Practical European Tax Strategies

REPORT ON TAX PLANNING FOR INTERNATIONAL COMPANIES OPERATING IN EUROPE

WorldTrade Executive, Inc.
The International Business Information Source™

October 2006
Volume 8, Number 10

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Proposals Designed to Make Dutch Corporate Income Tax Regime More Competitive

by Eric van der Stoel, Hans Drijer and Jos Hellebrekers (Otterspeer, Haasnoot & Partners)

Introduction

On October 3, 2006, the Lower House of Dutch Parliament passed the 2007 Corporate Income Tax Reform Bill (2007 Bill). The Upper House of Dutch Parliament is currently reviewing the 2007 Bill and it is expected that they will pass the 2007 Bill prior to year end. The Upper House cannot amend the 2007 Bill, but the Upper House discussions may lead to more detailed explanations. The intended effective date is January 1, 2007.

The object is to make the Dutch corporate income tax (CIT) system more competitive and to make its legislation more "EU proof." Rates are reduced but the tax base is broadened.

The Proposals

Corporate Income Tax

CIT rates will be reduced, introducing the following scale (current top rate: 29.6 percent).

Taxable amount	Percentage
< € 25.000	20.0 percent
€ 25.000 - € 60.000	23.5 percent
> € 60.000	25.5 percent

Dividend Withholding Tax

The dividend withholding tax rate will be reduced to 15 percent (current rate: 25 percent).

For qualifying EU parent companies, a 5 percent threshold in a qualifying Dutch subsidiary company will be sufficient to benefit from a full exemption of the dividend withholding tax (instead of the current 20 percent threshold).

Tax exempt EU funds, which are comparable to Dutch exempt funds (e.g., Dutch pension funds), will also be entitled to a refund of Dutch dividend withholding tax.

Group Interest Income

In order to make the Netherlands more attractive for group financing activities, the so-called Group Interest Income Box is introduced. At request of the company, an effective 5 percent CIT rate will apply to the net group interest income of a company (broadly, the difference between interest income and interest costs for loans granted to or taken up from group companies). Positive net group interest income is taken into account only insofar as it does not exceed a certain percentage (at present: 4.25 percent) of the average equities of the company at the beginning and the end of the book year. The relevant net group interest income includes proceeds of short term investments held for the intended acquisition of subsidiaries, as well as costs (except for currency results) regarding intercompany loans. In order to avoid abuse, all Dutch companies belonging to the group must file a request for this tax regime, and the minimum period for which the regime applies is three years.

The tax on interest income from intercompany loans has been reduced to 5 percent.

As this measure (and also the Patent Box discussed in 4. below) is generally applicable, it should not be a form of state aid prohibited by the EC Treaty. Nevertheless discussions with the Commission of the EU are taking place, as a result of which it is expected that the effective date will be January 1, 2008 instead of January 1, 2007 for both the Group Interest Income Box and the Patent Box below.

Reduced Tax on Income from Patents

In order to stimulate innovation, a so-called Patent Box is introduced to stimulate development of intangible assets.

If opted for the Patent Box, an effective 10 percent CIT rate will apply to the net income—proceeds less amortization and other related costs—for such patents. If not opted for the Patent Box, companies are no longer required to capitalize their development costs as part of the cost price of such intangibles, but instead can fully deduct the development costs.

If opted at a later stage, the Patent Box will apply only from the moment when earlier deducted development costs have been compensated by the income arising from the Patent.

In order to avoid abuse and to some extent lengthy discussions, qualifying net income subject to the low tax

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Transfer Pricing Will Soon Apply to All Private Equity Debt

by Paul Minness and John Neighbour (KPMG LLP (UK))

The end of the grandfathering period means that the transfer pricing legislation will apply to all shareholder debt with effect from April 1, 2007. It is essential that companies review their transfer pricing position now to ascertain their arm's length capacity and so evaluate their options for enhancing their interest deductions going forward.

For many years, private equity backed companies have been primarily funded by debt, confident that their interest deductions would not be challenged for tax purposes under the transfer pricing legislation. This comfortable position ended abruptly last year when the Finance Act (No2) 2005 introduced Para 4A Sch 28AA ICTA 1988. This new paragraph, known as the 'acting together' rules, effectively brings any shareholder debt advanced in private equity situations within the transfer pricing rules. The paragraph says that where persons act together to provide finance and, when considered collectively, the persons control the borrower, the financing arrangements need to be arm's length. In summary, this means that in order to get an interest deduction in their tax return, the borrower will need to be able to demonstrate that an independent third party would have lent a similar amount of debt on similar terms at the time the finance was arranged.

This change impacted on new deals in accounting periods starting after March 4, 2005 but did not affect debt that was in existence prior to that date; these debts were grandfathered (i.e., outside the new rules) until the earlier of April 1, 2007 and the date that the terms of the loan were changed.

As April 1, 2007 is fast approaching, it is essential that companies start to review their position now to understand whether their tax deductions and their cash tax payments will be changed. Of course, some companies may choose to do nothing and continue to claim interest deductions on the debt. This approach, however, is potentially very costly as HMRC are intending to review all private equity backed deals and there is a possibility of penalties of up to 100 percent of the tax lost if a company is considered to be negligent in the calculation of its arm's length position. Further, the change in the late payment rules means that many companies may be considering refinancing with PIK notes; if so, they will also need to look at their arm's length debt capacity at the time of the refinancing.

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How Can Companies Demonstrate that Their Borrowings are Arm's Length?

Traditionally, companies have sought reassurance from their relationship bank that they would have been willing to provide a facility equivalent to the shareholder debt. However, unless such reassurance is provided by way of a full credit committee approved offer, it is unlikely that HMRC will regard it as meaningful evidence.

In the absence of a formal alternative offer, companies will need to undertake some financial and business analysis to support the level of debt and will need to benchmark the interest rate, especially on the shareholder debt. The purpose of the analysis is to recreate the decision-making process at the time that the shareholder debt was advanced and to demonstrate that the debt would have been advanced by a third party. There is no legislative guidance as to what ratios would support additional debt, but it is generally accepted that private equity companies often have lower income cover and are more highly geared than established companies operating in mature industries.

Companies will need to prepare transfer pricing studies to support their filing position.

Once the ratio analysis has been performed, it will be necessary to consider the specific circumstances of the company and industry to ensure that the whole lending position is supportable. For example, an investment that has similar characteristics to a PFI-type investment is likely to be able to attract more debt than a riskier start-up operation.

What Next?

Once the position has been assessed and the company has concluded what level of interest deduction is available, there is a choice to be made. The company can choose to claim the relevant interest deduction and await challenge from HMRC if the tax authority questions the return. Alternatively, the company can take the approach that many companies are taking and apply to HMRC for clearance under their CoP10 process.

The benefit of the CoP10 process is that HMRC will review the detailed circumstances of the case and provide a binding opinion as to what level of debt is arm's length. This not only confirms the position for the purposes of

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Minimum Shareholding for Participation Exemption Upheld

by Marc Verbeek (BDO Atrio)

The Belgian Constitutional Court (*Cour d'Arbitrage/ Arbitragehof*) has held that the minimum participation requirement (as it applied in 1998 and 1999) for qualifying for the participation exemption was in compliance with the country's constitution.

Under the participation exemption, 95 percent of the dividends received by a Belgian company from another company were exempt from corporate income tax, provided that the recipient company held at least 5 percent of the distributing company's capital or, alternatively, that the recipient company's holding had an acquisition cost of at least EUR 1,200,000 (expressed as BEF 50 million at the time; now equal to approximately $1,525 000). However, insurance companies, investment companies and certain other types of company did not have to satisfy this requirement in order to qualify for the exemption.

The taxpayer company, which was a holding company, contended that it too should qualify for the exemption, and that this form of discrimination was incompatible with the Belgian constitution. It also argued that imposition of the requirement for dividends from Belgian companies was in excess of what was necessary under the EC Parent Subsidiary Directive, which applied only to companies resident in other Member States.

The Constitutional Court rejected the taxpayer's arguments. It noted that there was authority under the Directive to impose the minimum shareholding requirement with regard to distributions from domestic companies also. As to discrimination under the Belgian constitution, the court ruled that exclusion of investment companies, etc., from the requirement was justified on the grounds that such companies were by law prevented from holding significant participations in other companies.

Had it lost the case, the Belgian government would have been faced with a large and costly number of repayment claims going back over a number of years.

The participation exemption for dividends now stipulates that the recipient company have a holding of 10 percent or more in the distributing company or one with an acquisition cost of at least EUR 1.2 million. There is also a minimum holding period of one year. ❑

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GERMANY

ECJ Inflicts Further Defeats on German Tax Rules

by Gerhard Engler (BDO Deutsche Warentreuhand AG)

Germany's run of defeats before the European Court of Justice has continued, with one further reverse, and what looks like two more in prospect. In *Conijn*, the Court ruled against the denial to non-residents of a deduction for tax advice; and in *Centro Equestre da Leziria*, it was the rules on withholding tax for non-resident artists and sportspeople that are likely to be found to be in breach of the EC Treaty. A further defeat is also likely in a case concerning impairment losses of non-resident companies, following an adverse opinion by the Advocate-General. In contrast to these defeats, Germany did manage to chalk up a victory (yet to be confirmed) on the general principle of artists' withholding tax rules.

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Conijn Case

The *Conijn* case (C-346/04) concerned a Netherlands national deriving income from his interest in a German limited partnership. Whereas residents of Germany are allowed a tax deduction for the costs of tax advice, such a deduction is not available to non-residents (unless they are treated as quasi-residents because 90 percent or more of their taxable income is derived in Germany).

The European Court held that this constituted a breach of the freedom of establishment, for which there was no sufficient justification.

Centro Equestre and *FKP Skorpio*

Two different cases involve the withholding tax rules on the fees of non-resident athletes, artists, etc., for performances in Germany. In *Centro Equestre*, the rule in

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question was one that stipulated that non-resident artists and athletes could only deduct costs against taxable income if these were directly economically connected to the income, thus excluding general costs and overheads, whereas resident artists and athletes were not subject to this rule. Second, unless costs exceeded half the income, non-residents were not allowed to deduct any costs, whereas residents were not subject to this restriction. The Advocate-General's Opinion is that both rules are unjustly discriminatory and thus in breach of the EC Treaty. On the other hand, in another case (*FKP Skorpio*), the same Advocate-General has concluded that the non-resident artists' withholding rules are as such not incompatible with the freedom to provide services guaranteed under Article 49 of the EC Treaty.

Rewe ZentralfinanzeG

Finally, in a case involving corporate tax, the German rule under scrutiny was that under which a holding company may deduct impairment losses relating to a holding in a German-resident subsidiary without restriction, whereas impairment losses relating to a foreign subsidiary may only be set off against income from the same subsidiary going forward and only in cases where the subsidiary is considered to be active. The Advocate-General in the case (*Rewe ZentralfinanzeG*, Case C-347/04) concluded that this rule is in breach of the freedom of establishment and cannot be justified.

The European Court is not obliged to follow the Advocate-General's Opinion in any case, but it is comparatively rarely that its decision is to the contrary. ❑

German REITs: Almost Ready for Take-off

by Arndt Stengel and Klaus Weinand-Härer (Clifford Chance)

REITs (real estate investment trusts), have by now been introduced in some 20 countries, including the U.S., Australia, Japan and France. The UK will follow suit by January 2007. REITs are tax-exempt companies that hold and manage real estate and almost fully distribute their profits. In most countries REIT shares must be publicly listed.

Since 2004, when the former Federal Government started a legislative initiative considering the introduction of real estate investment trusts in Germany (G-REIT), there have been on-going political discussions about the fiscal and economic impact of REITs, mainly in relation to REITs' tax-exempt status. There was a concern that major tax breaks for businesses are inappropriate against the backdrop of ongoing fiscal deficits and a steep rise in consumer taxation (3 percent increase in VAT from 2007). The Federal Finance Minister has maintained the view that there will be a net increase in tax income resulting from the mobilization of real estate and the influx of investment.

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One has to ensure that—unlike in France—foreign holders of REIT shares cannot benefit from tax treaties or the EU Parent-Subsidiary Directive, both of which reduce the withholding tax on dividends in case of a shareholding of 10 percent or more. The German legislature now favors the same solution that is envisaged for UK REITs: No shareholder will be able to hold 10 percent or more in a G-REIT.

Where the shares sold were held as part of a German permanent establishment, however, the capital gains will be fully taxable.

Most political obstacles seem to have been cleared and the G-REIT legislation is expected to be effective in the first quarter of 2007. After a first draft bill that leaked in early August, the Federal Ministry of Finance officially distributed the first bill for G-REIT legislation (Bill) on September 25, 2006. The Bill will be further developed and amended, as discussions with lobbyists, ministries and the states (*Bundesländer*) have only been started. In particular, it is heavily discussed whether residential properties should be allowed as possible assets of a G-REIT.

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REITs *(from page 5)*

Nonetheless, the Bill provides a useful starting point for a general outline of G-REITs. It is expected that the Federal Cabinet (*Bundeskabinett*) will pass the Bill in November, 2006.

Corporate Structure and G-REIT Requirements

General Requirements

The G-REIT must be a German joint-stock company (*Aktiengesellschaft*):

- tax resident in Germany;
- with a minimum share capital of EUR 15 million;
- with its shares listed on an organized market within the European Economic Area;
- with an initial free float of at least 25 percent and a permanent minimum free float of 15 percent of the shares;
- whose corporate object is limited to acquiring, holding, managing, leasing, letting and selling real estate.

A G-REIT can be formed by conversion or de-merger into a G-REIT or by formation of a new stock corporation. No shareholder may directly hold 10 percent or more of the shares in a G-REIT. Indirect holdings through more than one entity can be higher than that, however:

- tenants of the REIT must not hold a majority in the REIT. This will become relevant in particular for industrial companies that form a REIT with property used by the company;
- if one shareholder directly and indirectly holds 85 percent or more of the shares, then the minimum free float threshold will be passed, allowing a squeeze-out (as opposed to 95 percent threshold in other joint-stock companies).

The rights of a 10 percent+ shareholder are limited to the rights of a less-than-10-percent-shareholder (in particular, no benefit from tax treaties will be available). However, a 10 percent+ shareholder does not lose its voting rights and its right to receive dividends from the G-REIT. The tax exemption of the G-REIT will not be jeopardized if a shareholder holds 10 percent or more of shares in a G-REIT.

Requirements for Asset Composition

To qualify for REIT status, certain requirements have to be satisfied:

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- at least 75 percent of the total assets less profit distribution and reserves (Total Assets) of the G-REIT must be composed of real estate (not yet clear whether residential properties will be included, or not);
- the assets of all REIT-subsidiaries, providing real estate management to others (ServiceCos) may not exceed 20 percent of G-REIT's Total Assets;
- debt financing is limited to 60 percent of the value of G-REIT's assets.

Requirements for Profit Distribution and Earnings

- At least 90 percent of its distributable profits have to be distributed by the end of the following fiscal year.
- At least 75 percent of the gross earnings of the G-REIT must come from leasing and letting (or selling) real property.

The objective of the Federal Minister of Finance is to implement G-REIT legislation in the first quarter of 2007 with retroactive effect from January 1, 2007.

- A maximum of 20 percent of the gross earnings may come from ServiceCos.
- The G-REIT will lose its tax exemption if gross revenues generated during the last five years derived from sales of real estate exceed 50 percent of the average fair market value of its real estate assets held during that period.

Tax Treatment

Exit Tax

In order to promote the G-REIT, the Bill provides for a favorable exit tax for real estate transferred into the G-REIT (Exit Tax). Only 50 percent of the realized hidden reserves of the real property are subject to income tax upon transfer into G-REIT. However, such tax benefit is only available, if

- the real estate has been a German business asset capitalized for at least 10 years; and
- the sale takes place before January 1, 2010.

Real estate, which has been subject to the Exit Tax has to be held for at least four years by the G-REIT; otherwise the tax benefit will not be applicable retroactively and the G-REIT will be liable for any additional income tax. In addition, such tax benefit is also available for open-end real estate investment funds and for Pre-REITs (being stock corporations not yet meeting all, but most of G-REIT requirements). Further, sale and leaseback transactions are possible, provided neither G-REIT nor any affiliate of G-REIT uses the real properties acquired via a sale and leaseback for its own purpose.

EK02 Lump Sum Taxation

In the past, there have been restrictions for profit distributions of former tax-exempt housing companies (*Wohnungsbaugesellschaften*). The companies often have high amounts of so-called "EK02." Under current income tax law, distributions trigger corporate income tax of 3/7 of the dividend paid-out to the extent EK02 is deemed to be used for the profit distribution. The corporate income tax liability has to be borne by the distributing housing company. A conversion of a former tax-exempt housing company into a G-REIT would also lead to a taxation of EK02 (3/7 of EK02). The Bill now introduces an opportunity to tax EK02 amounts at a favorable tax rate of 7.5 percent. However, this option is only available until December 31, 2007.

Real Estate Transfer Tax

There will be no relief for real estate transfer tax, hence, a 3.5 percent charge (based on the real estate's market value) applies to each transfer. Additional tax income from this tax is among the key arguments in support of the Federal Finance Minister's view that the introduction of G-REITs will not lead to lesser overall tax income for the German government.

Ongoing Taxation

After qualifying for REIT status the G-REIT will be tax-exempt from corporate income tax and trade tax in Germany. However, this tax exemption does not include subsidiaries of the G-REIT, which remain subject to general taxation rules. Profit distributions of the G-REIT are subject to withholding tax (WHT) at a rate of 26.375 percent (including solidarity surcharge) and are fully subject to income tax for German tax residents as the regular tax-exemption for dividends (so-called half income system or exemption of 95 percent of dividends for corporations) is not applicable. This will also apply for income generated abroad which is taxed abroad and would thus be subject to double-taxation. This is hardly understandable as it means the G-REIT cannot tax-efficiently hold non-German real estate.

The sale of the shares in the G-REIT is subject to general taxation rules, hence for non-business investors, not holding a 1 percent+ participation in the G-REIT at any point in time within the last five years, no tax falls due, if the holding period of one year has expired. Capital gains from the sale of shares in G-REITs are fully taxable for all other German investors.

The sale of shares does not trigger WHT at the level of foreign shareholders. While in principle, the resulting capital gains will be taxable in Germany, most tax treaties exempt such gains from German taxation. Where the shares sold were held as part of a German permanent

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establishment, however, the capital gains will be fully taxable.

Possible Amendments to the Bill—What Next?

In some respects the Bill is not altogether clear and/or is likely to change. These include:

- no residential properties allowed as assets of the G-REIT;
- double taxation of foreign income—hoped that it will fall away;
- double taxation of income from subsidiaries (e.g., ServiceCos)—regular tax exemption might come for G-REIT shareholders;
- 10-year holding period as a business asset to qualify for Exit Tax—a reduction is hoped for;
- lack of clarity whether real estate can be held through partnerships in the main bracket of 75 percent of the assets. Unofficially available information suggests that partnerships could also fall in the 75 percent main bracket of assets to ensure that G-REITs are not put in worse tax position than open ended real estate funds (*Immobiliensondervermögen*) and real estate stock companies (*Immobilien AG*);
- disincentives for shareholders reaching or exceeding the 10 percent direct holding threshold—a stronger penalization could come.

Preparing for the REIT

The objective of the Federal Minister of Finance is to implement G-REIT legislation in the first quarter of 2007 with retroactive effect from January 1, 2007. To get a head start in the market, it may be worth considering setting up an investment structure which could easily be converted into a G-REIT when the G-REIT legislation becomes effective. With the exception of acquiring real estate being long-term fixed business assets—for which the effectiveness of the Exit Tax should be awaited—the REIT requirements can be fulfilled in advance.

Other real estate, especially real estate owned by private investors, could already be acquired without any adverse tax consequences for the seller and the Pre-REIT.

The conversion of former tax-exempt housing companies should be postponed in order to benefit from the possible immediate taxation of EK 02 at a favorable rate of 7.5 percent. ❑

NETHERLANDS

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rate, is limited to four times the development costs and costs for further improvement.

Participation Exemption

The number of requirements under which a Dutch parent company can claim the participation exemption (i.e., a full exemption of dividends and capital gains realized with a qualifying shareholding) is reduced to two:

- the participation should have a capital divided in shares;
- the shareholding must be at least 5 percent or more of the nominal paid up share capital of the subsidiary.

At present a shareholding of less than 5 percent may also qualify for the participation exemption. Under the proposals shareholdings of less than 5 percent will not qualify anymore. However, if a shareholding of 5 percent or more, which is held for at least one year, drops below the 5 percent, the participation exemption remains applicable for a maximum of three years.

Furthermore, the current subject to tax test and the non-passive portfolio investment are abolished and replaced by a new requirement. The participation exemption shall not apply to a shareholding in a "low taxed passive portfolio subsidiary." This is a company that *(i)* is a passive portfolio subsidiary and *(ii)* is subject to an effective CIT rate of less than 10 percent. In such cases, double tax relief is not given by way of the participation exemption but instead by way of a tax credit system. A passive portfolio subsidiary is a company the assets—including attributed assets of direct and indirect participations—of which consist of more than 50 percent of passive portfolio investments. Unless an exception applies, group financing is generally deemed to be passive as well as other forms of making assets available within a group of companies. However, a shareholding in a qualifying real estate subsidiary is deemed not to be a shareholding in a low taxed passive portfolio subsidiary (i.e., may qualify for the participation exemption even if passive and low taxed).

The possibility of recognizing losses realized upon the finalization of the liquidation (winding up) of a subsidiary remains, notwithstanding the fact that the shareholding qualified for the participation exemption.

Interest on Related-Party Loans

As a result of the introduction of general thin capitalization rules in 2004, the existing specific anti-abuse rules regarding interest deduction became superfluous or unnecessarily complicated. Accordingly, in the proposal, specific rules on hybrid loans are abolished and the rules for loans (artificially) created within a group are streamlined. However, interest on a related-party loan to finance a third party acquisition can be non-deductible

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under the proposal. Non-deductibility of interest on related-party loans can be avoided if *(i)* the interest is effectively subject to at least a 10 percent CIT at the level of the recipient or/and *(ii)* there is a sound business reason for the transaction and the loan conditions are at arm's length.

Broadening the Tax Base

Reduction of the CIT rates is largely compensated by the following measures to broaden the tax base:

- annual depreciation period of fixed assets may not be more than 20 percent;
- annual amortization of goodwill may not be more than 10 percent;
- depreciation of real estate used in an enterprise of the company or a related company stops where the book value would drop below 50 percent of the (fair market) value determined for real estate tax purposes;
- depreciation of real estate used as passive portfolio investment stops where the book value drops below 100 percent of the (fair market) value determined for real estate tax purposes;
- compensation of tax losses will be limited to one year carry back and nine years carry forward;
- companies which have granted stock options to employees are not able to deduct employment costs when these options "vest." ❑

The changes are designed to make the Dutch tax system more competitive.

REGIONAL

Impact of Cadbury Schweppes on CFC Legislation

by Philip Gershuny, Herve Israel, Domenico Borzumato and Ingmar Dörr (Lovells)

The decision of the European Court of Justice (ECJ) on September 12, 2006 in the case of *Cadbury Schweppes plc & Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* C-196/04 will, yet again, cause EU governments to consider whether their tax legislation needs amending to comply with EU law, this time in relation to controlled foreign companies (CFCs). The Danish government has already announced that draft legislation to amend its CFC legislation will be introduced in December this year. This article examines the impact of the judgment in the UK, France, Italy and Germany.

Background

Cadbury Schweppes concerned the UK's CFC rules. Under UK legislation, which has since been amended, profits of a foreign company in which a UK resident company owned a holding of more than 50 percent (a CFC) were attributed to the resident company and subjected to tax in the UK, where the corporation tax in the foreign country was less than three-quarters of the rate applicable in the UK.

Cadbury Schweppes formed two subsidiaries in Ireland, where at the relevant time the tax rate was 10 percent, to raise finance and to provide finance to the group. The UK Revenue took the view that the CFC rules applied. Cadbury Schweppes appealed before the Special Commissioners on the basis that the CFC legislation was contrary to Community law, in particular in the light of freedom of establishment. The case was referred to the ECJ for a decision on whether Community law precluded rules such as the CFC legislation.

In Italy, cross-border mergers could be affected by the Cadbury Schweppes case and other ECJ decisions.

The Decision

The ECJ noted that companies cannot improperly or fraudulently take advantage of the provisions of Community law. However, the fact that a company was established in a jurisdiction in order to take advantage of a

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lower tax rate does not of itself constitute an abuse of the freedom of establishment. Accordingly, the fact that Cadbury Schweppes decided to establish subsidiaries in Dublin for the purpose of benefiting from a favorable tax regime did not in itself constitute abuse and did not prevent Cadbury Schweppes from relying on Community law.

The ECJ then decided that the UK CFC legislation involved a difference in the treatment of resident companies on the basis of the level of taxation imposed on the company in which they had a controlling holding.

The Cadbury Schweppes decision will probably have a significant impact on the French CFC rules for individuals.

The difference in treatment caused a tax disadvantage for the resident company to which the CFC legislation was applicable. The result was that the CFC legislation did constitute a restriction on the freedom of establishment within the meaning of Community law.

The ECJ noted that a national measure may be justified where it specifically relates to wholly artificial arrangements aimed solely at escaping national tax normally due and where that measure does not go beyond what is necessary to achieve this purpose. It went on to consider the criteria by which the 'motive test' in the UK CFC legislation should be judged, to determine whether the motive test limited the application of the CFC legislation to wholly artificial arrangements. The motive test provides that a company which fails to satisfy the other tests may nevertheless escape the CFC tax charge if the reduction in UK tax was not a main purpose of the arrangements. The ECJ criteria included an objective assessment of whether the CFC was an actual establishment intended to carry on genuine economic activities in the host state, as well as the more subjective test of whether the incorporation of the CFC was prompted by the intention to obtain tax relief.

The Implications

United Kingdom

This decision, in particular the finding that establishing a subsidiary in a jurisdiction in order to take advantage of lower tax rates does not constitute an abuse of the freedom of establishment, appears to throw the UK's CFC rules into disarray. It will be interesting to see whether the authorities attempt to amend the CFC rules to make them compatible with Community law or whether they decide to adopt some different approach, such as imposing restrictions on the availability of interest relief, in order to protect the UK's financial position.

It is not yet clear whether the government has formulated a final view on the steps to be taken. Its decision may be left until the Special Commissioners determine whether the motive test lends itself to an interpretation that takes account of sufficiently objective criteria such that a company will only be within the ambit of the CFC legislation when there is evidence of a wholly artificial arrangement. Other pending ECJ cases may also have an effect on the government's decision as to whether it can continue to use CFC legislation to protect against loss of tax.

In due course, groups will need to review their existing CFC arrangements and assess whether there is any advantage in establishing their finance or intellectual property holding companies in lower tax jurisdictions within the EU or EEA.

France

The impact of the decision differs between the French CFC rules applicable to companies and those applicable to individuals.

The French CFC rules for companies apply to any legal person liable to French corporate income tax

- operating a branch out of France, or
- holding (either directly or indirectly) more than 50 percent of the shares, financial rights, or voting rights in a legal entity (whether a legal person, an organization, a trust or similar institution) established or set up out of France

when such branch or legal entity is subject to a "privileged tax regime" in the jurisdiction where it is established. A privileged tax regime is one where the entity is subject to an amount of income taxes of less than half the amount of income taxes to which it would have been subject to in France under normal conditions.

Following the judgment of the ECJ of July 16, 1998 in the *"ICI"* Case (Case C-264/96), which ruled that the restriction imposed by the domestic tax laws of a Member State of the European Communities to the rights deriving from the European Communities laws can only be justified to the extent that it has "the specific purpose of preventing wholly artificial arrangements, set up to circumvent [domestic] tax legislation, from attracting tax benefits," the French rules on CFCs were modified in 2004 so that they now specifically state that they do not apply with respect to a foreign organization established in a Member State of the European Communities, except when the establishment of such a foreign organization can be considered as an "artificial arrangement whose aim would be to evade the French tax laws."

The Cadbury Schweppes decision should therefore have no impact on the CFC rules for companies.

In contrast, the French CFC rules for individuals have not been modified to take account of earlier ECJ decisions. Such French rules on CFCs automatically apply to any French tax resident individual holding directly or

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indirectly (either on his/her own or through his/her ascendants, descendants or spouse) at least 10 percent of the shares, financial, or voting rights in a legal entity:

- established outside France;
- whose assets mainly consist of securities, debts, deposits or current accounts; and
- which benefits from a "privileged tax regime" as defined above.

It is therefore probable that the ECJ decision in Cadbury Schweppes will have a significant impact on the French CFC rules for individuals, since those rules apply regardless of whether there are objective factors, which are ascertainable by third parties, that despite the existence of tax motives, the CFC is actually established in the host Member State and carries on genuine economic activities there. In those circumstances, the rules for individuals may be challenged as a breach of EU law.

Italy

The Italian CFC rules provide that where a resident company controls another company resident in a country included on a "black-list," the income realized by the CFC should be taxed in the hands of the Italian company regardless of any dividend distribution. The Italian CFC rules are, therefore, restrictive domestic measures aimed at avoiding the establishment of CFCs in tax haven countries.

The Italian black-list, dating from 2001, provides for the application of the CFC rules to a 1929 Holding Company resident in Luxembourg, to certain specific entities resident in Malta and to any entity located in Cyprus. When the black list was issued, Malta and Cyprus were not then members of the EU. By a resolution dated December 12, 2005, the Ministry of Finance stated that, even though Malta had become an EU Member State, CFC rules should still apply on the basis that they apply irrespective of EU membership status.

However, the Italian CFC rules do allow the taxpayer to submit a ruling to the Italian Tax Authorities in order to avoid the application of CFC rules, by demonstrating that the controlled foreign company carries out an effective business activity. In other words, the Italian rules would seem to challenge only artificial structures. As a consequence, the Italian CFC rules appear to comply with the principles set out by the ECJ.

There are two possible arguments that the Italian CFC rules may still breach EU law:

- The requirement imposed on the taxpayer to submit a ruling to establish that the CFC rules do not apply might itself represent an excessive burden. This, according to the ECJ *de Lasteyrie* decision (Case C-9/02) might in substance produce the same effect of limiting the right of freedom of establishment.
- The Italian CFC rules do not identify the objective elements by which the "artificiality" of foreign arrangements should be investigated nor allow for these elements to be considered from an objective third party point of view. Both the evaluation and the identification of these elements are attributed to the competence of the Tax Authorities which might not be considered to be "third" parties.

It is more likely that other areas of Italian tax law might be affected by Cadbury-Schweppes and other ECJ decisions. These include cross-border transactions executed by an Italian company such as:

- a cross-border merger in which an Italian company is incorporated into another company resident in the EU. Italian tax law imposes a capital gain taxable in Italy if the going concern of the company incorporated does not flow into an Italian branch of the foreign incorporating company, irrespective of any evaluation of the economic reasons for the transaction;
- a transfer abroad of the headquarters company. Italian tax law imposes a taxable capital gain if the assets of the transferred company do not flow to an Italian branch.

These provisions allow the taxation of unrealized capital gains, irrespective of whether the transfer abroad is real, has valid economic reasons (which may now include saving tax) and does not represent an abusive transaction.

Under the German general anti-avoidance provision an Irish financial company does not qualify as a wholly artificial arrangement for German tax purposes but the CFC rules will still apply.

Germany

In general the German CFC rules are comparable to the UK rules. However, a major difference with respect to the requirements is that the scope of application is wider for income of the CFC derived from passive operations. In contrast to the UK rules, there is no possibility granted to the taxpayer to provide counter-evidence that the purpose of the transaction was not a reduction in the German tax base or a profit-shift to the CFC state. Moreover, the tax consequences of the application of the rules is stricter than in the UK since the direct attribution of non-distributed profits of the CFC to the German taxpayer will on a subsequent profit distribution result in a final tax payment instead of a preliminary tax payment. In brief, the German CFC rules are more restrictive than the UK provisions and the resident shareholders of the foreign company suffer a heavier tax burden.

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Thus, the principles of the Cadbury Schweppes decision can, by analogy, be applied to the German CFC concept to an even greater extent than to the UK concept. Consequently the question arises whether the German provisions aim at wholly artificial arrangements. The answer to this is in the negative since the German Federal Tax Court as well as the German tax authority very clearly state that the general anti-avoidance provision takes priority over the German CFC provisions to the extent tax avoidance schemes are in place. To put it another way, the sole earning of passive income from a CFC will only trigger the CFC rules but not the allegation of tax avoidance, so that the CFC rules will apply regardless of whether there is tax avoidance. In four decisions concerning the Dublin Dock IFSC companies the German Federal tax court decided that a minimum degree of personal and material substance that ensures the decision-making process in the CFC entity is sufficient to deny tax avoidance. Thus, even under the German general anti-avoidance provision an Irish financial company does not qualify as a wholly artificial arrangement for German tax purposes but the CFC rules will still apply.

As a conclusion, the German CFC rules are not linked to tax avoidance at all and, therefore, infringe the EC Treaty. There also seems to be a difference in the interpretation of the ECJ and the German Federal Tax Court of what a "wholly artificial tax arrangement" looks like and the German case law appears to be more liberal. However, this taxpayer-friendly outcome unfortunately only exists in theory. Taxpayers and their advisors have to face the problem that the German Ministry of Finance is not willing to transfer ECJ decisions on the tax law of a foreign Member State nor to analyze the consistency of the comparable German provisions with the EC law. This "wait and see"-mentality results in a further lack of certainty for German taxpayers and clarity can only be achieved in a separate case on German CFC rules that still needs to be brought forward to the ECJ. ❏

RUSSIA

Recent Trends in Transfer Pricing in Russia

by Maxim Maximov and Alina Gaynanshina (Ernst & Young)

Court practice shows that the Tax Code does not address transfer pricing effectively. Historically, the courts have decided in taxpayers' favor in all but a handful of cases. In many cases it appeared that little effort was required from the taxpayer to defend its position in court because the tax authorities could not comply with the requirements of Article 40 of the Tax Code concerning proof of the level of comparable market prices. In other words, the tax authorities lose many court cases without the taxpayer having to justify its position. This lead to complacency among taxpayers.

The main reason for this situation is that there is rarely reliable information regarding comparable market prices. Some believe that information from the State Statistics Committee can be used to determine market prices. However, the courts have been known to reject such data as not being derived from official sources.

The times are changing despite the absence of amendments to the transfer pricing provisions. Available court practice indicates that the percentage of court cases won by the tax authorities has increased in the last 18 months, although taxpayers continue to win approximately 75 percent of court cases connected with transfer pricing. There are increasing numbers of court cases in which the tax authorities demonstrate a more sophisticated approach to the challenge of transfer pricing and succeed in collecting additional taxes and tax sanctions. Below we provide an overview of the approaches which could be used by the tax authorities in challenging companies' prices.

Application of Comparable Non-Controlled Prices

The tax authorities can make a transfer pricing adjustment if they prove that a company's prices deviate by more than 20 percent from comparable prices prevailing on the market.

Information regarding such market prices is usually taken by the tax authorities from the State Statistics Committee, specialist information agencies, industrial unions or even from industry-related magazines.

Prices taken from the sources mentioned above tend not to satisfy the requirements concerning the market price for the purposes of Article 40. Such prices are usually average prices rather than actual prices and they are calculated based on data including, among others, prices

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applied by related parties. Furthermore, information regarding the terms of the transactions to which the prices included in the calculation of the average applied (e.g., terms of payment) is usually unavailable.

Numerous court decisions have rejected claims by the tax authorities based on such prices for these very reasons. However, the logic applied by the courts in deciding which prices can be considered market prices is sometimes unclear. Here are some examples of sources of information regarding market prices which have been accepted by courts:

Court Decision	Source
East-Siberian Region No. 78-5802/03-2-17/381-F02-2869/04-S1 of September 1, 2004	Prices published by the Union of Timbermen and Exporters of Russia
Moscow Region No. KA-A40/10292-05 of October 26, 2005	Prices published by the regional statistics committee
North-West Region No. 56-8127/04 of November 12, 2004	Prices used by competitors collected by the tax authorities
Ural Region No. F09-868/05-S2 of December 22, 2005	Prices used by competitors collected by the tax authorities

The courts have started more often to support tax authorities' claims for additional taxes based on deviations between prices used by a taxpayer in the same period. In other words, one cannot exclude the possibility that if there is a deviation between prices applied by a taxpayer in sales to different customers, the court would accept the highest of these prices as the market price. Examples of this approach are provided in the following Federal Arbitration Court decisions:

- North-West Region No. 26-7928/04-213 of February 21, 2005
- Povolzhskiy region No. 72-7609/04-7/588 of January 25, 2005

Export prices are still rarely challenged by the tax authorities. However, there is one available court decision[1] which showed that the tax authorities performed a comprehensive study of comparable prices for goods exported by a company, i.e., based on information received from a Russian scientific-research institute, they found comparable goods on the European market and requested prices for these goods from the European producers. Having established that the European producers' prices were higher than the prices used by the Russian exporter, the tax authorities managed to collect additional profits tax and tax sanctions from that exporter.

Application of Other Pricing Methods

The tax authorities have become more successful in applying two other methods for determining market prices provided by Article 40, namely:

- the price of subsequent sale (or resale minus) method;
- the "cost plus" method.

This can be explained by the fact that the tax authorities have become more experienced in proving the absence of information regarding comparable market prices. This is a prerequisite for applying the alternative methods. The courts have accepted letters from the regional statistics committee as evidence of the absence of market prices. Here are examples of court cases in which the tax authorities succeeded in making a transfer pricing adjustment based on prices calculated using the subsequent sale method:

The Russian tax authorities are becoming more skillful in their transfer pricing challenges.

- Povolzhskiy Region 65-20830/03 SA1-32 of September 7, 2004
- North-Caucasus Region F08-6499/2004-2474 of January 18, 2005
- West-Siberian Region No. F04-2659/2005(10971-46-25) of May 5, 2005

The available court decisions do not explain how the tax authorities calculated the market price under the subsequent sale method.

We have identified only one published court decision where the tax authorities succeeded in making a transfer pricing adjustment using the "cost plus" method before 2005. In 2005 the tax authorities managed to apply this method successfully in at least three cases which have been brought to the Federal Arbitration Courts. The details of these decisions are as follows:

- Moscow Region No. 40/11239-05 of November 21, 2005
- Moscow Region No. 40/11827-05 of December 8, 2005 (these two court decisions relate to the same taxpayer and situation but different tax periods)
- Urals Region No. F09-232/05 of February 14, 2005
- Central Region No. 54-2769/04-S4 of February 24, 2005

The decision of the Federal Arbitration Court for the Moscow Region explains that the tax authorities used the profitability of comparable companies in order to calculate the "normal" profit for the activity in question which was used to determine the market price. The other

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court decisions do not explain how the tax authorities calculated the market price.

To conclude, the results of our analysis of the available court practice show that the tax authorities have recently become more rigorous with respect to constructing challenges to prices used for taxation purposes. The number of available court cases which were considered by the Federal Arbitration Courts in 2005 is high in comparison to the number of cases which were considered during the preceding three years (111 vs. 178). The percentage of court cases won by taxpayers has decreased from 85 percent in 2002 to 2004 to 78 percent in 2005. Mere statistics cannot, of course, serve as evidence of an increase in the probability of a transfer pricing risk crystallizing with respect to a particular company. Nevertheless, one cannot disagree that the tax authorities have clearly given some thought to transfer pricing issues and with increased experience are becoming more effective in pursuing litigation in this area.

Prospects for Legislative Change

Given the tax authorities' marked lack of success in litigation based on the transfer pricing rules to date, the continued absence of significant legislative developments in this area is surprising. A number of drafts have been circulated for consideration over the years but no changes have been enacted since July 1999. The current situation is that a draft circulated early in 2005 seems to have been dusted off and is being talked of as the basis for amendments to be enacted sometime in 2007. It is far too early to say what final form the amendments will take or whether indeed they will be enacted next year. However, potential changes include the shifting of the burden of proof to taxpayers, the introduction of documentation requirements and the abolition of the so-called "20 percent safe-harbor" provision. If enacted, such changes would undoubtedly have significant implications, not least in that the tax authorities would expect to enjoy much greater success when transfer pricing disputes are referred to the courts for resolution.

[1] Decision of the Federal Arbitration Court for Volgo-Vyatskiy Region No. A79-9855/2004-CR1-9264 of September 12, 2005. ❑

UK

Private Equity Debt *(from page 3)*

the tax return, but also provides certainty for any future exit strategy. It could provide shareholders with greater negotiating power and avoid the need for the provision of potentially high value indemnities relating to tax deductions that have been claimed.

Even if companies do not wish to go for a CoP10, they will need to prepare transfer pricing studies to support their filing position both as to the amount of debt and its interest rate.

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Published by WorldTrade Executive, Inc.

Publisher: Gary A. Brown, Esq.
Managing Editor: Scott P. Studebaker, Esq.

Assistant Editor: Edie Creter
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Marketing: Jon Martel
Production Assistance: Dana Pierce

PRACTICAL EUROPEAN TAX STRATEGIES
is published monthly by
WorldTrade Executive, Inc.
P.O. Box 761, Concord, MA 01742 USA
Tel: 978-287-0301, Fax: 978-287-0302
E-mail: info@wtexec.com
Homepage: www.wtexec.com

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New U.S.-UK Competent Authority Agreement Provides Relief from Mirror Legislation Rule in Dual Consolidated Loss Regulations

by Diana L. Hickey (Baker & McKenzie)

On October 6, 2006, the Treasury Department announced that the United States and the United Kingdom competent authorities have entered into an agreement that will allow certain taxpayers with dual consolidated losses (DCLs) to elect to use those losses to offset income of their affiliates in either the United States or the United Kingdom. This agreement is the first of its kind, providing taxpayers welcome relief from the draconian mirror legislation rule in the current final and proposed DCL regulations.

(g)(2)(i) Election

Section 1503(d) of the Code and the regulations thereunder generally provide that DCLs may not be used to reduce the taxable income of a U.S. affiliate unless the taxpayer makes an election ((g)(2)(i) election) under which the taxpayer certifies that no portion of the loss has been or will be used to offset the income of any other person under the relevant foreign income tax law. If a taxpayer that has made a (g)(2)(i) election engages in a transaction that constitutes a "triggering event" under the regulations including, among other things, a use of the loss to offset an affiliate's income under foreign law, the taxpayer must recapture the loss, plus an interest component, on its tax return for the year including the triggering event.

The current regulations as well as the proposed DCL regulations issued in May, 2006 include a so-called "mirror legislation rule," which generally provides that a dual resident corporation or separate unit is deemed to have used the loss to offset income of an affiliate in the foreign jurisdiction if such foreign jurisdiction has enacted legislation similar to the U.S. DCL rules that prohibit the use of the loss in the foreign jurisdiction. Thus, if a dual resident corporation is treated as a resident of a country that has a DCL-type rule such as the United Kingdom, the taxpayer is precluded from making a (g)(2)(i) election. In that case, it is possible that the taxpayer may be prohibited from using the loss to reduce any affiliate's income in both the United States and the United Kingdom.

Election of where to Use the Loss

Taxpayers, tax practitioners and commentators have criticized this rule as particularly harsh and demanded relief. The current and new proposed DCL regulations provide an exception to the mirror legislation rule and thus would allow taxpayers to make (g)(2)(i) elections where the taxpayer elects under Treas. Reg. § 1.1503-2(g)(1) to use the loss in the United States under an agreement entered into between the United States and the relevant foreign country that permits a taxpayer to

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Greece Requested to End Discriminatory Taxation of EU Dividends

Dividends paid by Greek companies to individual shareholders are exempt from income tax in Greece. The aim of this exemption is to avoid double taxation of company profits.

However, dividends paid by companies of other Member States to individual shareholders in Greece are taxed. According to the Commission, such a difference in treatment constitutes a restriction on the free movement of capital. Therefore, the Commission has requested Greece to abolish discriminatory taxation of dividends paid by companies of other Member States.

If Greece does not reply satisfactorily to the Commission within two months, the Commission may refer the case to the European Court of Justice. — *Geert Dierickx (gdierickx@europe.mwe.com), McDermott Will & Emery/Stanbrook LLP, Brussels*

DCLs *(from page 15)*

elect which jurisdiction it wishes to use the loss. Until now, however, there have been no such agreements on which taxpayers could rely for relief from the mirror legislation rule.

Recognizing that the interaction between the mirror legislation rule in the U.S. DCL regulations and the UK DCL-type rules may result in double taxation inconsistent with the Business Profits and Relief of Double Taxation articles of the U.S.-UK tax treaty, the new competent authority agreement, or the first "G-1 Agreement" (by reference to the relevant provision in the current DCL regulations), allows taxpayers who meet certain conditions and follow certain procedures to make an annual, irrevocable election to use the DCL incurred in a particular year to reduce an affiliate's taxable income in any open year in either the United States or the United Kingdom, but not both. The G-1 Agreement does not apply to *(i)* dual resident corporations that are not UK permanent establishments; *(ii)* hybrid entity separate units; or *(iii)* separate units owned indirectly through a hybrid entity separate unit. Further, the G-1 Agreement provides that a taxpayer may only elect to use the DCL under the G-1 Agreement in a manner that is consistent with the domestic law generally applicable to the relief of losses of the country in which the taxpayer is seeking to use the loss. Moreover, if any part of a loss that has been relieved, used or claimed in one country under the G-1 Agreement subsequently is used in the other country in a manner inconsistent with the domestic law of the first country in which the loss was used, the taxpayer must recover or recapture the loss in accordance with the first country's laws.

The election must be made in accordance with the procedures and conditions provided in the body and the annexes to the G-1 Agreement. Annex A, which sets forth the rules and conditions applicable to taxpayers who wish to elect to use the DCLs in the United States, requires electing taxpayers to file "modified (g)(2)(i) agreements." "Modified (g)(2)(i) agreements" are (g)(2)(i) elections (as provided under the current regulations) that contain the caption, Election under § 1.1503-2(g)(1) to Use Dual Consolidated Loss of a UK Permanent Establishment under U.S./UK Competent Authority Agreement" and provide some information and representations in addition to those required under the current DCL regulations. Such representations include a representation that the DCL of the taxpayer's UK permanent establishment is eligible for relief under the G-1 Agreement and that the taxpayer agrees to notify both the U.S. and UK competent authorities in the event that a triggering event occurs. In addition to providing a modified (g)(2)(i) agreement with the taxpayer's timely filed U.S. federal income tax return for the year in which the loss is incurred, an electing taxpayer must provide a copy of the modified (g)(2)(i) agreement to both the US and UK competent authorities by the deadline for the taxpayer's US federal income tax return for that year.

Annex A to the G-1 Agreement also provides special rules for taxpayers who wish to elect relief under the G-1 Agreement for DCLs that were incurred in open tax years for which the deadline (including extensions) for the taxpayer's U.S. federal income tax return for such year is on or before January 4, 2007. These rules allow taxpayers to make elections under the G-1 Agreement by amending their tax returns for the relevant year, provided such amendments are filed on or before the due date of the taxpayers' U.S. federal income tax return due for the first tax year ending after January 4, 2007. The G-1 Agreement also affords potential relief under section 9100 and Notice 2006-13, 2006-8 I.R.B. 496, under certain circumstances to taxpayers intending to elect relief under the G-1 Agreement, but whose filings under the G-1 Agreement were not timely.

Annex B to the G-1 Agreement provides similar rules and conditions to taxpayers electing relief under the agreement to reduce the taxable income of UK affiliates.

The G-1 Agreement provides that any reference to the law of a Contracting State includes any successor provisions to such law provided that such provisions are not "materially inconsistent" with the G-1 Agreement. The G-1 Agreement expressly provides that the May 2006 proposed DCL regulations, when finalized, will be treated as successor provisions that are not materially inconsistent with the G-1 Agreement.

The G-1 Agreement may be terminated only by joint agreement of the competent authorities prior to January 1, 2012. After 2011, either competent authority may unilaterally terminate the agreement by providing written notice to the other competent authority three months in advance of the actual termination date. ❑

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