

# Global Tax INSIGHT

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# An overview of this issue

We are delighted to publish the 3rd edition of Global Tax Insight. This edition discusses some interesting developments. Transfer pricing cases are few and far between and the Australian Federal Court decision in the case of Chevron and the discussion on recent Spanish case law are likely to be of interest to transfer pricing specialists. Tax residence is always a hot topic for multinational corporations and the close scrutiny given to this by the UK's First-Tier Tribunal in the case of Development Securities will provide interesting lessons for good corporate governance practices to ensure that companies are not inadvertently brought into another jurisdiction's tax net. Likewise, following Emmanuel Macron's recent election, there have been significant reforms to the French tax system with the aim of making the regime more competitive and encouraging multinationals to invest more in France. Seasoned tax professionals will be aware that tax is never static and our prediction for 2018 is that there will be no shortage of further developments for us to report on.

We hope you find this edition interesting and would be delighted to receive any suggestions to improve future additions or requests for articles.

## Editors



**Eduardo Gracia**  
Partner, Madrid  
T +34 91 364 9854  
eduardo.gracia@ashurst.com



**Nicholas Gardner**  
Partner, London  
T +44 (0)20 7859 2321  
nicholas.gardner@ashurst.com

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## AUSTRALIA

# Landmark Australian transfer pricing decision may have global implications

by Peter McCullough, Paul Glover and Sanjay Wavde

Transfer pricing is being increasingly scrutinised by tax authorities throughout the world in light of globalisation and the increasing reach of Multinational Enterprises (MNEs). As such, the landmark dispute in *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* [2017] FCAFC 62 (Chevron) not only impacts MNEs with Australian cross-border financing arrangements but may also influence transfer pricing law and practice in other jurisdictions.

### INSIGHTS

- 📍 The Chevron decision represents a significant transfer pricing win for the Australian tax authorities that could impact on many existing and future cross-border arrangements with related parties.
- 📍 The Full Federal Court was prepared to “rewrite” the terms of the taxpayer’s loan agreement to determine the arm’s length price, demonstrating that it cannot be assumed that the terms of intercompany agreements (other than price) will be respected when courts apply the Australian transfer pricing provisions. That is, taxpayers will need to price arrangements based on hypothetical arm’s length terms for matters other than just the price.
- 📍 Corporate groups with Australian operations should review their intra-group arrangements and supporting documentation and consider whether the actual terms of such arrangements would be sustainable between independent parties in the real commercial world.



On 21 April 2017, the Full Federal Court of Australia unanimously dismissed the appeal by Chevron Australia Holdings Pty Ltd (CAHPL) against the Federal Court decision in favour of the Australian Taxation Office (ATO). The amended assessments issued by the ATO were ultimately affirmed, denying a portion of the interest deductions claimed by CAHPL in respect of a loan from its US subsidiary. Although this dispute specifically concerned Australian matters of administrative, procedural and constitutional law, the Full Federal Court decision is most striking in terms of its emphasis on “commercial reality” and the appropriate factors to be weighed up in analysing the transfer pricing risks associated with intra-group financing.

Following this decision, CAHPL settled with the ATO for an undisclosed sum on 18 August 2017.

The ATO has estimated that the decision in Chevron could result in an additional A\$10bn in tax revenues over the next 10 years from revised related party financing arrangements.

## Full Federal Court Decision

### Relevant transfer pricing rules

The relevant transfer pricing rules that were the subject of the dispute in Chevron were the former Division 13 of the Income Tax Assessment Act 1936 (ITAA 36) and the provisions of Division 815-A of the Income Tax Assessment Act 1997 (ITAA 97) (both of which ceased to have effect from 1 July 2013).

Although this dispute concerned the “old” transfer pricing rules, which no longer operate, the court’s discussion of the “arm’s length principle” will be relevant in interpreting similar concepts under the “new” transfer pricing provisions in Division 815 of the ITAA 97.

### Chevron’s inter-company loan

The dispute centred around a US\$2.5bn loan from Chevron Texaco Funding Corporation (CFC), a wholly owned US subsidiary of CAHPL, to CAHPL at the interest rate of LIBOR plus 4.14%. At times, over the loan term, this rate exceeded 9%. No guarantee or security was provided for the loan and there were no financial or operational covenants that bound CAHPL to conduct its business in any particular way. CFC raised the funds by issuing commercial paper in the US, for which it paid interest at rates which were at times as low as 1.2%.



Throughout the period between the income tax years 2004 to 2008, CAHPL claimed significant income tax deductions in Australia for its interest payments to CFC while, in due course, having these funds returned back onshore in the form of non-assessable dividend payments from CFC to CAHPL.

The ATO asserted that CAHPL's interest deductions on the loan exceeded an arm's length amount. In response, CAHPL argued that the interest amounts were not excessive because the cost of finance for a similar loan with no guarantee, security or financial or operational covenants could reasonably be expected to exceed 9%.

### **The decision**

In determining whether the parties had dealt with each other at arm's length, the court found it necessary to account for actual commercial realities when pricing the loan.

For the purposes of applying the relevant transfer pricing rules, the court held that an arm's length borrower should be assumed to be independent from the lender, but not necessarily from its multinational group. In other words, the borrower is not assumed to be a stand-alone entity divorced entirely from its parent or wider group. This means, for example, that matters such as the availability of a guarantee from a multinational parent may be a relevant factor in determining the arm's length interest rate on a loan. In the case of Chevron, group policy was to borrow externally at the lowest rate possible and it was usual commercial policy for a parent company guarantee to be provided for external borrowings by subsidiaries.

The court also held that the "consideration" provided for a loan is not limited solely to the interest rate but can include such matters as the giving of security, financial covenants or a guarantee by a parent company. In the court's view of a hypothetical arm's length agreement, a borrower of CAHPL's standing would have offered something additional (e.g. security, covenants, guarantee) for the loan to obtain the best possible interest rate and, as mentioned above, this analysis was consistent with the commercial reality of Chevron's group policy for external borrowings. Accordingly, the absence of those elements meant that the actual loan between the parties, which contained none of those elements, was not an arm's length agreement.

The taxpayer submitted that, if the hypothetical arm's length loan agreement included a parent company guarantee, then the agreement should also assume that a (deductible) fee would be payable to its parent for the provision of that guarantee. While the court acknowledged that this submission had some force, there was insufficient evidence presented by the taxpayer to warrant the conclusion that a fee might reasonably have been expected to have been paid by CAHPL under the hypothetical loan.

The impact of the court's decision is that, in determining an arm's length rate of interest, one needs to hypothetically assume an agreement with arm's length terms – one does not take the actual agreement between the parties and determine an interest rate based on those terms if that agreement does not in fact reflect an arm's length agreement. This means, for example, that parties cannot choose a higher interest rate on a loan by offering





lenders slender protections and reflecting the increased risk associated with such loan terms, where that type of arrangement would not reasonably be expected to be seen in an arm's length agreement.

### Final Comments

The key message from Chevron is that Australian courts will not interpret transfer pricing rules “pedantically” and that the ATO may take a “rational and commercially practical” approach in pricing related party arrangements. In construing what an arm's length arrangement would be, the idea that a court can assume that a parent would provide a guarantee to reduce the cost of finance for its subsidiary, is also a significant development. Similarly, the fact that the court was prepared to “rewrite” the terms of an agreement in order to determine the arm's length price means that taxpayers cannot simply assume that the terms of intercompany agreements (other than price) will be respected, and will need to price arrangements based on hypothetical arm's length terms for matters other than just the price.

It was unfortunate that the taxpayer's submission that a (deductible) guarantee fee should be imputed into the terms of the hypothetical loan was not considered by the court due to insufficient evidence. It would be interesting to know how the court would have chosen between the actual loan and the hypothetical loan where the value of the overall consideration payable by the taxpayer in connection with each loan was similar in amount.

Taxpayers should review their internal borrowing policies, intra-group arrangements and supporting

documentation in light of Chevron and consider whether the actual terms of such arrangements would be sustainable between independent parties in the real commercial world.

Success in the Full Federal Court and the subsequent settlement of the appeal will underpin the ATO's continuing focus on international-related party arrangements. The ATO has subsequently released Draft Practical Compliance Guideline PCG 2017/D4, summarising its approach to reviewing such arrangements, and has indicated that a number of taxpayers are already restructuring as a result of the Chevron decision.

Australian taxpayers should review both historic and future arrangements in light of the decision and continue to monitor any updated guidance, rulings or other developments from the ATO.



**Peter McCullough**

Partner

T +61 2 9258 6078  
peter.mccullough@ashurst.com



**Paul Glover**

Counsel

T +61 2 958 6016  
paul.glover@ashurst.com



**Sanjay Wavde**

Senior Associate

T +61 2 9258 6135  
sanjaywavde@ashurst.com



UK

# Why a company may not be tax resident where you think

## What are the implications of the Development Securities case for tax residence procedures?

by Nicholas Gardner and Preena Gandhi

Questions frequently arise as to what steps must be taken to ensure a company is tax resident in a particular jurisdiction. This is important as tax residence determines the tax regime principally applicable to the company and whether it is entitled to claim the benefit of double tax treaty relief as a resident for treaty claims for withholding tax exemptions, etc.

The *First Tier Tribunal decision Development Securities (No.9) Limited and others -v- HMRC* [2017] UKFTT 0565 (TC) held that a company was treated as resident in the

UK because its “central management and control” was exercised by its UK parent company, and not by its board of directors which met in Jersey.

In the light of this decision, this briefing note recaps and sets out:

- a when companies are treated as non-resident;
- b how board control can be usurped; and
- c the implications of this decision for best practice in setting governance procedures for offshore tax residence to mitigate the risk of HM Revenue & Customs challenge.



## UK Tax Residence

Companies incorporated in the UK (or SEs or SCEs which have or have previously had a UK registered office) are only treated as non-resident for tax purposes if they are treated as non-resident by a double taxation treaty.

This generally means that they must be resident in a territory party to such a double taxation treaty and their place of effective management for the purposes of the treaty is the other treaty state.

Companies incorporated elsewhere are treated as UK-resident if they are centrally managed and controlled in the UK and are not treated as non-resident by a double taxation treaty.

The main principles of this test are set out in “Central Management and Control” below.

There are certain specific provisions applicable to UCITs or AIFs which deem them to be non-resident if certain conditions are satisfied.

## Central Management and Control

The current residence test emerged from the De Beers case, which was decided in accordance with the principle that the court must look to where the central management and control of the company abides. This is a question of fact in each case, but usually the articles of

association of a company will vest control in the board of directors. If the board habitually meets in a particular country to discuss the high-level strategic decisions of the company (as opposed to day-to-day management) and applies its mind to such decisions, the company will normally be treated as residing in that country; however, the test looks at where decisions are actually made, and the location of meetings may not be determinative if the evidence suggests that decisions are taken elsewhere.

If it can be demonstrated that the directors merely “rubber-stamp” the decisions of another individual or body, the court will be willing to find that central management and control is exercised by that other individual or body. Mere influence over the board by another party will not necessarily amount to central management and control, but directing the decision-making of the board or outright usurpation of control of the company most likely will.

Shareholder control, such as control by a parent company, is not sufficient per se to constitute central management and control. However, if the board of directors merely implements decisions already taken by the parent company and does not exercise any strategic autonomy then there is a risk that central management and control will be found to belong to the parent.

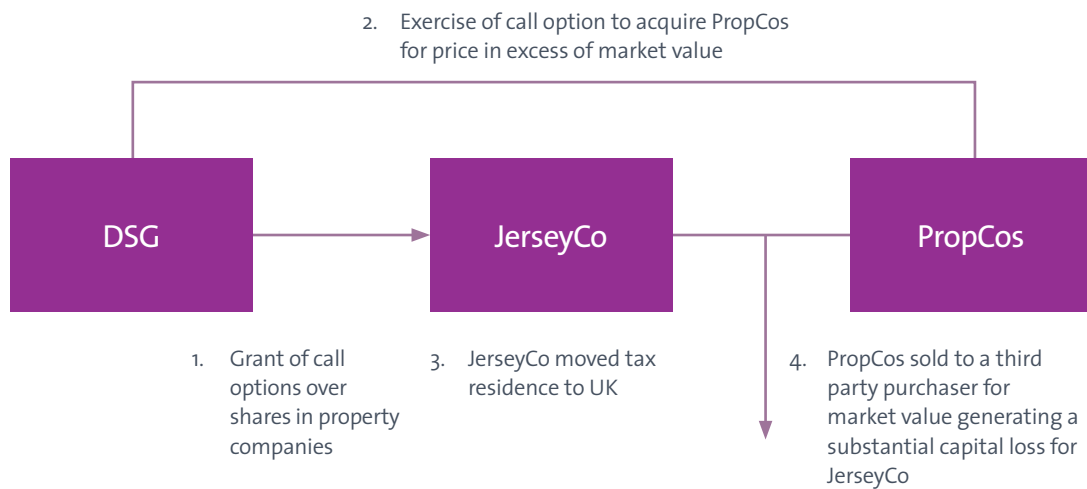
## INSIGHTS

- 📍 The recent decision of the First Tier Tribunal in *Development Securities* has held that a company was tax resident in the UK, where its parent company was located, even though its board of directors met outside the UK.
- 📍 Non-UK incorporated companies are only treated as non-resident for UK tax purposes if their central management and control is exercised from outside the UK or a double tax residence tiebreaker applies.
- 📍 Central management and control is exercised by the person or persons who make the high-level strategic business decisions. This decision-making, in a tax treaty, will involve consideration of the commercial rationale for any decision and not just procedural requirements or the legality of it.
- 📍 Courts will look behind board minutes to determine how decisions were reached. While the evidence of directors is helpful, contemporaneous written records of the discussions will be invaluable. Conversely, any inaccuracies or mistakes in the board minutes may give rise to an inference that the board did not properly consider the transaction.





## The Transaction Steps



The time-frame within which Steps 1-3 took place was a mere six weeks.

### So what happened in Development Securities?

Three companies were incorporated in Jersey ("JerseyCos"), as subsidiaries of Development Securities Plc ("DS Plc"). It was proposed that the UK members of the Development Securities group ("DSG") would grant the three JerseyCos call options, which, if certain conditions were satisfied, would enable the JerseyCos to acquire shares in property owning companies and certain properties. The sole reason for incorporating the JerseyCos was to enable DSG to implement a plan to crystallise latent capital losses.

First, the price payable by the JerseyCos on exercise of the call options was an amount equal to the historic base cost of the asset (rather than its current market value) plus indexation accrued to that time. This meant that the price paid was significantly in excess of the then market value (as the assets were standing at a loss for capital gains purposes). Second, shortly after the acquisition, the JerseyCos would become UK tax resident and when such assets were eventually sold to a third party, the resulting increased capital loss could be set off against DSG's capital gains, reducing the group's tax liability.

The facts of this case were unusual for the following reasons:

- a the JerseyCos were incorporated to implement one transaction, which was inherently uncommercial from the JerseyCos' perspective as they would acquire assets standing at a loss for significantly more than their market value;
- b given that the transaction was so uncommercial, the JerseyCos required, under Jersey corporate law, approval from their UK parent, DS Plc. DS Plc also funded the entire acquisition of the assets by subscribing for shares and making a capital contribution; and
- c from the outset the scheme envisaged that the JerseyCos were set up to be tax resident in Jersey for a period of only six weeks, before being brought back onshore.



### Where were the JerseyCos tax resident?

The court decision contained a detailed assessment of all the factual background to the decision-making by the JerseyCos, which amounted to 82 pages in total. This investigated what role individuals at these companies had in making decisions and investigated the functions of the board of directors examining board minutes, written documentation, contemporaneous meeting notes and the witness evidence of the directors.

Given that (i) the key decisions to enter into and exercise the options were taken at board meetings in Jersey, (ii) the majority of directors were Jersey residents and were professionals with a real estate background and (iii) the directors applied their minds properly to the decisions that required resolution (they reviewed paperwork provided to them prior to board meetings, asked questions and requested counsel's opinion on the legality of entering into the transaction), it might have been suspected that it was the directors who exercised the central management and control of the JerseyCos from Jersey.

The court rejected HMRC's submission that the question to be considered was whether there was a "scheme of management" in the UK and preferred an analysis as to where the central management and control was exercised.

While considering that "the lines of distinction as regards who is controlling a subsidiary for a limited and/or specific purpose may be rather fine ones", the decision draws a distinction between a subsidiary established to perform a finance function for a group which responds to proposals put by the parent in the expectation that they will be approved (because they make commercial sense) and a subsidiary which is asked to perform a single transaction which is wholly uncommercial.

It found that the directors appointed to the board were in reality, in accepting their appointment, agreeing to implement the parent's decisions barring any legal impediment. While the board of directors took every effort to ensure its action was legal there was no evidence that it took the commercial decision to implement the transaction or that it considered its merits. Rather DS Plc had taken this decision and the board of directors was merely verifying that it could be implemented legally. Therefore, the JerseyCos were centrally managed and controlled and resident in the UK and not in Jersey where the board meetings were held.

### How does this compare with previous residence cases?

The facts of this case were similar to *Wood -v- Holden* where the Court of Appeal held that the Dutch company was managed and controlled by the board of directors in the Netherlands even though (i) the directors acted under guidance and influence from its UK parent company and (ii) the Dutch company had a limited remit. It was solely incorporated into the structure to save tax.

However, in *Wood -v- Holden* there were strong commercial reasons for the Dutch company to resolve to enter into the transaction, the Dutch company made a substantial profit on sale of the assets so even though the directors were adopting their UK parent's recommendation, it made commercial sense for the Dutch company in its own right. In contrast, there was no commercial rationale nor corporate benefit to the JerseyCos to approve entering into the transactions.

Two other points to note are: (i) in *Wood -v- Holden* the directors took advice from PwC who made a positive recommendation to sell the assets, whereas in this case the only advice taken by the directors was to the legality of entering into the transaction, rather than whether the transaction should be entered into at all; and (ii) in *Wood -v- Holden* the burden of proof was on HMRC to prove the Dutch company was tax resident in the UK, as it had an established history of non-UK residence, whereas in this case the burden of proof was on the Appellant to establish the newly incorporated JerseyCos was tax resident in Jersey.

### Appointment of Offshore Directors to UK Boards

Although the Tribunal found that it was the parent company, DS Plc, that was exercising central management and control of the JerseyCos, rather than the UK resident director, it would be prudent to ensure that any UK resident director is not conducting any negotiations as regards strategic and management matters by himself without consultation with the offshore directors. That person should also avoid being the only contact with UK advisers of strategic plans. The Court expressly confirmed that in other circumstances a UK-based director could exercise central management and control through actions taken outside of board meetings.

Going forward it should be noted that all correspondence that relates to a disputed transaction can constitute evidence which the courts consider. It is important to consider whether the tone of email exchanges reflects the timing of the decision-making process. For example, individuals should be careful about loose terminology (for example, stating that events "will" occur, rather than "may" occur before they have been considered by the offshore board).







### Lessons to be learnt about offshore residence

- If a non-UK company is entering into a transaction which, absent tax advantages lacks commercial rationale, this will be scrutinised by the courts and they will make every effort to uncover why such decision was taken and by whom it was taken. Directors who sit on multiple boards should keep detailed notes of each meeting, ask relevant questions and seek advice where necessary. They must ensure they have given real consideration to any proposal and are actively engaged in any strategic or management decision.
- Conversely where the non-UK company is taking the strategic decision to implement commercial transactions proposed to it by its UK parent, provided it can be established that these commercial decisions were made outside the UK, by its board, the fact that the transaction was proposed by its UK parent will not of itself cast doubt on its offshore residence.
- Courts will not take board meeting minutes at face value, and will look to uncover the substance of the meeting and the board's discussions, including handwritten notes and emails. Loose terminology will be scrutinised and errors will indicate a lack of attention by directors.
- When appointing directors for a non-UK resident company, it is important to not only check that they have the relevant background and expertise, but that they are fully aware of the role they are undertaking

and have sufficient expertise to be involved in taking commercial decisions for the company.

- The offshore company should have access to all relevant information that is required to allow them to make informed strategic decisions, for example, legal and tax structure papers, step plans and projected cash flows.
- The entire relevant period of the business will be scrutinised, not only what happens at board meetings.

### What next?

It remains to be seen whether this decision will be subject to appeal but in the meantime this decision should serve as a useful reminder that following tax residence procedures and guidelines is extremely important. Ultimately these decisions are highly fact-dependent and careful attention to this issue will be the best course of action to minimise the risk of residence challenge.



**Nicholas Gardner**

Partner

T +44 (0)20 7859 2321  
nicholas.gardner@ashurst.com



**Preena Gandhi**

Associate

T +44 (0)20 7859 2252  
preena.gandhi@ashurst.com





SPAIN

# The latest relevant Spanish case law on transfer pricing

by Eduardo Gracia and Lorena Viñas

**T**his article aims to highlight the most relevant rulings issued recently by the Spanish courts in relation to a matter as broad and complex as transfer pricing.

We will begin by noting that the Spanish Supreme Court (*Tribunal Supremo*) has recently issued several judgments that all follow similar reasoning regarding the interpretative value of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration (hereinafter the “OECD Transfer Pricing Guidelines”).

In all these judgments the Spanish Supreme Court has concluded that the aforementioned Guidelines are merely recommendations that bind the Tax Administration, but not the courts. This statement implies minimising the interpretive value of the OECD Transfer Pricing Guidelines, which is of serious concern to the Spanish Tax Administration.

The first judgment dated 19 October 2016, was issued in the **Zeraim** case (hereinafter the “Zeraim Judgment”), in which the appellant company denounces the infringement of the OECD Transfer Pricing Guidelines, to the extent that secret comparables have been used in determining the market value of certain related transactions consisting of acquisitions of raw materials by the recurring company to its Dutch parent company.

Regarding secret comparables, we should remember that the OECD Transfer Pricing Guidelines state that information undisclosed to taxpayers may not be used by the Tax Authorities in order to calculate the arm’s length price for their related transactions. Thus, paragraph 3.36 of the OECD Transfer Pricing Guidelines, (which is included in Chapter III, titled “Comparative Analysis”) states that: “Tax administrators may have information

## INSIGHTS

- 📍 According to recent jurisprudence of the Spanish Supreme Court, the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration are merely recommendations and have no binding value for the Spanish courts, not even when a tax treaty provision is interpreted by the courts.
- 📍 The practical effects deriving from the above-mentioned jurisprudence of the Spanish Supreme Court result in a minimisation of the interpretative value of the aforementioned Guidelines.
- 📍 The Spanish National High Court has refused to carry out a “dynamic interpretation” of Article 7(2) of the tax treaty for the avoidance of double taxation between Spain and the Netherlands (dating from 1971), when it comes to the attribution of profits to permanent establishments.

available to them from examinations of other taxpayers or from other sources of information that may not be disclosed to the taxpayer. However, it would be unfair to apply a transfer pricing method on the basis of such data unless the Tax Administration was able, within the limits of its domestic confidentiality requirements, to disclose such data to the taxpayer so that there would be an adequate opportunity for the taxpayer to defend its own position and to safeguard effective judicial control by the courts.”

In the Zeraim Judgment it is expressly stated that the offence invoked before the Spanish Supreme Court must fall on the rules of the legal system, that is, on the formal sources that comprise it and which are enunciated in Article 1.1 of the Spanish Civil Code, according to which “the sources of the Spanish legal system are the law, custom and general principles of law”. The Spanish Supreme Court points out that within the substantive concept of “law” expressed in the aforementioned provision, it is possible to include the various, hierarchically ordered, manifestations of the regulatory power (Constitution, International Treaties, Organic Law, Ordinary Law, Regulations, etc.), but it is not possible to substantiate a plea in breach of the above-mentioned OECD Transfer Pricing Guidelines, given the lack of its legal nature. The Court also points out that in previous judgments (e.g. a judgment dated 18 July 2012, issued by the Spanish Supreme Court in the BICC case), it had already concluded that such Guidelines are considered to be merely recommendations to States, which are given an interpretative value.

In another judgment dated 21 February 2017, issued in the **Citresa** case (hereinafter the “Citresa Judgment”), related to Corporate Income Tax assessments for the financial years 2003, 2004, 2005 and 2006 (January and February), the Spanish Supreme Court ruled in favour



of the appellant company on the grounds that in 2003, 2004, 2005 and 2006 (January and February) what is known as “Transactional Net Margin Method” could not be applied as a method of valuation of the market value of certain related transactions because this method was not provided for in the Spanish legislation applicable at that time, since it did not reach legal validity in Spain until “Law 36/2006, of 29 November, on measures for the prevention of fiscal fraud” entered into force on 1 December 2006.

Prior to 1 December 2006, the Spanish Corporate Income Tax Act (hereinafter the “CIT Act”) established three valuation methods of related transactions (the “Comparable Uncontrolled Price Method”, the “Cost Plus Method” and the “Resale Price Method”) and if none were applicable it established the application of the “Transactional Profit Split Method”. Thus, the “Transactional Net Margin Method” was not included at that time on the list of possible methods available to the Tax Authorities when establishing the market value of related transactions. However, the Spanish Tax Authorities applied the “Transactional Net Margin Method” based on the provisions of Article 3 of the CIT Act, which states that “what is established in the CIT Act shall be understood without prejudice to the provisions of international



treaties and conventions that have become part of the internal system in accordance with Article 96 of the Spanish Constitution”. According to the Spanish Tax Authorities, when a tax treaty for the avoidance of double taxation (hereinafter, the “Tax Treaty”) is applicable, the OECD Transfer Pricing Guidelines are directly applicable because the Commentaries on the articles of the OECD Model Convention refer to them.

In the case in dispute, as the Tax Treaty between Spain and the Netherlands was applicable, the Spanish Tax Authorities considered that the OECD Transfer Pricing Guidelines could be directly applicable. Consequently, as the “Transactional Net Margin Method” was envisaged in the above-mentioned Guidelines, the Spanish Tax Authorities understood that this method could be used as a valid valuation method.

In the Citresa Judgment the Spanish Supreme Court clarifies that Article 3 of the CIT Act refers to those legal provisions that have been integrated in the internal Spanish system (international treaties and conventions), without the OECD Transfer Pricing Guidelines having legal nature. Therefore, the Supreme Court concludes that the “Transactional Net Margin Method” could not be applied in the financial years 2003, 2004, 2005 and 2006 (January and February).







Following the same rationale, the Spanish Supreme Court issued a judgment dated 2 March 2017, in the **McDonald's case**, in which it reiterates that it is not possible to substantiate a plea in breach of the OECD Transfer Pricing Guidelines before the Spanish Supreme Court, given the lack of its legal nature.

In addition to the above-mentioned rulings of the Spanish Supreme Court, it is also worth mentioning the judgment of the Spanish National High Court (*Audiencia Nacional*) dated 10 July 2015, issued in the **ING case**, concerning the Non-resident Corporate Income Tax assessments for the financial years 2002 and 2003 of a Spanish branch of a foreign bank. In this judgment the Spanish National High Court expresses its view on the application of the “dynamic interpretation” or “static interpretation” of Article 7(2) of the Tax Treaty between Spain and the Netherlands, which deals with the issue of the attribution of profits to permanent establishments.

The litigation which is the subject of the aforementioned judgment arises from the recharacterisation carried out by the Tax Inspectorate of a part of the interest-bearing debt of the bank branch as “free” capital, with the consequent reduction of the tax-deductible expenses for debt interest. All this, on the basis of a “dynamic interpretation” of Article 7 of the applicable Tax Treaty, since the Tax Inspectorate applied the relevant Commentaries on the OECD Model Convention approved in 2008 to tax situations which took place in 2002 and 2003. It is worth remembering that, for many scholars, the Commentaries on Article 7 approved in 2008 substantially modify the interpretation of Article 7 of the applicable Tax Treaty.

The Spanish National High Court, relying on the arguments of the appellant branch, refuses to carry out

a “dynamic interpretation” of Article 7 of the applicable Tax Treaty (dating from 1971) because, in relation to “free” capital, it considers that very significant amendments have been introduced into the Commentaries on Article 7 of the OECD Model Convention of 2008 and into the OECD Report of 2006 on “Attribution of profits to permanent establishments”. In this sense, the Spanish National High Court recalls that subsequent Commentaries will only affect previous Tax Treaties when the text of the article of the Tax Treaty that purports to be interpreted with the new Commentaries has not varied so that under the new Commentaries it has a meaning substantially different from the one it had in previous versions of the OECD Model Convention.

Finally, we would like to mention that it should not be inferred from the previous court ruling that, in general, Spanish courts always choose to apply a “static interpretation” of the provisions of Tax Treaties, although the fact is that to date they have only accepted the application of “dynamic interpretations” in cases of Tax Treaty provisions not related to Transfer Pricing matters.



**Eduardo Gracia**

Partner, Head of Tax EMEA and US

T +34 91 364 9854

eduardo.gracia@ashurst.com



**Lorena Viñas**

Expertise Lawyer

T +34 91 364 9417

lorena.vinas@ashurst.com





UK

# Tax and Blockchain

by Paul Miller and James Seddon

**T**his article discusses three aspects of the interaction between the emergent technology of blockchain and the international tax system. We will explain some concepts in context in this article but it is not otherwise a technical discussion of the operation of a blockchain. Readers looking for a technical discussion of the technology underlying blockchain itself (or distributed ledger technology as it is sometimes also known) may find our introductory guide, *Blockchain 101*<sup>1</sup>, helpful.

## Taxation of Blockchain transactions

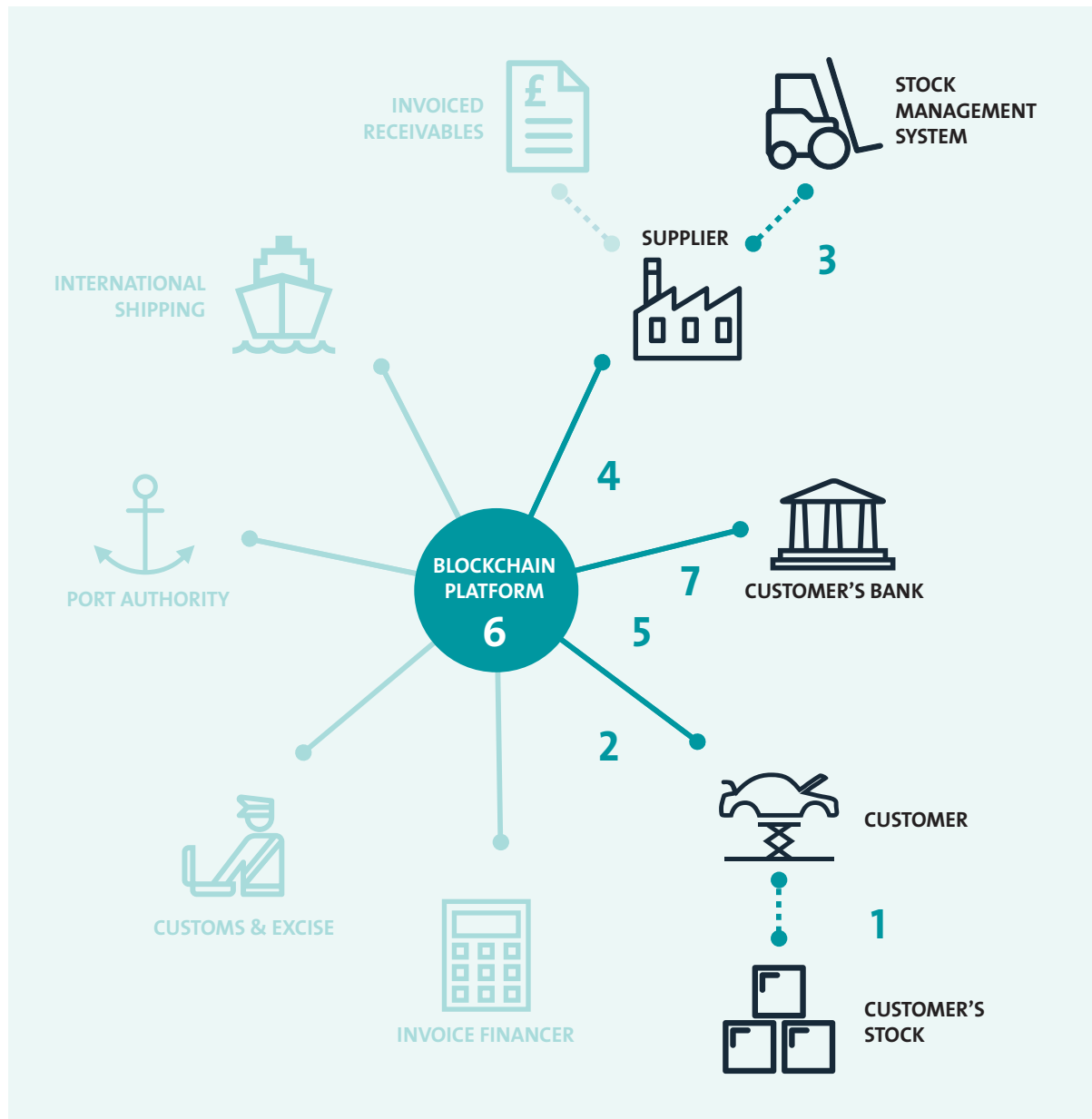
At the outset it is worth noting that bespoke tax regimes for blockchain transactions do not currently exist. Analysing their tax implications is therefore an exercise in applying existing principles to new technology, occasionally in the light of new tax authority guidance. Let us use the simple stock purchase transaction overleaf by way of example.

## INSIGHTS

- 📍 There is little or no express new legislation legislating for the taxation of transactions that occur “on chain”. Instead existing tax rules can usually be applied to “on chain” transactions in much the same way as they apply to ‘off chain’ transactions.
- 📍 The use of “on chain” smart contracts changes who does what and where. That may increase the pressure that the ‘digital economy’ already exerts on national and international tax systems.
- 📍 Blockchain technology has the potential to revolutionise tax compliance and collection.

<sup>1</sup> <https://www.ashurst.com/en/news-and-insights/insights/blockchain-101/>

## Stock ordering and purchase



The first part of the example blockchain transaction is as follows.

1. Customer's inventory management system detects Customer is running out of parts stock;
2. Once stock falls below defined threshold, a purchase order is automatically created and sent to Customer's preferred parts Supplier;
3. Supplier captures purchase order and scans its stock management system, confirming it holds requested parts;
4. Supplier issues draft invoice to the Customer;
5. Customer receives invoice, authenticates Supplier as sender and digitally signs the invoice with a cryptographic signature;
6. Smart contract formed between Customer and Supplier with obligation for Customer to pay invoiced sums on 30 days after receipt of parts; and
7. Smart contract terms include irrevocable instruction to Customer's bank to release payment on due date, provided certain conditions met (i.e. parts received, good condition, correct spec etc.).



As noted above, one expects the tax consequences to flow from the actual transaction undertaken; so here a purchase and sale of stock. Where both supplier and customer are in the same country, the use of smart contracts adds little to the tax analysis. We set out the basic consequences below. In a cross-border context, one could imagine that the use of smart contracts could impact the practicalities of what is done where. That could alter the taxing rights of different jurisdictions and that is considered later in this article.

#### **VAT**

The VAT consequences are as for any other stock purchase. So the supplier of the stock will need to issue a VAT invoice. If the transaction is purely domestic within one EU state, the supplier will charge VAT at the domestic rate and account for it to its home state authorities. If the transaction is cross-border and the customer is an EU resident then the customer will reverse charge the

VAT in accordance with its home state rules. So far so straightforward.

#### **Corporate income tax**

- a If the transaction is cross-border, the supplier will need to think about whether to include the net sale proceeds in its corporate income tax computation in the customer state. That is a key point that we will return to in the discussion below. Either way, the supplier will need to consider whether it should include the net sale proceeds in its home jurisdiction corporate income tax computation (and there is a system of rules that mean the supplier should not bear tax in both states on those profits).
- b The customer will treat the price paid as cost of stock for accounting and tax purposes.

Now by way of further example, suppose we overlay invoice factoring as per the diagram on the next page.

## Invoice factoring



The second part of the example transaction is an invoice factoring transaction.

8. Supplier's system programmed to factor receivables due under invoice if Supplier's working capital is below set threshold and discount rates offered are acceptable commercially;
9. Supplier's system calls out to preferred Invoice Financer to obtain latest discount rates;
10. Customer's invoice is represented as a digital asset on the blockchain;
11. Invoice Financer checks Customer's bank to assess credit risk of Customer paying invoice;
12. Invoice Financer and Supplier enter into a smart contract in respect of the invoice (Invoice Financer pays 85% of receivables to Supplier and ownership of invoice is transferred to Invoice Financer on the blockchain);
13. Various stakeholders in export/import process input on status of sale onto blockchain, enabling Supplier, Customer and Invoice Financer to monitor progress in near real-time;
14. Disputes/delays managed between parties and blockchain updated on resolution;
15. Customer's smart contract with Supplier automatically pays invoice when due, payment recorded on blockchain and Invoice Financer notified; and
16. Invoice Financer releases remainder of receivables balance due to Supplier, less fee.





The stock supplier and invoice financier will need to consider how to account for this both as a matter of VAT and corporate income tax. Again, fundamentally the mere use of blockchain to facilitate invoice factoring does not generally change the analysis.

#### **VAT**

Depending on the precise arrangements, the invoice financier will probably make partly standard-rated and partly exempt supplies to the supplier.

#### **Corporate income tax**

- a The stock supplier will ultimately show the net sale proceeds net of invoice discount as its net profit for corporate income tax purposes. (And as set out above, the question of which state's tax returns that should be recognised in may be difficult.)

- b The invoice financier will ultimately include the net profit on the factoring transaction in its P&L.

So far we have just applied existing principles; nothing is new. However, there are areas where there may be differences, whether on this blockchain transaction or generally for e-commerce transactions.

#### **Cross-border business and the changing tax landscape**

As with other forms of e-commerce, blockchain potentially offers new ways of doing business. Those new business models in turn alter the requirements for people and assets in particular jurisdictions. That change in the activities actually undertaken in each jurisdiction can radically alter the tax take of particular jurisdictions as compared to more traditional business models.



To understand how this has become an issue, it is useful to appreciate that, with some notable exceptions (such as the US), and as a very broad generalisation, most countries (“source states”) have similar nexus tests to decide whether foreign companies should be subject to tax on those profits that in some sense derive from the source state. That nexus test requirement involves a concept known as a “permanent establishment”. At a first level of approximation a permanent establishment might be thought of as a place where a foreign company has “its own people on the ground” in the source state. Turning then to the nexus test, a source state will generally tax those profits of foreign companies that arise in the source state if and only if there is a “permanent establishment” in the source state to which the profits are attributable.

In source states where those are the rules, there are then two commonly seen approaches to minimising corporate income tax in the source state arising from business customers in that source state:

1. avoiding creating a permanent establishment in that source state in the first place; or
2. if there is such a permanent establishment, limiting the profits that are attributable to that permanent establishment; usually by demonstrating that the real profit generating activities do not occur in that source state. Rather it will only be low risk (and thus low profit margin) activities that occur in the source state.

The definition of a permanent establishment is still (in the main) driven by physical attributes like buildings and employees. Generally renting a local computer server, without more, is not a permanent establishment.

Given that background, one can imagine that, if smart contracts reduce the need for the presence of individuals in a particular country, that that could impact the jurisdictions in which a company has to pay corporate income tax.

In a UK context you may be aware of the controversy about the level of corporation tax paid in the UK by non-UK headed multinational groups. This ultimately drove a number of changes to certain aspects of UK tax – in particular the introduction of the UK diverted profits tax (publicly and somewhat unfairly labelled the “Google tax” by many).

Whatever the economic arguments, from a public policy perspective, we are increasingly seeing states taking the position that companies that derive revenue from within their respective markets have a filing obligation or 'nexus' despite a lack of physical presence in the state or arguments that the value in the transaction with the customer in that state properly sits in another jurisdiction.

The last few months have seen a number of differing proposals to address the (non) taxation of digital businesses, in part driven by the Estonian Presidency of the Council of the European Union. The 'Issues Note'<sup>2</sup> issued by the Estonian Presidency, discussing the corporation tax challenges of the digital economy gave an indication of the divergence in preferred approaches. By the time you read this that will have been overtaken by the December 2017 ECOFIN meeting which is also due to seek a consensus on a way forward.

Absent some level of EU or international agreement, the danger is that there will be a plethora of local measures. For example, in September the finance ministers of France, Germany, Italy and Spain presented a proposal for a turnover based "equalisation tax" for tech companies of between 2 and 5 per cent of turnover at the ECOFIN meeting in Tallinn. The result of the December 2017 ECOFIN meeting is therefore awaited with interest. Though given the divergence of interests between EU states with different types of economy, we suspect that any EU-wide proposals will ultimately be incremental rather than transformational. By way of further example the UK government also announced in November a further consultation on the taxation of digital businesses.

Changes on the VAT side are more straightforward since VAT is an EU-wide tax; though still one that requires unanimity to develop. ECOFIN have announced<sup>3</sup> that they are looking to revamp the application of VAT rules to e-commerce and online transactions.

### Taxation of virtual currency

What if one pays for goods or services in bitcoin or other cryptocurrencies?

#### UK

In the UK, bitcoin and other similar cryptocurrencies are treated as foreign currency. That is a practical view and was taken by HMRC in Business Brief 9 in 2014. The UK says that a cryptocurrency is just like cash (albeit foreign cash). There may be some valuation issues (particularly for more volatile cryptocurrencies) but, ultimately, the rules are clear since the tax system has developed over time to deal with foreign exchange issues.

It is important to note at this point that the HMRC guidance refers to other cryptocurrencies that are "similar" to Bitcoin. Those that follow the financial

news will have noticed there has been increased media coverage of what have been termed "initial coin offerings" (ICOs) over the course of this year. ICOs come in a variety of forms and one should not assume that simply because something is described as a coin it is equivalent to currency – as the interest of the SEC in the US and FCA in the UK indicates, in many cases what investors acquire in these offerings may in fact be some form of security or other chose in action which would not be treated as foreign exchange for the purposes of UK taxation.

#### The EU

In 2015, in *Skatteverket -v- David Hedqvist* (C-264/14), the CJEU followed the approach of HMRC in relation to VAT at least. Mr Hedqvist intended to carry out the purchase and sale of Bitcoin in exchange for traditional currencies, such as the Swedish crown. He intended to make a spread. The CJEU held this was akin to any other currency exchange service and thus exempt from VAT. The judgment should mean that from a VAT perspective the tax treatment of Bitcoin transactions is the same throughout the EU.

### Treatment otherwise than as a currency

In cases where the relevant cryptocurrency is treated as some other form of property (as is we understand the case in the US) that can quickly give rise to awkward compliance points.



2 [https://www.eu2017.ee/sites/default/files/2017-09/Ecofin%20Informal\\_WS%20II\\_digital%20economy\\_15-16.Sept.\\_17.pdf](https://www.eu2017.ee/sites/default/files/2017-09/Ecofin%20Informal_WS%20II_digital%20economy_15-16.Sept._17.pdf)

3 <http://www.consilium.europa.eu/media/31474/st13932em17v2.pdf>





## Tax administration

First on the practical side, if taxpayers automate transactions using smart contracts, it should be relatively straightforward to feed the outputs into their internal accounting systems and their VAT and other tax compliance software packages. So for those that want to be compliant, that may simplify things. But that is not really the prize here. Let's look further afield. First, compare and contrast:

### Estonia

The Estonian government has been experimenting with blockchain for a number of years using a form of distributed ledger technology known as Keyless Signature Infrastructure (KSI), developed by an Estonian company, Guardtime. That system allows taxpayers to access their account, change details and pay online. According to the former President of Estonia, Toomas Hendrik Ilves, writing for the World Bank in 2016, nearly 95 per cent of Estonians now declare their income to the tax authority online (Mr Ilves claims that it "takes less than five minutes and no accountants", although this may be as much a function of the efficiency of Estonian tax law as the technology for filing returns), reducing the cost of collecting tax and saving citizens time – reportedly 5.4 workdays a year.

### The UK

The UK is (slowly) moving towards a paperless digital tax system under the banner of "making tax digital". The process of "making tax digital" is ongoing and has had numerous teething issues. For example the implementation for businesses has been put on hold until April 2019 for VAT (although this is a rather low-hanging







fruit as 98 per cent of businesses already file electronic returns) and April 2020 at the earliest for taxes other than VAT. It is also a traditional system where all information is provided to HMRC who keep an internal record rather than a distributed ledger.

### So what is the UK attitude to blockchain?

The UK government Chief Scientific Adviser (GCSA) in the 2016 report “Distributed ledger technology: beyond block chain” wrote that “distributed ledger technologies have the potential to help governments to collect taxes, deliver benefits, issue passports, record land registries, assure the supply chain of goods and generally ensure the integrity of government records and services”.

Steve Walters, HMRC’s CTO in March 2017 said the UK is taking blockchain seriously as a technology for tax administration but described HMRC as adopting a “a slow-and-go approach”. He cited regulatory oversight, security concerns and reputational risk as factors causing HMRC to proceed with caution.

So what should one do? There are some lower-hanging fruit that people are talking about. For example, many people are focused on preventing one particular type of VAT fraud, known as MTIC or carousel fraud. The 2016 GCSA report proposed a pan-EU blockchain-based VAT system to facilitate the use of artificial intelligence (machine-learning) to identify VAT fraud in real time. The report viewed this as already technologically possible but also acknowledged that government agencies “need to be able to handle distributed ledger technology for tax” – it may be harder to tell when that requirement is met.

According to a World Economic Forum survey of technology company executives, most respondents expected that tax would be collected for the first time by a government using blockchain technology before 2025.

In theory tax collection generally could be revolutionised. For example, a blockchain-based transaction using “smart contracts” (a computer protocol to facilitate self-executing contracts) could be used to automatically pay transaction-based taxes such as VAT to HMRC on a real-time basis.

Ultimately, the use of blockchain technology for the collection of tax may reduce or remove the need for tax advisers to help produce tax returns. Rather their input would be much more important in ensuring that the rules had been encoded correctly within the relevant software.

### Conclusion

Our current expectation is that blockchain is more likely to facilitate revolution in administration than fundamentally change the taxation of transactions.



**Paul Miller**

Partner

T +44 (0)20 7859 1786  
paul.miller@ashurst.com



**James Seddon**

Senior Associate

T +44 (0)20 7859 2556  
james.seddon@ashurst.com



## AUSTRALIA

# Residential housing – increased taxes for foreigners

by Barbara Phair and Struan Davidson

In a booming residential property market, with strong foreign investment, Australian State governments have followed the lead of other countries to introduce additional real estate transaction taxes in the form of foreign purchasers duty and land tax surcharges. While aimed at assisting housing affordability and capturing greater contribution by foreigners to local infrastructure, the measures also have the potential to impact local development projects and investment where there is an element of foreign ownership.

### A curb on rising prices?

Following the lead of other jurisdictions, such as Singapore, Hong Kong and British Columbia, five of the eight States and Territories of Australia have introduced, or announced

the introduction, of additional transfer taxes aimed at foreign purchasers of residential land.

The rationale for these measures has variously been described as ensuring that foreign investors contribute appropriately to local infrastructure, or to ease the pressure on housing supplies for Australian residents, in particular first home buyers.

Measures announced in the recent New South Wales Budget, for example, are forecast to raise up to AUD\$2 billion in additional tax revenue in the next four years, and will be directed to assisting first home buyers by way of stamp duty concessions.

At the same time, the Federal Government has announced generous concessions to encourage investment in affordable housing projects (“build to rent”)



through managed investment trusts and these trusts will be subject to the State surcharges where they are regarded as “foreign”.

The jury is still out as to the likely combined impact of these measures on housing affordability. However, the fact that the foreign surcharges extend to purchases by foreign controlled developers, as well as investments by foreign controlled funds and corporations, means that the measures may have a broader impact on the Australian residential development market than expected.

#### **Key elements of the surcharges on land purchases**

Each of the eight Australian States and Territories impose a real estate transfer duty payable on the purchase of land. The rate and scope of the duty varies between States, but is generally about 5.5% of the GST inclusive purchase price.

Whether known as “Surcharge Purchaser Duty” in New South Wales, “Additional Foreign Acquirer Duty” in Queensland, “Foreign Purchaser Additional Duty” in Victoria, “Foreign Purchaser Duty Surcharge” in South Australia (as proposed) or “Foreign Owner Duty Surcharge” in Western Australia (as announced), the surcharge imposes additional duty on the transfer of residential property to “foreign persons” on top of the existing

#### **INSIGHTS**

- 📍 Various Australian State governments have introduced, or are proposing to introduce, a range of new taxes on foreign investment in Australian property, both in the form of the transfer duty surcharge and the land tax surcharge.
- 📍 While the rate and scope of the transfer duty surcharge varies between States, it is the transfer of residential property to a non-resident that will generally attract the surcharge. Similarly, residential land held by a non-resident (or in some cases, held by an absentee owner or left vacant) may attract a land tax or similar surcharge.
- 📍 Exemptions may be available. However, these are largely discretionary and a myriad of guidelines and restrictions may apply.





duty. The duty is not limited to the transfer of fee simple interests in land but extends also to other transactions affecting interests in land, such as the transfer of a lease at a premium if the transferee is a foreign person.

A foreign person includes a foreign individual, a foreign corporation or the trustee of a foreign trust. In New South Wales, a foreign person also includes a foreign government. The tests are complex, and vary between States, but a corporation or a trust can be treated as “foreign” under the New South Wales rules, for example, if a “substantial interest” of at least 20% is held by a foreign person (or an aggregate substantial interest of 40% if there are two or more foreign persons) i.e. equivalent to the Foreign Investment Review Board requirements. In Queensland and South Australia the entity must be 50% or more foreign controlled (shares and voting rights). Curiously, the Victorian provisions require a single foreign person to have a 50% (capital) interest and the interests of unrelated foreigners are not aggregated. Due to tracing and deeming provisions the potential scope for an investor to be “foreign” is far reaching, and not always obvious.

Combined with this, the concept of residential property varies between States and can be broad. For example, the provisions in New South Wales apply to any land, not including primary production land, on which there are one or more dwellings and also includes vacant land zoned residential. “Residential property” in Victoria is defined as land capable of being used solely or primarily for residential purposes and that may lawfully be used in that way. The rules and their interpretation vary such that serviced apartments, retirement villages and student accommodation can be in or out of the provisions depending on the State, and the precise attributes of the facility.





To add to the complexity, some of the rules have a forward-looking test. For example, in Victoria where a foreign purchaser acquires property that is not residential property, and that foreign purchaser forms the intention to use the land for residential purposes after the property is acquired, the foreign purchaser is required to notify the revenue authority and pay the foreign purchaser duty surcharge. In Queensland and South Australia, the foreign purchaser duty surcharge attaches if the purchaser is a corporation or a trust which becomes foreign controlled within three years after the time the liability for transfer duty arose.

### **Developer exemptions**

The provisions in New South Wales, Victoria and Queensland do recognise, to varying degrees, that the surcharge should not operate to discourage foreign developers, or to create an uneven playing field with local developers. Each has introduced some measures to take certain activities outside the surcharge. However, these measures are largely discretionary, and apply a myriad of guidelines and restrictions which can be cumbersome. In each case, applications must be made for exemptions to apply and this can delay transactions.

For example, the Queensland provisions give the Commissioner of State Revenue a discretionary power to grant *ex gratia* relief if the foreign purchaser is, amongst other things, a “significant developer”. In Victoria, the Treasurer may grant an exemption for a company incorporated in Australia if its activities in the development or re-development of property adds to the supply of housing in Victoria. However, a foreign company is not eligible for exemption.

Previously, there was no similar exemption in New South Wales for developers. However, the recent New South Wales State Budget announced the introduction of a refund system for companies incorporated in Australia, who are not otherwise exempted developers, that construct new homes on residential land where the developer is incorporated in Australia. These measures have received assent and will commence on a day to be appointed by proclamation. Again, incorporation in Australia is essential for these rules to operate, presumably to allow greater surveillance of the entity's

activities. The need to pay the surcharge and seek a refund (possibly several years later) adds complexity to the system.

Under the New South Wales developer exemption, a refund of the foreign purchaser duty surcharge paid will be available where the revenue authority is satisfied that:

- a the Australian developer or a related body corporate constructed a new home on the residential land to which the residential-related property relates after completion of the transfer of the property to the Australian developer;

### Summary of current measures

State or Territory	Foreign purchaser duty surcharge	Foreign owner land tax surcharge	Vacant residential property tax	Key Features
New South Wales	8%	2%	N/A	The normal off-the-plan stamp duty concession is not available to foreign purchasers
Victoria	7%	1.5% (up from 0.5% for the 2016 land tax year)	1% of the capital improved value (from 1 January 2018, applies to certain areas of Melbourne only)	Requirement to notify change in intention of use
Queensland	3%	1.5% (does not apply to corporations or trusts)	N/A	Three year reassessment if purchaser becomes "foreign"
South Australia	4% (from 1 January 2018. However, the South Australian government has proposed introducing a new Bill to raise this to 7%)	Nil	N/A	In addition to three year reassessment if purchaser becomes foreign, there is a refund mechanism if the purchaser ceases to be foreign within one year
Western Australia	4% (as announced but not yet implemented)	N/A	N/A	The surcharge applies to residential property but excludes residential developments of ten or more properties, commercial residential property and retirement villages, and mixed use properties that are used primarily for commercial purposes
Northern Territory, Australian Capital Territory and Tasmania	N/A	N/A	N/A	
Commonwealth (applies to land held in any State or Territory)	N/A	N/A	An amount equal to the FIRB application fee imposed at the time of acquisition of the property	Represents an annual cost. For example, currently approx. AUD\$100,000 p.a. for residential property where the purchase price was more than AUD\$9 million and less than AUD\$10 million



- b the Australian developer has sold the new home to a person other than an associated person; and
- c the home was not occupied or used as a place of residence or for any other purpose at any time between completion of construction of the home and completion of its sale.

An application for refund must be made within 12 months after completion of the sale of the new home and no later than 5 years after completion of the transfer of the residential-related property to the Australian developer.

### Ongoing land tax surcharges

In addition to stamp duty on purchases, all Australian States and Territories, other than the Northern Territory, impose a land tax on an annual basis on the unimproved value of land. The rate of annual land tax varies but is typically between 1.5% and 2.25% of the unimproved land value. Land tax applies in the same manner to all types of land (e.g. commercial, industrial and residential), subject to exemptions for principal place of residence and primary production land.

The measures aimed at foreign purchasers extend to foreign ownership in the form of a land tax surcharge which applies on top of the normal land tax where a foreign person owns residential land in New South Wales or any land in Victoria. The surcharge payable in New South Wales and Victoria on top of the general land tax rate for the 2017 land tax year is 0.75% and 1.5% respectively. For the 2018 land tax year the foreign owner land tax surcharge is increased to 2% in New South Wales.

Exemptions from the foreign owner land tax surcharge may be available.

### Vacant residential property tax

Finally, in a move to discourage residential land being left unrented, from 1 January 2018, Victoria will impose a Vacant Residential Property Tax of 1% of the capital improved value of property in certain areas of Melbourne which is left unoccupied for six months or more in a calendar year. Based on the Minister's Second Reading Speech, this aims to "incentivis[e] Melbourne's current housing stock to be put to its most efficient use". There is no concession for land held vacant pending redevelopment.

The Federal government also proposes to introduce a charge on foreign owners of residential property where the property is not occupied or genuinely available on the rental market for at least six months a year. The charge will be levied annually and will be equivalent to the foreign investment application fee imposed at the time of acquisition of the property.

### Harmonisation

Probably the most striking feature of the new rules, is the lack of consistency between States and, due to the State/Federal system, the overlay of Commonwealth initiatives. These don't always work coherently together and may lead to distortions in the market. It is hoped that if these measures are to become an enduring feature of local taxes, that they will be harmonised and simplified to reduce compliance cost.



**Barbara Phair**

Partner

T +61 2 92586584  
barabara.phair@ashurst.com



**Struan Davidson**

Lawyer

T + 61 2 9258 6098  
struan.davidson@ashurst.com





FRANCE

# Make the French tax system great again!

by Emmanuelle Pontnau-Faure and Solène Guyon

**T**he French government aims to implement Emmanuel Macron's campaign promises to revitalise businesses in France as set out in the draft finance bill for 2018 and presented to the legislative bodies on 27 September 2017.

The announced measures follow the Government's will to encourage consumption and attract inward investments in France while respecting European constraints in terms of budget deficit that should not exceed 3% of the gross domestic product. Some of the measures may be amended or adjusted. The final vote of the 2018 finance bill will occur before the end of the year.

- Several measures are planned to encourage purchasing power, such as reform of the council tax (*taxe d'habitation*) on principal abode and the abolition of payroll contributions from employees to finance unemployment and illness insurances. But

this will be partially compensated by an increase in social contributions by 1.7 per cent payable on all types of revenues levied on the French taxpayer. The purpose of these changes is to offer an effective decrease of the tax burden to most people. However, 20 per cent of the taxpayers will not benefit from the exemption of council tax and retired people will suffer the increase of the social contribution element on their pensions without any compensation.

The 30% flat tax<sup>1</sup> on capital revenues such as dividends, capital gains or interests aims to reduce and simplify the tax rules applicable to individuals. Some exceptions will survive when the existing progressive taxation and applicable allowance is more favourable than the flat tax.

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<sup>1</sup> It includes all social contributions



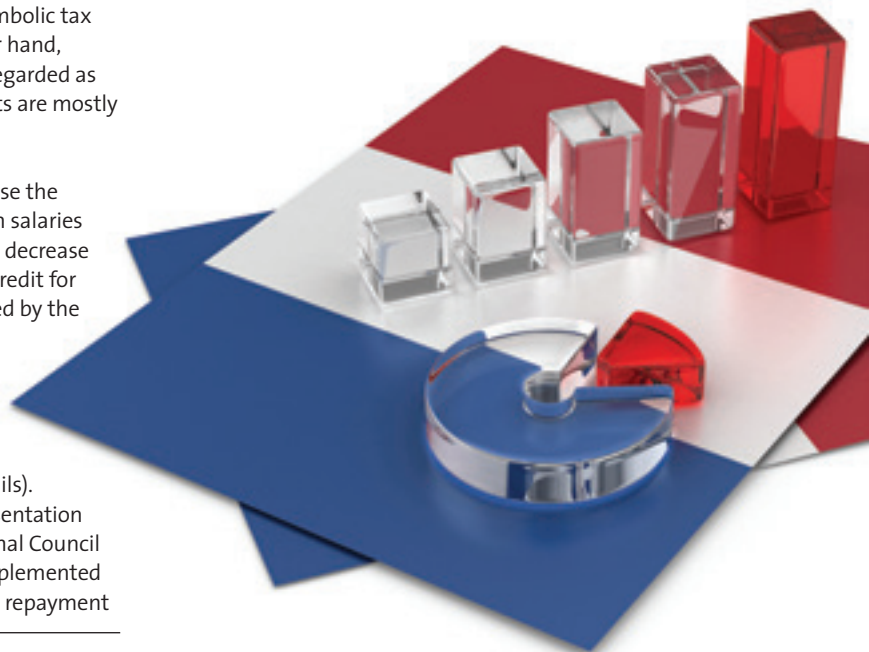
## INSIGHTS

- 📍 The draft finance bill for 2018 follows the Government's will to encourage purchasing power and attract inward investments in France notably by reducing and simplifying tax rules applicable to individuals and revitalising French companies.
- 📍 In order to align France with its European neighbours, companies will benefit from a progressive reduction in the French corporate income tax rate from 33.33% to 25% by 2022. However, the benefit of such incentive will be impaired by the implementation of an exceptional surtax (applying to large French businesses) in order to finance the retroactive cancellation of the 3% tax on dividends which was declared contrary to the EU and French constitutional laws.
- 📍 The scope of the French wealth tax will be restricted to real estate assets and property rights. This reform, which is viewed as a big step to make France attractive again, remains controversial.
- 📍 The final vote will occur before the end of the year, after possible adjustments.

The most controversial measure for individuals is the limitation of the scope of the current French wealth tax to real estate assets. Although France is one of the last jurisdictions with a wealth tax, it remains a symbolic tax and the reform is badly perceived. On the other hand, keeping a tax focused on real estate assets is regarded as unfair by the wealthy middle class whose assets are mostly invested in bricks and mortars (see below for more details).

Measures will also be introduced to revitalise the French companies through a decrease of tax on salaries payable by companies not subject to VAT and a decrease of employers contributions (replacing the tax credit for competitiveness and employment implemented by the previous government).

More generally, companies should have been the real winners of the reform with a drastic reduction of the corporate income tax over the next five years to align France with its European neighbours (see below for more details). But by a whim of fate, a few days after the presentation of the draft finance bill, the French Constitutional Council declared illegal the 3% tax on distributions<sup>2</sup> implemented 5 years ago by François Hollande to finance the repayment



2 Constitutional Court, 6 October 2017, QPC 2017/660



of withholding tax on distribution to UCITs which had itself been declared contrary to the free movement of goods by a decision of the European Court of Justice rendered in May 2012<sup>3</sup>. In order to finance the repayment of the 3% tax amounting to 9 billion euros, the French Government is currently working on the implementation of an exceptional surtax that would apply to large French businesses or to negotiate a repayment deferral with those entities. The setting up of the exceptional tax on large French businesses might interfere with the initial communication.

Among the panel of propositions, the two following measures might contribute to the attractiveness of France.

### Massive reduction in the French corporate income tax rate within the next five years

The standard French corporate income tax is 33.33% (but in practice 34.43% due to the 3.3% social contribution from companies other than small and medium-sized businesses with an income tax exceeding €763,000) whereas the

average income tax rate is around 26.2% in the major European countries.

The purpose of the reform is to align the French corporate income tax rate with those applicable in most other European countries.

Along the same lines as the finance bill for 2017 that implemented a progressive decrease of the French corporate income tax rate down to 28%<sup>4</sup>, the draft finance bill for 2018 accelerates and simplifies this measure to end up with a standard 25% rate for all French companies in 2022 (in practice up to 25.82% with the social contribution).

The situation for 2018 will remain unchanged, with a reduced corporate income tax rate of 15% or 28% for the portion of taxable result below 500,000 euros. The new rates (28%, 26.5% and 25%) will apply to all companies as from 2020.

3 ECJ 10 May 2012 aff 338/11 and 347/11 Santander Asset Management

4 Finance Act for 2017 n° 2016/1917, dated 29 December 2017

French taxable result of the company	2018	2019	2020	2021	2022
under €38,120 (*)	15%	15%	15%	15%	15%
under €500k	28%	28%	28%	26.5%	25%
above €500k	33.33%	31%			

\*reduced corporate income tax rate applying to companies incurring a turnover below €7.63m





### Reform of the French wealth tax on individuals which focuses on real estate assets so-called “impôt sur la fortune immobilière” (real estate wealth tax)

The current wealth tax regime provides that individual taxpayers are subject to the French wealth tax on their worldwide net wealth if it exceeds 1.3 million euros.

The reform aims to restrict the scope of the wealth tax to real estate assets and property rights such as flats, houses, fields, shares for the portion corresponding to the real estate assets value.

- The real estate wealth tax will cover all properties owned in France and abroad by the French tax residents and only the properties located in France for non-French tax residents. Individuals who became French tax residents after at least 5 years of residency outside France, will only be taxable on their properties located in France during the first five calendar years.

Shares in entities holding real estate assets, including stake in a SCPI (Société Civile de Placement Immobilier) and an OPCI (Organisme de Placement Collectif en Immobilier), are within the scope of the real estate wealth tax for the portion of their value representing the underlying real estate assets or property rights.

By exception, the new regime does not include professional real estate assets, i.e. properties held by an entity which assigns it for its professional use or for

the use of a related company. It does not either include shares in a company with properties if the company operates an industrial or commercial activity and the taxpayer owns less than 10% of its share capital (alone or together with his relatives).

- The 30% allowance on the taxable basis of the principal abode will still apply.
- The real estate wealth tax will be computed on the value of the properties after deduction of the debt. All debts existing as at 1 January, contracted and effectively supported by the taxpayer and related to the taxable assets are deductible.

Two restrictions will be implemented to prevent tax evasion: when the property is located in a company set up by the taxpayer, the loans granted by said taxpayer and his tax home relatives or by related companies are not deductible. In addition, when the aggregate value of the real estate assets exceeds 5 million euros and the debt exceeds 60% of this value, only half of the debt exceeding this threshold will be deductible.

- The progressive tax rates of the real estate wealth tax will be similar to the current wealth tax regime:

Net taxable value of the real estate assets	2018
From €800k to €1.3m	0.50%
From €1.3m to €2.57m	0.70%
From €2.57m to €5m	1.00%
From €5m to €10m	1.25%
Above €10m	1.50%

- The amount of the real estate wealth tax will remain capped at 75% of the taxpayer's revenues.

Practitioners consider that refocusing the wealth tax on real estate assets could be considered as interfering in the equality between taxpayers depending on whether they own their real estate properties, or not, instead of taking into consideration their capacity to contribute to the tax burden. The French Constitutional Council will probably have to consider the compliance of this new tax in light of constitutional principles.



**Emmanuelle Pontnau-Faure**

Partner

T +33 1 53 53 54 31

emmanuelle.pontnau-faure@ashurst.com



**Solène Guyon**

Associate

T +33 1 53 53 53 64

solene.guyon@Ashurst.com



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