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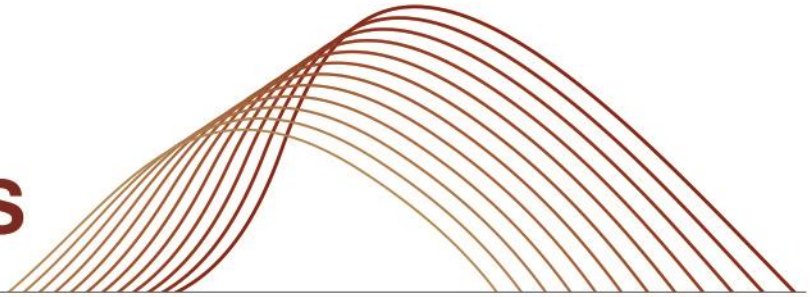
PH PERSPECTIVES



**March 2018**

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# *European Tax Update*

## INTRODUCTION

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

In these uncertain times, the changing landscape extends to global tax regimes. In Europe, we await the bedding down of the multilateral instrument put in place as a response to the OECD's base erosion and profit shifting project. In the U.S., we have seen the recent and well-publicised tax reforms.

The U.S. tax reform legislation will have a significant impact on structuring cross-border investments. Many aspects of applicable U.S. tax law have changed. The rate of taxation for both corporations and many owners of pass-through business entities has been reduced. At the same time, significant restrictions have been placed on the ability of U.S. businesses to deduct interest, but a U.S. business has a much greater opportunity to currently deduct the cost of investment in business assets. Many structures for conducting U.S. business operations will be re-evaluated in light of these changes.

Multinationals also have a host of new rules to contend with, the most prominent being the conversion of the U.S. tax system to a partial territorial system. With such change, the U.S., like Europe, has increased its focus on base erosion. A number of new provisions impose new tax regimes on foreign generated profits, and other new tax regimes impose taxes on U.S. businesses that make deductible payments to related foreign entities.

Much of this legislation was drafted quickly and with significant ambiguities, resulting in a continuous stream of government interpretative pronouncements. Although the legislation is applicable today, sorting it out will be a multi-year process. Watch this space.

This update provides a snapshot of some of the current tax issues across the U.K., Italy, Germany, and France.

## UNITED KINGDOM

### *Intangible Fixed Assets*

In 2002, the U.K. introduced the Intangible Fixed Assets regime (the "IFA Regime"), aimed at providing relief for companies on the cost of acquiring intangible fixed assets and goodwill. The regime involved allowing deductions from income for amortisation and impairment debits (such reliefs had not previously been allowed) and also taxes receipts in respect of these assets as income (subject to reliefs such as reinvestment relief and tax neutral intra-group transfers).

Given the continuing (and increasing) importance of intellectual property within the U.K. and the global economy and to multinational businesses, the U.K. government has announced a

consultation on the IFA Regime in order to determine whether the regime continues to be appropriate in supporting and promoting the competiveness of the U.K. The U.K. government may be looking to introduce changes as part of their post-Brexit planning.

The consultation focuses on a few specific areas, including (i) the impact of the pre-2002 commencement rule, (ii) restrictions on goodwill and customer related intangibles, (iii) de-grouping rules, and (iv) use and competitiveness of election for 4% fixed rate relief. These are all areas in which it could be argued that the U.K. may be less competitive than the regimes operated in other jurisdictions, and the government has asked for examples of the practical impact and restrictions of the current IFA Regime.

One area of particular interest going forward, and where arguably the IFA Regime is overly burdensome for U.K. companies, is the de-grouping rules on mergers and acquisition. The current IFA Regime contains a "degrouping charge", which is broadly imposed where assets are transferred intra-group and the transferee leaves the same group within a period of six years from the transfer (similar to the capital gains regime). However, unlike in the capital gains regime, the Substantial Shareholding Exemption does not apply to the IFA Regime.

The results of the consultation could be very positive.

### *Does a U.K. Broker Create a U.K. VAT Establishment?*

A recent case of interest to U.K. investment fund managers who manage funds with offshore general partners has recently been brought before the First Tier Tribunal of the Tax Chamber (Hastings Insurance Services v HMRC [2018] UKFTT 27 (19 January 2018)). The court has determined that a broker established and operating in the U.K. did not constitute a U.K. fixed establishment of one of its clients.

The issue for the court to consider was whether Hastings could recover input tax attributable to the supplies of broking, underwriting support, and claims handling services made to U.K. customers on behalf of a company related to Hastings, based in Gibraltar, by virtue of acting as a fixed U.K. establishment of the Gibraltan company.

The court looked at the factors required to constitute a fixed establishment in such a case, i.e., that the establishment is a permanent presence with the "necessary", "adequate", or "suitable" human and technical resources for the provision of supplies on a standalone basis, and determined that Hastings was not a fixed establishment of the Gibraltan company. The court noted that close cooperation between parties with regard to a single economic activity is not of itself determinative of whether one is a fixed establishment of the other and that there should be a degree of control over the resources of the establishment by the other entity.

### *Digital Economy*

The U.K. government has published an update regarding its position on corporate tax and the digital economy (first published in November 2017), recognising that this is an area in which it will be required to review and assess its policy objectives on an ongoing basis against the practicalities of implementation within the digital economy.

The government continues to agree with the principle that a multinational group's profits should be taxed in the countries in which it generates value and favours an allocation of profit model where a group's profits are allocated to countries based on user contribution. Given the OECD Model Tax Convention does not currently recognise any such value for the purposes of taxable profit, the international tax rules and double tax treaties would need a global review and update.

In the meantime, the U.K. government supports the implementation of interim measures that are designed to tax the revenues of digital businesses deriving value from U.K. users, and it advocates for multilateral coordination in finalising these proposals.

### *Future Developments—Taxation of Non-Residents*

In November 2017, the U.K. Government announced that from April 2019, U.K. tax will be charged on gains made by non-residents on disposals of all types of U.K. immovable property. Such changes are being introduced to bring the U.K. in line with many other jurisdictions and will extend the existing rules, which apply to disposals of residential property. The consultation remained open until February 2018, and further details will become available as the consultation proceeds; however, we have set out below an outline of the proposals to date.

Currently, the U.K. does not exercise its full taxing rights where non-residents dispose of non-residential U.K. immoveable property. Under the U.K. Government proposal, non-U.K. residents will become subject to U.K. tax on gains from disposal of commercial property from April 2019. The proposals will apply to direct and indirect disposals.

There will be an indirect U.K. tax charge covering the sale of an entity (or group) where greater than 75% of the gross asset value derives from U.K. land (i.e., "property rich companies"), triggered by the sale of an interest by any owner who has held at least 25% interest in the entity over the last 5 years prior to disposal. Non-U.K. land is excluded when calculating the 75%.

The current proposals include the option for a rebasing to April 2019 for direct and indirect disposals (although the taxpayer has the option to revoke the rebasing on a direct disposal of an asset if the rebasing would increase a gain). In addition, an anti-forestalling rule will apply to certain arrangements that were entered into on or after the publication of the consultation document, which aims to counteract arrangements that seek to avoid the new charge on non-U.K. residents.

To date, the consultation does not state whether those who are exempt from all U.K. capital gains, or otherwise not in the scope of U.K. tax for reasons other than being non-resident, will continue to be exempt or out of scope. However, as noted above, this consultation is at the early stages, and there are likely to be further developments and clarification as the process continues.

We have submitted our thoughts on the consultation to the U.K. government.

## ITALY

### *Foreign Dividends Excluded from EBITDA as Threshold for Interest Expense*

Italy Finance Law for 2018 (Law 27 December 2017 n.205), Sec. 994 ("Law 205"), has provided for the exclusion of foreign dividends from the calculation of EBITDA (*ROL: Reddito Operativo Lordo*), which is used by non-financial companies as a threshold for the yearly deduction of interest expense. According to Sec. 995, such new provision applies from 2017, so it will affect company tax returns to be submitted during 2018.

### *Brief Description of Present Interest Expense Regime for Non-Financial Companies*

The ordinary tax regime related to interest expense deduction is contained at art. 96 of the Italian corporate income tax consolidated text, which has been affected by the change of law described above.

For non-financial companies (i.e., companies which, in a broad sense, are not financial intermediaries and insurance companies) the applicable rules provide that interest expenses are

fully deductible up to the same amount of interest income, while the excess is deductible where it is under the threshold of 30% of EBITDA.

Interest expense deduction exceeding 30% of EBITDA is carried forward to future years indefinitely, which implies in any case a financial burden for over-indebted companies.

Before the enactment of Law 205, dividends received from foreign participations (foreign dividends) were included in the calculation of EBITDA for interest expense deduction purposes.

After the change of the law, foreign dividends have been excluded from such calculation, thus decreasing the previous EBITDA threshold and making larger amounts of interest expenses temporarily non-deductible.

This issue may be particularly worrying for industrial holding companies, i.e., companies devoted to keeping and managing participations in non-financial companies, where the only or most relevant income source is from dividends. If participations are held in non-Italian resident companies, the threshold for interest expense deduction may in fact shrink dramatically.

On the other hand, there is no change in respect of domestic dividends, which continue to be fully included in the EBITDA calculation.

***A Taste of Discrimination?***

Non-discrimination is a concept that may present different features in national jurisdictions, but has reached common application in the EU due to the significant jurisprudence of the EU Court of Justice in this area.

Non-discrimination is in fact one of the principles which is considered a pillar of EU law and because of this status it is applicable to any sector, domain, area of EU law, tax law included.

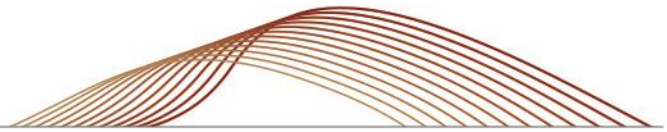
Italy, as well as deriving from EU law, has a general non-discrimination principle fixed at art. 3 of the Italian Constitution that sets and describes the principle of equality.

In a nutshell, if the principle of equality is violated, a discrimination is said to exist so that the principle of equality represents "per se" the principle of non-discrimination in the Italian Constitution.

Non-discrimination means that identical situations must be considered and treated in the same way, and no difference should be made by reason of sex, race, nationality, political belief, and other parameters.

Applying this principle to the foreign dividend exclusion from EBITDA, we should consider the following situation: two Italian resident holding companies, with exactly the same asset value, in one case represented by participations in Italian resident companies (HoldCo 1) while in the second case represented by non-Italian resident companies (HoldCo 2). Practically speaking, if the two holding companies incur also the same amount of interest expense, HoldCo 1 will be entitled to deduct a higher amount of such expense in respect of HoldCo 2. As such, two identical situations are treated differently from a tax perspective without any reasonable justification.

Finally, in our experience, the presence of discrimination should not be overlooked or a conclusion prematurely reached as only a judicial valuation by competent national or EU courts, can confirm whether or not the non-discrimination principle has been violated by Sec. 994 of Italian Finance Law for 2018.



However, in the case at hand, we would argue that there is at least an element of discrimination. Companies in situations similar to that of HoldCo 2 should carefully consider the suitability of taking action before the Italian Constitutional Court or the EU Court of Justice according to the applicable procedure rules.

## GERMANY

### *License Ceiling*

Under action point 5 of the OECD BEPS project, the OECD has implemented measures to combat regimes where enterprises own their intellectual property in certain low tax jurisdictions. These measures should be implemented by jurisdictions by mid-2021. However, Germany does not want to wait so long. From 1 January 2018 onwards, German tax law restricts the deductibility of license fees paid by licensees tax resident in Germany to certain non-German affiliates as licensors. These rules apply for licensors that benefit from a favourable tax regime that will not be subject to amendment until mid-2021 as further outlined in the OECD BEPS project). The German rules penalise the licensee for tax benefits of the licensor.

However, this rule might violate the German constitution, which states that taking into account their financial strength, all taxpayers shall be treated equally. This principle would be violated where two German licensees have the same financial strength, but one licensee is entitled to fully deduct the license fees whereas the other is restricted in doing so.

### *Investment Funds*

For many years, Germany has treated investment funds as tax transparent. The investor should in principal be treated as if owning the investment directly. As of 1 January 2018 this principal no longer applies. The reasons for this change include the complex determination of the tax base, obstacles in enforcing tax claims after a tax audit, and the potential infringement of European law.

Investment funds are now treated as taxable persons subject to tax on their German-based income (e.g., dividend income from German companies, rental income from German properties). The tax rate depends—amongst other things—upon the category of the investment fund (e.g., equity fund, mixed fund, and real estate investment fund). So called special funds are entitled to continue to be treated as tax transparent provided they comply with a list of criteria (in particular: supervision by a regulator, annual retention, compliance with certain investment, and leverage ratios; and being limited to not more than 100 institutional investors).

### *Anti-treaty Shopping Rules*

Under the Parent-Subsidiary Directive, as well as under several double tax treaties, Germany has to reimburse the withholding tax on dividends paid by a German subsidiary to a shareholder with a significant interest in a German company.

Germany has overridden these rules for structures that are deemed to be tax abusive and has listed several criteria to be met when such tax abuse is deemed to exist (e.g., where there is a shareholder with lack of economic substance or insignificant income other than from dividends). The European Court of Justice rejected the predecessor rule to the existing German anti-treating shopping rule (ECJ C-504/16). As a result, an abuse must not be defined by pre-determined general criteria but must be identified by an individual examination of the specific facts and circumstances of the relevant structure. It is very likely that the ECJ ruling applies analogously to the current version of the anti-abuse law. In addition, it is disputed whether shareholders outside of the European Union could seek to rely on this ruling.

### *Licensee Fees for Software/Data Bases*

Under German national tax law, a license fee paid by a German licensee to a non-German licensor for the right to use software or databases is subject to withholding tax if the licensee is entitled to "exploit" the software/database. It has previously been unclear how the term "exploitation" should be interpreted. On 27 October 2017, the German fiscal authorities published a circular to explain their view. Exploitation means the right to duplicate/amend and to re-sell/publish the amended/edited licensed product.

The use of the licensed product without any amendments within the licensee's business generally does not trigger a withholding tax obligation. Also not subject to withholding are access, read-only, and printing rights.

If the licensee mistakenly assesses the license fees as exempt from withholding tax the licensee becomes secondarily liable vis-à-vis fiscal authorities for taxes not withheld. It then depends upon the agreed terms in the license agreement as to whether the licensee is able to charge these taxes to the licensor. If the license agreement contains a tax gross-up clause, the licensee has to bear these taxes unless the licensor is protected by a double tax treaty.

### *Cryptocurrencies*

Bitcoins and other cryptocurrencies are not legal tender. If the value of a cryptocurrency has increased since its acquisition, any gain realised when paying with such cryptocurrency may be taxable. This rule may not apply for private individuals owning the cryptocurrency for more than one year.

For companies accepting cryptocurrencies as a means of payment, the VAT consequences have been clarified by a tax circular of the Federal Ministry of Finance dated 27 February 2018. Such companies render an exchange service when changing cryptocurrencies into legal tender and vice versa. The remuneration for this service should be equal to the bid-ask spread.

There was some uncertainty as to whether the fee for this service is VAT exempt or not. For Swedish VAT law, the ECJ ruled that such exchange service is exempt from VAT (ECJ, C-264/14). Within the EU, national VAT laws are harmonised and national VAT law is derived from a common European guideline. However, it was questionable whether this ECJ ruling for Swedish VAT law would also apply to Germany as member states have implemented the European VAT guideline differently in their national tax laws. According to the mere wording of German VAT law, the exchange of bitcoins against a legal tender should not be VAT exempt. Notwithstanding, in the above-mentioned circular, the German fiscal authorities confirmed that the ECJ decision applies to German law; i.e., the exchange is VAT exempt.

## FRANCE

In an interesting development, the French supreme administrative court refused, in a recent case (Conseil d'Etat, 25 October 2017 n°396954), the application of the double tax treaty concluded on 1 April 1953 between France and Luxembourg (the "Tax Treaty") on the basis of the French tax concept of abuse of law.

The facts were simple. A French tax resident had required an option to purchase real estate located in France. On the same day, a Luxembourg holding company was set up, whose only purpose was the purchase of the real estate under option. A few months later, the Luxembourg company was substituted for the French resident in the option and purchased the real estate. Less than two years after the purchase, the Luxembourg company sold the real estate at a gain. The sale was exempted from capital gain taxes both in Luxembourg and in France pursuant to Article 4

of the Tax Treaty in force at that date. However, the French tax authorities refused to apply the Tax Treaty, considering the situation as an abuse of law pursuant to the French domestic rules.

In a nutshell, the abuse of law theory allows French tax authorities to disregard any given agreement or situation and, therefore, to tax the corresponding transaction on the basis of its actual substance and to apply an additional penalty of up to 80% of the amount. The abuse of law theory applies in two types of situations: (i) legal fiction and (ii) when the agreement is purely motivated by tax considerations and the parties have obtained a tax benefit by a literal application of the relevant rules while disregarding the spirit of such rules. The question of application of this purely French domestic concept to a situation deriving from the application of a double tax treaty was at that point not settled by French courts.

In the present case, the French supreme administrative court ruled, for the first time, that French tax authorities are in a position to apply the theory of abuse of law in a double tax treaty situation even when such treaty does not itself provide for any general anti-abuse clause. The argument being that the signatory states party to the relevant treaty could not be regarded as having intended to apply the said treaty to purely artificial arrangements without any economic justification. The application of a double tax treaty to an artificial arrangement is therefore presumed contrary to its intention and does not offer protection in case of an abuse of law.

According to this case, treaty protection can be ensured only if the creation of an interposed company not only satisfies the requirements to be considered as a resident within the meaning of a double tax treaty (in terms of "substance") but also is not motivated purely by tax considerations (for which "substance" may not be sufficient). As a result, in the future, the French tax authorities can be expected to challenge the benefit of a double tax treaty and apply the French abuse of law theory in cases where non-French interposed holding companies are set up with the main purpose of avoiding French capital gain or withholding taxes.

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