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International Tax

World Tax Advisor

8 April 2011

In this issue:

U.K. Court of Appeal rules on double tax relief and hybrid entities

In a decision issued 23 March 2011, the U.K. Court of Appeal unanimously reversed the High Court's taxpayer-favorable decision in *Bayfine v. HMRC*, a case involving the double tax relief position of a U.K. unlimited company that was a disregarded entity for U.S. tax purposes and whether U.S. tax paid by the U.S. owner of the disregarded entity could be creditable in the U.K. The decision is likely to be of broad interest to multinationals doing business in the U.K.

Facts of the case

The case involved two U.K. resident unlimited companies, Bayfine UK (BUK) and Bayfine UK Products (BUKP), which are part of the same group of companies. The immediate parent companies of both companies are U.S. corporations. BUK is classified as a disregarded entity for U.S. federal income tax purposes because it has a single shareholder, unlimited liability and did not elect under the U.S. check-the-box rules to change its entity status, meaning that because BUK and its U.S. parent company were treated as a single entity, the U.S. parent had to pay U.S. tax on BUK's profits.

BUK and BUKP entered into third-party forward contracts with a U.S. bank, which were dependent on the three-month U.S. dollar LIBOR. The contracts were designed so that one company would make a gain and the other a loss in an equal amount, with the result that, taken together, they would be in a break-even position. (The companies accepted that this was a tax scheme, without additional commercial purpose.)

BUK realized a gain on its forward contract, which it included in its taxable profits. As a result of BUK being classified as a disregarded entity, BUK's profits also were treated as profits of its U.S. parent. Therefore, the profit was also subject to U.S. federal income tax, which was paid, and BUK claimed double tax relief under both the U.K.-U.S. treaty and unilaterally against its U.K. corporation tax liability. As a result, no U.K. corporation tax was payable. The losses incurred by BUKP were treated as tax-deductible in the U.K. and used mainly to offset taxable profits in other U.K. group companies. BUKP made a check-the-box election so that it was not treated as a disregarded entity in the U.S., but as a corporation so that its losses were not treated as losses of the U.S. parent company.

Tax treaty relief from double taxation

The U.K. has over 120 tax treaties with other countries, which are intended to avoid double taxation and prevent tax avoidance.

Because the period under dispute ended on 30 November 2000, the 1975 treaty between the U.K. and U.S. applied, rather than the current (2001) treaty between the two countries. The applicability of double taxation relief under the treaty is found in article 23. However, the treaty does not address the situation in which the same profit is taxed in the hands of different persons; the problem arises because the U.K. considers the resident taxpayer to be BUK, while the U.S. treats BUK's parent company as the resident taxpayer because it disregards BUK. If the same taxpayer is a resident of both the U.K. and the U.S., the dual residence provisions of the 1975 treaty would resolve the residence issue in favor of one of the states.

For U.S. foreign tax credit purposes, the profits of BUK would be deemed to have a U.K. source. The 1975 treaty does not include any provisions addressing which country should give credit first and, therefore, the question arose as to which country should provide double tax relief.

U.K. unilateral relief from double taxation

U.K. domestic law provides unilateral relief for tax payable or paid under the law of a territory outside the U.K. if the overseas tax is charged on income or chargeable gains and corresponds to the U.K. corporation tax. It is also a requirement that the overseas tax is calculated by reference to income arising, or any chargeable gain accruing, in the overseas territory. Therefore, to determine whether double tax relief was available under U.K. domestic tax legislation, it was necessary to determine the source of the profit. Relief would only be available if the profit had a U.S. source.

The taxpayer's position was that the profit did have a U.S. source under principles established in U.K. case law. The relevant forward contract was executed in the U.S., was partially negotiated there, the counterparty was a U.S. corporation acting out of its U.S. office, the contract related to assets situated in the U.S. and was governed by U.S. law.

The U.K. tax authorities' view was that, since the profit was computed by the relatively mechanical calculations set out in the U.K. tax legislation for forward contracts, this legislation determined its source, i.e. it was U.K. source.

Court of Appeal decision

The Special Commissioners (the lowest level of independent tax tribunal) first considered the Bayfine case and took a "common sense" approach by concluding that no double tax relief was available in the U.K., either under the U.K.'s unilateral relief provisions or under the treaty, because the profits were U.K. source. On appeal, the High Court decided in favor of Bayfine, and ruled that the profits in question were U.S. source, which gave the U.S. primary taxing rights and so the U.K. should provide credit for the U.S. tax.

The Court of Appeal has now reversed the High Court's decision, concluding that the 1975 treaty must be construed "purposively." Specifically, the basic mechanics of the treaty allocated the profits to the U.K. as business profits under article 7, while article 1(3) ("savings clause") allowed the U.S. to override the treaty and charge tax in respect of the same profits. The Court of Appeal interpreted this interplay of provisions to mean that it was incumbent upon the U.S. to allow credit for the U.K. tax, thus making unilateral relief in the U.K. unavailable. The Court added that unilateral relief could be available in situations in which there is no treaty provision or where the provision is inadequate or deficient to give the taxpayer relief from double taxation.

Conclusion

The classification of overseas companies as disregarded entities has been a feature of the U.S. tax code for a number of years. However, this is the first U.K. case that has considered the double tax relief position for such entities (and the position would be the same under the current treaty between the U.K. and the U.S.). For many, the reversal of the High Court's decision will not be surprising, but the detailed technical analysis that the courts needed to consider highlights the complexity of the issue. The decision will apply not only to a tax scheme, as here, but also in other commercial cases.

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Australia:
Tax consolidation and rights to future income rules under review

The Australian government announced on 30 March 2011 that the Board of Taxation will review the consolidation rights to future income (RTFI) and residual tax cost setting rules (Rules) because of concerns about the potential scope of the measures and their impact on revenue.

First introduced in 2010 (but with retroactive effect), the Rules apply in the context of a 100% acquisition of an Australian company that has an RTFI asset and that joins an Australian tax consolidated group. In relevant circumstances, the Rules will permit the tax consolidated group to claim a tax deduction over time for certain contractual rights and other intangible assets, i.e. if an entity that joins a consolidated group holds an asset that is a right to future income, the tax cost allocated to the asset is deductible over the life of the relevant contract or 10 years (whichever is shorter). This can provide a significant tax opportunity in the context of Australian merger and acquisition activities.

Uncertainty relating to the operation of the Rules has led the government to initiate a review of their scope. Specifically, the government is concerned that tax deductibility may be claimed for types of assets that were not contemplated when the Rules were introduced. This could result in the Rules having a substantially greater revenue impact than anticipated.

The Board of Taxation will examine the operation of the Rules with a view to clarifying and limiting their scope (the latter, if necessary), and advise on the date of effect of proposed changes (including whether they should apply on a retroactive basis). In undertaking the review, the Board will consider the following:

- The taxation outcome when assets of the type that are covered by the Rules are acquired directly by a company as part of a business acquisition outside of the consolidation regime;
- Whether there are any circumstances in which such outcomes should be different if the assets are held by a company that joins a consolidated group;
- If a difference in tax outcome is warranted, the appropriate basis for recognizing the tax costs of any assets that should be treated differently on entry into a consolidated group; and
- The revenue impact of any proposed changes to the Rules.

The Board has invited comments on the Rules and will report to the Assistant Treasurer by 31 May 2011, before completing its post-implementation review of aspects of the consolidation regime.

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Canada:
Tax effects of dissolution of Parliament

The 2011 Canadian federal budget, presented by the minority Conservative government in the House of Commons on 22 March 2011, included a projected deficit of CAD 40.5 billion and projected the federal debt-to-GDP ratio to be just over 34%. There were no tax increases contained in the budget, nor any changes to previously planned corporate tax rate reductions. However, the budget proposed some notable changes that included preventing the deferral of tax by the use of partnerships and eliminating the ability to avoid capital gains tax when flow-through shares are donated to a charity. No changes were proposed for the Scientific Research and Experimental Development tax credit system, although there had been hope that the program would be expanded.

The minority government was defeated in a non-confidence vote on 25 March 2011, setting the stage for the dissolution of Parliament and a federal election on 2 May 2011. As a consequence of Parliament being dissolved, the legislative proposals tabled in the 2011 budget died. However, budget proposals that only require amendments to the regulations may move forward.

The corporate income tax rate reductions, as well as other legislative measures that were announced in a previous budget and received Royal Assent are unaffected by the dissolution of Parliament. As a result, the federal corporate income tax rate became 16.5% effective 1 January 2011, and will decrease to 15% as from 1 January 2012. The various provincial corporate income tax rate reductions that will take effect over the next few years also are unaffected by the dissolution of Parliament.

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Germany:
Government to request annulment of Commission decision on financial restructuring exception

The government recently announced that it intends to file an application to the European Court of First Instance (CFI) for an action to annul the European Commission's 26 January 2011 decision that the financial restructuring exception in German tax law constitutes incompatible state aid.

Under the change-in-ownership rules applicable as from 1 January 2008, a direct or indirect share transfer of more than 25% (and up to 50%) of the shares in a company that has loss carryforwards results in a pro rata (or full) forfeiture of those carryforwards. The financial restructuring exception, which allows ailing companies to keep their loss carryforwards even if there is a harmful change in ownership, was introduced in mid-2009, without being notified to the Commission. Accordingly, the measure was considered unlawful aid and the Commission has ordered Germany to recover all aid granted under the financial restructuring exception since it came into effect.

The German government, however, has maintained the position that the financial restructuring exception does not confer a selective advantage and thus does not constitute state aid. If the government is successful in its application, the exception could again apply to fiscal years 2008-2010. However, until the CFI issues a final decision, all tax advantages granted under the financial restructuring exception have to be recovered because the annulment action does not suspend the effect of the European Commission's decision. The Federal Ministry of Finance has announced that it is preparing guidance that will clarify how the advantages will be recovered under German procedural rules.

Taxpayers that have made use of the financial restructuring exception should carefully analyze their situations to ensure they will be able to benefit from a potentially successful outcome of the action for annulment. Taxpayers will not be able to present arguments in the case because companies and similar parties do not have the right to intervene in such proceedings even if they can establish an interest in the results of the case. However, any company that is directly and individually affected by the decision of the Commission, e.g. because the company made use of the financial restructuring exception in the past, should have the right to bring an action for annulment before the CFI. A careful analysis is necessary, however, to determine whether this action would be sensible.

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Honduras:
Overview of 2010 tax law changes

The Income Strengthening, Social Equity and Public Expense Rationalization Law, which came into effect on 22 May 2010, made changes to direct and indirect taxes in Honduras. Key among the amendments are extensive changes to the withholding tax rates applicable to payments of Honduran source-income made to nonresident companies and individuals.

A 10% withholding tax has been introduced on dividends and profits shares paid to resident individuals (but not domestic legal entities) and to foreign individuals and foreign business entities (including corporations), and on remittances of profits by a Honduran entity or branch to its foreign head office. Now that dividends are subject to tax, payments related to resident individual shareholder loans may be deemed to be dividends if certain criteria are met.

In addition, the withholding tax rate on the following income has been changed to 10%:

- Royalties or other amounts payable for the use of patents, trademarks, copyrights, know-how, designs and procedures, etc., as reduced from 25% (the rate on royalties from the operation of mines, quarries or other natural resources already was 10%);
- Earnings from movable or immovable assets (other than dividends or profit distributions), as reduced from 30%;
- Wages, salaries, commissions and other remuneration for services rendered inside or outside Honduras, as reduced from 35%;
- Interest on commercial transactions, bonds and securities, as increased from 5%;
- Income from public entertainment, as reduced from 30% (the rate on movies and video tapes for movie theatres, TV and cable TV fees already was 10%);
- Income from operations carried out by telecommunication companies, as increased from 5%;
- Income from insurance premiums and guarantees, as reduced from 15%; and
- Other income, as reduced from 20%.

Other changes introduced by the law include:

Social contribution tax – The rate of the temporary social contribution tax payable by taxpayers whose net income exceeds HNL 1 million is increased to 10% for fiscal years 2010 and 2011, but will progressively decrease to 0% by 2015. The social contribution tax is levied as a surtax on the income tax.

Income tax withholding – A new tax liability was created for entities or individuals with annual sales over HNL 15 million – a 1% tax must be withheld on payments made to suppliers that are not required to make income tax installment payments. The withholding tax is considered a payment on account of the seller's (supplier's) income tax or net assets tax liability (whichever is higher at the end of the relevant fiscal year). The withholding tax is levied on purchases of goods, with the taxable base being the gross sale price less returns and discounts. The buyer must remit the withholding tax to the tax authorities on a monthly basis.

Asset revaluation tax – The 6% asset revaluation tax was reinstituted. The tax applies to revaluations of assets made by individuals or entities engaged in commercial activities and the production of goods or rendering of services. For purposes of calculating the tax, the 6% rate is applied to the taxable base, which is the difference between the value of the assets on revaluation and the book (depreciated) value of the assets on the date on which the revaluation is carried out. The asset valuation tax is not creditable against income tax or other tax payable. Individuals and entities that revalued their assets during FY 2010 and paid the reinstituted asset valuation tax on the FY 2010 revaluation will not have to pay net assets tax in FY 2011.

Tourism incentives – The Tourism Incentives Law has been amended to provide:

- A non-extendable 15-year income tax exemption for new projects (the exemption does not apply to the expansion or remodeling of buildings, changes in ownership or changes to the commercial, business or corporate name);
- A one-time exemption from customs duties and taxes on the import of goods and new equipment necessary for the construction and commencement of specified types of activities;
- A 15-year exemption from taxes and duties on the import of printed material for the promotion or advertising of new projects or of Honduras as a tourist destination; and
- A 10-year exemption from custom taxes and duties on the import of parts for the repair of property and equipment.

Entities and individuals whose business or capital is directly connected with tourism and the provision of the designated travel-related amenities and services can benefit from the incentives.

Conclusion

The reduction in the withholding tax rates and attractive tourism-related incentives should be considered in any restructuring of companies with investments in Honduras. At the same time, however, the new withholding tax on dividends and profit shares cannot be ignored.

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Norway:
Court rules commissionaire constitutes agency PE

A Norwegian Court of Appeal ruled on 2 March 2011 that Dell AS, a Norwegian commissionaire company, constituted a permanent establishment (PE) in Norway for its undisclosed Irish principal, with the result that part of the profits of the Irish company are taxable in Norway.

Facts of the case

Dell AS was established as a commissionaire company to market and sell Dell products in the Norwegian market. Under an arrangement with Dell AS's Irish resident principal company, Dell Products Ltd., Dell AS would sell products in its own name, but for the risk and account of the Irish principal. Dell AS received a commission on its sales. The Norwegian tax authorities took the position that Dell AS was a PE of Dell Products Ltd. under article 5(5) of the Norway-Ireland tax treaty and, hence, that a significant proportion of the Norwegian-source profits of the Irish entity should be subject to Norwegian tax, rather than just the commission fee received by Dell AS.

Ruling of the court

The Court of Appeal agreed with the tax authorities on both the agency PE issue and the allocation of profits.

PE issue The main issue before the Court of Appeals was whether Dell AS was a PE of Dell Products Ltd. under article 5 of the Norway-Ireland tax treaty, specifically whether the agency PE rule applied. To be a PE of Dell Products Ltd., Dell AS had to be dependent and have and habitually exercise in Norway an authority to conclude contracts in the name of Dell Products Ltd.

The dependent status was disputed, but the Court of Appeal ruled that the parties were clearly related. Hence, the case focused on whether Dell AS had the authority to conclude contracts in the name of Dell Products Ltd.

Dell AS argued that it did not have such authority because it was a legally separate entity concluding contracts in its own name that were not binding on Dell Products Ltd. The tax authorities argued that Dell AS committed Dell Products Ltd. to the contracts that it had entered into.

The Court adopted a substance-over-form approach in concluding that Dell AS in fact was able to conclude contracts in the name of Dell Products Ltd. In particular, the Court emphasized the following factors in reaching its conclusion that Dell AS was a PE of Dell Products Ltd. in Norway:

- All sales were made under the Dell trademark, so it was impossible for customers to determine whether the sale was made by Dell AS or Dell Products Ltd.;
- The sales were made on standard terms provided by Dell Products Ltd. Although sales on other terms required advance approval from Dell Products Ltd., in practice, non-standard contracts were not reviewed by Dell Products Ltd., but were simply accepted;
- Dell AS was not able to point to any instance where Dell Products Ltd. had not approved a contract drafted by Dell AS; and
- Even if Dell AS were to exceed its authority under the commissionaire structure, Dell Products Ltd. would not refuse to deliver Dell products to the customers of Dell AS.

Allocation of profits   The Court of Appeal accepted the functional analysis prepared by the Norwegian tax authorities, which emphasized Dell AS's dominant part in the value chain and the limited functions and risks of Dell Products Ltd. This analysis resulted in the allocation of 60% of the Norwegian-source profits of Dell Products Ltd. to the PE, in addition to Dell AS's existing taxable profits.

Consequences of decision

Notwithstanding the fact that Dell AS likely will appeal the decision to the Norwegian Supreme Court, there are several noteworthy aspects of the ruling.

First, and somewhat surprisingly, the Court of Appeal gave little weight to the 2010 decision of the French Supreme Court in the *Zimmer Ltd.* case, a case involving a similar commissionaire structure. Overruling the decisions of lower French courts, the Supreme Court held that, under French law, a company that acts under a commissionaire structure cannot be regarded as a dependent agent with authority to bind its foreign principal and, therefore, cannot create a PE of the principal in France, regardless of the fact that the commissionaire is dependent on the principal. There had been some expectation in the international tax community that the Zimmer decision would provide more certainty on the PE risk of (at least European) commissionaire structures, but that hope remains unfulfilled.

Second, the Dell commissionaire structure is typical of the way such companies are established in Norway. Should the case ultimately be decided in favor of the Norwegian tax authorities, the tax effectiveness of such structures likely would be reduced significantly, unless it is possible to sufficiently distinguish the facts from those in the Dell case.

Finally, although the 60/40 attribution of profits was based on the specific functional analysis of the case, it gives an indication of the ratio the Norwegian tax authorities can attempt to apply. It is also notable that the Court of Appeal accepted the functional analysis prepared by the Norwegian tax authorities with little or no examination of its accuracy or appropriateness.

The main consequence of the decision is to create uncertainty as to the viability of conventional commissionaire structures in Norway. Groups that have such structures, or that are considering implementing them, should be aware of the potential risk and review the potential application of the Dell decision to their fact pattern. Transactions involving companies in commissionaire structures also should be properly documented, including a detailed functional analysis, to enable the allocation of profits to Norway to be minimized in the event of a successful PE attack by the Norwegian tax authorities.

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In brief

Latvia – Latvia has introduced the requirement that a nonresident must appoint a tax representative for VAT purposes. The tax representative will be responsible for paying VAT on behalf of the nonresident and for fulfilling administrative obligations relating to: the import of goods followed by an intra-Community or domestic supply; the receipt of goods in Latvia and storage of the goods in a warehouse for subsequent export; and the intra-Community acquisition of goods in Latvia and storage of the goods in a warehouse for eventual export.

Slovenia – As from 1 January 2011, companies established outside the EU and doing business in Slovenia are required to appoint a fiscal representative in Slovenia for VAT purposes. The fiscal representative requirement is applicable to companies registering for VAT in Slovenia after 1 January, as well as to companies that were registered when the law went into effect. The fiscal representative can be a legal person or an individual but must have a registered office or permanent residence in Slovenia, carry out business transactions in the country and be registered for VAT purposes in Slovenia. However, a branch office may not act as a fiscal representative.

United States The Treasury Department and Internal Revenue Service released final regulations on 6 April 2011, providing guidance on the 2004 legislative reduction in the number of separate foreign tax credit limitation categories from eight to two for taxable years beginning after 2006. Modifying temporary and proposed regulations issued in December 2007, the final regulations further clarify: rules on losses in and with respect to the pre-2007 basket for high withholding tax interest; rules on controlled foreign corporation (CFC) recapture accounts; the use of safe harbors to be applied in lieu of general rules; and gains from the sale of a partnership interest (applying the look-through rule for sales by any 25% owner, rather than only CFC owners).

Vietnam The Ministry of Finance issued guidance on 28 March 2011 for invoices generated from accounting/sales software. The guidance provides that multinational companies using accounting/sales software integrated with their group's worldwide systems, as well as enterprises, banks and credit institutions using accounting software purchased in Vietnam or from overseas, may issue invoices with a comma (,) as the thousands separator, a decimal point as the decimal separator and Vietnamese text without accents if their accounting software uses such conventions and would be technically difficult to modify. However, the amount of total payment must be represented in words, with no ambiguity or misinterpretation caused by the use of unaccented Vietnamese text; and enterprises must register with local tax authorities and be fully responsible for the accuracy of the invoices they issue.

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Luxembourg
Tax credit extended to qualifying investments in EEA countries
The tax authorities have issued a circular that extends the benefits of the investment tax credit to qualifying investments that are physically used in a country in the EEA. [Issued: 1 April 2011]
URL: http://www.deloitte.com/view/en_GX/global/services/tax/6701f9104e01f210VgnVCM3000001c56f00aRCRD.htm?id=us_email_Tax_WTA_040811
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