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PAUL HASTINGS

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UK and German Tax Update

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Set out below is a snapshot of certain recent UK and German tax developments.

UK

THE 2011 AUTUMN STATEMENT

On 29 November 2011, the UK Chancellor made his Autumn Statement. The Statement was relatively light as regards the impact on business. A few highlights include:

- an increase in the full bank levy rate with effect from 1 January 2012;
- plans to introduce an 'above the line' tax credit in 2013 to encourage R&D; and
- the introduction of a new scheme (See Enterprise Investment Scheme) to encourage investment in new start-up companies from April 2012.
- A proposal for legislation to be introduced in connection with employers' tax relief for asset-backed pension contributions; ensuring that this tax relief accurately reflects the employer's total payments to the pension scheme directly or through a special purpose vehicle.

DRAFT FINANCE BILL 2012

On the 6 December 2011, following the 2011 Autumn Statement, the Government published a draft of the Finance Bill 2012 (the "**Draft Bill**") together with a number of technical notes, responses to consultations that had been previously held and other supplementary documents. Included within the Draft Bill was proposed legislation for the new UK Controlled Foreign Companies ("**CFCS**") regime and also draft legislation in connection with profits arising from the exploitation of patents.

New UK Regime for CFCS

Update

The UK Government's lengthy consultation on the reform to the UK's CFC rules (the "**CFC Reform**") continues to progress with the publication of draft legislation and explanatory notes on 6 December 2011. This CFC Reform can largely be attributed to the fact that UK companies are increasingly operating across national borders and becoming even more internationally diverse. The CFC Reform focuses on rules that permit the income and capital profits of non-UK tax resident companies being brought within the UK tax net in certain circumstances. The CFC Reform is specifically focused on the artificial

diversion of profits from the UK to low tax jurisdictions, notably in the areas of monetary assets and intellectual property where the scope for such diversion is greatest.

Under the CFC Reform, if the CFC rules apply, certain of the CFC's profits will be allocated to their UK parent entity for tax purposes. However, there are two ways to fall outside the net of this CFC Reform. The first of these is provided by the welcome incorporation of an optional "gateway" test and certain mechanical "safe harbours", which include provisioning for trading income arising from commercial activities outside of the UK, incidental finance income and insurance and banking activities. Where these do not apply (or where businesses prefer not to use them) profits may instead be exempt via one of the entity level exemptions.

The gateway test seeks to define which profits will fall within the scope of the CFC regime so that foreign profits not covered by the definition are therefore outside the scope of UK tax. The gateway provides that only profits that fail all of the conditions represent profits that are being artificially diverted from the UK and therefore fall within the scope of the CFC reform. In reviewing these conditions, amongst other factors, it will be necessary to ascertain if a majority of the profits or risks of the CFC are connected with "significant people functions" or "key entrepreneurial risk-taking functions" carried out in the UK and relate to the risks or assets which give rise to the profits of the CFC.

Following on from the gateway test, there are the various entity level exemptions, which need only be considered where there are any "chargeable profits" (i.e. where the "gateway" has been failed). These include (amongst others) a low profits exemption, a low profit margin exemption (broadly where the relevant CFC's profit is no more than 10 per cent of the CFC's relevant operating expenditure) and an excluded territories exemption (which looks to the headline corporation tax rate of the jurisdiction in question).

It is also noted that there has been no general motive test included and, currently, no time limited exemption for the acquisition of new groups (although it is understood that the government intends to include provisions accommodating this in the next draft of the legislation).

While these are welcome changes to the existing regime, complexity in working through the gateway test and exemptions is still present and, as the CFC Reform has now entered a further period of consultation, certainty on this matter is not yet present. The consultation period is set to close on 10 February 2012.

UK Patent Box proposals

Update

The Draft Bill sets out the next stage of the Government's Patent Box proposal, which broadly proposes an effective 10% rate of corporation tax for companies who own or license-in a patent or any of the other limited qualifying intellectual property rights and who have created or significantly contributed to the creation of that patented invention or products incorporating that patented invention.

It is noted that the Patent Box regime has been structured to be elective in nature. As such, those companies who wish to seek the benefit of the regime must make the relevant election for the regime to apply. It is understood that this approach stems

purely from the Government's wish not to impose an additional compliance burden on those companies not wishing to fall within the regime.

It was announced in the Draft Bill that the introduction of the Patent Box regime is to be phased in over the first five years, with 60% of the full benefit being allowed in the first financial year (2013) with the percentage of the full benefit which is available being increased by 10% each year until the full benefit is available from 1 April 2017.

The Draft Bill also saw the Patent Box regime being extended to patents registered in some other member states and also allowing some companies to claim the benefit of the effective 10% rate where they own the rights to exploit a patent in the UK while other companies own it for other jurisdictions. Helpfully, changes have also been made to simplify the calculation of profits falling within the patent box. As with the CFC Reform, the draft Patent Box legislation is open for consultation until 10 February 2012.

THE ANSON (FORMERLY 'SWIFT') DECISION:

The Upper Tribunal has overturned the decision of the First-Tier Tribunal in the case originally reported as *Swift v HMRC*[1]. The case was concerned with whether an individual (Mr Anson) who was a member of a Delaware limited liability company ("LLC"), was entitled to double taxation relief for US tax paid on the profits of the LLC, his share of which was taxed on him personally in the US on the basis that for US tax purposes the LLC was a transparent entity. In the UK, HMRC contended that the LLC was to be treated as an opaque entity that had paid the equivalent of a dividend. On this basis HMRC argued that Mr Anson could not claim double tax relief beyond any withholding tax. The First-Tier Tribunal held that the effect of the LLC's constitutional documents and Delaware law meant that the members were entitled to the profits as they arose and as such the same profits were taxed in the UK and US and a credit for the US tax paid by Mr Anson should therefore be available.

The Upper Tribunal disagreed however and held that it would be wrong on the facts as found to say that Mr Anson had any form of proprietary entitlement to profits made by the LLC and as such stated that it was not possible to see how there could be any 'ownership' of profits made by the LLC. It was determined that Mr Anson was not taxed in the UK on the same profits that were taxed in the US. The LLC was resultantly held to be an opaque entity, which lead to the conclusion that the profits on which tax had been paid in the US were the profits of the LLC and Mr Anson was taxed in the UK on his entitlement under the LLC agreement. On this basis it was held that there were two different sources, so the double taxation treaty test would not be fulfilled.

This decision will be of some relief to HMRC, who even after the First-Tier Tax Tribunal decision in *Swift v HMRC*, had continued to maintain that, in general, they viewed Delaware LLCs as being opaque entities from a UK tax perspective. While not necessarily a desirable outcome for taxpayers, the Upper Tribunal decision does at least now sit aligned with HMRC's approach, and there is therefore greater certainty as to the position of an LLC.

[1] This decision was the subject of our June 2010 client alert "To LLC or not to LLC, That is the Question".

GERMANY

TAXATION OF PRIVATE EQUITY FUNDS

Due to a recent ruling of the German High Fiscal Court (24 August 2011, I-R-46/10) the taxation for private equity funds has become more uncertain. Typically German private equity funds are structured as partnerships. Their business activities are restricted (e.g. by the articles of the fund). The aim of such restrictions is to generate income from asset administration at the level of the fund. Then the gains on the disposal of the fund's investments are taxed on the level of the investors only. For German institutional investors the definite tax burden on such gains is nearly zero.

This favorable tax treatment does not apply if the fund generates income from trade and business. In such case the disposal gains are also subject to trade tax at the level of the fund. To boost the German private equity industry and to increase the legal security the German Ministry of Finance has published an administrative pronouncement in 2003 which defines – amongst others – a list of criteria to be met by the fund in order to generate income from asset administration but not from trade and business (BMF IV A 6 – S 2240 – 153/03).

Due to the above mentioned ruling of the German High Fiscal Court it is highly questionable whether the High Fiscal Court accepts these criteria. The disputed case occurred in 1998. German institutional investors invested in a UK private equity fund and claimed to obtain income from trade and business. Due to the double taxation treaty between Germany and UK income from trade and business is taxable in the UK only. German fiscal authorities treated the fund's income as income from asset administration, allocated this income to the partners on a pro rata basis and taxed it at their level. The High Fiscal Court therefore had to classify the fund's income. In this context the court also referred to the criteria listed in the above-mentioned administrative pronouncement arguing that the income was from asset administration (e.g. no leverage at the level of the fund, no short term investments, no reinvestment of disposal proceeds, no exercise of management rights in portfolio companies). The High Fiscal Court expressed its strong concerns whether he will classify a fund as an asset administrating fund if the fund's business activities completely match these requirements. However, in the case at hand these criteria were not decisive. Even under the narrow regime of the criteria from the administrative pronouncement the fund's income was classified as income from trade and business and therefore was not subject to German taxation.

The ruling will be highly appreciated by German institutional investors being engaged in a foreign private equity fund. They have a good chance of not being taxed in Germany. However, for German private equity funds the tax situation has significantly deteriorated. In a worst case scenario even German private equity funds that fully comply with the prerequisites set up in the administrative pronouncement could be deemed to run a trade and business, i.e. disposal gains would be subject to trade tax. The German tax burden on a German private equity fund thereby would be significantly higher than the burden on a foreign fund, e.g. a UK private equity fund. This results in a competitive disadvantage for German private equity funds. The reaction of the German legislator and the German fiscal authorities to the above-mentioned ruling therefore has to be eagerly awaited.

TAXATION OF FOREIGN INSTITUTIONAL INVESTORS ON DIVIDENDS FROM GERMAN CORPORATIONS

The Federal Republic of Germany recently lost a lawsuit against the European Commission, dealing with the taxation of dividends for institutional investors (European Court of Justice, C-284/09, 20 October 2011). The European Commission reproached that Germany has infringed the free movement of capital enshrined in Art. 56 of the Treaty establishing the European Community and in Art. 40 of the Agreement on the European Economic Area.

For corporations not falling within the scope of the Parent-Subsidiary Directive (Guideline 90/435 of the Agreement on the European Economic Area; i.e. shareholders holding less than 10% of the share capital in a German corporation) Germany levies a withholding tax (generally 25%) on dividends distributed by a German corporation. This tax is withheld regardless of whether the shareholder is resident in Germany or in another EU Member State.

The violation of the above-mentioned rules results from the fact that the ultimate tax burden for a German institutional investor differs from the tax burden of a corporate shareholder resident in another EU member state.

- For a German corporate investor the dividend income is nearly tax exempt and the withholding tax is treated as a prepayment on the corporate investor's final tax burden. This tax credit is reimbursed to the German corporate investor to the extent that the amount of corporate income tax to be paid is less than the amount withheld. Therefore German companies receiving dividends do not bear a tax burden as a result of the withholding tax.

- For parent companies resident in a EU Member State which do not fall within the scope of the Parent-Subsidiary-Directive the withholding rate indeed is reduced by double taxation treaties (usually to 10% or 15%) and also can – to a certain extent - be set off against the amount of tax due in the Member state in which the shareholder is established. A reimbursement of any excess tax is not possible.

As a result of these rules the above-mentioned foreign shareholders are taxed more heavily in economic terms than German corporate shareholders. This different tax treatment cannot be justified by a potential tax advantage for the foreign institutional investors resulting from the fact that these investors are not subject to German trade tax. The additional tax burden for foreign institutional investors can also not be legitimated by the coherence of the German tax system which compensates the tax advantage granted to German institutional investors on dividend income by a tax disadvantage when such corporate investor distribute such dividend income to individuals resident in Germany and being their shareholders.

It has to be awaited as to how the German legislator will react to this ruling. It could increase the tax burden for German institutional investors, lower the tax burden for the above mentioned foreign corporate investors or combine both methods.

TRANSFER OF GOING CONCERN ("TOGC")

On 10 November 2011, the European Court of Justice released its judgment in the German case of Christel Schriever concerning the interpretation of the TOGC VAT-free treatment provisions. Ms Schriever ran a retail business and transferred the stock and fittings of her shop to a purchaser. At the same time Ms Schriever leased out the

premises where the business was carried on to the purchaser for an undefinite period. Under the terms of the lease contract, the lease could be terminated by either party by the giving short term notice. The purchaser continued to run the business for nearly two years. The German tax authorities denied TOGC treatment on the grounds that the seller leased rather than sold the premises to the purchaser.

The European Court of Justice held that where the continuation of the economic activity in question requires that the purchaser uses the same premises as were used by the seller, there is no reason in principle why possession of those premises may not be transferred by means of a lease. Accordingly, the fact that the seller granted a new interest (lease) in the property rather than transferring its existing interest in property did not prevent the continuation of the seller's activity by that purchaser. Therefore, the transaction fell to be treated as a VAT-free TOGC.

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

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