McDermott Will & Emery

Global Tax Highlights A focus on China, Europe and the United States

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In this *White Paper*, McDermott Will & Emery tax leaders provide a year to date high-level overview of key tax issues in their countries.

The International Fiscal Association (IFA) held its 65th Congress in Paris, France, this year from September 11 to 16, 2011. A number of McDermott Will & Emery lawyers attended the conference and participated on panels. Additionally, our newly opened Paris office hosted a luncheon for tax executives that week, at which our country-specific tax leaders provided high-level overviews of key tax issues in their respective countries. Below, we share those highlights with you.

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China

TAX SELF-AUDIT MAY BE CONTINUED AND EXPANDED

The 2009–2010 exercise where the Chinese State Administration of Taxation (SAT) required 10 large-scale multinational companies in China to conduct tax self-investigations proved effective to China tax authorities as a means to collect tax revenues from foreign enterprises (and their Chinese subsidiaries). Tax authorities at the local level (*e.g.*, Shanghai) have also launched similar tax self-investigations or tax audits against some foreign enterprises or foreign invested companies. It is possible that the tax audit and tax self-investigation work will continue to be a priority for many local-level tax authorities in the next few years. According to an internal notice/instruction issued in early 2011 regarding the tax audit working approaches within the tax bureau system, inspection of equity transactions (including equity transfer by non-resident enterprises) by listed companies and non-listed companies will be a first priority on the tax audit agenda. In addition, with the issuance of the new Tax Invoice Administrative Measure this year, tax audit of appropriate tax invoice (or *Fapiao* in Chinese) is another major area for tax inspection in 2011.

ANTI-TAX AVOIDANCE TREND

With the publication in 2009 of special tax adjustment rules (covering the tax adjustments for transfer pricing, tax avoidance, *etc*.), the new Chinese Corporate Income Tax Law clarified the definition of "beneficial owner" for tax treaty benefits. The new guidance also clarified tax treaty treatment under relevant double tax treaties (including determination of permanent establishment, treatment of dividend, interest and royalties derived from China and treatment of capital gains, *etc*.) and the attack on "indirectly transferring" Chinese equity without "reasonable commercial purpose" and business substance. In practice, some "tax-exempted" equity transactions have been challenged by China tax authorities and some applications for tax exemption/reduction under tax treaties have been rejected by tax authorities. In addition, from a transfer pricing perspective, equity transfers between related parties at cost or net book value might no longer be simply accepted by tax authorities without an appropriate valuation method to justify that the equity transfer is conducted at arm's length.

TAX ADMINISTRATION OF LARGE BUSINESS ENTERPRISES

Recent trends from SAT for large business enterprises (LBEs) show the tax authority's move from a "collection-driven" tax administration approach to a more "service-oriented" tax administration approach. Circular Guoshuifa [2011] No. 71 (Circular 71), released on July 13, 2011, sets out more detailed guidelines regarding major issues of tax service and administration on LBEs. Dialogue and interaction between tax authorities and LBEs are encouraged prior to enactment of important tax policies; tax authorities will offer LBEs guidance and collect feedback on the implementation of new tax rules. The relatively new concept of "Tax Compliance Agreement" between tax authorities and enterprises is discussed with the objective of facilitating and reducing overall tax administrative costs. Tax authorities will also investigate and evaluate the internal risk control system of

LBEs and, based upon the evaluation and other relevant information, LBEs will be categorized into different risk levels and subject to different administrative measures.

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Europe

FRANCE

To reduce the budget deficit down to 5.7 percent of the gross domestic product in 2011 and 4.6 percent in 2012, the French Government recently announced several tax measures that may have a drastic impact on enterprises and on individuals.

- **Limitation on the use of tax losses:** Up until now, enterprises subject to corporate tax have had the option of carrying forward losses for an unlimited time against the profit realized the following years or, subject to certain conditions, of carrying back the loss against the profit of the previous three years. It is now proposed that enterprises will be authorized to carry back their tax losses only for one year prior to the year in which the losses have been incurred. Enterprises will be authorized to carry forward the remaining tax losses. However, the amount of the tax losses that can be offset against future profits will be limited to 60 percent of the taxable profit. In other words, whatever the amount of tax losses, enterprises with overall current year profit will have to pay corporate tax on 40 percent of their profit; the remaining losses will continue to carry over against future profits under the same conditions. An exception to this rule is that it does not apply to the part of tax losses below 1 million euros. This measure will enter into force this year for all enterprises with a tax year closing after the entering into force of the amended Finance Law.

- **Long-term capital gains on the sale of shares:** Enterprises subject to corporate tax, which realize capital gains on the sale of shares, must currently add to their taxable result an amount equal to 5 percent of their capital gains. It is proposed that this amount be increased to 10 percent of the capital gains. This measure will be included in the Finance Law for 2012.

- **Real estate capital gains:** Individuals will bear an increased tax burden on capital gains from disposition of immovable properties (except for capital gains on the sale of a private residence, which will remain tax exempt). Under current law, the amount of capital gain from disposition of immovable property that is subject to tax is discounted by 10 percent each year, starting after year five, so that after the 15th year, there is no tax on capital gain. As of September 2011, it is proposed that the 15-year period be extended to 30 years. If voted in, this measure would have a major impact on the real estate market.

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GERMANY

REORGANIZATION TAX

On May 2, 2011, the German Federal Finance Ministry published draft guidelines regarding the application of the German Reorganization Tax Act 2006. The final guidelines are expected in fall 2011. Though the act is applicable to restructurings after December 12, 2006, up to date no binding administrative guidelines exist. The draft guidelines address critical issues regarding the application of the Reorganization Tax Act and contain a number of surprising positions taken by the tax authorities, which are mostly unfavorable for the taxpayer. For example, in cases of retroactive reorganizations, it is no longer deemed sufficient if the requirements for a business or partial business are fulfilled on the day the reorganization documents are signed. The draft guidelines instead refer to the tax effective day, which may be up to eight months in the past.

GERMAN-SWISS AGREEMENT ON UNDECLARED ACCOUNTS

Germany and Switzerland have initialed a tax agreement dated August 10, 2011, regarding undeclared accounts of German residents held at Swiss banks; the agreement is subject to the approval of both parliaments. The agreement includes two remarkable rules. For the future, Switzerland will apply (and remit to the German tax authorities) a final withholding tax at a rate of 26.375 percent on investment income and capital gains derived by German residents from Swiss bank accounts. In addition, a retroactive taxation for established accounts takes place and constitutes an exemption from punishment due to tax fraud. German residents may either make an anonymous lump-sum payment or voluntarily disclose their accounts to German tax authorities. The amount of the lump-sum payment varies between 19 percent and 34 percent of the account value and depends on the duration of the client relationship with the bank and the growth in the account's assets during such period. Swiss banks will make a CHF 2-billion guarantee prepayment in order to ensure a minimum income from the retroactive taxation, which will be offset by the actual lump-sum payments.

GROUP TAXATION

The German Federal Fiscal Court recently ruled that the exclusion of nonresident parent companies from forming a tax group with a German resident subsidiary violates the nondiscrimination principle of the German-UK double taxation treaty. Furthermore, there is ongoing discussion regarding the formal requirements of a profit- and loss-pooling agreement between parent and subsidiary that is a prerequisite to form a tax group. The formal requirements are so strict that the formation of a tax group has failed in many cases. Both developments, together with the general EU-law concerns, sharpen the need for a fundamental reform of the tax group rules. The topic is basically on the agenda of the current coalition government but no concept has been presented yet. In particular, it has been proposed to entirely abolish the requirement of a profit- and loss-pooling agreement.

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ITALY

ABUSE OF LAW DOCTRINE

Over the past years several judgments of the Italian Supreme Court have progressively developed an original "abuse of law" doctrine. The court has stated that the ground for a general principle—whereby a transaction is deemed to constitute an abuse of law if its essential aim is to obtain a tax advantage—directly descends from the Constitution, and therefore is generally applicable in all taxation matters. Consequently, a transaction that constitutes an abuse of law can be disregarded by the Tax Administration even if there is no specific provision of law allowing it. Another consequence is that there is a risk of challenge even in those cases where the law offers tax regimes, which are absolutely alternative, and the taxpayer chooses the most favorable one only due to tax reasons. Tax authorities have been using the "abuse of law" doctrine very aggressively by challenging transactions on the sole basis of the alleged lack of valid business reasons, without inquiring whether the tax advantage obtained by the taxpayer is actually contrary to the purpose of the law. Recent Supreme Court decisions are, however, contrasting such aggressive use of the doctrine, ruling favorably for the taxpayer in cases where the tax administration was unable to prove that an undue tax advantage was obtained or where the taxpayer followed the most tax effective route between two legitimate and alternative choices.

WAVE OF AUDITS ON TYPICAL INTERNATIONAL TAX ISSUES

There is increased attention by the tax administration on effective place of management, especially for intellectual property (IP) and holding companies (challenge of fictitious foreign residency) or dependent agent/foreign principal arrangements (challenge of permanent establishment). There are aggressive audits on transfer pricing issues especially on management services, royalties, interest and parent company guarantees, and conduit companies on bond emissions. The new law on transfer pricing documentation requirements seems to have attracted further attention of the tax auditors on transfer pricing matters (specialized teams for large corporations).

HUNTING FOR REVENUE

The financial crisis has put even stronger pressure on revenue. Two budget laws were enacted in 30 days. The first has restricted the use of tax loss carry-forwards (only 80 percent of the yearly taxable income can be offset by losses, which no longer expire), increased personal income tax on bonuses and stock options for bankers, enacted more stringent rules on tax collection and tax investigations, and set a specific withholding tax for conduit companies. The second budget law was enacted after only 30 days as a government reaction to a request by the European Central Bank calling for more severe measures. Pursuant to the second budget law, the tax on capital gains and the withholding tax on interest (except interest on treasury bonds) has been increased from 12.5 percent to 20 percent. This latter law is still under discussion in Parliament and a number of additional measures are being considered, including the increase of the VAT rate by 1 percent (the ordinary rate could be increased from 20 percent to 21 percent), a surtax on personal income of wealthy individuals, the public disclosure of the individual tax returns and the enactment of more stringent instruments to fight tax evasion.

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UNITED KINGDOM

CFC REFORM—REMOVING THE LAST OBSTACLE BETWEEN THE UNITED KINGDOM AND HOLDING COMPANY JURISDICTION STATUS

Faced with the prospect of a wave of corporate inversions by UK multinationals, the UK Government embarked on a "road-map" of reform as a result of which it aims to have the most competitive corporate tax regime in the G20. Already in place are a dividend exemption for repatriated profits, the substantial shareholding exemption for the disposal of subsidiaries, an exemption for foreign branches, which have been added to the longstanding advantages of a comprehensive treaty network, and no withholding on dividends paid out of the United Kingdom. In moving toward a territorial system of taxation, the United Kingdom is arguably an increasingly attractive holding company jurisdiction, especially now that the one remaining obstacle—the Controlled Foreign Company rules—is undergoing comprehensive reform. The proposals promise exemptions that are mechanical, sector-specific and easier to apply, and which focus on achieving fair and practical results, including in relation to intra-group IP and financing operations.

COLLABORATIVE DISPUTE RESOLUTION

One positive development in 2011 has been HM Revenue and Customs' (HMRC) initiative to improve the way they handle disputes, with the aim of reducing the need to resort to litigation. Resolving disputes remains, however, very much a two-way process, and taxpayers should understand that flexibility and collaboration are required on both sides if the initiative is to be successful. In particular, taxpayers should be prepared to use tools such as mediation and expert determination to avoid deadlock and to manage the issues in dispute, whilst at the same time being mindful of their position in litigation should final settlement prove elusive.

INTERNATIONALLY MOBILE AND NON-UK DOMICILED INDIVIDUALS

The UK Government recognizes the common law test of residence can be a deterrent to individuals and businesses looking to invest in the United Kingdom. A combination of old case law and HMRC interpretation has created an unpredictable environment for internationally mobile individuals, and it is now proposed to introduce a transparent, objective test based on the number of connections (*e.g.*, family, accommodation, business) the individual has with the United Kingdom, as well as the number of days spent there. It has also been recognized that taxing non-UK domiciled individuals only on the income and gains they remit to the United Kingdom encourages their wealth to be kept outside the United Kingdom, rather than being invested here. At the same time there is domestic political pressure on the UK Government to ensure non-domiciled individuals make a greater tax contribution when they have been resident in the United Kingdom for a substantial period.

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United States

INTANGIBLE RESTRUCTURING PLANNING

Careful consideration should be given to any tax planning involving the migration of intangibles by a U.S. company (either existing or acquired) to a non-U.S. company (generally with a lower effective tax rate) as Internal Revenue Service (IRS) scrutiny of intangible restructuring has increased significantly, and the Obama administration's 2012 revenue proposals include provisions that will significantly increase the tax cost of intangibles planning. Issues to consider are the best way to migrate the intangible for tax purposes (*e.g*., through direct transfer or cost-sharing agreement), taking into account the legal protection of the IP itself (possible to split beneficial and legal ownership of IP if desirable to remain legally owned by U.S. company) and U.S. tax elections that can be made in the case of an acquisition to increase the basis of the assets of the acquired company, valuation considerations and jurisdiction of non-U.S. IP-holding companies.

FINANCING U.S. OPERATIONS

Careful review should be given to any cross-border financing transaction in which a U.S. company is the borrowing entity claiming an interest deduction, especially if a hybrid entity or hybrid instrument is involved, as such issues have been designated as IRS "Tier 1/Monitoring Status" audit issues (meaning they will be subject to heightened scrutiny). One way the IRS may attack these structures and deny interest deductions is to take the position that the instrument should be treated as equity for U.S. tax purposes (as the IRS is not bound to follow the form of the instrument). There is currently at least one case docketed in court for litigation on such a structure.

STATE TAX NEXUS ISSUES

Companies doing business in the United States that do not have a permanent establishment there may still have "nexus" in a state based on their assets or activities in that state, as treaties do not apply to state income taxes. In addition, employees who travel to the United States may be subject to state income tax as a result of spending time in the state even though their income may be exempt from federal income tax under an applicable treaty. As a result, state nexus issues should be considered when considering the tax consequences of doing business in the United States.

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This *White Paper* was prepared by McDermott tax leaders. For more information, please contact your regular McDermott lawyer.

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