PAUL HASTINGS

PH PERSPECTIVES

April 2017

Follow @Paul_Hastings

European Tax Update

INTRODUCTION

By Andy Short (Chair of the Paul Hastings Global Tax Group) & Arun Birla (Vice-Chair of the Global Tax Group)

Governments, many of whom are facing large annual deficits, have in recent years sought to introduce new tax rules to ensure that multinationals and large businesses pay their 'fair share' of taxes. In the international arena, the OECD is in the process of implementing a multi-tier plan as part of the Base Erosion and Profit Shifting ("BEPS") action plan. In addition, domestic governments have sought to tighten existing rules, and introduce new tax legislation together with additional tax compliance requirements through the Common Reporting Standard ("CRS") and Country By Country Reporting ("CBCR"). These events have given rise to additional complexity and uncertainty for the tax payer.

There is, however, good news on the horizon in the U.K. The U.K. government has eased particular areas of the tax code (such as with respect to the U.K.'s own participation exemption) to encourage further investment in the U.K. This is a welcome development.

This report provides a snapshot of some of the critical tax issues across the U.K., Italy, Germany, and France. We are assisting many of our clients in navigating these developments and we have been liaising with local tax authorities on their behalf.

These are no doubt exciting (and busy!) times ahead for tax practitioners.

UNITED KINGDOM

Corporate Interest Restriction

The new corporate interest restriction rules implement Action 4 of the BEPS project. The U.K. government has published draft legislation which forms part of the 2017 Finance Bill, and the rules take effect from 1 April 2017.

The Restriction

Broadly, the new interest restriction rule seeks to cap the amount of U.K. corporation tax relief for interest expenses arising in U.K. resident companies (and U.K. permanent establishments ("PE")), in relation to both related party and third party debt. There is a £2m per annum threshold for U.K. net interest expenses, which, according to HMRC, will exclude 95% of groups from the new rules. HMRC estimates that the new measure is expected to affect up to 3,800 large businesses operating in the U.K., many of which will be multinationals, and also raise £3.9 billion of extra tax by 2021.

Under the new rules, groups may apply the fixed ratio rule which disallows U.K. corporation tax relief for net interest expenses (broadly each U.K. company's (and U.K. PE's) tax-interest expense less its tax-interest income) to the extent they exceed 30% of the aggregate of the group's tax EBITDA (broadly, taxable profits less interest and tax).

Alternatively, groups may elect for the interest restriction to be based on a group ratio test (the group ratio figure replaces the 30% figure used in the fixed ratio test). The group ratio figure is the proportion of the net interest expense of the group compared to the group EBITDA; both are accounting measures.

The worldwide debt cap is to be abolished and will be replaced with a modified debt cap which will form part of the new interest restriction rules. This will ensure, broadly, that net interest deductions pursuant to the fixed ratio rule or group ratio rule, do not exceed the total net interest expenses of the worldwide group.

Public Benefit Infrastructure Exemption (PBIE)

The new rules also include an exemption for "qualifying infrastructure companies." It operates by reference to the provision of "qualifying infrastructure assets" or certain related activities. If the exemption applies, interest expenses fall outside the new rules.

A company is a "qualifying infrastructure company" if it is fully taxed in the U.K. and all but an insignificant proportion of a company's income derives from:

- tangible assets that are "public infrastructure assets";
- shares in a "qualifying infrastructure company"; or
- loan relationships or other financial arrangements (including derivatives) and the other party is a "qualifying infrastructure company".

A company must also make an election in order to enter into the regime.

"Public infrastructure assets" include assets procured by a relevant public body or used for an activity that is regulated by specific authorities. More significantly, the test is also satisfied if it is used for the purpose of a U.K. property rental business, and the following rules are also satisfied:

- the building is let for 50 years or less to unrelated third parties; and
- the building has had (or is expected to have) an expected economic life of at least ten years.

There is a specific regime for REITs and we have been in touch with HMRC on certain aspects of this regime.

Compliance

The new rules also impose additional compliance restrictions. The group is required to appoint a U.K. company to be a "reporting company" for a specified period of account, and the appointment must be signed by 50% of the U.K. group members. The reporting company is in turn required to file an annual "interest restriction return" which sets out the amounts of interest that are disallowed under the rules, and how the disallowance is to be allocated amongst the U.K. group companies.

Other U.K. tax rules that restrict interest relief, such as transfer pricing and hybrid mismatch rules, should be applied in priority to the interest restriction rules.

Conclusion

The new rules are likely to increase the cost of borrowing for multinationals that often have proportionately higher borrowing in the U.K. as compared to the rest of the worldwide group. The compliance costs (and, if necessary, restructuring of financing) are likely to be significant for some groups.

Hybrid Tax Mismatches

In response to Action 2 of the BEPS project, the U.K. Government has published draft guidance on the application of the hybrid mismatch legislation introduced in the Finance Act 2016, which took effect on 1 January 2017. Additional legislative amendments have also been introduced into the Finance Bill, published on 20 March 2017.

Broadly, hybrid mismatch outcomes can arise from hybrid financial instruments (both equity and debt), hybrid entities, and from arrangements involving permanent establishments. They can also arise from hybrid transfers and dual resident companies. Generally (but not always), a hybrid mismatch arises where the payer seeks a deduction in relation to a payment, and this is not matched by the payee receiving a corresponding amount of taxable income or where the same item of expenditure is deductible in more than one jurisdiction. Tax avoidance motive is not a general condition for the rules to operate.

The rules are drafted widely and would, for example, need to be considered if a U.S. parent makes an interest bearing loan to its U.K. subsidiary which is transparent ("checked the box") for U.S. tax purposes. This is because, from a U.K. tax perspective, the U.K. borrower is opaque and the interest payment is tax deductible. By contrast, the U.S. parent would not be taxed on the interest receipt in the U.S., as the interest receipt is ignored (due to the U.K. subsidiary being treated as a branch of the U.S. parent). The rules would disallow the interest deduction for U.K. tax purposes. Similarly, the rules could technically bite where U.S. asset managers operate in the U.K.

Taxpayers operating in the U.K. will therefore need to review their financing and operating structures in order to assess if they are caught by the new rules.

Corporate Loss Reform

As part of the 2016 Budget, the U.K. government announced that it would reform the tax treatment of corporation tax losses, in order to help deliver its aim of providing a competitive and stable business tax regime. The Finance Bill published on 20 March 2017 sets out these rules in detail, and the new rules apply from 1 April 2017.

Under the new rules, losses arising in an accounting period commencing on or after 1 April 2017 will have increased flexibility. In addition, group relief will also be extended so that carried forward losses (arising in a period commencing on or after 1 April 2017) will be able to be surrendered to a group company in certain circumstances.

The reform also imposes additional restrictions to the use of losses by a U.K. company, so that carried forward losses will be restricted to 50% of the company's profits. Each standalone company or group will be entitled to a £5 million annual allowance of unrestricted profits which can be relieved at 100%.

There are also new anti-avoidance rules and, in particular, changes have been introduced to rules restricting losses of a company on a change of ownership. The period in which losses are restricted on a share sale if the target company makes a "major change" to the business has been increased from 3 years to 5 years.

The new rules, whilst providing some flexibility as to how losses can be used, will have to be considered carefully as the devil is in the detail.

ITALY

Controlled Foreign Corporation ("CFC") Rules

The CFC rules have been amended, so that the list of jurisdictions considered to have a more favorable tax treatment for the purposes of the CFC rules has been replaced with a new "black list" which looks at a range of criteria. Jurisdictions with a tax rate lower than 50% of the applicable rate in Italy are to be included on the "black list". The CFC rules can now also apply to companies located in EU member states and European Economic Area countries which have entered into an exchange of information agreement with Italy.

The new rules provide that the CFC's income is attributable to the Italian parent in proportion to its participation in the foreign entity. Where an Italian parent, directly or indirectly, controls a CFC, the income is subject to tax at the Italian parent's average income tax rate (subject to a minimum rate equal to the Italian ordinary corporate income tax rate, i.e., 24%). The CFC income is subject to the normal rules in determining taxable income.

Country By Country Reporting

With a view to conform to the OECD guidelines on Action 13 of the BEPS plan, new rules have been introduced implementing Country by Country Reporting. According to such rules, multinational entities must file a yearly report describing worldwide transactions in order to allow the Italian Inland Revenue to monitor intra-group transactions.

Where the relevant filing is not made or incomplete or false data is submitted, the multinational entity is subject to a fine ranging from €10,000 to €50,000.

New "White List"

The Italian Ministry of Economy and Finance issued a ministerial decree on 9 August 2016, which amended the list of jurisdictions that allow an adequate exchange of information with Italy (the so-called "white list").

The decree has been in force since then and adds 51 new countries to the previous "white list" (including Cayman Islands, Bermuda, Jersey, and Guernsey—which previously lacked access to relevant favorable domestic Italian tax regimes). The Vatican State has also recently been added to the list.

The main benefit for jurisdictions on the new, longer "white list" is exemption from Italian interest withholding tax, which is typically 26% (or 12.5% on interest from Government bonds) and can usually be reduced to 10% by application of relevant tax treaty provisions, where applicable.

The benefits of being resident in a jurisdiction included on the "white list" include inter alia:

- interest and other income from bonds and commercial papers (with a maturity greater than 18 months), issued by Italian banks or joint stock companies with shares traded on recognised EU and non-EU regulated markets (for example, NYSE and NASDAQ are recognised as regulated markets for tax purposes) and paid to recipients who are effective beneficiaries resident in "white list" countries, are fully exempt from Italian withholding tax provided that they submit a self-declaration attesting their status of residence in such "white list" country;

- capital gains deriving from the transfer of debt instruments are exempt from withholding tax, if the recipient is resident in a “white list” country. The exemption also includes capital gains deriving from the disposal of quotas in Italian undertakings for collective investments in transferable securities (“UCITS”) and real estate funds (“REFs”);
- income deriving from participation in REFs and SICAF (*società di investimento a capitale fisso*) is exempt from withholding tax, if the income is received by pension funds or UCITS established in a “white list” country and certain conditions are met; and
- income deriving from stock lending, repos, and issuance of guarantees is exempt, if the recipient is resident in a “white list” country.

A further exemption from withholding tax is currently under doctrinal debate. This relates to the applicability of an exemption from withholding tax for interest paid by Italian companies on medium/long term loans provided by non-EU banks.

Following reform in 2014, interest paid on medium/long term loans from EU resident banks has been exempted from withholding tax. However, there are still doubts that such exemption would also apply in favour of non-EU banks, despite them being resident in a “white list” country.

For example, from a practical perspective, whilst it is generally accepted that a U.S. bank would not suffer any Italian withholding tax on interest received from a bond issued by an Italian bank, or a listed Italian company, the same principle would not apply where the interest derives from a medium/long term loan from a U.S. bank to an Italian company. In the latter case, interest would be subject to withholding tax according to the Italy/U.S. tax treaty.

The application of this rule in practice appears somewhat illogical and Italian practitioners have raised their concerns with the tax authority. A decision by the Italian tax authority to abolish interest withholding tax on medium/long term loans from non-EU banks would open up the market and allow non-EU banks access to the fast developing Italian lending market.

GERMANY

Dividend Stripping

Dividends paid to foreign investors from German companies are normally subject to non-refundable withholding tax. Historically, foreign investors found ways to avoid this. For example, foreign investors could sell and deliver the shares immediately prior to the dividend record date to a German credit institution with a view to buying the shares back at a pre-agreed purchased price shortly thereafter. The German credit institution would be seen as the shareholder, thereby being eligible for a dividend withholding tax credit, which was then economically shared between the parties of the trade.

To combat these kinds of transactions, German tax law now contains stricter requirements for being entitled to credit the withholding tax, including: (i) rules relating to the ownership of the shares during a certain period before and after the dividend record date; and (ii) requiring the shareholder to be exposed to the risk of fluctuations in the stock price.

Another example of a dividend stripping transaction, which has allegedly resulted in tax deficits of several billions, arises from the duplication of withholding tax certificates. This practice is now under a great deal of scrutiny, in particular from a parliamentary investigation committee set up to explore why loopholes in the relevant legislation have not been closed earlier, as well as from public prosecutors in cases of suspected fraudulent tax practices.

Tax Exemption for Waiver Gains

German tax legislation does not provide specific tax treatment for companies in the process of restructuring and the general rule that a waiver of claims against a company triggers a taxable gain will still apply to a distressed company.

Prior to its abolition in 1998, companies in financial difficulties could rely on an exemption for waiver gains. However, fiscal authorities considered the imposition of tax on waiver gains was unfair in circumstances where company creditors would waive their claims when approving an insolvency plan for the company. Fiscal authorities sought to rely on a provision contained in the German tax code which permitted fiscal authorities not to assess taxes, in deviation from the ordinary rules, if the ordinary rules resulted in an individual case suffering unreasonable consequences.

However, the High Fiscal Court (GrS 1/15, 28 November 2016) has ruled that fiscal authorities are bound by the legislation and must apply the law equally to all taxpayers. The previous deviations from the legislation violated the clear intention that a preferential treatment should not apply to restructuring gains. Our understanding is that the legislator is now looking to create a legally acceptable form of procedure as soon as possible which allows for non-assessment of taxes in certain circumstances.

Qualified Subordination

An over-indebted company may ask its creditors to deeply subordinate their debt claims. This subordination reduces liabilities in the company's balance sheet, measuring the over-indebtedness, but does not impact the liabilities for tax purposes, i.e., it will not be treated as a debt waiver, which gives rise to a potential tax charge for the debtor.

In the past, fiscal authorities have tolerated this balance between insolvency and tax law in circumstances where the liability was "deeply" subordinated, and the liability was to be repaid from the debtor's future profits, its liquidation proceeds or other free assets. More recently, in light of amendments to the legislation and a ruling from the Federal Supreme Court in March 2015, it has been questioned whether this analysis still holds true, given that the inability of the debtor to repay its debt might automatically lead to the liability no longer being recognised in the tax balance sheet and therefore triggering a tax charge.

However, in its ruling of 10 August 2016, the German High Fiscal Court (I R 25/15) confirmed that the former principles for a tax neutral waiver will still apply. The fact that a debtor is not in a position to repay a subordinated liability does not affect this analysis since the debtor's legal obligation to repay the liability still exists.

Tax Losses Carried Forward

Historically, a transfer of shares in a loss-making company generally resulted in forfeiture of the company's tax carry-forward losses. This meant that the tax profile of two identical loss-making companies would differ if the shares in one company were sold, whereas the shareholders of the other company remained the same. The German Constitutional Court is yet to reach a decision on whether these differences are in line with the constitutional requirement to treat all tax payers equally (2 BvL 6/11). Following an amendment to German tax law in December 2016, carry-forward losses are, in principle, no longer affected by a change of the company's shareholders, provided that the business operations which created the tax losses are the same as those using the losses.

BEPS

Following the BEPS action plan, changes in law are anticipated to restrict the deductibility of licence fees paid to certain non-German licensors where they are affiliated with the licensee (see BEPS Action 5). These changes are aimed at reducing the attractiveness of jurisdictions that grant tax privileges to companies which solely own, but do not create, intangibles. Furthermore, the legislator intends to introduce a duty—amongst others for tax advisors and lawyers—to inform fiscal authorities about tax structures generating tax advantages for their clients (see Action 12 BEPS). In this regard many questions are still open, e.g., whether such information duty complies with typical professional principles (such as the principle of confidentiality or the advisor's obligation to act in the best duty of the client).

FRANCE

At this stage, the only provision suggested by the BEPS action plan which has been implemented into French law is the country-by-country ("CbC") reporting obligations (BEPS Action 13). This measure was implemented by the French Finance Law 2016 and is set out in article 223 quinquies C of the French Tax Code.

French companies that fulfill all of the following four conditions are required to file a CbC report:

- companies with consolidated accounts;
- companies that control, directly or indirectly, subsidiaries located abroad, or that have branches located abroad;
- companies with annual consolidated group revenue equal to, or in excess of, €750 million; and
- companies that are not owned by another French entity obligated to file a CbC report or by a foreign entity that is obligated to file a CbC report due to a similar provision under its local legislation.

A decree relating to CbC reporting provides an insight into the practical application of CbC reporting and introduces into French law certain provisions included in BEPS Action 13 (decree no. 2016-1288 of 29 September 2016).

According to this decree, the CbC report must include the following information:

- aggregate information for the company in each jurisdiction, which includes: related party revenue; unrelated party revenue; total revenue; profit or loss before income tax; income tax paid; income tax accrued; stated capital; accumulated earnings; number of employees; and any tangible assets other than cash and cash equivalents;
- the identity of all entities located in a jurisdiction, including branches of a legal person located in another jurisdiction; and
- the nature of the main activity carried on by each entity, which is to be chosen from the following list: R&D; holding or managing intellectual property; purchasing or procurement; manufacturing or production; sales, marketing or distribution; administrative, management or support services; provision of services to unrelated parties; internal group finance; regulated financial services; insurance; and holding shares or other equity instruments.

For fiscal years starting on or after 1 January 2016, the annual CbC report must be filed with the French tax authorities within 12 months after the taxpayer's fiscal year-end. Failure to comply with this measure may trigger annual penalties of up to €100,000 for each non-compliant French entity.

It is worth noting that on 8 December 2016, the French constitutional Court judged that a provision of French law regarding "transparency, fight against corruption and modernisation of the economic life" (also known as Loi Sapin II), which also imposed a country by country type of public financial reporting, resulted in a disproportionate breach with respect to the freedom of enterprise and was as such unconstitutional.

✧ ✧ ✧

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

London

Arun K. Birla
44.020.3023.5176
arunbirla@paulhastings.com

London

Jiten Tank
44.020.3023.5133
jitentank@paulhastings.com

London

Hannah Gray
44.020.3023.5118
hannahgray@paulhastings.com

Milan

Patrizio Braccioni
39.02.30414.210
patriziobraccioni@paulhastings.com

Frankfurt

Uwe Halbig
49.69.907485.105
uwehalbig@paulhastings.com

Paris

Allard de Waal
33.1.42.99.04.25
allarddewaal@paulhastings.com

Paris

Thomas Pulcini
33.1.42.99.04.46
thomaspulcini@paulhastings.com

New York

Andrew M. Short
1.212.318.6018
andrewshort@paulhastings.com

New York

David Makso
1.212.318.6296
davidmakso@paulhastings.com

Chicago

Jim Smulkowski
1.312.499.6056
ziemowitsmulkowski@paulhastings.com

Paul Hastings LLP

PH Perspectives is published solely for the interests of friends and clients of Paul Hastings LLP and should in no way be relied upon or construed as legal advice. The views expressed in this publication reflect those of the authors and not necessarily the views of Paul Hastings. For specific information on recent developments or particular factual situations, the opinion of legal counsel should be sought. These materials may be considered ATTORNEY ADVERTISING in some jurisdictions. Paul Hastings is a limited liability partnership. Copyright © 2017 Paul Hastings LLP.