Hogan Lovells

International Tax Newsletter

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Tax

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Introduction

Welcome to the first edition of the International Tax Newsletter produced by the merged firm Hogan Lovells. Through this quarterly publication we aim to keep you up to date with trends and changes to tax law around the world. We hope you find it informative and useful.

Recent market recognition
We are pleased to announce that our Italian office won "Italy Tax Firm of the Year" in this year's International Tax Review European Tax Awards and we were nominated in 9 other categories:

- European Indirect Tax Firm of the Year
- European M&A Tax Team of the Year
- European Capital Markets Tax Team of the Year
- Germany Tax Firm of the Year
- Italy Transfer Pricing Firm of the Year
- Netherlands Tax Firm of the Year
- Poland Tax Firm of the Year
- Spain Tax Firm of the Year
- UK Tax Firm of the Year

We are delighted that our practice has been so widely recognised and we thank you for the support that you have shown us throughout the year.

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Law to accelerate economic growth in Germany – fiscal turbo for 2010?!

Ingmar Dörr confirms the detail of the tax changes that were ultimately introduced in Germany in response to the economic crisis.

Key points

- Change of ownership rule affecting use of tax losses
  - The exception for share transfers as part of a financial restructuring continues after 31 December 2009
  - New relief for transfers within a 100% group
  - Hidden reserves of acquired company now dictate the amount of tax losses that can be used in the acquisition group
- Interest stripping rule limiting deductions for costs of external borrowing
  - €3m cap for immediate deduction extended indefinitely
  - Introduction of an "EBITDA carry-forward" to give additional tax relief in the following business year to the extent that current year net interest expense does not exceed 30% of the taxable EBITDA
  - Ability to elect to use a notionally determined EBITDA carry-forward from the years 2007–2009 to increase the EBITDA taken into account in the first year of the new rule (that is, the business year ending after 31 December 2009)
- Immediate write-off or pooling of expenditure for capital allowances purposes on certain low-value, movable assets
- New exemption to real estate transfer tax for certain forms of group reorganization

INTRODUCTION

The immediate fiscal program announced by the new German government for measures to cope with the economic crisis came into effect on 1 January 2010. From that date, the German tax framework for companies is amended in a number of respects but particularly in relation to:

- real estate transfer tax and the deduction of losses in reorganisations (including those involving a change-in-ownership)
- the deduction of interest, and
- the immediate write-off of low-value assets.

Whether the title of the Act, "Law to Accelerate Economic Growth", will live up to its grandiose promise in relation to each of these changes is considered below.

RELIEF UNDER THE CHANGE-IN-OWNERSHIP RULE FOR LOSS DEDUCTION

The Business Tax Reform 2008 made extensive changes from 1 January 2008 to the rules for acquiring German companies that have net operating losses, loss carry-forwards or interest carry-forwards as a result of the application of the interest deduction limitation (otherwise known as the interest stripping rule, described below).

If, within five years of an acquisition, more than 25% of a company's shares are directly or indirectly transferred to a single shareholder (or a person related to such shareholder or to persons having aligned their interest), the company's net operating losses and loss/interest carry-forwards are reduced proportionately. If, within such period, more than 50% of the shares are directly or indirectly transferred, the company's accumulated losses are entirely forfeited. These rules therefore not only potentially apply in almost every M&A and private equity share deal but also in many (intragroup) share restructurings and reorganizations, disproportional capital increases and mergers. They also potentially affect trade losses and interest carry-forwards of partnerships with a corporate member. A share acquisition to which these loss utilization restriction rules apply is referred to below as a "detrimental share acquisition".

Particularly in times of financial and economic crisis, operating and book losses (for example, through the accumulation of higher provisions for severance payments) increase a company's tax losses and loss carry-forwards. This potential ability to reduce tax that would otherwise be payable in future, more profitable times will not be available if losses arising in share reorganizations and restructurings or on the introduction of new investors are forfeited under the rules.

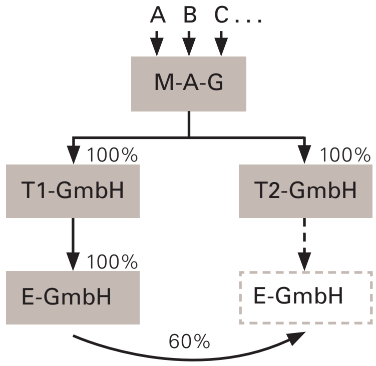
Exceptions and reliefs

A temporary relief, in the form of the qualified financial restructurings exception, was introduced in mid-2009 with retrospective effect. Under that exception, share purchases aimed at restructuring the business in order to avoid insolvency do not result in the adverse tax consequences brought about by the application of the change-in-ownership rule described above. Until the recent changes, however, this exception only applied until 31 December 2009. The new law removes this time limit so that share acquisitions for qualified financial restructurings after 31 December 2009 will still benefit from the exception.

Another extremely helpful amendment is the introduction of a group relief clause. Under this clause, from 1 January 2010, there will be no detrimental share acquisition if the same person directly or indirectly holds 100% of the shares in both the transferor and transferee entity.

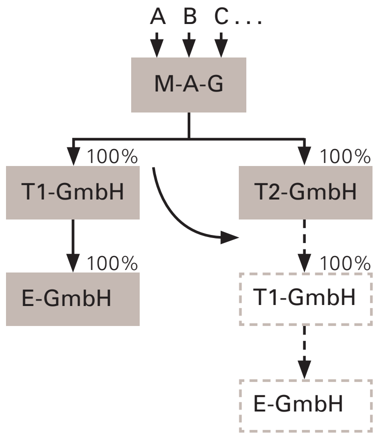
Continued

Example 1: The listed stock corporation, M-AG, is the sole shareholder of its subsidiaries, T1-GmbH and T2-GmbH. In turn, T1-GmbH holds 100% of the shares in E-GmbH, E-GmbH having tax loss carry-forwards of €5 million. T1-GmbH transfers 60% of the shares in E-GmbH to T2-GmbH.



The tax loss carry-forwards of E-GmbH are fully preserved due to the new group relief clause. If the share transfer had instead been made in 2009, the tax loss carry-forwards of E-GmbH would have been entirely forfeited under the rules because at that time the group relief clause did not exist.

Example 2: Unfortunately, the group relief clause is, to some extent, awkwardly formulated so that, in the example above, a transfer of shares in T1-GmbH by M-AG to T2-GmbH would not fall within the wording.



As several persons – and not just one person, as the group relief clause stipulates – hold shares in the transferring legal entity, that is, the listed M-AG, on a strict reading of the legislation this would still lead to a forfeiture of T1-GmbH's losses. This seems an unintended result as it is still a pure intra-group transaction. One must wait and hope that the tax authorities will act promptly in publishing their interpretation of the scope of the new group relief clause for intra-group changes-in-ownership.

Finally, for the 2010 tax year onwards, a detrimental share acquisition will not affect net operating losses and loss carry-forwards to the extent that the acquired company has hidden reserves (*stille Reserven*), provided they are subject to tax in Germany. Where neither the qualified financial restructurings exception nor the group relief clause applies to preserve a company's losses in full, the hidden reserves rule may be available to preserve them. This will depend on the size of the reserves and the "loss off-setting potential" of the reserves is calculated according to the following formula:

fair market value of the purchased shares
(purchase price or company value)

minus pro-rata/total tax equity of the company

= purchased hidden reserves

minus hidden reserves not subject to German taxation (for example, shareholdings)

= not forfeited loss off-setting potential

Example 3: On 1 February 2010, X-AG purchases 100% of the shares of Y-AG, a non-affiliated company, for €10 million. Y-AG has a taxable equity capital of €3 million and hidden reserves within its shareholding in Z-GmbH of €1 million, a tax loss carry-forward of €5 million and an interest carry-forward of €4 million.

The value of the hidden reserves of Y-GmbH is €6 million (that is, €10 million – €3 million – €1 million). Thus the complete tax loss carry-forward of €5 million as well as an interest carry-forward of €1 million is still available to Y-GmbH. An interest carry-forward of €3 million is, however, forfeited.

INTEREST STRIPPING RULE – EXTENDED RELIEF

The special rules to limit the deduction for external financing charges have also been extensively reformed under the Business Tax Reform 2008.

A profit-related "interest stripping rule" was introduced for all businesses, irrespective of their legal form, with accounting periods beginning after 25 May 2007, intended to prevent deductions for excessive interest rates on external borrowing.

Under the interest stripping rule, the amount of interest expense that is equal to the interest earned in the same business year remains tax deductible. To the extent that interest expense exceeds interest earnings in the business year ("net interest expense"), a full, immediate deduction is only available if the excess is less than €3 million for the business year. If this tax threshold is exceeded it triggers the interest stripping rule for the full net interest expense. If this happens, only a net interest expense of up to 30% of the taxable EBITDA can be deducted immediately. Additional interest expense is not immediately deductible and will be carried forward to the following years (interest carry-forward).

The interest stripping rule does not apply if the affected company does not form part of a group of companies ("stand alone clause"). A company is regarded as part of a controlled group if it is or could be included in consolidated financial statements in accordance with IFRS, German Commercial Code (HGB) or US GAAP. The "stand alone clause" only applies, however, where interest payments made by the company to substantial shareholders (that is, those owning more than 25% of the company) or to a person related to such shareholders or to third parties entitled to recourse, do not account for more than 10% of the net interest expense.

If the company belongs to a group of companies, the interest stripping rule can be avoided by using the "escape clause". For this to apply, the equity capital ratio of the affected company must not fall short of the capital equity ratio of the group as a whole by more than 2 percentage points. This comparison is generally based on IFRS-accounting, although the German Commercial Code, US-GAAP or the accounting law of any other member of the EU may apply. The escape clause only applies if less than 10% of the net interest expense of the company (or any other company belonging to the same group) is paid on shareholder debt. Shareholder debt is defined as debt capital shown in the fully consolidated statement that is received from a substantial shareholder or a person related to such shareholder or third parties entitled to recourse against a substantial shareholder outside the group or a related person.

The tax threshold serves as a relief for medium-sized businesses and had already been increased mid-2009 from €1 million to €3 million per business year to assist companies. This change had retrospective effect but was intended to apply only until 31 December 2009. The "Law to Accelerate Economic Growth" now abrogates this limited duration so that this tax threshold rate is now permanent.

Note that it was the recent amendments that increased the tolerance frame for the equity ratio test under this rule from 1 percentage point to 2 percentage points. Due to its complexity, however, the escape clause is difficult to apply in practice and these amendments will not make the situation any easier for groups of companies.

The most important amendment to the rule is the introduction of an EBITDA carry-forward, intended to ensure a consistent interest deduction. This is achieved by enhancing the allowable deduction for interest expense in the five years following the accrual of the respective amount of EBITDA carry-forward. The enhanced amount available for carry-forward is equal to the amount by which the "clearable" EBITDA (that is, 30% of the taxable EBITDA) exceeds the actual net interest expense incurred in the relevant year. An election can be made to use the notionally determined EBITDA carry-forward of the years 2007-2009 to increase the clearable EBITDA of the first business year ending after 31 December 2009.

An EBITDA carry-forward is not possible, however, if one of the exemptions to the interest stripping rule applies in the relevant year. Also, the carry-forward will be forfeited if the business ends, is disposed of or is the subject of a reorganization (for example, it is merged or spun off) under the Reorganization Tax Act (*Umwandlungssteuergesetz*), although, for these purposes, a detrimental share acquisition is ignored and so will not affect the availability of the EBITDA carry-forward.

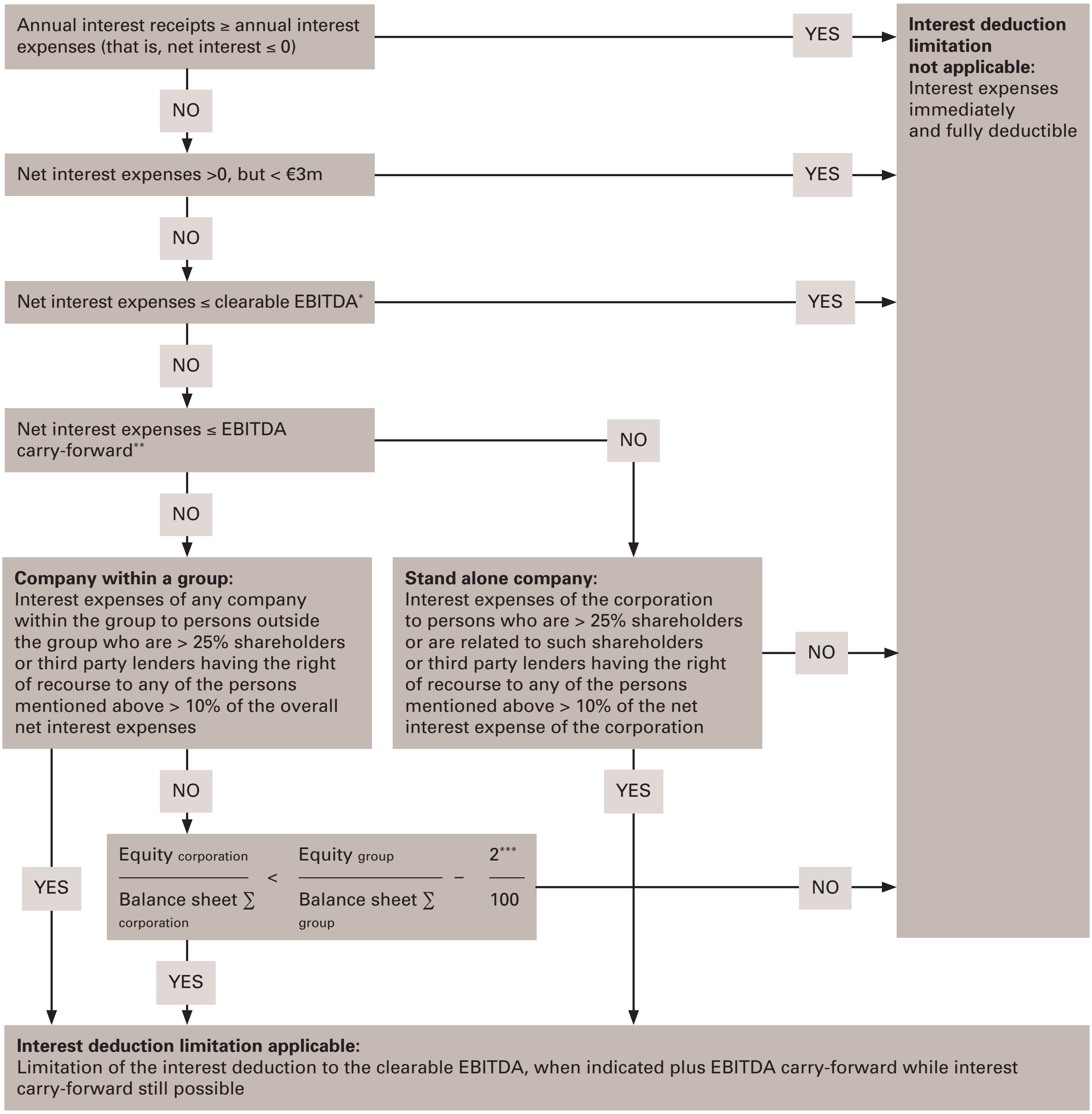
Example 4: In 2010, X-GmbH has a €20 million fiscal EBITDA and could therefore deduct up to €6 million (30% of €20 million) of net interest expense for tax purposes. If X-GmbH in fact has a net interest expense of only to €4.5 million, the clearable EBITDA that has not been used, €1.5 million, can be carried forward.

Assuming the net interest expense for 2010-2014 is equal to the amount of the clearable EBITDA (that is, 30% of €20 million) but exceeds this in 2015, in that year an additional net interest expense of up to €1.5 million (that is, the EBITDA carry-forward) can be claimed by X-GmbH.

Recommendation: Companies should review past years to see if they can determine a notional EBITDA carry-forward for the business years beginning after 31 December 2006 and ending before 1 January 2010 so that they can file for an increase in their clearable EBITDA and thereby obtain a higher tax deduction for interest in 2010.

Continued

The interest stripping rule now applies as follows:



* For business years terminating after 31 December 2009. The clearable EBITDA amounts to 30% of the EBITDA calculated for fiscal purposes (as before).

** Primarily for business years ending after 31 December 2009.

*** Primarily for business years ending after 31 December 2010, formerly 1/100.

LOW-VALUE ASSETS – IMMEDIATE WRITE-OFF

In future, businesses will be granted an option in relation to tax-depreciable movable assets that are capable of stand-alone use:

- an immediate write-off where the acquisition cost is less than €410 (in accordance with the legal status applicable until 31 December 2007) with a requirement to record minor assets with a value of between €150 and €410 in a continuous register

- a "pool-amortization" where the acquisition or production cost is between €150 and €1,000. The assets are pooled and the cost written off for capital gains tax purposes on a straight-line basis over a period of five years beginning with the year of acquisition. If the asset ceases to be used in the business within that five year period, the amount in the pool is not reduced. The acquisition of assets falling within this rule has to be recorded by book-entry. Assets with a value of up to €150 can, however, be deducted as immediate expense.

An important consideration in exercising the option is that the treatment will apply uniformly to all assets acquired, produced or contributed in the particular business year.

The new regulations apply for assets acquired, produced or contributed after 31 December 2009.

EXEMPTION FROM REAL ESTATE TRANSFER TAX IN CERTAIN REORGANIZATIONS

The "corporate group clause" for real estate transfer tax, that was announced in the 2009 coalition agreement, has not been included in the "Law to Accelerate Economic Growth". There is, however, provision for a tax exemption aimed at making certain reorganizations "crisis-proof", reliable and "middle-class friendly". To achieve this, transfers of real estate as part of a reorganization falling within section 1 para.1 no. 1-3 of the Reorganization Act (*Umwandlungsgesetz*), that is, mergers, split-ups and spin-offs or transfers of legal estate, or the corresponding transaction in an EU member State or in the European Economic Area, are exempt from real estate transfer tax pursuant to Section 6a of the Real Estate Transfer Tax Act (*Grunderwerbsteuergesetz*).

The provision therefore applies to the aforementioned, exclusive types of reorganization, if a tax-relevant activity is triggered under any of the following provisions of the Real Estate Transfer Tax Act:

- section 1 para.1 no. 3 – transfer of domestic real estate, not preceded by an asset purchase agreement

- section 1 para. 2a – transfer of more than 95% of the interests in a partnership that owns German real estate within a five year period

- section 1 para. 3 – share consolidation involving 95% or more of the shares in a company that owns German real estate

- section 1 para. 2 – alterations to any powers of disposal of German real estate.

Real estate transfer tax is charged at a rate of 4.5% of fiscal estate value in Hamburg, Berlin and Sachsen-Anhalt and 3.5% for the other German Federal States. The aim of the new provision is to ensure that the impact of real estate transfer tax is not a disincentive to essential reorganizations. The tax relief therefore only applies to reorganizations involving either only the controlling company and one or more "affiliated" companies or only "affiliated" companies. A company is an "affiliated" company if at least 95% of its shares are owned, directly or indirectly, by the controlling entity.

The provision is narrower than a simple corporate group clause because an exemption is only provided for the type of reorganization transactions mentioned above. It does not, for example, apply to the transfer of shares within a group of companies either by purchase or share swap.

The provision contains retention periods to prevent abuses of this relief. For example, no exemption will be granted if the controlling company acquired the affiliated company within a five year period prior to the relevant reorganization. Also, the relief is clawed-back where the controlling company's shareholding in any one of the affiliated companies involved falls below 95% within the five year period following the reorganization. There is a duty on the company to disclose to the tax authorities any such reduction in the shareholding.

TRADE TAX ADD-BACK RELATING TO RENTAL INCOME

A final note relevant to commercial tenants, the add-back on trade income of currently 16.25% of rent for immovable assets (in particular realty rent and ground rent) is reduced to 12.5%.

Generally, this equates to a reduction in business tax of approximately 0.53% from 2010. Hardly sufficient to accelerate economic growth.

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Investment funds and partnerships – vehicles for effective tax structuring of investments in Poland

Andrzej Dębiec and Zbigniew Marczyk explain the benefits of using an investment fund in Poland and the proposed changes to make Polish tax rules for investment and pension funds EU law compliant.

Key points

- Polish investment funds operating under the 2004 Polish Act on Investment Funds (and certain Polish pensions funds) are exempt from income tax in Poland
- Income tax on fund income is generally chargeable only at investor level and structuring to avoid Polish income tax for overseas investors in Polish funds is possible, depending on the provisions of any relevant double tax treaty
- Current form of exemption for both investment and pension funds contravenes two of the fundamental freedoms established under the EC Treaty since it applies only to Polish funds but changes are proposed to extend the exemption to similar vehicles based in other EU and EEA countries provided the fund is both authorised and regulated and meets certain other conditions.

INTRODUCTION

One of the popular legal vehicles used in Poland for investment purposes is the investment fund. Since the regulations relating to such vehicles are quite flexible, an investment fund can be used in a wide range of business areas, including trading, manufacturing, real estate, provision of services, etc.

Aside from a number of other benefits of using this legal form, the most important one, not surprisingly, relates to tax. This is because the Polish Corporate Income Tax Act dated 15 February 1992 ("**CITA 1992**") exempts from income tax in Poland, investment funds operating under the provisions of the Polish Act on Investment Funds of 27 May 2004.

In general, investment funds are used for indirect investment which means that investment funds are usually used as vehicles holding shares in special purpose vehicles ("**SPVs**"). In the case of real estate business, however, investment funds can directly invest in the real estate market through direct acquisition of real property and benefit from its lease or sale.

USE OF INVESTMENT FUNDS IN INVESTMENT STRUCTURES

As mentioned above, the income obtained by an investment fund is exempt from tax on the part of the fund, whether such income is derived from direct investment in the real estate or as dividends received from subsidiaries. Moreover, specific structuring of the investment can be used; investing through an SPV enables the SPV to use tax optimisation procedures, for example.

Assuming that an SPV is established as a limited joint-stock partnership (in which an investment fund holds 99% of shares, for example), it will be transparent for income tax purposes. This means that the income arising to the partnership will not be taxed at the level of the partnership itself but at shareholder level. Bearing in mind, however, that the main shareholder of an SPV would be an investment fund, exempt from income tax, the income arising to the SPV will not be taxed at the level of the fund either (a small part of the partnership's income would fall to be taxed only on the general partner who, for this reason, should have as minimal interest in the company as possible).

The income obtained by the investment fund will basically be taxed only at the moment when the profit is paid to the investors (most frequently as a result of redemption of their certificates or fund participation units). In the case of foreign investors investing in Polish investment funds, additional tax optimisation could be considered, aimed at excluding taxation in Poland. The tax treatment of the income received by such investors from Polish funds will depend, in any case, on the provisions of a relevant double tax treaty between Poland and the country of tax residence of a given investor (Poland has concluded over 80 double tax treaties).

IMPACT OF EU LAW AND PROPOSED CHANGES

As mentioned above, the literal wording of CITA 1992 indicates that the exemption relates solely to investment funds operating under the provisions of the Polish Act on Investment Funds. A similar rule is provided in CITA 1992 for the exemption from income tax of Polish pension funds established under Polish legislation relating to the organisation and activity of pension funds.

As a result, in May 2009, the European Commission sent a complaint to the Polish government stating that the regulations referred to above are in breach of two principal rules of the EC Treaty, that is, the free movement of capital guaranteed in Article 56 and the free movement of services provided under Article 43. There have also already been some judgments issued by the Polish courts in favour of foreign investment funds under the current wording of CITA 1992. The courts concluded that direct application of the EC Treaty also allows for the grant of an exemption to investment funds based in other EU countries.

Consequently, the Polish government is currently working on amendments to CITA 1992 to extend the tax exemption provided for Polish investment funds and pension funds to similar vehicles based in other EU countries and countries belonging to the European Economic Area ("**EEA**").

The introduction of these changes to Polish legislation, however, will not be a straightforward issue. This is due to significant differences between Polish investment/pension funds and similar funds operating in other EU/EEA countries.

The rules relating to the establishment and operation of investment funds have not been harmonised within the EU. The only Act regulating the rules of collective investment in securities is Council Directive 85/611/EEC of 20 December 1985, on the coordination of rules relating to undertakings for collective investment in transferrable securities ("UCITS Directive"). The scope of vehicles covered by the UCITS Directive, however, differs from the definition of Polish investment funds that currently benefit from the income tax exemption in Poland (for example, the UCITS Directive excludes close-ended funds or funds offering participation units on a private market).

Taking into account the various legal forms of investment funds operating within the EU and EEA, the proposed income tax exemption in Poland should apply to collective investment institutions based in an EU country other than Poland, or in another country belonging to the EEA, provided they fulfil all of the following conditions:

- they are subject to tax in the country of their seat on their worldwide income
- the subject of their activity is solely collective investment of financial resources (through either a public or private proposal) in securities, financial market instruments or other assets
- they conduct their activity under a permit issued by a relevant authority in the country of their seat
- their activity is subject to the regulation of the relevant authorities in the country of their seat and
- their assets are held in a depositary.

As regards pension funds, the situation seems to be slightly easier. In this case, it is proposed that the definition of pension funds that are exempt from Polish tax should be based on Directive 2003/41/EC of the European Parliament and of the Council, dated 3 June 2003. As a result, entities based in other EU or EEA countries that maintain a pension program would be exempt from income tax in Poland on income connected with accumulating savings for retirement purposes provided they fulfil all the following conditions:

- they are subject to tax in the country of their seat on their worldwide income
- the subject of their activity is solely accumulating financial resources and investing them with the aim of distributing that wealth to the participants of the retirement program after reaching pensionable age
- they conduct their activity under a permit issued by a relevant authority in the country of their seat
- their activity is subject to the regulation of relevant authorities in the country of their seat and
- their assets are held in a depositary.

The planned rules will include an anti-abuse clause. This clause would state that the exemption applies provided that there is a legal basis under a relevant double tax treaty or other ratified international treaty that gives the Polish tax authorities the right to obtain necessary tax information from the tax authority of the country in which the exempt entity is seated. It should be noted in this regard that, in practice, all double tax treaties concluded by Poland with EU and EEA countries provide for exchange of information (except for Liechtenstein).

It is also proposed that exemption from withholding tax on interest and dividends paid to the type of investment funds and pension funds that are the subject of this article, would depend additionally on the provision of a certificate of tax residence by the fund to the entity distributing such income, as well as a written statement confirming that all the above-mentioned conditions for the tax exemption are met by the investment/pension fund.

The regulations referred to are still under legislative procedure. It is very likely, however, that they will be introduced into Polish legislation shortly, since, as already mentioned, the current wording is in breach of EU law.

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New US withholding tax on payments to foreign entities

Cristina Arumi, Scott Lilienthal, Stephen Giordano and Eunice Kim describe new documentation and withholding tax requirements that will apply to payments of US-source income to foreign entities from 2013.

Key points

- Additional withholding tax requirements will apply on or after 1 January 2013 to payments of US-source income (including dividends, interest and royalties and sale proceeds of certain types of stock and debt)
- No tax will be required to be withheld provided that the recipient complies with applicable documenting, reporting and other requirements
- Foreign financial institutions are treated differently from "non-financial foreign entities", and can avoid withholding by entering into an agreement with the US Treasury Department to implement institution-wide due diligence, reporting and compliance procedures in relation to US-held accounts
- "Non-financial foreign entities" can avoid withholding by providing a certificate to the payor as to the identity of any "substantial US owners" (generally, US persons owning more than 10% of the entity).

INTRODUCTION

On 18 March 2010, President Obama signed into law the Hiring Incentives to Restore Employment Act ("**HIRE**"). Among other things, HIRE institutes a new withholding tax which applies to "withholdable payments" made to certain foreign entities. The withholding tax is equal to 30% of the gross amount of any withholdable payment. Although this new withholding tax is only effective for payments made on or after 1 January 2013 (and includes a grandfathering provision exempting payments for obligations outstanding on 18 March 2012), US payors should be aware of the possible impact of this new withholding obligation on their current or upcoming disclosures and contractual obligations, including, for example, loan contracts that require a US borrower to gross-up interest payments to foreign lenders for amounts withheld.

The purpose of the new withholding tax is to better ensure proper documentation of US persons' income by causing foreign entity-recipients of "withholdable payments" to provide information relating to their US account holders and investors. This withholding tax is not intended to constitute a substantive tax. If the foreign entity-recipient complies with applicable documentation, reporting, and other rules, no withholding will be required. The documentation, reporting, and other requirements are in addition to present law regarding foreign bank account reporting or "FBAR" requirements, and the reporting requirements applicable to "qualified intermediaries."

The withholding tax applies to foreign entities that receive withholdable payments. Separate sets of rules apply to (i) "foreign financial institutions" and (ii) "non-financial foreign entities."

It is expected that the Treasury Department and/or the IRS will issue guidance relating to the operation of the new withholding tax and associated documentation and information reporting requirements. This guidance would be expected to include coordination with existing provisions of law (for instance, to prevent "double withholding") and to provide for exceptions to the general framework described below.

PAYMENTS SUBJECT TO WITHHOLDING

The new withholding tax applies only to "withholdable payments." Withholdable payments include US-source, passive-type income, which currently are subject to withholding under the Internal Revenue Code when paid to foreign persons: dividends, interest, rent, royalties, etc. Withholdable payments also include gross proceeds on the sale of stock or debt that can produce US-source dividends or interest, which currently are not subject to withholding as a general matter.

Payments made in respect of securities of foreign issuers, and proceeds from the sales of such securities, generally are not subject to the new withholding tax.

EFFECTIVE DATE

The new withholding tax applies to withholdable payments made on or after 1 January 2013. Under a grandfathering provision, however, the withholding tax does not apply to payments made under, or gross proceeds from the sale of, any obligations outstanding on 18 March 2012.

New Treasury Regulations or other forthcoming guidance may limit the benefit of this grandfather rule. For instance, the legislative history to HIRE states that it is expected that the IRS will issue guidance regarding the effect on "grandfathered" debt in the event that a modification of a debt instrument results in an exchange of that debt instrument for US federal income tax purposes.

PAYMENTS TO FOREIGN FINANCIAL INSTITUTIONS

A withholding agent will be required to withhold 30% of any withholdable payment to a foreign financial institution unless the foreign financial institution complies with certain withholding, information reporting, and documentation requirements.

A "foreign financial institution" is a foreign entity that (i) accepts deposits in the ordinary course of business; (ii) as a substantial portion of its business, holds financial accounts for others; or (iii) is engaged primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities (and derivatives of the foregoing).

As a general matter, no withholding is required in connection with a withholdable payment to a foreign financial institution that enters into an agreement with the Treasury Department (we refer to this agreement as an "Account

Documentation Agreement"). This agreement will require the foreign financial institution to do the following:

- provide information to the IRS regarding its account holders as is necessary to determine which of its accounts are "US accounts"
- comply with verification and due diligence requirements relating to the identification of its US accounts
- provide an annual report relating to its US accounts (name, address, and EIN of the account holder; the account number; the account balance or value; and certain account activity)
- withhold 30% of any withholdable payment to (i) other foreign financial institutions which have not entered into an Account Documentation Agreement, and (ii) insufficiently documented accounts and
- comply with requests for additional information with respect to any of its US accounts.

Instead of being required to provide annual reports relating to its US accounts and to withhold, a foreign financial institution may elect to be required to issue IRS Forms 1099 and report other information to the IRS as if it were a US financial institution. In addition, where foreign bank secrecy and similar laws prevent a foreign financial institution from disclosing information relating to an account, the Account Documentation Agreement will also require the foreign financial institution to either seek a waiver of such law, or if a waiver is not forthcoming, close the relevant account(s).

A "US account" is a "financial account" maintained with a foreign financial institution by either a US person or a "United States owned foreign entity." A "financial account" includes both depositary and custodial accounts. It also includes equity securities in, and debt securities of, the foreign financial institution, but only if such securities are not publicly traded, regardless of whether the equity or debt securities are actually held in an account maintained by that foreign financial institution.

Accounts which otherwise meet the definition of a "US account" but are held by certain categories of US persons are exempt from the definition of a "US account." These persons include:

- Real estate investment trusts, or REITs
- Regulated investment companies, or RICs
- Publicly traded corporations and their affiliates
- Banks
- Tax-exempt entities
- IRAs
- Pension funds
- US federal government
- State and local governments.

A US account also does not include depositary accounts held by individuals where the aggregate value of all depositary accounts maintained by the individual with that foreign financial institution is no more than $50,000. HIRE gives the Treasury Department authority to aggregate accounts held by financial institutions which are affiliates for the purposes of whether the $50,000 threshold has been exceeded. Note that, as described above, this exception only applies to depositary accounts and not custodial accounts or holdings in non-publicly traded securities.

In addition, as described above, an account held by a "United States owned foreign entity" is also a US account. A United States owned foreign entity is a foreign entity where at least one US person (other than those persons exempted, a partial list of which is included above) "directly or indirectly" owns more than 10% of the foreign entity. Where the foreign entity itself is a foreign financial institution because it is engaged primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, and derivatives therein, the foreign financial institution is a "United States owned foreign entity" if it has any direct or indirect US owners. It is not clear to what extent the indirect ownership rules will apply or to what extent they will incorporate concepts of "constructive ownership" relevant in other areas of the tax law.

PAYMENTS TO OTHER FOREIGN ENTITIES

A different set of rules applies to payments to "non-financial foreign entities." Non-financial foreign entities are foreign entities that are not foreign financial institutions. As a general matter, no withholding is required in connection with the payment of a withholdable payment if a non-financial foreign entity provides a certification to the withholding agent regarding the identity of its "substantial US owners." Specifically, a non-financial foreign entity must provide to the withholding agent either:

- a certification to the effect that the non-financial foreign entity has no substantial owners or
- the name, address, and TIN (taxpayer identification number) of each of its substantial US owners.

The withholding agent must then provide information relating to substantial US owners to the IRS. The withholding agent is entitled to rely upon the certification or information provided by the withholding agent so long as the agent does not know or have reason to know that the certification or information is incorrect.

A "substantial US owner" generally is a "US person" (that is, a US citizen or resident alien, a domestic corporation or partnership, and domestic trusts and estates) that:

Continued

- "directly or indirectly" owns more than 10% of the foreign corporation or foreign partnership (including, presumably, a foreign entity taxable as a partnership for US federal income tax purposes) or

- is treated as the owner of any portion of a foreign grantor trust.

In addition, HIRE gives the Treasury Department authority to include as "substantial US owners" US persons that own 10% or more of a foreign trust that is not a grantor trust. It is not clear to what extent the indirect ownership rules will apply or to what extent they will incorporate concepts of "constructive ownership" relevant in other areas of the tax law.

The same categories of persons listed above whose accounts are excluded from the definition of "US accounts" are also exempt from the definition of a "substantial US owner."

NON-COMPLIANCE
Withholding agents that fail to withhold in accordance with the rules described above are liable for any such withholding tax, as well as interest and penalties.

DISCLOSURE OF PARTICIPATING FOREIGN FINANCIAL INSTITUTIONS
Foreign financial institutions which have or are deemed to have entered into an Account Documentation Agreement may be publicly disclosed.

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The French impatriates regime

Hervé Israël outlines new provisions designed to attract overseas executives to live and work in France.

Key points

- Overseas employees are exempt from French income tax for up to six years on their salary from employment activities in France if they become France tax resident and have not been domiciled there in the past five years
- Part of any income earned in employment activities carried on outside France for the employer may also be exempt
- Both exemptions are subject to a choice of cap on the amount of exempt income
- Interest and dividends received from abroad as well as certain capital gains from transfers of shares and securities benefit from a partial exemption

INTRODUCTION

The "impatriates regime" was implemented to increase France's appeal to overseas entities and individuals. It is intended to encourage companies to set up in France and to keep skills and capital in France.

With impatriation bonuses, that is, the portion of salary directly linked to the activity carried out in France, exempt from income tax, the aim is clear: to attract to France high level executives from abroad who, given the short length of their stay in France, are in a different position from residents in that they have to bear the specific costs of settling in France (which are high in relation to the length of their stay) but do not, in the long term, enjoy access to the social security benefits available to residents. A specific regime is applicable for non-salaried impatriates.

CONDITIONS TO FULFIL IN ORDER TO BENEFIT FROM THE EXEMPTION

The new regime, introduced by the Law for the Modernisation of the Economy, adopted by Parliament on 23 July 2008, is applicable to those who took up their duties in France as from 1 January 2008.

The regime concerns employees and executives similar to employees for tax purposes. The regime is therefore aimed at employees who come to work in France in the context of a move within an international group[1]. Moreover, those recruited directly from abroad to come and work for a company established in France may also benefit from this measure. Previously, only employees moving to France in the context of a move within an international group could benefit from the impatriates regime.

In addition, the following conditions must be fulfilled in order to benefit from the impatriates regime:

- the impatriate must not have been tax domiciled in France during the five years preceding the year in which they take up their duties
- they must also, from the point at which they assume their duties, become resident in France within the meaning of Article 4 B 1 a and b of the French Tax Code, that is, their home or principal place of residence *and* principal place of work must be in France[2].

LENGTH OF EXEMPTION

The exemption applies to salary and passive income, relating to the carrying out of the activity in France, received up to 31 December of the fifth year following that in which the impatriate took up the position in France, that is, a maximum period of six years. Beyond this period, the impatriate is subject to tax on their entire salary, including the impatriation bonus if it is still being paid to them.

SCOPE OF THE EXEMPTIONS UNDER THE REGIME

The impatriation bonus exemption

Company employees and managers are exempt from income tax on the impatriation bonus under certain conditions.

The impatriation bonus is exempt up to its full amount only when the salary of the impatriate liable to income tax is greater than, or equal to, the salary received for analogous duties in the same company or similar companies established in France.

Under certain conditions and on election, non-salaried impatriates directly recruited abroad, are entitled to an exemption set at 30% of their remuneration.

Exemption relating to remuneration for activities carried out outside France

The portion of an impatriate's income relating to their employment activity carried on outside France may also be exempt from income tax. In order to benefit from this exemption, stays abroad must be in the direct and exclusive interest of the employer.

CAP ON EXEMPTIONS

Salaried and non salaried impatriates have the choice between:

- a global cap on exemptions (impatriation bonus and portion of salary corresponding to activity carried out abroad) of 50% of their total salary and
- exemption of the portion of salary relating to the activity carried out abroad equivalent to a maximum of 20% of the salary relating to the activity carried out in France, excluding the impatriation bonus.

Continued

OTHER ADVANTAGES FOR IMPATRIATES

Passive income

The new impatriates regime introduces a partial exemption of certain kinds of passive income (that is, interest and dividends) from abroad and certain capital gains from the transfer of securities and shareholders rights.

Wealth tax

Individuals who, after 6 August 2008, become France domiciled after having been tax domiciled abroad for the five previous calendar years are temporarily subject to ISF (wealth tax) on their French assets only.

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1 Instruction of 30 July 2009 5 F-13-09 n°10

2 Instruction of 30 July 2009 5 F-13-09 n°24

Start-up companies do not meet the "commercial" requirement for the purposes of the Italian participation exemption

Fulvia Astolfi explains how the Italian tax exemption for capital gains on share disposals applies in the case of disposals of start-up companies.

Key points

- The Italian participation exemption exempts from corporate income tax 95% of capital gains on the disposal of shares
- The exemption requires that the company whose shares are being disposed of carries on a commercial activity
- Following a tax authority ruling, the Parliamentary Finance Commission has clarified that this requirement will not be met where the business activity envisaged in the company's articles of association has not begun. This particularly affects start-up companies, where the actual business production cannot begin until preparatory works have been completed.

INTRODUCTION

A start-up company, which has only begun preparing for business but is not yet able to carry on productive activity, does not meet the "commercial" requirement necessary for its shareholders to benefit from the so-called participation exemption on a sale of their shares in the company. This has been recently clarified by the Finance Commission of the Italian Parliament (*Camera dei Deputati, Commissione Finanze*) with a written answer to a formal request of clarification (n. 5-01695).

PARTICIPATION EXEMPTION

Article 87 of the Italian Income Tax Code (Decree no. 917 of 1986) sets out an exemption from IRES (*imposta sul reddito delle società*, that is, corporate income tax) for 95% of capital gains realised from the sale of shareholdings. Only the remaining 5% of the capital gain will be subject to IRES, with the result that the actual tax burden on the gain is 1.375% (27.5 x 5%).

To benefit from the exemption various requirements must be met, among them the exercise of a business activity by the participated company (that is, the company the shares of which are sold). If this requirement is not met 100% of the capital gain will be taxable.

The issue clarified by the Finance Commission of the Italian Parliament concerns how this requirement applies to companies during the start-up period: in other words, whether a company that is undertaking only preparatory activities for the exercise of its business but has not yet started to carry on the business activity itself, meets the "commercial" requirement necessary to benefit from the participation exemption. Obviously, the issue concerns the shareholders of the start-up company who intend to transfer their shareholdings in the company and to benefit from the partial tax exemption.

PREVIOUS INTERPRETATION OF THE ITALIAN TAX AUTHORITIES

The Italian tax authorities have already issued a ruling on the point (no. 323 of 9 November 2007) in which they denied the application of the tax exemption in relation to a shareholding in a company owning real estate to be destined to a hotel activity. In particular, the company had already started restructuring and repair works to the property in the hotel site but had not yet started the hotel activity itself.

Clarifications of the Italian Parliament

The Finance Commission, also referring to this tax authority ruling, clarified that, pursuant to the ratio of the rule, one must consider the activity actually carried on and not the incorporation in the form of a company. Accordingly, if it is not considered that the activity envisaged in the articles of association has started, the "commercial" requirement necessary for the application of the partial exemption on capital gains is not met.

The clarifications concern companies involved in long and complex preparatory activities necessary to start their business. An example is any company that produces renewable energy (for example, wind energy). Before starting the actual production and sale of energy, the company will have to build the production plants (turbines), obtain the necessary authorisations, etc and these activities may take several years. Other examples include companies engaged in the management of shopping centres, where lengthy administrative procedures and building activities need to be completed prior to beginning the management function and any manufacturing company that, due to the specific nature of the product being manufactured, needs to establish new and complex production plants.

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Pay for play or fees for faces? Footballers' image rights under tax scrutiny in the UK

Philip Gershuny and Fiona Bantock highlight HMRC's increasing focus on the value attributed to footballers' image rights.

Key points

- Payments under contracts relating to footballers' image rights are susceptible to challenge by HMRC as a disguised form of employment income, resulting in a NICs saving
- Relevant issues for the court include whether there is real value in the player's image, as distinct from their skills on the field and the extent to which the football club intends to exploit that image
- If the payment is determined to be employment income, there is a risk that HMRC may seek to recover the additional tax liability from the employer football club, the player's personal service company or the player.

INTRODUCTION

Footballers have been in the news a great deal recently for all the wrong reasons. Now, it seems some of them may be forced to accept there is a right and a wrong way to conduct their (financial) affairs as HMRC continues its investigations into "image rights" arrangements in the football industry.

It is fairly common practice for top players to receive payment from their football club in return for image rights, which are usually held by the players' offshore personal service companies. Such arrangements are reported to save both players and their clubs an estimated £100 million a year in tax.

CASELAW

HMRC's objection to arrangements of this nature is nothing new. Ten years ago, in *Sports Club plc v Inspector of Taxes*,[1] HMRC challenged similar image rights arrangements in place between Arsenal Football Club and two of its top players, Dennis Bergkamp and David Platt (or Evelyn and Jocelyn as they were referred to in the judgment). In those cases, HMRC argued that the agreements in question had only been created to give an excuse for the payment of money to the players. After a careful analysis of the facts, however, the Special Commissioners rejected this argument and held that the contracts in question were genuine commercial arrangements and not a "smokescreen" for additional pay.

What was the basis for the *Sports Club* decision?

The key issues that the Special Commissioners considered in coming to their decision that payments under the contracts did not constitute employment income included:

- whether the image rights agreements had a value – such value was dependent on the players' value, not as footballers, but as recognisable personalities
- whether the payments made under such agreements were excessive when compared with the players' value for wider commercial exploitation
- what evidence there was that the football club intended to exploit the players' image rights
- whether there was any other commercial reason why part of the players' remuneration might have been paid under the image rights agreements, for example, a pay ceiling.

CURRENT APPROACH OF HMRC

Whilst there have been no material changes in law since the decision in the *Sports Club* case, life has, nonetheless, moved on. In particular, society's attitudes have changed as regards the level of tax suffered by the super-rich and the current economic climate means that the Government is constantly looking for alternative ways to increase tax revenue. HMRC has, therefore, been investing additional resources into challenging what it perceives as tax-driven structures.

In this respect, the fact that image rights structures can be beneficially taxed in comparison to normal salary payments makes them more susceptible to attack than other commercial arrangements.

The potential for image rights contracts to result in tax evasion was recognised in the July 2009 Financial Action Task Force report on money laundering in football. One of the examples given is where a club pays a fee to acquire the image rights of a player with "high football qualities" but poor or minimal exposure, in circumstances where the fee bears no relation to the actual value of the image rights and the club has made very little commercial use of the rights.

This would suggest that the key point, which HMRC is now looking to challenge, is the value of the image rights in each individual case – that is, whether the payments are truly made in order to obtain the image rights or whether they are, in fact, disguised salary. When answering this question, it is likely that a court will ask similar questions to those in the *Sports Club* case. Just as the decision in *Sports Club* was heavily dependent on the facts, HMRC's chances of success in any appeal will depend upon the facts of each individual case.

Who bears the risk of any challenge by HMRC?

In the event that payments under an image rights contract do constitute employment income, HMRC has powers to recover:

- PAYE and primary and secondary Class 1 NICs from the intermediary personal services company, including where such company is non-UK resident (although such recovery would be difficult in practice unless the non-resident company has assets located in the UK)
- PAYE and primary Class 1 NICs from the UK resident footballer whose image rights are being dealt in
- PAYE and primary and secondary Class 1 NICs from the football club.

CONCLUSION

Given that the success of any appeal will be predicated on the facts, it seems unavoidable that the taxpayers in question will be subjected to expensive and time-consuming reviews. Yet, as with the recent spate of residency cases, it is difficult to argue that such reviews represent a fundamental change in HMRC policy. In the words of Ward LJ in the recent judicial review case of *Davies, James and Gaines-Cooper*[2], they result, rather, from a "closer and more rigorous scrutiny and policing" by HMRC. Let the taxpayer beware.

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1 [2000] STC (SCD) 443

2 R (Davies) v Revenue and Customs Comrs [2010] EWCA Civ 83 at paragraph 121.

Weight Watchers

VAT appeal agains HMRC decision

Watchers (UK) Limited

Loyalty Management

Revenue & Customs Commissioners v Loyalty Management UK Ltd, a reference from the House of Lords to the ECJ

Management UK Limited

Royal Mail Group

VAT aspects of Post Office Limited's successful competitive bid for the Government Card Account

Mail Group plc

M&G

Launch of the £1 billion Prudential/M&G UK Companies Financing Fund

Lovells advised M&G

Semperian

Acquisition of PPP management business from Land Securities Trillium, creating Europe's largerst specialist PPP investment partnership

Semperian

SEGRO plc

Acquisition of Brixton and associated £250 million placing and open offer

Lovells advised SEGRO

GIC

c. €1 billion purchase of a stake in Sintonia SA, (owned by the Benetton family, Goldman Sachs and Mediobanca)

Ltd

Henderson Global Investors Limited

Acquisition of three designer retail malls for £365 million for new UK retail property fund, the UK Outlet Mall Fund

Investors Limited

Autogrill S.p.A.

£545 million acquisition of World Duty Free Europe Limited from BAA Limited

Autogrill S.p.A.

Notes

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