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Global M&A transaction and indirect sale for capital gains taxation – how to deal with the attribution of price and lack of regulation

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<u>Session Co-Chairs</u>

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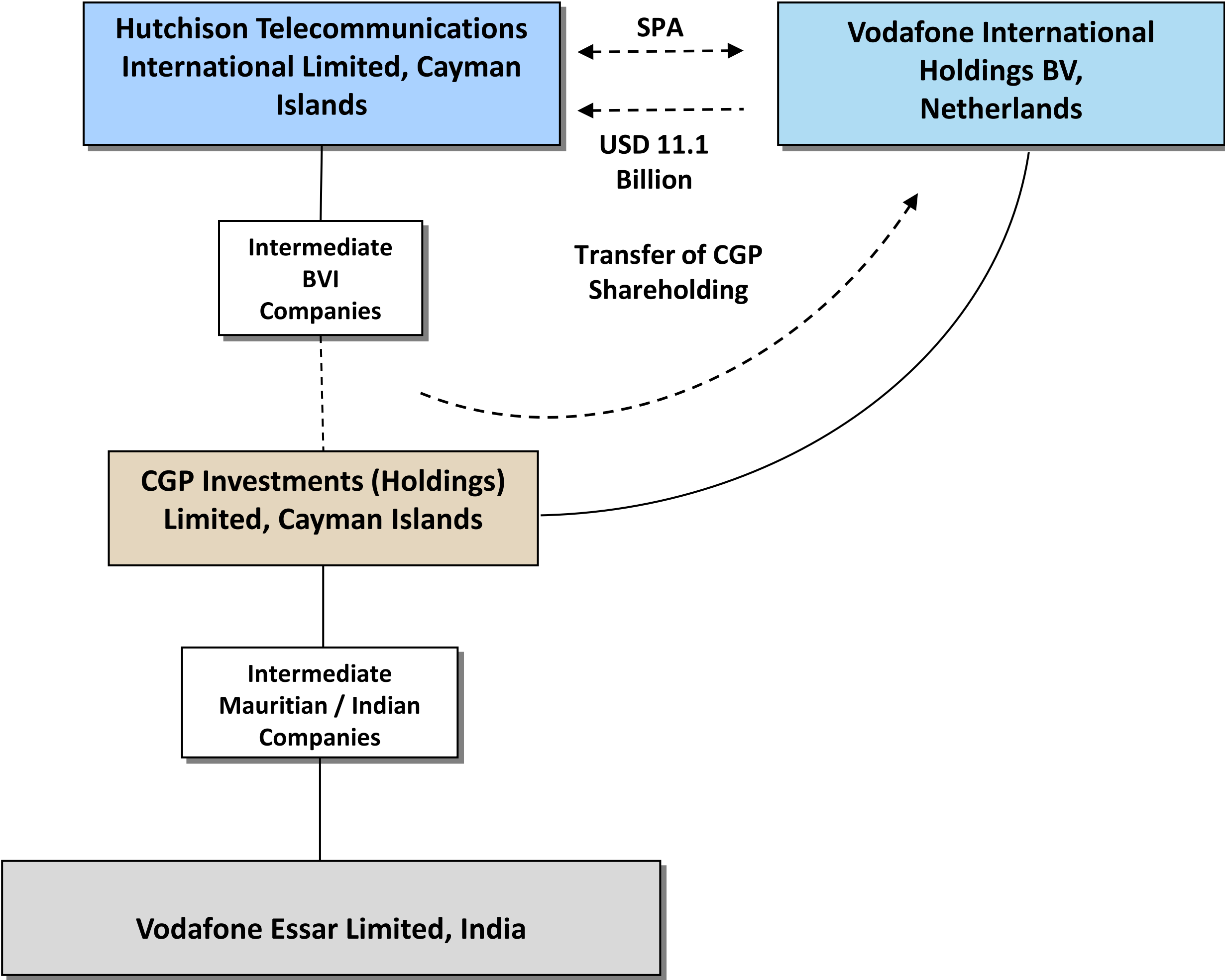
Overview of the Session

1. Origins of the offshore indirect transfer rules - famous tax controversies and policy basis
2. Legal design of indirect transfer rules
   - Tax liability rule
   - Valuation and attribution of capital gains
   - Enforcement and collection mechanisms (tax withholding and reporting obligations)
3. Interface of offshore indirect transfer rules with tax treaties
4. Case study - practical implications on global M&A deals and transaction documentation

Origins of the offshore indirect transfer rules

India’s Vodafone case



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Chilean Indirect Transfer Rules - Origins

Disputada Las Condes mine case 2001-2002:

- Exxon Mobil, owner of Disputada Las Condes, intended to sale on indirect transfer the mine to Anglo American.
- The transaction would imply a US$1.2 billion income with no capital gain tax applicable.
- Reaction of President Lagos and Congress: regulate taxation of capital gains on indirect transfer.
- Relevant negotiations ended through an agreement to sale the mine through a local vehicle with a local tax to be paid around US$50 million.

Indirect sales regulation - 2002:

- Reaction to a specific operation (taylor made).
- Political “noise” due to other benefits of mining projects which implied no paying corporate tax as deductions allowed generating continuous NOLs.
- Loophole: Buyer must be resident or domiciled in Chile.
- WHT of 35%.
- Value threshold of Chilean assets: 10%.

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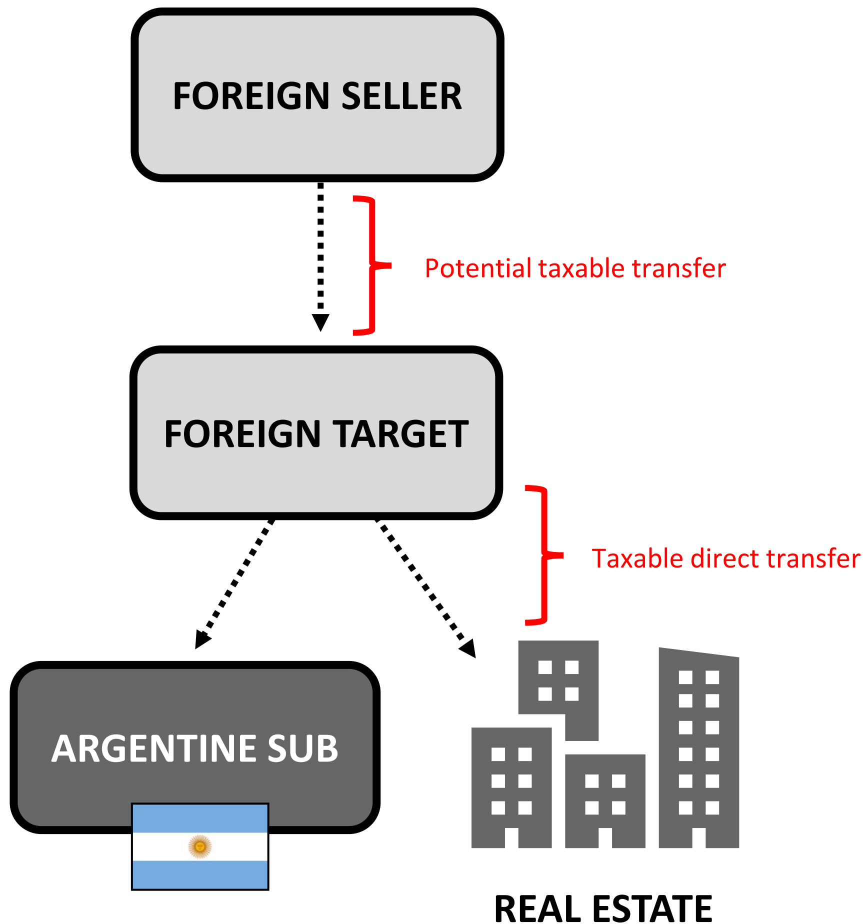
Argentinian Indirect Transfer Rules



- Up until 2017, Argentina exclusively applied capital gains tax (CGT) on direct transfers of assets. Applicable rates: (i) 13.5% on gross sale price; (ii) 15% on actual net income; (iii) reduced treaty rate (if applicable). Seller resident in non-cooperative jurisdiction: 31.5%.
- Exemption only applies on direct sale of Argentine shares in IPO context (listing on Argentine SEC is required).
- Prior to tax reform in 2017, indirect sales of Argentine assets was used as tax planning strategy by non-Argentine resident sellers.
- Impact of Vodafone case in India. Material tax reform in 2017 introduced indirect capital gains taxation. Grandfathering rule included.
- Indirect capital gains taxation does not require evidence of an evasion purpose as a condition for its application, so this provision generally raises tax nexus controversy since it generates a source rule, based on a legal fiction.

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Dutch Indirect Transfer Rules

- No indirect capital gains taxation included in Dutch domestic legislation
- Same goes for most EU countries
- Increasing focus on genuineness of structure
- ATAD 3 / Unshell proposal
  - EU initiative to combat use of shell entities
  - Many aspects and details still uncertain
  - Current EU presidency of Spain (July – Dec 2023): ATAD 3 (back) on the agenda for this period
  - Updated text of the Unshell Directive proposal expected in November
  - Netherlands in favour EU initiative for ATAD 3 – prefers multilateral instrument instead of unilateral initiatives and actions

Spanish Indirect Transfer Rules

- No indirect capital gains taxation included in Spanish domestic legislation
- Same considerations as the ones mentioned by Kristin for the EU
- A 2013 Spanish tax ruling concluded that section 13.1 of the Luxembourg-Spain DTT should also apply for the indirect transfer of shares in a Spanish real estate company. However there is a current open discussion on whether this section may only apply to the direct transfer of shares.
- Spanish CFC rules that have broaden its application since January 2021 due to the limitation of the Spanish participation exemption regime to a 95% exemption, i.e. effective tax rate of 1,25% on qualifying income instead of 0%.

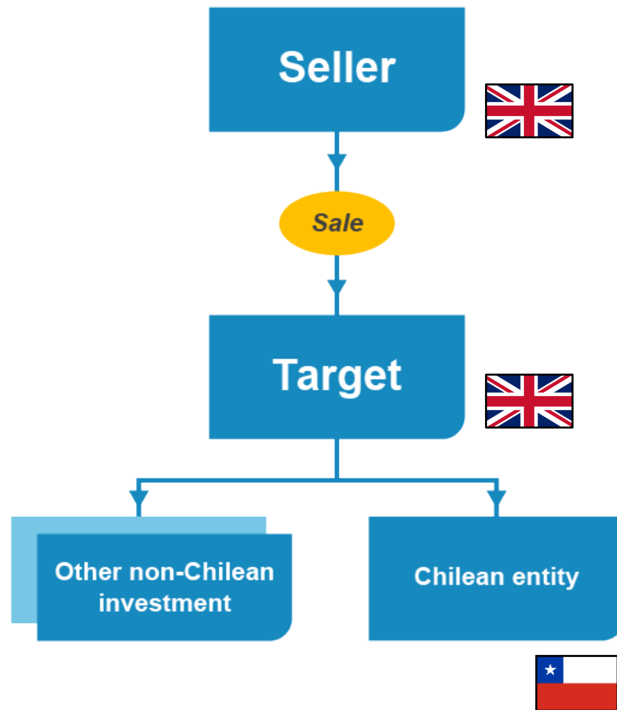
Colombia – Origins of indirect transfer rules.

- In 2012 Colombia introduced its first general anti-abuse rule (“**GAAR**”). This rule required that transactions have a business purpose.
- The regime of indirect sales is one of the country’s specific anti-abuse rules (“**SAAR**”) and it was first introduced to Colombian regulations through laws 1943 of 2018 and 2010 of 2019.
- According to such laws, the indirect transfer regime is addressed to prevent “tax evasion and tax abuse practices”.
- To this day, Colombian high courts have not ruled any indirect sales cases, where assets located in Colombia are transferred through the sale of a foreign entity. The previous cases of indirect sales in Colombia have not been made public.

Legal design of indirect transfer rules

Chilean Indirect Transfer Rules – Taxable events

General taxable event

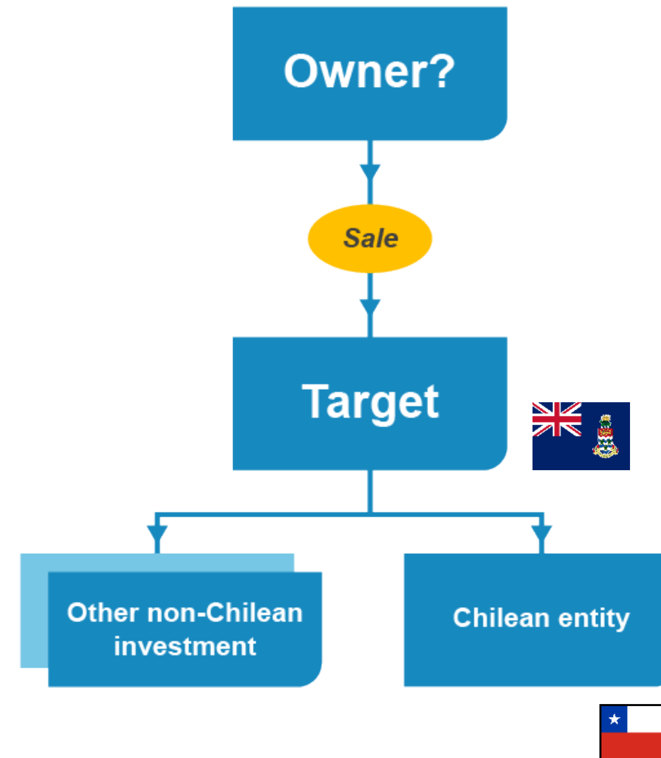


1) Sale of 10%-or-more of Target; and

2.1) Chile represents 20% of foreign Target's FMV; or

2.2) Chile is valued at approx. USD 200 million

Tax haven taxable event



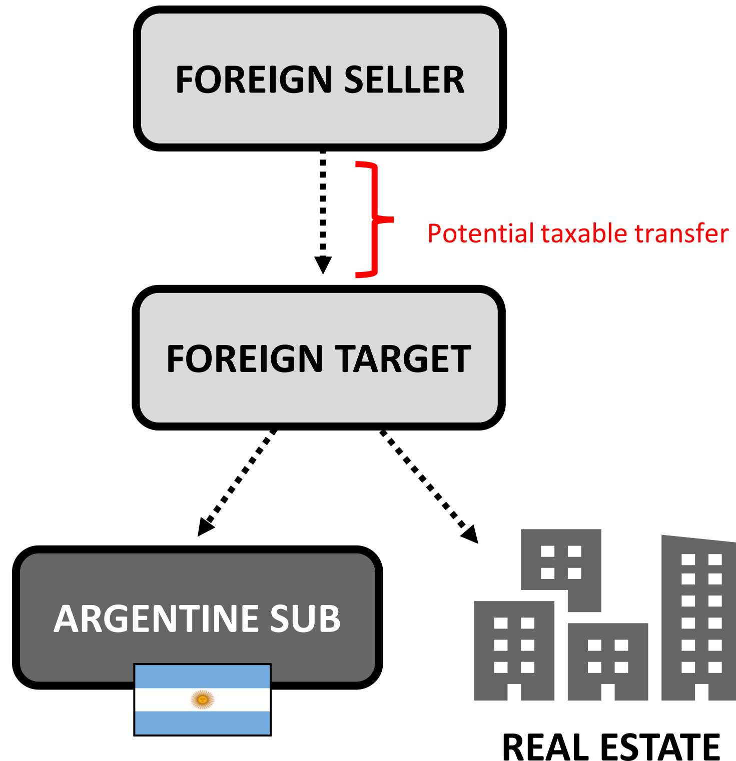
All indirect transfers through tax haven are taxed, unless:

a) no Chilean-resident shareholder owns 5% or more of interest in Target; and

b) direct or indirect controller (50%) is not in a tax haven jurisdiction.

If exemptions apply, general taxable event should still be tested.

Argentinian Indirect Transfer Rules – Taxable events



- Since 2018, indirect sale of Argentine assets could be potentially subject to CGT to the extent two conditions are concurrently met:
  - sale of at least **10%** of the equity value of a foreign company; and
  - at least **30%** of the market value of the equity that the non-Argentine resident seller holds in the foreign company derives from the fair market value of Argentine assets.
- Applicable rates: (i) 13.5% on gross sale price; (ii) 15% on actual net income; (iii) reduced treaty rate (if applicable). Seller resident in non-cooperative jurisdiction: 31.5%.
- CGT payable by seller unless buyer is an Argentine tax resident.

Indirect capital gains taxation does not require evidence of an evasion purpose as a condition for its application, so this provision generally raises tax nexus controversy since it generates a source rule, based on a legal fiction.

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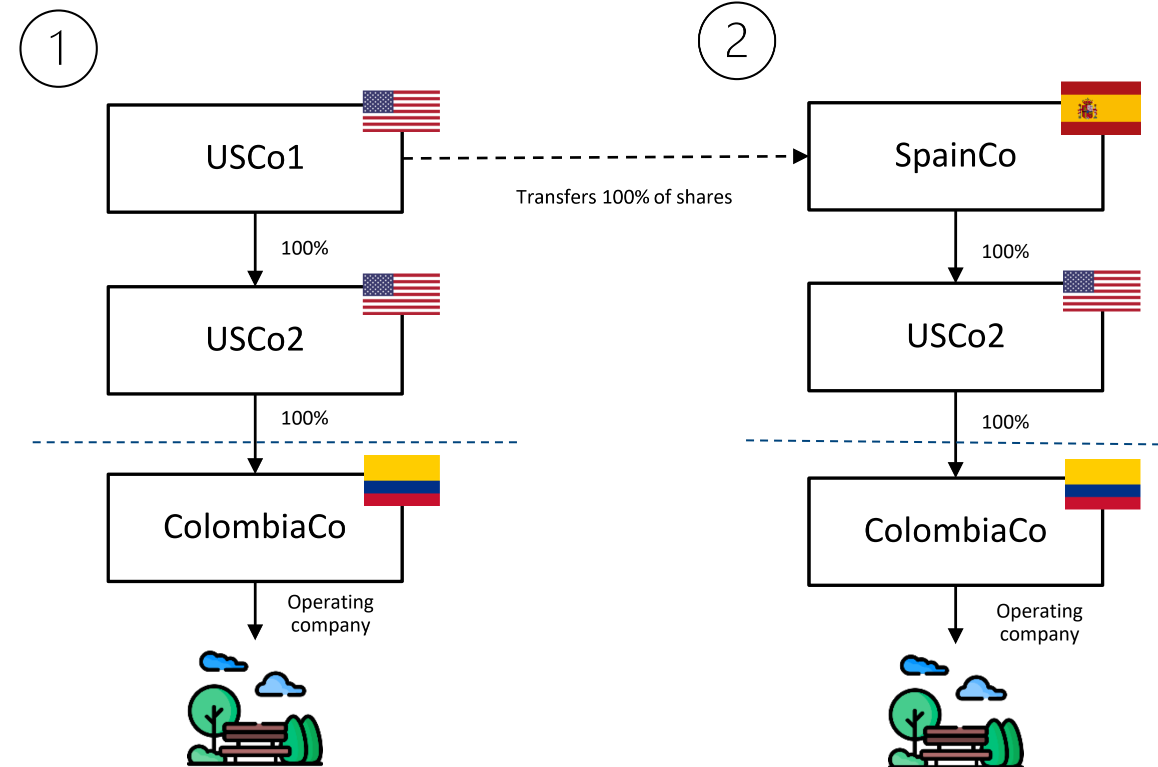
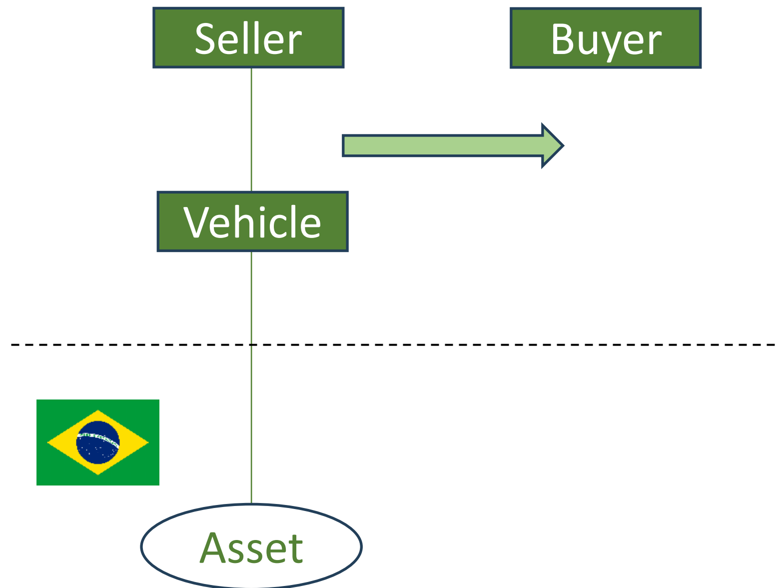
Colombian Indirect Transfer Rules – Taxable events

- The indirect transfer of assets is subject to taxes in Colombia as if the transfer of the underlying asset had been carried out directly in the country.
- When the "first point of contact" in Colombia is a domestic company, the underlying asset shall be deemed to be the shares, participations or rights in said domestic company.
- If the value of the assets located in Colombia is less than 20% of the book value, and 20% of the fair market value of the total assets held by the foreign entity, the indirect transfer rules do not apply.
- Concept of **"Transfer"?** Capitalizations?/Capital reductions

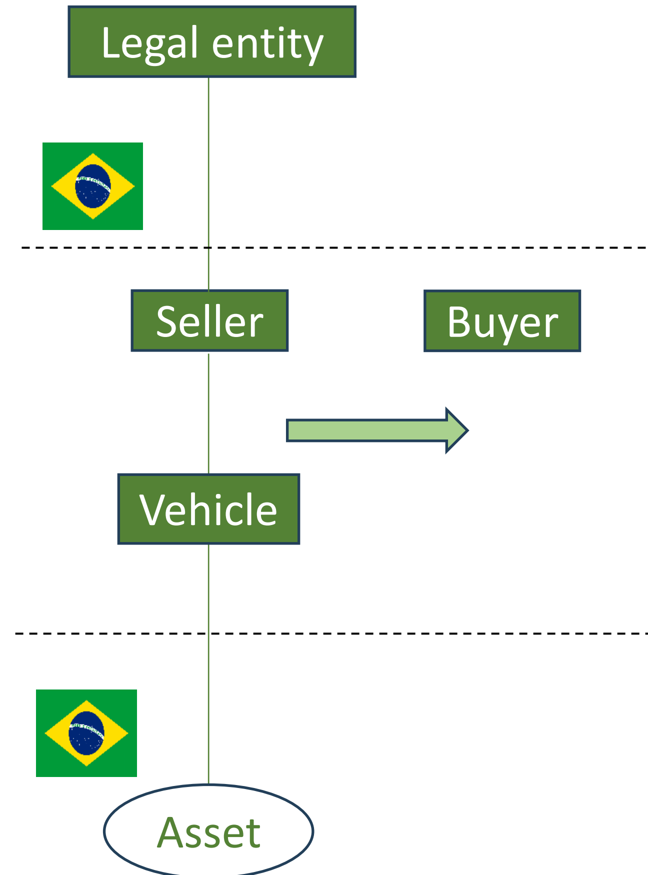


Brazilian Indirect Transfer Rules – Initiatives



- The original wording of Bill ("Projeto de Lei") n. 2,337/2021 set forth the taxation of capital gain on indirect sale of Brazilian assets, if:
    - anytime within a 12-month period before the sale, the Brazilian assets correspond to 50% or more of the market value of the foreign transferred entity, and the sale involves 10% or more of the ownership or economic rights of the foreign transferred entity;
    - OR
    - the Brazilian assets market value exceeds USD100MM and the sale involves 10% or more of the ownership or economic rights of the foreign transferred entity
- This provision was excluded in the version of the Bill n. 2,337/2021 approved by the Chamber of Deputies (currently awaits analysis by the Senate)

Brazilian Indirect Transfer Rules – CFC rules



Law n. 12,973/2014

- Law n. 12,973/2014 set forth the automatic taxation of profits derived by foreign entities controlled by Brazilian entities, on December 31st of each year.

- Therefore, if the capital gain in the sale cause the Seller to derive profits in the end of the year, indirectly this capital gain may be taxed in Brazil .

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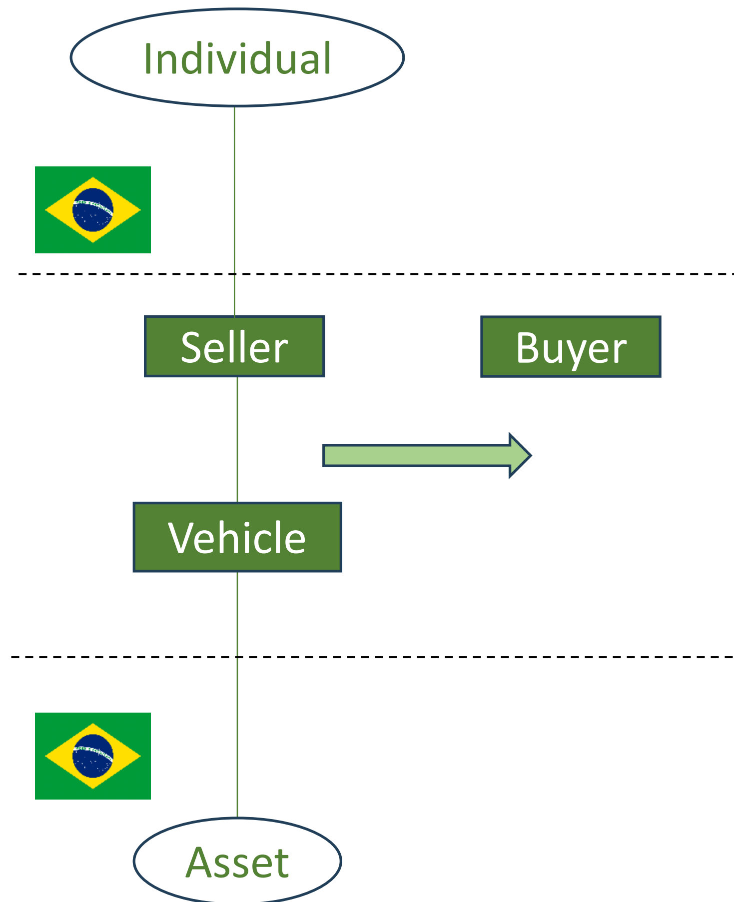
Brazilian Indirect Transfer Rules – CFC rules



Bill n. 4,173/2023

- Similarly to Law n. 12,973/2014, Bill n. 4,173/2023 set forth the automatic taxation of profits derived by foreign entities, on December 31st of each year, but in this case it applies to entities controlled by individuals residing in Brazil.
- Bill n. 4,173/2023 still needs to be approved by National Congress and sanctioned by the President.
- Therefore, if the capital gain in the sale cause the Seller to derive profits in the end of the year, indirectly this capital gain may also be taxed in Brazil.

Spanish Indirect Transfer Rules – CFC rules

- A non-Spanish subsidiary (including permanent establishments) will be subject to Spanish CFC rules if the following requirements are met:
  - The Spanish tax resident entity holds, individually or jointly with its related parties for transfer pricing purposes, a participation of at least 50% in the foreign entity's share capital, equity, profits or voting rights on the last day of the financial year of the non-resident entity, and
  - Taxation on the income obtained by the foreign entity is less than 75% of the Spanish CIT that would have been due if that same entity was tax resident in Spain (i.e., below 18.75% for general income and 0.93% for dividends and capital gains that would have benefit from the participation exemption regime).
  - If the entity has not material and humans means to obtain the income (unless proven that these means are in a different entity of the corporate group or that the incorporation of this entity is based in sound business reasons), all income obtained will be subject to CFC.
  - Otherwise, only passive income, as defined by the Spanish CIT Act, will subject to CFC. Passive income includes, among others, dividends and capital gains from shareholdings. If passive income is below 15% of the total income obtained by the foreign entity, CFC rules do not apply.

- If Spanish CFC rules apply:
  - Any indirect transfer of shares (capital gain – passive income) may be taxable in Spain
  - Dividends should be taxable in Spain even if those dividends are not effectively distributed to Spain
  - Spanish participation exemption regime does not apply on the capital gain triggered for the transfer of an entity qualified as CFC, this limitation only applies for the periods in which the entity is qualified as CFC

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Legal design rules – The Netherlands

- Direct capital gains taxation included for non-resident shareholders (both for corporate and individual shareholders) holding 5% or more of the share capital in a Dutch entity
  - Domestic rate of 25.8% corporate income tax levied from non resident shareholder
  - Non resident shareholder qualifying as non resident corporate taxpayer needs to register as taxpayer in the Netherlands
  - Tax levied by means of filing a corporate income tax return by non resident shareholder
  - Only applies in structures considered abusive (mainly structures involving tax havens) – in practice limited as possible to structure
  - Active structures
  - Tax treaty protection

Exemptions under indirect transfer rules

Argentina

Equity participations acquired before December 30, 2017 (grandfathering rule).

Transfers within the same economic group (no step-up basis).:

Colombia

The shares or rights subject of the indirect sale are listed on a stock exchange market recognized by a government authority.

20% rule.

Mergers and spin-offs with certain requirements.

India

Small shareholder exemption for holdings <5%

Limited exemptions for offshore business reorganizations

Chile

Transfer in the context of restructuring of a business group (common controller) that does not entail income or gain for the disposing entity

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Valuation and capital gains tax attribution

Argentina

FMV reports issued by independent professionals

Capital gains = gross basis or net basis (purchase price less acquisition cost in Pesos; exchange differences taxed)

Increased tax rate for seller in non-cooperative jurisdiction

Only proportionate capital gains taxed

Colombia

- Fiscal basis of the underlying asset.
- Capital gains are calculated on the difference between the fiscal basis and the fair market value of the underlying asset located in Colombia.
  - 15% or 35% rate depending on the time of ownership over the assets.
- Step up for buyer.

Brazil: If deemed a direct sale:

capital gain (price less acquisition cost); or, in some cases, investment registered with Brazilian Central Bank accepted as cost

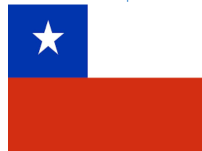
15% to 22,5% progressive tax rates for sellers in general; 25% tax rate for sellers in tax havens

India: FMV reports required for Indian assets and shares of foreign target (methodology prescribed)

Capital gains = purchase consideration less cost basis in foreign target

Only proportionate capital gains taxed [long term: 10.92%; short term 43.68%]

No step-up in cost basis of local asset



Chile

Tax basis alternatives:

Foreign basis: [(transaction value – historic acquisition value of foreign shares) x (FMV of Chilean asset / transaction value) = capital gain];

Local basis: [FMV of Chilean asset – tax basis in Chilean asset = capital gain]

Tax basis documentation (proof of cash flow)

Enforcement and collection measures

Argentina

Withholding tax obligation on seller unless buyer is an Argentine tax resident.

Reporting obligations on the underlying target (transactions with related parties or parties domiciled in certain jurisdictions)

Colombia

Brazil

If deemed a direct sale:

Withholding tax obligation on Buyer

Reporting obligations

Penalties up to 225%

Criminal charges

India

Withholding tax obligation on Buyer (including non-resident buyer with no taxable presence in India)

Representative assessee risk for the buyer

Reporting obligations on the underlying target

Chile

Buyer's withholding obligations: 20% of gross price or 35% of net gain;

Released withholding if seller files and pays tax in the month following the sale;

Target, buyer and seller are jointly liable, and;

Informative tax return, whether taxable or not.

Interface with tax treaties

ARTICLE 13

CAPITAL GAINS

1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.

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2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other State.

3. Gains that an enterprise of a Contracting State that operates ships or aircraft in international traffic derives from the alienation of such ships or aircraft, or of movable property pertaining to the operation of such ships or aircraft, shall be taxable only in that State.

4. Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property, as defined in Article 6, situated in that other State.

5. Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.

Chilean indirect tax rule interface with Tax Treaties

Seller:

- Treaty does not grant taxing rights to Chile for indirect sales.
- Spanish resident seller entitled to a refund of the capital gains tax.

Chilean IRS and Tax Court:

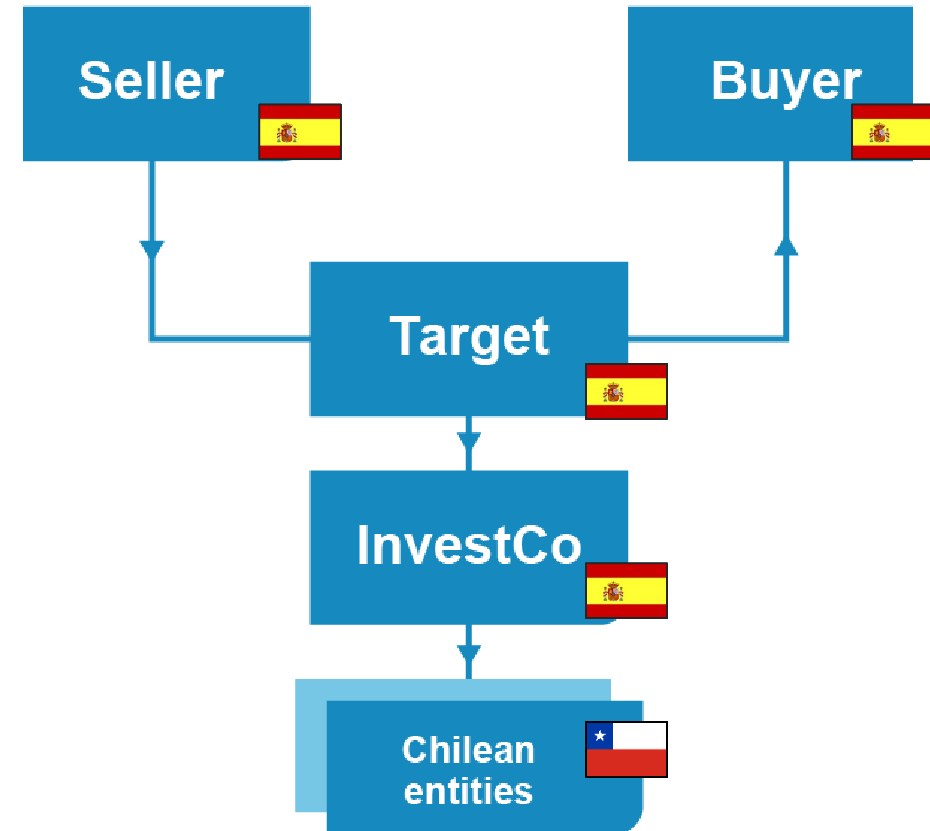
- Art. 13 (4)(b) Chile gives Chile the right to tax indirect sales.
- Residual rule of art. 13 (5) would not apply as there is a specific regulation in (4)(b).

Appeal Court:

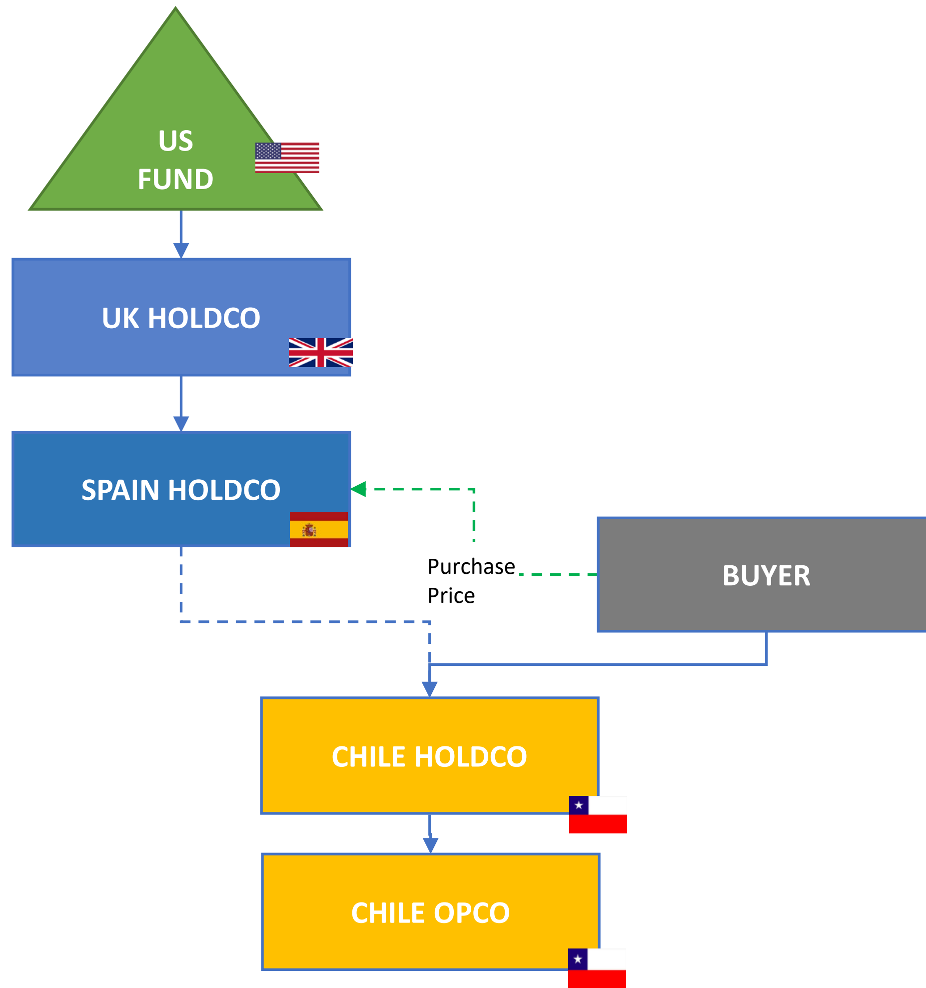
- Chile is not always entitled to tax indirect sales under a treaty scenario.
- Not all tax treaty regulate such events and a contextual interpretation of the relevant treaty has to be done.
- "Disputada Law"(in force at time of subscription of the treaty) did not cover this hypothesis. Can subsequent internal law amendment modify a treaty?

Supreme Court?

- Refund opportunities?
- MAP to avoid double taxation?



Tax Treaties, indirect tax & CFC



Spain HoldCo sells Chile HoldCo

Chile HoldCo is a CFC for Spanish purposes (25%)

Spain HoldCo is a Spanish tax resident for purposes of the Chile – Spain DTC (16%)

No UK taxation on dividends received from Spain UK HoldCo under substantial shareholder exemption rules (SSE) and no UK taxation on dividends paid to the U.S.

<u>Sale happens before Chile-U.S. DTC is in effect</u>

No relief is available in the U.S. for Chilean and Spanish taxes (blended rate 21%)

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Argentinian indirect tax rule interface with Tax Treaties

- Exceptions to application of CGT on indirect sales of Argentine assets:
  - Equity participations acquired before December 30, 2017 (grandfathering rule).
  - Transfers within the same economic group (no step-up basis).

Certain treaties to avoid double taxation could provide protection against CGT on indirect transfers of Argentine assets.

- Treaties may not override domestic tax rules (Argentine source rules would determine if a given transaction is under the indirect CGT scope); but GAARs may override tax treaties.

- Potential concerns – PPT rules and GAARs (economic reality principle). No precedents nor case law on this matter yet.

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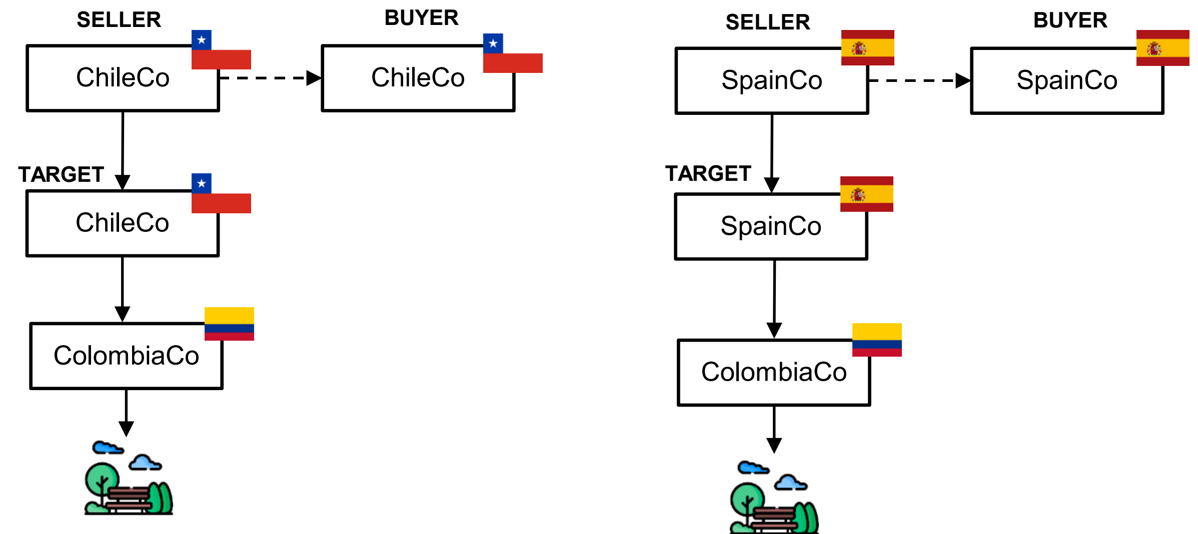
Colombian indirect tax rule interface with Tax Treaties

- Double Taxation Agreement ("**DTA**") prevails
- DTA Colombia – Chile: transfer of shares or "comparable interest" of a <u>resident</u> entity. Vs.
- DTA Colombia – Spain: transfer of shares or "comparable interest" derived more than 50% of their value directly or indirectly from immovable property.



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Indirect Sales of Brazilian Assets – Interface with Tax Treaties

Treaties entered into by Brazil in general do not set forth rules on indirect sales.

Notwithstanding, under some recent treaties entered into by Brazil the *situs* Contracting State may tax indirect sales whenever more than 50% of the value of the entity derives from real estate within such State (e.g., Emirates, Israel, Singapore, South Africa, Uruguay).

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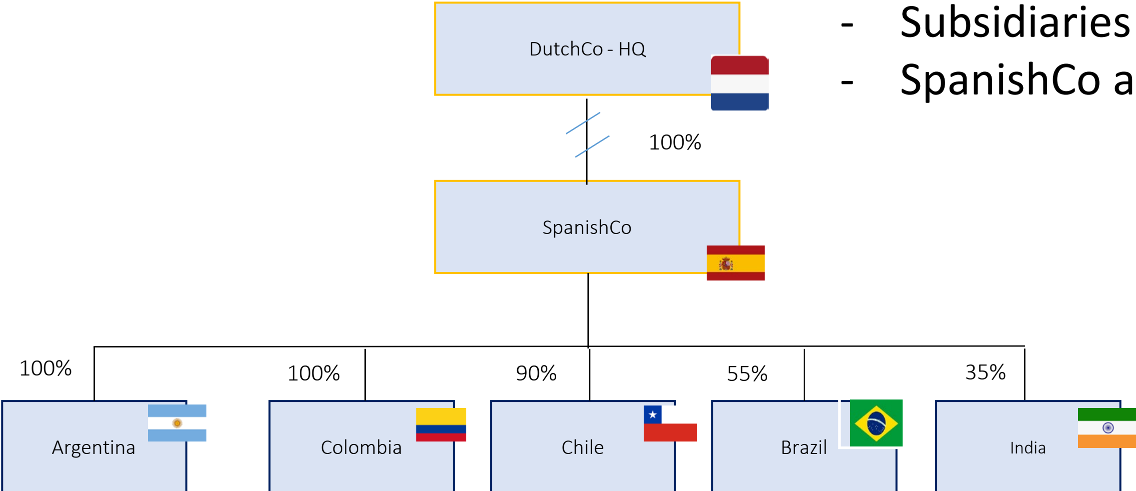
The Netherlands interface with Tax Treaties

- The Netherlands has extensive tax treaty network (and bilateral investment treaties)
  - Currently over 90 tax treaties in force
  - Still further expanding the tax treaty network, recently concluded tax treaties with e.g. Chile (since end 2022) and Colombia (pending ratification)
  - Tax treaties may limit the indirect capital gains taxation

- Entry into force of MLI
  - PPT introduced: more difficult to interpose tax treaty jurisdiction only for tax treaty protection
  - Increased focus on genuineness of the structure

Practical implications on global M&A deals



- DutchCo transfers shares in SpanishCo
- Subsidiaries are engaged in the data centers business
- SpanishCo applied for the ETVE regime

Practical Implications on global M&A deals - Minefield

- Indirect transfer tax must be considered within the total tax burden of the transaction
- Tax basis assessment
- Buyers tend to be extremely careful, forcing the withholding or immediate declaration by the seller
- Full indemnities and escrow
- Valuation reports are common. Double purpose:
  - Testing the thresholds
  - Purchase price allocation
- Application of CFC
- Prior restructurings
- Increasing trend in M&A for tax insurance – during the (due diligence) process.

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