

Cross Border Planning:

Impact of New Germany/UK Double Tax Treaty
Recent developments in UK tax regime affecting international business

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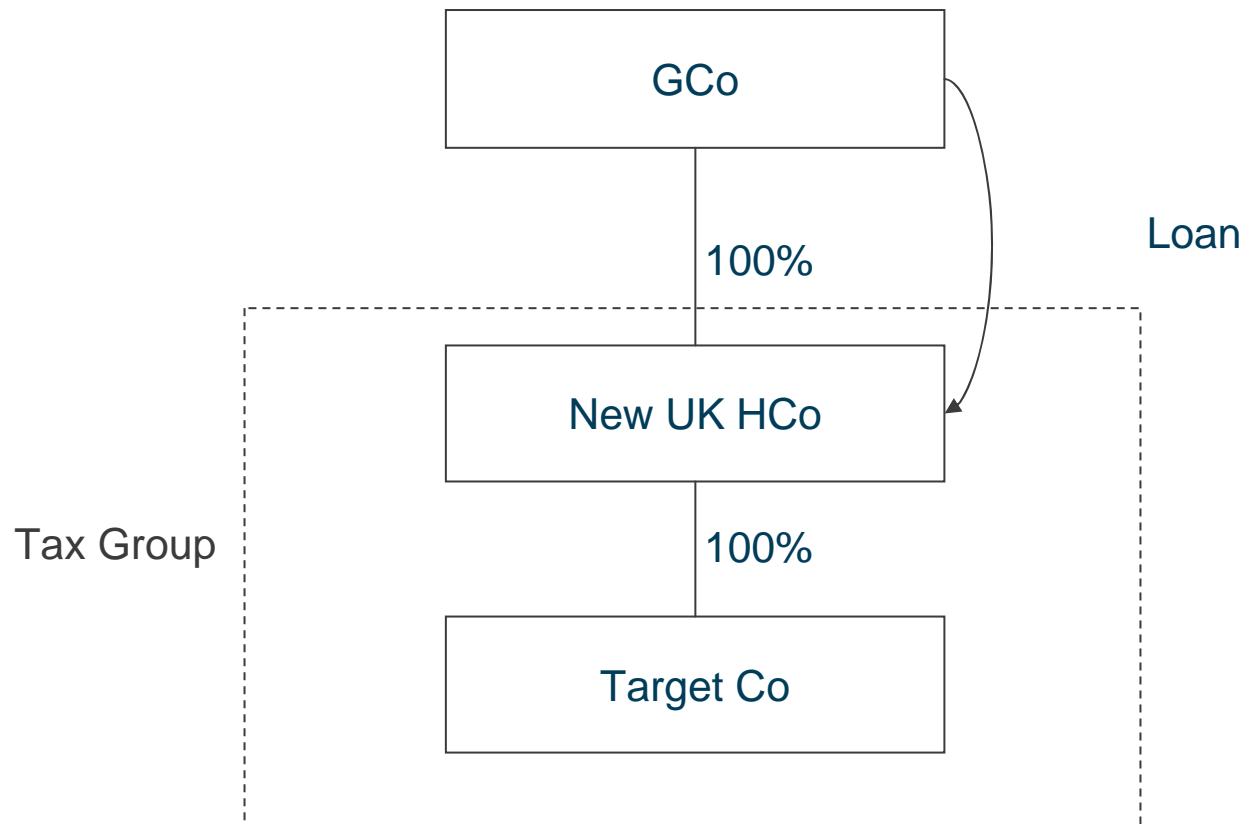
- UK Developments
 - Inbound investment
 - Outbound investment
- Germany/UK Double Tax Treaty
 - Principal changes
- Cross Border Issues
 - Beneficial ownership
 - Restructuring: Commissionaire/Agent arrangements
 - Anti-avoidance

- Corporation tax rate – 28% reducing to 24% by 2014
 - Lowest of G20 countries
- Income tax rates
 - 20% up to £37,400
 - 40% above £37,400
 - 50% above £150,000
- Capital Gains Tax rates – 18% and 28% (for higher rate income tax payers)
- Social Security (National Insurance): Employers' rate 12.8% rising to 13.8% April 2011
Employee rate: for higher rate payers 1% rising to 2%
- VAT 17.5% rising to 20% on 4 January 2011
- Remittance basis taxation: UK resident non-domiciled individuals
£30,000 voluntary annual charge for long term non doms (7 out of 9 or more years residence)

- Largest network of double tax treaties (in excess of 120)
- No withholding tax on dividends
- OECD Compliant
 - Transfer Pricing – Arms length standard
 - Business restructuring – no “Industrial Intangible”
- EU Compliant? Marks & Spencer
Cadbury Schweppes
Thin capitalisation cases

- Statutory and Non Statutory Rulings and Clearances Programme
 - HMRC business like and commercial
 - APA and ATCA programme
- Compliance Programme: dialogue with HMRC
“low risk” status
- Foreign Profits Reform
 - Dividend exemption
 - Worldwide debt cap; no interest attribution
 - CFC and branch tax reforms: 2011/2012

UK: Inbound Investment Structure



- Foreign Profits Reforms

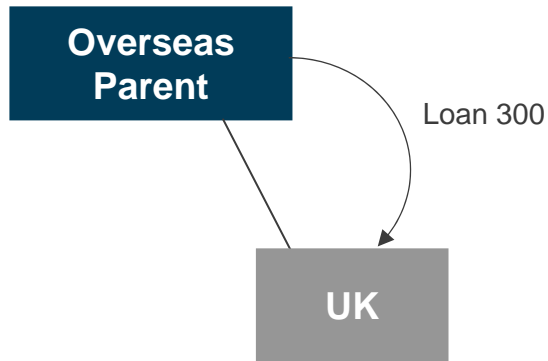
- June 2007: 3 part package
- 2008: extensive consultation – (passive) income not entity based to target “artificial diversion of profits” from UK
- 2009 legislation
 - Foreign dividend exemption, and
 - Worldwide debt cap, but
 - CFC reforms delayed

- Inversion transactions

- Foreign dividend exemption introduced 1 July 2009
 - Exemption for dividends:
 - Paid by controlled companies
 - On non-redeemable ordinary shares
 - In respect of portfolio holdings
 - Derived from transactions not designed to reduce tax
 - In respect of shares accounted for as liabilities
 - Certain non-dividend distributions excluded
 - UK and foreign dividends treated alike

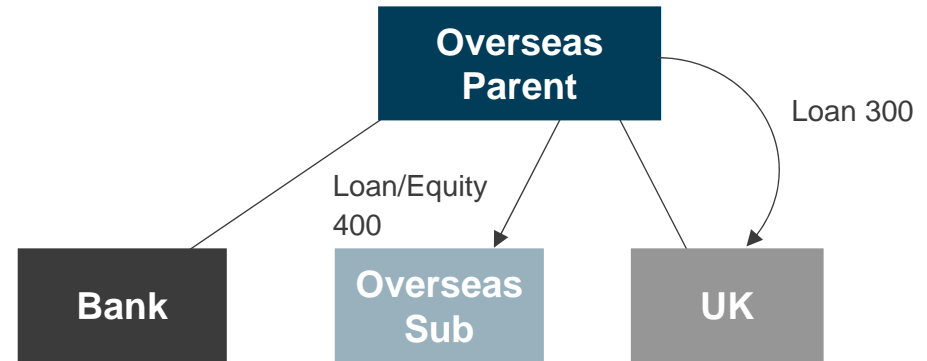
- Introduced for periods commencing on/after 1 January 2010
- Measures net finance expense of UK group entities against gross finance expense of worldwide group
- Foreign parented groups may be able to rely on gateway test:
 - If UK net debt is <75% of worldwide gross debt of group, then the rules do not apply
- Companies can elect for short term finance and treasury companies to be excluded
- The rules can hit upstream loans to UK, or where foreign parent is largely equity-financed

Debt Cap Gateway Test



Debt Cap Analysis

Consolidated group has no external debt:
therefore all interest on Loan to UK
will be disallowed



Debt Cap Analysis

If Overseas Parent borrows (e.g. to invest in
overseas sub) UK interest could
become allowable

Possible incentive for groups to gear up/disincentive to de-leverage?

- Revised Consultation Document, January 2010
- Scheduled to be introduced in 2011; now delayed to 2012
 - Intended to be more targeted on “artificial diversion” of profits away from UK
 - Territorial basis
- To be assessed on entity basis (as now): not by reference to income streams
- Possible gateway test: is foreign jurisdiction’s tax rate and base similar to UK?
- Remove presumption that most intra-group activities are caught, and that activities which could be carried out in the UK should be
- Focus on “genuine trading activities” – meaning?
- Target profits “artificially diverted from UK” – meaning?
- Not “cliff edge”: all or nothing
- 2011 interim improvements: commercially justified activities test
 foreign to foreign non-monetary exemption

CFC Rules: Exemptions

- Specific exemption for foreign **treasury** companies
- Contrast: foreign **finance** companies subject to a debt: equity test: provided they do not lend back to the UK
- Specific exemption for “active” **IP management** companies
 - Will be tested by reference to expertise of local staff
- Contrast: “passive” IP management companies may be caught if equity financed, or if there is a licence back to the UK
- Possible “earn-out” charge: on IP transferred out from the UK when value is “difficult to determine”

Taxation of Foreign Branch Profits

- Possible corollary of foreign dividend exemption
- Alternatives:
 - Tax branch profits and relieve losses
 - Exempt branch profits and give no relief for losses
 - Exempt branch profits and relieve losses, subject to claw-back
 - Exempt branch profits and give terminal loss relief
- Possible pooling approach?
- Principally relevant to banks and oil companies

Germany/UK Double Tax Treaty

- 1964 existing treaty (amended by 1970 Protocol)

- 2010 new treaty
 - OECD Model based
 - Signed 30th March 2010
 - Ratification –

Germany:	Bundestag - October
	Bundesrad - November
United Kingdom:	Parliamentary Debate – 29 th November
	Order in Council – 15 December

- **Article 31** - entry into force after exchange of instruments of ratification – December?
- effective 1st January 2011?

- **Article 3** - general definitions
- Article 3(2) meaning of terms not defined

- **Article 4** - definition of resident

- **Article 5** - permanent establishment
- Article 5(5) dependent agent
*“personhabitually exercises an authority to conclude contracts in the name of **on behalf of** the enterprise”*

- **Article 7 (Business Profits)**

- Attribution of profits as if p.e. was a “distinct and separate” enterprise
- Expenses?
- Dealings?
- Capital Attribution?

- **Article 7(4):**

“Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.”

Treaty Provisions – Article 10 (Dividends)

- Dividends taxable in source state
- If recipient resident in other Contracting State is “beneficial owner” tax restricted to following percentages of gross amount of dividend:
 - 5% where recipient is company owning 10% of capital
 - 10% where recipient is pension scheme
 - 15% all other cases
- No withholding tax on UK dividends
- Dividends connected to p.e. taxable under Article 7

“Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment situated in that other State, nor subject the company’s undistributed profits to a tax on the company’s undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.”

- In practice restricts Germany from taxing UK company’s undistributed profits or dividends paid by it out of profits earned in Germany unless connected to Germany p.e. or paid to German resident.
- Main purpose anti-avoidance test (Article 10 (6))

- **Article 11** (Interest), **12** (Royalties) and **21** (Other Income)

- All contain a main purpose anti-avoidance provision:

“No relief shall be available under this Article if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the debt-claim in respect of which the interest is paid to take advantage of this Article by means of that creation or assignment.”

(Article 11(5))

- The Interest and Royalties Articles also contain a “special relationship” anti-avoidance article:

“Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest paid, exceeds, for whatever reason, the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payment shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention”.

(Article 11(4))

- **Article 14** (Employment Income)
 - OECD Model Form and subject to:
 - Article 15 – directors fees
 - Article 17 – Pensions, Annuities and Similar Payments
 - Article 18 – Government Service

- Source State taxing right subject to 183 day rule
 - Who is “employer”?
 - Who pays remuneration/bears its cost?

- **Article 16** (Artistes and Sportsmen)

- **Article 23** (Elimination of Double Taxation)

 - New provisions dealing with assessment basis calculation in Germany

- **Article 24** (Limitation of Relief)

 - The “remittance” article
 - No Treaty relief on income/gains taxed in state of residence on remittance basis unless remitted
 - Applies to UK resident non UK - domiciled individuals on their German source income and gains

- **Article 26** (Mutual Agreement Procedure)

- Taxpayer presents case:

- within **3 years** from first notification of action resulting in taxation not in accordance with Convention; or

- within **6 years** from end of taxable year for which tax is imposed/proposed

- Arbitration provision if Competent Authorities cannot agree
(Article 26(5))

- **Article 27** (Exchange of Information)

- **Article 28** (Assistance in Collection of Taxes)

- **Article 29** (Procedural Rules for Taxation at Source)

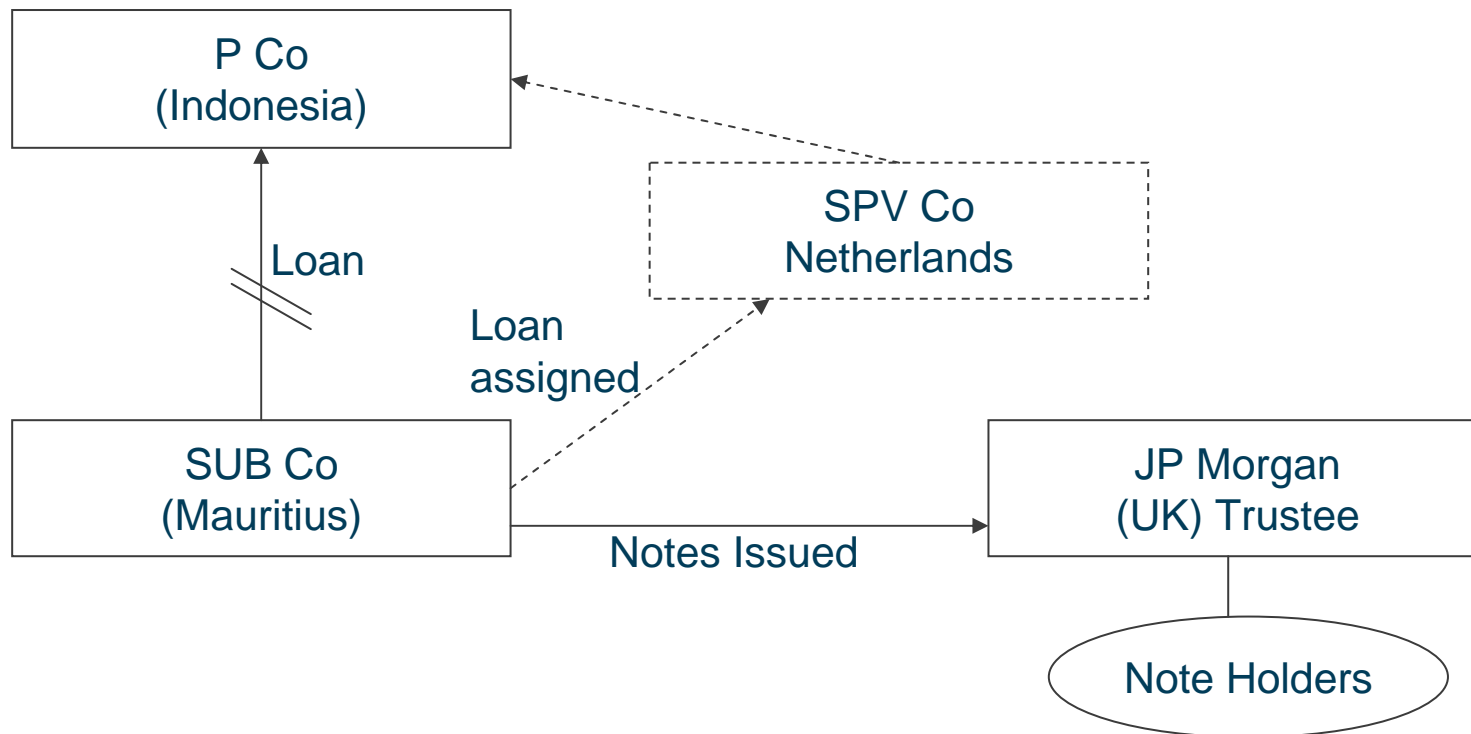
CROSS-BORDER ISSUES

- “Interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State”. (Article 11(1)).
- “As regards the application of the Convention at any time by a Contracting State any term not defined shall, *unless the context otherwise requires*, have the meaning that it has at that time under the laws of the Contracting State for the purposes of the taxes to which the Convention applies”. (Article 3(2)).
- Under English law, if lender does not declare trust over its rights under loan agreement and does not otherwise assign those rights, it will generally be treated as beneficial owner of interest.
- Contractual obligations to pass on interest usually irrelevant

- Would “context require” alternative approach?
- Obvious consideration is OECD model on which UK treaties are predominantly based and associated commentary.
- “ a company cannot normally be regarded as the beneficial owner if, though, the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties”.
(OECD Commentary on Article 11).
- Indofood case.

- Borrowing by Indofood (Indonesian Company) structured through a Mauritian SUBCo to get benefit of reduced (10%) WHT rate
- Loan provisions allowed early redemption if WHT rate increased unless “reasonable measure” available to avoid increase
- Borrower wanted to redeem since loan interest rate higher than market rate
- Was restructuring through a Netherlands SPV a “reasonable measure”?
- Issue: would Netherlands SPV have been **beneficial owner** and **resident** in Netherlands for purposes of Indonesian/Netherlands DTT?
- Fact: Netherlands SPV would be bound to pay interest received to security trustee; back-to-back contractual arrangement. No spread; possibly a fee
- Court looked at legal, practical and commercial structure.

Indofood - Structure



UK Court of Appeal
Reference: [2006] EWCA Cw 158

- Precedent Value:

The Court's conclusion on "beneficial ownership"
a finding of fact not law; not binding on UK Courts

International precedent value?

- Meaning of beneficial ownership:

Court applied and interpreted OECD Model
Convention Commentaries (2003/2005) and
1986 Report on Conduit Companies

*"... not used in a narrow technical sense ... understood in its context and in
the light of the object and purpose of the Convention including ... prevention of
fiscal evasion and avoidance"*

did SPV Co have *"the full privilege to directly benefit from the income"*
(Indonesian Government submission)

what does this mean?

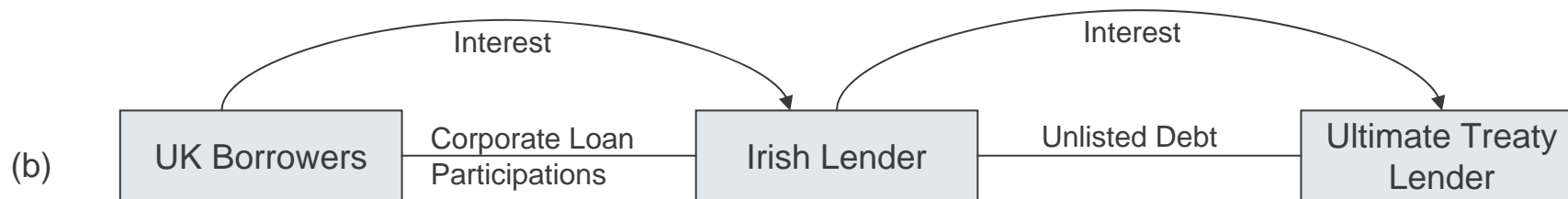
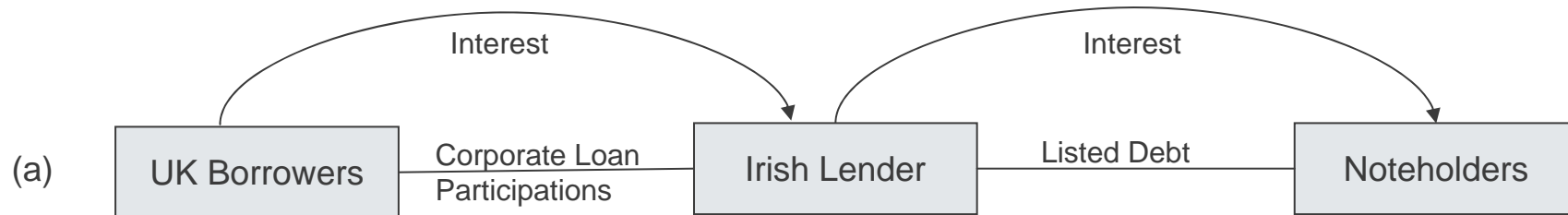
- Not a UK tax case

- Beneficial ownership: Domestic/international meaning
 - In absence of Treaty definition domestic meaning applies
 - “*save where the context otherwise requires*”
 - Article 3 (2) OECD Model Convention
 - Is there an overriding context?
 - DTR to be “*interpreted in good faith and in accordance with the ordinary meaning to be given to [its] terms in their context and in the light of its object and purpose*”
 - Article 31(1) Vienna Convention on the Law of Treaties
 - International meaning: “switched on” where treaty abuse
 - Wider than UK domestic law
 - Wider than conduit, nominee, “pass through”
 - HMRC have adopted Indofood as wide-ranging weapon against perceived withholding tax avoidance in conduit/SPV structures

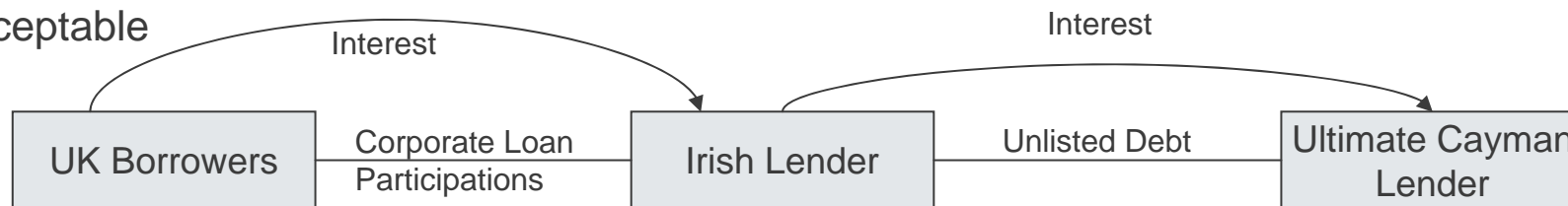
- UK Tax Authorities reaction
 - Guidance: INTM 332050
 - Few cases of material difference between DTC “international fiscal meaning” and UK domestic meaning of beneficial ownership
 - Will use international fiscal meaning where Treaty abuse e.g. treaty shopping
 - No change to HMRC Policy; just not applied fully up to now!
 - Gap between mere administration and full ownership – more open to challenge!
 - Added words: “... and that tests of the legal structure, and of the commercial and practical substance of the scheme, should be adopted to determine beneficial ownership”.
 - “Safe harbour” for certain capital markets structures using SPVs

HMRC Guidance: acceptable and non-acceptable SPV Structures

Acceptable



Unacceptable

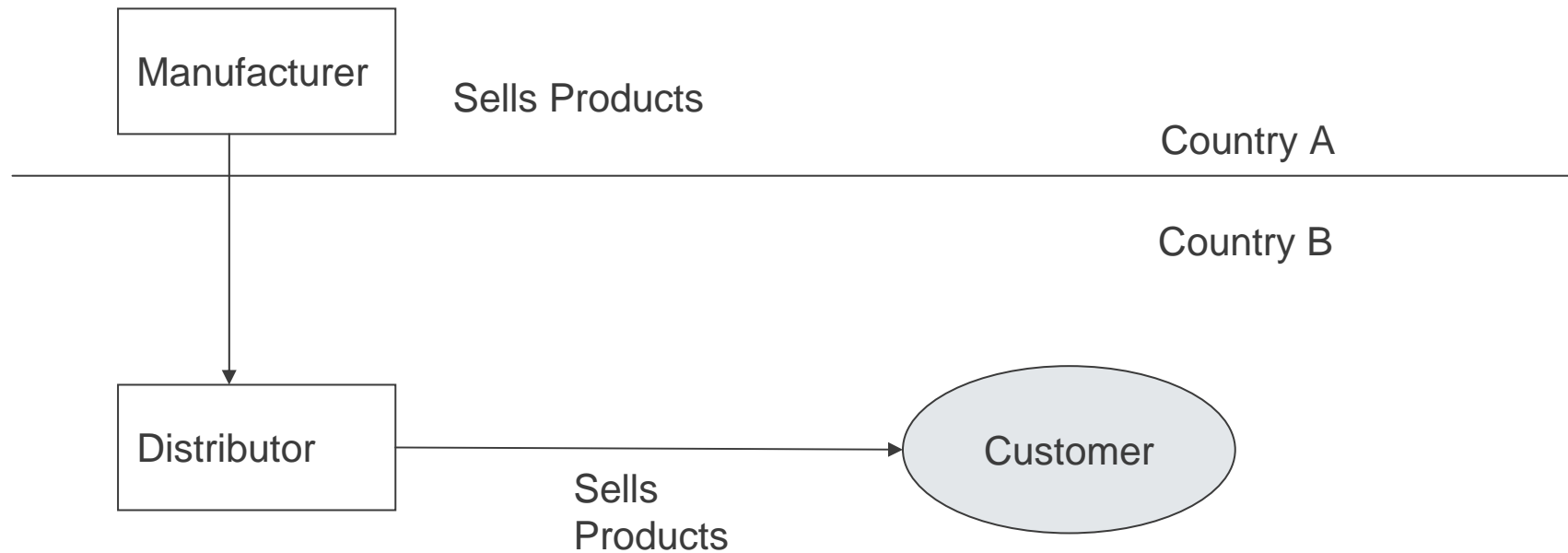


COMMISSIONAIRE/AGENT ISSUES

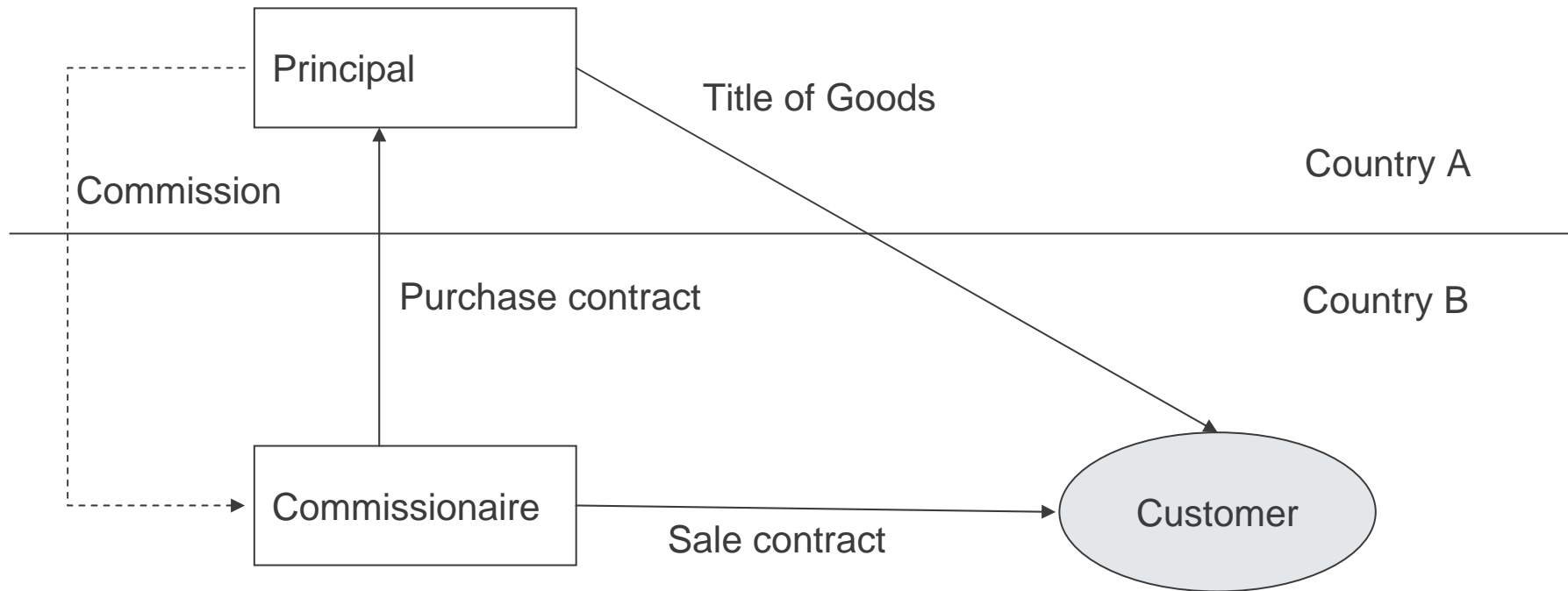
Business Restructurings – OECD Overview

- Arms length principle does not require compensation for loss of profit/loss potential per se; not an asset in itself – not an “industrial intangible”
(see 2005 Paper)
- No presumption of indemnification for all contract terminations/renegotiations
- Non recognition of transactions: dealt with if possible by pricing adjustment
- Approach to post-restructuring: no different application of TP Guidelines and arms length principle
- “Commercially rational behaviour” test (para. 37 TP Guidelines) can include restructuring to obtain tax savings if functions, assets and/or risks actually transferred
 - i.e. can be tax motivated provided non-business tax purpose present

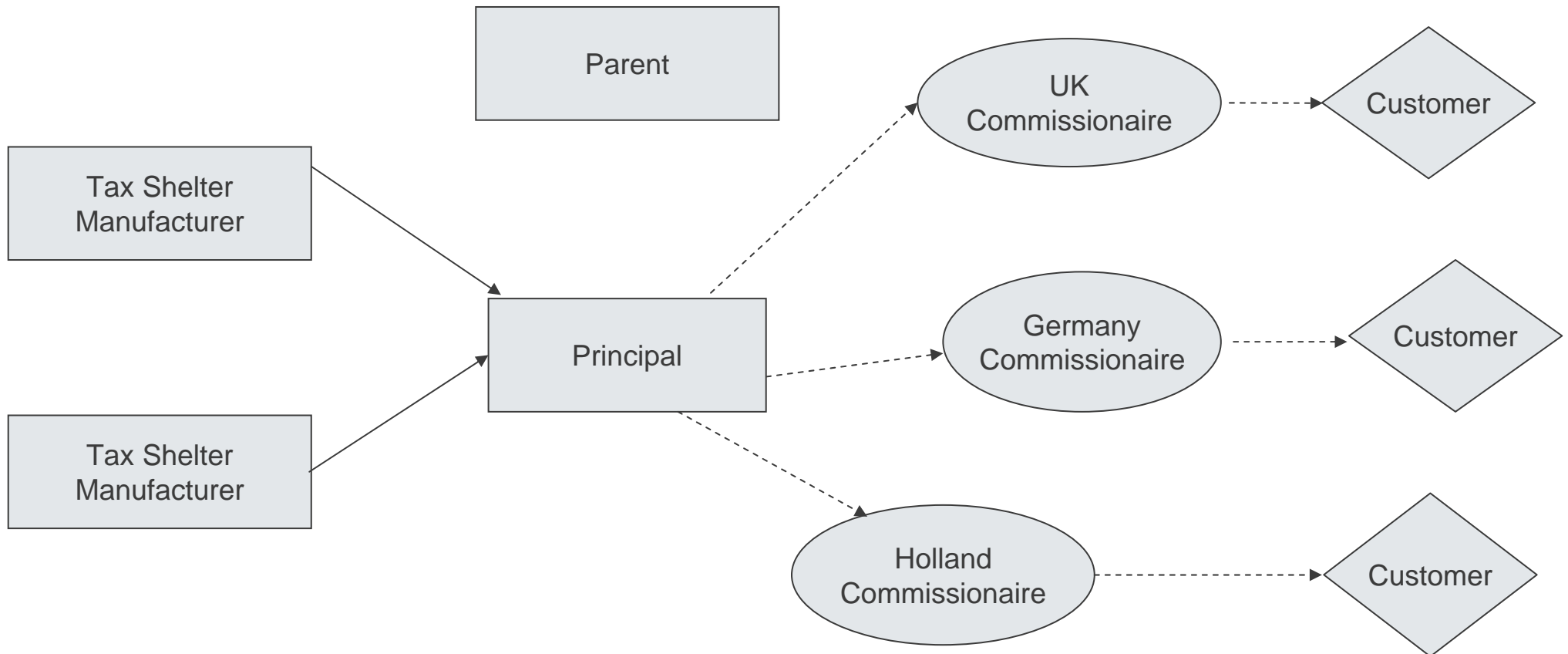
Traditional Way of Selling in the UK



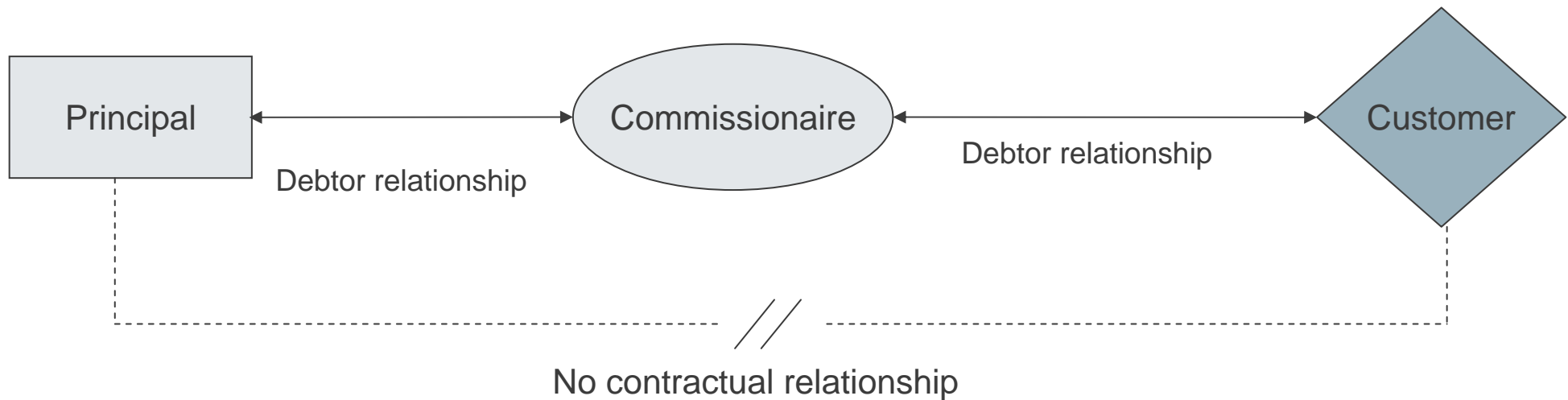
Commissionaire



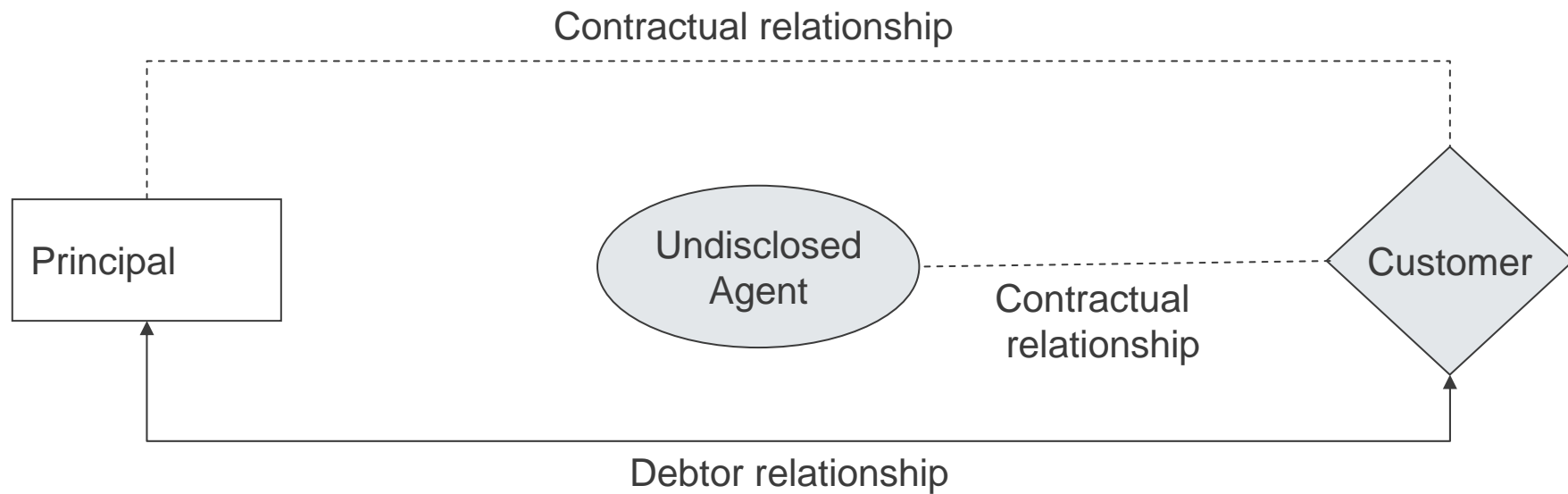
Commissionaire In Overall Structure



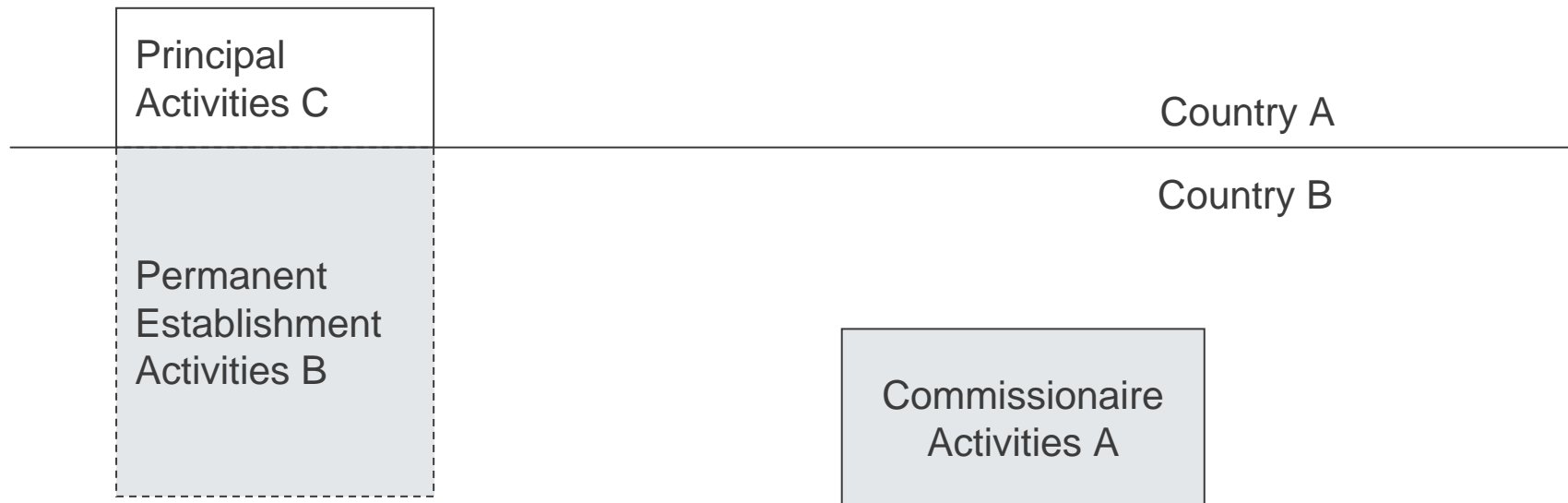
Commissionaire – Civil Law



Undisclosed Agent



Arm's Length Reward



- Case law
- No General Anti-Avoidance Statutory Test (GAAR)
- Series of Targeted Anti-Avoidance Rules (TAARs)
- Impact of EU case law?
 - Anti-abuse doctrine

- The journey from literal interpretation of tax statutes and the formalistic insistence on examining steps in a composite scheme separately to a purposive construction applied to the transactions viewed realistically.

- *“No commercial man in his senses is going to carry out a commercial transaction except upon the footing of paying the smallest amount of tax that he can”.*

Lord Upjohn IRC v Brebner [1967]2 AC18 at 30

IRC v. Duke of Westminster (1935) 19 TC 490

“Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow tax-payers may be of his ingenuity, he cannot be compelled to pay an increased tax.” Lord Tomlin, at p520

- Traditional approach to tax avoidance – lasted until the 1980’s.
- In a complex transaction, legislation would be applied to each part separately – the courts would not examine the overall purpose.
- Parliament enacted precise tax avoidance legislation.

WT Ramsay v. IRC (1982) S4 TC 101

- Change from the traditional approach – the “*Ramsay Principle*”.
- The courts began looking at a series of transactions as a whole - “*to force the court to adopt, in relation to closely integrated situations, a step-by-step dissecting approach which the parties themselves may have negated, would be a denial rather than an affirmation of the true judicial process.*” (p.187)
- When deciding the nature of a series of transactions, any steps taken that just to avoid tax were to be considered a fiscal nullity.
- Even if “commercial effect” ignored if no “commercial purpose”.

Furniss v. Dawson (1984) SSTC 324

- Endorsed *Ramsay* and detailed more conditions to be met before applying tax legislation.
- Not directly overruled but *BMBF & SPI* stated that this case had no future role in considering anti-avoidance legislation.

MacNiven v. Westmoreland (2001) 73 TC1

- A new approach that drew on *Ramsay* with little reliance on *Furniss*.
- *Ramsay* stated key points:
 - Identify the legal nature of the transaction.
 - No transaction is to be treated as a sham, each must be put in their legal context.
 - Courts must relate the transaction to the statute in a purposive way.
- Lord Hoffman – dichotomy between “legal” and “commercial” concepts in tax legislation.
- No tax avoidance principle; no “broad spectrum antibiotic”

Collector of Stamp Revenue v. Arrowtown Assets [2003] HK CFA 46

- Stated that the dichotomy was wrong.
- Last case to involve concepts external from the legislation.

BMBF v. Mawson [2003] UK HL 51

- *“Ramsay did not introduce a new doctrine operating within the special field of revenue statutes.”* [2003] UKHL 51 at paragraph 32.
- *“The question is always whether the relevant provision of the statute, upon its true construction, applies to the facts as found.”* [2003] UKHL 51 at paragraph 32
- Statutory provisions should be given a purposive construction to determine the type of transaction to which they are intended to apply and then look at the transaction in question to decide whether it answers to the statutory description.
- This was not a rigid two step process, so courts should be flexible.

IRC v. SPI [2004] UK HL 52

- Confirmed *BMBF*.

Duke of Westminster

- Legislation applied to each separate transaction.
- Anti-avoidance legislation very specific.

Ramsay

- Complex transactions should be looked at as a whole.
- Any transaction inserted only to avoid tax should be treated as a nullity.

Westmoreland

- Start of the new approach to interpreting tax legislation – using a purposive construction rather than external rules.
- Lord Hoffman identified a dichotomy between “legal” and “commercial” concepts in tax legislation. Later rejected.

BMBF

- Tax legislation should be constructed in a purposive manner and then applied to the facts of the transaction – flexible.