BDO

BDO Seidman, LLP
Accountants and Consultants

May 2004 – No. 13

International Tax

In this issue:

- Ireland Exempts Gains on Substantial Shareholdings
- European Court Strikes Down Exit Charges
- Ireland Eases Foreign Tax Credit Rules
- German Tax Authorities Rule on Status of U.S. LLCs
- Netherlands and U.S. Amend Treaty
- New Opportunity Created By German Thin Capitalization Rules
- US – Japan Treaty in Force

Ireland Exempts Gains on Substantial Shareholdings

Ireland has recently passed legislation exempting capital gains from the sale of substantial corporate shareholdings from tax. The exemption is contained in Ireland's Finance Bill currently being considered by the Dáil, and will take effect retroactively from January 1, 2004.

The exemption will apply to companies selling substantial shareholdings in other companies that they have held for a certain minimum period; however, both the investor and investee companies have to satisfy certain activity criteria.

Broadly speaking, an Irish (investor) company selling shares in another (investee) company (which need not be resident in Ireland) will be exempt from Irish corporation tax on chargeable gains where:

- the shareholding amounts to at least 10% of the investee company's share capital and has a value of at least 15 million, or, alternatively, to at least 5% and has a value of at least 50 million;
- the investee company is a trading company or a holding company of a primarily trading group; and
- the shares have been held for a minimum 12 months in the preceding three-year period.

Dividends paid within Ireland are already exempt from corporation tax but foreign dividends are normally subject to corporation tax.

The exemptions and other changes in the Finance Bill should undoubtedly increase Ireland's attractiveness as a holding-company location.

European Court Strikes Down Exit Charges

Most EC member states levy exit charges on emigrating individuals or companies. Typically, the charge arises from a deemed disposal by the individual or company of capital assets. However, following the recent judgment of the European Court in the case of *Hughes de Lasteyrie du Saillant v Ministère de l'Economie, de la Finance et de l'Industrie*, Case C-9/02 ruled that companies wishing to relocate from EC member states should no longer face a tax penalty ("exit charge").

This is the latest blow the European Court has struck for taxpayers and against the tax authorities of member states that stand to lose millions in tax revenue as a result.

As expected, following the earlier opinion of the Advocate-General in this case, the European Court has held that exit charges — at least where emigration to another member state is concerned — are in breach of the EC Treaty.

The case actually concerns a wealthy French national who emigrated to Belgium. In accordance with French law, he was deemed to have realized his significant shareholding in a French company. If he had remained in France, he would, of course, not have been liable to tax unless and until he had actually disposed of the holding. He contended that this exit charge was in breach of article 43 of the EC Treaty, which guarantees freedom of establishment. The case was referred to the European Court.

The court concluded unequivocally that an exit charge on taxpayers who transfer their residence to another member state, which takes the form of a deemed disposal of assets where no such disposal has in fact taken place, is in breach of article 43 of the EC Treaty.

Although the case was brought by an individual, the judgment applies equally to companies (the court refers to taxpayers in general). The exchequers of the member states (including U.K., France, and Germany) may be faced with potentially significant demands for repayment of tax and interest on past corporate (and in some cases, individual) migrations. In addition, in the future, companies may be able to use this change in law to their advantage if they are planning to relocate, e.g. to Malta, Cyprus, or any other member state.

Protective claims should be considered for taxpayers who have faced an exit charge on migration to another EC state. ■

Ireland Eases Foreign Tax Credit Rules

Other international measures in Ireland's Finance Bill make it easier for Irish companies owning foreign shareholdings to claim relief for foreign tax paid on foreign dividends and the profits from which they are paid.

Until now, Irish companies have had to have a minimum direct holding of 25% in a foreign company before they could claim relief against foreign tax on dividends received or on the profits out of which the dividend is paid ("underlying tax"). This was the case whether or not the country of residence of the company paying the dividend had a tax treaty with Ireland. With retroactive effect from January 1, 2004, the minimum holding is reduced to 5%. Further changes will:

- for the first time allow credit to be claimed for foreign tax on second and lower-tier subsidiaries;
- allow foreign tax credits to be averaged across all 5%-plus holdings (to reduce the possibility of wasted foreign tax credit where there is insufficient Irish tax payable in respect of a single dividend); and
- allow credit for some "subnational" taxes (such as U.S. state taxes) not currently eligible for relief under a double tax treaty. ■

German Tax Authorities Rule on Status of U.S. LLCs

The German tax authorities have issued guidance on the tax treatment of U.S. LLCs (limited-liability companies). LLCs are a hybrid type of entity that are much used in international tax planning, as they are normally transparent for tax purposes in the U.S. whereas they have many of the characteristics of a company.

The new guidance simplifies existing principles, rather than breaking particularly new ground. Essentially, the German tax authorities use eight criteria to determine whether to treat a particular LLC as a corporation or a partnership for German tax purposes. Those criteria are:

- Centralization of management
- Limited liability
- Free transferability of interests
- Accessibility of profits
- Equity contributions
- Continuity of life
- Profit allocation
- Formation requirements

Because of the wide range of options to structure an LLC under the laws of the various states of the U.S., the Germans conclude that classification of U.S. LLCs is to be made on a case-by-case basis, taking into account the structure of the LLC under examination, based on applicable state laws and the LLC agreement or other relevant organizational documents.

The classification decision rests on an overall assessment of whether these characteristics of the given LLC more closely resemble those of a typical German company or those of a partnership. Each of the criteria must be reviewed according to its particular relevance, and no single criterion is decisive.

If the LLC is treated as a partnership for German, but not for U.S., tax purposes, its profits are exempt from German taxation under article 23 (2)(a) of the treaty, to the extent that they can be allocated to a U.S. permanent establishment (for example, a place of management) of the LLC. There is no credit for any U.S. withholding taxes imposed on LLC distributions.

If the LLC is treated as a company for German, but not for U.S., tax purposes, Germany will treat the LLC distributions as dividends. In the case of LLC members who are German individuals, this would result in the double taxation of U.S. earnings without credit for any U.S. taxes paid. In principle, German corporate members would benefit from the 95% German exemption for foreign dividends; however, to the extent that the LLC earns certain forms of passive income, this could be taxable under German controlled-foreign-company (CFC) rules.

The new guidance should pave the way for a wider use of LLCs for investment into the U.S. from Germany. Those investors who have already taken advantage of LLC structures should review the classification of their existing LLCs. Other investors and MNCs may wish to consider use of LLCs given the greater certainty under the new guidance. ■

Netherlands and U.S. Amend Treaty

Though the timing of its ratification by the U.S. Senate is an open question, the U.S. and the Netherlands signed a protocol on March 8, amending the existing 12-year-old income tax treaty. The focus of the new treaty is a zero rate on certain intercompany dividends and changes to the limitation on benefits provision, thereby making the Netherlands a more attractive investment location. Under the new protocol, dividends paid by U.S. companies to certain Netherlands' companies are free of U.S. withholding tax, though the existing U.S. tax rates of 5% and 15% would remain on "direct" and "portfolio" dividends, respectively. The types of companies qualifying for the exemption are quoted companies that have held 80% or more of the U.S. paying company for at least 12 months and acquired the shares before October 1, 1998. The U.S.-Netherlands protocol also:

- eliminates U.S. branch tax on profits remitted by U.S. branches of Netherlands companies to their head office, and
- simplifies the complicated and extensive anti-avoidance article in the treaty.

Many international structures will have Netherlands holding or subholding companies. Where these companies have U.S. subsidiaries, those subsidiaries will now be able to pay dividends to their Netherlands parent without deducting withholding tax where the relevant conditions are satisfied. The protocol will not take effect for some time, but probably no later than January 1, 2005, so it may be advisable to defer such dividends until it does take effect. ■

New Opportunity Created By German Thin Capitalization Rules

Recent German guidance presents new planning opportunities to German companies with significant intercompany loans to U.S. subsidiaries.

As recently addressed in our Tax Alert entitled *New German Tax Law Changes to Severely Impact Businesses* dated January 8, 2004, the new German tax law contains *inter alia* changes relating to the thin capitalization rules. These changes were made in order to conform to EU Law, so as to eliminate the distinction between how the thin capitalization rules were applied to non-resident and domestic shareholders of German entities.

This rule may also benefit German parents of U.S. subsidiaries. More specifically, if a German parent loans to its U.S. subsidiaries, based upon the new rules, certain interest income of the German entity could be deemed dividend income. The dividend income could qualify for the 95 percent exemption by the German parent. Thus, if the payments made by the U.S. subsidiary are deductible interest for U.S. tax purposes, this financing may yield income tax benefits.

Consequently, in certain circumstances, and with careful implementation, strategic tax planning might work to successfully minimize the overall tax burden in Germany and the U.S. In summary, this could have the same income tax benefits as a hybrid loan without the harsh consequences otherwise imposed by the U.S./Germany income tax treaty on hybrid loans.

Recommended Action:
Our international tax consultants can assist you in determining how this new opportunity can apply to your financing arrangement. Well-versed in the changing German tax rules, we provide value-added, practical advice for a wide variety of multinational companies. ■

US – Japan Treaty in Force

The new double tax treaty between the U.S. and Japan has entered into force. It has effect from various dates, the earliest of which is July 1, 2004. The main changes from the previous treaty are:

- the elimination of withholding tax on royalty income (previously 5%), although royalties judged to be in excess of arm's-length rates will continue to be taxed at 5% in the source country;
- the elimination of withholding tax on certain dividends, notably those paid by a subsidiary in one country to a parent company in the other, provided that the parent has owned more than 50% of the subsidiary for at least 12 months before the payment;
- the reduction of withholding tax on other dividends from 10% to 5% and from 15% to 10%, with some exceptions; and
- the elimination of branch tax on remittances of profits by the branches of publicly quoted companies.

However, there is a comprehensive anti-avoidance article to deny the benefits of the treaty to conduit arrangements and in certain other circumstances.

Arrangements for existing or planned investments from one country to the other should be reviewed immediately. In particular, this applies to international structures that have made use of intermediate entities to reduce withholding tax on flows of income between Japan and the U.S. ■

For More Information:

Jack Frame

BDO Seidman, LLP

330 Madison Avenue

New York, NY 10017

Tel : 212-885-8125

Fax : 707-982-0633

Email: jframe@bdo.com

Editorial Commentary Provided By:

Nick Udal, Partner

BDO Stoy Hayward, LLP, London

Robert Pedersen, Partner

BDO Seidman, LLP, New York

Shawn Carson, Partner

BDO Seidman, LLP, New York

John Santa Maria, Senior Manager

BDO Seidman, LLP, New York

The Tax Practice at **BDO Seidman, LLP** is among the largest tax advisory practices in the U.S. With 35 offices and more than 250 alliance firm locations in the U.S., BDO Seidman, LLP has the bench strength and coverage to serve you.

As a member firm of BDO International, BDO Seidman, LLP belongs to a worldwide network of independent professional firms that combined offer 23,000 partners and staff operating in 99 countries and close to 600 offices.

Material Discussed in this newsletter is meant to provide general information and should not be acted on without professional advice tailored to your firm's individual needs.