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INSIGHTS

PRIVATE INVESTMENT FUNDS IN ISRAEL

NEW ITALIAN TRANSFER PRICING REGULATIONS AFFECT MULTINATIONAL ENTERPRISES

TAX COMPETITION BETWEEN MEMBER STATES OF THE EUROPEAN UNION – AN ACADEMIC VIEW

AND MORE

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About Us

EDITORS' NOTE

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

- **Private Investment Funds in Israel.** The State of Israel has encouraged foreign investments in Israel for many years. One of its primary tools is the special tax regime applicable to private investment funds. If listed conditions are met, a range of tax benefit benefits are granted to the fund and its investors. These include exemptions from Israeli tax for non-Israeli limited partners with respect to (i) income derived from non-Israeli investments, (ii) capital gains, dividends, and interest form venture capital investments, and (iii) income derived from the realization of Qualified Investments. Anat Shavit, a partner of FBC & Co., Tel Aviv, and Yuval Peled, a senior associate at FBC & Co., Tel Aviv explain the conditions that must be met.

- **New Italian Transfer Pricing Regulations Affect Multinational Enterprises.** Italian transfer pricing documentation rules were introduced in 2010. The system affords taxpayers the possibility of penalty protection for transfer pricing adjustments, provided that qualifying transfer pricing documentation is maintained by the taxpayer. Late in 2020, new regulations were introduced. The new regulations contain several important changes for multinational enterprises based in Italy or having an Italian member. Marco Valdonio, a partner of Maisto e Associati, Milan, and Mirko Severi, an associate of Maisto e Associati, Milan, explain the principal revisions to the Italian rules. They address the changes that broaden the scope of companies required to maintain a master file, reductions in the scope of the exception to annual filing for certain local members of a foreign-based multinational group, and changes to the content of both the master file and the local file.

- **Tax Competition Between Member States of the European Union – An Academic View.** In May, the European Commission lost its second case in the E.U. General Court when Amazon's tax arrangement in Luxembourg was found to be onside as to rules prohibiting illegal state aid among Member States. A companion case was issued the same day in which the penalty asserted by the European Commission was upheld. These cases bring the Commission's record before the Court to two wins and three losses, with three cases in progress. For those readers asking why Commissioner Vestager continues to bring these cases, the answer is explained by Professor Pietro Boria, of Sapienza University of Rome. A new electorate has arisen in Europe that is multinational in its scope and led by a governing body answerable to all Member States. Parochial interests that existed through the end of the 20th Century no longer control. Tax policy is no longer the realm of national governments.

- **The 15 Most Important Questions That Should be Asked When Estate Planning for a Foreign Parent With U.S. Children.** U.S. estate tax planning is said to be among the most complicated aspect of tax planning because of the numerous moving parts and the changing needs and objectives of the family. The exercise becomes complicated when the client is not a U.S. person, but the heirs live in the U.S. and have started families in the U.S. For an estate planner with a focus on domestic clients, the customary tools may

not work. It is easy to know what you know, but not always easy to know what you don't know. Neha Rastogi and Stanley C. Ruchelman ask and answer 15 questions that highlight the favorable and unfavorable provisions of U.S. tax law affecting nonresident, non-citizen individuals having U.S. persons as heirs.

- **Final Regulations for Withholding on Foreign Partners' Transfers of Specified Partnership Interests – Construct, Exceptions, and Reporting.** For U.S. tax purposes, gain or loss upon a sale or exchange of property is generally sourced based on the tax home of the seller. For a foreign person investing in a partnership conducting a U.S. trade or business, the source rules change. A foreign partner that sells an investment in a U.S. partnership operating in the U.S. will be subject to tax on the portion of the gain deemed to be effectively connected with a U.S. trade or business. This change stems from Code §864(c)(4), which recharacterizes a sale of a partnership interest as an indirect sale of partnership assets, resulting in gain to the selling foreign partner. Under Code §1446(f), withholding tax of 10% applies to the seller's amount realized. Andreas A. Apostolides and Nina Krauthamer take a deep dive in the I.R.S. regulations issued in late 2020. A must read for advisers to foreign partners in partnerships with U.S. fixed offices and U.S. trades or businesses.

- **Clarity on Recharacterization of Carried Interests.** Earlier this year, the I.R.S. issued final regulations providing guidance on Code §1061, which recharacterizes certain long-term capital gains as short-term gains for holders of partnership interests entitled to carried interests. The provision impacts fund managers of alternative investments, such as private equity and hedge funds, who receive carried interests. When gains are derived through a carried interest, they are treated as long-term capital gains only when the carried interest is held for 36 months and one day, significantly longer than the 12 months and one day ordinarily required. In her article written while an extern at Ruchelman P.L.L.C., Susan F. Robinson explains how the final regulations address two workarounds that were widely proposed to circumvent the lengthened holding period and cautions that the policy debate on carried interests may not be over.

- **Beauty is in the Eye of the Taxpayer.** As a counterpoint to the view in Europe regarding tax competition, the view in the U.S. is that tax competition is an acceptable policy to influence a multinational corporation to locate operations in a particular State. In his article written while an extern at Ruchelman P.L.L.C., Corey L. Gibbs looks at policies adopted by the State of Alabama pointing out that U.S. citizens and residents are "voting with their feet," when relocating to States that impose lower taxes. In Europe, there may be a duty to pay tax, in the U.S. there is a right to carry on one's affairs in a way that results in the lowest tax possible.

We hope you enjoy this issue.

- The Editors

TAX COMPETITION BETWEEN MEMBER STATES OF THE EUROPEAN UNION – AN ACADEMIC VIEW

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Tags
European Commission
Globalization
State Aid
Tax Competition
Tax Policy

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INTRODUCTION

In May, the European Commission lost its second case in the E.U. General Court when Amazon's tax arrangement in Luxembourg was found to be onside as to rules prohibiting illegal state aid among Member States. In a companion case having a lesser amount in issue, the tax arrangement between Luxembourg and Engie, a French power company, was found to violate the illegal state aid rules in the E.U. Commissioner Vestager's record stands at two wins (Engie and Fiat) and three losses (Amazon, Apple, and Starbucks) at the E.U. General Court. Three investigations continue, involving Ikea and Nike in the Netherlands and Huhtamaki in Luxembourg. This article examines policy views that support Commissioner Vestager's position in attacking tax arrangements under illegal state aid rules.

THE ABSENCE OF A CENTRALIZED TAX POLICY LEADS TO FRAGMENTATION OF TAX SYSTEMS WITHIN THE E.U.

The rise of favorable tax rulings based solely on accepted tax concepts – without considerations of other factors – has disrupted the normal functioning of the tax systems of Member States. Historically, the role of a national tax system of a Member State was to fund government expenditures for the benefit of residents of that State. However, with globalization and the advent of unilateral advance pricing agreements ("A.P.A.'s"), the Member State's role in governing the economy has taken second seat to promoting the interests of multinational financial and business entities, with the expectation that jobs will be created as a bi-product. Because these A.P.A.'s often favor multinational groups based outside the Member State, they tend to favor nonresidents over residents and detract from the role of the state as a model of political unity within a community.

It is acknowledged that the economic strength of multinational enterprises competes with governmental power and has led to political pluralism. However, it has diminished the main function of a Member State as the sole political decision maker elected by the voters. The tax function is an example of decision-making that is no longer the exclusive province of governments of Member States or the governance structure of the E.U. Where the right to issue favorable A.P.A.'s on a selective basis solely belonged to the Member State, recent cases brought by the European Commission to address tax subsidies reflect limitations now applicable to the authority of Member States to use tax policy for the sole benefit of that State.

THE DISCONNECT BETWEEN NATIONAL TAX POLICY AND PLURALISTIC VALUES WITHIN THE E.U.

The economic power of multinational financial and business entities has contributed to the diminished role of the national government in managing a country's economy. In the 20th Century, the tax system exclusively reflected goals of the government of each Member State. Tax policy reflected local needs. In a sense, this was true whether the government was formed by a party holding a majority in parliament or was a coalition formed by political parties have different constituencies. Granted, policies changed from time to time, reflecting the outcome of parliamentary elections. But either way, government policy was set by the elected government and its various constituencies within the Member State. In this context, the obligation to contribute to public expenses became a fundamental obligation of citizenship. Whether a resident voted for a political party in government or in opposition, the payment of taxes funded local goals.

In a liberal single-class State, legislative decisions are conceived in such a way as to reflect the homogeneous values of the ruling class. Government decision-making responsibilities are shared by political parties reflecting the view of the majority according to accepted guidelines of the national constitution. In comparison, in a modern multiclass state, a need exists to include the values of various classes and interest groups in political life.

The arrival of economically powerful multinational enterprises was accompanied by a shift of fiscal sovereignty in Europe from Member States to E.U. administrators. The issuance of Directives on Administrative Cooperation issued by the European Commission has reduced the role of Member States in making funding choices.

Nineteenth-century concepts regarding the rule of law led to the recognition of the inherent legitimacy of policy choices made by a parliamentary majority. This acceptance of majority rule, as an underlying philosophy, no longer exists. In a modern democracy that reflects a pluralistic society, legitimacy is based on shared values. The liberal state tax system was a legal instrument for achieving the objectives set by the ruling class. Inherently, the policy reflected the ideological convictions of society. The transition to a single policy center within the E.U. has undermined the connection between the tax system within a Member State and the values of the supporters of the majority party. Instead, E.U. mandated tax policy reflects a plurality of collective purposes and aims, and for that reason, often contradicts values in a particular Member State.

Stated simply, the 21st Century has witnessed the devolution of national tax systems within the E.U. into an E.U.-wide tax system that reflects its own values, often promoting a broader pluralist society designed to be homogeneous throughout the E.U.

TAX COMPETITION AMONG E.U. MEMBER STATES – IS IT HELPFUL OR HARMFUL?

The spread of globalization has had a significant impact on the mechanisms which shape the tax choices of Member States. Tax burden is an expense that directly or indirectly contributes to the pricing of a product. Corporate effective tax rates

vary among Member States and tax burden has become an important factor when deciding the location for the next plant or value driver. Consequently, the choices made by Member States regarding effective tax rates affects a company's decision on where to locate production plants or other value drivers. While tax is only one of many factors that are considered by management, a Member State that has adopted a taxpayer-friendly tax system for companies has an advantage in attracting multinational companies to the Member State.

The illegal state aid cases brought by the European Commission serve as evidence of (i) the absence of mechanisms to regulate the behavior of companies seeking lower effective tax rates and (ii) the competition among certain Member States attempting to attract plants and value drivers by offering lower effective tax rates. The question posed is whether a Member State should be free to shape its tax system to meet its own goals related to employment and general welfare brought about through investments made by a particular multinational enterprise seeking lower effective tax rates.

At the level of the European Commission, the answer is straightforward. A Member State cannot offer an effective tax rate that is below the effective rate paid by its resident companies, whether based on reduced nominal rates or special deductions under an A.P.A. In policing this concept, the European Commission inherently attacks the independence of Member States to independently manage local tax policy, potentially creating local economic problems.

FASHIONING A COMPETITIVE TAX SYSTEM IN A MEMBER STATE

Tax competition between Member States is a decidedly recent strategy designed to attract capital and business to the territory of a Member State through use of an attractive effective rate of corporate income tax. A Member State that participates in this competition is called upon to configure a tax system capable of convincing multinational enterprises to establish production plants and value drivers within its territory. To be attractive, the effective rate must be lower than the average for all Member States in the E.U., possibly tending towards zero or close to zero.

A Member State participating in this strategy assumes that the establishment of companies and capital compensates for the low effective rate of tax through an increase in other benefits for the population. The benefits may include direct employment of employees, indirect employment of companies and self-employed individuals providing goods and services to the local branch established by a multinational enterprise, higher levels of consumption of consumer goods by residents, infrastructure development, and increases of available capital. The reduction in corporate income tax is offset by an increase in individual tax rates and collections of value added tax. It may also be offset by a reduction in the overall cost of unemployment benefits. In light of these anticipated benefits, offering a lower effective tax rate to a multinational enterprise does not damage the Member State or its residents. Rather, the opposite is achieved because of the stimulus of the national economy.

A different view is held by the European Commission. It views tax competition as a never-ending race to lower effective tax rates. Consequently, it proposes greater coordination of tax policies among Member States to prevent effective tax rates from being eroded in other Member States. The O.E.C.D. supports this approach. Both

maintain the view that international tax competition penalizes Member States that do not participate in the competition, ultimately resulting in fiscal problems in those states.

MEMBERSHIP IN THE E.U. TRANSFERS FISCAL POLICY TO NEUTRAL E.U. ADMINISTRATORS

The phenomenon of tax competition has long been the subject of advanced economic studies, in which the differential use of tax policy as a productive system growth lever has been analyzed. Studies typically focus on the economies of developing countries. By and large, the studies conclude that tax competition does not result automatically in market distortion. Rather, it is a legitimate tool of economic policy to the extent it promotes the development of certain business initiatives or investments through foreign capital that would otherwise be available in the country.

"The phenomenon of tax competition has long been the subject of advanced economic studies, in which the differential use of tax policy as a productive system growth lever has been analyzed."

Beginning in the late 20th century, the notion of harmful tax competition among Member States developed, looking at tax competition as an inappropriate lever to distort normal market logic. Under this view, the harm results from the selective process of determining which industries will benefit from a reduction in effective tax rates. Certain activities were favored, typically the financial sector, and the beneficiaries were multinational companies, rather than companies involved in the local economy and its internal production system. In the end, benefits were given to revenue streams consisting of interest, dividends, royalties, rather than the production of goods for local consumption.

Whether due to the growth in economic power of multinational enterprises, or the rise of transnational advisory bodies such as the O.E.C.D., or the empowerment of centralized policy organs of the E.U., such as the European Commission, globalization diminished the role of Member States in setting tax policies. In a sense, pluralism overtook the central governing function of Member States as to economic policy decisions. The tax function no longer is identified with the central function of the Member State. The result is a fragmentation of the tax system into a plurality of systems, each responding to values expressed by the various legal systems. No single Member State has the power or authority to choose a path that is destructive to other Member States as determined by the governing agencies of the European Union.

In this context, the duty to contribute to public expenses is considered a responsibility connected to membership in the European Union. In terms of fiscal policy, paying taxes is a fundamental obligation of citizenship necessary for the survival of the European Union. The shift of fiscal sovereignty from the Member States to the various organs of the European Union has led to a profound transformation in the ethical concept of the tax system. The European Union is a multi-class community comprised of various cultures each with its own value system and interest groups that need to combine interests of majorities and minorities throughout the Community.

Nineteenth-century formation of the rule of law consisted of neutrality in respect to society in a single state, which led to t the validity of decision-making choices of a parliamentary majority. This has been overturned within the E.U. by the inclusion of pluralist communities in all Member States that share a common value system.

Consistent with this transformation, all tax systems within the E.U. reflect an open structure that is not supported by the pre-eminence of values coming from a particular social class in any particular country. Instead, tax systems of member states reflect compromise solutions resulting from the political and social mediation of a plurality of demands emerging from various stakeholders throughout the E.U.

CONCLUSON

The spread of globalization and market approximation processes have limited the range of choices by Member States in regard to tax policy. Use of tax policy to make one Member State more attractive than another for the location of foreign investments is no longer acceptable. Rather, tax policy has become an instrument governing the allocation of foreign investment throughout the E.U. based on the combined needs of all Member States. The importance of greater coordination of tax policies among Member States prevents inappropriate distortions that erode the tax base of other States.

Increasingly, it can be argued that the tax system is the result of the concurrent action of a plurality of sources, located at the state, sub-state, and international levels. To the extent that divergent goals exist, the differences are addressed in the regulatory process that takes into account community-wide needs.