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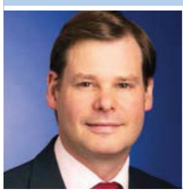
Analysis

The international briefing for July

SPEED READ This month the CJEU has held a hearing to consider infringement proceedings against the UK brought by the EC in relation to the UK cross-border group relief legislation. Also at the EU, an amendment to the Parent-Subsidiary Directive on hybrids has now been formally adopted. Further afield, India has held its first Budget following the recent change in government; and the Japanese government has announced its intention to reduce the corporate tax rate and expand the taxable base. There are also brief updates regarding the developments mentioned last month in relation to Sweden and Poland.



Chris Morgan has been an international corporate tax partner for 15 years and is head of tax policy and the EU tax group at KPMG in the UK. Email: christopher.morgan@kpmg.co.uk; tel: 020 7694 1714.

The Committee on Fiscal Affairs (CFA) has adopted seven papers on the 2014 actions of the OECD's action plan on base erosion and profit shifting (BEPS). The papers will now go to the G20 for approval at the summit on 20–21 September. The papers will only become public on or just before that date so it has been another quiet month in terms of public announcements. This month, I am focusing on two important matters at the EU, plus some overseas developments, including a couple of updates on topics I reported last month.

EU update

UK – cross-border group relief infringement proceedings: The Court of Justice of the European Union (CJEU) held a hearing on 15 July to consider infringement proceedings against the UK brought by the European Commission. The proceedings relate to the lawfulness of the cross-border group relief provisions that were introduced in FA 2006 following the landmark judgment in the *Marks & Spencer* case (C-446/03) in December 2005.

The rules introduced by FA 2006 allow for cross-border group relief claims in principle, but only in extremely limited circumstances that are almost impossible for taxpayers to satisfy. Essentially the 'no possibilities test' (NPT) needs to be satisfied at the end of the period in which the losses arose. However, in the recent conclusion of the long running series of *M&S* cases going through the UK courts, the two Supreme Court judgments of 2013 ([2013] UKSC 30) and 2014 ([2014] UKSC 11) held that the NPT should be assessed at the date the claim for cross-border group relief is actually made by the taxpayer and not at the end of the period in which the losses arose. Further, the filing of updated or 'sequential/cumulative' claims for the same losses and periods may be valid as long as the original claim was made within time.

The flaws in the FA 2006 legislation have been apparent from the outset and widely commented on. It will be surprising if the CJEU concludes that the legislation complies with EU law. The judgment that will follow this hearing will be significant for UK taxpayers with existing cross-border group relief claims, as well as those considering new claims in all periods that follow the introduction of the FA 2006 rules.

Parent-Subsidiary Directive: On 8 July, the European Commission announced that the Economic and Financial Affairs Council (ECOFIN) has formally adopted an amendment to the EU Parent-Subsidiary Directive, following political agreement at the Council's meeting on 20 June. The amendment contains measures to combat the use of hybrid loans.

The primary aim of the Directive is to prevent double taxation of the same income across members of a corporate group that are based in different member states. This is realised by providing for a withholding tax exemption on distributed profits and an exemption or credit for the recipient. The amendment is specifically aimed at preventing the Directive from facilitating double non-taxation arising, for example, where a loan is treated as debt in the member state of the debtor/subsidiary and as equity in the member state of the lender/parent, whereby payments on the loan are deductible in the former and exempt in the latter member state. The amendment is intended to ensure that the payments would no longer be exempt in the latter member state, which would then be required to tax the portion of the payments that is deductible in the member state of the paying subsidiary. Member states will have to implement the new anti-hybrid rules in their domestic legislation by 31 December 2015 at the latest. It is unlikely that UK law will need to be changed, because the UK already taxes the interest on such hybrid loans, as well as dividends which are tax deductible in the paying company.

This amendment originated from the action plan on tax fraud and evasion published by the European Commission in December 2012 and is part of the increased action we are seeing at an international level to combat aggressive tax planning, not least with the OECD BEPS project, which also includes a workstream looking at hybrids.

Agreement has not yet been reached on a second proposal to introduce a general anti-abuse rule into the Directive and discussions on this are expected to continue.

Global update

India – 2014 Budget: The India Union Budget was presented on 10 July, less than 45 days

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after the new government took office. Given the challenging economic conditions in India at the moment and the speed with which this Budget was pulled together, it is not altogether surprising that the finance minister chose to present a 'working budget', perhaps as an interim measure and as a prelude to more concrete measures in the short to medium term.

Few of the formal tax proposals published alongside the Budget are of interest from an international tax perspective but some of the promises made in the speech are worth a mention.

Several administrative and legislative measures are being proposed to reduce the amount of direct tax litigation that takes place. These include extending the provision of advanced rulings to residents, the establishment of a committee to interact with trade and industry on a regular basis to ascertain areas of tax legislation that require clarification, and several taxpayer friendly changes proposed to transfer pricing regulations. There was also a promise to review the entire Direct Tax Code and to establish a committee to scrutinise all fresh tax cases arising from the controversial retrospective amendments of 2012 that apply to indirect transfers.

Although it is too early to judge, the promised proposals are generally positive and hopefully signal an intention to tackle some of the more problematic areas of the Indian tax system.

Japan – corporate tax changes: The Japanese government's current focus on changing the tax system to make Japan a more attractive place to do business and make Japanese companies more competitive has been fairly widely reported in the UK press. As part of these efforts, on 24 June the Cabinet of the Japanese government approved the report *Basic policies for the economic and fiscal management and reform 2014*, which included two key announcements on corporate tax reform:

- The government aims to lower the effective corporate tax rate to the 20% range (i.e. 20%–30%) within several years, by starting reductions from the next fiscal year.
- Detailed plans to secure permanent funding sources by expanding the taxable base will be discussed further, to be announced by the end of 2014.

For a Tokyo-based company whose paid-in capital is over JPY100m, the current effective tax rate is 35.64% in Japan, which is higher than that of most other major foreign countries. It is understood that a 1% decrease in the effective corporate tax rate will require approximately JPY 500bn in additional government funding. Various matters – such as expansion of the size-based taxation system, reductions in tax incentives, reduction in benefits from the dividends received deduction and revision of depreciation – have been on the table as part of the discussion on how to expand the taxable base to secure the funding sources and these discussions will continue to the end of this year.

The Japanese government is in a difficult position because it needs to raise tax revenue (partly to reduce the very large government debt). However, over 70% of Japanese companies do not pay tax on profits, mainly because there are a lot of small companies, and the current high tax rate is not attractive when trying to bring in foreign investment.

Final decisions have not yet been made, but it is quite possible that the government will decide to expand the scope of size-based tax, which currently only applies to companies with capital over JPY100m, in order to help fund the decrease in the tax rate on profits.

> **The Indian Budget proposals hopefully signal an intention to tackle some of the more problematic areas of its tax system**

Poland – update on proposed CFC rules: I mentioned the proposed introduction of controlled foreign company (CFC) rules in Poland last month (see *Tax Journal*, 27 June 2014), suggesting they may come into force with effect from January 2015. However, there have been further developments on this. On 26 June, the lower chamber of the Polish parliament passed the Bill and it is now being debated in the upper chamber. The CFC provisions are intended to be effective on the first day of the fourth month following official promulgation of the law, which means that if the legislation were to be published in July the CFC rules would be effective from November 2014.

Sweden – update on corporate tax reform: I also mentioned last month a proposal put forward by a committee in Sweden for the introduction of a financing allowance in place of a deduction for net interest expense. The Swedish government's reaction to this proposal was not known at that time. However, a formal consultation on these proposals has now commenced, which will remain open until 24 October 2014. Following this consultation process, the Ministry of Finance will consider the proposals. After that, if a decision is made to proceed, the question will be referred to the Legal Council and then a Bill will be issued which will finally be approved by parliament. The consultation process and impending general election are likely to have a major impact on the end result.

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