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insights for the private equity and hedge fund communities

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Germany

by Hans Martin Eckstein, Thomas Swoboda and Oscar Teunissen

2007 German Tax Bills

On November 24, 2006, the German Bundesrat approved the 2007 Annual Tax Bill (“Jahressteuergesetz 2007 (JStG 2007)”) as well as the Bill on the Tax Features for the Introduction of the European Company and Amendment of Other Tax Rules (“Gesetz über steuerliche Begleitmaßnahmen zur Einführung der Europäischen Gesellschaft und zur Änderung weiterer steuerrechtlicher Vorschriften (SEStG)”). Both tax bills are important for companies doing business in Germany, as they introduce/amend rules relevant for tax (re-)structuring starting in 2007.

2007 Annual Tax Bill

From an international tax structuring point of view, the most relevant changes brought by the 2007 Annual Tax Bill are the tightened anti-treaty/anti-directive shopping rule, the new domestic subject-to-tax clause, and the fee for binding rulings and advanced pricing agreements (“APAs”).

Anti-treaty/anti-directive shopping rule

Under the 2007 Annual Tax Bill, a foreign company is not entitled to full or partial treaty or EU directive relief from withholding taxes to the extent it has shareholders who would not be entitled to the same relief if they received the income of the foreign company directly, and:

- i. There are no economic or other important nontax reasons for the interposition of the foreign company; or
- ii. The foreign company does not derive more than 10% of its gross income from its own commercial activities (this does not include income that the foreign company generates from the administration of its own assets (such as shareholdings), nor does it include activities that have been outsourced to other parties); or
- iii. The foreign company does not have its own business infrastructure (e.g., office, communication framework, employees) enabling it to participate in the business community.

Any organizational, economical or other attributes from companies that are related to the foreign company will be disregarded. The rule shall not be applicable to a foreign company if there is substantial and regular trading in its main class of shares at a recognized stock exchange or if the German Investment Tax Act applies. The new law shall apply to all dividends (when subject to EU directives or treaties), interest and royalties (both when subject to treaties) paid after December 31, 2006.

Domestic subject-to-tax clause

The 2007 Annual Tax Bill introduces a unilateral subject-to-tax clause. According to this new rule, Germany does not provide for an exemption under a double tax treaty where the income is tax exempt or subject to low taxation in the other country. The domestic subject-to-tax clause shall apply to all years that are not yet finally assessed by the tax authorities, i.e., is retroactive for open tax years for most taxpayers.

Fee for binding rulings and APA

Binding rulings requested from the German tax authorities will be subject to a fee depending on the value of the ruling for the taxpayer. The value of the ruling would need to be provided by the taxpayer but the minimum value is EUR 5,000. If no value is available and the tax authorities cannot estimate it, they charge the taxpayer on a time spent basis; which is EUR 50 per half hour, with a minimum of EUR 100.

Processing an APA will also be subject to fees in the future. The base fee will be EUR 20,000. For an application to extend an APA, the fee is EUR 15,000 and, where an amendment is envisaged, the fee is EUR 10,000. In some circumstances, these fees may be reduced.

Bill on the Tax Features for the Introduction of the European Company and Amendment of Further Tax Rules

- This bill allows for tax-neutral cross-border reorganizations within the EU and European Economic Area as well as the tax-neutral formation and migration of the European Company (“SE”) and European Cooperative (“SCE”).
- In reaction to the European Court of Justice’s decision in the Case Lasteyrie du Saillant (C-9/02) and further EU developments, Germany introduces general exit taxation rules for cases where Germany is definitively losing the right to tax. These rules are applicable to all tax years ending after December 31, 2005, i.e., the rules are retroactive.
- Loss carryforwards can no longer be transferred in any reorganization.
- The new law would be applicable for (re-)structurings filed with the commercial register after the date of the enactment of the bill, which was December 12, 2006. ■

Mexico

by Oscar Castaneda and Oscar Teunissen

2007 Mexican tax reform bill approved by Congress

The 2007 tax reform bill was approved by the Mexican Congress December 21, 2006. The following highlights the most salient points of the final legislation, the provisions of which are generally expected to take effect on January 1, 2007. Please note that the final text of the proposed legislation includes some differences vis-à-vis the prior draft.

Asset tax

The Asset Tax Law previously allowed liabilities to be deducted from the tax base for purposes of computing the asset tax. The new law does not allow any liabilities to be deducted from the asset tax base.

Additionally, the asset tax rate is reduced from 1.8% to 1.25%. This modification also applies for estimated tax purposes in 2007.

Income tax

Thin capitalization: The thin capitalization rules were modified. In accordance with the new legislation, all liabilities that generate interest are considered for purposes of calculating the excess debt amount based on the 3:1 debt-to-equity ratio. Prior income tax law appeared to refer solely to liabilities arising from loans.

In addition, the law previously provided that certain loans were excluded from the computation of the 3:1 ratio calculation, such as debts with certain covenants. However, the new legislation no longer allows such debt to be ignored.

The new legislation now provides that the disallowance only applies to interest on debts between related parties resident abroad.

Additionally, tax basis capital (capital contributed adjusted for inflation—“CUCA”) plus tax basis earnings and profits (“CUFIN”) may be used for purposes of the 3:1 debt-to-equity ratio calculation, and is required in certain circumstances.

Net operating losses: The new legislation limits the utilization of net operating losses attributable to prior changes in ownership. The new rule generally provides that changes in ownership representing more than 50% of the voting shares triggers the limitation of the utilization of tax losses against income obtained in the same trade or business (“giro”), with certain exceptions.

Change of tax residence: Prior legislation provided that the migration of tax residence from Mexico to a country abroad is viewed as a liquidation for tax purposes. The new legislation expands this concept to characterize the liquidating company’s assets as being sold at fair market value in connection with this deemed liquidation.

Mexican REITS: There are a number of changes concerning Mexican Real Estate Investment Trusts (“REITS”). One significant provision establishes that REITS are no longer required to sell/alienate their underlying real estate. However, the real estate must be held for at least four years prior to sale.

Bank interest withholding rate: The favorable withholding tax rate on interest payments to registered banks which are residents of tax treaty countries (currently 4.9%) is extended for another year.

Trusts: The new law clarifies that payments of Mexican source income by Mexican trusts to nonresidents are subject to income tax withholding. ■

Luxembourg

by Laurent de La Mettrie, Begga Sigurdardottir and Oscar Teunissen

Luxembourg 2007 Budget Law passed by the Parliament on December 20, 2006 (published in the Luxembourg Gazette on December 29, 2006) modified article 148 ITL. The new law decreased the withholding tax rate on dividends to 15% from 20% for dividend payments taking place from January 1, 2007.

This change has the following practical consequences:

- For foreign investors that are not entitled to a reduced rate (e.g., they cannot benefit from the treaty provisions due to a preferential tax status or because there is no applicable tax treaty), the

withholding tax reduction will represent a permanent tax saving.

- For investors entitled to treaty benefits, it will simplify the administrative process as the requests for reimbursement of the withholding tax (partially or in full) that will have to be filed will now be limited to situations where the investor is entitled to a rate lower than 15%. ■

Netherlands

by Clark Noordhuis, Oscar Teunissen and Martin Vink

Impact on the alternative investment industry of the legislative changes to the Dutch dividend withholding tax act

The Dutch dividend withholding tax rate is reduced from 25% to 15%, effective as of January 1, 2007. This should reduce the administrative burden for companies and shareholders as many shareholders will no longer be required to apply for a reduction from the general rate of 25% to the more common 15% treaty rate for portfolio dividends. Besides the reduction of the statutory dividend withholding tax rate, as of January 1, 2007 dividend withholding tax on dividend payments made to pension funds can be reclaimed by the pension fund provided the pension fund is domiciled in an EU member state. Furthermore, as of January 1, 2007 the EU parent subsidiary directive will apply for shareholdings of 5% or more. As a result dividend payments are in general exempt from dividend withholding tax if the receiving entity owns a stake of at least 5% and is domiciled in an EU member state.

Impact for the alternative investment industry

In 2002 the Netherlands introduced dividend stripping rules aimed at discouraging abusive dividend stripping transactions. Broadly, these rules seek to deny the availability of beneficial Dutch dividend withholding tax entitlements (i.e., exemption, reduction, credit or refund) to any recipient of a Dutch dividend distribution that is not considered to be its ultimate beneficiary or “beneficial owner.” Although the rules are aimed at abusive transactions, regular cross-border stock lending and derivative transactions could also fall under these rules.

The Dutch dividend stripping rules, however, apply only in situations where the “legal” recipient of the dividend is entitled to a more beneficial

entitlement (i.e., a lower dividend withholding tax rate) than the person considered to be the ultimate beneficiary. If this and other conditions are met, it is the view of the State Secretary of Finance that treaty access should be denied. Therefore, as the general rate of 25% has now been reduced to the more common 15% treaty rate for portfolio dividends, most cross-border stock lending and derivative transactions no longer fall under the Dutch dividend stripping rules.

The Dutch dividend stripping rules are still relevant if the “legal” recipient of the Dutch dividends benefits from a treaty with a less than 15% treaty rate for portfolio dividends or if the legal recipient has access to the EU parent subsidiary directive or is an EU-domiciled pension fund. In these cases it should be verified whether or not the dividend stripping rules apply in these particular circumstances. Tax treaties concluded by the Netherlands that provide for a lower than 15% tax rate for portfolio dividends are the treaties with China, the Czech Republic, Indonesia, Portugal, Slovakia, Taiwan and Venezuela. All treaties provide for a 10% tax rate on portfolio dividends. ■

India

by Puneet Arora, Gautham Mehra and Oscar Teunissen

Foreign institutional investor (“FII”) ruling on income characterization

The Authority for Advance Ruling (“AAR”) has recently pronounced a tax ruling holding, inter alia, that the profits arising to the Applicant FIIs from the sale of portfolio investments in India (“the said income”) could not be treated as “business income” of the Applicant, and was instead taxable as “capital gains.”

Background

A large majority of FIIs have been classifying the said income as capital gains and offering the same to tax under the special provisions contained in section 115AD of the Income Tax Act, 1961 (“the Act”), subject to treaty protection where applicable. A few FIIs had adopted the position that the said income was in the nature of business income and, in the absence of a permanent establishment in India, had argued that the same was not taxable in India as per the provisions of the relevant tax treaty. This has been accepted by the AAR in a few rulings in the past.

Facts of the present case

The present ruling was pronounced for a consolidated bunch of forty applications filed before the AAR. The facts of one of the cases were accepted as a representative set of facts, which included:

- The Applicant was a scheme of investment funds organized as a Massachusetts Business Trust under the laws of The Commonwealth of Massachusetts [USA];
- It made investment in different parts of the world including India, and was registered with the Securities Exchange Board of India (“SEBI”) as a sub account of Fidelity Management and Research Company (“FMR”);
- The Applicant had a global custodian who in turn had appointed a local custodian, both of whom were acting in their ordinary course of business and providing similar services for many other FIIs;
- The investment manager of the Applicant was located outside India and the Applicant did not have any presence in India; and
- In the initial tax returns filed by the Applicant, the said income had been characterized as capital gains, and the same was subsequently characterized as business profits.

Tax Department’s arguments

The Tax Department had raised a preliminary objection arguing that the AAR did not have jurisdiction to rule on these applications since the same covered a “series” of transactions and not “a” transaction undertaken or

proposed to be undertaken. The AAR did not find merit in that objection and proceeded to deal with the applications on merits.

The main arguments raised by the Tax Department included:

- A perusal of the provisions of the FII regulations for investment in India indicate that FIIs are only allowed to “invest” in India and not to engage in the business of trading in securities. This is supported by the wording of the tax legislation as well.
- The claim of the Applicant was not supported by underlying documents—the FII application; the Trust Deed and SEBI’s letter.
- In the earlier rulings issued by the AAR to the contrary, full facts and legal issues involved were not brought to the notice of the AAR.
- Alternatively, the Department further pleaded that the Applicants, being trusts, could not be regarded as tax residents under the applicable India-US tax treaty and even if they were, the local custodian would constitute a PE of the Applicant in India inasmuch as the local custodian was involved in the regular delivery of goods in India.

Applicant’s arguments

The main arguments raised by the applicants included:

- The FII regulations cannot be taken into consideration for deciding on the income characterization under the tax law and specific portions of these regulations, as well as the specific tax regulations, indicated that business activity was indeed permitted.
- The facts of the case supported the conclusion that the Applicant was “trading” in securities.

Views of AAR

The AAR brushed aside the contention of the Applicant that the FII regulations could not be used for the purposes of characterization under tax law. The AAR went on to make the following observations:

- The AAR analyzed various provisions of the FII regulations, including those laid out by SEBI, the Reserve Bank of India and the tax law. The AAR concluded that the circumstances and the plethora of legislative provisions unmistakably point out that an FII is not registered for conducting trade in securities. In their analysis, the AAR referred to the following: the SEBI guidelines issued in a press note dated September 14, 1992; the Foreign Exchange Management (Foreign Exchange Derivative Contracts) Regulations 2000; and the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulation 2000.
- It noted that foreign exchange regulations specifically permitted FIIs to “trade” in all exchange-traded derivative contracts and interpreted this to mean that trading in other securities was prohibited.
- It did not agree with the Applicant’s argument that the wording of certain specific portions of the regulatory and tax law could be interpreted as permitting business activities as well. In response to the Applicant’s argument that even if trading were prohibited, the income could be profits from an illegal business, the AAR remarked that it would be preposterous to impute an intention to FIIs that they, in the very first step, intended to violate the legislative requirements which provided them the opportunity to enter the capital markets in India.
- The AAR referred to certain principles regarding income characterization laid down in earlier precedents. In this context, it noted that the manner of treatment of the portfolio investments in the accounts of the Applicant was not known to the AAR nor were necessary records produced by the Applicants in this regard to rebut the presumption that the assets were capital assets.

- The AAR also referred to its own rulings pronounced earlier in the case of Fidelity Advisor Series VIII Morgan Stanley and XYZ/ABC Equity Fund, wherein it was held that the income on a sale of securities should be characterized as business profits. The AAR held that these rulings could not be considered an authority because in all those cases the judgment of the Supreme Court case of CIT v. H. Holck Larsen was not referred to or cited and the test laid down in that case was not applied. Further, the AAR observed that since the question was essentially a mixed question of law and fact, the conclusion of the Authority would merely provide persuasive value.

Conclusion

In the past and on applications with similar facts, the AAR has held that the said income can be characterized as business income under tax laws. While AAR rulings have only persuasive value and are not binding on other tax assessees, this ruling has indeed added a new dimension to the tax issues applicable to FIIs. ■

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