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WTS ICT Service Line Newsletter

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Europe

European Commission Communication on Business Taxation for the 21st century

On 18 May 2021, the European Commission ("**EC**") published the long-awaited Communication on Business Taxation for the 21st Century (the "**Communication**"). The Communication provides a roadmap with short- and long-term initiatives to address perceived problems in business taxation in the European Union ("**EU**"). The Communication is highly ambitious and shows that the EC in no way intends to slow down its efforts of creating a more level playing field within the EU, increasing its own influence and authority, and tightening the corporate tax environment along the way.

Executive Summary

- The EC will publish the following proposals by July 2021, which are all aimed at generating new **own** resources for the EU to finance its budget:
  - **New EU digital levy:** An EU digital levy that will be independent of Pillar 1. The EC indicates it is working on a design that does not undermine or impede the G20/OECD discussions. The old 2018 proposals for an EU Digital Services Tax (which was a proposed temporary measure) and a Significant Digital Presence (a digital PE) will be withdrawn;
  - **A Financial Transaction Tax:** The EC indicates it may potentially present proposals to introduce a Financial Transaction Tax and an own resource linked to the corporate sector;
  - **Carbon import duty:** A Carbon Border Adjustment Mechanism ("**CBAM**") that aims to reduce the risk of carbon leakage by ensuring that the price of imports reflects their carbon content;
  - **EU Emissions Trading System:** A revised EU Emissions Trading System.

- In addition, the Communication presents a plan for a new framework for business taxation in the EU, along the lines of five short- and long-term proposals:
  - **BEPS 2.0 (when consensus):** The EC proposes to implement Pillar 1 and Pillar 2 – once global agreement has been reached – into EU Directives, which, if adopted unanimously, are binding on Member States;
  - **Publication of effective tax rates (by 2022):** The EC will put forward a new proposal for the annual publication of the ETR of certain large companies with operations in the EU, using the methodology agreed for in the Pillar 2 calculations;
  - **ATAD 3 (by Q4 2021):** The EC will put forward a new proposal aimed at discouraging the use of legal entities with no or minimal substance and economic activity. The measures will be aimed at information sharing, monitoring, transparency and denying certain tax benefits. In the Q&A, this proposal has been referred to as ATAD 3, which implies an amendment of the ATAD Directive (which must be adopted with unanimous consent);
  - **More equal treatment of debt vs. equity financing (by Q1 2022):** The EC will put forward a new proposal aimed at introducing an allowance system for equity financing, thus contributing to the re-equitisation of financially vulnerable highly leveraged companies;

- **Common EU tax base for multinationals and formulary apportionment (by 2023):** The EC will propose a new framework titled Business in Europe: Framework for Income Taxation (or "**BEFIT**"). BEFIT would consolidate the profits of certain (likely large) EU multinationals into a single EU tax base, and reallocate these profits to Member States through formulary apportionment, replacing the current transfer pricing rules. This proposal will replace the Common Consolidated Corporate Tax Base ("**CCCTB**") proposal that has been floating around since 2011.

- Alongside the Communication, the EC has recommended Member States to allow loss carry back for businesses to at least the previous fiscal year. This would allow businesses to set off 2020 and 2021 losses with earlier profits, with a recommended cap of €3 million per loss-making year. It is up to the Member States themselves to determine whether they follow this recommendation.

- Finally, the EC recommends that Member States set their domestic corporate income tax rates, which will remain a national competence in the EU, above the minimum levels to be agreed under Pillar 2.

Background

From 4 March 2020 to 1 April 2020, the EC sought input from stakeholders on reforming the EU business taxation system to ensure it remains appropriate for the modern economy. The resulting Communication has since been delayed multiple times, likely caused by the pandemic and changes in EU business taxation policy in the past year. The Communication states that the substance of the international discussions on the reallocation of taxing rights and minimum effective taxation will influence the shape of the EU business tax agenda going forward, regardless of whether a concrete global agreement is reached.

The Communication essentially comprises two blocks of proposed measures. The first block of proposed measures is aimed at generating own resources to finance the EU budget. The second block of measures is a roadmap comprising short- and long-term proposed measures aimed at implementing the OECD agreement (Pillar 1 and Pillar 2) supplemented by additional measures that go beyond the OECD agreement.

Financing of EUs own budget

- The EC will propose new and reformed pricing mechanisms to support EU climate objectives (a reduction of emissions by 55% by 2030 and climate neutrality by 2050), notably the CBAM. The CBAM aims to ensure that the price of imports more accurately reflects their carbon content, if third countries do not have similarly ambitious climate policies in place. The Communication states that CBAM will be compatible with WTO and other international obligations.
- The 2018 proposals on a Digital Services Tax and a Significant Digital Presence will be withdrawn and a new digital levy will be introduced. It will be designed in such a way that it is independent of Pillar 1 and is compatible with WTO and other international obligations. After its establishment, it will coexist with the Pillar 1 proposal, once the latter is ratified and transposed in EU law through a proposed new EU Directive (see below).
- Finally, the EC may propose additional new own resources, potentially in the form of a Financial Transaction Tax and an own resource linked to the corporate sector.

The EC calls upon Member States that the progress at EU level should be complemented by supporting national action in areas where Member States may be best placed to judge the needs of their economy and society (or: where the EC currently lacks authority). In this context, the EC recommends setting the domestic EU corporate tax rate above the minimum levels to be agreed internationally.

Road map

The Communication further sets out the EC's agenda on measures in the area of business taxation in both the short and longer term.

Short term – OECD agreement

- **BEPS 2.0:** The EC proposes to implement Pillar 1 and Pillar 2 – once global agreement has been reached – into EU Directives, which – if adopted unanimously – are binding on Member States. The EC seems positive about the US's proposal to simplify Pillar 1 by making it applicable to the largest multinationals and all types of businesses, rather than only to businesses that sell automated digital services or consumer-facing businesses. Existing and pending EU initiatives will need to be amended to take into account Pillar 2 (the ATAD, the Interest & Royalty Directive and the EU list of non-cooperative jurisdictions).

Short term – beyond OECD agreement

- **Action 1:** A legislative proposal for the annual publication of effective tax rates paid by large companies operating in the EU, based on the methodology agreed upon for determining the Pillar 2 calculations (by 2022). This new proposal would supplement the public country-by-country reporting proposal that is being considered in the EU, which would require companies to publish information for every country they operate in.
- **Action 2:** A legislative proposal – likely in the form of an amendment of the ATAD Directive, i.e. ATAD 3 – targeting shell/conduit companies set up for tax purposes (by Q4 2021). The proposal would include measures such as information sharing with tax authorities on the level of substance and economic activity, denying certain tax benefits for abusive shell/conduit companies, and further monitoring and tax transparency requirements. The EC also intends to take further steps to prevent royalty and interest payments leaving the EU without taxation. No further details or guidance on these rules has been made available yet.
- **Action 3:** Together with the Communication, the EC issued a non-binding recommendation (in a Q&A accompanying the Communication), in which it recommends that Member States allow for the carry back of losses to at least the previous tax year. This means that companies would be allowed to offset their 2020 and 2021 losses against taxes paid before 2020. A cap of €3 million per loss-making fiscal year is suggested.
- **Action 4:** A legislative proposal creating a Debt Equity Bias Reduction Allowance ("**DEBRA**") (by Q1 2022). This proposal should address the debt-equity bias in corporate taxation, via an allowance system for equity financing, thus contributing to the re-equitisation of financially vulnerable companies, flanked by anti-abuse measures.

Longer term – Going beyond the OECD agreement

→ **Action 5:** The pending proposals for a CCCTB will be withdrawn. Instead, the EU Commission will propose a new framework under BEFIT. BEFIT will be a single corporate tax rulebook for the EU, based on the key features of a common tax base and the allocation of profits between Member States based on a formula (formulary apportionment). BEFIT will consolidate the profits of the EU members of a multinational group into a single tax base, which will then be allocated to Member States using a formula, to be taxed at national corporate income tax rates.

  The formula will consider sales by destination, to reflect the importance of the market where a multinational group does business, as well as how assets (including intangibles) and labour (personnel and salaries) should be reflected, to approximate a supposedly fair distribution of corporate tax revenue across Member States with different economic profiles. The use of a formula to allocate profits would thus remove the need for the application of complex transfer pricing rules within the EU for the companies within scope (likely large multinationals).

  Whilst BEFIT seems to be based on largely similar principles as the previous CCCTB proposal, it aims to incorporate changes that have occurred since then by building on the tax basis agreements of Pillar 2 and improving the allocation formula (in particular by taking better account of digitalisation). The CCCTB, even in its slimmed-down version without the consolidation, was heavily scrutinised and remained a bridge too far for most Member States. It remains to be seen whether the revised tax base and revised formulary apportionment, together with the changes in the economic and political landscape, will result in the required (unanimous) support for BEFIT.

Please click here for the full "Communication on Business Taxation for the 21st Century".

Last minute update

On 1 July the OECD/G20 Inclusive Framework (IF) has published a statement that 130 (of 139) IF countries and jurisdictions sign on to the new proposed OECD BEPS 2.0 framework. The statement broadly clarifies how Pillar One will be revised (only applicable to MNEs with EUR 20+ billion turnover with a profit margin exceeding 10%), with a comprehensive update on both Pillar One and Pillar Two to follow. Notably, 9 IF countries have not (yet) agreed to the revised Pillar One and Pillar Two, 3 of which are EU Member States that have lower statutory tax rates than the agreed Pillar Two rate of at least 15% (Estonia, Hungary and Ireland). In its Communication, the EC indicated that it will propose an EU Directive for the implementation of the OECD Pillar One and Two proposals, once global agreement has been reached to ensure a consistent implementation in all EU Member States (including those that are not OECD-members and do not participate in the Inclusive Framework). Given that EU Directives require unanimous consent, it will be interesting to monitor these dynamics in the coming months.

Austria

Austrian Supreme Administrative Court on beneficial ownership of trademarks

In its decision dated 27/11/2020, RA 2019/15/0162, the Austrian Administrative Supreme Court (Verwaltungsgerichtshof) had to deal with a trademark licensing between Malta and Austria. The Austrian trading company MCo had demerged its business and real estate to the Austrian company XCo in 2007. The trademarks stayed with MCo. In a next step, the management of MCo and the trademarks were transferred to a Maltese permanent establishment of MCo. In an Austrian tax audit, the tax authorities denied the deductibility of the licence payments of approximately MEUR 50 for 2008 and 2009 from XCo to MCo. The Austrian Fiscal Court and the Austrian Supreme Court also denied the deductibility of the licence payments and attributed the beneficial ownership of the trademarks to XCo.

Arguments brought forward by XCo

XCo had argued that the trademarks were generated by MCo and registered in the name of MCo. Furthermore, MCo was in charge of the international trademark protection, exercised its functions as an owner and bore the risk of an owner.

Reasons for the decision of the Supreme Court

The main reasoning for the attribution of the beneficial ownership to XCo was that the main functions and decisions regarding the use of the trademarks were allocated to the – formal licensee – XCo. Based on the decision of the Supreme Court, the following points seemed crucial for the attribution of the beneficial ownership to XCo:

- The activities of XCo in Austria were mainly relevant for the appreciation of value of the trademarks, as XCo bore the substantial part of the advertising and marketing expenses. Whilst XCo's expenses, in this regard, amounted to EUR 56 or 68 million, MCo's marketing expenses amounted to not even EUR 500,000 in the respective years. Furthermore, the advertising strategy was based on the requirements of XCo and other group companies (the licensees).
- No new trademarks have been generated since the re-structuring. Additionally, the main aspects of the licence agreements and the value of the trademarks had already been decided before the re-structuring.
- Whilst the Maltese directors of MCo were present for meetings in Austria, they only had administrative and support functions. They had no authority to decide on marketing activities.
- MCo only had one employee who was in charge of trademark administration, registration, licence agreements and oversight of the brand activities.
- MCo only had one full-time employee and 7 part-timers. Hence, the personnel expenses were well below EUR 100,000 each year. Comparing this with the trademarks worth almost EUR 400 million, the court stated that there was an imbalance. Hence, the decisive functions as regards brand administration, maintenance and management must have been with other group companies or external specialists (lawyers, advertising agencies), whilst MCo only had supporting functions.

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Unfortunately, the decision of the Fiscal Court has not been made publicly available. It would have offered a much better view on the facts of the case and the argumentation of XCo than the decision of the Supreme Court. Nevertheless, the decision should be analysed as regards any comparable structure. Especially with IP structures in low tax jurisdictions, taxpayers must look very closely as to whether the substance and the substance and risk profile are in a balanced relationship with the income attributed to that entity.

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China

Will an expatriate's China tax position change due to COVID-19?

One question may arise due to COVID-19: will an expatriate change his/her tax position if he/she is stranded overseas for a long period of time due to COVID-19? Unfortunately, there is no definite answer, given that the situation still needs to be assessed on a case-by-case basis. Having said that, the China State Administration of Taxation (SAT) has recently responded to certain hot questions in interpreting the COVID-19-affected tax treaty clauses and has taken a concession view.

In the SAT's response, it explains that, if an individual has to live elsewhere due to COVID-19 control measures and has become a resident in both places, said temporary stay usually should not cause a person to relocate his or her permanent home or centre of vital interests. Thus, it should not affect the residency under a tax treaty.

For example, an expatriate assuming only one position in China cannot return to China due to a travel ban or quarantine requirements. He/she is asked to continue his/her work from his/her German home for as long as the COVID-19 outbreak continues and still receives a salary from the Chinese company. Will his/her taxation change from China IIT perspective?

Situation 1: This expatriate stays in China for more than 183 days in 2020

As per China IIT law, the expatriate will be a Chinese tax resident for the calendar year concerned. But he/she may also become a resident in Germany due to the travel restrictions and quarantine measures. The challenge here is to determine the final place of residence of the individual.

According to the tax treaty clauses, the tax residency should be assessed on four factors in sequence if two or more countries consider an individual a tax resident: a. permanent home; b. centre of vital interests; c. habitual abode; d. nationality.

The "permanent home" should be "permanent", rather than a temporary stay. Special attention shall be paid to acts of the individual for being the centre of vital interests, i.e. the country in which an individual always lives, works and has his/her family and property.

In the recent interpretation by SAT on the tax treaty, the COVID-19 situation will not affect the treaty residence position, given that said temporary dislocation will not change an individual's permanent home or centre of vital interest. Therefore, the expatriate is still considered to have his permanent home in China and thus treated as a Chinese tax resident. As a result, the income received from the Chinese employer during his/her prolonged stay in Germany is still treated as China-sourced income and should be fully subject to Chinese tax. His/her taxation scope remains unchanged in China.

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Situation 2: This expatriate resides in China for less than 183 days

Under this situation, the expatriate is a non-tax resident in China. However, given that he/she assumes only one position in China and receives all of his/her remuneration from the Chinese company, he/she is still taxed on his/her full employment income as a China-sourced income, regardless of where he/she is working.

Conflicts may occur once the expatriate is also taxed as a tax resident in Germany. OECD has issued recommendations on the implications of COVID-19. It urges that the residence country should avoid double taxation, either by exempting the income or by taxing it and giving a credit for the source country tax. Given the new interpretation by SAT, it is suggested to seek the possibility for the home country to exempt the income that has been taxed in China.

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France

The French Supreme Court refers to the international definitions of permanent establishment

The French Supreme Court has just refined its definition of permanent establishment in France for VAT and corporate income tax (CIT) purposes (CE, 11 December 2020, No. 420174, Min. c/ Société Conversant International Ltd).

In this case, an Irish company, named Valueclick International Ltd. at the time of the dispute, carried on an online advertising business in France through its sister company then named Valueclick France.

The two companies had entered into a service agreement under which the French company provided marketing assistance services consisting of acting as a representative of Valueclick International by identifying, prospecting and reporting potential customers.

The French tax authorities considered that Valueclick International carried on an activity in France subject to VAT and CIT through a permanent establishment set up by Valueclick France.

The French Supreme Court, ruling on the case, confirms the position of the French tax authorities.

With respect to VAT, it should be recalled that, pursuant to Article 192a of the VAT Directive and Articles 53.1 and 53.2 of the Council implementing regulation (282/2011) and the case law of the ECJ *Berkohlz* (4 July 1985, C-168/84) and *Welmory* (16 October 2014, C-605/12), in order for a permanent establishment to be set up in France, the French company must have the human and technical resources enabling it to provide services autonomously.

The French Supreme Court states that these two conditions are met since the employees of the French company could decide to sign a contract with the advertiser and that they have access to the data centres of the group located in the US (creation, configuration and management of the customer account), which allow them to conclude contracts with the advertiser customers of the Irish company, without the specific intervention of the foreign companies of the group.

With respect to CIT, Valueclick has a permanent establishment in France within the meaning of the Franco-Irish Convention dated 21 March 1968, as a company resident in Ireland, which uses the services of a non-independent person ordinarily exercising powers in France enabling it to engage in a commercial relationship relating to transactions constituting its own activities.

The French Supreme Court rules that a French company constitutes a permanent establishment of the Irish company if, as presented by the Irish company, it has the power to negotiate contracts with the Irish company's customers, which enables it to decide in the usual way on transactions that the Irish company merely endorses (by automatic signature), even if the French company does not formally conclude the contracts.

The French Supreme Court refers to the definition of permanent establishment in paragraphs 32, 1 and 33 of the commentaries to the OECD Model Convention published, respectively, on 28 January 2003 and 15 July 2005, which state that a permanent establishment is a dependent agent with powers that it habitually exercises that enable it to conclude contracts on behalf of the foreign company, even if those contracts are not actually concluded in the name of the foreign company.

This decision makes it possible to consider that companies in the digital sector may, in certain cases, have a permanent establishment in France, within the framework of current French and international tax law.

While this case has similarities with the Google case (CAA Paris, 25 April 2019, No. 17PA03067 and No. 17PA03068), it nevertheless presents differences, as the employees of Google France were contractually prohibited from negotiating contracts with the Irish company's customers. Furthermore, in the Google case, the French tax authorities had not demonstrated that the signing of the contracts by the Irish company was purely formal.

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Germany

German registered IP of foreigners subject to tax in Germany

According to a German tax provision dating back to 1925 (Sec. 49 (1) No. 2 lit. f EStG), the mere fact that IP owned by foreigners is either exploited in a German permanent establishment or registered in a German register could trigger non-resident taxation in Germany, even if there is no further nexus in Germany (e.g. none of the affected parties – payer and payee – are German tax residents). Even though the wording of the relevant German tax provision seems to be quite clear with respect to this, it has never been applied in that way in the past. As German tax authorities started to apply the provision according to its literal meaning in 2020, it was proposed to amend the respective provision and to exclude such cases from the scope of limited tax liability. However, at least to date, there was no political agreement on such approach.

E.g. patents that are registered with the German patent register, but are owned by tax non-residents generally fall under the provision. This means that income and capital gains derived from such patents are generally subject to German non-resident taxation. In case of

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the payment of royalties, the payer is generally obliged to withhold taxes, file a withholding tax return and remit the taxes to the German tax authorities.

In case a double taxation agreement (DTA) is applicable, provided tax reliefs will be available only upon application. Nevertheless, the application for a tax relief would require a careful analysis with respect to German anti-treaty shopping rules.

The German tax authorities recently published a guidance for ongoing cases, which makes clear that action is required now. For payments which are made before 1 October 2021 and which benefit from a DTA relief, the tax authorities provide a simplified application procedure (to be filed up to 31 December 2021). For payments after 30 September 2021, licensors should file a regular application before July 2021 as the application procedure could take several months. In any case, foreign owners of IP registered or exploited in Germany are advised to check their arrangements with a German tax lawyer to mitigate adverse implications for the past and the future.

Update of German anti-treaty shopping rules

If a foreign company claims any tax reliefs for German withholding taxes (refund, reduction or full exemption), the German Federal Tax Office will in principle assess whether the anti-treaty shopping rules do apply. As the current rules are partially incompatible with EU law, the German legislator envisages amending and tightening the rules and has published a draft new wording of the German anti-treaty shopping rule (Sec. 50d (3) EStG).

With respect to the current draft bill, the foreign company is entitled to a WHT relief only to the extent that:
- → persons hold shares in the foreign company who would be entitled to the relief on the same legal basis in case they earned the income directly (personal entitlement); OR
- → the income subject to withholding tax has a nexus to an economic activity at the level of the foreign company (factual entitlement).

This anti-treaty shopping rule would not apply if the foreign company:
- → could prove that none of the main purposes of its involvement is the obtaining of a tax benefit (motive test), OR
- → could prove that there is substantial and regular trading in its main class of shares on a recognised stock exchange (stock exchange exemption clause).

Based on a preliminary analysis, we envisage that in a lot of cases the proof of the personal or factual entitlement would hardly be possible. Thus, in our view, the evidence of the motive test will become more important.

It is envisaged that the draft bill will have passed the legislative procedure by the end of May 2021.

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Italy

Step-up and realignment procedure for businesses

Article 110 of Decree Law No. 104 of 2020 contains a measure of great interest for companies, introducing the possibility to step-up the costs of tangible and intangible assets in the financial statements following that of the financial year as at 31 December 2019 (i.e. for companies with financial year matching the calendar year, the year ending as at 31 December 2020).

The step-up can be carried out by non IFRS/IAS adopters, namely:
a) corporations;
b) commercial entities;
c) partnerships;
d) individual entrepreneurs;
e) non-commercial entities;
e) foreign entities with permanent establishment in Italy.

The step-up can be carried out to tangible assets, intangible assets and shareholdings in controlled and associated companies resulting from the financial statements for the year as at 31 December 2019 and still existing at the end of the following year.

Real estate and other immovable properties which are built or for sale are excluded.
The step-up is to be carried out in the financial statements for the year 2020 and may also relate to a single asset and can be carried out solely for statutory purposes or even with a tax effect.

To obtain tax recognition of the higher values resulting from the step-up, the payment of a substitute IRES tax of IRAP at a rate of 3% is required.

The tax can be paid in three equal yearly instalments – without interest – starting from 2021 and is due within the deadline for payment of the balance of income taxes (i.e. June 2021 for companies with financial year matching the calendar year).

The stepped-up values must be recorded in a specific equity reserve.

If the step-up is carried out also for tax purposes, the reserve is subject to taxation in case of distribution to shareholders.

It is possible to remove, in whole or in part, the aforementioned restriction and make the reserve freely distributable by paying a substitute tax of 10% which can be paid in three instalments in the same terms as for the substitute tax on the step-up.

In the case of disposal of a stepped-up asset (through sale, assignment to shareholder and so forth) before the beginning of the fourth financial year following that of the step-up (i.e. before 1 January 2024), capital gains/losses are determined on the basis of the values existing before the step-up and the substitute tax paid in the meantime on the assets sold is credited as a tax credit.

IFRS/IAS adopters can opt for the realignment of the tax values up to the higher book values in the financial statements. Realignment is also allowed in relation to goodwill and other intangible assets resulting from the financial statements as at 31 December 2019.

To obtain the realignment, it is necessary to pay a substitute tax at a rate of 3% with the same deadlines seen for the step-up procedure.

In case of realignment (i.e. increasing the tax value of assets without a corresponding increase in their accounting values), there is no accounting impact on the equity of the taxpayer; thus a constraint must be placed on the company's equity reserves equal to the tax values realigned.

This reserve is under a tax suspension regime and can be freed by paying a substitute tax of 10% with the same rules provided for the step-up procedure.

Lastly, according to some scholars, even in case of realignment a recapture measure like the one seen in case of the step-up procedure applies.

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Netherlands

Proposal to disallow unilateral downward transfer pricing adjustments

Yesterday, the Dutch Ministry of Finance kicked off an internet consultation on a draft proposal (the "Draft Bill") to amend the Dutch codification of the arm's-length principle. The Draft Bill intends to disallow, as of 1 January 2022, downward transfer pricing adjustments to the taxable profit of Dutch group companies, to the extent that the corresponding upward adjustment is not included in the taxable base of the foreign counterparty to the transaction. Group companies operating in the Netherlands are recommended to review their existing advance pricing agreements and/or tax rulings as well as their transfer pricing policies to assess the impact of this proposed amendment of the arm's-length principle.

Background

In past years, the Dutch government has focused intensively on combatting tax planning schemes. This, for instance, resulted in the introduction of a conditional withholding tax on certain interest and royalty payments, and the Dutch implementation of the EU Anti-Tax Avoidance Directive II ("ATAD II"). ATAD II, amongst other things, denies the deduction of payments made on hybrid instruments and to hybrid entities. However, ATAD II did not affect 'transfer pricing mismatches', such as unilateral downward transfer pricing adjustments.

Current transfer pricing rules

Based on Dutch transfer pricing rules, a taxpayer has to deal with related entities on arm's-length terms. This means that where conditions (transfer prices) of the transactions between related entities differ from market conditions, the entity's profit will be determined as if "arm's-length" conditions applied.

This may result in a unilateral downward adjustment of the (commercial) profit of a Dutch group company, i.e. not mirrored by a corresponding adjustment at the counterparty. This concept of a unilateral downward adjustment was confirmed by the Dutch Supreme Court in a situation where an arm's-length interest was deducted on an interest free intercompany loan granted to a Dutch company.

The downward transfer pricing adjustment is currently not dependent on the recognition of the corresponding upward adjustment in the other jurisdiction. As an example, this means that it is entirely possible that certain costs are tax-deducted in the Netherlands based on the arm's-length principle (a so-called 'deemed deduction'), but that there is no pick-up of the revenues elsewhere.

Proposal

The Draft Bill proposes to only allow downward adjustments to the extent that a corresponding adjustment is included in the taxable basis in the other jurisdiction. This implies that, for instance, deemed deductions that are not picked up elsewhere, would no longer be allowed.

The Draft Bill also impacts situations where the country of the other group company does not levy corporate income tax at all. However, the Draft Bill should not have an impact if the corresponding adjustment is effectively untaxed due to offset against losses available for carry forward or is taxed at a rate of 0%.

In addition, under the Draft Bill the purchase price of an asset can no longer be adjusted upwards to the fair market value (a 'step-up in basis') to the extent that the fair market value of the asset is not taken into account in the country of the seller. This would have the effect that taxpayers can no longer claim a tax- deductible depreciation of such fair market value. The proposed measures also limit the tax depreciation of such assets acquired in the five years prior to FY2022.

The Draft Bill does not provide for grandfathering rules. Therefore, if enacted, it is expected that existing rulings and/or advance pricing agreements in which a unilateral downward transfer pricing adjustment is endorsed will expire as of 1 January 2022, as such rulings and advance pricing agreements generally include a termination clause in case of a change of the relevant laws and regulations.

Status

This Draft Bill is currently subject to public consultation and input can be provided until 2 April 2021. We note that that parliamentary elections will be held in the Netherlands on 17 March 2021. Although there is a possibility that a new government will not introduce this Draft Bill, this is currently not expected.

Authors' note

The Netherlands has always been proud to be among the few countries in the world to apply a truly consistent interpretation of the arm's-length principle: non-arm's-length conditions are to be adjusted, regardless of whether the counterpart country also applies the holy principle of transfer pricing as it was intended. Arguably, the conceptually superior way to

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solve transfer pricing mismatches is that other countries start following our example. In practice, however, it seems inevitable that the Netherlands gives in to the overwhelming international pressure to take the easy road in the battle against effective tax structuring.

Takeaway

Groups with companies in the Netherlands applying contractual terms and conditions that deviate from the arm's-length principle, should closely follow the legislative process of this Draft Bill. In anticipation of its implementation, it is well-advised to review the transfer pricing policies and to assess whether existing rulings and/or advance pricing agreements would be terminated as of 1 January 2022.

Russia

Russian Federal Tax Service on intragroup services by MNCs to subsidiaries located in Russian Federation

Recently, MNCs have been faced with the issue of providing intra-group services to its subsidiaries located in the Russian Federation, as expenses under such services are often challenged by the Russian tax authorities within the tax audits. Due to the request from the business community, the Russian Federal Tax Service (FTS) issued two Letters, specifically Letter No.ШЮ-4-13 / 12599 dated 6 August 2020 (hereinafter Letter #1) and the second Letter No. ШЮ-4-13/1749@ dated 12 February 2021 (hereinafter Letter #2).

We would like to introduce to you the high-level comments in respect of these Letters.

Letter #1

Under Letter #1, the FTS systematised the criteria assessing the legality of including expenses for intragroup services. The letter contains a practical approach to checking expenses for the intercompany services that should be deductible for profit tax purposes.

The letter highlights the main "tests" that are already applied by the Russian tax authorities in the framework of tax audits, specifically:

- "Reality test" – meaning that services were actually rendered as is provided by the Service Agreement (SA) and reflected in other documents that evidence the relationship of the parties. In this case, the taxpayer should justify the need to involve a foreign company in service activity.
- "Utility test" - the actions actually performed (services rendered) were useful to the recipient of the services; that is, an independent person would agree to pay for them.
- "Test for duplication of services" - it is necessary to demonstrate that there is no duplication of costs for identical services. At the same time, in order to assess the presence of this criterion, the tax authority can conduct a functional analysis, an analysis of the experience and competencies that a Russian taxpayer receives and not be limited to establishing the fact that the names of departments coincide or the presence of employees in positions with similar names.
- "Test for documentary confirmation" - the FTS, as an example, provides a list of documents and information to confirm expenses, which are currently already actually requested from

taxpayers as part of inspections and pre-audit analysis (business correspondence and emails, telephone details calls, minutes of meetings, timesheets, reports, etc.). The list of documents is open, whilst documents (such as acts) should not be abstract, containing conflicting information.

- "Test of the market price level" - the letter emphasises the need to check the transparency and documentary support of the pricing mechanism. The FTS emphasises that control over the prices to the market level is not a subject of on-site and cameral tax audits. At the same time, the price factor, the mechanism and the principle of its formation are an integral characteristic of the service itself. Therefore, attention should be paid to checking the availability of a transparent methodology for the formation of the cost of services. The price for intercompany services can be defined as "costs plus margin", whilst the fact of using such a pricing model should not be considered as a cost allocation for the Group.

Letter #2

Within Letter #2, FTS provided additional clarifications in respect of deduction of expenses for shareholding activity incurred by Russian companies that purchase intra-group services.

The letter contains a list of practical examples of the functions of a shareholder in the framework of the strategic management of the Group, as well as the planning and control of the Group's business, which are considered as shareholder activities and cannot be recognised as the provision of services.

Letter #2 concludes that the expenses of Russian shareholders for the shareholder activities (with the exception of the expenses directly named in Article 270 of the Russian Tax Code) cannot be considered economically unjustified, meaning that, in general, it is tax deductible, provided that it is properly documented.

Taxpayers received the guideline regarding what kind of activity can be regarded as shareholder activity. It is important to note that, in the event that the tax authority challenges the deductibility of said expenses on shareholder activity, said payments **can be reclassified** into income from a Russian source and be taxable at source under Article 310 of the RTC *("The specifics of the calculation and payment of tax on income received by a foreign company from a Russian source, withheld by the tax agent").*

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Spain

5% taxation on dividends and capital gains

The General State Budget of Spain that entered into force as of 1 January 2021 includes new relevant tax measures, especially with regard to Corporate Income Tax. Specifically, the General State Budget sets out that the exemption for dividends and capital gains arisen due to the transfer of shares obtained by a Spanish entity from national and foreign subsidiaries is now limited to 95% of the income. Therefore, 5% of such income is treated as non-deductible expenses. Considering that the standard CIT rate in Spain is 25%, the effective tax rate on dividends and capital gains is 1.25%. Furthermore, this measure is applicable even in a tax consolidation regime, as the 5% rate cannot be eliminated from the consolidated group's taxable base.

Lastly, it is important to bear in mind that this measure is only related to Corporate Income Tax, but it is not foreseen in the Non-Resident Income Tax regulation. Consequently, it can be assumed that such limit does not apply when the dividends or capital gains are obtained by Non-Resident entities.

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United Kingdom

FTI Consulting – Tax Implications of the 2021 UK Budget

Setting out, during a time of 'challenge and change', the 2021 Budget, including some key new tax policies and measures to begin to navigate out in the wake of COVID-19.

As the UK Government continues its unprecedented spending to support the economy and jobs, the Chancellor, on 3rd March 2021, announced his first measures to promote a recovery whilst addressing the growing deficit. These included:

- An increase in Corporation Tax rates to 25% from April 2023
- A new super deduction of 130% for investment in plant and machinery
- Ongoing support measures for businesses to secure their survival and emergence from the pandemic
- The announcement of 8 new freeports across England attracting a wealth of tax incentives for new investment

Corporation Tax Rates

The rate of corporation tax will increase, from April 2023, to 25% on profits over £250,000. The rate for small profits under £50,000 will remain at 19% and there will be relief for businesses with profits under £250,000, so that they pay less than the main rate. In line with the increase in the main rate, the Diverted Profits Tax rate will rise to 31% from April 2023 so that it remains an effective deterrent against diverting profits out of the UK.

Super-deduction for Expenditure on Plant and Machinery

The Government is seeking to stimulate business investment by introducing a "super-deduction" for qualifying expenditure on plant and machinery from 1 April 2021 to 31 March 2023. The temporary tax reliefs will be:

- A super-deduction in the form of an enhanced first-year allowance of 130% on assets that ordinarily qualify for 18% main rate writing down allowances.
- A first-year allowance of 50% on assets that ordinarily qualify for 6% special rate writing down allowances.

Multiple conditions and exclusions apply, including that the expenditure must be incurred from 1 April 2021 to 31 March 2023 and expenditure is excluded if incurred under a contract made before 3 March 2021. An additional tax savings of up to £25 per £100 invested will be welcomed by businesses, but these enhanced allowances are only available in the period of investment. For many, this may simply create additional tax losses to carry forward.

Loss carry back relief

The provisions allowing the carry back of trading losses against total profits will be temporarily extended from the existing one year to three years. Companies will be able to obtain relief for up to £2 million (per group) of losses in each relevant accounting period ending between 1 April 2020 and 31 March 2021 and between 1 April 2021 and 31 March 2022, subject to a group level limit of £2 million. The amount of trading losses that can be carried back to the preceding year remains unlimited for companies.

Repeal of Interest and Royalties Directive

Following the UK's withdrawal from the European Union and the end of the transition period on 31 December 2020, the Government has resolved to repeal the UK's implementation of the Interest and Royalties Directive with effect for payments made from 1 June 2021 (although there are provisions to prevent the payments due after 1 June 2021 being brought forward to benefit from the rules). From 1 June 2021, payments of interest and royalties to EU associated enterprises which would have previously been exempt will now be subject to UK income tax at a rate of 20% (unless a double taxation agreement applies).

Interest and royalty payments from UK companies to major EU territories (including Germany, France, the Netherlands and Spain) are likely to qualify for relief under the relevant double taxation agreement, such that the repeal of the Interest and Royalties Directive is unlikely to have a significant economic impact. However, there are a number of instances where either interest or royalties are not reduced to 0% under the relevant double taxation treaty (e.g. interest/royalties paid to Italy, royalties paid to Luxembourg, interest/royalties paid to Portugal). Companies making interest payments under the directive may need to make new treaty claims to obtain reduced withholding rates although this should not be required for royalties.

Changes to Hybrid Mismatch Rules

Following on from the published response to the Consultation in November 2020, the Government has confirmed that it will be amending the UK's hybrid mismatch provisions. Key changes are to the treatment of exempt investors under the hybrid entities provisions, extension of dual inclusion income for groups and the exclusion of investors with less than 10% in transparent funds. These changes should put the UK provisions on a level playing field with comparable provisions in other European territories (such as Luxembourg and the Netherlands).

Reporting rules for digital platforms

The Government will introduce legislation that enables regulations to be made implementing the OECD's rules on reporting by digital platform operators. The provisions will require UK digital platform operators that facilitate the provision of services by UK and/or other taxpayers to report information regarding the income of sellers to both HMRC and the sellers. These provisions are not intended to apply to digital platforms which facilitate the sale of goods.

The provisions will be subject to consultation in Summer 2021 and are not expected to come into force before 1 January 2023, with the first reports not due until 1 January 2024.

COVID-19 support measures

The Government is extending the Coronavirus Job Retention Scheme (CJRS) until the end of September 2021. Employees will continue to receive 80% of their current salary for hours not worked. From July, the Government will introduce an employer contribution towards the cost of unworked hours of 10% in July and 20% in August and September.

The Government will continue to provide eligible retail, hospitality and leisure properties in England 100% business rates relief from 1 April 2021 to 30 June 2021 (followed by 66% business rates relief for the period from 1 July 2021 to 31 March 2022, capped at £2 million per business for properties that were required to be closed on 5 January 2021, or £105,000 per business for other eligible properties).

The Government will provide 'Restart Grants' in England of up to £6,000 per premises for non-essential retail businesses and up to £18,000 per premises for hospitality, accommodation, leisure, personal care and gym businesses. From 6 April 2021, the Recovery Loan Scheme will provide lenders with a guarantee of 80% on eligible loans between £25,000 and £10 million.

Freeports

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The Government has announced plans to create eight "Freeports" in the UK in early 2020. The tax incentives available will include enhanced capital allowances (a first-year allowance of 100% for qualifying expenditure on new and unused plant and machinery for use within the tax site until 30 September 2026), an enhanced rate of structures and buildings allowance of 10% on a straight-line basis for expenditure on qualifying assets brought into use by 30 September 2026 and an SDLT relief for purchases of land and buildings within a Freeport tax site.

USA

Debt Financing in the U.S. – What a foreign investor needs to know

The Tax Cuts and Jobs Act ("TCJA"), also known as U.S. Tax Reform, brought on many changes to the U.S. tax landscape, perhaps none further reaching than the changes to interest expense deductibility. Prior to 2018, Internal Revenue Code ("IRC") Section 163(j) applied to interest paid or accrued by a U.S. corporation to a related party and disqualified some or all of the deduction if two thresholds were met – an excessive debt-to-equity ratio and excessive interest expense compared to adjusted taxable income ("ATI").

In the post-TCJA tax world, IRC Section 163(j) is a larger catch-all. All taxpayers are now subject to this interest expense provision that, generally speaking, limits the deduction of business interest expense to the sum of business interest income plus 30% of ATI. The calculation for ATI is now akin to tax-adjusted EBITDA (note: after 2021, the formula will change to simply tax EBIT). In response to the COVID-19 pandemic, the Coronavirus Aid, Relief and Economic Security ("CARES") Act raised the limitation temporarily to 50% instead of 30%.

Last year and earlier this year, final regulations were issued under IRC Section 163(j) that added clarity to the mechanics of the calculation and covered issues such as:

→ The add-back of depreciation and amortisation deductions that were capitalised under the inventory cost capitalisation rules of IRC Section 263A

- The subtraction of recaptured depreciation and amortisation deductions when tangible and intangible assets are sold
- The treatment of certain types of equity capitalisation transactions as debt transactions
- The treatment of business interest expense attributed through a tiered partnership structure
- The limitation of carry-forward business interest expense when there is a change of ownership
- Self-charged interest remedy when a partner lends money to a partnership

Certain regulations remain in proposed form including the rules related to the application of IRC Section 163(j) to foreign persons with income effectively connected with a U.S. trade or business ("ECI"). Amongst other provisions, the proposed regulation states that a foreign person's business interest expense, business interest income and ATI is only measured using ECI items. For foreign persons who are allocated ECI from a partnership, the proposed regulation defines how the foreign partner's distributable shares of IRC Section 163(j) items are determined. The proposed rule also sets out to keep the calculation of branch profits tax unaffected by any impacts of IRC Section 163(j).

Why is this important? When a foreign investor enters the U.S. market, whether via a U.S. branch, an interest in a U.S. partnership, or by organising a legal entity subsidiary, there is a decision to be made about how to fund those operations – debt or equity? There is an inclination to choose debt in order to take advantage of an interest expense deduction. However, in addition to IRC Section 163(j), there are more considerations spread throughout the IRC that make the decision to choose debt a bit less clear-cut. Here are a few more:

- Since the U.S. Tax Reform was enacted, the U.S. is no longer the high tax jurisdiction it once was when compared to the rest of the world after the corporate tax rate was cut from 35% to 21%. Therefore, pushing expenses into the U.S. while shifting [interest] income to another jurisdiction may not always create a favourable result. When debt is in fact pushed down, transfer pricing principles should be considered to ensure proper arms-length rates are used.
- Before IRC Section 163(j) is considered, there are other provisions that come first in the ordering rules that could affect how much interest is potentially deductible. For example, certain provisions can permanently disallow interest expense. Notably, rules and regulations under IRC Section 267 can disallow interest expense accrued to a foreign related party unless those amounts were actually paid. After the provisions that disallow interest expense, a foreign corporation that does business directly in the U.S. through a branch or via an interest in a partnership must apportion its interest expense based on the complex set of rules under IRC Section 882. The takeaway is that debt pushed down to a foreign person's U.S. business may not get a deduction of interest expense at full face value of the note.
- The aforementioned provision of IRC Section 267 that requires foreign related party interest expense to be deducted on the cash method brings with it additional complexities. When cash interest payments are made to a foreign person, the U.S. by statute levies a 30% withholding tax against such payments. Whilst that withholding tax can be reduced or even eliminated under an applicable income tax treaty, the global landscape has shifted over the years to require corporations to have a substantive presence in a jurisdiction in order to qualify for treaty benefits.

While there are pitfalls related to debt-funded U.S. operations, there are also opportunities. A U.S. corporation may, in lieu of a cash distribution, issue a dividend payable to its shareholder(s). This payable effectively creates debt in the U.S. subsidiary and allows for an interest deduction. There are provisions to disallow this treatment and recast it as equity under IRC Section 385, but there are exceptions to the rule that still allow for this type of transaction. The interest expense is still subject to the limitation rules discussed above, but it is nevertheless a method to create a deduction out of an equity transaction.

To summarise, the TCJA has added a level of complexity to the debate of debt vs. equity funding of U.S. operations. While debt is not necessarily an antiquated strategy, the ability to deduct interest expense is subject to various rules, regulations, and limitations that a foreign investor should consider before making that important decision. With the recent change in the political regime in the U.S., we patiently await what new rules we will have to consider in the future.

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