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Articles

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Planning Perspective

International Tax Issues to be Considered when Structuring Acquisitions of Intellectual Property

By Mathew Oliver and Ingrid Toth (Bird & Bird)

This article looks at the international tax issues arising when structuring an acquisition of IP.

Broadly speaking, the issues that need to be considered include:

- How can one invest in the IP without giving rise to a material tax charge in the seller or the IP holding entity?
- How can the effective tax rate of the IP holding entity and/or investor be minimized?
- How can taxes be minimized on exit?

Each issue must take into account the myriad of taxes applicable to the relevant jurisdictions such as capital gains taxes, corporate income taxes, stamp duties, transfer taxes, capital duties, withholding taxes and sales taxes (e.g., VAT).

All of these considerations are inter-related and there is no "one size fits all" structure. Rather, the actual structure used is, in practice, a result of careful tax planning (having regard to the above issues), commercial practicalities and bargaining strength.

Type of Acquisition Vehicle—Taxable vs. Non-Taxable Entity

The type of entity to hold the intellectual property (IP) will be a relevant consideration regardless of whether the IP itself is acquired or shares in an IP holding company (or other interests in an IP holding entity) are acquired. This entity will be subject to:

- profits tax in that entity;
- withholding taxes on payments by that entity; and
- withholding taxes on royalty payments to that entity.

Therefore, tax planning will involve considering which entity would be effective in reducing profits tax and withholding tax, thereby assisting to lower the effective rate.

This entity could either be:

- an entity subject to tax (taxable entity) such as a company incorporated in the UK; or
- an entity not subject to tax (non-taxable entity) such as a company incorporated in a tax haven.

If a taxable entity is required it may be possible to make it resident in a territory with a preferential regime for holding IP (e.g., Luxembourg, Belgium, The Netherlands, Cyprus or Ireland) (IP holding regime).

The flow chart on page 14 could assist in determining whether to use a taxable or a non-taxable entity.

Asking whether a tax advantage exists in holding the IP in a taxable entity (second question) might seem like an unusual question. However, since tax havens do not tend to have decent tax treaty networks, withholding taxes may dictate having a taxable entity in the structure (and therefore access to a tax treaty network). The availability of certain tax advantages could nevertheless result in a competitive effective tax rate. Such advantages include:

- low corporate tax rate on royalty income;
- availability of reliefs—the "taxable" jurisdiction may offer attractive reliefs for holding IP or undertaking research and development activities. For example, in Belgium and Luxembourg a partial exemption of royalty income, in the UK amortization of purchased IP and, in the UK and France, the availability of research and development tax credits;
- benefits to investing shareholders—there may be tax (or commercial) advantages arising to an investor in that jurisdiction;
- availability of a double tax treaty or an EU Directive—withholding taxes in the country of source of the IP may arise that could be eliminated through suitable double tax treaties. Double tax treaties are only likely to be available in a taxable territory. The EU's Interest and Royalty Directive (applicable to payments between EU Member States) would also reduce withholding taxes on royalties to nil; and
- commercial practicalities—the relevant people developing the IP are based in a taxable jurisdiction making the IP profits subject to tax there in any event. However, it may be possible to hold IP in one jurisdiction while the company's research and development center is located in another, and still

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VAT in Relation to Holding Companies

By Martijn Kouffeld (Greenberg Traurig, LLP)

Pure holding companies are not considered to be entrepreneurs for VAT purposes. In many cases, however, a holding company has some VAT relevant activities, such as the management of its subsidiaries or granting interest-bearing loans. Especially when these activities are combined, the issue arises of whether or not the holding company is entitled to refunds of the input VAT and, if so, to what extent. In a recent case, a lower court in the Netherlands decided that the interest generated by the loans must be be taken into account to determine the right to deduct the input VAT.

Entrepreneurs for VAT Purposes

A mere holding company is not an entrepreneur for VAT purposes as it does not generate any turnover. Dividends are not considered to be the remuneration for any activity, but follow from the ownership of the shares. As a result, a pure holding company cannot deduct the input VAT. Any VAT charged to it or due because of the reverse charge mechanism is a cost.

If a holding company also grants interest-bearing loans, it becomes an entrepreneur, provided that the magnitude loans is not negligible. When it becomes an entrepreneur, it is, in principle, entitled to deduct the input VAT. The granting of loans is a VAT exempt activity, which eliminates this right except when the loans are granted to a party established outside the EU. In this case, the service is still VAT exempt, but the company is nevertheless entitled to deduct the input VAT.

Another activity often seen is that the holding company is also managing its subsidiaries. Where a fee is charged for management, the company will be an entrepreneur. As management is a VAT taxable activity, the company will be entitled to deduct the input VAT. When a holding company performs both activities, the question of how to determine the right to deduct the input VAT arises.

Calculation of Pro Rata Right to Deduct the Input VAT

If a company performs both VAT taxable and VAT exempt activities, a calculation must be made for the deductible input VAT. The input VAT attributable to the VAT taxable activity is fully deductible, while the input VAT attributable to the VAT exempt activity is not deductible at all. The input VAT that is not specifically related to any activity is pro rata deductible. The pro rata right to deduct the input VAT is calculated as follows: total VAT taxable turnover divided by the total turnover. The percentage may be rounded up to the next whole digit.

The input VAT attributable to the VAT taxable activity is fully deductible, while the input VAT attributable to the VAT exempt activity is not deductible at all.

The turnover (interest) generated with loans is not taken into account when that activity is subordinate to the other activities. According to case law of the European Court of Justice (ECJ), subordinate means that the activity is not too costly to perform. Nevertheless, in a recent case, the Court of The Hague ruled that the interest had to be taken into account to calculate the pro rata, because the company was not able to prove that it used its expenditures for the VAT taxable activity. This conclusion seems odd when compared to the guideline provided by the ECJ. Perhaps an appeal against this decision will produce another result.

Conclusion

Companies that are merely holding companies do not have the right to deduct the input VAT. If such a company does perform other activities, it may become an entrepreneur and subsequently be entitled to a right to deduct input VAT, depending on the nature of its activities. Especially when both VAT taxable and VAT exempt activities are performed, the calculation of the right to deduct the input VAT may be difficult. ❑

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EU Cross-Border Merger Directive and "SEVIC" — Implications for Corporate Restructurings in Europe

—Effects of Local Tax Regimes on Transactions

By Robert Alan Heym and Constantin Conrads (Reed Smith LLP)

Introduction

There are numerous reasons to initiate corporate restructuring activities and once started, such activities appear to be an ongoing process that never ends. For example, restructuring activities driven only by business reasons only will often impose legal and in particular tax risks. Restructuring activities are often also driven by M&A activities as post-closing restructuring activities by the purchaser and/or pre-closing restructuring activities by the vendor. The increasing number of changes in tax legislation internationally questions previous restructuring activities and will often give cause to rethink previous decisions or initiate, from a strategic perspective, new restructuring activities.

From a purely business perspective, the restructuring of business operations often appears as a simple operative process with clear objectives and responsibilities. However, cross-border restructuring activities are restricted in various ways because they often involve the coordination of the tax and legal regimes of several jurisdictions that are usually not adapted to each other. Once these issues and associated risks are taken into account, the desire to restructure activities can wane.

EU legislation eases cross-border restructuring activities. On October 26, 2005, the EU Parliament and the EU Council passed the EU Directive regarding cross-border mergers of corporations (EU Directive 2005/56/EG) which became effective on December 15, 2005 (EU Merger Directive). The EU Merger Directive required all member states of the EU to adapt the directive to their national legislation by December 2007. As is often the case, some member states have yet to adopt the EU merger directive into their national laws.

The EU Merger Directive was implemented into German law by the Second Act on Amendments to the German Reorganization Act (*Zweites Gesetz zur Änderung des Umwandlungsgesetzes*) on April 25, 2007. Employee participation is stipulated in the Act on the Co-determination of Employees in Connection with a Cross-border Merger (*Gesetz über die Mitbestimmung der Arbeitnehmer bei grenzüberschreitenden Verschmelzungen—MgVG*) as of December 29, 2006. Tax matters in connection with cross-border mergers have already been addressed by the Act on Tax Measures regarding the Introduction of the European Stock Corporation (SEStEG), which went into force on December 13, 2006.

Almost simultaneously with the enactment of the EU Merger Directive, the European Court of Justice (ECJ) issued the "SEVIC" decision in December 2005. The decision made cross-border mergers possible by linking the admissibility of cross-border mergers to the freedom of establishment under Article 43 of the EU Treaty.

The EU Directives of July 23, 1990 and February 17, 2005, already implemented in France, provide for tax neutrality of cross-border mergers.

Restructuring Possibilities Prior to Implementation of the EU Merger Directive into National Law

Germany

The usual legal "tools" applied in connection with group-internal corporate restructurings under German law are the following:

- a transfer of shares and/or assets within the group in exchange for claims (e.g., sale) or shares (e.g., contribution);
- a contractual combination of affiliated companies, e.g., by profit and loss pooling agreements;
- corporate restructuring activities under the German Transformation Act (*Umwandlungsgesetz*).

According to the German Transformation Act, there are several possibilities to combine, split or to transform legal entities. A combination of legal entities is carried out by a so-called merger (*Verschmelzung*) whereby one entity transfers all its assets to another entity, which assumes all rights and obligations of the transferring entity. One important aspect of a merger, according to the German Transformation Act, is that the surviving entity is the universal legal successor of the transferring entity. In addition thereto, the merger can be conducted

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Merger Directive *(from page 4)*

at book value and as such will be in principal, from a tax perspective, tax neutral without creating a taxable merger gain.

Until recently, a merger under the provisions of the German Transformation Act could only be carried out with those legal entities that were explicitly listed in this act. According to the prevailing opinion in Germany, cross-border mergers were not covered by the German Transformation Act prior to the adoption of the EU Merger Directive into German law because the act only listed legal entities incorporated under German law. Consequently, a cross-border merger between a German legal entity and a legal entity of another jurisdiction was not possible.

From a commercial perspective, a result similar to a merger under the German Transformation Act can be achieved by contractual agreements, e.g., an asset assignment and transfer agreement with subsequent liquidation of the transferring company, but there are two major drawbacks:

Cross-border restructuring activities are problematic because they often involve the tax and legal regimes of several jurisdictions that are usually not adapted to each other.

- First, an asset assignment and transfer agreement does not result in one company being the universal legal successor of the other company. This is important in case assets are transferred where third parties are involved, e.g., customer contracts. According to German law, such contracts will not be transferred without the third party's consent. Therefore, all third parties would have to be contacted, to be explicitly informed and would have to agree to the transfer of the contracts.
- Second, the asset assignment and transfer agreement will often trigger adverse tax consequences because the transaction cannot be made at book value, but has to be made (at arm's length principles) at market value. Hidden reserves—which are supported to a certain degree by German GAAP—would therefore have to be disclosed and be subject to taxation. In a cross-border merger situation, the German Financial Authorities have some means to prevent such a transaction because it could factually financially punish the German company that intends to move its assets outside of Germany by treating this as an adverse realization of hidden reserves.

For these reasons, cross-border mergers have not been common in Germany.

United Kingdom

Save for the new EU Merger process described below, there are no comprehensive provisions under UK company law relating to mergers. In particular, there is no concept of a "legal merger," in which one entity disappears. The usual process in the UK is to begin with a share acquisition in order to bring the acquired company within the same group as the acquiring company. This may then be followed by a transfer of business or assets between companies within a 100 percent owned group in order to avoid many of the company law and taxation complexities otherwise arising. Therefore, the most commonly used restructuring and acquisition structures in the UK are a transfer of either the shares of the target company or a transfer of the assets or business of a company.

It is possible to structure a share acquisition as a "takeover offer." This is much more common for public company acquisitions but is sometimes also used for private companies especially if there is a larger number of target company shareholders and/or if less than 100 percent of the target company's shareholders are willing to sell on the same terms. The English Companies Act 1985 enables a buyer who has made an offer to acquire all the shares of a particular class or classes (or all the shares of a company that has only one class) that has been accepted by the holders of 90 percent of each class to which the offer relates to "squeeze out" the minority on the terms accepted by the majority.

Another possible structure is a "scheme of arrangement" under which (among other possibilities) a target company's existing shares can be cancelled and replaced by new shares issued to the buyer either in exchange for a cash consideration to the target company's shareholders or the issue of debt or equity securities of the buyer to the target company's shareholders. Among other things, this requires the target company shareholders' approval in the form of a 75 percent majority vote (and similar majorities at separate class meetings if applicable) and the approval of the Court. A scheme of arrangement is relatively rare but might typically be used if less than 90 percent (therefore meaning that the squeeze out procedure described above cannot be used) of the shareholders are willing to sell on the same terms.

France

Corporate restructurings are regulated by the French Commercial Code. According to French law, there are several possibilities to combine or split companies:

- first, a merger entails that two or more entities become one single entity. Mergers are created in two situations: either a new company is created that absorbs one or several existing companies, or one company absorbs another, which is the most common scenario;
- another way of restructuring is a split-off. A split-off enables the company to split its various business activities that are simultaneously transferred to

Merger Directive, continued on page 6

Merger Directive *(from page 5)*

existing or new companies.

The main legal consequences of mergers and split-offs are:

- the transfer of all of the absorbed company's assets and liabilities in exchange for shares in the absorbing company;
- the dissolution of the company that is absorbed or split off.

A corporate restructuring can also be carried out by way of a partial split-off (known as *apport partiel d'actif*): a company contributes to another company part of its assets and liabilities and receives, in exchange, shares issued by the beneficiary company. The company will either keep such shares in its own balance sheet, or distribute them to its shareholders.

This type of contribution allows for the transfer of one or several lines of business to a subsidiary resulting in legal, accounting and tax autonomy. It also allows for cooperation among several companies when creating a joint venture.

From a corporate income tax and registration tax standpoint, mergers, split-offs and partial split-offs are neutral.

European Legislative Action

Overview

On the level of the EU, the possibility of cross-border mergers was already included as a task in the European Community Treaty (Article 293) but member states could not agree on a joint approach, in particular because issues of employee co-determination could not be resolved.

Eventually, after employee co-determination issues had been resolved, the European Community issued an order on the introduction of the European Stock Corporation (*Societas Europea*—SE) in 2003 and issued the EU Merger Directive in December 2005.

European Stock Corporation

Companies with registered offices in the EU have another option with regard to the choice of legal form since the end of 2004: the European Stock Corporation (SE). The introduction of the SE by the EU in 2004 allowed—to some extent—cross-border mergers within the EU since stock corporations of different EU member states could execute cross-border mergers in order to incorporate a SE.

Merger Directive, continued on page 7

Merger Directive *(from page 6)*

One advantage is that this does not require a unanimous approval of the shareholders, but only a two-third majority. However, the cross-border merger is only feasible in connection with the incorporation process of the SE and cannot be done separately. Furthermore, this option is only available for stock corporations.

EU Merger Directive

On October 26, 2005, the EU Parliament and the EU Council passed the EU Directive regarding cross-border mergers of corporations (EU Directive 2005/56/EG) which became effective on December 15, 2005. As a directive, it had no immediate legal effect, but required member states of the EU to implement the content of the directive into their national law by December 2007 at the latest (see Art. 19 of the EU Merger Directive).

The EU Merger Directive intends to allow for the merger of corporations that were established pursuant to the laws of an EU member state and that have their registered office, their administrative office or their principal place of business in the European Community. As possible merger alternatives, the EU Merger Directive refers to a merger by way of absorption (*Verschmelzung durch Aufnahme*), a merger by way of incorporation (*Verschmelzung durch Neugründung*), and intra-group mergers (*Konzernverschmelzung*) as feasible cross-border merger alternatives. The EU Merger Directive does not permit cross-border demergers (*Spaltung*) and cross-border changes of the legal form (*Formwechsel*).

Employee Co-Determination

Employee co-determination was a major point of discussion during the legislative procedure of the EU Merger Directive as this issue is treated very differently in EU member states. According to the EU Merger Directive, employee co-determination applies in cross-border mergers if at least one of the participating companies is subject to employee co-determination. According to the Directive, the form of co-determination in the new company shall in principle be a matter of negotiation.

Implementation of the EU Merger Directive

EU directives address the EU member states that are required to implement the regulations as provided in the directive. They do not have direct impact in principle.

Germany

In Germany, the EU Merger Directive was implemented by respective amendments to the German Transformation Act. The German Department of Justice issued the first draft of the bill (*Referentenentwurf*) amending the German Transformation Act on February 13, 2006. The German Bundestag debated the amendments of the German Transformation Act in a first and second reading on February 1, 2007. Finally, the amendments of the German Transformation Act became effective on April 25, 2007.

Only corporations can participate in a cross-border merger. The respective legal entities in Germany are the limited liability company (*GmbH*), the stock corporation (*AG*), the association limited by shares (*KGaA*) and also the SE with its registered office in Germany. The new legislation is not applicable to partnerships.

The part of the EU Merger Directive treating the issue of co-determination was implemented into German law by an own "corollary act" to the amendments of the German Transformation Act which is the Act on the Co-determination of Employees in Connection with a Cross-border Merger (*Gesetz über die Mitbestimmung der Arbeitnehmer bei grenzüberschreitenden Verschmelzungen—MgVG*). This act already became effective on December 29, 2006. According to the MgVG, employers and a "negotiation committee" to be constituted by employees shall primarily decide amicably on the terms and scope of the employee co-determination that shall apply after the merger. These negotiations may take six months with a possibility to extend this term by another six months. In the event that an amicable decision cannot be achieved, those employee co-determination rules applicable to the participating company will apply that are most stringent. The parties may also decide that the most stringent rules apply without any prior negotiations.

EU legislation eases some of the concerns over cross-border restructuring activities.

As regards tax matters in connection with cross-border mergers, one of the disadvantages of cross-border mergers (if feasible at all) was the realization of hidden reserves. The new taxation provisions for cross-border mergers, stipulated in the SEStEG (see above), now provide that under certain preconditions, the book value can be taken in the final tax balance sheet. Thus, a realization of hidden reserves is no longer necessary.

United Kingdom

The Companies Cross-Border Mergers Regulations came into force in the UK on December 15, 2007, thereby implementing the EU Merger Directive (UK Merger Regulations). For the UK Merger Regulations to apply, a merger must involve at least one company that is incorporated in the UK (a UK company) and one incorporated in a different EEA state.

The UK Merger Regulations lay down a standard procedure that must be followed by every UK company

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Merger Directive *(from page 7)*

involved in a cross-border merger. Briefly, the UK Merger Regulations require a UK company to prepare and allow its shareholders and employees or their representatives to inspect draft terms of the merger and reports by the company's directors and independent auditors. Application is then made to the High Court for an order that such meetings of the company's shareholders and creditors (or different classes of shareholders and creditors) be held as the court determines. At any such meetings, the draft terms of the merger must be approved by a majority in number, representing 75 percent in value, of the relevant shareholders or creditors. Once these formalities have been completed, the company can apply to the High Court for a pre-merger certificate.

The asset assignment and transfer agreement will often trigger adverse tax consequences because the transaction cannot be made at book value.

The UK Merger Regulations include, as is required by the EU Merger Directive, provisions protecting employee participation rights. This is likely to be a significant consideration for any UK company considering such a merger as employee participation rights generally do not exist in the UK and a merger by way of the UK Merger Regulations could require the UK company to introduce employee participation rights.

France

In France, the EU Merger Directive was implemented by the July 3, 2008 Act, applicable to cross-border mergers between companies incorporated in two different EU member states.

From a corporate standpoint, the new law provides for a limited number of rules specifically applicable to cross-border mergers and generally refers to provisions already governing mergers between two French companies. Most of the local mergers rules were indeed very close to the provisions of the EU Merger Directive. As a result, a two-third voting majority is now required in France to approve any kind of merger, provided only EU-located companies are involved.

One good example of a rule specific to cross-border mergers consists in the possibility for the absorbing company to pay in cash an amount exceeding 10 percent of the par value of the new shares allocated to the shareholders of the absorbed entity. This option is only available if the following two-prong condition is met: *(i)* the merger involves two EU companies; and *(ii)* the other EU member state has similar rules.

French law also provides for a post-completion compliance control specific to cross-border mergers.

Like in Germany, French law provides for strict rules aimed at preserving employee participation rights.

The employer and a "special negotiation committee" representing the employees must conduct negotiations with a view to defining the terms and the scope of the employee participation rights that will apply to the combined entity after the merger. These negotiations can last up to one year.

However:

- this process need not be followed when *(i)* none of the companies involved has more than 500 employees or has already granted participation rights to its employees or *(ii)* the level of employee participation rights is not lowered as a result of the merger;
- shareholders who decide on the merger may subject completion of the merger to their prior approval of the terms and scope of the employee participation rights in the combined entity;
- the managers of the companies involved may decide not to go through this negotiation process provided they opt for a set of default rules, which are very favorable to employees.

From a tax standpoint, the EU Directives of July 23, 1990 and February 17, 2005, already implemented in France, provide for tax neutrality of cross-border mergers.

The "SEVIC" Decision of the European Court of Justice

Cross-border cases are regularly decided by the ECJ as they have a natural nexus to the principle of freedom of establishment which is guaranteed under the European Community Treaty. A factual inability of cross-border mergers is not in line with the principle of freedom of establishment as this situation is similar to the one of a registered office of a company moving from one member state to another. The ECJ already ruled in these cases (Centros, Ueberseering, Inspire Arts) that the freedom of establishment eventually prevails.

A further decision of the ECJ in this regard was the "SEVIC" decision that was decided by the ECJ on December 13, 2005, only a few weeks after the EU Merger Directive was issued. This decision was based on an attempt to merge a Luxembourg stock corporation (S.A.) into a German stock corporation (AG) under application of the respective rules of the German Transformation Act. The competent German commercial register rejected the registration of the merger by referring to the prevailing opinion under German law that cross-border mergers were not covered by the German Transformation Act (see above).

The ECJ held that the denial of the registration of the cross-border merger between companies of two different

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EU member states was a violation of the principle of freedom of establishment guaranteed under the European Community Treaty if this denial was based *only* on the fact that German law did not cover non-German legal entities and such registration would have been admissible in case both companies had their administrative office in one member state provided that certain preconditions of this member state were fulfilled.

The ECJ only decided on the issue of the rejection of the registration of the cross-border merger in Germany. The court did not comment on how such a merger could or should legally be executed. The conclusions of legal annotators after the "SEVIC" decision indicated that a cross-border merger should—even before the implementation of the Merger Directive in other EU member states—be based solely on the principle of freedom of establishment.

Conclusion

Corporate law of the member states of the EU has been further harmonized by EU legislation and the recent decisions of the ECJ. The EU Merger Directive, once implemented by all EU member states, will, from a transnational perspective, grant additional options for entering into corporate reorganization activities. However, the legal framework for European cross-border mergers may not yet be complete, in particular as to tax treatment and employee co-determination issues. Also, the new German legislation on cross-border mergers only applies to corporations and not to partnerships. However, the principles of the "SEVIC" decision apply to partnerships as well. The "SEVIC" decision and future decisions expected to be made by the ECJ (presumably based on the principle of freedom of establishment) may further ease cross-border restructuring activities. ❑

ECJ Clarifies the Criteria for Assessing Selectivity of Regional Tax Measures

By Pascal Faes (Van Bael & Bellis)

In a judgment of September 11, 2008, the European Court of Justice (ECJ) clarified the criteria for determining whether tax measures adopted by a regional authority are to be considered as selective and thus amounting to State aid.

This judgment relates to a tax measure adopted by the so-called foral authorities in three historic territories of the Basque Country, which all possess autonomous jurisdiction to legislate on tax matters. In 2005, they each set the corporate tax rate at 32.5 percent, while the basic rate of corporate tax elsewhere in Spain was fixed at 35 percent. In addition, the foral authorities granted special deductions from the taxes that were not provided for by the regular Spanish tax system. A complaint was lodged against this special tax regime by the neighboring regions as they considered that such a system, in addition to infringing superior national legislation, constituted unlawful State aid contrary to Community law. Consequently, as part of the national proceedings, the Spanish Court referred to the ECJ for preliminary ruling on a question of whether the provision of a lower tax rate by the autonomous regional authority must be regarded as a selective measure and thus covered by the definition of State aid under Article 87(1) EC on the basis that the tax measure does not apply to the whole territory of the Member State.

Question of Autonomy

Relying on its previous case law, the ECJ began by stating that the mere fact that a measure confers an advantage in only one part of the national territory does not make it selective on that ground alone for the purpose of Article 87(1) EC. Instead, the ECJ indicated that, in order to determine whether tax measures adopted by an infra-State body constitute selective State aid, it is necessary to evaluate whether that body has sufficient institutional, procedural and economic autonomy to adopt the measure

Can a lower tax rate by the autonomous regional authority be regarded as State aid?

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in question. In the event the infra-State body has exercised sufficiently autonomous powers in the adoption of the measure and thus played a fundamental role in the definition of the economic and political environment in which undertakings operate, the measure in question can be considered to be of general application in the region concerned and thus not selective within the meaning of Article 87(1) EC.

The ECJ went on to consider each of the three autonomy criteria separately. First, with respect to the institutional autonomy, the ECJ stated that it needs to be assessed whether the infra-State body has a political and administrative status distinct from that of the central government. In the present case, the ECJ found that the Basque authorities satisfied this criterion.

Second, regarding the procedural autonomy, the ECJ concluded that in order for this criterion to be satisfied, the decision taken by the infra-State body must be adopted independently, without the central government being able to intervene as regards the content of the measure. The ECJ further noted that the obligation on the infra-State body to take into consideration the State interest when making use of its powers does not, in general, call into question its procedural autonomy. However, the ECJ left it for the national court to determine whether the procedural autonomy criterion was fulfilled in the present case.

Third, as regards economic and financial autonomy, the ECJ stated that this requirement entails that the financial consequences of a reduction of the national tax rate for undertakings in a particular region must not be offset by aid or subsidies from other regions or central government. In this respect, the ECJ examined in detail the economic relations between the Basque region and the Spanish State in order to assess whether the Spanish State compensated the consequences of a reduction of a tax rate by the Basque authorities. However, in the end, it was left for the national court to determine whether the Basque authorities assumed the political and financial consequences of the lower tax rate they had adopted and, as a result, whether the measure in question could be considered as being of general application in that region and thus not selective within the meaning of Article 87(1) EC.

GERMANY

New German Change-in-Ownership Rules Severely Restrict NOL Carryovers

By Martin Karges and David T. Lan (BDO Seidman, LLP)

On July 4, 2008, the German tax authorities published the long-awaited final guidance on the change-in-ownership rules introduced by the Business Tax Reform 2008, and their impact on entities with loss carryforwards. The new rules jeopardize loss carryforwards upon share transfers, mergers and acquisitions, and even intragroup reorganizations. The rules affect U.S. companies that directly or indirectly own a German entity with loss carryforwards contemplating a reorganization, merger, or acquisition.

Former Rules

Under the previous rules (now superseded), loss carryforwards of German entities were generally forfeited if a new owner directly acquired over 50 percent of the shares and the loss entity received contributions of predominantly new assets during a testing period of two to five years following the acquisition. This testing period provision continues to apply to share transfers that occurred prior to January 1, 2008, so long as no new transfers are made.

New Shareholder Test

Under the new change-in-ownership rules, however, a direct or indirect transfer of a more than 25 percent interest in the shares of a German corporation to any one shareholder within a five-year period will result in a pro rata forfeiture of loss carryforwards for German tax purposes. Furthermore, a direct or indirect transfer of more than 50 percent to a new shareholder within a five-year period will result in a complete forfeiture of loss carryforwards.

The new rules disallow the loss carryforwards existing at the time of the transfer. Current year losses incurred before the date of transfer may not be carried back to previous years. Additionally, the final guidance prevents

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profits generated up to the time of the transfer from offsetting existing loss carryforwards.

Related Parties

Related parties or groups with a common interest are treated as one shareholder under the new rule. Thus, any reorganization anywhere within the chain of ownership above the German loss entity may result in the forfeiture of German loss carryforwards. For example, if a foreign or German subsidiary that holds an interest in a German loss entity is merged upstream into its parent, the new rules would construe the transaction to be a 100 percent indirect transfer of shares in the loss entity to a new shareholder and thus, disallow all loss carryforwards in the loss entity. The same result would occur if the parent merged downstream into the subsidiary or if a liquidation took place above the German loss entity.

Related parties or groups with a common interest are treated as one shareholder under the new rule.

In contrast, a mere change in the legal form of a shareholder of a loss entity (e.g., corporation to partnership, etc.) should not be harmful. In some instances an asset disposition may be preferable to a transfer of shares.

The new rules are effective for fiscal years ending after December 31, 2007, and transfers made after December 31, 2007.

Recommendation

Taxpayers contemplating a share transfer, reorganization, merger, or acquisition at any group level above any German loss entity should carefully consider the impact this transaction may have on the German loss carryforwards.

Recent Legislative Developments Regarding the Treatment of Losses from EU/EEA Countries

By Raimund Behnes and Juergen Luedicke (PricewaterhouseCoopers)

In response to the EU Commission's move to open an infringement procedure against Germany there have been significant legislative initiatives in order to bring the treatment of losses according to Sec. 2a German Income Tax Act (ITA) in line with EC law requirements. While an Official Decree by the Federal Ministry of Finance has been issued to suspend adverse effects for the time being, Sec. 2a ITA is due to be amended at the end of this year.

In general, German residents are taxable on their worldwide income comprising both positive and negative income (i.e., losses). Due to Sec. 2a ITA, specific types of losses from so-called passive income generated abroad that are not tax exempt by double tax treaties can only be offset against positive income from the same category and the same state. As losses generated in Germany can be offset without any restriction, on October 18, 2007, the Commission took the view that the different deductibility of domestic and cross-border losses is incompatible with the EC Law principles.

The tax administration has responded to the infringement procedure by issuing an Official Decree dated July 30, 2008, which suspends the applicability of Sec. 2a ITA as regards tax losses created in EU/EEA states. As a result, such foreign losses are deductible without restriction for the time being (unless exempt under a double tax treaty).

The Decree may also have effect on the determination of the progressive income tax rate in cases where income is tax-exempt under the applicable double taxation treaty. Under German tax law, tax-exempt foreign income is generally taken into account for determining the progressive income tax rate. However, whereas positive income is always being taken into account, negative income may only be considered if not passive. This was contested in the *Ritter-Coulais* case. Although the Decree does not explicitly deal with this issue, it principally allows the consideration of EU/EEA losses for the purpose of calculating the progressive income tax rate.

As an EC Law infringement may only effectively be

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Treatment of Losses *(from page 11)*

remedied by a measure of the same legal quality as the infringement itself, Sec. 2a ITA will be materially changed by the Annual Tax Bill 2009 which is due to be enacted by the end of this year.

A draft that has been circulated recently provides for the taking into account of losses generated in EU/EEA states without restrictions (unless of course, exempt under a double tax treaty). Third country losses, however, will remain subject to the restrictions described above. With respect to the determination of the income tax rate, the draft explicitly states that certain (positive or negative) income from another EU country will not affect the calculation of the progressive rate, including land and forestry income, business income from a passive permanent establishment, and property income. Tax exempt income from active permanent establishments will still be considered when determining the progressive tax rate. ❑

ITALY

Stock Options in Italy: Beneficial Tax Regime Repealed

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

On June 25, 2008, the Italian government issued Law Decree No. 112 (Decree) contemplating, inter alia, the repeal of the tax and social security benefits for stock options granted to top executives and management.

Generally, any type of compensation, including equity incentives, earned by Italian tax resident employees in connection with their employment relationship is characterized as employment income and, as such, it is subject to personal income tax (levied at progressive rates, currently up to 43 percent, plus local surcharges up to 2.2 percent) and to social security charges[1].

Gains now Taxed at Personal Income Tax Rates

Under the repealed rules (Old Rules)[2], the difference between the fair market value (FMV)[3] of the shares upon an option's exercise and the strike price (such difference, the "Gain") was exempt from personal income tax and social security charges, insofar as certain conditions were met, including, but not limited to: (i) the strike price not being lower than the FMV of the shares at the time of the grant, (ii) the plan providing for a minimum three-year vesting period, (iii) the shares being listed on a regulated market at the time the options became exercisable, and (iv) the beneficiary holding an investment in the shares not lower than the Gain for at least five years from delivery. As a result, the Gain would have been taxed at a flat 12.5 percent rate only upon a disposal of the shares for consideration.

The repeal of the Old Rules means that built-in Gains will now be fully taxed at progressive rates of personal income tax. As the language of the Decree does not contemplate a grandfathering rule for plans already launched or awards granted when the Decree became effective, the new regime will apply to any shares delivered on or after June 25, 2008.

Questions over New Social Security Exemption

However, during the Decree's confirmation procedure[4], in an attempt to partially mitigate the harshness of the new taxation regime, the Italian Parliament approved an amendment providing that the Gain will be exempt from social security charges while still subject to personal income taxation.

The new social security exemption regime is not subject to any of the conditions required under the Old Rules. As a result, the Gain would be exempt for social security purposes regardless of whether, for example, the strike price is lower than the FMV of the underlying shares, or the options are fully vested, at grant.

According to Art. 82(24ter) of the Decree, as introduced with the Decree's confirming law (Law No. 133 of August 6, 2008, the Confirmation Law), the social security exemption will apply to any shares delivered as of June

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Stock Options *(from page 12)*

25, 2008. However, the Confirmation Law established a grandfathering rule[5] whereby amendments to the Decree made thereunder do not affect any rights and obligations arising from the application of the Decree's rules either amended or not confirmed by the Confirmation Law. As the enactment of the social security exemption should be characterized as an amendment to the Decree's rules, Gains realized in connection with options exercised between June 25, 2008 and August 22, 2008 (i.e., the date on which the Confirmation Law entered into force) should be subject to both income taxes and social security charges[6].

Built-in gains will no longer be exempt.

In addition, it is not clear whether the application of the social security exemption applies to employees (including top executives) only, or to quasi-employees as well, who are subject to a different set of rules for tax and social security purposes[7] (corporate directors generally fall under this category). As the Confirmation Law amended the rules regarding the determination of employees' social security basis without modifying the social security basis for quasi-employees, it appears that the new social security exemption should not apply to quasi-employees.

A clarification from the Italian tax administration in this respect would be useful. However, in a recently issued statement specifically regarding the repeal of the Old Rules[8], the tax administration did not address either the scope of the grandfathering rule cited above, or the application of the social security exemption to quasi-employees.

The repeal of the limited tax advantages still available in connection with stock options following the enactment of the Old Rules[9] will gear the market towards different means to structure equity-linked remuneration, featuring at the opposite ends of the spectrum: (i) compensation in cash (fully taxed for tax and social security purposes but, at the same time, entirely deductible as labor expense in the employer's hands); and (ii) employees' equity investments that are economically similar to an option right, but legally and tax-wise can be characterized as an asset generating passive income subject to the preferential tax treatment generally applicable to such type of income, and falling out of the scope of social security.

[1]Social security charges vary depending on the industry in which the company operates and the specific classification made by the Italian social security authority (INPS) for these purposes. Generally, social security charges for executives amount to approximately 36 percent; employees bear approximately 9 percent of such charges. Post-1996 hires may benefit from a social security exemption on any portion of their compensation currently exceeding approximately Euro 88,000.

[2]The Old Rules were enacted with Law Decree No. 262 of October 3, 2006.

[3]For tax purposes, the stock FMV is calculated on the basis of (i) for listed stock, its average trading price in the rolling month preceding the exercise date; and (ii) for non-listed stock, the pro-rata value of the issuing company's net equity.

[4]Law decrees have force of law upon their publication in the Italian Official Gazette, but lapse unless confirmed (i.e., approved with a specific law) by the Italian Parliament within the following 60 days. Law decrees may be amended by the Parliament during the confirmation procedure.

[5]See Art. 1(2) of the Confirmation Law.

[6]As a result, employers and employees should not be eligible for a refund of social security charges due in connection with options exercised during this timeframe.

[7]See Art. 2(29) of Law No. 335 of August 8, 1995.

[8]See *Agenzia delle Entrate*, Circular No. 54/E of September 9, 2008.

[9]The Old Rules, introduced in 2006, resulted in a substantial impairment of the availability and tax efficiency of stock option plans, as they (i) limited the tax benefits to listed companies only, and (ii) entailed a minimum investment period of 8 years (three years for the required vesting period, plus the additional 5 years of minimum holding). ❑

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IP Acquisitions *(from page 2)*

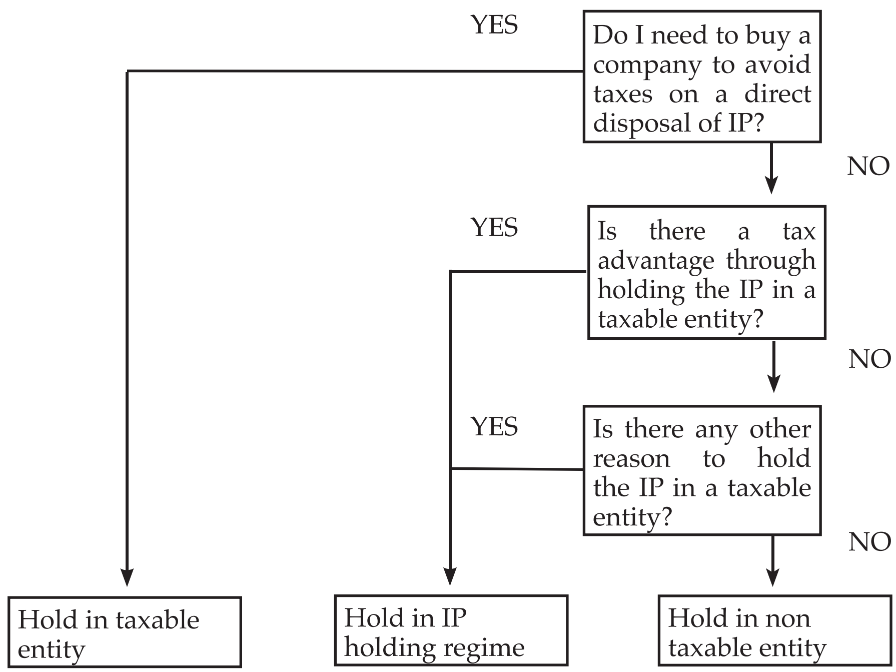
benefit from the tax rules from the first jurisdiction.

Minimizing Taxes—IP Held in Taxable Entity

If IP is held in a taxable structure, tax planning will concentrate around minimizing the tax rate (e.g., using special tax regimes applicable in that jurisdiction) and maximizing reliefs (e.g., amortization of acquisition cost, research and development reliefs and finance costs).

If any debt financing is required to fund the acquisition, a local SPV (acting as the borrower) may be required. The trick would be to form a consolidated local tax group with the taxable entity or to merge the SPV and the IP company in order to offset interest charges against IP income. The structure may then be as shown in Chart 2.

Chart 1



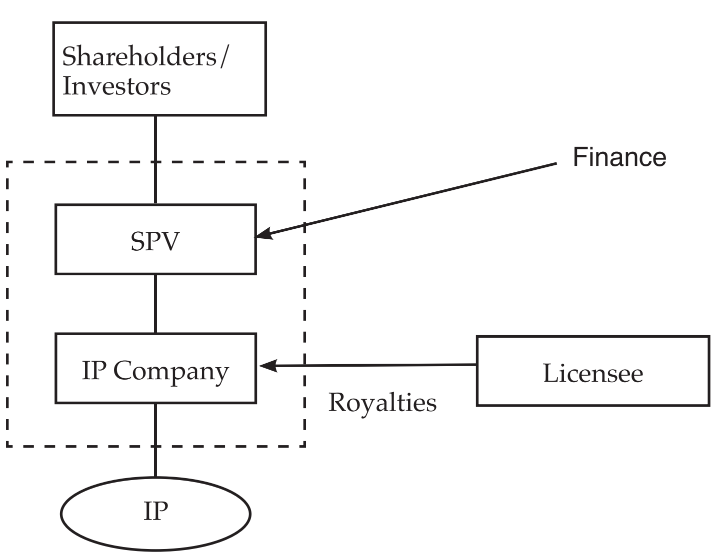
Withholding tax potentially arises on royalties to the IP company (and through any royalty conduit vehicle), dividends up the chain to SPV/shareholders/investors and on debt finance.

Ideally, the licensees would be residents of jurisdictions that do not apply withholding tax on the relevant payments or that have suitable double tax treaties that reduce or eliminate any withholding tax.

Additionally, taxes in all the taxable entities must be mitigated to the extent possible. Taking each company in turn:

- IP company—in this scenario, the IP company would be subject to tax on the royalty income. The key is to reduce the tax liability to the extent possible by making deductible interest payments to the SPV in respect of the debt funding, amortizing (for tax purposes) the IP and obtaining any other tax benefits (e.g., on research and development costs). This requires an analysis of the local rules restricting interest deductions, particularly in respect of any shareholder debt (e.g., thin capitalization or transfer pricing rules). It may be possible to further enhance the tax efficiency of debt by using structures that provide a "double dip" (two tax deductions for one interest payment) or a one-sided deduction (i.e., an interest deduction in the SPV treated as a distribution for the noteholder).
- SPV—this should only have dividend income from the IP company that is in the same jurisdiction. In most jurisdictions one would hope that the dividends are not taxable (e.g., under a "participation exemption" or because the two companies form a consolidated tax group or are merged such that dividends are not taxable in the SPV). If the SPV is located in a different jurisdiction to the IP company, and does not benefit from a participation exemption, then there may be tax on the IP company dividends. There may also be "controlled foreign company" (CFC) or similar

Chart 2



IP Acquisitions, continued on page 15

IP Acquisitions *(from page 14)*

rules that could impute income of the IP company to the SPV or to the ultimate shareholders. These would need to be considered in detail in light of the relevant jurisdiction.

It may be possible to enhance the structure using a royalty company where the IP company does not have a good treaty of tax networks.

Minimizing Taxes—IP Held in Non-Taxable Entity

If IP is acquired through a non-taxable company and then licensed, the licensee may be required to withhold tax on the royalty income (the amount of which would probably not be reduced as tax havens do not generally benefit from double tax treaties).

One way to reduce withholding taxes is by using another entity (royalty company) through which the royalties would flow. The structure could be as shown in Chart 3.

There should be no withholding tax on any interest paid by the non-taxable entity in respect of debt finance or in respect of the payment of dividends to the shareholders.

By flowing the royalties through a royalty company that:

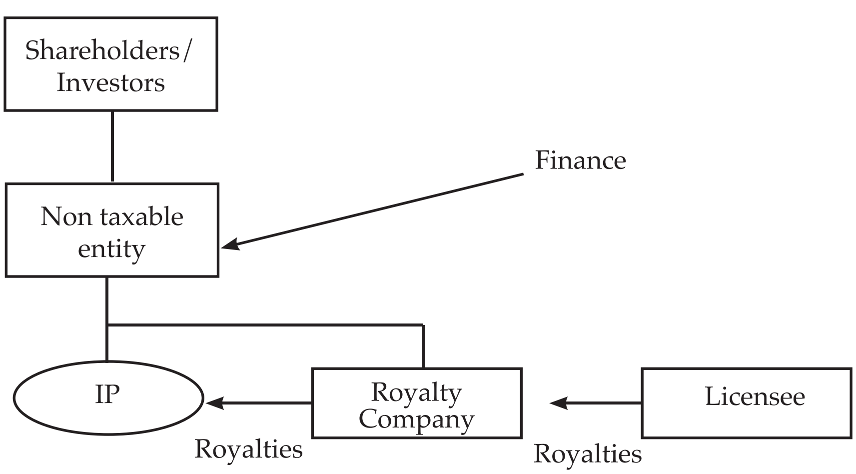
- has a suitable tax treaty with the licensee's jurisdiction (which eliminates or reduces withholding taxes on royalties); and
- is incorporated in a country that does not levy withholding tax on royalty payments, withholding taxes on the royalties could be mitigated (subject to anti-avoidance rules).

Additionally, the taxes in all the entities should be mitigated to the extent possible. This will either be through:

- making the entity non-taxable (e.g., located in a tax haven); or
- ensuring that income is matched by expenditure for tax purposes.

In the case of the royalty company, in order to benefit from appropriate double tax treaties, one would envisage the royalty company to be taxable. The key is to match royalty income to royalty payments such that there is no taxable income (or a very limited turn). Care is needed here as various tax treaty provisions prevent "treaty shopping." Additionally, anti-avoidance rules may apply to deny treaty benefits or the tax authorities may not view the royalty company as being entitled to the royalties for treaty purposes (see *Indofood International Finance Ltd v JP Morgan Chase Bank NA London Branch* [2006] STC 1195).

Chart 3



Minimizing Taxes on Entry

In many jurisdictions, a taxable gain will arise when the selling owner disposes of the IP asset. Such a gain could potentially be reduced or avoided with careful planning. For example, assume the IP is owned by a company. A disposal of this IP could be structured by selling the IP or alternatively, the shares in that company could be sold.

Is There a Participation Exemption on Share Disposals?

Many jurisdictions are exempt from tax disposals of shares, but not assets. Therefore, in such jurisdictions a share disposal is more attractive.

Where Does the Seller have "Tax Basis"?

The "tax basis" (i.e., the amount to be deducted from any taxable gain) in the IP may be different than the base cost in the shares. Therefore, a seller may obtain a better tax outcome by selling shares rather than assets.

The down side to a share deal (besides fixing the location as mentioned above) is that the purchaser will usually inherit the seller's historic tax base cost position in the IP asset giving rise to an increased liability to tax in the event of a future sale and, generally speaking, no ability to amortize the acquisition cost for tax purposes. This "deferred" tax liability will usually be factored into the price that the purchaser is willing to pay for the shares.

Does the Seller/Holding Entity have Tax Assets that It Can Utilize Against a Gain?

For example, the seller/holding entity may have losses that it can use against a gain to mitigate the tax.

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UK Must Properly Implement ECJ Ruling on Cross-Border Loss Compensation

The European Commission has sent the United Kingdom a formal request to properly implement the December 3, 2005 Judgment of the European Court of Justice (ECJ) in *Marks & Spencer v David Halsey* (Her Majesty's Inspector of Taxes) [C-446/03] 2005.

In its ruling, the ECJ held that the UK ban on cross-border loss relief was disproportionate, insofar as it denied loss relief where a non-resident subsidiary had exhausted all possibilities for relief in the EU Member State in which it was established. Following this ruling, the United Kingdom should in principle have granted relief for definitive losses of a subsidiary established in another Member State.

In the legislation implementing the *Marks & Spencer* ruling, however, the United Kingdom has imposed conditions on cross-border group relief that makes it virtually impossible for taxpayers to benefit from this relief. One of these conditions includes the restrictive interpretation that there should be no possibility of using the loss in the subsidiary's State. In addition, this condition must be determined immediately after the end of the accounting period in which the loss arises.

The Commission considers these conditions contrary to the EC Treaty, and if the United Kingdom does not reply satisfactorily to the reasoned opinion within two months, the matter may be referred to the ECJ. — *Geert Dierickx (gdierickx@europe.mwe.com), McDermott Will & Emery/Stanbrook LLP, Brussels* ❑

IP Acquisitions *(from page 15)*

Can the Seller License the IP Rather than Sell It?

A license of IP may not give rise to a disposal of the asset. Instead the seller may be taxed over a number of years on the income or have income losses to offset against the taxable income.

Whether or not the license amounts to a disposal depends on its terms. An exclusive license for a long period is likely to constitute a disposal whereas a non-exclusive license for a short period is not. However this will vary among jurisdictions.

Similarly, in some jurisdictions one may distinguish between a sale of the IP and a right of "usufruct" (i.e., right to use/benefit from the IP).

Equity Investment

Rather than sell IP or a company, the seller might issue shares to the purchaser—effectively creating a joint venture between the seller and the purchaser. The purchaser's economic rights in the IP would be reflected in the share rights.

From a tax perspective, value shifting rules might make this transaction a deemed disposal of the shares of the seller. Also, care needs to be taken to ensure that this will not trigger a "de-grouping charge" in the IP holding company or the forfeiture of losses carried forward in the IP holding company as a consequence of "change of control" rules.

Minimizing Taxes on Exit

It can be expected that some tax on exiting the structure could arise. However, one should ensure that cash taxes are not payable before the cash returns from the investment are received.

Where an IP holding entity is used, the preferred exit will be the disposal of that entity—particularly if the vendor is a company that benefits from a participation exemption on disposal of shares.

In some jurisdictions, non-residents are taxed on gains. While this is often mitigated through an appropriate double tax treaty, if this is not possible an additional holding company is often inserted into the structure to allow a disposal at a level that will not give rise to such tax. ❑