Tax News

March 2007

Dear Reader,

Swiss parliament has accomplished a breakthrough with regard to the corporate tax reform II. On March 19, 2007, the Council of States has eliminated the differences and followed the decisions of the National Council in the remaining open points. Therefore, the corporate tax reform II has been passed by the parliament in the spring session which concluded last Friday, March 23. In particular with regard to the partial taxation procedure for dividends of privately held shares, the councils have agreed to a compromise. Prior to the latest vote the Council of States voted for a partial taxation of 70% whereas the National Council previously wanted a taxation of 50% only, provided a minimum shareholding quota of 10% is observed. Both councils have now agreed to a taxation of 60% of the dividend income.

On the international level we witnessed yet another exchange of arguments between the European Commission and Switzerland on the issue of sustainability of Swiss cantonal tax regimes. Since September 2005, the European Commission has been claiming that holding, mixed, and auxiliary companies constitute a prohibited state aid under the 1972 Swiss-EC Free Trade Agreement. Faced with the refusal of the Swiss government to even consider negotiating on what it views as pure fiscal sovereignty, the Commission has gradually increased pressure. On February 13, 2007, it formally "decided" that these regimes are incompatible with the Free Trade Agreement, and asked that Switzerland withdraws or substantially amends them.

Many aspects of this process are surprising. The first is the odd timing. The targeted regimes have been in existence for quite a while, long before the Free Trade Agreement came into effect. The EU recently said the Swiss regimes were "unfair," but in that case they could also have been targeted at the peak of the EU move against "harmful tax competition" back in 1997.

Then comes an undiplomatic roughness vis-à-vis an independent but close neighbor. Switzerland is asked to abide by EU law, to which it is not subject, by means of a purportedly authoritative "decision." Sharp words have been used by Commission officials, treating Switzerland like "the Iraq of the Alps" (as Jean-Claude Juncker put it), for instance when they launched a media offensive the day after the Swiss approved a contribution of one billion Swiss francs to the development of the newly admitted members of the EU in Eastern Europe.

Finally, the Commission displays biased or even flawed legal arguments. For example, a sound economic relationship between relief granted to pure holding companies and trade in goods is yet to be established for the Free Trade Agreement to come into play on this. The idea that auxiliary tax relief benefits Swiss exporters is simply not true, as one of the conditions is precisely that the goods traded are neither purchased nor sold in Switzerland.

What this process demonstrates, however, is considerable political determination on the part of the Commission, who

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distillates pressure and pushes the argument forward at a time when Switzerland, which refused to join the EEA in 1992, has however concluded a series of bilateral agreements for closer cooperation with its largest neighbor, including in tax matters an agreement on access to the participation exemption system.

Although more attacks should be expected in the months and years to come, as the Commission attempts to coerce Switzerland into negotiations, the experience of changes in tax law in Switzerland and in the EU shows that the combined horizon of political negotiations and legislative changes in tax matters is years if not decades, for sovereignty and legal security reasons. This, together with the continued monitoring, assistance and expertise of Ernst & Young in Switzerland and around the globe, means that even in a worst case scenario we would always be able to plan ahead for any needed adaptations. We will of course provide you with ongoing information and analysis as the issue develops, and we remain at your entire disposal should you need further advice on the matter.

It is reassuring to note that the Swiss government stands unmoved by the Commission's attacks to date and remains firmly committed to preserving the attractiveness of Switzerland for foreign investment. The same is true of cantonal authorities, which have always practiced tax competition amongst themselves. In this regard one may note that many independent territories associated with the EU (such as the Channel Islands), targeted by the Commission in the past, have chosen to comply with EU requests by repealing any "special" regimes and introducing a general, across-the-board 0% corporate income tax rate. For businesses and governments alike, there is always a way forward.

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US Tax Desk: Easing of Subpart F Rules

The US relaxes the US subpart F rules for performance of services by a foreign subsidiary on behalf of a related party due to related party substantial assistance.

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Under existing IRS regulations, when a controlled foreign corporation (CFC) performs services on behalf of a related party, and such services are performed by the CFC outside of its country of incorporation, then the profits from such activities are considered "subpart F" income. Under the subpart F rules, subpart F income is deemed to be repatriated back to its US shareholder in the year earned and thus subject to current US taxation (versus nonsubpart F income of the CFC, which is only subject to US taxation when actually repatriated back to the US shareholder). Under this rule, where a related person had provided substantial assistance to the CFC, the CFC was considered to have performed the proscribed services on behalf of a related party.

Recognizing that the global economy has changed since the 1960s when these rules were enacted, the IRS has now issued regulations indicating that where a foreign related party provides assistance to a CFC in providing services to unrelated parties, then such services will not be treated as tainted subpart F income producing activities. Further, where US related parties assist the CFC, then the income realized from the services to unrelated parties will not constitute subpart F income as long as the costs to the CFC for the services rendered by the US related party do not equal or exceed 80% of the total cost to the CFC to perform the services for the unrelated party.

The changes will be effective for tax years of foreign corporations beginning on or after January 1, 2007.

President's Proposed 2008 Budget Proposal to Tighten US "Earnings Stripping" Rules

Of particular interest to Swiss and European multinational companies with US operations is the Bush Administration's proposal to tighten the US Earnings Stripping rules. Under these rules, the amount of deductible interest expense paid to foreign related parties (or paid to unrelated parties but guaranteed by foreign related parties) is limited where the interest is subject to reduced US interest withholding taxes. Under current law, the amount of such interest is limited to 50% of the US payor's adjusted taxable income (ATI). Roughly stated: ATI is accrual basis taxable income converted to "cash" basis income with typical adjustments for depreciation and amortization. The disallowed interest can be carried forward indefinitely and deducted in future years. Under a safe harbor rule, the restrictions do not apply if the corporate taxpayer has a debt/equity ratio of 1.5 to 1 or less.

The 2008 budget proposal would:

- eliminate the 1.5 to 1 safe harbor rule
- reduce the 50% ATI threshold to 25% (but keep the 50% limit for related party guaranteed debt)
- limit the indefinite carry-forward period to 10 years
- eliminate the 3-year period carry-forward for excess limitation (i.e. the opposite of those taxpayers that had excess interest)

The measure would be effective as of the date the measure is approved and signed into law.

Proposals similar to this have been proposed in the past but rejected by Congress. How the US Senate or House will view the bill is too early to predict. However, the proposal is a net revenue raiser in a very difficult fiscal deficit environment. Possible modifications to the bill may be proposed once the US Treasury Department (of which the IRS is a part) completes a study of the effectiveness of the US Earnings Stripping rules. This study was mandated by Congress and was due June 30, 2005! However, the study is expected to be delivered soon as part of Administration's general proposals on fundamental tax reform. ■

China: 2008 Tax Reform

On March 16, 2007, China's National People's Congress adopted the new Corporate Income Tax Law. The new tax law will become effective on January 1, 2008.

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The main aim of the new tax law is to equalize the tax treatment of domestic and foreign-invested enterprises. A unified tax on income will be introduced for both types of company, thus eliminating the preferential tax treatment of foreign-invested companies and creating a level playing field.

Current Tax System

Current legislation provides various – usually location- or activity-based – tax benefits to foreign-invested enterprises; for example, instead of the standard 33% tax rate on income that domestic companies have to pay, foreign enterprises are usually taxed at a rate of 15% or 24%. Furthermore, foreign-invested enterprises can apply for various other incentives (such as tax holidays, the refund of tax paid on reinvested profits, etc.).

Domestic and foreign-invested enterprises are also treated differently with regard to tax deductibility of expenses, which puts domestic companies, for which restrictions apply, at a disadvantage (e.g. salary costs are tax deductible up to a maximum of CNY 1,600 per person and month).

New Corporate Income Tax Law

The main changes of the new Corporate Income Tax Law can be summarized as follows:

- Introduction of a nationwide, unified tax rate of 25%, or 20% for qualified small-scale enterprises and enterprises with very low profits;
- Unification of tax deductibility rules for expenses (reasonable salary costs up to the amount of actual cost, advertising expenses up to a reasonable amount to be determined in detailed implementation regulations, donations up to 12% of taxable earnings, super-deductions for R&D cost);
- Elimination of location-based tax benefits as well as of tax holidays or rate reductions for manufacturing or export-oriented companies in favor of tax incentives for specific sectors and branches of industry (e.g. hi-tech, agriculture, infrastructure, etc.), as well as for companies in the economically developing areas of Western China;
- Introduction of general anti-abuse provisions such as the possibility of profit adjustments for transactions that are not supported by a rational business purpose, the introduction of CFC rules as well as thin capitalization rules and detailed transfer pricing regulations;
- Introduction of a concept of effective management in determining tax residency of a company and its associated limited or unlimited tax liability;
- Introduction of a general 20% withholding tax on dividends, interest, royalties and capital gains. In this regard, it is expected that based on detailed implementation rules a potential reduction or even a complete exemption from withholding tax on dividends may be granted.

Transitional Provisions

Current tax holidays and rate reductions will be adjusted to the new tax law over a five-year transition period.

1. Gradual Rate Adjustment

Foreign-invested enterprises which currently benefit from a reduced tax rate will gradually adjust to the new tax rate of 25%.

2. Using Agreed Tax Holidays

Enterprises eligible to enjoy tax holidays which have already been granted can continue to benefit from these tax holidays until the date of expiry. If tax holidays have not yet commenced due to accumulated losses, they will be deemed to commence as of the date of implementation of the new tax law.

3. Right to Choose

Companies to which the transitional provisions apply and which could also benefit from tax incentives under the new tax law have the choice of being taxed in line with the provisions of the "old" or new law. ■

Germany: Current Trends

There is a lot going on in the German tax area. Therefore we would like to give you a closer understanding of the following three current developments in Germany.

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2008 Corporate Tax Reform – Draft Bill of February 5, 2007

On February 5, 2007, the German Ministry of Finance published the draft bill on the 2008 corporate tax reform. The German Government passed the draft bill on March 14, 2007. The draft bill does not deviate significantly from the report in the December 2006 issue of Ernst & Young Tax News (p. 6). However, in the legislative procedure the reform package might be subject to further amendments and debate, especially with regard to the relaxation of the planned "interest limit" (so-called *"Zinsschranke"*). According to the current schedule, the legislative process will be completed before the summer recess (approval by the Bundestag on June 15, 2007, and the Bundesrat on July 6, 2007). However, this is a very ambitious timescale.

The German Ministry of Finance Statement on the Foreign Tax Relations Act of January 8, 2007 (Cadbury Schweppes)

Background: Various anti-abuse norms, including Controlled Foreign Companies (CFC) rules (Section 7ff. of the Foreign Tax Relations Act), are used by German legislators to defeat attempts of German investors using foreign firms to prevent paying German taxes. In September 2006, however, the European Court of Justice ruled in the case of Cadbury Schweppes that British CFC rules, which are essentially comparable to the German norms in terms of their content, largely contravene European law. As predicted in the October 2006 issue of Ernst & Young Tax News (p. 10), the German tax authorities have responded to the ECJ ruling on Cadbury Schweppes. The Federal Ministry of Finance (FMF) seized the initiative and published a new decree on January 8, 2007, which announced that German CFC rules remain in force with few changes. One *exception,* however, has been made for companies with their headquarters or management board in a member state of the EU or EEA. In this case the German CFC rules no longer apply if the tax-liable company can prove that it carries out genuine economic activities in this state. In particular, the company must demonstrate:

a) active and regular participation – as part of its usual business activities – in the market place of the member state in which its head office or management board is situated;
b) that it employs managerial and support staff in the country on a permanent basis to carry out its activities;
c) that the company's employees possess the qualifications needed to carry out the tasks assigned to the company independently and at their own responsibility;
d) that the company's income is generated by its own activities;
e) that the services of the company – insofar as it conducts its business primarily with associates as defined by Section 1, Subsection 2 of the Foreign Tax Relations Act – are significant in creating added value for the service recipient and that the added value of the services is commensurate with the capital invested.

The requirements listed from a) to e) exceed the guidelines of the ECJ ruling on Cadbury Schweppes and some appear incompatible with them. All that the ECJ required of Cadbury Schweppes was that the company use the infrastructure of the country of residence and carry out genuine economic activities.

The FMF decree contains *exceptions.* The above-mentioned relieves do not apply to earnings that are used for the purpose of passive investment income (so-called *"Zwischeneinkünfte mit Kapitalanlagecharakter"),* for investment outside the EU/EEA or if the country of residence (such as Liechtenstein) does not offer administrative assistance in tax matters. Swiss companies will thus not benefit from the restriction of the German CFC rules in special cases. For the relaxation of the rules to be extended to third countries such as Switzerland, this would require an ECJ ruling on the free movement of capital.

This application of this FMF decree expires upon the legal revision of this norm and applies to all currently pending cases.

FFC Decision on Senior Management Employees Published

In relations between Germany and Switzerland, individuals who live in one contracting state and work as senior management employees *("leitender Angestellter")* of a company in another are taxed in the latter country. This fiction was implemented in Section 15, Subsection 4 of the German-Swiss DTA following its partial revision in 1971. With its decree of July 7, 1997, the German tax authorities exempted the salary of senior management employees who worked for Swiss corporations from German taxation only insofar as they could demonstrate that their activities were physically carried out in Switzerland. For all other working days (in third countries and/or Germany, for example) the tax credit method applied, which

meant that individuals were regularly taxed at the higher German level.

In its judgment of October 25, 2006 (Az. I R 81/04) published on February 7, 2007, the FFC ruled that the German tax authorities could not unilaterally correct the fiction of Section 15, Subsection 4 of the German-Swiss DTA in its favor after the event. In principle, therefore, the *exemption method* also applies in Germany. While the German tax authorities are currently examining a nonapplication decree, pending cases should be completed with reference to the FFC decision. ■

The Successful Management of Tax Risks Is One of the Top Priorities of Tax Managers

In the past two years tax planning has become increasingly risk averse. This was the finding of an international survey conducted by Ernst & Young amongst tax directors in a total of 470 companies in 14 countries, including 25 in Switzerland.

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According to the study, the most important functions of a tax department are the successful management of tax risks and the correct disclosure of tax data. The further development of international accounting standards, such as the interpretation of uncertain tax positions in balance sheet accounting under US GAAP (FIN 48), will push this issue further into the spotlight, requiring even more time and money.

Swiss firms are agreed that the management of tax risks has become increasingly important: 86% of the respondents confirm this trend. The management of tax risks was named the most important function of tax departments, followed by the cultivation of successful relationships with the tax authorities. This is a specifically Swiss response; few other countries consider maintaining close contacts with the tax authorities important. The possibility of discussing matters in advance with the tax authorities reduces possible tax risks or helps eliminate them altogether. In this sense, dealing with the tax authorities proactively can be seen as a means of managing tax risks. This Swiss practice is thus a competitive advantage which is worth holding on to and not something to be hastily ditched out of fear of developments in tax practice.

Swiss firms stress that tax risks are becoming increasingly important but 64% believe that tax planning has not become more risk averse, thereby bucking the worldwide trend, which points to most firms becoming less risk tolerant. This should not be seen as a contradiction but has more to do with the fact that companies that identify risks can tackle them in a more systematic and controlled manner.

The correct disclosure of tax data is most frequently named as the most important measure for tax departments around the world. In Switzerland much less importance is attached to this issue, which comes in at fourth place. However, this does not mean that the international accounting standards are considered less important, but, in my opinion, shows that Switzerland has been operating in line with these standards much longer than other European countries.

As accounting standards continue to develop, especially in the field of taxation, compliance with the new rules looks set to become an increasingly important issue in Switzerland. Under FIN 48, the rules for posting "uncertain tax positions" in financial statements in line with US GAAP has been comprehensively revised. Clear provisions governing when and to what extent so-called tax benefits or tax risk provisions have to be posted increase the risk of incorrect entries and misrepresentation in the financial statement. Compliance with these regulations means much more work for the tax departments and, in particular, highlights the need for a worldwide approach to recording and managing tax risks. And US GAAP is in no way alone – the standard-setters at IFRS are currently working on detailed regulations for recording tax risks in IFRS financial statements.

The changes to the regulatory environment have sharply increased the importance of tax risk management in companies worldwide. A systematic approach to tax risks is therefore unavoidable if we are to successfully overcome the current challenges of this rapidly changing environment and deal with its risks professionally. ■

New Draft VAT Act Under Consultation

Soon after his announcement in the fall of 2005 that Swiss VAT would be radically reformed into an "ideal" tax, the Swiss Finance Minister Hans-Rudolf Merz turned his words into actions. Peter Spori, whom Mr Merz appointed to conduct comprehensive research into the VAT reform, presented his final report in May 2006. In November an initial draft proposal was submitted for consultation, the results of which were evaluated and included in the bill submitted for consultation.

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On February 15, 2007, the submission (comprising the draft act and an explanatory report) was officially put out for consultation. The draft is modular in structure and presents various versions for comment. Each version is based on fundamental alterations to the act's structure and system and, in addition to various editorial changes, envisages about 50 adjustments to the current legal provisions (so-called "tax law" module). On the basis of this model, two possible ways of simplifying the VAT system are suggested, namely by reducing the number of tax exemptions and the number of tax rates ("single rate" module and "two rates" module). The new act is unlikely to enter into force before 2011/2012.

The most far-reaching changes submitted for consultation – the introduction of a single tax rate and the removal of numerous exemptions – would in principle simplify the tax system as many differentiations and thus many elements of complexity would be removed. However, both measures would result in a redistribution of VAT among different types of supplies. The political discussions on this issue are thus already under way.

The political decisions on these controversial issues notwithstanding, the aims of the VAT reform can largely be attained with other probably less contentious adjustments to the law. For example, the problem could be alleviated by making targeted changes to the provisions governing input tax relief and subjective tax liability, so that VAT is a consumption tax – as it should be – and not a tax on enterprises. Procedural law can – indeed must – be structured in such a way that taxpayers' legal security is significantly improved.

A range of individual measures for eliminating problems and irritations that have been under consideration for some time could finally be implemented within the scope of the legislative changes. One example would be to widen the applicability of net tax rates, which would enable some SMEs to simplify their administrative procedures significantly. Various improvements to the act's system and to the formulation of individual provisions would also help increase transparency and comprehensibility.

A new act should create clarity and transparency – particularly with regard to the provisions governing the burden of proof and the importance of the formal regulations. For the amount of red tape associated with VAT, which the Swiss Federal Tax Administration has been heavily criticized for, is due to the way the current act was interpreted by the Administration. Fundamental changes to administrative practices can realistically only be achieved by making fundamental changes to the law, such as setting out clear provisions which give clear priority to substantive issues and prescribe the free evaluation of proof.

The proposal for a new VAT act must be judged primarily on whether it can significantly improve the current law by achieving the fundamental aims of simplifying the system, increasing legal security and transparency and cutting red tape. At first glance the draft act appears to contain a number of significant improvements on the current version. It remains to be seen whether the in-depth analysis as part of the consultation process confirms this impression. Of course, we will follow these discussions and keep you abreast of the main developments. ■

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