pilot trusts will just hold a nominal amount (say, £10) so there will be no tax payable until other assets are added to the trust.
Settlor-interested trust	*Does not* prevent the trust from being required to register.	Yes, if even though tax is assessed upon the settlor.
Statutory trust	No – these are created by law, such as under intestacy; and they are not express trusts.	Yes, if there is a UK tax liability.
Will trust	*There is no need to report for the first two years after death*. Reporting requirements will then be determined by the type of trust created (for example, a discretionary trust will need to register after two years but a bereaved minors trust would not).	Will trusts will need to register immediately following death *if there is a UK tax liability*.

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Secondment tax woes – the saga continues

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Secondment of employees between multi-national organisations is a common practice and can no longer be considered exceptional. Typically, overseas parent companies second their employees to other group companies/subsidiaries, to assist in them in certain specific assignments and/or provide technical support and expertise for the business of the group company/subsidiary.

In most such cases, the seconded employees continue to preserve social security coverage in the home country. The foreign company usually pays such social security contributions (along with some portion of the employee's salary) in the home country and recovers this outgo (on a cost-to-cost basis without charging any mark-up) from the group company to which the employee has been seconded.

Secondment to India

In India, secondment has been a subject of protracted litigation, with the tax authorities alleging that the secondment arrangement is a contract *for services* and not a contract *of service*. In other words, the tax authorities contend that the foreign parent provides services to its group company in India through the seconded employees. Consequently, they argue that such an arrangement either creates a permanent establishment (PE) of the foreign parent in India or they argue that any reimbursement, to the foreign parent by the Indian group company, of social security contributions including salary paid in the home country, is in the form of a "fee for technical services" (FTS) and hence taxable in India.

The key principle emerging from court rulings on secondment arrangements in India is that the facts of each case need to be analysed and substance, not form, taken into consideration in deciding whether the secondment arrangement is a contract for services or contract of service.

Usually under secondment arrangements, the seconded employees are on the payroll of the Indian company and work for the Indian company under the direction, supervision and control of the Indian company. Further, the entire salary of the seconded employee and related costs (such as social security contributions etc. paid in the home country) is borne by the Indian company. The Indian company takes responsibility for the work done by the seconded employee during the period of secondment in India and usually retains the right to terminate the secondment.

On such facts various courts have held that,[1] while the foreign parent may be the employer on paper, in substance the Indian company is the real employer of such seconded employees. Where such is the case, it cannot be said that the foreign parent is providing services to the Indian company through the seconded employees. The foreign parent is not rendering any services to the Indian company. Mere secondment of employees cannot be construed to be provision of services. Further, the seconded employees cannot be said to be providing services to the Indian company on behalf of the foreign parent.

However, despite this, other courts have rejected the argument that the Indian company is the real employer of the seconded employees,[2] primarily on the grounds that during secondment the seconded employees remain entitled to social security benefits of the foreign employer and remain on the payroll of the foreign company. Another factor repeatedly pointed out and relied upon by courts has been that, when the secondment period ends, the employees usually return to their jobs with the foreign parent. Hence the employees retain lien over their employment with the foreign company and therefore the foreign company remains the employer of the seconded employees, even during the period of secondment to India.

The crucial point in a secondment arrangement therefore is whether the overseas company or the Indian company qualifies as the real employer of the seconded employee during the period of secondment to India. Based on "real employer" test income tax implications need to be evaluated.

It is pertinent to note that how indirect taxes (the erstwhile service tax and the current goods and service tax (GST) regime) apply to secondment arrangements has also been a matter of litigation. The issue that arises is whether expatriates seconded by an overseas parent to an Indian company are treated as "*manpower recruitment or supply agency service*" and whether service tax/GST would be applicable under a reverse charge mechanism to manpower recruitment or supply agency service.

It is also pertinent to note that, under the service tax/GST regime, no taxes are liable where there is an employer–employee relationship.

Thus, in a secondment situation, the applicability of service tax/GST depends on whether the Indian company qualifies as the employer of the seconded employee. Where the Indian company is established as the employer of the seconded employee, service tax/GST would not be applicable.

While there have been rulings to this conclusion, however recently the **Hon'ble Supreme Court in the case of M/s Northern Operation Systems Pvt. Ltd. (Assessee)** has held that service tax would be applicable on the impugned secondment arrangement.

In this case the assessee agreed with an overseas group company to pay salary and other perquisites for employees seconded from that overseas company. The seconded employees operated under the control, direction and supervision of the assessee. Further, the assessee withheld tax on the salary paid to these employees as required by the Income Tax Act, 1961. The salary payment to such employees was made by the overseas group company, then the assessee reimbursed the overseas group company the salary cost. The tax authorities issued a demand ordering discharge of service tax under the reverse charge mechanism in relation to the reimbursement of salary by the Indian company, as an import of manpower supply services.

The Hon'ble Supreme Court held that during the period of secondment the assessee received manpower recruitment and supply services provided by the overseas group company via the employees seconded to India. As a result, the assessee was liable for service tax in relation to the relevant periods.

The Hon'ble Court based its decision on the particular facts of this case and the following key observations:

- While during secondment the seconded employees appeared to be under the control of assessee and to work under its direction, they remained on the payroll of the overseas employer which, for whatever reason, paid them their salaries.
- In reality, secondment was part of the global policy of the overseas employer, loaning their services on a temporary basis.
- At the end of the secondment period the employees would be repatriated in accordance with the global repatriation policy of the overseas company.

- The letter of understanding between the assessee and the seconded employees did not state that the latter would be treated as the former's employees after the seconded period. In fact they would revert to their overseas employment and might, in practice, be sent elsewhere on secondment.
- The salary packages, including allowances, perks etc. were expressed in foreign currency and being substantial amounts appeared to accord with the standardised policy of the overseas employer. The terms of employment, even during the secondment, were in accordance with the policy of the overseas company, who was their employer.
- All the agreements clearly showed that the overseas company had a pool of highly skilled employees, who were entitled to a certain salary structure and social security benefits. These employees were seconded to the assessee to make use of their expertise and specialisation. Upon cessation of the term of secondment, they would return to their overseas employment, or be deployed on some other secondment.

The Supreme Court observed that, while control (over performance of the seconded employees' work) and the right to ask them to return home if that performance was not as desired rested with the assessee, the overseas employer remained their employer in relation to its business and deployed them to the assessee, on secondment. Basing its opinion on the above observations, the Court held that the assessee was the recipient of manpower recruitment and supply services provided by the overseas group company via the secondment of employees, and hence liable to service tax under the reverse charge mechanism.

In this case the Hon'ble Supreme Court ruling was based on the specific facts of the case. However, the Court reiterated the principle that, in the absence of an employer–employee relationship, liability for service tax would be triggered under reverse charge. The facts led the Supreme Court to conclude that the foreign company remained the real employer of the seconded employees during their secondment in India and, since the secondment was governed by a global repatriation policy, it held that the Indian company had received manpower recruitment and supply services from the foreign entity.

Who qualifies as the real employer?

It is worth noting that both under income tax and service tax/GST, the crux remains who qualifies as the real employer of the seconded employees. The Hon'ble Supreme Court has reiterated this. While the Court's judgment is based on the facts, it is possible to distinguish where it might have concluded differently if the facts of the case had been different.

While the judgment has been passed down in the context of the service tax regime, it would be interesting to see how this judgment might impact on income tax matters in respect to secondment arrangements.

Where the tax authorities attempt to apply this ruling in income tax cases, it may be possible for the assessee to establish its case based on the specific facts. Having said this, it is indisputable that the Indian company must be able to establish beyond any doubt that it is the real employer of the seconded employees, during their secondment in India. Robust documentation to that effect would aid the assessee's case before the tax authorities.

While the judgment has been passed down in the context of the service tax regime, it would be interesting to see how this judgment might impact on income tax matters in respect to secondment arrangements

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1. Burt Hill Design (P.) Ltd v. DDIT [2017] 79 taxmann.com 459 (Ahmedabad bench, Tribunal), Goldman Sachs Services Pvt. Ltd [TS-341-ITAT-2022(Bang)], Toyota Boshoku Automotive India Pvt. Ltd [TS-315-ITAT-2022(Bang)], DIT v. HCL Infosystems Ltd [reported in (2005) 144 taxman 492], Yum! Restaurants (Asia) Pte Ltd [TS-336-ITAT-2020(Del)].
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Theory – Capital gains to be computed on 'real income'

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In most M&A deals involving acquisition of the shares of a target company, the sale consideration is structured in various ways, e.g. full payment up front, additional consideration payable upon happening of certain event, etc. In some cases, the buyer retains part of the sale consideration in an escrow account, release depending on the fulfilment/non-fulfilment of mutually agreed covenants between the buyer and the seller. To illustrate, part of the sale consideration could be retained towards tax litigation pending against the target company.

An issue that arises is whether the sale consideration receivable by the seller can be reduced for computing capital gains.

Background

Recently, this issue arose in the case of an individual taxpayer,[3] and the Bombay High Court ('Bombay HC') held that the amount withdrawn from the escrow account does not accrue to the taxpayer and can be deducted from the sale consideration.

In this case, the taxpayer was holding certain shares in an Indian company. During FY 2010/11, the taxpayer (along with the promoters) sold these shares under a share purchase agreement ('SPA'), under which the buyer was liable to pay consideration of INR1,550 million (part to the promoters, part to the taxpayer). Of this, INR1,250 million was paid up front at the time of transfer and the balance of INR300 million was deposited in an escrow account, to be released after two years, provided there was no liability on the promoters (and/or the taxpayer) under specific indemnity terms in the SPA. The taxpayer filed a tax return disclosing his share in the total consideration (INR1,550 million), though he had not received his share of the amount retained in the escrow account. The Tax Officer audited the tax return and accepted the income figure.

Thereafter, liabilities arose in the target company to the tune of INR90 million, for which an indemnification obligation was triggered under the SPA, and this amount was withdrawn from the escrow account by the buyer. The taxpayer filed an application to the Principal Commissioner of Income Tax ('PCIT') under section 264 of the Income Tax Act, 1961 (ITA),[4] claiming his share of the INR90 million deducted from the sale proceeds. However, the PCIT did not accept this claim. Aggrieved by the PCIT order, the taxpayer submitted a writ petition to the Bombay HC.

Bombay High Court's decision

The Bombay HC quashed the PCIT order and accepted the taxpayer's arguments. In rendering its decision, the Bombay HC observed as follows:

- The purchase price, as defined in the SPA, was not an absolute amount, but subject to liabilities that might arise to the promoters (including the taxpayer) on the occurrence of certain subsequent events. Thus, the sale consideration would be the actual amount received by the taxpayer.
- Capital gains are computed under section 48 of the ITA by deducting the costs of acquisition, of improvement and of transfer from the sale price received by or accruing to the seller. In this case, INR90 million was neither received by the taxpayer (and the promoters), nor accrued, since the amount was directly transferred to the escrow account and later withdrawn from that account by the buyer. Since INR90 million was neither received nor accrued, the same cannot be taken as sale consideration in computing any capital gains on the transfer of the shares.

- Relying upon the 'real income' theory applied by the Apex Court in *CIT v. Shoorji Vallabhdas and Co.*,[5] the Bombay HC held that the capital gains can be computed only after deducting the amount withdrawn from the escrow account. Further, it observed that a taxpayer can be asked to pay only such amount of tax as is legally due under the ITA.
- It was the duty of the Revenue authorities to compute the correct income and grant a refund of the taxes erroneously paid by the taxpayer, even where the capital gains computation results in income being lower than the figure disclosed on the return.

This ruling provides major relief for taxpayers (resident or non-resident shareholders, whether or not protected by a tax treaty) executing an agreement to transfer Indian capital assets for a sale consideration, which may depend upon contingencies between the parties. In this case, the taxpayer was able to apply for revision under section 264 within the deadline prescribed under the ITA. However, in practice the period allowed may expire, in which case it would be a practical challenge to negotiate a lower income figure for computing the correct capital gains tax liability. Needless to say, the taxpayer would have to ensure that such claims are raised before the Tax Officers at the earliest opportunity, lest they are rejected as barred by limitation.

Similar cases

In the similar case of *CIT v. Mrs Hemal Raju Shete*,[6] the Bombay HC held that, where sale consideration is receivable in future and contingent upon an event, any capital gains cannot be charged to tax in the year the capital asset is transferred, on the ground that the seller has not acquired any right to receive such income. Adopting a contrary view, in the case of *Ajay Guliya v. ACIT* the Delhi HC held that it cannot be said that the income had not accrued in the year of transfer merely because the agreement provides for payment of remaining consideration upon the happening of certain events in the future,[7] and accordingly the entire sum receivable on the transfer of shares would be chargeable to tax in the year of transfer.

What this means for taxpayers

Thus, it should be noted that the above issues are controversial and litigious. The problem arises because the timing of the event and thus taxability is determined by the date of transfer. If a part of the consideration is indeterminate or contingent, this theory suggests the indeterminate or contingent consideration ought not to be taxed in the year of transfer. Having said this, to support potential future claims it is important that the SPA contains clauses allowing the sale consideration to be adjusted based on the outcome of the visualised events, or postponing the accrual of consideration to a future date.

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4. Section 264 empowers the PCIT to revise any order passed by a subordinate.
5. (1962) 46 ITR 144 (SC) @148.
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