WorldTrade Executive, Inc.

THOMSON REUTERS

PRACTICAL EUROPEAN TAX STRATEGIES

www.wtexec.com/tax.html
The International Business Information Source™

A Monthly Report on European Tax Planning

July 2010
Volume 12, Number 7

Articles

IN THIS ISSUE

New Tax Agreement between UK and Hong Kong Creates New Opportunities for Tax Efficient Structuring
The agreement provides a favorable framework for UK companies (or European companies via a UK intermediate holding company) to invest into Asia via Hong Kong. The agreement reduces withholding tax on interest and most royalty payments. Page 2

Italy Places Special Tax on Bonuses and Stock Options
Under the new law, bonuses and stock options that are more than three times the employee's fixed salary will be subject to a 10 percent additional withholding tax. Payments from plans that were in effect before the new law will still be subject to the additional tax. Page 6

Tax Planning Considerations for a Multinational Holding Company in Holland
An examination of the Dutch participation exemption, withholding rates, the tax treaty network and other reasons why the Netherlands remains the most popular country for establishing a holding company. Page 8

Opportunity for Refunds of VAT
A "click-though" online introductory service is exempt from VAT because it constitutes "intermediary" services, the UK Court of Appeal has held. Some insurance service providers should apply for VAT refunds. Page 11

Advisory Board page 6

Planning Perspective

New United Kingdom-Hong Kong Double Taxation Agreement Brings Planning Possibilities

By Michael A. Olesnicky, Jacqueline Y. M. Shek, L. Travis Benjamin, James E. macLachlan and Patrick O'Gara (Baker & McKenzie)

Overview

Until now, there has been no comprehensive Double Taxation Agreement (DTA) between the United Kingdom and Hong Kong, so businesses and individuals will welcome the fact that a first full DTA was signed on June 21, 2010. The DTA will enter into force when both the UK and Hong Kong have completed their respective legislative procedures, expected to be at some point this year. If this is the case, it will take effect in Hong Kong from April 1, 2011 and in the UK from April 1, 2011 for corporation tax and from April 6, 2011 for income and capital gains tax , so businesses and individuals should be prepared. Many aspects of the DTA are beneficial and will create new opportunities for tax-efficient structuring. However, there are some provisions of which businesses and individuals need to be aware in order to avoid unexpected tax liabilities.

Michael Olesnicky (michael.olesnicky@bakermckenzie.com) and Jacqueline Shek (jacqueline.shek@bakermckenzie.com) are Partners, and Travis Benjamin (travis.benjamin@bakermckenzie.com) is Special Counsel, in the Hong Kong office of Baker & McKenzie. James macLachlan (james.maclachlan@bakermckenzie.com) is a Partner and Patrick O'Gara (patrick.o'gara@bakermckenzie.com) is an Associate, with the London office of Baker & McKenzie. Mr. Olesnicky heads the Tax Group in Asia. He is also head of the Hong Kong and China tax practice. His practice is focused on Hong Kong and Asian regional tax advisory work, tax disputes and litigation, as well as wealth management and estate planning. Ms. Shek's practice is concentrated in corporate restructuring, financial products, employee remuneration planning and private wealth planning. Mr. Benjamin specializes in international tax advisory and tax controversy matters, including cross-border mergers and acquisitions, restructurings, fund formation and revenue authority audits. Mr. macLachlan's practice is focused on UK corporate taxation for domestic and multinational corporations, as well as financial intuitions. Mr. O'Gara's practice is concentrated in international tax planning, corporate mergers, acquisitions and restructurings, including all aspects of UK corporate and commercial tax, as well as value added tax.

Key Features of the DTA

Withholding Tax Rates

The DTA provides for the following rates of withholding tax on payments arising in one state and paid to a beneficial owner of the income concerned resident in the other state:

- on interest, 0 percent (the current rate of withholding tax on payments from the UK to Hong Kong is 20 percent);
- on royalties, up to a maximum of 3 percent.

The rate of withholding tax on dividends remains at 0 percent except for dividends paid out of the UK by real estate investment trusts (REITs), on which the rate is 15 percent.

The DTA strengthens the positions of both the UK and Hong Kong as tax-efficient investment hubs in their respective regions.

Anti-avoidance Provisions

The withholding rates compare favorably with those in the UK's DTAs with other jurisdictions in Asia (for example, the withholding rate for interest and royalties is 10 percent under the UK-Singapore DTA) but are not available under the new DTA if the main purpose (or one of the main purposes) of any person concerned with the creation or assignment of the right giving rise to the relevant income is to take advantage of the DTA.

Interest from a UK company to an unlisted Hong Kong company can only be paid free of UK withholding tax if the UK tax authorities (HM Revenue & Customs) give an advance ruling that, in their view, the main purpose (or one of the main purposes) of establishing, acquiring or maintaining the Hong Kong company was not the securing of benefits under the DTA.

Tax Agreement, continued on page 16

Draft Annual Tax Act 2010: Currently Proposed Changes

By Dr. Uwe Eppler, Martin Heinsius, Heinz Zimmermann, Henning-Uwe Milberg, Dr. Falko Tappen and Dr. Brigitte Gallenkemper (DLA Piper)

On March 29, 2010, the German Federal Ministry of Finance published its draft of the 2010 Annual Tax Act (*Jahressteuergesetz 2010*). Further, on July 9, the second chamber (*Bundesrat*) published its comments on the Annual Tax Act. This article reviews some interesting issues currently discussed in the legislative process. However, the legislative process is not complete and further changes are more than likely. The Annual Tax Act 2010 is expected to be finalized and promulgated in the Federal Gazette at year end.

Electronic Bookkeeping Outside Germany

The draft Annual Tax Act intends to ease the requirements to be met when transferring electronic bookkeeping outside Germany. In the future, if certain requirements are met, a German company or German permanent establishment should be able to keep its books in a non-EU/non-EEA country. Generally, it is currently only possible to relocate bookkeeping to an EU/EEA country. In particular, the draft Annual Tax Act abolishes the requirement that the relevant foreign country must consent to electronic access for the German tax authorities. In practice this requirement factually hampers the relocation of bookkeeping to a foreign country. However, under the draft Annual Tax Act, taxpayers still must disclose the physical location of the IT system. Further, also under the new rules, the German tax authorities would still have to be able to access the system electronically.

Tighter German CFC Rules

The German CFC rules contain provisions that require the addition of a foreign (intermediate) company's income to a German shareholder's income if specific requirements are met. Whether a foreign company qualifies as an intermediate company depends on the tax rate applied to the company's income. Only if "low tax income" is assumed, the company will be regarded as an intermediate company and a proportionate amount of its income will be added to the income of a shareholder, provided (as a general rule) the shareholder is subject to unlimited tax liability in Germany and holds a participation of more than 50 percent of the company's shares.

Company participations are regarded as productive property, unless more than 50 percent of the held company's total assets are investment assets.

Now, the draft Annual Tax Act intends to broaden the definition of what qualifies as "low taxation" for purposes of the German CFC legislation. According to the draft law, in the future tax credits and tax refunds at the shareholder level would also be considered when determining whether the requirement of "low taxation" (effective tax rate below 25 percent) is met.

The measures are taken in particular because of a tax saving model commonly known as "Malta-structure." This structure makes use of specific features of the Maltese tax system as a result of which passive income via corporate entities in Malta were not subject to German CFC rules.

Taxation of Derivatives and Investments in Investment Funds

The Bundesrat now requests to include a wording in the law, according to which Section 15, para. 4, cl. 3 of the Income Tax Act should also apply to (1) physically settled derivatives, and (2) derivatives that are held by an investment fund. The suggestions are meant (*inter alia*) to address structures that aim at (cumulatively) generating *(i)* effectively a 95 percent tax exempt gain from the disposal of shares, and *(ii)* a fully deductible loss from the derivative investment.

Tax Act 2010, continued on page 4

Dr. Uwe Eppler (uwe.eppler@dlapiper.com), Martin Heinsius (martin.heinsius@dlapiper.com) and Heinz Zimmermann (heinz.zimmermann@dlapiper.com) are Partners with DLA Piper. Henning-Uwe Milberg (henning-uwe.milberg@dlapiper.com) is Of Counsel in the Hamburg office. Dr. Falko Tappen (falko.tappen@dlapiper.com) is a Senior Associate in the Frankfurt office. Dr. Brigitte Gallenkemper (brigitte.gallenkemper@dlapiper.com) is a Senior Associate in the Hamburg office. Dr. Eppler's practice is primarily focused on cross-border tax and accounting aspects of mergers and acquisitions, restructurings and financings. Mr. Heinsius is in the Frankfurt office; his practice is concentrated in securities, corporate and tax law, and particularly venture capital and structuring venture capital funds. Mr. Zimmermann's practice is focused on national and international tax issues for both corporations and individuals, and particularly in relation to real estate funds, renewable energy and capital markets products. Mr. Milberg's practice is concentrated in tax law. Dr. Tappen is a member of the firm's German Corporate Group. Dr. Gallenkemper's practice is focused on national and international business tax law relating to mergers and acquisitions, restructurings and financings.

Federal Ministry of Finance Guidance on the Application of the Anti-Treaty/Directive-Shopping Provision

By Dr. Martin Lenz (KPMG)

The 2007 Tax Act represented a significant tightening of the requirements set out in the anti-treaty/directive-shopping provision (§ 50d (3) EStG—German Income Tax Law) with respect to the reduction of withholding taxes. Under this provision a foreign company is not entitled to a (complete or partial) reduced withholding tax rate to the extent persons are holding ownership interests in the company that would not be entitled to the relief if they derived the income directly, and

- there are no economic or other valid reasons for the interposition of the foreign company (motive test), or
- the foreign company fails to derive more than 10 percent of its total gross earnings from its own business activities (gross earnings test), or
- the foreign company fails to engage in general commerce by means of a business organization with resources appropriate to its business purpose (substance test).

In its guidance of April 3, 2007, the German Federal Ministry of Finance (BMF) commented on this. This Guidance has now been supplemented by the BMF guidance of June 21, 2010.

Entitlement to Relief in Case of Multi-Tiered Ownership Structures

The newly issued BMF guidance has also officially clarified that in case of a company that is individually entitled to relief but does not meet the substance requirements, it needs to be considered whether or not a company holding direct or indirect ownership interests in it is individually entitled to relief and meets the functional requirements (multi-tiered ownership structures). It is to be noted, however, that for each company in the chain the individual entitlement to relief must be available.

Special Cases

A reduction of the withholding tax rate on the basis of double tax treaties or EU guidelines must be granted under the anti-treaty/directive-shopping provision, if

- the foreign company's principal class of stock is regularly traded in substantial volume on a recognized stock exchange (stock exchange clause), or
- the foreign company is subject to the provisions of the German Investment Tax Law.

The BMF guidance of June 21, 2010 has now clarified the following: if the foreign company does not meet the requirements of the special cases it must be considered whether or not one of the companies holding direct or indirect ownership interests in it meets one of the criteria set out above and thereby qualifies for the reduced rate. The entitlement to relief is conditional on the fact that both the listed company and each interposed company are individually entitled to relief.

Outlook

Despite the clarification provided through the BMF guidance, a number of questions of doubt remain to be answered, and legal uncertainty in connection with the anti-treaty/directive-shopping provision persists.

Moreover, it must be observed that the EU Commission initiated treaty violation proceedings against Germany. It is conceivable that Germany will adjust the regulations in order to avoid proceedings before the European Court of Justice.

Dr. Martin Lenz (mlenz@kpmg.com) is a Tax Partner and Head of National Tax with KPMG in Frankfurt/Main.

Tax Act 2010 *(from page 3)*

Moreover, all structures that involve the physical settlement of derivatives may be affected if such new language is introduced. The Bundesrat explicitly wants to support the legal point of view of the tax authorities, according to which a loss of a physical settled derivative is ring-fenced by Section 15, para. 4, cl. 3 of the Income Tax Act. Finally, the Bundesrat intends to broaden the applicability of Section 15, para. 4, cl. 3 of the Income Tax Act so that it also affects the income determination of investment funds. That would likewise qualify as a significant change compared to the current legal situation. Currently, the income determination of investment funds follows—principally—the rules applicable to private investors.

New "Tax Exemption" for Certificates

According to the draft Annual Tax Act, Section 20, para. 4a of the Income Tax Act should be amended so that no taxable gain is triggered in the case of certificates that qualify as so-called "other capital claims" and that provide for an option of the holder or the issuer to settle the certificate by delivering securities.

In our view, the amendment is a springboard for optimizing certificates that currently only provide for a cash settlement (e.g., by granting an option for a physical settlement).

Successions and Inheritance Tax Act

The new German inheritance tax law (generally

Tax Act 2010, continued on page 5

Tax Act 2010 *(from page 4)*

effective as of January 1, 2009) provides for a full tax exemption for successions of businesses whose assets consist of at least 90 percent productive property, provided specific further requirements are met.

Company participations are regarded as productive property, unless more than 50 percent of the held company's total assets are investment assets (i.e., non-productive assets).

Companies holding participations in other companies are currently able to use this provision for tax planning by, for example, transferring their own non-productive assets into affiliated companies that do not exceed the 50 percent threshold.

In order to address these tax planning structures, the new law imposes a 90 percent non-investment-asset requirement on the companies in which the inherited business holds participations. Only if the new 90 percent test is met will the participation be regarded as a productive asset. If the relevant subsidiary falls short of the threshold, the participation in the subsidiary qualifies as non-productive property.

If the subsidiary falls short of the threshold, the participation in the subsidiary qualifies as non-productive property.

VAT Fraud: Germany Expands Prosecution

According to the draft Annual Tax Act 2010, VAT fraud to the detriment of another European member state will be prosecuted by German authorities. Currently, the prosecution was contingent on a reciprocal treatment of a VAT fraud to the detriment of Germany in the relevant other European member state, cf. Section 370, para. 6, cl. 3 and 4 of the German Fiscal Code. Now, the draft Annual Tax Act intends to abolish this requirement. Thus, German prosecutors will be free to prosecute cross-border VAT fraud that affects taxes levied by other EU member states without fulfilling any further requirements.

VAT: The End of "Seeling"

By introducing a new paragraph 1b in Section 15 of the VAT Act, the Annual Tax Act intends to address the so-called "Seeling-model."

Under currently applicable law, the Seeling-model effectively results in a 10-year interest free loan granted by the revenue to the VAT taxpayer:

A taxpayer that acquires or erects a mixed-use building (business as well as private use) can treat the entire building as a business asset in which case the taxpayer can deduct all input VAT paid for acquiring or erecting the building rather than just the input VAT allocable to the business use section.

Subsequent private use of the building was, however, subject to VAT. By this, the input VAT is effectively paid back to the revenue over a 10-year period of time.

The draft Annual Tax Act now intends to limit the deductible input VAT to the amount allocable to the business-use part of the building.

Thus, the "interest-free loan" under the Seeling-model would henceforth be denied. The amended regulation would not apply to real estate acquired or erected prior to January 1, 2011.

German Tax Loss Forfeiture Rules

The Bundesrat suggests amendments to the German tax loss forfeiture rules (Section 8c of the Corporate Income Tax Act).

Section 8c of the Corporate Income Tax Act contains an exemption from the general loss forfeiture rule, according to which losses are preserved on a pro rata basis (irrespective of a principally detrimental share transfer) to the extent that the domestic (i.e., German) assets of a business contain hidden reserves—so-called "hidden-reserve exemption."

The Bundesrat suggests to broaden the applicability of the hidden-reserve exemption to the effect that also foreign assets that contain hidden reserves will be considered, provided Germany has the right to tax these hidden reserves once they are realized.

At the same time, the Bundesrat suggests to limit the scope of applicability of the hidden-reserve exemption to entities that have a positive equity balance.

Requirements of Fiscal Unity for Corporate Income Tax Purposes

The Bundesrat suggests to amend Section 17 of the Corporate Income Tax Act so that the formal requirements for drafting the profit and loss agreement are eased. In the past, the Federal Fiscal Court has ruled (most recently: in its decision of March 3, 2010, I R 68/09, DStR 2010 p. 858) that the requirement to agree on a loss assumption is only fulfilled, if the relevant agreement explicitly refers to Section 302 of the Stock Corporation Act in its currently applicable version. Otherwise, the agreement will be disregarded for tax purposes and the fiscal unity would not be recognized. This can result in disastrous tax consequences.

Tighter Rules on "Voluntary Disclosure" of Tax Fraud

The Bundesrat suggests to tighten the rules on a voluntary disclosure of tax fraud that lead to impunity, cf. Section 371 of the German Fiscal Code. In particular, impunity will *inter alia* be denied *(i)* once the tax audit order was sent to the taxpayer, or *(ii)* the tax audit was closed, or *(iii)* the tax fraud was revealed to the authorities (irrespective of whether the taxpayer was aware of that fact). According to the Bundesrat, impunity should also be denied in cases where the taxpayer reveals the tax fraud only in parts or via a third person.

Italian 10 Percent Additional Tax on Variable Compensation Paid to Certain Executives Employed in the Financial Services Sector Confirmed

By Vania Petrella and Gianluca Russo (Cleary Gottlieb Steen & Hamilton LLP)

With Law No. 122 of July 30, 2010, the Italian Parliament confirmed Law Decree No. 78 of May 31, 2010, that introduced, *inter alia*, an additional 10 percent tax (Additional Tax) to be levied on bonuses and stock options paid to certain executives employed in the financial services sector. Law Decree No. 78 became effective on May 31, 2010, but would have lapsed if not confirmed by the Italian Parliament within the next 60 days.

The rule introducing the Additional Tax has not been amended during the confirmation procedure. Therefore, as of May 31, 2010, any portion of variable compensation taking the form of bonuses or stock options exceeding three times the remuneration's fixed component is subject to the Additional Tax. However, such tax is applied exclusively to certain executives (i.e., employees treated as *dirigenti* and certain consultants and directors characterized as quasi-employees *(collaboratori coordinati e continuativi)* for labor law purposes) employed in the financial services sector.

The Additional Tax takes the form of a withholding tax and is effectively borne by the recipient; it does not

Tax on Bonuses, continued on page 7

Vania Petrella (vpetrella@cgsh.com) is a Partner, and Gianluca Russo (grusso@cgsh.com) is an Associate, in the Rome office of Cleary Gottlieb Steen & Hamilton LLP. Ms. Petrella's practice is focused on Italian and international tax issues relating to capital markets, mergers and acquisitions, financial products, and domestic and cross-border transactions. Mr. Russo's practice is concentrated in Italian and international tax issues, including executive compensation and tax implications of employee incentive plans.

Tax on Bonuses *(from page 6)*

affect the applicable social security regime.

Since the new legislation does not include a grandfathering rule for plans already launched or awards already vested at the time Law Decree No. 78 became effective, such plans and awards should be subject to the Additional Tax.

Black-letter law raises some doubts as to the actual scope and application of the new rule. For instance, it is not clear whether it applies to options only or also to other equity-settled awards, and how to determine the time frame material to compute the relevant threshold (i.e., three times the fixed component). For the time being, there is no indication as to whether and when the tax administration will issue any guidance with respect to this rule. ❑

NETHERLANDS

European Court of Justice Decision—No Abuse of the Merger Directive if the Avoided Tax is Not Covered by the Directive

By Ramona Vervuurt and Gerwin de Wilde (Greenberg Traurig, LLP)

On May 20, 2010, the European Court of Justice (ECJ) issued its judgment in the Modehuis Zwijnenburg case (C-352/08) regarding the interpretation of the anti-avoidance provision in the EU Merger Directive (Directive). In this case, it became clear that a merger that is primarily undertaken for tax purposes (specifically, to avoid Dutch transfer tax) is not covered by the anti-abuse regulation of the Directive to the extent that the avoided tax does not fall within the scope of the Directive.

The case involved a transfer of a Dutch company from father to son within the Netherlands. The son, indirectly (through a Dutch holding company), held a Dutch operating company. One of the assets of the operating company was a building, which housed a retail business. The father was the owner of another company, which also owned a building. This latter building was being leased to the son for purposes of operating the business. The intention was to transfer all of the assets from the father to the son. However, a direct transfer of the building from father to son would have resulted in transfer tax and Corporate Income Tax (CIT).

Dutch Exemption Permitted by Directive

Under Dutch tax law, in principle, no transfer tax (regarding the sale of real estate) or CIT is levied in the event of a company merger. This exemption, derived from the Directive, was implemented in Dutch national law and applies both to domestic as well as cross-border mergers. Based on the Directive, no CIT is levied by an EU-member-state in the event of a merger.

Consequently, a merger was planned in which the son's operating company would merge with the father's company whereby the son would receive shares of the latter company. Eventually, the father would sell his shares in the company to his son. However, art. 14 sub 4 Corporate Income Tax Act prevents the exemption from the CIT if the merger is mainly designed to avoid or defer taxation. However, no such provision is implemented in the Dutch transfer tax Act. Therefore, there are no legal grounds for denying the exemption for transfer tax, even though the merger was primarily structured in order to avoid or defer this transfer tax.

In principle, transfer tax does not fall within the scope of the Directive. However, since no anti-avoidance provision is implemented in the Dutch transfer tax Act, the Dutch Supreme Court questioned whether the anti-avoidance provision of the Directive (art. 11 sub 1a of the Directive) may be interpreted in such a way that as to deny the Directive's advantages for transactions that are predominantly structured to avoid or defer a tax that is not included in the scope of the Directive. Therefore, the Dutch Supreme Court filed for a preliminary ruling with the ECJ regarding the interpretation of the anti-avoidance provision in the Directive.

Since the Netherlands has implemented the Directive both for domestic as well as cross-border mergers, the ECJ held that it was competent to answer the question with regard to the purely internal situation (in accordance with previous case law, e.g., Leur-Bloem, C-28/95, July 17, 1997).

Moreover, according to the ECJ, art. 11 sub 1a of the Directive should be interpreted restrictively since it sets out an exception. Therefore, the Court held that the Directive solely applies to mergers and other reorganizations, and only the taxes specifically referred to in the Directive (such as CIT) may fall within the scope of the Directive.

Consequently, the ECJ determined that the benefits of the Directive may not be denied if the main purpose of a merger is the avoidance of a tax that is not covered by the Directive.

Ramona Vervuurt (vervuurtr@eu.gtlaw.com) is an Associate and Gerwin de Wilde (dewildeg@eu.gtlaw.com) is Of Counsel, with the Amsterdam office of Greenberg Traurig, LLP. Ms. Vervuurt's practice is focused on International corporate tax planning, tax effective restructuring, European tax law and IP tax planning. Mr. de Wilde's practice is focused on corporate and international taxation and tax planning, with emphasis on multinational corporations.

The Netherlands: The Location for International Holding Companies

By Heico Reinoud and Henrik Stipdonk (Baker & McKenzie)

The Netherlands has a long-lasting reputation as a holding jurisdiction for multinationals. From a tax point of view, the main drivers are the participation exemption in combination with the extensive network of over 90 tax treaties providing for low withholding rates, the Parent Subsidiary Directive, and membership in the European Union (EU). Further, the Netherlands has an extensive investment protection treaty network. The legal forms that are commonly used as a holding company are:

- private limited liability company (*Besloten Vennootschap*—BV), minimum capital €18,000;
- public limited liability company (*Naamloze Vennootschap*—NV), minimum capital €45,000;
- cooperative association (*Cooperatieve Vereniging*—Co-op), no minimum capital;
- limited partnership with freely transferable partnership interests (*Open Commanditaire Vennootschap*—Open CV), no minimum capital.

No registration fees or duties are due on contributions of capital.

Corporate Income Tax

A Dutch resident company is subject to corporate income tax with respect to its worldwide income (including capital gains). A company is considered a tax resident if has its place of effective management in the Netherlands or if it is incorporated under Dutch law.

The corporate income tax rate amounts to 25.5 percent (20 percent for profits of €200,000 or less). Tax losses can be carried back one year, and carried forward nine years. For holding and financing companies, certain restrictions exist with respect to the use of tax losses.

Participation Exemption

Dividends and capital gains are exempt provided the holding company holds a substantial participation in a (resident or non-resident) subsidiary. Foreign exchange gains, liquidation proceeds, earn out payments, and price adjustment payments are also covered.

Most tax treaties allocate the right to levy capital gains tax on the sale of shares exclusively to the country of residence of the holding company.

A substantial participation means that the Dutch holding company:

1) holds at least 5 percent of the nominal paid-up capital of a company having capital divided into shares;
2) holds at least 5 percent of the units in a collective investment fund;
3) is a member of a cooperative association; or
4) is a limited partner in a partnership, and in addition is entitled to at least 5 percent of the profits.

If the taxpayer is entitled to all economic benefits related to the shares (but does not own the legal title), the participation may still qualify. Non-voting shares as well as shares that are only entitled to a preferred dividend may also qualify. If the taxpayer does not meet the 5 percent threshold, the participation still qualifies if companies belonging to the same group as the taxpayer hold (indirectly) an interest of 5 percent or more in the subsidiary. Once a substantial participation is held for more than 12 months, the participation may still qualify in the 36 months following the date where the interest dropped below 5 percent.

Dividends and capital gains are exempt provided the holding company holds a substantial participation in a subsidiary.

The income from the participation qualifies for the exemption if:

(i) the participation is not held as a portfolio investment;
(ii) the participation qualifies for the subject-to-tax test; or
(iii) the participation qualifies for the business-asset test.

There is no minimum holding period. The participation will usually not be regarded as a portfolio investment if the holding company owns more than 50 percent of the voting shares and the subsidiary carries out a business enterprise. The participation may, however, be held as a portfolio investment if, e.g., the holding company owns 50 percent or less of the voting shares in an operating subsidiary, without being actively involved through a board membership in the management of that subsidiary, or where the subsidiary mainly owns cash at banks or tradable securities. Such participation will, however, still

Holding Companies, continued on page 9

Heico Reinoud (heico.reinoud@bakermckenzie.com) is a Tax Partner in the Amsterdam office of Baker & McKenzie. He has extensive experience in Dutch and Luxembourg corporate income tax law, international tax planning and, in particular, tax efficient supply chain management for multinationals. Henrik Stipdonk (henrik.stipdonk@bakermckenzie.com) is an Associate in the Amsterdam direct tax practice group.

Holding Companies *(from page 8)*

qualify if:

a) the subsidiary itself is subject to a profit tax that results in a real levy. This means that the taxable basis of the subsidiary is comparable to the Dutch taxable basis (if that subsidiary would have been a Dutch resident company) and the statutory rate is at least 10 percent; and/or

b) 50 percent or more of the market value of the assets (directly or indirectly) held by the subsidiary is attributable to business assets (as opposed to portfolio assets). Portfolio assets are those assets that are not reasonably necessary in the business enterprise of that subsidiary and the income from these assets is not subject to a profit tax that results in a real levy (see (a) above). If, however, less than 30 percent of the market value of the assets is attributable to the portfolio assets, all assets of the subsidiary will qualify as business assets.

A write-off loss, or a loss suffered on the disposal of a qualifying participation is not deductible.

With respect to the exception (b) the excess cash and tradable securities (among which shareholdings of less than 5 percent) will generally be regarded as portfolio assets. Intra-group loans and assets put at the disposal of group companies (e.g., intellectual property rights, ships, airplanes, machinery) are by fiction regarded as portfolio assets, unless *(i)* the subsidiary that holds these assets meets a strict activity test, or *(ii)* these assets are mainly financed out of third-party debt. Real estate, whether utilized by the subsidiary itself or rented out (to the group or third parties) qualifies as a business asset. Also, self-created goodwill qualifies as business asset.

Other Qualifying Instruments

If the taxpayer (or a group member) holds a qualifying participation, other instruments such as long-term profit participating subordinated loans and profit certificates (*winstbewijzen*) issued by the subsidiary also qualify for the participation exemption. Further, capital gains on rights to purchase or sell 5 percent or more of the existing shares (options) and rights to obtain 5 percent or more of new shares (convertible loans/bonds, warrants) may also qualify.

The participation exemption also applies to results derived from hedging instruments (including loans) that cover the foreign exchange exposure related to the participation in the subsidiary, provided the taxpayer has requested a formal decision in advance.

Costs and Losses

Costs related to the acquisition and sale of a qualifying participation are not deductible. Acquisition costs must be added to the cost price. Goodwill embedded in the cost price of the participation cannot be amortized against the taxpayer's taxable income.

Generally, the interest due on debt that finances the acquisition of a qualifying participation is deductible. The deductibility of interest due on intra-group debt, however, may be restricted under the thin capitalization rule. This is the case to the extent that the net loan payables exceed the higher of the 3:1 debt-to-equity (safe harbor) ratio and the group ratio. Further, interest due on artificially created intra-group debt is generally not deductible.

A write-off loss, or a loss suffered on the disposal of a qualifying participation is not deductible. Provided certain conditions are met, a liquidation loss, however, is deductible.

Inbound Dividends

Dividends distributed by a qualifying participation to the Dutch holding company may be subject to withholding tax in the source country. Dividends distributed by a subsidiary resident in an EU member state are generally exempt from withholding tax if the Dutch holding company owns at least 10 percent of the capital (or, if opted for by means of a bilateral agreement, holds 10 percent of the voting rights). Certain countries require a minimum holding period. This holding period cannot exceed two years (Council Directive 90/435/EEC). Further, on the basis of tax treaties concluded by the Netherlands, dividend withholding tax rates are often reduced for substantial shareholdings. Foreign dividend withholding tax (if any) cannot be deducted or credited against Dutch corporate income tax if the dividend is exempt.

Outbound Dividends

Dividend distributions by a BV, NV and Open CV (to its limited partners) are subject to 15 percent withholding tax, unless an exemption or a lower tax treaty rate applies. Profits distributed by a Co-op are not subject to dividend withholding tax provided membership rights are not freely transferable (i.e., transfer is subject to prior approval of all members). An exemption applies if the parent company holds an interest of at least 5 percent in the Dutch company and is a resident of a member state of the EU, Norway or Iceland (Liechtenstein is excluded, but should qualify as soon as the exchange of information treaty comes into force). There is no minimum holding period, subject to tax or legal form requirement. Many tax treaties, such as the ones with Singapore and the U.S., provide for a 0 percent withholding tax rate, provided certain conditions are met.

Tax-exempt entities resident in the EU or European Economic Area (EEA) can claim a refund of Dutch dividend withholding tax, unless the refund is related to collective

Holding Companies, continued on page 10

Holding Companies *(from page 9)*

investment vehicles. Pension funds will generally qualify for such refund.

The repayment of share premium is subject to a dividend withholding tax to the extent that retained earnings and profits exist. The repurchase of own shares is subject to withholding tax to the extent the purchase price exceeds the average contributed capital on the shares. However, tradable shares that are repurchased by the holding company in order to sell them within a short period of time are generally not subject to withholding tax. A reduction of the par value per share is also not subject to dividend withholding tax.

Costs related to the acquisition and sale of a qualifying participation are not deductible.

There is no withholding tax on interest payments.

Functional Currency

The default currency for tax reporting is the euro. However, a foreign currency may also be used provided that the taxpayer draws up its statutory accounts in this currency. A request must be filed prior to the year in which the taxpayer wishes to calculate its taxable income in the foreign currency.

Non-resident Taxation

A non-resident company will, in principle, not be taxed in addition to the Dutch dividend withholding tax (if any), unless it holds a participation of 5 percent and the participation in the Dutch company is held as a portfolio investment. In such case, dividends and capital gains are subject to Dutch corporate income tax. Under most of the tax treaties, however, the Netherlands has no right to levy tax on capital gains and the dividend withholding tax is often reduced to less than 15 percent.

Private equity funds and real estate development funds will usually not be subject to this non-resident corporate income tax if one of the key managers is actively involved in the management of the operating companies through a (supervisory) board membership and the fund has its own equipped office and employees. A substantial shareholding held by pension funds and insurance companies is usually not regarded as a portfolio investment.

Advance Tax Ruling

Advance tax rulings can be obtained with respect to the participation exemption, dividend withholding tax exemption and absence of non-resident taxation. Advance confirmation can generally be obtained between six to eight weeks. To avoid beneficial ownership issues, the ruling team requires that the cost price of the participation is financed out of at least 15 percent equity.

Value Added Tax

A holding company that does not render services to other entities is not regarded as a VAT payer. As a consequence, VAT due on fees charged to the holding company will form a cost.

If the holding company renders services to other entities (e.g., management, advisory or support), it must register for Dutch VAT purposes prior to commencing these activities. Output-VAT must be charged to the recipient of these services, unless an exemption or the reverse charge method applies. Input-VAT on acquired services and goods can generally be deducted to the extent that they are directly attributable to these taxable activities.

THOMSON REUTERS WorldTrade Executive

WorldTrade Executive's
Practical European
Tax Strategies

Senior Editor: Scott P. Studebaker, Esq.

Assistant Editor: Edie Creter
Contributing Editor: George Boerger, Esq.
Special Interviews: Scott P. Studebaker
Marketing: Jon Martel
Production Assistance: Dana Pierce

PRACTICAL EUROPEAN TAX STRATEGIES
is published monthly by
WorldTrade Executive,
a part of Thomson Reuters
P.O. Box 761, Concord, MA 01742 USA
Tel: 978-287-0301, Fax: 978-287-0302
info@wtexec.com
www.wtexecutive.com

VAT Victory for Insurance Introductory Service Providers

By Judith Harger and Farheen Raza (Dewey & LeBoeuf)

Summary

Following the Court of Appeal decision in favor of the taxpayer in *HMRC v. InsuranceWide.Com Services Limited and Trader Media Group Limited* [2010] EWCA 422 *(IW & TMG)*, Her Majesty's Revenue & Customs (HMRC) have published Revenue & Customs Brief 31/10 (Brief) confirming their decision not to appeal the judgment.

Those introducing prospective customers to insurance providers, via the Internet or otherwise, that fall within the scope of the *IW & TMG* ruling, may have the opportunity to claim back overpaid value added tax (VAT) on such transactions. This article outlines the content of the HMRC Brief and what this means for insurance intermediary service providers.

Background

European Union law provides that "insurance and reinsurance transactions, including related services performed by insurance brokers and insurance agents," are exempt from VAT (Article 135(I)(a) of the Directive 2006/112/EC). In the UK, this exemption is set out at item 4 of Group 2 of Schedule 9 to the Value Added Tax Act 1994, which provides that "the provision by an insurance broker or insurance agent of any of the services of an insurance intermediary in a case in which those services are related (whether or not a contract of insurance or reinsurance is finally concluded) to an insurance transaction or a reinsurance transaction" is an exempt supply.

The exemption essentially relies on a two-part test. First, the service provider must be an "insurance broker" or "insurance agent" and, second, the nature of the activities carried out by the service provider must constitute activities "related" to insurance transactions.

This means that an on-line insurance introductory service provider must form part of the chain of communication between the insurer and the insured, and be instrumental in bringing together the two parties to the insurance contract by finding prospective clients and introducing them to the insurer (and not merely advertising, which is not an exempt activity).

Judith Harger (jharger@dl.com) is a Partner and Farheen Raza (fraza@dl.com) is an Associate, in the London office of Dewey & LeBoeuf. Ms. Harger's practice is concentrated in corporate tax, where she provides tax advice and planning for a wide range of corporate, commercial and financial transactions and international structures. She has participated in numerous corporate acquisitions and disposals, both public and private, including management buyouts; cross border tax planning; and domestic and international joint ventures/partnerships and funds. Ms. Raza's practice is concentrated in tax.

Court of Appeal Decision

The Court of Appeal upheld the decision of the High Court in favor of the taxpayers in the two recent joined appeals—*InsuranceWide.com Services Ltd v. Commissioners for Her Majesty's Revenue & Customs; Commissioners for Her Majesty's Revenue & Customs v. Trader Media Group Ltd* [2009] EWHC 999 (Ch). HMRC contested the availability of the insurance intermediary services exemption in both cases on the basis that the criteria in their published guidance at the time were not satisfied. The appeals raised the question of whether the provision of "click-through" on-line introductory services, by an insurance comparison website and an automobile advertisement website respectively, between people seeking insurance and a panel of insurers, with no further involvement in the negotiation of the terms of the insurance policy or in its preparation or the collection of premiums or the handling of claims or any authority to bind either party, constituted "intermediary" services. The facts of both cases were similar but not identical.

HMRC now accept that insurance introductory services will be exempt from VAT when a business is doing much more than acting as a "mere conduit" through which a potential customer is passed to an insurance provider.

In *InsuranceWide*, customers could get a quote for insurance on the InsuranceWide comparison website itself, which best matched their requirements. From there, a customer was able to "click-through" to the insurer's/broker's website to complete a transaction. In *Trader Media*, prospects would browse the automobile advertiser's website, which contained a "click-through" to a third party co-branded insurance broker website from which they could obtain a quote for insurance. Both InsuranceWide and Trader Media were paid a commission for any policy sold via their website.

The Court of Appeal, confirming the decision of the High Court, found both services to be exempt—widening the understanding of the scope of the insurance intermediary services exemption to encompass the provision of certain "click-through" introductory services between insurers and insureds, without the need for further involvement in the intermediation of the insurance contract, provided

VAT, continued on page 12

VAT *(from page 11)*

that they were not acting as "mere conduits."

Crucially, the taxpayers were providing more than just a "click-through" service. They were, among other things, involved in identifying as well as appraising and selecting appropriate insurers for their target markets, having regard to the competitiveness of their pricing and products and their level of consumer service. In the case of *InsuranceWide*, customers were given access to the most appropriate insurers, either directly or through another intermediary. In the case of *Trader Media*, it not only had an input into the questions to be answered by those seeking insurance but, importantly, it made suggestions for the composition of the insurance panel based on its understanding of the experience and demographics of the customers and with a view to providing customers with insurers that would quote competitive prices. These were activities that were more indicative of an insurance broker as opposed to an advertiser or "mere conduit."

The decision is relevant to other non-Internet based introductory services—for example, those provided by affinity groups.

HMRC's Response

In light of the decision of the Court of Appeal, HMRC now accept that insurance introductory services will be exempt from VAT when a business is doing much more than acting as a "mere conduit" through which a potential customer is passed to an insurance provider. They cite the following four conditions that must all be met for the supply of insurance related introductory services to be exempt:

- The services are provided by someone engaged in the business of putting insurance companies in touch with potential clients or more generally acting as intermediaries between the two parties (although this may not necessarily be their principal business activity).
- The business provides the means (that is, by way of an Internet "click through" or some other form of introduction) by which a person seeking insurance is introduced to a provider of insurance or to another intermediary in a chain leading to an insurance provider.
- That introduction takes place at the time a customer is seeking to enter into an insurance contract (although in some instances an insurance contract may not actually go on to be finally concluded).
- The introducer also plays a proactive part in putting in place the arrangements under which that introduction is effected.

  For the purposes of the last condition above, HMRC say that evidence that the introducer has been proactive in putting in place the arrangements under which the introduction is effected could, for example, take the form of some or all of the following:

—active endorsement of the insurer or the insurance product;
—involvement in the selection of the insurance products and/or providers;
—involvement in the process under which the insurance contract is entered into, even though the intermediation of the contact itself is undertaken by a third party (for example, by having input into what questions should be asked of the prospective insured or the design of the third party's website);
—negotiating a special rate for the insurance product(s) on behalf of its customers or membership base; and
—some form of assessment of the customer's requirements so that they are directed to the most appropriate insurer for them.

Analysis

The crux of the matter, with which the domestic and European Court of Justice case law and the tax authorities in Member States have grappled, is the distinction between introductory services, on the one hand, and non-exempt advertising or ancillary/administrative activities on the other hand.

In the *IW & TMG* decision, the key question was whether the provision of on-line introductory services was sufficiently instrumental in "marrying up" an insurer with an insured and not merely a line of communication.

In that context, as a practical matter, the more "active" role an insurance intermediary service provider plays in "bringing together" the insured and the insurer, the more likely it is that the services supplied fall on the exempt side of the line and reduce the likelihood that they are considered merely advertising/administrative in nature.

It is clear from the *IW & TMG* ruling that the outcome is determined by the substance of what is actually done, not the form—i.e., it is based on the activities actually performed by the service provider and not according to how it describes its business activities nor whether it is regulated as an insurance intermediary. Further, it should be noted that the Brief points out that "whilst remuneration based on successful take-up may indicate an introduction, it is not enough in itself to determine exemption and it is always important to consider what is actually being done rather than how it is paid for."

The decision of the Court of Appeal was generally a welcome one for those providing on-line introductory services to the insurance industry, and their insurance company clients, and recognizes the way in which the Internet has changed how business is conducted.

VAT, continued on page 13

VAT *(from page 12)*

The decision is also relevant to other non-Internet based introductory services—for example, those provided by affinity groups.

The publication of the Brief by HMRC and confirmation of the decision not to appeal provides further certainty to those involved in providing and receiving such services and greater practical guidance on the boundaries of the exemption.

The case highlights a broader problem of defining the scope of the VAT insurance exemption. The problem has become more acute over recent years because of commercial pressure to outsource various functions of an insurance business-creating a risk that such "hived off" activities lose their "insurance" nature on a stand-alone basis and become purely administrative in nature. This remains an issue for the insurance (and banking) industry. The EU Commission is currently considering a wide-ranging reform of VAT exemptions for the insurance and financing sectors.

Action Points

A claim can be made by those insurance introductory service providers falling within the scope of the *IW & TMG* ruling to recover overpaid tax charged on their fees. This is subject to the usual limitations.

The three-year "cap" (or time limit) on repayment claims needs to be watched, which means that businesses should consider making any refund claims as soon as possible.

In addition, HMRC can refuse a repayment claim if repayment would unjustly enrich the claimant. This would be the case if the relevant VAT cost has been passed on to the insurance company client, unless the repayment is also passed back to the client (either in fulfillment of contractual obligations to the client or to enhance the client relationship). In practice, it can be difficult to determine whether the VAT cost has actually been passed on or whether, instead, the claimant business has absorbed the VAT cost or suffered a loss of profit as a result of having wrongly charged VAT to its customers.

Although the insurance company receiving the services is unlikely to be in a position to make a direct repayment claim against HMRC, it should look at the terms of its contract with its insurance introductory service provider to see whether it has a right to insist on the service provider making a repayment claim and, if so, the proportion of any repayment that it is entitled to receive and the effect of the exemption on the level of future fees.

The direct "benefit" of the exemption for the insurance company will depend on the extent to which it can recover input VAT under its partial exemption arrangements, which in turn will depend on the nature of its underlying business. However, the overall net effect on the insurance company is harder to quantify. If the service provider makes exempt supplies to its insurance company customer, then the service provider's ability to recover input VAT on its own costs will be reduced. In other words, although the application of the VAT exemption to the insurance introductory services, in principle, reduces the insurance business's irrecoverable input VAT costs, the service provider's own cost base will increase. This in turn will affect the proportion of any repayment that the service provider will wish to pass on to its insurance company client and also the level of fees that it will wish to charge the insurance business for its services in the future.

The EU Commission is currently considering a wide-ranging reform of VAT exemptions for the insurance and financing sectors.

The precise economic impact of the *IW & TMG* decision on particular businesses in the insurance industry will involve some careful analysis.

Astra Zeneca and VAT: When Sacrifices Can Be Painful

By Richard Woolich and David Thompson (DLA Piper UK LLP)

The European Court of Justice (ECJ) has delivered its judgment in *Astra Zeneca UK Limited v HMRC* (Case C-40/09).

The reference to the ECJ was for a preliminary ruling on the VAT implications of an employer issuing to its employees vouchers with a cash value exchangeable for goods or services at certain well-known retailers, in return for the employees giving up part of their remuneration (a salary sacrifice).

The ECJ's ruling that the remuneration given up constitutes consideration for the issue of the vouchers, giving rise to a VAT liability for the employer, has important implications for employers running similar schemes.

Facts

Astra Zeneca offered its employees a remuneration package consisting of a fixed annual remuneration known as the Advantage Fund, made up of an amount in cash and benefits chosen beforehand by the employee. The benefits selected by the employee gave rise to a specific deduction from that employee's fund. Included in the choice of benefits were retail vouchers to be used in certain shops. The ECJ judgment states that while the vouchers had a face value of £10, they gave rise to a deduction from the employee's fund of between £9.25 and £9.55.

Initially, Astra Zeneca completed its VAT returns on the basis that there was no output VAT on the provision of the vouchers and no entitlement to deduct input VAT on the cost of the vouchers. However, Astra Zeneca subsequently claimed that the input VAT on the purchase of the vouchers was a business overhead and was deductible, but that there was still no output VAT because the vouchers were provided for free.

HM Revenue & Customs (HMRC) rejected this claim, arguing that the input VAT was not deductible because the vouchers were not used for the purpose of any taxable transactions; or alternatively that though the input VAT on the purchase of the vouchers was deductible, there was an output tax liability on providing the vouchers to the employees, either because the amount sacrificed was consideration, or because the vouchers were made available otherwise than for a business purpose (Value Added Tax Act 1994 [VATA] Schedule 6 paragraph 7).

Referral to ECJ

The case reached the Tribunal, which referred three questions to the ECJ. Because the ECJ answered the first question affirmatively, there was no need to deal with questions 2 or 3. The first question was: When an employee is entitled under the terms of his or her contract of employment to opt to take part of his or her remuneration as a face-value voucher, is Article 2(1) of the Sixth Directive to be interpreted such that the provision of the vouchers by the employer to the employee constitutes a supply of services for consideration?

The *Astra Zeneca* case means that HMRC can no longer ignore output tax being chargeable when benefits are provided in return for a reduction in salary.

In concluding that the provision of vouchers was for a consideration, the ECJ found that Astra Zeneca was carrying out an economic activity when it gave its employees vouchers in exchange for them giving up part of their cash; that the provision of the vouchers was a supply of services, not goods, because the vouchers could be used to buy a range of goods and services; that the remuneration given up constituted consideration received by Astra Zeneca which could be expressed in money; and that there was a "direct link" between the remuneration given up and the provision of the vouchers, so there was a supply of services for consideration.

Previous Law and Practice

When goods or services are provided to employees for their private use, *for free*, there is a supply deemed to be made equal to the cost to the employer of providing the goods or services: VATA, Schedule 6 paragraph 6 and 7 and Article 26 of EU Directive 2006/112/EC (Directive). In the UK, there is a *de minimis* threshold for goods of £50 per gift, or per series of gifts to the same person in the same year (VATA Schedule 4 paragraph 5(2)), below which there is no deemed supply. These rules are known as the business gift rules, and are

Astra Zeneca, continued on page 15

Richard Woolich (richard.woolich@dlapiper.com) is a Partner in the London office of DLA Piper UK LLP. His practice is focused on development of real estate practice nationally and internationally as well as VAT. He chairs the DLA Piper VAT practice. David Thompson (david.thompson@dlapiper.com) is a Partner with the Manchester office of DLA Piper UK LLP. His practice is focused on the tax aspects of acquisitions, mergers, reorganizations, joint ventures and international transactions.

Astra Zeneca *(from page 14)*

applicable generally, not just to gifts to employees. In the context of employees, HMRC Manual V1-3 para 5.3 confirms that employees' services under their employment contract are not seen as consideration.

In practice in the past, HMRC has not sought to impose output VAT on benefits provided to employees, even though the input tax on the purchase of those benefits has been deductible. In *RW & MJ Goodfellow* (1986) VATTR 119 employers provided food and accommodation to their employees, deducting the cost from the employees' salary. These deductions from salaries did not constitute consideration, so no VAT was chargeable. This decision was enacted in VATA Schedule 6, paragraph 10, although it only applies to the provision of food and accommodation. In these cases, the legislation provides that no VAT is chargeable unless money consideration is paid by the employee or a third party. Furthermore, VAT (Treatment of Transactions) Order 1992 S.I. 1992/630 extends this treatment to cars supplied by employers to employees. When the employee chooses to sacrifice salary in return for the right to use a car privately, there is no supply of goods or services. This Order followed *Co-operative Insurance Society Ltd* (1992) VATTR 44.

Employers that operate salary sacrifice arrangements should review their schemes promptly to determine whether any of the benefits they provide pose a VAT problem.

"Consideration" has a community meaning and means everything received in return for a supply of goods or services. "In return for" means there must be a "direct link" between the supply and the consideration. Is it possible to avoid this "direct link" in the employment context where the parties will, of course, want certainty? In the *Dutch Potato Case* (1981) ECR 445, a co-operative waived storage charges, resulting in a drop in the value of its shares. The Dutch tax authorities argued that the reduction in value of each member's share was consideration for the storage. The ECJ held there was no taxable supply, because there was no direct link between the services of storage and the decrease in the share values. The reduction in value of the services could be not equated directly to the cost or any other measure of the services provided; so to break the direct link would mean to divorce the salary sacrifice from the value of the benefits awarded. In effect, the employees would need to accept "lower" salaries, despite the award of the vouchers they may or may not receive. There could be no contractual link between the reduction in salary and the value of vouchers awarded.

Implications of the Decision

HMRC will need to review its law and practice in relation to this sort of scheme in which benefits, not only vouchers, are awarded in return for a reduction in salary. The *Astra Zeneca* case means that HMRC can no longer ignore output tax being chargeable when benefits are provided in return for a reduction in salary. Consideration must be capable of being expressed in money. Simply agreeing to carry out one's duties as an employee should still not constitute consideration, but one must query whether the business gift rules should be strictly applied.

It is not yet clear whether HMRC will implement the changes only for the future, or will assess employers for VAT for the past four years. Employers that have reclaimed input VAT, but not accounted for output VAT, are the most vulnerable. Those employers that have not reclaimed input VAT should not be at risk of real cost overall because the input VAT reclaim should equal the output VAT payable as a result of this case, assuming there was no profit margin for the employer built into the salary sacrifice. The deemed consideration (equal to the cost to the employer) on a "free" supply is displaced by actual consideration equal to the salary "sacrificed," so the output tax could be higher or lower than the input tax, depending on the amount sacrificed.

Employers that operate salary sacrifice arrangements should review their schemes promptly to determine whether any of the benefits they provide pose a VAT problem. Certain benefits, such as pension contributions, will not give rise to a taxable supply. Furthermore, retail vouchers, issued by the retailer to its own employees, giving employees the right to redeem the voucher in return for the retailer's own goods, would not generally give rise to a supply (VATA 1994 Schedule 10A, paragraph 4).

This is also a good opportunity to review benefit schemes generally because there are different schemes available and there may be an alternative scheme that works for the business and is more tax efficient, particularly bearing in mind the increase to both employers and employees NICs in April next year. Childcare vouchers, for example, have some NIC advantage within certain limits. Also of interest is a recent case, *TBS (South Wales) Ltd* (1981) VATTR 183, in which the employer provided a car to the employee but retained 10 percent of the ownership of it. The tribunal held that due to the joint ownership there was no supply of the car to the employee.

Conclusions

Employers and HMRC alike cannot ignore the implications of this important case. Employers should review their benefit and salary sacrifice arrangements.

Tax Agreement *(from page 2)*

Unlike some of Hong Kong's other DTAs, there is no provision allowing Hong Kong to apply its domestic laws and measures concerning tax avoidance in relation to the DTA. There is no requirement for income (in respect of which a claim for treaty relief could be made) to be subject to tax.

There are no specific limitation of benefit provisions.

Exchange of Information

The Exchange of Information provisions require the tax authorities in both the UK and Hong Kong to provide administrative assistance and information when requested to do so, but only for taxes covered by the DTA. The protocol to the DTA specifically provides that there shall be no automatic or spontaneous exchange of information.

It is expected that HM Revenue & Customs will be very active in seeking an exchange of information from the Hong Kong Inland Revenue Department in relation to UK residents with bank accounts in Hong Kong.

Other Provisions

Transfer pricing: The UK and Hong Kong tax authorities will be able to agree on downward adjustments in UK taxable profits for transfer pricing purposes where a tax liability for the same profits also arises in Hong Kong. From a UK perspective, this was not previously possible.

Dual residence: Where a person other than an individual (e.g., a company) is treated as resident in both Hong Kong and the UK, it will be deemed resident where its place of effective management is situated. In cases of doubt the issue will be determined by mutual agreement by the tax authorities of both states. The main benefits of the DTA will not be available to a dual resident entity if an agreement on residence cannot be reached.

Permanent establishment: Developing/constructing businesses need to be aware that a building site that lasts for more than six months will constitute a permanent establishment for the purposes of the DTA.

Shipping/air transport: There are no major differences from the existing agreements relating to revenues from shipping and air services, and the wide definition of profits attributable to such activities is likely to be welcomed by industry.

Pensions: Expatriates returning to the UK or Hong Kong will welcome the provision that pensions and similar remuneration will only be taxable in the source state (namely, where they are paid).

Tax Planning Opportunities

The DTA strengthens the positions of both the UK and Hong Kong as tax efficient investment hubs in their respective regions, and compares favorably with DTAs that Hong Kong has recently entered into with other EU countries.

The zero rate of UK withholding tax on interest payments and the reduced rate of withholding tax on most royalty payments will mean that Asia-Pacific based groups may be able to use Hong Kong as a hub to hold, finance or license intellectual property into the UK (or into the EU via a UK intermediate holding company). Similarly, the DTA provides a favorable framework for UK companies (or European companies via a UK intermediate holding company) to invest into Asia via Hong Kong. ❑

Submission of Articles

The editors of *Tax Strategies* invite in-house tax counsel, tax practitioners and other tax specialists to submit original articles for publication. *Tax Strategies* reserves the right to make revisions to articles. Please send inquiries and articles to scott.studebaker@thomsonreuters.com