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Tax Connect

The increasing budget requirements of European countries and their implications for taxpayers

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CMS Tax Connect

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Editorial

Since Summer 2011, we have witnessed an unprecedented sovereign debt crisis in Europe.

A highly tense G20 summit, and some fifteen European summits, now seem to have stabilised the situation in financial terms.

This has only been possible at the cost of a succession of austerity plans in many European states.

We know the immediate consequences of this: a general increase in all taxes (corporation tax, income tax, VAT) throughout Europe.

This document will consider the medium and long term repercussions of these developments for European tax law (mutual assistance directive and CCCTB), and the consequences, for European taxpayers, of increased tax pressure in two particular areas (finance and real property).

The first article will therefore consider the new Directive on assistance in recovering taxes, which ought to enable more efficient cooperation in this area.

The second considers the possible impact of the draft Common Consolidated Corporate Tax Base (CCCTB) and compares it with the national tax integration regimes of selected European countries.

> In this regard, the European Commission has produced a report on the common consolidated tax base, which was filed with the French Parliament on 1 February 2012 (no. 4290). Noting in support of its conclusions that nominal rates and tax bases vary among European Union Member States, while at the same time business profits are less heavily taxed in Europe than in other comparable or emerging economies, the report underlines the advantages of the CCCTB proposal. It also restates the terms under which France and Germany have recently begun to converge.

The third article considers the various mechanisms available for tax management of international financing. The approach is to focus on the opportunities that exist, as well as the increased tax constraints and associated tax risks.

Finally, the last article is concerned with cross-border investments in real property, at a time when the traditional model for structuring such investments is open to question, either because of renegotiation of historically favourable tax conventions (such as the Franco-Luxembourg convention), or because of novel and widespread tax inspections introduced by some national authorities.

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Mutual assistance in tax collection in the European Union: what practical consequences for taxpayers?

1. Current rules within the EU and historical development

a) Definitions of mutual assistance and cooperation within the European Union

Mutual assistance: refers to a set of mechanisms which enable the tax authorities of the Member States to cooperate with a view to ensuring that taxes are paid.

Cooperation: refers in particular to the implementation of administrative procedures (exchange of information, assistance with collection, etc.) enabling the taxes and charges due to the tax administration of any Member State to be calculated and collected more efficiently.

b) Practical examples

Administrative cooperation in tax matters may be very useful in a number of situations, in particular:

— where the taxpayer is not in the Member State demanding the tax, and has no tangible or intangible assets within that state's territory;

— where the taxpayer has relocated his assets to another Member State, or where there is a risk of this being done;

— where tax investigations are ongoing in several states at the same time.

The objective of these measures is to prevent tax evasion or relocation of assets by taxpayers wishing to create a position of insolvency in order to escape taxes.

c) Historical development of the applicable rules

Directive 76/308/EC: This directive was the first piece of legislation in the field of mutual assistance.

Its scope was quite limited since, in relation to tax and similar matters, the mutual assistance procedures put in place mainly concerned the recovery of customs duties.

Practical implementation of this directive was dealt with in directive 77/794/EC.

It quickly became apparent that further measures were necessary in relation to mutual assistance, and as a result directives *2001/44/EC* and *2004/56/EC* were adopted in 2001 and 2004 respectively.

The scope of these directives was considerably wider than that of the 1976 directive. The 2001 directive, for example, extended the 1976 directive to tax credits relating to certain revenue and property taxes, so as to protect the finances of Member States.

As a result of these two directives, mutual assistance procedures could now be used in respect of import duties, export duties, VAT, excise duties on tobacco, alcohol and oil-derived products, taxes on revenue and wealth, insurance premiums, and interest, additional payments and penalties relating to tax (excluding criminal penalties).

Furthermore, this directive contemplated the possibility of Member States making various kinds of requests: requests for information, requests for notification and requests for recovery.

Directive *2008/55/EC* of 26 May 2008 further enlarged the scope of the mutual assistance procedures.

The same year, a **Commission Report** assessed the impact of the directives referred to above, over the period from **2005 to 2008.**

The report reached the following conclusions:

— the overall collection rate for recovery requests made by Member States during the period in question was 5%,

— the amounts actually recovered in 2006 and 2008 had risen by over 600% by comparison with the 2003 figures,

— for each year studied, 80% of the amounts recovered in that year related to requests made during the preceding 24-month period. A certain period of time thus appeared necessary between the request and implementation of the recovery procedure.

The report's assessment was that the measures had been neither an unqualified success nor an unqualified failure over the period in question.

Directive 2010/24/EU, which was adopted on 16 March 2010 and came into force on 1 January 2012, has supplemented the existing mechanisms.

Its scope is much wider than that of the previous directives as it covers all taxes and charges of a public nature that are collected by the state or one of its subdivisions (i.e. by local government), with some exceptions such as social security contributions.

The directive further provides for a new organisational structure facilitating its implementation.

It lays down the following principles:

On request, a Member State is obliged to supply all information which is foreseeably relevant to the requesting Member State.

However, information need not be supplied to the other Member State where:

— the state receiving the request would not be able to obtain such information for the purposes of collecting its own taxes,

— there is a risk of commercial, industrial or professional secrets being disclosed,

— there is a risk of prejudice to the security or public policy of the receiving state.

The authority receiving the request may not refuse to supply information on the sole ground that it is held by a bank or similar financial institution. This is a significant improvement because numerous Member States had previously been invoking banking secrecy as a basis for refusing requests by their counterparts.

There is no assistance obligation where the debt is more than five years old or where it is less than 1500 euros in amount.

The requesting authority may not issue a request for recovery if - and for as long as - the demand for payment and/or the instrument giving it effect in that authority's country is contested.

As regards recovery in the Member State receiving the request, all recovery requests must be treated as if they had been issued by that state, subject to certain exceptions set out in the Directive.

If the authority receiving the request does not consider that the same or a similar tax is levied within its territory, it must use the powers and procedures laid down by the law of the requesting Member State (in relation to the tax in question), subject to those powers and procedures being compatible with its own law.

The authority receiving the demand may, if the applicable law of its state so permits, grant the debtor a period for payment, or allow payment by instalments and claim interest.

However the request itself may be the subject of dispute. Such disputes are dealt with as follows:

— if the dispute relates to the request itself, or to an enforcement procedure used in the requesting Member State, it must be brought before the competent institutions of that state,

— if the dispute relates to enforcement procedures used in the receiving Member State, it must be brought before the competent institutions of that state.

The Directive also prescribes standard forms for notifications in mutual assistance matters.

It further empowers the receiving state to take precautionary measures.

Even before it had been used, the 2010 directive was supplemented by *Directive 2011/16/EU of 15 February 2011,* on mutual assistance in tax matters, which will come into force on 31 December 2012.

Once again its scope is wider than that of the previous directives.

This Directive contains among other things:

— a provision limiting requests for information to the period after 1 January 2011 in relation to banking secrecy.

— mandatory timescales for responding to requests: 2 months if the authority receiving the request already has the information and 6 months if the request in question requires enquiries to be made.

— automatic exchange of information:
  - up to 2017: in relation to salaries, directors' fees, pensions, life assurance products and income from immovable property,
  - from 2017: in relation to dividends, royalties and capital gains.

— procedural provisions for:
  - border controls,
  - simultaneous tax investigations,
  - feedback and discussion of best practice.

2. Actual use in relation to direct taxes

The mutual assistance procedures are rarely used at present but this should change in the future.

a) Example 1: the case of a French company liable for a foreign tax

In this example, the tax authorities of a European state are claiming that a French company has a permanent establishment in their territory. In the meantime, the company has relocated its assets such that it no longer has any assets in the foreign state in question. Accordingly, the tax authorities of the foreign state invoke the mutual assistance procedure.

On these facts, the relevant sources of law are as follows:

— the European Directives and the tax conventions on revenue and wealth taxes, which may also contain assistance clauses,

— articles L283 A and following of the French Tax Procedures Handbook, as recently amended by the Fourth Amending Finance Law 2011, dated 28 December 2011 and transposing the 2010 Directive, which are applicable to requests made on or after 1 January 2012.

It should be remembered that the mutual assistance procedure is not available unless:

— an instrument permitting its use existed in the receiving state prior to the date of the request,

— the demand exceeds €1500,

— neither the demand nor the instrument making it enforceable is contested in the state where the requesting authority is based,

— the use of the appropriate procedure in the requesting state would not result in payment of the entire sum due.

This last condition is presumed to be fulfilled where the taxpayer has no assets in the country whose administration is making the request.

The stages in the procedure are as follows:

— a request for recovery is sent to the French tax authority,

— the authority acknowledges receipt of the request,

— recovery is to be made in accordance with French legislation but the applicable limitation rules are those of the requesting state,

— the procedure may be suspended if (i) France and the other Member State proceed instead by mutual agreement (ii) the demand or the instrument making the relevant procedure available are challenged in the requesting state.

In relation to the mutual assistance procedure, the main steps to be taken can be summarised as follows:

— checking that the procedure is available:
  - ensuring that the conditions for the use of the mutual assistance procedure are in fact fulfilled,
  - ensuring that the relevant procedural rules have been correctly followed,

— requesting a suspension of payment in France,

— contesting the tax claim on its merits before the relevant jurisdiction of the requesting state, if there are proper grounds for doing so. This is a means of having the procedure automatically suspended.

b) Example 2: the case of a non-resident company which is liable for French tax

In this second example, the French tax authority is claiming that the company, which is resident in an EU Member State, has not declared the existence of a permanent establishment in France.

It therefore demands that the company in question pay corporation tax in France.

If the company does not comply, the French tax authority may seize the French assets of the company or, if there are no assets capable of being seized or the entire sum due cannot be recovered, it can initiate the mutual assistance procedure (see example 1).

c) Other sources of law which might be relied on by the French tax authority

The French tax authority might also rely on civil law (transactions in fraud of creditors) or criminal law.

Proceedings based on a transaction in fraud of creditors (art. 1167 of the Civil Code)

Proceedings of this kind enable a creditor to pursue a debtor which has arranged its own insolvency, or reduced the value of its assets, with a view to defeating enforcement measures.

In a tax context, they enable the tax authority to maintain that the taxpayer cannot rely, as against the authority, on its fraudulent dissipation of assets.

That said, the French tax authority must overcome a number of difficulties before it can proceed in this way.

— **First difficulty:** identifying the competent jurisdiction for the purposes of such proceedings

This issue is not addressed by any Directive. It should nevertheless be noted that art. 5.5 of European Regulation 44/2001 appears to support the proposition that the competent jurisdiction is that of the country where the alleged permanent establishment is situated.

— **Second difficulty:** enforcement of the judgment

On the assumption that the French courts have jurisdiction, it is not certain that a civil judgment given in France will be enforceable in another Member State.

— **Third difficulty:** establishing dissipation of assets

The French tax authority must prove that the taxpayer has dissipated assets.

Criminal law

Art. 1741 of the General Tax Code empowers a French criminal judge to sentence a company resident in another Member State for tax evasion.

Under art. 113-2 of the Penal Code, such a fraud may be committed on French territory by a foreign company.

The criminal law does not stop there because, if certain conditions are satisfied, the shareholders of the company in question can be also treated as having committed the tax evasion which has been established.

The question which then arises is as to enforcement of the judgment of a French criminal judge in another Member State.

Under a framework decision of the European Council dated 6 October 2006, all Member States must recognise and enforce confiscation orders made in other Member States.

This principle is also set out in art. 713 and following of the Criminal Procedure Code.

In conclusion: Mutual assistance procedures within the European Union are becoming more and more effective. At the same time they remain highly circumscribed: a state receiving a request for assistance cannot act for as long as there is a dispute as to liability in the requesting state, and the steps open to the receiving state are limited to what is permitted on its soil. Also, as is clear from the recent decisions of the French Court of Cassation in the HSBC matters, the state must act in strict accordance with the law, and was thus prohibited from seeking redress on the basis of information which was initially stolen and then forwarded to the French prosecution service.

3. Mutual assistance and VAT - Case studies

a) Regulation 904/2010/EC

Adopted on 7 October 2010, **European Regulation 904/2010/EC,** which relates to administrative cooperation and exchange of information in VAT matters, lays down a number of rules and procedures as to cooperation and exchange of information between the tax authorities of EU countries, with the objective of:

— ensuring that the VAT rules are correctly followed,

— assessing the VAT due from taxpayers correctly,

— combating tax fraud,

— protecting VAT revenues.

Under this Regulation, each Member State must designate a single central liaison office to act as a point of contact for the purposes of cooperation with other Member States and the Commission.

The Regulation lays down certain procedures for cooperation in VAT matters:

— Use of electronic communication: one authority sends a request for information and enquiries to another, using a standard form. The requested information must be supplied as quickly as possible and no later than three months after receipt.

— The requesting authority may take part in an investigation carried out in the receiving state (a measure which, incidentally, has been extended beyond VAT matters as from 1 January 2012, under art. L.-612-6 of the Tax Procedures Handbook).

— In certain cases, the competent authorities may exchange some categories of information automatically using standard forms, without the need for a prior request.

The 2010 Regulation has also enabled an IT platform for storage and exchange of information, known as Eurofisc, to be created. Its purpose is to combat VAT fraud, and especially carousel fraud (see below).

Access to the system is not automatic: the authorities collect information on taxpayers and store it in a database. The information so collected is stored for five years. When a country wishes to access the information, it has to make a request and will receive a response within a maximum of three months.

The problem arising with this system is as to the quality of the information, since the taxpayer data entered by the various authorities is not updated.

b) Case study: carousel fraud

Summary of the mechanism

Simplified considerably, carousel fraud can be summarised as follows:

— **Company A,** located in Spain (or any other Member State) sells goods to company B, located in France. There is thus an intracommunity supply which is exempt from VAT under art. 262 ter of the General Tax Code,

— **Company B** resells the same goods (invoicing VAT) to company C, also located in France, but does not declare or pay the VAT due on the resale,

— **Company C** deducts or seeks reimbursement of the VAT paid against company B's invoice, under the general law,

— **Company C** resells the goods in question, possibly to company A or to any other company located in another Member State, such resale being exempt from VAT.

The VAT revenue lost by the tax authority is the amount of VAT that company C pays to company B, and that company B fails to repay to the tax authority (while C deducts it or claims reimbursement).

In practice, it appears that:

— this type of scheme is generally circular (C resells the goods to A),

— A, B and C often belong to the same natural or legal person,

— it sometimes happens that one of the entities involved in the scheme (C) is unaware of the fraudulent intentions of the other two.

Two observations can be made in this respect:

— **Firstly,** the taxpayer does not have the same resources as the tax authority, which prevents it from determining with any certainty whether its potential trading partners are fulfilling their obligations with regard to VAT.

A company can therefore find itself involved in a carousel fraud without its knowledge.

— **Secondly,** in the event of an inspection, company C will have to demonstrate that its participation in the carousel fraud was unwitting. In other words, company C must «prove a negative», which is a particularly difficult exercise.

Applicable penalties

Where a carousel fraud is established, the taxpayers involved may be subject to a wide range of penalties, in particular:

— reopening of VAT deductions,

— payment of the VAT due (all participants in the fraud are jointly liable for the sum claimed),

— reconsideration of the VAT exemption on the intra-community supplies made,

— criminal proceedings for tax evasion, under art. 1741 and following of the Penal Code; the maximum penalty is a fine of €500,000 and five years' imprisonment; where the fraud was carried out or facilitated by means of purchases or sales without corresponding invoices, or by means of invoices not corresponding to genuine transactions, or where its purpose was to obtain unwarranted reimbursements from the state, the person responsible may be fined €750,000 and imprisoned for five years. The legal officers of the companies involved may also be prosecuted (see art.

121-2 of the Penal Code), as may accounts staff and any other persons who have drawn up false accounts,

— criminal proceedings for fraud under art. 313-1 of the Penal Code. The maximum penalty is a fine of €375,000 and five years' imprisonment.

Stages of a carousel fraud investigation

In the case considered above, the tax authority may inspect company B's accounts to verify their validity.

In order to prove the carousel fraud, the authority must obtain information from the Member State where company A is established.

The French tax authority will therefore send a request to the central liaison office of the Member State in question, in which it will ask:

— for information concerning trade between company A and company B,

— for the authority to begin an inspection as to the amounts declared by company A, especially in relation to intra-community supplies,

— for information concerning the legal officers of company B,

— for information concerning company A, with a view to establishing whether that company has any genuine economic activity.

Representatives of the French tax authority may also attend the central liaison office of the other Member State in order to consult various copy documents (showing deliveries of goods, payment methods, etc.).

In this kind of procedure, it is crucial that the information sent by the other Member State is accurate. In some cases the information sent has been inaccurate and penalties have therefore been wrongly imposed on taxpayers.

In practice, this is why the Member States affected by a carousel fraud often prefer to launch simultaneous tax inspections relating to the taxpayers involved (rather than simply exchanging information).

4. A further question: observing the taxpayer's rights

The question of whether a Member State can legitimately use the information obtained from a state whose legislation does not provide sufficient guarantees for the taxpayer (such as a taxpayer's charter) has not yet been considered by the courts.

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The Common Consolidated Corporate Tax Base: what does the future hold?

After approximately eight years of preparation, in May 2011 the EU Commission released a Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB). If adopted, these provisions could enable European Union (EU) companies having one or more subsidiaries or one or more permanent establishments (PEs) in any EU Member State (including the Member State where the parent company has its registered seat) and certain third-country companies having a PE in the EU:

— to calculate the taxable result of all of their EU taxable entities (i.e., subsidiaries and/or PEs) using a common corporate tax base;

and

— to consolidate EU taxable results at group level by offsetting losses incurred by an EU taxable entity against taxable profits deriving from the activities of the group's other EU taxable entities.

Each EU entity in the group would then be apportioned a fraction of the overall tax base under an apportionment formula based on three criteria (sales, labour and tangible assets).

The fraction allocated to each entity would then be taxed at the corporate tax rate of the local EU Member State (there is no common corporate tax rate in the EU Commission's Proposal).

The CCCTB would apply to EU groups on an optional basis. Consequently, EU companies would have to make a choice between their domestic corporate income tax rules and the CCCTB rules, depending on their respective merits.

The purpose of this paper is to give an overview of the main rules contained in the Proposal released by the EU Commission and to try to evaluate the impact that the introduction of a CCCTB would have on EU groups. Broad indications of the possible developments of this project from a political point of view are also presented in the first section.

1. The content of the Proposal for an EU Directive on a CCCTB

a) General Overview

In its present form, the Proposal of the EU Commission provides for a common consolidated corporate tax base.

The concept of a **common** corporate tax base would allow EU companies to apply the same corporate income tax rules in all the Member States where they maintain a presence or where they carry out their business. This part of the Proposal therefore targets the lack of harmonization between Member States regarding the definition of the corporate tax base, which was frequently emphasized by prior communications of the EU Commission. By contrast, the concept of a consolidated corporate income tax base refers to the option given to EU companies to aggregate the taxable results achieved in the Member States where they carry out their business to obtain a global figure for taxable profit. This is probably the most ambitious part of the Proposal, since it involves apportioning the global taxable profit of the group between Member States by using an apportionment formula. Taken individually, very few EU member States are familiar with this method for determining the amount of tax payable under their domestic rules. Group taxation in the EU does not usually take the form of a profit apportionment. From the point of view of Member States, therefore, the most uncertain aspect of the Proposal is the way tax base would be apportioned to them if the Proposal were adopted in the future.

Practically speaking, the amount of corporate income tax due from groups which would opt for the CCCTB would be calculated by applying a **four-step method.**

First, the tax results of all the consolidated entities would be assessed according to a single set of tax rules across the EU.

In a second step, the tax results of the consolidated entities would be aggregated at the level of the group. Tax losses incurred in one Member State might then be offset against tax profits derived in another Member State.

Third, the consolidated tax profit would be apportioned to each group entity (i.e., to its subsidiaries or EU permanent establishments) according to predetermined legal criteria (sales, labour factor, tangible assets).

Finally, each group entity would pay the corporate income tax due on the profits allocated to it according to the corporate income tax rate of its own state of residence, which would not be harmonized.

Once the group had opted for the CCCTB, the scope of the CCCTB group would have to remain unchanged for 5 years (in contrast to the French consolidated tax regime – *"intégration fiscale"* – which allows the scope of the group to be changed annually). Therefore, it is relatively clear that tax competition between EU Member States would take the form of reductions in their respective corporate income tax rates and corporate tax reductions (various credits).

Since the CCCTB would only apply to corporate income tax and not to local business taxes, Member States where no local taxes exist would also have a clear advantage over Member States where local taxes represent a significant burden on businesses.

By introducing a CCCTB, the EU Commission is pursuing three main objectives.

The first of these is to allow companies to benefit from **cross-border tax loss offsets.** The issue has already been pointed out by the EU Commission on several occasions before[1] and after[2] the Marks and Spencer case. This objective is achieved by the measure allowing tax losses incurred in one Member State to be offset against tax profits derived from other EU member States without any limitation.

The second is to **simplify transfer pricing issues** within the EU so that current high costs of compliance will no longer have to be incurred. More innovatively, the CCCTB would allow corporations to go beyond the current "transaction by transaction" method, which has remained the reference to date, at least for EU transactions (transactions between EU entities and non-EU entities would however remain governed by the usual OECD rules).

Another objective is to provide EU multinationals with a **"One-stop-shop"** for filing their tax declarations. If the CCCTB enters into force, consolidated groups would then deal with a single tax administration within the EU, i.e. the tax administration of the EU Member State where the parent company is established.

b) Content of the Proposal

In its present form, the Proposal provides for the **scope of consolidation** to be limited to companies incorporated in the EU and subject to corporate income tax in their EU Member State of establishment. However, companies incorporated in third countries which maintain a PE in the EU would also be allowed to opt in to the system.

The **membership** of the consolidated group would comprise all the companies in which the parent company holds, directly or indirectly, more than 50% of the voting rights and more than 75% of the economic ownership. All EU PEs of such companies would also fall within the scope of the consolidated group. For the purposes of determining whether the thresholds of 50% of voting rights and of 75% of economic ownership are both met, the Proposal lays down two specific rules: first, where the 50% threshold is reached, the parent company is deemed to hold 100% of such rights; second, economic ownership is assessed against the 75% threshold by multiplying the interest held by the company in intermediate subsidiaries at each tier.

As far as the **common tax base** is concerned, the detailed provisions of the Proposal may be summarized as follows:

— The definition of taxable profit is wide. As a general rule, in fact, all profits are included in the taxable profit of the company. The Proposal nevertheless lists as exempt revenues received by way of profit distributions, proceeds from the disposal of shares and income from a PE located in a third country. The Proposal for a common tax base has therefore opted in favour of the introduction of a participation exemption regime inspired by the regimes of the Netherlands, Luxembourg and Belgium, which has been adopted (sometimes with variants) by most EU Member States to date (Germany, Austria, Portugal, Spain, Cyprus, Denmark, Hungary, Malta, Sweden, France and the United Kingdom).

— The definition of deductible expenses is also wide. In principle, all costs incurred with a view to obtaining or securing income are taken into account, including costs of research and development and costs incurred in raising equity or debt for the purpose of the business (including provisions and depreciation of fixed assets). Among the main non-deductible expenses are profit distributions and repayment of equity or debt, a proportion of the entertainment costs incurred by the company, corporate tax, fines and penalties, monetary gifts and donations, costs relating to the acquisition, construction or development of fixed assets, as well as costs incurred by a company for the purpose of deriving income which is exempt from corporate income tax (such as profit distributions received or proceeds from the disposal of shares). These latter costs are fixed at a flat rate of 5% of the exempt income, unless the taxpayer is able to demonstrate that it has incurred a lower cost.

Once the taxable profit of the group has been determined, and the tax losses incurred by some group entities offset against the taxable profits derived by the other group entities, the group's tax result is to be **apportioned** between the different entities. Under the present Proposal, any resulting CCCTB group taxable profit would be reallocated to companies using an apportionment formula based on the following criteria:

— number of employees (weighted 1:6 in the apportionment formula);

— payroll (also weighted 1:6 in the apportionment formula, leading to an overall labour factor weighting 1:3);

— tangible assets (weighted 1:3);

— sales, taking into account only those sales made to entities outside the group (weighted 1:3).

Under specific circumstances (notably where the taxpayer or the tax authorities of one of the Member States where the group is to pay its corporate income tax consider that the outcome of the apportionment method does not fairly represent the extent of the business activity of that group member) the use of an alternative method may be requested. In such circumstances, the alternative method may only be used if all the authorities agree to it.

Finally, it should be mentioned that anti-abuse rules have also been included in the Proposal. Notably, artificial transactions carried out for the sole purpose of avoiding taxation are to be ignored for the purposes of calculating the tax base of the group. The Proposal also contains rules restricting the deduction of interest where interest has been paid to a non-EU country and (i) there is no agreement on the exchange of information with that country that is

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1 See e.g. the 1991 Commission Proposal to allow offsetting of cross-border losses (COM (90) 595 final, OJEC C53/30 [1991]) which had to be withdrawn.
2 COM (2006) 824 final, 19 December 2006.

comparable to the exchange of information on request provided for in the EU Directive and (ii) the recipient of the interest benefits from a privileged tax regime in the third country. It should also be noted that a complex CFC rule has been included in the Proposal, targeting profits derived from companies held as to more than 50% and benefiting from a privileged tax regime where a substantial part of the revenues accruing to such a company (at least 30%) consist of passive income. However, no thin-capitalization mechanism has been included.

c) Main issues remaining

Considering the ambitiousness of the Proposal, the first issue to be addressed here is the possibility that not enough Member States want to go further with this project. Some EU Member States such as Ireland, the United Kingdom and most of the Eastern countries are notoriously reluctant to adopt the CCCTB. Other Member States such as Germany (which opposes the consolidation part of the Proposal but favours the idea of a common tax base) and the Netherlands do not share the same extreme position, but have nevertheless made their opposition to the project public. To date, three groups of EU Member States are emerging:

— 6 EU Member States are in favour or leaning in favour of the Proposal: Belgium, Czech Republic, France, Italy, Luxembourg and Spain;

— 12 EU Member States are against or leaning against the Proposal: Bulgaria, Cyprus, Estonia, Germany, Ireland, Latvia, Malta, Netherlands, Poland, Slovakia, Slovenia, United Kingdom;

— 9 EU Member States have not made public their opinion or have no opinion regarding the Proposal: Austria, Denmark, Finland, Greece, Hungary, Lithuania, Portugal, Romania, Sweden.

Considering the number of the Member States opposing the CCCTB and the economic weight of these countries within the EU, it seems doubtful that the Proposal will be adopted in the short term, at least in its present form.

In many respects, therefore, the current Proposal for a Council Directive for a CCCTB is more likely to serve as a starting point for negotiations among Member States rather than the conclusion of the long and laborious technical work carried out by the EU Commission since 2001.

Another obvious – and linked - issue is the timeframe needed for the Proposal to become law.

As the EU Commission introduced the Proposal under article 115 TFUE, it requires the unanimous consent of all 27 Member States in order to be adopted. This means that any Member State can veto the Proposal and that the EU Parliament has only a consultative role in the process, with no right to approve or reject the Proposal. As noted above, such unanimity seems highly unlikely.

Another way of introducing the CCCTB would be under the 'enhanced cooperation' procedure, which would require the agreement of only 9 EU Member States. There are, however, a number of administrative and substantive conditions that would need to be met before this procedure could be initiated, including conditions that the enhanced cooperation procedure:

— may only be used as a last resort, meaning that all other available options must be exhausted prior to implementation of this procedure (in practice, a veto by one or several Member States would probably satisfy this requirement);

— must not constitute a barrier to or discrimination in trade between Member States, or distort competition between them;

— must not entail any administrative cost for non participating EU Member States, which means that all administrative costs resulting from the enhanced cooperation must be borne by the participating Member States;

— must be approved by the Council, acting by qualified majority vote and with the consent of the European Parliament.

In practice, it seems realistic to expect that 9 Member States would be able to agree on a CCCTB model, considering the number of countries already in favour of the Proposal. However, the other requirements, and particularly the requirement that enhanced cooperation must not distort trade or competition in the EU internal market, could constitute a significant obstacle to enhanced cooperation since the Member States opposing the CCCTB would be likely to argue strongly that implementing a CCCTB within a subset of Member States would breach this requirement.

d) Next Steps

Pursuant to article 115 TFUE, the EU Commission released its Proposal for a Council Directive on CCCTB on 16 March 2011. Since the special legislative procedure applies to the adoption of this directive, the following steps will have to be completed:

— Consultation of the Economic and Social Committee;

— Consultation of the Committee of the Regions;

— Mandatory consultation of the European Parliament;

— Vote of the Council (unanimous assent required);

— If the unanimous assent of the Council cannot be achieved, then the enhanced cooperation procedure may be pursued by 9 Member States (see above).

On 26 and 27 October 2011, the Economic and Social Committee adopted the Proposal for a CCCTB. The Committee of the Regions also adopted the Proposal in its opinion of 14 December 2011.

At the time of writing, the process before the European Parliament is ongoing. According to the information available on the website of the EU institutions, the EU Parliament should vote on the consultation in mid-April 2012. The Council vote will take place later.

2. Case Study

By way of a closer examination of the way multinational groups with EU links could benefit from the CCCTB regime, the case study below provides a global comparison between the CCCTB rules and the domestic corporate income tax rules of four EU Member States (France, Germany, Italy and Portugal).

a) Description of the case

The FGIP group carries out business in four EU member States: France (F), Germany (G), Italy (I) and Portugal (P).

In **France,** the FGIP group maintains a presence through the following structure:

	F1 (SAS)	F2 (SA)	F3 (SA)
Activity	Holding	R&D	Marketing & Sales
Shareholders	-	Held as to 80% by F1	Held as to 100% by F1
Tax result	- €10,000,000 (case assumption)		
Turnover (intra-group)	€2,000,000	€50,000,000	€25,000,000
Employees	5	400	15
Total Salaries	€500,000	€35,000,000	€5,000,000
Fixed tangible assets	€100,000	€15,000,000	€2,000,000

In **Germany,** the FGIP group maintains a presence through the following structure:

	G1 (AG)	G2 (AG)	G3 (AG)	G4 (GmbH)
Activity	Local Holding	Production	Distribution	IT/IP
Shareholders	Held as to 100% by F1	Held as to 100% by G1	Held as to 100% by G1	Held as to 100% by G1
Tax result	+ €10,000,000 (case assumption)			
Turnover (intra-group, except G3)	€0	€250,000,000	€300,000,000	€15,000,000
Employees	0	1,000	60	8
Total Salaries	€0	€120,000,000	€6,000,000	€1,000,000
Fixed tangible assets	€0	€50,000,000	€3,000,000	€0

In **Italy,** the FGIP group maintains a presence through the following structure:

	It 1 (Sp.A)	It 2 (Sp.A)	It 3 (Sp.A)
Activity	Local Holding	Production	
Shareholders	Held as to 100% by F1	All Held as to 100% by It 1	
Tax result	+ €10,000,000 (case assumption)		
Turnover (intra-group)	€55,000,000 (consolidated)		
Employees	150 (consolidated)		
Total Salaries	€10,000,000 (consolidated)		
Fixed tangible assets	€20,000,000 (consolidated)		

In **Portugal,** the FGIP group maintains a presence through the following structure:

	Po 1 (LDA)	Po 2 (LDA)	Po 3 (LDA)
Activity	Local Holding	Production	
Shareholders	Held as to 100% by F1	Held as to 100% by Po 1	
Tax result	+ €10,000,000 (case assumption)		
Turnover (intra-group)	€40,000,000 (consolidated)		
Employees	100 (consolidated)		
Total Salaries	€5,000,000 (consolidated)		
Fixed tangible assets	€10,000,000 (consolidated)		

The FGIP group incurs tax losses in France, at the level of the FGIP holding company (F1). All the other companies in the group generate tax profits.

This case study will allow us to investigate two issues which would arise with the introduction of the CCCTB, as follows:

— Assuming that the current version of the CCCTB enters into force, should the FGIP group opt in to the regime?

— Assuming that the current version of the CCCTB enters into force, would a non-EU entity wishing to acquire the group have any incentive to structure the acquisition through the CCCTB, or in other words to have the target group opt in to the regime prior to acquisition of its holding company?

b) Opportunity to elect for the CCCTB

Under CCCTB rules, a parent company opting in to the CCCTB would have to consolidate its tax result with all the EU entities which are eligible for the regime (i.e. PEs located in the EU and EU subsidiaries or EU PEs of third-country subsidiaries in which the parent company holds more than 50% of the voting rights and 75% of the financial rights) under the 'all-in / all-out' rule. In the case at hand, therefore, only the French parent company of the group would be able to elect for the CCCTB. Consequently, CCCTB rules would only apply to the companies in the other Member States if F1 actually elected for the regime.

France

— Scope of consolidation

The advantages expected from opting in would be to allow foreign losses to be offset against domestic profits and, conversely, to allow domestic tax losses to be immediately offset against foreign tax profits.

Under present assumptions, with the application of the all in / all out rule, every company in the group described above would be part of the CCCTB if the group elected for the regime.

— Tax losses

Under French law, foreign tax losses incurred by EU permanent establishments of a French company may not be offset against French tax profits. Similarly, in principle foreign losses incurred by foreign subsidiaries of French companies may not be offset against French tax profits. The French domestic tax consolidation regime does not extend to foreign subsidiaries.

French law provides that tax losses may be carried forward indefinitely. However, the aggregated losses can only reduce the annual profit up to €1m plus 60% of the fraction of profits above this amount (new rules introduced in September 2011). Losses may be carried-back for one previous year, subject to a limit of €1m.

Whereas French law and practice regarding tax losses was more favourable than the CCCTB when the Council Directive was made public, the situation is now different due to the enactment of the second Rectifying Finance Act for 2011. The CCCTB rules are now more favourable regarding loss carry forward. However, French domestic rules remain more favourable regarding carry-back (although being capped this advantage should not rule out opting for the CCCTB).

— Calculation of the tax base

DEPRECIATION RULES

Under French rules, in principle assets are depreciated over their useful life on a straight-line basis. Elements forming part of a complex asset should be depreciated separately according to their own useful life when this differs substantially from that of the structure as a whole. Companies may rely on usage in determining the annual rate of depreciation. Pooling depreciation does not exist under French law, whereas it is the rule under the CCCTB. In certain cases, decreasing rates and accelerated depreciation methods may sometimes be allowed instead of the straight-line method. This possibility is not offered under the CCCTB.

The application of CCCTB rules could be advantageous for certain assets (certain intangible assets, goodwill, etc.), but not for others (buildings would be depreciated over 30 years and not 40, assets formerly eligible for accelerated depreciation would lose this status, etc.).

WRITE-OFFS

Under French Law, a decrease in the value of the assets booked in the relevant tax year may be deducted as long as it corresponds to exceptional depreciation of fixed assets, intangible assets or certain inventories and investment properties.

By comparison with the CCCTB rules, in terms of eligible assets, the French domestic regime is preferable to the CCCTB as the provisions of the CCCTB Proposal (article 41) are limited to fixed assets that are not subject to depreciation.

WAIVER OF DEBTS

French tax law distinguishes commercial from financial waivers of debts.

- Commercial waivers of debts arise where there is a trading relationship between the creditor and the debtor. Such waivers may be tax deductible if the creditor can demonstrate an interest in the operation.
- Financial "waivers of debts" or financial aids arise where there are merely financial relations (i.e. shareholding links) between the debtor and the creditor. These aids may be deductible up to the amount of any deficit in the debtor's net equity and, as to the balance, in proportion to the amount of the debtor's capital which is not held by the creditor.

It is generally accepted that the French rules governing waivers of debts are rather liberal in comparison with those of other jurisdictions.

By comparison, CCCTB deduction rules for waivers of debts could be less favourable than French domestic rules. It is however difficult to reach a final conclusion on this issue at this stage.

OTHER EXPENSES

Under French rules, in principle salaries and social contributions are fully deductible for corporate income tax purposes. The CCCTB therefore offers no particular advantage or disadvantage in this respect.

As a general rule, interest is fully deductible in France, even if it is incurred in the acquisition of an asset which does not generate taxable revenues. Thin capitalization rules and other anti-avoidance rules may however apply, in particular the newly introduced limitation on the deductibility of interest incurred by French entities in purchasing participation shares where the decision to acquire the shares was made abroad.

Since the CCCTB restricts the deduction of interest in comparatively limited circumstances, the regime may often be more favourable than the ordinary French provisions. However, since French tax law does not prevent the deduction of interest incurred in financing an asset which does not generate any taxable profits in France, domestic rules could sometimes remain advantageous, despite the recent introduction of a new anti-avoidance rule targeting certain acquisitions of participations.

— Comparison of the tax due from FGIP in France under domestic rules and under CCCTB rules

In the case at hand, if FGIP were (was?) to elect for the CCCTB, France would be apportioned 13% of the consolidated tax result of the FGIP Group, taking into account the situation of the French group companies in terms of assets, salaries, employees and turnover. The amount of tax due in France would thus be determined as follows:

- Consolidated tax return: €20m (i.e. - €10m + €10m + €10m + €10m)
- Tax base attributed to France: €2.6m
- Tax rate: 34.43%
- Tax collected by France: **€0.9m**

If FGIP did not elect for the CCCTB, the following corporate income tax would be due in France:

- Tax base: - €10m
- Tax rate: 34.43%
- Tax collected by France: **€0**

The election for the CCCTB therefore **increases** the total amount of tax paid by the group in France, which is logical since the French tax results determined according to domestic law were negative while the consolidated result determined under the CCTB is highly positive.

Germany

— Scope of consolidation

Opting in would be beneficial in that losses from subsidiaries in other (low tax) countries would be brought in. Under article 43 of the Proposal, profits and losses from all group members would be mutually offset, leaving only the net profit to be allocated to the group companies based on turnover, number of employees and tangible assets.

In the case at hand, the taxable base in Germany – where the overall tax rate is high – could be reduced by setting off losses from France.

Another expected advantage of the CCCTB would be simplified reporting. However, since the CCCTB rules would apply only to corporate income tax and not local taxes, the German FGIP companies would still have to file additional annual accounts, based on German accounting standards, for trade tax purposes. In Germany, therefore, the reporting situation would actually be worse under the CCCTB regime. However, at group level this drawback would be compensated for by FGIP's ability to offset French losses against German taxable profit.

— Tax losses

In the year when losses occur, the CCCTB rules are more restrictive than the German rules because losses may not be carried back to the previous year, whereas in Germany it is possible to carry losses back to the immediately preceding year, up to the amount of €511,500. In subsequent years, however, the CCCTB rules are more favourable. It is true that in Germany, losses may be carried forward for an unlimited period of time, but they can only reduce the annual profit up to €1m plus 60% of the fraction of profits above this amount aggregated. It follows that 40% of the profits exceeding €1m is always subject to tax ("minimum taxation rule"), which is not the case under the CCCTB rules.

Overall, it seems that the CCCTB rules are favourable for a large group since the carry back option of up to €511,500 is not very significant compared to the possibility of setting off losses in the future without limitation. Another advantage of the CCCTB lies in the fact that the German carry forward mechanism for losses is subject to change-of-control provisions according to which such losses may expire upon transfer of more than 25% of the shares in the company. The CCCTB is therefore of interest in that it enables this rule to be circumvented.

— Calculation of the tax base

DEPRECIATION RULES

Under German accounting rules, assets are depreciated over their useful life on a straight-line basis. Only assets with a value of €1,000 or less may be depreciated together in an asset pool over a time period of 5 years. Assets with a value of €410 or less may be deducted as expenses. Non-residential buildings are depreciated on a straight line basis over 33 years (a shorter depreciation term may be applied if a shorter useful life is demonstrated).

Under CCCTB rules, only assets with a useful life of 15 years or more are to be depreciated individually on a straight-line basis. Buildings are to be depreciated over a period of 40 years. Assets, costs and construction or improvement expenses of less than €1,000 do not qualify as assets and are deductible expenses.

The fact that the CCCTB proposal does not allow declining balance depreciation is not disadvantageous at the moment, because there are no such provisions in German tax law, either. However, in the past Germany has introduced special depreciation methods for assets purchased in certain periods when the German government was attempting to stimulate the economy (e.g. until 2007 and 2009-2010). It could therefore be disadvantageous in the future to be bound to straight-line depreciation when opting for the CCCTB in the event that accelerated depreciation became available under German law.

WRITE-OFFS

In Germany, in the event of a permanent decrease in value, fixed assets may be written down to their going concern value. If their value increases in subsequent years, the book value must be written up again (to a maximum of historic cost less any regular depreciation). This is preferable to the CCCTB as the provisions in article 41 of the Directive Proposal are limited to fixed assets that are not subject to depreciation. Even assets that are depreciated individually may not be written down. It should also be noted that there is no definition of the decreased value (market value) in the CCCTB proposal.

Under the German rules, write-downs on current assets are possible only where there is a permanent decrease in value. However, in such cases, the average profit may be deducted from the net realizable value. This is not the case under article 29, paragraph 4, of the Proposal for a CCCTB.

WAIVER OF DEBTS

Under the German tax regime, waivers of debts are treated as hidden capital contributions. Waivers of debts therefore lead to a (retroactive) increase in the acquisition cost of the shareholding in the company in favour of which the debt is waived. If part of a "bad debt" is waived, only that part of the debt will be regarded as a hidden contribution. The part of the nominal value that is reduced represents expenditure by the creditor and taxable profit for the debtor – provided that the debt has not been written down accordingly. Also, German tax groups do not require waivers of debts or other such capital measures. It is a precondition for tax consolidation in Germany (where foreign companies cannot be included in the tax group) that a profit-and loss transfer agreement is in place, under which all P&L accounts of the group's subsidiaries are settled at zero.

In light of these rules, the CCCTB rules seem clearer, but not necessarily more favourable.

OTHER EXPENSES

In Germany, deduction of interest is limited by the interest-barrier rules. Under these rules, the excess of interest payable over interest received may only be deducted up to 30% of EBITDA (exceptions: net payable interest does not exceed 3 million; company is not part of a group; capital ratio of the group is not higher than the company's). 25% of interest paid is added to the taxable base for the purposes of German trade tax.

Despite the high threshold of 3 million Euros applicable under the German rules, the rules of the CCCTB proposal are more favourable because they are limited to cases of actual misuse, where the company receiving the interest is subject to significantly lower taxation. The CCCTB does not contain any provisions targeting thin capitalization.

— Comparison of the tax due from FGIP in Germany under domestic rules and under CCCTB rules

In the present case, if the group were to opt in to the CCCTB then, considering the situation of its German companies in terms of assets, salaries, employees and turnover, Germany would be apportioned 73% of the

consolidated tax result of the FGIP Group. Therefore, the following amount of corporate income tax would be due in Germany (trade tax is not dealt with in this example):

- Consolidated tax return: €20m (i.e. - €1m + €10m + €10m + €10m)
- Tax base attributed to Germany: €14.6m
- Tax rate: 15.83%
- Tax collected by Germany: **€2.31m**

Conversely, if German tax rules applied, the following amount of tax would be due:

- Tax base: + €10m
- Tax rate: 15.83%
- Tax collected by Germany: **€1.58m**

Opting in to the CCCTB increases the total amount of tax paid by the group in Germany by 46%. This is due to the magnitude of the factors causing profits to be apportioned to Germany under the assumptions of the case, in terms of employees, turnover and assets.

Italy

— Scope of consolidation

Assuming a high tax loss position in France and a tax profit position in the other countries, opting in to the CCCTB will be advantageous since it enables profits and losses to be off-set at a consolidated level. If the group opts in, all the Italian entities will be included in the CCCTB.

— Tax losses

Following the new rules introduced in 2011, Italy permits losses to be carried forward indefinitely. In each tax period, previous tax losses can only be off-set up to a ceiling of 80% of taxable income for the period (i.e. a minimum tax is always payable). Start-up losses (i.e. losses incurred in the first three years) can be off-set indefinitely up to 100% of taxable income. Carrying back is not possible in Italy.

Compared to the domestic rules, the CCCTB rules are equally favourable or more favourable since there are no limits in terms of time or the amount that can be off-set.

— Calculation of the tax base

DEPRECIATION

Under Italian rules, tangible assets are depreciated individually on a straight-line basis. For each industry sector, specific tax depreciation rates (reduced by 50% in the year of acquisition of the asset) are provided for the various categories of assets normally used in that sector. There is no pooled assets depreciation. For assets with a unit cost of €516 or less, full deduction is permitted in the year during which the cost is incurred.

The CCCTB regime may be more or less favourable than the domestic rules, depending on the industry sector and type of assets. For buildings, the Italian domestic rules (yearly depreciation generally not lower than 3%) are more favourable than the CCCTB regime (2.5%).

There are specific provisions for intangible assets. Costs incurred in respect of intellectual property rights are deductible over 2 years (as against 15 under the CCCTB regime) with the exception of trademarks which are deductible over 18 years. The CCCTB is therefore not always advantageous.

It should be noted that a reform of the depreciation tax methods / rates is expected in Italy. The new depreciation rules should in principle be similar to the depreciation methods provided for by the CCCTB.

WRITE-OFFS

As a general rule under Italian law, write-offs of assets based on a permanent decrease in value are not deductible. Irrecoverable trade receivables can be written down (see below).There are no rules similar to those contained in article 41 of the CCCTB Proposal and, as such, the CCCTB regime appears more favourable than the Italian rules.

WAIVER OF DEBTS

Under Italian tax law, a waiver of debts – in the sense of a waiver by a shareholder of an amount due to it from the share-issuing company – is not deductible by the shareholder and is treated as increasing the tax cost of the shareholding. Equally, as regards the beneficiary company, the waiver is not taxable. Irrecoverable trade receivables are deductible if (i) the debtor goes bankrupt or (ii) the loss is proven by "certain and definite elements". A case by case analysis is always required. A write down of such bad debts is deductible in any given tax period subject to a minimum of 0.5% of face value and a maximum of 5%.

Regarding "bad debts", the CCCTB seems to be clearer since it lists the conditions to be satisfied for deduction.

OTHER EXPENSES

In Italy, as a general rule and with small exceptions for certain items, salaries are fully deductible for corporate income tax purposes. The CCCTB offers no particular advantage or disadvantage in this respect.

Any excess of interest payable over interest receivable may be deducted up to 30% of EBITDA. Any portion of that 30% that is not used in a given tax year can be carried forward. Furthermore, interest over and above 30% of EBITDA can be deducted in a subsequent tax year if 30% of that year's EBITDA is higher than the interest to be deducted for the same year. Since the CCCTB does not contain any thin capitalization rules (other than cases of misuse where the interest receiving company is subject to significantly lower taxation), in principle it is more favourable than domestic law.

— Comparison of the tax due in Italy under domestic tax rules and under CCCTB rules

In the case at hand, if the group were to opt in to the CCCTB then, considering the situation of its Italian companies in terms of assets, salaries, employees and turnover, Italy would be apportioned 10% of the consolidated tax result.

The amount of corporate income tax due in Italy under the CCCTB rules would be as follows:

- Consolidated tax return: €20m (i.e. - €10m + €10m + €10m + €10m)
- Tax base attributed to Italy: €1.80m
- Tax rate: 31.4%
- Tax collected by Italy: **€0.57m**

Conversely, if Italian rules applied, the following amount of tax would be due in Italy:

- Tax base: + €10m
- Tax rate: 31.4%
- Tax collected by Italy: **€3.14m**

Opting in to the CCCTB **decreases** the total amount of tax paid by the group in Italy by 82%.

Portugal

— Scope of consolidation

In the present case, electing for the CCCTB would mean that tax losses incurred abroad would be available indefinitely for set-off against the group's profit. Since all group entities would be subject to a common tax base and to the 'one stop shop principle', administrative and compliance costs should also be reduced, at least in Portugal.

All Portuguese companies which are deemed to be part of the group will be part of the tax group if F1 elects for the regime.

— Tax losses

Under Portuguese rules, cross-border losses cannot in principle be taken into consideration in ascertaining taxable profit. Tax losses may be carried forward for no more than 5 years and only up to 75% of taxable profit; no carry-back of tax losses is allowed. Furthermore, the transfer of tax losses within the context of group reorganization is only possible if the transfer is previously authorized by the Finance Minister and the economic substance of the transactions can be demonstrated.

In light of the above, the CCCTB rules would be more favourable since the set-off of tax losses is done on a consolidated basis, with no time limit and, provided certain conditions are met, it does not seem to be affected by a reorganization of the group.

— Calculation of the tax base

DEPRECIATION

Under Portuguese accounting rules, assets are depreciated over their useful life on a straight-line basis, and the law provides for maximum depreciation rates according to category of assets or industry. Assets are usually depreciated on a segregated basis using specific depreciation rates laid down by law. In certain cases, decreasing rates and accelerated depreciation methods may sometimes be allowed instead of the straight-line method.

By comparison, the application of CCCTB rules will result in a more simple process (most fixed assets will be depreciated through a pool system using a 25% annual rate).

WRITE-OFFS

Under Portuguese Law, a decrease in value of the assets booked in the relevant tax year may be deducted as long as it corresponds to exceptional depreciation of fixed assets, intangible assets or certain inventories and investment properties. Such deduction is only allowed if the tax payer obtains authorization from the tax authorities and is able to produce evidence of exceptional depreciation.

By comparison with CCCTB rules, in terms of eligible assets, the Portuguese domestic regime is preferable as the provisions of article 41 are limited to fixed assets that are not subject to depreciation. However, the Portuguese regime is subject to authorization from the tax authorities, which is not required under the CCCTB.

WAIVER OF DEBTS

Portuguese tax law distinguishes between waivers that are based on recognition of a bad debt, and waivers amounting to voluntary forgiveness of debt. Whereas a waiver of bad debt may be tax deductible as long as certain requirements are met regarding time, amount and collection procedures followed, a waiver amounting to voluntary forgiveness, with no collection procedures being followed, will not be considered tax deductible.

By comparison, CCCTB rules as to deduction of non-performing receivables seem to be more favourable (notably because they recognize past experience as a valid justification). Nevertheless the wording of the CCCTB rules is generic and the expression "the taxpayer has taken all reasonable steps to pursue payment" remains open to interpretation.

OTHER EXPENSES

In Portugal, salaries are generally tax deductible, as long as they are duly supported and relate to the company's taxable activity. The CCCTB offers no particular advantage or disadvantage in this regard.

Interest is also generally tax deductible. However, interest paid to related parties and to entities domiciled in listed offshore jurisdictions is only deductible for tax purposes if the transaction conforms to transfer pricing rules/arms length conditions. Interest paid to shareholders can only be deducted up to a rate of Euribor/12 months.

All in all, the CCCTB rules would be generally more favourable and less complex than the domestic rules.

— Comparison of the tax due in Portugal under domestic tax rules and under CCCTB rules

In the circumstances of the case study, if the group opted in to the CCCTB then, considering the situation of its Portuguese companies in terms of assets, salaries, employees and turnover, Portugal would be apportioned 4% of the consolidated tax result of the FGIP Group.

Under the CCCTB rules, the following amount of tax would be due in Portugal:

Consolidated tax return: €20m (i.e. - €10m + €10m + €10m + €10m)

- Tax base attributed to Portugal: €0.95m
- Tax rate: 25%
- Tax collected by Portugal : **€0.24m**

Conversely, if Portuguese rules applied, the amount of tax due in Portugal would be as follows:

- Tax base: + €10m
- Tax rate: 25%
- Tax collected by Portugal: **€2.50m**

Electing for the CCCTB **decreases** the total amount of tax paid by FGIP in Portugal by 90%.

Conclusion

In the case at hand, the main advantage of the CCCTB is the ability to offset the tax losses incurred in France against the taxable profits of all the other EU entities of the FGIP group. The practical consequences of this possibility are radical in this situation since the French tax consolidation regime does not allow FGIP to offset French tax losses against foreign profits. As a result, only €4.02m of corporate income tax will be due under CCCTB rules, whereas total corporate income tax of €7.22m would have been borne by the group under domestic rules. **The FGIP group would therefore make a saving of 44.3% by opting in to the CCCTB.**

Where tax losses incurred in a Member State may be offset against tax profits derived in the same Member State, e.g. pursuant to the rules of a domestic tax consolidation regime, the benefits of electing for the CCCTB are less clear and depend upon (i) the result of a detailed comparison between the common tax base of the CCCTB and the domestic corporate income tax basis of the Member States where the group carries out its business and (ii) the localization of the production factors. That comparison would have to be made since, as noted at the beginning of this study, in its present form the CCCTB may also apply to purely national groups with no presence in other EU Member states.

Indeed, it is worth noting that had the French companies made a profit of €10m instead of a loss of €10m, the conclusion of the study would not have changed drastically. In that case, the total amount of corporate income tax due from the FGIP group under the CCCTB would have been €8.07m, whereas the total amount of corporate income tax due under domestic rules would have been €10.66m. The saving achieved by electing for the CCCTB would still have been of critical importance, therefore, at 24.30%. This gain should not however be expected to last very long, since the purpose of the CCCTB is to refocus tax competition between EU member states on their corporate income tax rates. From a theoretical point of view at least, the possibility should not be excluded that some EU Member states would raise their rates to adjust to the introduction of the CCCTB.

c) Structuring an acquisition by reference to the CCCTB rules

Case study

ABC is a US group intending to acquire 100% of FGIP by acquiring 100% of the shares in its holding company (F1, G1, It1 or Po1, depending on the scenario). The target is valued at €250,000,000.

The acquisition price would be paid half in cash and half by means of a bank loan. The acquisition loan would be taken over a 5-year term at an annual interest rate of 5.00%, and reimbursable in fine.

ABC expects to receive an annual distribution from FGIP of at least €20,000,000 in cash.

We assume that the target group elected for the CCCTB prior to acquisition.

Acquisition of the French holding company

The income of FGIP Fr (Newco) consists of dividends from F1 and the foreign holding companies G1, It1 and Po1. These dividends are exempt from taxation, except that 5% of their amount is added back to the tax base.

	No tax group	French tax group	CCCTB
Germany	€3,750,000	€3,750,000	€4,096,248
France	€0	€0	€866,380
Italy	€3,925,000	€3,925,000	€244,694
Portugal	€3,125,000	€3,125,000	€422,423
Total Tax Due	€10,800,000	€10,800,000	€5,629,745

Conclusion: the tax burden is significantly lower under the CCCTB because the benefits of tax consolidation extend beyond France.

Acquisition of the German holding company

We assume here that G1 is the parent company of the FGIP group (instead of F1) and that ABC acquires 100% of G1 (and therefore 100% of the group).

The income of FGIP AG (Newco) consists of dividends from G1. These dividends are exempt from taxation, except that 5% of their amount is added back to the tax base.

	No tax group	German tax group	CCCTB
Germany	€4,161,750	€4,030,500	€4,096,248
France	€0	€0	€866,380
Italy	€3,925,000	€3,925,000	€244,694
Portugal	€3,125,000	€3,125,000	€422,423
Total Tax Due	€11,211,750	€11,080,500	€5,629,745

Conclusion: the total tax burden is significantly lower under the CCCTB because the French tax losses and the finance costs are fully deductible from the tax base. However, since the CCCTB does not extend to German trade tax, a quarter of the interest paid will be added to Newco's taxable base for the purposes of trade tax.

Acquisition of the Italian holding company

We assume finally that It1 is the parent company of the FGIP group (instead of F1) and that ABC acquires 100% of It1 (and therefore 100% of the group).

The income of FGIP It (Newco) consists of dividends from It1. These dividends are exempt from taxation, except that 5% of their amount is added back to the tax base.

	No tax group	German tax group	CCCTB
Germany	3 795000€	3 750000€	4 096 248€
France	0€	0€	866 380€
Italy	4 343 631€	3 416 702€	244 694€
Portugal	3 162 500€	3 125000€	422 423€
Total Tax Due	11 301 131€	10 291 702€	5 629 745€

Conclusion: the tax burden is significantly lower under the CCCTB because the French tax losses and the finance costs are fully deductible from the tax base. Dividends are also treated as exempt revenues. Since IRAP is outside the ambit of the CCCTB, an additional tax burden of 3.9% will be borne in Italy.

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Tax-efficient cross-border finance structures: opportunities and constraints

Heavier tax burdens, increasing harmonisation of tax in Europe and the development of international administrative assistance are all making European cross-border financing a more delicate exercise. In the example we have chosen, a Belgian or Luxembourg finance vehicle is interposed between a French parent company and an operating company in Eastern Europe.

In a second section, we consider the case of loans made by a parent company in one state and a subsidiary established in another. The question addressed is as to taxation of cross-border debt waivers.

1. Cross-border financing through hybrid debt

International financing of an operating company through hybrid debt involves creating a finance company situated between the ultimate parent company and the company requiring finance. Using an intermediate company is a complex exercise and the tax advantage must therefore be significant in order to justify the involvement of the finance company. This tax advantage is based on the combined possibilities:

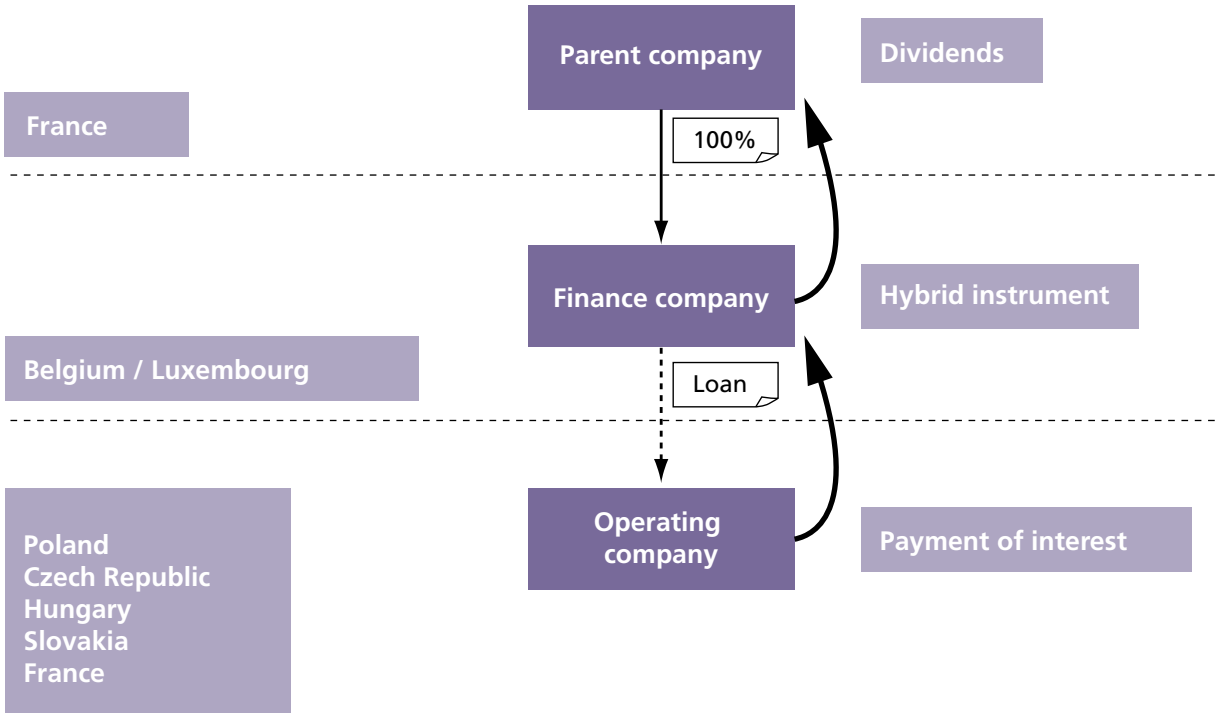
— of the operating company deducting its interest payments and avoiding withholding tax;

— of the finance company limiting tax on its income;

— of the ultimate holding company avoiding tax on the dividends distributed by the finance company, again without withholding tax.

The structure of this international finance scheme thus involves three parties. For the purposes of this case study, the parent company will be a French company wishing to invest in Eastern Europe. The finance company will be in Belgium or Luxembourg and the company to be financed may be in Poland, Hungary, the Czech Republic, Slovakia or even in France. The feasibility of this operation from the point of view of the three parties involved will be considered below.

Its structure is shown in the following diagram:



a) The parent company's position

International financing is not worthwhile unless the tax implications for the parent company are favourable. It is therefore essential to begin by ensuring that the dividends received by the holding company will be subject to the normal parent/subsidiary rules and that the operation will not be treated as an artificial structure or an abuse of legislation.

In France the normal parent/subsidiary rules exempt dividends received as to 95% of their amount where the parent company has held at least 5% of the capital and voting rights in the subsidiary for at least two years. There is no legal requirement for the subsidiary to be subject to corporation tax in order for the exemption to apply. This is a particular feature of the French system which has an important role to play in international structures.

The applicability of these rules does not create any particular difficulty in principle, therefore, and only requires that the need for the parent company to opt in is not overlooked.

Nevertheless, there is a risk of the dividends received being recharacterised as profits subject to corporation tax at the usual rate.

Art. 209 B of the General Tax Code enables the tax authorities to tax the parent company in respect of the profits made by a foreign subsidiary, where that subsidiary is subject to a privileged tax regime. The meaning of "privileged tax regime" is not altogether settled, as shown by a series of Conseil d'Etat decisions. For this reason, close attention should be paid to the location of the subsidiary, in order to ensure that it does not fall under such a regime. While French law provides that art. 209 B does not apply to subsidiaries established in a European Community State, this is subject to an exception for artificial structures designed to circumvent French tax legislation. To prevent the parent company falling foul of this, the finance company must be given some substance in terms of human, physical and financial resources.

Taking this precaution also limits the risk, arising once more under the abuse of legislation principle (see below), of the dividends distributed by the finance company being recharacterised as interest.

b) The finance company's position

Since it is at the level of the finance company that the tax advantage can be achieved, its place of establishment is critical. The intermediate company has links with both the operating company (as lender) and the parent company (as subsidiary). It is therefore essential for the tax regime to which it is subject to be compatible with the legislation of the other two states. In this regard, Belgium and Luxembourg offer lower effective taxation of the interest, while also avoiding withholding tax.

— Establishment of the finance company in Belgium

The choice of Belgium as the place of establishment of the finance company is based on the system of deducting notional interest. This system is intended to reduce tax discrimination between equity-financed and debt-financed entities. Entities in the first group are therefore permitted to deduct a notional interest payment calculated on their equity capital. It should be noted that the equity capital figure used in the calculation of this interest payment is adjusted, in particular by excluding financial assets. The finance scheme should therefore avoid a situation where the operating company is held by the finance company. Otherwise, the amount used to calculate the notional interest - and the permitted deduction - would be reduced to the extent of the shareholding shown as a financial asset on the finance company's balance sheet.

Example

Assumed figures:

- Equity capital of the Belgian finance company: 1,000
- Loan to the operating company: 1,000
- Rate of interest on the loan: 4%
- No withholding tax (Directive 2003/49/CE)
- Rate of corporation tax: 33.99%

Tax calculation for the Belgian finance company:

- Finance company's profit per accounts: 40
- Deductible notional interest (2012 rate of 3%): 30
- Taxable profit: 10
- Tax due: 3.399
- Finance company's effective rate of tax: 8.497%

The saving achieved by the group is based on this deduction of notional interest. It should be noted that, for budgetary reasons, the Belgian legislature has recently tightened the system of notional interest. As from 1 January 2012 the rate of notional interest is subject to a ceiling of 3% and it is no longer possible to carry forward non-deducted interest. Transitional measures have been put in place to prevent this change from operating retrospectively. Accumulated non-deducted interest as at 31 December 2011 can therefore be carried forward indefinitely, subject to a ceiling of 1 million euros. Above that ceiling, accumulated interest can only be deducted up to 60% of the tax base.

Belgian hybrid financing remains of interest despite these new measures, but they will inevitably reduce the scheme's effectiveness. Close attention to the situation is needed, as notional interest is not the only area of tax that the Belgian government wishes to reconsider.

The thin capitalisation rules are another. It will be recalled that this regime, in its current form, is relatively unrestrictive. It only applies where the finance company is established in a "tax haven" or "privileged tax regime" or where the lender (a foreign corporation) holds an office within the debtor company. The measure envisaged by the government would involve extending the scope of the thin capitalisation rules by analogy with the French regime, which would make them much more generally applicable than currently.

The government has also submitted a piece of anti-avoidance legislation to Parliament, which is based on a reversal of the burden of proof as against taxpayers in respect of operations carried out principally for tax purposes. Under that legislation, it would be for the taxpayer accused by the tax authorities to prove that it had not been principally motivated by tax reasons. Fortunately, the Belgian Conseil d'Etat has expressed serious doubts as to whether such a measure would be constitutional, and as a result the government can be expected to review the text.

— Establishment of the finance company in Luxembourg

Luxembourg's relatively flexible tax regime has been attracting financing structures for a number of years. Nevertheless, it too is undergoing changes. In this regard a recent circular on transfer pricing requires a transfer pricing dossier to be produced in order to obtain government approval of the rate of interest, and presupposes that the Luxembourg company has a degree of real substance. Furthermore, interest may only be deducted if the arm's length principle has been observed. Otherwise, the interest payments are treated as dividends.

In principle, the tax rate on interest received by a Luxembourg company is 28.8%. Several specific structures exist, however, which can make the situation more attractive.

Back-to-back financing, for example, is based on the intermediate company borrowing in order to finance the loans made to subsidiaries. A system of deduction similar to that applicable to Belgian notional interest can also be used. Finally, the use of hybrid instruments creates opportunities - which may be more or less significant depending on the state - for tax optimisation, and these should be illustrated.

Example 1

We will first consider the case where the Luxembourg company makes a hybrid loan to the operating company. The purpose of this is to assimilate the loan to capital, so that the income received can be treated as dividends falling under the parent / subsidiary exemption. The need for approval from the Luxembourg tax authority presupposes a certain amount of work on the nature of the loan, in particular on its duration, bearing in mind that it may (or may not) be participating, convertible, etc.

Example 2

In the second case we consider the position where the Luxembourg subsidiary is not able to make a hybrid loan to the operating subsidiary. An ordinary loan is therefore made. The parent company will endow the Luxembourg subsidiary with traditional company capital, but the shares issued by the subsidiary will have certain special features. For example, the shares may be repurchaseable at short notice, or may carry a right to preferential dividends (voting rights are then very restricted). Taken together, these features will enable the Luxembourg company to assimilate the capital contribution to a loan. In this way, the Luxembourg company will be treated as making deductible interest payments, which will be treated as exempt dividends by the parent company.

Example 3

The last case involves the use of a concept similar to that of Belgian notional interest. The Luxembourg subsidiary forms a new subsidiary of its own, which makes it an interest-free loan in the same amount as the loan to the operating subsidiary. The state in which the new subsidiary is established must allow such a loan to be made without reference to transfer pricing legislation. With the loaned funds, the Luxembourg company will be in a position to finance the operating company and will receive taxable interest. However, in order to restore market conditions in accordance with the arm's length principle, the taxable amount will be reduced by the notional cost of the loan received free of charge from the new subsidiary. The tax paid by the Luxembourg finance company will therefore be reduced to a corresponding extent.

All of these schemes limit the extent to which the finance company is taxed on interest, so that larger dividends can flow upstream to the parent company. The simplicity of the Belgian scheme may be preferable, as the complexity of the Luxembourg structures may attract attention. However, in reality it is the tax exemption of the dividends received by the French parent company, under the parent / subsidiary rules, that will give rise to suspicion on the part of the tax authority.

The French parent / subsidiary rules can be prevented from applying in two ways. The first involves undertaking a legal analysis in which the parent company is held not to be a shareholder within the meaning of French law.

The second is based on the concept of abuse of legislation. The associated procedure is particularly cumbersome and can lead to heavy penalties. Its use is subject to a legal framework which the courts are tending to refine, as illustrated by the recent Alcatel decision of 2011 (Conseil d'Etat, 9th et 10th subdivisions, case 322610 Min. v. Sté Alcatel CIT 15 April 2011).

In that case, a French company had made a capital contribution to a Belgian coordination centre in exchange for shares. Over a two-year period, the capital provided to the Belgian organisation was used to finance other subsidiaries within the group, and the dividends paid to the French parent company were exempted from taxation under the parent / subsidiary rules. At the end of that period, the French company resolved to resell the shares at cost price. The tax authorities considered that the operation as a whole amounted to an abuse of legislation. The purpose of the parent / subsidiary rules was, in its view, to avoid double taxation. There was no reason to apply them in the present case because the finance income received by the coordination centre was not taxed. The Conseil d'Etat rejected the tax authorities' argument as:

- the coordination centre had real substance in that there were 80 qualified employees working there;

- since the rules did not require that the subsidiary was subject to tax, the mere fact that it was not taxed could not constitute an abuse of legislation.

c) The operating company's position

The operating company is the last link in the international financing chain. For present purposes, we have assumed that the operating company is established either in certain Eastern European countries, or in France. In both situations, the tax issues are the deductibility of interest and the lack of any withholding tax on that interest when paid to the finance company.

— Where the operating company is Polish, Czech, Hungarian or Slovakian

Whether the operating company is established in Poland, Hungary, the Czech Republic or Slovakia, the interest paid to the finance company is deductible from its taxable income. It should be noted that only actual payment of such interest triggers the right to deduct. Interest may nonetheless be rendered non-deductible under thin capitalisation rules. In this regard, Poland's legislation is rather flexible as loans from a parent or sister company are ignored in calculating the ratio. By contrast, the Hungarian thin capitalisation rules are strict in that all the company's borrowing is taken into account. Only bank loans are excluded from the thin capitalisation rules.

In Hungary, the Czech Republic and Slovakia, there is no real issue as to withholding tax on interest payments. The 2003 Directive (Directive 2003/49/CE of 3 June 2003) applies such that interest payments between EU companies are exempt from withholding tax.

In Poland, on the other hand, a 20% withholding tax continues to apply. Poland has a long period for transposing the Directive, which will come to an end in June 2013. Until the European exemption, which applies where the debtor company is held as to 25% by the creditor, becomes available, bilateral tax conventions provide the only basis for reducing the withholding tax.

— French company

The case where the operating company is established in France is relatively common but requires greater care and attention.

In principle, the fact that the company is self-governing, and the absence of any involvement by the tax authorities in its management are sufficient to ensure that the interest is deductible. However, the abuse of legislation principle remains available to the tax authorities, and can be used as a weapon enabling it to challenge the deduction of interest in certain cases, as some opinions of the Committee on Abuse of Tax Legislation demonstrate.

For example, an opinion recently issued by the Committee concerning a subsidiary which had been refinanced by its parent company, using bonds which were convertible into shares, concluded that there was an abuse of legislation since:

- this form of financing, used for the first time, did not improve the financial structure of the company;
- the issue of bonds did not give rise to any actual movement of money but only to accounting entries;
- the interest due depended on the company's net profits;
- the interest was not taxed in the recipient's jurisdiction.

The Committee therefore approved the recharacterisation of the interest as non-deductible dividends.

On the other hand, the Committee issued an opinion adverse to the tax authorities in 2011, in relation to a subsidiary which had received a participating loan enabling it to improve its financial structure considerably. In justifying its position, the Committee pointed out that the loan did have the characteristics of a debt in legal and accounting terms.

It should be noted in this regard that the battleground for disputes as to deductibility of interest and abuse of legislation is slowly changing in favour of a correlation between deductibility of interest and taxation in the recipient's hands. This argument, already advanced by the tax authorities in Van Ommeren Tankers (Paris Administrative Court case 94-1885, 29 October 1998), is based on the interdependence that exists in French law between the deductibility of a sum in the hands of one party and its taxation in those of another. On the facts, the Paris Administrative Court nevertheless rejected the contention that there was an abuse of legislation, as the interest had in fact been taxed in the Netherlands. This new argument should be borne in mind, and the tax authorities' future efforts monitored, as certain schemes involve the exemption of interest (albeit partial) in the hands of the finance company.

Moreover, the drive towards tax harmonisation in Europe has very recently given rise to the publication of the "green book" on Franco-German convergence. Attention should be drawn to two areas under consideration, which are directly linked to international financing:

- deductibility of interest could be made subject to a general ceiling;
- a degree of symmetry could be required between the interest deducted and the exempt income received.

Finally, it should be pointed out that in France, since March 2010, withholding tax no longer applies to interest paid to a foreign creditor, where that creditor is not established in a non-cooperative state or territory.

2. Waiver of cross-border debts

We will now address the issue of waivers of cross-border debts. In this situation, the tax efficiency of cross-border financing depends on enabling the parent company (the creditor) to deduct the waiver while the subsidiary (the debtor) remains exempt from taxation on the same amount, or at least able to offset losses against it.

Where the creditor company is French, the agreed waiver will be deductible provided that it is justified by reference to the interests of the creditor company itself, and not the interests of the group (a concept which of course is not recognised in French law).

Two types of debt waivers should be distinguished. Commercial waivers, made in favour of trading partners in order to preserve future profitability, are deductible without limitation. Pure financial waivers, made in favour of subsidiaries, are only deductible to the extent that the subsidiary has a balance sheet deficit. This dichotomy, simple as it is in principle, has nevertheless given rise to extensive case law, illustrating the need to remain vigilant in terms of justifying such waivers.

In addition, while neither the tax authorities nor the cases have, so far, made the deductibility of cross-border debt waivers subject to their actual taxation in the debtor's jurisdiction, there is no guarantee that this will remain the case in future.

The position of a Luxembourg company that waives a debt in favour of a foreign debtor company does not pose any problem since the Luxembourg company can deduct the waiver from its profits. By contrast, when such a waiver is made in its favour, the corresponding increase in its net assets is taxable, but the law permits losses made elsewhere by the company to be deducted from the resulting taxable profit. Inspired by the German concept of a hidden capital contribution, the law of Luxembourg even enables the waiver to be treated in some circumstances as a non-taxable capital contribution, if it is made with a view to restoring the company's financial position.

In principle, Belgian legislation also permits a debt waiver to be deducted but there is a difficulty in relation to "abnormal and voluntary advantages". Thus, debt waivers are only deductible when made in favour of a subsidiary whose financial viability is threatened to the point of endangering the reputation of the shareholder.

Where that is the case, the company in whose favour the debt is waived will in principle be taxed on the extraordinary profit it makes by virtue of the waiver, with the right to set off losses incurred elsewhere. If the company's viability is not in question, the group might suffer twice. The parent company will be unable to deduct the waiver from its taxable income, and the foreign subsidiary may be taxed on the same sum. In the case of a group where parent and subsidiary are established in Belgium, the subsidiary is even prevented from setting off its losses against the extraordinary profit. Belgian law nevertheless provides that where the company is under insolvency procedure, the parent company may deduct the amounts waived while the subsidiary is not taxed on them. Finally, it is possible to protect against unpleasant surprises by seeking an advance ruling from the Belgian tax authority. It will be necessary to demonstrate the economic and financial necessity for the waiver and, potentially, to insert a clause providing for repayment in the event of a return to financial health. Clauses of this kind should not be inserted in the absence of an advance ruling, as the case law is very unclear as to their effects.

The case study set out in the first section above considered financing for a company established in Eastern Europe. We would draw attention to a particularity of Polish tax law: a Polish company that waives all or part of a debt in favour of one of its subsidiaries may not deduct the waiver, while the subsidiary is taxed on the principal amount of the waived debt. There is a debate as to the taxation of unpaid interest. One school of thought is that unpaid interest cannot be taxed since the debt has been extinguished. A second school of thought, to which the Polish tax authority subscribes, maintains that a gratuitous transfer of property should always be taxed. Adding the waived interest back into the tax base would make this possible. Fortunately the case law appears to support the first school of thought, as the courts have so far refused to add waived interest back into the beneficiary company's tax base.

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Real estate acquisition structures in Europe: the main tax issues

Any real estate investment raises the issue of acquisition structures. Should an ad hoc vehicle be created, in the country where the building is located, to hold the property or the shares of the target real estate company? Is it appropriate to create an intermediate holding company in a third state, either to hold the building directly or to hold the shares in the locally-formed real estate company?

The different holding structures have varying tax consequences attached, in terms of taxation of lease income, deductibility of acquisition costs and finance charges, taxation of passive income (dividends and interest), taxation of capital gains on subsequent transfers and registration duties.

Certain acquisition schemes or structures give (or gave) rise to tax advantages well known to investors and their advisers. These advantages may arise from provisions of domestic tax law, or from bilateral or international tax conventions.

The tax authorities in the state where the investor is resident, or where the property is located, are paying closer and closer attention to these schemes and the real motives for their adoption: is the rationale based exclusively on tax considerations, or did other factors lead to the particular structure being adopted? On varying legal grounds, the authorities are attempting to challenge such schemes and contest the applicability of the advantageous provisions of domestic or convention law.

These challenges may be based on anti tax evasion measures, treaty shopping, or disputing the reality of the operation or the substance of the holding company. We will describe recent trends in various countries.

In what follows, we focus on investors in France, Germany or the UK. The intended real estate investments are in Russia and Hungary.

1. Deductibility of loan interest

The choice of finance type (debt or capital), and the selection of the structure which is to pay loan interest, have consequences for the tax deductibility of loan interest.

While legislation generally allows interest to be deducted, it may lay down limitations.

In **Germany,** interest is calculated at the level of the individual legal entity and is deductible up to 30% of tax EBITDA (in contrast to France, where the debt ratio is calculated on the basis of profit before tax and recurrent items, determined in accordance with the accounting definition but subject to certain adjustments). Dividends on share investments are taken at their taxable amount only, namely 5% of the gross dividend. For example, a German holding company that receives 1 million euros in dividends from a wholly-owned subsidiary may only deduct 15,000 euros in interest, being 30% of the dividends received, taken at 5% of their amount.

This limit applies not only to interest paid to related companies, but also to that paid to other lenders (including any financial institution). In contrast to France, where the limit applies to interest paid without deduction of interest received, the German limit relates to the net amount of interest, or in other words the amount remaining after interest received has been offset (in France, if interest received exceeds interest paid, the limit is similarly inapplicable).

The impact of these rules is softened by various safeguarding provisions, and in particular by the fact that interest may be deducted in its entirety where it does not exceed three million euros per annum per company (compare the excess interest exemption of 150,000 euros which applies in France).

In **France,** the thin capitalisation rules apply to loan interest paid to related companies or, in certain cases to bank loans, where the lending financial institution has procured a guarantee from a company associated with the borrower. The French thin capitalisation rules apply to interest on loans taken out to finance the acquisition of buildings or shares in real estate companies, whether the buildings are located in France or abroad (and whether the shares relate to a French or a foreign company).

A new limit on the deduction of loan interest came into force on 1 January 2012. It relates to interest on debts incurred in the acquisition of shares (and not the acquisition of real estate) and applies where the borrowing company does not have control over its subsidiary. Nevertheless, this limit does not apply to interest on loans taken out to finance the acquisition of shares in predominantly real estate companies (on the other hand, there is no exemption for capital gains on the sale of such shares, as they do not fall within the definition of participation shares). Equally, the limit does not apply where shares are acquired in foreign real estate companies, whether they hold properties mainly in France or mainly abroad. Indeed, shares in predominantly real estate companies are not regarded as participation shares wherever they relate to a company whose assets are mainly real estate assets, irrespective of their location.

Investors should pay close attention to any move by France to align its thin capitalisation rules with the legislation currently applicable in Germany.

In **the UK** and **Russia,** the deductibility of interest is again limited by domestic thin capitalisation rules (in relation to Russia, we refer to the CMS Tax Connect Flash of 19th of March 2012 titled "Russia: Thin capitalization provisions - old rules, new trends").

2. Carrying-forward of losses

We should also mention a change which has occurred in **France,** inspired once again by the German system, in the way tax losses are carried forward. Since the 2011 tax year, carried forward tax losses have only been deductible, where profits exceed 1 million euros, to the extent of 60% of the profits exceeding that threshold. Consequently, 40% of the profits exceeding 1 million will now always be subject to corporation tax. If profits are less than 1 million euros, carried forward tax losses can still be deducted in their entirety. Losses that cannot be deducted as a result of this limit can still be carried forward indefinitely.

These new rules have a particular impact on real estate investors who may realise very significant profits from time to time, through capital gains on the sale of buildings, or shares in predominantly real estate companies, because such capital gains, where they are taxable in France, are subject to the standard rate of corporation tax.

3. Capital gains on the sale of shares or buildings

With only a few exceptions, capital gains on the sale of real estate assets are taxable in the country where the property is located (this is the case under most tax conventions). It will be recalled that Luxembourg investors could formerly obtain double exemption in respect of capital gains on the sale of buildings located in France. This anomaly came to an end in 2008, when France and Luxembourg adopted a protocol to their tax convention. The same anomaly was brought to an end in relation to France and Denmark, again in 2008, through Denmark's termination of its tax convention with France.

As regards taxation of capital gains on the sale of shares in real estate companies, while national legislation generally provides for these to be taxed locally, tax conventions may divide the right to tax in different ways. Certain conventions adopt the principle of taxation in the beneficiary's state, with a possible exception for substantial holdings, while others (recent conventions based on the OECD model) provide for taxation in the state where the properties are located.

In **France,** capital gains on the sale of equity shares are 90% exempt (this exemption is subject to an add-back representing expenses and charges, which has been 10% since 2011 and was 5% up to 2010). This exemption does not apply, however, to capital gains on the sale of shares in predominantly real estate companies, which are not regarded as participation shares. Such gains are therefore subject to corporation tax at the general rate (33 1/3%, or 36.10% taking into account the additional corporation tax contributions due from certain companies).

On the other hand, capital gains on the sale of shares in listed real estate companies (SIICs in France, or equivalent companies in France or abroad) are taxed at the reduced rate of 19% (20.57% with surtaxes).

2012 has nevertheless seen the withdrawal of the reduced rate (19%) which applied to sales of buildings or shares in unlisted real estate companies to SIICs. Such gains are now subject to the normal corporation tax rate of 33 1/3%.

In **the UK** too, capital gains on the sale of shares in real estate companies fall outside the exemption for sales of substantial holdings.

Equally, in **Germany,** capital gains on the sale of shares in real estate companies are taxable in the normal way, and the 95% exemption for gains on the sale of equity shares is not available.

In **Russia,** capital gains on the sale of shares, including shares in real estate companies, are taxable at the rate of 20%. Nonetheless, for shares acquired since 1 January 2011, a total exemption in respect of such gains will be available in Russia where the shares have been held for at least 5 years. Consequently, the effects of this new provision will not be felt until 2016. The exemption will also be available in respect of capital gains on sales made by real estate companies.

It should be noted that the current tax conventions with Luxembourg, Cyprus and Switzerland are in the process of being renegotiated. At present, those conventions give non-negligible advantages to entities which are established in those states and invest in real estate in Russia, with regard to taxation of capital gains on the sale of shares in Russian real estate companies (reduced rates, generally 0%). If the negotiations reach a conclusion, the current exemptions may cease to apply in relation to those three countries.

In addition, Cyprus is currently on the blacklist of tax havens produced by the Russian administration, and particular attention is now given to companies established there.

4. Taxation of dividends

Various countries have introduced exemptions for dividends received from subsidiaries, subject to minimum capital interests and holding periods, or to a requirement that the subsidiary is taxed under a particular regime.

Thus, in **France,** dividends on participation shares are 95% exempt (capital gains are only 90% exempt, hence there is a difference of treatment between dividends and capital gains), subject to an add-back of 5% representing expenses and charges. A comparable system applies in Germany and the UK.

In France, dividends distributed by SIICs or equivalent foreign companies whose profits are exempt do not have the benefit of the parent / subsidiary rules. Such dividends are therefore chargeable to corporation tax at the standard rate.

This tax advantage is generally refused where the dividends are paid by subsidiaries established in tax havens. Thus, in Russia, dividends distributed by subsidiaries (held as to more than 50% for more than one year) in countries appearing on the "blacklist" are excluded from the exemption. It should be noted that there are two European Union Member States on this list: Malta and Cyprus.

5. Registration duties

In **Russia,** there are currently no registration duties to be paid on the sale of real estate assets or company shares.

In **Germany,** there are again no duties payable on the sale of shares, except where the company in question holds real estate in Germany and the sale relates to at least 95% of the shares. The sale of real estate assets located in Germany always involves paying duties (at rates of between 3.5 and 5%).

In 2012, it is intended to make the sale of shares in listed companies subject to registration duty.

In **the UK,** the sale of shares in foreign companies is not subject to duty unless the sale is concluded in the UK.

In **France,** registration duties (5% on the purchase of shares, 5.09% on the purchase of buildings) are payable whether the transfer is executed in France or abroad.

In addition, if it is to be valid, a transfer of shares in a company whose assets consist mainly of buildings located in France must now be registered with a French notaire, even if the transfer was originally executed abroad, within one month. This was already required for transfers of buildings executed abroad, and has been extended to transfers of shares.

6. REIT and equivalents

Certain countries have introduced favourable tax regimes for listed real estate companies, under which such companies are wholly or partly exempted from corporation tax provided that they bind themselves to distributing a significant proportion of their profits. The tax on such profits is therefore borne indirectly by the shareholders.

At present there is no equivalent of the REIT in **Russia**.

In **Germany** a similar regime does exist but, having been introduced at the time of the financial crisis, so far it has not proved attractive to many companies.

Hungary was the first Eastern European country to introduce an REIT regime. It has been available since 1 January 2012.

In order to be eligible for this regime, the conditions that must be fulfilled include the following:

— at least 25% of the shares must be traded on a stock exchange,

— at least 25% of the shares must be held by small investors, each with a capital interest of less than 5%,

— insurance companies and financial institutions may not hold more than 10% of voting rights or capital.

The main features of the tax regime are as follows:

— exemption from corporation tax,

— exemption from business tax,

— reduced rate (2% instead of 4%) of registration duty payable on building acquisitions.

Dividends paid by a Hungarian REIT to a Hungarian shareholder are exempt from corporation tax in the hands of the recipient company (parent / subsidiary rules). Equally, the dividend is exempt from withholding tax if it is paid to a company established within the European Union. Certain states also exempt such dividends (in whole or in part) when received. In France, however, they are not exempt (see above).

Lastly, capital gains on the sale of shares in a Hungarian REIT by a Hungarian parent company are exempt. Where the shares are held by a foreign company, the tax treatment will depend partly on the provisions of the tax convention with Hungary and partly on the way such gains are taxed in the case of a listed real estate company. In France, such gains are subject to the reduced rate of 19%.

For the time being, dividends distributed by Hungarian REIT are not subject to any specific withholding tax.

7. Choosing between a local holding structure and a foreign acquisition company

We will set out some considerations which are relevant to this choice, using the example of a real estate investment in Russia.

Regarding foreign holding structures, the following matters need to be borne in mind:

— Whether the provisions of the acquisition contract can be enforced where the property is located abroad.

— Choice of law in the event that such a contract has to be enforced in Russia or abroad.

— Applicability of anti-tax evasion and money laundering legislation.

— Impact on the taxation of passive income: dividends, interest and capital gains on sales.

Regarding local (Russian) structures, the following matters need to be borne in mind:

— Some local commercial partners may insist on a local structure, especially if they are state bodies.

— Where the Russian party has few or no assets abroad, a

local structure may prove advantageous.

— Where the project generates regular income or requires cashflow advances, transferring such revenue or advances back from abroad may be problematic.

— Lastly, a Russian minority shareholder may find that the tax treatment that applies in the case of a direct association with a Russian structure is disadvantageous.

The question also arises as to whether the local body should be a branch or a subsidiary.

If the investment is made through a branch:

— the branch is a taxable entity,

— the expenses of the branch can easily be repatriated to the parent company,

— there is no tax on repatriated profits,

— the Russian thin capitalisation rules do not apply to branches,

— capital gains on sales are taxable locally.

An investment made through a subsidiary has the following characteristics:

— capital gains on the sale of shares in the Russian subsidiary (even if it is a real estate company) are not always taxable in Russia but are potentially taxable in the country of residence of the parent company,

— dividends paid to the foreign shareholder are subject to a withholding tax (generally between 5% and 15%),

— the thin capitalisation rules apply.

8. Tax investigations

In relation to tax investigations, the authorities are attaching increasing importance to the need to demonstrate that intermediate holding companies have substance, even where they are incorporated in the state where the building is located.

For example, in **France** the tax authority examines Luxembourg structures very carefully.

Initially, they sought to demonstrate that the Luxembourg company had a permanent establishment in France, and that the profit on sales of buildings located in France accrued to that permanent establishment. This took place in the context of the previous tax convention between France and Luxembourg (or Denmark), which was interpreted by the two countries in such a way as to enable double exemption of profits, in particular profits from trading in real estate.

To make this demonstration, the French tax authority was authorised to carry out searches for the specific purpose of demonstrating that a foreign (generally Luxembourg) company had a permanent establishment in France. These procedures developed in the course of litigation between France and Luxembourg or Denmark, relating to real estate trading in the period prior to 2008. Since then, the Franco-Luxembourg convention has been amended in this regard, and Denmark has unilaterally terminated its convention with France.

Despite the amendment of the Franco-Luxembourg tax convention, sales by Luxembourg residents of shares in French (or Luxembourg) companies holding real estate in France are still double exempt. The tax authority is now taking more interest in real estate acquisition structures involving Luxembourg and trying to demonstrate that the Luxembourg company has a permanent establishment in France which manages the investments in real estate companies. Capital gains on sales thus become taxable in France.

Another approach is to contest whether the foreign holding company is the true beneficiary of the dividends. This is a condition of applicability of the European Directive by virtue of which dividends paid by a French company to a European shareholder are exempt from withholding tax. Without resorting to the law on abuse or fraudulent use of legislation, the authority only needs to show that the true beneficiary of the dividends is an ultimate shareholder resident outside the European Union. This issue is frequently encountered in relation to holding companies established in Luxembourg, the Netherlands, or more recently Cyprus (since it joined the Union).

It is more difficult to prevent the provisions of tax conventions from taking effect (as to reduced rates of withholding tax or exemptions) on the sole ground that the structure established in the other state is a sham. Where that structure is locally registered in accordance with the applicable rules, where it is properly recognised by the other state, and insofar as the convention criteria for tax residence are fulfilled (generally, in order to be treated as a resident, the company must prove that it is subject to local tax under the applicable rules), it is difficult for the French tax authority to refuse the foreign company the benefit of the convention provisions.

In **Germany,** the tax authority seeks to contest the classification of certain expenses as deductible charges and to classify them as charges relating to the acquisition of shares in the foreign subsidiary. Such charges are not tax deductible.

There are also disputes over the classification of the acquisition structure's income: is this trading income or income from the holding and management of shares or real estate? What is at stake in such disputes is whether the income is subject to trade tax (Gewerbesteuer).

In the **UK,** the tax authority looks at the interest payments made to shareholders and in particular the debt ratio. Besides the thin capitalisation rules, which limit the deduction of finance charges, the debt ratio is also assessed.

In addition, the authority is quicker to impose penalties for failure to file returns or non-conformity.

In **Russia,** the tax authority contests certain acquisition structures and can invoke the concept of unjustified tax advantage where it can show:

— the absence of any reasonable commercial justification,

— the existence of intermediate companies,
— the lack of any advantages to the transaction,
— the link between the parties involved in the operation.

9. Subsidiaries in privileged tax regimes

Some of the countries considered have put anti-evasion mechanisms in place to penalise arrangements under which profits are located in subsidiaries in tax havens. To determine whether the entity is situated in a privileged tax regime, a comparison is made between the tax actually due locally (under the local rules and rates) and the tax that would theoretically have been due under the rules and rates applicable in the state where the parent company is located.

In **France,** legislation of this kind applies where the profits of subsidiaries are taxed locally at a rate less than half of the equivalent French tax (i.e. less than 17%).

However, these provisions do not apply within the European Union where the purpose of the operation is not purely tax-related. Generally speaking, they will not apply to subsidiaries whose business activity is to hold real estate assets which are situated locally.

In **Germany,** the rules apply where local taxation is less than 25%.

In **the UK,** the mechanism operates where taxation is less than 75% of what it would be in the UK.

To date, **Russia** has not enacted legislation of this kind.

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