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Exchange rates are subject to fluctuation and the figures contained in International News are not intended to be used as anything other than a general guide. The figures in this edition are based on the exchange rate on September 12, 2005, of €1 = US\$1.24 and US\$1 = €0.81; 1 Chinese Yuan Renminbi = US\$0.12 and US\$1 = 8.08 Chinese Yuan Renminbi.

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Welcome to the winter edition of *International News*.

Our issue begins with a very topical article on marketing and advertising relating to the Olympic Games. The Games generate huge revenues for the International Olympic Committee and for those who successfully negotiate licenses to produce merchandise bearing the Olympic brand. The benefits of having a strong, well-managed and protected global brand protected by legislation are clearly evident. Brand hijackers are liable to find themselves facing fines of up to £20,000 (approximately US\$37,700) if they attempt to ambush any of the Olympic Games trademarks.

Other features include European Union (EU) control over the cosmetics sector, a €70 billion (approximately US\$85 billion) industry involving some of the largest and most international companies. The feature underlines how compliance with EU regulations from the outset will stand you in good stead across all 26 Member States.

We also feature a very practical “how to” piece on managing cross-border mergers and acquisitions that details how differences in time zones, language, documentation and deal culture all conspire to hinder communication on these very complex deals. This is paired with an article that outlines the differences in EU and U.S. Merger Control. Procedural differences can cause huge logistical problems for clients with counsel who only understand either EU or U.S. controls—it is evidently key to have integrated legal advice in both jurisdictions.

We examine the issue of equal treatment in takeovers under German law as the management board and the supervisory board of HypoVereinsbank (HVB), the second largest bank in Germany, have agreed with Unicredito Group on a takeover by the Italian banking giant. At the time of going to press, the market is waiting to see if other banks or financial institutions will make counteroffers and set off a takeover contest for HVB.

In this issue we focus on tax. It is increasingly evident that tax professionals can help to save billions of dollars every year and tax efficiency and careful planning are the concern of every multinational company. It is clear that when it comes to transfer pricing, the way the United States’ Internal Revenue Service defines arm length pricing and the way that US Customs and Border Protection define it are completely different—and you need to be fully aware of the challenges you may face if you’re not aware of the discrepancy. We take a particular look at China, as it continues to define and strengthen its transfer pricing rules. Their application has taken on greater importance in dealing with the influx of multinational companies doing business across the multiplicity of regions in the People’s Republic. Finally we, move to the UK and explore the taxation of hedge funds, and managing the cost of tax. It is evident that clear documentation and a genuine business aim are key to legitimacy. In addition, in the case of hedge funds, it is critical to make sure the fund isn’t regarded as resident in the UK to avoid subjecting its profits to any significant level of taxation.



We hope that you find this edition of relevance to your business. We very much welcome your feedback and your questions. If you would like to contribute an article, please do feel free to contact Sarah Hargrove at shargrove@europe.mwe.com.

A handwritten signature in black ink, appearing to read 'David R. Ryder'.

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Marketing and Advertising at the London 2012 Olympic Games

By Duncan Curley and Rohan Massey

The 2000 Olympic Games in Sydney, Australia, generated revenues of almost US\$500 million for those parties who successfully negotiated licenses with the International Olympic Committee (IOC) to produce merchandise bearing the Olympic brand.

A strong Olympic brand is crucial to the commercial success of the Games. For this reason, the IOC fiercely protects its intellectual property rights in the Olympic Games brand, the Olympic logo and its authority over the advertising and marketing of the Olympics in the host city during the Games. Tight control of marketing has become critical to the IOC's commercial success as more and more parties try to benefit from being associated with the Games without paying the 10-15 percent royalty fees requested by the IOC from its official partners. For example, in the 1984 Games in Los Angeles, Kodak sponsored TV broadcasts of the Olympics as well as the U.S. track team, yet Fuji was the official sponsor of the Los Angeles Games.

Until now, unofficial or "ambush" marketing has been an annoyance to those who have invested in sponsoring an event. However, unless the marketing breaches local laws or infringes intellectual property rights, it has been difficult to prevent. Immediately following the announcement that London was to be the host city for the 2012 Olympic Games, The Olympic Games Bill was published by the UK government. The proposed legislation deals not only with the infrastructure requirements for hosting the Games, but also a provision that will make unauthorized ambush marketing in certain areas of London during the Olympic Games an offense.

The Bill does not provide details of how wide any marketing "exclusion zone" around the Olympic venues will be. It does, however, make clear that any unauthorized advertising within the exclusion zone, whether printed word, sound or light media, whether commercial or non-commercial, could result in a fine of up to £20,000 (approximately US\$37,700). The Bill also sets out to control the use of certain words and phrases relating to the Games so that they can be used only by those officially licensed by the IOC. The restricted words include Olympic, Olympiad, Olympian, Citius, Altius, Fortius, (the Olympic motto), London 2012 and even (in some circumstances) Games, medals, gold, silver and bronze.

The initial reaction to these provisions has not been positive as many perceive an unjustified criminalization of competitive marketing techniques in a free economy. The UK Government has argued that it is only fair that those officially associated with the London Olympics get the maximum protection and full benefit from their investment.

Although the London Olympics are not until 2012, the UK government and the IOC have already made clear that only officially sanctioned companies will be able to share in the commercial benefits of the 2012 Games. Any companies wishing to stake their interest in the commercial possibilities associated with the London Olympics should start considering their strategy, whether it be in merchandising or advertising in London.

If you wish to be kept up to date on the legal framework for advertising and marketing during the London Olympic Games in 2012, please contact the authors, your usual McDermott Will & Emery contact or any of the attorneys in McDermott Will & Emery's Intellectual Property, Media and Technology Group.



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Cosmetics and European Union Regulations

By Frank Schoneveld and Mélanie Bruneau

The European cosmetics market is a world leader, with an annual turnover of approximately €70 billion (approximately US\$ 87 billion) and an output value of over €35 billion (approximately US\$43 billion). Over five billion cosmetic products are sold every year to some 450 million consumers in the European Union (EU).

The marketing of cosmetic products in the EU is regulated principally by an EU Council Directive of July 27, 1976 (the Cosmetics Directive). This Directive harmonizes EU Member States' national cosmetic regulations, and ensures the free circulation of cosmetic products in the EU market and the safety of cosmetic products placed on the market. At the national level, regulations have been adopted by all the EU Member States in order to implement the Cosmetics Directive, including its amendments. While there may be some lingering differences in the national legislation concerning cosmetic products, compliance with the EU Cosmetics Directive enables the marketing of a cosmetic product anywhere in the 25 EU Member States.

Defining Cosmetic Products

Under the Cosmetics Directive, a cosmetic is any substance or preparation intended to be placed in contact with external parts of the human body or with the teeth or mucous membranes of the mouth. It can exclusively or mainly perform the following functions on the body: cleaning, protecting, perfuming, correcting body odors, changing its appearance and keeping it in good condition.

Composition of Cosmetic Products and Black-Listed Substances

The safety requirements that relate in particular to composition, packaging and information, are the responsibility of the manufacturer or the importer into the EU.

The manufacturer or company marketing the cosmetic in the EU must itself be established in the EU, or appoint a representative established in the EU, to be responsible for notification, assessment and data information requirements.

There is no premarket authorization necessary for cosmetic products at Member State or EU level. However, the manufacturer or the importer into the EU must maintain an information/data dossier readily accessible to the Member States' competent authorities at the EU address on the product label. This dossier must include details of the person, who must hold relevant EU-recognized qualifications, responsible for the assessment of the product for human safety. The manufacturer or importer must also notify the relevant Member State competent authority of the product's place of manufacture or initial importation into the EU. In addition, Member States may require that information on substances used in cosmetic products be available to the competent authority.

Cosmetic products cannot contain substances prohibited by the Cosmetics Directive (the substance black list). Any substances listed as carcinogenic, mutagenic or "toxic for reproduction" under another EU Directive on dangerous substances, are also banned. Cosmetic products may only contain substances, coloring agents, preservatives and UV filters listed in the Directive within the limits and under the conditions laid down therein (the white list). Failure to comply with these rules can result in the cosmetic being provisionally or permanently banned from the market.

Proposal on REACH

The EU Commission has proposed a sweeping new system to regulate all chemicals produced or imported into the EU: Registration, Evaluation, Authorization and Restriction of Chemicals (REACH). The new system will also apply to cosmetics and cosmetic ingredients produced or imported in quantities of more than one metric ton. The REACH system will have significant cost and management implications for cosmetics and ingredient producers. Risk data and procedures to manage human health and environmental risk must be registered and, in many cases, a more detailed Chemical Safety Report will need to be submitted for evaluation. If evaluation shows high concern for human health and/or the environment, specific authorization for marketing in the EU must be obtained. REACH will be introduced gradually over a number of years, the exact timetable for which is still being finalized.

For each type of alternative test for cosmetic ingredients replacing animal testing, the European Commission will lay down a timetable including a precise date of implementation.

Packaging and Labeling Cosmetic Products

Cosmetic products may be marketed only if the container and packaging bear certain information:

- name and address of manufacturer or person established within the EU responsible for marketing the cosmetic
- nominal content
- date of minimum durability indicated by the words “best used before the end of...”
- precautions for use
- batch number or reference for identifying the goods
- the function of the product unless it is clear from the presentation of the product
- a list of ingredients

Member States may require these indications to be expressed in their own language (except the name and address and the list of ingredients). Since March 2005, a new symbol showing a final “use-after-opening” date is progressively being introduced.

Prohibition Against Animal Testing

Following a vigorous and partially on-going debate, the Cosmetics Directive prohibits, over a period of time, the marketing of finished cosmetic products and cosmetic ingredients that have been tested on animals (marketing ban). The Directive also prohibits, over time, the testing of finished cosmetic products and cosmetic ingredients on animals (testing ban). The testing and marketing bans will apply, step by step, once alternative methods are validated and adopted. For each type of alternative test replacing animal testing, the European Commission will lay down a timetable including a precise date of implementation. Deadlines of 2009 and 2013 are foreseen, irrespective of the availability of alternative non-animal testing.

Unfair Business-to-Consumer Commercial Practices

Under the Cosmetics Directive, all labeling, marketing and advertising of cosmetic products must not imply that these products have characteristics that they do not have. In addition, under an EU 2005 Directive concerning unfair business-to-consumer commercial practices, certain commercial practices,

including advertising, can be considered unfair and subject to significant penalties. For example, presentation of a product may be factually correct, but if the associated advertising campaign or presentation of the product is misleading, fines can result.

Product Liability

According to the 1985 EU Council Directive, both producers, importers and any person putting their name, trademark or other distinguishing feature on a product are liable, without any fault necessary on their part, for damage (including death and personal injuries) caused by the cosmetic product imported or marketed in the EU.

Competition/Antitrust Rules

Agreements for the purpose of distributing cosmetic products may contain certain competition restrictions. EU Competition rules can involve fines of up to 10 percent of worldwide turnover being imposed on companies breaking the rules. In particular, it can very often be illegal to try to break up the EU market by restricting sales of cosmetics from one EU country to another. Before entering or expanding business in the EU, cosmetic manufacturers and importers should seek advice to ensure that they are in compliance with the complex EU rules on distribution and agency arrangements.



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Managing Cross-Border M&A Transactions

By John Hession and Dennis J. White

Managing a complicated M&A transaction is akin to playing three-dimensional chess. Success requires intimate knowledge of the rules, the ability to assess the entire chessboard and anticipation of the other party's moves.

When cross-border elements are introduced, the degree of difficulty increases exponentially. New rules come into play, viewing the entire chessboard can be a stretch, and sizing up the other party becomes more difficult.

As with most acquisitions, knowledge of the deal landscape and preparation are critical. The following points, although by no means exhaustive, describe some key elements to success. Some relate to “hard” realities, such as legal and accounting rules; others involve “soft” issues such as appreciating different deal cultures. Regardless of their texture, all these issues must be considered.

Timing and Time Zones

Although most business today is handled through e-mails that can zip around the globe in seconds, cross-border deals typically take longer. Differences in time zones, language, documentation and deal culture all conspire to impair communication. Also, non-U.S. players generally tend to move at a more measured and deliberative pace. It is helpful to appreciate these cultural aspects up front, and avoid reliance upon an overly aggressive and perhaps unattainable timetable, resulting in frustration and misguided expectations.

Differences in time zones, language, documentation and deal culture all conspire to impair communication.

When parties are in disparate time zones, it is helpful to adopt protocols relating to the time of day when conference calls will be scheduled and drafts circulated. Adroit management of time differences can enhance the sense of deal momentum as well as the client's comfort.

The Depth of Due Diligence

The thoroughness of buyer due diligence has increased markedly in the new millennium. Beyond this global phenomenon, European Union (EU) due diligence is generally more exhaustive than in the United States. The maxim caveat emptor is the operative doctrine in the EU. A buyer is presumed to have protected itself by thorough investigation and protective representations. Frequently, the due diligence is captured in extensive written reports to the buyer.

The difficulties of conducting cross-border due diligence have eased dramatically with the introduction of electronic data rooms. Buyers no longer need dispatch small armies of associates to distant venues to forage among boxes in windowless rooms. The information is now a keystroke away. Moreover, the target can more readily control access and monitor what prospective buyers are viewing.

Deal Cultures

Although generalities are dangerous, U.S. players are often more direct (some would say “transparent”) in their dealings and proceed to the bottom line with breathtaking (some would say “reckless”) speed. The rest of the world does not operate in this fashion. Many deal cultures place emphasis on the preliminaries: getting to know the other party and establishing a level of trust. In other cultures, the most successful deal negotiators are the most patient. It is important to understand not only the other party, but also the deal culture in which it operates.

Structuring the Deal

Buyers, wherever located, typically prefer asset deals, principally because they can more easily isolate seller liabilities and immunize themselves from post-transaction consequences. By contrast, in stock transactions, buyers inherit all the liabilities of the target business. U.S. merger statutes also present mind-numbing intricacies to foreign buyers. In many non-U.S. jurisdictions, the concept of a merger is unknown.

My Document or Yours?

Selecting the “drafter of the document” can generate considerable controversy. Probably in no area are there more pronounced

chasms in style and approach. While Europeans are often regarded by U.S. deal players as obsessive-compulsive concerning due diligence, they are viewed as having a very light touch in their production of documents.

The “tonal effect” of documents can have profound ramifications. Frequently, poor tonal quality can also infiltrate the negotiations, resulting in unanticipated tensions. Depending on the transaction, astute and diplomatic counsel often assimilates the style and approach of the target’s deal culture.

An astute buyer will want to know the rules under which it can hire, incentivize and fire members of the target’s workforce.

Tax Planning

The purchase price is an obvious focal point in the negotiations. However, well-advised players also explore tax planning opportunities, since these can yield economic benefits that are every bit as real. In a cross-border deal, those opportunities are more complex and difficult to analyze, but can be even more rewarding. Among other things, parties might advantageously arbitrage tax laws in a favorable manner. For example, the deal consideration might include buyer stock that is treated as a taxable consideration in the buyer’s country, but tax-free in the seller’s country, or the transaction might be financed with an instrument that is treated as “debt” in one country, but “equity” in the other. Acquisition debt can be placed in a legal entity (and country) where the interest expense deduction can provide the largest tax benefit. Ownership of the acquired company can be structured so as to minimize withholding taxes on repatriation of profits. Tax planning opportunities abound. However, in order to discern them, a party needs an advisor who is conversant in the tax regimes of multiple countries. Geographically compartmentalized tax advice is inherently inadequate.

Accounting Differences

There also exist significant accounting differences in cross-border transactions that can generate unintended consequences. For example, in transactions that include an “earn out” component, that is, contingent payments based on the future operating results of the target, such payments may be classified as an expense item for the paying acquirer, rather than transaction consideration. Also, while U.S. generally accepted accounting principles (GAAP) on revenue recognition for software companies is regarded as stringent, UK GAAP on identical fact patterns is relaxed. Consequently, the use of UK versus U.S. GAAP will produce different results. Accounting advisors who are conversant in these disparate treatments can contribute significantly to deal structuring.

Employment and Employee Benefit Issues

Issues relating to labor laws, employee benefits and personal data protection policies differ markedly among countries. In the United States, employees are generally employed on an “at will” basis, that is, they may be terminated at any time and for any reason that is not unlawfully discriminatory. In the EU, for example, employee dismissal is subject to tighter restrictions or can trigger substantial severance payments. In the United States, employees have no collective voice unless unionized. In the EU, employers over a certain size must establish worker’s

councils where employees must be consulted. In the realm of employee benefits, stock options and other forms of equity-based incentive compensation are commonplace in the United States, but rare in the EU. Under EU directives, protection of employee data is significantly tighter than the United States. An astute buyer will want to know the rules under which it can hire, incentivize and fire members of the target’s workforce.

Post-Closing/Dispute Resolution

In the United States, the volume of post-closing litigation for alleged breaches of representations has grown significantly in recent years. At times, it seems like such disputes are the naturally succeeding chapters to the deal itself. In the EU, post-closing litigation remains relatively rare. Again, caveat emptor is the operative doctrine. Nonetheless, in a cross-border transaction it is prudent not to leave dispute resolution to chance. Among other things, it may be wise to stipulate arbitration under international rules in a neutral city.



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Navigating the Differences Between EU and U.S. Merger Controls

By Scott S. Megregian and Davina Garrod

Many global deals require antitrust clearance in both the United States and in the European Union (EU). The good news is that the EU and U.S. authorities now generally consult and cooperate with each other in transatlantic cases, in the interests of reaching consistent outcomes and minimizing transaction costs. It is ever more important that U.S. and EU legal counsel for merging parties also coordinate their advice and action.

Whilst the trend in EU merger control in recent years has broadly been towards convergence with the U.S. regime, important procedural differences still exist. Merging parties need to be aware of these differences in order to obtain EU and U.S. clearances as quickly and as cost-effectively as possible.

Reviewing Authority

In the European Union, the European Commission has exclusive jurisdiction over transactions falling within the EC Merger Regulation. Parties to such deals must file a submission about the deal to the European Commission and obtain clearance before completing the deal. Individual Member States may have jurisdiction over deals falling outside of the EC Merger Regulation; such transactions are not exempt from review.

By contrast, the Department of Justice (DOJ) and the Federal Trade Commission (FTC) have jurisdiction over all mergers above or below the U.S. jurisdictional thresholds. Only a qualifying merger needs to be filed with the U.S. authorities, however, and then either the DOJ or the FTC will review it.

Jurisdiction

U.S. merger control law casts a wider net in terms of qualifying transactions, encompassing parties and types of transactions that are more diverse, such as acquisitions of partial equity stakes. The U.S. jurisdictional thresholds are also lower, catching a higher proportion of transactions than those in the EU. Although the European Commission's jurisdiction is exclusive, it can refer certain transactions (or parts of transactions) to Member State authorities for their review. Conversely, Member States can refer certain cross-border transactions to the Commission.

Preparation Is Everything

The European Commission recommends that merging parties submit a draft filing before formal notification so the review process can be started early. By contrast, the U.S. authorities tend to engage in pre-notification discussions only where deals are likely to raise significant antitrust concerns.

The EU filing requires submission of detailed legal, economic and industry information, whereas the U.S. filing focuses on financial and organizational details of the merging parties. However, the U.S. filing does ask the merging parties to supply a wide spectrum of deal-related documents, including directors' hand-written notes and emails, and presentations about the deal, whereas the EU only requests formal representations or studies.

First Phase Review

The first phase reviews in the European Union and the United States generally take around one month for the authorities to complete. Most transactions are cleared within this period on the grounds that they are unlikely to raise significant competition concerns. Where the authorities require more time to substantively analyze the deal, or where the deal clearly gives rise to concerns, the authorities will undertake an in-depth analysis (see below). In the European Union, merging parties have a greater opportunity to "fix" competition concerns upfront within Phase I, whereas problematic U.S. deals tend to be subjected to an in-depth review.

Analyze That

The in-depth investigation in the United States is launched when a Second Request is sent to the merging parties. A Second Request is a long list of questions that acts as both a subpoena for documents and a set of interrogatories. There is no clear articulation of the U.S. authorities' concerns. By contrast, the European Commission notifies its initiation of an in-depth investigation to the merging parties by letter indicating that it has serious doubts as to the competitive impact of the transaction, and explaining those doubts.

The EU filing requires submission of detailed legal, economic and industry information, whereas the U.S. filing focuses on financial and organizational details of the merging parties.

Whereas the timing of the EU Phase II investigation is carefully prescribed (generally taking 75 to 90 working days), the U.S. Second Request process is more open-ended. This gives the U.S. authorities more time to investigate the deal and, if appropriate, market test commitments. One key advantage for merging parties in the European Union, however, is their legally recognized “rights of defense.” Merging parties in the European Union have much greater opportunity to understand the Commission’s evolving view of the deal by access to the Commission’s Statement of Objections and case file, and by attendance at an oral hearing with the Commission staff. Under the U.S. system, merging parties do not have equivalent procedural safeguards until the U.S. authorities actually seek to block a transaction. Consequently, the U.S. in-depth investigation is significantly less transparent.

Blocking the Deal

The EU and U.S. authorities rarely block deals today. Instead, transactions that raise competition concerns normally get “fixed” by remedies. The U.S. authorities must obtain a court injunction in order to block a deal. By contrast, the European Commission itself blocks the deal, acting as its own judge and jury.

Quick and Slow Fixes

Merging parties are generally free to submit remedies to the authorities during the in-depth review in order to fix any competition concerns. Remedies are broadly divided into structural (e.g., business divestments, IP assignments) and behavioral (e.g., agreements to grant access) remedies. There is a strong preference for structural remedies on both sides of the Atlantic because they do not require ongoing monitoring. The U.S. authorities are particularly reluctant to accept behavioral remedies, and will not accept undertakings relating to pricing.

Complainants

Beware third parties – they can play a significant role in both U.S. and EU merger investigations. Third parties in the European Union have greater access to information and procedural safeguards than in the United States, which means that it can be easier for them to influence the Commission’s findings and the nature of any the remedies ordered.

Six Recommendations

Many deals do not raise significant antitrust concerns. They will either not be notifiable at all, or will be cleared within an initial investigation. Deals between leading, competing companies, however, and other deals that raise significant competition concerns will require significantly more attention in order to obtain clearance and may even involve the merging parties divesting business assets. For these transactions, although we approach each case on its own merits, we would recommend the following as a general approach:

- enable EU and U.S. counsel to coordinate gathering of information, substantive analysis, any necessary remedies and deal strategy;
- consider the need for external specialists, such as economists and public relations experts;
- investigate and address any possible third-party complaints;
- engage the EU and, if appropriate, U.S. authorities at an early stage;
- coordinate the timing of the filings to maximize positive outcomes; and
- deal proactively with the U.S. and EU authorities throughout their investigations.



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Equal Treatment in Takeovers Under German Law

By Christian von Sydow and Oliver Beyer

The management board and the supervisory board of HypoVereinsbank (HVB), the second largest bank in Germany, have agreed with Unicredito Group on a takeover by the Italian banking giant. At the time of going to press, the market is waiting to see if other banks or financial institutions will make counteroffers and set off a takeover contest for HVB.

Some market observers have suggested that a hostile counteroffer is not likely because a competing investor would not be able to conduct adequate due diligence with the cooperation of HVB. Although these observers appear to assume that the board of HVB is not obligated to assist another bidder with due diligence, it is unclear whether, under German law, this is the case. The German Take-Over Code (WpÜG) does not specifically cover this issue and the German Financial Supervisory Authority (BaFin) has not issued any relevant regulations. The subject has been the topic of heated discussion in the financial press.

In short, the WpÜG does encourage competitive take-over offers. A number of the WpÜG's information and process rules are designed to promote additional offers. For example, the duty to publish one's intention to attempt a takeover directs public attention to the target company and invites healthy scrutiny of the bidder's strategy with regard to the target company's business. Further, because the minimum term for the acceptance of takeover offers is four weeks—which may be prolonged to 10 weeks—competitive investors have ample time to create and make a counteroffer. In addition, the WpÜG encourages competition by allowing the board to search for a “white knight” if a takeover offer is deemed inadequate.

Paragraph 33(1) of the WpÜG is the legal basis for obligating the board to treat competing investors equally. Under this provision, no activities may be conducted that could prevent the success of one of the offers. But this provision is only applicable after publishing the decision to issue an offer and, in practice, due diligence usually has to be conducted in advance of the announcement.

The real basis for the argument that the board would have to assist an alternative investor stems from the reality that the board of a target company is obliged to act in accordance with the interests of the shareholders, who are usually best served by obtaining the highest possible purchase price. In undertaking due diligence, the investor minimizes his risk of the takeover failing. By giving an investor the chance to conduct due diligence, the subsequent lowered risk leads to a higher purchase price. Because it is therefore in the interests of the stockholders, each potential investor must be given, by the board, the same equal chance to undertake due diligence.

There is, however, a caveat. If there is a risk to the target company from the due diligence process (*e.g.*, if the potential investor is a direct competitor), the target company's board would, out of necessity, have to withhold sensitive information. In this way, the best interests of the shareholder, which are served by protecting information from the scrutiny of competitors, actually prevents the equal treatment of potential investors.



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Multinational Transfer Pricing: It's a Tax-Based World... but Beware of the Customs Consequences

By David J. Levine and Robin J. Bowen

Multinational companies set the prices for transactions between affiliates based principally on international tax considerations. McDermott tax attorneys have assisted many clients with transfer pricing matters, including advance pricing agreements (APAs), before the U.S. Internal Revenue Service (IRS) and the tax authorities of other countries. The IRS and other tax authorities have well-established, if complex, rules concerning “arm’s length” pricing, *i.e.*, pricing that is unaffected by the involved parties being affiliated.

Companies are well-advised to pay close attention to the valuation of imported goods entering under U.S. Bureau of Customs and Border Protection (CBP) rules, as these rules impose an arm’s length standard for related company transfer pricing that differs from the standard applied by the IRS. Therefore, pricing that satisfies business objectives and tax rules may raise serious questions from CBP if used for customs valuation purposes.

Well over 90 percent of the merchandise imported into the United States today is properly appraised according to its “transaction value,” as preferred by CBP under U.S. law. The transaction value of imported goods is defined as “the price actually paid or payable for the merchandise when sold for exportation to the United States” (typically, the invoice price) plus certain additional amounts.

For sales between a related buyer and seller, U.S. customs law imposes stricter requirements for imports to be appraised according to transaction value. Transaction value may be used to appraise related company imports if either:

- the circumstances of sale indicate that the relationship between buyer and seller did not influence the price (“circumstances of sale” or COS method), or
- the transaction value closely approximates the value of identical or similar merchandise sales to unrelated U.S. buyers (“test values” method)

In order to satisfy the COS method to show arm’s length pricing (test values are typically not available), regulations and rulings by CBP dictate that importers must be able to show either that the pricing was set consistent with sales to unaffiliated customers or with “normal pricing practices of the industry,” or that the pricing covers all costs plus a profit.

For multinational companies with transfer pricing policies based on relevant tax rules, affiliated importers have argued that the tax standards satisfy the COS method for customs valuation. To the dismay of many importers, CBP has rejected these arguments. In a series of rulings, CBP has been reluctant to rely on tax compliance, or even on specific pricing terms under APAs negotiated with tax authorities, as objective proof that a related importer’s transaction value reflected arm’s length pricing. Thus, for example, for multitiered sales among affiliates (manufacturer to distributor to U.S. importer), U.S. customs law allows appraisal of the imports at the “first tier” value, but only if that sale meets, among others, the transaction value test.

In today’s tax-based world, some have argued that U.S. customs valuation laws and rules are outdated relics that must be amended. Unless and until this occurs, related-company importers of goods into the United States must carefully consider their customs valuation. McDermott tax and trade lawyers have worked seamlessly with several clients to ensure that the benefits derived from careful tax planning are not compromised by inattention to customs consequences, and vice versa.



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China Continues to Define and Strengthen Its Transfer Pricing Policies

By Vivien Chan and Larry R. Kemm

As trade barriers have eased following China's accession to the World Trade Organization in 2001, the application of transfer pricing rules has taken on greater importance in dealing with the influx of multinational companies doing business in the People's Republic of China (PRC). Recent circulars issued by the State Administration of Taxation (SAT) demonstrate that the authorities wish to make transfer pricing one of their priorities. Under recent initiatives, there are provisions to coordinate tax authorities nationwide, to expand the transactions available to tax investigation and to provide new guidelines on methods of adjustment for tax authorities.

What Types of Transactions Will Be Caught?

A transaction may be subject to the deeming provisions under PRC law if it is not considered to have been conducted at arm's length or if it has been made between affiliated enterprises (both local and foreign). The definition of affiliation between enterprises is broad, and is considered to arise when an enterprise has a direct or indirect shareholding that is more than 25 percent, has granted a loan that exceeds 50 percent of the lender's registered capital, has guaranteed 10 percent or more of another's loan, controls over half of the senior management, controls intellectual property rights, controls the supply of raw materials and accessories, or controls the sales of the enterprise.

The types of transactions that may be caught include the sale, purchase or transfer of assets (whether tangible or intangible), financial support (loans at inflated rates as well as credit sales) and, importantly, the provision of professional services.

Expanded Powers of Investigation

The scope of powers of investigation of transfer pricing transactions now extend for up to three years from the date that audit notice is issued to the taxpayer or, under special circumstances, up to 10 years. These circumstances include:

- transactions between associated companies with a value of more than Renminbi 100,000 (approximately US\$12,400)
- transactions with companies incorporated in tax havens
- situations where the company has not provided sufficient documentation in the past.

- situations where the adjustment to income from transactions between companies is expected to be more than Renminbi 500,000 (*approximately US\$62,000*).

On an increasing basis, coordinated national transfer pricing audits of multinational companies are being jointly conducted by tax authorities across China, thereby facilitating a more efficient audit process for the taxing authorities.

Adjustments by Tax Authorities

Where pricing is not arm's length and reasonable, adjustments will be determined by the tax authorities. The adjustments may now be based on profit-based methods or transaction-based methods, including:

- pricing of the same or similar business transactions between unaffiliated enterprises (comparable uncontrolled price or transactions method)
- profit margin obtainable if the goods were resold to a non-affiliated party (resale price method)
- cost plus a percentage mark-up.

Where the above methodologies cannot be applied, the tax authorities may assess liability by various other methods, including reference to profit levels of companies that are of similar size or operations. In those situations, "like industry" comparables will be decisive. To further strengthen such comparables analysis, the SAT recently issued a circular instructing that adjustments should be made for differences between the utilization of operating capital (so-called capital intensity adjustments) to increase the reliability of operating profit determinations and enhance the comparability of profit levels.

The tax authorities have the power to require disclosure (although not publication) of intercompany pricing, the nature of a transaction (*i.e.*, quantity and size), the transfer of tangible and intangible assets, capital financing and the provision of services (including administration services, technology and design services).

Targets of Tax Authorities

In addition to random audits, the tax authorities will conduct investigations of companies, in particular those who have been:

Several forms of inter-company transactions may be particularly susceptible to challenge under Hong Kong transfer pricing rules.

- reporting losses or fluctuating/erratic profits for an extended period
- reporting lower profitability rates after exhaustion of tax holidays/benefits, or paying unnecessary and exorbitant fees to related parties
- conducting a significant volume of transactions with associated enterprises or group companies, in particular when pricing may have an effect on other forms of tax
- experiencing rapid growth in turnover without any corresponding increase in profitability.

What to Do?

Under PRC law, the onus is on the taxpayer to prove that the intercompany transactions are reasonable and at arm's length. Corporations are thus advised to document the commercial justifications for transactions, as well as comply with procedures for declaration of transactions with associated enterprises or related parties by filing an annual declaration form.

In addition, an Advance Pricing Agreement (APA) for dealings with associated enterprises may be submitted for clearance with the tax authorities prior to embarking upon the transactions. In September 2004, the SAT issued trial implementation rules that included specific requirements for the coordination and supervision of the APA process among state and local tax authorities. These new rules may facilitate the negotiation process directly with the SAT where multiple affiliated entities are operating in different regions throughout China. Although an APA serves as a blessing in advance, care must be taken for reconciliation with past transactions to avoid an admission of past improper pricing.

Hong Kong Approach

The taxation laws in Hong Kong target those transactions that have been entered into to achieve a tax benefit for a person, with the Inland Revenue Department (IRD) empowered to disregard artificial/fictitious transactions and impose tax liability if a transaction has the "effect of conferring a tax benefit on another." The basic criteria for the exercise of such powers is two-fold, and involves examining whether the "sole and

dominant" purpose of the transaction was to obtain a tax benefit and whether a tax benefit was actually obtained.

Determining Tax Liability

Where it is determined that there has been a transaction between affiliated enterprises, tax adjustments can be made by treating the transaction or any part of it as if it had not been entered into, or counteracting the tax benefit. Furthermore, the IRD has extremely broad powers to obtain full information from any person, in respect of "any matter" affecting the tax liability or obligation of a person.

Tax-Sensitive Transactions?

Several forms of intercompany transactions may be particularly susceptible to challenge under Hong Kong transfer pricing rules. In particular, "connected" or related party transactions and business activities of a nonresident company with a local "connected" party may be subject to attack. The nexus for determining whether a party is connected is quite wide, and may be established either where there is substantially identical ownership or where the ultimate controlling interest of each is owned or deemed to be owned by the same person or controlling interest of a company. In such case, if the local connected party records nil profit, the business of the nonresident company is deemed to be carried on in Hong Kong.



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It Needn't Be Taxing: A UK Perspective of the Taxation of Hedge Funds

By William Yonge and Sylvia Choi

Tax is a key driver in the context of setting up hedge funds. Broadly, the business aim is to minimize tax on the fund and fund manager and to ensure that investors do not suffer any additional taxation by virtue of investing in the fund. Through careful structuring and close coordination with those responsible for the business and general legal requirements, the optimum position can be achieved. However, there are pitfalls that need to be avoided.

Typically, a hedge fund will be set up as an offshore company in a low tax jurisdiction to ensure that the fund's profits will not be subject to any significant level of taxation. A UK investment manager may be appointed who would be responsible for investing the assets of the fund and for its day-to-day operation. The UK investment manager would usually make investment decisions on behalf of the fund, subject to the overall parameters and strategy set by the fund's directors.

The limited liability partnership has, since its creation in 2001, become the vehicle of choice for start-up UK hedge fund managers.

Tax Residence of the Fund

It will be critical to ensure that the fund (*i.e.*, the offshore company) is not regarded as resident in the United Kingdom to avoid subjecting the fund's profits to UK taxation. A fund that is incorporated outside the United Kingdom may still be regarded as UK-resident if it is centrally managed and controlled in the United Kingdom. Central management and control refers to the place where the highest level of management decision-making takes place. This would normally be where the board of directors meets.

As a matter of best practice, the board should generally comprise mainly non-UK directors of a caliber and character to make the strategic decisions required of them. The board should not be seen simply to "rubber stamp" decisions made elsewhere but must exercise management and control regularly outside the United Kingdom. Care needs to be taken in the choice

of location of board meetings to ensure that taxation does not become payable in that jurisdiction. Any enquiry into the fund's residence is likely to involve a detailed examination of board minutes and other documents surrounding the decision-making process.

Trading in the United Kingdom Through a UK Permanent Establishment

The fund could also become subject to UK corporation tax on its profits if it is trading in the United Kingdom through a permanent establishment there. The distinction between trading activities and investment activities can be very fine. A UK investment manager, who enters into transactions on behalf of the fund as agent, could be regarded as the UK permanent establishment for it.

However, the UK rules, known as the Investment Management Exemption, ensure that if certain conditions are met, a UK investment manager will not be regarded as a permanent establishment and no UK tax liability will thereby arise for the fund.

For the Investment Management Exemption to apply, the UK investment manager must:

- be in the business of providing investment management services. Investment transactions carried out by the UK investment manager on behalf of the fund must be undertaken in the ordinary course of that business
- carry out such transactions in an independent capacity
- charge a "customary" rate for the type of business transacted
- not carry on any other trade in the UK on behalf of the fund in relation to which it might be treated as its permanent establishment.

In addition, any persons connected with the fund must not have more than 20 percent of the beneficial entitlement to the fund's trading income.

As the conditions must be met at all times, the investment manager will need continuously to review its position.

Any enquiry into the fund's residence is likely to involve a detailed examination of board minutes and other documents surrounding the decision-making process.

The UK Investment Management Vehicle

The limited liability partnership (LLP) has, since its creation in 2001, become the vehicle of choice for start-up UK hedge fund managers. In the United Kingdom, provided that the LLP carries on an active business, the members of the LLP are taxed on their share of the LLP's annual profits and the LLP itself is not taxed. In addition, interests in the LLP may be varied without transferring UK tax liabilities when new members join the LLP, and employment tax rules do not apply as individual members of the LLP are not its employees. Notably, no employer National Insurance contributions (NICs) are payable by the LLP and no employee NICs are payable by the members of the LLP; this is particularly relevant in the context of performance fee distribution.

Where there needs to be an employee compensation structure (which depends on the existence of an employer/employee relationship), it is necessary to use a hybrid structure.

Transfer Pricing

Sometimes hedge funds are structured using an offshore fund manager with a related UK investment manager. Care needs to be taken in such circumstances to ensure that, for transfer pricing purposes, an adequate arm's length (*i.e.*, pricing that is unaffected by the involved parties being affiliated) remuneration is received by the UK investment manager for its provision of investment management services, based on an analysis of the functions of the parties involved in the structure. It is vital that contemporaneous documentation evidencing arm's length prices in compliance with the transfer pricing code is maintained.

This is particularly important given that in recent years, HM Revenue and Customs (HMRC) has, through its Special Compliance Office, increased its interest in offshore funds and has shown a willingness to challenge structures on transfer pricing grounds.

Investors

UK-resident investors will normally be liable for UK tax in respect of income distributions of the offshore fund. In addition, the United Kingdom's offshore fund rules may, if applicable, treat any gain arising to investors on the disposal or redemption of their interests in an offshore fund as income rather than chargeable gains. For corporate investors, income treatment means that they will not be able to utilize indexation allowance. Shareholders who are individuals will not be able to take advantage of their annual exemption or capital gains taper relief to reduce gains arising on disposal.

However, such income treatment will not apply if the fund is certified as a "distributing fund." A fund may apply to be certified if it follows a "full distribution policy" and meets certain other conditions. A fund follows a full distribution policy if, in respect of each accounting period, it distributes at least 85 percent of its income as shown in its accounts for that period, and not less than 85 percent of the fund's "UK-equivalent profits."

Since 2004, the United Kingdom has had a more accommodating offshore funds regime, which makes it simpler for funds to obtain distributing fund status. Separate share classes and sub-funds may now qualify for distributing fund status independently without the need for the entire fund to satisfy the tests.



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Managing the Cost of Taxation: Avoidance or Savings?

By Peter Nias

When does (acceptable) tax savings planning become (unacceptable) tax avoidance?

Never before has the spotlight focused as much on this dichotomy for the multinational company and Tax Authority alike. The (acceptable) tax savings plan of the taxpayer is often the (unacceptable) tax avoidance scheme to the Revenue Authority.

The challenge for the taxpayer, is to find how far any structuring can be developed so as to remain acceptable in the view of the Tax Authority without being vulnerable to successful challenge or, ideally, any challenge at all.

Finding that point is fast becoming the principal challenge of the multinational faced with growing pressure to reduce costs—and taxation is indeed a cost.

The UK Tax Authority still accepts that tax planning can play a legitimate part in commercial activity. When the anti-avoidance provisions in the loan relationships legislation were introduced, the Economic Secretary to the Treasury, Angela Knight, confirmed “where a company is choosing between different ways of arranging its commercial affairs, it is acceptable for it to choose the course that gives the most favorable tax outcome.”

More recently, when the anti-avoidance cross-border arbitrage provisions were introduced, the Government acknowledged there was “nothing wrong with arbitrage itself, which is inevitable, given the variations between national codes and the existence of laws that apply to some companies and not to others.” However, they felt it was necessary to introduce new anti-avoidance legislation to combat “distortion of the commercial behavior of multinational groups” which was exploiting arbitrage to avoid UK tax.

The acknowledgement that saving tax is acceptable behavior is perhaps not surprising, however, in the context of judicial pronouncements over the years that have included Lord Upjohn observing that “no commercial man in his senses is going to carry out a commercial transaction except upon the footing of paying the smallest amount of tax” (*I.R.C. v. Brebner, 1967*) and the decision in the House of Lords (the highest court in the land) that there is no general anti-avoidance doctrine in

English law—no “broad spectrum antibiotic” that kills off all tax avoidance schemes—merely a requirement to construe statutory provisions in their commercial context.

So where does that leave the multinational company and its advisers? The key is the context—the particular facts and circumstances of the proposed transaction or structuring.

Where the proposal is based on sound commercial objectives, with any tax saving not being one of the main objects (although still a relevant feature in the decision to proceed), favorable tax structures can be included and should not be vulnerable to successful challenge.

But the commercial objectives must have evidential support, and be fully documented; and the transaction documents must be properly implemented and managed.

The concern and vulnerability to challenge arise where inconsistencies occur between the documentation (and its adequacy) and how the transaction is being implemented in practice.

In the UK, multinationals should have little to fear where tax planning is introduced as part of a process to achieve a commercial objective. However, there is a heightened interest on the part of the UK authorities to protect their revenue and this will lead to increasing scrutiny of arrangements entered into by multinationals in the future.

It is therefore prudent to prepare for this eventuality and ensure there is contemporaneous evidential support for any assertion that the tax-planning feature of any arrangement was not, in itself, a means to an end, but just part of a better way of achieving the commercial end. It is equally important that the arrangements are implemented in a way that is consistent with that evidence that should also legitimately support the commercial aim.



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