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*Willem Specken**

Going Horizontal

For half a decade there has been a worldwide appeal for tax transparency and enhanced relationships between taxpayers, intermediaries and the tax authorities. International organizations like the OECD and the International Fiscal Association (IFA) have joined the ranks of the promoters. The Netherlands, traditionally famous for its consensus culture, has put this item high on its agenda and announced initiatives back in 2005. A progress report is expected in the spring of 2012 on the Dutch programme that is known by the catchy name "Horizontal Supervision" (*horizontaal toezicht*).

Oddly enough, this name immediately points to the very heart of the problem. The term "horizontal" suggests a level playing field, while the term "supervision" implies authority that comes from above. The tax authorities argue that for taxpayers which opt in to this new way of communication, supervision will turn from vertical to horizontal, although if one takes a closer look at what is really happening, a 90-degree turn is far from obvious. The idea is that a (corporate) taxpayer enters into a private covenant with the tax authorities. Such covenant set behavioural rules for the taxpayer with respect to internal tax control and disclosure of any matter that could potentially give rise to a discussion with the tax authorities. In return the tax authorities commit to a standstill on tax audits and to responding swiftly to issues raised by the taxpayer.

So, what is in it for the taxpayer? No more tax audits! This stands to reason, as the taxpayer has agreed to internal due diligence processes based on the rules laid down by the tax authorities. A swift response! Now, this could be seen as a benefit, provided that the word "swift" has the same meaning for a fast moving business organization as for the tax authorities. The starting point originally was a response time of two weeks, which looked promising. Recently, however, the authorities have relaxed this fixed time period, replacing it with "we will do the best we can". This was of course bound to happen as soon as the initiative would become a victim of its own success. Also, it does not require a crystal ball to predict that it will be the law-abiding corporate citizens signing up to this, which leaves a group of more arbitrage-prone taxpayers continuing to give the tax authorities the same handful as before.

Admittedly, there will be taxpayers that will be happy to sign on to the covenant in order to buy security and to enhance control over own their tax affairs. From a wider perspective, however, I can see a worrying development in that interpretation of the law may shift from the courtroom to private one-on-one dealings outside the public domain, and "going horizontal" will become synonymous with "going underground".

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Netherlands

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The Proposed Bank Tax: To Tax or Not To Tax?

This article considers the bank tax proposed by the Dutch government in late 2011. This bank tax is considered along with two anticipated measures, namely amendments to the regulatory capital requirements for Dutch banks, which are expected to be introduced via an EU Regulation and an EU Directive, and amendments to the Dutch deposit guarantee scheme.

1. Introduction

The Netherlands has a relatively large financial sector, which is greatly beneficial to the Dutch economy. During the financial crisis, however, the Dutch government had to give support to certain of the largest financial institutions in the Netherlands.[1] In addition, payouts had to be made by the Dutch Central Bank (*De Nederlandsche Bank*) under the deposit guarantee scheme (*depositogarantiestelsel*), which protects deposit holders against a default of the bank where such deposits are held.[2]

On account of these events, the Dutch government reviewed the legal framework governing the financial sector in order to assess what improvements could be made to avoid government support in the future. The European Commission performed a similar review. As a result of these reviews, certain measures have been introduced or proposed to strengthen the legal framework, while other measures are still under debate. The main topic of this article is one of the measures proposed by the Dutch government with respect to the banking sector, namely the introduction of a bank tax. A legislative proposal to this effect was submitted to the Dutch parliament on 15 December 2011.

The introduction of a bank tax should not be analysed in isolation, but rather along with two other anticipated measures. First, amendments to the regulatory capital requirements for Dutch banks are expected to be introduced via an EU Regulation and an EU Directive (summarized in section 2.1.). Secondly, amendments to the Dutch deposit guarantee scheme are expected to be introduced (summarized in section 2.2.). These anticipated measures interact with the proposed bank tax. Conceptually, because these measures jointly cover the entire liabilities side of a bank's balance sheet. Legally, because the taxable amount under the proposed bank tax is a residual amount determined by reducing a bank's balance sheet total by its regulatory capital and its guaranteed deposits. The considerations of the Dutch government for introducing a bank tax, taking into account the complementary measures referred to above, are analysed in section 2.3.

The Dutch government has considered alternatives to a bank tax, such as the introduction of a financial activities tax or a financial transaction tax. The financial transaction tax in particular has been a hot topic of debate since the release of a proposal for an EU Directive on a common system of financial transaction tax in September of 2011. The reasons the Dutch government has for preferring a bank tax over these alternatives are summarized in section 3. Details of the legislative proposal for the introduction of a bank tax are subsequently analysed in section 4.

2. Three Measures To Improve Stability of the Financial Sector

2.1. Regulatory capital requirements

A bank is required to maintain a certain amount of regulatory capital (referred to as "own funds"). For the European Union, these requirements (currently) follow from the Capital Requirements Directives[3] (CRDs). The CRDs form a legal framework in which the recommendations for capital measures and capital standards issued by the Basel Committee on Banking Supervision are implemented. Recommendations issued by the Basel Committee are referred to as Basel Accords. The 1988 and 2004 Basel Accords are commonly known as Basel I and Basel II, respectively. In December 2010, the Basel Committee released a Basel Accord commonly known as Basel III, in response to deficiencies revealed in the financial crisis and with the aim of improving the banking sector's ability to absorb shocks arising from financial and economic stress, regardless of the source.

CRD I implemented Basel I and Basel II. Under CRD I, banks are required to retain minimum own funds of 8% of their risk-weighted assets, comprising at least 50% of so-called "Tier 1 capital" and for the remainder of so-called "Tier 2 capital". Tier 1 capital must comprise, in its turn, at least 50% of so-called "Core Tier 1 capital".[4] CRD II and

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1. Including Fortis, ABN Amro, ING Group, SNS REAAL, SNS Bank, AEGON, Leaseplan and NIBC. Government support took various forms: guarantee for bonds issued by a financial institution, acquisition of shares in a financial institution and capital injections in a financial institution. For an overview, *see ING wil meer dan genoegdoening van Hof*, Het Financieele Dagblad (1 Mar. 2012).
2. I.e. Icesave/Landsbanki, DSB Bank and Indover Bank.
3. The original Capital Requirements Directive (CRD I) comprises Directives 2006/48/EC and 2006/49/EC. Capital Requirements Directive II (CRD II) comprises Directives 2009/27/EC, 2009/83/EC and 2009/111/EC. Capital Requirements Directive III (CRD III) comprises directive 2010/76/EC. CRD II and CRD III amended the Directives that comprise CRD I.
4. Arts. 57, 66 and 75 Directive 2006/48/EC. On 8 December 2011, the European Banking Authority issued a Recommendation (EBA/REC/2011/1) on the basis of EU Regulation 1093/2010. The European Banking Authority recommended that European banks build up a

CRD III entered into force in 2009 and 2010, respectively, partly in response to the financial crisis. CRD II introduced tighter criteria for the inclusion of hybrid capital instruments in Tier 1 capital and tighter asset risk-weighting rules.[5] CRD III did not amend the minimum own funds requirements as such, but introduced tighter asset risk-weighting rules, as well.

On 20 July 2011, a proposal for Capital Requirements Directive IV (CRD IV) was released, comprising a draft Regulation and a draft Directive.[6] CRD IV implements Basel III. The majority of the proposed requirements on minimum own funds are included in the draft Regulation. Inclusion in a Regulation entails that the requirements will be directly applicable to banks within the European Union. This should ensure a level playing field by preventing divergent national requirements as a result of transposition of a Directive into national law, and should enable the European Union to implement any future changes more quickly than it could with a Directive.[7]

Under CRD IV, banks generally continue to be required to retain minimum own funds of 8% of their risk-weighted assets. However, at least 75% thereof must comprise Tier 1 capital (i.e. 6%; the remainder may consist of Tier 2 capital).[8] Tier 1 capital must comprise at least 75% of so-called "Common Equity Tier 1" (the remainder may consist of so-called "Additional Tier 1").[9] Only capital instruments satisfying a list of strict substantive conditions are classified as "Common Equity Tier 1". Based on these criteria, only common shares, or capital instruments that closely resemble common shares, should be recognized as Common Equity Tier 1. Other capital instruments qualify as Additional Tier 1 capital if they satisfy certain substantive conditions, such as having a principal loss absorption feature, either through principal write-down or through conversion into Common Equity Tier 1 capital upon the Common Equity Tier 1 ratio falling below 5.125%.[10]

In addition to the minimum own funds requirements described above, CRD IV proposes introducing capital buffers, comprising a so-called "Capital Conservation Buffer" and a so-called "Countercyclical Capital Buffer".[11] The Capital Conservation Buffer must comprise Common Equity Tier 1 of 2.5% of the risk-weighted assets, and imposes restrictions on the payments of dividends and certain coupons and bonuses. The Countercyclical Capital Buffer also must comprise Common Equity Tier 1. Each EU Member State sets a rate for the Countercyclical Capital Buffer for its jurisdiction quarterly, based on factors such as the deviation of the "credit to gross domestic product" ratio from its long-term trend. This rate should, as a general rule, be set between 0% and 2.5% of the risk-weighted assets. As a result of its rate-setting mechanism, the Countercyclical Capital Buffer is built up in periods of credit provision growth and is subsequently released in a credit provision downturn.

It is intended that CRD IV will apply from 1 January 2013. The minimum own funds requirements would be implemented gradually, from 1 January 2013 until 31 December 2014. The capital buffer requirements would be implemented gradually from 1 January 2016 to 31 December 2018. The European Commission estimates that new regulatory capital needs to be raised in the amount of EUR 84 billion by 2015, and EUR 460 billion by 2019, in order to meet the requirements of CRD IV to maintain sufficient high-quality regulatory capital.[12]

2.2. Deposit guarantee scheme levy

The Netherlands has a deposit guarantee scheme (*depositogarantiestelsel*), which is in accordance with the EU Directive on Deposit Guarantee Schemes.[13] The deposit guarantee scheme endeavours to compensate deposit holders if the bank where such deposits are held defaults. The objective of the deposit guarantee scheme is to protect deposit holders against risks taken by banks, as well as to ensure that deposit holders retain confidence in the banking sector in order to avoid a run on the banks. As a general rule, deposits are guaranteed under the deposit guarantee scheme up to an amount of EUR 100,000 per holder per bank.[14] Currently, only deposits held by individuals and small companies are guaranteed by the deposit guarantee scheme.[15]

The deposit guarantee scheme applies to banks with their corporate seat in the Netherlands. Subject to certain conditions, entities with their corporate seat in an EU Member State carrying out bank activities in the Netherlands via a branch office may also elect to apply the deposit guarantee scheme. Under the current EU Directive on Deposit Guarantee Schemes, providing for such election is mandatory.[16] However, the European Com-

temporary capital buffer to reach a 9% Core Tier 1 ratio (definition based on the CRD in force, but adjusted by the European Banking Authority) by 30 June 2012.

5. Arts. 57, 63, 63a and 66 Directive 2006/48/EC, as amended by Directive 2009/111/EC.
6. COM(2011) 452 final and COM(2011) 453 final. CRD IV replaces CRD I as amended by CRD II and CRD III.
7. COM(2011) 452 final, Explanatory Memorandum, at 8.
8. Art. 87 draft CRD IV Regulation. Tier 1 capital is defined in Part Two, Title II, Chapter 1 of the draft CRD IV Regulation. Tier 2 capital is defined in Part Two, Title II, Chapter 4 of the draft CRD IV Regulation.
9. Art. 87 draft CRD IV Regulation. Common Equity Tier 1 capital is defined in Part Two, Title II, Chapter 2 of the draft CRD IV Regulation. Additional Tier 1 capital is defined in Part Two, Title II, Chapter 3 of the draft CRD IV Regulation.
10. Arts. 49 and 51 draft CRD IV Regulation. Under CRD IV, the Common Equity Tier 1 ratio should be at least 7%, considering (1) the minimum own funds requirements (4.5%) and (2) the Capital Conservation Buffer (2.5%) discussed below.
11. Arts. 123 to 130 draft CRD IV Directive.
12. COM(2011) 452 final, Explanatory Memorandum, at 7.
13. EU Directive 1994/19/EC, as amended by EU Directive 2009/14/EC. The deposit guarantee scheme is laid down, predominantly, in the Financial Supervision Act (*Wet op het financieel toezicht*, FSA) and the Decree on Special Prudential Measures, Investors' Compensation and the Deposit Guarantee FSA (*Besluit bijzondere prudentiele maatregelen, beleggerscompensatie en depositogarantie Wft*, DGS Decree).
14. Art. 29.03 DGS Decree.
15. EU Directive on Deposit Guarantee Schemes (1994/19/EC), as amended by EU Directive 2009/14/EC, provides an option for EU Member States to exclude certain types of deposit holders from the deposit guarantee scheme, including large companies (art. 7, para. 2, in conjunction with Annex 1). The Netherlands has made use of this option in Annex B, sub 10 of the DGS Decree. This option to exclude will be abolished if the Amendment to DGS Decree (as defined below) is adopted.
16. Art. 4 Directive 1994/19/EC.

mission released a proposal in 2010 to amend this Directive.[17] It proposed, among other things, to abolish the possibility for entities with their corporate seat in an EU Member State to elect to apply the deposit guarantee scheme of another EU Member State.[18] The proposed Directive does not change that EU Member States must check whether entities with their corporate seat outside the European Union, which carry out bank activities in the European Union via a branch office, are governed by an equivalent deposit guarantee scheme. Failing that, EU Member States may stipulate that such branches must join the deposit guarantee scheme of the EU Member State.[19]

Currently, the deposit guarantee scheme is financed *ex post,* through a system where a payout by the Dutch Central Bank under the deposit guarantee scheme must be repaid by participating banks. The Dutch government acknowledged, after the financial crisis, that the financing of the deposit guarantee scheme could be improved and that the current set-up may give wrong incentives. First, banks may view deposits as cheap funding because of the existence of the deposit guarantee scheme. Secondly, holders of deposits have no interest in the risk profile of banks to the extent that their deposits are guaranteed under the deposit guarantee scheme. Thirdly, when a payout is made under the deposit guarantee scheme, the bank causing such payout does not share in the (*ex post*) repayment of the payout to the Dutch Central Bank. Fourthly, a payout is most likely to occur in times of financial crisis. The obligation for other participating banks to repay their part of the payout under the deposit guarantee scheme may lead to significant costs and, possibly, create a chain reaction of negative events.[20]

In view hereof, the Dutch government intends to change the system for financing the deposit guarantee scheme from 1 July 2012.[21] It proposed to finance the deposit guarantee scheme *ex ante* instead of *ex post*. Two advantages of *ex ante* financing over *ex post* financing have been identified. First, a participating bank unable to repay its deposit holders will already have contributed towards a payout under the deposit guarantee scheme. Secondly, contributions to the deposit guarantee scheme are made over time rather than at once, which eliminates the eventuality that participating banks must contribute their pro rata share of a payout under the deposit guarantee scheme (in full) during a financial crisis.[22]

Ex ante financing of the deposit guarantee scheme is proposed to be implemented as follows. First, banks must make a base contribution (*basisbijdrage*), on a quarterly basis, equal to the so-called "base amount" (*basisbedrag*). The base amount is equal to 0.025% (2.5 basis points) of the amount of its guaranteed deposits. The base contribution must be paid until a participating bank has contributed a total amount equal to 1% (100 basis points) of its guaranteed deposits (i.e. over a period of approximately 10 years).[23] Secondly, participating banks must pay a risk-based contribution (*risicobijdrage*) equal to 0%, 25%, 50% or 100% of the general amount.[24] Whether a risk-based contribution is due, and at which rate, depends on the risk profile of each bank as determined by the Dutch Central Bank. Such risk-based contribution is intended to discourage banks from taking risks. Contrary to the general contribution, the risk-based contribution is therefore levied for an indefinite period of time.

Under the proposed *ex ante* financed deposit guarantee scheme, all contributions by participating banks are paid into a certain fund. Base contributions are deposited into individual accounts for the respective banks. Risk-based contributions are deposited into a joint account. If a participating bank is unable to repay its deposit holders, the Dutch Central Bank will make a payout under the deposit guarantee scheme and be refunded by the fund. The order of payments made by the fund is as follows: (1) individual account of defaulting bank, (2) joint account, (3) individual accounts of the other banks and (4) incidental (*ex post*) contributions from the participating banks for the remaining shortage.[25] In addition, depending on the amount of the fund remaining after a payout under the deposit guarantee scheme, participating banks may be required to make a recovery contribution (*herstelbijdrage*) for an aggregate amount up to 0.5% (50 basis points) of their guaranteed deposits.[26,27]

2.3. Bank tax

The Dutch government has proposed introducing a bank tax based on the bank levy that has been introduced by the United Kingdom. Revenues of the proposed Dutch bank tax are estimated to be EUR 300 million per year. The estimated revenues would be contributed to the general budget (i.e. not just used for purposes of strengthening the Dutch financial sector).

17. COM(2010) 368 final.
18. Art. 12 proposed Directive. It furthermore proposes to harmonize the financing of the deposit guarantee scheme within the European Union (Arts. 9 and 11 proposed Directive).
19. Art. 6 Directive 1994/19/EC, renumbered to Art. 13 proposed Directive.
20. *Kamerstukken II*, 2008/09, 32 013, No. 1, at 40.
21. A draft Governmental Decree (*Algemene Maatregel van Bestuur*), amending the DGS Decree (the Amendment to the DGS Decree), was released for public consultation on 1 August 2011; available at www.internetconsultatie.nl/financieringdgs. Changing the financing of the deposit guarantee scheme from *ex post* to *ex ante* is in line with the proposed Directive (COM(2010) 368 final).
22. For a more elaborate analysis of the proposed changes to the deposit guarantee scheme, *see* J.M. van Poelgeest, 19 *Onderneming en Financiering* 4 (2011), at 47-61.
23. Art. 23h Amendment to the DGS Decree. Because the amount of deposits outstanding varies over time, the general contribution is adjusted every quarter on the basis of the amount outstanding as then. Furthermore, an additional contribution (*suppletie*) is due in that case, in order to make a correction for the period over which the general contributions were already paid (art. 23j Amendment to the DGS Decree).
24. Art. 23m Amendment to the DGS Decree.
25. Arts. 23p and 23r Amendment to the DGS Decree. The amount of the incidental contribution per bank is equal to its pro rata share in the shortage, based on the amount of guaranteed deposits held with each bank.
26. Art. 23u Amendment to the DGS Decree.
27. No bank is required to contribute (whether by way of general, additional, risk-based, incidental or recovery contribution) an amount per year that exceeds 5% of its equity in the previous financial year, with a catch-up in the next financial year(s) (art. 23l Amendment to the DGS Decree).

The primary objective of the proposed bank tax is putting a price on the implicit guarantee that has been granted by the Dutch government to its banking sector.[28] Secondary objectives of the proposed bank tax are (1) discouraging the use of (short-term) unsecured debt[29] and (2) discouraging variable remuneration (bonuses) of directors. According to the Dutch government, the bank tax complements the measures discussed in sections 2.1. and 2.2., as they cover, jointly but without overlap, the entire liabilities side of a bank's balance sheet (i.e. regulatory capital, guaranteed deposits and unsecured debt).

The Dutch government consistently indicated in parliamentary documents[30] that a bank tax will be introduced only if the following three preconditions are met:

– EU coordination exists, in order to retain an international level playing field;
– the impact of a bank tax on the extension of credit by banks is taken into account; and
– the overlap of measures is taken into account, including the concurrence of a bank tax with the deposit guarantee scheme and the increased regulatory capital requirements.

The Dutch government believes that each of these three preconditions is met. The position of the Dutch government with regard to each of these preconditions is discussed below.

2.3.1. Precondition 1: EU coordination and a level playing field[31]

Regarding the existence of a level playing field, the Dutch government has concluded that the estimated revenues of the proposed bank tax are in line with the revenues of the bank tax introduced by France and the bank levy introduced by Germany, adjusted for the respective gross domestic products of France and Germany.[32] The Dutch government stated that Dutch banks, like French banks and German banks, generally have a larger focus on retail activities and mature markets compared to UK banks (and, consequently, a smaller focus on wholesale activities and emerging markets compared to UK banks). If this is true, the choice to use the UK bank levy as a model for the proposed bank tax (and not the French bank tax or the German bank levy) appears to be a move away from the creation of a level playing field.

Furthermore, no matter what bank tax or levy is used as a model, there are several major differences between the bank taxes and levies introduced by these EU Member States, which makes it virtually impossible to create a level playing field. First, the revenues of the German bank levy are used to strengthen the financial sector, whilst the revenues of the French bank tax and the UK bank levy are used not just to strengthen the financial sector. Secondly, the definition of "taxpayer" varies significantly from state to state (e.g. branches of EU/EEA banks are subject to UK bank levy, whereas such branches are not subject to French bank tax). Thirdly, the French bank tax is based on the asset side of the bank's balance sheet, whereas the UK and German bank levies are based on the liabilities side.[33] Fourthly, French bank tax is deductible for corporate income tax purposes, whereas UK and German bank levies are not.

There is no EU harmonization with respect to bank taxes at the moment. Several EU Member States have introduced a bank tax or bank levy: Austria, Belgium, Cyprus, Hungary, Portugal, Romania, Slovakia, Slovenia and Sweden, in addition to France, Germany and the United Kingdom. However, several other EU Member States, who might have competitors to Dutch banks, have not introduced or proposed a bank tax or bank levy; for example, pain and Italy. The Dutch government takes the position that EU coordination does not require EU harmonization. Coordination will exist, in its view, as long as several EU Member States voluntarily attempt to harmonize their fiscal legislation through exchanging best practices. The Dutch government feels that coordination exists, because it has specifically reviewed the bank taxes and levies that other EU Member States have introduced or developed. However, neither official nor unofficial discussions took place with other EU Member States regarding bank taxes.[34]

In view of the differences in bank taxes and levies among EU Member States, and in accordance with the advice rendered by the Dutch Council of State (*Raad van State*), the author believes that increased EU coordination is required for this precondition to be met. The only cross-border coordination within the European Union at the moment is, ironically, the attempt to resolve double bank taxation, which is a sign that the introduction of the various bank taxes and levies lacks coordination. Consequences of this precondition not being met could be international double (or non-) taxation, distortion, and migration of activities.[35]

28. *Kamerstukken II*, 2011/12, 33 121, No. 3, at 1-3. The Dutch government made it clear, however, that a bank tax should not be considered an insurance premium for future government support, in order to avoid moral hazard. *See* also *Kamerstukken II* 2009/10, 31 980, No. 9, at 10; *Kamerstukken II* 2010/11, 21 501-07, No. 791, at 15.
29. The Dutch government stated that research has shown that short-term funding accelerated the spreading of liquidity problems in the banking sector in recent years (*Kamerstukken II*, 2011/12, 33 121, No. 4, at 7).
30. For example *Kamerstukken II* 2009/10, 31 980, No. 9, at 10; *Kamerstukken II* 2009/10, 21 501-07, No. 791, at 14.
31. *Kamerstukken II*, 2011/12, 33 121, No. 3, at 9-10; *Kamerstukken II*, 2011/12, 33 121, No. 4, at 8-11.
32. *Kamerstukken II*, 2011/12, 33 121, No. 6, at 16. It would, in the author's view, be better if the respective sizes of the financial sectors had been compared instead of gross domestic products, or that the amount of bank tax or bank levy due by similar banks in two different states had been compared, as suggested by the Dutch Council of State (*Kamerstukken II*, 2011/12, 33 121, No. 4, at 9).
33. Furthermore, several differences exist in determining the taxable amount, among states that base the taxable amount on the liabilities side of the balance sheet. *See* for example the overview included in *Kamerstukken II*, 2011/12, 21 501-7, No. 776, at 4 (annex).
34. *Kamerstukken II*, 2011/12, 33 121, No. 6, at 19.
35. *Kamerstukken II*, 2011/12, 33 121, No. 4, at 8.

2.3.2. Precondition 2: No unnecessary overlap of measures[36]

The Dutch government stated that this precondition played an important role in developing the proposed bank tax. Overlap of measures is, in its view, avoided because the three measures discussed in this section (i.e. regulatory capital requirements, deposit guarantee scheme levy and bank tax) jointly but without overlap cover the liabilities side of a bank's balance sheet. There is indeed no direct overlap, but there is, in the author's view, an indirect overlap. First, all measures that impose additional obligations on banks can be considered to overlap. For example any bank tax and deposit guarantee scheme levy paid by banks will reduce, as a rule, the regulatory capital on a euro-for-euro basis. Because the regulatory capital must be increased under CRD IV, and thus additionally if deposit guarantee scheme levy and bank tax will be paid, there is an indirect overlap of measures. Secondly, any "benefits" under CRD IV are (partly) offset through the levy of bank tax. For example a bank with a low risk profile may retain less regulatory capital than a bank with a high risk profile, and thus may retain more unsecured debt (*ceteris paribus*). However, more unsecured debt entails a higher taxable amount for bank tax purposes, whilst the risks that both banks impose on the financial system should, as a general rule, be equal.[37]

2.3.3. Precondition 3: No substantial negative impact on the extension of credit[38]

The Dutch government acknowledges that the proposed bank tax will have a negative impact on the extension of credit by banks. This is understandable. Any bank tax paid will increase a bank's expenses, which will in turn be passed on to clients. In addition, banks need to increase regulatory capital under CRD IV, in order to cover the risks associated with their activities (including the extension of credit). Any bank tax paid (as well as losses; for example as a result of asset write-downs) will reduce regulatory capital. Banks must therefore increase their regulatory capital additionally, either in relative terms or in absolute terms. There are generally two alternatives for increasing regulatory capital. First, a bank could attract new regulatory capital by issuing shares or retaining profits,[39] or through buying back subordinated debt trading below par;[40] however it is difficult in current times, if not impossible, for banks to issue new shares in the market.[41] Therefore, this first alternative may not be available. Secondly, banks could reduce the aggregate amount of their risk-weighted assets, for example by reducing credit extension activities. The smaller the credit portfolio, the smaller the amount of regulatory capital that must be maintained to cover the associated risks. This second alternative seems to be the easiest way to meet the increased regulatory capital requirements.

In light of the above, it cannot be ignored that the introduction of a bank tax may substantially impact the credit extension by banks. The Dutch government believes, however, that the proposed bank tax does not have a substantial negative impact on the credit extension by banks. It requested the Dutch Central Bank to investigate the isolated effects of the proposed bank tax, which concluded that the bank tax is anticipated to have a relatively limited negative impact on the banks' ability to extend credit. The Dutch Central Bank expects that banks will cover the anticipated reduction of regulatory capital, as a result of the bank tax, either by reducing assets other than credit portfolios, or by attracting new capital. As mentioned above, attracting new capital is difficult in current times, which may be why banking clients are already experiencing a reduction in the availability of credit.[42] The author holds the view, therefore, that the effects of the proposed bank tax should not be investigated in isolation, but rather in tandem with economic developments, and specifically with the other two anticipated measures discussed in this section.

3. Alternatives to a Bank Tax

The explanatory notes, which were released with the legislative proposal for the introduction of a bank tax, summarize the following four alternatives to the introduction of a bank tax: (1) a financial activities tax, (2) a financial transaction tax, (3) a Dutch corporate income tax surcharge for banks and (4) a bank tax based on the assets side of the balance sheet.[43] The Dutch government dismissed alternatives (3) and (4). Alternatives (1) and (2) were initiated by the European Commission, and have therefore been considered at length by the Dutch government. The position of the Dutch government as to these alternatives is complicated (particularly with regard to the financial transaction tax) and may be subject to change, as discussed in brief below.

3.1. Financial activities tax

The financial activities tax was proposed by the International Monetary Fund in 2010 and presented in a Euro-

36. *Kamerstukken II*, 2011/12, 33 121, No. 3, at 10; *Kamerstukken II*, 2011/12, 33 121, No. 4, at 9, 11 and 12.
37. *See* also the advice rendered by the Dutch Council of State (*Kamerstukken II*, 2011/12, 33 121, No. 4, at 6 and 9). The Dutch government holds the view that the implicit government guarantee is larger for banks that are required to maintain a relatively small amount of regulatory capital (*Kamerstukken II*, 2011/12, 33 121, No. 6, at 7). The author disagrees with this view.
38. *Kamerstukken II*, 2011/12, 33 121, No. 3, at 10-11.
39. The Bank Nederlandse Gemeenten and De Nederlandse Waterschapsbank have announced to cut dividends in order to increase their regulatory capital. *See* also *BNG halveert dividend aan gemeenten door Basel 3*, Het Financieele Dagblad (6 Mar. 2012).
40. Among others, ING, Van Lanschot and SNS Bank recently bought back subordinated debt trading below par. *See* also *Terugkopen obligaties levert ING € 745 mln kapitaal op*, Het Financieele Dagblad (24 Dec. 2011). Another incentive to buy back subordinated debt is the (proposed) limitation for the classification of such debt instruments as Tier 1 capital under the regulatory capital requirements discussed in section 2.1.
41. *See* also *Niet de klant maar de bank staat centraal*, Het Financieele Dagblad (17 Dec. 2011).
42. The Dutch Federation of Small and Medium-Sized Enterprises (*MKB Nederland*) and the Confederation of Dutch Industry and Employers (*VNO NCW*) consider it imprudent to introduce a bank tax at this time, in part because they expect a substantial negative impact on the credit provision by banks. *See* their commentary on bank tax proposal, as released on 26 January 2012 (available at www.vno-ncw.nl/publicaties/brieven_en_commentaren).
43. *Kamerstukken II*, 2011/12, 33 121, No. 3, at 11-13.

pean Commission Communication[44] on 7 October 2010. In its most extensive form, a financial activities tax is assessed on total profit and wages, and can be viewed as a tax on a proxy for total value added by a financial sector company. The European Commission views a financial activities tax as a potential solution to the current VAT exemption of financial services, which the Commission feels provides (undesired) benefits to the financial sector. A proposal for a financial activities tax has not been released, however. An explanation could be that, since October of 2010, the European Commission has had an increased interest in introducing a financial transaction tax. The Dutch government has taken the position that a financial activities tax requires further development, including its interaction with the VAT, before it will be considered.

3.2. Financial transaction tax

A financial transaction tax is designed to tax the value of single financial transactions, for example the purchase or sale of financial instruments (including equities, bonds, currencies and derivatives). The financial transaction tax was also addressed by the European Commission in the above-mentioned Communication of 7 October 2010. In response, the Dutch government took the position that a financial transaction tax should be adopted on a global scale, as such a tax could otherwise easily be avoided, which would distort the level playing field.

Since the release of the Communication, the discussion has shifted from introducing a financial transaction tax on a global scale to introducing a financial transaction tax within the European Union. On 28 September 2011, the European Commission released a proposal for an EU Directive on a common system of financial transaction tax.[45] The Dutch government requested that the Dutch Bureau for Economic Policy Analysis (*Centraal Plan Bureau*) study the effects of the proposed Directive.[46] The Dutch government will determine its definitive position with regard to the financial transaction tax, in consultation with Dutch parliament, on the basis of its response to the Dutch Bureau for Economic Policy Analysis study.[47] The Dutch government believes that a bank tax and a financial transaction tax cannot, in principle, co-exist. It confirmed that if a financial transaction tax is introduced and if its revenues for the Netherlands exceed the revenues of the bank tax, the bank tax will be abolished.[48]

44. COM(2010) 549 final.
45. COM(2011) 594 final.
46. The results of the study were released by the Dutch Bureau for Economic Policy Analysis (*Centraal Plan Bureau*) on 21 December 2011 in the note *Evaluatie van de financiële transactiebelasting*. On the same date, a background note (*achtergronddocument*) was released in English. Both documents are available at www.cpb.nl/publicaties. In summary, the Dutch Bureau for Economic Policy Analysis study finds little evidence that the introduction of a financial transaction tax within the EU will be effective in correcting market failures, and finds that other taxes are likely to be more efficient in raising revenues, involving lower deadweight losses. The Dutch Central Bank also finds the introduction of a financial transaction tax within the European Union undesirable. *See* DNBulletin (6 Feb. 2012), available at www.dnb.nl/nieuws/dnbulletin.
47. *Kamerstukken II*, 2011/12, 33 121, No. 6, at 21.
48. *Kamerstukken II*, 2011/12, 33 121, No. 3, at 14; *Kamerstukken II*, 2011/12, 33 121, No. 6, at 21.

4. Details of the Proposed Bank Tax

4.1. General

On 15 December 2011, the Dutch government released a proposal for a bank tax, to be included in the Bank Tax Act (*Wet bankenbelasting*). As the proposal is pending before the Dutch parliament, details of the bank tax, as summarized in this section are subject to change. The Dutch government intends that the bank tax will enter into force by the middle of 2012, but it may decide to delay the entry into force date if exceptional (market) circumstances require it to do so.[49]

The Financial Supervision Act (*Wet op het financieel toezicht*) plays a central role in the bank tax because the definitions of many terms in the Bank Tax Act refer to the definitions of the same terms in the Financial Supervision Act.[50] For example "bank" for purposes of the Bank Tax Act means "bank" as defined in Art. 1:1 of the Financial Supervision Act: "a person whose business it is to obtain redeemable funds from third parties other than professional market parties, and to make extensions of credit for its own account".

4.2. Taxpayers

The bank tax is intended to be applied to all possible legal forms of carrying out bank activities in the Netherlands.[51] As a general rule, taxpayers for purposes of the bank tax[52] may be defined as follows:
- entities with their corporate seat in the Netherlands that are authorized by the Dutch Central Bank to carry out bank activities;
- entities with their corporate seat in an EU/EEA Member State that are authorized to carry out bank activities by the supervisor of the EU/EEA Member State in which they have their corporate seat (European passport), and that have received a confirmation from the Dutch Central Bank that it is aware of the entity's intention to carry out bank activities in the Netherlands via a branch office; and
- other entities with their corporate seat outside the Netherlands that are authorized by the Dutch Central Bank to carry out bank activities in the Netherlands via a branch office.

The concept of "taxpayer" may be widened to a larger group. If a taxpayer on the basis of the general rule is part of a group of entities, and its financial results are included in the consolidated annual accounts of a Dutch resident entity, then the latter Dutch resident entity is subject to bank tax in lieu of the former taxpayer.[53] These special group rules for determining the taxpayer apply, by analogy, if the Dutch resident entity is exempt from

49. *Kamerstukken II*, 2011/12, 33 121, No. 4, at 8; *Kamerstukken II*, 2011/12, 33 121, No. 6, at 5.
50. Art. 2 Bank Tax Act (BTA).
51. *Kamerstukken II*, 2011/12, 33 121, No. 3, at 3.
52. Art. 3 BTA.
53. Art. 4, paras. 1 and 2 BTA. If the financial results of a Dutch resident entity preparing consolidated annual accounts are, in turn, included in the consolidated annual accounts of another Dutch resident entity, only the latter entity can be subject to bank tax.

preparing consolidated annual accounts because its financial results are included in the consolidated annual accounts of an entity residing outside the Netherlands.[54] Notwithstanding these special group rules, a Dutch resident entity will not be subject to bank tax if the Dutch banking activities carried on by the group of which it is part are considered minor. This is the case if the (aggregate) stand-alone balance sheet total of entities within the group that qualify as taxpayers under the general rule (1) does not exceed EUR 20 billion (the so-called "efficiency threshold") or (2) does not exceed 10% of the consolidated balance sheet total of the group.[55] If neither threshold is reached, the Dutch resident entity preparing consolidated annual accounts is not subject to bank tax. However, entities within the group qualifying as taxpayers under the general rule remain subject to bank tax on an individual basis.

4.3. Taxable base[56]

Bank tax is due on the taxable amount, which is derived from the balance sheet at the end of the preceding financial year. If the taxpayer is subject to bank tax under the general rule, the taxable amount is based on the stand-alone balance sheet, unless it is required or would have been required to prepare consolidated accounts. In that case, the taxable amount is based on the consolidated balance sheet (which it has prepared or would have prepared). If the taxpayer is a Dutch resident entity subject to bank tax under the special group rules, the taxable amount is, in any case, based on the consolidated balance sheet (which it has prepared or would have prepared). In view of these rules, entities subject to bank tax may need to prepare a consolidated balance sheet solely for purposes of determining their taxable amount.

The method to determine the taxable amount entails that bank tax may be assessed on both banking and non-banking activities, and regardless of whether these activities are carried out in or outside of the Netherlands. The explanation provided by the Dutch government for the inclusion of non-Dutch (banking) activities is that these activities may also affect the stability of the Dutch financial sector.[57] The author understands the inclusion of non-Dutch banking activities in the taxable amount, in view of the cause of government support granted by the Netherlands to Dutch banks in the financial crisis.[58] However, he finds the reasons for including non-banking activities in the taxable amount unconvincing. The German bank levy, for example, excludes certain non-banking activities from the taxable amount.

The taxable amount is equal to the balance sheet total less (1) the amount of regulatory capital, (2) the amount of deposits guaranteed under a (Dutch or non-Dutch) deposit guarantee scheme,[59] (3) if insurance activities are carried on within the group, the liabilities attributable to insurance activities[60] and (4) the amount of the efficiency threshold.

Regulatory capital for purposes of the bank tax is defined as follows:[61] "capital that is determined in accordance with the rules set through a governmental decree as meant in article 3:57 of the Financial Supervision Act or in accordance with rules of another state that are in nature and intent comparable thereto". As described in section 2.1., the EU Regulation included in the proposed CRD IV would directly apply to banks within the European Union (i.e. without transposition into national law of the EU Member States). It would have been better if the definition of regulatory capital had taken into account the expected introduction of CRD IV.[62]

The efficiency threshold is equal to the lesser of (1) the balance sheet total less the regulatory capital, the guaranteed deposits and the insurance liabilities and (2) EUR 20 billion.[63] In view of the relatively high cap on the efficiency threshold, only a limited number of entities will be actually obliged to pay bank tax.[64] In view of the floor on the efficiency threshold, the taxable amount cannot be negative.

The taxable amount is intended to estimate the amount of the taxpayer's unsecured debt. The author consid-

54. Art. 5 BTA. In order for the Dutch resident entity to be released from the obligation of preparing consolidated annual accounts, a non-Dutch parent company must issue a certain declaration pursuant to article 2:403, sub f of the Dutch Civil Code (*Burgerlijk Wetboek*).
55. Art. 4, para. 3 BTA. There is a (possibly theoretical) risk of double counting towards either threshold if an entity authorized to carry out bank activities owns shares of another entity authorized to carry out bank activities.
56. Arts. 6 to 9 BTA.
57. *Kamerstukken II*, 2011/12, 33 121, No. 3, at 5; *Kamerstukken II*, 2011/12, 33 121, No. 6, at 27.
58. For example, government support by the Netherlands to the ING Group related to losses suffered by ING Direct in the United States. *See* also *ING zag onheil in verste verte niet aankomen*, Het Financieele Dagblad (18 Nov. 2011).
59. Article 2, sub e of the BTA includes the definition of "deposit guarantee scheme" (*depositogarantiestelsel*). This definition does not (explicitly) include non-Dutch equivalents, contrary to the definition of "deposit" (*deposito*) included in article 2, sub d of the BTA. Based on parliamentary documents, non-Dutch equivalents are included in the definition of deposit guarantee scheme (*Kamerstukken II*, 2011/12, 33 121, No. 6, at 33).
60. The Dutch government provided two reasons for the exclusion of insurance liabilities. First, insurance companies are subject to regulatory capital requirements on the basis of EU Directive 2009/138/EC (Solvency II). Secondly, excluding insurance liabilities creates a level playing field among banks that carry on insurance activities and banks that do not.
61. Art. 2, sub j BTA.
62. Furthermore, a decree amending the Decree on Prudential Rules FSA (*Besluit prudentiële regels Wft*) was released on 22 December 2011 (*Staatsblad* 2011, 672), which would transpose the amendments to the regulatory capital requirements, introduced by CRD II, into the laws of the Netherlands. These changes are currently not included in the definition of regulatory capital for purposes of the bank tax.
63. The EUR 20 billion efficiency threshold for purposes of determining the taxpayer under the special group rules is applied to the balance sheet total, but the EUR 20 billion efficiency threshold for purposes of determining the taxable amount is applied to the residual amount after reducing the balance sheet total by regulatory capital, guaranteed deposits and insurance liabilities. In view hereof, a Dutch resident entity may be subject to bank tax under the special group rules because the efficiency threshold is exceeded, but may nonetheless end up with a taxable amount of nil as a result of the efficiency threshold. Furthermore, the efficiency threshold for purposes of determining the taxable amount is the same for taxpayers subject to bank tax under the general rule and taxpayers subject to bank tax under the special group rules (a group could comprise more than one entity that would have been a taxpayer under the general rule).
64. The Dutch government expects that approximately 10 banks (out of 86) will actually be obliged to pay bank tax (*Kamerstukken II*, 2011/12, 33 121, No. 6, at 12 and 14).

ers it questionable, however, that the proposed rules will achieve this objective. It is unlikely that the residual taxable amount will accurately reflect the amount of unsecured debt. For example the bank levy introduced by the United Kingdom includes sophisticated rules to determine the taxable amount.[65] In view of (1) the limited number of entities that are anticipated to be actually obliged to pay bank tax (i.e. limited aggregate compliance burden) and (2) the objective of the Dutch government to discourage the use of unsecured debt, the author believes that additional rules should be instituted to accurately estimate the amount of unsecured debt.

As mentioned above, for Dutch resident entities subject to bank tax under the special group rules, the taxable amount is based on the consolidated balance sheet. It is unclear how, in such cases, regulatory capital will be determined if the Dutch resident entity itself does not carry out bank activities. For entities with their corporate seat outside the Netherlands who carry out bank activities in the Netherlands via a branch office, the balance sheet total is considered equal to the aggregate amount of liabilities attributable to the Dutch branch office. Because the attribution of liabilities to branch offices is not required for accounting purposes, the Dutch government stated that the Decree on Profits Attribution to Permanent Establishments (*Besluit winstallocatie vaste inrichtingen*, PE Decree)[66] may be applied by analogy in order to attribute liabilities to the branch office. To determine the taxable amount, the deemed balance sheet total is subsequently reduced by regulatory capital and guaranteed deposits attributable to the Dutch branch office.

The PE Decree endorses the conclusions reached by the OECD in the PE Report.[67] The PE Report includes the so-called "authorized OECD approach", to set a limit on the amount of profits that may be taxed in the host state of a permanent establishment. Under the authorized OECD approach, the permanent establishment is treated as having an appropriate amount of funding (comprising free capital and interest-bearing debt) in order to support the functions it performs, the assets it uses and the risks it assumes. For the banking sector, funding is generally attributed to the permanent establishment in accordance with the risks assumed by the permanent establishment as determined on the basis of a functional and factual analysis. Funding is attributed to a permanent establishment to serve the objective of the PE Decree, attributing profits. A number of issues arise, therefore, when using the PE Decree to attribute liabilities to a permanent establishment to determine the taxable amount for purposes of the bank tax.

The starting point under the authorized OECD approach for the attribution of funding to a permanent establishment is the allocation of free capital. Any residual funding is subsequently allocated to the permanent establishment as interest-bearing debt. The authorized OECD approach allows three approaches for allocating free capital to a permanent establishment in the banking sector.[68] The PE Decree expresses a preference for one of these three approaches, the so-called "capital allocation approach", as confirmed by the Dutch government for purposes of the bank tax.[69] Under the capital allocation approach, the enterprise's actual free capital is allocated to the permanent establishment in proportion to functions performed and risks assumed (and to a lesser extent, assets used). Compared to the other two approaches, the capital allocation approach is least likely to achieve, in the author's view, neutrality between branches and entities for bank tax purposes. Under the other two approaches, capital is allocated through a comparison with similar independent enterprises residing in the host state of the permanent establishment.

The difference between free capital and interest-bearing debt is that free capital does not give rise to a return to investors in the nature of interest that is tax deductible under the rules of the host state of the permanent establishment. Therefore, as a general rule, the attribution of funding does not take into account the various forms of funding (such as regulatory capital and guaranteed deposits). The PE Report allows that (1) regulatory capital that does not qualify as free capital be treated in the same way as free capital or (2) only actual free capital be attributed to a permanent establishment.[70] The PE Decree does not discuss this issue, however.

In view of the above, it is unclear how regulatory capital, guaranteed deposits and unsecured debt should be allocated to a permanent establishment for bank tax purposes.[71] Surprisingly, however, the Protocol to the Convention between the United Kingdom and the Federal Republic Germany for the Avoidance of Double Charging of Bank Levies[72] (the United Kingdom-Germany Bank Levy Agreement), discussed in section 4.5., also stipulates that the principles of the PE Report are applied when attributing capital and debt to a permanent establishment.

65. In addition to regulatory capital, guaranteed deposits and insurance liabilities, the balance sheet total is reduced by for example (1) sovereign repos, (2) sovereign stock-lending liabilities, (3) plant, property and equipment reserves (IAS 16), (4) current/deferred tax liabilities, (5) retirement benefit liabilities, (6) liabilities arising from the UK deposit guarantee scheme and (7) segregated client money. Furthermore, certain liabilities may be netted with certain assets, and certain high-quality liquid assets may be deducted from the taxable amount. *See* generally paragraphs 28 to 39, Schedule 19 UK Finance Act 2011.
66. Decree issued by the State Secretary for Finance on 15 January 2011 (IFZ2010/457M) in connection with (1) the OECD Report on the Attribution of Profits to the Permanent Establishments of 17 July of 2008, as amended on 22 July 2010 (the PE Report) and (2) amendments to art. 7 of the OECD Model Convention on Income and on Capital, and the OECD commentary thereto, pursuant to the PE Report.
67. As defined in *supra* n. 67.
68. The capital allocation approach, the thin capitalization approach and the quasi thin capitalization/regulatory minimum capital approach. *See* Part II, section D-1, sub (iii)(a) 2010 PE Report. The quasi thin capitalization/regulatory minimum capital approach is only allowed as a safe harbour.
69. *Kamerstukken II*, 2011/12, 33 121, No. 6, at 33 and 34.
70. *See* Part II, section D-1, sub (iii)(b) 2010 PE Report.
71. *See* also the commentary of the Dutch Association of Tax Advisers on the BTA (Part B, para. 9); and Kavelaars, *Bankenbelasting*, Weekblad fiscaal recht 6938, 121.
72. As signed in London on 7 Dec. 2011.

4.4. Tax rates[73]

In determining the amount of bank tax due, the taxable amount is divided between short-term debt and long-term debt. Short-term debt is taxed at a rate of 0.022% and long-term debt is taxed at a rate of 0.011%.

Short-term debt is debt with a term of less than one year. In the author's view, it would be fair if the original term is the decisive factor in determining whether debt is short term or long term.[74] However, the Dutch government stated that the term remaining until maturity is decisive, because (1) for accounting purposes generally the same principle is applied for making a division between short-term debt and long-term debt (i.e. compliance costs are reduced) and (2) such debt must be refinanced in the near future which exposes the bank to interest fluctuation and liquidity shortage risks.[75]

The taxable amount of short-term debt is determined as the full taxable amount multiplied by the fraction A/B, wherein A represents the aggregate amount of short-term debt and B represents the aggregate amount of all debt as derived from the balance sheet.[76] Any taxable amount remaining is considered long-term debt.

The objective of the higher rate for short-term debt is to discourage banks from taking risks, and to improve financial stability. Loans taken up by banks generally have a shorter term than the investments financed with the proceeds of these loans. The interest rate on short-term loans is generally lower than the interest rate on long-term loans, which allows a bank to take advantage of the interest rate yield curve. However, short-term loans need to be refinanced frequently, which may create problems when interest rates rise, or in times of liquidity shortage. Taking up long-term loans instead of short-term loans could reduce risks, but it may, in certain circumstances, be more risky to take up long-term loans instead of short-term loans,[77] for example if short-term credit has been extended and the interest rate falls. In response, the Dutch government stated that it wishes to create an incentive across the board to take up long-term loans, with a reference to the UK bank levy, which has a similar rate system. However, as mentioned above, the UK bank levy has sophisticated rules to determine the taxable amount. For example the UK bank levy allows netting liabilities with assets under certain circumstances. The difference in rates strengthens the author's view that additional rules must be instituted to determine the taxable amount for bank tax purposes.

In addition, a sufficient incentive for taking up long-term debt rather than short-term debt may already be provided by CRD IV, which contains measures for managing liquidity and leverage risks. CRD IV proposes introducing a Liquidity Coverage Ratio in 2015, in order to improve the short-term resilience of the risk profile of financial institutions. Furthermore, as part of CRD IV, the European Commission is considering proposing a Net Stable Funding Ratio in 2018, in order to address funding problems arising from asset-liability mismatches. Finally, CRD IV proposes introducing a (non-risk based) Leverage Ratio which would become binding in 2018, in order to discourage excessive leverage.[78] In view of these measures, in particular the Net Stable Funding Ratio, the differing rates for short-term debt and long-term debt might be unnecessary, and could even affect the balance that CRD IV would create.

The introduction of a bank tax is intended to discourage banks from taking risks, and includes a particular disincentive for bonus payments to directors. The tax rates are multiplied by 1.05 if any director receives a variable remuneration over the relevant financial year that exceeds its fixed remuneration over that same financial year. This "surcharge" is based on the Dutch Banking Code,[79] but applies to any (Dutch or non-Dutch) taxpayer for purposes of the bank tax. The Banking Code does not extend to variable remuneration of employees (only directors); the tax rates are not multiplied if an employee receives a variable remuneration that exceeds his or her fixed remuneration. The Dutch government trusts nonetheless that the surcharge will, in practice, influence the remuneration of employees.[80] The exclusion of employees was identified, in a report on the implementation of the Dutch Banking Code, as a point of attention for future monitoring.[81] It may not be excluded therefore that such future monitoring could result in an amendment of the Dutch Banking Code and a corresponding amendment of the Bank Tax Act.

4.5. Avoidance of international double bank taxation

Existing treaties for the avoidance of double taxation do not cover bank taxes, and the legislative proposal does not include double bank taxation relief either. The Dutch government has acknowledged that double bank taxation may arise, and that additional legislation is required.[82] The Dutch government intends that double bank taxation relief be provided from the date the Bank Tax Act enters into force.[83] The Dutch government has approached several EU member states to discuss entering into a bilateral agreement for the avoidance of double bank taxa-

73. Art. 10 BTA.
74. *See* also the commentary of the Dutch Association of Tax Advisers on the BTA (Part B, para. 12); Kavelaars, *Bankenbelasting*, Weekblad fiscaal recht 6938, at 122.
75. *Kamerstukken II*, 2011/12, 33 121, No. 6, at 8.
76. "All debt" includes guaranteed deposits. *See* also *Kamerstukken II*, 2011/12, 33 121, No. 6, at 34. This is beneficial to taxpayers because it increases (only) the denominator and thus decreases the amount of short-term debt.
77. *See* also the advice rendered by the Dutch Council of State (*Kamerstukken II*, 2011/12, 33 121, No. 4, at 6).
78. COM(2011) 452 final, Explanatory Memorandum, at 6-7.
79. Para. 6.4.2 Dutch Banking Code (*Code Banken*), *Staatscourant* No. 20060, 23 Dec. 2009.
80. *Kamerstukken II*, 2011/12, 33 121, No. 4, at 7.
81. *Rapportage Implementatie Code Banken* by the *Monitoring Commissie Code Banken*, Dec. 2011, at 27. The report concludes that all directors of the large Dutch banks currently receive a variable remuneration that is less than their fixed remuneration. However, approximately 600 employees of Dutch banks do not. Out of these 600 employees, 200 are based in the Netherlands. The Dutch Minister of Finance expressed his support for further monitoring of the situation (*Kamerbrief*, 20 Oct. 2011, FM/2011/9075M, at 12).
82. *Kamerstukken II*, 2011/12, 33 121, No. 3, at 8-9.
83. *Kamerstukken II*, 2011/12, 33 121, No. 4, at 11.

tion. Furthermore, the Dutch government announced that provisions to avoid double bank taxation will be added to the Dutch unilateral regulation for the avoidance of double taxation (*Besluit voorkoming dubbele belasting 2001*).[84]

In attributing taxing rights among states, the Netherlands intends to adhere to the principle that the state where the parent company of the banking group is located, is assigned primary taxing rights. Under this principle, the state in which a branch office or bank subsidiary is located, is restricted in imposing its bank tax (whereas, for corporate income tax purposes, such a state is generally granted primary taxing rights under tax treaties). In view hereof, the unilateral rules for the avoidance of double bank taxation would only apply to Dutch branch offices and subsidiaries of non-Dutch banking groups.

The author generally concurs with the principle that the state where the parent company of the banking group is located, is assigned primary taxing rights: first, because the state where the parent company of the banking group resides is generally the state granting government support in times of crisis;[85] secondly, because this makes the bank tax less prone to migration of activities from the Netherlands to foreign branch offices or subsidiaries. This approach furthermore corresponds, for permanent establishments in other EU Member States, with the approach taken in the proposed EU Directive on Deposit Guarantee Schemes (*see* section 2.2.).[86]

On 7 December 2011, the United Kingdom-Germany Bank Levy Agreement was signed. This agreement contains the following provisions for eliminating double bank levies.[87] In the case of Germany, (1) the UK bank levy allocable to a German subsidiary of a UK bank is allowed as a credit against the German bank levy and (2) a German branch office of a UK bank is exempt from German bank levy. In the case of the United Kingdom, (1) the German bank levy allocable to a UK subsidiary of a German bank is allowed as a credit against the UK bank levy and (2) the German bank levy on a UK permanent establishment of a German bank is also allowed as a credit against the UK bank levy. The approach taken in this agreement, therefore, adheres to the principle that the state of residence of the parent company of the banking group is granted primary taxing rights.

4.6. Miscellaneous

The author considers it likely that entities that qualify as taxpayers under the general rule, or, if applicable, the special group rules, will be invited by the Dutch tax authorities to file a bank tax return, even if their taxable amount is nil.[88]

As a general rule, bank tax is due on the first day of the tenth month following the end of the financial year in question. The amount of bank tax due must be paid within one month of the due date.[89] The Dutch government intends that the Bank Tax Act will enter into force in the middle of 2012. The choice for a due date at the first day of the tenth month following the end of the financial year in question would facilitate that bank tax will, effectively, be levied over 2011 (or, if the financial year is not equal to the calendar year, a financial year that ended in the nine months prior to the date of entry into force). The Bank Tax Act would thus, in the author's view, have retroactive effect.[90]

A governmental decree may implement regulations pursuant to which the Dutch tax authorities can allow taxpayers to determine the taxable amount in a currency other than euro.[91] It is unclear, however, what the benefits of such an election would be. If a taxpayer draws up its financial statements in a currency other than euro and elects to determine its taxable amount in that other currency, it would still be obliged to pay the bank tax in euro around the tenth month following the end of the financial year, and thus run currency risks.[92]

Any bank tax due is not allowed to be deducted in determining the taxable profits for Dutch corporation tax (*vennootschapsbelasting*) purposes,[93] contrary to certain EU Member States that have introduced a bank tax (e.g. France).

5. Conclusion

Whether one supports or opposes the introduction of a bank tax in the Netherlands, it cannot be denied that the legislative proposal has loose ends. On the one hand, elements of the proposed bank tax have been copied from the UK bank levy, seemingly without (fully) analysing what consequences these elements would have on the Dutch banking sector. On the other hand, certain elements of the UK bank levy have been omitted, likely to keep the proposed bank tax simple. However, in the author's opinion, this simplicity comes at the expense of the quality of the legislation.

The author finds the explanations provided by the Dutch government as to why each of the preconditions for introducing a bank tax is met unconvincing. The lack of international coordination may create issues that are not easy to

84. *Kamerstukken II*, 2011/12, 33 121, No. 6, at 26.
85. *See* also *Kamerstukken II*, 2011/12, 33 121, No. 6, at 27. However, as the Dutch government's guarantee to provide government support is only an implicit one, other states may not be willing to accept the primary taxing right of the Netherlands.
86. *See* also *supra* n. 18.
87. Art. 7 United Kingdom-Germany Bank Levy Agreement.
88. The editorial staff of *Vakstudie Nieuws* holds the view that taxpayers with a taxable amount of nil should not be invited to file, and should thus not need to file, a tax return (V-N 2012/3.3, at 15). A statement made by the Dutch government in parliamentary documents could also point in that direction (*Kamerstukken II*, 2011/12, 33 121, No. 6, at 24).
89. Art. 11 BTA in conjunction with art. 19, para. 3 General Taxes Act (*Algemene wet inzake rijksbelastingen*).
90. The Dutch government takes the position, however, that the Bank Tax Act would not have retroactive effect because the due date lies after the entry into force date (*Kamerstukken II*, 2011/12, 33 121, No. 6, at 31).
91. Art. 13 BTA.
92. The Dutch government admitted that this functional currency election has limited benefits (*Kamerstukken II*, 2011/12, 33 121, No. 6, at 34).
93. Art. 14 BTA.

resolve, such as double bank taxation and migration of activities. The overlapping measures and the negative impact on the extension of credit by banks have been designated by the Dutch government as two separate preconditions, but one likely impacts the other. Banks are confronted with several measures, each targeting a different aspect of the banking business, but taken together these are likely to have a substantial negative impact on the extension of credit.

Finally, the proposed bank tax includes certain incentives that may conflict with incentives created by other measures (e.g. CRD IV). Introducing these incentives via a bank tax may result in either (1) not achieving the objectives or (2) upending the balance created by these other measures. In the author's opinion, further research on the effects that all measures, introduced or proposed, might have on the banking sector, both separately and in combination, is needed to consider the true merits of a bank tax.

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New Upstream Loan Rules: Policy Issues and Unexpected Applications

In August, 2011 the Canadian Department of Finance released draft legislation amending Canada's foreign affiliate rules. This article reviews the proposed amendments relating to upstream loans and how they fit within Canada's foreign affiliate system, discusses issues that have been identified with the Proposed Amendments and Finance's comments on some of these issues, and considers the policy rationale behind, and possible consequences of, the proposed amendments.

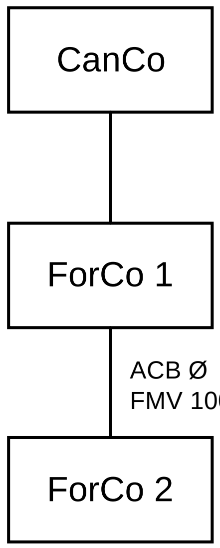
1. Introduction

In August 2011 the Canadian Department of Finance (Finance) released draft legislation amending Canada's foreign affiliate rules. These rules have been in a state of uncertainty for a number of years, with alternative amendments proposed to address various perceived deficiencies. This latest package of amendments is the most significant set of proposals since 2004 and contains some surprising changes, including rules that address so-called "upstream loans" from a foreign affiliate to a Canadian corporate shareholder. This article will (1) review the proposed amendments relating to upstream loans (the Proposed Amendments) and how they fit within Canada's foreign affiliate system, (2) discuss issues that have been identified with the Proposed Amendments and Finance's comments on some of these issues and (3) consider the policy rationale behind, and possible consequences of, the Proposed Amendments.

The Canadian rules for taxing the earnings of foreign affiliates and controlled foreign affiliates of Canadian corporate taxpayers incorporate aspects of accrual, credit and exemption systems. Most passive income earned by a controlled foreign affiliate of a Canadian corporation is included in income of the corporation in the year it accrues (such income is called "foreign accrual property income" or "FAPI"), whereas active business income earned by a foreign affiliate or controlled foreign affiliate is subject to Canadian tax only when repatriated. Certain passive income received by a foreign affiliate is treated as active business income if the passive income is deductible in computing the active business income of another foreign affiliate. On repatriation, dividends that are paid to the Canadian corporate shareholder from active business income earned or deemed to be earned by the foreign affiliate in countries with which Canada has a tax treaty or a tax information exchange agreement (exempt surplus) are exempt from Canadian tax, whereas dividends paid from business income earned in other countries or from FAPI (taxable surplus) are subject to Canadian tax with a credit for foreign tax paid (referred to as "underlying foreign tax"). Dividends not paid from exempt or taxable surplus (pre-acquisition surplus) may be received tax free, but reduce the tax cost of the shares of the foreign affiliate and may result in realization of a capital gain if the tax cost becomes negative. Prior to the introduction of the concept of "hybrid surplus", another new concept introduced in the August draft legislation, capital gains realized by a foreign affiliate on the disposition of property were divided with 50% of the gain allocated to exempt surplus and 50% to taxable surplus (including FAPI), depending on the type of property. Such division reflects the fact that only 50% of a capital gain realized by a Canadian resident taxpayer is taxable.

As a simple example, assume that CanCo, a company resident in Canada, has a wholly owned subsidiary, ForCo 1, which is resident in a country with which Canada has a tax treaty or a tax information exchange agreement (Country X). ForCo 1 owns all of the shares of ForCo 2, a company resident in Country X whose shares are considered exempt property. The ForCo 2 shares have an adjusted cost base of nil. The beginning structure is shown in Figure 1.

Figure 1



During a taxation year, ForCo 1 earns active business income of CAD 100 from an active business carried on in Country X and CAD 100 of passive investment income. Assuming its surplus balances were nil at the start of the year, Figure 2 shows the result at the end of the year:

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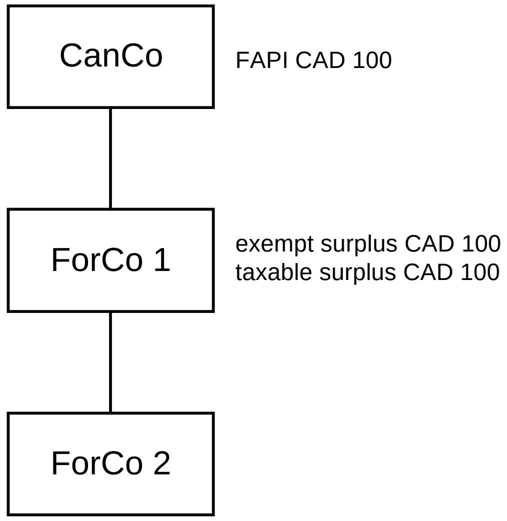
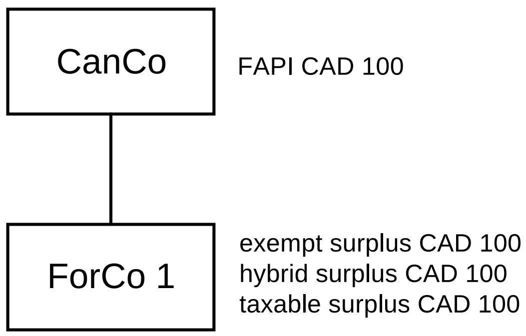
Figure 2



The CAD 100 of active business income earned by ForCo 1 is added to its exempt surplus and may be repatriated to CanCo free of Canadian tax. The CAD 100 of passive investment income is considered FAPI and included in CanCo's income for Canadian tax purposes for the current taxation year. This amount of FAPI is also added to ForCo 1's taxable surplus, but may be repatriated free of additional Canadian tax. Now assume that ForCo 1 also disposes of all of its shares of ForCo 2 for CAD 100.

Figure 3



ForCo 1 will realize a CAD 100 capital gain on the sale of the shares of ForCo 2. Prior to the August 2011 amendments, one half of this gain would have been included in exempt surplus and one half in taxable surplus. However, assuming that the August 2011 amendments are passed into law, the entire amount of the gain will now be included in hybrid surplus and must be repatriated at the same time, although one half of such gain will be exempt from Canadian tax. ForCo 1 will still be able to repatriate its exempt surplus (and, by making an election, its taxable surplus) prior to repatriating its hybrid surplus.

Prior to the Proposed Amendments, a foreign affiliate could make a bona fide loan to a Canadian corporate shareholder, instead of paying a dividend from taxable surplus that would be subject to tax in Canada as a result of insufficient underlying foreign tax, without any adverse Canadian tax consequences. After the Canada Revenue Agency (CRA) issued tax rulings on this type of planning in the late 1990s,[1] it became common practice to make upstream loans of taxable surplus that was not supported by sufficient underlying foreign tax. This type of loan structure was also used to avoid foreign withholding tax on dividends and in situations where foreign tax or commercial law considerations prevented the payment of dividends. The Proposed Amendments are an unexpected change to this long established practice.

2. The Proposed Rules

2.1. General overview

The Proposed Amendments are modelled on the domestic shareholder loan rules[2] which generally require a shareholder other than a Canadian corporation to include in income the amount of any loan received from a corporation if the loan is not repaid within one year after the end of the shareholder's taxation year in which the loan was made. Given that the concept underlying the Proposed Amendments is that the loan is a dividend substitute, the amount of the loan included in income is pro-rated based on the shareholder's "surplus entitlement percentage", which is a rough measure of the shareholder's interest in the surplus of the affiliate. References to loan amounts hereinafter refer to the pro-rated amounts. Proposed section 90(4) to (10) will generally include the amount of a loan or indebtedness owing to a foreign affiliate of a Canadian corporation by a "specified debtor" (described in section 2.2. below) in the income of the corporation, unless one of three exceptions applies:

– the first exception, contained in section 90(5)(a), will apply where the loan or indebtedness is repaid within two years of the date on which the loan was made or the indebtedness incurred. Existing loans and indebtedness are deemed to have been made or incurred on 19 August 2011 (the day the Proposed Amendments were announced) so that they can benefit from a limited two-year grandfathering. Such loans will qualify for the section 90(5)(a) exception if they are repaid before 19 August 2013;
– the second exception, contained in section 90(5)(b), will apply where indebtedness arises in the ordinary course of the creditor's business or a loan is made in the ordinary course of the creditor's business of lending money; or
– the third exception, contained in section 90(6), generally will apply where, at the time the loan is made or the indebtedness incurred, the foreign affiliate could have paid a dividend equal to the amount of the loan that would have been exempt from Canadian tax because the foreign affiliate either had sufficient exempt surplus or sufficient underlying foreign tax to support a payment of the dividend from taxable surplus without the imposition of Canadian tax.

1. *See* CRA documents 9807063 (17 Dec. 1998), 9826443 (1 Sep. 1999) and 9830143 (12 Oct. 1999).

2. Sec. 15(2) Income Tax Act (Canada). Other statutory references in this article are to the Income Tax Act as it would be amended by the Proposed Amendments.

2.2. Issues[3]

The Proposed Amendments will apply to loans or indebtedness made or incurred before 19 August 2011. The limited two-year grandfathering period has been criticized, particularly as such arrangements were entered into based on published CRA tax rulings. It may be difficult, or even impossible, for taxpayers to repay such loans and indebtedness within the two-year period. Moreover, even where repayment is possible, it could lead to negative Canadian or foreign tax or commercial consequences. In some cases, taxpayers may have made long-term commitments of capital and will simply not have the available cash necessary for repayment within the two year time frame. The terms of a loan may not permit early repayment or may provide for early repayment penalties. In addition, the Canadian tax treatment of foreign exchange gains and losses realized on repayment of foreign currency denominated debt will need to be considered. Finance has received submissions on this issue recommending that pre-existing loans be grandfathered and that the two-year grace period be extended to five years, but has not yet provided any indication of its willingness to address this issue.

Another key issue is the extremely broad definition of a "specified debtor", which includes the Canadian taxpayer and any person that does not deal at arm's length with the Canadian taxpayer, with the exception of controlled foreign affiliates of the taxpayer. A specified debtor is not limited to Canadian resident entities, so loans from a foreign affiliate to a non-resident corporation that is not a controlled foreign affiliate of the Canadian taxpayer could be caught. The policy rationale behind the inclusion of non-Canadian entities in the definition of specified debtor is not clear (it may be aimed at indirect loans to a foreign parent of the Canadian taxpayer) and it has been suggested to Finance that the definition be amended to include only Canadian-resident entities. This is of particular concern in the context of corporate groups that use cash pooling arrangements, as loans made between non-resident entities under these arrangements may be caught by the Proposed Amendments.

There are also issues with the third exception described above. First, it does not provide relief for taxpayers that may have tax cost, known as adjusted cost base, in shares of the foreign affiliate at the time that the foreign affiliate makes the loan. This is surprising given that if a dividend had actually been paid, and the foreign affiliate had no taxable surplus, the dividend would have been treated as a pre-acquisition surplus dividend and reduced the adjusted cost base before being subject to Canadian tax. Even if the foreign affiliate had taxable surplus, an election may have been available to deem the dividend to reduce the adjusted cost base as a pre-acquisition surplus dividend before any portion of the dividend would be deemed to be paid out of taxable surplus. Second, the exception will not apply if the foreign affiliate pays a dividend while the loan is outstanding, regardless of whether there is enough surplus available to cover both the loan and the dividend. Finance has indicated that it is considering providing relief in this second circumstance.

3. Practical Effect of the Proposed Amendments

One of the more interesting issues with respect to the Proposed Amendments is what will be the actual effect of the Proposed Amendments. Given that certain upstream loans circumvent the apparent scheme of the taxable surplus rules, and always have, it is not surprising that this type of planning was raised as an issue long before now.[4] Finance and the CRA were aware that such planning was commonplace, as evidenced by the rulings issued by the CRA. The acceptance of upstream loan planning may have reflected the practical reality that corporations would simply choose not to repatriate such foreign earnings if they would be subject to Canadian tax, meaning the domestic economy misses out on capital that may have been invested in Canada. This is a universal problem with respect to credit systems, and is not unique to Canada.[5] The 2008 Final Report of the Advisory Panel on Canada's System of International Taxation (the 2008 Report) considered the fact that very little taxable surplus is actually repatriated to Canada as a factor in its decision to recommend that Canada move to a full exemption system for active business income earned by foreign affiliates.[6] Taxable surplus has not generated substantial tax revenue, and it may be that the Proposed Amendments will not increase tax revenue by a significant amount.

With Canada's extensive treaty network and new policy towards tax information exchange agreements,[7] the majority of foreign affiliate active business income is exempt surplus and most passive income is taxed under the FAPI regime, leaving little in the way of taxable surplus, at least with respect to current activities of foreign affiliates. In fact, excluding FAPI of controlled foreign affiliates, taxable surplus now mainly consists of the FAPI of non-controlled foreign affiliates and the taxable portion of capital gains realized from dispositions of excluded property. Excluded property includes shares

3. Other issues that have been identified with the proposed upstream loan rules are described in S. Wong and K. Kjellander, *The Proposed Upstream Loan Rules – Traps and Anomalies*, Corporate Finance (Federated Press) (forthcoming); D. Bunns & S. Slaats, *A Critique of Proposed Subsections 90(4) to (10)*, XVII International Tax Planning 1 (Federated Press, 2011); and N. Boidman, *Canadian Foreign Affiliate Proposals Will Affect US Operations*, 40 Tax Management International Journal 12 (BNA, 9 Dec. 2011). *See* also the submissions made to the Department of Finance on the Proposed Amendments by the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants (available online at http://www.cba.org/cba/submissions/PDF/11-48-eng.pdf) and the Tax Executives Institutes (available online at http://www.tei.org/news/Pages/Proposed-Foreign-Affiliate-Legislation.aspx).

4. The 1992 Auditor General's report mentioned upstream loan planning at para. 2.49.

5. *See* Boidman, *supra* n. 3, for an interesting comparison of the US and Canadian experiences with this issue.

6. Advisory Panel on Canada's System of International Taxation, *Final Report: Enhancing Canada's International Tax Advantage* (Ottawa: Department of Finance, Dec. 2008), 25-26.

7. In 2008, the government began exempting active business income earned in countries with which a tax information exchange agreement had entered into force. The more such agreements the government enters into, the closer Canada comes to having a complete exemption system with respect to active business income of foreign affiliates.

of a foreign affiliate that carries on an active business, however, capital gains on the disposition of such shares will be classified as hybrid surplus (discussed above and below) under the August 2011 draft legislation and will no longer create taxable surplus.

The Explanatory Notes issued with the Proposed Amendments state that their purpose is "to protect the integrity of the existing taxable surplus and the new hybrid surplus regimes". The hybrid surplus regime, introduced in the August draft legislation, establishes a new category of surplus that will include capital gains realized on dispositions of certain property. The hybrid surplus system will prevent the repatriation of the non-taxable half of such capital gains (which was previously included in exempt surplus) without the repatriation of the taxable half (which was previously included in taxable surplus). The Proposed Amendments prevent the avoidance of this new hybrid surplus system.

Considering Canada's recent moves toward a broader exemption system with respect to active business income (by way of its policy permitting exempt surplus to be earned in countries entering into a tax information exchange agreement with Canada) and the recommendations of the 2008 Panel that Canada adopt a complete exemption system with respect to active business income and capital gains, the tightening of the taxable surplus system is surprising.

As noted previously, it is unlikely that taxable surplus having a low rate of underlying foreign tax will be repatriated to Canada. Consequently the Proposed Amendments are more likely to act as anti-avoidance rules preventing circumvention of the hybrid surplus rules, as opposed to rules meant to generate tax revenue by encouraging the repatriation of taxable surplus. Of course, it may be unlikely that hybrid surplus with a low rate of underlying foreign tax will be repatriated to Canada in any event.

4. Conclusion

The introduction of changes in tax policy without prior consultation has been a feature of the Canadian fiscal environment for many years.[8] Such practice does little to allay taxpayers' frustration with the legislative process, particularly, as in the case of the Proposed Amendments, where the amendments change established CRA policy and have retrospective effect on existing loans. The news release issued with the Proposed Amendments states that "[t]he Government remains committed to continuing its review and analysis of all of the [2008] Panel's recommendations and consideration of further legislative amendments".[9] It remains to be seen whether more of the Panel's recommendations will be implemented.

Corporate groups with foreign affiliates of Canadian corporations should review existing loans made by, and indebtedness owing to, such foreign affiliates in order to determine if such loans or indebtedness will be subject to the proposed upstream loan rules, and consider alternative financing arrangements for the future. It is hoped that the issues that have been described here and elsewhere will be addressed by Finance before the upstream loan proposals are enacted.

8. Previous examples include the 2007 introduction of rules denying the deductibility of interest on funds borrowed to invest in foreign affiliates (subsequently repealed before they took effect) and the 2006 introduction of rules relating to the taxation of income trusts.
9. News Release 2011-070, *Government of Canada Releases Draft Foreign Affiliate Rules* (Ottawa, 19 Aug. 2011).

Barry Larking*

Overview of National Taxation of the Financial Sector

The author presents an overview of past and present practices in various countries and in the European Union with regard to the taxation of financial transactions, with a focus on financial transaction taxes, financial activities taxes and bank levies.

1. Introduction

The difficulty of drawing up a reliable account of different countries' tax systems is exemplified in the European Commission's 758-page report on current country practices in taxing the financial sector,[1] which was issued together with their financial transaction tax proposal,[2] where the Commission states that "the answers received in the questionnaires are high-level and not exhaustive". This article presents an overview not only of current but also past practices that may be of some practical relevance in evaluating the current developments in this area. It will be no surprise that this account does not aim to be exhaustive, and at times may also be somewhat high level. Nevertheless, it is hoped that it will provide some useful context to the current discussion and, perhaps also help formulate opinions and ideas on the subject.[3]

This article will focus on the three taxes that have been the subject of most public debate since the financial sector crisis, namely the financial transaction tax, the financial activities tax and bank levies. As will be seen below, these concepts are not set in stone and there can be many variations within one tax type as well as overlaps between the different types. Before addressing the country practices and experience with these taxes, it may be helpful to describe what might be covered by these taxes. This article will introduce the concept of financial sector taxes, set forth a brief outline of three topical financial sector taxes and provide more detail on these three types of tax in the context of different countries' experiences of applying them.

2. Variations on a Theme

One of the problems in talking about taxation of the financial sector is to define what is meant by "taxation". Much confusion has already been caused by a failure to apply "labels" consistently to identify the different forms of "taxation". This is most apparent for one of the most "popular" instruments currently mentioned in this context, which the European Commission (and some countries such as the United Kingdom) tends to refer to as "bank levies", but has also been described as a "financial sector contribution" (IMF), a "financial crisis responsibility fee" (United States) or "bank tax" (e.g. the Netherlands). The particular label chosen by a country may reflect the socio-economic purpose behind the instrument, such as in the case of the US fee, or in some cases, the idea that "while a tax is usually defined as a payment which is directed to the general budget without any equivalent given, a levy is usually associated with the payment entitles [sic] the payer to receive some equivalent for the levy".[4] The significance of this will become apparent further below. At the risk of adding to the confusion, but for the sake of simplicity, this article will in general use the term "tax" to cover the above.

While a survey of financial sector taxation should for completeness include both direct and indirect taxes, in practice the current public debate tends to focus on indirect taxes rather than financial sector taxation within traditional direct tax systems. This still leaves plenty of scope for variety, as the following list demonstrates:
- financial transaction tax;
- securities transaction tax (stamp duty, registration duty);
- currency transaction tax (so-called "Tobin tax");
- capital levy/duty;
- bank transaction tax;

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1. *Review of current practices for taxation of financial instruments, profits and remuneration of the financial sector*, European Commission, Impact Assessment, vol. 4, SEC(2011) 1102 final.
2. Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC, COM(2011) 594 final.
3. Any attempt at providing a global overview of any kind of tax is dependent on the reliability and consistency of the source materials and the conventions they use, including definitions. The overview in this article is limited to publicly available current and historical sources. These do not necessarily follow the same conventions and are not always consistent. Moreover, the global position is constantly shifting as countries introduce, revise, and repeal such taxes. It should accordingly be read as it is intended to be read: to give a general impression and identify common themes and issues rather than as a comprehensive scientific or academic treatise. The main sources used for this article are as follows: *Impact Assessment accompanying the proposed financial transaction directive*, European Commission, SEC(2011) 1102 final, especially volumes 1 and 4; *Financial sector taxation* accompanying Commission Communication *Taxation of the Financial Sector*, SEC(2010) 1166; *Taxing financial transactions: issues and evidence*, Thornton Matheson, IMF WP/11/54 (2011); *Taxing financial transactions: an assessment of administrative feasibility*, John D. Brondolo, IMF, WP/11/185 (2011); *Financial sector taxation: The IMF's report to the G-20 and background material*, IMF, September 2010; *A Financial transaction tax for Europe*, Cortez and Vogel, EC Tax Review 2011-1.
4. *Monitoring tax revenues and tax reforms in EU Member States 2010*, European Commission, Working Paper No. 24 (2010), at 59.

- insurance premium tax;
- financial activities tax;
- bank payroll tax;
- bank levy/financial sector/stability contribution/ financial crisis responsibility fee;
- deposit guarantee levy; and
- VAT.

3. Focus on Three Financial Sector Taxes

3.1. Financial transaction tax

As the European Commission points out, the financial transaction tax can better be described as a "group of taxes", sharing a common root, i.e. "the taxing of trading in financial instruments such as shares and bonds and of trading in derivatives thereof".[5] Interestingly, the Commission's financial transaction tax proposal would include not only derivatives of financial instruments but also currency and commodity derivatives, even though the trading of the underlying would not be covered by the tax. The IMF distinguishes a number of related taxes that may be described as financial transaction taxes.[6] These include a securities transaction tax that is described as a tax on trades in all or certain types of securities (equity, debt and their derivatives), possibly including original issuance, a currency transaction tax, being a tax imposed specifically on foreign exchange transactions and possibly their derivatives, and a bank transaction tax imposed on deposits and/or withdrawals from bank accounts. Views seem to differ as regards whether and how original issuance of securities should be taxed. Although the Commission suggests that a distinction should be drawn between securities transaction taxes and capital duties, the Commission does not elaborate on this.[7] The IMF takes the position that a securities transaction tax could possibly include original issuance,[8] whereas the Commission's financial transaction tax proposal would exclude primary market transactions (other than issue and redemption of UCITS and shares in alternative investment funds).

Incidentally, although the financial transaction tax that has been the subject of much recent public debate is often referred to as a "Tobin tax", this term is more properly used in relation to the currency transaction tax, as it was the proposal for such a tax that is commonly attributed to the late Professor Tobin from which the term derives its name. Financial transaction taxes are sometimes popularly referred to as "Robin Hood taxes", in recognition of their potential capacity for economic redistribution.

Apart from the subject matter of this kind of tax, variations are also possible as regards rates and personal scope. In practice, financial transaction tax rates are generally low, a matter of a few basis points and charged on an ad valorem basis. Differentiated rates can also apply. While financial transaction taxes are generally "aimed" at the financial sector, and therefore typically apply to financial institutions, in some cases they are not so limited. It should also be noted that nominal differences such as the identity of the party liable to the tax do not necessarily reflect the actual incidence of the tax, which may, in practice, be passed on to third parties, such as customers or shareholders, or even be dealt with in the same way as a withholding tax. No doubt it was with this in mind that the European Commission in its above-mentioned survey formulated the question on liability in terms of not only who is liable for levying the tax, but also who is liable to support the tax. Financial transaction taxes may also be subject to jurisdictional limitations as regards either the persons involved or the subject matter of the transaction. These differences will be examined in more detail further below.

3.2. Financial activities tax

A financial activities tax may in broad terms be described as a tax on the sum of profit and remuneration of financial institutions. However, like the financial transaction tax, the financial activities tax also comes in a number of different varieties. The IMF identifies three main types, namely a tax on "rents" (broadly high remuneration and above-normal profits, also referred to as the "rent taxing" financial activities tax), a tax on excessive returns (also referred to as the "risk-taking" financial activities tax, in view of its ability to mitigate risk taking) and a tax on all profits and remuneration (also referred to as the "addition" financial activities tax). Because the latter effectively taxes value added, it is often viewed as a solution to perceived under-taxation of businesses, such as those in the financial sector, which are exempt from VAT. A variation on the theme of the rent-taxing financial activities tax, is a tax on bonuses, in view of the perceived correlation between excessive profits and managers' high bonuses. Country examples of such taxes will be outlined further below. Although the financial activities tax, unlike VAT, is not deductible by a business' customers, the IMF points out a similar relationship between the financial transaction tax and financial activities tax on the one hand, and turnover taxes and VAT on the other, in the sense that financial transaction tax taxes gross transactions, whereas a financial activities tax taxes net transactions.[9] This is of particular note given the above-mentioned use of financial activities taxes to rectify the VAT exemption generally applicable to the financial sector.

3.3. Bank levies

The IMF describes bank levies (or, in IMF terminology, a financial stability contribution) as a levy to pay for the fiscal cost of any future government support to the sector. In practice, countries differ as regards the financing purpose of the levy, which may indeed be focused on the future, but, as in the United States, instead be designed

5. *Instruments for the taxation of the financial sector*, European Commission, Impact Assessment , vol. 1, SEC(2011) 1102 final.
6. *Taxing financial transactions: issues and evidence*, Thornton Matheson, IMF WP/11/54 (2011).
7. *Review of current practices for taxation of financial instruments, profits and remuneration of the financial sector*, European Commission, Impact Assessment , vol. 4, SEC(2011) 1102 final.
8. *Taxing financial transactions: issues and evidence*, Thornton Matheson, IMF WP/11/54 (2011).
9. *A fair and substantial contribution by the financial sector – final report for the G-20*, IMF (June 2010).

to recoup expenditure already incurred. In most cases, however, such levies are aimed generally at ensuring financial stability and reducing the risk of future financial sector crises. Such levies are therefore mostly aimed at taxing leverage, which is seen as a major risk indicator. Typically, this means that the tax base consists of adjusted balance sheet positions, most commonly on the liabilities side but sometimes on the assets side. Whilst such levies are typically associated with some form of "resolution mechanism", practice differs as to whether this implies a direct link between the revenue from the levy and a "resolution fund" (e.g. Sweden, whose government raised the idea of such a levy at EU level in early 2010)[10] or whether the revenue generated flows into the general budget (e.g. the United Kingdom). This link is probably the main reason for many countries to use the term "levy" (or its local language equivalent) rather than "tax" to describe this kind of instrument, as it implies that there is some "equivalent" in return for the payment. As in the case of the financial transaction tax, there are numerous variations on the bank levy theme in practice, notably as regards the personal scope, such as the definition of a bank, the jurisdictional scope, the tax base and the tax rates. Again, these differences will be examined in more detail further below.

4. Country Experience

Having laid out the groundwork on financial sector taxation, the discussion will now turn to how countries have approached these three main types of tax. As already indicated, although current practice is informative, valuable lessons can be learned from countries' past experiences with these taxes.

4.1. Financial transaction taxes

4.1.1. Country practice, past and present

4.1.1.1. Generally

Despite the recent interest in financial transaction taxes, they are not new. The United States even introduced such a tax back in 1914 and managed to retain this for more than 50 years! Even within the European Union there are already nine Member States applying such a tax on share trades: Belgium, Cyprus, Finland, France, Greece, Ireland, Poland, Romania and the United Kingdom. Within the G-20 there are another five (excluding the United Kingdom) that apply such a tax: China,[11] India, Indonesia, South Africa, South Korea and a further four outside the G-20: Hong Kong, Singapore, Switzerland and Taiwan. Most countries limit their taxes to share trades. A small number of countries also tax bond trades (Switzerland),[12] while others would tax bond issuance (Chile, Russia and Turkey). Financial transaction taxes on derivatives are generally less common, but also exist (Belgium, Greece, India, Taiwan and the United Kingdom).

Having said that, there is also evidence that financial transaction taxes are not popular, as the following historical account demonstrates:[13]

- 1966: United States abolished securities transaction tax (introduced 1914!);
- 1988: Spain abolished financial transaction tax;
- 1990: Netherlands abolished securities transaction tax;
- 1991: Sweden abolished remaining securities transaction taxes;
- 1991: Germany abolished securities transaction tax;
- 1992: Germany abolished capital duty;
- 1999: Denmark abolished financial transaction tax;
- 1999: Japan abolished securities transaction tax;
- 2001: Australia abolished securities transaction tax;
- 2001: Austria abolished securities transaction tax;
- 2006: EU Commission recommended abolition of all capital duties;
- 2008: France abolished securities transaction tax; and
- 2008: Italy abolished securities transaction tax.

4.1.1.2. The Swedish horror story

To get an insight into some of the likely reasons for this lack of popularity, consider the "Swedish horror story".

The plot

The story begins in 1984 when popular pressure was put on the Swedish government to do something about the high level of returns in the financial sector (the reader will be forgiven for experiencing a certain déjà vu at this point). The government responded by introducing a financial transaction tax (popularly known as the "puppy tax" or "*valpskatt*" by way of reference to the highly paid "finance puppies") on share and derivative transactions carried out in Sweden using local brokerage services. A similarity with the European Union's current proposal is that this was a round-trip tax, i.e. both the buying and selling sides of the transaction were taxed. However, the rates were considerably higher than under the European Union's proposal.[14] The rate on share transactions was 0.5% (i.e. a total of 1%), while share options were taxed at a total of 2% (round trip) plus the additional 1% on exercise. Two years later, perhaps thinking they were on to a good thing, or as an act of desperation, the government raised the round-trip rate on share transactions to 2%. During the following three years there were various adjustments, generally intended to broaden its scope, including the introduction of a transfer tax on fixed-income securities. Two years later the tax was dead.

10. *Innovative financing at global level*, European Commission, Working Document, SEC(2010) 409 final.
11. *Taxing financial transactions: issues and evidence*, Thornton Matheson, IMF WP/11/54 (2011). The EU Commission concludes that there is no financial transaction tax as such in China (*Review of current practices for taxation of financial instruments, profits and remuneration of the financial sector*, European Commission, Impact Assessment , vol. 4, SEC(2011) 1102 final).
12. And Taiwan up to 2010. A seven-year exemption for trading of corporate and financial bonds issued by Taiwanese issuers or companies was introduced from 2010 (www.cepd.gov.tw).
13. Again, views may differ as regards classification of these taxes. For example, the Spanish tax was applicable to more assets than just securities.
14. Under the proposed Financial Transaction Tax Directive, the minimum rates would be 0.1% on financial transactions generally, and 0.01% on derivative transactions.

Unravelling the plot

A closer investigation into the consequences of introducing the tax reveals some clues as to why the tax was repealed. What the Swedish government had failed to anticipate was that imposing such a high levy on financial transactions created an incentive to look for alternative locations to carry out the same transactions. This, combined with the relative proximity of alternative markets, in particular in London, meant that business migrated. So given there was both motive and opportunity, the end result was more or less inevitable. It is believed that by 1986, some 60% of the trading volume in the 11 leading Swedish stocks had moved to London, and by 1990 the trading volume as whole had contracted by 50%. The impact on fixed-income securities trading was even more dramatic, with the volume falling by 85% within the first week. Obviously this contraction of the volume of trading meant that the anticipated revenue also dropped. But even before this, the anticipated revenue had not materialized. There were are a number of probable reasons for this, such as the fact that with a reduction in the number of transactions, there was a significant reduction in other taxes on transaction gains, as well as the fact that there were readily available non-taxed substitutes for the securities that were subject to the Swedish financial transaction tax.

Lessons learned

A number of tentative conclusions can be drawn from the above as regards the feasibility of a financial transaction tax:
- the rate should be low enough to minimize the incentive to relocate;[15]
- limited jurisdictional scope (e.g. Swedish brokers) combined with availability of alternative trading markets creates relocation opportunities; and
- tax base exceptions create substitute opportunities that undermine effectiveness.

4.1.2. Reasons for applying

In light of the above horror story, which has clearly not gone unnoticed by governments around the world, the question arises as to why financial transaction taxes are still applied in some countries, including some of the major financial centres. One possible answer is that a financial transaction tax is a quick, reliable and easy source of – potentially – much revenue. There are a number of reasons for this. One is that it harnesses existing infrastructures such as clearing house systems and financial institutions' own systems and records. No doubt for this reason China, India, Korea, the United States and the United Kingdom apply a financial transaction tax to exchange-traded securities.[16] Similarly, Belgium and Switzerland apply their financial transaction tax to trades carried out through local financial intermediaries. Only exceptionally, such as in the case of Greece, do financial transaction taxes appear to be extended to individuals. Another possible reason for financial transaction taxes' still being applied is the ability to apply them to a very wide base. This has the double advantage of increasing revenue while reducing the opportunities for non-taxed substitutes. But obviously, with the Swedish horror story fresh in mind, there remains the consideration of business relocation if there are suitable substitute markets available. It might be noted that in practice, financial transaction tax countries have not universally adopted this broad base policy, and various combinations are encountered, for example as follows:
- shares only: South Africa;
- shares and derivatives: Greece;
- shares and bonds: Switzerland; and
- shares, bonds and derivatives: Belgium, Romania.

4.1.3. The United Kingdom's stamp duty and the European Union's financial transaction tax proposal

If Sweden's financial transaction tax was such a disaster, why has the United Kingdom's stamp duty – which at the time the Swedish financial transaction tax was introduced effectively resulted in the same 1% burden – been such a success? Success for these purposes means that it has generated significant revenue[17] without apparently having had an overtly damaging effect on the UK financial markets. In fact the United Kingdom extended the scope of its stamp duty regime in 1986 by introducing stamp duty reserve tax which ensures that tax would be payable even where there was no transfer document involved, such as transactions through electronic share dealing systems. The standard rate of both taxes was also reduced to the current 0.5%. Stamp duty reserve tax is now understood to account for the majority of the revenue collected on share transactions effected through the United Kingdom's stock exchanges.

A number of factors could have contributed to the success of the United Kingdom's transaction taxes. Some could just be attributable to the sheer depth of the UK market. Another factor could be – somewhat ironically in view of Sweden's experience – the limited scope of the tax. For example the tax is in general only due on UK shares, so foreign shares traded on the London stock exchange are unaffected. Similarly, the tax does not apply to derivative transactions as such, so indirect share investments would still be possible through the use of – non-taxed – derivatives. There are a number of exemptions, notably as regards transactions between qualifying financial intermediaries transacting on a recognized market. Another important exemption is for transactions effected through a clearance system or depositary receipt system (although

15. The Commission also notes in the explanatory memorandum to its proposed Directive that "the minimum tax rates (above which there is room of manoeuvre for national policies) are proposed to be set at a level sufficiently high for the harmonisation objective of this Directive to be achieved. At the same time, the proposed rates are situated low enough so that delocalisation risks are minimised". COM(2011) 594 final.
16. It might be questioned how easy it is to harness these infrastructures in light of the United Kingdom's experience with introducing the CREST system (discussed further below), which was a huge and cumbersome exercise to put in place.
17. According to the IMF, an average of GBP 3.3 billion annually since 2000. *Taxing financial transactions: issues and evidence*, Thornton Matheson, IMF WP/11/54 (2011).

this comes with a 1.5% cost, as the duty is tripled on transfer into such systems). In addition to the limitations on scope, as noted above, there is an efficient infrastructure in place for administering stamp duty reserve tax, namely the automated transaction system of the London Stock Exchange (CREST).[18] This makes the tax difficult to avoid in practice. Although stamp duty – unlike stamp duty reserve tax – could in principle be avoided by having the transfer executed outside the United Kingdom, an interesting "self-enforcement" feature of the stamp duty system is that there is an incentive to pay the tax, as an owner cannot otherwise enforce its ownership rights.

Notwithstanding the apparent success of the United Kingdom's stamp duty/stamp duty reserve tax system, the United Kingdom has been prominent in its opposition to the European Commission's EU financial transaction tax proposals.[19] There are various reasons for this, both economic and political, a detailed discussion of which is outside the scope of this article. For present purposes the following comments may be of relevance. In common with other EU Member States, the United Kingdom does not favour limited introduction, i.e. without a global buy-in. The generally expressed concern here is that financial sector business would relocate to financial transaction tax-free jurisdictions. The wider scope of the EU financial transaction tax than the United Kingdom's stamp duty/stamp duty reserve tax would obviously be a factor here, although there is still a significant rate differential between the two.[20] There is also public debate as to whether the financial transaction tax would in fact achieve its economic objectives.[21] Another likely concern for the UK government would be the fact that it would have to give up its current taxing regime – and the revenue it produces – in favour of the financial transaction tax. If the financial transaction tax revenue flows into the EU budget, that would mean an absolute loss to the UK budget. The Commission is currently pushing for a least part of the financial transaction tax revenue to be used as an "own resource", but this issue has still to be debated, as has the question, if some of the revenue were to be shared between Member States, on what basis this would be done.[22]

4.1.4. Connecting factors

It will already be apparent from the above that the choice of connecting factor in the design of a financial transaction tax can be crucial to its success or failure, or at least an important factor as regards its impact on the local financial sector. For example a key weakness of the Swedish financial transaction tax was that it applied only to transactions through Swedish intermediaries. Conversely, the ring-fencing of the United Kingdom's stamp duty to UK shares may have helped limit damage to London's financial sector. Similar examples can be found in the financial transaction tax systems of other countries. For example the Swiss financial transaction tax is chargeable if one of the parties or intermediaries is a Swiss securities dealer. The related risk of avoidance has been acknowledged by the Swiss tax authorities, but they are understood to consider that non-compliance and associated revenue loss is small and that traders are unlikely to incur the inconvenience and additional costs to avoid the tax (0.15%-0.30%). It should also be noted that the Swiss rules provide for numerous personal and transactional exemptions, and that it has been posited that these enhance the attraction of the Swiss capital market and reflect a concern as regards the relocation risk.[23] There is an obvious parallel with the UK stamp duty/stamp duty reserve tax in this regard. Belgium applies a similar connecting factor under its financial transaction tax and requires a Belgian intermediary and a transaction carried out or concluded in Belgium. However, it is perhaps not unimportant that there is a EUR 500/750 cap on each transaction.

The location of the parties can also play an important part in the design of financial transaction tax systems. For example the Belgian financial transaction tax, like the proposed EU financial transaction tax and the former Swedish financial transaction tax, in principle applies to both parties to the transaction. However, the Belgian tax would not apply as regards a non-resident party acting on its own account (the Belgian party would be liable for its own share). The location of the parties is sometimes also relevant in combination with the location of the security. Poland, for example, taxes foreign securities only if the buyer and the transaction are in Poland. Greece applies a similar rule. Finland applies an even more pragmatic rule and limits its financial transaction tax to Finnish securities – and then only where there is a Finnish buyer or seller. In contrast, although the United Kingdom's stamp duty reserve tax is limited to UK shares, it is charged irrespective of where the transaction takes place and whether or not there is a UK party.

4.1.5. Exemptions and rates

Financial transaction tax systems often contain important exemptions. Some examples have already been noted above, in particular those based on a jurisdictional factor such as the residence of the parties or the location of the security. These may be viewed in part as pragmatic measures and in part designed to protect the local financial sector. Some countries also apply exemptions that appear directly aimed at protecting the local capital markets. Some are broadly based, such as exemptions for securities traded on regulated markets and the like, applied in Finland, France and Poland. Others are more narrowly based, such

18. It appears that this is regarded as a settlement system rather than a clearance system, so the above-mentioned exemption for transfers within a clearance system do not apply. See para. 74, AG's opinion to the EU Court of Justice, *HSBC* case (C-569/07).
19. Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC, COM(2011) 594.
20. Unlike the EU financial transaction tax proposal, stamp duty/stamp duty reserve tax is payable only once per transaction, and the rate differential may in practice be further eroded through mechanisms designed to prevent cumulation.
21. The IMF in its final report for the G-20 in June 2010 concluded that "with multiple objectives to be served … an FTT is not the best instrument for these purposes".
22. *Proposal for a council regulation on the methods and procedure for making available the own resource based on the financial transaction tax*, COM(2011) 738 final.
23. Id.

as exemptions for certain market traders applied in, for example, Switzerland and the United Kingdom.

It has been noted that financial transaction taxes appear to conform to the tax policy precept of levying a low rate on a broad base, with most rates noted between 0.1% and 0.5%. Some countries in fact apply more than one rate, reflecting a number of underlying policy considerations. For example, Switzerland doubles its 0.15% tax when foreign securities are involved. India, as in the case of the EU financial transaction tax proposal, applies differentiated rates for equities and derivatives. While the United Kingdom triples its normal rate (0.5%) on shares that are transferred into a clearing or depositary receipt system, the resulting 1.5% operates as an effective "passport" for tax-free trades within the clearing system. Sometimes the tax may be capped, such as in the case of Belgium as mentioned above. In general, and unlike appears to be the case under the EU proposal, financial transaction tax is payable only once in respect of a transaction. However, exceptions exist, such as in Belgium where the tax is, in principle, payable by each party, and in Switzerland where a similar rule applies.

4.2. Financial activities tax

A financial activities tax (FAT) was one of the two taxes (the other was the financial stability contribution) put forward by the IMF in its report to the G20 in 2010.[24] As already explained, there are three basic variants of the tax: the addition method, the rent taxing and the risk taxing, referred to by the IMF as, respectively, FAT1, FAT2 and FAT3. A financial activities tax may generally be described as a tax levied on the sum of the profits and remuneration of financial institutions, and paid to general revenue. The European Commission also addressed the financial activities tax and, at least initially, expressed a preference for this over the financial transaction tax, the latter being more suited to development at the G-20 level.[25] Subsequently, the Commission changed course and opted in favour of the financial transaction tax.[26]

Unlike financial transaction taxes, financial activities taxes are not so common. The European Commission actually notes the "innovative nature" of this tax.[27] The Commission goes on to outline details of three EU Member States that apply FAT-like taxes: Denmark, France and Italy. The Danish tax seems to come closest to the general definition of a financial activities tax, in as much as it applies to both wages and profits. As the European Commission points out, as the French tax only targets remuneration, it is not a financial activities tax per se, although the underlying concept is the same. The same might be said for the Italian and UK payroll taxes. It might be noted that both the Danish and French taxes are clearly designed to address the perceived under-taxation of businesses as a result of the VAT exemption; accordingly they are aimed more broadly than just the financial sector.

The Italian regional tax on productive activities (IRAP) is another Italian tax with FAT1-like characteristics, in particular given the tax base of accounting profit plus most remuneration, even though apparently not introduced to address the under-taxation of the financial sector. Similar taxes may be noted in Israel and the province of Quebec in Canada.[28]

4.3. Bank levies

The idea of a bank levy entered fully into the public debate on financial sector taxation during 2010. Both the IMF and the European Commission addressed this as a means of making the financial sector contribute to the costs of the financial sector crisis and preventing the occurrence of future crises.[29]

Where the popularity of financial transaction taxes appears to be decreasing, there is little doubt that bank levies are on the rise. In November 2010, the European Commission noted 10 Member States that had already introduced or were in the process of introducing such a levy.[30] A year later, in its survey of bank levies, KPMG reports 11 Member States[31] as having introduced such a levy.[32] Although noticeably less popular outside the European Union, they are not unknown, with KPMG reporting these as being proposed in Iceland, Korea and the United States. Interestingly, notwithstanding its bad experience with bank taxes, Sweden seems to have been the first to come forward with a proposal for a bank levy, and introduced its own version in 2009.

Although popular, as the European Commission notes, these levies tend to be country-specific and their parameters (base, rate and scope) differ considerably. As already mentioned, other differences relate to the use of the revenue (ex ante, as promoted by the European Commission, or ex post, as in the case of the proposed US levy) and whether this flows into resolution funds or general budget.

Despite the many differences, as mentioned above, in most cases, the tax base focuses on liabilities. This is not surprising, given the common objective of these levies to limit "excessive" risk and the generally perceived con-

24. *A fair and substantial contribution by the financial sector – final report for the G-20*, IMF (June 2010).
25. *Taxation of the financial sector*, COM(2010) 549 final.
26. The Commission explains the reasons for its choice in the following way: "Essentially, the choice of taxation instrument is a trade off depending on criteria and objectives chosen ... the Commission decision 42 to put forward a legislative proposal on a FTT must be seen not only on the basis of its isolated economic merits but also in terms of the global context and the potential for influencing international developments, as well as on its aspects of providing a new sources of European revenue". "Instruments for the taxation of the financial sector", European Commission, Impact Assessment, vol. 1, SEC(2011) 1102 final.
27. *Financial sector taxation*, accompanying Commission Communication *Taxation of the Financial Sector*, SEC(2010) 1166.
28. Keen, Krelove and Norregaard, *The financial activities tax*, in *The IMF's Report to the G-20 and background material*, Chap. 7 (September 2010).
29. *Bank resolution funds*, European Commission, COM(2010) 254 final; *A fair and substantial contribution by the financial sector – final report for the G-20*, IMF (June 2010).
30. *Draft ECOFIN report on financial levies*, 17009/10 (Nov. 2010).
31. Austria, Cyprus, France, Germany, Hungary, Portugal, Romania, Slovakia, Slovenia, Sweden and the United Kingdom.
32. *Proposed bank levies – comparison of certain jurisdictions*, Edition VII, KPMG (November 2011). See www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Pages/Proposed-bank-levies-comparison-of-certain-jurisdictions.aspx. Since then, the Netherlands has announced its intention to introduce a bank levy along the lines of the United Kingdom's.

tribution of excessive leverage to such risk. To underscore the focus on risk, the United Kingdom has introduced a dual rate, whereby a lower rate applies to longer maturity (i.e. less risky) funding. In some cases, levies are based on consolidated balance sheets (including foreign group members), but more commonly on stand-alone balance sheet liabilities. This is one of the factors that has led to concerns of double taxation arising from overlapping jurisdictions. Double taxation concerns also arise due to overlapping source and residence jurisdictions and differences or uncertainties regarding the personal scope. As already noted, bank levies may be considered conceptually different from taxes, and that is reflected in the concern that bank levies would not be covered by standard income tax treaties. This position has certainly been taken by a number of countries, and this has led to other solutions being considered. These include unilateral measures such as an exemption for branches of EU-passported banks, or, as France has done, a credit for foreign head office or consolidating parent tax (subject to conditions) or specific (bilateral) income tax treaties (such as the United Kingdom has been pursuing).

The extent of the differences in the structuring of different countries' bank levies may be illustrated by the overview below derived from KPMG's above-mentioned bank levy survey.

	France	Germany	United States*
Paid to	Treasury	Banking fund	TARP funding
Tax base	Regulatory capital	Relevant liabilities (excluding retail deposits, equity)	Covered liabilities (excluding insured deposits, Tier 1 capital)
Scope: outbound	Global consolidated group (and foreign branches)	Local entities only (and foreign branches)	Global consolidated group (and foreign branches)
Scope: inbound	EU-passported French branches: exempt	EU-passported German branches: probably exempt	No exemption for US branches of foreign banks
Bank definition	Wide: includes regulated financial entities, stand-alone market operators	Narrow: regulated credit entities	Wide: includes bank holding companies, securities houses, broker dealers
Threshold for tax	EUR 500 million equity	No (progressive rates apply)	USD 50 billion assets
Maximum rate (%)	0.25	0.04 (> EUR 100 million)	0.075
Cap on charge	No	Yes; 15% annual net income	No

* Before September 2011 recast.
Source: KPMG's Proposed bank levies – comparison of certain jurisdictions, Edition VIII (Nov. 2011).

5. Conclusion

There is a wide variety of different types of tax that can impact the financial sector. Attitudes towards financial transaction taxes are ambivalent, many countries having tried and then rejected such taxes in the past, but with still a relatively large number still applying them. This ambivalence reflects to some extent the conflicting objectives of protecting the local financial sector and the attraction of a potentially easy generator of revenue. The relatively wide application of financial transaction taxes and bank levies may be contrasted with the much less common application of financial activities taxes. The EU's decision to favour financial transaction taxes over financial activities taxes is illustrative of this. Whether this will remain so in future, remains to be seen.

Even within the three variants on which this article focuses (the financial transaction tax, the financial activities tax and bank levies), there are considerable differences in design. History, such as the Swedish financial transaction tax experience, shows that these differences can be crucial for the success or failure of a given tax. Some of these differences simply reflect different emphases on competing economic objectives, such as the different types of financial activities tax. Others seem to reflect attempts by countries to find a balance between achieving the economic objectives in question and practicalities such as collection and the prevention of avoidance. The relatively low tax rates for financial transaction taxes are a good example. The various financial transaction tax connecting factors applied by different countries are another. Both financial transaction taxes and bank levies reflect mechanisms designed to prevent overlaps and cumulations, in particular by limiting the jurisdictional scope of the taxes. That these mechanisms are not fully effective, at least in the case of bank levies, is clear from KPMG's above-mentioned survey and the potential for double taxation it demonstrates. This is also reflected in the underlying aims of the EU financial transaction tax proposal.[33]

That there are potential benefits from a more coordinated, streamlined approach to taxation within the financial sector may seem obvious. The extent to which such efforts will be successful will, however, in particular depend on the extent to which competing political interests and conflicting economic objectives can be overcome.

33. One of these aims described in the Explanatory Memorandum to the proposed Financial Transaction Tax Directive is "to avoid fragmentation in the internal market for financial services, bearing in mind the increasing number of uncoordinated national tax measures being put in place".

Paul Carman*

US Dividend Equivalents: Repos and Swaps Subject to Dividend Tax

The author considers temporary and proposed regulations on the US characterization of dividend equivalent payments to non-US persons, issued on 23 January 2012 by the US Internal Revenue Service.

1. Introduction

On 23 January 2012, the US Internal Revenue Service (IRS) issued temporary and proposed regulations on the US characterization of dividend equivalent payments to non-US persons. In particular, the new regulations would provide detail and clarification to the US Internal Revenue Code of 1986, as amended (the Code),[1] section 871(m). The US Congress enacted section 871(m) (originally designated as section 871(l)) in 2010 in section 541 of the Hiring Incentives to Restore Employment Act (the HIRE Act),[2] which also introduced the FATCA provisions.[3]

Section 871(m) applies to securities loans, sale-repurchase transactions (REPOs), certain notional principal contracts (NPCs) defined as "specified notional principal contracts" (specified NPCs) and any similar transactions that provide for a payment contingent upon or determined by reference to a US-source dividend (dividend equivalent). Section 871(m) treats a dividend equivalent as a dividend from sources within the United States for purposes of sections 871(a), 881 and 4948(a), and chapters 3 and 4 of subtitle A of the Code.[4] Thus, a payment that is determined to be a dividend equivalent payment may be subject to US withholding tax either under the normal US rules or under the FATCA withholding regime.

Section 871(m) generally applies to any dividend equivalent made after 14 September 2010. With respect to payments made after 18 March 2012, section 871(m)(3)(B) provides that any NPC will be a specified NPC unless the Secretary determines that such contract is of a type which does not have the potential for tax avoidance.

Notice 2010-46[5] outlined a proposed framework for limiting withholding in the case of a series of securities lending or REPO transactions. While the preamble to the temporary regulations indicates that the IRS anticipates issuing proposed regulations addressing the issues raised in Notice 2010-46, the current temporary and proposed regulations do not address these concerns.

2. A Note about REPOs

REPOs are used in a variety of contexts. Under US tax principles, a REPO is typically characterized as a collateralized loan where the purchaser of the underlying security is deemed to be a lender of funds to the seller in the amount of the purchase price.[6] The seller of the security is treated as the borrower. The loan is for the period until the REPO matures, when the securities are sold back to the original seller (i.e. the cash borrower). Typically, the repurchase price exceeds the original sales price, giving rise to a charge consisting of financing interest.

Under the law that has existed in the United States for quite some time, if the amounts that would otherwise be characterized as interest are substitute dividend payments, the payments are treated as if they were dividends for US source rules and US rules determining the amount of withholding tax due.

A substitute dividend payment is a payment, made to the transferor of a security in a securities lending transaction or a REPO, of an amount equivalent to a dividend distribution which the owner of the transferred security is entitled to receive during the term of the transaction.[7] A substitute dividend payment is sourced under US rules in the same manner as the distributions with respect to the transferred security. The substitute dividend payments have the same character as distributions with respect to the transferred security for purposes of US domestic law[8] and for purposes of applying US tax treaties.[9]

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1. References to sections in this article are references to sections of the Code unless otherwise indicated.
2. Public Law 111-147 (124 Stat. 71).
3. Secs. 1471-1474 of the Foreign Account Tax Compliance Act, which will impose a new 30% withholding tax on certain payments to non-US entities.
4. Chap. 3 of subtitle A of the Code applies the normal US withholding rules to fixed, determinable, annual and periodic payments (FDAP payments) such as interest, rents, royalties and dividends. Chap. 4 of subtitle A of the Code includes the FATCA provisions.
5. 2010-24 IRB 757.
6. *See* Rev. Rul. 74-27, 1974-1 C.B. 24; Rev. Rul. 77-59, 1977-1 C.B. 196; Rev. Rul. 79-108, 1979-1 C.B. 75; Rev. Rul. 79-195, 1979-1 C.B. 177. The US Supreme Court cited the IRS's position in *Nebraska Dept. of Revenue v. Loewenstein*, 513 US 123, 128 n. 3 (1994), in holding that repos are collateralized lending agreements for purposes of characterizing payments with respect to such transactions for state tax purposes. *See* also *First American Nat'l Bank of Nashville v. United States*, 467 F.2d 1098 (6th Cir. 1972); *Union Planters Nat'l Bank of Memphis v. United States*, 426 F.2d 115 (6th Cir.), cert. denied, 400 US 827 (1970); *American Nat'l Bank of Austin v. United States*, 421 F.2d 442 (5th Cir.), cert. denied, 400 US 819 (1970).
7. Treas. Reg. sec. 1.861-3(a)(6).
8. Treas. Reg. secs. 1.864-5(b)(2)(ii), 1.871-7(b)(2) and 1.881-2(b)(2).
9. Treas. Reg. sec. 1.894-1(c).

If the underlying security is a US stock, then, even though the typical characterization of the transaction may be as debt, the payments on the contract may be substitute dividend payments rather than interest. Under both US domestic law and a number of the US tax treaties, no (or a substantially reduced rate of) withholding is due on payments of interest in a variety of circumstances. However, dividends are typically subject to withholding even when the recipient is entitled to treaty benefits. In many cases, characterizing a payment as a substituted dividend payment may increase the amount of withholding tax due.

Because the concept of substitute dividend payments in respect of REPOs already existed in the US tax regulations, section 871(m) appears to merely codify the rules that already existed in regard to REPOs. Section 871(m) uses the term "dividend equivalent" rather than "substitute dividend payment", but "dividend equivalent" seems to be broader than "substitute dividend payment" to also include payments on NPCs. The treatment of substitute dividend payments does not appear to have changed.

3. Summary of the Temporary Regulations

3.1. NPC payments

Section 1.871-16T(b) of the temporary regulations incorporates the definition of a specified NPC as provided in section 871(m)(3)(A).[10] The temporary regulations extend the applicability of the section 871(m)(3)(A) statutory definition of a specified NPC through 31 December 2012. The preamble to the temporary regulations indicates that the IRS believes that an extension of the statutory definition of the term "specified NPC" is necessary to allow taxpayers and withholding agents to modify their systems and other operating procedures to comply with the rules described in the notice of proposed rulemaking.

The temporary regulations also amend several existing regulations to clarify the application of section 871(m) in areas that overlap with such existing regulations. For example the temporary regulations modify Treas. Reg. section 1.863-7, which relates to the source rules for NPC payments generally, to provide that that section does not apply to a dividend equivalent under section 871(m). Treas. Reg. section 1.881- 2T(b)(3), which relates to US tax on payments to non-US corporations, provides that section 871(m) and Treas. Reg. section 1.871-16T apply to dividend equivalents received by foreign corporations. Certain regulations under section 1441, which relates to US chapter 3 withholding on payments to non-US persons, have been amended by the temporary regulations to require a withholding agent to withhold tax owed with respect to a dividend equivalent payment.

Notwithstanding the temporary regulations, the IRS may challenge transactions that are designed to avoid the application of the temporary regulations under applicable judicial doctrines. Nothing in the temporary regulations precludes the IRS from asserting that a contract labelled as an NPC or other equity derivative is in fact an ownership interest in the equity referenced in the contract under a substance-over-form or other similar doctrine. In other words, the temporary regulations should not be broadly seen as a safe harbour in respect of which the technical rules may be applied without regard to the intent.

3.2. Specific Provisions of the Temporary Regulations

Treas. Reg. section 1.863-7T(a) provides rules relating to the source and, in certain cases, the character of NPC income. NPC income is income attributable to an NPC as defined in Treas. Reg. section 1.446-3(c).[11] Under prior US law (and current US law to the extent an NPC is not a specified NPC), the source of NPC income is generally determined by reference to the residence of the taxpayer as determined under section 988(a)(3)(B)(i).[12]

Under the current regulations,[13] the source of NPC income is determined by reference to the residence of a qualified business unit of a taxpayer if (1) the taxpayer's residence is the United States, (2) the qualified business unit's residence is outside the United States, (3) the qualified business unit is engaged in the conduct of a trade or business where it is a resident and (4) the NPC is properly reflected on the books of the qualified business unit. Whether an NPC is properly reflected on the books of a qualified business unit is a question of fact. The degree of participation in the negotiation and acquisition of an NPC is considered in this determination. Participation in connection with the negotiation or acquisition of an NPC may be disregarded if the IRS determines that a purpose for such participation was to affect the source of NPC income.

Treas. Reg. section 1.871-16T provides that, with respect to payments made after 18 March 2012 and before 1 January 2013, the term "specified NPC" means any NPC if (1) in connection with entering into such contract, any long party[14] to the contract transfers the underlying security to any short party to the contract, (2) in connection

10. Described more fully below.

11. Treas. Reg. sec. 1.446-3(c) defines an NPC as a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. An agreement between a taxpayer and a qualified business unit (as defined in sec. 989(a)) of the taxpayer, or among qualified business units of the same taxpayer, is not an NPC because a taxpayer cannot enter into a contract with itself. NPCs include interest rate swaps, currency swaps, basis swaps, interest rate caps, interest rate floors, commodity swaps, equity swaps, equity index swaps and similar agreements.
12. Under Sec. 988(a)(3)(B), the residence of any person is (1) in the case of an individual, the country in which such individual's tax home is located, (2) in the case of any corporation, partnership, trust or estate which is a US person (as defined in section 7701(a)(30)), the United States and (3) in the case of any corporation, partnership, trust or estate which is not a United States person, a country other than the United States.
13. Treas. Reg. sec. 1.863-7(b).
14. Under section 871(m)(4), the term "long party" means, with respect to any underlying security of any NPC, any party to the contract which is entitled to receive any payment pursuant to such contract which is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States with respect to such underlying security.

with the termination of such contract, any short party[15] to the contract transfers the underlying security[16] to any long party to the contract, (3) the underlying security is not readily tradable on an established securities market or (4) in connection with entering into such contract, the underlying security is posted as collateral by any short party to the contract with any long party to the contract.

The preamble to the proposed regulations[17] indicates that the IRS believes that when a short party posts the underlying security as collateral with the long party, the related NPC should be a specified NPC. In the event of default by the short party, the fact that the underlying security is posted as collateral guarantees that the value of the collateral moves in tandem with the contract.

Treas. Reg. section 1.1441-2T(b)(6) provides that amounts subject to withholding for the purposes of section 1441, applying the US general 30% withholding on FDAP[18] payments under Chapter 3, include the payment of a dividend equivalent described in section 871(m). For this purpose under Treas. Reg. section 1.1441-2T, the term "payment" includes any gross amount that is used in computing any net amount that is transferred to or from the taxpayer under the terms of the contract.

With respect to a dividend equivalent described in section 871(m), a payment is considered made to a person when any gross amount is used in computing any net amount that is transferred to or from the person under the terms of the contract pursuant to a transaction described in section 871(m)(2).[19] When a dividend equivalent is used to determine a net payment, the person entitled to the gross dividend equivalent is considered to have received a payment even if that person receives no actual payment because the net payment equals zero or the deemed recipient actually makes a net payment.

The provision has the result that in a swap contract, which would often be an NPC, if the payment to a non-US party is based upon a dividend from a US security, the gross amount of the short party's payment obligation will be treated as a dividend equivalent payment even if the short party actually makes no payment because the short party's payment obligation is netted against the long party's payment obligation. Thus, a withholding obligation may accrue even if no actual payment is made.[20]

For example, the terms of an NPC may provide for periodic payments by each of the counterparties that occur at quarterly intervals. Because these payments may offset each other, in whole or in part, the terms of such contracts generally provide for payment of only the net amount owed between the counterparties (that is, the difference between the amounts owed between the counterparties).

15. Under section 871(m)(4), the term "short party" means, with respect to any underlying security of any NPC, any party to the contract which is not a long party with respect to such underlying security.
16. Under section 871(m)(4)(C), the term "underlying security" means, with respect to any NPC, the security with respect to which the dividend is paid. Any index or fixed basket of securities is treated as a single security.
17. REG-120282-10, 77 Fed. Reg. 3202 (23 January 2012).
18. Fixed, determinable, annual or periodical.
19. Treas. Reg. sec. 1.1441-2T(b)(7).
20. Treas. Reg. sec. 1.1441-3T(h)(1).

A dividend equivalent is equal to the gross amount that is contingent upon or determined by reference to a dividend used to determine a net amount, even if no net payment is made or the party entitled to a gross amount determined by reference to a dividend is required to make a net payment to the other contracting party.

In determining the amount subject to withholding as a dividend equivalent, a withholding agent may use a distributing corporation's estimate or other determination with respect to the underlying security.[21] However, a withholding agent that elects to use any such estimate will be liable for the amount by which the actual amount required to be withheld exceeds the amount actually withheld and applicable penalties and interest resulting from its reliance on such estimate or determination. Failure of the withholding agent to withhold the required amount may not be attributed to the distributing corporation.[22]

In general, under US law, a withholding agent that pays amounts attributable to an NPC described in Treas. Reg. section 1.863-7(a) or Treas. Reg. section 1.988-2(e) has no obligation to withhold on the amounts paid under the terms of the NPC, regardless of whether a withholding certificate is provided.[23] However, a withholding agent must file returns under Treas. Reg. section 1.1461-1(b) and (c) reporting the income that it must treat as effectively connected with the conduct of a trade or business in the United States. In general, a withholding agent must treat the income as effectively connected with the conduct of a US trade or business if the income is paid to, or to the account of, a qualified business unit of a foreign person located in the United States or, if the payment is paid to, or to the account of, a qualified business unit of a foreign person located outside the United States, the withholding agent knows, or has reason to know, the payment is effectively connected with the conduct of a trade or business within the United States. Income on an NPC that is generally excluded from withholding does not include the amount characterized as interest under the provisions of Treas. Reg. section 1.446- 3(g)(4).[24]

A withholding agent[25] that makes (or is deemed to have made) a payment attributable to a specified NPC described in section 871(m), or Treas. Reg. section 1.871-16T that is not treated as effectively connected with the conduct of a trade or business within the United States has an obligation to withhold on the amount of such payment that is a dividend equivalent.[26]

The temporary regulations provide the following example:

21. Treas. Reg. sec. 1.1441-3T(h)(2)(i).
22. A failure of the short part to pay the full amount of withholding tax due would also result in the long party being required to file a US tax return. *See* Treas. Reg. sec. 1.1441-7T(a)(3) ex. 6.
23. Treas. Reg. sec. 1.1441-4T(a)(3)(i).
24. Treas. Reg. sec. 1.446-3(g)(4) relates to substantial non-periodic payments made under NPCs and creates a deemed loan to exist between the parties.
25. Each person that is a party to any contract or arrangement that provides for the payment of a dividend equivalent, as defined in section 871(m), is treated as having control and custody of such payment and, thus, may be the withholding agent. Treas. Reg. sec. 1.1441-7T(a)(2).
26. Treas. Reg. sec. 1.1441-4T(a)(3)(iii).

FC, a foreign corporation, enters into an NPC with Bank *X*, a bank organized in the United States. The NPC is a specified NPC for purposes of section 871(m). FC is the long party to the contract and Bank *X* is the short party. The NPC references a specified number of shares of dividend-paying common stock issued by a domestic corporation. As the long party, FC receives payments from Bank *X* based on any appreciation in the value of the common stock and dividends paid with respect to the common stock. As the short party, Bank *X* receives payment from FC based on any depreciation in the value of the common stock and a payment based on LIBOR. Bank *X* is a withholding agent because Bank *X* is deemed to have control and custody of a dividend equivalent as a party to the NPC. If FC's tax liability under section 881 has not been satisfied in full by Bank *X* as withholding agent, FC is required to file a return on Form 1120-F (US Income Tax Return of a Foreign Corporation).[27]

4. The Proposed Regulations

The proposed regulations largely incorporate the same terms as the temporary regulations, but expand and modify a number of significant concepts in regard to payments after 31 December 2012. The following summary attempts to eliminate the duplication of discussions where the provisions are the same and highlights only the differences.

The proposed regulations define "underlying security" as the security with respect to which the dividend referred to in Prop. Reg. sec. 1.871–15(b)(1)(ii) is paid.[28] Under the proposed regulations, if an NPC references more than one security or a customized index, each security or component of such customized index is treated as an underlying security in a separate NPC for purposes of section 871(m). For these purposes, a "customized index" means any index, as determined on the date that the long party and short party enter into an NPC, that is (1) a narrow-based index or (2) any other index unless futures contracts or option contracts on such index trade on a qualified board or exchange, as defined in section 1256(g)(7).[29]

The term "narrow-based index" means an index (1) that has nine or fewer component securities, (2) in which a component security comprises more than 30% of the index's weighting, (3) in which the five highest weighted component securities in the aggregate comprise more than 60% of the index's weighting or (4) in which the lowest weighted component securities comprising, in the aggregate, 25% of the index's weighting have an aggregate dollar value of average daily trading volume of less than USD 50 million (or in the case of an index with 15 or more component securities, USD 30 million), except that if there are two or more securities with equal weighting that could be included in the calculation of the lowest weighted component securities comprising, in the aggregate, 25% of the index's weighting, such securities are ranked from lowest to highest dollar value of average daily trading volume and are included in the calculation based on their ranking starting with the lowest ranked security.[30]

The second category of customized index, one in respect of which options or futures are not traded on a qualified board or exchange, may have the result of causing some "private label" indexes to be customized indexes for purposes of the proposed regulations even though the private label indexes may be very broad indexes. The result of being treated as a customized index is that an NPC referencing the customized index is treated as referencing each underlying security. When a private label index includes 100 or 200 stocks in the index, classification as a customized index would create administrative issues in calculating the gross payments on the underlying stocks.

The proposed regulations provide that a payment is not a dividend equivalent if it is determined by reference to an estimate of an expected (but not yet announced) dividend without reference to or adjustment for the amount of any actual dividend.[31] For such purposes, an expected dividend is not considered an estimate of expected dividends on or after the date that the corporate issuer announces a dividend. A dividend announcement occurs on the earliest date on which the corporation declares, announces or agrees to the amount or payment of such dividend.[32]

Prop. Reg. section 1.871-15(d) describes payments that are considered substantially similar to substitute dividends made pursuant to securities lending and REPO transactions and to payments made pursuant to specified NPCs. Substantially similar payments are (1) gross-up amounts paid by a short party in satisfaction of the long party's tax liability with respect to a dividend equivalent and (2) payments calculated by reference to a dividend from sources within the United States that are made pursuant to an equity-linked instrument other than an NPC.[33] An equity-linked instrument is a financial instrument or combination of financial instruments that references one or more underlying securities to determine its value, including a futures contract, forward contract, option or other contractual arrangement.[34] An equity-linked instrument that provides for a payment that is a substantially similar payment is treated for the purposes of the proposed regulations as an NPC. Thus, an equity-linked instrument would then be tested to determine if the equity-linked instrument should be treated as a specified NPC.

The preamble to the proposed regulations indicates that the IRS will continue to monitor equity-linked transactions, and may identify in separate guidance other payments that are substantially similar to a substitute dividend payment or a payment made pursuant to a specified NPC. Informal comments by representatives of the US Treasury indicate that among other things being considered, earn-out agreements in corporate merger and acquisition transactions when the earn-out has a dividend adjustment clause and employee equity-linked compen-

27. Treas. Reg. sec. 1.1441-7T(a)(3) ex. 6.
28. Prop. Reg. sec. 1.871-16(f)(1).
29. Prop. Reg. sec. 1.871-16(f)(3)(i).
30. Prop. Reg. sec. 1.871-15(f)(3)(ii).
31. Prop. Reg. sec. 1.871-15(b)(2)(i).
32. Prop. Reg. sec. 1.871-15(b)(2)(ii).
33. Prop. Reg. sec. 1.871-15(d)(1).
34. Prop. Reg. sec. 1.871-15(d)(2)(i). An equity-linked note is not specifically listed in the proposed regulations but could be an equity-linked instrument.

sation have a potential for being treated as equity-linked instruments.

Prop. Reg. section 1.871-16 defines the term "specified NPC" for payments made after 18 March 2012. Beginning on 1 January 2013, an NPC generally will be a specified NPC for purposes of section 871(m) if (1) the long party[35] is "in the market" on the same day that the parties price the NPC or when the NPC terminates, (2) the underlying security is not regularly traded on a qualified exchange, (3) the short party posts the underlying security as collateral and the underlying security represents more than 10% of the collateral posted by the short party, (4) the term of the NPC has fewer than 90 days, (5) the long party controls the short party's hedge, (6) the notional principal amount is greater than 5% of the total public float of the underlying security or greater than 20% of the 30-day daily average trading volume, as determined at the close of business on the day immediately preceding the first day of the term of the NPC or (7) the NPC is entered into on or after the announcement of a special dividend and prior to the ex-dividend date.[36]

A long party is considered to be "in the market" if the long party sells the underlying security on the same day that the parties price an NPC or purchases the underlying security on the day that the parties terminate an NPC.[37] An NPC is sometimes entered into in tranches that spread the execution over more than one day; in that case, the preamble to the proposed regulations indicates that the IRS intends to consider each day that a tranche is executed or settled as a testing date. Similarly, if the long party to an NPC sells or purchases an underlying security on a day other than the pricing date or the settlement date of an NPC, but sets the price to align with the price of the NPC (such as with a forward contract), the preamble indicates that the IRS intends to treat the long party as in the market on that day.

The proposed regulations provide a *de minimis* exception to the "in the market" test. Under the proposed regulations, the long party will not be deemed to be in the market with respect to the underlying security if the amount of the underlying securities disposed of on a pricing date or acquired on a termination date is less than 10% of the notional principal amount of the NPC.[38]

The Code and regulations define "readily tradable on an established securities market" (and similar phrases) differently depending on the context. The preamble to the proposed regulations indicates that the IRS believes that "readily tradable on an established securities market", as used in section 871(m), is intended to ensure that the underlying securities trade in sufficient volume to provide ample liquidity in the position. The proposed regulations provide that if the underlying security is not regularly traded on a qualified exchange, an NPC referencing that security is a specified NPC.[39] An underlying security is "regularly traded" for this purpose if it is traded on a qualified exchange[40] and it was traded on at least 15 out of the 30 trading days prior to the date that the parties entered into an NPC.[41] When a corporation initiates a public offering of a security, such security is regularly traded if such security is traded during at least 15 trading days on one or more qualified exchanges during the 30 trading days subsequent to the initial offering.[42]

As mentioned above, section 871(m)(3)(A)(iv) provides that prior to 18 March 2012, an NPC will be a specified NPC if the short party to the contract posts the underlying security as collateral with any long party to the contract. The preamble to the proposed regulations[43] indicates that the IRS believes that when a short party posts the underlying security as collateral with the long party, the related NPC should be a specified NPC. In the event of default by the short party, the fact that the underlying security is posted as collateral guarantees that the value of the collateral moves in tandem with the contract. This concern is less applicable when the value of the underlying securities posted as collateral is a small portion of the total amount of cash or other property posted as collateral for the NPC. The proposed regulations treat an NPC as a specified NPC only if the underlying security is posted as collateral and the underlying security represents more than 10% of the total fair market value posted as collateral on any day that the NPC is in effect.[44] The underlying securities will be considered traded only on those days in which the underlying securities are traded in quantities that exceed 10% of the 30-day average daily trading volume.[45]

The proposed regulations treat an NPC as a specified NPC if the term of the contract has fewer than 90 days. As the market for equity-linked NPCs grew and evolved, taxpayers began to purchase and sell NPCs in lieu of trading the underlying equities. Many transactions entered into to avoid US withholding tax on dividends involved short-term equity swaps around an ex-dividend date. In many cases, the taxpayer entered into an NPC with a financial institution that acquired the underlying security as a hedge of a contract; the parties then settled or terminated that contract within days or weeks of the date it was entered into. When an NPC has a short duration and is in effect over an ex-dividend date, the source rule of section 871(m) should take precedence over the general source rule for NPC income in Prop. Reg. section 1.863-7.

For purposes of Prop. Reg. section 1.871-16, the term of any NPC is the number of days that the contract is actually outstanding, including the date on which the

35. For the purposes of testing whether an NPC is a specified NPC, a related person is considered a party to an NPC. Thus, actions taken by a party related to the long party may cause the NPC to be a specified NPC. Prop. Reg. sec. 1.871-16(e).
36. Prop. Reg. sec. 1.871-16(c).
37. Prop. Reg. sec. 1.871-16(c)(1)(i).
38. Prop. Reg. sec. 1.871-16(c)(1)(ii).
39. Prop. Reg. sec. 1.871-16(c)(2).
40. The term "qualified exchange" means a national securities exchange that is registered with the Securities and Exchange Commission or the national market system established pursuant to section 11A of the Securities Exchange Act of 1934 (15 USC 78f).
41. Prop. Reg. sec. 1.871-16(c)(2)(i)(A).
42. Prop. Reg. sec. 1.871-16(c)(2)(i)(B).
43. REG-120282-10, 77 Fed. Reg. 3202 (23 January 2012).
44. Prop. Reg. sec. 871-16(c)(3).
45. Prop. Reg. sec. 1.871-16(c)(2)(i)(C).

NPC is terminated, but not the date that the NPC was entered into.[46] For purposes of determining whether a contract is a specified NPC, an NPC is treated as terminated, in whole or in part, on the date that a long party enters into any position to the extent that the position offsets a portion of the long party's position with respect to an underlying security in the NPC.[47]

In some situations, the long party controls the acquisition of stock that the short party uses to hedge its position under the contract or has directed the short party to sell the short party's hedge to a particular purchaser at a specific price and date. The proposed regulations treat an NPC as a specified NPC when a foreign investor controls the short party's hedge or participates in an underlying equity control program.[48] The long party in these situations may exercise such control over the short party's hedge pursuant to terms of a written agreement or through course of conduct. An underlying equity control program is any system, whether carried out electronically or otherwise, that allows a long party to direct its counterparty's hedge of an NPC or that allows a long party to acquire economic exposure to an underlying security and to determine the form of the transaction later.[49] An underlying equity control program, however, does not include an electronic trading platform that allows a customer to place an order to enter into an NPC with a dealer, provided that the dealer independently determines whether and how to hedge its position without customer direction.

The question of whether the long party controls the short party's hedge may impact business and financial terms if the pricing of the contract is determined in part by the short party's hedging costs. In some situations, the long party may have historically wanted to insert some controls over the short party's hedge in order to control the anticipated costs. Such provisions may, after the proposed regulations become final, cause NPCs to unexpectedly become specified NPCs.

The proposed regulations treat an equity swap as a specified NPC when the notional principal amount of an NPC is a significant percentage of the trading volume.[50] Specifically, when the notional principal amount of the NPC is greater than 5% of the total public float or 20% of the 30-day average daily trading volume, such contract is treated as a specified NPC. If a long party has multiple NPCs that reference the same underlying security, the notional principal amounts of those contracts must be aggregated when determining whether the notional principal amount represents a significant percentage of the trading volume.

The proposed regulations provide that any NPC is a specified NPC when the parties enter into the NPC after the announcement of a special dividend on the underlying stock.[51] A special dividend is a non-recurring payment to shareholders that is in addition to any recurring dividend payment. The preamble to the proposed regulations indicates that the IRS believes that an NPC entered into after the announcement of a special dividend and before the ex-dividend date is more likely to be entered into for the purpose of avoiding US tax than an NPC referencing a stock that pays only a recurring dividend.

If an NPC that is not a specified NPC on the date the parties enter into the contract subsequently becomes a specified NPC, any payment made during the term of the contract (including any payment during the period between the date the contract is entered into and the date the contract becomes a specified NPC) that is contingent upon or determined by reference to the payment of a dividend from sources within the United States is a dividend equivalent.[52]

This would mean, for example, an NPC that references a non-US corporation that later becomes a US corporation, would become a specified NPC. Under these facts, however, payments under the NPC would not be dividend equivalent payments until the corporation became a US corporation because the payments prior to such time would not be based upon payments of dividends from US sources. It may be possible under some circumstances, however, for an NPC that references US stock from the beginning to not be a specified NPC originally and then become a specified NPC later in the term. It such a situation, the NPC could have dividend equivalent payments from the beginning of the contract.

When an NPC becomes a specified NPC during the term of the contract, any tax owed with respect to a dividend equivalent made prior to the NPC becoming a specified NPC is payable when the next payment as described in Prop. Reg. sec. 1.1871-15(c), including a termination payment, is made pursuant to the contract.[53] In computing the amount of tax owed with respect to the termination of the specified NPC or the first payment that occurs after the NPC becomes a specified NPC, the dividend equivalent equals the sum of all the dividend equivalents with respect to the NPC arising before the date the NPC became a specified NPC and the amount of any dividend equivalent arising upon the termination or payment.[54]

To prevent taxpayers from avoiding these rules through related parties, the proposed regulations provide that each related person (within the meaning of sections 267(b) or 707(b)(1)) is treated as a party to the contract.[55] Sections 267(b) and 707(b)(1) would generally cause persons that have more than 50% common ownership to be treated as related.

Although this rule may created administrative issues for the long party, it creates a variety of practical issues for

46. Prop. Reg. sec. 1.871-16(c)(4)(ii).
47. The termination date may be difficult for the short party to determine unless contractual provisions specifically provide a notice requirement (before the payment obligation is due).
48. Prop. Reg. sec. 1.871-16(c)(5).
49. Prop. Reg. sec. 1.871-16(f)(2).
50. Prop. Reg. sec. 1.871-16(c)(6).
51. Prop. Reg. sec. 1.871-16(c)(7).
52. Prop. Reg. sec. 1.871-16(d)(1).
53. Prop. Reg. sec. 1.871-16(d)(2)(i).
54. Prop. Reg. sec. 1.871-16(d)(2)(ii).
55. Prop. Reg. sec. 1.871-16(e)(1).

the short party. Persons that are not parties to the contract may cause the contract to become a specified NPC creating a withholding obligation on the part of the short party. Current documentation may exclude tax incurred under section 871(m) from gross-up obligations of the short party, but the short party may incur the obligation to withhold without being aware of the obligation. Current documentation may need to be reviewed to determine if it is adequate from a short party's perspective in this regard.

The proposed regulations also provide that an NPC entered into between two related dealers is not a specified NPC if the NPC hedges risk associated with another NPC entered into with a third party.[56] The preamble to the proposed regulations indicates that the related dealer rule is intended to avoid excessive withholding tax on transactions commonly employed by dealers to transfer risk from one entity to another within their affiliated group.[57]

5. Conclusion

International financial transactions generally are intended to be structured in a way such that they are not subject to withholding. The dividend equivalent rules under section 871(m) create a shift in the treatment of a variety of financial products, if the products reference US equities. Both counterparties to contracts referencing US equities may be well advised to examine their exposure to US tax carefully in light of the temporary and proposed regulations. Current ISDA contracts may not be adequate to protect short parties, and long parties may need to examine their own institutional affiliated group procedures to determine if they are capable of determining whether contracts they enter into are specified NPCs.

The potential application of the proposed regulations may go far beyond the financial markets. Any contract referencing US equities that has an adjustment for dividends paid may result in a dividend equivalent under some circumstances. Corporate acquisitions and employee benefit agreements are two areas that have been specifically identified as raising questions by the IRS. The effective date of the proposed regulations is deferred until they are published as final in the US federal register. Persons that enter into NPCs may wish to consider the increased exposure carefully when entering into the contracts.

56. Prop. Reg. sec. 1.871-16(e)(1).
57. Prop. Reg. sec. 1.871-16(e)(1).

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Eurozone Exits: Dutch Legal and Tax Aspects

Even though Greece was recently bailed out for a second time, there is still a realistic possibility that one or more weaker Eurozone Member States will exit the Eurozone. This article addresses the legal and tax aspects of such an exit from a Dutch perspective. In a legal context, a key issue is the redenomination risk resulting from the new currency and monetary laws introduced by the exiting state. From a tax perspective, the main issue is if and when currency results on investments or liabilities that will be expressed in the new currency introduced by a Member State upon its exit from the Eurozone may be recognized.

1. Introduction

The year 2012 may be a crucial one for the survival of the euro. A turbulent period started when the problems concerning Greece became apparent in 2009.[1] For European politicians, the past two years have been "years of living dangerously", and the lack of decisiveness has driven the Eurozone into recession. Even though Greece was bailed-out for a second time, the danger has not disappeared and during the next few months the future of the euro may be decided. If one weaker Eurozone Member State were to default, other Member States, including bigger states such as Italy, might be the next dominoes to fall. It is generally expected that the other EU countries would not be able to offer sufficient support to keep a large country such as Italy afloat. Italy's default could be the beginning of the end of the euro as we know it. This could lead to (1) one or more countries leaving the euro or (2), although extremely unlikely, a wholesale implosion of the euro or (3) the split of the Eurozone into a northern (the Neuron) and southern part (the Euro).

As the second and third scenario would involve extensive EU regulation the contents of which are not actually possible to predict, this article focuses on the scenario which at the present stage is the most realistic one: one or more weaker countries leaving the Eurozone. Based on the experience with countries that in the past converted their currency into a new one, the steps that might need to be taken can be anticipated to some extent.

This article describes certain typical cases by reference to which the legal and, subsequently, tax aspects are analysed. This analysis is based on the rules of Dutch civil law and relevant international private law as interpreted from a Dutch perspective, and on the relevant rules of Dutch tax law as they apply to corporate taxpayers. For purposes of illustration, this article assumes that the EU Member State exiting the euro will be Italy. The authors wish to state explicitly that no opinion is expressed as to the likelihood of such event.

2. Scenario and Case Study

The three cases are based on the following scenario:
- Italy defaults on its sovereign debt and decides to exit the Eurozone;
- Italy remains an EU Member State. No specific exit arrangements are agreed between the Eurozone members or the EU Member States;
- upon its exit from the Eurozone, Italy re-establishes the lira as the lawful currency of Italy;
- Italy imposes capital and exchange controls, which entail that (1) no payment may be made in euro by Italian companies and (2) no payments may be made in Italy in euro;
- Italy sets a fixed euro/lira conversion rate for existing payment obligations of Italian companies denominated in euro; and
- subsequently, the lira depreciates substantially relative to the euro.

Case I

- Party NL is a corporation that is tax resident in the Netherlands.
- Party IT is a corporation that is tax resident in Italy.
- Under a loan agreement entered into on 18 December 2009, Party NL made a euro loan to Party IT.
- The loan agreement refers to Dutch law as applicable law, and to Dutch courts exclusively as the competent forum.
- Special feature: Party NL attracts a euro loan from a third party to fund the loan made to Party IT.

Case II

- Party NL is a corporation that is tax resident in the Netherlands.
- Party NL holds all shares in Party IT, an Italian corporation.
- Party IT earns all its revenues from operations in Italy.
- Special feature: Party NL uses US dollars as functional currency and may accordingly report its taxable profits in US dollars. It has attracted a euro loan to fund its investment in Party IT.

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1. *See* e.g. *Greece rejects speculation of bail-out*, Financial Times (6 Jan. 2010) and *Why Greece will have to leave the eurozone*, Financial Times (11 Jan. 2010).

Case III

– Party NL is a corporation that is tax resident in the Netherlands.
– Party NL has a permanent establishment in Italy.
– All revenue attributable to the permanent establishment is earned from operations in Italy.

The one commercial element of overriding importance in relation to Case I is the question of which party is to bear the newly "created" currency risks resulting from the re-establishment and subsequent depreciation of the lira. If the monetary legislation introduced by Italy upon its exit were to be held applicable by the competent courts and consequently the currency of payment under the loan agreement were redenominated in lira, Party NL would incur significant currency exchange losses due to the fixed conversion rate and the subsequent depreciation of the lira relative to the euro. If, however, Party IT were to continue to be under an obligation to make payments under the loan agreement in euro, it would incur significant currency exchange losses because the revenue it earns would be expressed in lira. The international private law and Dutch contract law considerations are particularly relevant in third-party relationships. For that reason, section 3. focuses on Case I only.

The Dutch tax implications in respect of all three cases are summarized in section 4. For tax purposes, it is important to determine, both in the context of intra-group and third-party relations, if, when and to what extent currency results may or should be recognized, because this may have immediate or future effects on the tax burden and, accordingly, the liquidity position of the company.

3. Dutch International Private Law and Contract Law implications

In order to determine the Dutch civil law implications of the case, answering the following questions is essential:

(1) What law is (or what laws are) applicable to the loan agreement?
(2) What are the relevant provisions of Dutch law, where applicable?
(3) What is the competent forum?
(4) Will a judgment by a Dutch court be recognized and enforceable in the relevant other countries, particularly in Italy in this case?

Questions (1), (3) and (4) are questions of international private law. Question (2) is a question of domestic contract law.

3.1. Question 1: What law is applicable to the loan agreement?

3.1.1. Contractual choice of law

According to Rome I Regulation 593/2008,[2] which is applicable to contracts entered into after 17 December 2009,[3] the law applicable to a contract governs issues such as the contract's interpretation and performance, the consequences of a total or partial breach of obligations, the various ways of extinguishing obligations and the consequences of nullity of the contract.[4]

The parties have the freedom to choose the applicable law according to article 3 Rome I Regulation by, for instance including a choice of law provision in the contract. In Case I, Party IT and Party NL have expressly chosen Dutch law. In principle, the law of choice (Dutch law) governs all elements of the contract and contractual issues that may arise in that respect.

However, the Rome I Regulation provides for two exceptions that could be of relevance in Case I.[5] These are described in sections 3.1.2. and 3.1.3.

3.1.2. Laws of the place of payment

Article 12, paragraph 2 of the Rome I Regulation prescribes that in relation to "the manner of performance and the steps to be taken in the event of defective performance, regard shall be had to the law of the country in which performance takes place". The place of performance for payment obligations in principle is the place where payment takes place. This means that in Case I, notwithstanding the contractual choice of Dutch law, Italian law could nonetheless be found applicable in respect of those elements of the loan agreement that regard the manner of performance.

The question arises as to the scope of this manner of performance exception. In Case I, it is particularly important to determine whether the obligation to make payments in a certain currency, in this case euro, falls within the scope of this exception. If the manner of performance were to comprise the currency in which payment should be made, this means that the monetary laws of the country where payment takes place (Italy) which prohibit payment in a certain currency (euro) could set aside the contractual choice of payment in a certain currency (euro).

There is no case law on whether the manner of performance comprises an obligation to make payments in a certain currency. In the authors' opinion, the more likely interpretation would be that the manner of performance indeed comprises the currency in which payment should be made. However, one could also argue that the manner of performance should be interpreted more restrictively and only comprises technical matters regarding the payment, such as payment in cash, by wire transfer or cheque or the location of payment.

2. OJ L 177, 4.7.2008, at 6.
3. The 1980 Contracts Convention, OJ C 334, 30 Dec. 2005, at 1, applies to contracts entered into between 1 Sep. 1991 and 17 Dec. 2009.
4. *See* article 12, paragraph 1 of the Rome I Regulation.
5. The *lex monetae* has been referred to in (Anglo-Saxon) legal literature as a basis for application, in respect of monetary obligations under the contract, of the laws of the country of the currency in which payment should take place, regardless of the choice of law. *See* e.g. C. Proctor, *The euro – fragmentation and the financial markets*, 6 Capital Markets Law Journal 1, 5-28 (23 Nov. 2010). Based on the applicable rules of (Dutch) international private law, the authors do not recognize a basis for application of the *lex monetae* by Dutch courts.

3.1.3. Overriding mandatory provisions

Article 9, paragraph 3 of the Rome I Regulation provides for another exception to the contractual choice of law that could be of relevance. Under this exception, courts have the discretionary power to give effect to mandatory overriding provisions of another state if (1) the performance of contractual obligations should take place, according to the contract, or has taken place in that other state and (2) those mandatory overriding provisions would render performance of contractual obligations unlawful. In considering whether effect will be given to such overriding mandatory provisions, regard is to be had to the nature and purpose of the legislation and to the consequences of its application or non-application.

Mandatory overriding provisions of another EU Member State include legislation "for safeguarding its public interest, such as its political, social and economic organization".[6] The Italian monetary legislation introduced in Case I would certainly qualify as mandatory overriding provisions, which could compel a Dutch court to apply these rules regardless of the contractual choice of Dutch law.

3.1.4. Public policy

Notwithstanding the afore-mentioned rules, a Dutch court may refuse application of any (foreign) legal rules on the ground of manifest incompatibility of these rules with Dutch public policy (*ordre public*).[7] In Case I, if the Italian monetary legislation were found to be applicable based on the exceptions described in sections 3.1.2. and 3.1.3., a Dutch court could nonetheless refuse application of this legislation based on public policy concerns.

The case law of the European Court of Justice under the Brussels I Regulation suggests that public policy refers to "fundamental principles" and "fundamental rights", such as those enshrined in the European Human Rights Convention. In Case I, an argument that could be used by a Dutch court to refuse application of Italian monetary legislation would be that this would result in a de facto expropriation of property of Party NL, which is in violation of the First Protocol to the European Human Rights Convention. The effect of Italian monetary legislation would be that the loan, including any accrued interest, made by Party NL to Party IT would significantly decrease in value due to the conversion from euro to lira against the fixed conversion rate and the subsequent depreciation of the lira relative to the euro.[8]

3.2. Question 2: What are the relevant provisions of Dutch law?

Where Dutch law is found applicable to the contract pursuant to the rules described in section 3.1., the relevant provisions of Dutch contract law need to be analysed.

3.2.1. Freedom of contract: interpretation

The starting point is that the parties are in principle free to agree, and are bound by, the terms of the contract (the freedom of contract). Accordingly, the parties are free to select the currency in which payments under the contract should take place.

The intention of the parties upon entering into the contract is decisive for interpreting the terms of the contract, including any reference to the currency of payment (the *Haviltex* criterion, named after the Supreme Court ruling).[9] The authors believe that it follows from subsequent Supreme Court case law that, at least in relation to contracts between commercial parties, the *Haviltex* criterion should be applied objectively. This objective approach entails that contracts are in principle construed based on the most self-evident grammatical meaning of the words, read in light of the other clauses of the contract which are relevant for the interpretation [10]

In Case I, the reference to euro as the currency in which payment should take place under the loan agreement is to be interpreted on the basis of the afore-mentioned *Haviltex* criterion and subsequent Supreme Court case law. Unless a definition of "euro" had been included, which at least until recently was not common practice, the reference to euro could be interpreted differently – either (1) as lawful currency of the jurisdiction of the creditor (the Netherlands), (2) as lawful currency of the jurisdiction of the obligor (Italy) or (3) as lawful currency of the Eurozone from time to time, irrespective of the question as to whether the jurisdiction of the obligor or the creditor is part of the Eurozone. If the second interpretation were accepted, this would imply that upon the exit of Italy from the Eurozone, the reference to euro should be interpreted as a reference to lira.

In the absence of clear indications that would point to the contrary, the third interpretation is, however, most plausible. In Case I, this interpretation entails that Party IT should continue paying interest and principal on the loan in euro upon an exit of Italy from the Eurozone.

3.2.2. Unforeseen circumstances doctrine (imprévision)

A Dutch court may, at the request of a party, modify the implications of a contract or dissolve a contract in whole or in part on the basis of (1) unforeseen circumstances which are (2) of such nature that the other party, according to criteria of reasonableness and equity, may not expect the contract to be maintained without modification.[11]

In Case I, it is unlikely that a Dutch court would set aside the contractual arrangements between Party IT and Party NL based on the unforeseen circumstances doc-

6. *See* article 9, paragraph 1 of the Rome I Regulation.
7. *See* article 21 of the Rome I Regulation.
8. Another question that needs to be answered is whether Italian monetary legislation would be a violation of the Treaty on the Functioning of the European Union (TFEU), in particular the freedom of capital, and whether such violation would be justifiable. For the implications of an exit under the TFEU, *see* Proctor, *supra* n. 5.
9. Dutch Supreme Court (*Hoge Raad*, HR), 11 647, 13 Mar. 1981, NJ 1981, 635 (*Haviltex*).
10. HR, 19 Jan. 2007, JOR 2007, 166 (*PontMeyer*); HR, 29 June 2007, JOR 2007, 198 (*Derksen/Homburg*); HR, 7 Sep. 2007, JOR 2007, 291 (*Phoenix/Philips*).
11. *See* section 6:258, paragraph 1 Dutch Civil Code. This concept is comparable to the concept of "frustration" as applied under English law. *See* Proctor, *supra* n. 5.

trine. Although this doctrine has been applied in cases of serious distortion of the value of the parties' respective obligations, the consensus is that, where this distortion is caused by devaluation or inflation, additional caution with application of the doctrine is required in view of the importance of the nominality of debts in a market economy.[12] Moreover, Dutch courts may not modify or dissolve contracts if and to the extent the relevant circumstances should, according to the nature of the contract or common opinion, be for the account of the applicant which makes the request to the court. It is the authors' strong view that the (currency) risks of Italy's exit should be borne by the party residing in Italy rather than the party residing in the state that continues to be part of the Eurozone, which would otherwise incur significant exchange losses. It is noted, however, that this risk allocation generally depends on all relevant facts and circumstances.

3.2.3. Payment in a different currency

If a payment obligation is denominated in a currency which is not the currency of the place of payment, the obligor will be entitled to make the payment in the currency of the place of payment.[13] If, in Case I, the place of payment is Italy, Party IT would be allowed to make payments under the loan agreement in lira. However, the creditor (Party NL) would be entitled to receive such an amount in lira as will be needed to forthwith acquire the relevant amount in euro that is due.

If payment is denominated in a currency which is not the currency of the place of payment and the obligor is not able or claims that it is not able to make the payment in the agreed currency, the creditor may require payment in the currency of the place of payment.[14] If, as in Case I, the place of payment is Italy and Party IT argues that it is not able pay in euro, Party NL may request that payments under the loan agreement be made in lira. Again, the exchange rate would be set such that Party NL could forthwith acquire the relevant amount in euro that is due.

Under Dutch contract law, the place of payment is in principle the place of residence of the creditor.[15] Accordingly, Party IT may in Case I only pay in lira and Party NL may only require payment in lira if the loan agreement provides that the place of payment is in Italy.

3.3. Question 3: What is the competent forum?

The jurisdiction of courts of the EU Member States in civil and commercial matters is to be determined in accordance with Brussels I Regulation 44/2001.[16] According to article 23 of the Brussels I Regulation, parties to a commercial contract may make use of their contractual freedom and agree on a choice of forum clause to confer exclusive jurisdiction on the courts of a certain EU Member State.

In principle, the introduction of monetary legislation by Italy, as in Case I, would have no effect on the jurisdiction of Dutch courts based on the Brussels I Regulation. This jurisdiction is to be determined without taking into account the substantive law which the court having jurisdiction is bound to apply under the Rome I Regulation.[17]

3.4. Question 4: Will a judgment by a Dutch court be recognized and enforceable in the relevant other countries, particularly in Italy in this case?

Judgments in civil and commercial matters rendered by courts of an EU Member State will be recognized and enforceable in other EU Member States in accordance with the Brussels I Regulation. Accordingly, in Case I, Italy would in principle need to recognize and allow enforcement of a judgment by a Dutch court that confirms that Party IT should make payments in euro to Party NL, notwithstanding Italy's exit from the Eurozone and the introduction of monetary legislation by Italy.

However, according to article 34, paragraph 1 and article 45, paragraph 1 of the Brussels I Regulation, recognition and enforcement will be refused if such recognition or enforcement is manifestly incompatible with public policy of the relevant EU Member State in which recognition or enforcement is sought.

Thus, if in Case I a Dutch court were to decide not to give effect to the monetary legislation of Italy, the Dutch court's judgment may nonetheless be refused recognition and enforcement in Italy on the ground of its incompatibility with Italy's public policy. The location of Party IT's assets will consequently be very important for Party NL's possibilities to seek recourse. If all of Party IT's assets are located in Italy, Party NL could effectively incur losses similar to the currency losses it would incur had the payments obligation been redenominated into lira because of the unenforceability of the Dutch court's judgment.

4. Tax Implications

4.1. General

It follows from the above that significant (currency) losses may be incurred as a result of the exit of an EU Member State and the re-establishment of a national currency by that Member State. If in Case I the euro debt owed by Party IT to Party NL were legally converted into lira, Party NL would incur substantial currency exchange losses. In respect of Cases II and III, Party NL would incur substantial currency losses because the fair market value expressed in euro of the Italian subsidiary or the assets

12. Sec. 6:111 Dutch Civil Code, HR, 2 Jan. 1931, NJ 1931, 274 (*Mark is Mark*). A.R. Bloembergen, WPNR 1967/4965, at 399; S. Royer, RMThemis 1972, at 541; Asser & Hartkamp II, 338; W.A.K. Rank, *Geld, geldschuld en betaling* 128-129, (diss. Leiden) (Deventer, 1996).
13. Sec. 6:121, para. 1 Dutch Civil Code (*Burgerlijk Wetboek*, BW). Payment in the currency of the place of payment is not allowed in situations where it follows from the law, usage or contract that the obligor must effectively pay in the nominated currency.
14. Sec. 6:122, para. 1 Dutch Civil Code. This statutory provision implements the principle that the statutory force majeure exception does not similarly apply to monetary obligations.
15. Secs. 6:116 through 6:118 Dutch Civil Code.
16. OCJ L 12, 16 Jan. 2001, at 1.
17. *See*, in the context of a choice of forum clause, ECJ, Case C-159/97, *Castelletti v. Trumpy* (1999) ECR I-1597.

and liabilities attributable to the Italian permanent establishment respectively would likely decrease as a result of Italy's exit from the Eurozone.

The relevant questions for tax purposes can be summarized as follows: (1) when will currency profits or losses need to be recognized and (2) in relation to investments in foreign subsidiaries to which the participation exemption applies, or for profits and losses attributable to foreign permanent establishments, will currency gains and losses fall within the scope of such exemptions.

At this point, the consequences for Dutch tax purposes do not differ in any respect from the case in which any other foreign currency devalues relative to the euro. For that reason, the following merely lists the issues that the authors have identified as key aspects in this context; it does not discuss all relevant aspects in depth.

4.2. Recognition of (currency) results

The recognition of currency results is a matter of allocation to specific taxable years rather than a matter of taxation of the total profits earned by a taxpayer during the period of its existence. The question regarding in which taxable year (rather than whether) currency gains and losses need to be or can be recognized is governed by the doctrine of "sound business practice".[18] As the law only provides an "open norm", the application of this doctrine in specific cases has been developed – and is subject to continuous further development – in case law.[19] The main rules in respect of the valuation of assets can be described as follows:

– assets *may* generally be valued at cost price[20] or at the lower of cost price and value in use (*Niederstwertprinzip*),[21] except for cash deposits and highly tradable assets which are valued at fair market value.[22] For receivables expressed in a currency that differs from the currency in which the Dutch taxpayer reports its taxable profits,[23] this implies that they are valued, in principle, at either cost price (i.e. by using the historical exchange rate) or the lower of cost price or the fair market value (i.e. by using the (lower) current spot rate);[24] and
– loans payable (and other liabilities) expressed in a different currency generally *must* be valued at nominal value and at the higher of the historical exchange rate and the current spot rate [25]

Consequently, contingent currency losses on receivables may, and currency losses on payables must, be taken into account by the Dutch corporate taxpayer immediately, but contingent currency gains may be deferred until realization.[26] If in Case I the debt owed by Party IT to Party NL were converted into lira, Party NL may immediately take into account the currency losses upon depreciation of the lira for Dutch tax purposes, lowering its tax burden in the year of depreciation, regardless of whether these losses were actually realized at that time.

In principle, assets and liabilities must be valued separately.[27] However, based on the matching principle, instruments that serve as an effective hedge against a currency or other exposure in respect of certain assets or liabilities may need to be valued in coherence with such assets or liabilities.[28] The following two aspects are decisive for determining whether there is an obligation for matching valuations: (1) the relationship between the relevant contracts, assets and liabilities[29] and (2) the effectiveness of the hedge.[30] The conversion of a currency that only affects one leg and not the other could lead to the principle of matching no longer applying. In the context of Case I, this could only be relevant if Party NL reported its taxable profits in a different currency, say US dollars, and funded the loan made to Party IT with a euro loan.[31] If the loan made to Party IT were redenominated into lira while the

18. Sec. 3.25 Dutch Income Tax Act (*Wet op de Inkomstenbelasting* 2001) (ITA) in conjunction with sec. 8 Dutch Corporate Income Tax Act (*Wet op de Vennootschapsbelasting* 1969) (CITA).
19. The important principles of sound business practice that have been developed in case law are: (1) the realization principle, (2) the principle of reality, (3) the matching principle, (4) the principle of prudence and (5) the principle of simplicity.
20. For fixed assets, "cost price" means historical cost price minus depreciation or amortization.
21. Value in use is the highest of the direct realizable value and the indirect realizable value. The direct realizable value is the net cash proceeds that would be received upon the direct sale of the asset. The indirect realizable value is the net present value of the future cash flows that can be attributed to the relevant asset. The value in use must be determined objectively, i.e. by determining the part of the total value of the business that a third-party purchaser would allocate to the relevant asset if this purchaser were to continue the business as a going concern. *See* HR, 26 632, 17 Apr. 1991, FED 1991/551 with annotation L.G.M. Stevens; HR, 23 159, 11 Dec. 1985, BNB 1987/187. *See* also IAS 36.6, which defines value in use as "the discounted present value of the future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life".
22. For certain specific asset classes, such as real estate, Dutch tax law provides for specific valuation rules.
23. Pursuant to section 7 paragraph 5 of the CITA, a Dutch corporate income taxpayer may report its taxable income in another currency than euro if, among other things, it also prepares its commercial accounts in that other currency. Further conditions are set out in Functional Currency Decree No. WDB97/348M, dated 21 Aug. 1997, as most recently amended by No. DB2010/281M, 23 Dec. 2010, *Stcrt.* 2010, 21111, VN 2011/5.2.33.
24. Receivables that are immediately due and payable and current account receivables always need to be valued at the current spot rates. *See* The Hague Court of Appeal (*Gerechtshof Den Haag*), No. 99/01680, 11 Dec. 2001, V-N 2002/33.21.
25. P.G. Kroon, S.F.M. Niekel & J.W. Tangelder, *Wisselkoersveranderingen en fiscus*, Fed Fiscale Brochures 75-76 (Fed Deventer 2000).
26. Exceptions may apply, and contingent currency gains may not be deferred, if and to the extent (1) the exchange rate of the foreign currency has significantly and permanently changed relative to the currency in which the taxpayer reports its taxable income (see The Hague Court of Appeal (*Gerechtshof Den Haag*), 83/74, 29 Oct. 1974, BNB 1975/201) and (2) currency losses on the relevant assets were previously taken into account.
27. HR, 11 115, 3 Dec. 1952, BNB 1953/19; HR, 12 303, 25 May 1955, BNB 1955/247; HR, 12.931, 8 May 1957, BNB 1957/208. *See* also W. Bruins Slot, *Cacaobonenarrest: stellig onbedoelde gevolgen*, NTFR Beschouwingen, 2009/27; S. Peelen & B. van Kasteren, *Of Hedges and Cacao Beans: Supreme Court Ruling on Hedge Accounting for Tax Purposes*, 11 Derivs. & Fin. Instrums. 4, sec. 2.2. (2009), Journals IBFD; L.A. Lutz & W.J.W. Vosse, *Het Cacaobonen-arrest: nadere regels met betrekking tot (verplichte) samenhangende waardering*, MBB 2, pp. 69-76 (2010).
28. HR, 37 893, 23 Jan. 2004, BNB 2004/214 (*Hedge* case); HR, 42 970, 16 Nov. 2007, BNB 2008/26 (*Call Option* case); HR, 42 916, 10 Apr. 2009, BNB 2009/271 (*Cacao beans* case).
29. From the *Cacao beans* case, which concerned forward sales and purchase contracts for cacao beans and cacao products, it appears that the nature of the contracts and the intention of the taxpayer are relevant in this context.
30. In the *Cacao beans* case, the Supreme Court considered a hedge effective if it correlates between 80% and 125%, which is the same range as used under IAS 39.
31. *See supra* n. 23.

funding loan remained denominated in euro, the matching principle would no longer apply to the valuation of the loan to Party IT and the funding loan. This would allow Party NL to report a currency loss on the lira loan made to Party IT, but deferring a currency gain on the euro funding loan, if any, until actual realization.

Furthermore, even if no redenomination were to take place, there may be obvious reasons based on the valuation principles described above for Party NL to take an impairment on the loan made to Party IT. For instance the fair market value of the loan is likely to have decreased as a consequence of a deterioration of the solvency and liquidity position of Party IT or long payment delays are expected resulting from Italy's introduction of exchange and capital controls.

4.3. Participation exemption

4.3.1. Currency results on qualifying participations exempt

Pursuant to the participation exemption, profits and losses derived by a Dutch corporate taxpayer from Dutch or foreign subsidiaries are generally exempt from Dutch corporate income tax if the Dutch corporate taxpayer holds at least 5% of the share capital of such subsidiary.

In Case II, Party NL may incur substantial currency losses on its equity participation in Party IT as a result of Italy's exit from the Eurozone and the subsequent depreciation of the lira. From the date of such exit, Party IT's assets and liabilities, and future revenues, would likely be effectively expressed in lira and, accordingly, the fair market value of Party NL's investment in Party IT would decrease. Pursuant to the participation exemption, the loss in the form of a reduction of fair market value will in principle not be deductible for corporate income tax purposes.[32]

4.3.2. Possible exception: Deutsche Shell

Deutsche Shell[33] involved a German corporate taxpayer which, prior to introduction of the euro, carried on business in Italy through a permanent establishment. When the lira depreciated relative to the Deutsche Mark, the German taxpayer incurred a loss on the investment in Italian assets through the permanent establishment.[34] No currency loss was incurred for Italian corporate income tax purposes because the profits of the permanent establishment were determined in lira. In Germany, the currency losses were not taken into account for corporate income tax purposes, as all profits and losses attributable to the Italian permanent establishment were eliminated from the taxable base. The European Court of Justice (ECJ) ruled that the German rules constituted a violation of the freedom of establishment.

Dutch commentators on *Deutsche Shell* have argued that the rationale of this case can equally be applied to the non-deductibility of capital losses on qualifying EU participations, in that it violates the EU freedom of establishment.[35] In Case II, Party NL would argue that deduction of the currency losses incurred on Party IT must be allowed because these currency losses cannot be taken into account in Italy because Party IT accounts in lira as from Italy's exit from the Eurozone.[36]

In response to *Deutsche Shell*, on 10 December 2011 the Dutch legislature introduced "remedial" legislation[37] with retroactive effect as from 8 April 2011, 5 p.m. CET.[38] The legislation provides that, if a taxpayer successfully reports a currency loss based on the rationale of *Deutsche Shell*, the participation exemption will not apply to any currency gain in respect of all qualifying participations held by that taxpayer.

4.3.3. Treatment of currency results on currency hedging instruments relating to participations

In principle, the participation exemption applies only to investments in qualifying participations and not to liabilities incurred in connection with such investments. As a result, profits or losses as a result of currency fluctuations on loans payable or on (other) currency hedging instruments relating to qualifying participations are not exempt pursuant to the participation exemption. As an exception to this rule, positive and negative results on instruments that were entered into with the aim to serve as hedges for currency exposures on qualifying participations are nonetheless exempt pursuant to the participation exemption if the Dutch tax authorities have issued a ruling to that effect upon a request that was filed by the taxpayer in advance of entering into the hedging instrument.[39]

It is possible that a debt or other hedge instrument denominated in euro which, pursuant to a ruling as described above, qualified for the participation exemption does no longer serve as a hedge as a consequence of Italy exiting the euro, resulting in a reduction of the value of the Italian participation expressed in euro. In the context of Case II, this may be of relevance if Party NL (1) reports in a functional currency, say US dollars and (2) obtained a ruling from the Dutch tax authorities that US dollar/euro currency results on the funding loan are exempt pursuant to the participation exemption.

4.4. Permanent establishments

The Netherlands introduced a new regime regarding foreign permanent establishments of Dutch corporate taxpayers as from 1 January 2012.[40] As a rule, profits and

32. HR, 21 142, 9 June 1982, BNB 1982/230.
33. DE: ECJ, 28 Feb. 2008, Case C-293/06, *Deutsche Shell GmbH v. Finanzamt für Grossunternehmen in Hamburg*, ECJ Case Law IBFD.
34. Actually, the permanent establishment was converted into an Italian subsidiary which was disposed of shortly after this conversion for a purchase price in lira. Upon conversion of the lira amount into Deutsche Mark, the taxpayer actually realized the currency loss.
35. Liquidation losses on qualifying participation are generally tax deductible pursuant to section 13d of the CITA.
36. This assumes that the subsidiary does not report in a functional currency in Italy. The authors are not aware of the possibility to report in a functional currency in Italy.
37. Sec. 28b CITA.
38. On this date, the new legislation was announced by the Dutch State Secretary of Finance.
39. Sec. 13, para. 7 CITA.
40. Sec. 15e-j CITA.

losses attributable to a foreign permanent establishment are fully exempt from Dutch corporate income tax, by means of deducting the profits attributable to the permanent establishment (the "exempt" profits) from the Dutch taxpayer's worldwide profits (which include the permanent establishment profits). As an important exception to this rule, while a taxpayer's worldwide profits are calculated and reported in euro or in its "functional currency",[41] for purposes of calculating the exempt profits attributable to the foreign permanent establishment, the local currency must be applied.[42] Subsequently, the profits in the local currency are converted into euro (or, if applicable, into the functional currency). Such conversion of the exemption profits, in principle, must be based on the average of the exchange rate at the beginning and at the end of the fiscal year.[43,44] As a result of this system, currency exchange results from exchange rate fluctuations between the euro or, where applicable, the Dutch taxpayer's functional currency and the currency of its foreign permanent establishment are included in the Dutch taxable profits.[45]

In Case III, this means that Party NL may deduct from its taxable profits in the Netherlands (contingent) currency losses on its Italian permanent establishment following Italy's exit. In respect of cash deposits and highly tradable assets, (contingent) currency losses may be recognized immediately upon the depreciation of the lira because these assets are valued at fair market value. In respect of fixed assets, recognition of currency losses will depend on the valuation method that Party NL applies. If Party NL applies cost price or lower value in use (*see* 4.2.), Party NL may, in the view of the authors, immediately recognize (contingent) currency losses, provided that the depreciation has resulted in a lower value in use.[46] If Party NL applies cost price as valuation method, Party NL may only recognize currency losses upon realization resulting from a disposal or otherwise or to the extent of any depreciation or amortization of the relevant fixed assets.[47]

4.5. Credit for foreign withholding taxes

A Dutch corporate taxpayer is generally eligible for an ordinary credit for foreign withholding tax on interest, royalties and, if not exempt pursuant to the participation exemption, dividends withheld by (1) a country which has entered into a treaty for the avoidance of double taxation with the Netherlands or (2) a developing country.[48]

This credit is subject to certain limitations. One limitation is that the amount of the credit may not exceed the Dutch corporate income tax on the net amount of the interest, royalties or dividends in the relevant year. This net amount will be determined by reducing the gross amount of interest, royalties or dividends received by related costs and expenses. In a recent case, the Dutch Supreme Court ruled that, under the Netherlands–Brazil tax treaty, currency losses on a loan made by a Dutch taxpayer to a Brazilian debtor cannot be considered "related costs and expenses" and consequently do not reduce the maximum credit for withholding tax withheld on interest paid or received on that loan.[49]

In Case I, Party NL would be eligible for a credit for Italian withholding tax on interest payments by Party IT.[50] The credit would not be reduced by any currency losses that Party NL would incur, and reporting for Dutch tax purposes, on the loan made to Party IT following the Italy's exit from the Eurozone. However, costs and fees, including foreign exchange margins, for any currency hedges entered into by Party NL, at any stage after Italy's exit (or prior to Italy's exit if it can find a proxy), would arguably reduce the maximum amount of the credit for Italian withholding tax.[51]

The withholding tax withheld in the local currency (in Case I, lira) would be converted at the exchange rate on the payment date of the interest, dividend or royalties.[52]

41. *See supra* n. 23.
42. This follows from rulings in the *Rupiah* cases, HR, 31 Mar. 1954, BNB 1954-180; HR, 21 Mar. 1956, BNB 1956-158; HR, 27 Apr. 1960, BNB 1960/161 t/m 166. The exempt profits may even take into account currency results which are not taken into account in the taxpayer's general profits in the event that the permanent establishment has assets or liabilities expressed in the currency of the taxpayer while the local currency or, if applicable functional currency of the permanent establishment, is different (HR, 37 893, 23 Jan. 2004, BNB 2004/214). As an exception, if the taxable profits of the permanent establishment are calculated in a different currency or accounting unit than the local currency of the country where the permanent establishment is located, this other currency or accounting needs to be used for calculating the exempt profits (HR, 37 743, 5 Dec. 2003, BNB 2004/139 (*Cruzeiros*)). This is confirmed in a Resolution of the Dutch State Secretary of Finance dated 11 May 2011, BLKB2011/392M.
43. Recently confirmed in HR, 37 743, 5 Dec. 2004, BNB 2004/139. Conversion may also be based on the year-end rate; *see* HR, 31 Mar. 1954, BNB 1954/180; Court of Appeal Amsterdam (*Gerechtshof Amsterdam*), 1352/75, 28 Feb. 1977, BNB 1978/134; HR, 26 050, 17 June 1990, BNB 1990/252.
44. As an exception, if profits in the local currency are not evenly spread over the year, shorter conversion periods must be applied in cases of hyperinflation (e.g. the average rate at the beginning and the end of a month). *See* HR, 37 743, 5 Dec. 2004, BNB 2004/139.
45. A credit system applies to low-taxed passive portfolio investment permanent establishment. *See* section 15e, paragraph 7 in conjunction with section 15g of the CITA.
46. In a resolution dated 20 Sep. 1957, BNB 1957/272, the Dutch Minister of Finance took the position that currency losses on fixed assets may not be recognized in the taxpayer's total profits. This position is, in the authors' opinion, not in accordance with the principles of sound business practice and the (previous and current) mechanism for the exemption of profits attributable to a permanent establishment. *See* also Amsterdam Court of Appeal (*Gerechtshof Amsterdam*), 92/2206, 25 May 1993, BNB 1994/161, which suggests that if a taxpayer values assets at the lower of cost price or value in use and it can demonstrate that the value in use is lower than the cost price as a result of currency fluctuations, it may recognize the difference as a loss for Dutch tax purposes.
47. Because the value of Party NL's permanent establishment assets expressed in euro based on historical cost price (general taxable profits) is higher than based on the current spot rate (exempt profits), the amount of depreciation or amortization in the general profits will be higher than in the exempt profits and, accordingly, the difference may be taken into account for Dutch tax purposes as "currency" loss.
48. Sec. 36 Decree for the Avoidance of Double Taxation.
49. HR, 10/00076, 17 June 2011, BNB 2012/23.
50. Based on the Netherlands–Italy tax treaty, the withholding tax rate is limited to 10%. Because Party IT and Party NL are unrelated, the Interest and Royalty Directive exemption does not apply.
51. A.C. van der Linde, *De tweede limiet en het disagio op een valutatermijncontract*, WFR 2011/1513.
52. In the Resolution of the Dutch State Secretary of Finance dated 11 May 2011, BLKB 2011/392M, *Stcrt.* 2011, 8702, it is approved that if the taxpayer reports in a functional currency, it may convert the amount of withholding tax in the local currency into the functional currency at the exchange rates applicable on the transaction date.

5. Conclusion

It follows from the above that the contract law implications of the exit of a Eurozone Member State may be very severe and cause uncertainties. It cannot be ruled out that, even if Dutch courts would be competent, euro payment obligations will be redenominated into lira payment obligations and, consequently, creditors may be exposed to new currency risks. Furthermore, courts of law in exiting Eurozone Member States may refuse recognition and enforcement of judgments which stipulate that no redenomination should occur.

Taxpayers may incur significant currency losses if assets or liabilities will be expressed in, or the value of which will become heavily dependent on, the new currency introduced by a Member State upon its exit from the Eurozone. However, the tax implications are not different from the situation that a taxpayer holds assets or liabilities in any other foreign currency and are primarily related to the question as to if and when currency results may be recognized for tax purposes.

Cumulative Index

India

P. Raj Kumar Jhabakh*

Recent Case Law: Indirect Transfer of Interest and Controlling Stake in an Indian Company Held Taxable

This article analyses a recent ruling of the Authority for Advance Ruling (AAR) in the case of *Groupe Industrial Marcel Dassault and Murieux Alliance*[1] wherein the AAR held that, despite a transaction being legally valid but having the purpose to create a legal smokescreen to avoid the payment of tax, the legal effect of such transaction in the context of the taxing statute must be considered in determining the taxability of that transaction.

1. Introduction

Recently, there has been a spate of rulings by the Indian courts relating to the indirect transfer of assets and a controlling interest in an Indian company by transferring shares of a foreign holding company to another non-resident company. The AAR ruling in the *Dassault and Murieux Alliance* case is in line with the ongoing debate on such transfers, and the AAR held that the transfer of shares of a French company to another French company which relates to an indirect acquisition of assets and a controlling interest in an Indian company is taxable and is a guise to avoid payment of taxes.

2. Factual Background

Murieux Alliance, a company incorporated in France, incorporated a wholly owned subsidiary, ShanH (acquisition vehicle), in France on 31 October 2006. On 6 November 2006, Murieux Alliance entered into a share purchase agreement to acquire the shares of an Indian company, Shantha Biotechnics Ltd (Shantha). The shares in Shantha were acquired by ShanH or in the name of ShanH by Murieux Alliance. The original capital flowed from Murieux Alliance, and even the stamp duty was paid by Murieux Alliance, which was subsequently repaid by ShanH. On 12 March 2007, Groupe Industrial Marcel Dassault (Dassault) acquired 20% of the ShanH shares from Murieux Alliance. A commercial transaction was carried out between the parties whereby Sanofi Pasteur Holding (Sanofi), another French company, came forward to participate actively with Murieux Alliance and Dassault as a strategic investor. Further, with a view to improve the business and performance of Shantha, Murieux Alliance and Dassault sold their shares in ShanH to Sanofi in August 2009.

3. Issue before the AAR

On 20 November 2009, Murieux Alliance and Dassault filed applications before the AAR under the Indian Income Tax Act, 1961 (the Act) seeking an advance ruling on whether, under the India–France income tax treaty of 6 September 1994 (India–France treaty) read with section 90[2] of the Act, the capital gains arising from the sale of ShanH shares by Murieux Alliance and Dassault to Sanofi is liable to tax in France or in India.

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1. AAR 846 and 847 (2009).

2. Sec. 90 Agreement with foreign countries or specified territories.
(1) The Central Government may enter into an agreement with the Government of any country outside India or specified territory outside India:
(a) for the granting of relief in respect of:
(i) income on which have been paid both income-tax under this Act and income-tax in that country or specified territory, as the case may be, or
(ii) income-tax chargeable under this Act and under the corresponding law in force in that country or specified territory, as the case may be, to promote mutual economic relations, trade and investment, or
(b) for the avoidance of double taxation of income under this Act and under the corresponding law in force in that country or specified territory, as the case may be, or
(c) for exchange of information for the prevention of evasion or avoidance of income-tax chargeable under this Act or under the corresponding law in force in that country or specified territory, as the case may be, or investigation of cases of such evasion or avoidance, or
(d) for recovery of income-tax under this Act and under the corresponding law in force in that country or specified territory, as the case may be,
and may, by notification in the Official Gazette, make such provisions as may be necessary for implementing the agreement.
(2) Where the Central Government has entered into an agreement with the Government of any country outside India or specified territory outside India, as the case may be, under sub-section (1) for granting relief of tax, or as the case may be, avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of this Act shall apply to the extent they are more beneficial to that assessee.
(3) Any term used but not defined in this Act or in the agreement referred to in sub-section (1) shall, unless the context otherwise requires, and is not inconsistent with the provisions of this Act or the agreement, have the same meaning as assigned to it in the notification issued by the Central Government in the Official Gazette in this behalf.
Explanation 1. For the removal of doubts, it is hereby declared that the charge of tax in respect of a foreign company at a rate higher than the rate at which a domestic company is chargeable, shall not be regarded as less favourable charge or levy of tax in respect of such foreign company.
Explanation 2. For the purposes of this section, "specified territory" means any area outside India which may be notified as such by the Central Government.

4. Contentions of the Parties

Murieux Alliance and Dassault put forth the following arguments before the AAR:

- the transaction related only to the sale of ShanH shares, and that had nothing to do with the Shantha shares. The establishment of a subsidiary company for making fresh acquisitions was a legal, permissible and known method of conducting business, and there was nothing illegal in forming a subsidiary for the purpose of acquiring shares in Shantha. The Shantha shares were not being dealt with, although the consequence of the buying of ShanH shares by Sanofi might be to give control of the affairs of Shantha to Sanofi – which was a legal and legitimate business route which did not attract taxability as capital gains in India;
- any attempt to tax the sale of ShanH shares to Sanofi was sanctioned by neither the Act nor the India–France treaty. The power to tax was with France and not with India. Further, there was no treaty shopping or evasion of tax involved, as any capital gain was taxable in France; and
- the tax authorities needed to take into account the incorporation of ShanH in France, the tax residency certificate produced and the recognition of the transaction even by the Indian government. Thus, in light of the principle settled in the *Azadi Bachao Andolan* case,[3] there is no question of attempting to pierce the corporate veil and attempting to go behind the existence of ShanH in the eyes of law, ignoring the tax residency certificate issued to it by the French tax authorities.

It was argued on behalf of the Indian tax authorities (Department of Income Tax) that:

- ShanH was merely a company on paper, having no office and no employees. Further, it was Murieux Alliance that entered into the share purchase agreement. ShanH had no other business and it held no assets other than the shares in Shantha;
- the prior transactions leading to the present transaction of the sale of Shantha shares were only transactions on paper, and they were part of an elaborate scheme to avoid tax in India. ShanH was created merely for the purpose of dealing with the assets of Shantha, and its creation was merely to avoid the tax that may be due from the transaction involving the Shantha shares. What was involved in the alleged sale of ShanH shares by Murieux Alliance and Dassault to Sanofi was the transfer of the assets of an Indian company and certainly the controlling interest in the Indian company, Shantha; and
- in reality, the sale of shares in ShanH held by Murieux Alliance and Dassault to Sanofi, attracted capital gains tax in India and the transaction was liable to be taxed in India.

3. IN: SC, 7 October 2003, 263 ITR 706 (SC), *Union of India and another v. Azadi Bachao Andolan and another*, Tax Treaty Case Law IBFD.

5. Issue To Be Considered Prior to Addressing the Application for a Ruling

5.1. Generally

Prior to addressing the issue raised before the AAR in the request for a ruling, the AAR considered the question of whether the present transaction related to avoidance of tax in India. The Indian tax authorities raised this objection, stating that the AAR may not issue a ruling, as the present transaction related to avoidance of tax. The AAR therefore dealt with this issue before answering the issue raised by Murieux Alliance and Dassault in their request for a ruling.

5.2. Applicability of holding in Azadi Bachao Andolan to the present transaction

The AAR noted that the decision of the Supreme Court in the case of *Azadi Bachao Andolan*, although binding on the AAR, was not the final word in a given situation, when this AAR was approached for an advance ruling. The proviso to section 245R(2) of the Act mandates that the AAR may not allow any application for a ruling where the question raised in the application relates to a transaction or issue which is designed, prima facie, for the avoidance of income tax. Thus, in considering whether a transaction is for avoidance of tax, the AAR is not piercing the veil of the corporate entity, but is merely asking the question of whether there was a step taken or a series of steps taken, that may have a business purpose but is clearly a device to avoid the liability to pay tax, and to look at the transaction within the confines of the proviso.

The AAR further noted that *Azadi Bachao Andolan* considered the effect of the judgment of the earlier constitution bench decision of the Supreme Court in the *McDowell* case.[4] One of the main issues involved was whether a tax avoidance scheme or attempt at avoidance of tax was liable to be accepted by a court once it was shown that it was not an objectionable evasion. The AAR held that, speaking through Ranganath Misra J. in the *McDowell* case, the four other judges left it to Chinnappa Reddy, J. to deal with this issue. The four judges referred to some of the earlier decisions on the subject, observing:

> The [tax] planning may be legitimate provided it is within the framework of law. Colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax by resorting to dubious methods. It is the obligation of every citizen to pay the taxes honestly without resorting to subterfuges.

They further noted: "On this aspect, one of us, Chinnappa Reddy, J. has proposed a separate and detailed opinion with which we agree".

Thus, according to the AAR, *Azadi Bachao Andolan* therefore seemed to proceed on the basis that the views expressed by Chinnappa Reddy, J. in the *McDowell* case are his own and do not represent the view of the Court as a whole, which does not appear to be correct according to the AAR.

4. IN: *McDowell and Co. Ltd. v. Commercial Tax Officer*, 154 ITR 148.

The AAR reviewed certain English judgments and noted that in the recent case of *HMRC v. Tower MCashback LLC*[5] the Supreme Court of England reiterated and applied the Ramsay principle to find whether a transaction is genuine or is to be regarded as part of a tax avoidance scheme so as to deny the full relief to the taxpayer. Thus, according to the AAR on review of the judgments, the view that has emerged is that notwithstanding the legal validity of a transaction or a set of transactions, if the purpose was to create a legal smokescreen to avoid the payment of tax that would legitimately be due as having arisen on the basis of a transaction or an event, the legal effect of the transaction in the context of the taxing statute, must be considered, notwithstanding its reality or validity.

5.3. Analysis of the above principle in context of the *Murieux Alliance and Dassault* case

The AAR applied the above principle to the facts of the present case to determine whether the transaction involved the avoidance of tax. According to the AAR's view of the facts in this case, a company in France invested in acquiring shares in an Indian company and ultimately acquired a controlling interest. For this purpose, it created a wholly owned subsidiary, ShanH. The shares were taken in the name of ShanH. Subsequently, another company also came in and acquired some of the shares in ShanH. The only asset of ShanH was the shares of the Indian company; it had no other business. Further, the two shareholders of ShanH sold the ShanH shares to Sanofi. In that process, what really passed was the underlying assets and the control of the Indian company, Shantha. Thus, this transaction generated a gain. By repeating the process, control over the Indian assets and business could pass from one party to another without incurring any liability to tax in India, if the transaction were to be accepted at face value. This type of attempt is what was frowned upon in the *McDowell* decision. This also reflects the line of reasoning in the English Courts. The payment of tax on capital gains over the Shantha shares could be perpetually avoided by dealing with the ShanH shares by passing effective control over the assets and the business of Shantha. It is the adoption of such devices that is not accepted at face value by courts and treated as ineffectual for the purpose of averting payment of tax due under the statute.

It was argued on behalf of Murieux Alliance and Dassault that what is taxed by the taxing statute is the gain arising from the sale of the shares of an Indian company, and that taxing event had not taken place. Further, the concepts of underlying assets and controlling interest are not concepts that are recognized when interpreting the taxing statute. A taxing statute is to be construed strictly and nothing is to be added or subtracted. Nor can it be interpreted in such a manner that transactions not directly falling within its ambit, are also roped in based on presumed intention or purpose.

5. (2011) UK SC 19.

The AAR further noted that the legal validity of a transaction or the adoption of a series of transactions commonly used, like creating a wholly owned subsidiary for making such investments in another country, cannot stand in the way of the question being asked, namely whether it is acceptable in the context of the taxing statute. What is therefore happening is that by accepting the present transaction in the context of the taxing statute, the assets and control of an Indian company are being indirectly transferred repeatedly without the shares of the Indian company being touched. Therefore, the AAR held that when dealing with such a question, the AAR may not ignore the aspects of underlying assets and control over the affairs of the company, passing from one party to another.

The AAR asked the question as to when a commonly adopted business scheme may be treated as an attempt at avoidance of tax liability not to be accepted by the tax regime. In its response, the AAR noted that this will depend on the effect of the scheme as a whole on the liability of the entity to be taxed. In this case, a permissible commercial scheme was adopted to acquire the shares, the underlying assets and control of an Indian company. But thereafter, in the guise of dealing with the shares of a subsidiary formed for such acquisition, the underlying assets, business and control of an Indian company were passed from one party to another. By repeating this process, without touching the shares of the Indian company, the right and dominant control over its assets and business could pass from one party to another. Looking at the series of transactions from the commencement of the formation of ShanH, it appears that it was a preordained scheme to produce a given result, namely to deal with the assets and control of Shantha without actually dealing with the Shantha shares or its assets and business.

This adopted scheme must be seen as one for avoiding payment of capital gains tax which would otherwise arise if the shares of the Indian company were transferred, leading to the same result as now achieved. The AAR therefore held that a scheme of this nature cannot be accepted simply for the reason that "upon the true construction of the Statute, the transaction which was designed to avoid the charge to tax, actually comes within it".

6. Issue Answered

After dealing with the preliminary issue as raised by the Indian tax authorities, the AAR moved on to consider the issue raised by Murieux Alliance and Dassault. The AAR noted that the object of the India–France treaty is not only to avoid double taxation, but also to prevent fiscal evasion with respect to taxes on income and capital as envisaged in the preamble, which provides as follows:

> The Government of the Republic of India and Government of the French Republic, desiring to conclude a convention for avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on Income and capital.

Thus, to test whether an adopted scheme has the object of avoidance of tax which would have otherwise been payable, an enquiry in that regard is contemplated by the India–France treaty.

It was argued on behalf of Murieux Alliance and Dassault that the transaction in question is governed by article 14 of the India–France treaty. Under article 14(5), gains from the alienation of shares representing a participation of at least 10% in a French-resident company is taxable in France. Further, as the shares being sold are of a company incorporated in France and which is a tax resident of France, to another tax resident of France, the gain therefrom is taxable only in France. It was further asserted that unlike article 14(1) relating to immoveable property, article 14(5) does not permit look-through, and the transaction must be accepted as it is. The fact that the asset is located in another country is irrelevant. Indeed, although the India–France treaty could have provided for such look-through, the agreed text contains no such provision. Alternatively, it was submitted that even if article 14(5) were held not to be applicable to bring about the above result, under article 14(6)[6] of the treaty, the transaction is taxable only in France. It was submitted that the applicants – the alienators in this case – are resident in France and, under article 14(6), the transaction would be taxable in France.

The Indian tax authorities asserted that "alienation" is a word of wide import and, read with the words "participation of at least 10% in a company", would mean that the conveying of such rights of participation would also attract tax in India, if the interest of participation is of an Indian company. It was asserted that the transfer of the right of participation in an Indian company – even by a non-resident – outside India which allows the transfer of a participation interest in an Indian company would be taxable in India under article 14(5) of the India–France treaty. Participation in a company would mean the right to vote, the right to nominate directors, control and management, day-to-day decision making and right to receive profit distributions. It was therefore argued that all these rights in respect of the Indian company, Shantha, are with Murieux Alliance and Dassault, and hence the transfer being considered in this case is taxable in India under article 14(5).

The AAR held that a true interpretation of the India–France treaty article 14(5) would lead to the position that the transfer of ShanH shares may be taxed only in France. However, the AAR noted that according to the contention of the Indian tax authorities, the situs of the underlying assets and the controlling interest are those of a company both incorporated and resident in India. Thus, what is involved in the present case is an alienation of the assets and controlling interest of an Indian company. As the present transaction is a scheme for the avoidance of tax, the gain from the sale of shares is taxable in India.

Therefore, on a purposive interpretation of article 14(5) of the India–France treaty, the AAR concluded that the capital gains arising from the transaction are taxable in India. The essence of the transaction takes within its scope various rights, including a change in the controlling interest of an Indian company having assets, business and income in India.

7. Conclusion

The present ruling departs significantly from the ruling of the Supreme Court in the case of *Azadi Bachao Andolan*, including with regard to the validity of the submitted tax residency certificate. This ruling also sets a benchmark for the AAR to delve into the preliminary issue of avoidance of tax. In the present case, the AAR merely factually analysed the situation without providing or citing any relevant legal provisions of the India–France treaty or the Act.

However, this ruling is dependent on a specific fact pattern and is binding only on the applicant; it may not be taken as a general proposition of law.

6. Gains from the alienation of any property other than that mentioned in paragraphs 1, 2, 4 and 5 shall be taxable only in the contracting state of which the alienator is a resident.

Viva Hammer*

Recent Developments in the Legislative and Regulatory Arena

The author considers numerous recent developments in the United States, including court decisions and IRS revenue rulings, notices, field advice and regulations.

1. Court of Federal Claims Allows Insurance Company's Deductions for Dividend Guarantees

In *Massachusetts Mutual Life Insurance Co. v. United States*,[1] the US Court of Federal Claims upheld the deductibility of the taxpayer's aggregate, declared and guaranteed policyholder dividends against challenges by the government that the taxpayer's liability for the dividends was not fixed in the year the dividends were declared, that economic performance had not occurred by year-end and that the taxpayer's dividend guarantees lacked economic substance.

The opinion reaches what tax professionals believe is the correct technical result and contains favourable language for taxpayers regarding the applicability (or lack thereof) of the economic substance doctrine. Given the strongly worded opinion, it will be interesting to see whether the government will appeal the decision to the US Court of Appeals for the Federal Circuit.

In this 83-page decision, the issue was for each of the three years whether for federal income tax purposes the taxpayer was entitled to a policyholder dividend deduction based on the declared guaranteed minimum dividend amount in the year of declaration.

The taxpayer asserted that its liability for the guaranteed amount of the policyholder dividends satisfied the requirements of the "all events test" and that it was entitled to deduct in tax years 1995, 1996 and 1997 a portion of the guaranteed minimum amount of policyholder dividends declared by the taxpayer's board of directors in 1995, 1996 and 1997. The IRS countered that the guaranteed minimum amount of policyholder dividends could not be deducted in the year in which the boards adopted the resolutions because the dividend guarantees did not meet the all-events test for accrual.

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1. *Massachusetts Mutual Life Insurance Co. v. United States*, 07-648T (Fed. Cl. 30 January 2012).

2. IRS Transitional Relief for Section 6045B Issuer Returns and Statements for 2011 Corporate Actions Affecting Tax Basis of Securities

The IRS released an advance copy of Notice 2012-11 which provides transitional relief with respect to information reporting requirements under section 6045B for issuers of stock with respect to organizational actions that affect the basis of the stock.

New reporting rules under section 6045B require an issuer – foreign or domestic – to file an information return (Form 8937) with the IRS whenever the issuer engages in a corporate action that affects the tax basis of a "specified security". In addition, an issuer is required to furnish to its security holders a written statement containing the same information. An issuer is not required to file a return with the IRS or to furnish information statements to security holders if it timely posts the return on its primary public website in a readily accessible format.

The IRS previously announced in Notice 2011-18 that issuers may report 2011 organizational actions without penalty if Form 8937 was filed by 17 January 2011.

The transitional relief contained in Notice 2012-11 is limited to reporting organizational actions occurring in 2011, and does not apply to issuers of stock in a regulated investment company (RIC), which are not subject to the issuer reporting requirements for 2011 organizational actions.

Notice 2012-11 reiterates that posting either Form 8937, Report of Organizational Actions Affecting Basis of Securities, or the required information in a readily accessible format to an issuer's primary public website will satisfy an issuer's requirement to file and furnish Form 8937 for organizational actions occurring in 2011.

Notice 2012-11 states that the IRS will not impose section 6721 or 6722 penalties for reporting incorrect information against issuers related to filing and furnishing Form 8937 for 2011 organizational actions, provided that issuers make good-faith efforts in (1) timely posting the Form 8937 or the required information on the issuers' primary public websites or (2) filing accurate Forms 8937 and furnishing the corresponding issuer statements.

As explained in Notice 2012-11, the IRS learned that a number of questions have arisen following the release of the final Form 8937 and instructions (on 5 January 2012) and recognizes that the release date provided a very limited timeframe remaining before the due date of the form.

Because of this uncertainty, the IRS stated that it will permit an issuer to publicly report an organizational action by posting either Form 8937 or the required information in a readily accessible format to an area of its primary public website, and will treat the issuer as having filed Form 8937 and furnished issuer statements to stockholders or nominees on the date of posting of the Form 8937 or the required information.

The IRS concluded that the issues addressed in Notice 2012-11 will be considered in assessing reasonable cause with respect to broker reporting required under section 6045(g).

Notice 2012-11 appeared in *Internal Revenue Bulletin* 2012-5, dated 30 January 2012.

3. Tenth Circuit Affirms Tax Court's Finding that Prepaid Variable Forward and Stock-Lending Transactions Were Completed Sales

In *Anschutz Co. v. Commissioner*,[2] the US Court of Appeals for the Tenth Circuit affirmed a decision of the Tax Court that certain prepaid variable forward sale agreements with concurrent share lending were completed sales. The Tenth Circuit upheld the Tax Court's July 2010 determination of income tax deficiencies for tax years 2000 and 2001, by finding that the deficiencies resulted from the taxpayers' failure to recognize taxable gain when a subsidiary entered into a series of related agreements that included a variable prepaid forward contract for the sale of certain shares of stock and accompanying share-lending agreements.

4. IRS Guidance Providing Safe Harbour Methods for REMICs to Use to Satisfy Certain Reporting Obligations

The IRS released advance copies of guidance providing safe harbour methods for real estate mortgage investment conduits (REMICs) to use to satisfy certain reporting obligations.

Notice 2012-5 provides a safe harbour reporting method that an eligible REMIC may use to satisfy its reporting obligations with respect to information regarding REMIC assets that the REMIC must report to residual interest holders on a Schedule Q (Form 1066), *Quarterly Notice to Residual Interest Holder of REMIC Taxable Income or Net Loss Allocation*.

Rev. Proc. 2012-14 sets forth a safe harbour method providing the extent to which investments by a real estate investment trust (REIT) in a regular or a residual interest in certain REMICs may be treated as a real estate asset (i.e. qualifying investments) and generate qualifying income for REIT purposes under section 856(c).

5. IRS Provides Temporary Relief for IRA Owners Who Have Entered into Certain Indemnification Agreements or Granted Security Interests to Brokers or Financial Institutions

According to an IRS announcement, the Labour Department has advised the IRS that Labour is considering further action with respect to these issues, including consideration of a class-exemption request expected to be submitted to the Labour Department.

The IRS announcement states that until there is further action by the Labour Department and the IRS, the IRS will determine the tax consequences relating to an IRA without taking into account the consequences that might otherwise result from a prohibited transaction under section 4975, resulting from entering into any indemnification agreement or any cross-collateralization agreement similar to the agreements described in Department of Labour Advisory Opinions 2009-03A and 2011-09A – provided that there has been no execution or other enforcement action pursuant to the agreement against the assets of an IRA account of the individual granting the security interest or entering into the cross-collateralization agreement.

The IRS announcement concludes that no inference with respect to the application of any Code section other than section 4975 is to be drawn from this announcement.

6. Final Regulations on Interaction between Check-the-box Regulations and Multiple-Party Financing Arrangements

The Treasury Department and the IRS released for publication in the Federal Register final regulations[3] relating to conduit financing arrangements. The regulations apply to multiple-party financing arrangements that are effected through disregarded entities, and identify which arrangements need to be recharacterized under section 7701(l) and Reg. section 1.881-3.

The final regulations adopt regulations that were proposed in late 2008, with "minor edits" to an example to clarify application of the effective date.

The Code authorizes the Treasury Department to prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any two or more of these parties when it is determined that the recharacterization would be appropriate to prevent the avoidance of any tax imposed by the Code.

In 1995, regulations under Reg. section 1.881-3 relating to conduit financing arrangements were issued. In general, these regulations allow the IRS (1) to disregard the participation of one or more intermediate entities in a financing arrangement when the entities are acting as conduit entities and (2) to recharacterize the financing arrangement as a transaction directly between the remaining parties to the financing arrangement for pur-

2. *Anschutz Co. v. Commissioner*, No. 11-9001 (10th Cir. 27 December 2011).

3. TD 9562.

poses of imposing tax under sections 871, 881, 1441 and 1442.

Under the 1995 final regulations, a financing arrangement is defined as a series of financing transactions by which one person (the financing entity) advances money or other property, or grants rights to use property, and another person (the financed entity) receives money or other property, or rights to use property, if the advance and receipt are effected through one or more other persons (intermediate entities). Except for a special rule for related parties, the regulations apply only if financing transactions link the financing entity, each of the intermediate entities and the financed entity.

Subsequently, the check-the-box regulations were issued, and provide that an entity which is not classified as a corporation and which has a single owner may elect to be disregarded as an entity separate from its owner (a disregarded entity).

Because there were questions regarding the proper treatment of disregarded entities under Reg. section 1.881-3, Treasury and the IRS in December 2008 proposed the issuance of new regulations, to clarify that a disregarded entity is a person for purposes of Reg. section 1.881-3. Thus, the 2008 proposed regulations provided that transactions which a disregarded entity enters into would be taken into account for purposes of determining whether a financing arrangement exists.

According to the preamble to the final regulations, a change has been made to Example 3 of the proposed regulations, to clarify that the effective date of the final regulations applies to this example.

The preamble also indicates that Treasury and the IRS will continue to study how the rules would relate to the treatment of financing transactions entered into with disregarded entities before the effective date of these final regulations or transactions involving hybrid instruments. As stated in the preamble:

> No inference should be drawn from any provision of these final regulations as to the treatment of financing transactions entered into with disregarded entities before the effective date of these final regulations or involving hybrid instruments.

TD 9562 is effective for payments made on or after 9 December 2011 – which is the date of publication in the Federal Register.

7. Regulations on Tax Treatment of Treasury Inflation-Protected Securities Issued with More Than *De Minimis* Amount of Premium

The Treasury Department and the IRS released for publication in the Federal Register temporary regulations[4] and, by cross reference, proposed regulations[5] concerning the tax treatment of Treasury Inflation-Protected Securities (TIPS) issued with more than a *de minimis* amount of premium. TIPS are securities issued by the Treasury Department, of which the principal amount is adjusted for any inflation (or deflation) that occurs over the term of the security. The temporary regulations reflect guidance issued by the IRS in April 2011, and apply to TIPS issued on or after 8 April 2011.

In April 2011, the IRS issued Notice 2011-21 announcing that regulations would be issued to provide a more uniform method for the federal income taxation of TIPS. The regulations were to provide that taxpayers must apply the coupon bond method described in Reg. section 1.1275-7(d) with respect to TIPS issued with more than a *de minimis* amount of premium. Thus, the discount bond method described in Reg. section 1.1275-7(e) would not apply to TIPS issued with more than a *de minimis* amount of premium.

The *temporary regulations* released contain the rules that were described in Notice 2011-21.

Under the temporary regulations, a taxpayer must use the coupon bond method described in Reg. section 1.1275-7(d) for TIPS that are issued with more than a *de minimis* amount of premium. The temporary regulations include an example of how to apply the coupon bond method to TIPS issued with more than a *de minimis* amount of premium.

TD 9561 and REG-130777-11 were published in the Federal Register on 5 December 2011. Comments on the proposed regulations or requests to present oral comments at a public hearing on the proposed regulations (including an outline of the topics to be discussed and the time to be devoted to each topic) must be received by 7 March 2012. A public hearing has been scheduled for 28 March 2012.

8. IRS Guidance Extends the Optional Safe Harbour for Allowing Investors to Claim a Theft Loss from Certain Criminally Fraudulent Arrangements, Including Ponzi Schemes

The IRS released Rev. Proc. 2011-58 that makes certain modifications to prior guidance, Rev. Proc. 2009-20, concerning an optional safe harbour method for certain taxpayers to deduct theft losses incurred in connection with a Ponzi scheme. Specifically, the revenue procedure modifies the definition of a qualified loss, makes a conforming modification to the definition of a discovery year, and clarifies the terms “indictment”, “information” and “criminal complaint”.

As the IRS explained in 2009, certain investment arrangements have been discovered to be fraudulent, resulting in significant losses to taxpayers. Very generally, the arrangements take the form of a Ponzi scheme – in which the party perpetrating the fraud receives cash or property from investors, purports to earn income for the investors, and reports to them income amounts that are wholly or partially fictitious. Payments, if any, of purported income or return of principal to investors are made from cash or property that other investors have invested in the fraudulent arrangement. The investors’ cash or property generally is appropriated by the criminal party.

4. TD 9561.
5. REG-130777-11.

In 2009, the IRS issued guidance to address these types of losses:

– Rev. Rul. 2009-09 addresses the proper income tax treatment for losses resulting from a Ponzi scheme (as described in the revenue ruling), and concludes that the losses are theft losses – not capital losses; and
– Rev. Proc. 2009-20 provides an optional safe harbour method for certain taxpayers to deduct theft losses incurred in connection with a Ponzi scheme (as described in the revenue procedure).

Since the publication of Rev. Proc 2009-20, the deaths of some lead figures have foreclosed the ability of authorities to charge them with criminal theft. Qualified investors in these cases are unable to meet the definition of "qualified loss" and, therefore, are precluded from using the optional safe harbour solely because of the death of a lead figure.

Rev. Proc 2011-58 modifies the definition of "qualified loss", as provided in Rev. Proc 2009-20, to address certain situations in which the death of a lead figure has foreclosed the possibility of criminal charges. The definition of "qualified loss" is expanded specifically to include situations in which a lead figure or associated entity is the subject of a state or federal government civil complaint alleging the elements of a specified fraudulent arrangement.

Rev. Proc. 2011-58 also makes a conforming modification to the definition of a discovery year, and clarifies that the terms "indictment", information" and "criminal complaint" have meanings similar to those terms in the Federal Rules of Criminal Procedure.

Rev. Proc. 2011-58 appeared in *Internal Revenue Bulletin* 2011-50, dated 12 December 2011.

9. IRS Field Advice: Providing Financial Statements Using IFRS to Taxpayer's Lending Bank Violates LIFO Conformity Requirements

The IRS posted a Memorandum of Legal Advice[6] concluding that a taxpayer's providing financial statements prepared using IFRS (International Financial Reporting Standards) to its lending bank violated the LIFO (last in, first out) conformity requirements.[7]

The taxpayer's foreign parent required the taxpayer to adopt IFRS to facilitate the processing of preparing worldwide consolidated financial statements. The taxpayer had used, and continued to use, the LIFO inventory method for a portion of its inventory for both tax and financial reporting purposes.

The taxpayer provided the IFRS-only balance sheet and income statement to its lending bank, related to lending requirements imposed by the bank related to a letter of credit. It also provided tabulated financial statements (including LIFO adjustments) to the IFRS column to arrive at US GAAP. However, the taxpayer did not make a distinction between primary or supplemental information with these financial statements and did not include explanatory footnotes regarding the change. The IRS concluded that the documents did not meet the exception for supplemental or explanatory information, and that the issuance of these financial statements to the lending bank violated the LIFO conformity requirements.

10. IRS Proposed Simplified Method of Accounting for Original Issue Discount on a Pool of Credit Card Receivables

The IRS released an advance copy of Notice 2011-99 which sets forth a proposed revenue procedure for the use of a simplified method to accrue original issue discount (OID) on a pool of credit card receivables. The proposed revenue procedure would allow a taxpayer to use a safe harbour method of accounting for OID, namely the "proportional method". The proportional method generally allocates to an accrual period an amount of unaccrued OID that is proportional to the amount of the stated redemption price at maturity (principal) of the pool that is paid by cardholders during the period. The method is intended to reduce administrative burdens and controversy for taxpayers and the IRS in computing OID accruals on a pool of credit card receivables under section 1272(a)(6).

Notice 2011-99 requests comments on the proposed revenue procedure; comments are to be submitted on or before 16 March 2012.

10.1. Background

Accruals of OID are generally taken into account over the term of a debt instrument using the constant yield method. Special rules apply for certain debt instruments for which the principal is subject to acceleration. Under section 1272(a)(6), if the principal is subject to acceleration, OID accruals are determined (under the statutory method) based on a prepayment assumption and a formula involving the present value of:

– all remaining payments as of the close of the accrual period;
– payments during the accrual period of amounts included in the stated redemption price at maturity; and
– the adjusted issue price of the debt instrument at the beginning of the accrual period.

Section 1272(a)(6) applies to OID on any pool of debt instruments which may be affected by reason of prepayments, including a pool of credit card receivables. However, the balance of a pool of credit card receivables can be increased – as well as decreased – from one accrual period to the next, which adds complexity to the application of section 1272(a)(6).

The IRS has challenged the method of accounting for OID on a pool of receivables adopted by some taxpayers

6. Pursuant to sec. 6110(k)(3), written determinations such as field service advice represent the IRS's analysis of the law as applied to a taxpayer's specific facts, and they are not intended to be relied upon by third parties and may not be cited as precedent. They do, however, provide an indication of the IRS's position on the issues addressed.
7. Legal Advice 20114702F (released 25 November 2011).

as not clearly reflecting income. In *Capital One Financial Corp v. Commissioner*,[8] the Tax Court held that the model used by the taxpayer for computing OID was a reasonable method after some modifications by the Court.

10.2. Proposed revenue procedure in Notice 2011-99

According to the notice, under certain assumptions, the proportional method is a simplified method of calculation that generally produces the same results as an implementation of the statutory method. The proposed revenue procedure would apply to a taxpayer generally if:
- the taxpayer issues credit cards allowing cardholders to access a revolving line of credit;
- the taxpayer does not treat the credit card purchase transactions of its cardholders as creating debt given for the sale or exchange of property;
- the taxpayer maintains one or more pools of receivables with respect to the credit cards; and
- in the case of a taxpayer that maintains more than one pool of credit card receivables, the manner in which the pools are maintained does not achieve a result that is unreasonable.

Generally, under the proportional method of accounting for OID on a pool of receivables that would be permitted under the proposed revenue procedure:
- the required computations must be made monthly;
- at the beginning of each computation period, the taxpayer must determine certain specified information for each pool of credit card receivables;
- during each computation period, the taxpayer must determine for each pool the sum of the payments that reduce the beginning stated redemption price at maturity for the period; and
- for each computation period, the taxpayer must compute the OID allocated to the period based on a formula.

Under the proposed revenue procedure, if the proportional method of accounting is used for any pool of credit card receivables, it would have to be used for every pool of credit card receivables. The revenue procedure would provide rules for changing to the proportional method of accounting for OID on a pool of credit card receivables. Under those proposed rules, the change would be made on a cut-off basis without a section 481 adjustment.

No effective date is set forth for the proposed revenue procedure; that section is "reserved".

11. Proposed Regulations on Basis Reporting by Securities Brokers and Basis Determination for Debt Instruments and Options

Treasury and the IRS released for publication in the Federal Register a notice of proposed rulemaking relating to reporting by brokers for transactions related to debt instruments and options.[9] The proposed regulations reflect changes in the law made by the Energy Improvement and Extension Act of 2008 (the Act) that require brokers, when reporting the sale of securities to the IRS, to include the customer's adjusted basis in the sold securities and to classify any gain or loss as long term or short term.

The proposed regulations also implement the Act's requirement that a broker report gross proceeds from a sale or closing transaction with respect to certain options. In addition, the release contains proposed regulations that implement reporting requirements for a transfer of a debt instrument or an option to another broker and for an organizational action that affects the basis of a debt instrument or option.

12. Final Regulations on Partnership's Discharge of Indebtedness Income on Transfer of Partnership Interest to Creditor in Satisfaction of Partnership's Debt

Treasury and the IRS released for publication in the Federal Register final regulations[10] concerning certain federal income tax consequences that occur when a partnership transfers a partnership interest to a creditor in satisfaction of the partnership's indebtedness (i.e. a debt-for-equity exchange). The final regulations generally retain the provisions of regulations that were proposed in 2008, but with certain modifications (described below) in response to comments.

Before the American Jobs Creation Act of 2004, section 108(e)(8) applied only to discharges of corporate indebtedness. Because it was unclear whether a partnership would generate cancellation of indebtedness (COD) income if it transferred a capital or profits interest to a creditor in satisfaction of debt, section 108(e)(8) was amended by the 2004 Act to apply to partnership interests. Thus, with the 2004 legislative changes, if a partnership transfers a capital or profits interest to a creditor to satisfy partnership debt, the partnership has COD income in the amount that it would have if the debt were satisfied with money equal to the fair market value of the partnership interest. The same rule applies regardless of whether the cancelled debt is recourse or non-recourse.

The 2004 Act provisions also provided that any COD income recognized under this rule must be allocated solely among the partners who held partnership interests immediately prior to the satisfaction of the debt.

Proposed regulations were published on 31 October 2008, proposing amendments to the regulations regarding the application of section 108(e)(8) to partnerships and their partners, including the determination of COD income of a partnership that transfers a partnership interest to a creditor in satisfaction of the partnership's indebtedness (debt-for-equity exchange). The proposed regulations also provided that section 721 generally applies to a contribution of a partnership's recourse or non-recourse indebtedness by a creditor to the partnership in exchange for a capital or profits interest in the partnership.

8. 133 TC 136 (2009).
9. REG-102988-11.
10. TD 9557.

As noted in the preamble to the release, the *final regulations* generally retain the provisions of the proposed regulations, but with certain modifications.

Valuation of partnership interest transferred in satisfaction of partnership debt. Under the final regulations, for purposes of applying section 108(e)(8), the fair market value of a debt-for-equity interest is the liquidation value of that debt-for-equity interest, if the following requirements are satisfied:

- the creditor, debtor partnership and its partners treat the fair market value of the indebtedness as being equal to the liquidation value of the debt-for-equity interest for purposes of determining the tax consequences of the debt-for-equity exchange;
- if, as part of the same overall transaction, the debtor partnership transfers more than one debt-for-equity interest to one or more creditors, then each creditor, debtor partnership and its partners treat the fair market value of each debt-for-equity interest transferred by the debtor partnership to such creditors as equal to its liquidation value;
- the debt-for-equity exchange is a transaction which has terms that are comparable to terms that would be agreed to by unrelated parties negotiating with adverse interests; and
- subsequent to the debt-for-equity exchange, the debtor partnership does not redeem the debt-for-equity interest, and no person bearing a relationship to the debtor partnership or its partners that is specified in section 267(b) or section 707(b) purchases the debt-for-equity interest, as part of a plan at the time of the debt-for-equity exchange that has as a principal purpose the avoidance of COD income by the debtor partnership.

If these conditions are not satisfied, all of the facts and circumstances are considered in determining the fair market value of the debt-for-equity interest for purposes of applying section 108(e)(8). If the fair market value of the debt-for-equity interest does not equal the fair market value of the indebtedness exchanged, general tax law principles apply to account for the difference.

Embedded in the requirements (stated above) are modifications made to the proposed regulations in response to comments. First, to eliminate confusion over the capital account maintenance requirement in the liquidation value safe harbour, Treasury and the IRS decided to remove the capital account maintenance requirement from the liquidation value safe harbour contained in the proposed regulations because the maintenance of capital accounts is not necessary to the determination of the liquidation value of the partner's interest. Next, to accommodate related-party debt-for-equity exchanges, the third requirement was modified to require that the debt-for-equity exchange have terms that are comparable to terms that would be agreed to by unrelated parties. In addition, the regulations define "related party" for purposes of the last requirement by reference to sections 267(b) and 707(b).

Valuation of lower tier partnership interests. The liquidation value of a debt-for-equity interest in a partnership (upper-tier partnership) that directly or indirectly owns an interest in one or more partnerships (lower-tier partnership(s)) is determined by taking into account the liquidation value of such lower-tier partnership interests.

Application of section 721 to debt-for-equity exchanges. The final regulations retain the general rule of the proposed regulations that, with certain exceptions, section 721 applies to debt-for-equity exchanges. The final regulations also retain the exception for unpaid rent, royalties or interest, but only apply the exception with respect to unpaid rent, royalties, or interest (including accrued original issue discount) that accrued on or after the beginning of the creditor's holding period for the indebtedness. In addition, the final regulations address the debtor partnership's tax consequences related to this exception, providing that the debtor partnership will not recognize gain or loss upon the transfer of a partnership interest to a creditor in a debt-for-equity exchange for unpaid rent, royalties or interest (including accrued original issue discount).

Treasury and the IRS decided not to adopt suggestions to allow a bifurcation of the debt-for-equity exchange into two transactions – namely the cancellation of a portion of the indebtedness, and the contribution of the balance in exchange for an interest in the partnership in a transaction to which section 721 applies.

The preamble to the final regulations indicates that Treasury and the IRS intend to propose regulations under section 453B to clarify that a creditor who disposes of an instalment obligation of a partnership by contributing it to the debtor partnership must recognize gain or loss, if any, under section 453B.

COD income as first-tier item for minimum gain chargeback rules. The final regulations provide that COD income arising from a discharge of a partnership or partner nonrecourse indebtedness is treated as a first-tier item for minimum gain chargeback purposes.

Allocation of COD income by the partnership. Treasury and the IRS determined that existing guidance provides a framework for allocating COD income; thus, the final regulations do not adopt any additional guidance regarding the allocation of COD income among partners in a debt-for-equity exchange.

The final regulations apply to debt for equity exchanges occurring on or after the date when they are published in the Federal Register, which took place on 17 November 2011.

13. Treasury Requires Information Reporting of US Ownership of Foreign Securities as of End of 2011; Reporting Due by 2 March 2012

Treasury released for publication in the Federal Register a notice of reporting requirements, under 31 USC (i.e. bank secrecy provisions), notifying that it is conducting a mandatory survey of ownership of foreign securities by US residents as of 31 December 2011. The information must be reported by 2 March 2012. This release constitutes legal notification to all "United States persons" who meet the reporting requirements to file the reporting form SHC (2011).

For these purposes, a "United States person" is any individual, branch, partnership, associated group, association, estate, trust, corporation or other organization (whether or not organized under the laws of any state), and any government (including a foreign government, the US government, a state or local government and any agency, corporation, financial institution or other entity or instrumentality thereof, including a government-sponsored agency), who resides in the United States or is subject to the jurisdiction of the United States.

The following US persons must file a report under this survey:

– US persons who manage, as custodians, the safekeeping of foreign securities for themselves and other US persons. These US persons, which include the affiliates in the United States of foreign entities, must report on this survey if the total fair value of the foreign securities the safekeeping of which they manage on behalf of US persons – aggregated over all accounts and for all US branches and affiliates of their firm – is USD 100 million or more as of the close of business on 31 December 2011;
– US persons that own foreign securities and/or that invest in foreign securities on behalf of others, such as investment mangers/fund sponsors. These US persons (referred to as "end-investors"), which include the affiliates in the United States of foreign entities, must report on this survey if the total fair value of these foreign securities – aggregated over all accounts and for all US branches and affiliates of their firm – is USD 100 million or more as of the close of business on 31 December 2011; and
– US persons that are notified by letter from the Federal Reserve Bank of New York. These US persons must file Schedule 1, even if the recipient of the letter is under the reporting threshold of USD 100 million and need only report "exempt" on Schedule 1. These US persons that meet the reporting threshold must also file Schedule 2 and/or Schedule 3.

The Treasury report will collect information on holdings by US residents of foreign securities, including equities, long-term debt securities and short-term debt securities (including selected money market instruments).

Completed reports can be submitted electronically or mailed to the Federal Reserve Bank of New York, Statistics Function, 4th Floor, 33 Liberty Street, New York, NY 10045-0001. Data must be submitted to the Federal Reserve Bank of New York, by 2 March 2012.

14. Proposed Regulations under Section 892 Provide Some Immediate Opportunities for Certain Sovereign Wealth Funds

14.1. Generally

Treasury and the IRS released for publication in the Federal Register proposed regulations under section 892 concerning the taxation of income of foreign governments from investments in the United States.[11] The proposed rules are intended to apply on the date that final regulations are published in the Federal Register; however, the preamble states that taxpayers may rely on this guidance until final regulations are issued. The proposed regulations leave applicable existing temporary regulations under section 892, which were promulgated on 24 June 1988.

Because the proposed regulations contain important, taxpayer-favourable rules that may be currently relied upon, sovereign wealth funds need to consider the potential immediate effect of these rules on existing and near-term investments opportunities.

Section 892 and the 1988 temporary regulations have received significant attention and scrutiny over the past decade, due in large part to the massive accumulation of cash reserves in net exporter countries. Many commentators have expressed dissatisfaction with the application of the temporary regulations to modern financing structures and transactions.

The proposed regulations are therefore intended to overhaul and modernize the section 892 regulatory regime.

14.2. Background

Section 892 provides an exemption from US income tax for certain income earned by a "foreign government", as that term is defined in regulations issued pursuant to section 892. Although many sovereign wealth funds qualify as a "foreign government" under section 892, the Code does not provide any special exemptions for sovereign wealth funds. A sovereign wealth fund is entitled to US income tax benefits under section 892 only if the sovereign wealth fund constitutes a foreign government for purposes of section 892.

A foreign government is treated as a corporate resident of its country for purposes of the Code under section 892(a)(3). A foreign government, therefore, is subject to income tax on US-source FiDAP (fixed or determinable annual or period) income and effectively connected income (ECI). section 892 provides:

– an exemption for a foreign government from US income tax for most US-source FiDAP income; and
– an exemption for gain on the disposition of a non-controlled US real property holding corporation (USRPHC).

The temporary regulations contain apparent drafting ambiguities with respect to certain partnership issues,

11. REG-146537-06.

and create particularly difficult structuring impediments because of the broad definition of commercial activities.

14.3. Proposed regulations

In response to comments, the proposed regulations provide the following.

14.3.1. *Inadvertent commercial activities exception*

The section 892 exemption does not apply to income received by or from a controlled commercial entity (CCE) or to income derived by the disposition of any interest in a CCE. A CCE is an entity controlled by a foreign government that conducts commercial activities. Commercial activities are any activities conducted with a view towards current or future income or gain, unless specifically exempted under the section 892 regulations.

Under the temporary regulations, a controlled entity is a CCE (and thus ineligible for a section 892 exemption) even if it conducts a scintilla of activities that are deemed commercial activities. This "all or nothing" rule creates massive traps for the unwary and often requires inefficient tax planning or discourages US investment altogether.

The proposed regulations contain a helpful inadvertency exception that allows a controlled entity that has become a CCE to "cleanse" its status as a CCE or avoid such classification altogether, if (1) the failure to avoid commercial activities is reasonable, (2) the commercial activity is timely cured and (3) record maintenance requirements are satisfied. This rule, coupled with the annual determination rule (described below), is expected to prove helpful to certain sovereign wealth funds.

14.3.2. *Safe harbour*

The proposed regulations also contain a helpful safe harbour to avoid CCE status. Under the safe harbour, a controlled entity will be deemed to have inadvertent commercial activities (and thus will not be a CCE) if the controlled entity meets an asset test and an income test. The asset test requires that the value of the assets used in or held for use in commercial activities not exceed 5% of the total value of the entity's assets for the tax year (based on the balance sheet). The income test requires that the income earned from commercial activities not exceed 5% of the entity's gross income (as shown on the income statement) for the tax year. The safe harbour also can be invoked only if there are adequate written policies and procedures in place to monitor the entity's worldwide activities.

14.3.3. *Annual determination that entity is a controlled commercial entity*

The proposed regulations provide that the CCE determination will be made on an annual basis.

The temporary regulations do not specify the testing period for controlled entities. This lack of clarity creates a spectrum of possibilities. Many practitioners are concerned that a single commercial activity would render a controlled entity forever a CCE – not unlike the "once a PFIC, always a PFIC" rule.

The proposed regulations contain an annual testing period, and state expressly that a controlled entity will not be considered to be a CCE for a tax year solely because it was engaged in commercial activities in the prior tax year.

14.3.4. *Defining "commercial activity"*

The proposed regulations restate the general rule, as adopted in the 1988 temporary regulations, that all activities (with certain exceptions) ordinarily conducted for the current or future production of income or gain are commercial activities. The proposed regulations also:

– state that only the nature of the activity – not the purpose or motivation for conducting the activity – determines whether the activity is a commercial activity;
– clarify the 1988 temporary regulations in that an activity may be a commercial activity even if it does not constitute a trade or business under section 162;
– modify the list of exceptions of commercial activities to clarify that investments in financial instruments will not be treated as commercial activities under section 892 regardless of whether the financial instruments are held in the execution of government financial or monetary policy, and expand the existing exceptions for the trading of stocks, securities and commodities to include financial instruments (however, as noted in the preamble, these changes only address the definition of commercial activity, not whether income from such activities will be exempt from tax under section 892); and
– provide that a disposition (including a deemed disposition under section 897(h)(1)) of a US real property interest does not constitute the conduct of commercial activities, even though such income is treated as income that is effectively connected to a US trade or business. This clarification, however, does not change whether such gain qualifies for the exemption from tax under section 892.

14.3.5. *Partnerships*

The temporary regulations provide that commercial activities of a partnership are attributable to its general and limited partners, except for certain interest in publicly traded partnerships. This commercial activity attribution rule creates significant impediments to foreign investment in the United States by sovereign wealth funds because any ownership interest in a flow-through entity could render a controlled entity a CCE, even if the commercial activity is conducted several tiers below the sovereign wealth fund investment.

The proposed regulations create two new exceptions. The first exception provides that a controlled entity will not be rendered a CCE solely because it owns an interest in a partnership that effects transactions in stocks, bonds, other securities, commodities or financial instruments for the partnership's own account. This exception is designed to remove an anomaly in the temporary regulations that allows a controlled entity to effect transactions for its own account, but does not provide a similar commercial activities exception if the controlled entity owns an interest in a partnership that effects transactions for its own account.

The second exception states that the general rule (attribution of commercial activities from a partnership to its partners) does not apply if the controlled entity owns only a limited partnership interest in a limited partnership that conducts commercial activities. A limited partnership interest is defined as an interest that affords no rights to participate in the management and conduct of the partnership's business. This second exception is expected to be very helpful for sovereign wealth funds that have certain legal or practical restrictions on investment.

14.3.6. Comments, request for hearing

Comments and requests for a public hearing concerning the proposed regulations are due by a date that is 90 days after the proposed regulations appear in the Federal Register, which took place on 3 November 2011.

15. IRS Postpones to 2013 Backup Withholding for Payments Made in Payment Card and Third-Party Network Transactions and Provides Transitional Penalty Relief for Section 6050W Filers

The IRS released an advance copy of Notice 2011-88, which postpones the effective date for backup withholding obligations for payments made in settlement of payment card and third-party network transactions (i.e. section 6050W payments) to payments made after 31 December 2012.

The IRS also released an advance copy of Notice 2011-89, which provides transitional relief from penalties for a section 6050W information return filer that reports incorrect information on information returns (Form 1099-K) and payee statements. The penalty relief, however, is available for information returns and payee statements to be filed in 2012 only – that is, for payments made in 2011 – provided that the section 6050W filer makes "a good faith effort to accurately file the appropriate information return and the accompanying payee statement".

15.1. Notice 2011-88 postpones backup withholding

Under rules added to the Code in 2008, information returns are required for payments made in settlement of payment card transactions and third-party payment network transactions when made by certain payers. Payments made to settle third-party network transactions are required to be reported only if the amount exceeds USD 20,000 and the aggregate number of transactions exceeds 200 for any payee within a calendar year.

The regulations require backup withholding for section 6050W payments made after 31 December 2011.

In response to requests to postpone the effective date for backup withholding on section 6050W payments, Notice 2011-88 announces that the effective date for application of backup withholding is postponed for payments made after 31 December 2012.

15.2. Notice 2011-89 provides transitional penalty relief

Penalties are imposed under sections 6721 and 6722 on a person who fails to include all required information or who includes incorrect information on an information return and payee statement, respectively. The penalties apply to section 6050W payers who must file information returns for payments made in settlement of reportable payment transactions relating to payment card transactions and third-party network transactions.

Notice 2011-89 provides penalty relief to allow time to develop appropriate procedures for compliance with the new reporting requirements. The IRS, therefore, will not impose these penalties on payers that must file information returns and payee statements, provided that they make a good faith effort in filing accurate Forms 1099-K and furnish the accompanying payee statements. Notice 2011-89 states that the penalty relief does not apply to a payer who erroneously fails to file an information return or payee statement, and the relief applies only for reportable payments made in calendar year 2011.

Notice 2011-88 and Notice 2011-89 appeared in *Internal Revenue Bulletin* 2011-46, dated 14 November 2011.

16. Proposed Regulations Intended to Clarify Bank's S Corporation Status Does Not Affect Applicability of Code's "Special Bank Rules" Are Withdrawn

The Treasury Department and the IRS released for publication in the Federal Register a withdrawal of notice of proposed rulemaking[12] announcing the withdrawal of proposed regulations seeking to clarify that if a bank is an S corporation, its status as an S corporation does not affect the applicability of the special rules for banks under the Code. The proposed regulations were issued in August 2006.

17. Fourth Circuit Affirms Tax Court's Decision Concerning Bank's Tax Accounting Treatment of Issues Relating to Its Credit Card Business

In *Capital One Financial Corp. v. Commissioner*,[13] the US Court of Appeals for the Fourth Circuit affirmed a decision of the Tax Court concerning whether a credit card issuer could:

– treat a retroactive change to report credit card late fees on its 1998 and 1999 tax returns as the correction of an error, rather than a change in method of accounting; and

12. REG-158677-05.
13. *Capital One Financial Corp. v. Commissioner*, No. 10-1788 (4th Cir. 21 October 2011).

– deduct the estimated costs of coupon redemption related to its mileage credit card programme before the credit card customers actually redeemed the coupons.

The Fourth Circuit did not accept the taxpayer's position on either question, and affirmed the Tax Court's decision.

18. Draft IRS Instructions on Reporting Officer Compensation, and Organizational Actions Affecting Basis of Securities; Draft IRS Publication on Substitute Information Returns

The IRS has posted the following draft instructions and draft publication on the IRS website:
– instructions for Form 1125-E, Compensation of Officers;
– instructions for Form 8937, Report of Organizational Actions Affecting Basis of Securities;
– instructions for Schedule C (Form 1065) Additional Information for Schedule M-3 Filers; and
– Publication 1179: General Rules and Specifications for Substitute Forms 1096, 1099, 5498 and W-2G (and 1042-S).

The IRS has requested comments on the draft instructions and publication. Also, the draft instructions and publication are subject to change and approval by the Office of Management and Budget (OMB) before being officially released.

19. Fifth Circuit Affirms District Court's Judgment that Partnership Was a Sham and that Accuracy-Related Penalties Do Not Apply

In *Southgate Master Fund, LLC v. United States*,[14] the US Court of Appeals for the Fifth Circuit affirmed a District Court's judgment that a partnership formed for the purpose of acquiring a portfolio of Chinese non-performing loans (NPLs) and generating tax losses was a sham partnership. In addition, the Fifth Circuit affirmed the District Court's findings that the acquisition of the NPLs had economic substance. Finally, the Fifth Circuit also affirmed the District Court's holding that the taxpayer acted in good faith in reliance on the advice of a professional tax advisor and that accuracy-related penalties were not appropriate.

As background, in the late 1990s, China's "big four" state-owned commercial banks were holding huge numbers of NPLs. In order to assist its banks, the Chinese government created four new state-owned asset-management companies (one of which was Cinda) to purchase the NPLs from the banks at face value. The objective was to improve the bank's balance sheet and to infuse cash. The Chinese asset management companies then held the NPLs with a cost basis that far exceeded value. The asset management companies were given "super powers" by statute in an attempt to improve collections on the NPLs. Because of these super powers, certain investors saw the potential for increased collections and profit in acquiring the NPLs.

The taxpayers in this case did not acquire the NPLs directly, but had Cinda contribute the NPLs to a partnership, Southgate Master Fund, LLC. Through use of certain technical rules in the partnership provisions of the Code, Southgate then generated more than USD 1 billion in paper losses when it sold its portfolio of NPLs. Approximately USD 200 million of these losses were claimed as a deduction by one of Southgate's partners.

The Fifth Circuit found that, while the purchase of the NPLs had economic substance, the use of the partnership form was driven by tax considerations and not by a genuine business purpose. Thus, the Court determined that the partnership was a sham and that the NPLs had been purchased from Cinda at fair market value. Thus, no loss was generated in excess of the purchase price paid. The Fifth Circuit also found that the taxpayers had acted with reasonable cause in reliance on a tax advisor's opinion and that accuracy-related penalties were not appropriate. The Court noted that the tax opinion was not based upon unreasonable factual or legal assumptions and the taxpayer actually followed the advice.

20. IRS Provides Exception from Application of Section 6050W Regulations for Insurance Companies that Administer Certain Self-Insured Arrangements for Employers

The IRS released an advance copy of Notice 2011-78 which provides interim guidance – until Treasury and the IRS amend the regulations under section 6050W – concerning payment card and third-party network transactions, to provide an exception from application of the regulations for an insurance company (or affiliate) administrating a self-insured arrangement on behalf of an employer or other entity, on a cost-plus basis, under an Administrative Services Only (ASO) plan, or under an Administrative Services Contract (ASC) plan.

Notice 2011-78 states that insurance companies that administer these arrangements will not be treated as third-party settlement organizations and, thus, will not be subject to application of the section 6050W regulations.

In August 2010, final regulations relating to information reporting requirements, information reporting penalties and backup withholding requirements for payment card and third-party network transactions pursuant to section 6050W were finalized.

With the release of Notice 2011-78, the IRS stated that under the August 2010 final regulations, a healthcare network is treated as generally outside the scope of section 6050W because a healthcare network does not enable the transfer of funds from buyers to sellers. The preamble to the August 2010 regulations also acknowledged, in response to a comment, that a self-insurance arrange-

14. *Southgate Master Fund, LLC v. United States*, No. 09-11166 (5th Cir. 30 September 2011).

ment also is to be treated as being outside the scope of section 6050W.

The IRS explained that while the final regulations did not address this issue directly, the preamble to the final regulations stated that the comment was not adopted because such an arrangement could create a third-party payment network of which the health insurance entity is the third-party settlement organization to the extent that the health insurance entity effectively enables buyers (the self-insuring companies) to transfer funds to sellers of healthcare goods or services.

With Notice 2011-78, the IRS and Treasury announced a decision to amend the existing regulations under section 6050W to provide in clear terms that an insurance company (or affiliate) administering a self-insured arrangement on behalf of an employer will not be treated as a third-party settlement organization. The notice states that insurance companies may rely on the notice as interim guidance until the regulations are amended.

21. Ninth Circuit Affirms Tax Court Concerning Securities Lending Arrangement under Section 1058(b)(3)

In *Samueli v. Commissioner*,[15] the US Court of Appeals for the Ninth Circuit affirmed the Tax Court's decision in a case concerning the interpretation of section 1058(b)(3) with respect to a securities lending arrangement. The Tax Court in March 2009 concluded that the transaction at issue did not qualify as a securities lending arrangement because the limited ability of the taxpayers to require the return of identical securities in only three days during the approximate 450 days during the transaction period reduced the taxpayers' opportunity for gain in the securities transferred in the transaction.

The Ninth Circuit affirmed the Tax Court's opinion, with Circuit Judge Rawlings concurring in part and concurring in the judgment.

22. Proposed Regulations for Determining Amounts of Investment Advisory Fees Paid by Trusts and Estates Subject to 2% Floor for Miscellaneous Itemized Deductions

Treasury and the IRS released for publication in the Federal Register proposed regulations providing guidance on which costs incurred by estates or trusts other than grantor trusts (non-grantor trusts) are subject to the 2% floor for miscellaneous itemized deductions under section 67(a).[16] These proposed regulations reflect the holding of a 2008 US Supreme Court decision.

With this release, regulations that were proposed in July 2007 are withdrawn.

22.1. Background

In July 2007, regulations were proposed under section 67(e) to clarify which costs are unique to an estate or a non-grantor trust and are therefore not subject to the 2% floor for miscellaneous itemized deductions. The 2007 proposed regulations included a non-exclusive list of services or products for which the costs would be unique (and therefore fully deductible) and, conversely, a non-exclusive list of services or products (including investment advisory fees) that would be subject to the 2% floor.

In early 2008, the US Supreme Court held in *Michael J. Knight, Trustee of the William L. Rudkin Testamentary Trust v. Commissioner* that fees paid to an investment advisor by a non-grantor trust or estate generally are subject to the 2% floor for miscellaneous itemized deductions under section 67(a) – thus, reaching a position that differed from that set forth in the 2007 proposed regulations.[17]

The Supreme Court held that the proper reading of the language in section 67(e) – which asks whether the expense "would not have been incurred if the property were not held in such trust or estate" – requires an inquiry into whether a hypothetical individual who held the same property outside of a trust "customarily" or "commonly" would incur such expenses. Thus, expenses that are "customarily" or "commonly" incurred by individuals would be subject to the 2% floor.

Following the Supreme Court's decision in *Knight*, the IRS issued Notice 2008-32 as interim guidance on the treatment of "bundled fiduciary fees". Notice 2008-32 provides that taxpayers are not required to determine the portion of a bundled fiduciary fee that is subject to the 2% floor under section 67 for any tax year beginning before 1 January 2008.

Subsequently, the IRS issued a series of notices extending the interim guidance provided in Notice 2008-32 to tax years that begin before 1 January 2009, that begin before 1 January 2010 and ultimately to tax years that begin before the publication of final regulations in the Federal Register.

22.2. Proposed regulations

The Supreme Court in *Knight* held that the deductibility of an expense under section 67(e)(1) depends upon whether the cost is "commonly" or "customarily" incurred when the property is held instead by an individual. In other words, as the Court restated its holding, section 67(e)(1) excepts from the 2% floor "…only those costs that it would be *un*common (or unusual, or unlikely) for such a hypothetical individual..." holding the same property to incur (emphasis in original).

In applying this interpretation to investment advisory fees incurred by a trust, Treasury and the IRS explained that the Supreme Court found that generally such fees are not uncommonly incurred by individual investors and

15. *Samueli v. Commissioner*, No. 09-72457 (9th Cir. 15 September 2011).
16. REG-128244-06.
17. *Michael J. Knight, Trustee of the William L. Rudkin Testamentary Trust v. Commissioner*, 552 US 181 (2008).

thus are subject to the 2% floor. Further, Treasury and the IRS noted that the Court had found it is conceivable that:

> … a trust may have an unusual investment objective, or may require a specialized balancing of the interests of various parties, such that a reasonable comparison with individual investors would be improper... in such a case, the incremental cost of expert advice beyond what would normally be required for the ordinary taxpayer would not be subject to the 2-percent floor.

The Supreme Court held that the investment advisory fees of the trust in *Knight* properly were subject to the 2% floor, and that the trustee did not assert any such unusual facts that would have brought this cost within the exception.

With this release, Treasury and the IRS explained that the newly proposed regulations reflect the reasoning and holding in *Knight* and provide guidance relating to the limited portion of the cost of investment advice that is not subject to the 2% floor. The proposed regulations provide that to the extent that a portion (if any) of an investment advisory fee exceeds the fee generally charged to an individual investor – and that excess is attributable to an unusual investment objective of the trust or estate or to a specialized balancing of the interests of various parties such that a reasonable comparison with individual investors would be improper – the excess is not subject to the 2% floor. However, the explanation indicates that the cost attributable to taking into account the varying interests of current beneficiaries and remaindermen is included in the usual investment advisory fees and is not the type of cost that is excluded from the 2% floor under this narrow exception. The explanation reasons that an individual often has investment objectives that balance investing for income and investing for growth, or that include a specialized approach for particular assets.

The newly proposed regulations also provide guidance regarding the deductibility of bundled fiduciary fees not charged on an hourly basis by establishing rules for allocating a portion of such fees to non-deductible advisory fees and to third-party payments for non-deductible costs. The newly proposed regulations:

- do not require the allocation described in the July 2007 proposed regulations, but apply section 67(e) (as interpreted by the Supreme Court);
- limit the costs that are subject to allocations pursuant to section 67(e) and allow the use of any reasonable method to perform such allocations;
- provide that the portion of a bundled fee attributable to investment advice (including any related services that would be provided to any individual investor as part of the investment advisory fee) will be subject to the 2% floor;
- provide that, except for the portion so allocated to investment advice, a fiduciary fee not computed on an hourly basis is fully deductible with the exception of payments made to third parties out of the bundled fee that would have been subject to the 2% floor if they had been paid directly by the non-grantor trust or estate;
- provide for the non-deductibility of any payments for expenses separately assessed (in addition to the usual or basic fiduciary fee or commission) by the fiduciary or other service provider that are commonly or customarily incurred by an individual owner of such property (for example an additional fee for managing rental real estate owned by the non-grantor trust or estate); and
- allow the fiduciary and/or return preparer to use any reasonable method to make the allocations.

22.3. Requests for comments, public hearing

The proposed regulations request comments on the types of incremental investment advisory charges that may be incurred by trusts or estates, as well as a specific description and rationale for any such charges.

Comments also are requested on the types of methods for making a reasonable allocation, including possible factors on which a reasonable allocation is most likely to be based, and on the related substantiation that will be needed to satisfy the reasonable method standard proposed in these regulations.

Concerning methods based, in whole or in part, on time devoted to providing investment advice, Treasury and the IRS have asked for suggestions for alternatives to contemporaneous time records for specific activities that could be used to substantiate the reasonableness of the allocation.

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