Law . Tax

Tax Connect

After the crisis, a new tax landscape
Summary report - 2011 Annual tax conference

June 2011

Contents

CMS Tax Connect

GRAPHIC DESIGN
Creative Room / 18 rue Lécluse / 75017 Paris

Editorial

More than two years after the economic turmoils triggered by the bankruptcy of the Lehman Brothers bank, businesses are still dealing with the legislative and regulatory repercussions of the crisis and the resultant new tax landscape.

One of the main consequences is the need for most governments to find new tax resources in order to deal with the budget crisis. That situation has led to various taxes, particularly in the financial sector. As far as company tax is concerned, tax authorities are focusing their efforts in the transfer pricing area. The issue for States is not only finding new resources but “defending” the national share of tax receipts deriving from international operations. The ever-expanding requirement to document intra-group transactions forms part of that increased scrutiny. In that connection, intangible assets are a favoured target.

Intensifying international cooperation is at the same time being brought to bear on preventing tax evasion, with a concomitant “hardening up” by some tax authorities. Even if it is still the exception in most countries, resort to criminal law provisions is now being envisaged for operations which hitherto have rarely if all been under scrutiny. There is a growing tendency to impose greater demands with respect to economic “substance”. In order however to move away from a purely “repressive” approach, some tax authorities are establishing dialogue procedures with some taxpayers with a view to guaranteeing greater legal certainty to the latter in return for greater a priori transparency.

Those developments are occurring in a context in which tax competition between States is still intense, including within the European Union, in order to attract investors. Hence, businesses investments or acquisitions can always lend themselves to favourable tax trade-offs, particularly in the finance area, once the scope of potentially applicable anti-abuse rules has been analysed.

The 2011 CMS Annual Tax Conference provided an opportunity to take stock of the above topics. The nature and extent of the changes European multinational companies are now facing were very clearly illustrated by way of introduction by executives from the Dexia group. Subsequently specific workshops enabled CMS network lawyers to delve into the abovementioned topics: tax management and intangible asset transfer pricing policy, criminalisation of taxation law, and acquisition financing. They were topped off with other current technical developments: changes to real estate VAT and legislative developments in Central and Eastern Europe. The edition of CMS Tax Connect takes account of the above work and allows us to continue with our shared analysis. So please do not hesitate to let us have your comments or suggestions about the issues dealt with here, or indeed any other topics of more immediate concern to you!

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2010: a consolidation year for CMS tax services

Here at CMS our taxation services draw on over 350 lawyers in 54 offices, all of whom are at our clients' service nationally and internationally. And our practice favours an across the board pan-European approach structured around such specialities as VAT, transfer pricing, and European Union tax law.

Our tax teams are regularly rated by national and international industry guides (e.g. Legal 500 and Chambers) as among the best reputed not only in France but also several of the other 29 countries in the network. In other words, we take this practice seriously, which is why we are constantly progressing and strengthening it to bring you the best possible added value.
Thus 2010 was significant for two big developments:
— Pressing on with structuring our transfer pricing and VAT services,
— Strengthening our European presence by extending our network to Luxembourg and entering into a cooperative agreement with a Portuguese firm.

Structured Services

We have continued to restructure the services we provide with respect to:
— Transfer pricing, where our French teams, already well known in the market for both their expertise and economic analysis, are now supported by specialists in those matters in most CMS countries,
— VAT, with Elisabeth Ashworth heading up the coordination of our European practice in this area as of September 2010.

An increased European Presence

Our increased presence in Europe is the second big development for 2010. In Luxembourg we prepared for the opening of the CMS DeBacker Leclère Walry office, effective as of 1st January 2011, where Diogo Duarte de Oliveira is now in charge of developing our local taxation practice. Further, we have entered into a cooperation agreement with the Portuguese firm Rui Pena, Arnaut & Associados, where the tax team is co-ordinated by Patrick Dewerbe.

Rest assured that finding the best ways of meeting your requirements is the sole purpose driving our efforts towards strengthening and growing our taxation practice. Besides our annual conference we are listening to your needs and we are adapting the CMS tax strategy to meet them as fully as possible.

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The CMS network groups together 9 European law firms which are leaders in their field. Its 2,800 lawyers including 770 partners in 29 mainly European countries – in particular Central and Eastern Europe, where CMS is very well established, but also in North Africa, China and Latin America.

Acquisition financing in Europe

The worldwide economic and financial crisis has forced tax authorities to readjust in particular by adopting new regulatory laws, increasing taxes or discussing tax convergence and information exchange issues.
Do those changes affect the instruments of acquisition financing? Furthermore, has a whole new tax landscape emerged after the crisis as far as acquisition financing in Europe is concerned?

Those questions are discussed below first through the presentation of an update on the various domestic legal regimes, including inter alia the treatment of net operating losses (hereafter "NOLs"), the tax consolidation regime and the rules on interest deduction. This discussion is then illustrated by a case study focusing on the tax aspects of the acquisition by a French investor of target companies located in Central and Eastern European countries (Hungary, Poland and Russia).

General acquisition finance considerations in Central Europe

When dealing with the tax structuring of an acquisition, various aspects must be taken into account such as the effective tax rate, the tax base and especially the treatment of interest expenses.

The present tax environment and major tax features in Western and Central Europe are summarized in the following tables.

a) Domestic rules on NOLs and tax grouping
All the countries cited in the following table allow corporate taxpayers to carry forward NOLs within certain limits. NOLs carry-forward may be limited in time (Italy: 5 years, Poland: 5 years, Russia: 10 years, Spain: 15 years), or, in some countries, reduced (or forfeited) as a result of certain events: change of control and/or change of activity. Though common to several countries, those limitations do not have identical meaning and scope. While most European countries allow tax grouping, such tax consolidation is not yet available in countries such as Belgium, Hungary and Russia. Among the most flexible available regimes, the UK regime notably allows tax grouping on an annual basis, reducing constraints attached to a "pure" tax consolidation regime.

	Effective CIT rate	NOL carried forward	Impact of change of control / Loss of NOL	Domestic tax grouping	Ownership percentage
Belgium	33,99%	No time limit	Change of control (50% of the share-capital and/or a majority of the board members) without legitimate economic or Impact financial needs	No	N/A
France	34,43%	No time limit	Loss of NOLs only in the event of a deep change in the activity	Yes	95%
Germany	30-33%	No time limit	Change of ownership of > 25% and ≤ 50% -> partial cancellation Change of ownership > 50% -> full cancellation	Yes	> 50%
Hungary	10-19%	No time limit	No	No	N/A
Italy	27,5 + 3,9%	5 years	Change of control and change of activity	Yes	> 50%
Poland	19%	5 years	No	Yes	95%
Russia	20%	10 years	No	No	N/A
Spain	30%	15 years	Change of control where the sold company has not developed any economic activity prior to the change	Yes	75%
UK	21-28%	No time limit	Change of control, and major change in the nature or conduct of the trade	Yes	75%

Among the most recently revised legislation, **Germany** still allows NOLs to be carried forward with no time limitation, but under strict limitations. Thus, up to the first million of profits in the subsequent year, full deductibility is possible. The balance of NOLs, if any, can be deducted only up to 60%. Any balance of losses can be carried on to the next year, with the use of the above-described mechanism.

Should a change of control occur, NOLs may be forfeited. Indeed, the German regime provides for a partial loss of NOLs in case of partial change of ownership (more than 25%) and full cancellation in the event more than 50% of the ownership is transferred directly or indirectly.

Still, there are exceptions to the above-mentioned forfeiture of losses: the restructuring clause, the group clause and a specific safe haven for losses carried forward. The restructuring clause has however recently been suspended due to a violation of EU law. Consequently, this possibility is no longer available. The Group restructuring clause applies if a company is sold within a group of companies, meaning that the seller and the purchaser have to be 100% controlled by the same ultimate entity.

The hidden reserve clause is the situation where the company that is being sold has so called "hidden reserves". Up to the amount of such hidden reserves, NOLs carried forward can be protected. Those hidden reserves must be encapsulated in assets which are subject to German taxation (excluding participations in other corporate entities).

As far as German tax groups are concerned, hidden reserves in the controlled entity are not automatically identified as hidden reserves of the parent company. Consequently, when contemplating an acquisition in a German group of companies which have established a tax group, a pre-closing restructuring should be agreed with the seller in order to make sure that hidden reserves will be protected after the acquisition of the company.

b) Domestic rules on interest expenses deduction

The following table presents the domestic rules on interest expenses deduction within several European countries.

It appears that all the countries cited in the following table allow the deduction of interest, subject to certain limitations and specific anti-abuse rules. Thus, in France and Spain specific limitations apply in the case of intra-group acquisitions. From a more general perspective, rules governing the tax treatment of interest expenses (such as thin capitalization rules) have recently evolved in several jurisdictions such as France, Germany and Spain.

	General rule	Interest deduction for acquisition finance	Thin cap rules	Other limitations
Belgium	Generally deductible, but limited to fair market interest rate	No special provision	1:1 debt/equity ratio: • shareholder restriction if appointed as a director 7:1 debt/equity ratio: • tax haven restriction	Possible disallowance if interest is paid to a non-resident and is not subject to taxation in this jurisdiction
France	Generally deductible, but limitations apply to loans granted by related entities (which include interest paid to third party but upon a loan secured by a related party)	General rules apply. Limitations also apply to certain intra-group acquisitions of shares (anti-abuse rules applicable in fiscal unities; "Amendement Charasse")	Disallowance for interest expenses exceeding the following limitations: • loans granted by related parties exceed 1.5 times the net equity of the company • 25% of adjusted net operating income • interest income received from related entities	None. Exceptions and safe haven tests are however available.
Germany	Generally deductible	No special provision	No thin cap rule, but arm's length interest rate required for related parties	Interest barrier rule: • net interest expenses deduction limited to 30% EBITDA • exemptions: (a) threshold, (b) group clause, (c) escape clause
Hungary	Generally deductible	Interest allocated to fixed assets increases depreciation volume	Disallowance for interest expenses if debt exceeds 3 times equity of company	No specific anti-abuse rule
Italy	Generally deductible	No special provision	No thin cap rule	Interest barrier rule: • net interest expenses deduction limited to 30% EBITDA
Poland	Generally deductible	Interest allocated to fixed assets increases depreciation volume	Disallowance for interest paid to a qualifying lender (25% shareholding) if and to the extent that qualifying loan exceeds 3 times the paid-up share capital	No specific anti-abuse rule

Russia	Generally deductible	No special provision	Disallowance for interest paid to a qualifying lender (foreign company owning directly or indirectly more than 20% shareholding) or guaranteed by such lender if and to the extent that qualifying loan exceeds 3 times the own capital (~net assets) of the company	The interest rate can not deviate for more than 20% from the rate on comparable loans
Spain	Generally deductible	Intra-group acquisition: • acquisition must be carried out due to very strong commercial reasons, otherwise interest deduction disallowed • interest rate for debt used for an acquisition must be at arm's length	If lender is as related party non EU resident and the debt/equity ratio exceeds 3:1 the exceeding interest expenses are treated as dividend	Shareholder loans must be at arm's length interest rate
UK	Generally deductible	Interest on acquisition loan (non-trading transaction) is not fully deductible but offsetable against current profit of the company or the group, offsetable against previous non-trading income and carried forward	• Interest paid to a related party is not allowable unless the granting of the loan is at arm's length. • Historically a debt/equity ratio of 1:1 and an earnings / interest cover of 3:1 were accepted but nowadays HMRC has adapted a case by case approach	Worldwide debt cap rules: • In a large group the interest deduction is restricted if the UK net debt of the whole group exceeds 75% of the worldwide gross debt of the group

As far as changes in thin capitalization rules throughout Europe are concerned, French and Italian tax rules can be used for the purposes of illustrating such evolution.
Thus, as a general rule, French tax law provides limitations to the deductibility of interest expenses upon loans granted by related parties. The provisions of article 212 of the French tax code (hereafter "FTC") thus apply to interest expenses accrued by a French company on borrowings from related companies within the meaning of article 39-12 FTC, i.e. (i) from a shareholder which directly or indirectly holds the majority of the borrower's share capital, (ii) or from companies of which the majority of the share capital is directly or indirectly held by the same ultimate shareholder as the borrower, (iii) or de facto managed by the same ultimate entity. Under such rules, bank loans, even though secured by related parties, did not fall within the scope of French tax limitations.
Under the Finance Bill for FY 2011 (applicable to fiscal years ending as from 31 December 2010), bank debt whose reimbursement is secured by a related entity will be deemed as a related party debt and will consequently fall within the scope of article 212 FTC. Certain exceptions have however been set out in respect of funds lent:
— In relation to bonds issued within the context of public offerings,
— Up to the amount whose reimbursement is exclusively secured by a pledge on the shares of the borrowing entity (or receivables of the latter) or on the shares of the entity holding the shares in the borrowing entity provided that the holder of said shares and the borrowing entity are part of the same fiscal unity,
— Subsequently to the reimbursement of a preexisting debt, such reimbursement being compulsory under a change of control clause provided for in the original loan agreement,
— In relation to loans concluded prior to 1 January 2011, within the context of the acquisition of shares or within the context of the refinancing of such operations (e.g., notably LBOs and related refinancing).

Under the extended scope of "related" debt, and given the banks' demands in terms of securing loans, it will be increasingly difficult to structure the financing so that interest expenses remain tax deductible.

In **Italy**, the tax authorities moved from a rather complex thin capitalization system to more straightforward tax deductibility rules. Indeed, the interest expenses are deductible for an amount corresponding to interest income accrued in the relevant fiscal year and 30% of the EBITDA generated by the taxpayer in the relevant fiscal year.
This rule applies to both related party and third party debts. Different rules apply to banks, insurance companies and other financial institutions, different from holding companies (i.e. interest expenses are deductible for 96% of their amount).
A carry forward mechanism is also available, with no time limitation, which provides that non-deductible interest in a given fiscal year may be deducted against future 30% EBITDA capacity. Moreover, "unused" EBITDA excess over interest expenses of a fiscal year can be carried forward to increase the EBITDA capacity of future fiscal years. No exception to this limitation is available under Italian tax legislation. Thus, interest expenses deductibility is a major issue for pure holding companies. Indeed, the income of holding companies generally consists of dividends, interest income and capital gains. Holding companies obviously lack eligible EBITDA.
Solutions are however available to remedy or mitigate this issue:
— Election for tax consolidation,
— Virtual tax consolidation,
— Quick merger.
Election for tax consolidation: non-deductible interest expenses pertaining to a consolidated entity (e.g. a holding company) can be offset, and then deducted on a consolidated tax basis, against any excess of 30% EBITDA generated by other tax group members.

Virtual tax consolidation: for the purposes of computing deductible interest expenses, the taxpayer is entitled to take into account any excess of 30% EBITDA pertaining to its foreign subsidiaries, provided the latter meet the conditions on electing for domestic tax consolidation. *Quick merger:* non-deductible interest expenses of merged companies may be offset against the future EBITDA capacity of the merging company. In this respect, in the event of merger any interest can be carried forward within the same limits as those provided for tax losses upon mergers.

c) Domestic rules on interest expenses deduction after restructurings

The following table summarizes consolidation opportunities available in the major European countries, i.e. opportunities to consolidate interest expenses and operating income for tax purposes. Tax grouping is one of the most efficient ways to achieve this goal. However, as mentioned above, tax grouping is not available in every jurisdiction yet (e.g. Belgium, Hungary and Russia). In the absence of a tax grouping regime, post-acquisition merger may, in certain countries, represent a tax efficient alternative.

	Tax group	Upstream merger	Downstream merger
Belgium	Not applicable	No restriction of interest deductibility	Interest on loan for acquisition of absorbing company might be challenged by tax authorities
France	General rules apply, however additional limitation for interest deduction may apply in the event of certain intragroup acquisition of shares (“Amendement Charasse”)	General rules apply. A specific limitation on interest deduction may apply in the event of so-called “quick merger”	General rules apply. A specific limitation on interest deduction may apply in the event of so-called “quick merger”
Germany	Interest deduction subject to general rules, i.e. interest barrier rule	Interest deduction subject to general rules, i.e. interest barrier rule	Interest deduction subject to general rules, i.e. interest barrier rule
Hungary	Not applicable	General rules apply	General rules apply
Italy	General rules apply, however special group relief for interest barrier rule	General rules apply	General rules apply
Poland	Interest deduction subject to general rules, i.e. interest barrier rule	Interest deduction subject to general rules, i.e. interest barrier rule	Interest deduction subject to general rules, i.e. interest barrier rule
Russia	Not applicable	General rules apply	General rules apply
Spain	General rules apply	General rules apply	General rules apply
UK	General rules apply, however at level of Holdco, the provision regarding so-called non-trading transactions might affect full deductibility of interest	Mergers are not favourable under UK law	Mergers are not favourable under UK law

Even though tax grouping may be available in a given jurisdiction, still various issues can arise which may prevent investors from efficiently deducting interest expenses incurred at the level of the acquisition holding company.

In the **United Kingdom**, there are two current relevance risks on acquisition and retention in existence of a UK target company:

— Insufficient profits in the target company for the UK acquisition holding company to enjoy (tax) group relief by way of interest deduction, such excess interest being then only available to carry forward and set off against future non-trading income and capital gains in the UK acquisition holding company. This issue is particularly relevant now the United Kingdom has tax exemption on sale of shares in trading subsidiaries (“SSE”) i.e. no taxable profit on exit against which to set excess interest,
— The UK target company has carry-forward trading losses, and a change in the nature of or the way the trade of the target is carried on may occur post-acquisition (e.g. in order to try to turn the business around), which can forfeit the benefit of the losses.

Those risks may be remedied through the use of the hive-up mechanism. This mechanism consists of transferring the target company’s business to the acquisition holding company. This transfer from the target company to the acquisition holding company is tax neutral. The target company’s trading losses should be preserved in the acquisition holding company even if the trade of the target company is altered after the hive-up into the acquisition holding company. Interest expenses will continue to be off-settable against trading profits arising from the transferred trade provided there is pre-acquisition and pre-funding evidence (e.g. board minutes etc.) that the UK acquisition holding company is intending to acquire the trade through the acquisition of the Target company and the hive-up mechanism. If there are carry-forward trading losses in the target

company, it is inadvisable for the hive-up to be effected immediately as part of the UK share purchase vehicle's acquisition of the Target. Indeed, the risk is that the UK tax authorities may argue that the target company did not beneficially own the trade after completion of the acquisition of the target company. In such a case it is best if the hive-up is deferred until the end of the month of the target company's acquisition at the earliest. However, to maximise the ability to account for interest on the acquisition debt, the hive-up must not be delayed much longer than that. Post hive-up, generally the target company is left dormant and then eventually struck off. The liquidation of the target is also possible.
Apart from tax consolidation opportunities and alternatives, when structuring the financing of an acquisition, attention should also be paid to specific anti-abuse regulations and to local developments in this respect.

Thus, in **Spain**, the tax authority may overuse the anti-abuse provisions provided for in respect of interest expenses deductibility.
Interest expenses are deductible in Spain provided the following conditions are fulfilled:
— Interest expenses are properly and timely booked in the accounts of the borrower,
— In case of related party transactions, thin capitalization rules and arm's length rules may be applied.
There is no specific anti-abuse provision in the environment of acquisition financing.
Yet the Spanish tax authorities reject, as a principle, the deductibility of interest expenses in relation to intra-group acquisitions insofar as a Spanish entity funded with debt acquires a stake in a foreign entity especially (but not necessarily) if such stake was previously held by another group company.
The Spanish tax authorities challenge the above-described scenario by using the following two procedural tools:
— The general anti-abuse provision (close to a "substance over form" approach),
— The "simulation" procedure.
The general anti-abuse provision is rarely used because it requires the implementation of a specific procedure which is rather difficult for the Spanish tax authorities to comply with properly. Moreover, even though such a procedure may result in the re-characterization of the interest expenses as "non deductible" items, still no penalties can be imposed. In such cases, for an acquisition structuring to pass the "substance over form" test, the existence of valid economic reasons for all business operations is of utmost importance for Spanish taxpayers, far beyond the achievement of a tax benefit.
The "simulation" procedure is a rather broad concept whose scope is difficult to ascertain. This procedure may also result in the re-characterization of interest expenses into non-deductible items. In addition, unlike the general anti-abuse provision, under this procedure the Spanish tax authorities are allowed to apply penalties. Furthermore, if the amounts at stake exceed EUR 120,000, a "simulated" scheme can fall within the scope of criminal tax offences.
As a consequence, the Spanish tax authorities tend to follow the "simulation" route to challenge controversial schemes. However, according to many practitioners, the "simulation" procedure is not appropriate in such cases and could therefore not be used to challenge aggressive schemes.

d) Other structuring opportunities
Other structuring opportunities should also be borne in mind which are still of use in spite of changes in tax legislation throughout Europe.
Thus, when a French investor is willing to acquire a target company in Germany, the double-dip structure for interest deduction between Germany and France is still effective. Under this well-known acquisition structuring, a German commercial partnership (such as the GmbH & Co. KG) is set up by a French company as a local acquisition vehicle. The French company will get the interest deduction (subject to thin capitalization rules) as well as the German partnership according to German tax regulations if the loan has been taken up to finance the acquisition of the partnership interest or the increase of the capital interest. In France, this structure has not yet been identified as abusive.
As far as the structuring of acquisition financing is concerned, and notwithstanding "standard" opportunities (such as tax consolidation, whatever the means to achieve such tax consolidation), specific acquisition financing opportunities may also be available in certain jurisdictions.

In **Belgium**, for instance, notional interest deduction is an innovative measure allowing all companies subject to Belgian corporate tax (or non-resident corporate tax) to deduct from their taxable income a fictitious interest calculated on the basis of their shareholder's equity (net assets). This measure aims at reducing the tax discrimination between debt financing and equity financing. More specifically, it enables counterbalancing the repeal of the specific tax regime applicable to coordination headquarters.
This measure mainly results in the general reduction of the effective corporate tax rate and a higher return on investment after tax, and the promotion of capital-intensive investments in Belgium and an incentive for multinationals to allocate such activities as notably intra-group financing and central procurement to a Belgian group entity.
As a result, the amount that can be deducted from the taxable base equals the fictitious interest cost on the "adjusted equity capital". If the company makes insufficient profits, the deduction can be carried forward during the following seven (financial) years.
The "adjusted equity capital" corresponds to the equity capital, i.e. share-capital, share premium, revaluation gains, reserves, profits/losses as stated in the company's opening balance-sheet and reduced notably by:
— Fiscal net value of own shares held on the balance sheet,
— Fiscal net value of financial fixed assets qualifying as "participations & other shares" (non-portfolio participations),

— Fiscal net value of shares issued by investment companies,
— Net equity assigned to foreign permanent establishments or real estate property or rights (situated in a country with which Belgium has concluded a tax treaty),
— Net book value of tangible fixed assets; if costs do not unreasonably exceed professional needs,
— Book value of tangible fixed assets that are considered as an investment not acquired in order to produce a regular income,
— Book value of real estate where its use is granted to directors (their spouses or children),
— Tax-free revaluation gains and capital subsidies.

The "fictitious" interest rate for accounting year 2011 (fiscal year 2012) amounts to 3.425% (3.8% for 2010). Small and medium sized companies are entitled to an upgrade of 0.5% (i.e., 3.925% for 2011). The interest rate is not allowed to deviate more than 1% from the rate of the previous tax year and must not exceed 6.5%.

If the financial year of a company is shorter or longer than 12 months, the reference notional interest rate is adjusted *prorata temporis*.

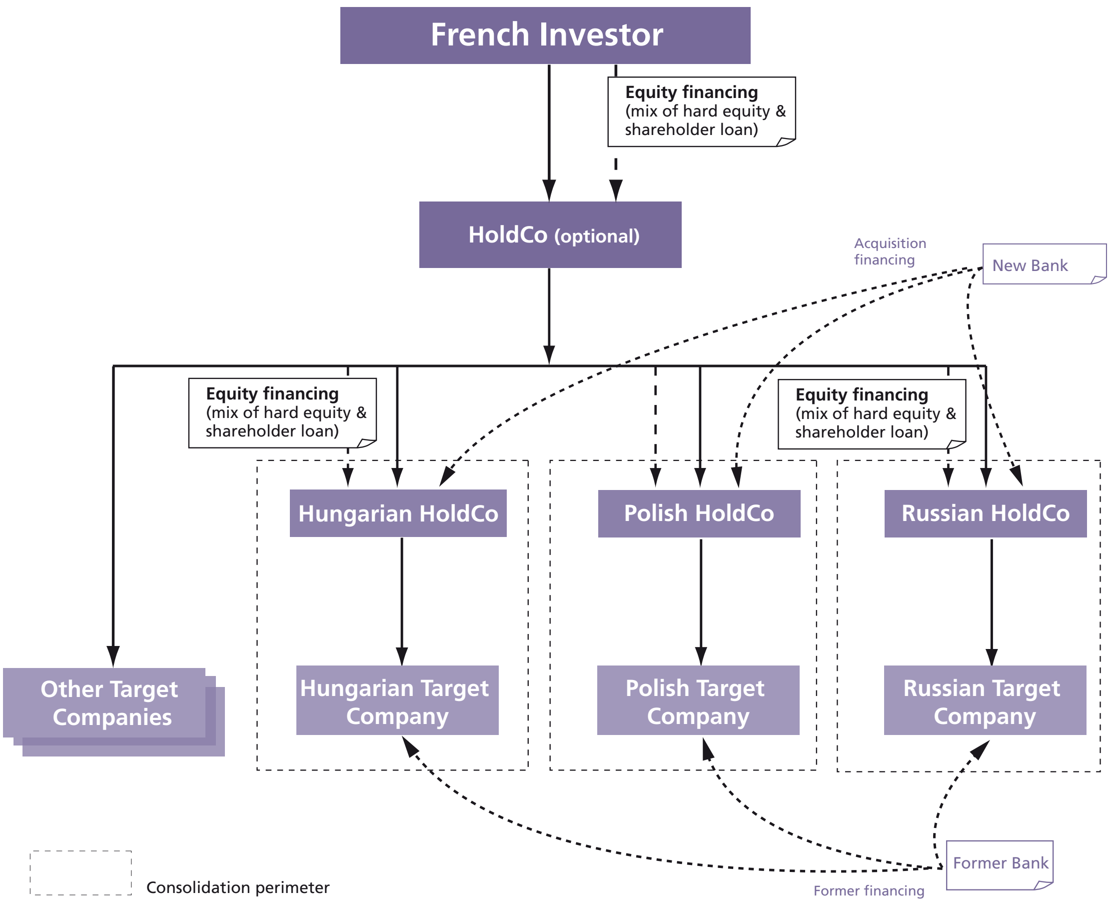
The rate is equal to the annual average of the monthly published interest rates for 10-year linear Belgian government bonds ("OLO's") over the year taken two years before the fiscal year concerned (e.g. the average of the interest rates of 2008 for fiscal year 2010).

Such a regime also has specific features which must be pointed out: (i) as above-mentioned, if the company makes insufficient profit, the deduction can be carried forward to the following seven years, (ii) the notional interest cannot be deducted from received abnormal or gratuitous benefits, (iii) in case of a change in control of a company, the carry-forward privilege is only maintained when such a change is based on sound financial and/or economic reasons, (iv) no withholding tax applies on the notional interest deduction, (v) no acknowledgement (or ruling) is required for the notional interest deduction to apply (the only formal requirement consisting in the filing of an enclosure with the corporate tax return).

Now that the main features of acquisition financing have been recapitulated, their use and combination can be illustrated through the case study set out below. This case study focuses on the acquisition of shares in target companies located in selected Eastern European countries, notably with a view to further explore the tax environment of acquisition financing, out of well-known Western European jurisdictions.

Extensive case study: focus on Eastern European countries

A French investor contemplates acquiring the shares of several target companies among which are targets located in Hungary, Poland and Russia (we assumed that



those companies were not predominantly real estate holding companies). This acquisition could be realised through a top holding company (hereafter "HoldCo") located in a typical holding jurisdiction such as the Netherlands, Luxembourg or Cyprus.
To acquire the selected target companies, the French investor (or its holding company) would set up local holding companies in each target jurisdiction (Hungarian/Polish/Russian local share purchase vehicles). Each local SPV would be financed (either directly by the investor or through the top holding company) by (i) a mix of hard equity and subordinated loan, and (ii) by bank loans (acquisition financing). Each target company would already be financed (operational needs / CAPEX) by a bank loan (former financing).
Once the acquisition has been completed, each SPV would be consolidated for tax purposes with the relevant target company, so that the profits of the target company would be offset against interest expenses incurred upon acquisition.

a) Choice of HoldCo

The French investor will structure its acquisition through a HoldCo set up in a low tax jurisdiction. This might be the Netherlands, Luxembourg or Cyprus. Those countries are interesting notably in terms of taxation of capital gains upon disposal given those countries have advantageous participation exemptions regimes. It is assumed that HoldCo has adequate substance in its country of location. In the event of a future disposal by HoldCo of the shares in target companies, capital gain tax upon disposal of shares would not be taxable in Hungary and Poland according to local tax regulations. In Russia, tax treaties with Luxembourg and The Netherlands provide for a full exemption on capital gains on such sale of shares.

b) Equity financing

The local holding companies would be financed by equity (shareholders loans and typical equity) and external (bank) debt.
There would be no stamp tax on debt or equity financing in Hungary and Russia. In Poland, as a rule, equity financing is subject to a 0.5% tax on Civil Law transactions (hereafter "TCLT" - stamp tax equivalent). The TCLT does not apply to financing through premium. Loan agreements subject to TCLT are generally taxed at the 2% tax rate. However, loans granted to a company by its shareholders are exempt from TCLT. Further exceptions are also available. Thus, according to the most common interpretation, a loan which is granted from abroad is not subject to TCLT if the loan agreement was signed abroad and if the funds lent are deposited in a non-Polish bank account on the date of the loan.
In Hungary, Poland and Russia, thin capitalization rules basically provide for a debt/equity ratio of 3:1 (reference to capital). Hungarian rules are particularly strict in this respect. Indeed, thin capitalization rules cover any debt financing provided to a company (including bank loans). In Poland, thin capitalization rules only apply to direct shareholder's loans (and loans granted by sister companies). In Russia, thin capitalization rules apply to loans granted or secured by a foreign company owning directly or indirectly more than 20% of the borrower's capital. Excess interest is not tax deductible and it may be recharacterized as a constructive dividend. The Russian legislation allows full deductibility of interest expenses not subject to thin capitalization rules. However, the amount of deductible interest may not deviate by more than 20% from the average interest rate calculated on the basis of debt capital of a similar nature. The basis for comparison is limited to loans granted by resident companies. In the absence of such comparable loans, currently the Russian tax authorities accept an interest rate of 6.2% on loans denominated in a foreign currency. Under certain tax treaties (e.g. the tax treaty between France and Russia), thin capitalization rules do not apply (non-discrimination clause).
In Hungary and Poland, interest expenses constitute a tax deductible item while the Russian tax legislation remains unclear as to the method for deducting interest.
Hungary and Poland have implemented the EU Directives. Consequently, dividends and interest payments should be exempted. Nevertheless, in Poland, as far as interest is concerned, the implementation of the Directive is not yet completed. Therefore, until 2013, interest payments are subject to withholding tax. In Russia, dividends are subject to 5%, 10% or 15% withholding tax depending on applicable tax treaties. In Russia, there is no withholding tax on interest.

c) Purchase of shares in target companies

Target companies should be acquired by local acquisition vehicles (pure holding companies) held directly or indirectly (through HoldCo) by the French investor. Upon such acquisition of shares, the acquisition vehicles may be liable to local transfer taxes. In Russia and Hungary, no such transfer tax is applicable. In Poland, the sale of shares in a Polish company is subject to 1% transfer tax.

d) Tax consolidation

This phase aims at consolidating the interest incurred at the local SPVs' level and the operating profits generated by the target companies acquired.
Tax grouping is not available in Russia and in Hungary. As far as Poland is concerned, local regulations provide for a tax group concept, but that is actually very difficult to implement in practice.
Tax Consolidation may also be achieved through the conversion of the target companies into partnerships. In that case, in Poland and Russia, undistributed profits of the target company would be considered as a dividend payment (exempt from tax in Poland under the Parent-Subsidiary regime). In all three countries, interest expenses deduction would still be available after conversion.
Such conversion of the target company into a partnership would however not be feasible in Hungary.

Tax consolidation may alternatively be achieved by liquidating the target into its parent company.
This liquidation would however be a tax triggering event and would not be tax neutral. Thus, in Hungary, such liquidation would be taxable and the assets of the target company would be reevaluated up to their fair market value. In Russia, the debt would have to be repaid beforehand. Furthermore, in Poland and in Russia NOLs could not be carried forward any more.
In light of the above, it appears that the most convenient way to (tax) consolidate local acquisition vehicles and the target companies is to merge them. In Hungary, Poland and Russia, such a merger would be tax neutral. In this case, in Hungary and in Russia, the utilization of the target company's losses would still be possible whereas in Poland the target company's losses would not be available any more. In any case, interest expenses deduction would still be available (subject to thin capitalization rules) in all three countries. Though in practice, in Hungary the interest expenses deduction on acquisition financing may be challenged by local tax authorities.
Based on the above developments, it is reasonable to conclude that taxpayers do not face a whole new tax landscape, the main tax features of acquisition financing remaining mostly unchanged (though more strict in certain jurisdictions). This conclusion can definitely be applied to most Eastern European jurisdictions even though there may be currently more flexibility in certain of those countries in terms of acquisition financing, than in Western European countries where various anti-abuse rules have been enacted.

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Intangibles, a key source of growth

2010 was an important year for the transfer pricing aspects of intangibles. On 22 July 2010, the OECD released a major revision of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. The changes made to a number of chapters changes relate specifically to intangibles.

During the revision process, the need to clarify a number of issues regarding intangibles was recognized. This was identified as a key concern and the OECD therefore decided to launch a new initiative, inviting both interested parties and the Member States to provide comments on the scope of a potential project on the transfer pricing aspects of intangibles(1).
Accordingly, on 25 January 2011, the Committee on Fiscal Affairs approved the publication of a new document addressing the scope of the project in detail.
From the issues raised in the OECD programme of work for 2011, it is apparent that this area is extremely topical and delicate from both a theoretical and a practical perspective.
With this in mind, CMS practitioners decided to address various scenarios which can give rise to transfer pricing issues relating to intangibles (Part I) as well as the criteria that should be taken into account when choosing the most suitable location for an IP Holding Company (Part II).

Issues raised by intangibles for transfer pricing purposes

The CMS Annual Tax Conference was especially important given that in January the OECD had approved a project which is intended to provide clearer international guidance on specific issues relating to intangibles and to avoid uncertainty. The major issues identified as needing OECD work include:

- The framework for analysis of intangible-related transfer pricing issues,
- Definitional aspects not clearly addressed in the current Chapter VI and VIII of the guidelines,
- Specific categories of intangibles, including differentiation between intangible transfers and services, marketing intangibles, and other intangibles and business attributes,
- Cost contribution arrangements in cases where the costs and risks of developing, producing or obtaining intangibles are shared,
- Intangible transfers,
- Valuation, and
- Economic ownership of intangibles.

(1) As an example, see "comments on the scoping of OECD's future project on the transfer pricing aspects of intangibles from the CMS organization"

During the conference, CMS practitioners provided practical illustrations of issues they had encountered with respect to intangible transfers (a), valuation (b) and the concept of economic ownership (c).

a) Transfers of intangibles

The OECD identified transfers of intangibles as raising the issues of whether a transfer is considered to have taken place and what forms such a transfer may take, as well as recharacterisation issues. As an illustration, Angelika Thies described a particular type of transfer that is encountered in Germany.

The German case: the transfer of business functions

When it comes to intangibles in Germany, a particular issue that requires consideration is the transfer of business functions.
In 2008, Germany introduced tax legislation *(Funktionsverlagerung(2))* designed to tax the entire value of business functions which are developed in Germany but subsequently transferred to a group company outside Germany.

WHAT IS A FUNCTION?

In approaching with the transfer of business functions, one might first want to know what is considered a function for these purposes. This question is not clearly addressed in the German legislation, which provides broad definitions that are confusing and difficult to apply in actual cases. One definition of a function is given in an 81-page guidance document published by the tax administration in October 2010, but other legislative documents provide distinct descriptions.
Under the legislation, "a function is an organic part of an enterprise which does not qualify as a separate division of the enterprise for tax purposes". In practice, the tax administration tends to break down the function to the lowest level possible so that, depending on the nature of the business, even a single activity or product may be considered a function.

WHAT IS A TRANSFER, AND WHAT CAN IT INCLUDE?

The transfer a business function may obviously involve – although it is not limited to – the transfer of intangibles. The law describes the transfer of business function

(2) *Funktionsverlagerung*: section 1 paragraph 1 German Foreign Tax Act - *Außensteuergesetz*

as “including the opportunities and risks relating thereto, as well as the business assets transferred or leased in connection therewith or other advantages”. This is the general definition and it corresponds more or less to a specific aspect of a business such as production, R&D or sales. However it is always possible to break down the analysis a little further, for example by distinguishing between different types of sale as in the 2010 guidance document.

WHAT ABOUT DUPLICATION OF FUNCTIONS?
According to the tax administration, a duplication of functions can give rise to a transfer. Thus if a function is duplicated outside Germany, and the German function operates at a reduced level in the following five years, this will be treated as a relocation. The implication is that the principle will not apply where, for example, a factory is established outside Germany but no German plant is closed. The tax administration has indicated that the question of whether the German function is operating at a reduced level is to be addressed by reference to the turnover attributable to it. The 2010 guidelines have introduced an exemption, which applies where annual turnover falls by no more than the threshold of EUR 1 million.

b) Valuation
After identifying a particular type of transfer, the crucial issue of valuation should be discussed. In this regard, the OECD is seeking to provide clearer guidance on the selection of the appropriate method and on whether the valuation methods should include those used for non-tax purposes (financial valuation methods, aggregation of intangibles for valuation purposes, and valuations carried out at a time when the value is highly uncertain). Meanwhile, tax authorities sometimes adopt unexpected approaches that raise challenging transfer pricing issues and create uncertainty for taxpayers.

The valuation of the transfer package under German law relating to the transfer of business functions
It is important to note that the value of the relocated function is not based on the value of an individual asset, but on the total value of the entire function. This is usually referred to as a “transfer package”.
When dealing with intangible assets, it can be difficult or impossible to find comparables. As a result, the German tax administration has introduced the hypothetical arm’s length price as a new pricing category, to be used if an adequate transfer price cannot be determined by applying the standard transfer pricing methods.
To calculate the hypothetical arm’s length price of the assets, it is necessary to determine the range between the transferor’s minimum price and the transferee’s maximum price (assuming full information and an adequate interest rate). Within this range, if the price most likely to correspond to the arm’s length price cannot be readily assessed, the median value should be used.
The valuation is carried out on the basis of net profits, including any asset or benefit and any market advantages of the acquiring entity. As a consequence (and to the extent that it affects the transaction) the hypothetical arm’s length price takes goodwill into account.
Additionally, the law assumes that independent parties would have agreed on a one-time price adjustment clause, which would bite in the event of a major change in price. A clause of this kind, applicable for a ten-year period, will be deemed to apply unless it can be demonstrated that such clauses are not common as between independent parties in the relevant sector.
However, the relevant regulation limits the scope of the hypothetical arm’s length price so that valuation of individual assets will be allowed in cases where:
— Only single assets are transferred or leased,
— Only services are provided,
— The transaction does not fall to be treated as a transfer of a business function by an independent party,
— Only staff are transferred,
— The receiving entity is to perform the function only for the benefit of the transferring entity, and the remuneration is to be based on the cost-plus method,
— The intangible assets have a value less than 25% of the total value of all transferred assets (based on individual valuations),
— A relevant intangible asset forming part of the transfer package can be clearly distinguished and is exactly defined. “Relevant” means that the value of the asset is at least 25% of the total value of all single assets transferred (based on individual valuations).

As a result, overall valuation of the transfer package can be avoided if one of the (fairly numerous) conditions for exemption is met. The intangible asset in question may then be valued on a single asset basis, using a standard valuation method. Needless to say, this process must be properly documented.
Finally, the German regulation on the transfer of business functions may conflict with many double tax treaties and with European Union (EU) law, as, for example, there is a risk of double taxation. Therefore, the relatively new law on relocation of functions will be subject to further interpretation and should be monitored by German taxpayers and their advisers.

The French case: valuation for the purposes of determining a royalty rate(3)
The case detailed below illustrates valuation issues encountered in a French action.

THE FACTS
A French group called ABC acquired a foreign group, DEF, which owned a prominent international brand. Following the acquisition the parent company decided to rebrand some of its activities using the DEF brand.
The French company bore the cost of the rebranding process in part, but not in full as some of the marketing

(3) Presented by Arnaud Le Boulanger

costs were borne by the foreign company which owned the knowledge and know-how.
In order to use the DEF brand, the French company concluded a “brand licence agreement” with DEF, its legal owner. In addition to the right to use the brand, the licence gave ABC the benefit of DEF’s foreign marketing expertise and know-how, and of the advice this enabled DEF to provide with a view to maximizing the impact of the rebranding exercise. Accordingly, the French company had to pay a minimal royalty fee (less than 2%) to DEF.
At the point of its acquisition by ABC, DEF had already entered into agreements of this type with various other parties, some related, some absolutely unrelated, and some practically unrelated. This latter category consisted of companies which were controlled by either ABC or DEF, but which had constitutional restrictions under which certain decisions could not be made unless (i) shareholders were unanimous, or (ii) a specific proportion of votes was achieved (with neither ABC nor DEF having sufficient voting rights for this purpose).
The need to persuade minority shareholders to approve the transaction meant that the negotiation was at arm’s length when viewed from an economic perspective, even though from a legal perspective the licensor and licensee could be regarded as related parties.

THE DETERMINATION OF THE ROYALTY RATE

The determination of the royalty rate was based on a complex economic model. This had not been devised purely for tax purposes, and in fact the group intended to enter into royalty agreements with unrelated and practically unrelated parties. The nature of these transactions was therefore such that they were concluded at arm’s length.
The model was primarily based on a profit split method. The added value the DEF brand could bring to the licensee was assessed and then split between licensee and licensor. A number of criteria were used to determine the split. These included various measures of the parties’ respective bargaining power, and whether it was possible to capture the brand’s potential added value.
A Comparable Uncontrolled Price (CUP) method was also used, under which there was direct reference to comparable uncontrolled price royalty rates which had been applied to transactions between unrelated parties. This was used as a supporting method to verify that the intended rate satisfied the arm’s length principle. Reliable data was available for this purpose, since DEF had already granted licences of exactly the same type to unrelated parties in various countries. Accordingly, there was a relatively robust basis for the determination.

DISPUTE WITH THE TAX ADMINISTRATION

A tax audit took place in France a few years later. This was restricted to a certain number of years under a statute of limitation.
In a first attempt to adjust the companies’ results, the French tax administration (FTA) issued a reassessment notice based solely on the brand transfer. The FTA accepted in writing that the model had been suitable and that it had been appropriate to use the profit split method, stating that the CUP method was not robust enough to be used on its own. However, it disputed the royalty rate. In so doing it challenged almost all the variables on which the profit split had been based, resulting in a different split and thus a different royalty rate. The FTA provided quite a detailed economic analysis in support of position. It relied not only on information which the taxpayer, as a listed company, had made public, but also on external standards and material which did not always have a clear objective rationale.
One of these was the so-called “rule of thumb”. This derives from the judgment of a US tax court in the thirties, where a judge held that under a licence agreement, as a rule of thumb (or in other words a kind of reasonable guess), 75% of the profits should be retained by the licensee, and 25% should go to the licensor. Although this hypothesis was purely speculative, a significant part of the tax administration’s analysis revolved around the rule, which it believed to be based on economic reasoning.
The FTA also refused to accept the CUP method, stating that there were no comparable situations or markets.
The company had such strong grounds for challenging the FTA’s position that it had no choice but to abandon its first attack.
In spite of this, it decided to issue a revised reassessment notice based on a totally different approach.
One of the arguments the FTA used was that the DEF brand had no value in France, and consequently there had never been any basis for royalties to be paid.
The underlying reasoning was that the replaced brand had had significant value and the taxpayer had not demonstrated that the new brand had brought any value into the French market. The challenge was therefore to the principle of royalty payments and not the royalty rate.
Again, the taxpayer had strong counter-arguments.
To mention only one, net profit in France had increased very significantly after the rebranding exercise, making it unreasonable for the administration to claim that the brand had no value.
This example shows how valuation can be approached differently by taxpayers and tax administrations, meaning that the taxpayer may need to produce very detailed economic analyses in order to defend itself against the administration. The taxpayer may also have the difficulty of facing an analysis by the tax administration which appears to be based on extensive and objective (since external) data, but which is actually invalid because the data has been misused. The sheer volume of data requiring analysis, and the sheer number of false claims, means that it is not always easy to show how wrong the tax administration’s position is. In this particular French case, valuation was not the only issue raised.

c) The concept of economic ownership

The question of economic ownership is of particular importance when it comes to the transfer pricing aspects of intangibles. Indeed, this issue is among those identified

for the OECD programme of work for 2011. The OECD intends to provide guidance on the position where an enterprise is entitled to share in the return from an intangible it does not legally own.
Although there is no legal basis for this concept in French law, in the case in question the FTA relied on ABC's economic ownership of the DEF brand within the French market as a basis for adjusting the company's results. The brand was in fact sold to a related company located in the same foreign country as the previous owner. The capital gain resulting from the sale was significant. The FTA claimed that a substantial part of the capital gain was taxable in France because the French company "was the economic owner of the brand, as it had developed the associated brand awareness in the French market". Completely overlooking the inconsistency this involved, and showing a serious misunderstanding of the actual facts (including what entity had borne marketing costs relating to the brand, and in what amount), the administration issued another massive reassessment notice.
Although the matter is not yet resolved, it is possible to make several interesting comments at this stage. If, in spite of the lack of any legal basis, the FTA is prepared to use economic ownership as the sole basis for determining where value is located, it could become relatively easy for a French taxpayer to move IP out of France. This could be done simply by moving the "economic" ownership.
From a practical standpoint, the case underlines the importance of sophisticated and complex economic analyses as the best defence against irrational attacks motivated by the amounts at stake. It also emphasizes the lack of any clear methodology for determining the existence and value of intangibles. The notion of economic ownership of an intangible, amongst other issues, is a delicate topic that will clearly need to be addressed in the foreseeable future.

Choosing the best location for an intellectual property (IP) holding company

Irrespective of the difficulties already described, when dealing with tax planning in relation to intellectual property, multinational groups will often, if not always, take steps to maximize the benefit of their intangible assets. From this perspective, and to the extent that companies are able to centralize ownership and control of the group's intellectual property, consideration needs to be given as to the most appropriate legal structure for ensuring ongoing benefits in terms of both tax and transfer pricing. Such structures, whose value is primarily constituted of intangible assets, are often referred to as Intellectual Property Holding Companies ('IPHC' or 'IP HoldCo').

Three working examples, provided by Nick Foster-Taylor (CMS Cameron McKenna, London), Tamás Fehér (CMS Cameron McKenna, Budapest) and Agnieszka Wierzbicka (CMS Cameron McKenna, Warsaw), identify the criteria to be taken into account in choosing the best location for a HoldCo.

a) The UK case

The first case involved a multinational group based in the UK that already had significant IP ownership and substance in other jurisdictions, specifically in the United States and in Belgium. Historically the group's strategy had been to acquire businesses in local jurisdiction in order to provide them with footprint, staff, brands and manufacturing capacity. However, those locations had different tax structures and the organic growth had not generally been integrated into an overall tax plan. It had subsequently been determined that the group needed to establish a clear IP strategy. And this would also be a good opportunity to positively influence their global tax position using the valuable intangibles owned by the group.
Several criteria were used in order to decide where the IPHC would be located, addressing a number of different commercial and logistic issues. In the first instance the primary driver was to maximize the effective tax rate management, addressing the immediate and long-term cash and tax costs and benefits that would result from the IPHC structure. A critical factor in this instance was the potential one-off tax cost of transferring key IP into the IPHC, and the extent to which ongoing inbound royalty revenue to the IPHC could be sheltered. (For TP purposes, any movement of an IP asset or an intangible generally needs to be remunerated at an arm's length rate and a capital gain will usually be generated in the jurisdiction selling the intangible.)
The combination of enduring tax losses in the target IPHC jurisdiction, and the potential to ultimately offset any capital gain on transfer of the existing IP against anticipated capital losses in the legal entity selling that asset, meant that the tax cash position on establishing the IPHC was extremely attractive to the group.
Another significant aspect of the choice of jurisdiction is the issue of the legal protection of the IP in question. It is often an area which is marginalised in the process of tax and transfer pricing planning. Typically, an off-the shelf IPHC structure will concentrate on jurisdictions that are low tax, but the intricacies of legal protection of different types of intellectual property should not be neglected. There have been cases where clients have anticipated establishing their HoldCo in a typical low tax jurisdiction before realizing that they would have significantly reduced rights in contesting infringement, and the commercial risk ultimately negated any potential tax benefit.
Underwriting any IPHC structure and minimizing the risks of tax authorities contesting the basis of any tax planning exercise of this kind is critical. With this in mind, the implementation of Advanced Pricing Agreement (APA)

procedures is extremely attractive when considering the location of the IPHC. With more consistency on a European and global basis for bilateral and multinational agreements, choosing an IPHC location which has prescribed APA methods is always attractive.
Finally, an increasingly important element in IPHC location is the perception of the external market to any asset offshoring, highlighted by ongoing vehement criticism in the US of multinationals exporting key intangible assets to so-called tax 'havens'. Given this type of scrutiny, any IP management exercise that has a high-profile impact should be analyzed and managed accordingly.
In this instance, to offer a combination of business substance and long-term tax cash benefit, and to satisfy commercial and regulatory requirements in relation to the group's IP, the location chosen for the IPHC was Belgium. The use of an apparently unusual jurisdiction in this exercise is a good example of how only detailed analysis of all current and future tax and business influences in each individual case will result in the most effective IPHC structure.

b) The Hungarian case

Tamás Fehér, of CMS Cameron McKenna's Budapest office, also presented criteria that might be taken into account when choosing a suitable jurisdiction for an IP holding company.
The first issue to be considered is the corporate tax rate. In Hungary, the rate is quite peculiar as it is progressive. The lowest tax rate is 10% and the highest is 19%.
Then comes the issue of whether IP purchases or transfers are tax deductible. In Hungary, where intellectual property and royalties are concerned, 50% of gross royalty income is deductible from the tax base.
Another point which should not be overlooked is that there is an unlimited tax loss carry forward regime, so that where a company uses tax losses or generates tax losses in any given year (observing the anti-avoidance rules) that company can carry those losses forward indefinitely.
Another key factor is whether or not withholding tax applies on royalties. In Hungary, there is actually no withholding tax on outbound royalty, interest and dividend payments, as long as these are paid to non-individuals. This applies irrespective of the jurisdiction of receipt, which may be within or outside the EU, and may be a high or low tax jurisdiction.
Enhanced tax deductibility of R&D costs and deductibility of subcontracted R&D are also factors to be taken into account. In Hungary there are generous R&D incentives, and these extend to subcontracted R&D. Under this regime, it is possible to deduct 200% of the direct R&D costs from the tax base. The scope for optimizing the tax position is enhanced by the fact that, as long as the HoldCo does not subcontract its R&D activities to another Hungarian entity (which would be able to benefit from the same deduction) subcontracted R&D costs may be deducted in the same way.
Anti-avoidance legislation is another matter to be considered. Such legislation is especially relevant to the question of whether costs are tax deductible.
This needs to be looked at carefully because there is a general provision under which costs which are not associated with the business activities are not deductible. This rule is very often used – and sometimes misused – by the Hungarian tax administration as a basis for carrying out reassessments.
In light of the above, Hungary might initially appear to be an "idyllic location" for establishing an IPHC. However, Tamás Fehér's view is that Hungary's rapidly changing tax laws present a major problem. To a certain extent it is true to say that such changes are commonplace in many other countries, but in Hungary it is possible for very fundamental changes to occur over very short periods of time. This, combined with an uncertain political climate and the potential for other unforeseen changes, reduces Hungary's attractiveness as an IPHC location.
One effective way to mitigate some of these risks could be to apply for a binding ruling or APA (as the case may be) both of which are available in Hungary. Although these options are somewhat costly, when used correctly they offer a reasonable level of certainty with regard to future taxes (in the case of a binding ruling), or arm's length prices (in the case of an APA). This of course is subject to any changes in the law.
In conclusion, when choosing a location for an IPHC many criteria need to be scrutinized, and it is of the utmost importance to be aware of all the consequences of the choice. This is clearly illustrated by the following case.

c) The Polish case

It is always crucial to be aware of the law in force in the jurisdiction in which you are planning to acquire or sell a business. This factor can dictate the success or failure of a transaction.
To illustrate this statement, Agnieszka Wierzbicka presented a Polish example that took place a few years ago.
The case concerned a client which was selling a business in Poland. The business involved was in fact a branch consisting mainly of intangible rights (a product brand). The seller and buyer entered into negotiations and agreed that the branch would be sold without its debts.
The price proposed was EUR 50 million. It seemed possible to regard the branch as the organized part of an enterprise, since it had its own customers, employees, suppliers, contracts, assets, IP rights etc.
Nevertheless, as the debts were not to be transferred the parties decided to ask the tax authorities whether the subject-matter of the transfer was to be considered as part of an enterprise. Surprisingly, the tax administration determined that only assets that were being transferred, and not a part of an enterprise.
This issue is of crucial importance in Poland, since transaction tax does not apply where VAT is payable, but does apply to a transfer of part of an enterprise which is not subject to VAT.
Accordingly, the tax authority's ruling fundamentally

changed the transaction, and the price increased from EUR 50 million to EUR 50 million plus EUR 11 million in VAT (instead of EUR 1 million in transaction tax), because the transaction was viewed as a sale of assets. Finally, special consideration should be given to the timing of the application for a ruling. In fact, in Poland this leads to different types of protection. On the one hand, if the application is made before the transaction, and therefore before any tax consequences have occurred, the applicant is fully exempt from paying any tax which would otherwise arise from the factual situation covered by the ruling. This is the fullest protection which can be achieved. On the other hand, if the ruling is obtained after the transaction, the applicant is only protected from fiscal penalties, and the tax itself will remain payable.

In conclusion, there are significant and complex issues surrounding the value and impact of intangibles on any given business, and this has made them a priority for multinationals as well as tax authorities worldwide. The aim of this article, and above all the conference to which it relates, was to present concrete and practical examples of the different problems that may arise in relation to intangibles. For the time being, a major conclusion that might be drawn is that in order to achieve effective tax and asset management, dealing appropriately with intangibles, a multi-jurisdictional, technical and cultural approach is key.
This crucial subject remains delicate, and until clear guidance is given both taxpayers and tax advisors should be sure to give it particular attention.

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Improved relations with tax authorities vs. criminalisation of tax law (the carrot & the stick…)

Until recently, the relations between taxpayers and the tax administrations often followed a traditional pattern:

— Taxpayers were expected to comply with their tax obligations by filing tax returns, and there was limited possibility to ask questions to the tax administration at such stage,

— Non compliance issues were usually addressed through tax reassessments and tax audits and in some cases administrative penalties were applied,

— The consequences of this have been distrust and defiance between taxpayers and the tax administration.

But things have changed in some jurisdictions, are changing or are about to change in others.

In many countries, improved interactions with taxpayers in the process of the creation of tax law have been introduced. In the **United Kingdom** for instance, where the relation was traditionally based on defiance, it now is based much more on co-operation on both parts. Tax authorities seek public comments on the elaboration of the law, or before the modification of the law, and taxpayer disclosure has become more usual. Interactions between the tax authorities and the taxpayers in everyday life (both formal and informal) have become more usual.

The other noticeable evolution is that in a number of jurisdictions more effective prior ruling procedures have been introduced, particularly in fields where legal uncertainty was high due to technical complexity like transfer pricing for instance. As for creation of tax law, the interpretation of tax law is becoming more cooperative, tax administrations are more open to answer taxpayer questions before setting up complex operations or just filing tax returns.

And in the most advanced jurisdictions, tax control processes are now being implemented through a cooperative framework between taxpayer and tax administration. Taxpayers are taking on commitments to introduce internal tax compliance procedures which are in a form approved by the tax administration, like in the Tax Control Framework system introduced in the Netherlands in which in return taxpayers get a less burdensome and more trustworthy relationship with the tax administration.

All those innovations and evolutions are changing the traditional relationship between taxpayers and tax administrations. Tax administrations adopted more user friendly policies that led them to distinguish between taxpayers who are willing to comply with their tax obligations and taxpayers who are more reluctant to disclose their situation and are taking more risks in this respect. In **Germany**, this leads to a change in ethics. Taxpayers tend to have a greater sense of responsibility. They now often disregard the most aggressive tax planning and tend to consider that criminalising tax non-compliance is more acceptable than it used to be.

The use of criminal procedures in the fight against tax fraud is nothing new in most jurisdictions. It is more developed in some jurisdictions than in others, but most tax administrations have recourse to criminal penalties, at least in the most obvious cases of tax fraud. In **Italy**, the application of criminal laws for tax purposes has been the case for several years: however, the use of criminal procedures depends not only on the type of operations but also very much on the amount involved (i.e. not only fraudulent matters). What is new however is the trend that it is common in more and more jurisdictions to use criminal procedures much more frequently.

There are several factors that could explain this new trend:

— The emphasis put on the fight against international tax fraud at the political level (OECD, G20 initiatives…),

— Increased transparency due to the multiplication of exchange of information agreements with low tax jurisdictions,

— But also the fact that more frequent recourse to criminal procedures is for tax administrations closely related to their more taxpayer friendly approach. Tax administrations will be nicer to taxpayers who disclose their situation but will use tougher procedures to fight against potential tax fraud. The stick used by tax administrations is the other side of the coin.

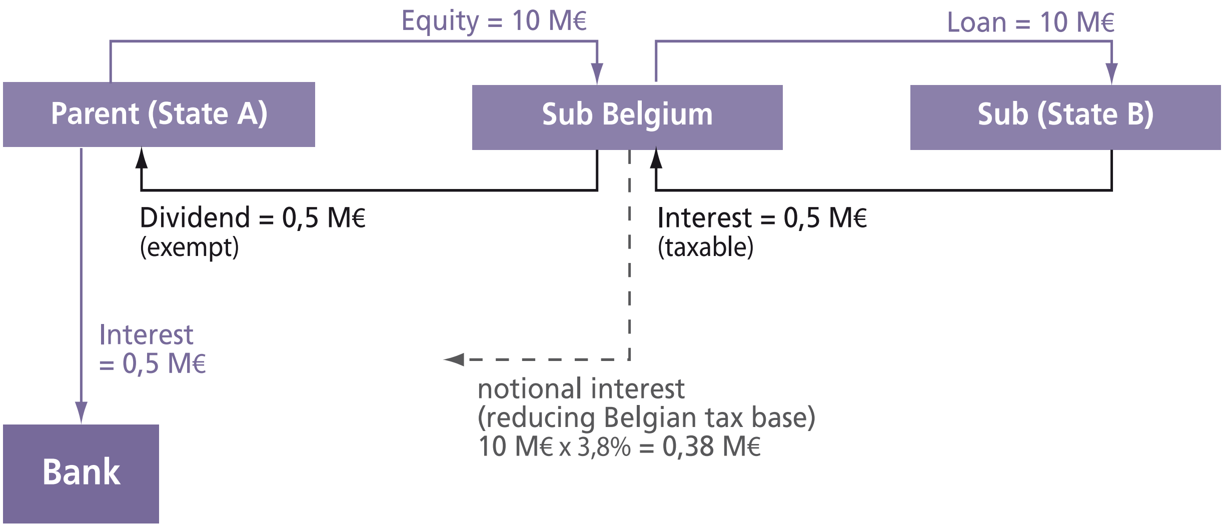
Disclosure of a financing operation

In some countries, there is an obligation to disclose arrangements/transactions (the UK appears to be the only jurisdiction where this is compulsory for all taxpayers), while in others this might be desirable to avoid recharacterisation and/or penalties.

When not compulsory, the taxpayers may have the option of disclosing certain tax planning. Let us consider the position where use is made of the Belgian notional interest regime.

On the face of it, this financing structure does not create a tax advantage because the interest paid by Sub B

is deductible in State B but taxable in Belgium and the dividend exempted in State A is not deductible in Belgium.
But the Belgian notional interest regime makes it possible to deduct a "notional interest" allowing an unusual deduction (related to the equity contribution in the Belgian subsidiary) that is advantageous to the group.
The advantage arises in that the use of the Belgian finance company allows deductions in both State A and State B for the same economic expense – a kind of "double dip".



This example is only used to illustrate tax planning that may or may not lead to disclosure.

In the **UK**, a statutory regime for the disclosure of tax avoidance schemes (DOTAS) applies. The promoter (and, in certain circumstances, the user) of a prescribed tax avoidance scheme must notify HMRC of the existence of the scheme and any subsequent use. A scheme must be disclosed when one or more hallmarks are met (which are typical of commoditised rather than bespoke tax planning) including confidentiality from competitors and/or a premium fee or otherwise off-market terms. It is remarkable that the disclosure rules are tighter when the client pays a success fee or double fees.
Experience shows that these disclosure rules have given HMRC advance notice of numerous tax planning products. For tax administration, these rules are seen as a means to save large amounts of money in respect of tax audits, but also as a way to change the legislation more quickly. Moreover, large businesses will now be appointed a "customer relationship manager" normally a dedicated HMRC officer to act as a liaison point for HMRC. His or her role will be to encourage early disclosure and discussion of tax aggressive strategies.
UK banking businesses are also likely to be signatories of the so called voluntary 'banking code of conduct' which imposes restrictions on a bank's ability to employ and/or promote to its customers certain tax avoidance strategies.
There is also a non-statutory clearance procedure available in most situations to obtain binding tax rulings on areas of genuine interpretative difficulty and commercial importance.

In **France**, as in most jurisdictions, taxpayers have no obligation to declare their schemes: they have the opportunity to ask the French tax administration to agree the tax treatment of these schemes (in certain prescribed circumstances, if the tax administration does not answer within 6 months, then the abuse of law procedure cannot be applied).
There have been several attempts to introduce a disclosure obligation in French law. First draft legislation was considered in 2005 but was removed before being discussed in Parliament. But such legislation is still under consideration by the tax administration and has not been ruled out by the Parliament (an October 2010 parliamentary report on tax loopholes/shelters includes it among other proposals). The 2005 draft legislation was removed when taxpayers argued that disclosure rules were not necessary due to the existence of an abuse of law procedure. But in the UK, the disclosure regime now co-exists with a willingness of the courts to counteract tax avoidance on abuse of law or equivalent principles (especially in VAT) so it is reasonable to think that disclosure rules may, in the future, be imaginable in France.

In **the Netherlands**, there is no obligation to disclose. But, on a voluntary basis, a corporate taxpayer can enter into a Tax Control Framework (TCF) agreement with the tax authorities.
A TCF agreement is based on and assumes trust on both sides. Under a TCF agreement, the taxpayer benefits from a 'lighter' supervision of the tax authorities, e.g. less stringent and frequent tax audits. In exchange, the tax payer needs to (i) have in place a tax control framework, safeguarding the correct tax application, and (ii) disclose to the tax authorities a potentially controversial tax issue.
In other words, under a TCF agreement there may be an obligation to disclose a tax scheme.

Quite a number of Dutch large tax payers have concluded a TCF agreement with the Dutch tax administration. A TCF agreement provides more certainty, it often enhances the relationship with the tax administration, it means less burdensome tax audits and more swift answers from the tax authorities in case of questions or issues put forward to the tax administration. There are no plans to introduce obligatory disclosure rules in the Netherlands.

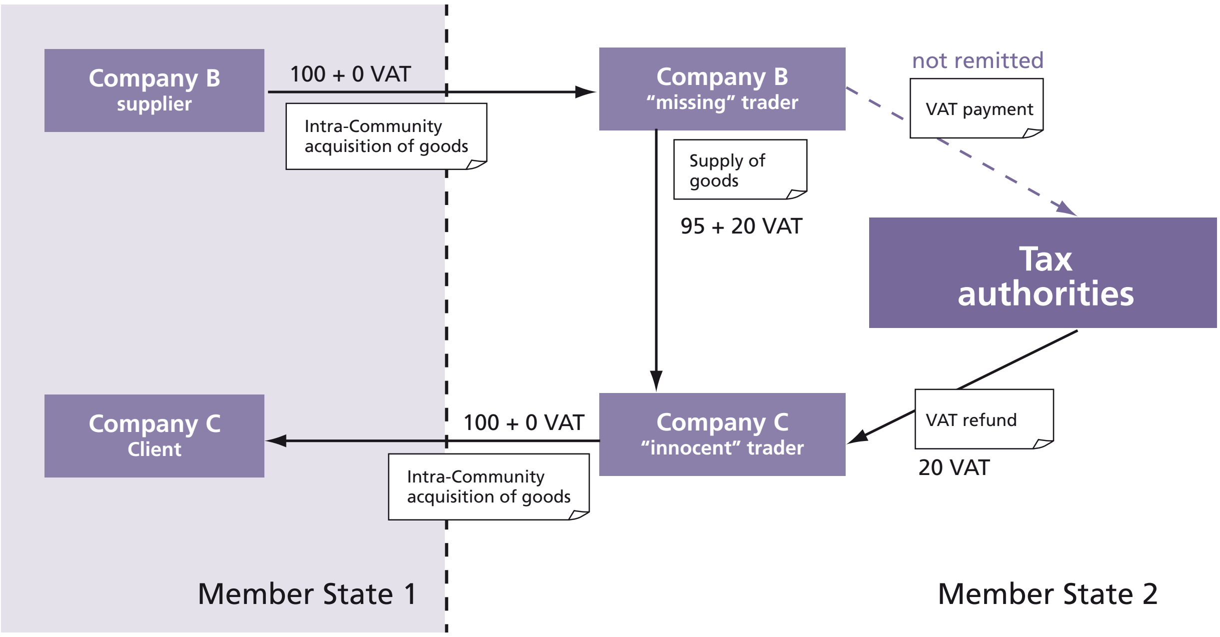
In **Germany**, no rule explicitly demands disclosure of tax avoidance schemes (such legislation was considered in 2008, but not introduced). Tax authorities may find a tax planning scheme to be "misuse of tax planning options" in respect of the underlying economic purpose: they can then apply "appropriate" rules instead. Misuse of tax planning options is not criminal, concealing facts which constitute a misuse may be.
The taxpayer may request a binding statement from the tax authorities on taxation of prospective schemes, unless the only purpose is to determine if a scheme will be considered criminal or not. The issuance of a binding ruling is subject to the discretion of the tax authorities; the taxpayer does not have a legal claim and may decide whether or not to proceed with the envisaged transaction. In a way, large German companies are in a situation that is similar to that of the Netherlands companies under the TCF or the UK companies with the "customer relationship manager". Large German companies have standing audits, which allows a good discussion with the auditors. This is a way to clear schemes that are not too aggressive: the position of the auditor is not binding but will have, say, 95% of chances to survive the next tax audit.

In **Italy**, the taxpayer may request a preliminary opinion (tax ruling) from the tax administration in order to clarify if a certain arrangement/transaction could fall within the anti-avoidance rule or could constitute an abuse of law. The tax ruling is not mandatory and in certain circumstances, if the tax administration does not answer, the applicable tax treatment will be the one proposed by the taxpayer. If the tax ruling admits that the transaction/operation does not fall within the anti-avoidance rule or does not constitute an abuse of law, the risk of assessment, and consequent application of penalties, can be excluded. If, on the contrary, the ruling pretends that the transaction/operation falls within the anti-avoidance rule or constitutes an abuse of law, the taxpayer could disregard the ruling and accept the risks of the assessment: in that case, the risk of assessment is almost impossible to avoid, but there will be a discussion in front of the Tax Court, with the chance of a favourable decision. Taxpayers will be more reluctant when there is a risk of criminal procedure.

In **Belgium, Hungary or Spain**, there is usually no obligation to report tax schemes, but taxpayers can report on a voluntary basis (ruling request).
In Belgium, a ruling can clarify the possible application of the anti-avoidance rule or recharacterisation for tax purposes in case of an abuse of law (tax authorities are bound by the ruling decision for a maximum of 5 financial years) but cannot relate to the application of tax laws on transactions already implemented / carried out. It can only be used by the taxpayer who has requested it, but they are generally published by extract on an anonymous basis.
In Hungary, a ruling is possible if the taxpayer describes the planned transaction in detail (also giving names of the parties involved) and requests confirmation of the tax treatment from the Ministry of Finance. It is only used for larger transactions, as the official fee payable is around EUR 28,500.
In Spain, although customary practice is that most (if not all) tax ruling requests are answered, the fact is that there is no provision establishing the obligation of the Spanish Tax Administration to answer a tax ruling request, nor is there a specific deadline by which the STA must compulsorily deal with the request.

Risk of criminal procedure rather than tax

Companies might be engaged in operations that could lead to a criminal procedure. This can happen even if the company or its directors are not themselves to be blamed for a fraud.
"Carousel fraud" is a usual case for use of criminal law and a case in which an "innocent" trader might be liable for tax liabilities of another (the "missing" trader). Here is an example (in practice, schemes can be much more complicated).
In a carousel fraud, a company is not remitting the VAT to tax authorities. Tax authorities will not immediately detect the fraud because company B (the "missing" trader) does not deduct any input VAT and because it is difficult to follow the movements of goods.
When tax authorities detect the fraud, the "missing" trader (company B) will typically have disappeared.
So tax authorities will try to have company A (supplier) bear the risk of tax recovery (+ late interest payments and additional penalties) by denying the exemption on the Intra-Community acquisition. They may also try to have company C ("innocent" trader) bear that risk, by denying the deduction of input VAT, or joint responsibility for the payment of the tax not remitted by the "missing" trader.
A criminal suit might also follow. Although the innocent trader has not participated in a criminal act, tax authorities may seek to show that this taxpayer is not that "innocent" and knew (or should have known) the fraud.
As far as criminal prosecution is concerned, there are various practices: the criminal suit may be automatic or not. The criminal liability can be a personal liability (of the company's representatives) or a corporate liability.
Criminal prosecution could occur in the same procedure as the tax recovery or in a separate one.



In **France**, the tax authorities have a legal obligation to refer any crime or misdemeanour (such as tax fraud or swindling) to the prosecutor who then decides whether or not to refer the case to the criminal judge. In tax fraud cases, the tax administration needs to place a complaint (which requires the assent of a special Commission, the Commission des infractions fiscales); otherwise the prosecutor cannot refer the case.
Corporate and personal liability might be engaged on criminal grounds. In carousel fraud cases, personal criminal liability is very common.
Tax and criminal procedures are separate and parallel.
As regards carousel fraud, the result of a criminal and of a tax procedure is practically based on the same criterion (the taxpayer knew or should have known that he participated in a VAT fraud) but practice shows that the criminal judge (who generally rules first) may decide that a taxpayer has not committed any criminal offence, while the tax judge, informed of this decision, may consider that there is room for a tax reassessment.

In the **UK**, suspected cases of tax fraud may be pursued under civil (tax) and/or criminal codes. Choice is normally in the hands of the tax authorities who have no obligation to follow criminal procedures.
HMRC tends to deal with suspected tax fraud via its cost effective civil procedures where possible (burden of proof on tax administration is also lower) although it may reserve the right to conduct a criminal investigation. Carousel fraud however is usually dealt with via a criminal prosecution.
Criminal charges are pursued by the Revenue and Customs Prosecutions Office, part of the Crown Prosecution Service (independent from the tax administration). Criminal prosecutors have extended powers of search, arrest etc.

In **Germany**, as far as tax fraud is concerned, special forces within the tax administration decide to pursue a criminal case or not. If there is initial suspicion of a tax crime, the tax authorities are forced to investigate on criminal grounds.
Tax and criminal procedures are legally separated, but both will be carried out by the tax authorities in the first phase (in such a case, tax auditors will let the tax fraud auditors take the lead, which causes more pressure). Financial and criminal Courts are independent and may rule differently in the same case.
Tax crimes can be committed by individuals only. There is no criminal liability for companies. They can only be subject to fines in administrative procedures.

In **Italy**, tax authorities have the obligation to refer any fact that could potentially constitute an infringement of the tax criminal law to the prosecutor who then decides whether or not to refer the case to the criminal judge. For VAT purposes, the infringement of the tax criminal law occurs in case of: (i) utilization of invoices that relate to non-existent transactions, (ii) amounts of tax involved above certain thresholds.
The liability of the company may be criminal only in very serious cases: in particular, when the judge considers that a crime is committed against the state. Criminal procedure against a director would be more common.
Tax and criminal procedures are parallel and independent: the different burden of proofs required in the tax and in the criminal procedures might also lead to different decisions (e.g., sentence in the tax procedure and acquittal in the criminal procedure, or vice versa).

In **the Netherlands**, a taxpayer generally does not suffer from uncollectible taxes if another entity commits fraud; the tax authorities will (need to) try to collect the tax from the "missing" trader.
In case of fraud, the case may become a criminal case, depending on the amounts involved and various other criteria. In practice, criminal prosecution usually is limited to serious fraud cases or situations involving public persons (for

example, an internationally well known football trainer). A criminal case can be against the entity as well as an individual involved; usually it is only against individuals, i.e. decision makers and persons actively engaged in the fraudulent actions.

In **Spain**, tax authorities have an obligation to refer to the criminal authorities (prosecutor or criminal judge) any potential crime as soon as they become aware of it. Due to the vague definition of tax crime, in practice, a tax infringement must amount to at least EUR 120,000 of unpaid tax (per tax and per year) to be reported to the prosecutor.
Criminal liability can apply to the company itself based on new legislation. From the moment the tax file is referred to the criminal authorities, the tax administrative procedure must stop, but if criminal authorities do not find the existence of a tax criminal offence, then the tax (administrative) procedure can be reopened.
Tax authorities are using more and more anti tax crime rules referring many files to criminal courts (but most of them are rejected).

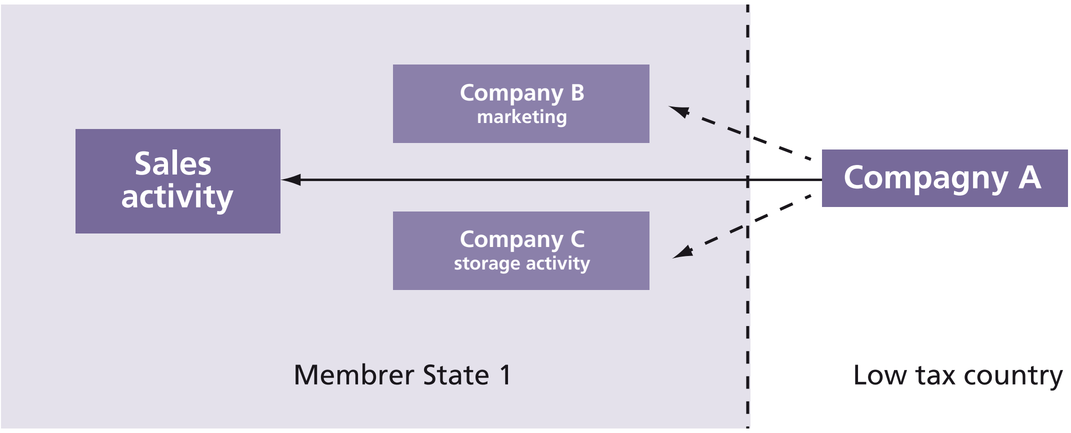
In **Belgium**, the tax authorities can refer any crime or misdemeanour (such as tax fraud or tax evasion) to the prosecutor who then decides whether or not to refer the case to the criminal judge. Corporate and personal liability might be engaged on criminal grounds.
Tax/civil courts are held by the decision of the criminal courts; different procedures cannot lead to contradictory decisions.

In **Hungary**, criminal liability applies only to private individuals; however companies may be subject to criminal sanctions in a case where they benefited from a crime committed by their director.

Complex operations and liability of directors

Can liability of directors be involved when the tax authorities argue that a company resident in a low tax country has a PE locally?
A company resident in a low tax country will try to have most of the margin generated by an operation in its own country. It therefore may resort to local agents to help with, for example, storage and other auxiliary operations or sales and marketing.
If such local agent is an independent agent, it does not constitute a PE of the foreign company provided the agent acts in the ordinary course of its business. Otherwise, there may be a PE.

Investment scheme:



a) Can tax liability be aimed at directors of Company A?
In **France**, any person considered to be managing the company can be held liable for the payment of tax but only in case of fraudulent acts or serious and repeated failure to fulfil tax requirements.

In **Germany**, statutory directors of companies, foreign or domestic, are liable for taxes owed by the company, if those taxes are lost through gross negligence of the directors in respect of their fiscal reporting duties or by a committed tax fraud.
In **the Netherlands**, a statutory director is not personally liable for unpaid CIT. But he can be held liable for unpaid wage tax (and VAT); it is generally very difficult to avoid such liability, even in case he did not have any knowledge or involvement. This is also true for a PE manager.

In **Italy**, the director cannot be held liable for the payment of tax (nor for related penalties).

In the **UK**, generally speaking an understated UK tax liability remains the liability of the taxpayer company, subject to any offence committed or civil liability imposed on the directors. However, the UK corporation tax liability of a non-UK incorporated company may be recovered from an officer of the company (who has a corresponding right of indemnity). Where a penalty is payable by a company for a deliberate inaccuracy in a return or other document relating to tax for which an officer was responsible, HMRC may pursue the officer for such portion of the penalty (up to 100%) as it determines.

In **Belgium**, as a general rule, directors are responsible for the performance of their duties and are individually liable to the company for any shortcoming.
In case of company bankruptcy, a special liability rule applies if it is established that a manifestly serious mistake has contributed to the company bankruptcy (e.g. by a director or person who had authority to manage the company).
Any person considered to be managing the company can be held liable for the payment of VAT (and the professional withholding tax) in case of failure to pay the tax.
Under certain conditions (mainly, in case of "cash companies"), any shareholder of a Belgian company who holds at least 33% of the shares and sells at least 75% of his shares within a period of one year could be liable for the taxes owed by the company.

b) Can criminal liability be aimed at directors?
In **France**, the tax administration was traditionally reluctant to report tax fraud cases to the prosecutor. It usually applied to very obvious cases of tax fraud, like individuals having a business but failing to file tax returns.
Recently, the tax administration tends to threaten with criminal prosecution not only in case of simple operations but also in more complex issues, like the existence of a PE.

In **Italy**, if on the basis of certain elements the Italian tax authorities argue that Company A has a PE in Italy and criminal laws were infringed, they are obliged to refer the case to the prosecutor. The prosecutor then decides whether or not to refer the case to the judge.
Personal liability of directors, foreign or domestic, might be engaged on criminal grounds.

In **Germany**, criminal liability of a director requires that he has himself knowledge of a wrong tax return being filed on behalf of the company. PE managers, if not statutory directors, may be subject to criminal charges, only if they file wrong or incomplete tax returns on behalf of the company.

In **the Netherlands**, criminal liability of a director is not really imaginable, unless he has actively been involved in seriously wrong tax reporting.
Criminal liability of a person actively involved in the Netherlands in the wrong tax reporting is possible and imaginable, but not very likely to happen in practice.
More importantly, a person involved in wrong tax reporting is liable to fines in the same way as the taxpayer; for example tax advisors preparing tax returns; this stems from new legislation, which may play an important role in future.

In the **UK**, criminal liability can be imposed for tax fraud. There is a statutory offence of VAT evasion, with penalties of a fine of the statutory maximum or three times the amount of the VAT (whichever is the greater) or imprisonment for a term not exceeding 6 months or both or a fine of any amount or imprisonment for a term not exceeding 7 years or both.
Criminal liability does not apply to companies but to individuals only.

In the **UK**, in case of criminal conviction, there is no civil penalty from a company officer.
This however does not preclude HMRC investigating with a view to bringing both civil and criminal proceedings (or indeed the Prosecutions Office running criminal proceedings concurrently) against an individual.
Directors found guilty of a criminal offence can be disqualified from acting as directors for up to 15 years.

In **Belgium**, the tax authorities can refer any crime or misdemeanour (such as tax fraud or swindling) to the prosecutor who then decides whether or not to refer the case to the criminal judge. Only serious tax fraud cases are reported to the prosecutor. In case of serious (tax) fraud or fraudulent organization of insolvency, the liability of the directors could be engaged on criminal grounds.

In **Hungary**, tax authorities have an obligation to refer any crime they become aware of; on the other hand, tax planning schemes are generally not considered to be a crime. In practice usually only serious fraud cases are dealt with as a crime (false invoices, failing to declare income…) but the definition of tax fraud is quite vague and allows for ad hoc decisions (with sometimes a political component).

In **Spain**, criminal liability doesn't exist under EUR 120,000 of unpaid tax. Administrative proceeding is suspended during criminal proceeding and criminal liability excludes administrative liability.

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VAT: immovable property transactions

Immovable property transactions involve significant tax costs. These include value added tax (VAT), which may impact on cash-flow or constitute an irrecoverable expense increasing the investment cost when the operator is not authorised to recover it or can only partially recover it.
VAT may consequently be a substantial factor in choosing between different ways of carrying out or financing a real estate investment.

For immovable property transactions, the common VAT system gives Member States numerous options making it hard at times to grasp the how the rules apply.

That is why the VAT workshop devoted itself to a general survey of several topics relating to those operations. The environment created by the important reform of the rules applying to real estate operations which took place in France in 2010 together with recent case law has been conducive to the choice of this particular subject. It enables us in a non-exhaustive fashion to tackle the following matters:

— A general survey of the latitude allowed to Member States,
— Issues surrounding the categorisation of land,
— Leasing and lease purchase: the Belgian exception,
— The ECJ's contributions as to timeshare property,
— Drawing the line between an astute financing arrangement and an abusive scheme.

The latitude allowed to Member States by EU law

The common VAT system (currently set out in Directive 2006/112/EC of 28 November 2006) gives Member States significant elbow-room with respect to such matters as how property or the rights in question are defined, the treatment of real estate transactions conducted by parties who are not normally taxable for VAT purposes, taxation of self-supplies, traders' rights to opt in to or out of taxation of certain transactions such as transfers of existing buildings or leases of immovable property, or methods of calculating the taxable amount or identifying the correct taxpayer.
Below are some illustrations indicating the issues where there may be significant regulatory divergence between Member States:

— Member States do not all apply the mechanism for taxing self supplies of immovable property in the same way. This applies to buildings erected by a VAT taxpayer (or a third party on its behalf) where there would not be a full right of deduction in respect if the building had been purchased from a third party (Directive, art. 18(a)). In fact taxing self supply and the other elements which, where applicable, may make up the taxable amount may result in a significant increase in the construction cost.
— Real estate transactions carried out by non VAT taxpayers may at the discretion of the State in question be considered to be operations either outside the scope of VAT or mandatorily caught whether the operations relate to a new building or a building land (art. 12).
— The line between a new building and an existing building can be drawn according to different criteria in different jurisdictions, entailing the application of different rules, to wit compulsory taxation of transactions carried out by a taxable person with respect to new buildings, whilst in principle the transfer of an existing building is exempt with or without the right to opt for taxation under national regulations. Article 12(2) of the Directive authorises Member States to set criteria which may be based on the date of first occupation, the completion date or the date of the first subsequent supply (art. 12(2)).
— Two other important illustrations can be cited with respect firstly to the taxable amount, which can consist of the margin for construction sites and existing buildings (art. 392), and secondly to the rate applicable to operations. States may choose whether or not to apply the reduced tax rate to operations involving provision, construction, renovation or alternation of housing as part of a social policy (Annex III paragraph 10).

Other illustrations will be provided below to show that a case by case examination of each State is needed to ascertain which VAT regime applies to real estate operations.

Issues associated with the characterisation of real property

The VAT system established by the Directive depends in particular on the characterisation of the property the transaction relates to: transfers may be taxable

or exempt (with or without an option to tax) depending on whether they involve a building or a plot of land, and where they involve a plot of land, whether it is to be built on or not. Where a building is involved, we must look at its characterisation as new or existing.
Besides the fact that the definition of immovable property varies from State to State (see above), doubts are encountered in most jurisdictions as to the dividing line between certain concepts.
For instance, the Directive defines a building as any construction fixed to or in the ground, which according to ECJ case law means objects which cannot easily be dismantled or moved (ECJ, case C-315/00, Maierhofer [2003] ECR I-00563). The transfer of enclosed land, or land with underground lines or conduits, may thus be deemed to relate to a building.

Uncertainties can also arise as to the characterisation of an operation whose purpose is works of alteration to an existing building. Such works may or may not, depending on their magnitude, be deemed to result in the construction of a new building, together with the VAT consequences that characterisation entails.
Not all national legislation sets criteria making it possible to distinguish works which are restricted to mere renovation of a building from works resulting in construction of a new building, and EU case law is not particularly abundant in this regard (the case of Jespers, C-233/05 [2006] ECR I-00072, concerning replacement of a façade, may be cited).

In this connection, France appears to be one of the only Member States to have laid down objective criteria in legislation. The merit of those criteria obviously lies in the fact that they have considerably reduced litigation on this issue, which was previously voluminous.
A further question arises as to how to characterise the transfer of a plot of land on which there is a building intended for demolition. The ECJ has recently handed down a decision on that issue, noting that in principle transfers relate to plots of land if the land in question is vacant, but deciding that built on land is to be likened to vacant land where the edifice is in a state of ruin and the vendor is responsible for its demolition (case C-461/08, Don Bosco [2009] ECR I-11079).

Similarly, some Member States are of the view that transfer of built on land must be treated as relating to vacant land where the building in question cannot be used in any manner whatsoever, or in other words when it is in a state of ruin.
Hence, for such characterisation issues, it is highly advisable to assemble and preserve all material evidence showing the condition of the property at the time of the transaction, so as to be in a position to justify its VAT treatment at a later stage.

Leasing and lease purchase: the Belgian exception

EU law provides for exemption of leasing and letting except for hotel operations, holiday camps, campsites, the letting of car-parking spaces and the hire of safes (art. 135(1) and (2)).

However, the VAT Directive gives Member States the right to enable taxable persons to opt to tax rental payments, subject to conditions they set.
A large majority of Member States grant the rental taxation option, especially where the premises concerned are for business use.
That is not the case in Belgium. Real property leases in that country are exempt in principle, thus naturally entailing that the lessor is unable to recover the tax on acquisition or construction of a building.
To get around that rule however several methods are available.
Thus provided that the premises are made available with certain services included among those listed in the national regulations, the leasing of business centres can be subject to VAT.
Similarly, national regulations provide a specific taxing mechanism for shopping malls. The tax on the cost of acquisition or construction of a mall can in practice be recovered for up to 90% by virtue of the distinction that can be made between the concrete "shell" being provided to businesses occupying the premises, which remains exempt, as against provision of common areas which may be seen to constitute provision of services to the occupants, and therefore attracts VAT. "Hybrid" parts remain such as the foundations, in respect of which the lessor can recover VAT on a *pro rata* scale.
Those tax authority rules apart, operators may also have recourse to a converse reading of the definition of leasing given by the ECJ in which leasing is the right to occupy a building as owner for an agreed period in consideration of payment (see in particular the judgments in cases C-346/95 Blasi, [1998] ECR I-00481, C-326/99, Goed Woenen [2001] ECR I-06831 and C-284/03 Temco Europe [2004] ECR I-11237).
Operators need only ensure that the agreement does not contain all of those features in order for the provision of property not to attract exemption.

CJUE findings on the system applicable to time-share

Timesharing was developed from the end of the 60s and involves transactions in real property rights over a building. However, today's schemes also involve all kinds of services ancillary to timeshare ownership.
As regards the application of VAT, the analytical problem lies in settling on the place of supply, and the place for determining which VAT regime applies, the tax

treatment of the remuneration received by the intermediary who manages the scheme, and, where relevant, the supply of other services to owners.

In practice, there are principally two places of supply that may be envisaged: the place where the building is located or the service provider's place of establishment.
In principle the place of taxation of a supply of services by a taxable person to a non taxable person is the place where the service provider is established (that principle was not affected by the entry into force, on 1 January 2010, of Directive 2008/8 of 12 February 2008 on the place of supply of services).
However, the rule has certain exceptions regarding in particular the provision of services pertaining to a building which are taxable where the building is situated.

When the service relates to management of the rights to use a building, the link to the place where the building is located would seem naturally enough to be the most appropriate, but the existence of various remuneration components (contributions, scheme membership fees, and other services) led some Member States (in practice, Member States in which the service provider was established) to take the view that the link with a building was not close enough to engage the rule of taxation in the place where the building is located.
The ECJ has in that connection decided that a service relating to a building is a service with a sufficiently close link with the building, because the building constitutes a central and essential item in the supply of the service (case C-165/05, Heger [2006] ECR I-07749).

The Court has where timeshare management is concerned provided the following clarifications in two recently decided matters.

In the matter of RCI Europe (case C-37/08 [2009] ECR I-07533), the timeshare scheme was based on a business model in which members deposited their usage rights in a timeshare accommodation "pool", and were able to obtain the benefit of other members' usage rights, in consideration of an enrolment fee and subscriptions.
When the Court was asked about the place of assessment of the provision of services by the manager of the timeshare scheme, it found that it was the location of the building in respect of which the member concerned held usage rights.

In the matter of MacDonald Resorts Limited (case C-270/09 [2010] ECR I-00000), the scheme involved a mechanism for subscribers to acquire points.
The mechanism entitled them to then convert the points acquired into a temporary right of usage of a property, or into other services such as hotel services. The Court was asked not merely about the characterisation of the services rendered by the managing company and their place of supply but also about the time at which that characterisation had to operate.

The Court held in that instance that the actual service for which "points rights" are purchased was that of making various offers available to be obtained through the said points. The Court held that the chargeable event occurred at the time of the conversion of points, which was when the operation was to be characterised.
The place of supply was where the buildings in question were located, whether the points had been used for the enjoyment of temporary residential rights or for hotel services. Further, the Court specified that the service might be covered by the exemption for leasing of immovable property (Dir. Art. 135(1)(l) when it related to a temporary right of enjoyment.

Nonetheless from those cases may be seen the diversity of business models that timeshare scheme managers may develop: other difficulties may appear in the future.

Where to draw the line between a prudent finance scheme and a fraudulent arrangement

For those investors not entitled to full deduction, minimising the cost of residual tax is one of the factors in choosing financing for the investment. Naturally, that is so for public bodies, associations, banks, insurance companies, or medical sector operators whose activities do not generally carry the right of deduction.

Arrangements calculated to assist in minimising residual VAT include lease-purchasing and externalising the investment through a land development structure which leases the property.
Care must be taken to ensure that the arrangement envisaged is not objectionable as abusive practice.
In relation to arrangements designed to limit residual VAT for those without the right of deduction, the Court of Justice recently had occasion to make some useful clarifications with respect to abuse of rights.

The case law defines abuse of rights on the basis of two criteria:
— The transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth Directive and the national legislation transposing it, result in the accrual of a tax advantage the grant of which would be contrary to the purpose of the common VAT system,
— It is apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain such a tax advantage.

Those criteria emerge from the Halifax case in particular, where the ECJ held to be abusive an arrangement by which a group, whose banking activity entitled it to VAT recovery of less than 5%, had obtained recovery of almost the whole of the tax on the construction cost of banking "call centre" premises, by virtue of the fact that the investment was made by a structure with a meaningful right of deduction, and through a system of reinvoicing the construction works carried out by that structure at lower prices (case C-255/02 [2006] ECR I-01609).

Likewise, in the context of a real estate arrangement the ECJ handed down some useful clarifications with respect to lease-purchase (ECJ case C-103/09 Weald Leasing [2010] ECR I-00000).

Within an insurance group entitled to recover around 1% of VAT, real estate investments were placed in a group subsidiary which made them available to a company outside the group which then sublet them to various companies in the group. The two lessors exercised their full entitlement to deductions arising from taxation of the rents.
As the Court of Justice viewed it, the tax advantage resulting from an undertaking which was not a VAT taxpayer financing its real estate investments through lease-purchase rather than direct purchase was not contrary to the Directive's purpose.
Where a trader is not authorised to recover the tax on its investments, lease-purchase financing has the benefit of evening out over the term of the contract the residual VAT burden, which is payable as and when rents are paid. The Court therefore held that the terms of a contract can give a transaction an abusive character, especially where rents have not been determined in market conditions.

The Court held that where an arrangement is found to be abusive transactions should be redefined so as to re-establish the VAT position as it would have been in the absence of factors having an abusive character In other words, and without prejudice to the penalties to be applied in each jurisdiction by reason of the existence of an abusive arrangement, when tax authorities review an arrangement it should not lead to a party being assessed for a greater amount of tax than it would have borne without such an arrangement.

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Tax news from Central and Eastern European countries

Introduction

Before the economic crisis, the Central and Eastern European ("CEE") market had been a driving force behind European economic growth. Although CEE countries have been strongly hit by the crisis, economic growth is expected in future.
In this context, there is an interesting trend of tax reforms in CEE countries which have not yet reached the tax "maturity" of Western Europe. In the following pages, we will focus on Bulgaria (recently integrated into European Union "EU"), Croatia (a non EU state), Hungary (an "old" EU country in the area) and Russia (non OECD and non EU).

General commentary on the CEE tax systems

We made a study in the middle of the crisis about the different tax regimes in the CEE region (see CMS Tax Connect - 2009 October issue). It showed that the countries were in tough tax competition to attract foreign investment in order to pass through the crisis. Very few anti-crisis measures were adopted at that time.
Now that the crisis seems to be behind us, we would like to focus on the consequence of this tough tax competition and analyze whether the tax policies implemented in the CEE may be maintained over the long term.
Basically, the CEE tax regimes are based on the same political concept: develop the growth of the country and attract investors by very low corporate income tax rates (10-20%) as opposed to pretty high VAT rates (20-25%).
Despite this political observation partly explaining the low rates in the area, we can see that CEE tax systems are similar in many ways to those of "Old Europe": the types of taxes, the incidence of taxation and the logic of calculating the tax base are largely similar or at least comparable to those of Western Europe.
However, they frequently lack certain aspects that are typically present in Western European tax regimes, e.g. group tax consolidation, the possibility of tax-neutral asset/business transfers within a corporate group, tax neutral reorganisation of a corporate group, roll-over relief and anti-avoidance rules.
The tax systems remain rather simple, and may be too simple to respond to business demands.
We assume that this type of tax policy may be much more difficult to maintain in the future since more and more international groups of companies are investing in the area and the CEE governments are under pressure to plug any holes in national budgets by cutting public expenditure and increasing tax revenue, without harming the competitiveness of the national economy.
In most CEE jurisdictions, the new policies have resulted in tax reform packages (anti-crisis or sophistication of the tax system). It remains to be seen whether CEE governments will respond to the demands of business and market development and also implement the missing aspects of the CEE tax puzzle marking the next phase of CEE tax development.
Another driving force behind tax changes in the CEE region is the harmonization of the CEE tax systems with European regulations and directives, which has been in progress since the recent (2004 and 2007) EU accession of many CEE countries.

Overview of significant changes in tax laws

The tax legislations in CEE countries have considerably changed during the last few years. We will focus on the main trend of tax reforms. It is particularly noteworthy that in the CEE the tax reforms focus mainly around 3 axes: harmonization with EU regulation, crisis reforms and sophistication of the tax system.

a) Harmonization with EU regulation (Bulgaria)
In Bulgaria, from 1 January 2011 interest and royalties paid to qualifying EU companies will be reduced to 5% (from 10% before 1 January 2011) withholding tax provided that the recipient is a related company which is holding at least 25% of the capital for a period of two years or where a third EU company has held at least 25% of the capital of the payer and the recipient for a period of two years.
In all other cases the withholding tax rate on interest and royalties remains 10%.

b) Crisis reforms (Hungary)
In response to the financial crisis, the Hungarian government introduced a number of changes, rates for direct taxes were lowered (10% for CIT up to 1.8 million profits, implementing of various tax holidays) and made more attractive to improve positions in the CEE tax competition. On the other hand VAT was increased (up to 25%).
Hungary was among the first countries to introduce a bank levy, which in fact is a levy not only for banks but for

the whole financial sector, including insurance companies, investment fund managers and investment service providers. Branches of foreign banks and insurance companies are also subject to the financial levy which could very well lead to double taxation and currently the general understanding is that double tax treaties do not apply.

In addition to taxing the financial sector, the Hungarian government went further in thinking about where it could find some money left and pinpointed three other sectors which have to pay a special levy on their net sales revenues.

- Retail activities, applicable rate is progressive between 0-2.5%
- Telecommunications: 0-6.5%
- Energy suppliers: 1.05%

c) Sophistication reforms (Croatia, Russia)

Croatia

Croatia is in the process of negotiation for joining the EU and in the last few years it has been intensively working on harmonization of its tax legislation with EU tax legislation. The result is that most of the tax laws are already harmonized with the EU. Currently the Government is preparing amendments to the VAT Law by which the VAT system should be fully in line with that of the EU.

Most significant changes to the Croatian CIT legislation introduced in 2010 relate to the following:

- Limitations of the right to carry forward losses during mergers, acquisitions, divisions and changes of the ownership structure for more than 50% under certain conditions,
- Extension of the transfer pricing rules to transactions between resident companies under certain conditions,
- Introducing withholding tax on payments for all kinds of services made to persons having their business headquarters or place of management in tax havens (countries outside the European Union in which the general or average CIT rate is below 12.5%),
- Including rules from the Merger Directive and the Directive on Interest and Royalties in the Corporate Profit Tax Law (these will be applicable as of the date Croatia joins EU).

Russia

Russia recently implemented a parent subsidiary regime allowing a 0% rate on dividends received by Russian companies, provided that on the day of the recipient of dividends continuously holds no less than 50% in the share capital of the subsidiary during one year. This favourable regime is not applicable to dividends received from subsidiaries located in "black listed" jurisdictions (the list of countries being adopted by the Russian government).

Further, a new 0% rate on capital gains resulting from the transfer of shares or securities of Russian entities held for more than 5 years has been adopted (for non listed companies).

d) Special focus on Ukraine (new tax code)

The Ukrainian Parliament has adopted a new Tax Code which became effective on 1 January 2011. However, the corporate income tax section will come into force on 1 April 2011.

We outline below some of the most interesting CIT provisions that may affect international business in Ukraine.

Decrease of corporate income tax rate

The standard CIT rate under the Tax Code is 23% and will apply from 1 April 2011. The 23% rate is subject to a further annual gradual decrease to 16% by 2014. Notwithstanding the tax rate reduction from the current 25% down to 16% in 4 years, the actual tax burden on Ukrainian companies with foreign investments and Ukrainian businesses doing business with foreign partners may in fact increase.

Restricted deductibility of fees for certain services

The deductibility of the costs of consultancy, marketing and advertising services received from a non-resident provider by a Ukrainian company is now limited to 4% of such company's income for the preceding reporting year.

The deductibility of expenses incurred with respect to the purchase of engineering services from non-residents is also subject to limitation to 5% of the customs value of the equipment imported into Ukraine to which such engineering services relate.

If a non-resident service provider is an off-shore company (located in an off-shore jurisdiction per the list adopted by the Ukrainian government), then the Tax Code disallows the deduction of all expenses incurred with respect to the purchase of consultancy, marketing, advertising and engineering services.

The expenses related to engineering services can also be disallowed from deduction where a non-resident service provider is not the beneficial owner of such payment.

Restricted deductibility of royalties

The deductibility of royalties paid by a Ukrainian company to a non-resident is now limited to 4% of the Ukrainian company's income for the preceding reporting year, save for royalties paid by Ukrainian broadcasting companies and licences for foreign films and music and literary works. At the same time, the Tax Code completely disallows deduction by Ukrainian companies of royalties paid to a non-resident if:

- The non-resident recipient is an offshore company, or
- The non-resident recipient is not a beneficial owner of royalties, or
- The non-resident recipient is not taxable with respect to such royalties in a country where such recipient is a resident, or
- Intellectual property rights with respect to which royalties are paid have initially originated in Ukraine.

Restricted deductibility of interest on foreign shareholder loans

The interest paid by a Ukrainian borrower to its non-resident shareholder having, directly or indirectly, at least

50% of the shares in such a borrower or to such a shareholder's related parties is subject to a limited deduction. Such a deduction must not exceed: (i) an amount of interest income, if any, received by the borrower from placement of its own assets plus (ii) an amount equal to 50% of the taxable profit of the Ukrainian company for the reporting period (calculated without accounting for interest income). The disallowed balance can be carried forward by the borrower to the next reporting period subject to the same limitation. The amount of the allowed deductible expenses in relation to transactions with related parties shall not exceed an interest rate calculated on an arm's length basis.

Taxation of capital gain on Ukrainian shares

The capital gain realised upon alienation of Ukrainian shares is subject to withholding tax at a rate of 15%, unless exempt or taxed at a lower rate under the relevant double tax treaty.

Notably, according to the Tax Code, the cost of shares/ corporate rights acquired by a founding investor from a Ukrainian issuer is not included in the tax base for the purpose of determining capital gain from disposal of such shares. The rules are somewhat vague, however, if such costs are indeed excluded from the tax base: then, for example, a founding foreign shareholder disposing of its shares in a Ukrainian company would be subject to withholding tax on the entire amount of the received proceeds.

The majority of Ukrainian Double Taxation Treaties envisage that capital gain on disposal of shares of a Ukrainian company deriving their value mostly from real estate situated in Ukraine are normally subject to a withholding tax in Ukraine at a standard and not a reduced rate. Thus, the abovementioned provisions of the Ukrainian Tax Code may have an adverse tax effect on disposal of shares in Ukrainian special purpose companies holding real estate. Structuring of investment in such companies would require attention to making the right choice of a Double Taxation Treaty to ensure that capital gain on disposal of shares is exempt from withholding tax in Ukraine.

Interest free loans by a foreign shareholder to its Ukrainian company

Contrary to the old rules, interest free loans ("repayable financial aid") provided by a foreign shareholder of a Ukrainian company to the said company are not included in the company's taxable income if repaid within 365 days upon disbursement.

Beneficial ownership requirement as a condition for Double Taxation Treaty protection

A Ukrainian payer of Ukraine-sourced income (being a tax agent) has the right to apply withholding tax exemption or a reduced tax rate under a relevant Double Taxation Treaty only if a non-resident recipient of such income is a beneficial owner of the income. The Tax Code provides that a non-resident income recipient is not deemed to be a beneficial owner if the said recipient acts as "an agent, nominal holder (nominal owner), or merely an intermediary with respect to such income".

As one of the potential outcomes of the concept, the Ukrainian tax authorities could view a facility agent under a syndicated loan to a Ukrainian borrower as not being a beneficial owner of income. In that case, a Ukrainian borrower would be required to withhold tax at a 15% rate on income paid to such facility agent without applying the benefits of the Double Taxation Treaty. In order to recover overpaid amounts of withholding tax, each beneficial recipient entitled to a relevant Double Taxation Treaty exemption or reduction will then need to reclaim the overpaid amounts from the Ukrainian tax authorities and treasury.

Given exuberant novelties in the Tax Code and a very short period to adapt to the new rules, financial penalties for non-compliance with tax laws (purportedly except for tax evasion) occurring within the period from 1 January 2011 until 1 June 2011 are set at the maximum level of 1 UAH (approximately $ 10 cents) for each such violation.

Case study

a) Assumptions

In the following, we are going to analyze in a case study the local tax rules related to establishing a business in these jurisdictions (withholding taxes and anti-avoidance rules) and the tax risks that may arise when distributing in these jurisdictions (risk of permanent establishment and transfer pricing rules).

The case study is based on the following assumptions:

— A French group of companies in the retail industry already established in the CEE decides to develop its business in Bulgaria, Croatia, Hungary and Russia,
— The group is already distributing its products through agents in some of these jurisdictions and has a representative office in Russia,
— The group contemplates setting up a subsidiary in Bulgaria and Croatia and purchasing the local distributor in Russia and Hungary.

b) Establishing business in CEE

When determining the place of residence of a holding company, one may take into consideration, not only the political stability of the jurisdiction, the existence of a tax treaty network, the tax regime in the founder's jurisdiction (participation exemption regime, taxation of royalties, taxation of interest, tax regime of outgoing dividends) but also the local anti-avoidance rules (beneficial ownership, conduit companies, effective place of management, and black-listed countries).

Regarding this latter criteria, one must keep in mind the OECD Commentaries on the model tax treaty (2010) stating that:

"A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or

arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions".
On the basis of these principles, we will analyze the withholding taxes and tax regime in all 4 jurisdictions studied in our case.

Bulgaria

STATUTORY DEFINITION OF "BENEFICIAL OWNER"

A statutory definition of beneficial owner was inserted in the Tax and Social Security Procedure Code for the purposes of application of tax treaties.
Foreign companies would be considered as beneficial owners of the income received if they are entitled to dispose of the income, bear the entire risk or significant part thereof related to the business activities giving rise to the income and do not act as conduits.
Under the statutory definition conduits are companies controlled by persons or companies not entitled to treaty benefits and without sufficient equity, assets or manpower for the performance of the activities giving rise to the income. The lack of control over the assets, rights or incomes is also considered to be an indication of a conduit. Companies 50% of whose voting shares are publicly traded are not considered as conduits.
The definition is very broad and allows interpretations by the tax authorities. There are still no developed practices as to the amount of equity at risk which should be put by the company.

NEW CONCEPT OF "COUNTRIES WITH A PREFERENTIAL TAX REGIME"

Countries or territories with a preferential tax regime are those which do not have a tax treaty with Bulgaria and the applicable CIT or similar tax levied on the incomes sourced in Bulgaria is lower by more than 60% than the Bulgarian CIT.
Bulgarian tax law also introduced a list of countries with preferential tax regime. Present in the list are countries such as Monaco, Virgin Islands (US and UK), Aruba, San Marino, Guam, Dutch Antilles, Hong Kong, Gibraltar.
Incomes from services or rights as well as penalties and compensation payments (indemnities and remedies) of any kind paid to residents of countries with a preferential tax regime shall be subject to withholding tax at the rate of 10%. The withholding tax is applied even to incomes which generally would not be subject to such tax.
The withholding tax is not levied on incomes from services and rights where the services or rights have been actually rendered or granted respectively and such income constitutes non-taxable income under Bulgarian law.

DIVIDENDS

The domestic rate is 5%. Dividends paid to corporate shareholders residents of EU/EEA states are not subject to withholding tax, regardless of the size or duration of the participation in the Bulgarian subsidiary.

ROYALTIES AND INTEREST

The general rate of the WHT is 10% unless otherwise provided for by a treaty. The lowest rate available under a treaty is 0%. 5% WHT tax is levied on qualifying and related companies receiving interest or royalties from Bulgaria (see *supra*).
The preferential rate of 5% does not apply to convertible loans, loans without a maturity date or with a maturity in excess of 50 years, loans granting right to participation in profits or loans disguising distribution of profits or return of capital, to payments which represent non-deductible expenses, to income from dealings aimed at avoiding taxation, etc.

THIN CAP RULES

The deduction of interest paid on loans taken from third parties is limited to the total interest received by the company plus 75% of its positive financial result (calculated without taking into account interest income and expenses for interest). Thin capitalization rules apply only where the debt/equity ratio exceeds 3:1.
Subject to the thin cap regulations would be also loans granted by commercial banks where the parent company or other borrower-related company have provided security as a guarantee for the borrowers' obligations under the loan.
In general, non-deductible interest can be carried forward and deducted from the company's profits for five years subject to specific conditions and requirements.

CAPITAL GAINS

Capital gains realized by a foreign entity from the sale of shares in a Bulgarian entity are subject to 10% withholding tax.

Croatia

ANTI AVOIDANCE RULES

As of 1 July 2010 withholding tax at the rate of 20% has been introduced on payments for all kind of services provided to persons having their business headquarters or place of management in countries outside the European Union, in which the general or average CIT rate is below 12.5%.
Croatia has signed an extensive list of double tax treaties, which provide preferential tax treatment of income derived by a non-resident.
The majority of Double Taxation Treaties Croatia has signed or taken over from former Yugoslavia follows OECD Model convention. Croatia generally applies the OECD Commentary on the Model Convention, including anti-avoidance rules manifested in principles such as beneficial owner principle and place of effective management principle.
In order to apply a particular Double Taxation Treaty, there is a certain administrative procedure to be followed, which is prescribed in the Croatian Corporate Profit Tax legislation. According to that, a non-resident recipient of income needs to provide certain forms proving his residency in the country party to Double Taxation Treaty.

WITHHOLDING TAXES

Croatia levies 15% withholding tax on the income derived by a non-resident in the Republic of Croatia based on interest, royalties and other intellectual property rights (copyrights, patents, licenses, trademarks, designs or patterns, production processes, production formulas, drafts, plans, industrial or scientific know-how and similar rights) and service fees (for market research services, tax and business advisory and auditor service fees paid to non-residents).
No withholding tax is payable on dividends.

THIN CAPITALISATION

Croatia applies a 4:1 debt equity ratio, i.e. the interest on the excess amount of the loan received from a shareholder holding at least 25% of the shares or equity capital or voting rights in a taxable person, is not tax-deductible.
The thin capitalisation rule does not apply to interest on loans provided by financial organisations.

INTEREST BETWEEN RELATED PARTIES

The maximum tax-deductible interest rate is the rate which would apply to non-associated persons at the time of granting a loan (currently this is 9%). The applicable interest rate should be determined and published by the finance minister prior to the beginning of the tax period in which it will be applied. If it is not published by the finance minister, the discount rate of the Croatian National Bank applies.

CAPITAL GAINS

Capital gains by a non-resident from the sale of shares in Croatian companies are not taxable in Croatia. Capital gains by resident companies are included in the regular corporate income tax base and subject to 20% corporate income tax.

Hungary

When it comes to tax treaties and withholding taxes, Hungary is very easy to deal with: pursuant to domestic law there are no withholding taxes on dividends, royalties, interest or service fees irrespective of to which country the payments are being made.
Thin capitalization requirements provide a 3:1 ratio, failing which proportionate interest on the excess debt is not deductible.

Russia

BENEFICIAL OWNERSHIP

According to a clarification by the Ministry of Finance, a foreign company is treated as beneficial owner of dividends, if:

— It has the legal right to dividends, and
— It has the right to determine the "economic destination" of dividends (i.e. has the right to use, dispose off, distribute or retain them).

This clarification of Russian tax authorities is in line with the principles, which are stated in the OECD's tax committee's comments on Article 10 to the OECD Model Double Taxation Treaty, and it serves the same purpose (to preclude treaty shopping arrangements).

PLACE OF EFFECTIVE MANAGEMENT

The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made. All relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time.
However, there is a risk that the residency of the holding company could be disputed by the Russian tax administration on the ground that all decisions relating to the company's management are effectively made in Russia if the company's directors take all their instructions from the Russian residents.
For the time being, there is no legislation in Russia making it possible to reassess the residency of a foreign company and subject it to taxation in Russia.

RESPONSIBILITY UNDER THE ABUSE OF TAX LAW DOCTRINE

In the event a Russian tax agent be investigated for the amount of underpaid tax (the marginal difference between the Double Taxation Treaty and domestic tax rate), the tax authority might try to strengthen its position by following the general line of the abuse of tax law doctrine.
According to the doctrine, the taxpayer is treated as having received an "unjustified tax benefit" mostly in the following situations:

— When the form of the transaction does not correspond to its economic substance ("substance-over-form" concept),
— When the transaction itself (or the business operations of parties thereto) lack a business purpose.

Under this doctrine, the tax authority may try to prove that the distribution of dividends (or interest or royalties) is a "cover" transaction for the effective distribution of income to a third company, or it would try to prove that the recipient has no business purpose (i.e. is a mere conduit company, established solely for tax optimization reasons).
If the tax authority succeeds in proving its position under this doctrine, the potential outcome may be similar to the one described in the case of the failure to qualify for the "beneficial owner" test (i.e. the denial of Double Taxation Treaty benefits and imposition of the domestic withholding tax rate).

DIVIDENDS

Under the Double Taxation Treaty, the dividends are subject to withholding tax at the lowest rate of 5%. Otherwise, the rate of 15% (domestic withholding tax rate) becomes applicable.
In practice, this means that, in order to benefit from the reduced 5% withholding tax rate, the beneficial owner of dividends should have purchased or subscribed the shares of the Russian operation company either directly at

their initial issuance or in a secondary market.
According to an arguable position of the Russian tax authorities, other forms of acquisition of share capital do not qualify as ”directly” performed and, thus, do not allow the application of the reduced 5% withholding tax rate. According to this doctrine, for example, if a foreign company purchases the shares of a Russian company, this would not be treated as ”direct” acquisition of such shares for the purposes of the Double Taxation Treaty.

INTEREST
Under Russian tax law, interest is treated as a deductible expense, provided that the amount of interest incurred by the taxpayer in respect of the debt obligation does not deviate significantly from the average level of interest charged on debt obligations issued in the same quarter under comparable conditions. Debt obligations issued under comparable conditions shall be understood as:
— Debt obligations issued in the same currency,
— For the same periods,
— In comparable amounts against similar collateral.
In this respect, a significant deviation of the amount of interest charged on a debt obligation shall be understood as an upward or downward deviation of more than 20% against the average level of interest charged on similar debt obligations issued in the same quarter under comparable conditions.
If there were no debt obligations to Russian organizations issued in the same quarter under comparable conditions, or at the taxpayer’s choice, the maximum amount of interest which may be recognized as an expense shall be taken to be equal to the refinancing rate of the Central Bank of the Russian Federation increased by a factor of 1.8 in the case of a debt in Roubles and of 0.8 in the case of debt in a foreign currency. This is applicable for 2011 and 2012 (otherwise 15% for foreign currency loans and 110% of CBR refinancing rate for loans in roubles).

THIN CAPITALIZATION RULES
Russian thin capitalization rules focus on limiting the deductibility of interest payable by a Russian company in the following cases:
— A foreign creditor holds directly or indirectly more than 20% of the share capital of the Russian company (borrower), or
— A Russian creditor is affiliated to such a foreign company according to Russian law (i.e. a Russian sister company of the Russian borrower), or
— A third party making the loan to a Russian company under the guarantee of such a foreign ”parent” or Russian ”sister”.
If the amount of the outstanding loan exceeds more than three times the amount of the net assets of the Russian borrower at the last date of the quarter concerned and if the outstanding loan meets the above requirements, it is characterised as ”controlled debt”.
The non deductible interest payments are deemed to be dividends subject to withholding tax at the domestic rate of 15% (unless otherwise provided for by a tax treaty).

ROYALTIES
The domestic withholding tax rate on royalties is 20% but is excluded in most tax treaties.

c) Distribution in the CEE region

Distribution through an agent: risk of permanent establishment

BULGARIA
Under Bulgarian law an agent will create a permanent establishment (“PE”) for the foreign company when the agent is authorized to execute contracts in the name of the foreign company. Exceptions are trade representatives who act as independent agents.
Under Bulgarian law the continuous performance of commercial transactions with place of supply in Bulgaria also gives ground for recognition of a PE of the foreign person even in cases where the foreign company does not have a fixed place of business or does not act through an agent in Bulgaria.

CROATIA
Croatia generally follows the OECD Model Convention definition of a PE. However, it has also adopted the “service PE” concept whereupon a PE is created by performing services, including consultancy or business services for the same or related project, longer than 3 months in any period of 12 months in a row. Where a double taxation treaty applies, a service PE is however avoided by applying the respective Double Taxation Treaties in force.
In the past the Croatian tax authorities in practice did not primarily focus on PE issues. However, it may be expected that this will change as there are some indications that they will expand their focus in that direction.

HUNGARY
Hungary follows the OECD principles. At the moment permanent establishment issues are not really in the focus of the Hungarian Tax Authority.

RUSSIA
As a general rule, the definition of a PE according to the Russian tax code follows the OECD definition. However, a foreign company having a permanent position (i.e. one employee) in Russia during an aggregate period exceeding 30 days during a year is subject to registration with the Russian tax authorities. Formally, the mere fact of tax registration in Russia does not lead to qualification of a PE in Russia unless other criteria of a PE are met.
Nevertheless, in practice, Russian tax authorities assume that any foreign company tax registered in Russia carries out activities on a regular basis and, therefore, attempt to scrutinize whether such activities could qualify a PE in Russia. Furthermore, once registered with the tax authorities, the foreign company is liable to keep its accounting and file tax returns in accordance with Russian law.

Distribution through a subsidiary: transfer pricing rules

BULGARIA

Transfer pricing rules and regulations in Bulgaria apply to both international and purely domestic transactions. They apply not only to dealings between companies but also between permanent establishments and other parts of the company located outside of the country.

The definition of "associated enterprises" generally follows the definition contained in article 9 of the OECD Model Convention. The definition is somewhat broadened in Bulgarian domestic law.

Holding 5% of the voting shares in companies meets the qualification test. Trade representatives and the companies they represent are also related persons under Bulgarian law. The exercise of control on the grounds of agreements and other arrangements between the shareholders and managers and a third person makes the company and the third person related under Bulgarian law.

In case of cross-border transactions the foreign and domestic company will be considered related where the foreign company is established in a non-EU country in which the respective tax due on the income of the foreign entity is more than 60% lower than the Bulgarian tax. This rule does not apply where the audited person could adduce evidence that the foreign company is not subject to special taxation regimes or that the goods or services were realised on the respective market. Foreign companies would be treated as related to its Bulgarian commercial partners in the event that the state of the foreign company does not exchange information about dealings when there is a tax treaty with Bulgaria.

The transfer pricing guidelines produced by the Bulgarian tax authorities recommend that taxpayers prepare and maintain transfer pricing documentation contemporaneously with the transaction or by the date of filing the tax return at the latest. However, taxpayers are not obliged by law to create and maintain transfer pricing documentation before or at the time of the controlled transaction.

In the event of a tax audit the taxpayers have to be able to provide sufficient data and documents to show conformity with market principles. The burden of proof rests on the taxpayer.

CROATIA

Croatia incorporated the general OECD transfer pricing rules and principles into its corporate profit tax legislation and it generally follows OECD Transfer Pricing Guidelines. With the latest amendments to the Corporate Profit Tax Law as of July 2010, the transfer pricing rules were extended to transactions between resident companies under certain conditions.

In recent years the Croatian tax authorities were very focused on transfer pricing issues. They have been disputing related party transactions on a regular basis (either arguing that the documentation in support of the claim that the services were provided is insufficient or that the prices applied are not arm's length).

HUNGARY

Hungary follows the OECD principles in terms of transfer pricing, and has already implemented the change resulting in the transactional net margin method and profit split method being acknowledged as accepted methods. Documentation requirements are rather strict, and require paperwork to be drawn up on a transaction by transaction basis and be available by the time the corporate income tax return is to be submitted. Documentation is also required in cases where only Hungarian parties are involved.

RUSSIA

Russian tax authorities are entitled to challenge a transaction and adjust the contractual price if it differs, upwards or downwards, by more than 20% from the fair market value of the goods or services provided.

The Russian Tax Code (article 40) sets out an exhaustive list of situations where the Russian tax authorities are entitled to review a transaction, namely:

- Contracts concluded between affiliated companies (under Russian law legal entities are deemed to be affiliated persons if the relations that exist between them affect the outcome of such transactions. In any case legal entities are deemed related persons if one of them holds (directly or indirectly) more than 20% of the capital of another),
- Barter transactions,
- International transactions,
- When the price differs (upwards or downwards) by more than 20% for the same products in a short period of time.

When reviewing the adequacy of the prices used in transactions, tax authorities have to prove that the contractual price does not satisfy the conditions of article 40 of the Tax Code. In other words, the tax authorities in comparing the prices have to determine whether or not the contractual price is comparable to fair market prices.

We note that a bill of law on transfer pricing which aimed at implementing OECD rules in Russian law has been adopted (first reading) in Spring 2010. One expects this law to be voted at the Russian parliament by the end of this year.

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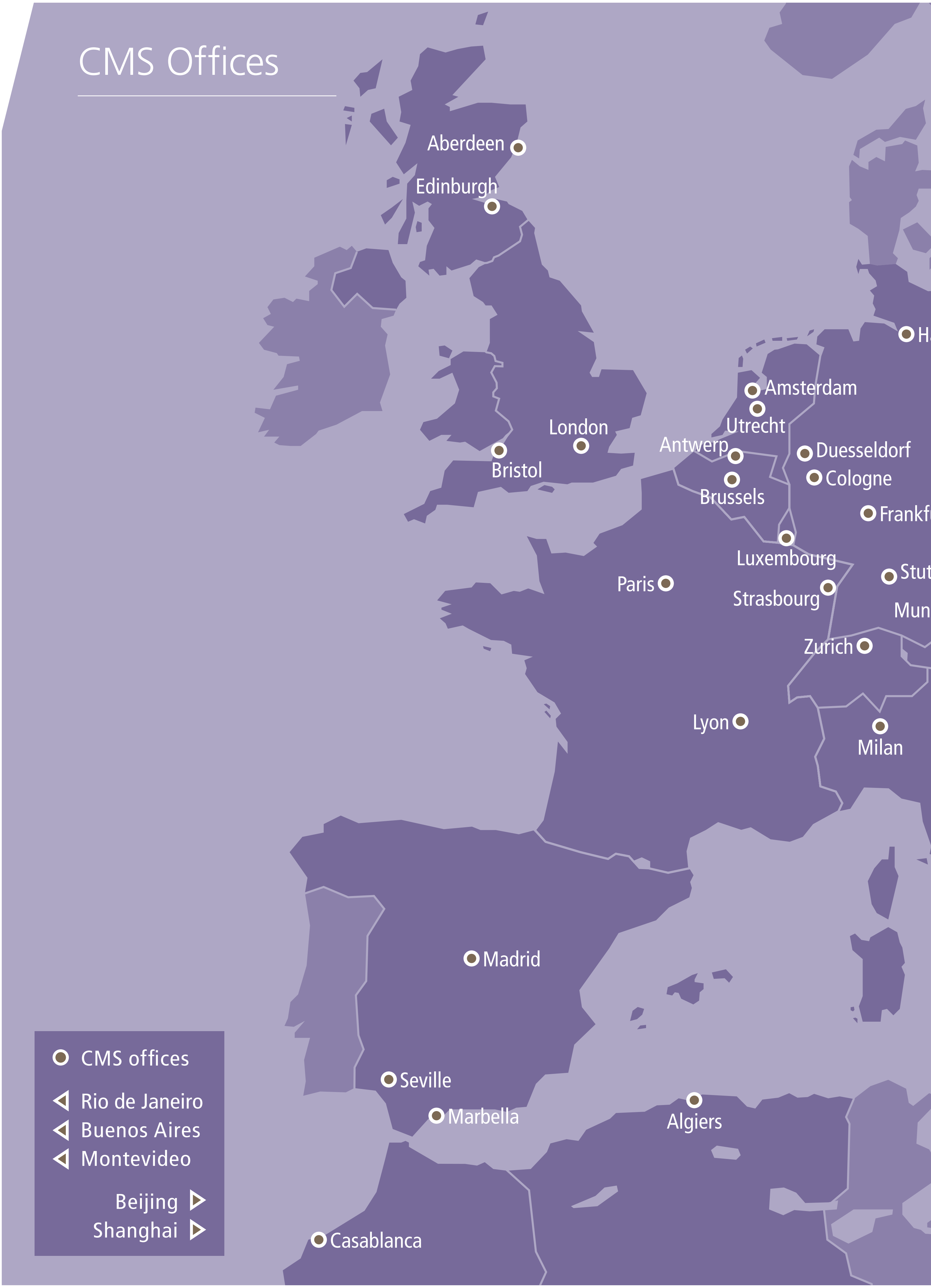

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