Important international tax developments

Transfer pricing, corporation tax and stock options are areas where tax changes are under way, notably in Europe. Jan Kooi of Omnicom Finance explains.

In the past year, we have seen a flurry of international tax developments – this article will deal with some of them.

German finance bill

In a forthcoming issue of *The Treasurer*, the draft Finance Bill for Germany, which was sent to parliament on 11 November, will be discussed. At this point in time, it should be noted that the beneficial tax treatment for capital gains realised by individuals on substantial shareholdings is likely to be abolished as per 1 January 1999. Certain deals may therefore have to be concluded before year end. The proposed abolition of extra-ordinary write downs from 1 January 1999 may likewise be an issue for year-end tax planning. The good news from Germany is a proposal to reduce the corporate income tax on undistributed income from 45% to 40% and in 1999 and to 35% in 2000.

Development elsewhere

Elsewhere, Japan had a tax overhaul – see *The Treasurer* of June 1998; The Netherlands published a proposal for a major tax reform after 2000; France recently published its new finance bill introducing inter alia CFC-type legislation for privately-owned foreign, low-taxed companies; Russia was forced to revise its entire tax system; and Australia is contemplating introduction of a VAT system.

The euro

In the countries that will be part of the first wave of the Emu, a number of laws have been passed to deal with the introduction of the euro. Most laws treat issues like the conversion gains or losses of converting from the local currency to the euro (see 'Tax aspects relating to the introduction of the euro' in *The Treasurer*, December 1997).

The US has issued regulations which determine that the introduction of the euro should, in general, not lead to a taxable realisation of a currency gain or loss and that taxation of such gain or loss will be postponed to the year in which the relevant asset or liability is disposed of.

European code

As far as other European legislation or court decisions are concerned, one should first examine the code of conduct, published in the EU official gazette of 6 January 1998.

The countries that are party to this code have basically agreed to combat unfair fiscal regimes which could lead to competition on taxation between different countries. As a consequence of this code, discussions are presently going on between the EU and Spain about the privileged tax regime in the Canary Islands. Similarly, Ireland has agreed to phase out the special tax treatment for IFSCs and to limit the number of licenses to be granted.

Instead, Ireland has come up with the creative solution of reducing its corporate income tax rate across the board from 2003, which coincides with the phase-out period. This will ensure that Ireland remains an attractive country for certain types of investment. The next victim of the code of conduct could be Belgium co-ordination centres and perhaps even the new regime for finance companies in the Netherlands, introduced in 1997.

Jan Kooi

It is clear that the EU wants neither positive nor negative discrimination in the tax arena within the member states. In that context, the recent decision of the European Court in Luxembourg in the ICI case is worth mentioning.

Here, the freedom of establishment article (52) in the Treaty of Rome was invoked by the tax payer to claim that the UK group relief system should apply not only to UK members of a tax group but also to non-UK members that would qualify if they would have been resident of the UK. The plaintiff won.

It is too early to judge whether this decision will have substantive consequences in the international tax field but it would seem that specific legislation will be required in certain countries to deal with this issue. An interesting comment of the European court, given in various instances, was that the loss of revenue which might arise to a certain country as a consequence of the application of the principle of freedom of establishment was not a valid reason for any government to deny certain tax benefits to non-residents or in respect of foreign source income.

Transfer pricing

Although more specific, but still in the same international context, one should note the extensive legislation in various countries, ranging from Vietnam to Denmark, on transfer pricing.

In this context one should certainly look

at the UK Budget that will become effective from 6 April 1999 which requires taxpayers to ascertain under the self-assessment system that they have complied with the arms-length pricing principle.

Other countries, such as Argentina, the Ukraine, Denmark, Poland, the Czech Republic and Australia have also issued new regulations on the type of documentation that taxpayers are required to provide to demonstrate that they have complied with the arms'-length principle.

In all cases, complying with the documentation requirements will not necessarily result in the tax administration not correcting the inter-company pricing. It will, in general, provide protection against a reversal of the burden of proof and against penalties, which may occasionally be higher than the tax due.

Advance corporation tax

In April 1999, the UK will abolish advance corporation tax (ACT). This may make the UK a very interesting country for European-bound investments, especially for US multi nationals.

Dividend payments from continental European subsidiaries which are 25% or more owned will generally not be subject to any withholding tax due to the parent-subsidiary directive. In view of the low UK corporate income tax rate, generally no further UK tax will be due, while onward distributions will be exempt from UK withholding tax on dividends.

Provided that the source country would not consider interposing the UK as abusive, routing dividends through the UK may be an interesting alternative. It should be noted that certain countries in the EU, such as France and Spain, take the position that interposing a foreign company in order to reduce withholding taxes is abusive. It is questionable whether this position will be upheld by the European court in Luxembourg.

Swiss-based holding companies

Another interesting development within Europe is the new tax regime in Switzerland, which aims at promoting Switzerland as a country for holding companies. Aware of its reducing attractiveness position as a base for holding companies, because of the taxation of capital gains, Switzerland has reacted to rising stars such as the Netherlands, Belgium, Luxembourg and since 1996 Spain (with the special holding companies for foreign participations, 'EVE').

Under the old regime, capital gains on substantial participations (20% or more or exceeding SFr. 2,000,000) were taxed at 9.8% at the federal level, while dividends from such substantial participations benefited from a dividends received deduction.

The new regime grants also a participation reduction for gains on 20% or more held foreign subsidiaries, acquired after January 1, 1997. Gains on 20% or more subsidiaries acquired prior to January 1, 1997 will still be taxable until January 1, 2007.

The Netherlands

For treasury people, it should be of particular interest that the first 10-year rulings have been granted in the Netherlands to some 25 companies on the application of the new (1997) legislation of group financing companies.

The requirements as far as required substance are indeed rather strong, but in those cases where the actual financial management of a group can, to a large extent, be managed from the Netherlands, the relatively new regime is still compatible with most other alternatives.

UK tax credits

Attention should also be paid to a lesser-known change in UK legislation regarding the tax credit available to banks and financial traders for dividends received from foreign subsidiaries.

Existing legislation limited the credit for foreign taxes on interest for these taxpayers basically to the tax due on the margin realised by the bank or financial trader.

Arrangements were made whereby loans were actually converted into preference shares with a fixed dividend. New legislation looks at combating these arrangements.

Stock options

Internationally, there have also been certain developments in the field of stock options.

Belgium has introduced new legislation which results in taxation of an estimated intrinsic value of the options at the date of grant equal to 7.5% of the fair market value of the shares in case of an unconditional option with a maximum exercise period of five years. For any additional year, 0.5% is added.

The Netherlands has modified its regime, on which the Belgium regime is modelled, leading to an inclusion in taxable income of a value of 20% (formerly 7.5%) of the fair-market value of the underlying share for the grant of a five-year unconditional option to an inclusion of 35% for a similar 10-year option.

The latest news from the UK is that new proposals may come forward to enhance the use of remuneration in the form of stock options.

Documentation

As a final point, I would like to remind readers of an ongoing development which concerns all of us. Earlier, I already mentioned the increasing activity in the field of transfer pricing.

Governments are concentrating increasingly on this issue, often forgetting the realities of the trading world. In many cases CFOs of companies will conclude a deal on the basis of a long-standing business relationship and in most cases such deals will be at arms' length.

When the respective negotiators are furthermore remunerated on basis of performance, such agreements will be at arms' length, even in a group relationship. A problem is often that the actual negotiations are not always well-documented (many deals are done by phone or over a glass of claret).

In the last few years, the tax administration in almost all countries (not least the UK, with the new self-assessment system) has become much better organised. The revenue authorities in the various countries are now organised in industry groups, giving them often more inside knowledge than the taxpayers.

There is, furthermore, an increase in the formal and informal – sometimes automatic – exchange of information between countries. In addition the advent of the euro will make transfer pricing issues, which are a very hot topic in any event, a top item on the list of any CFO or tax director in the coming years.

The only advice that I can give you at this stage is to make sure that you have proper documentation in place regarding both the final agreement as well as the negotiations that led to the ultimate result. ■

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