SPOTLIGHT ON TAX

A LOOK INSIDE

INTRODUCTION TO US TAXATION OF NFTS

GERMAN TAX ASPECTS OF CROSS-BORDER REMOTE WORKING

RELAUNCHING THE UNITED KINGDOM AS THE EUROPEAN CENTRE OF ALTERNATIVE ASSET MANAGEMENT

McDermott Will & Emery

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It is always the case that businesses must keep up with changes to tax rules, but never have tax rules had to pay equally close attention to changes in business. The evolution of technology and the internet age have driven seismic shifts in the ways companies operate, and presented new challenges for tax regimes.

The long-awaited Organisation for Economic Co-operation and Development (OECD)/G20 Global Anti-Base Erosion Model Rules, intended to address perceived challenges to longstanding international taxation principles by the increasing digitalisation of the economy, are coming closer to becoming a reality with the agreement by 137 OECD/G20 countries and jurisdictions to join the official statement of the Two-Pillar Solution. But we're still not there yet. Similarly, despite the Non Fungible Token (NFT) market being worth US$21 billion, the US Internal Revenue Service (IRS) still hasn't explicitly stated how NFTs will be taxed.

Without clear rules and guidance, businesses need to be highly vigilant. The continuing trend of working outside the office means international companies must ensure their remote workforce doesn't inadvertently trigger tax liabilities by creating a permanent establishment or permanent representative; and trustees must undertake regular reviews to ensure changes within the trust don't generate new taxable events. In addition, companies need to be aware of how expected changes to tax laws may be more aggressive than anticipated, such as the withdrawal by the US IRS of certain foreign tax credits.

Please contact the authors directly if you have any comments on our articles, or would like to discuss any of the issues raised.

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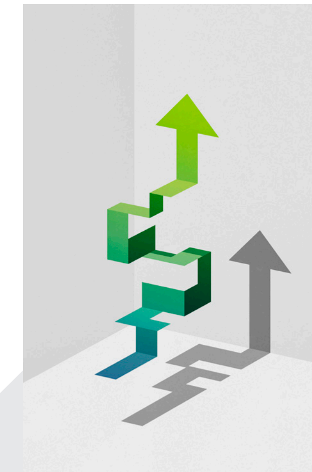

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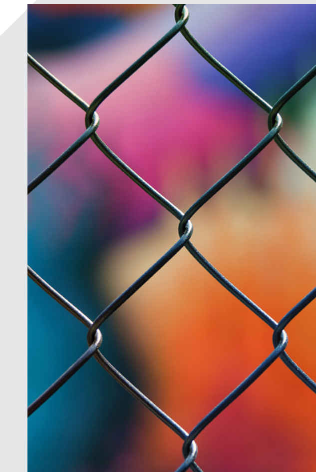

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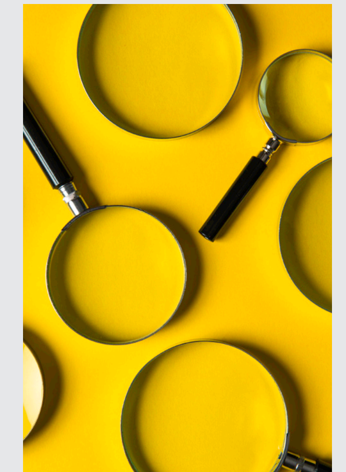

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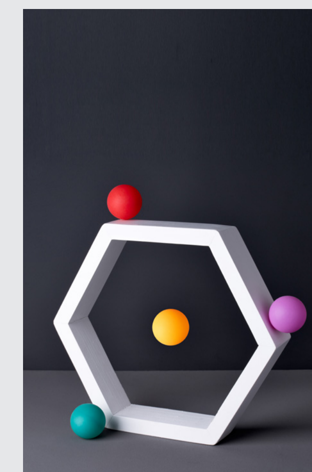

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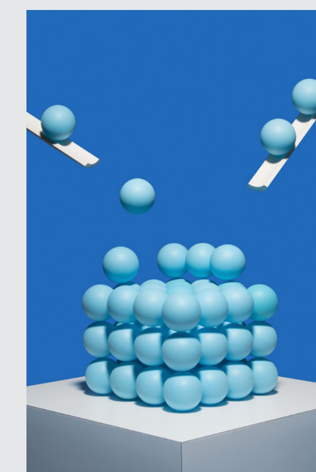

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INTRODUCTION TO US TAXATION OF NFTS

Andrea S. Kramer

Despite Non Fungible Token (NFT) sales hitting nearly US$21 billion by the end of 2021, making NFTs almost as valuable as the global art market, they are currently completely ignored by the US Internal Revenue Service (IRS) in the agency's pronouncements on the taxation of cryptocurrencies.

An NFT is a unique, digitised certificate (a token) stored on a blockchain. It can be a representation of something tangible, *e.g.*, a piece of music, or it can be an original creation that exists only in digital form.

NFTs are "smart contracts"; their embedded metadata allows relevant information to be visible and stored on the blockchain in a transparent and immutable way. The token is non-fungible because its metadata cannot be duplicated or replicated: even if multiple replicas are created using the same content, each NFT has unique metadata.

Without specific guidance from the US Government, general tax principles must be examined to determine, by analogy, how NFTs are likely to be taxed.

TAXING BUYERS AND SELLERS

The IRS treats convertible cryptocurrency as property, not currency. As a result, the general tax principles that apply to property transactions apply to convertible virtual currency. Although Notice 2014-21 (2014-16 I.R.B. 938) and the March 2019 updated Frequently Asked Questions does not address non-convertible cryptocurrencies or NFTs, it is likely that NFTs are property for tax purposes.

Property transactions are taxed as barter transactions. If the buyer pays for an NFT with "property", such as cryptocurrency, both the buyer and seller have a taxable transaction to the buyer if the fair market value of the cryptocurrency used to buy the NFT is greater than the taxpayer's tax basis in that cryptocurrency. The seller has taxable gain/loss equal to the difference between the seller's tax basis and the value of the property received in payment for the NFT.

If the NFT is purchased with actual currency, such as US dollars, the seller has a taxable sale but the buyer does not. The seller's gain/loss is the difference between the NFT's adjusted tax basis and the amount of currency used to purchase it.

The taxpayer bears the burden of proving investment intent with respect to NFTs.

If the buyer uses appreciated property to buy the NFT (*i.e.*, the fair market value of the property used to buy the NFT is greater than the buyer's tax basis),

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the buyer has taxable gain equal to the amount of this appreciation. The buyer's tax basis in that property is what is relevant for tax purposes.

Loss and Gain

Gain or loss is treated as capital or ordinary, depending on whether the taxpayer is an investor or trader (capital), or a creator or dealer (ordinary). Ordinary losses are fully deductible but capital losses are subject to the special loss limitations that apply to capital assets. As a result, some capital losses might not be deductible. In addition, if the taxpayer holds an NFT as a personal asset, losses can be permanently denied under Code § 183, which prohibits deductions for losses incurred on activities that are not engaged in for profit.

In addition, a taxpayer's intent in acquiring an NFT must be established to determine if the NFT is a "personal use" asset not held for investment.

Collectibles

Collectibles are a unique category of items subject to a higher capital gain tax rate of 28%. NFTs that are similar to collectibles and are held for the long-term holding period, are subject to the higher rate. Short-term capital gains are subject to the same tax rates that generally apply to capital assets, without regard to whether they would be treated as collectibles. Losses on the sale of collectibles are subject to the limitations on losses that generally apply to capital assets.

Other types of NFTs, such as those that represent ownership of actual assets or provide for experiences, might not be classified as collectibles, and are instead subject to regular capital gain tax rates.

Personal Use Assets

The taxpayer bears the burden of proving investment intent with respect to NFTs. A taxpayer's NFTs would probably be treated as personal use assets if the taxpayer's activities are too infrequent to rise to the level of investment activities, or the taxpayer does not maintain adequate books and records to support an investment intent.

TAXING CREATORS

Although the market for NFTs is too new to make sweeping generalisations, the tax treatment of creators of NFTs should be fairly straightforward. Minting (the process by which the creator initially records the NFT on the blockchain) an NFT should not be a taxable event because it does not arise from or represent the sale or exchange of property. The creator does have a taxable event, however, when the NFT is sold or exchanged for real currency or property, including cryptocurrency or another NFT.

Whether an NFT sale triggers ordinary or capital gain or loss turns on whether it is an ordinary or capital asset in the hands of the taxpayer. For creators, an NFT is an likely to be an ordinary asset in the taxpayer's hands.

NFT donations are treated as any other noncash contribution of property.

The creator's tax basis is determined by reference to the creator's costs and expenses in creating the NFT. Ordinary and necessary expenses are deductible if paid or incurred by a taxpayer in carrying on the trade or business of creating and selling NFTs, *e.g.*, the costs of creating the NFT, adding it to a blockchain, or selling it.

Gain or loss is taxable when it is realised or sustained. It is the amount by which the value of the cash or property received on the sale or exchange is more, or less, than the amount of the taxpayer's adjusted tax basis.

Rules for computing the amount of gain or loss are contained in Code § 1001 and the regulations issued under that section. Although NFTs are intangible assets, the tax rules that allow for the amortization of the tax basis in certain intangible assets do not apply to creators of intangible assets. Only holders of NFTs who did not create them and who are in a trade or business can amortize NFT tax basis.

CHARITABLE CONTRIBUTIONS

As nonfungible assets, NFTs are not suitable for most direct charitable contributions. The few charities that are set up to accept cryptocurrency generally convert crypto to *fiat* currency as soon as possible. They cannot do this with NFTs because they are not convertible. Direct contributions of appreciated NFTs can, however, provide donors that are not NFT creators with significant tax advantages, so they are worth exploring.

From the Donor's Perspective

Donors that can meet IRS reporting requirements can avoid paying tax on the amount of gain they would otherwise incur if they had sold the appreciated NFT in the market and donated cash to the charity. Donors can receive a deduction for an appreciated NFT's full value up to the percentage cap of their adjusted gross income. This means that the best NFT for a direct charitable contribution is one that has significantly appreciated in value and has been held by a taxpayer classified as an investor for more than one year.

NFT donations are treated as any other noncash contribution of property. It is therefore more tax efficient for a taxpayer with a loss in an NFT that is a capital asset to sell it in the market, report a capital loss for tax purposes, and donate US dollars to the charity to receive a charitable contribution equal to the amount of cash contributed.

From the Charity's Perspective

Charities must address several issues before accepting donations of NFTs or cryptocurrency received from sales of NFTs. They must determine the protocols for accepting NFTs and cryptocurrency, and the ways in which donated digital assets can be converted to US dollars. In addition, a charity must also familiarise itself with the unique issues raised by accepting, storing, and displaying NFTs.

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KNOWLEDGE CENTRE

Andrea S. Kramer was named the 2020 go-to Thought Leader in Virtual Currencies by the National Law Review, and a 2021 Readers' Choice Top Author by JD Supra for her article series on cryptocurrency tax.

- What You Need to Know About the Taxation of NFTs
- Introduction to NFTs
- Taxation of NFT Creators
- Taxation of the Purchase and Sale of NFTs
- NFTs and Charitable Fundraising
- A Primer on Charitable Contributions of Virtual Currency

UK VAT AND WITHHOLDING TAX CONSIDERATIONS FOR IMPACT BOND STRUCTURES

Ranajoy Basu, James Ross, Sarah Gabbai and Priya Taneja

Designing the tax structure early on in the process of developing "pay for performance" cross border funding mechanisms is as important as designing clear impact metrics.

Impact bond structures, and other forms of "pay-for-performance" or outcome-based financing mechanisms, undergo considerable design and structuring phases. As with most transaction structures, tax considerations will be important in determining what is most effective. This is particularly relevant when considering cross border Development Impact Bonds, which involve fund flows between different types of counterparties across multiple jurisdictions.

Certain jurisdictions also impose withholding taxes on technical services fees.

Important factors in determining the impact of withholding tax and the value added tax (VAT) treatment of the cashflows include the nature of cashflows within the impact structure; the type of entities holding, granting, or receiving funds; the jurisdictions involved; the roles of the various transaction parties; and the contract terms between them.

There are several ways an impact bond can be structured, but a typical structure includes the following:

- An upfront investor(s) provides risk capital to achieve pre-agreed target outcomes.
- A project management entity, such as a charity, acts as intermediary to coordinate all the transaction parties to facilitate the success of the project.
- One or more service providers use the risk capital to carry out work "on the ground", coordinating with the intermediary to implement the project and achieve certain pre-agreed success metrics.
- An independent evaluator evaluates and confirms whether and to what extent the success metrics, as agreed between all key stakeholders, have been met.
- An outcome funder agrees to provide a return to the investor in relation to its initial risk capital on the basis that success metrics have been met.

Care must be taken to ensure that the risk capital flowing from the investor to the intermediary to the service providers does not in substance amount to consideration for any services, particularly given the role of the intermediary and the service providers. If it does, VAT may be chargeable, either on a domestic supply basis or on a reverse-charge basis, depending on where the parties are established. If the VAT-charging party is a UK charity, it may have difficulty recovering VAT incurred on related input costs. Certain jurisdictions, such as India, also impose withholding taxes on technical services fees.

Although it is sometimes possible to reduce these taxes under domestic law or an applicable double tax treaty, it may not be possible to eliminate them altogether. VAT and withholding tax risk can be eliminated if the risk capital flows are structured effectively, usually either as funding grants or as a reimbursement of costs incurred by the recipient of the funds. UK charities that receive funds as an intermediary should ensure that the funds are applied for charitable purposes, and thus exempt from UK income or corporation tax, as applicable. This includes ensuring that any grant money paid on to service providers is used by them for charitable purposes.

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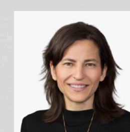
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NEW US TREASURY REGULATIONS DENY FOREIGN TAX CREDITS FOR PREVIOUSLY CREDITABLE FOREIGN TAXES

Brian H. Jenn

New regulations adopt a new "attribution requirement" that restricts the availability of foreign tax credits (FTCs) to foreign taxes that the US Treasury and Internal Revenue Service (IRS) consider to be similar to US taxes.

On 4 January 2022, the US Department of the Treasury and the IRS issued final regulations (Final Regulations) that deny FTCs for certain foreign taxes that have been creditable for as long as Section 901 has been in the Internal Revenue Code. Additionally, the Final Regulations tighten a longstanding requirement (the cost recovery requirement) that foreign income taxes allow taxpayers to fully deduct certain expenses.

Although these rules were previewed in 2020 proposed regulations that were intended to limit the creditability of certain "novel extraterritorial taxes" like gross-basis digital services taxes (DSTs), many observers expected that the Final Regulations would pare back the scope of the proposed regulations. To the surprise of many, the Treasury and the IRS held to the aggressively broad scope of the proposed regulations in the Final Regulations. As a result, taxpayers are now faced with cataloguing the various foreign taxes for which they have claimed an FTC, and determining whether or not an FTC will be available under the Final Regulations.

Although a number of industry groups have begun asking the Treasury to withdraw portions of the Final Regulations—in light of the significant costs that the regulations would impose on US-based companies—that effort's prospects for success are uncertain, with the Treasury initially publicly defending its approach.

The new rules are generally applicable for taxable years beginning on or after 28 December 2021.

THE ATTRIBUTION REQUIREMENT

The new attribution requirement takes a different form when applied to a tax on residents of the country imposing the tax, as compared to a tax on nonresidents. For a tax imposed on a resident of the country imposing the tax, the attribution requirement demands that allocations of income among related parties to the taxpayer, *i.e.*, the country's transfer pricing rules, must be determined under arm's length principles. For a tax on a nonresident of the country imposing the tax, the attribution requirement generally provides that one of the following three conditions must be met:

1. **Attribution based on activities.** A foreign tax imposed on the basis of a nonresident's activities must be limited to the gross receipts and costs that are attributable, "under reasonable principles," to the nonresident's activities within the foreign country imposing the tax.
2. **Attribution based on source.** A foreign tax imposed on a nonresident based on a source rule must be limited to gross income arising from sources within the foreign country that imposes the tax. The sourcing rules of the foreign tax law must also be "reasonably similar" to the sourcing rules of the Code.
3. **Attribution based on *situs* of property.** A foreign tax based on gains of nonresidents from the sale or disposition of property, including stock or partnership interests, must, generally, only apply in cases where US law would tax a nonresident's capital gains.

A withholding tax is only creditable if it satisfies the requirement for attribution based on source.

THE COST RECOVERY REQUIREMENT

Under prior regulations, a foreign income tax could satisfy the cost recovery requirement if, based on its "predominant character", *i.e.*, how the tax applies to all affected taxpayers, the foreign tax permitted the recovery of significant costs. The Final Regulations tighten the cost recovery requirement by eliminating the flexible "predominant character" standard and requiring that certain enumerated expenses—including interest, rents, royalties, wages, and research expenses—are always significant and must be allowed as a deduction.

The Treasury and the IRS held to the aggressively broad scope of the proposed regulations.

The only exception is where a deduction limitation under foreign law resembles a deduction limitation under US law, such as an interest deduction limitation that applies where interest deductions exceed a specified percentage of earnings before interest, taxes, depreciation, and amortization.

INTERACTION WITH TREATIES

Although the Final Regulations acknowledge that their requirements need not be met where a foreign tax credit for a particular foreign tax is allowed under a US tax treaty, a treaty-based foreign tax credit will only be helpful in certain cases. In particular, a treaty-based foreign tax credit generally would only apply for foreign taxes imposed on transactions directly involving a US person, and not for foreign taxes imposed on transactions between a US group's foreign affiliates.

FOREIGN TAXES FOR WHICH FTCS COULD BE DENIED UNDER THE FINAL REGULATIONS

As noted above, although the Treasury and the IRS cited "novel extraterritorial taxes", particularly DSTs and so-called "diverted profits taxes" (DPTs) adopted in the United Kingdom and elsewhere, as the motivation for modifying the Prior Regulations, the Final Regulations potentially apply to a significantly broader range of commonly imposed foreign taxes, including the following.

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Corporate Income Taxes That Disallow Certain Deductions

Corporate income taxes that do not permit taxpayers to amortize goodwill, or that limit interest, royalty, or stock-based compensation deductions, may fail the cost recovery requirement and thus not be creditable.

Royalty Withholding Taxes

In order for a royalty withholding tax to be creditable, withholding must be limited to royalties for the use of IP in that foreign country. This requirement excludes the wide variety of withholding taxes that countries impose on any outbound royalty payment.

Service Payment Withholding Taxes

A withholding tax imposed on a service payment would not be creditable if, as is the case with many developing countries, the withholding tax applies even if no services are performed in-country.

Capital Gains Taxes on Share Disposal

Taxes imposed on a nonresident's sales of shares in a company other than a real property holding company may not be creditable under the attribution requirement.

Taxes on Sales of Copyrighted Articles

A tax imposed by a country on the sale of a copyrighted article—such as software, and regardless of whether or not it is digitally delivered—by a nonresident may not satisfy the attribution requirement if imposed without regard to in-country activities of the seller.

Organisation for Economic Co-operation and Development (OECD) Pillar 1 and 2 Taxes.

New taxes proposed for adoption by countries under Pillars 1 and 2 of the OECD base erosion and profit shifting 2.0 project, would fail the attribution requirement. Although the preambles to the Prior Regulations and the Final Regulations indicate that the Treasury and the IRS may revisit the application of the Final Regulations in the event a new international consensus is reached through the OECD, this is not guaranteed in light of the uncertain prospects that Congress will implement Pillars 1 and 2 in the United States. See page 15 for an overview of OECD Pillar 2.

MOVING FORWARD

The Final Regulations potentially disallow FTCs for foreign withholding taxes that have long been eligible for one, as well as the "novel extraterritorial taxes" explicitly targeted by the Treasury and the IRS. As such, taxpayers may need to survey the foreign taxes they currently incur around the world and consider whether or not these taxes satisfy the attribution requirement.

In making this determination, it may be necessary to seek the advice of foreign counsel in order to understand the basis under foreign law for the imposition of the tax. If it is determined that a particular foreign tax is not eligible for an FTC under the Final Regulations, taxpayers may wish to consider alternative structures that could alter the particular mix of foreign taxes that apply with respect to their commercial engagement in a country.

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The Final Regulations tighten the cost recovery requirement.

TRUSTEES AND THE NEED FOR REVIEWS

Simon Goldring

A recent case illustrates the importance of regular trust reviews.

Trustees must take the time to review the trusts they administer to take into account changes in circumstances that have arisen since the trusts were first established so as to ensure there are no new potential tax issues. Likely changes include, for example, the investments made by the trust, and beneficiaries' residences. A case I recently acted on provides an excellent example of why reviews are so important.

I was instructed by non-UK resident Bermudan trustees of a number of trusts established in the 1950s for the benefit of US resident beneficiaries. Over many years, the trustees invested directly in UK *situs* investments. Having cleared off potential UK inheritance tax issues, attention turned to potential income tax issues when it transpired that some of the original family's descendants had become resident in the United Kingdom. It was therefore important to consider whether the UK source income was now subject to UK tax.

Section 811 of the UK Income Tax Act (ITA) 2007 limits the income tax liability of a non-resident individual or trustee in respect of UK source income to any sums deducted, or treated as deducted, from disregarded income.

Section 812 ITA 2007, however, states that the exemption under Section 811 is not available if one of the trust's beneficiaries is "an individual who is UK resident or a UK resident company". A person is a beneficiary of the trust if "an actual or potential beneficiary of the trust" and meets one of two conditions.

- "Condition A is that the person is, will, or may become entitled under the trust to receive some or all of any income under the trust."
- "Condition B is that some, or all, of any income under the trust may be paid to or used for the benefit of the person in the exercise of a discretion conferred by the trust."

The references to income include a reference to any capital insofar as it represents accumulated income. If Section 812 were to apply in this case, all UK source income of the trustees would be subject to UK income tax in the hands of the trustees.

Under the terms of the trusts under consideration, as matters currently stood there was only one principal beneficiary now entitled to the income: a US resident, who took the majority of the income each year and paid US tax on it. Crucially, his UK resident family members would only be able to take an income from the trusts in the event of his death.

It transpired that some of the original family's descendants had become resident in the UK.

We were instructed by the trustees to advise whether existing and future UK resident family members, who had never received income from the trusts and who would not receive income from the trusts until the principal beneficiary died, could trigger Section 812, which would give rise to UK income tax liabilities for the trustees of over £1.5 million. In addition, I was asked to consider whether a tax credit for tax paid in the US by the principal beneficiary could offset the trustees' liability.

CONTINUED ▸

Because of the potential liability for interest and penalties if a liability for UK tax arose, the trustees made a nil disclosure to Her Majesty's Revenue and Customs (HMRC) and the worldwide disclosure facility. HMRC advised that they would investigate the claim for a nil disclosure and, for over three years, I argued with HMRC on the application of Section 812.

HMRC contended that the wording of Section 812 was sufficiently wide that, notwithstanding the fact that the UK resident family members had not received, and might never receive, any income from the trusts if they died before the US principal beneficiary, the trustees were liable to UK tax on the UK source income. HMRC noted the reference in Section 812 to "an actual or potential beneficiary of the trust" who "is, or will or may become, entitled under the trust to receive some or all of any income under the trust."

All UK source income of the trustees would be subject to UK income tax.

I first argued that, because Section 812 applied by reference to a "tax year", and as no UK resident family member had received income in the tax years under investigation (the majority of the income being paid to the principal beneficiary), Section 812 did not apply.

I also argued that Section 812 could not apply, as it could not presently be ascertained if the UK resident family members would ever be beneficiaries of the trusts, as this would be dependent on them being alive at the date of the principal beneficiary's death.

HMRC rejected these arguments because of the broad wording contained in Section 812, and continued to assert that the trustees were subject to UK tax as a result.

In order to reach a negotiated settlement with HMRC, I proposed a compromise under which the trustees would agree to pay UK tax on a proportion of income not distributed to the principal beneficiary during the tax years in question. This was rejected by HMRC, noting that Section 812 was an all or nothing section where there could be no scope for compromise.

HMRC advised that they had considered the meaning of the words "potential beneficiary", which is not defined in any part of ITA07. They indicated that they found it hard to consider any other terminology that could apply to the UK resident family members other than "potential beneficiaries".

I disagreed, referring HMRC's to its own glossary to the Trusts, Settlements and Estates Manual, which defines a beneficiary as "the person for whose benefit property is held". I then went on to introduce the concept of a "contingent beneficiary", referencing HMRC's International Manual, which defines a "contingent interest" as follows: "A beneficiary has an interest in the trust dependent on something happening (the 'contingency')."

In line with these definitions, I argued that the wording of Section 812 should be construed as follows:

- An "actual" beneficiary is one who has an immediate entitlement to income, for example a life tenant of an interest in possession trust.
- A "potential" beneficiary is one who has an entitlement to income if the trustees exercise their discretion to make an income distribution in the beneficiary's favour, for example a beneficiary who is a member of the immediate discretionary class.

I then argued that the UK resident family members had no right to the present income of the trusts as they were neither life tenants nor members of the immediate discretionary class. I asserted that they only have a potential right to income if they are alive on the death of the principal beneficiary, and so are "contingent" beneficiaries. With this, I had given HMRC a way out under the strict wording of Section 812.

HMRC accepted my argument and the nil disclosure, which also rendered moot the issue of whether or not there would be a tax credit for tax paid in the United States. The moral of the story is: "never give up!"

Finally, to ensure this issue never arose again, I recommended the trustees interpose underlying companies.

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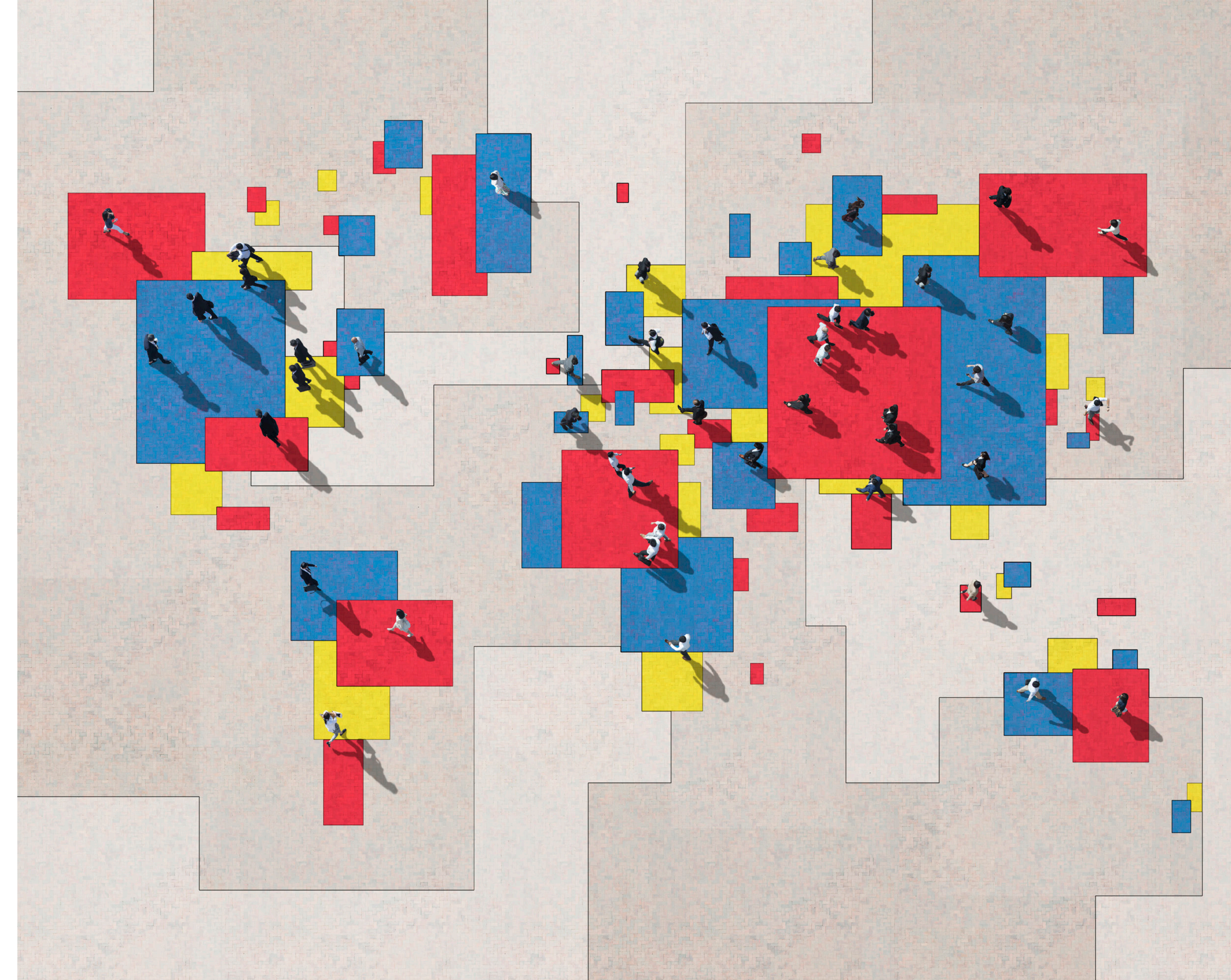

AN OVERVIEW OF OECD PILLAR 2

Brian H. Jenn, Annette Keller, Dr. Dirk Pohl, James Ross, Andrea Tempestini, Antoine Vergnat, Romain Desmonts and Alessio Persiani

Potential new tax rules would significantly impact the taxation of multinational groups, introducing new complexity to international taxation and nullifying the benefit of tax incentive regimes employed by many countries to attract foreign investment.

The Organisation for Economic Co-operation and Development (OECD)/G20 Global Anti-Base Erosion (GloBE, Pillar 2) Model Rules, published in December 2021, intend to address perceived challenges to long-standing international taxation principles raised by the increasing digitalisation of the economy.

As of 4 November 2021, 137 OECD/G20 countries and jurisdictions—representing more than 90% of global gross domestic product—agreed to join the official statement of the Two-Pillar Solution. Pillar 1 foresees

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the reallocation of international taxing rights and stabilisation of the international system of tax law. Pillar 2 imposes a global minimum 15% tax rate for certain multinational enterprises from 2023 onwards.

The OECD outlined key aspects of Pillar 2 in a blueprint published in 2020. The Model Rules published in December 2021 offer an indication of how the rules might apply in practice. A commentary on the Model Rules published in the first quarter of 2022 provides additional guidance and is available here.

PILLAR 2 AT A GLANCE

Pillar 2 rules apply to multinational groups with global revenues exceeding EUR750 million. A "group" is defined as a collection of enterprises that are consolidated for financial accounting purposes. Pillar 2 applies to the constituent entities (CEs), *i.e.*, subsidiaries included in the consolidation, and permanent establishments (PEs), including branch operations and entities that are disregarded for US income tax purposes.

Pillar 2 includes two proposals that operate almost independently of each other:

1. A global anti-base erosion regime (GloBE rules) applies through an income inclusion rule (IIR) and an undertaxed payments rule (UTPR) with support from a switchover rule (SOR) as required.
2. A minimum level of tax on certain payments between connected parties, which are deemed as having a heightened base eroding potential, subject to tax rule (STTR).

The interaction between the two is that the top-up tax imposed under the STTR is taken into consideration for the purpose of calculating the effective tax rate (ETR) under GloBE rules, so the STTR operates in priority to GloBE rules.

The IIR requires the ultimate parent entity (UPE) to pay a top-up tax on its proportionate share of the income of any low-taxed CE in which the UPE has a direct or indirect ownership interest. The tax is the top-up amount required to bring the overall tax on the profits up to the 15% ETR. The IIR is a residence-based income tax rule. However, further to the OECD Model Rules, the amount of the top-up tax payable under the IIR and the UTPR are net of any Qualified Domestic Minimum Top-Up Tax (QDMTT). This ensures that source countries retain the primary right to tax profits sourced in their territory at the 15% rate if they so choose.

The UPE is given priority for applying the IIR. If the UPE is located in a jurisdiction that has not implemented the IIR, then responsibility for its application falls on the CE that is directly owned and controlled by that UPE, and so on, down the chain of ownership.

The IIR is complemented by a tax treaty-based SOR that allows a jurisdiction to override the exemption method and switch to the credit method to the extent necessary to apply the IIR to the profits of a PE. This ensures equality of treatment of exempt PEs and foreign subsidiaries under GloBE rules.

The UTPR serves as a backstop to the IIR and is aimed at dealing with cases in which the IIR is unable to bring low tax jurisdictions in line with the 15% minimum ETR. The UTPR allocates the taxing rights over the under-taxed income to jurisdictions different from the UPE residence.

The STTR complements GloBE rules. It is a tax treaty rule that specifically targets intragroup payments that benefit from low nominal tax rates in the jurisdiction of the payee. The STTR operates before the IIR and confers a primary taxing right to the source jurisdiction. To a certain extent, the STTR constitutes a counterweight (in addition to QDMTT) for source jurisdictions against the IIR, which is a residence-based tax rule. It is activated where intragroup payments are made by an entity in one contracting state to a group entity in another contracting state that is subject to an adjusted nominal tax rate below the 15% minimum ETR. In that case, the source state may levy a withholding tax equal to the top-up tax on the gross payment.

GLOBE RULES AT A GLANCE

In-Scope Entities

A group will not be subject to GloBE rules if it does not have at least one subsidiary or PE located in a jurisdiction different from the one of the UPE, or does not have annual revenues of €750 million or more in the consolidated financial statements of at least two of the four fiscal years preceding the tested one.

Some specific exclusion rules are provided. The most relevant exclusions are pension funds, investment funds or real estate investment vehicles qualifying as UPE, nonprofit organisations, and governmental entities and international organisations.

Application of GloBE Rules

First, each CE should determine its GloBE income or loss. The CE income or loss as reported in the UPE's consolidated financial statements (before the elimination of intragroup transactions) constitutes the starting point.

The CE's accounting income or loss must then be adjusted to remove specific book-to-tax differences. GloBE income includes tax credits refundable within four years (Qualified Refundable Tax Credits), while tax credits that do not meet this requirement are excluded. International shipping income is also excluded for GloBE purposes. Further details and rules are laid under Chapter 3 of the OECD Model Rules.

Chapter 4 of the OECD Model Rules provides the calculation of the tax attributable to the GloBE income. Covered taxes include all income taxes, including taxes on distributed profits and deemed profit distributions, accrued for financial statements purposes.

GloBE rules should be applied in the following steps:

- Calculation of the ETR
- Calculation of the top-up tax
- Determination of the liability for the top-up tax
- Calculation of the ETR.

COEXISTENCE WITH GILTI

US global intangible low-taxed income (GILTI) rules and other income inclusion regimes are currently being examined to determine if they meet the objectives of GloBE rules. In that context, the OECD has indicated that consideration will be given to the conditions under which the GILTI regime will coexist with GloBE rules to ensure a level playing field. The GILTI rules might not be considered a qualifying IIR unless US Congress modifies the GILTI regime so that it applies a 15% minimum ETR on a country-by country basis, which is currently unlikely. If the existing regime is not amended, US-parented groups may be subject to application of UTPRs to top-up tax amounts of their CFCs.

Additionally, regardless of whether or not GILTI is modified, other countries' UTPRs may apply to top-up tax calculated with respect to the US parent company and any disregarded entities or foreign branches it owns.

DRAFT EU DIRECTIVE

In parallel with OECD elaborations, in December 2021, the European Commission proposed the adoption of a directive with regard to the European Union. The draft directive closely follows the OECD Model Rules but extends their scope to large-scale, purely domestic groups. This means that, in the European Union, GloBE rules would also apply to

Pillar 2 imposes a global minimum 15% tax rate for certain multinational enterprises

Pillar 2 rules apply to multinational groups with global revenues exceeding €750 million

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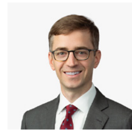
groups that do not have subsidiaries/PEs in more than one jurisdiction. While the Commission officially stated that the extension is provided "in order to ensure compliance with the EU fundamental freedoms," a few scholars have raised some doubts on the compliance of the directive with those freedoms.

The draft directive also exercises an option set out in the OECD's commentary for the Model Rules to require an EU Member State of an in-scope multinational enterprise applying the IIR to ensure effective taxation at the minimum agreed level (15%) not only for foreign subsidiaries but also for all CEs resident in that EU Member State and the PEs of the group established in that Member State.

Provided that the draft directive is approved by EU institutions (remarkably, a unanimous agreement of EU Member States at the Council level is required), the relevant rules should be implemented in the domestic tax systems by the end of 2022 and should apply as from 2023.

It is notable that the Spanish Budget Law for 2022 has already provided a 15% minimum tax applicable from 1 January 2022. The minimum tax applies to taxpayers with a net turnover of at least EUR20 million and those subject to the tax consolidation regime, giving it a scope of application wider than both the OECD rules and the proposed EU directive.

A longer version of this article and an example of the application of GloBE rules can be found here.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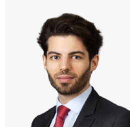
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GERMAN TAX ASPECTS OF CROSS-BORDER REMOTE WORKING

Dr Gero Burwitz and Dr Isabella Denninger

As a result of the COVID-19 pandemic, remote working became a necessity. Despite the easing of lockdowns, the trend is likely to stay, particularly with "workations" being actively promoted by the travel industry, but there are considerable tax consequences for international employers.

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PERMANENT ESTABLISHMENT (PE)
AND PERMANENT REPRESENTATIVE (PR)

A fixed place of business (PE) or an agent who both has and exercises authority to conclude contracts on behalf of the business (PR).

Note that some tax treaties have a broader definition of the provision of services, and some jurisdictions have introduced temporary changes to law or guidance during the pandemic to accommodate individuals working remotely.

Each tax jurisdiction has its own rules and tax consequences covering an employer's obligation to withhold payroll taxes, and the risk of creating an additional tax nexus in another jurisdiction by creating a permanent establishment (PE) or permanent representative (PR) in that jurisdiction. There is also the added challenge of how these jurisdiction-specific rules interact with each other. Employers that are tax resident in one jurisdiction and employ individuals who choose to work remotely in another jurisdiction (inbound employer), and *vice versa* (outbound employer), must therefore be alert to the potential risks of remote working. The situation in Germany provides a snapshot of the complexity this new working order creates for international businesses.

A workplace in an employee's home generally does not constitute a permanent establishment.

MAIN TAX RISKS

By allowing remote working, inbound or outbound employers may unintentionally create a PE or PR in Germany or abroad. A PE/PR may result in the employer triggering a limited tax liability in other states under their national tax laws, which may in turn lead to obligations, *e.g.*, registration, tax filing, and allocation of profits; possibly sanctions in the event of non-compliance; and double taxation risks. It also triggers certain obligations, such as keeping records and documentation for transfer pricing, plus the PE is obliged to withhold employees' payroll taxes under certain circumstances.

At the same time, inbound or outbound employers may face an obligation to withhold payroll taxes in Germany or abroad. This may require the implementation of additional internal processes, such as determination of the days the employee worked abroad and/or other obligations, such as registering, filing, and paying payroll taxes or other taxes in the states concerned. As a result, employees may need to undertake administrative efforts to mitigate double taxation risks.

Inbound and outbound employers may also need to check and monitor changes in the employee's social security status, which may involve complex procedures with the respective social security agencies.

LIKELIHOOD OF CREATING A PE IN GERMANY (INBOUND EMPLOYER)

Under German tax law, a PE is defined as

- A fixed place of business (established at a distinct location with a certain degree of permanence (at least six months))
- Over which the taxpaying enterprise has power of disposal (exclusive and independent entitlement to access premises)
- And is where the taxpaying enterprise performs business activities.

In terms of a workplace in an employee's home located in Germany, the employer will generally not have power of disposal as it does not have full access to the employee's premises. A workplace in an employee's home therefore generally does not constitute a PE, even if the employee works there almost exclusively.

If, however, the employee lives in an apartment owned by the employer, or the employee rents the premises in his own name specifically for the purpose of working from that location for the employer, the premises may be considered a PE. For non-German resident companies, this should usually trigger the obligation to withhold payroll taxes in Germany. It is therefore crucial for companies that are tax resident outside Germany to check whether or not remote work undertaken outside the companies' premises, *e.g.*, in an employee's home or hotel located in Germany, may create a PE in Germany.

With regard to any potential limited corporate income tax and trade tax liability in Germany on business income deriving from a PE, under German tax law the rules under an applicable double tax treaty between Germany and the jurisdiction where the employer is tax resident needs to be taken into account.

PE Under German Double Tax Treaties

If a PE is assumed under national tax law, a potential double taxation situation may be resolved by a double tax treaty between the states concerned, provided both states conclude that a PE has been created.

Most German double tax treaties follow the definition of a PE in the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention 2017 (OECD-MA 2017), according to which a PE is defined as a fixed place of business through which the business of an enterprise is wholly or partly carried out.

In terms of carrying on business activities at an employee's home, the commentary on Article 5 of the OECD-MA 2017 points out that, in many cases these will be so intermittent or incidental that the home will not be a location at the disposal of the enterprise, and thus will not create a PE. If, however, a home office is used on a continuous basis for carrying on business activities for an enterprise, and it is clear from the facts and circumstances that the enterprise has required the individual to use that location to carry on its business, *e.g.*, by not providing an office to the employee in circumstances where the nature of the employment clearly requires an office, the home office may be considered to be at the disposal of the enterprise, and thus creates a PE.

To mitigate the risk of creating a PE during the COVID-19 pandemic, the OECD published a non-binding recommendation, according to which temporary remote work necessary due to the pandemic should not create a (new) PE under treaty law as "the degree of permanence of the activity or the power of disposition of the enterprise required for the assumption of a PE is lacking". This recommendation was implemented in the bilateral consultation agreements between Germany and Austria, and between Germany and Switzerland.

It is likely that these agreements will be repealed once the pandemic is over, so an internationally coordinated approach reflecting the "new work era", supported and promoted by the OECD, is now necessary. It is to be hoped that this approach will provide employers with a defined set of clear and comprehensible criteria to enable them to decide in which cases PEs are created by cross-border remote work. In the meantime, however, employers must consider whether or not a PE or PR is created under established national tax law.

LIKELIHOOD OF APPOINTING A PR

Even if the employee's home does not create a PE, corporate income tax (but not trade tax) liabilities may still be established if the employee working cross-border qualifies as a PR.

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If an employee i) acts on behalf of an enterprise; ii) habitually concludes contracts on behalf of that enterprise, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise; and iii) conducts contract negotiations from home (located in a state different to the employer's tax residence) with third parties until the contract is ready to be signed, that employee is generally considered a PR (under German tax law and German tax treaties) in the state the employee is working from, regardless of whether or not the contract is signed in the employer's state of residency.

Corporate income tax liabilities may be established if the employee working cross-border qualifies as a PR.

HOW TO MITIGATE CREATING A PE/PR

When offering employees the opportunity to work remotely cross border, inbound and outbound employers are well advised to allow it only intermittently or incidentally; introduce an approval process; and undertake a comprehensive review of any potential tax consequences triggered by remote working activities in another jurisdiction.

In addition, employers should establish a set of rules to reduce PE/PR risks. These rules must obviously be tailored to each set of circumstances, but should include the following as a minimum:

- Prevent management functions from being exercised by employees from their home outside the employer's state of tax residency
- Undertake detailed reviews of potential tax consequences when core business activities are performed abroad
- Allow only remote working activities that are of a preparatory or auxiliary nature
- Prevent employees from concluding contracts and/or playing a principal role leading to the conclusion of contracts that are routinely concluded without material modification
- Continue to provide office premises for those employees
- Limit the employer's access to the employee's home outside the employer's state of tax residency
- Exclude employers from the employee's home rental or purchase agreements

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THE UK PERSPECTIVE

The presence of a worker in a jurisdiction other than the United Kingdom could create a taxable PE for a UK-tax resident employer. The threshold will depend on the domestic law provisions of the jurisdiction in which the employee is working.

Where a double tax treaty is in place between the United Kingdom and the jurisdiction in question, a taxable presence will normally only arise where the employee's activities give rise to a PE in the relevant jurisdiction.

The nature of the employee's work activities, the length of time spent working remotely, and the scope of the role (internal/administrative or customer facing/revenue generating) will all be key considerations in establishing whether or not the remote work constitutes a taxable presence. In short, any proposed arrangement will require careful consideration at the outset.

A UK national who elects to work abroad for an extended period may cease to be a UK tax resident if they spend fewer than 183 days in the United Kingdom in a tax year. They may become liable for income tax in the country in which they are working, and their employer likewise liable to pay social security contributions in that country.

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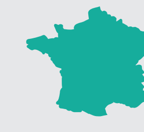

THE FRANCE PERSPECTIVE

Depending on the employee's activity and role, and the applicable bilateral treaties, a French employee working remotely abroad may create a taxable PE for a French-tax resident employer in the State where the employee resides and works remotely. A portion of the employer's profits may be subject to corporate tax in the jurisdiction where the employee is working. Working remotely abroad may also give rise to income tax withholding obligations in the State where the employee is established. The employer may be subject to another EU jurisdiction's social security rules and be required to set up a local payroll if an employee carries out more than 25% of activities in that jurisdiction. For non-EU jurisdictions, the rules will depend on the applicable bilateral social security treaties.

A foreign entity may be assumed to have a French PE if it operates an autonomous establishment in France, or carries out transactions in France *via* a dependent representative, or carries out transactions that are part of a complete business cycle. It will also be regarded as having a French PE if it has a French PE under an applicable double tax treaty.

A foreign employee of a foreign company becomes subject to income tax in France if their main place of abode is in France, or they carry on a professional activity in France (unless on an ancillary basis), and/or their economic activities are based in France.

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RELAUNCHING THE UNITED KINGDOM AS THE EUROPEAN CENTRE OF ALTERNATIVE ASSET MANAGEMENT

Kevin Cummings

In an attempt to claw back some of the business lost as a result of Brexit, the UK Government has launched a version of the "asset holding companies" (AHCs) that made Luxembourg and Ireland such attractive destinations.

The UK asset management world, whether traditional or alternative, has historically thrived from its base in the City of London. Big headlines around the time of Brexit honed in on the ability of the UK funds industry to withstand the loss of marketing, distribution, and investment management passporting rights across the European Union, given the withdrawal of the United Kingdom from the Eurozone and the European regulatory regimes under the Markets in Financial Instruments Directive and the Alternative Investment Fund Managers Directive.

Whilst the United Kingdom has no doubt lost some business to the Eurozone, particularly in the banking and capital markets sectors, asset management has been relatively lightly impacted as a result of these factors. Nevertheless, since the 2020 Spring Budget, the UK Government has been, behind the scenes, cooking up quite revolutionary plans to transform the UK funds regime in a drive to ensure the ongoing competitiveness and sustainability of the financial services sector from a tax and regulatory standpoint.

In short, this has the look and feel of a territorial "land grab" in an effort to recapture the US$ trillions of assets under management gradually lost to Luxembourg and Irish-domiciled funds and asset holding companies, both in the traditional and alternative funds markets, because of more favourable tax and regulatory regimes in those jurisdictions.

LAUNCH OF THE UK ASSET HOLDING COMPANY TAX REGIME

Against that backdrop, as of 1 April 2022 the United Kingdom has launched its own version of the more typical Luxembourg or Irish AHC that is aimed at housing non-publicly listed or traded debt or equity, the customary investment assets of choice of the global private equity and credit industries.

Given the considerable expertise in portfolio management sat in London, it is expected that this enhanced attractiveness of UK funds will help open doors for asset managers to sell UK funds around the world, with a view to capturing a greater slice of the tax revenues and service fee income that integrally surrounds the housing and servicing of fund asset portfolios.

What Exactly is an Asset Holding Company?

An AHC is the entity that sits beneath a fund and typically holds the investment assets. It will also customarily be the counterparty to the fund's agreements with counterparties, such as asset managers, asset servicers, custodians, banks, and others. The "asset holder" will ordinarily be in corporate form—as limited liability status will ensure that external liabilities to creditors and counterparties will not taint the fund vehicle—usually a transparent entity such as a partnership in the alternative funds market.

Corporate form also historically guaranteed an asset holding company's access to double taxation treaties and related benefits, including treaty residence and eligibility to reliefs from withholding tax on interest and dividends, as well as source country exemption from capital gains when exiting investment positions held in third countries.

Why Does the United Kingdom Need a New Tax Regime for AHCs?

Put simply, whilst the United Kingdom has all the talent and expertise needed to drive a thriving funds industry, the actual assets under management tend to be housed overseas because of long-standing difficulties with the UK tax regime. Whilst Cayman and the Channel Islands have grabbed hedge funds' assets (hedge fund assets not typically needing the benefit of tax treaties), Luxembourg and Ireland have adopted flexible tax regimes in order to attract the more illiquid asset classes associated with private equity, credit, and direct lending.

It is expected that this enhanced attractiveness of UK funds will help open doors for asset managers.

The legacy UK tax regime struggled with the concept that an AHC is nothing more than a "conduit" and should not interpose a new level of taxation between the investment asset and investor. Whilst European competitors permit payments on equity to be deducted from the tax base as a means to maintain AHC tax neutrality, this was not the case in the United Kingdom; investment gains *may* have been exempt from UK tax, but only after a labyrinthine and tortuous tax analysis. And paying cash up to the fund by the AHC would typically require managers to list debt instruments on a stock market, adding deal costs and requiring a level of public disclosure about the investment strategy. These were the principal, but not all, of the obstacles.

What's So Good About the New Tax Regime?

The new UK tax regime is a big deal for UK, European, and US managers in the alternative funds space. The UK Government has largely addressed all the legacy tax issues that made the UK less attractive as a location for AHCs in private equity and credit structures. The new regime closely mirrors, but improves on, the tax regimes for AHCs in Luxembourg and Ireland, and means that all alternative managers will need to consider the UK AHC as a base for global and pan-European structures.

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Key features of the new regime include

- Allowing returns on equity at the AHC level to be tax deductible
- Exempting dividends on assets from treaty jurisdictions, and granting a blanket exemption on capital gains
- Switching off the UK withholding tax rules when the AHC pays up the chain to the fund/investors
- Allowing investment returns to investors to be taxed as "capital" where the return mirrors underlying capital gains on exiting an investment
- Permitting AHC shares to be bought back by the fund, as a way to repatriate capital, without penal UK stamp taxes.

This all represents a seismic shift in the UK tax landscape and mirrors the very successful legislative reforms enacted to prop up the UK securitisation market in the mid-2000s.

The arrival of the UK AHC regime also comes at a poignant moment in the context of international and European tax developments. The common "go to" private equity and credit structures, typically involving one or more European asset holding companies stacked under the fund, have been battered by the winds of global tax reform: asset holding companies lacking (what is commonly referred to as) "substance" have had problems accessing treaty benefits (under "principal purpose" and limitation on benefits" clauses) and investee jurisdictions, including the United Kingdom, are increasingly challenging (post-*Indofoods* and the *Danish Cases*) whether standard AHCs can establish beneficial ownership of assets and income flows, resulting in increased withholding taxes on cash flows and devastated fund internal rates of return.

This all represents a seismic shift in the UK tax landscape.

If that were not bad news enough, the proposed new "substance" rules intended to apply to European holding companies under the anti-tax avoidance Directive III (ATAD III) is only expected to make typical European structures more onerous and costly to run, given the Directive's requirements to employ local operational staff, rent real premises (rather than just a brass plate), and initiate local banking arrangements in the AHC jurisdiction.

Crucially, the new UK AHC is expected to be unaffected by the tax problems that beset legacy structures and that are afoot under ATAD III. Managers will almost certainly have real management and operational substance in the United Kingdom anyway, and are less likely therefore to be dogged by calls for evidence from overseas entities as to all the non-tax reasons why their holding companies are sited in jurisdictions distant from their leadership and operational capabilities.

NEXT STEPS

Alternative managers, given the winds of tax reform, will be wise to consider eligibility under the new rules. At the very least, if an existing overseas fund platform is long-established, it should consider if the platform is sufficiently robust to withstand increased muscle-flexing from revenue authorities.

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