

## Index

### Legal developments 2

#### LEGISLATION 2

- |               |                 |
|---------------|-----------------|
| 1. France     | 6. Malaysia     |
| 2. India      | 7. Poland       |
| 3. Indonesia  | 8. Spain        |
| 4. Italy      | 9. Sweden       |
| 5. Luxembourg | 10. Switzerland |

#### COURT CASES AND RULINGS 12

##### A) EUROPEAN UNION

1. "Abuse of right" – How it applies to VAT - The Halifax Case
2. The Bond House Case
3. ECJ Decisions in relation to Germany
4. The IRAP Case

##### B) COUNTRIES

1. India
2. Luxembourg
3. Spain

#### SPECIAL FEATURE: THE MARKS & SPENCER CASE 19

1. UK Government reaction
2. Transposition of the decision to the case of France
3. Implications of the M&S case in Germany
4. Possible impact on Italian tax law
5. Practical implications in Spain
6. U.S. perspective

#### OTHER NEWS 24

- |               |                  |
|---------------|------------------|
| 1. EU news    | 3. Spain         |
| 2. Luxembourg | 4. United States |

### Taxand news 28

### Contact information 29



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# Legal developments

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## LEGISLATION

### 1. FRANCE

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#### 1.1 Administrative Guideline<sup>1</sup> specifying the tax consequences of the new accounting standards applicable to restructuring operations

The accounting treatment of restructuring operations (mergers, spin-offs, or partial business transfers) has undergone far-reaching changes since 1 January 2005. In particular, restructuring operations within groups of companies must now be carried out at book value (assets transferred under these operations cannot be revalued).

Furthermore, the accounting treatment of the loss incurred by a merging company due to the merger of the shares that it holds in the merged company has been clarified: where the merger is carried out at book value, the loss must be recognized in the merging company's assets.

In order to take into account these new accounting principles, the Amended Finance Act for 2004 had already adjusted the tax treatment applicable to mergers in several respects. The tax authorities have recently published a guideline on these new provisions.

#### 1.2 Amended Finance Act for 2005<sup>2</sup>: Changes to the parent/subsidiary regime (tax exemption of dividends)

The Amended Finance Act for 2005 has made the French parent/subsidiary regime more flexible by widening its scope to include non-voting securities, where the other shares held in the subsidiary represent at least 5% of the capital stock and 5% of the company's voting rights. This measure is aimed specifically at extending the scope of the parent/subsidiary regime to non-voting preferred shares.

It should be noted that the French parent/subsidiary regime applies to dividends received by companies subject to corporate income tax that hold an investment representing at least 5% of the capital stock of the company making the distribution. The regime consists in

granting a tax exemption for dividends received from subsidiaries, after deduction of a prorated share of costs and expenses assessed at 5% of the dividend.

#### 1.3 Administrative Guideline<sup>3</sup> on the tax audit of computerized accounting systems

The tax authorities have recently published a guideline providing additional details of the terms and conditions of the tax audit of computerized accounting systems kept by companies.

This guideline specifies the conditions required in order to consider that computerized accounts give a true and fair view of the company's operations, are duly and properly kept, and are conclusive.

The scope of an audit of the computerized accounts is also clarified (data in the accounting and management fields that is directly or indirectly used in the creation of an accounting entry: chart of accounts, inventory master file, cash registers, inventory management, etc.).

Furthermore, the obligations with regard to the retention of accounting documents and computer data are summarized and clarified.

Lastly, the tax authorities have issued a warning to companies that outsource their accounting to outside service providers regarding the problems of accessibility of the documents at the time of a tax audit, particularly where the documents are not kept in France. These companies are reminded that the records or supporting documents (in particular electronic invoices) must be accessible and consultable in France in the event of a tax audit.

### 2. INDIA

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#### India Budget 2006

The Indian Finance Minister presented the annual budget of the Government for the 2006-07 fiscal year on 28 February 2006. Most direct tax proposals will be effective from April 2006, subject to approval by the Indian Parliament, whereas most indirect tax proposals take effect immediately. Listed below are the key tax proposals:

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<sup>1</sup> Guideline 4I-1-05 of 30 December 2005.

<sup>2</sup> Act No. 2005-1720 of 30 December 2005, Official Journal of 31 December 2005.

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<sup>3</sup> Guideline 13L-1-06 of 24 January 2006.

a) *Direct taxes*

- No change in the tax rates for companies or individuals is introduced: the effective corporate tax rate for domestic companies stays at 33.66% and for foreign companies at 41.82%.
- Rate of Minimum Alternate Tax ("MAT") that is levied on companies has been increased from 7.5% to 10%; however the carryforward period for MAT credit has also been increased from 5 years to 7 years.
- Long-term capital gains on the sale of listed securities, which is otherwise tax exempt, will now have to be considered for MAT purposes.
- The following changes have been made to the Fringe Benefit Tax ("FBT") provisions (FBT was introduced in 2005):
  - Superannuation contributions by the employer of Rupees 100,000 per employee per year will not be liable to FBT.
  - Costs incurred on distribution of free samples of medicines or medical equipment to doctors, costs incurred on celebrity endorsements/brand ambassadors, and costs for providing free transportation facilities (home-office-home) to employees will not be liable to FBT.
  - Tour and travel expenses incurred by all companies and hospitality, boarding and lodging expenses incurred by airline and shipping companies will now be valued at 5% of the expenses for the purposes of FBT, instead of 20%.
- The deadline for claiming tax holidays for the development of "industrial parks" has been extended to 31 March 2009, and for power generation/distribution to 31 March 2010.

b) *Indirect taxes*

- Peak rate of Basic Customs Duty is reduced from 15% to 12.5%.
- 4% Additional Customs Duty ("ACD") is levied on imports of all goods (subject to specified exceptions) to counter sales taxes at state level: manufacturers can take credit in this connection against their output excise duty liability.

- A basic excise duty of 8% is imposed on packaged software.
- The rate of excise duty for clearances to domestic tariff area by export-oriented units/software technology park units and electronic hardware technology park units is restructured.
- The scope of advance rulings is extended to the determination of excise duty liability and service tax.
- The rate of service tax is to be increased from 10% to 12%.
- Service tax has been introduced on 15 new services.
- Changes in the scope of 9 existing taxable services are introduced.
- Provisions on the levying of service tax on services received from outside India have been amended. Draft import service rules have also been published.

### 3. INDONESIA

#### Protocol to the Indonesia-Malaysia tax treaty has been signed

A protocol to the Indonesia-Malaysia tax treaty has been signed recently. According to an official at the International Taxation Sub-Directorate under the Indonesian Directorate-General of Taxation, the protocol reduces the withholding tax on dividends, interest and royalties from 15% to 10% and excludes Labuan from the scope of the tax treaty.

Labuan, an island located off the coast of East Malaysia, is an international offshore financial center. In the past, Labuan's well-structured financial and foreign exchange rules have made it an attractive place to establish offshore companies. With the exclusion of Labuan from the tax treaty, it is advisable for companies with an existing Labuan parent to consider migrating their corporate group to a more favourable and treaty-friendly structure.

With the reduced withholding tax, Malaysia has now become more attractive as a base for holding companies.

The implementation of the protocol is subject to the signing of a Presidential Decree, and is expected to take effect in 2007.

## 4. ITALY

### 4.1 Step up of tax value of corporate assets

The Finance Act for 2006 provides for the possibility for resident companies, and nonresident companies with a permanent establishment in Italy, to increase the tax value of corporate tangible and intangible fixed assets, under certain conditions, upon payment of a substitute tax. Such step-up is available for assets recorded in the financial statements as of 31 December 2004, and still recorded in the financial statements as of 31 December 2005.

The step-up is conditional upon the payment of a substitute tax to be levied (at 12% in the case of depreciable assets and at 6% in the case of non-depreciable assets and shares) on the difference between the stepped-up value of the assets and their current tax value; such substitute tax must be paid in a lump sum by 20 June 2006.

However, the step-up is fully effective for income tax purposes as from the third fiscal period following the fiscal period in which it takes place; therefore, the tax relief (higher deductible depreciation or lower taxable gains) would apply as from the 2008 fiscal period.

The amount of the step-up must be included in the net equity of the company in an *ad hoc* tax-suspended reserve (net of the substitute tax) taxable in the event of distribution.

The Finance Act provides for the possibility to release any tax-suspended reserve (including the same reserve created with the above step-up) upon payment of a 7% substitute tax. In such a case the reserve may be subsequently distributed without any further taxation.

### 4.2 Amendments to participation exemption regime, capital losses and dividend washing

The participation exemption regime has been modified. Capital gains arising on the disposal of shares and other participations qualifying for the participation exemption regime are:

- 95% exempt from tax if realised between 4 October 2005 and 2 December 2005;
- 91% exempt from tax if realised between 3 December 2005 and 31 December 2006; or

- 84% exempt from tax if realised on or after 1 January 2007.

The original 12-month minimum holding period to qualify for the participation exemption regime has been extended to 18 months; the LIFO principle applies in this respect.

On the other hand, capital losses realised upon disposal of shares and other participations qualifying for the participation exemption regime are fully non-tax-deductible if the relevant shareholding has been held continuously for 12 months prior to the disposal.

Moreover, in order to combat dividend washing practices, it is provided that on or after 1 January 2006, capital losses arising from the disposal of shares, interests or other financial instruments akin to shares and not qualifying for the participation exemption of a company that is not resident in a country classed as a tax haven and engages in an active business activity are not deductible where the interest was acquired in the 36 months preceding the disposal. The non-tax-deductible amount is equal to 95% of the dividend distributed in the 36 months preceding the disposal.

### 4.3 Amortization of goodwill

As from the 2005 tax period, goodwill recorded in the balance sheet may be amortized by up to one-eighteenth of its value for each tax period, i.e., at a rate of 5.55%. Prior to the amendment introduced by the Finance Act for 2006, goodwill was amortizable at a rate of 10%, i.e., up to one-tenth of its value for each tax period.

## 5. LUXEMBOURG

### 5.1 Tax treaties ratified by Luxembourg

Luxembourg has ratified the tax treaties concluded with Latvia, Lithuania and Israel.

#### *a) Treaty between Luxembourg and Lithuania*

The first-time income and capital tax treaty signed on 22 November 2004 was ratified by Luxembourg on 16 February 2006. The tax treaty generally follows the OECD Model Tax Convention on Income and Capital (the "OECD MTC").

The maximum withholding tax rates are:

- 15% on dividends (5% if the beneficial owner is a company—other than a partnership—which directly holds at least 25% of the capital of the company paying the dividends);
- 10% on interest (exemptions of interest on loans secured by the Government and interest in connection with any indebtedness arising following the sale on credit by an enterprise of any merchandise or industrial, commercial or scientific equipment; and
- 10% on royalties (5% on royalties paid for the use of industrial, commercial or scientific equipment).

There are some deviations from the OECD MTC, including the concept of ‘residence’ where conflicts of residence of enterprises should be resolved by mutual agreement (i.e., there is no reference to the “place of effective management” as in the OECD MTC to resolve conflicts of residence between enterprises).

#### b) *Treaty between Luxembourg and Latvia*

The first-ever income and capital tax treaty signed on 14 June 2004 was ratified by Luxembourg on 16 February 2006. The treaty generally follows the OECD MTC.

The maximum withholding taxes are:

- 10% on dividends (5% if the beneficial owner is a company other than a partnership which directly holds at least 25% of the capital of the company paying the dividends);
- 10% on interest, subject to certain exemptions; and
- 10% on royalties (5% on royalties paid for the use of industrial, commercial or scientific equipment).

There are also some deviations from the OECD MTC, including the concept of ‘residence’ (as in the case of the Luxembourg-Lithuania tax treaty).

#### c) *Treaty between Luxembourg and Israel*

The first income and capital tax treaty signed on 13 December 2004 between Luxembourg and Israel was ratified by Luxembourg on 15 March 2006. Despite Israel not being an OECD member country, the tax treaty generally follows the OECD MTC.

The maximum withholding tax rates are:

- 15% on dividends (5% if the beneficial owner is a company other than a partnership that directly holds at least 10% of the capital of the company paying the dividends, and 10% if the beneficial owner is a Luxembourg company that directly holds at least 10% of the capital of the Israeli company paying the dividends, if the profits of the Israeli company are taxed at a special rate);
- 10% on interest (5% on interest on loans approved by one of the Contracting States and paid by a bank of the other State. Exemptions apply to interest on specified loans secured by the Government of a State and interest on any indebtedness arising as a consequence of the sale on credit of industrial, commercial or scientific equipment, or the sale on credit of merchandise); and
- 5% on royalties. The definition of royalties includes software payments.

The tax treaty includes a specific provision on capital gains realised on the sale of shares in real estate companies which are taxable in the country where the real estate is located.

### 5.2 Mutual agreement on the application of the Denmark-Luxembourg tax treaty to Luxembourg SICAVs/SICAFs

Based on an exchange of letters on 30 December 2005 and 15 February 2006, the Luxembourg and Denmark tax authorities have agreed to consider SICAVs, SICAFs and Danish UCIs to be ‘tax resident’ within the meaning of the tax treaty.

The list of the tax treaties concluded by Luxembourg and applicable to Luxembourg SICAVs/SICAFs is available on the website of the Luxembourg tax authorities:

<http://www.impotsdirects.public.lu/dossiers/conventions/opc/sicav/index.html>

## 6. MALAYSIA

### 6.1 Finance Act 2005

The Finance Act 2005 (Act 644) was gazetted on 31 December 2005. This legislation incorporated most of the proposals presented in the 2006 Budget on 30 September 2005.

Some of the more pertinent amendments involved the following issues.

- Limitation on the carrying forward of unabsorbed businesses losses and capital allowances.
- Extension of group relief for current year business losses to all sectors subject to various conditions.
- New rules regarding the definition and tax treatment of investment holding companies.
- Treatment of employees' share option schemes.

Other proposals will be legislated through the issuance of specific gazette orders by the Government.

## **6.2 Goods and Services Tax (GST)**

The GST was intended to replace the existing Sales Tax and Service Tax on 1 January 2007. Various discussions have been held by the Tax Renew Panel of the Ministry of Finance with industry groups. Draft legislation has been prepared but not made public yet. Calls have been made to request for more time so that businesses can have additional time to modify their systems and prepare for the GST. As a result, the Ministry of Finance announced on 22 February 2006 that the implementation date for GST will be deferred. However, no new date has been mentioned yet.

## **6.3 New Malaysia-Singapore double tax treaty**

A new treaty with Singapore has been ratified and entered into force on 13 February 2006. The provisions of the new agreement will cover income derived on or after 1 January 2007. Major amendments include:

### *a) Permanent Establishment (Article 5)*

Different modifications are introduced regarding the concept of permanent establishment (PE). For example, a PE will only be created if a building site or construction, installation or assembly project or supervisory activities in connection with the above projects exist in Malaysia for more than 6 months. The time frame is not mentioned under the previous tax treaty.

### *b) Interest (Article 11)*

Interest payments between Malaysia and Singapore will be subject to a maximum withholding tax of 10% (the rate is 15% under the domestic legislation).

### *c) Royalties (Article 12)*

Royalties are deemed to arise in a State where the payer is a resident. If a PE or fixed base bears the royalty, then the royalty is deemed to arise in the State where the PE or fixed base is situated.

Under the previous treaty, royalties were deemed to be derived from sources within the State in which the property from which the royalty is derived is used.

Royalty payments between Malaysia and Singapore will be subject to a maximum withholding tax of 8% (the rate is 10% under the domestic legislation).

### *d) Technical Fees (Article 13)*

A new article on fees for technical services has been introduced in the new treaty. The maximum withholding tax rate is 5% (10% under the domestic legislation). The term 'technical fees' refers to payments to any person other than an employee of the person, for services of a technical, management or consultancy nature.

### *e) Dividends (Article 10)*

It is provided by way of a protocol that, for the purposes of this article, a company that is resident in Malaysia or Singapore may, when paying a dividend, declare itself to be a resident of the other Contracting State. This provision would however cease to have effect for dividends paid on or after 1 January 2008.

### *f) Independent Personal Service (Article 14)*

A resident individual of one Contracting State will only be taxable on income earned in the other State provided that he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities.

### *g) Tax Sparing*

Mutual tax sparing relief will apply to the first ten years of the agreement.

## 7. POLAND

### 7.1 Amendment in tax procedure

In February 2006, the Polish Senate approved an amendment to the Polish Tax Code. Pursuant to the amendment, large taxpayers will no longer be excluded from the ordinary rules on tax audits. Until now, such taxpayers have, in principle, been audited by specialized tax offices which have tailored their procedures to the specific characteristics of large companies, thus making the tax audit process more efficient and less disruptive to the ordinary course of business. If the amendment is approved by the Polish President, this favourable exception will no longer be applicable in the future.

### 7.2 Tax reform

The new Government is working on a general tax reform. The main aim of the reform is to simplify procedures. Changes to all tax laws are planned to be introduced. Currently, the Government is focusing on a study of certain VAT changes. Other taxes will be considered in a later phase.

The initial VAT proposals are as follows:

- Elimination of 30% VAT penalty rate: if the planned changes are introduced, the financial consequences of contesting the amounts reported in VAT returns will be limited to payment of the outstanding tax along with the VAT penalty (an additional penalty of 30% of the VAT deficiency is currently applicable).
- Simplification by applying a zero rate to intra-Community trade: according to the Government proposal, the complicated system of rectifying the VAT rate retrospectively if the taxable person does not possess the documentation required to apply the zero rate, will be abolished.
- Acceleration of VAT recovery: according to binding regulations, taxable persons who are newly registered for VAT purposes in Poland (with regard to domestic or intra-community transactions) have limited chances of obtaining a refund of excess of input VAT.

Specifically, such taxpayers may benefit from the possibility to claim a VAT refund within shorter time periods (60, or even 25, days, instead of the standard 180 days) only if they make a security deposit of PLN 250,000 (approximately EUR 66,000) at a tax office.

The planned elimination of security deposits would facilitate the recovery of excess VAT by new (in particular foreign) investors.

According to the latest timetable released by the Polish Ministry of Finance, the preparatory work will not be concluded before May 2006 (at the earliest).

## 8. SPAIN

### 8.1 Bill on anti-avoidance tax measures

The Spanish Government has approved a Bill on anti-avoidance tax measures that will affect various taxes. The Bill will undergo passage through the Spanish Parliament in the next few months together with the forthcoming legislation reforming income taxes. The most significant proposals are as follows:

- The transfer pricing rules will be modified so as to (i) require the taxpayer to keep the corresponding documentation; (iii) somehow expand on the concept of “related entity”; (iv) amend the regulations on APAs; (iv) confirm the TNM method as an acceptable secondary method; (v) expressly regulate a secondary adjustment; and (vi) a penalty regime.
- Modifications will be made in the nonresident income tax area with respect to residents of countries classed as tax havens who obtain income or hold assets in Spain.
- The rules on transactions with related parties will be defined in a more precise way from a value added tax standpoint.
- New measures will be introduced for transfers of shares in real estate companies in the transfer tax area.

Although earlier versions of the Bill contained other internationally-oriented measures, they have not been included in the final version. However, it cannot be ruled out that they may be introduced in a later phase of the passage of the Bill through the Spanish Parliament or in the forthcoming legislation reforming corporate income tax.

### 8.2 Tax reform under way

On 10 March 2006, the Government approved the Tax Reform Bill. It has been laid before the Lower House of Parliament for debate. The Law should come into force on 1 January 2007.

The main reforms envisaged are as follows:

a) *Personal income tax*

- The maximum marginal rate is reduced by two percentage points, to 43 percent, and the scale will have four tax brackets, instead of five.
- All saving-related income will be taxed at a flat rate of 18 percent.

b) *Corporate income tax*

- The standard corporate income tax rate will gradually be reduced from 35 percent to 30 percent between 2007 and 2011, as will the rate for SMEs, which will fall from 30 percent to 25 percent.
- At the same time, all tax credits (except those relating to domestic and international double taxation) will be progressively phased out until there are almost none as from 2011. In particular, the R&D tax credit will be reduced more slowly than the rest of the tax credits and will be eliminated effective 2012, rather than 2011.

The tax credit for investments to establish companies abroad, which served as an incentive for internationalization applicable to investments in foreign companies that were not tax resident in the European Union, and which consisted of a temporary deduction from the taxpayer's tax base of the amount of the investment made, subject to certain limits, is eliminated effective 1 January 2007.

c) *Nonresident income tax*

The principal changes in this tax relate to tax rates. A distinction can be drawn between the rates applicable to income and/or gains obtained through a permanent establishment and those applicable to income and/or gains obtained other than through a permanent establishment.

- Income and/or gains obtained through a permanent establishment:

First of all, consistent with the reduction established for corporate income tax, the tax rate applicable to permanent establishments is reduced in the same proportion, namely, one percentage point per year from 2007 through 2011, to leave the rate applicable on or after 1 January 2011 standing at 30%.

Second, the same reduction (one percentage point per year) applies to permanent establishments engaging in oil and gas research and exploitation, which will be taxed at 35% from 2011 onwards (currently 40%)

Lastly, branch profit tax is increased by 3 percentage points to 18% (up from 15% at present).

- Income and/or gains obtained other than through a permanent establishment:

First, the standard tax rate (applicable, inter alia, to royalties, unless the reduced rate of 10% for certain EU payees applies) has been reduced by one percentage point to 24%, thus bringing it into line with the minimum rate applicable to the general component of taxable income for personal income tax purposes.

Second, the tax rate applicable to capital gains obtained by nonresidents has also been reduced to 18% (down from the current 35%), irrespective of their residence or of the type of asset transferred, so that it is also placed on the same footing as the rate applicable to resident individuals.

The third modification is an increase in the tax rate applicable to dividends and interest, which will now be taxed at 18%. It should be emphasised that this is the same tax rate as the rate applying to dividends derived by individuals resident in Spain.

Fourth, the withholding tax on transfers of real estate situated in Spain by nonresidents other than through a permanent establishment has been modified. At present, the purchaser is obliged to withhold and pay over to the tax authorities 5% of the sale price on account of the final tax liability of the nonresident seller; in the Bill this is reduced to only 3%.

### **8.3 Agreement between the Spain and U.S tax authorities extending treaty benefits**

The competent authorities of the United States and Spain have reached an agreement extending treaty benefits to limited liability companies (LLCs), Subchapter S corporations, and other flow-through entities.

The agreement operates under the U.S.-Spain income tax treaty signed in Madrid in 1990, as well as a related protocol, and deals with the interpretation of Article 26, which sets out a mutual agreement procedure for competent authority disputes.

Under the existing protocol, the term "any other body of persons" who are eligible for benefits is understood to include trusts, estates, and partnerships. The new agreement specifies that the term also is understood to include foreign and domestic LLCs. In addition, it applies to other entities treated as partnerships or disregarded as entities separate and apart from their owners for U.S. federal tax purposes.

Income from these business structures will be treated as being derived from a U.S. resident to the extent the income is taxable in the United States as earned by a U.S. resident.

## 9. SWEDEN

### 9.1 Amendments to the tax treaty between Sweden and the United States

The tax treaty between Sweden and the U.S. has undergone changes related mainly to withholding tax. According to the new wording of the treaty, the lowest treaty rate of withholding tax on dividends received by corporate entities is reduced from the previous 5% rate to a 0% rate. Eligibility for the zero withholding tax rate is conditional upon certain conditions imposed in the extensive Article 17 regarding *limitation on benefits*. Furthermore dividends to pension funds will, under certain circumstances, be subject to a 0% withholding tax rate.

### 9.2 Rules on division of companies

On 1 January 2006, a new Swedish Corporation Act was enacted. In contrast to the old Act, the new Corporation Act contains rules on spin-offs, i.e. the division of existing companies. The rules apply to two different types of spin-off; the first type is **the classic spin-off**, where the assets and liabilities of an existing company are transferred to two or more transferee companies in exchange for a consideration paid to the shareholders of the transferor company. The transferor company is

dissolved without going into liquidation. The second type is **the partial spin-off**, where a part of the assets and liabilities of an existing company are transferred to one or more transferee companies in exchange for a consideration paid to the shareholders of the transferor company. In a partial spin-off, the transferor company is not dissolved.

From an income tax perspective, rules on classic spin-offs have existed since 1999. The rules are based on the E.C. Mergers Directive and consequently stipulate a deferral of taxation based on the continuity principle. If loss carryforwards are also transferred, certain restrictions may apply. At shareholder level, taxation is normally deferred either as a result of the Swedish participation exemption rules being applicable, or as a result of the share-for-share exemption.

Income tax rules regarding partial spin-offs will be introduced as from 1 January 2007. Until then, official statements suggests that partial spin-offs should be viewed as a combined assets-for-share deal and dividend distribution from an income tax perspective. At least within the corporate sector, this means that a partial spin-off should be able to qualify for deferral both at company and shareholder levels, provided that certain conditions are met.

The rules on spin-offs supplement the existing, very favourable deferral rules regarding asset transfers at tax base values, providing Swedish companies with a full set of deferral rules for restructuring purposes. The main advantage of the spin-off rules, compared with existing deferral rules, is probably the possibility to transfer real estate without having to pay 3% stamp tax. The expectation is therefore that it will become a commonly-used tool in the real estate industry.

### 9.3 Transfer pricing documentation requirements

Swedish tax law presently does not impose any specific transfer pricing documentation requirements. However, in the Finance Bill for 2006 the Government has stated that it intends to present a Bill during 2006 on compulsory documentation requirements for transfer pricing purposes.

It is suggested that all members of a group of companies, which include non-Swedish companies and Swedish companies controlled by foreign persons, should be covered by the documentation

requirement. It is further suggested that Swedish permanent establishments (PEs) or foreign PEs of Swedish companies should not, for the time being, be required to keep documentation.

It is proposed that the type of documentation should be based on the OECD guidelines and should generally consist of:

- a description of the company and its business;
- the scope and character of intercompany transactions;
- a functional analysis;
- a description of the chosen methods for determining transfer prices; and
- a comparable analysis.

It is not likely that the documentation will have to be filed with the tax return, but rather that it will have to be produced upon request. No specific transfer pricing penalties are proposed. The existing penalties will apply also to transfer pricing adjustments.

#### **9.4 Foreign tax credits for indirect holdings**

In the past, Swedish companies ran into difficulties when they held interests in Swedish or foreign partnerships, and where the partnerships were subject to foreign taxes. Under the Swedish rules on foreign tax credits, only a person liable to tax in Sweden on a certain item of income is allowed to credit the foreign tax relating to that income. From a Swedish perspective, although partnerships are normally considered to be fiscally transparent, they are still often treated as legal entities. The effect of these principles has been that when a foreign tax has been levied on a partnership, the Swedish partner of the partnership has been taxed in Sweden on its share of the partnership income, but has not been able to credit the foreign tax paid by the partnership.

This anomaly has now been corrected. A new piece of legislation has been enacted which allows a Swedish company to credit the taxes paid by certain foreign or Swedish partnerships, of which the Swedish company is a partner. The new legislation entered into force on 1 January 2006, but will be applicable to years of assessment starting from 2000 (1999 fiscal year). This means that there may be refunds available for Swedish companies that have been disallowed a tax credit in previous years.

## **10. SWITZERLAND**

### **10.1 Radical simplification of Swiss VAT?**

The Federal Department of Finance (FDF) is currently preparing a consultation paper with the objective of radically simplifying the Swiss VAT system. The goal of the FDF is to eliminate most VAT-exempt supplies and to introduce only one single VAT rate (currently Switzerland applies three different VAT rates). The presentation of the final draft of this paper is scheduled for July 2006.

### **10.2 Capital issuance tax**

Swiss capital issuance tax is levied on share issues and other capital contributions to Swiss corporations. The tax rate is 1%. Since 1 January 2006, the exemption limit has been increased from CHF 250,000 to CHF 1,000,000, which means that no Swiss capital issuance stamp tax is due on the first CHF 1,000,000 of capital.

### **10.3 Reporting procedures for dividends paid to foreign companies**

Since 1 January 2005, Swiss stock corporations have been able to fulfill their withholding tax obligations for dividends paid to their non-domestic parent company by making a report instead of paying the tax and then claiming a refund. The Swiss stock corporation must request permission to use the reporting procedure from the Federal Tax Administration (FTA) before the dividends become due (form 823 / 823B). Before such requests are approved, the following conditions must be met:

- The non-domestic payee must be a stock corporation with a beneficial entitlement.
- The non-domestic payee must be domiciled in a State with which Switzerland has signed a tax treaty. It must qualify for the corresponding treaty entitlement.
- The non-domestic payee must own a significant stake, on the basis of which it is qualified in accordance with the corresponding treaty to claim an additional or comprehensive release from the withholding tax. Insofar as the treaty does not contain a corresponding provision, the non-domestic stock corporation must directly own at least 20% of the capital.

#### **10.4 Swiss corporate tax rates still falling**

Over the past few years, the level of Swiss corporate taxation has been lowered continuously. Federal tax has come down to a level of 7.83% and a further reduction is proposed, bringing it down to approximately 7.4% in the course of the next reform (not yet finalized). In addition, most Cantons have followed suit in the past years with the last remaining Cantons completing their reforms this year or the next.

Currently all Cantons, bar one, offer combined Cantonal / Communal and Federal rates that do not exceed a 25% top rate. A number of Cantons have already reduced their top tax rate to between 17% and 20%.

#### **10.5 Lump-sum cost deductions for business outside of Switzerland abolished**

Until 30 June 2005 Swiss corporations were entitled to claim lump-sum cost deductions for certain foreign trade and commission transactions instead of having to justify each individual cost item (generally by using a special tax ruling received from the FTA, called the 'fifty-fifty ruling'). Also in response to pressure from the OECD, as of 1 July 2005 the FTA no longer issues such tax rulings. Therefore, all costs have to be commercially justified and have to be documented by the company. Grandfathering for existing 50/50 situations is granted up to 2007/08.

# COURT CASES AND RULINGS

## A) EUROPEAN UNION

### 1. "ABUSE OF RIGHT" – HOW IT APPLIES TO VAT – THE HALIFAX CASE

On 21 February 2006, the European Court of Justice (ECJ) gave its judgments in three cases referred to it by the VAT and Duties Tribunal of the United Kingdom. All three cases involved challenges made by the United Kingdom tax authorities against tax planning transactions. The most important judgment was that relating to the case of *Halifax and Others* (C-255/02), perhaps the most significant VAT Court Judgment in the 33 years since VAT was introduced in the UK, as it outlined the approach of the ECJ towards transactions in which "abuse of right" is alleged.

#### a) *Background*

The Halifax case concerned a planning scheme introduced to allow recovery of VAT on the development of property for a bank. The bank was partly exempt and its normal rate of VAT recovery was about 5%. By careful timing and the careful structuring of a series of transactions involving related entities, the bank was able to recover 100% of the VAT incurred on the development.

The United Kingdom tax authorities challenged the claims for repayment of tax. They argued that when a transaction was undertaken solely for reasons of tax planning it was not an economic activity, so that no right arose to credit for VAT paid. This argument was accepted by the VAT and Duties Tribunal; nevertheless, the question of whether this was the correct approach was referred to the European Court of Justice. The Tribunal also asked for guidance concerning the application of the concept of "abuse of right" to the E.C. VAT system.

#### b) *Decision of the Court*

The ECJ supported the conclusions reached by the UK authorities and the VAT Tribunal, but took a slightly different approach. The ECJ pointed out that the transactions constituted supplies of goods or services and an economic activity, even though they were carried out with the sole aim of obtaining a tax advantage, without any other economic objective.

However, the ECJ decided that although the European VAT legislation does not require a business to choose a route which results in it paying the highest amount of VAT, it does not confer a right to deduct input tax where that right arises from an abuse of the rules.

The ECJ outlined a two-stage test to determine if there is abuse: firstly, that the transactions concerned result in a tax advantage contrary to the purpose of the VAT law and, secondly, that the essential aim of the transactions is to obtain a tax advantage. The ECJ also endorsed the opinion of the Advocate General that where there is an explanation for the transactions other than obtaining a tax advantage, then the arrangements should not be seen as abusive.

The ECJ concluded that if abuse is found, then the transactions must be redefined to the situation that would have existed in the absence of the abusive transactions.

#### c) *Practical consequences*

There can be little doubt that the tax authorities will be very satisfied with this Judgment. However, there remains some good news for taxpayers.

Firstly, the ECJ states that a finding of an abusive practice must not lead to a fiscal penalty, and that where transactions are redefined, then any restricted input tax or declared output tax must be taken into account so that the business is in no worse a position than if the abusive transactions had not taken place.

This statement removes a large part of the potential downside risk for a business contemplating entering into a transaction aimed at reducing its VAT cost. It will not, therefore, be welcomed by the UK VAT authorities, who have been at pains to warn businesses about the penalties they will face if they try to avoid VAT.

Secondly, the ECJ has emphasised that businesses are entitled to structure their affairs in a way which can limit their VAT costs, and that doing so will not be regarded as abusive where a tax advantage is not the only explanation for entering into a transaction. The ECJ states that it is for the national courts to determine if abuse has taken place, and that the national courts must take account of the guidelines the ECJ has provided.

In conclusion, the Judgment does not signal the end of VAT planning, but it does provide a watershed, and provides clearer guidance on what types of planning will fail, and which may succeed. It also seems clear that the more aggressive planning schemes will not survive. However, sensible structuring of transactions in conjunction with an underlying business purpose should not be at risk.

## 2. THE BOND HOUSE CASE

The ECJ ruled on the "Bond House" case on 12 January 2006. The case concerned a type of VAT fraud known as "Carousel Fraud" or "Missing Intra-Community Trader Fraud", and is estimated to have cost up to £11bn in the past five years.

Carousel Fraud exploits the fact that trading between EU Member States is effectively VAT-free. Criminals buy high-value items such as mobile phones or electronics VAT-free in the EU, which they then sell on in the UK, charging the next customer the extra VAT. The criminal trader then fails to pay the VAT.

Frequently the goods pass through several parties in a series of transactions in a cycle or "carousel", which may involve innocent parties who are unaware of a fraud taking place elsewhere in the chain.

Since 2002, the UK VAT authorities has taken a heavy-handed approach to tackling this fraud, by withholding VAT refunds from traders in certain industries (principally mobile phone and computer chips), based on the premise that where a "missing trader" exists somewhere in the supply chain, then there is no economic activity anywhere in the chain.

The ECJ ruled that the withholding of VAT refunds by the authorities is illegal, unless it can be established that the trader concerned knew, or had 'any means of knowing', that a transaction formed part of a chain involved in VAT fraud.

As a result, the UK VAT authorities must now refund the three companies who brought the case nearly £40 million of VAT. However, this is likely to be only the tip of the iceberg as many other innocent traders have also suffered their VAT refunds being withheld for years, and they will now be seeking what is rightfully owed, plus interest.

## 3. ECJ DECISIONS IN RELATION TO GERMANY

### a) *Taxation of profits of German branch*

The ECJ ruled in its judgment of 23 February 2006 that it is contrary to freedom of establishment if a national law provides for a different taxation of the profits of a branch of a company having its seat in another Member State from those of a subsidiary of such a company.

The ECJ held that the action brought by the Luxembourg company CLT-UFA, now part of the RTL Group, was founded. In 1994, the company had to pay taxes at a rate of 42% instead of 30% due to the fact that it held a branch in Germany and not a subsidiary. If the Luxembourg company had carried on its activity in Germany in the legal form of a limited liability company or public limited company having its seat or its central administration in Germany it would have been treated differently and more favourably. This imposition of differing tax rates, however, is now held to be discriminatory and an infringement of the right to freedom of establishment.

This ECJ judgment is relevant for any cases before 2001; the different tax rates were abolished in 2001 and the uniform tax rate has been 25% since then.

### b) *German provision on "negative foreign-source income" contrary to E.C. law*

The dispute before the German courts involved individuals employed as teachers in a German state secondary school who claimed that rental income losses relating to their private dwelling in France should be taken into account for determining their income tax liability in Germany. Under the national legislation (German Income Tax Act of 1987), positive income deriving from the use of a dwelling situated abroad is taken into account for the purposes of determining the rate of taxation; in the absence of such positive income, no account is taken of income losses of that type. In contrast, individuals working and residing in their own homes in Germany would have been entitled to have income losses relating to the use of their homes taken into account for determining their income tax rate.

The ECJ therefore held in its judgment of 21 February 2006 that it is contrary to Community law if national legislation does not permit individuals in receipt of income from employment in one Member State and liable to tax on their total income there, to have income losses relating to their own use of a private dwelling in another Member State taken into account for the purposes of determining the rate of taxation applicable to their income in the former State, whereas positive rental income relating to such dwelling is taken into account.

#### 4. THE IRAP CASE

On 14 March 2006, Advocate General Stix-Hackl delivered a second opinion in the case raised by *Banca Popolare di Cremona v. Agenzia Entrate Ufficio Cremona* (C-475/03) regarding the compatibility of the Italian regional tax on productive activities (IRAP) with Art. 33(1) of the Sixth VAT Directive, which prohibits the EU Member States from introducing or maintaining taxes, duties or charges in the nature of turnover taxes.

The first opinion was delivered by Advocate General Jacobs on 17 March 2005. In that opinion IRAP was considered incompatible with the Sixth VAT Directive. The second opinion reached very similar conclusions to the ones expressed in the first one on the incompatibility of IRAP with the Sixth Directive, where the tax was already considered to be in breach of the Directive. This issue was not actually debated after the first opinion, nor was it deemed necessary to reopen the procedure to discuss it further.

The new conclusions, however, suggest to the national referring Court a further condition to be ascertained to assess the incompatibility of IRAP with the Sixth Directive, that is, whether, for a representative sample of businesses subject to both VAT and IRAP, the ratio between the amounts paid in VAT and the amounts paid in IRAP is substantially constant.

Indeed, the most awaited conclusion on the case was that regarding the temporal effects of the future decision to be taken by the Court.

The opinion of Advocate General Stix-Hackl analyses the relevant precedents in the Court's case law regarding the temporal limitation of the effects of its preliminary rulings; in particular, besides the *ex tunc* and *ex nunc* effect, the opinion makes reference to the new approach proposed by

Advocate General Tizzano in his opinion on the pending *Meilicke* case, and suggests the possibility to set a future date from which the preliminary ruling can be relied on.

Therefore, on the basis of the consideration that the case under discussion deserves a limitation of the temporal effects of the future decision of the Court, and, in particular, that a future effect is the appropriate approach in the specific circumstances of the case, AG Stix-Hackl concludes that the ruling of the Court may not be relied on before the end of the tax period current when the Court's judgment is delivered. That would enable Italy to replace IRAP with a different, EC law compatible, financing mechanism in a smooth and effective manner.

From a practical point of view, the most important consequences would, however, derive from the decision that the Court will take on the issue whether any exception will be made in favor of claims raised by the taxpayers for the refund of IRAP before a certain date. Indeed, an impressive number of claims have been filed in Italy for the refund of IRAP, although whether they will actually succeed is still unpredictable.

In this respect, AG Stix-Hackl identified the criteria that should be satisfied in the choice of the date relevant for the exception to the temporal limitation of the effects of the ruling of the Court, as follows:

- the date should be chosen in a manner that is as objective as possible;
- the date to be chosen should be one that ensures a different treatment, on the one hand, to the "genuine" earlier claims, brought in the belief that they were well founded, but nonetheless at some risk in view of the uncertainty of their outcome, and, on the other hand, to the "speculative" claims brought at a later date in the light of a perceived probability of success;
- the date should make it possible to substantially dispose of the problem posed by the extremely large number of claims.

On the basis of such criteria, the date of delivery of Advocate General Jacobs's Opinion, i.e. 17 March 2005, is identified as the least arbitrary and most objective date.

This means that the claims for a refund submitted prior to 17 March 2005 will be satisfied, on the basis of the interpretation suggested by AG Stix-Hackl, if IRAP is definitively held to be incompatible with the Sixth Directive.

Yet, the second opinion by AG Stix-Hackl is not totally clear on one point, which will have -if the opinion as drafted is followed by the Court- a strong impact on the application of the interpretation to be given with the ruling.

In fact, the claims which will be satisfied under the interpretation proposed by AG Stix-Hackl are referred to as “*legal proceedings or (...) equivalent administrative claim*”. In this respect, it is not totally clear whether a literal interpretation should be given to such terms, *rectius* to the Italian official translation of such terms, or rather an extensive interpretation based on the rationale of the interpretation proposed by AG Stix-Hackl.

In the first case, a literal interpretation would imply that the refund can be obtained solely where a jurisdictional proceeding has been started, i.e. solely where a claim has been submitted to a judge.

In the second case, i.e. where an extensive interpretation is adopted, the refund could be obtained also by those taxpayers who merely filed a request for a refund with the competent tax authorities. Indeed, such an interpretation would satisfy the perceived need to distinguish between earlier “genuine” claims and “speculative” later claims.

Such issue will be very likely solved either by the ECJ in deciding the ruling, or by the Italian referring Court, which is ultimately competent to decide whether and how the Italian laws establishing IRAP will apply.

## B) COUNTRIES

### 1. INDIA

#### Indian Advance Ruling Authority rules on permanent establishment (“PE”) constitution

Morgan Stanley and Co Inc., U.S. (“Applicant”) submitted an application to the Advance Ruling Authority (“AAR”) in India for a ruling on whether a PE would be constituted in India as a result of its Indian group company rendering support services

to it, and on whether sending its people to the Indian group company for “stewardship activities” for short stays and assigning people to India for longer stays (in both cases more than 90 days) would constitute a “Service PE” in India. The Applicant also asked the AAR whether the Transactional Net Margin Method used by it for determining the arm’s-length price for the transactions between itself and the Indian company would be the most appropriate method from an Indian transfer pricing perspective and whether the margin determined by the transfer pricing study was appropriate. The Applicant sought a ruling on whether, if there was a PE, there would be a further attribution of income to the PE if the transactions were performed at arm’s length.

Based on the facts presented to it, the AAR ruled that the Indian company would not constitute an “Agency PE”; however, the presence of employees for “stewardship activities” and the assignment of personnel to India for longer stays would constitute a “Service PE” of the Applicant in India. In arriving at this conclusion, the AAR observed that although the employees were present in India to set and implement Morgan Stanley’s group standards, the benefit of the employees’ activities was available to the Indian company. The AAR did not rule on the question pertaining to the appropriateness of the transfer pricing method used and the margin thus determined, stating that the AAR’s brief did not include ruling on what was the fair value of property involving intangible services and tangible properties. The AAR, however, did rule that if the transactions were at arm’s length (as determined by Indian transfer pricing provisions), no further income could be attributed to the PE in India.

While the ruling on most of the issues and, specifically, on the existence of a “Service PE” may be widely debated, the AAR’s ruling that there will be no attribution of income to a PE if the transactions are at arm’s length will provide much-needed comfort specifically to captive Business Process Outsourcing (“BPO”) entities in India.

### 2. LUXEMBOURG

#### 2.1 Municipal Business Tax may not be reduced by foreign tax credits in Luxembourg

In 2003 a Luxembourg-resident company received a tax assessment for 1998 from the Luxembourg tax authorities, pursuant to which the company was

disallowed the right to credit the Spanish withholding tax it had incurred against the Luxembourg municipal business tax (MBT). The company brought an action at the Luxembourg Administrative Tribunal. At first instance, the Tribunal decided (on 11 July 2005, 18793 & 19298) that the Spanish withholding tax could be credited against the Luxembourg MBT. The tax authorities appealed against this decision and the Administrative Court overturned (on 17 January 2006, 20316 C) the Administrative Tribunal's decision.

Spanish-source income received by a Luxembourg-resident company is subject to Spanish withholding tax. According to the Luxembourg taxpayer, the tax treaty concluded between Spain and Luxembourg (the "Treaty") allowed the Luxembourg company to credit the Spanish withholding tax against its Luxembourg corporate income tax ("CIT") as well as against the Luxembourg MBT.

The Luxembourg-resident company was disallowed the right to credit the Spanish withholding tax it had incurred against its Luxembourg municipal business tax burden by the Luxembourg tax authorities, which argued that MBT was not covered by the Treaty.

MBT is only levied on income from commercial, industrial, mining and skilled craft activities carried on in Luxembourg. The Luxembourg tax authorities based their refusal to allow the Spanish tax to be credited against the Luxembourg MBT, on the ground that MBT was levied by them on behalf of the Luxembourg municipal authorities. The municipal authorities were not, however, party to the tax treaties signed by the Luxembourg Government. As a result, they should not suffer a loss of revenue by allowing Luxembourg-resident companies to credit Spanish withholding tax against MBT.

In the opinion of the Luxembourg Administrative Tribunal, the Treaty clearly stated in Article 2.1 that "This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied."

Furthermore, the Tribunal noted that a municipal authority was not an independent body, but rather a subdivision of the Luxembourg State. In this respect, municipal authorities could be considered to be covered by the wording "local authorities or political subdivisions." It followed that tax credits

derived from the Treaty could be credited against MBT in Luxembourg.

However the Luxembourg Administrative Court held that the wording of Articles 23A and 23B of the OECD Model Convention did not provide for detailed rules on how to apply the tax credit provided by the Treaty.

Furthermore Article 3.2 specified that anything not covered by the Treaty would be treated in accordance with domestic law. These Articles only applied to personal and corporate income taxes, and not to MBT. In conclusion, the Luxembourg Administrative Court decided that the company could only credit the Spanish withholding tax against its Luxembourg corporate income tax, and not against MBT, as the method referred to in the Treaty only applied to CIT.

## 2.2 Application of Parent-Subsidiary Directive to Luxembourg SICAVs

The Finnish Central Tax Board (*Keskusverolautakunta*, or KVL) made an advance ruling on 25 January 2006 (KVL 2/2006) regarding Finland's right to levy, under E.C. law, withholding taxes on Finnish-source dividends received by a Luxembourg SICAV from its 100%-owned subsidiary in Finland.

The KVL disallowed the application to SICAVs of the parent-subsidiary regime on the ground that SICAVs are not referred to in the Annex to the E.C. Parent-Subsidiary Directive (90/435/EEC) and do not pay corporate tax in Luxembourg. The KVL therefore considered that SICAVs do not qualify for the exemption from withholding tax under the Finnish domestic rules implementing the Directive.

The taxpayer relied on the fundamental freedoms under the E.C. Treaty in its submissions. It reasoned that the E.C. Treaty precluded Finland from imposing withholding taxes on the dividend, as similar dividends received by Finnish resident limited liability companies or mutual funds would have been tax free. The KVL ruled that for Finnish purposes, a Luxembourg SICAV is similar to a Finnish limited liability company (*osakeyhtiö*), rather than, for example, a mutual fund, but that due to the differences between these two legal forms, the situations of resident and nonresident taxpayers were not objectively comparable. As a consequence, the E.C. Treaty would not prohibit Finland from levying withholding taxes on the dividends received by the SICAV.

The case may be appealed by the taxpayer to the Finnish Supreme Administrative Court, which could then decide to refer the case to the ECJ.

### **3. SPAIN**

#### **3.1 Valid economic reasons. Special regime for restructuring transactions: certain administrative management reasons**

The Revised Corporate Income Tax Law (the “TRLIS”) establishes that the tax neutrality regime for business restructuring transactions will not be applicable where the transaction is not performed for valid economic reasons, but rather for the mere purpose of achieving a tax advantage.

The applicability of the regime had traditionally been questioned where a company with tax losses was involved in the restructuring transaction.

In this connection, the Directorate-General of Taxes (the “DGT”) recently made a ruling on 19 September 2005, in a case where a family resident in Belgium sought to unify under one company the activities of all of its Spanish subsidiaries, one of which had tax losses.

In the ruling, relating to a transaction involving an exchange of securities between companies engaging in different activities, the DGT pointed out that “*resizing the business, unifying the administration and management of the entities, keeping one set of accounting records, reinforcing the financial structure, and impeding the dispersal of the family’s assets in Spain,*” were considered to be valid economic reasons, and the existence of tax losses had no adverse effect at all.

#### **3.2 Nonresident shareholders and joint ventures**

Spanish tax legislation contains a special tax regime for certain unincorporated joint ventures (JVs), whereby they pay corporate income tax only on the portion of their tax base which corresponds to members that are not resident in Spain. In contrast, the portion of the tax base attributable to resident members is directly attributed to them and they are taxed on it.

Since the legislation does not draw a distinction between residents that operate directly and nonresidents that operate through a permanent establishment, this may give rise to doubts

regarding the compatibility of the legislation with tax treaties that have a clause similar to Article 24(3) of the OECD Model Convention, given the different tax treatment of the members of a JV depending on whether they are resident companies or permanent establishments of nonresidents situated in Spain.

The DGT had already recognized the existence of discrimination when a permanent establishment incurred tax losses and the JV obtained income, or vice versa, since the failure to attribute to the permanent establishment the income obtained by the JV did not allow it to offset one against the other, unlike the situation with members resident in Spain.

In its ruling of 7 December, 2005, the DGT examined the existence of discrimination in two new cases relating to a JV and a permanent establishment of a company resident in Germany:

- Where both the JV and the permanent establishment generate income, and the latter is entitled to take tax credits, but cannot because the limit imposed by law is exceeded: in such case, the DGT recognized the existence of discrimination and allowed the income of the JV to be attributed to the permanent establishment, thereby raising the legal limit for taking the tax credits.
- Where both the permanent establishment and the JV incur tax losses: in this case the DGT pointed out that no discrimination was found by reason of the PE not being able to increase its tax losses by including those from the JV. However, discrimination could exist in a future year, if either the permanent establishment or the JV generated income and if in that year the relevant attribution of income to the PE did not take place. In such case, the income should be attributed pursuant to the interpretation commented on above.

#### **3.3 Calculation of the tax base of a foreign permanent establishment**

In a Decision of 30 November 2005, the Central Economic-Administrative Tribunal (TEAC) analyzed an issue that had traditionally been doubtful in Spanish tax law: pursuant to what legislation must the income of a permanent establishment (situated in Portugal) be determined for the purposes of calculating the tax base in Spain and applying the rules for the elimination of

the international double taxation of the Spanish head office?

The TEAC took the view that where the tax treaty provides that *“there shall ... be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise, ... and dealing wholly independently with the enterprise of which it is a permanent establishment,”* it is treating the permanent establishment as an enterprise which is resident in Portugal and the tax base of which is therefore calculated pursuant to the legislation of the country where it is situated.

Therefore, the TEAC concluded that the taxable income obtained by the PE for Spanish corporate income tax purposes must be the same as that established in accordance with Portuguese legislation, and that the Spanish tax authorities could not make attributions or adjustments to such taxable income.

This issue had already been discussed by the Supreme Court, in two judgments on 26 June 2000 and 18 September 2002, relating to the application of the rules eliminating Spanish double taxation and the Spain-Brazil tax treaty, and the line taken by the Supreme Court in those judgments has now been followed by the TEAC (a body forming part of the structure of the Spanish tax administration).

## SPECIAL FEATURE: THE MARKS & SPENCER CASE

Perhaps it is early to define the scope and importance of this ECJ decision, or to ascertain whether it will mark a shift in what has been the ECJ's position until now. In any case, or perhaps because of this, we think that it is interesting to set forth below the various implications that the decision may have in five different jurisdictions (namely, the U.K., France, Germany, Italy, Spain and the U.S.), bearing in mind their diverse national laws and systems.

### 1. UK GOVERNMENT REACTION

As detailed in Issue 1 of this Newsletter, in the recent Marks & Spencer case, the ECJ ruled that the losses of overseas subsidiaries can, in certain circumstances, be utilized in the UK under the UK's group relief loss rules.

The UK Government has reacted to this defeat by announcing legislation to deny loss relief where there are arrangements which either:

- result in losses becoming unrelievable outside the UK that were otherwise relievable; or
- give rise to unrelievable losses which would not have arisen but for the availability of relief in the UK;

if the main purpose, or one of the main purposes, of those arrangements is to obtain UK relief.

According to the UK Government, this legislation has been introduced because it has come to their attention that some tax advisers have been suggesting that groups with an EU loss-making company should prevent the loss-making company obtaining relief in its own country by, for example, liquidating that company whilst transferring its business to another company.

### 2. TRANSPOSITION OF THE DECISION IN THE CASE OF FRANCE

An issue has arisen regarding the possible transposition of this decision to the case of French parent companies of consolidated tax groups.

Unlike the English system of group relief, the French system of tax consolidation does not

involve the transfer of losses between companies that form part of the same group.

The French system of tax consolidation involves adding together the taxable income/tax losses generated/incurred by companies that form the same consolidated tax group in order to calculate consolidated taxable income at group level, with the tax calculated on the basis of consolidated income being paid by the group's parent company.

As a consequence, the transposition of the Marks & Spencer decision (particularly the view that exclusion from group relief is contrary to the principle of freedom of establishment prevailing in the EU) means that it would be necessary to be able to include within the scope of a French consolidated tax group companies that are resident in other EU Member States, i.e., it would mean taxing in France the income of nonresident companies.

However, as with any country, France does not tax the income of nonresident companies that do not carry out any operations there.

There is therefore no certainty that the ECJ would cite the principle of freedom of establishment in the case of the French system of tax consolidation.

In the event that the French system were deemed to contravene the principle of freedom of establishment, the ECJ would have to accept the same restrictions as those applied under the English system of group relief and conclude from this that only where a nonresident subsidiary has exhausted all possibilities for using its losses locally that such losses can be used by the French parent company of the consolidated tax group.

It should be noted that, for a long time now, French companies have had the possibility of taking into consideration the losses incurred by their foreign subsidiaries through the mechanism of subsidies and cancellations of receivables.

In fact, the scope of application of this mechanism is even wider than that under the M&S decision inasmuch as it makes it possible to take into account losses incurred by subsidiaries that are resident in another Member State and that may be taken into account locally, in particular within the scope of the local system of tax consolidation.

On the other hand, this mechanism may prove to be more restrictive in certain situations (the amount of losses incurred by foreign subsidiaries being taken into account to the extent of an amount

limited to the negative shareholders' equity of such subsidiaries – the system of cancellation of receivables and subsidies of a financial nature).

### 3. IMPLICATIONS OF THE M&S CASE IN GERMANY

In contrast to UK tax law, which allows for group relief, in Germany, profits and losses within a group of companies may be offset by way of fiscal unity. Fiscal unity may be established if:

- the parent company holds more than 50% of the voting rights in a corporation;
- the subsidiary has its registered office and place of management in Germany; and
- the affiliates have entered into a profit transfer agreement that is effective for at least five years. To come into effect the profit transfer agreement has to be entered in the commercial register at the registered office of the subsidiary.

Although the system of fiscal unity differs from the system of group relief, the Marks & Spencer case *does* have an indirect impact on the German system of fiscal unity, highlighted as follows:

#### a) *Subsidiary with registered office in Germany*

The fact that German law restricts the applicability of fiscal unity to subsidiaries with their registered office and place of management in Germany could constitute a restriction on freedom of establishment, as a foreign subsidiary may not be used as subsidiary company (*Organgesellschaft*). Consequently, pursuant to current German law, a domestic parent company is generally, and without exception, denied the possibility of offsetting losses incurred by a foreign subsidiary against its domestic profits, which is at odds with the principles set forth by the Court in the Marks & Spencer case.

#### b) *Conclusion of profit transfer agreement*

The requirement of having to enter into a profit transfer agreement could also constitute a restriction on freedom of establishment because it is difficult, if not legally impossible, to conclude a profit transfer agreement with a foreign subsidiary for the following reasons: the profit transfer agreement needs to be entered in the

commercial register at the registered office of the subsidiary, something which is not always possible; provisions of foreign corporate law, e.g. provisions regarding restriction on distributions, may constitute an obstacle.

#### c) *Outlook*

It remains to be seen whether, and if so how, the German legislature will react to the Marks & Spencer case. One possible reaction could be, for instance, to waive the formal requirement of having to enter into a (not always feasible) profit transfer agreement, but instead to allow the affiliates to enter into a contractual obligation that provides for an assumption of (definitive) losses by the German parent company. However, if the requirements for establishing fiscal unity are not amended and the German finance authorities refuse to accept cross-border fiscal unity, legal certainty will only be achieved by a subsequent ECJ decision on the provisions governing German fiscal unity.

### 4. POSSIBLE IMPACT ON ITALIAN TAX LAW

The cross-border offsetting of losses is already allowed by Italian income tax law under the provisions governing so-called international tax consolidation. Nevertheless, even though the core issue in the preliminary ruling requested by Marks & Spencer was to decide on whether the cross-border offsetting of losses should be allowed in the absence of a specific provision where it is allowed domestically, some reasoning contained in the decision might have an impact on the Italian rules.

Indeed, in recalling a very well-established case heard by the ECJ, the Court observed that “even though, according to their wording, the provisions concerning freedom of establishment are directed to ensuring that foreign nationals and companies are treated in the host Member State in the same way as nationals of that State, they also prohibit the Member State of origin from hindering the establishment in another Member State of one of its nationals or of a company incorporated under its legislation.” With reference to the offsetting of losses, this means that, from the standpoint of the Member State of origin, an unjustified difference between the tax treatment of a resident company

with a local subsidiary and the tax treatment of a resident company with a subsidiary in another Member State, is not compatible with E.C. law.

Such a line of reasoning might have an impact on Italian income tax law, due to fact that, even though, as stated, the cross-border offsetting of losses is already allowed, the conditions required for enjoying domestic compensation differ from those for cross-border tax consolidation. Indeed, as far as domestic tax consolidation is concerned, the following requirements are imposed by the law:

- consolidation can be total, regardless of the percentage holding in the controlled subsidiaries;
- consolidation must not include all of the controlled subsidiaries of the group; and
- consolidation must be for a minimum duration of three years.

In contrast, cross-border tax consolidation is subject to the following, clearly more restrictive, conditions:

- consolidation must be proportional;
- it must be subject to “all in, all out” clause; and
- It must be for a minimum duration of five years.

In this respect, in light of the outcome of the Marks & Spencer decision, one might wonder whether there can be any justification, which might be considered to pursue a legitimate interest such as those accepted by the ECJ, and which can support the differences between domestic and cross-border tax consolidation as described above. If not, the Italian income tax law governing tax consolidation, as currently worded, might be held to be incompatible with the principle of freedom of establishment.

## **5. PRACTICAL IMPLICATIONS IN SPAIN**

Only Spanish resident companies are currently eligible for the special consolidated tax regime. Therefore, the Spanish Corporate Income Tax Law (the CIT Law) clearly conflicts with EU regulations, as interpreted by the ECJ in the Marks & Spencer case. So far, however, there has been no official reaction from the Spanish authorities, nor do the envisaged amendments for the CIT Law (set to enter into force in January 2007) include any reference to this matter. In any case, it can be anticipated that Spanish CIT legislation will need to be amended in order to allow Spanish parent

companies to claim group relief for the EU losses available under the test set by the ECJ (i.e., there must be no possibility of using the losses in the country of residence of the subsidiary).

Bearing the above in mind, we summarize below the practical implications that the judgment may for Spanish companies:

### *a) Possible use in other EU jurisdictions of losses incurred by Spanish subsidiaries*

In order to ascertain whether the Spanish losses are no longer available in Spain and, therefore, utilizable in the parent’s country of residence (the so-called “no possibility test”) the following rules must be taken into account:

- According to the Spanish CIT Law, tax losses can be carried forward (but not back) for 15 years. Special rules apply for newly-incorporated companies (the offset period is computed as from the first tax period in which net positive income is recorded).
- The appropriateness and amount of the tax losses, the offset of which is sought, need to have documentary support when the losses are offset after the 4-year statute-of-limitations period has expired.
- There is also an express rule that limits the amount of losses that can be carried forward in cases where there has been a change in control of the loss-making company and the company has not carried out any economic operations in the six months prior to the change in control.
- As a general rule, the right to use losses lapses when the company is dissolved, except in certain specific cases where a tax-neutral reorganization is carried out under the Spanish legislation implementing the E.C. Merger Directive (although subject to certain limitations, these transactions could give rise to the assignment of the right to offset tax losses to the transferee).

### *b) Possible use in Spain of losses incurred by EU subsidiaries*

At the present time, there is no guidance on how the “no possibility” test will be regulated in the Spanish CIT Law. It is, however, likely that the Spanish legislation will follow the restrictive approach already adopted by other EU Governments (e.g. the UK).

It should, nonetheless, be noted that although EU cross-border consolidation is not available in Spain (except for Spanish branches of foreign companies which can head Spanish tax groups), provisions for the decline in value of foreign (or domestic) subsidiaries are, as a general rule, tax deductible in Spain (thus anticipating the use of book—rather than tax—losses in Spain).

Such deductibility is available as long as the expense (provision) per the books of the parent company relates to the losses incurred by the subsidiary (e.g. the decline in value deriving from the amortization of goodwill—except for the acquisition of foreign subsidiaries qualifying for the participation exemption—or from the distribution of an exempt dividend would not be tax deductible).

Although the ECJ stated that group relief for the losses of an EU subsidiary is not possible where such losses can be used in the country of residence of the subsidiary (nothing is said as regards the “duplication” of losses in the country of the residence of the parent) it could be expected that any amendment to be introduced into the Spanish CIT Law for the purposes of allowing (limited) EU group relief would prevent—as is currently the case of “domestic” tax groups—the deduction of provisions for decline in value where the tax loss incurred by the subsidiary can be offset against the taxable income of the Spanish group.

## 6. US PERSPECTIVE

Believe it or not the Marks & Spencer case may have an impact on the U.S. tax liabilities of U.S. companies doing business in the EU. In fact, at a recent tax conference in the U.S., the IRS indicated that they were in the process of studying the impact that the case would have on U.S. companies.

The issue arises under the U.S. dual consolidated loss (DCL) rules which were originally designed to prevent the double dipping of interest by a company that is incorporated in the U.S., but is also tax resident in another country (the UK for example). The U.S. DCL rules generally do not allow a loss incurred by a dual resident company to be deducted in the U.S. if that loss can also be used to offset the income of another entity (other than the company which incurred the loss) outside of the U.S. For example the surrender of the loss to

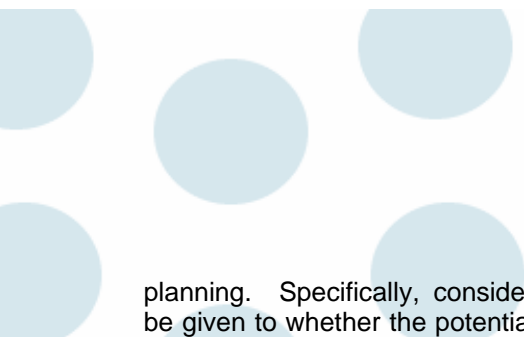
another UK group company. In certain situations however, a U.S. company can deduct a DCL if an election (referred to herein as the election) is made to indicate that the loss will not be surrendered, made available to, or otherwise used by another non-U.S. entity at any time. Violation of this election will result in an immediate tax liability in the U.S. for the tax on the loss, as well as the imposition of an interest charge on the tax due. It should be noted that the DCL rules also generally apply to branches, partnerships, and check-the-box hybrid entities where the loss incurred by the entity can potentially be used to offset the tax liability of another person under local tax law.

The DCL rules are extremely complex to apply in practice and there is a great deal of uncertainty about how the rules operate in certain situations. In order to help provide some clarity to the rules, a new set of proposed DCL regulations has recently been issued and it was in the context of discussing the proposed regulations that the IRS announced they were considering the impact of the Marks & Spencer case on U.S. companies.

To illustrate the potential U.S. tax issue raised by the case, consider the following situation. A U.S. parent company has a wholly-owned subsidiary in the UK. In addition to owning the UK operating subsidiaries, the UK subsidiary company also acts as a holding company for the group's subsidiaries in France, Belgium, and Germany. For U.S. tax purposes, check the box elections have been made for the UK holding company, as well as for its subsidiaries in France, Belgium, and Germany to treat each entity as a separate branch of the U.S. parent company. The entities in France, Belgium, and Germany each incur losses that are not available for offset against any other entity's income in that country.

Prior to the case, it would have been “normal” for the U.S. parent company to make the election to use the losses in the U.S. as they were incurred. Now, consideration must be given as to whether the loss could (or should) be used in another country. If it is decided to make the election and use the loss in the U.S., a monitoring mechanism must be established since a later use of the loss by another entity in a third country would violate the election and result in an immediate tax liability (plus interest charge) in the U.S.

Because of the Marks & Spencer case, U.S. companies with a presence in the EU and who have adopted check the box structures will now need to carefully review their tax loss utilization



planning. Specifically, consideration will need to be given to whether the potential use of a loss in a third country would be more beneficial than in the U.S. Additionally, if the election is made to use the loss in the U.S., the company's international tax plans will need to be closely monitored to ensure that the election is not violated at some future time. Finally, it is always possible that the IRS may alter the proposed regulations mentioned above to introduce rules dealing with the case.

## OTHER NEWS

### 1. EU NEWS

#### 1.1 Freedom of movement of capital in the EU

The ECJ rendered a Decision in the Bouanich case on 19 January 2006 (C-265/04). In that case, the ECJ analyzed the compatibility of Swedish tax legislation on a company's acquisition of treasury stock with the EU principle of freedom of movement of capital. The Swedish legislation does not allow nonresident shareholders to deduct the expenses relating to the acquisition of the treasury stock, unlike resident shareholders.

The ECJ recalled that, while direct taxation is within the jurisdiction of the Member States, they must exercise such jurisdiction observing EU law and that a transfer of shares to the issuing company, such as that by Ms. Bouanich, fell within the scope of EU rules on the freedom of movement of capital.

The ECJ stated that restricting the right to deduct to resident shareholders rendered the cross-border transfer of capital less attractive, as it discouraged investors who do not reside in Sweden from purchasing shares in companies resident in Sweden and restricted the possibilities of Swedish companies attracting capital from investors who do not reside in Sweden.

Therefore, the ECJ held that to deny nonresident shareholders the deduction of share acquisition expenses would constitute a restriction of the free movement of capital within the meaning of Article 56 of the E.C. Treaty that was not justified by any of the reasons envisaged in the EU Treaties.

#### 1.2 State Aid: Commission opens formal investigation into Luxembourg's 1929 tax-exempt holding companies

The European Commission has launched a formal investigation under E.C. Treaty state aid rules into Luxembourg's 1929 legislation exempting holding companies and financial companies from corporate taxation. The Commission is concerned that the 1929 legislation creates significant distortions in competition and market efficiency, particularly in the financial services industry, without contributing

to economic development to any significant extent. The inquiry will allow interested parties to comment on the measures under scrutiny. It does not prejudice the Commission's final decision.

#### 1.3 Spain referred to ECJ on the incompatibility of certain Spanish tax provisions with EU Law

On 16 January 2006, the European Commission announced its decision to refer Spain to the ECJ due to the incompatibility of certain provisions of Spanish tax law with EU law.

In particular, the referral relates to the 35% tax charged on capital gains obtained on real estate by nonresidents without the intermediation of a permanent establishment in Spain and the 25% tax charged on salary income received by nonresident taxpayers. In both cases, the tax treatment is more favourable if both types of income are obtained by residents for tax purposes in Spain.

Nonresident taxpayers pay a proportional rate of 35% on capital gains disclosed on the sale of real estate. Resident taxpayers, however, are subject to progressive tax rates if the real estate has been owned by the taxpayer for less than one year, and to a flat rate of 15% if the real estate is sold after having been owned for at least one year. Thus, nonresidents always bear a heavier tax burden if they sell their property after having owned it for one year.

Additionally, nonresidents are taxed at a minimum 25% rate on salary income, while resident taxpayers are taxed at a minimum 15% rate.

The Commission considers that, in both cases, Spanish tax legislation contravenes the principles set forth in the E.C. Treaty and, in particular, the principle of nondiscrimination.

However, as mentioned earlier in this Newsletter, the Tax Reform Bill introduces, among other measures, amendments to the Spanish tax system, in order, according to the Preamble of the Bill, "to bring its provisions into line with EU law." Those measures include a lowering of the tax on nonresident capital gains to 18%, and an increase in the minimum tax rate for residents to 24% (the same rate applying to nonresidents deriving salary income), effective 1 January 2007. The effect of this reform on the referral by the Commission is still unknown.

## 2. SPAIN

### Proposed measures to combat VAT fraud

Spain has requested authorization from the Council to apply a derogation from the Sixth Directive under Article 27(1) in order to provide that the taxable amount of a supply of goods or services, or of an intra-Community acquisition of goods, will be the open market value where the consideration agreed on between related parties is significantly lower than open market value and the recipient of the supply or the acquirer does not have a full right of deduction under Article 17 of the Directive. The aim of this measure is to counter tax avoidance or evasion.

The Commission submitted its proposal to the Council to authorize this derogation on 23 December 2005. If finally authorized, the measure would expire on the date of entry into force of the Directive and would streamline the derogations pursuant to Article 27 of Directive 77/388/EEC, which counter avoidance or evasion of value added tax by valuing supplies between connected (i.e., related) persons, or on 31 December 2009, whichever is the earlier.

This measure is included in new draft legislation to combat VAT fraud or evasion.

Together with the above-mentioned rules, the Bill establishes that taxable persons receiving goods or services will be secondarily liable for the VAT due on transactions where they may reasonably assume that the VAT charged has not been paid over.

In this connection, taxable persons will be held liable if they obtain an "extraordinary benefit," that is, they have paid a price for the goods or services that is clearly anomalous, unless there are reasons based on economic factors other than the underpayment of VAT.

## 3. UNITED STATES

### Do you have all the information you need on your international transactions to comply with the tax shelter reporting requirements?

#### *a) Don't be swallowed up by the treaty based return reporting requirements*

Although we have recently passed the 15 March corporate tax deadline, we thought it would still

be a useful reminder to highlight the need for many non-U.S. companies to file an annual treaty-based return with the IRS to report that, although the non-U.S. company may have a trade or business in the U.S. under U.S. domestic tax law, it does not have a permanent establishment (PE) under an applicable income tax treaty. In fact, it is our experience that, with the explosion of global business activities in the past few years, the treaty-based return filing requirements may be one of the most often misunderstood and uncertain rules in the entire tax law.

This part of the Newsletter will also walk through the various requirements and issues surrounding treaty-based returns and then set out an action plan to help ensure the costly penalties that could potentially be imposed are not imposed. We will also briefly discuss the ability of the IRS to tax a foreign corporation on gross income, rather than net income, if its tax return is not accurately filed. In fact, a recent Tax Court case, *Swallows Holding Ltd*, involved a situation where the taxpayer challenged a regulation requiring that the tax return of a foreign corporation be filed within specified time limits in order to be eligible to claim deductions against its U.S. taxable income and avoid taxation on its gross (rather than net) income in the U.S.

#### *b) Treaty based return filing requirements*

Under U.S. domestic tax law, a foreign corporation will have a taxable presence in the U.S. if it is determined that the corporation conducts a trade or business in the U.S. In the instance where a foreign corporation conducts a U.S. trade, the income that is effectively connected with that business is taxable in the U.S.

In general, a foreign corporation is required to file a U.S. federal income tax return in the U.S. for each year in which it has a U.S. trade or business, regardless of whether there is any income effectively connected with that business. Conversely, no tax return would generally be required if the foreign company does not conduct a trade or business in the U.S.

In the instance where a foreign corporation takes a position that it does not have a PE in the U.S. under an income tax treaty, but does potentially conduct a trade or business in the United States it is generally required to file a

treaty-based return with the IRS for each year in which the treaty position is claimed. The purpose of this treaty-based return is essentially to notify the IRS that the corporation is engaged in some activity in the U.S. which constitutes a U.S. trade or business (and is thus potentially subject to tax in the U.S.), but the treaty exempts the company from tax in the U.S. because it does not maintain a permanent establishment.

In order to prepare a treaty-based return, the foreign corporation is required to file Form 1120F (U.S. Income Tax Return of a Foreign Corporation). In completing Form 1120F only the administrative information on page 1 of the return, along with the questions at Item U on page 5 of the Form, must be completed. Additionally, a Form 8833 (Treaty-Based Return Position Disclosure under Section 6114 or 7701(b)) should be attached to the Form. This additional Form is used to provide such information as the specific income tax treaty under which an exemption is claimed and documentation that the requirements of the treaty have been met by the foreign corporation.

The treaty-based return must be filed on the 15<sup>th</sup> day of the third month following the close of the foreign corporation's U.S. tax year (15 March for a calendar year company) if the company has an office or other fixed place of business in the United States. On the other hand, if there is no U.S. office, the treaty based return is due on the 15<sup>th</sup> day of the sixth month following the close of the foreign corporation's U.S. tax year (15 June for a calendar year company).

c) *Penalties*

The penalties for a failure to file a treaty based return can be very steep. Specifically, Section 6712 imposes a \$10,000 flat fine on corporations for each failure to disclose a treaty position in accordance with the requirements of Section 6114. This means that where there are either multiple entities in a foreign group taking a treaty-based return position, or multiple positions, the penalties can mount up quickly.

d) *Tax on gross income*

It may be that a foreign corporation takes a position that it does not have either a U.S. trade or business or a PE in the U.S. As mentioned above, there would be no U.S. tax return filing requirement for the foreign corporation in that

case. However, what if the position ultimately proves to be wrong and there is a taxable presence in the U.S.? This may arise either because the foreign corporation subsequently ascertains that there is more activity in the U.S. than was originally believed to exist or the IRS successfully asserts that the activity constitutes a taxable presence in the U.S.

In this regard, Section 882(c)(2) states that no deductions will be allowed in computing the taxable income of the foreign corporation unless a true and accurate return is filed. This means that absent the filing of a return, the foreign corporation could be taxed in the U.S. on its gross income without the benefit of any deductions. This is clearly not a good thing.

The regulations under Reg. Section 1.882-4 have taken this rule one step further and indicated not only that a return must be filed to secure the benefit of deductions, but the return must generally be filed within 18 months of its original due date. However, the regulations also indicate that a protective return/statement may be made each year with the IRS such that if it is later determined there is a taxable presence in the U.S., it may still be possible to claim deductions in calculating taxable income. Many companies have chosen to make the protective election and have done so by attaching the required statement to their treaty-based returns each year.

It should be noted that the validity of the regulation containing the timely filing requirements referred to above has been the subject of much debate. In fact, the IRS has previously issued numerous rulings, including in situations where the taxpayer has voluntarily approached them and proactively tried to straighten out their tax affairs, in which the IRS has consistently upheld the validity of their regulations. However, on 26 January, the Tax Court at least temporarily reversed this trend and held that the regulation was invalid in the Swallows Holding Ltd. case. This victory may be short-lived since we are sure the IRS will appeal the case.

e) *What should I do now?*

Unfortunately, the concept of a U.S. trade or business is not clearly defined in the U.S. tax law and there is confusion and disagreement as to how much activity can take place in the U.S. before a U.S. trade or business is considered to exist. In light of this uncertainty, we have

encountered many instances where it is not necessarily clear whether a foreign company is engaged in a U.S. trade or business; however, it is certain (at least as certain as we can be in today's tax environment) that the company does not have a permanent establishment in the U.S. under the income tax treaty with its country of residence. This begs the question of whether a treaty-based return should be filed. Additionally, the question arises as to how best to deal with a potential tax on gross income if the IRS successfully later asserts that there is a taxable presence in the U.S.

Our view is that if there is sufficient activity in the U.S. to clearly constitute a U.S. trade or business (and no PE exists) a treaty-based return must be filed each year. Additionally, the protective statement under Reg. Section 1.882-4, mentioned above, should be attached to the treaty-based return to preserve the right to effectively be taxed on net, rather than gross income, if a PE is later determined to exist in the U.S.

Likewise, if there is any question on whether the activities in the U.S. are sufficient to create a U.S. trade or business, the filing of a treaty-based return would also generally be recommended. The protective statement should also be attached to this return. In reality, the potential penalties and risks of tax in the U.S. being assessed on gross income are too great not to file a treaty-based return.

In light of the uncertainty surrounding this entire issue, we would suggest that the following actions be taken as part of the 2005 tax process for all foreign corporations conducting activities in the U.S., especially where they currently view their U.S. activities as exempt from U.S. federal income tax because the company does not maintain a PE in the United States:

- Review their operations in the U.S., including the actions of agents and employees, etc., for the past several years to form (or reform) a view on whether a U.S. trade or business could potentially be considered to exist.
- In situations where activity has been identified, determine if a treaty-based return, including a protective election, has already been filed.

- Finally, determine whether any current or prior year treaty-based returns should be filed.

It should be kept in mind that the issues discussed in this Newsletter apply only to U.S. federal income tax matters. The various states in the U.S. maintain their own separate rules on what constitutes a taxable presence in their state and are not necessarily bound by the federal income tax rules. In any event, the U.S. income tax treaties are specifically not applicable for state income tax purposes. Therefore, it is entirely possible that a foreign corporation may not have a PE in the U.S. under an income tax treaty (and thus be exempted from federal income taxes), but could be subject to tax in one or more states.

### NEXT TAXAND CONFERENCES

The next Taxand conferences will take place in Nîmes and London.

The conference in France will be held on the 8<sup>th</sup> and 9<sup>th</sup> of June, while the UK conference will be on the 7<sup>th</sup> and 8<sup>th</sup> of December.

Once again we will have the opportunity to participate in numerous technical sessions on current developments in the different jurisdictions and in meetings to be organized by the service lines. Of course, we will also have time to hone our “networking” skills.

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