Significant Worldwide Taxation Developments in 2012

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Introduction

There have been a significant number of international tax developments in the past year. The economic climate has resulted in some countries strengthening their anti-avoidance legislation. Many European countries have introduced revenue-raising measures to tackle their economic deficits. Other countries have taken this opportunity to introduce new incentives or enhance current ones to attract foreign investment, particularly in relation to intellectual property (IP) regimes and research and development (R&D) credits. We outline some of the most significant changes and discuss a number of tax cases that were decided this year.

In addition, the US presidential election took place in November. Although both the Republican and the Democratic Party have issued taxation reform proposals in the past year, it will be interesting to see what changes President Obama will seek to introduce, including dealing with the impending fiscal "cliff".

Transfer pricing legislation has also seen a number of developments in 2012, most particularly the OECD's publication of three discussion drafts on the transfer pricing of intangibles, safe harbours and timing issues.

General Anti-Avoidance

In the last year, a number of countries have introduced or strengthened their general anti-avoidance rules. Both the UK and India have moved toward introducing a general anti-avoidance rule. In the 2012 Budget, the UK announced that it would introduce a general anti-avoidance rule, with legislation and further details to be included in Finance Bill 2013. Interestingly, the proposed UK rule is intended to have narrower application than those in most other jurisdictions, which usually have potential application to a broad spectrum of tax avoidance: the UK law is targeted at artificial and abusive arrangements (described as "egregious", "very aggressive" or "highly abusive, contrived and artificial").

Similarly, in March 2012 a general anti-avoidance rule was introduced by India, as a direct result of the *Vodafone International Holdings BV* case. In January 2012 the Indian Supreme Court held that the sale of shares outside India between two non-residents (Hutchison and Vodafone) was not liable to tax in India and, accordingly, Vodafone did not have an obligation to withhold tax on consideration that it paid for the acquisition of a Cayman Islands-resident entity, even though the Cayman entity derived its value from Indian assets. The Indian Supreme Court looked at the existing legislation and made its decision based on form over substance. The primary purpose of the new Indian general anti-avoidance rule is to codify the doctrine of substance over form and to deal with aggressive tax planning. It is interesting to note that in August 2012 the Indian Shome Committee released a draft report recommending that the Indian Government significantly relax India's new general anti-avoidance rule for fear of dissuading companies from investing in the country. We will need to wait to see how these rules will be implemented in the future.

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China has also made moves to strengthen its anti-avoidance regulations. China's State Administration of Taxation (SAT) has, for the first time, issued written comments on how to strengthen China's international tax administration in, *inter alia,* the areas of anti-avoidance and transfer pricing compliance. The Chinese SAT will also examine how taxpayers in selected industries avoid income taxes and in 2013 will develop a specialist team with the ability to perform anti-avoidance investigations in various industries. Similarly, as a result of the Italian tax reform, the Italian Government is taking steps to tighten its anti-avoidance laws by introducing new regulations aimed specifically at reducing avoidance and evasion. During 2012 Belgium also moved to strengthen its general anti-avoidance legislation by restricting the ability of taxpayers to challenge the tax administration's decision that an act is abusive under Belgian tax law.

Not all anti-avoidance measures taken during the year relate to general anti-avoidance rules. A number of countries have introduced anti-avoidance rules to deal with specific issues, in particular, interest deductibility. In the Netherlands new legislation has been introduced containing specific rules to limit the deduction of interest for companies that hold participations financed with debt. The legislation is intended to address what is known as the "*Bosal* gap", which has arisen from the European Court of Justice (ECJ) decision in the *Bosal* case, where the court held that the Dutch provision disallowing a deduction for costs incurred in connection with a foreign participation was in conflict with EU law and that interest costs relating to participations are, in principle, deductible.

Canada is bringing in foreign associate "dumping" legislation, aimed at restricting the interest deduction claimed by Canadian subsidiaries of multinationals that assume inter-group or third-party debt and use the funds to acquire other foreign group companies. Similarly, France has introduced a limit on the deductibility of a portion of interest expenses relating to the acquisition of shares in certain circumstances. France also announced the introduction of new anti-avoidance provisions relating to tax-optimisation structures implemented by companies, focusing particularly on the use of tax havens to reduce the tax charge in France.

Certain countries have been tightening their interest deductibility rules, with a particular focus on intra-group transactions. Earlier this year, the Swedish Finance Minister amended proposed new measures to restrict further the availability of corporate tax deductions relating to interest on intra-group debt. Finland's 2013 Budget proposal includes a restriction on interest deductibility in certain circumstances, including interest paid as a result of intra-group transactions, and Japan also released details on a new restriction on the deductibility of interest paid to certain foreign affiliates. The UK announced in its Budget earlier this year that it will be reviewing the tax treatment of interest. It has since published a consultation document focusing on withholding tax and proposing measures that, if implemented, would substantially restrict the available exemptions, most significantly the withholding tax exemptions for quoted Eurobonds, "short" interest and, potentially, deep discount bonds, which are typically used by groups to avoid withholding tax on intra-group interest payments.

Taxation Measures in Europe to Tackle Economic Deficits

The economic climate has had a significant impact on taxation policy in Europe in 2012. Earlier this year, the European Commission published its taxation trends report, which showed that the average standard VAT rate has risen consistently since 2008; EU personal and corporate income tax rates have also increased in 2012. These increases in VAT and personal tax rates are linked to the economic climate and the taxation measures introduced by various countries that are specifically aimed at reducing their deficits.

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Spain has introduced a series of tax measures aimed specifically at tackling the economic crisis and reducing the public deficit while attempting to guarantee Budget stability. The measures include restriction of the carry-forward of losses, a 3% increase in the standard VAT rate, limitations on the tax deduction of financial expenses and a reduction in the amortisation deduction in respect of intangible assets with an indefinite useful life.

Similarly, in July 2012 the French Government announced a series of new taxes intended to reduce the burgeoning deficit, with additional changes announced at the end of September 2012. The French tax changes are focused on banks, oil companies and wealthy individuals and include one-time surcharges, anti-avoidance provisions to attack tax-optimisation structures implemented by companies, a new 3% surcharge on distributed profits, a global cap on the deductibility of finance charges, and restrictions on the use and transfer of losses. France has also amended its controlled foreign company (CFC) legislation to make it more restrictive. Previously, there were a number of exceptions to the French CFC rules that applied to CFCs outside the EU. However, under the new rules, a French entity would have to demonstrate that the purpose of the operations of each of its non-EU CFCs is mainly not tax-driven to avoid the application of the CFC rules to that particular CFC. France's new president, François Hollande, had announced a number of other tax changes in his presidential campaign, one of which, a tax rate of 75% on incomes over €1m, has recently been introduced.

Italy has also introduced new measures intended to reduce the Italian public debt, such as an increase in real estate tax, a new levy on some luxury items and an increase in VAT rates. The Danish Parliament passed a Bill in June 2012 that contains a number of provisions designed to ensure, in particular, that multinational companies contribute to the financing of Danish welfare and to collect more revenue from such companies. The provisions include a cap on the carry-forward of tax losses, the reintroduction of joint and several liability for jointly taxed companies, and rules on the allocation of income to a permanent establishment.

Belgium has also introduced a number of measures with the aim of increasing taxation revenue. The withholding tax rate on interest has increased from 15% to 21%. In addition, a special

4% contribution has been introduced and applies to taxpayers with investment income in excess of €20,000.

Earlier this year, the Economic and Financial Affairs Council (Ecofin) held a policy debate on a proposed Directive introducing an EU-wide financial transaction tax (FTT). Although this was not an individual-country tax change, the concept of an FTT has arisen as a result of the economic crisis in Europe. The Council concluded that support for an FTT was not unanimous (e.g., Ireland and the UK did not support it), but a number of delegations supported the idea of enhanced co-operation, which would allow a limited number of Member States to proceed among themselves, making use of the EU institutions. France has already imposed a tax on financial transactions with effect from 1 August 2012.

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Taxation Measures to Attract Foreign Investment

Not all countries have increased their tax rates to deal with economic deficits. Many jurisdictions are choosing to reduce their corporate tax rates and improve other taxation incentives to attract foreign investment. The UK had previously announced a 1% reduction in its corporation tax rate in 2012. However, as part of the 2012 Budget, an additional decrease in the corporation tax rate was announced, resulting in a rate of 24% from 1 April 2012, as opposed to 25%, as previously planned. A number of other countries have also announced a reduction in their corporate tax rates. Finland's rate has been reduced from 26% to 24.5%, and Sweden has announced that it plans to reduce its rate from 26.3% to a possible 24%. Both Japan and Slovenia have announced a gradual reduction of their corporate tax rates in the coming years, Japan from the current 40% to approximately 36% and Slovenia from the current 20% to 15% by 2015.

A number of countries have also made changes to their CFC rules during the year. Most notably, the UK announced a full reform of its CFC regime in the 2012 Budget and has issued new legislation designed to reflect better the way that businesses operate in a global economy and to promote investment by foreign multinationals into and through the UK. The new rules will be effective for periods starting on or after 1 January 2013.

A number of other jurisdictions have announced or brought in changes to their tax regimes during the year to attract foreign investment. Cyprus has introduced changes to its tax legislation aimed at attracting foreign investment and stimulating growth, including a relaxation of interest limitation rules and group relief rules and an increase in accelerated capital allowances rates. Malta has also made a number of changes to its tax legislation to make it more attractive to local and foreign investors. The key change is the extension of the royalty exemption to cover works protected by copyright, such as books, film scripts, music and art. Malta has historically granted an income tax exemption for royalties derived for registered patents, wherever registered and regardless of where the underlying R&D is carried out. The extension of the exemption to copyright works aims to draw international artists to Malta and to make the country more attractive to the film industry.

Changes in Relation to IP and R&D Tax Credits

Given the success of certain European IP regimes in attracting inward investment, such as the Dutch "innovation box" regime or Luxembourg's IP regime, it is no surprise that other jurisdictions are introducing similar IP regimes or strengthening their existing regimes. Perhaps the most significant recent development has been the announcement in late 2011 of the introduction of a UK patent box regime, under which profits attributable to qualifying patents will be taxable at a reduced rate of 10%. The regime will be phased in over four years from April 2013 until 2017. Coupled with the corporation tax reduction also announced in 2011, the UK patent box regime is intended to increase the attractiveness of the UK to foreign groups for the centralisation of IP. However, unlike many other regimes, the UK patent box regime will apply only to qualifying patents, and not to other forms of IP, and the computational rules to ascertain the qualifying profits attributable to the patent box are relatively complex.

In May 2012 Cyprus announced a number of changes to its corporate income tax legislation, including the introduction of an IP regime, the aim of which is to allow Cyprus to compete more effectively as an IP holding and management location. The new Cyprus IP regime is broader than that of the UK, as it should cover all forms of IP. The regime allows for 80% of the net profits from the exploitation and disposal of qualifying intangibles to be exempt from income tax.

Hungary, which already has an attractive IP box regime, introduced a full exemption for capital gains tax on the sale/transfer of IP by a Hungarian company under certain circumstances. There are certain restrictions to this relief, including a minimum period of ownership of the IP. This change to its IP regime should increase Hungary's competitiveness in attracting companies to hold their IP there.

In the past year, countries have also been reviewing their R&D tax incentives to make them more attractive to foreign multinationals. In the 2012 Budget, the UK announced that an "above the line" R&D credit will be introduced in April 2013. This change is targeted particularly at US multinationals, as it can provide more beneficial results under US GAAP. Japan has also brought in new measures to encourage global companies to locate their R&D centres in Japan.

India announced in its Budget earlier this year that its current R&D tax regime was being extended until 2017. It has also taken steps to improve the regime, announcing the creation of a committee to carry out a review of the existing R&D legislation and provide recommendations to improve it.

Conversely, Canada, unlike most other jurisdictions, has announced proposals in its Budget that would restrict the benefit that companies can claim under the Canadian R&D tax regime. The Budget proposals reduce the tax credit on eligible expenditures from 20% to 10%, as well as restricting the expenditure that qualifies for the credit. Canada's R&D regime has historically been considered to be one of the most beneficial; however, this might change, given these new restrictions and the improvements in the R&D regimes of other countries.

Tax Cases

There have been a number of significant tax cases recently that have had wide-reaching implications. A key case this year was *National Grid*, where the ECJ held that Dutch exit tax provisions for companies were disproportionate because they provided for the immediate recovery at the time of transfer of tax on unrealised capital gains relating to assets of a company transferring its place of effective management to another Member State without granting the option of tax deferral. The Dutch exit tax legislation was amended as a result of this case.

In May 2012 the ECJ ruled that foreign investment funds that invest in French companies should not be liable to withholding tax on dividends. Previously, French investment funds were exempt from French tax on dividends received from a French company, while foreign funds were subject to withholding tax of 30% (as reduced by a tax treaty, if applicable). This is a significant victory for investment funds, and the decision will have implications for similar challenges against several other EU Member States by portfolio investments investing in those other Member States.

In the *Velcro Canada* case, the Tax Court of Canada ruled that the Canada–Netherlands tax treaty applies to reduce Canadian withholding tax applicable to royalties paid to a Dutch company, despite that company having a contractual obligation to make payment equal to 90% of the royalties to a Netherlands Antilles company within 30 days of receipt. The Canadian Government argued that the Dutch company should not be considered the beneficial owner of the royalties because of the contractual obligation. However, the Tax Court found that the Dutch company retained the attributes of beneficial ownership of the royalties, namely, the "use, enjoyment, risk and control". Further, the Dutch company was not an agent, a nominee or a conduit. In agreeing with the finding in a previous case, the court held that it is inappropriate to "pierce the corporate veil" and to ignore the existence of a holding company unless the company is a conduit with absolutely no discretion regarding the use or application of funds. The Tax Court stated that although the discretion of the holding company might be limited, it did exist in this case. Some facts pertained in this case that may not pertain in every back-to-back payment, but the decision is generally positive for taxpayers.

US Proposals

The US presidential election took place on 6 November 2012. Tax was a dominant issue in both the Republican and the Democratic campaign before the election. Both sides published proposals for tax reform that included a reduction in the US corporate tax rate, although many of the international tax proposals differed. As part of Obama's campaign, he announced a cut to the corporate rate from 35% to 28%. In addition, with particular focus on multinational firms, he wishes to limit their ability to delay paying US corporate tax by keeping non-US-source income overseas. Given the fact that the Republicans retained control of the Senate, it will be interesting to see the form of future international tax proposals. Given the election, there have been no significant US tax changes in recent months. Of most concern at the moment is the potential fiscal "cliff " if the Bush tax cuts that expire at the end of 2012 are not extended.

FATCA

In February 2012 the US Treasury Department and the Internal Revenue Service (IRS) released proposed regulations for the Foreign Account Tax Compliance Act (FATCA), which will apply from 2013. The aim of the legislation is to ensure that US persons with financial assets outside the US are paying US tax. The new legislation will require non-US banks to find any US account holders and disclose their balances and transactions to the IRS; if they do not comply, they will be subject to a 30% withholding tax on income from US financial assets held by the banks. In addition, the owners of these foreign-held assets must report them to the IRS irrespective of where they are resident. It is interesting to note that the US, France, Germany, Italy, Spain and the UK issued a statement earlier this year endorsing the underlying goals of the US FATCA provisions and declaring their support for the provisions. It is anticipated that similar reporting provisions may be introduced in these other countries in the future.

In February 2012 the US Treasury Department and the Internal Revenue Service (IRS) released proposed regulations for the Foreign Account Tax Compliance Act.

OECD Discussion Draft on Intangibles

Earlier this year, the OECD published three discussion drafts on transfer pricing (TP) matters. The most significant from an Irish perspective is the discussion draft on the transfer pricing of intangibles, which relates to a proposed revised version of Chapter VI of the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. The objective of this document is to focus on the definition, identification and valuation of intangibles for TP purposes. The thrust of the TP analysis is that TP should be determined by conditions prevailing between third parties and that, although the legal documents and contractual arrangements are the starting point, the actual conduct of the risk and management functions should be examined by reference to the location where individuals are based. The evolution to functional ownership will potentially impact on many of the structures that are used for business coming into Ireland. It will be interesting to see the final form of this document to establish where the balance is struck on what are fairly fundamental issues for global and international business and its profitability.

Conclusion

The past year has seen numerous tax changes, particularly in Eurozone countries, as a result of the economic climate. France Spain and Italy, in particular, have implemented measures to deal with their deficits. There has been a move to introduce general anti-avoidance legislation, such as in the UK and India, and to tighten existing anti-avoidance legislation, in particular to tackle abuse of interest deductibility reliefs, in a number of jurisdictions, such as the Netherlands, France and Canada. Meanwhile, many jurisdictions are focusing on attracting foreign investment and have made changes to their regimes to become more attractive locations from which to do business. A number of jurisdictions have brought in new reliefs to attract foreign investment, particularly in the IP and R&D areas, most notably the introduction of the UK patent box regime.

As we look forward, it will be interesting to see the impact of Obama's re-election on US taxation policy. Similarly, it will be interesting to see the final form of the OECD's guidance on the transfer pricing of intangibles and its impact on the structures that are used for business coming into Ireland.

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