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An overview of this issue

We are delighted to publish the fourth edition of Global Tax Insight. This edition discusses the new EU rules on cross-border tax planning, which requires intermediaries and taxpayers to report potentially aggressive cross-border tax arrangements. There is a discussion on Spanish REITS, known as SOCIMI, which benefit from a zero per cent rate on Corporate Income Tax. The EU's state aid investigation continues with an article considering the latest developments, the Amazon and Inter Ikea decisions and the consequences of the European Commission's investigation into the UK's CFC regime. We also have an article on the recent Australian decision on limited partnerships (Resource Capital Fund v FCT).

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

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EUROPE

EU reporting rules on cross-border tax planning

by Vicky Brown, Eduardo Gracia and Nicholas Gardner

New EU rules have been introduced which will require intermediaries or taxpayers to report information in respect of potentially aggressive cross-border tax planning arrangements to tax authorities. The rules also require automatic exchange of these disclosures between EU authorities.

Member States have until 31 December 2019 to implement these amendments to the Directive on Administrative Cooperation in the field of Taxation (known as DAC 6) with the first reports not being due until the latter half of 2020. However, a 'catch-up' provision means it will be necessary at that time to disclose relevant arrangements for which the first step is implemented on or after 25 June 2018.

For this reason and despite the fact that the detail of the legislation will not be known until the Member States implement DAC 6 into domestic law - intermediaries and taxpayers will immediately need to begin forming a view as to what arrangements will be notifiable, and keeping appropriate records, so that the future disclosure obligations can be complied with.

Why are these rules being introduced?

These rules are based on Action 12 of the OECD's Base Erosion and Profit Shifting (BEPS) project, which sets out a disclosure obligation in respect of aggressive tax planning, and also have a marked similarity to the UK's DOTAS (Disclosure of Tax Avoidance Schemes) rules, introduced in 2004.

The aim is to strengthen tax transparency by requiring intermediaries – those involved in aspects of the design, promotion or implementation of arrangements - or taxpayers to report to tax authorities details of any arrangements that display specified features or characteristics which are considered to be potential indicators of avoidance. The requirement to disclose does not, in itself, mark the arrangements as avoidance but will enable tax authorities of Member States to identify and counter cross-border tax avoidance schemes at an earlier stage.

What arrangements are in scope? "Aggressive tax planning"

The Directive does not attempt to define "aggressive tax planning arrangements". Instead, cross-border arrangements (those that involve at least one EU Member State) will be notifiable if at least one of a specified list of "hallmarks" is present. The hallmarks are intended to capture characteristics or features which are indicative of a potential risk of tax avoidance. This is a concept very familiar to UK intermediaries and taxpayers and, indeed, many of the hallmarks closely reflect those in the UK rules.

It is worth reiterating at this point that there is (currently) no downside, other than the administrative inconvenience, to reporting arrangements. It is an information gathering exercise only and reporting per se implies no wrong-doing on the part of the taxpayer.

That said, this was also the initial position with the UK DOTAS rules and it was therefore customary for advisers to err on the side of caution and, if in doubt, disclose. However, in more recent years, notifiability under DOTAS has become a trigger for application of more penal measures such as the accelerated payments regime and the Serial Tax Avoiders rules which can give rise to higher penalties and increased reporting obligations. There is no indication of this in the Directive itself, but it cannot be ruled out that some jurisdictions may in the future choose to use notifiability under DAC6 as a criterion for application of their domestic anti-avoidance or penalty regimes.

"Main benefit" test

The DAC 6 rules include a "main benefit" test so that, in respect of certain hallmarks, disclosure will not be necessary until obtaining a tax advantage is the main benefit or one of the main benefits that might be expected to arise from the arrangement.

The UK DOTAS regime contains a virtually identical threshold requirement but the key point to note in the context of the new European rules is that the main benefit test applies in conjunction with only some of the hallmarks. Therefore, in some circumstances purely commercial non-tax driven arrangements may be inside the scope of disclosure. In any case, it would be unwise to rely on this main benefit test if more than minimal tax advantages were expected to arise.

The lack of a main benefit test will be particularly noticeable in respect of certain cross-border transactions and the transfer pricing hallmarks. Depending on the exact wording of national legislation and any accompanying guidance, these hallmarks could be extremely broad; without any filter for genuine commercial arrangements, a potentially large number of arrangements currently considered to be inoffensive for tax purposes could be reportable. For example, the transfer pricing hallmark applies whenever there are cross border arrangements involving hard to value intangibles regardless of whether or not there is any tax avoidance motive.

The "hallmarks"

The hallmarks fall into a number of categories but can be summarised as follows. We have also included in the list below examples of situations falling within the Hallmarks which have been given based on examples by the EU Commission to the Working Party on Tax Questions (WK 9981/2017 INIT). These were developed before the DAC 6 rules were finalized but give some insight into the EU Commission's view of the scope of the regulations.

- General hallmarks linked to the "main benefit" test, i.e. a main benefit that a person may reasonably expect to derive from an arrangement is the obtaining of a tax advantage.
  - A confidentiality condition requiring a participant not to disclose how the arrangement could secure a tax advantage vis-a-vis other intermediaries or the tax authorities
    Example: a promoter would not want to disclose new and innovative elements to competitors to retain a competitive advantage.
  - A fee fixed by reference to the amount of the tax advantage or contingent on the advantage being obtained
    Example: a fee arrangement where the taxpayer pays no upfront costs until they obtain the tax benefit, but on receipt of the benefit pays a percentage of the tax benefit.
  - Substantially standardised documentation and/ or structure without the need for substantial customisation before use by different taxpayers
    Example: there is a general scheme that is not tailored to only meet the needs of the taxpayers or is only slightly modified to suit the circumstances each time. The value of take-up or manner in which the scheme is made available is considered irrelevant.
- Specific hallmarks linked to the "main benefit" test.
  - Contrived steps consisting of acquiring a loss-making company only to use those losses to reduce tax liabilities and involving the discontinuance of the loss making activity.
    Example: a profitable company buys another company which maintains a loss-making PE to offset against their profits in future years. This example was based on an earlier draft of this hallmark and it is unclear whether this is still

applicable given that such steps would not generally be considered 'contrived' and do not involve the discontinuance of the loss making activity.

  - Arrangements with the effect of converting income into capital, gifts or other categories of revenue taxed at a lower level
    Example: a CEO is given shares as part of a remuneration package in a group company that is tax resident in a jurisdiction where dividends are not subject to withholding tax and the CEO is tax resident in a jurisdiction that provides a full exemption from tax for foreign dividends paid to individuals.
  - Circular transactions resulting in the round-tripping of funds, through interposed entities with no commercial functions, or transactions that offset or cancel each other
    Example: a local business invests capital in a foreign subsidiary, disguising it as foreign capital and return it to fund local investment to take advantage of preferential treatment that is only available to foreign investors.
- Specific hallmarks related to cross-border transactions, including deductible cross-border payments between associated enterprises where the recipient pays a low rate of tax or benefits from a preferential regime (the "main benefit" test must also be met in relation to this hallmark), double deductions for depreciation, or double relief for the same item of income or capital in more than one jurisdiction.
  Example: a company is tax resident in a high-tax jurisdiction and licensed to use IP, which was given via an MNE group, tax resident in a country with 0% corporate tax. To avoid paying withholding tax, the group sets up a NewCo in an EU Member State where there is a tax treaty which provides a full exemption from withholding tax. The company will then pay royalties to NewCo under a tax treaty and the NewCo will pay no withholding tax as it is abolished on outflows.
- Specific hallmarks concerning automatic exchange of information and beneficial ownership, e.g. arrangements to avoid reporting obligations under agreements on automatic exchange of information, or those involving non-transparent legal or beneficial ownership chains with the use of entities in jurisdictions other than that of the beneficial owner, where the beneficial owner is made unidentifiable or that do not carry on substantive economic activity supported by adequate staff or assets.
  Example: the salary of employees is partly given in form of shares in bonds in that company; the income will not be captured by the automatic exchange of information and there will be no reporting obligations under the CRS.
- Specific hallmarks concerning transfer pricing, such as the use of unilateral safe harbour rules, transfer of hard to value intangibles and intra-group transfers of functions, assets or risks where this leads to a 50 per cent decline in a taxpayer's projected annual EBIT over the initial three years. Unless exceptions and/or clear guidance is introduced, these hallmarks are highly likely to result in a large proportion of these categories of transactions being disclosed.
  Example: an advance cross-border ruling under DAC 3 concerning the tax affairs of a natural person exclusively, which will not be required to be reported or exchanged.

Only one of the hallmarks needs be met for the arrangements to be reportable and it can be seen that these are wide-ranging and broad in scope. It should generally be relatively straightforward to determine if either of the first two categories of hallmark are in point, but an analysis of ownership structures, transfer pricing and cross-border deductions will involve greater consideration. It is worth noting that the last three specific hallmarks do not require that the main benefit of the arrangements is to obtain a tax advantage and therefore disclosure obligations may need to be considered even where no specific tax planning was involved.

Who is required to report the arrangements?

The primary reporting obligation falls on the intermediaries involved in the arrangements.

An intermediary is any person that designs, markets, organises or makes available for implementation or manages the implementation of a reportable cross-border arrangement. It also means any person that, having regard to the relevant facts and circumstances and based on available information and the relevant expertise and understanding required to provide such services, knows or could be reasonably expected to know that they have undertaken to provide help or advice with respect to any of those roles.

Persons who are not incorporated or tax resident in the EU or do not have certain other connections with the EU (such as registration with a legal or taxation professional association in the EU) will not be intermediaries for this purpose. Depending on the final terms of Brexit, therefore, it is possible that purely UK advisers and promoters may be under no direct obligation to report arrangements under the revised Directive, but given the UK's approach to international tax compliance initiatives at this stage that seems unlikely.

However, where there is no "intermediary", as defined, the "relevant taxpayer", i.e. the person to whom a reportable cross-border arrangement is made available for implementation, or who is ready to implement or has implemented such an arrangement, takes over the reporting obligation. UK advisers and advisers already based solely outside the EU but with EU clients are therefore likely to be called upon to advise whether arrangements with which they are involved fall within the scope of DAC 6, even if they are not ultimately affected by the rules directly.

The "relevant taxpayer" will also have to take over reporting duties in other situations. The Directive

recognises that in many jurisdictions, legal professional privilege prevents lawyers from disclosing certain information to third parties, including tax authorities, unless this is waived by the client. To avoid conflict with this principle, lawyers may be exempted from disclosing information that would be privileged under their national rules. There may well be other intermediaries involved with the arrangements who also have an obligation to report but, if not, the client taxpayer must do so and a lawyer asserting legal professional privilege will have a duty to inform his client of the disclosure obligations now falling upon it. The extent of legal professional privilege varies amongst EU member states and ultimately clients will need to clarify this with their advisers in the relevant EU member state.

The client will also be responsible for the closure of any in-house arrangements where no third party intermediary is involved at all.

When must arrangements be reported?

National legislation implementing DAC 6 does not need to be in place until 31 December 2019, with the new reporting requirements applying from 1 July 2020. While this seems some way off, the rules will apply to reportable arrangements where the first implementation step happens on or after 25 June 2018. This information must be filed by 31 August 2020.

From 1 July 2020, the intermediary (or taxpayer where there is no reporting intermediary) must provide information on a reportable cross-border arrangement within 30 days beginning on the day after the arrangement is made available or is ready for implementation or when the first step of such arrangement has been implemented.

Taxpayers will also be required to file information about their use of reportable arrangements in each of the years for which the arrangement is used.

Failure to report arrangements will attract a penalty but it is down to each Member State to determine the appropriate level of this; the Directive only indicates that the penalties must be effective, proportionate and dissuasive.

Member States will then exchange information quarterly, within one month from the end of the quarter in which the information was filed. The first automatic exchange of information will therefore take place by 31 October 2020 and will be carried out through the existing common communication network developed by the EU for other automatic exchanges of information.

Comment

The picture will be clearer once national implementing legislation is published and one would also hope for reasonably detailed guidance. However, this may not be forthcoming for some time yet; HM Revenue and Customs in the UK, for example, has indicated that it is not expecting to release guidance or any consultation on draft legislation until next year.

In the meantime, taxpayers and advisers should address the potential notifiability of cross-border arrangements in real time as a matter of course, and on the assumption that the rules will be as broad as currently appears the case. It will be easier to remove arrangements from the list of those to be reported than it will to go back over two years to identify arrangements that were not originally thought to be in scope.

Whether the rules are sufficiently targeted to achieve the twin aims of deterring taxpayers from cross-border tax avoidance and arming tax authorities with information required to challenge and close down schemes, however, will take far longer to determine.


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AUSTRALIA

The "resource capital" now on appeal – uncertainty in relation to the Australian taxation treatment of foreign limited partnerships

by Peter McCullough

Introduction

Limited partnerships are a commonly used investment vehicle for a range of foreign private equity fund and hedge fund investors to make Australian investments. Cayman Islands limited partnerships are the most commonly used of these vehicles as they are particularly well understood by US tax resident investors and enable moneys sourced from various countries to be pooled in a stable jurisdiction that does not create an additional tax burden for the investors.

For Australian income tax purposes, the taxation of limited partnerships will generally fall to be dealt with under a separate regime in the tax law. Unlike general partnerships, which are essentially "transparent" for Australian income tax purposes, limited partnerships are treated as companies for most Australian income tax purposes.

Limited partnerships operating under the banner of the "Resource Capital" group (a US managed private equity fund manager) held, amongst other things, significant investments in Australian listed mining companies. Those limited partnerships have been involved in a number of Australian tax cases dealing with

INSIGHTS

- **A decision of the Federal Court of Australia has created significant uncertainty as to how Australia's income tax laws operate in relation to "limited partnerships".**
- **Such partnerships had always been considered (by taxpayers and by the Commissioner of Taxation) to be "taxable entities" (that is, not transparent for Australian income tax purposes) and are a very common investment vehicle for foreign private equity investors to hold Australian assets.**
- **In the decision at first instance, the primary judge found that limited partnerships were, in fact, transparent, with the possible outcome that all prior Australian assessments of tax issued to all limited partnerships were invalid (as they should have been issued to the partners).**
- **An appeal to the Full Federal Court has just been heard. It is expected that the decision of the primary judge in this point will be overturned. If it is not, considerable administrative chaos could result which may require a legislative fix.**
- **Aside from this, and far less dramatically, the judgment is also of interest in relation to a number of other issues – most notably, it provides guidance on the question of the source of income that will be of interest for foreign private equity investors (amongst others).**

the profits realised from the sale of such shares, including the following:

- *Resource Capital Fund III LP v FC of T* (***RCF III***) – with a judgment delivered in 2013 by Edmonds J at first instance;
- *FC of T v Resource Capital Fund III LP* – with a judgment delivered by the Full Federal Court in 2014 on an appeal from the decision of Edmonds J; and
- *Resource Capital Fund IV LP v FC of T* (***RCF IV***) – with a judgment delivered in 2018 by Pagone J at first instance.

Each of these cases was heavily influenced by the challenge of providing Double Tax Agreement (**DTA**) relief where residents of a DTA country (in this case the US) derive profits in Australia through an entity, albeit not a separate legal entity, in a non-DTA country (in this case, the Cayman Islands) that is tax transparent for US tax purposes but is apparently opaque (that is, characterised as though it were a company) for Australian tax purposes.

As an administrative matter, the Commissioner of Taxation did not find that apparent mismatch challenging to deal with. In 2011, he issued a Tax Determination ("TD 2011/25") in which he directly addressed the issue. In essence, the Commissioner concluded in that Tax Determination that DTA protection could be afforded to US tax residents making Australian investments through a Cayman limited partnership, notwithstanding that the partnership is treated as though it were a company for Australian domestic income tax purposes.

The Commissioner's view was that the "business profits article" in the DTA still applies to the extent that the profits of the partners are treated as derived by them in their country of residence and do not fall to be dealt with otherwise than under the "business profits" article (for example, if they do not fall under the "alienation of property" article in the relevant DTA).

The Resource Capital cases arose because of the Commissioner's view that the relevant profits derived by the limited partnerships, being profits from the sale of shares in mining companies were not within the ambit of the business profits article (Article 7 of the US DTA). Rather, he considered that they were within the ambit of the "alienation of property" article (Article 13 of the US DTA) and that Australian taxing rights were therefore not restricted by the US DTA.

The Commissioner may well have anticipated that the resolution of this question would not generate much controversy and the Court would follow, in some manner, the approach he adopted in TD 2011/25.

He was wrong. The Resource Capital partnerships raised a number of interesting arguments for the Courts to consider and the Courts went in all directions in response in trying to deal with the problem of applying DTAs where there are misaligned entity characterisations (transparent versus opaque) between the relevant DTA countries.

Overview of the effect of the RCF judgments

The results of the cases to date have been very unsatisfactory and can be summarised as follows:

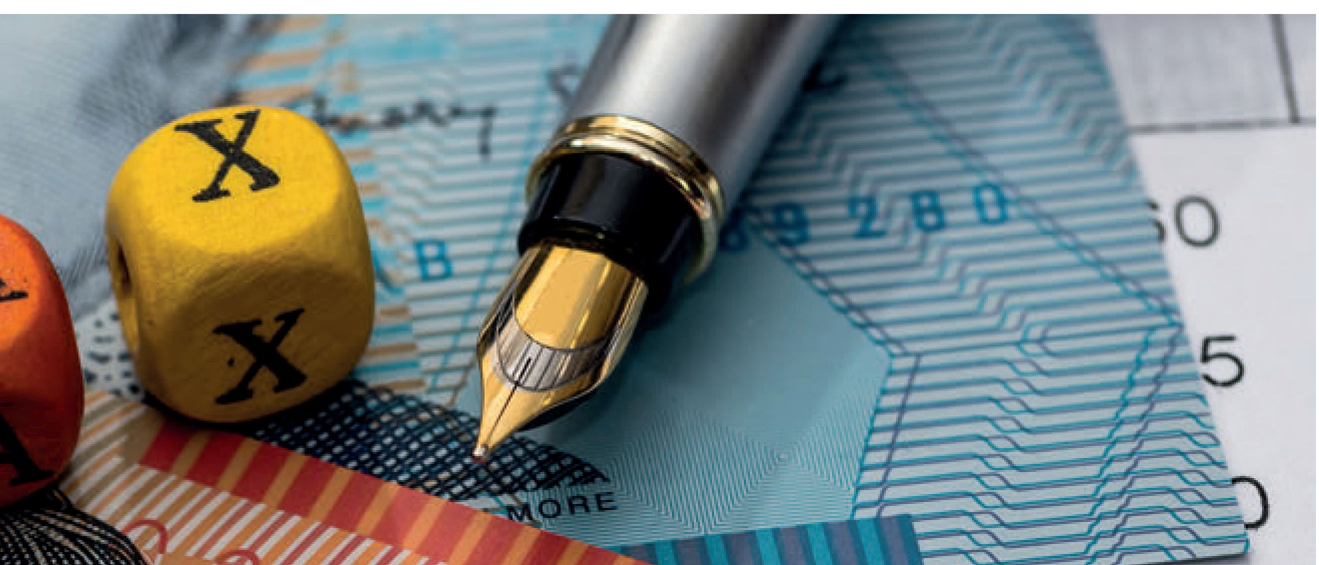
- *In RCF III*, Edmonds J sought to resolve the misalignment by following OECD guidelines for dealing with these problems through DTAs, even though the relevant entity causing the problem (the Cayman Islands limited partnership) was not within the ambit of the US DTA – with the outcome from his approach being that DTA relief was potentially extended well beyond its previously understood limits (too much DTA relief!);
- *In the RCF III appeal*, the Full Federal Court focused on avoiding the issue entirely on the basis that the relevant question that would bring the issue forward for their consideration was not asked – so that the potential DTA overreach problem from the decision at first instance was overcome, but taxpayers and the Commissioner were then left in a situation where they had no certainty as to whether, in fact, any DTA relief would be available in misalignment scenarios; and
- *In the RCF IV case*, Pagone J sought to resolve the issue by showing that there was, in fact, no misalignment on the basis that corporate limited partnerships are, in relevant respects, transparent for both Australian and US tax purposes–with the potential outcome that the apparently well understood tax treatment of limited partnerships in Australia was wrong and all tax assessments issued on the basis of that treatment were invalid.

Pagone J's observations on whether the limited partnership in the RCF IV case was a taxable entity caused a considerable stir – the headline in the Australian Financial Review following the judgment read "Private equity shaken by shock tax verdict" with the text indicating that "lawyers are stunned by some aspects of the decision".

Key points from the rcf iv decision

The most significant conclusion reached by Pagone J in RCF IV was that, despite the apparently clear design intent of the rules dealing with limited partnerships, those rules did not make limited partnerships "taxable entities".

Although it is not clear exactly what the term "taxable entity" means, it seems to follow from this that the partners and not the "partnership" must be treated as deriving the relevant profit. This has certainly not been the practice in Australia since the introduction of the limited partnership rules in the 1990s. The practice of the Commissioner (which reflected a generally understood and non-controversial position) was that the general partner of the partnership was assessed as a company



and tax was imposed at the company tax rate on the taxable income so assessed.

The conclusion reached by Pagone J creates the possibility that all prior assessments issued to limited partnerships (both foreign and Australian) were outside the power of the Commissioner (being issued to the wrong taxpayer) and therefore invalid. This would create administrative chaos for limited partnerships and for the Commissioner.

However, when the judgment is read closely, it is apparent that the judge did not conclude that the assessments he was considering were invalid. Rather, he was prepared to conclude that they should be treated as within power, being addressed to the correct taxpayers through the agency of the limited partnership. So it is possible that the case could be read as not leading to the invalidation of most limited partnership assessments.

The case was also notable for a number of other points, with the judge reaching the following conclusions:

- that the profits from the shares sales were income of the partners rather than a capital gain (this was uncontroversial, given the particular fact pattern before his Honour);
- that the profits had an Australian source;
- that tax relief was potentially available under the US DTA (because the limited partnership was transparent, as discussed above);
- that the Commissioner's Tax Determination was binding on the Commissioner to the extent that limited partnerships derive profits dealt with by the business profits article in a DTA, and so could be relied upon by those partnerships in determining their Australian income tax position; and
- that (in a part of the case dealing with complex valuation issues) various assets are not "taxable Australian property" for Australian capital gains tax purposes.

The conclusions reached by the judge in relation to the source of the profits will be of potential significance to a range of foreign investors. In this regard, while the share sale transaction giving rise to the profit was executed outside Australia (on the Toronto Stock Exchange), the judge did not give this much weight in determining the source of the profit.–Instead, he found the following facts more persuasive in deciding where the source of the profit was located:

- the business strategy included substantial business activities in Australia by agents of the limited partnership;
- a management entity for the limited partnership maintained an office in Australia with Australian employees and those employees played an active role in the initial investment, its management and ultimate disposal and assisted the non-Australian Investment Committee of the limited partnership to make the relevant investment decisions;
- those Australian employees were active on the boards of the investee companies in Australia; and
- the shares were sold pursuant to a scheme of arrangement carried out in Australia pursuant to the Corporations Act and under the supervision of the Federal Court of Australia.

Foreign investors should take note of the judge's focus on where the business activity takes place in relation to the both initial investment, the ongoing management and the disposal of Australian assets. Moreover, in considering whether the source of particular profits is from Australia or not, the approach of the judge suggests an almost binary analysis: there does not appear to be room in the analysis for some apportionment between Australian and foreign sources. Foreign investors may therefore wish to restrict the level of activities in Australia as far as possible.

The case on appeal

Not surprisingly, the Commissioner appealed the decision of the primary judge to the Full Federal Court. That appeal was heard recently (in early August this year).

While anything is, of course, possible, we think it likely that the Full Court will overturn the most contentious part of the decision of the primary judge and conclude that limited partnerships should be characterised as a "taxable entity" for Australian income tax purposes. This should ensure that prior assessments to such partnerships are not invalidated. Whether it also means that DTA relief is not available where investors invest through such partnerships remains to be seen.

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EUROPE

The continuing EU Tax and State Aid Saga

by Nicholas Gardner

The EU investigation into state aid and taxation continues to expand. In a speech late last year the European Competition Commissioner, Margrethe Vestager, confirmed that their investigation continues to grow. Following the well-publicised decisions against Amazon, Apple, Fiat and Starbucks, the investigation now stems well beyond technology. She said "We've looked at more than 1,000 tax rulings as part of [our] work. We've found the Fiat, Starbucks and a whole series of multinationals got illegal state aid".

In late June, the EU General Court heard the cases of Fiat, Starbucks and the Belgian Excess Profits Ruling and as at publication these judgments are yet to be published. It is hoped that the decision of the Court will provide more clarity as to the ambit of the state aid rules and narrow the scope of the European Commission's investigation. However if the General Court decides these cases in favour of the Commission this may well prompt the Commission to widen the scope of its investigation to include other tax payers.

In the meantime, this article considers three of the developments since we last reported on this topic – the Amazon and Inter IKEA decisions published earlier this year and the consequences of the European Commission's (the **"Commission"**) investigation into the UK's CFC regime.

INSIGHTS

- **Momentum continues to build from the European Commission on Tax and State Aid cases which could compel Member States to recover taxation from multinational companies which are considered to be unlawful state aid**
- **Taxpayers should expect to see a greater level of scrutiny from the Commission on transfer pricing rulings and methodology and consider whether any transfer pricing rulings are susceptible to challenge**
- **Multinationals with group financing companies should also monitor the Commission's continuing challenge against the UK's CFC finance exemption rules**

Amazon

The Amazon decision (published by the Commission on 26 February 2018) is another decision concerning the transfer pricing methodology. This was in respect of certain licence fee payments made by Amazon's Luxembourg Operating Company (Lux OpCo) to another Luxembourg entity (Lux SCS) which was a tax transparent partnership for tax purposes. In consideration for the payments, Lux OpCo was permitted to run Amazon's European websites. The licence fee chargeable under the agreement was calculated on the basis that Lux OpCo obtained a return equal to the lesser of (i) 4%-6% of its expenses or (ii) the total operating profit. The basis for this was that Lux OpCo was said to be undertaking 'routine' management functions over the intellectual property rights. Lux SCS also entered into licence and assignment agreements' and a 'cost-sharing agreement' with Amazon's parent companies in the US. The Luxembourg tax authorities gave a ruling at the time that the payments and mark up were in line with Luxembourg's transfer pricing rules (the **"Luxembourg Tax Ruling"**). However, the Commission argued that they were far below the value that would have been determined on an arm's length basis.

This decision followed the format of previous cases in assessing whether State Aid existed by reference to four factors:

a whether there was an Intervention by the State;
b whether any such intervention affected trade between member states;
c whether it conferred a selective advantage on Amazon; and
d whether it distorted or threatened competition.

In Tax State Aid cases the key consideration is whether the relevant measure conferred a selective advantage. The three other factors were held to be self-evidently satisfied here.

Selectivity

The Commission's approach to selectivity analysis was twofold. Following previous case law, the Commission considered that the existence of any economic advantage is in principle sufficient to support a presumption of selectivity.

However, for completeness it also approached the test by considering a three step process, namely:

a identify the reference system or benchmark;
b determine whether the State Intervention is a derogation from the reference system; and
c determine whether the intervention is justified.

The Commission first identified Luxembourg's general corporate income tax system as the reference system. Whilst Amazon and Luxembourg argued that the reference system should only be restricted to 'multinational corporate groups', the Commission instead expanded it to all corporate taxpayers as being in a similar situation. The Luxembourg Tax Ruling, therefore, granted a favourable tax treatment to Lux OpCo which was not available to other corporate taxpayers in Luxembourg whose taxable profits reflected prices negotiated at arm's length on the market, thereby derogating from the reference system. Finally, the Commission could not find any reason that the tax ruling was justified by the nature of Luxembourg's tax system.

Advantage

Regarding the existence of an advantage, the Commission held that this existed on two separate grounds. Firstly, there was an inaccurate analysis of the assets used, functions performed and risks assumed by Lux SCS and Lux OpCo in the Luxembourg Tax Ruling and Amazon's transfer pricing report. Secondly, even if such an analysis was accurate and correct, Amazon and Luxembourg did not follow the OECD's arm's length methodology. This resulted in a reduction in the amount of tax due from Amazon, amounting to an economic advantage.

The Commission differed from the Luxembourg Tax Ruling in concluding that Lux SCS performed no active and critical functions in relation to the development, enhancement, management and exploitation of the intellectual property rights (**"TP Use"**). It was merely a basic legal owner; Lux OpCo, which Amazon had argued only carried out 'routine' management functions, completed all of such functions relating to the rights. For example, Lux OpCo had oversight of the technology and data to customise Amazon's websites to specific markets and link Amazon's inventories on a pan-European basis. The licence agreement was essentially irrevocable and did not allow Lux SCS to use, manage or control such rights. Finally, Lux SCS never had the capability (operational capacity) or financial means (financial capacity) to respectively control or undertake any risks connected with the TP Use. Any liability or expenditure that Lux SCS may have had under the cost-sharing agreement was met by income received from Lux OpCo. Lux SCS's only associated cost related to the maintenance of legal ownership of the rights. Therefore, the mark-up arrangement on the basis of Lux OpCo performing solely 'routine' functions was not correct and should have been set higher to reflect its key role in the TP Use.

The Commission concluded that the choice of the transactional net margin method (**"TNMM"**) as the correct transfer pricing methodology, instead of the comparable uncontrolled price method, was appropriate, as only one of the parties to the licensing agreement performed unique and valuable contributions. Nevertheless, the TNMM requires the tested party to be the one undertaking the less complex functions to ensure the broadest scope of comparables. In the Commission's view Lux SCS should have been the tested party, not Lux OpCo as stated in the transfer pricing report. In addition, when using the TNMM, the Commission determined that the profit level indicator needs to indicate the value of the functions performed by the tested party. Since Lux SCS did not perform any of the key functions relating to the rights, the mark-up should have only applied to the operating costs in relation to Lux SCS's legal ownership maintenance. The effect of this analysis was that, the arm's length remuneration for Lux SCS was dramatically lower than stated in the Luxembourg Tax Ruling. Whilst it is common for transfer pricing arrangements to be disputed, the Commission's critique of these arrangements goes far beyond a criticism of the comparable used or aspects of the methodology and proposes almost a diametrically opposite analysis as being more appropriate.

Inter IKEA

The Commission's opening decision on Inter IKEA bears many similar similarities to the Amazon one.

The decision concerns two advanced pricing agreements (**"APAs"**) obtained in 2006 and 2011 by IKEA Systems BV (**"Systems"**). The 2006 APA had set out and endorsed the transfer pricing treatment of a licensing fee paid by Systems to a Luxembourg company (**"Holding"**). Holding was exempt from taxation on its income under a special tax scheme. Holding held the proprietary rights to exploit the IKEA franchise business, to which Systems had full entitlement under the licensing agreement.

In July 2006, the Commission held that the special tax scheme was illegal under EU State Aid rule and Holding would incur corporate tax liabilities from 2011 onwards. Consequently, Inter IKEA restructured to ensure that the 2006 APA was no longer applicable. Systems acquired the proprietary rights (formerly held by Holding) from its Lichtenstein-based parent entity, Interogo Foundation (the **"Foundation"**) for EUR 9 billion under a Sale Purchase Agreement (**"SPA"**). This was done in two parts – the Foundation contributed to Systems 40% of the beneficial interest in the rights as share premium reserves. Systems purchased the remaining 60% for a price of EUR 5.4 billion, which was converted into a loan granted by the Foundation to Systems. This loan, which had a 12-year maturity period, was unamortised and had a 6% yearly interest rate. The SPA also contained a price adjustment mechanism – if the fair market value of the rights was different to EUR 9 billion on 31 December 2023, the amount of debt owed to the Foundation will change so that it still represented 60% of the rights' value. The Netherlands government issued the second APA which endorsed the adjustment mechanism, the acquisition price, the interest payable under the loan and the deductions of the interest payments from Systems' taxable profit in the Netherlands.

Selectivity

The Commission reviewed both APAs and found that they constituted unlawful state aid. It believed that there was an economic advantage granted to Systems under both APAs, which raised the presumption that they were selective in nature. It also applied the three-step process (discussed in the Amazon case above) and reached the same conclusion. Again, the Commission applied a wide scope for the 'reference system', considering it to be the general corporate income tax system with the objective of taxing all companies subject to tax in the Netherlands, with no distinction between group companies and standalone companies. The APAs derogated from the reference system – they allowed Systems to lower its

taxable profit by departing from a reliable approximation of a market-based outcome in line with the arm's length principle. Finally, there appeared to be no justification in the reference system for this derogation, whether in the intrinsic, basic or guiding principles or as a result of inherent mechanisms necessary for the functioning and effectiveness of the system.

Advantage – 2006 APA

The Commission held that the 2006 APA incorrectly assumed that Systems was a party which carried out simple functions and was therefore the less complex (i.e. tested) party for TNMM purposes. Rather, Systems appeared to be responsible for the legal protection over the rights, managed the relationships with franchisees and third party providers and had the final say over the design of products and definition of the product range. Similar to Lux OpCo in the Amazon case, Systems was the primary party for the commercial, marketing, strategic and planning activities of the franchising business. Holding had a rather limited role – in fact, it was considered an exempt 1929 holding company under Luxembourg law and so was prevented from 'carrying on any industrial or commercial activity or providing any kind of service' or 'having direct involvement in the affairs of its subsidiaries', amongst other restrictions. As such, the Commission did


0.1750
0.1500
13
21

not consider the profit allocation between Systems and Holding under the licensing agreement to reflect the economic reality. There was a reduction in the corporate tax liability which did not reflect a reliable approximation of a market-based outcome with the arm's length principle.

Even if the above assumption was correct, the Commission held that Inter IKEA still did not apply the correct methodology. The APA based the decision on a 5% margin applied to the franchise revenue plus net catalogue revenue minus marketing support contributions to franchises. This margin was calculated on the individual operating profits arising from three different functions (catalogue operation, franchise contract management and IKEA Franchise Concept maintenance). The Commission considered parts of the calculation to be either unidentified or incorrect, as it did not agree that a single margin should have applied to all these activities and considered that no mark-up should have been applied where there was a pass through of expenses. A transfer pricing report produced also assumed that Systems incurred no or very limited market risk but at the same time included loss-making comparables. The inclusion of loss-making comparables contradicted the earlier analysis – if Systems was performing complex functions and could incur losses the use of TNMM would be questionable. Finally, Systems' operating profit did not include net financial and net extraordinary results, further reducing the operating profit figure.

Advantage – 2011 APA

The Commission considered two main aspects of the 2011 APA to be wrong. The first aspect concerned the valuation of the EUR 9 billion figure. The Commission considered the purchase price to be higher than what would have been agreed between two undertakings on an arm's length basis. As discussed earlier, Systems had performed a range of vital functions in relation to the rights – Systems' remuneration for its roles should have been subtracted from the value of the rights. Systems had also owned a particular right (the IKEA Franchise Concept) at this point and so profits attributable to it should have been subtracted from the purchase price. The Commission found there were only documents showing a limited discounted cash-flow model with no explanation. By endorsing the deduction of interest payments based on this inflated purchase price, the Netherlands tax authority had departed from a reliable approximation of a market-based outcome in line with the arm's length principle.

The Commission also did not consider that an independent lender would have granted a loan on such terms outlined above. It analysed Systems' financial reports and found it unlikely that Systems had the capability to repay more than EUR 4 billion of principal over eight years, whilst there was correspondence between one of the banks and Inter IKEA's chief financial officer expressing doubt over Systems ability to raise EUR 5 billion of external financing given the contemporary economic circumstances.

The second aspect considered by the Commission was the price adjustment mechanism – again, it did not find it would have been agreed on such terms between independent undertakings negotiating at arm's length under comparable circumstances. Furthermore, there were deductions of provisions for future interest related to the mechanism which did not seem to comply with Dutch tax law. Permitting such a mechanism meant that Systems ultimately benefited from a lower tax liability which was not available to other taxpayers in similar situations.

UK Controlled Foreign Companies ("CFC") Regime

The Commission has also opened an investigation into the UK's CFC regime. More specifically, the Commission was to look at the group financing exemption (**"GFE"**), which exempts from UK taxation financing income received by an offshore subsidiary from another foreign group company. The EU subsequently published a decision letter on 24 November 2017 elaborating on the reasons behind the investigation.

The GFE is not defined or specified in UK legislation, but the Commission clarified that it was targeting the differential treatment between companies with CFCs receiving non-trading finance profits (**"NTFPs"**) falling within Chapter 5 of Taxation (International and Other Provisions) Act 2010 and those receiving NTFPS under Chapter 9. Two exemptions are provided for under Chapter 9: (i) the qualifying loan relationship exemption, which results in a 75% reduction in the CFC charge for finance income arising from group loans between non-UK members of a UK headquartered company, and (ii) the qualifying resources exemption which provides complete exemption for financing income where the CFC was not funded by debt finance from the UK and that they were entirely funded by local assets or a new group equity capital.

Applying the three-step selectivity process, the Commission considered the entire CFC regime to be the relevant reference system. The derogation arose, in its view, from the rules treating certain companies (who carried out financing transactions with certain related foreign debtors – Chapter 9) better than other companies (carrying out the same transactions involving related UK or third party debtors – Chapter 5), since the latter cannot benefit from the GFE. Essentially, the UK CFC rules seem inconsistent – interest income earned by a qualifying CFC from loans under Chapter 9 should be considered artificially diverted under the regime, but nevertheless benefits from the two aforementioned exemptions. These two sets of companies, according to the Commission, are in factually and legally comparable positions under the regime.

Finally, there was no justification in the Commission's view as to the differing treatment between the two sets of companies. The UK authorities argued otherwise. Regarding the partial exemption, as it is often difficult to precisely establish the extent to which an equity investment in a CFC is sourced from UK borrowings, the exemption presupposes a 'deemed' debt-to-equity ratio of 25:75 to avoid the need to maintain complex cash flow records. The Commission did not find this convincing, since in reality, almost all CFCs are always fully equity financed – so this 75% exemption would apply to such CFCs regardless of how they are capitalised. The UK also argued that the use of fixed ratios was commonplace, for example under the Anti-Tax Avoidance Directive which exempts a CFC from the CFC rules if one third or less of its income concerns high risk income (i.e. income at risk of avoidance/diversion). The Commission countered by saying, in its opinion, the GFE does the exact opposite – it exempts a fixed ratio of a CFC's income which has the highest risk of diversion. In addition, this deemed ratio does not apply when determining whether UK companies are excessively debt-financed. Regarding the full exemption, the Commission saw this as being inconsistent with the approach under Chapter 5, where the conditions for the exemption did not require a relation between the NTFPs and a tax deduction in the UK. Furthermore, there was no equivalent exemption available to UK companies with NTFPs.

If the Commission concludes that the GFE constitutes unlawful state aid, there may be substantial tax penalties, since the UK government will need to recover an amount equal to the amount that would have been paid if the profits were not exempted by the GFE. Furthermore, it is unclear if Brexit will absolve such liabilities since the EU's negotiation guidelines specified that the UK must ensure a level playing field, notably in terms of competition and state aid. If a Brexit deal is achieved the acceptance of the ECJ's jurisdiction over any UK decisions until 31 December 2020 in the draft transitional agreement will likely compel compliance with any pre-Brexit state aid decisions.

Where Does This Leave Multinational Groups?

It is clear from the comments of Margrethe Vestager that EU State Aid investigations will continue, with the Commission becoming more aggressive in challenging transfer issues and rulings. Indeed, the Amazon and later IKEA case demonstrates how the Commission is willing to critically analyse transfer pricing rulings to the extent as to whether the methodology applied was correct or not. Multinational companies which have obtained tax rulings similar to those in the Amazon, Inter IKEA or the earlier cases should review the transfer pricing analysis and robustness of the methodology applied and consider the potential exposure in the case of an EU investigation of their position.

In addition, any group relying on the UK's Group Finance Exemption under the CFC rules would be well-advised to consider the potential impact if the EU's investigation gives rise to a determination that such rules breach its State Aid provisions. Multinational groups who may be affected should review the decisions of the General Court of the CJEU in relation to the June hearings and will be hoping that they will bring greater clarity as to the scope of these rules.

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SPAIN

The SOCIMI, an introduction to the Spanish REITs

by Juan De La Lastra and Jorge Ramírez

This article provides a brief explanation of the principal characteristics of the Spanish entity known as SOCIMI and the basics of the special tax regime applicable to those entities, emphasising its principal tax benefits.

SOCIMIs are public limited companies (sociedad anónima) whose corporate purpose is the holding of either (i) leased urban assets (by means of acquisition or development) or (ii) a stake in the share capital of other SOCIMI or foreign entities of analogous or similar activity (the vehicles known as Real Estate Investment Trusts or "REIT").

Principal tax benefits of the SOCIMI special tax regime

As a main feature of the regime, SOCIMIs are subject to CIT at a zero per cent rate, which make them attractive for any kind of investor, whether resident or non-resident in Spain and place them at the same level as other well-organised REIT created in Western countries.

Just as a general introduction to taxation for the investors, we may face three different scenarios:

- **Spanish CIT taxpayers** (or non-residents with a permanent establishment in Spain) will include the dividend in their CIT base without entitlement to the exemption to avoid double taxation, although these investors may still take advantage of the SOCIMI's regime;
- **Spanish individuals** will include the dividend in their taxable base subject to flat rates up to a maximum of 23 per cent; and
- **Non-residents without a permanent establishment in Spain** who receive dividends from a SOCIMI will be subject to a withholding tax of 19 per cent, unless an exemption (under the parent-subsidiary directive or otherwise) or reduced treaty rate is applicable.

In this regard, non-resident investors, in particular residents within the European Union, may use SOCIMIs to structure their investments in Spanish real estate and that any investment returns are taxed at a rate of zero per cent Spanish CIT, and also to reduce the tax rate on dividends paid by the SOCIMI to zero per cent on Spanish withholding taxes under the parent-subsidiary directive.

INSIGHTS

- **In general, SOCIMIs are entitled to apply a special tax regime, which provides for specific tax benefits in Spain, such as a total relief in Corporate Income Tax ("CIT") and abatements in indirect taxes.**
- **In order to apply the special tax regime and therefore benefit from the tax advantages, SOCIMIs must satisfy certain requirements. These include, amongst others, an obligation to be listed on a regulated market or a multilateral trading system with a minimum free float of minority shareholders representing either 25% of the SOCIMI's share capital or EUR 2m of fair market value and the fulfilment of a strict policy of dividend distribution.**
- **Although the SOCIMI regime was first created in 2009, the regime was substantially modified in 2012 and since then SOCIMIs have become an important vehicle to attract foreign investors lured by the benefits of their special tax regime.**
- **In general terms, the SOCIMI special tax regime allows foreign investors which acquire a relevant stake in the SOCIMI (minimum 5% participation) to obtain an effective taxation of 10% of its profits.**

However, since the zero per cent of CIT is withdrawn if dividends are distributed to a shareholder holding five per cent or more of the share capital of the SOCIMI, and such dividends, in the hands of such shareholder, are either exempt or subject to a tax rate under 10 per cent. In that case, the Spanish rules apply a special levy to the SOCIMI such that it is required to pay tax at a rate of 19 per cent on the amount of dividends paid to the shareholders who meet the above requirements (participation equal to or greater than 5 per cent of the share capital and taxation below 10 per cent).

This special levy will typically be triggered in the case of non-resident investors who are resident in either a tax haven territory or in a jurisdiction (even within the European Union) where the dividends collected by the relevant investor are entitled to a participation exemption regime.

Last but not least, SOCIMI are entitled to a 95 per cent reduction on the Transfer Tax triggered on the acquisition of real estate assets if they are residential properties to be leased or land for the promotion of residential properties to be leased, to the extent that the assets are leased for a minimum period of three years.

Basic requirements of SOCIMI special tax regime

The main requirements to apply for SOCIMI special tax regime are the following:

- SOCIMI's share capital must amount to, at least, five million euro.
- Mandatory trading on regulated markets or multilateral trading systems (such as the Mercado Alternativo Bursátil or MAB) either in Spain or another jurisdiction within the European Union or the European Economic Area with the minimum free float requirements described above.
- At least 80 per cent of the assets must be leasable urban properties, lands for development of leasable urban properties or shares of other SOCIMI or REIT.
- At least 80 per cent of the earnings (excluding any income arising from the sale of qualifying assets) must come from rental income or dividends distributed by any subsidiary SOCIMI.
- A mandatory distribution of dividends in a given proportion depending on the origin of the profits obtained:
    - 80 per cent of overall earnings, including rental income;

    - 50 per cent of the capital gains obtained from the transfer of assets (properties and shares) eligible for the application of the special tax regime (properties used for lease and shares in entities whose corporate object is the foregoing activities). The remaining 50 per cent will be reinvested in eligible assets within three years of the transfer.
    - 100 per cent of the profits coming from entities in which SOCIMI hold a stake.
- Property assets must be leased for a minimum three-year term (can be vacant for one year if being offered on the leasing market).

Not all of the above requirements must be satisfied at the time of opting for the applicable regime. In this regard, some of the requirements, and in particular the one related to the listing, may be met within the two years following the election of the SOCIMI regime, without prejudice to the application of SOCIMI's special tax regime from the fiscal year in which the communication to the competent tax authorities for the election of the special tax regime takes place (provided within the relevant deadline).

In addition, an entity that meets all of the relevant requirements to apply the SOCIMI special tax regime but its shares are not traded on a regulated market or a multilateral trading system, is also entitled to apply the SOCIMI special tax regime, provided that it is fully participated by a listed SOCIMI.

Finally, it must be noted that certain requirements may be breached in a fiscal year without losing the benefits of the special tax regime, provided that this situation is rectified in the following fiscal year.

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