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Contents

Forfeiture of German tax losses in a change-of-control - German Federal Ministry of Finance issues draft of renewed decree

Dr. Ingmar Doerr and Andreas Eggert discuss the recent draft decree on the interpretation of the corporate loss forfeiture rules.

Background

The German rules on the forfeiture of tax losses in the case of detrimental change-of-control pursuant to sec. 8c German Corporate Income Tax Act are very strict. A direct or indirect acquisition of shares of more than 25% in a German corporation (limited company or stock corporation) by a single purchaser, or by a single purchaser and related persons, or by a group with aligned interests, results in a partial forfeiture of losses; the acquisition of shares of more than 50% results in a complete forfeiture of losses.

If such a change-of-control occurs in several steps, the separate acquisitions are added together if they take place within a five year period. There are no further prerequisites. However, since 2010 there are exceptions for certain intra-group share transfers and for target corporations with unrealized taxable built-in gains.

The original idea behind the loss forfeiture rules was to avoid a trade with "shell" or "tax-loss" companies, but since those rules apply to every change in ownership of more than 25%, they also have the general aim of creating tax revenue.

The forfeiture concerns losses and loss carry-forwards for corporate income tax and trade tax purposes. The corporate income tax rate including the solidarity surcharge is 15.825%. In most cities the municipal trade tax is levied at rates between 14% and 17%. This results in an effective tax rate for German corporations between 30% and 33% in total. Thus, if a change in ownership of more than 50% occurs, and the corporation owning tax losses is profitable, the tax detriment of the forfeiture is between 30% and 33% of the forfeited loss amounts.

The draft decree

On 15 April 2014 the German Ministry of Finance issued the draft of a new decree for the interpretation of the corporate loss forfeiture rules. The renewed decree shall replace the existing decree for those rules that was issued on 4 July 2008. The draft decree partly repeats the existing decree, however, it also contains important new statements. In the draft decree the Ministry of Finance makes its first comprehensive statement regarding the consideration of losses and profits that occur during the fiscal year in which the change-of-control occurs and the exceptions for intra-group transactions and for target companies with built-in gains. The decree will not be binding for the courts. Nevertheless, it will be very important for tax practice, since the aim of tax planning and tax structuring should always be to avoid disputes with the tax authorities.

Change-of-control during the fiscal year

The loss forfeiture rules raise many questions when the share transfer takes place during the corporation's fiscal year and not at the end of it. The loss forfeiture rules do not only apply to a loss carry-forward from previous years, but also to losses that occur during the fiscal year up until the detrimental change-of-control (net operating losses until closing).

In the past the tax authorities were of the opinion that profits which arise during the fiscal year up until the detrimental change-of-control (net operating profits until closing) could not be offset against a loss carry-forward from previous years. In a judgment dated 30 November 2011 the German Federal Tax Court has, however, ruled that such an offsetting with net operating profits is possible, since net operating losses are also affected by the rules. The assessment of the net operating profits or losses that were realized until closing can be done via an interim financial statement or via an appropriate estimation method.

The possible offsetting of a loss carry-forward against net operating profits until closing has raised questions as to how the so called German minimum taxation rule (*Mindestbesteuerung*) should be applied in those cases. Under this rule a loss carry-forward can be fully offset against a net operating profit as long as the profit does not exceed € 1m. Of the profit exceeding € 1m only 60% can be offset. According to the draft decree the minimum taxation rule has to be applied to the net operating profit until closing. The maximum amount of loss carry-forward that can be offset against the net operating profit equals € 1m plus 60% of the profit of the entire fiscal year that exceeds € 1m.

Under German tax law it is possible to form a so- called fiscal unity (*Organschaft*) between a parent and a subsidiary company. During the fiscal unity the parent and the subsidiary are being taxed as a single legal entity. This has the advantage that losses can be surrendered for the purposes of corporate income and trade taxes. It is also possible to set off a loss carry-forward of the parent against profits of the subsidiary. On the other hand during the fiscal unity a loss carry-forward of the subsidiary that accrued prior to the establishment of the fiscal unity must not be used by either of the entities during the term of the fiscal unity.

A direct or indirect detrimental change-of-control at the level of the fiscal unity parent regularly also results in an indirect detrimental change-of-control at the level of the subsidiary. According to the draft decree in the case of a fiscal unity a change-of-control during the fiscal year of the entities can have severe disadvantages compared to a change-of-control at the end of the year. The tax authorities are of the opinion that the loss forfeiture takes place before the profits or losses of the subsidiary are being distributed to the parent. Hence, the losses forfeit individually at the level of each entity.

In order to avoid disadvantageous tax consequences in cases of a fiscal unity it should be considered to execute the detrimental change-of-control (closing of the share transfer) at the end of the fiscal year.

Intra-group share transfers

The exception for intra-group share transfers applies if the same person/entity holds 100% of the shares of both the entity that transfers and the entity that acquires the corporation owning tax losses. That is, three levels have to be differentiated:

- The person/entity that holds 100% of the shares of the transferor and the transferee (top tier level)
- The transferor and the transferee (transfer level)
- The entity with losses, that is, loss carry-forwards and / or net operating losses (level of the target corporation)

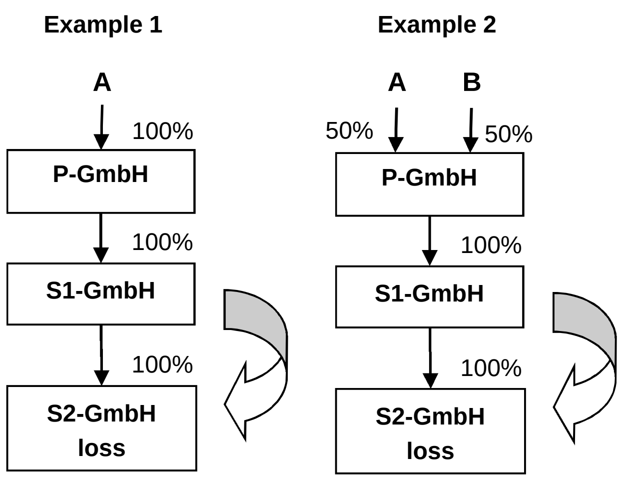
The wording of the exception for intra-group share transfers is very narrow. Many cases of mere intra-group transactions are outside the scope of the exception rule. Nevertheless, the draft decree provides an interpretation that strictly follows the narrow wording. That is problematic in cases where the person/entity at the attribution level is directly involved in the transfer of the loss entity or where the group is owned by several persons.

Example 1: Person A holds 100% of the shares of P-GmbH (GmbH = German ltd.). P-GmbH holds 100% of the shares of S1-GmbH directly and 100% of the shares of S2-GmbH indirectly. S2-GmbH has a loss carry-forward. S1-GmbH is merged downstream into S2-GmbH.

Through the merger 100% of S2-GmbH's shares are transferred from S1-GmbH to P-GmbH. In this case the exception should apply, since A holds 100% of the shares of the transferor indirectly and 100% of the shares of the transferee directly.

Example 2: Like example 1 except that A and B each hold 50% of the shares of P-GmbH.

According to the draft decree the exception for intra-group reorganizations should not apply in this case, since several persons own the group. One could argue that P-GmbH at the same time serves as entity at the top tier level and as transferee. The draft decree, however, states that the three levels have to be strictly separated.



In our view the interpretation of the tax authorities is too narrow. The exception should also apply in cases where the same persons have identical participations in the transferor and the transferee. It should also apply where the person at the top of the group acts directly at the transfer level.

The ultimate decision on the correct interpretation of the exception for intra-group share transfers will be up to the German Federal Tax Court. However, in many cases there are tax planning opportunities to avoid the loss forfeiture in intra-group share transfers. Before losses occur it is possible to set up the group structure in a way that will not result in a forfeiture of losses in the case of certain intra-group share transfers. In some cases it is also possible to avoid the forfeiture of losses through reorganizations even after the losses have occurred.

Exception for corporations with built-in gains

The corporation's losses do not forfeit in the amount of the built-in gains in the corporation's assets that are taxable in Germany. The correct assessment of a corporation's built-in gains can be difficult. The formula for the assessment for the built-in gains that are taxable in Germany is as follows:

value of the shares in the corporation

minus equity capital in the tax balance sheet

minus built-in gains that are not taxable in Germany

= built-in gains taxable in Germany

In the case of a partial forfeiture of losses (due to a change-of-control larger than 25% and less than or equal to 50%) the built-in gains are likewise considered only partially.

Generally the value of the shares can be derived from the purchase price of the shares. However, a valuation of the corporation is necessary if the parties are affiliated and the purchase price does not reflect the corporation's fair market value.

Built-in in gains are not taxable in Germany if the respective assets are located abroad and Germany has no right of taxation, for example, if they are located in a permanent establishment abroad and the treaty exemption method applies or if the respective profits are generally tax exempt.

The most important general tax exemption is the German participation exemption rule that provides general corporate income tax and trade tax exemptions for dividends and capital gains from the sale of shares. Therefore, built-in gains in shares are generally not considered for the exception.

The exclusion of built-in gains for shareholdings is problematic in groups of companies, where the losses often accrue in other entities than the taxable built-in gains. In particular this pertains for holding companies whose main assets are shareholdings in subsidiaries. Generally the problem that profits and losses often occur in different group entities can be avoided for German resident corporations through the formation of a fiscal unity. However, pursuant to the draft decree the entities of a fiscal unity are to be regarded separately for the purpose of the exception for built-in gains. This view can be very disadvantageous for fiscal unities because during the fiscal unity a loss carry-forward can only accrue to the parent, whereas built-in gains that are considered for the exemption rule from the loss forfeiture provision accrue to the subsidiary. It is questionable whether this section of the renewed decree would be upheld by the tax courts.

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Planned changes to hydrocarbon taxation in Poland

Paweł Chodzinski considers new Polish proposals for the taxation of hydrocarbons.

Introduction

On 23 April 2014, a government bill was submitted to the Polish Parliament on a new system of taxation of hydrocarbons in Poland (the ‘‘**bill**’’). Although the bill is still at the initial stages of the parliamentary process, it is worth considering the impact of its new regulations on the future position of the sector.

According to the bill, the following taxes will constitute new fiscal instruments in respect of the extraction of hydrocarbons.

Tax on extraction of hydrocarbons

This tax is to be implemented by way of an amendment to the bill ‘‘On the taxation of certain deposits and ores’’ (currently, these are mainly silver and copper, extracted by Polish blue-chip KGHM SA, which are subject to this tax).

According to the new law, the taxable basis will be determined as a product of the amount of extracted gas or oil (petroleum) and the average market price of those hydrocarbons (determined each month in an announcement by the minister of finance).

The tax rates in respect of the extraction of gas will be either 1.5% or 3% (depending on the quality of the deposits), while in the case of petroleum they will be 3% and 6% respectively.

The new tax will have features characteristic of an indirect tax, similar to excise duty. Consequently, certain significant doubts have arisen with respect to the compliance of the bill, in this part, with provisions of EU law, namely with the Horizontal Directive (Council Directive No. 2008/118/EC).

Special tax on hydrocarbons

The so-called special tax on hydrocarbons will be a completely new form of taxation. The construction of this tax is similar to an income tax; however, it will have certain accounting-related features, currently unknown in Poland. As compared to classic income taxes, the legislature decided to considerably limit the right to deduct investment-related costs, by introducing a category of the so-called qualified (eligible) expenses. Moreover, other plans comprise such elements as an electronic form of filing tax returns, as well as the taxation of a civil law partnership whose partners obtained a licence specified in the bill.

The taxable amount will be constituted by the profit from the hydrocarbon extraction activity, being the surplus of the revenue generated in a given tax year from the hydrocarbon extraction activity, over the qualified (eligible) expenses incurred in a given tax year.

The revenues from the hydrocarbon extraction activity will in turn be constituted by moneys received, pecuniary value, and the value of the dues satisfied in kind, including any advances and prepayments, on account of the supply of the extracted hydrocarbons.

As stated above, the bill contains an extensive list of costs, which will not be regarded as qualified (eligible) expenses, including expenses incurred for the purchase of intangible assets (including licences and patents), insurance contract premiums, or expenses for the repayment of loans (credit facilities) together with interest on them, as well as other commissions and fees connected with them. Those expenses generally form an important part of the costs in each exploration - and extraction-related budget. Consequently, it may turn out that the effective rate of fiscal charges within the so-called government take may be higher than the level of 40%, as planned by the finance minister.

The deduction of the special tax on hydrocarbons will be through the application of rates, relating to the profitability of the extraction projects.

Assessment of the planned regulations

The postponement of the due payments of new taxes until 1 January 2020 is definitely an advantageous aspect of proposed legislation. It should be remembered, however, that together with the entry into force of the planned regulations, taxpayers will face a number of new evidential requirements, as well as those regarding the filing of monthly and annual returns (only in an electronic form).

The complex nature of the new system of taxation as well as the considerable increase of administrative and evidence-related obligations have been criticised, along with the considerable number of exclusions on the list of qualified (eligible) expenses, the introduction of reference prices in the extraction tax and consequently, the determination of the taxable amount with no link to the profitability of the extraction-related projects.

Within the context of the tax law amendments as comprised in the bill, the minister of finance failed to introduce any solutions which would clarify the principles of the taxation of oil rigs and wells with real property tax. This may further result in doubts similar to those which arose in connection with the taxation of wind farms with real property tax.

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European decision in *Felixstowe Dock* to cause more changes to UK law

The European Court's decision in the Felixstowe Dock case is likely to affect the UK regime for loss surrender in at least two ways, explains Rupert Shiers.

Introduction

In *Felixstowe Dock and Railways Company Limited* (C-80/12), the Court of Justice of the EU ("**CJEU**") ruled a provision of the UK tax regime, for surrender of tax losses between related companies, to be unlawful.

The decision in *Felixstowe Dock* necessarily affects the UK provisions restricting surrender of losses, which replaced the provisions considered in the case. The provisions may be amended by future legislation. For now they should be read as if specific text had been deleted. Groups affected by the offending text may wish now to surrender or claim losses. The decision appears to undermine a key argument used by HM Revenue & Customs ("**HMRC**") in resisting some claims for surrender of non-UK tax losses, after *Marks and Spencer plc* (C-446/03).

The decision does not endorse certain statements made by Advocate General Jääskinen in his Opinion. If endorsed, those statements could have excluded a significant number of group structures from the protection of freedom of establishment. The groups which could have been affected should for now be able to pursue EU law arguments as previously expected. This issue may come to be reconsidered at a later stage.

Finally, as Advocate General Jääskinen had said in his Opinion, *Felixstowe Dock* is the third case in which the CJEU has had to consider "whether the exclusion of certain taxpayers from the United Kingdom group relief tax scheme is compatible with the freedom of establishment".

Those three cases - *ICI* (C-264/96), *Marks and Spencer*, and *Philips Electronics UK Limited* (C-18/11) – led to different reactions from the UK and from the courts. A clear development in attitude is apparent. Groups considering an EU-law challenge to UK corporation tax issues should be in no doubt that HMRC will resist the challenge. But they can take some comfort from the courts' developing approach.

Group relief claim

Felixstowe Dock concerned a claim by a UK company in the Hutchison Whampoa group for relief for losses incurred by a UK company in a separate group part owned by Hutchison Whampoa companies. Under UK law, now rewritten to section 133 Corporation Tax Act 2010 ("**CTA 2010**"), relief is available in such a situation (consortium relief) for a proportion of the losses broadly equivalent to the main group's proportionate holding in the joint venture group. However, under the law in force at the time, this was only the case where the main group company that owned part of the joint venture group (the link company) was UK resident or had a UK permanent establishment ("**PE**").

In *Felixstowe Dock*, the link company was resident in Luxembourg and did not have a UK PE. And the chain of ownership leading from it to the group companies claiming the loss was not composed purely of EEA companies. The UK tax authorities denied the claims for loss relief. The claimant companies, including Felixstowe Dock itself, appealed. The UK tax tribunal addressed a number of arguments and then referred to the CJEU the question of whether denial of loss relief by virtue of the non-UK link company and non-EEA chain of ownership was a prohibited restriction on freedom of establishment.

Before the tribunal decision ([2011] UKFTT 838 (TC)), section 133 CTA 2010 had been amended by Finance (No 3) Act 2010, making EEA companies eligible to be link companies, but also imposing a limitation on loss surrender where there was a non-EEA chain of ownership, consistently with HMRC's arguments in *Felixstowe Dock*.

Decision

The Grand Chamber of the CJEU decided on 1 April 2014 that HMRC's arguments were impermissible. Though the logic is not entirely clear, it appears that the CJEU found that:

- the loss-making company in the joint venture group was an establishment of the Luxembourg company

- the right to surrender losses benefited at least the loss-making company, which could monetise its losses if surrendered (previous case-law had held that it also benefited the claimant company, but this does not appear to have been material in *Felixstowe Dock*)
- as there would have been no restriction with a UK link company, there could be none with an EEA link company.

This is all straightforward analysis.

Effect on UK law

The decision is likely to affect the UK regime for loss surrender in at least two ways.

Specifically in relation to consortium relief, the decision makes clear that EEA companies are eligible to be link companies in periods before Finance (No 3) Act 2010 came into force. That legislation was not expressed to cover past periods. It also seems to make clear that the limitations on loss surrender introduced in that Act are invalid. Changes to UK legislation can be expected (probably in the summer of 2015) to formalise these points. Groups should also be able to rely on the CJEU's decision to give effect to them in the meantime.

More generally, the decision appears to confirm that a key argument in the UK's attempts to limit claims for relief for non-UK losses, under *Marks and Spencer*, is invalid. *Marks and Spencer* dealt with claims by a UK parent for losses of an EEA subsidiary. As is clear from *Finnforest UK Limited* [2011] UKFTT 342, HMRC has argued that *Marks and Spencer* establishes no wider principle allowing for surrender of non-UK losses. In particular, HMRC has sought to reject claims where the claimant and surrendering companies are sisters rather than parent/subsidiary. Paragraph 23 of *Felixstowe Dock* appears to make that argument impossible for HMRC to pursue. This will have real cash benefits for many groups.

AG concerns rejected

Paragraphs 63 to 70 of AG Jääskinen's Opinion had caused concern EEA-wide. He set out two views there, leading him to the conclusion that the UK's argument should succeed. The following paragraph explains these views by reference to an investment into the UK by an EEA company.

His first view was that where the EEA company holds the UK company through a non-EEA intermediate holding company, the UK company is not entitled to the protection of freedom of establishment. The effect would be that the UK company is not entitled to be treated as if the EEA company were a UK company.

Secondly, where equal treatment would depend on the tax treatment of a third company, his view was that equal treatment is available only if there is a purely-EEA ownership chain from the third company to the EEA company. AG Jääskinen said that in making these points he was simply "following the logic" in *Test Claimants in the Thin Cap Group Litigation* (C-524/04).

The CJEU did not adopt either of these views. The first was simply not addressed. On the second point the CJEU's view was in effect that equal treatment would be available whenever the UK company and the third company (also UK) were relevantly "linked" by the legislation in question (paragraph 23).

The UK's developing approach

After *ICI*, the UK introduced legislation in Finance Act 2000 which clearly removed the restriction identified by the CJEU. This legislation also went further, and:

- removed further similar restrictions in the same legislation, dramatically widening the scope of the UK group relief rules; and
- applied the wider rules not only to EEA companies but also to companies from outside the EEA.

However, the UK's approach then became more limited. After the CJEU decision in *Marks and Spencer*, HMRC pursued litigation through seven more hearings until Marks and Spencer broadly won their litigation earlier this year. The UK also introduced legislation in Finance Act 2006 which adopted a highly limited approach to removing the restriction. This legislation was the subject of infringement proceedings IP/12/1017 by the European Commission. The recent decision of the UK Supreme Court finalising the *Marks and Spencer* litigation, *Marks and Spencer* [2014] UKSC 11, strongly indicates further elements of that legislation to be incompatible with freedom of establishment.

In the third case, *Philips Electronics*, the UK tax tribunals considered the link company rules addressed in *Felixstowe Dock*. The First-tier Tribunal ([2009] UKFTT 226 (TC)) held that "section 406(2) is a clear case of a restriction" and so was to be disapplied (paragraphs 17 and 60). HMRC did not appeal against this decision. As discussed above, legislation was then introduced making EEA companies eligible to be link companies, but limiting that eligibility. Those limitations have, of course, also now been found to be inconsistent with freedom of establishment.

Further legislation was introduced in Finance Act 2013, after the CJEU's decision in *Philips Electronics*, in relation to the provision the CJEU addressed. This legislation attracted adverse comment during UK parliamentary debates as being, again, inconsistent with freedom of establishment.

However, the UK courts are taking a more robust approach to enforcement of EU rights. The *Philips Electronics* First-tier Tribunal decision was the first case in which a UK court had disapplied UK corporation tax rules without a reference to the CJEU. More may now follow.

Surprise hearing

Felixstowe Dock clarifies a point which many in the UK thought to have been clear already. Few understand why the Grand Chamber chose to hear the case (unless, as AG Jääskinen's Opinion indicates, the case appeared more interesting on first review). It is the wider points noted above that demand attention.

The factual background also adds colour to HMRC's approach. Its challenge to these claims is said by some to be politically motivated. The losses are reported to arise from the very significant expenditure by the loss-making joint-venture company (Hutchison 3G UK Limited) on a 3G licence. Hutchison and the other licence holders had previously sought to argue that part of the licence fee paid was VAT and so reclaimable. HMRC resisted this successfully in the CJEU (C-369/04). It is said to be no surprise that HMRC sought to resist this further attempt to obtain tax relief for the cost of the licence.

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Dutch Supreme Court clarifies position on tax treatment of hedging transactions

Anton Louwinger discusses a recent Dutch Supreme Court case concerning the Dutch corporate income tax treatment of a market maker and, in particular, how the principles of sound business practice should be applied to various hedging transactions entered into by the market maker.

Introduction

The principles of sound business practice govern the allocation of the total profit made by a corporate taxpayer during the existence of the company to its respective financial years. The concept of sound business practice has been developed in case law and is subject to constant changes triggered by developments in society. Important elements of the concept that should be observed when selecting and implementing an accounting method for Dutch tax purposes are:

- the reality principle - the profits are to be determined in a realistic manner, which means that:
  - the profit for a given year is to be determined with regard to the costs and benefits associated with that year
  - the real facts, and not necessarily the legal or other structures that are applied, constitute the basis for determining the profits, and
  - the taxpayer should not doubt what is certain and vice versa
- the prudence principle - unrealized losses may be recognized and unrealized profits may be ignored, and
- the principle of simplicity - the accounting method used must be manageable in view of the applicable circumstances.

The case (ECLI:NL:HR:2014:635, of 21 March 2014) concerned the application of the reality principle in combination with the prudence principle to determine the extent to which losses regarding specific assets - both unrealized and realized - can be recognized for Dutch tax purposes if they are matched by unrealized gains regarding other specific assets.

Facts

As a market maker, the taxpayer assumed and maintained positions in derivatives and underlying assets, particularly options and shares. Also, the taxpayer undertook arbitrage activities and tried to generate additional profits through hedging activities.

The taxpayer aimed to fully hedge the risks to which it was exposed in connection with its positions by means of delta hedging. For that purpose, the taxpayer engaged in transactions involving other options of the same funds, purchased and sold underlying securities, and created synthetic equivalents. These equivalents hedged the risks in a similar, but not identical, manner to shares.

The risk of price movement is reflected in the so-called delta. Also, there are risks reflected in the "other Greeks", - namely, the vega (volatility), theta (passage of time), gamma (mutation delta), and rho (interest). Further, the taxpayer was exposed to risks regarding dividends as well as liquidity. The taxpayer's goal was also to control those risks as much as possible. When the price of a fund changes, the delta changes, which causes the taxpayer to rebalance its positions in order to achieve a delta-neutral position.

In its financial statements, the market maker stated the derivatives and shares at fair market value ("**FMV**"), whereas for Dutch corporate income tax purposes, the long positions were stated at the lower of the historical cost price or FMV, and the short positions were stated at the higher of the amount of the option premium/share price received or FMV. This resulted in the recognition of losses in a given year that should not be suffered during the lifetime of the business because of compensating profits on other transactions.

Leaving aside a dispute over the Dutch tax authorities' ability to terminate an advance tax ruling, the issue, in the tax authorities' view, was that in light of the taxpayer's business strategy of full risk mitigation, the reality principle is not observed when transactions are economically linked, but the tax treatment of the transactions is nevertheless determined on an isolated basis.

Decision

The Supreme Court started by confirming its previous case law, in which it had ruled that an asset can be stated at cost and that a possible increase in value of that asset must be recognized for Dutch tax purposes only at the moment the increase is realized in a transfer of that asset to another party. At the same time, according to good business practice, if the FMV is less than the cost price, a taxpayer is allowed to apply that lower value.

If, however, connected valuation with other assets or liabilities is required, such a downward revaluation is allowed only to the extent that the aggregate value of the connected assets or liabilities is less than the combined cost. The Court previously ruled (ECLI:NL:HR:2009:AZ7364) that a connected valuation of assets or liabilities is required if there is a highly effective hedge. This is the case if, at the balance sheet date, it is anticipated that the value fluctuations of specific assets or liabilities will most certainly correlate within a range of 80 to 125% (the high efficiency test).

The Court added that this approach also applies to listed securities. This means that securities that are subject to this connected valuation cannot be stated below their combined market value. This is in line with the Court's decision of 16 November 2007 (ECLI:NL:HR:2007:AZ7371), which concerned the tax treatment of a writer of a call option over shares that it also owned.

However, deviating from previous decisions, the Court held in its 21 March ruling that sound business practice requires connected valuation for all assets or liabilities whose value is directly linked with that of shares. In those cases, the high efficiency test is no longer relevant. According to the Court, that test remains relevant for assets or liabilities that concern a group of (different) shares. For the purposes of the high efficiency test, it is irrelevant that the market maker applied a policy of delta hedging and that the assets and liabilities were stated at FMV in its financial statements, the Court held.

It also held that if it is a taxpayer's continuous goal to minimize exchange risks for a set of securities (which may include liabilities) through hedging, that is not in line with the principles of sound business practice if: 1) a loss realized by that taxpayer on some (but not all) assets or liabilities belonging to a set of assets and liabilities that is subject to connected valuation is taken into account for Dutch tax purposes; while 2) the FMV of the remaining assets and liabilities exceeds the cost price of the total assets and liabilities for which connected valuation was required (including those that are transferred).

According to the Supreme Court, in such a case, the realized loss cannot be taken into account but needs to be added to the cost price of the remaining securities. It can then be taken into account only if a loss is ultimately suffered on the entire set of securities.

Conclusion

This decision sheds additional light on the boundaries of the reality principle.

For securities, connected valuation is obligatory if the valuation fluctuations are directly linked to those of a set of identical shares. In other cases, the high efficiency test remains relevant.

The Supreme Court has also made clear that for a connected valuation of a set of securities, only an overall loss can be taken into account for Dutch tax purposes, and not a loss suffered on the sale of a portion of those securities if, at that time, the FMV of the set of securities exceeds the combined cost price.

In that respect, the Court considered it important that the taxpayer continuously attempted to minimize its exchange risks through hedging. It remains to be seen whether the Court will rule differently in the absence of such a goal.

Additional case law will provide clarity on whether the Supreme Court will also drop the high efficiency test for assets other than shares.

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An earlier version of this article has appeared on Tax Analysts.

Spanish National Court rules that Brazilian *juros* can benefit from the Spanish participation regime

Juan Garicano and Alejandro Moscoso del Prado analyse a recent Spanish National Court decision with regard to the application of the Spanish participation exemption regime to Brazilian juros.

Characterization of *juros* for Brazilian purposes

Legal features

*'Juros sobre o capital' ("**juros**")* are regulated by Brazilian Federal Law nº 9,249, of 26 December 1995, according to which the main characteristics of *juros* are the following:

- *juros* are defined as 'interest' by the above-mentioned Law
- their distribution is subject to the existence of profits
- *juros* are subject to Brazilian Income Tax as profits obtained by the Brazilian entity, and
- *juros*' payments have to be agreed at the shareholders' meeting.

Accounting treatment

From an accounting perspective, *juro*s do not constitute financial expenses and payments of juros are registered as dividend distributions.

Tax treatment

However, Brazilian tax law grants a deduction for the *juros* payments, limited to the periodical fluctuation of the Brazilian long-term interest rate.

Spanish participation exemption regime

Under the current legislation, Spanish domestic law sets forth a full participation exemption regime on dividends and profit participations received from foreign subsidiaries provided certain requirements are met:

- 5% holding interest
- one-year holding period
- "subject-to-tax test": this requirement is deemed to be met if the country of residence of the subsidiary has signed a double tax treaty with Spain which includes an information exchange clause, which is applicable to the subsidiary, and
- "active income test": the income received must come from an economic activity carried out abroad.

Spanish National Court decision

Repealing a previous resolution issued by the Spanish Administrative Court which followed the criteria of the Spanish Tax Authorities, the Spanish National Court has taken the view that, viewing the main features of *juros* from the perspective of Brazilian law and the double tax treaty signed between Brazil and Spain, they should qualify as dividends, rather than interest.

The National Court relied on the fact that such income is not in line with the concept of "interest" as remuneration derived from capital and that, from a Brazilian accounting standpoint, *juros* are not registered as a financial expense. Accordingly, the National Court resolved that *juros* should be considered a profit distribution for Brazilian purposes.

When analysing the double tax treaty signed between Spain and Brazil, the National Court held that *juros* should also be considered dividends for treaty purposes by virtue of the definitions provided by articles 10 (dividends) and 11 (interest) of that treaty. In this respect, without carrying out an in-depth analysis of these provisions, the National Court noted that *juros* cannot be viewed as interest since their main feature is the right to receive a participation in the company's profits, which in turn is the distinctive characteristic of a dividend.

Furthermore, with regards to the fulfilment of the third requirement of the Spanish participation exemption regime (that is, the "subject-to-tax test"), the National Court considered that (i) the deduction granted by Brazilian tax law is irrelevant for the purposes of this requirement and (ii) that such requirement is deemed to be met provided Brazil has signed a double tax treaty with Spain that contains an exchange of information clause.

Finally, the Spanish National Court cited a decision taken by the German Federal Court on 6 June 2012 that, with different reasoning, reached the same conclusion.

Main tax implications in Spain

Although this decision could be repealed by the Supreme Court, Spanish multinationals with interests in Brazil, and foreign groups that have (or are to have) a Spanish holding company, may take advantage of this decision since it will allow the repatriation of profits from Brazil to Spain without tax leakage in Spain.

Following the reasoning of the Spanish National Court, the so-called "subject-to-tax test" is deemed to be fulfilled provided the country of residence of the subsidiary has signed a double tax treaty with Spain that contains an exchange of information clause (that is, it is a presumption that does not admit evidence to the contrary). Thus, this requirement is automatically met if the subsidiary proves its residence through the corresponding certificate of tax residence.

Therefore, this decision, together with the Spanish participation exemption regime and the wide Spanish tax treaty network, enhances the position of Spain as one of the best platforms to invest in Latin America, in general, and in Brazil in particular.

Finally, it should be noted that this decision should also be analysed in light of the potential amendments to Spanish tax law as a result of:

- the OECD's Base Erosion and Profit Shifting (BEPS) initiative and, particularly in this case, the recommendations included in the public discussion draft recently issued by the OECD "BEPS Action 2: Neutralize The Effects Of Hybrid Mismatch Arrangements", and
- the reform of the Spanish tax system due in 2015.

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New rules on the deduction of acquisition debt in France

Bruno Knadjian summarises recent changes to the deductibility of interest in France.

Introduction

The French Finance Act for 2014 imposes a new restriction on interest deductions paid to a party that is directly or indirectly related to a French borrower. This adds to previous French measures which aim to limit or prevent the deduction of financial expenses (such as the rules on thin-capitalisation) and may impact on current and future financing arrangements set up by UK investors as part of their French investments.

New rules

Under the new rule, interest deductions will only be allowed if the French borrower demonstrates that the lender is, for the current financial year, subject to a corporate tax on the interest income that equals 25% or more of the corporate tax that would be due under French tax rules. When the lender is domiciled or established outside of France, the corporate tax determined under French law equals the tax liability that the lender would have owed on the interest had it been resident or domiciled in France. The French borrower will have to prove a "sufficient level of taxation" imposed on the related-party lender when requested by the French tax authorities. This new mechanism adopted on 30 December 2013 applies retroactively to tax years closed as from 25 September 2013.

Originally, this provision was aimed at counteracting hybrid arrangements which exploit the differences of characterisation of an income flow which thereby give rise to an inconsistent tax treatment in France and another country, for example, deductible interest in France but exempt dividend in another state. However, its scope is much wider than this and raises numerous concerns regarding its application to non-taxable entities (investment funds, pension funds, partnerships) and back-to-back loans.

The scope of the measure has been recently clarified by the French tax authorities, notably with respect to the factors to be taken into account in determining the effective tax on the interest income at lender level. In particular, it has been confirmed that the effective taxation will be determined on a net basis, after deduction of other expenses, and the 25% threshold will be considered after the offset of tax losses or tax credits.

Its retrospective effect means that UK funds with investments in France may need to review their past financing arrangements now to assess the impact of the new measure.

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Why companies should readdress their tax structures in Africa

Fabrizio Lolliri and Michiel Els discuss why companies investing in sub-Saharan Africa should keep their structures in line with the region's developing tax systems.

Introduction

Africa's economy has shown high growth potential in the last decade. Africa’s biggest trading partners in terms of value are either the European Union, or to a lesser degree, the United States. In the past decade trade between OECD countries and Africa has doubled in nominal value. Even though trade between Africa and OECD member countries has grown and will continue to grow, the rapid pace at which trade between Africa and non-OECD countries grows, through the likes of China, Russia and Brazil, signals that the emerging economies might surpass the OECD member countries in the not too distant future.

Accordingly, we have seen numerous European member companies trying to tap into the profit potential in Africa. In doing so there are a lot of uncertainties regarding the tax and legal regulations of entering and extracting the expected profits to be repatriated.

Asian countries such as India and China were often the targets for low cost and low risk manufacturing and service arrangements as part of tax efficient supply chain structures. However, the tax authorities both in China and India have become more aggressive and increasingly have been attacking the low margins left in the Asian jurisdictions. Africa offers an alternative location to large multinationals due to its low labour cost and less mature transfer pricing systems and regulations.

Increasing importance of transfer pricing

Transfer pricing ("**TP**") has been a focus of revenue authorities throughout the world, and we expect that this focus will also move into Africa given the increasing number of groups setting up operations in the Africa region. It has been said that TP is the lowest-hanging fruit, because it can be very subjective and most companies do not have adequate documentation to back up their in-house policies.

Over the last two decades the African continent has moved into the TP age and recently many African countries have adopted the OECD Guidelines to base their TP regulations on. Almost all European countries have TP regulations in place. Below we list the largest African countries together with their European trading partners, to show the differences from a TP perspective.

The table at the end of this article provides a general overview and considers the following:

TP Regulations: Whether formal TP rules and regulations exist in that country.

OECD Guidelines: Whether a country follows the OECD Guidelines relating to TP.

TP Documentation: Whether it is compulsory to submit TP documentation or if it is best practice to prepare TP documentation.

Methods Accepted: Whether the traditional methods (comparable uncontrolled price (“**CUP**”) method, the resale price (“**RP**”) method, and the cost plus (“**CP**”) method) and the transactional profit methods (transactional net margin method (“**TNMM**”) and the profits split method) are accepted.

APA Programme: Whether there is an APA programme in place to resolve actual or potential transfer pricing disputes in a principled, cooperative manner, as an alternative to the traditional adversarial process.

Achieving a cost-effective structure

There are a number of opportunities in Africa for large multinationals to achieve a more cost efficient structure and reduce the risk of being attacked by more aggressive tax authorities like in India and China. However, as the table suggests, most African jurisdictions are putting in place OECD compliant TP regulations. Therefore, it is important to look at the TP arrangements when moving functions and/or risk to Africa and documentation is key.

TP regulations might not be as advanced and tax authorities do not have the same level of experience as in other European jurisdictions, but African tax authorities are most definitely trying to step up their game. As in most cases where regulations are in an infant state, documentation and compliance become the major focus, so it is important to put in place, test and document TP policies in case of an inquiry.

Is Africa going to be the new China or India for outsourcing and manufacturing?

It could well be as trends show a large number of multinationals expanding into Africa. Africa offers both a growing market and a low cost base for operations. However, when planning efficient supply chain structures, groups should look back and learn from previous mistakes. Many of the structures currently under fire are the result of companies taking advantage of TP regulations that are not as advanced.

It is very important to plan new structures with the view that, eventually, most African TP regulations will align themselves with the rest of the world. It is also true that the arm's length principle has not, and will not, change. Therefore, transactions should always be priced based on functionality, risk and substance to reduce the risk of disputes in the future.

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Country	*TP Regulations*	*Follow OECD Guidelines*	*Compulsory to submit TP Documentation*	*Methods Accepted*	*APA Programme*
Angola	Yes	Yes	Yes, six months following tax year-end.	Only the traditional methods are accepted.	No
Kenya	Yes	Yes	Yes, to be prepared annually with a compliance penalty.	Both traditional and transactional methods may be used.	No
Namibia	Yes	Yes	No, but it is best practice to prepare documentation.	Both traditional and transactional methods may be used.	Yes
South Africa	Yes	Yes	No and yes, as it is best practice to prepare. The tax return (ITR14) also asked the question whether a TP report has been prepared.	Both traditional and transactional methods may be used.	No
Zambia	Yes	Yes	Yes, certain disclosures are required per tax return.	Arm's-length price is followed and no specific method is required.	No
Uganda	Yes	Yes	Yes, regulations state that it must be in place.	Both traditional and transactional methods may be used.	Yes
Tanzania	Yes	Yes	Should be prepared, but no need to submit unless requested.	Both traditional and transactional methods may be used.	No
Nigeria	Yes	Yes	Yes, when filing the ITR.	Both traditional and transactional methods may be used.	No
Ghana	No	No	No, but it is accepted that it may be useful in the event of a challenged transaction.	No specific methods are preferred.	No

Controlled Foreign Corporation tax regulations to be introduced in Poland

Andrzej Dębiec and Paweł Chodzinski consider new proposals for a Polish CFC regime.

Introduction

Following the introduction of the joint stock partnership's (SKA) CIT taxation as of 1 January 2014, the Polish Ministry of Finance ("**MF**") continues to limit available tax optimizations in Poland. The two main tax measures proposed by the MF in order to tackle tax planning (both most likely coming into force as of 1 January 2015) are specifically a general tax anti-avoidance clause and new regulations on the taxation of Controlled Foreign Corporations ("**CFC**"). The first proposal is still subject to discussions (and also widely criticized by non-governmental organizations, mainly businesses), while the latter one is part of draft law, already subject to legislative procedure.

New CFC proposals

The plan to introduce CFC rules in Poland as of 2015 is controversial - having in mind that Poland is a country that needs to increase and not decrease its investment attractiveness, and taking into account that similar legislation exists mainly in well-developed economies, such as the US, UK, Japan and Germany.

The new CFC regulations will affect both Polish corporate and individual income taxpayers, provided they hold a CFC that generates revenue resulting mainly from dividends, interest, royalties, capital gains and other similar sources of passive income that are subject to income tax in that foreign tax jurisdiction at an income tax rate significantly lower than in Poland (19%). The Polish individual or corporation will pay income tax in Poland provided that certain requirements stipulated in the new CFC regulations are fulfilled, mainly relating to the location of the CFC (tax havens are subject to the most restrictive treatment), the level of control possessed by the Polish individual or corporation, or whether the CFC renders actual business activity.

The additional income tax will be paid by the Polish owner of the CFC at the rate of 19%. Moreover, the Polish taxpayer will be subject to additional reporting and accountancy obligations in Poland, in particular relating to running the register of its CFCs, and separate financial and accountancy evidence for each CFC.

It should be noted that the new CFC regulations will affect not only the CFCs located in tax havens, but will also affect CFCs that are tax resident in the member countries of the EU or the EEA. However, the restrictiveness of the CFC regulations will depend on the location of the seat and management of the CFC.

Comment

Although, as mentioned, the new CFC law is still subject to legislative procedure, we believe that owners of holding structures that may possibly be affected by the contemplated draft law should start to assess the impact of the new CFC regime on their group, and consider modification of foreign structures in order to exclude or significantly limit any adverse effects the new law may have on their particular CFCs.

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