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Transfer Pricing Challenges – A View From Middle Europe

By Ionut Zeche

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The issue of transfer pricing has been gaining international traction since the 1970's when, with the growing globalisation of trade, multinational enterprises developed their activities and transactions between affiliated companies in other countries. In Romania, the issue of transfer pricing became a hot topic when government officials estimated multinational enterprises were transferring as much as €1 billion in profits to other countries or regions, allegedly avoiding taxation in Romania.

Bypassing the political and electoral layers of such statements, it is quite clear that the N.A.F.A. (National Agency of Fiscal Administration) identified that, in the transfer pricing area, a significant proportion of the state budget was being moved to other jurisdictions. To counter this, tax authorities triggered a series of audits and, by 2018, many of the large taxpayers encountered inspections focused on transfer pricing. In the face of this avalanche of audits, multinational enterprises were only able to respond in one way: by presenting a properly prepared transfer pricing file.

O.E.C.D. TRANSFER PRICING GUIDELINES

Even though the issue of transfer pricing surfaced more than one-half a century ago in certain countries, the 2008-2009 financial crisis pushed states into taking a number of measures and performing risk analyses to assess what was happening with corporate profits not matched by corporate taxation. The need for cash forced developed countries to look for other areas from which funds could be raised for the state budget. For example, the U.S. government conducted an analysis to see how much taxes on American companies contributed to the Federal budget. When it was reported that these companies were not paying commensurate with the published corporate tax rate, American authorities wanted to see where that money was going.

Although it began in the U.S., the issue of transfer pricing has since expanded. What is happening today in Romania is in line with the approach of tax authorities in most European countries. Currently, we are neither ahead of nor behind the trend, but it is clear that the Romanian authorities want to follow the beaten path and maybe even surpass

Western countries. Why? Because there is potential to attract revenues for the state budget.

From a legal point of view, transfer pricing has been regulated in Romania since 2004, when it was included in the first modern tax code. However, the actual methodology for applying and documenting transfer pricing practices was regulated in 2008, under a N.A.F.A. order. We can therefore only talk about the practical application of the law since 2008.

The local legislation includes the basic rules and principles and is supplemented by a 600-page document on transfer pricing, issued by the Organization for Economic Co-operation and Development (O.E.C.D.). This document is applied internationally, is recognized by the Romanian Fiscal Code, and is subject to amendment from time to time. Given that, at an international level, there is an increased focus on multinational enterprises and the way they recognize their taxable profits in countries where they operate, this document has undergone several significant changes, and it is, once again, currently under review. These changes are mainly focused on B.E.P.S. (Base Erosion and Profit Shifting), the shifting of profits from one country to another, which the O.E.C.D. has been monitoring since 2012. Furthermore, the O.E.C.D. investigation produced a report identifying multinational enterprises that seemed to have used leverage to avoid the taxation of profits in the regions where profits were taxed at higher rates.

Following this analysis, certain action points were created in order to act as a means for implementing certain international regulations. Romania has joined the B.E.P.S. initiative and has undertaken to apply all measures and to implement in its legislation everything that is approved at an international level. Essentially, multinational enterprises will be targeted by the tax authorities in Romania, just as they are in other countries, and will be subjected to tax audits, which will most likely focus on prior transactions.

Even if Romania is "up-to-date" with its transfer pricing legislation, authorities are able to intervene on a practical level in the application of this legislation. Since transfer pricing, as a field, has only existed in Romania for a mere nine years, both taxpayers and tax audit bodies have had a relatively short time in which to learn, especially when compared to other jurisdictions.

Transfer Pricing Challenges – A View From Middle Europe

In the best case scenario, when the audit team has solid training, it all comes together naturally. It's enough to look at the file, understand the basic issues, have a technical discussion, and try to apply the O.E.C.D. principles. However, audit teams may sometimes include inspectors who are not very familiar with the subject matter and who try to address the issue from another point of view, namely that of the services rendered. This, ultimately, leads to disallowance from a corporate income tax standpoint and to reverse charge input V.A.T. in most cases.

TARGETED TRANSACTIONS

Existing statistics show that the most thoroughly analysed transfer pricing transactions in Romania and in other countries are those involving services. Often, when tax inspectors fail to understand the principles of the transfer pricing file, they try another approach and claim that the provision of services cannot be proven. This is mainly because services transactions involve something difficult to prove and that are subject to many interpretations. What has been done? When? For how long? Has it been done or not?

Some of these scrutinised transactions also involve intangible assets, such as brands or know-how. For example, the parent company of a group claims that it will provide know-how to all group companies and that it will therefore bill certain amounts annually to all its subsidiaries around the world. This kind of situation leads to a number of questions. If the parent company no longer exists, will the Romanian subsidiary cease its activity? Will it no longer be able to sell the products or provide the services? How much is the know-how worth? How can the know-how be assessed? What benefits does the Romanian subsidiary enjoy?

> ***Transfer Pricing Challenges – A View From Middle Europe***

Intangible assets also include financial transactions and loans. In such cases, the discussion is mainly focused on the size of the interest rate. Is it the same as the rate at which an independent third party can borrow from a bank? Why is it higher when the taxpayer is a borrower? Why is it lower when the taxpayer is a lender?

Over the past two years, digital transactions have become a new target for tax authorities across the world. For now, we do not know whether digital service companies will be subjected to audits in Romania that raise transfer pricing other issues. However, this does not mean those issues may not arise in the near future. In any event, the issue of transfer pricing has become more prevalent now than it was ten years ago, because our country has come to play an important part on the "multinational map". Given the high number of subsidiaries and branches in Romania, we can say that we are well integrated into the European or even the world market.

Initially, Romanian authorities seemed to have stumbled into unexplored territory. Now, it seems they have realised, by performing their own risk analyses and working closely with counterparts in the tax authorities of other countries, that they can obtain more from multinational enterprises in Romania. Perhaps this is why we are now seeing audits of companies that never underwent inspections in the 15 or 20 years of presence in Romania. Until now, no risk profile existed from the view of the authorities.

LEARNING FROM PRACTICE

Transfer pricing is not an exact science. We have analysed the cases, and we have discovered that the issue remains the same. We watched as the courts learned how to apply the transfer pricing mechanisms to handle smaller cases, and now that they are faced with cases involving large taxpayers, they already know what they have to do based on past experience.

To be fair to the tax authorities and courts in Romania, we have been pleasantly surprised to find that there are courts across the country that apply the O.E.C.D. guidelines correctly, showing a proper understating of these mechanisms, despite a misguided public perception that transfer pricing is a form of legal tax evasion.

It is extremely important to correctly apply the results of the analysis performed during a transfer pricing audit. Any such audit must consider a number of arguments, relying on certain explanations and assumptions. When considering transfer pricing, most believe that only one particular transaction is being analysed: Company A sells a product to Company B within the same group, so the transfer pricing methodology involves finding the price at which the product is sold when, in fact, the transfer price is not the actual, individual price. Some methodologies, based on business analysis and statistics, may lead to a price range, which may be practiced between companies from the same group. Such price ranges, alongside their corresponding exhaustive analysis, are required to understand the correct market context for different companies. If all companies were to operate in the same market context, then a product would have the same price for all operators. However, the "market temperature" can determine whether the market price was higher or lower at a given time. Those who prepare transfer pricing files can choose from several methods that best fit their particular situations.

A definite "X" price cannot be identified. Transfer pricing is based on estimates, it takes into account a series of assumptions and the underlying arguments can tilt the balance to either side. For these reasons, auditing transfer pricing files may involve a number of risks. Disputes may arise whenever the tax inspectors who analyse the documents see things in a different light and decide to increase local profits leading to the imposition of additional tax. Such decisions can be challenged at administrative level or even before courts of law, which have the final word on the matter.

> ***Transfer Pricing Challenges - A View From Middle Europe***

Some niche industries such as insurance, oil and gas, and pharmaceuticals have custom methodologies extensively described in the group master files, which, when deployed locally, lead to complex compliance challenges and are valuable practical manuals both for tax administrations and consultants.

WHAT ARE THE RISK CRITERIA?

The N.A.F.A. recently decided to conduct a risk analysis on multinational enterprises. Even though the tax authorities did not disclose what risk criteria they took into account, they could be easily identified from recent cases the authorities pursued.

A first indicator for this analysis is the level of profitability in Romania, namely the taxable profit in relation to the turnover and the corporate tax actually paid. Losses recorded for several consecutive years are also deemed a risk factor. From the perspective of the tax inspectors, any commercial activity of the local member of an M.N.E. group should be profitable. If not, the business should be closed.

Another element is the number of transactions with affiliates compared to the total number of transactions. The risk of distorted profits increases as transactions with affiliates represent a greater percentage of all transactions. This category includes business sectors generating sales, service fees, or loans.

An additional area of interest is where a certain sector of activity is affected by an economic or political context. If this is not presented and explained in the corresponding transfer pricing documentation, the authorities will only see dangers or higher costs, they will not understand the *de facto* situation and will consider it a risk. As an example, let's take the price of a particular raw material, which increases at the international level but not in Romania. This increase generates greater costs for the company buying that raw material from another affiliate. The tax authority looks at the revenues, costs, and profits but fails to see the background or the clear explanation for such a situation. Practically, the transfer pricing file must provide a comprehensive presentation of the business activities and conditions in order to justify the results of certain transactions and explain the reasons why price policies were implemented.

THE INCREASING ROLE OF TRANSPARENCY

The degree of transparency between tax authorities in different countries has grown enormously since 2016, following the implementation of the "Country-by-Country Reporting" system, which had its first submission deadline on December 31, 2017. All multinational enterprises with a turnover exceeding €750 million are required to file a report in the countries where the parent companies are located. The report contains information on the turnover, taxable profit, corporate tax paid, and number of employees in each country in which a company operates.

There are many summaries that show the level of activity and profitability in different countries. Last June, these reports were centralised at a European level and were transmitted to all tax authorities across the E.U. The N.A.F.A. received such reports on multinational enterprises, including those that are present in Romania. As such, N.A.F.A. was able to see the global profile of businesses carried on, people employed, and profits generated pursuant to the group's global profile. N.A.F.A. was then able to identify risk profiles.

Tax authorities have understood that transparency and exchange of information are key elements in obtaining the data they require to be able to charge additional tax and collect more revenues for the budget. Notably, this exchange of information no longer takes place only at the request of an authority. It occurs automatically and is intended to provide greater transparency.

> ***Transfer Pricing Challenges – A View From Middle Europe***

AVOID CUT AND PASTE TRANSFER PRICING DOCUMENTATION

Taxpayers in Romania that are required to prepare transfer pricing documentation either outsource this task to external experts, typically lawyers, accountants, economists, or tax consultants, or draft the files in-house based on existing models at the group level. However, the second method carries various inherent risks. Copying and pasting the existing transfer pricing documentation from a parent company based abroad, say in the U.S. or France, does not necessarily demonstrate data relevant to Romania. This may not demonstrate to the tax authorities how a transaction was undertaken. As such, replicating the group file is a sure way to err. The group file does not reflect (i) data of interest to the tax authorities from a certain country, (ii) the way to organise a file preferred by local authorities, and (iii) the importance of the actual data presented in relation to the data that has not been presented.

A transfer pricing file covering a single transaction (e.g., a sale of products) may reach up to 200-300 pages. The descriptive part alone should reach, on average, between 50 and 200 pages, while the annexes, which must contain all the contracts with affiliates and the details on how those ranges were set, may reach several hundred pages.

LOST IN TRANSLATION

Another very important element that companies should take into account is that the transfer pricing documentation must be presented to the tax authorities in the national language.

Usually, multinational enterprises prepare their documentation in English. If it is required to be reviewed and amended by the management, which may include foreign citizens, or by representatives of the parent company only then is it translated when required.

If the translation into Romanian is not correctly rendered and does not accurately convey the meaning in English, misinterpretations may occur during a tax audit or, in a best case scenario, may lead to amusing situations. We agree with drafting the documentation in English, but the translation into Romanian performed by a professional translator must be reviewed by a specialist in order to ensure that the terminology and the final product written in Romanian are correct.

We should also bear in mind that the O.E.C.D. guidelines, which established the ground rules in the field of transfer pricing, are written English and that the Romanian authorities use a translated version from 2006-2008. This may also lead to issues, since the O.E.C.D. guidelines have undergone significant changes from the Romanian versions used by N.A.F.A. examiners.

In light of the language issues, when drafting transfer pricing documentation, the author must take into account the reality in Romania, the targeted transactions, the manner in which transfer prices are documented, the Romanian version of the O.E.C.D. guidelines, and the fact that tax authorities have access to relevant information.

PLANNING AHEAD CREATES A SAFETY NET FOR THE FUTURE

When tax audits are announced, large taxpayers are required to submit their files within ten days, and if the documents are not drawn up at the time of implementation, this deadline is impossible to meet.

Even if the taxpayer manages to prepare this file within ten days, there is a high risk of mistakes, and the results will be easily disputed by the audit bodies. It is, therefore, important to prepare the file on a timely basis not later than the preparation of a tax return. Data must be collected over time, as it will be increasingly difficult to retrieve after time passes. Company staff is ever changing, especially in the case of multinational enterprises, and newcomers will have no idea of the purpose or nuance of transactions that occurred in prior years. Preparing the transfer pricing file on a timely basis creates a safety net in anticipation of an examination of the taxable year that begins several years after the taxable year closes.

Even when the file is prepared on a timely basis and observes all requirements, unpleasant surprises may occur, nonetheless. The statute of limitations for fiscal matters of corporations is six years. In 2018, it was possible to audit the corporate tax reported as far back as 2012. Moreover, the audits conducted on companies that have not previously had their transfer pricing policy audited, which focussed on the 2012-2017 period, may run for a long time – between six and 18 months for a large taxpayer. During this period, the N.A.F.A. is able to analyse the documents submitted or to request further information. There are also cases in which the audit team that physically interacts with the client is not the same as the team that analyses the transfer pricing file, mainly because teams specialised in transfer pricing might be assembled for auditing certain large taxpayers.

IT'S NOT ABOUT THE FINES, IT'S ABOUT THE CONSEQUENCES

In the case of a transfer pricing audit, it is not the fines that raise problems for companies but rather the negative consequences of such audits.

Presently, the fine that may be charged for failing to submit or for submitting an incomplete transfer pricing file is between RON 12,000 and RON 14,000, an amount that may be deemed as small. However, the attached liability is immense. A substantial part of a challenged transaction may result in a complete disallowance of an expense. This is perhaps the greatest risk if the transaction is not really understood.

On the other hand, if transactions are not exhaustively documented, companies may find the company is subject to more serious accusations. In the course of a N.A.F.A. examination, the examiner might handle the matter in an old-fashioned way, saying:

> Forget about the transfer prices. What you did here was tax evasion. Because you only showed me an invoice, you failed to prove the existence of the service, and you recorded the expenses only in order to reduce your taxable profit.

After analysing the data collected by the N.A.F.A., during the audits performed in 2015-2018 and which targeted the transfer pricing area, the state found that more than €3 billion in profits had not been properly taxed. At this point, there are many ongoing audits, many of which are N.A.F.A. "corrections" that can translate into millions of euros payable by a single company. And since the targeted transactions are historical ones, the amounts due and payable by the Romanian corporation may be supplemented by late payment interest and penalties. These items may double the final bill, depending on the period under review and the six-year length of the statute of limitations in Romania.

CONCLUSION

The importance of proper transfer pricing documentation cannot be over-stressed. This is true in Romania and can be applied equally to other jurisdictions, resulting in the need for advisors to work together across borders. E.U. Member States are forming cross-border teams to examine M.N.E.s operating in several Member States. It is prudent for the M.N.E. to retain transfer pricing examiners that work together and are sensitive to the global scope of the issue.

Tax Changes for Businesses in the U.K. – Brexit and Beyond

By Caroline Fleet
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As one might expect, the issue of Brexit, the U.K.'s withdrawal from the European Union, has been at the centre of everyone's thinking for some time – from policymakers and business leaders to investors and consumers, both in the U.K. and abroad, the topic cannot be avoided.

As of summer 2019, the terms of how Brexit will be delivered remain to be decided, which has led to further uncertainty for those business leaders who are tasked with planning for the future and delivering their business plans in an uncertain landscape.

However, while Brexit has undoubtedly caused business leaders to reassess how they will operate in the future, both in the immediate aftermath and longer-term, it is easy to forget that there are a number of changes – particularly to the tax world – which need to be considered, no matter what occurs with Brexit within the next few months.

Here, we provide an overview of some of the main corporate tax changes that have occurred in recent months and will be taking place over the next year, identifying those entities that will be affected and suggesting action steps for required by those entities in order to remain compliant with ever-changing tax law.

MAKING TAX DIGITAL (M.T.D.)

M.T.D. is expected to be the most fundamental change to the tax administration system for at least 20 years, and organisations should be aware that the V.A.T. changes are just the starting point. M.T.D. was introduced by H.M.R.C., the U.K. tax authority, to simplify tax returns and propel the U.K. forward as a world-leading digital tax authority. Naturally, M.T.D. similarly created a lot of noise within the media, particularly around the timeframes involved and whether U.K. business – especially small and medium-sized enterprises – were prepared to meet the April 2019 deadline.

V.A.T. is at the forefront of the M.T.D. initiative and, from 1 April 2019, all organisations with a turnover above the V.A.T. threshold (£85,000) are required to keep their V.A.T. records digitally and submit their V.A.T. data to H.M.R.C. through compatible software.

For many businesses, this presented a significant change to pre-existing V.A.T. processes and procedures, especially if they relied heavily on spreadsheets in order to meet the V.A.T. reporting obligations. The changes capture almost all U.K. V.A.T.-registered persons, whether the organisation is (i) charitable or trading or (ii) established domestically or overseas. It may be a greater challenge for overseas organisations to comply with M.T.D. for V.A.T. as their U.K. activities are likely to be a single part of a larger activity. This could also be the case for U.K. organisations that are part of international groups required by their overseas head offices to operate specific accounting or reporting processes and software.

M.T.D. is likely to have far-reaching implications, as it applies to any V.A.T. registered U.K. business from 1 April. Given the timeframe, H.M.R.C. has issued guidance[1], particularly with regard to areas such as compatible software.

While there may be very few outright exemptions, H.M.R.C. has indicated that there will be a "soft landing" period between April 2019 and April 2020 for organisations to have in place digital links between all parts of their functional compatible software. For this first year, organisations are generally not required to have digital links between software programs. The submission of the V.A.T. return to H.M.R.C. is excluded from this relaxation, though, and must be done digitally with effect from April 2019.

As noted above, these V.A.T. changes are only the beginning of the process, and whilst H.M.R.C. have indicated that the earliest that M.T.D. will apply for direct tax purposes will be from April 2021, the trend toward digital tax administration is clear.

NON-RESIDENT CAPITAL GAINS TAX (N.R.C.G.T.)

All disposals of residential or non-residential real property in the U.K. by non-residents have been brought within the scope of U.K. capital gains tax as of April 2019. In addition, disposals of "property or land rich entities" (i.e., entities where 75% or more of the gross asset value is derived from U.K. land) now also fall within the scope of U.K. capital gains tax, where the non-resident and connected parties owned more than 25% interest in the entity in the two years prior to the disposal. There is an exemption from the tax where the land is used for the purposes of a qualifying trade before the disposal and it is intended to continue to be used for the trade after the disposal. This exemption will assist certain sectors, such as hotels, care homes, and serviced office accommodations. Where the tax applies, the land interests and appropriate shareholdings will be treated as being rebased on 1 April 2019. Any capital gains which accrue on an uplift in value after April 2019 will be subject to U.K. capital gains tax. For corporate entities, this will be charged at the rate of U.K. corporation tax, currently 19% and scheduled to be reduced to 17% in 2020.

There are also specific provisions with respect to collective investment schemes investing in U.K. land, which allows such entities to be treated as either exempt in certain circumstances or transparent. This may well mean that offshore trust structures become popular again, as they allow for this flexibility. However, overall, what this new legislation will do is further level the playing field between offshore and onshore investment in U.K. property.

[1] https://www.gov.uk/government/publications/vat-notice-70022-making-tax-digital-for-vat

Tax Changes for Businesses in the U.K. - Brexit and Beyond

NON-RESIDENT CORPORATE LANDLORDS HOLDING U.K. PROPERTY

Going forward, corporate entities will no longer be subject to income tax on income received from U.K. property.

Instead, from 1 April 2020, non-resident companies will be subject to a 19% corporation tax (reducing to 17% in 2020) on any income or capital gains that arise from U.K. property. This applies to non-U.K. companies that receive rental income or make a capital gain on the sale of U.K. property (note that from April 2019, such companies already pay corporate tax on their capital gains).

This means that companies must take into account the transitional rules between income tax and corporate tax and the implications of being a corporate taxpayer. For many companies this will mean consideration of the corporate interest restrictions rules (broadly, since April 2017, restrictions can be placed on interest deductions where a corporate group reports more than £2 million net interest expense during the year), the anti-hybrid legislation, as well as potentially falling within the quarterly payment regime. Again, coupled with the N.R.C.G.T. for all U.K. land, the benefit of holding U.K. land in offshore entities is reduced substantially.

CORPORATE TAX LOSSES

New legislation has introduced more flexibility in the use of corporate tax losses. Losses arising after 1 April 2017 can be carried forward and be set against most types of taxable profits of the company and other group members, irrespective of the activity associated with the losses. Losses generated prior to 1 April 2017 still face restrictions on how they can offset profits.

The new rules, however, introduce a restriction on the use of losses. A group relief group (broadly 75% or more corporate group) can offset losses up to a value of £5 million. Above the £5 million allowance only 50% of the profits can be offset by carried-forward losses, irrespective of when the losses arise.

H.M.R.C. has also now published draft legislation that will mean that from 1 April 2020 capital losses will be brought within the new loss restriction rules and the same £5 million allowance.

CHANGES IN CAPITAL ALLOWANCES (DEPRECIATION OF ASSETS FOR TAX PURPOSES)

On 1 January of this year, capital allowance changes came into effect, which were introduced by the government to stimulate business. The capital allowance annual investment allowance, which provides 100% relief in the year of acquisition, increases to £1 million (previously £200,000) for qualifying expenditures for the two-year period from 1 January 2019 to 31 December 2020. The main pool capital allowance rate remains at 18% writing down allowance per year. Whereas, the capital allowance special rate allowance was reduced from 8% to 6% per year from April 2019.

In addition, a new capital allowance was created for the construction costs of non-residential property applicable to the structure and building. Historically there has been no tax-deductible depreciation for the main structure and framework of such buildings. Going forward, however, a 2% annual deduction is available on construction costs of non-residential properties incurred after 29 October 2018. Interestingly, unlike other capital allowances, there is no balance charge or allowance on the disposal of the asset during its 50-year life. Rather, the relief passes to the new owner, and the allowances claimed are then deducted from the basis of the capital gains on the disposal of this asset. The latter is a feature often more commonly associated with other European tax regimes.

CORPORATE INTANGIBLE FIXED ASSETS: GOODWILL

Tax relief for goodwill was withdrawn for disposals on or after 8 July 2015. The government has now reinstated the relief for the costs of "acquired goodwill", an intangible asset that arises when a buyer acquires an existing business. Under the new legislation, relief will be available for up to six times the value of eligible intellectual property (I.P.) assets acquired with the business.

The main categories of eligible assets are:

- Patents
- Registered trade marks
- Registered designs
- Copyright and design rights
- Plant breeders' rights

Customer-related intangibles are not included.

Relief for eligible goodwill will be based on a fixed rate of 6.5% of the cost per year, rather than on an accounting basis. No relief will be available in relation to internally-generated goodwill acquired in relation to a related-party transaction. This tax relief applies to goodwill acquired after 1 April 2019 for any business acquiring a third-party business that includes goodwill as part of the consideration for payment.

PROFIT FRAGMENTATION ANTI-AVOIDANCE

Following the budget in 2017, the government introduced legislation to tackle tax avoidance involving the fragmentation of business profits. The proposed rules prevent companies, partners, or U.K. individuals from moving profits offshore by way of a "transfer of value" to a low-tax entity resulting in less U.K. tax being paid. This could be by decreasing U.K. income or increasing U.K. expenses.

The rules apply where the U.K. individual or someone connected with them then benefits from those offshore profits. When considering whether there has been a transfer of value from a business, the transfer can be traced through any number of individuals, companies, partnerships, trusts, or other entities.

The rules include an 80% payment test, comparing the tax suffered on the alienated profits against that due in the U.K. Broadly, a U.K. tax mismatch adjustment will be required where the tax paid offshore is less than 80% of that which would be due in the U.K.

Under these anti-avoidance rules the fragmented profits are taxed as U.K. profits, with payment of tax being due 30 days after H.M.R.C. issues a preliminary notice of taxation.

The rules apply to any company or individual shifting profits offshore from 1 April 2019 for companies or 6 April 2019 for individuals.

WITHHOLDING TAXES

The U.K.'s current withholding tax regime has been extended to royalty payments and payments for certain other I.P. rights. A 20% withholding tax will be applied where (i) payments relating to the exploitation of I.P. rights and other property rights in the U.K. are made to related parties and (ii) the recipient company is in a country which does have a double tax treaty with a non-discrimination article.

Where the rules apply, they will potentially create a significant additional tax and administrative burden for businesses. These rules are clearly aimed at the large global brands which have a significant U.K. sales presence and apply from 1 April 2019 and will affect such businesses paying royalties to low tax jurisdictions in relation to U.K. sales.

> ***Tax Changes for Businesses in the U.K. – Brexit and Beyond***

RESEARCH AND DEVELOPMENT (R&D) TAX RELIEF

R&D reliefs help companies that work in sectors such as technology, manufacturing, healthcare and biotechnology, property, construction, engineering and professional practices, to research or develop concepts in their field and can even be applied to those projects which are ultimately unsuccessful. It can be applied if a business is:

- Developing new or improved products or processes
- Investing in technology
- Investing in software which helps a business to run more efficiently

Businesses that are involved in R&D can claim tax relief to either lower their tax bill or if they have tax losses, these can be surrendered for cash from H.M.R.C.

Small and medium companies can claim additional relief of up to £33.35 for every £100 of qualifying R&D spend. For profitable companies, the additional relief can help reduce the corporate tax bill, while for loss-making organisations, the additional relief can be used to claim cash back from H.M.R.C., which improves cashflow and can increase company reserves.

From 1 April 2020, the amount of repayable cash credit claimable from H.M.R.C. in any one year will be restricted to three times the company's total PAYE/NIC bill for the year. The provision is intended to target the relief to companies that have a workforce in place.

Any tax loss that is restricted and cannot be surrendered for a repayable credit can be carried forward against future profits. This is most likely to affect start-up companies who often don't pay Directors/owners significant salaries during the early years.

ENTREPRENEURS' RELIEF (E.R.)

Entrepreneurs who sell their business (or 'qualifying assets'), may be able to claim E.R. This applies when an entrepreneur wishes to sell or dispose of part, or all of a business in its entirety. E.R. applies a flat rate of 10% capital gains tax on the sale of shares in a trading company or group where the shareholder is:

- both an employee/director, and
- holds no less than 5% of the issued shares immediately prior to sale.

However, from 6 April 2019, individuals whose shareholding is diluted below 5% as a result of a new share issue will get relief for gains up to the date of dilution. H.M.R.C. has announced measures designed to ensure that "entrepreneurs are not discouraged from seeking external investment to finance business growth in circumstances where their own shareholding becomes diluted." What this means is that certain shareholders will be able to bank E.R. up to the time of the dilution event and will have an option to defer the tax payment if they wish. The benefit of deferring the tax liability must be weighed against the risk of a change in circumstances (for example retirement) and/or a change in the E.R. rules, which may prevent the relief from applying.

DIGITAL SERVICES TAX (D.S.T.)

With the growth of digital economy expanding exponentially, governments across the world have been attempting to address an aging tax system so that it can be applied to new ways of trading, where digital giants operate across many jurisdictions. An additional problem is that many of these giants do not create traditional products or offer traditional services. As a result, imposing tax on value creation is extremely difficult.

In the 2018 Autumn Budget, the U.K. made the first foray into this area by looking to introduce a unilateral D.S.T. The O.E.C.D. subsequently followed suit and has recently put forward plans to modernise the global tax system, proposing fundamental changes to how companies will be taxed. Following the consultation, in July 2019, H.M.R.C. has now published draft legislation in respect of this proposed tax.

The U.K.'s D.S.T., introduced at a rate of 2%, will apply to businesses generating global revenues of more than £500 million and with U.K. revenues of at least £25 million from relevant activities. It will apply to businesses deriving revenue from search engine services, online marketplaces, and social media platforms to U.K. users (U.K. Revenue). Under the draft legislation, it will also be applied to "associated on-line advertising business" where the advertisement is intended to be viewed by a U.K. user and transaction including the sale or hiring of U.K. land or property.

The first £25 million of U.K. Revenue will be exempt from D.S.T. Where U.K. Revenue is combined with out-of-scope activities an apportionment must be made. D.S.T. will be payable and reportable on an annual basis.

In recognition that some digital business may have a low or negative operating margin, it will be possible to enter into an alternative "safe harbour election".

It is proposed that the 2% tax will be treated as a tax-deductible expense for U.K. corporation tax purposes.

On publishing the draft legislation, the government noted that it believes that the most sustainable long -term solution arising from digitalisation will be the reform of international corporate tax rules, and it is committed to dis-apply D.S.T. once an appropriate international solution is in place. However, it does not carry any sunset clause, which was one of the key recommendations suggested by the O.E.C.D.

WHAT NEXT?

As can be seen from the above, there is a lot of tax regulation which is due to change or has changed or which is expected to change in the near future. Businesses need to ensure that they stay aware of the latest developments to thrive and prosper in the new commercial landscape, wherever the U.K. lands in the post-Brexit era. Now more than ever it is essential that businesses seek specialist advice where necessary to stay up-to-date and to ensure they remain compliant and are able to make the most of the new opportunities which will undoubtedly present themselves.

Change of a Business Model Following an Acquisition – The New Broadcom Standard in Israel

By Meir Linzen, Guy Katz, and Aryeh Holtz
Herzog, Fox and Neeman (Israel)

GENERAL BACKGROUND

Israel has been known as a "Start-Up Nation", home to companies and entrepreneurs responsible for numerous inventions in all the technological fields, including some of great significance. Among them are:

- the Waze navigation system,
- MobilEye's safety systems for autonomous cars,
- Frutarom's biotechnology,
- M-Systems' USB drive,
- Checkpoint's firewall software,
- Mellanox's technology for communication equipment,
- online gaming technologies used by companies such as Playtika and Plarium, and
- technical pharma companies such as Teva and Lumines.

These comprise the tip of the iceberg.

For many years, the Israeli government understood the importance of the high-tech industry as an engine of the Israeli economy. It provided various incentives to technology companies, including significant tax benefits and grants. Recently, the Israeli Law for Encouragement of Investment of Capital was amended and new preferred tax regimes were presented in order to provide the local high-tech industry with additional incentives and to encourage M.N.E.s to invest in Israel. Several special regimes were introduced for high-tech companies that as a group have an annual worldwide income higher than NIS 10 billion, or roughly U.S. $2.8 billion based on exchange rates as of July 2019. Other regimes relate to companies providing research and development (R&D) services to non-Israeli enterprises.

In contrast to the above, tax experts in Israel have been witnessing a disturbing tendency in the Israeli Tax Authority (I.T.A.) to subject Israeli companies to an overly aggressive tax examination whenever an M&A

transaction occurs. The main issue pursued in these examinations involves an assertion that all functions, assets, and risks of the acquired business have been transferred to the acquiring M.N.E. at the time of the transaction or shortly thereafter. In the I.T.A.'s view, this creates a very significant capital gains tax event for the acquired Israeli company, usually equal to the amount involved in the acquisition plus secondary adjustment which is treated as a dividend.

BUSINESS RESTRUCTURING AND TRANSFER OF FUNCTIONS ASSETS AND RISKS

Local legislation and O.E.C.D. publications

In 2002, Section 85A "Transfer Pricing in an International Transaction" was added to the Israeli Income Tax Ordinance (New-Version) – 1961 (the Ordinance). The section provides as follows.

> In an international transaction, in which there are special relationships between the parties to the transaction…, the transaction shall be reported according to market terms and charged tax accordingly.

In November 2006, the I.T.A. published Income Tax Regulations (Determining Market Terms), 2006 (the Regulations), implementing Section 85A. The Regulations applied to all international transactions taking place from the date of publication. Nonetheless, a transfer pricing study conducted prior to the implementation date would continue to be admissible for a two-year period, provided it was conducted according to O.E.C.D. guidelines.

In 1996, the O.E.C.D. published the report "Transfer Pricing and Multinational Enterprises". This publication was supplemented several times until 22 July 2010, when the "O.E.C.D. Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" (the Guidelines) was published. In 2014, the O.E.C.D. and G-20 published the "Guidance on Transfer Pricing Aspects of Intangibles" as part of the B.E.P.S. Project. This amended Chapter VI of the Guidelines regarding Special Consideration for Intangibles. The chapter was completely deleted and replaced with a new one. On 10 July 2017, the O.E.C.D. released "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017". This guidance incorporates substantial revisions made in 2016 to reflect the clarifications and revisions agreed in the 2015 B.E.P.S. Reports on Actions 8-10 "Aligning Transfer pricing Outcomes with Value Creation" and Action 13 "Transfer Pricing Documentation and Country-by-Country Reporting". It also includes the revised guidance on safe harbours approved in 2013, which recognises that properly designed safe harbours can help to relieve some compliance burdens and provide taxpayers with greater certainty. On 21 June 2018, the O.E.C.D. released "Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles", under B.E.P.S. Action 8 and "Revised Guidance on the Application of the Transactional Profit Split Method", under B.E.P.S. Action 10.

Following the publication of the Guidelines and the B.E.P.S. Project, the I.T.A. began issuing tax assessments, asserting that functions, assets, and risks were transferred in connection with M&A transactions. The premise on which the assessments were based was that intangibles were acquired by the M.N.E. group effecting the acquisition at prices that were less than arm's length. These assessments also relied on Section 86 of the Ordinance, which relates to sham and artificial transactions. The I.T.A. has the authority to re-characterize transactions believed to be artificial and entered for the purpose of reducing or avoiding tax payments.

The Gteko court case

The *Gteko* case[1] is the leading court ruling in Israel

[1] 49444-01-13 *Gteko Ltd. v. Kfar Saba Tax Assessor* (6.6.2017)

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on business restructuring. It was decided in November 2017). Gteko Ltd. (Gteko) shares were purchased by Microsoft in November 2006 for a consideration of $90 million. Shortly thereafter, all of Gteko's workforce were transferred to Microsoft. In July 2007, Gteko and Microsoft signed an agreement under which Microsoft acquired all Gteko I.P. for a consideration of $26.6 million (the I.P. Value). The I.P. Value was determined based on the purchase price allocation (P.P.A.) of the Gteko shares for accounting purposes. The allocation was prepared by Duff & Phelps. The I.T.A.'s assessment to Gteko was based on the excess of $90 million (i.e., the P.P.A.) and the I.P. Value determined by Duff & Phelps. The I.T.A. claimed that, *de facto*, Gteko transferred all of its functions, assets, and risks to Microsoft and not only the I.P. as reported. The court ruled in favour of the I.T.A. on this point.

The I.T.A.'s circular

Following the *Gteko* case, the I.T.A. published a circular[2] in November 2018. In the circular, the I.T.A. instructed its local officers to identify post-acquisition business restructurings. Local officers were provided with a standard form questionnaire to be answered by the acquired companies.

According to the I.T.A., its position is based on amended Chapter VI and on Chapter IX of the O.E.C.D. Guidelines that were published in 2017 and on the *Gteko* case. Based on our understanding, the I.T.A.'s position appears to be an extremely aggressive application of the Guidelines towards companies that were acquired and restructured. The I.T.A. argues that the transfer of I.P. basically means that the M.N.E. is emptying out the Israeli target and leaving it somewhere between a low-risk distributer and an empty shell. In this way, the M.N.E. removes value from the Israeli target without adequate payment. In addition, the I.T.A. often argues for secondary adjustments contending that, once the transaction is restructured to be a sale at arm's length, the amount deemed to have been received was either distributed by the Israeli company to the M.N.E. as a dividend or advanced as a loan to the M.N.E. As a final adjustment, a penalty for improper reporting has been frequently asserted.

THE BROADCOM COURT CASE

In February 2019, an interim court ruling was published on the *Broadcom* case[3], regarding the burden of proof in business restructuring cases. The ruling sheds light both on new arguments raised by the I.T.A. and the view of the court on the validity of those arguments.

Broadcom Broadband Excess Ltd. is an Israeli resident company (the Israeli Company), that was held by Broadlight Inc. (the Parent Company). In March of 2012, Broadcom Corporation (Broadcom) purchased all of the Parent Company's shares for a consideration of $200 million. Less than three months later, the Israeli Company entered into three agreements with companies of the Broadcom group:

1. The sale of all the Israeli Company's I.P. for a consideration of $59.5 million
2. An agreement to provide R&D services for a cost + 8% margin
3. An agreement to provide marketing and technical support services for a cost + 10% margin

The I.T.A. claimed that the actual agreement was of a much larger scale and included a sale of most of the functions, assets, and risks of the Israeli Company.

According to the I.T.A.'s position, the transaction between the Israeli Company and a Broadcom Cayman Company in the framework of the R&D

[2] I.T.A. Circular 15/2018 – Business Restructure in Multinational Enterprises (1.11.18)

[3] 17419-02-18 Broadcom Broadband Excess Ltd. v. Dan Area Assessment Officer (20.2.2019)

Agreement was substantially more extensive than presented. The I.T.A. argued that the entire transaction included not only the Israeli Company's I.P., but all the tangible and intangible functions, assets, and risks. An interesting point is that the I.T.A. did not dispute the value of the I.P. sold or the cost-plus mark-up in the R&D and marketing contracts.

Following a tax assessment, an appeal for court review was filed. In the petition, Broadcom requested a shift in the burden of proof from the appellant – the taxpayer instituting the appeal to the appellee – the I.T.A. The dispute in the appeal is whether the sale of the I.P. by Broadcom should be considered as a business restructure in which the functions, assets, and risks were sold or be respected as a sale of I.P. At this stage, the discussion in the case has focused on the burden of proof in characterizing the sale of I.P. as a business restructure. No decision has been reached as to the scope of the transaction and whether it included functions, assets, and risks.

Section 86 – Sham and artificial transaction

The court decision began by acknowledging that the usual rule in tax appeals is that the burden of proof rests on the appellant, as it is the one raising the claim. This stems from the fact that the appellant has a preferred position. It has easy access to all the information regarding the conduct of the business and, therefore, is in the position to prove the relevant facts that refute the assessment.

However, the usual rule is reversed when the tax assessor relies on Section 86 of the Ordinance to argue that a transaction is a sham or artificial transaction. When the tax assessor claims artificiality under Section 86 of the Ordinance, it asserts the creation of a new transaction for tax purposes, rather than the transaction made by the taxpayer. In this case, the appellant's relative advantage of knowing the relevant facts no longer exists. The normative basis for imposing the burden of proof shifts to the I.T.A. The tax assessor has asserted a "new" transaction. Consequently, it is the assessor's responsibility to explain the validity of that assertion. Since the tax assessor is the one who knows the basis for claiming that the transaction is artificial, it is appropriate for the tax assessor to be the first to bring the court evidence for the basis of the claim. Only then should the taxpayer be required to present evidence to refute the assertion.

The taxpayer's argument regarding a shift in the burden of proof was unsuccessful. According to the court, the I.T.A. claimed that it did not make use of the special authority granted under Section 86 of the Ordinance to argue that the transaction was artificial but merely classified it differently according to its true economic nature. In order to explain the difference between the artificial transaction argument and the different classification argument, the court cited the holding in another case[4]:

> When the tax assessor uses his authority to 'reclassify the transaction' [i.e., different classification], he does not adopt the factual representation presented by the taxpayer, because in his opinion this representation does not accurately reflect the factual reality. And it is correct – he does not adopt the representation and therefore finds it necessary to make a different representation under it. He does not 'change' the facts. This activity of the tax assessor is 'in the world of action'…or for the least part, in the world of general law, rather than in the 'tax world', and in this respect he does not even need the special 'disregard' provision set out in Section 86 of the Ordinance.
>
> On the other hand, when the tax

[4] TA (Center) 34660-02-15 Tsemel Jacobson Ltd. v. Assessing Officer Petah Tikva (27.8.2015)

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assessor uses his authority under Section 86 of the Ordinance, and since this is a residual authority...he does so only after he reaches the conclusion that in the 'world of actions', or in the world of general law, the real transaction is as presented by the taxpayer and that it cannot be classified differently. Only then does the tax assessor turn to the special tools given to him by the Income Tax Ordinance, including Section 86 of the Ordinance, which allows him to 'ignore' the transaction (including the construction of another transaction under it, since both the '**destructive**' authority and the '**constructive**' (restructuring) as determined in CA 3415/97 *Pashmag vs. Yoav Rubinstein & Co.*, Misim 17/4, (2003)), and 'creates' a new transaction 'in the tax world' and for tax purposes only.

Section 85A – Transfer pricing

The Israeli Company also made the claim that Section 85A of the Ordinance (mentioned above) applies in this instance. This section states that in case the company files the required documentation, as required by the section, "the assessor shall have the duty of evidence if he has made determinations different from the agreements between the parties". The argument is that as the I.T.A.'s assessment was determined under Section 85A of the Ordinance, and given that Broadcom met all the requirements of Section 85A, the I.T.A. should have the burden of proof. The court's view was that the I.T.A. does not dispute the transfer pricing study provided but, rather, does not accept the scope of the transaction as presented. For this reason, the transfer pricing study is irrelevant for determining the value of the transaction, and therefore, the section does not apply. This is also in line with the court ruling in *Gteko*.

Transfer of assets v. transfer of functions & risks

One last interesting point is the argument that the transfer of functions, assets, and risks is not considered as a taxable event under any Israeli law, and at most, the transfer of assets can be taxed but not the transfer of functions and risks. This claim was rejected by the court, which stated that it has not found why general law does not allow the sale of an "activity", including the ability to perform certain functions and to carry certain associated risks.

Court decisions in context

Although Broadcom's appeal to shift the burden of proof to the I.T.A. was rejected by the court, the more important point is that the court has adopted an aggressive approach regarding M.N.E. business restructurings, which validates the tax officers' approach to these matters. More than the specific ruling, the court's harsh view of Broadcom is evidenced by fully accepting the I.T.A.'s claims, even if reaching that result requires convoluted legal acrobatics. This interim ruling can give us a glance of what companies are expected to face should they look to the courts restraining the I.T.A.'s business restructuring assessments. Indeed, on 25 March 2019, the court ruled on three appeals by Gottex Israel group[5] regarding seven requests to shift the burden of proof to the I.T.A. Not surprisingly, six out of the seven requests were denied.

Another interesting point in the *Broadcom* case, is that I.T.A. argued for a tax gross-up on the purchase price, adding approximately 25% to the assessments value. The I.T.A. claimed that the value of the shares of the Parent Company, in the amount of $200 million, should serve as a basis for determining the

[5] 65630-01-18 *Gottex Swimwear Brands Ltd. v. Tax Assessor for Large Enterprises* (25.3.2019); 65519-01-18 *Gottex Retail Brands Ltd. v. Tax Assessor for Large Enterprises* (25.3.2019); and 61394-10-15 *Gottex Swimwear Brands Ltd. v. Tax Assessor for Large Enterprises* (25.3.2019).

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market value of the assets that were released by the Israeli Company. However, the value of the shares cannot be equal to the value of the Israeli Company's property, as it does not take into account the corporate tax component that would be imposed on the Israeli Company had it sold its assets to a third party. As such, the I.T.A. made an adjustment for the Israeli Company's corporate tax component, at a rate of 25%, and grossed up the corporate tax at the value of the sale of the Parent Company's shares. It is not completely clear how this calculation was executed, but it should be explained when the final court ruling is published.

FINAL COMMENTS AND CONCLUSIONS

Broadcom is not the only case to address the I.T.A.'s policy of attacking business restructuring. We have encountered similar arguments in many acquisitions and in cases with various types of post-acquisition relationships between the M.N.E.'s and the Israeli companies, including the following:

- The Israeli company sells the I.P. to the M.N.E.
- The M.N.E. and the Israeli company initiate a joint venture for the development of a new technology to which each of the companies provided its I.P. The sale of I.P. argument has been contemplated, even where the Israeli company was entitled to arm's length compensation for the use of its I.P.
- The Israeli company grants the M.N.E. a license to its technology, under which the M.N.E. is entitled to utilize the I.P. and include it in its own technology or products, in consideration for arm's length royalty payments.
- The M.N.E. provides the Israeli company with sales and marketing services, where the I.P. remains owned by the Israeli company, which receives most the revenues from the product.

As the I.T.A.'s arguments on this matter are relatively new and innovative, most of the audits in which these arguments have been raised are still proceeding in first stage audits or administrative appeals to an I.T.A. team or are being argued within an appeal before a district court. The Israeli Supreme Court has not yet ruled on a case involving these issues.

Notably, the I.T.A.'s position was also upheld within an international arbitration process under which the U.S. technology company HP and the Israeli company Mercury argued that a NIS 1.6 billion transfer assessment based on functions, assets, and risks had no merits. In this case, the I.T.A. made significant progress in international arbitration.

As noted above, we believe that the I.T.A.'s position on this matter is not aligned with the Guidelines and, in many cases, does not have any merit. Accordingly, M.N.E. are advised to challenge the I.T.A.'s argument both within the audit procedures and by filing an appeal in court. In addition, it is recommended for the M.N.E. to initiate competent authority proceedings under an applicable double tax treaty. We are aware of several cases that are currently under discussion within such procedures.

Notwithstanding the above, it should be noted that a tax-efficient structuring of the M&A transaction and the Israeli company's activity following the acquisition may mitigate the exposure to a post-transaction audit regarding a transfer of functions, assets, and risks. Moreover, we believe that in certain cases, it may be possible to obtain a pre-ruling from the I.T.A. or an advance pricing agreement that should prevent later challenges from the I.T.A. in the course of a tax examination following the acquisition.

The German Investment Tax Reform – An Overview

By Dominik Berka
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INTRODUCTION

After discussions that took place over several years, a new German tax regime applicable to investment vehicles was introduced in July 2016. The basic idea of the reform was to move away from the approach of the former German Investment Tax Act, *Investmentsteuergesetz* (InvStG), which generally provided for transparent taxation at the fund level. The old law is replaced by the Investment Tax Reform Act, *Investmentsteuerreformgesetz* (InvStG 2018), which provides an opaque taxation concept for investment funds (*Investmentfonds*) and a semi-transparent taxation concept for special investment funds (*Spezial-Investmentfonds*).

The Investment Tax Reform Act was published in the Federal Law Gazette, the *Bundesgesetzblatt*, on 26 July 2016[1] and entered into force on 1 January 2018. During this period, a number of legislative amendments were adopted[2]. In addition, the InvStG 2018 was amended again after implementation[3].

This article provides an overview of the reformed investment tax regime in Germany applicable to domestic vehicles tax resident in Germany, foreign investment vehicles not tax resident in Germany, and the investors in each.

SCOPE OF THE INVSTG 2018 ON INVESTMENT FUNDS AND THEIR INVESTORS

Sec. 1 (1) InvStG 2018 applies to investment funds and investors in

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[1] Act on the Reform of Investment Taxation (*Gesetz zur Reform der Investmentbesteuerung (Investmentsteuerreformgesetz*, herein InvStRefG) (19 July 2016), Federal Law Gazette I, p. 1730 (2016).

[2] Act on the Implementation of the Amendments of the E.U. Mutual Assistance Directive and on further measures against profit reductions and shifting (*Gesetz zur Umsetzung der Änderungen der EU-Amtshilferichtlinie und von weiteren Maßnahmen gegen Gewinnkürzungen und –verlagerungen*), Art. 18 (20 Dec. 2016), Federal Law Gazette I, p. 3000 (2016) and Act on the prevention of tax circumvention (*Steuerumgehungsbekämpfungsgesetz*, herein StUmgBG), Art. 10 (23 June 2017), Federal Law Gazette I, p. 1682 (2017).

[3] Act for the avoidance of V.A.T. losses when trading goods on the Internet and for the amendment of other tax regulations (*Gesetzes zur Vermeidung von Umsatzsteuerausfällen beim Handel mit Waren im Internet und zur Änderung weiterer steuerlicher Vorschriften*), Art. 15 (11 Dec. 2018), Federal Law Gazette I, p. 2338 (2018).

investment funds. The definition of an investment fund[4] is rather broad and refers to the definition of an investment vehicle within Sec. 1 (1) of the German Capital Investment Act, *Kapitalanlage-gesetzbuch* (K.A.G.B.). Thus, an investment fund is a collective investment vehicle, raising funds from a certain number of investors and deploying the funds raised pursuant to a predetermined investment strategy for the benefit of investors. It carries on no business activities, whatsoever. A special investment fund is an investment fund that fulfils certain additional requirements set out within Sec. 26 InvStG[5]. InvStG 2018 also characterizes certain investment vehicles as investment funds that do not fulfil the requirements provided for in Sec. 1 (1) K.A.G.B. These include (i) single investor funds, (ii) tax-exempt corporations prohibited from carrying out operational activities, and (iii) alternative investment funds managed within a group.

In addition, the law provides several exceptions from the application of the InvStG 2018. With certain exceptions[6], partnerships are excluded from being characterized as special investment funds under InvStG 2018[7]. Consequently, the ordinary tax regime (e.g., the German Income Tax Act, *Einkommen-steuergesetz* (EStG), or the German Corporate Income Tax Act, *Körperschaftsteuergesetz* (KStG)) is applicable. Also applicable is the Trade Tax Act, G*ewerbesteuergesetz* (GewStG). Additionally, domestic and foreign real estate investment trusts are excluded from the scope of InvStG 2018.

If a German investor that is subject to German tax, invests in a foreign investment fund, the foreign investment fund must be classified according to German tax principles, including InvStG 2018. The same is true where a foreign investment fund invests in assets located in Germany. The foreign vehicle is characterized under the principles of InvStG 2018.

[4] Sec. 1 (2) InvStG 2018

[5] Cf. below under **Distinction between investment funds and special investment funds**.

[6] The exceptions include partnerships, which can be qualified as Undertakings for Collective Investments in Transferable Securities or as pension funds within the meaning of Sec. 53 InvStG 2018.

[7] Sec. 1 (3) InvStG 2018.

In case of an umbrella fund composed of sub-funds with segregated liability, every sub-fund constitutes a separate taxable entity[8]. In the case of a foreign sub-fund, that entity will qualify as a legal body within the meaning of Sec. 2 (1) KStG and may be subject to a limited corporate income tax liability in Germany[9].

DISTINCTION BETWEEN INVESTMENT FUNDS AND SPECIAL INVESTMENT FUNDS

If a domestic or foreign investment vehicle is subject to the InvStG 2018, a determination must be made whether the investment vehicle qualifies as an investment fund or a special investment fund. Depending upon the answer, different tax consequences follow.

The additional requirements for qualification as a special investment fund are as follows:

- The fund vehicle must not be "actively managed" and the purpose of the fund must be limited to the administration of its assets for the collective interest of its investors[10].
- The fund vehicle or the fund manager must be subject to a regulatory supervision[11].
- Investors must be allowed to redeem their interests, shares, or units in the fund vehicle at least once per year[12].
- The assets of the fund vehicle must be diversified pursuant to risk diversification principles[13].
- At least 90% of the value of the fund vehicle must be invested in specified assets (Eligible Assets), such as securities falling within Sec. 193

[8] Sec. 1 (4) InvStG.

[9] Sec. 6 (1) InvStG.

[10] Sec. 15 (2), (3) and 26 InvStG 2018.

[11] Sec. 26 (1) InvStG 2018.

[12] Sec. 26 (2) InvStG 2018.

[13] Sec. 26 (3) InvStG 2018.

K.A.G.B. or other capital assets within Sec. 198 K.A.G.B., money market instruments, derivatives, bank deposits, real estate and comparable rights, participations in real estate companies, interests in another investment fund which fulfils certain requirements for qualification as a special investment fund, interests in special investment funds, participations in public/private partnership companies, precious metals, receivables, or participations in corporations if the value of these corporations can be determined[14].

- Only 20% of the value of the fund vehicle can be invested in participations in corporations that are not traded[15].
- The participation in shares of a corporation that are held directly or indirectly via a partnership must remain below 10%[16].
- Debt obligations held by the fund must be taken up on a short-term basis and cannot exceed 30% of the value of the fund vehicle[17].
- The fund vehicle cannot have more than 100 investors. Individuals may invest only if they hold their interests as commercial assets or the investment is required by regulatory law[18].
- The fund vehicle's investment conditions must provide for an extraordinary termination right for the special investment fund if the requirements of Sec. 26 (8) InvStG 2018 are not met[19].
- The foregoing requirements must be set forth in the general investment conditions of the fund vehicle[20].

Each of the foregoing requirements must be met in order for the fund to be considered a special investment fund. Consequently, if any single requirement is not met, qualification as a special investment fund is unavailable. If all the special investment fund requirements are met at the beginning of the year but not at a later date, the special investment fund is deemed to be dissolved and newly established as an investment fund[21]. This may result in the realisation of hidden reserves.

TAXATION OF INVESTMENT FUNDS

Corporate income tax

Under the prior investment tax system, a German investment fund was fully tax transparent, i.e., there was no taxation at the level of the investment fund. In comparison, foreign investment funds investing in Germany did not benefit from the tax exemption available to German investment funds. Thus, it was highly disputed whether the dichotomy in tax treatment infringed a fundamental freedom of the E.U. Law.

Now, however, both domestic and foreign investment funds are subject to German corporate income tax (C.I.T.) at a rate of 15%, plus a 5.5% solidarity surcharge, *Solidaritätszuschlag,* on the C.I.T. amount, resulting in an effective C.I.T. rate of 15.825%. This taxation at the level of the investment fund was a key element of the investment tax reform in 2018. Tax is imposed on certain income that is derived from German sources. In some cases, German trade tax ("G.T.T.") will be imposed, too. Consequently, C.I.T. Is imposed with respect to:

- Income derived from participations in German corporations, *inländische Beteiligungseinnahmen*;
- Income derived from German real estate, *inländische Immobilienerträge*; and
- Other domestic German income, *sonstige inländische Einkünft,* which is subject to a limited German income tax liability[22].

[14] Sec 26 (4) InvStG 2018.
[15] Sec. 26 (5) InvStG 2018.
[16] Sec. 26 (6) InvStG 2018.
[17] Sec. 26 (7) InvStG 2018.
[18] Sec. 26 (8) InvStG 2018.
[19] Sec. 26 (9) InvStG 2018.
[20] Sec. 26 (10) InvStG 2018.
[21] Sec. 52 (1) InvStG 2018.
[22] Sec. 49 (1) EstG.

Capital gains derived from the sale of equity participations in German corporations are tax-exempt[23].

For German dividends and any other German income subject to withholding at source, the final C.I.T. liability is settled when the tax is withheld at source. With respect to income payable to an investment fund, the withholding tax rate, which is generally 26.375 %, is reduced to 15% (corporate income tax of 14.218% plus a solidarity surcharge of 0.782%). To obtain the benefit of the reduction in withholding tax rate, the paying agent must be provided with a confirmation of the status of the fund, *Statusbescheinigung*[24]. If an applicable income tax treaty provides a lower rate of withholding tax, the lower treaty rate generally will apply. In either event, expenses associated with the participation income are not deductible for tax purposes[25].

German income that is subject to taxation at the investment fund level and not subject to withholding tax at source is generally taxed at the general C.I.T. rate of 15.825%. Related expenses incurred at the fund level are deductible for tax purposes[26].

For certain investors, such as non-profit and charitable entities, the InvStG 2018 provides for a full tax exemption applicable at the level of the investment fund[27]. Upon application, and subject to further requirements[28], the income of the investment fund allocable to these investors is tax-exempt at the level of the investment fund such that no effective taxation will occur.

In addition, a partial exemption is provided at the level of the investment fund in two circumstances[29]:

- The investor is a public body, in which case, the interest or shares are not part of a commercial business of the public body.
- The investor is a tax-exempt corporate body, *Versorgungswerke,* or a pension, *Pensionskassen*. In each such case, a tax exemption is available if (i) the shares are held by a foreign corporate body that is comparable to a German tax-exempt corporate body and (ii) that foreign corporate body has its place of management and statutory seat in a country that provides for administrative cooperation.

G.T.T.

Investment funds that maintain a permanent establishment in Germany are generally subject to G.T.T. as well as C.I.T. G.T.T. rates range from approximately 12% to 18%, subject to several exceptions:

- Foreign investment funds that do not maintain a permanent establishment in Germany are not subject to G.T.T.
- G.T.T. is not imposed if and to the extent the income from actively managed assets does not exceed 5% of the overall income of the investment fund[30].
- An investment fund is not subject to G.T.T. if it has a business purpose that is limited to the investment and management of assets for the joint account of the investors and the fund does not actively manage its assets, *aktive unternehmerische Bewirtschaftung,* to a material extent.

[23] Sec. 6 (2) InvStG.
[24] Sec. 7 (3) InvStG.
[25] Sec. 6 (7) InvStG.
[26] Sec. 6 (7) InvStG.
[27] Sec. 8 (1) InvStG 2018.
[28] The tax exemption is granted if the investor holds the shares in the investment fund for at least three months (Sec. 8 (4) no. 1 InvStG 2018) and meets the requirements for withholding taxes according to Sec. 36a EStG (Sec. 8 (4) no. 2 InvStG 2018). Furthermore, the investment fund must file an application for the exemption and provide certain proof with regard to the tax status of the investor and his holding period (Sec. 9 (1) InvStG 2018).
[29] Sec. 8 (2) InvStG 2018.
[30] Sec. 15 (3) InvStG 2018.

For purposes of the last exception, the InvStG 2018 does not provide guidance to determine when an investment fund actively manages its assets. Nonetheless, an administrative decree issued many years ago[31] as well as the recently published administrative decree regarding questions on the application of the InvStG 2018[32] state that, while the general principles developed by case law for distinguishing between commercial and non-commercial activities are not directly on point, an activity that is clearly non-commercial under the case law cannot be regarded as active management of assets when such activity is carried out by an investment fund. In addition, where there is a participation in a real estate company, the active management of the real estate company is not considered to be active management of assets[33].

TAXATION OF INVESTORS

General rules

German resident investors in an investment fund are subject to taxation on distributions, *Ausschüttungen,* from the investment fund, capital gains from a sale or redemption, *Gewinne aus der Veräußerung von Investmentanteilen*, of interests or shares in the investment fund, and any minimum annual advance lump-sum amount, *Vorabpauschale*. The tax rules regarding each of these taxable events are as follows:

- **Distributions**: Distributions to a German resident investor are subject to taxation in the fiscal year in which the distribution is paid to the investor, or if earlier, reported by the investor.
- **Capital gains**: Capital gains are subject to taxation in the fiscal year in which the proceeds are received or credited for the account of the investor. The capital gain is the excess of the proceeds received from the disposal over the sum of (i) the acquisition costs comprised of the amount invested and related costs and (ii) any advance lump sums that were subject to taxation during the period of ownership.
- **Advance lump sums**: Advance lump sums are taxable on the first working day following the close of a calendar year. An advance lump sum is the amount by which the distributions made by the investment fund within a calendar year fall below the annual basic income for that calendar year. The annual basic income is generally calculated by multiplying the redemption price, *Rückgabepreis,* for the interests or shares at the beginning of the calendar year by 70% and applying the base rate, *Basiszins*[34]. The amount of the basic income is limited to the amount by which the last redemption price for the calendar year exceeds the sum of (i) the redemption price at the beginning of the calendar year plus (ii) all distributions paid during the calendar year to the investor. In the year in which the interests or shares are acquired, the advance lump sum is reduced by one-twelfth for each full month preceding the month of acquisition.

For persons that are not residents of Germany, no income tax or C.I.T. liability should arise. Dividends, capital gains, and advance lump sums are regarded as capital income[35]. Such capital income derived from a fund investment is not subject to income tax or C.I.T. according to the German Income Tax Act.[36]

Partial tax exemption

Because German investment funds are taxed in Germany, the InvStG 2018 provides for certain partial tax exemptions (*Teilfreistellungen*) for investors that are subject to German tax on income received from

[31] Federal Ministry of Finance, InvStG i.d.F. des AIFM-StAnpG; hier Auslegungsfragen zu Sec. 1 Absatz 1b no. 3 InvStG, IV C 1 – S 1980-1/13/10007 :003 (3 Mar. 2015), Federal Tax Gazette I, p. 227 (2015).

[32] Federal Ministry of Finance, Investmentsteuergesetz; Anwendungsfragen zum Investmentsteuergesetz in der ab dem 1. Januar 2018 gelten-den Fassung, IV C 1 - S 1980-1/16/10010 :001 (21 May 2019), not yet offi-cially published.

[33] Sec. 15 (2) s. 2 InvStG 2018.

[34] Sec. 18 (4) InvStG.

[35] Sec. 20 (1) no. 3 EstG.

[36] Sec. 49 (1) EStG.

an investment fund. Distributions, capital gains, and advance lump sums may be partially tax-exempt depending on the investment policy of the investment fund and the tax status of the investor[37]:

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- **Income realized from equity funds**: Equity funds, *Aktienfonds,* are investment funds for which equity participations in corporations represent more than 50% of the fund value at all times throughout the year[38]. An investor in a fund that qualifies as an equity fund is entitled to a partial exemption on the income realized from the fund. The exemption is 30% in the case of an individual holding the interests or shares as a private asset, 60% in the case of an individual holding the interests or shares as a business asset, and 80% tax-exempt in the case of an investor that is subject to C.I.T.

- **Income realized from mixed funds**: Mixed funds, *Mischfonds*, are investment funds for which equity participations in corporations represent at least 25% of the fund value at all times throughout the year[39]. An investor in a fund that qualifies as a mixed fund is entitled to a partial exemption on the income realized from the fund. The exemption is allowed at one-half of the percentages applicable to an investor in an equity fund.

- **Income realized from real estate funds**: Real estate funds, *Immobilienfonds,* are investment funds for which investments in real estate or real estate companies represent more than 50% of the fund value at all times throughout the year[40]: If the investment fund qualifies as a real estate fund, a tax exemption of 60% is allowed for all investors. The tax exemption is increased to 80% if investments in foreign real estate or foreign real estate companies represent more than 50% of the fund value throughout the year[41].

For G.T.T. purposes, only one-half of the tax-exemption percentages set forth above are allowed[42]. If an investment fund fails to qualify as an equity fund, mixed fund, or real estate fund – as would be the case for a debt fund – no tax exemption is applicable.

SPECIAL INVESTMENT FUNDS

Taxation of special investment funds

In general, special investment funds are subject to the same tax regime as investment funds. Thus, special investment funds qualify as tax opaque entities and are subject to C.I.T. with respect to income[43]. Subject to certain exceptions, the tax consequences set forth above generally apply to special investment funds. The exceptions are as follows:

- No tax exemption is applicable at the investment fund level if non-profit organizations and charitable entities are investors in the investment fund.

- Special investment funds may opt for transparent taxation, frequently referred to as the transparency option, *Transparenzoption*. Income subject to German withholding tax that is derived from participations in German corporations and other German income subject to withholding at source[44] may be exempted from tax at the level of the special investment fund if the fund irrevocably declares to the payor that tax certificates should be issued to the investors rather than the special investment fund itself[45]. In such cases, the investors are

[37] Sec. 20 InvStG 2018.
[38] Sec. 2 (6) InvStG 2018.
[39] Sec. 2 (7) InvStG 2018.
[40] Sec. 2 (9) InvStG 2018.
[41] Sec. 20 (3) no. 2 InvStG 2018.
[42] Sec. 20 (5) InvStG 2018.
[43] Sec. 6 (2) InvStG 2018.
[44] Sec. 30 (5) InvStG 2018.
[45] Sec. 30 (1) InvStG 2018.

generally treated as recipients of the income that is subject to withholding tax at source[46]. No tax is collected at the level of the special investment fund. Depending on the tax status of the investor, the respective paying agent might not be obliged to withhold tax[47].

- With regard to income derived from German sources and not subject to withholding at source (*i.e.*, income derived from real estate), a tax-exemption at the level of the special investment fund is applicable if the fund withholds 15% of the respective income and pays it to the competent German tax authority[48].

TAXATION OF INVESTORS IN SPECIAL INVESTMENT FUNDS

Transparency option

At the level of the investor, the income derived from the investment in the special investment fund is generally treated as capital income, unless the income is subject to withholding at source and is directly allocated to the investor[49]. As that type of income is not subject to a limited C.I.T. liability when received by persons resident outside of Germany, generally no C.I.T. liability arises in Germany[50]. In the case of income not subject to withholding at source (*i.e.*, income derived from real estate), no German taxation would take place, as the 15% withholding tax at the fund level would be refunded to the foreign investor because no German tax liability would exist. To prevent this result, such income is re-characterised[51] as real estate income or other domestic income within the meaning of Sec. 49 (1) EStG. Income that is subject to withholding tax at source is not re-characterised. In either set of circumstances, the income of the investor is subject to a limited income tax liability in Germany.

In the context of tiered investment funds or special investment funds, income derived from German real estate or other German sources is characterised as real estate income within the meaning of Sec. 6 (4) InvStG 2018[52]. The tax exposure of at the investor level may be summarized as follows:

- Where the upper-tier fund is an investment fund and the lower-tier fund is a special investment fund, the income is subject to C.I.T. at the level of the upper-tier investment fund.
- In comparison, where the upper-tier fund is, itself, a special investment fund, the withholding obligation of the lower-tier special investment fund is suspended. In that case the upper-tier special investment fund takes on the withholding tax obligation for its investors. Those investors are thereby treated as having directly received the real estate income of the lower-tier special investment fund[53]. This real estate transparency option (*Immobilien-Transparenzoption*) has the effect of directly allocating the income of the lower-tier special investment fund to the investors in the upper-tier special investment fund. If the investor in the upper-tier special investment fund is another special investment fund, a further real estate transparency option is permitted[54].

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[46] Sec. 31 (1) s. 1 InvStG 2018.
[47] Depending on whether a tax withholding is suspended according to the provisions of Sec. 44a EStG, which, inter alia, is the case if the investor is a non-profit or charitable entity.
[48] Sec. 33 (1) InvStG 2018 in conjunction with Sec 50 InvStG 2018.
[49] Sec. 20 (1) no. 3a EstG.
[50] Sec. 49 (1) EstG.
[51] Sec. 33 (3) and (5) InvStG 2018.
[52] Sec. 33 (2) and (4) InvStG 2018.
[53] Sec. 33 (2) InvStG 2018.
[54] Sec. 33 (2) s. 4 InvStG 2018.

Without transparency option

As the income within the meaning of Sec. 6 (2) InvStG 2018 is subject to taxation at the level of the special investment fund, no re-characterisation of income occurs at the level of the investors. Thus, with respect to persons that are not German tax residents, no limited C.I.T. liability arises.

For investors who are tax resident in Germany, the income derived from the special investment fund is generally 60% tax-exempt for C.I.T. purposes insofar as the income derives from participation income[55]. If the investor is subject to C.I.T. in Germany and the special investment fund cannot claim a reduction in the withholding tax rate according to a tax treaty, the tax exemption for C.I.T.-purposes is increased to 100%[56].

The treatment of the income for G.T.T purposes is somewhat different. For G.T.T. purposes, such income is generally fully taxable except for income derived from participations in certain corporations[57].

Income derived from German real estate or other taxable German sources[58] is generally 20% tax-exempt for C.I.T. and G.T.T. purposes[59]. This tax exemption is increased to 100% for C.I.T. and G.T.T. purposes when (i) the investor is subject to corporate income tax in Germany and (ii) the special investment fund cannot claim a reduction in the withholding tax rate under a tax treaty[60]. In sum, German real estate income of a special investment fund that has not opted for transparent taxation is generally subject to tax of 15.825% at the level of the special investment fund, whereas a full tax exemption might be applicable at the level of the German investor.

CONCLUSION

The reform of investment taxation in Germany offers investors and fund providers many tax advantages. The tax burden in Germany can be greatly optimised by means of forward-looking fund structuring that takes into account the respective investors and the intended investments. In particular, the existence of two different taxation concepts offers various possibilities for optimising the position arising under German tax law. Therefore, if an investment in German assets or a sale of fund units to German investors is sought, optimisation of the fund structure from a German tax law perspective is highly recommended.

[55] Sec. 42 (4) s. 1 InvStG 2018.
[56] Sec. 42 (4) s. 2 InvStG 2018.
[57] Sec. 26 no. 6 s. 2 InvStG 2018: certain real estate companies, certain public private partnerships and cer-tain renewable energy companies.
[58] Sec. 6 (5) InvStG 2018 in conjunction with Sec. 49 (1) EstG.
[59] Sec. 42 (5) s. 1 InvStG 2018.
[60] Sec. 42 (5) s. 2 and (4) s. 2 InvStG 2018.

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