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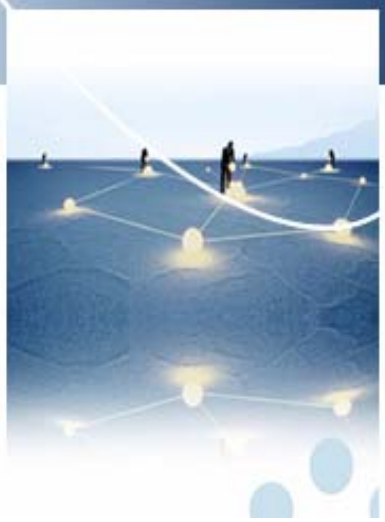

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LEGISLATION

1. CHINA

1.1 Business tax update

The State Administration of Taxation ("SAT") issued Circular 62 in April 2006. It superseded a previous 1997 Circular which provided for an exemption from 5% business tax ("BT") on loan interest and on income from the rental of tangible assets derived by foreign enterprises in China.

1.2 Update on permanent establishment ("PE") definition in China

The SAT issued Circular 35 in March 2006, which further defines "business" and "preparatory or auxiliary," based on the UN model, the OECD model and the practice in other countries.

The Chinese word for "business" is literally translated from English and includes profit-making activities as well as the activities of not-for-profit organizations. If the activity is not "preparatory or auxiliary," the enterprise in question should be regarded as having a PE in China.

In determining what activities are "preparatory or auxiliary," the following tests should serve as guidance:

- whether the fixed place of business carries on business solely with the head office, or with other parties as well;
- whether the business of the fixed place of business is identical to that of the head office;
- whether the business of the fixed place constitutes a key part of the business of the head office.

If the fixed place of business carries on business with parties other than the head office, or the business of the fixed place of business is the same as the business of the head office and constitutes a key part of the business of the head office, its ability to operate should not be regarded as "preparatory or auxiliary."

PRC personal income tax should be paid by expatriates working for the PE, although they may qualify for treaty exemption.

The competent tax authority must determine whether or not an enterprise has a PE.

1.3 Real estate-related tax

SAT issued Circular 74 in May 2006, although it came into effect on 1 June 2006. The sale of a dwelling within 5 years of purchase will be subject to 5% BT on the gross sale proceeds.

An exemption will apply if it is an "ordinary dwelling" and the sale takes place after 5 years. An "ordinary dwelling" is a small or medium-sized home below a threshold price in different cities.

2. FRANCE

Taxable person and extension of the scope of the reverse-charge mechanism

The amended French Finance Act for 2005 (Article 94, amending Article 283 of the French Tax Code) has extended the situations in which it is the responsibility of a customer registered for VAT in France to pay the VAT due itself, thus dispensing with the need for foreign suppliers and service providers to register for VAT in France.

The legislature has adopted this measure with the aim of combating certain types of VAT fraud.

Furthermore, this measure is aimed at simplifying administrative obligations for suppliers and service providers established outside France and making taxable supplies of goods and services in France to customers established in France. This simplification is in line with the spirit of Proposal COM (2004)178 by the European Commission aimed at extending the scope of the reverse-charge mechanism.

From now on, in addition to the situations in which the reverse-charge mechanism already applies (in particular, the provision of intangible services, work and expert appraisals of tangible moveable property, etc.), the following transactions by a company established outside France in favor of a customer registered for VAT in France will give rise to payment of this tax by the customer as from 1 September 2006: internal supplies, supplies after assembly and installation, services relating to property located in France, cultural, artistic, sporting, scientific, educational and recreational services, as well as services other than intra-Community transport and related services.

In respect of these transactions, suppliers and service providers established outside France need not register for VAT in France and can apply for a

refund of the VAT borne in France using the procedure provided for in the Eighth and Thirteenth EC VAT Directives so long as they do not carry out any other taxable transactions in France with regard to which they are liable for VAT. A customer registered in France must charge the VAT, although it will be able to deduct the VAT thus paid subject to the usual conditions.

A French ruling has been recently released by the French tax administration (23 June 2006), which comments the reform and provides some examples of practical situations.

Furthermore, this ruling provides an exception to the reverse-charge mechanism. According to this exception, the suppliers/service providers non-established in France will still be able to pay VAT in France provided the following conditions are met:

- the supplier/service provider will have to be registered for VAT purposes in France ;
- an agreement concerning the transfer of the VAT liability will have to be concluded between the supplier/service provider and the customer. This agreement will be valid for a year and will encompass all operations within the scope of the new provisions;
- an agent will have to be appointed by the supplier/service provider and this agent will be in charge of VAT returns and VAT payment to the tax authorities (when the supplier/service provider is not established within E.U, the agent will be the tax representative); and
- the name of the agent and the amount of the VAT collected by the agent on behalf of the customer will have to be mentioned on the invoices issued by the supplier/service provider.

The customer will still be liable for VAT if the agent does not fulfil his obligations.

3. INDIA

3.1 Update on Special Economic Zones

Subsequent to the enactment of the 2005 Special Economic Zones Act ("SEZ Act"), the SEZ Rules were issued in February 2006. The SEZ Rules provide the procedural frame work for the operation and maintenance of SEZs and contain provisions regarding the minimum size and other conditions for the development of sector-specific SEZs.

In order to iron out various pending issues relating to the implementation of the SEZ scheme, an Empowered Group of Ministers ("EGoM") was set up. The EGoM has stipulated a minimum land area of 10 hectares for Information Technology ("IT"), gems and jewelry and biotech SEZs, with the minimum built-up area varying from 100,000 square meters for IT SEZs, 50,000 square meters for gems and jewelry SEZs and 40,000 square meters for biotech SEZs. For all other SEZs, the land area requirement would remain at 1,000 hectares for multi-product SEZs and 100 hectares for multi-service and sector-specific SEZs. Furthermore, the processing area for multi-product SEZs has been reduced to 35% of the total area.

The Government has also decided to set an initial ceiling of 150 SEZs, although it is expected that the ceiling will be reviewed towards the end of the year. SEZs are granted significant direct and indirect tax benefits and, therefore, policy developments are been keenly watched by domestic and overseas investors.

3.2 Amendments to the India-Japan tax treaty

The Governments of India and Japan have entered into a protocol for amending the existing tax treaty between the two countries. As per the protocol, the tax rates on dividends (currently 15%), interest (currently 15%/10% for banks) and royalties/fees for technical services (currently 20%) have been reduced to 10% of the gross amounts. With this, the tax rates prescribed by the tax treaty on royalties and fees for technical services would be on par with the basic rate of 10% prescribed by the Indian tax law. The effective rate of 10.455% (after including surcharge and excess), prescribed by Indian tax law would still be marginally higher than the treaty rate.

The amendments will apply from the respective dates set forth in the protocol.

4. LUXEMBOURG

Tax and social security law changes from 2007 onwards

On 2 May 2006, following an agreement reached in April by the tripartite council (a council composed of representatives of the Luxembourg Government, employers and unions that discusses changes to key economic factors, including taxes), the

Luxembourg Government announced a number of corporate income tax, income tax, VAT and social security changes. The measures announced aim to reduce government expenditure and increase competitiveness and employment in Luxembourg.

We summarize below the most important measures, which would apply as from 1 January 2007:

a) *Solidarity surcharge*

It was announced that the solidarity surcharge for the employment fund paid by companies would be increased from 4% to 5%, thus pushing up the overall corporate income tax rate from 22.88% to 23.10%. Taking into account the current municipal business tax rate of 6.75% for the city of Luxembourg, the overall corporate income tax rate would have risen from 29.63% to 29.85% in the city of Luxembourg. The same would have applied for income tax purposes, meaning an increase from 2.5% to 3.5%, and raising the overall marginal income tax rate from 38.95% to 39.33%. The Luxembourg Government informed however recently the Parliament that the 1% increase would be abandoned.

b) *VAT*

The 12% VAT rate for services supplied by professionals ("*professions libérales*") would be increased to 15%, which is currently the standard VAT rate and the lowest in the EU.

c) *Social security*

The dependence contribution would be increased from 1% to 1.4%. The same social security program would apply to both blue-collar and white-collar workers. The minimum salary, and, by extension, the social security contributions cap would be increased by 2% on 1 January 2007.

d) *Indexation of salaries, pensions and family allowances*

Indexation of salaries would be restricted and payments postponed. The 2% indexation of pensions based on the cost of living would be postponed. The amount of family allowances, parental benefits (allowances paid during parental leave of absence) and the education allowance would no longer be based on the cost of living (i.e. no more indexation).

e) *Next steps*

The announced changes in respect of indexation of salaries, pensions, family allowances, education allowances and allowances paid during the parental leave of absence have already been enacted on 27 June 2006. The other measures announced do not have any legal force yet and a legislative process will need to be started in order to either amend the current provisions or introduce new laws.

5. MALTA

5.1 Rules on property transfer tax and amendments to capital gains tax rules published

The rules on the new property transfer tax were published on 19 May 2006. In essence the rules provide that certain transfers of real estate situated in Malta are subject to a final tax of 12% on the transfer value instead of capital gains tax. However, real estate that is exempt from capital gains tax is also exempt from the tax on property transfers.

Persons who are not resident in Malta and are tax resident in another country may elect to have their capital gains taxed at the normal rates (progressive rates of up to 35% for individuals and a standard rate of 35% for companies) rather than at 12% of the transfer value (property transfer tax).

5.2 Treaty news

Malta has started negotiations with the United States to negotiate a tax treaty. No details have been published yet on the terms of the treaty. The current agreement between Malta and the United States is limited to profits derived from the operation of ships and aircraft in international trade.

Malta has recently signed tax treaties with Singapore and the United Arab Emirates. There are now 13 tax treaties which have been signed and are awaiting ratification.

The tax treaty between Malta and Iceland came into force on 19 April 2006. The treaty has not yet been published in the Government Gazette, although the reduced treaty rates are 5% or 15% for dividends, 0% for interest and 5% for royalties. The percentage shareholding required to qualify for the lower withholding tax rate on dividends is 10%.

5.3 Tax Reform Commission

The Government has set up a Tax Reform Commission tasked with making recommendations to the Government on certain tax reforms. No specific details have been announced yet although reports in the media indicate that the main objective of the Commission is to make Malta more competitive from a fiscal point of view.

6. POLAND

Update on tax reform

The Ministry of Finance has recently announced an official Bill amending the Corporate Income Tax Law ("CIT Law"). The announced Bill is most likely to be the final government proposal to be laid before Parliament for debate.

The Government has reaffirmed its proposal to eliminate the step-up in value for tax purposes of assets with respect to contributions in kind of enterprises or part thereof. Nevertheless, additional changes to Polish CIT legislation implementing EU Directives are proposed. First, the Government intends to extend the scope of tax neutral reorganization and dividend flow regimes pursuant to the EU Merger Regulation and Parent-Subsidiary Directive to cover all companies in the European Economic Area.

Other noteworthy changes proposed by the Ministry of Finance include:

- The introduction of an alternative method for recognition of exchange differences for tax purposes. Taxpayers whose financial statements are subject to statutory audit requirements may switch from the rules on recognition of exchange differences under the CIT Law to the accounting rules.
- Additional transfer pricing requirements involving the obligation on nonresident taxpayers doing business in Poland through a permanent establishment to prepare transfer pricing documentation.

7. PUERTO RICO

7.1 Extraordinary Income Tax Act of 2006

The Extraordinary Income Tax Act of 2006 (Act No. 98 of 16 May 2006) imposes a 5% extraordinary income tax on the non-exempt net taxable income of every corporation and partnership with a gross income in excess of US$ 10,000,000 for the tax year ended during 2005. Corporations and partnerships holding a valid tax exemption will not be subject to extraordinary income tax on the net taxable income from their exempt operations.

Extraordinary income tax will only be imposed for one year using as a basis for its computation nonexempt net taxable income for the year ended during 2005. Every corporation and partnership paying extraordinary income tax will be able to take a credit for the amount paid against the income tax determined for the tax years starting after 31 December 2005. The Act provides for different rules on the use of the credit for domestic and foreign corporations and partnerships. However, the intention seems to be that it be taken in four equal installments. It also limits the use of the credit to foreign corporations and partnerships that cannot take a credit or make a deduction in their country of incorporation.

Every corporation and partnership subject to extraordinary income tax will need to file a special tax return and pay the extraordinary income tax on or before 31 July 2006.

The House of Representatives has filed House Bill 2712 to amend several provisions of the Extraordinary Income Tax Act. Among the proposed amendments, the most significant is the harmonization of the tax credit rules between domestic and foreign corporations and partnerships. The Bill provides that every taxpayer will have the right to claim a credit for extraordinary income tax paid in the tax years beginning after 31 July 2006. The credit taken for a particular year should not exceed 25% of the extraordinary income tax paid. We expect this Bill to be enacted.

7.2 Income tax increase for banks

Act No. 89 of 13 May 2006 imposes a 2% "special income tax" on all corporations subject to the Puerto Rico Banking Act. The 2% special income tax is applicable to net income subject to regular tax.

The special income tax is effective in the tax years commencing after 31 December 2005 and on or before 31 December 2006. Therefore, it is effective for only one full tax year.

7.3 Tax increase on royalty payments by corporations and partnerships holding a tax exemption under the 1998 Tax Incentive Act

Act No. 88 of 13 May 2006 amends the 1998 Puerto Rico Tax Incentive Act, as amended, by increasing to 15% the maximum income tax rate applicable to royalty payments to nonresident foreign corporations. Nevertheless, the wording of the Act still allows the Secretary of the Treasury discretion to set a lower tax rate than 15%, but at no time below 2%, if he decides that such reduced rate is in the best economic and social interests of Puerto Rico. It is expected that entities with a negotiated tax rate below 15% specifically established in their tax exemption grant will not be affected by the tax increase.

This Act is effective immediately after its signature.

7.4 Tax reform – sales and use tax

Early this year the Governor of Puerto Rico unveiled at a press conference a tax reform proposal which included the implementation of a sales and use tax system substituting the current excise tax on imports and manufactured goods. The tax reform also included significant changes to the personal income tax system.

It seems from the latest information available that the tax reform will only include the implementation of the sales and use tax system and the elimination of a significant portion of the current excise tax system. Although there is no specific agreement on the sales and use tax rate, it seems that the sales tax rate will be between 4% and 7%.

The Puerto Rico Governor and the Puerto Rico Legislature are still negotiating which products to exclude from sales and use tax. Currently, there seems to be agreement that prescription drugs should be excluded. The definition of the tax treatment of other products such as uncooked food and high-value goods is still under discussion. It is expected that services will be subject to the sales and use tax.

8. SPAIN

8.1 New transfer pricing developments in the tax reform

As mentioned in the previous issue of our Newsletter, the Bill on Anti-Avoidance Tax Measures introduced a number of important measures in the transfer pricing area. We now take a closer look at the main new developments:

a) *Adjustment of transfer prices by the tax authorities*

Unlike the initial wording in the Preliminary Bill, according to which the tax authorities were always obliged to adjust prices, even if it was to the detriment of the public purse, their power to correct the agreed price appears to be "optional" in the Bill and, accordingly, the adjustment "to market value" would not be obligatory for tax inspectors in cases where the adjustment gave rise to a higher deductible expense or to a lower computable revenue for the taxpayer.

b) *Checking procedure*

The new legislation also outlines the procedure for checking and adjusting transfer prices, notwithstanding reference to subsequent implementation by regulations. The main changes to the procedure include, most notably, the following:

- The Bill expressly provides that inspection activities will be deemed to be carried out exclusively with the taxpayer under inspection.
- Unlike current legislation, no reference is made to the possibility of making submissions before a provisional assessment is issued by the tax authorities.
- The Bill acknowledges the possibility of requesting a contrasting expert valuation in relation to the determination of normal market value, although it is not defined whether this will be possible in all cases, or only in the cases specifically envisaged in the General Taxation Law.
- Lastly, the Bill also clarifies that the filing of an appeal or a request for a contrasting expert valuation will toll the statute of limitations on the right of the tax authorities

to assess the tax debt, the running of which will resume once the valuation by the authorities has become final.

c) *Infringements and penalties*

In addition, the Bill also describes the specific tax infringements deriving from a breach of the new transfer pricing obligations:

- According to the Bill, the failure to furnish documentation or the furnishing of incomplete or inaccurate documentation or documentation containing untrue data and which, pursuant to the rules, must be kept available for the tax authorities, will be deemed a serious infringement.

- If the normal market value that can be deduced from the documentation furnished by the taxpayer (and there is a presumption that normal market value must be derived from such documentation) differs from that reported on returns for the taxes in question, this will also constitute a serious infringement.

- With respect to penalty proceedings, where a correction in value is not applicable, the penalty will be a fine of €15,000 "for each item or set of data that is omitted, inaccurate or untrue." In this connection, note that the Bill does not specify the cases in which it must be deemed that no correction of value is applicable, nor does it define the scope of the expression "each item or set of data," which, if taken to the extreme, could give rise to very heavy penalties.

  No mention is made either to the incompatibility of this penalty with others stipulated in the General Taxation Law for failure to cooperate in furnishing information and for breach of accounting or registration obligations, yet the Bill does indicate its compatibility with penalties for resisting, obstructing, making excuses or refusing to allow the activities of the tax authorities.

- Where corrections in value must be made, the penalty will be equal to 15% of the difference between the agreed value and the market value, with a minimum amount that is double the penalty applicable in the preceding point. In this case, the penalty is established as being incompatible with others under the General Taxation Law.

- The imposition of a penalty is expressly excluded in cases in which the taxpayer complied with its documentation obligations and reported the value deriving from it, but the tax authorities corrected the value because they disagreed with the value determined by the taxpayer.

- Lastly, the Bill provides that the foregoing penalties may be reduced if the proposed assessment is signed on an uncontested basis and the penalties are accepted and/or paid promptly.

8.2 Current status of the tax reform

At the time of writing this issue of the Newsletter, the tax reform was at the amendment stage in the Lower House of the Spanish Parliament.

Although nothing has been announced officially for the time being, it seems that the reduction in the corporate income tax rate, which was originally to have been reduced at the rate of one point per year over the next five years, could now be made at a faster rate over two years (that is, in 2007 and 2008), and that some of the tax credits that were originally to be phased out progressively could now be retained, albeit with certain changes.

Once the amendments are approved in the Lower House, the reform must continue its passage (with other possible changes) through the Upper House of the Spanish Parliament.

9. UNITED KINGDOM

UK REIT Regime – Final details

The UK Government has announced the final key details of the Real Estate Investment Trust ("REIT") regime, which will apply in relation to accounting periods from 1 January 2007 onwards:

- a conversion charge of 2% will apply to the gross open market value of the properties at the date at which the company (or group) joins the UK REIT regime. The conversion charge may be paid by way of four annual installments in which case the liability increases to 2.19%;

- the interest cover test to be applied has been reduced from 2.5 to 1.25. Effectively this means

that the ‘profits’ before interest must be at least 1.25 times the interest charge. ‘Profits’ for this test are the ‘taxable profits before capital allowances’ not accounting profits; and

- the distribution requirement for UK REITs has been reduced from 95% to 90% of the profits of the tax-exempt business.

We welcome the UK Government’s confirmation of the UK REIT regime, and it is encouraging to see that the UK Government has been willing to listen to and act upon the views of taxpayers in fashioning the legislation. The proposals have been generally well received and it is likely that a number of the UK’s largest property companies will convert to REITs during 2007.

COURT CASES AND RULINGS

A) EUROPEAN UNION

1. CADBURY-SCHWEPPES ("CS") CASE – ADVOCATE GENERAL'S OPINION

The Advocate General ("AG") recently delivered his opinion on the case brought by CS against the UK Government on the subject of the UK Controlled Foreign Companies (CFC) rules.

The case involved two Irish subsidiaries of CS based in the favorable International Financial Services Centre ("IFSC") in Dublin that provided finance to the CS worldwide group. The IFSC regime applied a 10% tax rate, and the UK Government therefore sought to tax the Irish profits in the hands of the UK resident parent company under the UK CFC rules. CS claimed that the CFC legislation constituted discrimination and contravened the principle of freedom of establishment.

The AG concluded that the establishment of a company in a more favorable tax regime does not, in itself, constitute an abuse of freedom of establishment. As a result, the AG concluded that the UK CFC rules could not be applied if the parent company could prove that the low-tax subsidiary was genuinely established overseas with appropriate resources and capabilities, and was not a "letter-box" company.

It should be noted that the AG's opinion only provides guidance to the European Court of Justice ("ECJ") and it is not, in itself, determinative. It is however rare for the ECJ to deviate from the AG's opinion.

2. BRITISH AMERICAN TOBACCO ("BAT") CASE – AG'S OPINION

The AG also recently issued his opinion on the case brought by BAT against the UK Government. He concluded that the UK system of taxing the receipt of dividends from EU subsidiaries is contrary to EU law because dividends received from UK subsidiaries are treated as exempt from UK tax.

Accordingly, the UK Government may be forced to introduce an exemption system for the receipt of foreign dividends. This could result in the large scale repatriation of overseas profits to UK parent companies, as recently happened in the US.

An exemption system may however come at a cost. In order to maintain revenue neutrality, the UK Government m

.0ay introduce limitations on the deductibility of interest costs where the loan has been undertaken to finance overseas investment.

This case is yet another example of the way that European issues are shaping the UK's tax system, notwithstanding the UK Government's insistence that it has a veto on tax issues.

3. SECOND POLISH CASE

The second reference for a preliminary ruling has been submitted by a Polish court to the European Court of Justice (C-168/06). The reference concerns the compatibility with the Sixth EC VAT Directive of the 30% additional tax liability applicable under the Polish VAT Law in the case of an understatement of the taxable amount. The Polish court also asked whether the additional tax liability imposed by the Polish VAT Law could be justified as a "*special measure*" serving to combat fraud and abuse, as defined in Art. 27(1) of the Sixth EC VAT Directive.

Although the opinion of the AG in the case has not yet been delivered, the Polish Government itself regards the 30% additional liability as not being in line with EU law. Planned amendments to the VAT Law proposed by the Polish Ministry of Finance provide for its elimination.

B) COUNTRIES

1. INDIA

Ruling of the Commissioner (Appeals) on Transfer Pricing

A Commissioner (Appeals) ("CIT(A)") in Bangalore has ruled in favor of the taxpayer (a software company entitled to a tax holiday) in a matter involving transfer pricing adjustments made by the Revenue. The CIT(A) is the first-instance appellate authority in the hierarchy of income tax appellate authorities in India.

In the instant case, the taxpayer had filed an appeal with the CIT(A) objecting to a transfer

pricing adjustment made by the Transfer Pricing Officer ("TPO") in its income tax audit. The taxpayer in India had engaged its wholly-owned subsidiary in the US to provide marketing and onsite software development services. In the assessment against the taxpayer in India, the TPO held that the payments to the subsidiary in the US were higher than the arm's-length price and made transfer pricing adjustments accordingly. In deciding the matter in the taxpayer's favor, the CIT(A) held as follows:

- Transfer pricing provisions are provisions pertaining to avoidance of tax and cannot be resorted to in a mechanical manner by the Assessing Officer ("AO"); in the instant case as the software unit of the company enjoyed a tax holiday, there could be no reason for resorting to excessive payments.
- The internal instructions issued by the Central Board of Direct Taxes to the AO pertaining to reference to a TPO for a transfer pricing audit (based on the monetary value of international transactions with related parties) are not good in law.
- Industry average hourly data provided by NASSCOM (an industry association of software service providers) cannot be used for comparison purposes.
- The TPO's order is not binding on the AO; an independent opinion of the AO on the adequacy and propriety of the order is required.

The ruling of the CIT(A) is likely to have an impact on similar appeals filed by other income taxpayers against transfer pricing adjustments. While other taxpayers could rely on this ruling, we understand that the Revenue authorities have not accepted the CIT(A)'s ruling and will be filing an appeal with the Tax Tribunal (the second-instance appellate authority) against the CIT(A)'s observations. The Revenue authorities may also cite the procedural defects pointed out by the CIT(A) in his ruling.

2. INDONESIA

"Beneficial ownership" principle in Indonesia

The "beneficial ownership" issue surfaced in July last year when the Director-General of Taxation (DGT) issued Circular Letter No. SE-04/PJ.34/2005 concerning the criteria for beneficial ownership as contained in tax treaties with Indonesia.

The said Circular Letter defined "beneficial owner" as the "actual owner of a dividend, interest income and royalty, whether a personal or corporate taxpayer, fully entitled to enjoy the direct benefit of the income." It also stated that special-purpose vehicles in the form of conduit companies, letter-box company, pass-through companies or the like did not fall within the definition of "beneficial owner."

The Circular Letter has, however, left the business community in the dark as it did not specify how it would be applied and did not specifically provide the criteria for determining how a company would qualify as a beneficial owner. It further stipulated that if parties who were not the beneficial owner received the payment of Indonesian-source dividends, interest and/or royalties, the payors would have to withhold tax at 20% in accordance with Article 26 of Indonesia's Income Tax Law.

Since the issuance of the Circular Letter, there has been no further clarification from the DGT. However, in a recent letter (No.S-95/PJ.342/2006) to a private company, the DGT set out the following tests pursuant to which a foreign company receiving Indonesian-source dividends, interest income and royalties can be considered the beneficial owner:

- if the company has been taxed in its country of residence on income qualifying for tax treaty protection and received from the source country; or
- if the company has an active business operation in its country of residence; or
- if the company is fully entitled to all of the income received from the source country and can use it to finance its business activities; or
- if the shares of the company are being traded on a recognized stock exchange.

In addition, a company claiming tax treaty protection is also required by the DGT to produce a certificate of tax residence.

3. ITALY

3.1 Applicability of Italian thin capitalization rules to permanent establishments

In ruling no. 44 of 30 March 2006, the Italian tax authorities expressed their view on the applicability of domestic thin capitalization rules to permanent establishments in Italy belonging to nonresident entities, and, in broader terms, set forth certain general principles regarding the attribution of profits to permanent establishments.

Under Italian thin capitalization rules, interest on related-party debt in excess of a certain threshold is not deductible for corporate income tax purposes. Related-party debt includes any financing directly or indirectly granted or guaranteed by a qualified shareholder or a related party. The thin capitalization rules are not triggered if, in aggregate, the related-party debt does not exceed four times the equity attributable to all qualifying shareholders and their related parties, nor do they apply if the borrower proves that the related-party financing is justified by its own borrowing capacity and that the same loan would have been granted by third parties with the sole guarantee of the borrower's assets.

Regarding the issue of the applicability of the thin capitalization rules to permanent establishments, the tax authorities confirmed that they apply with reference to the financing granted or guaranteed by the related parties of the nonresident company, to the extent of the pro-rata portion to be attributed to the permanent establishment. In this respect, the debt-equity ratio will be calculated according to the deemed equity of the permanent establishment.

As for the more general issues of attribution of profits to Italian permanent establishments, the tax authorities clearly took the “separate enterprise approach” established in Article 7 of the OECD Model Tax Convention, whereby, even though there is only one legal person, the nonresident entity and its permanent establishment will be treated for income tax purposes as if they were distinct and separate enterprises. In the tax authorities’ opinion, the rationale behind this is to enable the State in which the permanent establishment is located to exercise its right to tax those profits. Accordingly, it is up to that State to determine, based on the actual circumstances of the permanent establishment, what the debt-equity ratio should be and consequently the tax authorities will only deem interest on loans that would have been granted on the basis of an adequate endowment fund (i.e., an adequately capitalized permanent establishment) to be deductible, regardless of the amount determined for civil law purposes.

3.2 Application of CFC rules to Maltese International Trading Companies – tax treatment of dividends

In ruling no. 170 of 12 December 2005 the Italian tax authorities expressed their view on the applicability of Italian CFC rules to Maltese International Trading Companies (ITCs), and to the tax treatment of the imputation credit and of the corporate income tax refund by Malta to Italian parent companies upon distribution of dividends by a Maltese ITC.

With respect to the first issue, apart from specifying that Malta’s accession in the EU does not prevent the application of Italian CFC rules, the tax authorities ruled that companies regulated under the Malta Financial Services Centre Act, the Malta Merchant Shipping Act and the Malta Freeport Act are merely examples of Maltese companies falling within the scope of application of the Italian CFC rules, which apply to all Maltese companies deriving income from foreign sources, such as the one referred to in the request for a ruling.

As regards the tax treatment in Italy of the imputation credit and of the corporate income tax refund granted to shareholders receiving Maltese-source dividends, the tax authorities clarified that those amounts will not be treated as dividends for Italian income tax purposes, but rather as income from capital (and as such fully included in the Italian income tax base). Indeed, in the view of the tax authorities, even though the payment of the imputation credit and the refund are linked to shareholder status, it does not constitute a payment of dividends, since it is not being paid out of taxed corporate profits, and is being paid by the Maltese Government rather than by the controlled company.

3.3 Taxation of the profits attributed to a nonresident shareholder under the Italian optional pass-through regime

Under Italian income tax laws, if all the shareholders of an Italian-resident company are corporations, and each hold an interest of at least 10%, but not more than 50%, in the company, the

company can elect to apply a special pass-through regime, whereby its taxable income is attributed pro rata to each shareholder on an accrual basis, regardless of the actual distribution. Italian companies with nonresident shareholders can also elect to apply this regime, provided that the shareholders are not subject to withholding tax on Italian-source dividends (e.g. companies eligible for the regime under the Parent-Subsidiary Directive).

In this respect, in ruling no. 171 of 19 December 2005, the Italian tax authorities stated that where the income of an Italian resident company is attributed to a nonresident shareholder under the optional regime described above, Italy's right to tax that income remains unchanged; therefore, although the taxable income of the investee is attributed to the nonresident shareholders, it remains taxable in Italy under ordinary income tax rules. The tax authorities rejected the taxpayer's argument that such treatment contravened Articles 7 and 10 of the relevant tax treaty, and they confirmed that the profits of an Italian transparent company are still deemed to have to be made by the Italian company, even though the relevant taxes are paid in Italy by the foreign shareholders.

4. SPAIN

Burden of proof in related-party transactions

In the "transfer pricing" area and, specifically, in the pharmaceutical industry, tax inspectors have frequently conducted inspections to check whether or not Spanish companies' purchases of active ingredients or drugs from other foreign companies in the group were being made on an arm's-length basis.

In the context of these inspections, there has been a certain controversy over the possibility of using, as an arm's-length comparable, the prices charged in Spain on purchases of generic products and active ingredients, which are generally much lower than the prices charged between related companies.

Until now, the Central Economic-Administrative Tribunal had been siding with taxpayers on this issue. In various decisions, the Tribunal rejected the validity of the comparables used by the tax authorities, because they either wholly or partially failed to meet the comparability requirements established in the OECD transfer pricing guidelines. For this reason, the Tribunal considered that the price adjustments made by the tax authorities in these cases could not be admitted without analyzing whether or not the price set by the taxpayer was an arm's-length price.

Breaking with this approach, on 14 February 2006, the Supreme Court handed down a landmark judgment that represents a radical shift in the case law interpretation that had hitherto been followed on this issue. In its judgment, the Court held that it was not enough for the taxpayer to merely question the validity of the price set by the tax authorities based on the treatment of generic product prices as comparables. The taxpayer also had to prove that the agreed price was consistent with arm's-length principles (thereby ultimately shifting the burden of proving that it was onto the taxpayer).

Although the judgment refers to the former transfer pricing legislation contained in the former Law 61/1978 and which established that the duty to set arm's-length prices fell to taxpayers, this judgment seems to confirm the trend at various economic-administrative tribunals, namely, to interpret the OECD transfer pricing guidelines flexibly (in favor of the tax authorities). In addition, this change in interpretation by the Court is in line with the major overhaul of transfer pricing legislation set to take place with the Bill on Anti-Avoidance Tax Measures.

OTHER NEWS

1. CHINA

1.1 No more liaison offices for Foreign Investment Enterprises in China

As the new PRC Company Law eliminated the chapter on Liaison Office, the State Administration for Industry and Commerce ("SAIC") together with the Ministry of Commerce, the General Administration of Customs and the State Administration of Foreign Exchange have released a circular on various approval and registration procedures for Foreign Investment Enterprises ("FIEs").

SAIC will no longer accept applications for liaison office registration of FIEs. In the case of previously registered liaison offices, no applications for change of registration details such as the person in charge, or registered address, or renewal of registration, will be accepted.

Now FIEs may consider setting up branch offices with the same function as a liaison office (without issuing invoices or receiving payments from customers).

1.2 Foreign exchange update

The State Administration of Foreign Exchange ("SAFE") issued Circular (*Hui Fa*) [2006] 19 in April 2006 to further relax foreign exchange controls on current account items with effect from 1 May 2006.

Prior approval is no longer needed for entities in China to open, modify or close a foreign exchange account under current account items.

It is now simpler to make outbound remittances under non-trade items. In the case of outbound remittances of less than US$ 50,000 for an entity or US$ 5,000 for an individual, only the relevant contract or invoice need be shown to the bank.

PRC residents now are allowed to purchase up to US$ 20,000 of foreign currency per year to invest in foreign stock.

Fees paid in respect of royalties, distribution rights, and sale and other similar rights will be subject to duty under certain circumstances such as "condition of sale".

Expenses incurred in bonded zones/free trade zones, logistics parks, etc. will be included in the dutiable value of goods sold from the zones to mainland China.

2. FRANCE

Mutual agreement procedure: new administrative comments

The French tax authorities have published a guideline aimed at clarifying the scope of application, conditions for implementation and the conduct of the mutual agreement procedures provided for in bilateral tax treaties and the mutual agreement procedure provided for by the European Convention of 23 July 1990.

France is only extending the scope of application of the principles resulting from the code of conduct adopted by the Council of the European Union on 7 December 2004 and relating to the European arbitration convention to the mutual agreement procedures provided for by bilateral tax treaties (Tax Authorities' Guideline 14 F-1-06 of 23 February 2006).

3. LUXEMBOURG

Investigation by EU Commission into SICARs and securitization vehicles

Following a complaint from another Member State, the EU Commission was obliged to take action by sending a letter on 13 February 2006 to the Luxembourg Government raising questions concerning the Luxembourg SICAR regime (Law of 22 March 2004) and securitization regime (Law of 15 June 2004).

The Luxembourg Government had to answer several technical questions that should allow the EU Commission to better understand the SICAR and securitization regimes and determine whether or not they constitute unlawful state aid. Should the EU Commission come to the conclusion that either or both regimes constitute unlawful state aid, an official investigation may be launched in this connection, such as the investigation currently taking place on the Luxembourg 1929 holding companies regime. The position of the Luxembourg authorities remains that the SICAR and securitization vehicle regimes do not constitute unlawful state aid measures.

4. MALTA

Malta reaches agreement with European Commission on tax system

The Government of Malta has announced that Malta has reached an agreement with the European Commission that effectively keeps intact its competitive imputation tax system for business in Malta.

The proposal, which was submitted to the Commission by the Maltese Government, ensures that the tax system will not be discriminatory for EU state aid purposes.

The Government will be publishing the relevant legislation in the coming months once the Tax Reform Commission has concluded its work.

This is an important agreement for Malta and ensures its future ability to continue to be an attractive and competitive environment for international business and investment.

5. MEXICO

News on private equity

In order to promote venture capital investment in Mexico as from 2006, persons who invest through a Mexican trust in shares of companies that are unlisted at the time of the investment, or in loans granted to finance those companies, will pay income tax on income derived from such investments only when the trust distributes such income or gains to the investors. Tax will be payable by the investors and will be withheld by the trust upon distribution, depending on the investor's individually applicable tax regime applying any tax treaty benefits.

This regime is aimed at any type of investor, whether Mexican or foreign, and whether individual or legal entity, investing in promoted entities through a Mexican trust, the trustee of which is a Mexican bank and which meets the following requirements:

- Its main purpose must be to invest in Mexican unlisted companies and participate on their board to promote their development and provide them with financing.
- At least 80% of its assets must be invested in shares of, or in loans to, promoted companies, and the remainder in approved Mexican government securities or in shares of debt investment companies (*sociedades de inversión de deuda*).
- The shares of the promoted companies must be held for at least two years from the date of the investment.
- The term of the trust must not be greater than ten years.
- At least 80% of the trust income must be distributed to the investors during that year within the first two months following each year-end.
- Such other general requirements as may be established by the Mexican tax authorities must be satisfied.

As a result of the above, the taxpayers will be the member investors rather than the trust vehicles themselves, thus giving rise to a pass-through arrangement. In order for the correct tax treatment to be afforded to the trust's income and/or gains, the trustee must keep separate accounts for each kind of income/gain (dividends, interest and gains on disposals of securities, interest on loans to promoted entities, and gains on the sale of shares in promoted entities). Such accounts will be reduced by the distributions made to the investors. Also, the trustee must keep separate accounts for each member's contributions to the trust and reimbursements to the member.

Finally, if the promoted shares are sold earlier than the minimum two-year period, or if the trustee fails to distribute the trust's income as described above, the investors will have to pay income tax at 29%[1] on the gains obtained by the trust, instead of applying the specific withholding tax rates or treatment for dividend income, and capital gains, as from the year following that of noncompliance.

6. UNITED STATES

Repatriation planning for stock options

a) Introduction

Multinational companies seeking to roll out incentive compensation plans to a global workforce must comply with a myriad of rules and regulations in the various foreign

[1] The 28% rate will be applicable as from 1 January 2007.

jurisdictions. In addition, organizations may not be aware of various tax planning or cost-reduction opportunities that exist in foreign jurisdictions. The primary challenges in implementing a global incentive plan have historically included the following:

- understanding the individual income tax implications of granting awards in each foreign jurisdiction;
- implementing methods to ensure compliance with local payroll requirements, including the tracking of a mobile work force in order to properly allocate compensation amongst countries in which employees have provided services;
- implementing local country planning to take advantage of available corporate cost savings
- determining whether granting awards in a particular country may constitute a public offering, requiring detailed local prospectus filing requirements;
- achieving compliance with local data privacy and other employment laws; and
- implementing effective employee communications in order to ensure that global participants understand the program and the implications of participation.

Another overlooked issue that must be considered with respect to a global incentive plan is the income tax implications of expensing equity awards pursuant to Financial Accounting Standard 123R ("FAS 123R" or the "Statement"). The Statement is generally effective for calendar-year companies beginning on 1 January 2006. The income tax implications of expensing equity awards include the requirement to establish a deferred tax asset (DTA) under FAS 109 and the development of a hypothetical APIC pool under FAS 123R. For a detailed discussion of these rules, see A&M Tax Advisory Weekly, 2006 - Issue 9 "Expensing Stock Options: Income Tax Impact". This article discusses the often overlooked aspect of FAS 123R: the treatment of awards granted to employees of a US multinational's foreign affiliated companies.

b) *International grants*

A US multinational must expense all equity compensation awards it grants, even when these grants are made to foreign affiliate employees. In order for a deductible temporary difference to be established for such grants, there must be an expectation that the award would result in a later corporate income tax deduction. If the foreign affiliate is a branch of the US parent company, generally any income tax deduction will lie with the US parent (and potentially also qualify for a local deduction), as the branch is a pass-through entity. If the foreign affiliate is not a pass-through entity then the US company generally cannot claim a deduction for the compensation expense and the deduction will belong solely to the foreign affiliate if allowed under local tax law. If there is an expectation of a deduction, the foreign affiliated company generally will record a DTA based on its effective tax rate. The foreign affiliate then determines the ultimate excess tax benefit or shortfall at the time it claims an actual corporate income tax deduction (which can differ from the timing under US tax law). Therefore, determining whether or not a DTA can be established for grants to employees of foreign subsidiaries requires an understanding of the corporate income tax laws of the foreign locations. If a DTA is not established for a grant, the result can be an increase in the book effective tax rate. Accordingly, planning for foreign corporate income tax deductions may now be imperative for companies that have not previously implemented a deduction strategy.

There are very few foreign jurisdictions that allow a local company to claim a corporate income tax deduction with respect to a US parent company's incentive plan without the local company bearing an actual cost related to the award. Therefore, in order for a foreign subsidiary to claim a tax benefit related to the equity compensation program, a corporate income tax deduction strategy generally must be implemented. A common approach involves the implementation of inter-company chargeback agreements between the parent and its affiliates. However, there are often other requirements, such as documentation of a contractual obligation prior to the grant date, among other requirements, in addition to the chargeback that must be satisfied in order for a deduction to be claimed. Also, some jurisdictions will not allow a deduction even if a chargeback is implemented.

The following examples provide insight into the many issues that a US multinational will need to

consider in determining whether or not a DTA can be established for an international grant and how prior grants are treated for purposes of establishing the Hypothetical APIC Pool.

Australia: Where an actual financial cost is borne by the Australian entity with respect to the award, a corporate income tax deduction is generally available. However, even if there is a chargeback, the Australian tax authorities generally will not recognize a deductible cost if the shares used to satisfy the award are newly-issued shares. Accordingly, in order for a DTA to be established for an Australian grant, the methodologies for securing a deduction (inter-company chargeback arrangements and the use of treasury shares to satisfy an award) need to be in place at the date of grant. Note, these requirements relating to the use of treasury shares in order to substantiate a deductible cost (in addition to a chargeback) generally also apply in **France**, **Germany**, **Singapore** and many other countries.

Brazil: A corporate income tax deduction is possible if a chargeback arrangement is implemented. However, such arrangements are generally not implemented due to the assessment of a withholding tax on any chargeback payment and due to exchange control requirements. Accordingly, DTAs generally are not available for Brazilian grants because chargebacks generally are not implemented due to these complications.

Canada: Canada does not allow a corporate income tax deduction related to payments made in shares. Accordingly, DTAs generally cannot be expected to be established for grants to employees of Canadian affiliates.

United Kingdom: A corporate income tax deduction is generally available by statute (various requirements must be satisfied-such as the stock must be ordinary shares, fully paid-up and non-redeemable, the stock must be publicly traded or the company must satisfy certain additional conditions, and the employee is or would be subject to income tax if resident and employed in the UK) where the taxable event of the award occurs in company accounting periods commencing on or after 1 January 2003. Chargebacks were generally required to secure deductions related to taxable events occurring prior to 2003. Accordingly, DTAs are likely be established on a prospective basis for new grants.

c) Other corporate tax benefits related to global equity compensation

The primary benefit that a US multinational will recognize from implementing a chargeback strategy is the tax-free repatriation of cash pursuant to Treasury Regulation 1.1032-3. The tax-free repatriation of cash is a very significant benefit to the US parent company. Also, if these chargeback arrangements are structured correctly, the payment of the invoice by the foreign affiliate is generally, with very few exceptions, not subject to local withholding taxes.

Historically, repatriating foreign income that has previously been permanently reinvested has had a negative impact on the company's effective tax rate. Accordingly, companies generally took the position under APB 23 that low-cost off-shore income was permanently reinvested (for example, foreign earnings from operations in Hong Kong or Ireland have historically been treated as permanently reinvested under APB 23). Recent incentives, in the form of a 5.25% US income tax rate on the repatriation of certain income, have been introduced in order to promote the idea of repatriating these earnings to the US.

Pursuant to Regulation Section 1.1032-3, if the parent charges the foreign subsidiary for the compensation costs related to a stock option or other stock award, then the foreign subsidiary is deemed to purchase the shares from the parent at fair market value with cash contributed by the parent and then immediately transfer the shares to the employee. Any amount that the US parent receives in payment for the stock, be it in the form of the exercise price paid by an employee or the payment of an inter-company invoice by the subsidiary in connection with the chargeback, reduces the amount of cash deemed to be contributed by the parent to the subsidiary. Therefore, the payment of the invoice by the foreign subsidiary is treated as purchase price for the stock, and the cash payment is repatriated tax-free to the US.

In addition to allowing for the cash-free repatriation of cash to the US parent, the analysis of these option exercise transactions under Regulation Section 1.1032-3 also results in an increase in the parent's basis in foreign subsidiary stock. As discussed previously, Regulation Section 1.1032-3 results in a deemed capital contribution of cash from the

parent to the foreign subsidiary. Capital contributions to a corporation by a shareholder are treated as an additional price paid by the shareholder for the shares of the corporation increasing the shareholder's basis in the shares. The parent therefore increases its basis in its shares in the foreign subsidiary under Section 358(a)(1) for the option spread of the options exercised by employees of the foreign subsidiary. Any cash received by the parent in connection with a chargeback reduces the amount of the deemed capital contribution, thereby reducing the basis adjustment. However, because companies can generally apply Regulation Section 1.1032-3 to years prior to the effective date of the regulations, companies may calculate basis adjustments for option exercises occurring in years for which chargebacks had not been implemented.

A final issue related to international grants that is frequently missed by US multinationals is the available reduction in the foreign subsidiary's E&P. Controlled foreign corporations (generally, a foreign corporation where US shareholders own, on any day of the taxable year of the foreign corporation, more than 50% of the total combined voting power of all classes of stock entitled to vote or the total value of the stock of the corporation) are treated as US corporations for purposes of the calculation of earnings and profits ("E&P"). Regulation Section 1.83-6(d), relating to a US company's deduction for compensation expense related to most forms of equity compensation does not differentiate between foreign and domestic corporations. Accordingly, for the purposes of earnings and profits, the deduction for equity compensation follows the US timing, so the foreign rules on the timing of the taxable event are not applicable for these purposes. Therefore, at the time of the taxable event under US tax law (e.g., the exercise of a nonqualified stock option), an E&P reduction is available to the subsidiary. It is important to note that because the timing of this reduction relates to the timing of the taxable event and available deduction under US tax principles, this E&P reduction applies even if the US parent has not implemented a chargeback arrangement. The tracking of mobile employees does remain an issue for these purposes, however, since each affiliate has its own E&P- where the E&P deduction lies can impact the effective tax rate of the foreign affiliate.

d) Other considerations

The implementation of a chargeback arrangement can provide many benefits to the US parent. However, careful planning must be performed in order to achieve the desired results and to ensure that unanticipated complications are not triggered by the chargeback. It is therefore generally recommended that a company implement a foreign corporate income tax deduction strategy only after careful analysis of the company's foreign tax credit positions, the structure of the foreign affiliates (branch or subsidiary of the parent, existence of cost-plus arrangements), transfer pricing issues, and the overall impact the strategy may have on the company's effective tax rate.

The implementation of a corporate income tax deduction strategy may also trigger unanticipated payroll compliance requirements. In many countries, equity compensation earned by an employee from a plan of a foreign parent company is not subject to income tax withholding and/or local social taxes. However, the implementation of a chargeback arrangement between the US parent and local employer can create such requirements. For example, if an employee of a US parent company's Mexican subsidiary exercises a stock option in the parent, the exercise spread is generally not subject to income tax withholding or social tax contributions. However, when the parent charges the Mexican affiliate for the compensation costs related to the exercise, income tax withholding and social taxes (to the extent the employee's other compensation does not exceed applicable wage limits) become due. Accordingly, careful due diligence should be undertaken to ensure that the US parent understands the additional compliance requirements that may arise due to the implementation of a corporate income tax deduction strategy.

e) Final thoughts

The expensing of equity awards under FAS 123R is leading many companies to re-evaluate their cross-border tax planning. Companies that have not historically sought a foreign tax deduction for equity compensation may now desire to implement corporate income tax deduction strategies to achieve a deduction. Various incentives, such as the tax-free repatriation of cash exist for a company to

implement a foreign corporate income tax deduction strategy. However, it is imperative that appropriate due diligence be performed so that the strategy achieves the desired results without triggering unanticipated results such as additional corporate costs related to payroll obligations. We generally recommend that the due diligence process include the performance of a cost/benefit analysis.

1. INVESTMENT FUNDS AND VAT: MIXED FEELINGS THROUGHOUT THE EU AFTER THE ABBEY NATIONAL VERDICT

The verdict of the European Court of Justice (ECJ) in the VAT case "Abbey National" (C-169/04, Abbey National plc, with Inscape Investments Ltd as Joined Party, against Commissioners of Customs and Excise) has been released recently. This case is crucial for the asset management industry as it brings some clarity and consistency to the scope of the VAT exemption applicable to the management of investment funds. The impact of this ruling will differ from one Member State to the other due to the varying practices preceding this case law.

1.1 The ruling of the Court

In this case brought to the ECJ, Abbey National plc and Inscape Investment Fund ("the taxpayers") challenged the application of UK VAT on services rendered by certain depositaries of authorized unit trusts and of open-ended investment companies (OEIC), as well as on administration and accounting services outsourced by the management company of these OEICs to a third-party supplier.

The taxpayers considered that those services benefited from the VAT exemption applicable to the management of investment funds. HM Revenue & Customs disagreed with this view. After several years of proceedings, the case was brought before the ECJ. The Court released its ruling on 4 May 2006.

This long-awaited ruling can be summarized in three key points.

a) *The concept of "management" has its own independent meaning in Community law*

The Court confirmed that the concept of "management" of investment funds has its own independent meaning in Community law that Member States may not alter. The answer of the Court is in line with jurisprudence which states that VAT exemptions must be given a Community definition in order to avoid divergences in the application of the VAT system from one Member State to another.

b) *Depositary functions are not part of the concept of "management" unlike administrative functions*

The next step for the Court was then to consider the concept of "management" of investment funds. In the Abbey National case, the Court had to answer whether the VAT exemption applies to services provided by a depositary or trustee as part of the supervisory role entrusted to them on the basis of regulatory provisions.

The Court considered that tax neutrality as regards the choice between direct investment in securities and investment through investment funds must be ensured by the VAT system. Therefore, the VAT exemption must be understood as covering transactions that are specific to the business of investment funds.

Consequently, the Court ruled that tasks of portfolio management but also tasks of administering investment funds, which are functions specific to investment funds, come within the scope of the VAT exemption. The Court notably referred to the sub-heading "Administration" of Annex II to the regulatory Directive 85/611/EEC, as amended, to illustrate the point. This is good news for the asset management industry and investment fund unit holders.

The Court however considered that the functions of depositary cannot benefit from that VAT exemption because they do not fall under the management of investment funds but under the control and supervision of activities of investment funds.

The legal reasoning that led the Court to this conclusion can be understood in the light of the regulatory directives where the role of the depositary is clearly separated from management and administrative functions. Nonetheless the Court's interpretation of the Sixth EC VAT Directive dating from 1977 is based on regulatory directives dating originally from 1985 and subsequently amended to adapt to the evolution of the European market. One may regret that the Court did not give more weight to the approach of the Advocate General Kokott which was more subtle.

The Advocate General pointed out that the depositary also contributes to the protection of the investors and that its functions are specific

to the management of investment funds. They are not comparable, for example, with the functions of an auditor. When exercising its monitoring tasks, the depositary plays an active part in the daily business of a fund. Thus, according to the Advocate General, only custodian services focusing on purely technical operations should be taxable.

With respect to the VAT treatment of depositary functions, this ruling can therefore be regarded as disappointing.

c) *Outsourced functions can be VAT exempt under certain conditions*

Concerning the services performed by a third-party manager in respect of the administrative and accounting management of the funds, the Court stated that, viewed broadly, these services must form a distinct whole and be specific to and essential for the management of those funds in order to benefit from the exemption.

It is likely that the wording of the ruling and the somewhat abstract criteria established by the Court as a prerequisite for applying the exemption ("specific and essential" for example) to outsourced functions will in practice lead to different interpretations by Member States. This could also lead to litigation in the Member States where the tax authorities by tradition apply VAT exemptions, not "strictly" but restrictively.

Finally, the Court confirmed in its ruling that mere material or technical supplies, such as supplying an IT system are covered by the VAT exemption. This was rather widely expected.

1.2 Consequences of the Abbey national ruling throughout Europe

Here are a few examples of the impacts of the ruling throughout Europe.

a) *United Kingdom*

The decision will be broadly welcomed by the United Kingdom fund management industry, although the providers of depositary services to unit trusts and open-ended investment companies will be disappointed that their services are regarded as falling outside the exemption.

This retrospective change in treatment to these services appears at a time when the United Kingdom authorities are resisting attempts to overturn the three-year time limit that was applied to repayment claims with effect from 1 May 1997. Given the uncertainty of the authorities' position with regard to this time limit, claimants are likely to claim repayment of tax suffered well before three years ago. In any event, even if the three-year time limit were held to be valid for VAT, this would not prevent a fund reclaiming overpaid tax from a service provider on the basis of the contract between them.

In one respect, the judgment leaves an area of uncertainty. The United Kingdom currently exempts the services of "global" custodians of financial instruments, where the service goes beyond safekeeping and the custodian acts as nominee of the beneficial owner. The opinion of the Advocate General in the Abbey National case suggested that this practice could be incorrect, but the decision of the Court does not address the matter specifically. The United Kingdom tax authorities may be encouraged to review their current treatment of these services in the light of the Advocate General's comments. If United Kingdom VAT were to be imposed on these services, the likely response would be for funds to consider relocating to jurisdictions where the services could be received free of VAT.

b) *Sweden*

In Sweden, where the VAT treatment of management services has been very complex for years notably with a number of restrictive advance rulings and national court cases, the Abbey National case should bring welcome amendments and adjustments to the Swedish practice.

Notably, the Swedish Supreme Administrative Court stated that the concept of management services could not include administrative services rendered by a third-party manager and that consequently VAT was due on these services. Considering the findings of the ECJ in the Abbey National case, Swedish independent third-party managers specialized in pure fund administration should now be able to compete on equal terms with in-house administration companies which were generally included in a VAT group and were consequently rendering their services to other members of their VAT group without VAT. It seems likely that a number of fund companies will consider this an

opportunity to outsource some of their internal administration, aware that no additional VAT cost will be incurred when doing so.

Other Swedish court cases also seem to be contradictory to the outcome in the Abbey National ECJ case. It is therefore also likely that number of taxpayers should bring action towards the tax authorities taking into consideration the latest ECJ developments.

c) *Italy*

In Italy, the so-called concept of "dynamic management" is relevant in practice for determining whether fund services are VAT exempt, although the Ministerial resolution establishing this concept referred originally to the VAT exemption applicable to securities-based transactions. "Dynamic management" goes beyond the mere performance of custodian and administrative functions and entails the primary objective of maximizing profits in connection with shares and securities through investment and divestment decisions.

The Italian concept of "dynamic management" seems to exclude mere fund administration services from the exemption whereas the ECJ in the Abbey National case seems to consider these functions as specific to the management of collective investment and therefore as exempt. One can then hope that the Italian tax authorities may in the future follow a less conservative approach and include the supply of fund administration services within the scope of the VAT exemption.

d) *France*

As regards management services, legislative harmonization took place recently in France and the changes are set to come into force during 2006. Accordingly, the management of SICAVs (undertakings for collective investment with legal personality) and of FCPs (pools of assets without legal personality) should be VAT exempt. The litigation in the Abbey National case contributed to this change as it was expected that the historical position of the French tax administration could not be defended any longer. This harmonization was both logical and desirable for France.

As regards depositary services, the question of whether VAT had to be charged on depositary services was not "a hot issue" in France. In practice, most depositary agents generally charge VAT either as matter of prudence under common law or because they had exercised the global option to charge VAT on their financial operations. It should be noted that the split between depositary and custodian functions, proposed by Abbey National and ultimately rejected by the judge was in practice difficult or impossible to make in France, due to the lack of a "fair market value" for the depositary function.

Finally, since the French case law on "*sogefonds,*" it has been accepted that exempt management services could be outsourced without VAT under specific conditions. The Abbey National decision is perfectly in line with this previous French case law.

e) *Germany*

Broadly viewed, the ECJ judgment confirms the VAT treatment of this issue in Germany. Notably, the German VAT Law expressly states that management services outsourced to a third party by an investment company can also benefit from the VAT exemption.

As far as the German VAT authorities are concerned, depositary and custodian functions were already regarded as taxable services.

f) *Spain*

In Spain, the concept of management of investment funds covers all functions included in Annex II to the Directive 85/611 as amended (investment management, administration functions and marketing). The Spanish interpretation of the scope of the exemption is therefore not made broader by the ECJ ruling.

Interestingly, the ECJ ruling, based on the strict wording of the Sixth EC VAT Directive, has highlighted the contradiction between Spanish law and the Directive as regards the scope of the VAT exemption. Under Spanish law, the exemption applies to "the management and deposit of Collective Investment Institutions (…)" whereas the Sixth EC VAT Directive only refers to the term "management".

With respect to third-party management services, the previous interpretation by the Spanish VAT authorities has essentially been confirmed by the ECJ.

f) *Ireland*

To assist its well-developed funds industry, Ireland always has adopted a constructive approach to the taxation of services to fund managers. The fund management exemption generally applies to the services provided by the manager and the investment manager.

In Ireland, the fund services consisting of the three functions listed in Annex II to Directive 85/611, as amended, currently benefit from the VAT exemption when they are supplied by the manager of the fund. Where the management function is subcontracted to a third-party service provider, the exemption is also extended to that party, in effect to the *de facto* manager.

However, the Irish tax authorities are of the view that some services, when supplied individually are taxable. These services are most notably the safe custody of assets of the trust or investment company, the valuation of fund assets, the maintenance of the books and records of the investment fund and of the manager.

The Irish tax authorities consider that the supply of global custody services is a VAT-exempt financial service on the basis that the service is provided as part of a composite supply.

In practice, it is not expected that any significant changes in policy or legislation will be necessary as a result of the Abbey National decision.

g) *Luxembourg*

In Luxembourg, the scope of the exemption applicable to fund management services is relatively broad. For example, the daily management of a fund portfolio, research and investment advice, as well as accounting and administrative services, are VAT exempt when they are directly rendered to an undertaking for collective investment under the supervision of the "*Commission de Surveillance du Secteur Financier*", the Luxembourg regulator.

In summary, the verdict is not as bad as widely feared, although certain services performed by depositary agents exempt from Luxembourg VAT until now could become subject to VAT.

As the Court confirmed that outsourced fund services should remain exempt if they concern specific and essential elements of the management of investment funds, the highly-developed Luxembourg outsourcing model should not be affected in practice.

1.3 Conclusions

The ruling of the ECJ in the Abbey National case will have several practical implications. These could however differ depending on the Member State of establishment of investment funds and of their service providers.

For Member States where VAT was charged in the past on administration services, it should now be accepted that these services are VAT exempt. Repayment claims should be envisaged in these countries. On the other hand, providers of administration services will need to devise methods of identifying VAT on goods and services bought that relate to their exempt activities. This VAT cost might however have to be passed on in the price of their services. The savings for the investment funds might therefore not be as straightforward as the rate of VAT previously charged.

For Member States where depositary activities were exempt on the ground of national interpretations, certain services exempt from VAT until now could become subject to VAT. In this respect, certain Member States are likely to grant a "grandfather clause" in order to postpone the effective taxation of depositary functions and leave time to depositary agents to adapt their operations and IT systems. Paradoxically, although the ruling of the Court should bring a certain level of harmonization throughout Europe, the attractiveness of certain Member States as a place of establishment for investment funds could be strengthened due to their low VAT rates. The VAT impacts of the choice of the place of establishment of investment funds will need to be carefully considered, particularly for new UCITS with the "European passport."

In any case, investment funds and service providers will need to review the legal structure and nature of their operations, to understand the impact of this decision and how to mitigate any cost. For example, not all services rendered by depositary agents are of a supervisory or custodian nature. In this respect, the question of who pays the bill can also be interesting.

At this moment, the Commission is conducting a consultation on the modernization of the VAT treatment of banking and insurance services; the asset management industry should not be left on

the sidelines. One possible approach could be to reconsider the scope of the VAT exemption in the Sixth EC VAT Directive in the light of the evolution of the investment fund industry in the last 25 years. Depositary services could expressly be included in the wording of the exemption. Together with a flexible system of election for taxation, this could ensure tax neutrality between different investment products available to small investors. [2]

2. TAX ADVANTAGES OF ESTABLISHING A HOLDING COMPANY IN CYPRUS

Cyprus is a prime venue for the worldwide operations of multinational corporations, particularly through the use of Cyprus holding companies. The Cyprus holding company is considered a major vehicle for international tax planning for the following reasons:

- Incoming dividends remitted by the subsidiary to the Cyprus holding company are subject to low or no withholding tax in the country where the subsidiary is based. This is due to the highly beneficial tax treaties between Cyprus and many countries in the world, the effect of which is a reduction of withholding taxes on dividends remitted or total exemption from withholding taxes. Cyprus has signed 35 tax treaties with 40 countries. These treaties cover an array of countries stretching from the Americas to Central and Eastern Europe as well as Asia.

  Additionally, as a member of the EU, Cyprus is governed by the provisions of the EU's Parent-Subsidiary Directive. The effect of the Directive is that in cases where a Cyprus holding company controls at least 20% of the shares of an EU subsidiary for a minimum period of 24 months, any dividends remitted by the EU subsidiary to the Cyprus holding company are free from any withholding taxes in the other EU country. Where the provisions of the Directive do not apply (or where anti-avoidance provisions are in place), Cyprus holding companies can rely on the extensive network of tax treaties.

- Dividend income received by the Cyprus holding company from the subsidiary is not subject to corporation tax in Cyprus, provided the Cyprus holding company holds at least 1% of the share capital of the subsidiary.

- Profits realized by the Cyprus holding company from the sale of shares of the subsidiary, or from the sale of any other shares, are exempt from Cyprus corporation tax. This also encourages collective investment undertakings to set up in Cyprus as well.

- Outgoing dividends paid by the Cyprus holding company to the ultimate nonresident parent company are exempt from withholding tax irrespective of the existence of any tax treaties or of the applicability of the EU Parent-Subsidiary Directive.

  Unlike Cyprus, other holding company regimes only reduce or exempt withholding taxes on outgoing dividends where there is a tax treaty in force between the holding company jurisdiction and the ultimate parent company jurisdiction, or where both the holding company and the parent corporation are resident in the EU.

- The profits of all Cyprus companies are taxed at a rate of 10%, which is one of the lowest in the EU.

- Cyprus legislation conforms fully to EU law, and the EU Code of Conduct for Business Taxation, and abides by OECD standards.

- Companies established in the EU have an automatic right of establishment in Cyprus. In the Centros case (1999), the European Court of Justice sanctioned the principle that a body corporate established in the Community has the right of establishment throughout the EU, even to conduct all of its business outside the state of its origin. This means that any EU company or corporation can set up a holding company in Cyprus without restrictions.

- Cyprus law conforms to the relevant EU Directives thus enabling corporate reorganizations, mergers, acquisitions and amalgamations without any implications.

- There are no time restrictions on carrying forward losses to be offset against future taxable profits, i.e. a company incurring losses in the first three years of operations may carry their losses forward for offset in future years when they obtain taxable profits.

- There is group relief for the use of tax losses. A diversified group of companies belonging to a Cyprus holding company can therefore offset

[2] An extensive version of this Article has been Published in the June issue of International Tax Review.

the losses of its loss-making companies against the taxable profits of the best-performing subsidiaries and arrive at an aggregate taxable profit.

- The capital requirements for setting up a Cyprus holding company are very reasonable, as are the management and administration costs. Professional services are among the least costly in the EU, and yet the services offered by Cypriot professionals are of the highest quality.

As can be seen, multinational corporations and international businesses active in cross-border investment activities can increase their return on investment considerably by using a Cyprus holding company structure in their international tax planning. Cyprus encourages foreign investment and is committed to creating conditions favorable to both offshore entities and those seeking an operational base. The strategic location of the island, its modern and efficient legal, professional and banking services, the business infrastructure and environment, combined with the tax incentives and concessions available to foreign investors, are the most important factors attracting international companies to operate in and through Cyprus, which has thus established itself as a reputable center for international business.

Taxand news

1. 15 MONTHS AFTER BEING LAUNCHED, TAXAND NOW SPANS 30 COUNTRIES AND HAS 1,500 TAX PROFESSIONALS

Taxand Global Alliance has welcomed 8 new firms, expanding its presence to 30 countries only 15 months after its launch in March 2005. This rapid expansion reflects the increasing demand from global companies for independent tax advice from professionals who have no audit-based conflicts of interest.

Taxand's newest member firms and their respective countries include: Gowling Lafleur Henderson, LLP, **Canada**; Hendersen Consulting, **China**; Eurofast, **Cyprus**; Selmer, **Norway**; TaxHouse, **Romania**; Garrigues, Leonidas, Matos, **Portugal**; Gómez-Pinzón Linares Samper Suárez Villamil, **Colombia**; and Miranda & Amado, **Peru**.

Taxand now boasts 1,500 tax professionals with 259 international tax partners in 30 countries, and has become a key provider of global tax services.

Today, Taxand member firms work together to provide global companies with international tax services, including tax planning for cross-border transactions and tax litigation support.

Taxand is truly "global" in every sense of the word. Not only do we have a close relationship with clients in our local country and a deep understanding of their culture and needs, but we also offer seamless global tax services demanded by multinational companies.

2. NÎMES TAXAND CONFERENCE

On 7, 8 and 9 June, the thirty Taxand Firms met in Nîmes for the fourth Taxand conference.

During the conference, in addition to participating in numerous technical sessions on current developments of interest to our clients in different jurisdictions, such as Russia, China, Brazil, Mexico or Argentina, we took the opportunity of holding meetings between the members of the different service lines (real estate, VAT, transfer pricing and venture capital) and of the knowledge team.

Like previous events (which were staged in Paris, Madrid and Luxembourg), the fourth conference was a great success and has helped the 170 participants to hone their tax and "networking" skills.

The next Taxand conference will take place in London on 7 and 8 December 2006.

3. ATOZ AND GARRIGUES WIN EUROPEAN TAX AWARDS FOR "NATIONAL TAX FIRM OF THE YEAR" IN LUXEMBOURG AND SPAIN RESPECTIVELY. GARRIGUES ALSO WINS THE "TRANSFER PRICING FIRM OF THE YEAR" AWARD

On 24 May 2006, the European Tax Awards 2006 organized by International Tax Review took place in London at the Claridges Hotel. There were awards for Tax Firm of the Year in 17 European countries and Transfer Pricing Firm of the Year awards in 16 countries. The Awards aim to recognize the excellence in tax services of European firms in the past year.

For the second year running, **Garrigues** won the European Tax Awards for "National Tax Firm of the Year" and "Transfer Pricing Firm of the Year". The jury evaluated the Firm's tax work as a whole in 2005, which included advising on major transactions such as the sale of AUNA's cable and wireline telephony subsidiaries to Grupo Corporativo ONO; the creation of a new financial services venture between GE Capital and Caja de Ahorros del Mediterráneo and the tender offer for 100% of the Cortefiel's capital stock, to name but a few.

ATOZ was named Luxembourg Tax Firm of the year only 22 months following its incorporation. ATOZ was also short listed for the Luxembourg Transfer Pricing Firm of the Year 2006.

Other Taxand member firms were also short-listed for awards: Arsène in France, Fantozzi & Associati in Italy, Skeppsbron Skatt in Sweden and Tax Partner in Switzerland.

International Tax Review belongs to Legal Media Group, a publisher which has more than 15 years of experience in reporting on legal affairs in international business, making it a leader in the field.

4. THE IFLR MEXICO LAW FIRM OF THE YEAR AWARD WAS GIVEN TO OUR TAXAND FIRM

The Mexico Law Firm of the Year Award was given to **Mijares Angoitia Cortes y Fuentes, S.C.** by The International Financial Law Review on 16 March 2006, at a ceremony held in the New York Palace Hotel in presence of a select group of lawyers, bankers and other financial professionals of America.

The award symbolizes the recognition to the firm for the effort and leadership in the law field during 2005, among other areas in the financial field.

The International Financial Law Review, a leading magazine for practitioners in the financial markets, is part of the Euromoney Legal Media Group.

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