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UK extends transfer pricing and thin-cap rules to domestic transactions

Driven by concerns that the UK's transfer pricing and thin capitalization rules may be contrary to European law, the Government has decided to press ahead with proposals to extend the scope of these rules to transactions within the UK. Unlike Spain and Ireland, for example, which have decided to scrap their thin capitalization restrictions where the lender is a company resident elsewhere in the EC, the UK has decided to 'harmonize downwards'.

The UK's new legislation has been published in draft, and will bring thin capitalization rules into its transfer pricing legislation (so that there will be no separate thin capitalization regime as at present). The new legislation will take effect from 1 April 2004, although certain aspects are still open for consultation until 10 February 2004.

An exemption from UK transfer pricing rules (including thin-cap) is proposed for small businesses for transactions with companies in the UK or a country with which the UK has a comprehensive tax treaty, whilst medium size businesses will also enjoy this exemption in most circumstances. A medium size business is one with fewer than 250 employees and either turnover of less than €50 million or assets of less than €43 million. For a transitional period to April 2006, penalties for keeping insufficient records will not arise in certain circumstances.

The new regime will allow for a compensating reduction in the profits of a UK company where a transfer pricing adjustment has been made to increase the profits of another UK company. A tax-free 'balancing payment' will then be permitted between the companies.

RECOMMENDED ACTION:

Any groups not falling within the definition of 'small and medium-size', will need to give attention to the impact of the proposed legislation. An analysis of all intra-UK-group transactions and financing balances should be carried out as soon as possible, and in advance of 1 April 2004.

Spain relaxes thin-cap rules for EC borrowing

Spain is also planning to amend its thin-capitalization rules in the aftermath of the European Court's decision in *Lankhorst-Hohorst*. In that case, it will be remembered, the court held that German law was in breach of the EC Treaty by disallowing interest paid by a thinly capitalized German subsidiary to a foreign related company, but not doing so where the lender was a German-resident company. The changes made by Spain will make it easier to pay interest out of Spain to a related party elsewhere in the EC.

As a result of the *Lankhorst-Hohorst* case, several EC member states with similar legislation were obliged to amend their law to comply with the decision. Germany, like the UK, has opted to apply the thin-capitalization rules across the board. The Netherlands, which suffered a similar defeat at the hands of the European Court (in the *Bosal* case) over its interest-deduction rules, has introduced thin-capitalization rules (applying to domestic and foreign borrowings) for the first time. Ireland, on the other hand, which has a rule very similar to the UK's (under which, broadly, interest paid to a 75% foreign affiliate is treated as a dividend) has opted simply to scrap its thin capitalization restrictions where the lender is a company resident elsewhere in the EC.

Now Spain has followed Ireland's lead. In the Budget Bill for 2004, the Spanish government is proposing to disapply its thin-capitalization legislation (which treats interest paid by a

Spanish company to a foreign related-party lender as non-deductible to the extent that the Spanish company's debt-equity ratio exceeds 3:1) to cases where the foreign lender is resident in another EC member state, unless that state is officially regarded by Spain as a tax haven.

As is the case with Ireland, this leaves Spain vulnerable to having profits stripped out of that country by high interest payments to related EC companies. In Ireland, the authorities presumably hope that Ireland's low corporate tax rates would make this unlikely. Spain, with a 35% corporate tax rate is not in the same position.

NEC TEST CASE: Non-EU discrimination

A test case concerning whether ACT paid by a UK subsidiary of a Japanese parent was discriminatory was recently heard by the High Court. Whilst the litigants lost, the judgment can be seen as lending support to a number of other Group Litigation Orders being pursued by non-EC parented groups, for example in relation to the UK's loss relief and CFC rules.

The case echoed the *Hoescht/Metallgesellschaft* Litigation, where two German parented companies successfully claimed restitution for interest on ACT paid (in a case before the European Court of Justice) on the grounds of discrimination.

In the NEC case, Park LJ has held that the UK was in breach of the non-discrimination article of the UK/Japan tax treaty. He nevertheless dismissed the claim because ACT is not one of the taxes defined in Section 788(3) ICTA 1988 so that this aspect of the tax treaty never became part of domestic UK tax law.

Park LJ also decided that an alternative claim was not applicable under Article 56 of the EC Treaty. This article prohibits all restrictions on movements of capital between EU Member States and third countries. However the Judge was of the view that Article 57 rendered Article 56 inapplicable since a restriction on movement of capital with Japan (and other non-EU claimants) countries existed on 31 December 1993.

Permission to appeal has been granted.

UK Government tweaks rule on litigation time cap

A further amendment to the draft legislation imposing a six-year time limit on mistake of law claims was announced on 20 November 2003, with immediate effect from that date.

The six-year time limit was first announced on 8 September 2003, following the victory of Deutsche Morgan Grenfell in the High Court. The Court held that claims for repayment of tax on the grounds of restitution could be made at any time within six years of when it became known that the rule under which the tax was paid wrongly was not lawful, irrespective of when the tax was actually paid. The new legislation provides that such claims can only be made in respect of tax paid no more than six years previously.

The further amendment announced in November prevents taxpayers who had begun their court action before 8 September (and were thus unaffected by the six-year cap) from adding tax paid in years that would be out of date under the cap to their claims if they had not done so already.

If Deutsche Morgan Grenfell wins in the higher courts, the new six-year gap legislation itself may be open to challenge before the European Court for failing to provide an adequate transitional period before imposition of the cap.

EC Commission pushes on with harmonization plans

The Commission of the European Communities is reported to be ready to put forward plans for moves towards corporate tax harmonization across the EC, by proposing two pilot schemes.

The schemes are aimed at creating a level playing field for companies operating in two or more EC member states, and have been under discussion and examination by academics and tax practitioners for a number of years. Under 'home-state taxation' a company based in one member state but with subsidiaries or operations in other member states could opt to have its taxable profits for the group as a whole computed according to the rules of its home state. Each individual state would, however, continue to apply its own tax rates to its share of those profits according to an agreed formula.

The second scheme being put forward by the Commission would create a common tax base applicable throughout the EC. All member states would apply a common set of rules to compute taxable profits of an EC group, whereas their own rules would continue to apply to companies operating purely in their own jurisdiction. A possible platform for the common base would be the new International Financial Reporting Standards (IFRSs), which all EC quot-

ed companies must adopt by 1 January 2005.

Gordon Brown has strongly criticized the proposals on behalf of the UK government, and Ireland and Luxembourg are also hostile. Fiscal decisions still require unanimity from member states.

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Italy's tax reform moves closer

A radical reform of the Italian tax system has moved closer with bills implementing the reform, which has already has parliamentary approval in principle, now being debated by parliament. The reform affects both corporate and personal taxes, but its main effects on companies are as follows:

- A reduction in the corporate tax rate to from 34% to 33%. The dual system, under which there is a lower rate on a fixed percentage return on new equity capital is to be abolished
- Abolition of the imputation system for taxation of dividends. Currently, Italian dividends are taxable, with a tax credit. Foreign dividends are currently treated in one of three ways: EC dividends are 95% exempt; tax-haven dividends are fully taxable; other dividends are 60% exempt. Under the new régime, both domestic and foreign dividends received by Italian companies will be exempt from corporate tax to the extent of 95%. No threshold participation is indicated. The 95% exemption will not apply to dividends from tax-haven companies on the Blacklist.
- Capital gains from disposals of shareholdings in operating companies and of partnership interests will be exempt, subject to a minimum holding period of one year and some anti-avoidance provisions.
- Tax consolidation. Currently, Italy is in the minority of EC member states not allowing for tax consolidation or group relief within a domestic group of companies. Under the new régime, consolidation would be allowed. The parent company could be non-resident, provided that it has a permanent establishment in Italy and is resident in a treaty-partner country.
- What is more, worldwide consolidation under an Italian parent company would also be permitted in certain cases. Currently, only Denmark in the EC has this option, although worldwide consolidation is permitted in France in limited cases. All eligible companies controlled by the parent would have to be included. Dividends from any company in the worldwide group would be exempt from Italian corporate tax.
- Italy's CFC rules will be broadened to include companies in which the Italian resident is directly or indirectly entitled to over 20% of the controlled company's profits (or over 10% in the case of quoted companies).
- Thin-capitalization rules will be introduced, providing for non-deductibility of interest paid on loans from affiliates or guaranteed by them, to the extent that the

Luxembourg goes beyond new Interest & Royalties Directive

The new EC Interest & Royalties Directive, due to be implemented on 1 January 2004, exempts payments of interest and royalties between associated companies resident in different EC member states from withholding tax. The criterion for association is a participation of at least 25%.

Luxembourg has gone several steps beyond what is required in the Directive, however. In its Finance Bill for 2004, the Luxembourg government is proposing to abolish withholding tax on royalties paid by a Luxembourg company to an associated company in another EC member state regardless of the level of participation. There is already generally no Luxembourg withholding tax on interest paid to non-residents.

These changes will enhance Luxembourg's status as a home for finance and licensing companies.

borrower's debt-equity ratio exceeds 4:1; or a higher ratio if a third party lender would have advanced such funds. These rules apply to borrowings from Italian, as well as foreign affiliates. They thus achieve compliance with EU non-discrimination requirements.

- Italian-based shipping companies can opt for a new tonnage tax

The changes are due to be implemented from 1 January 2004.



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