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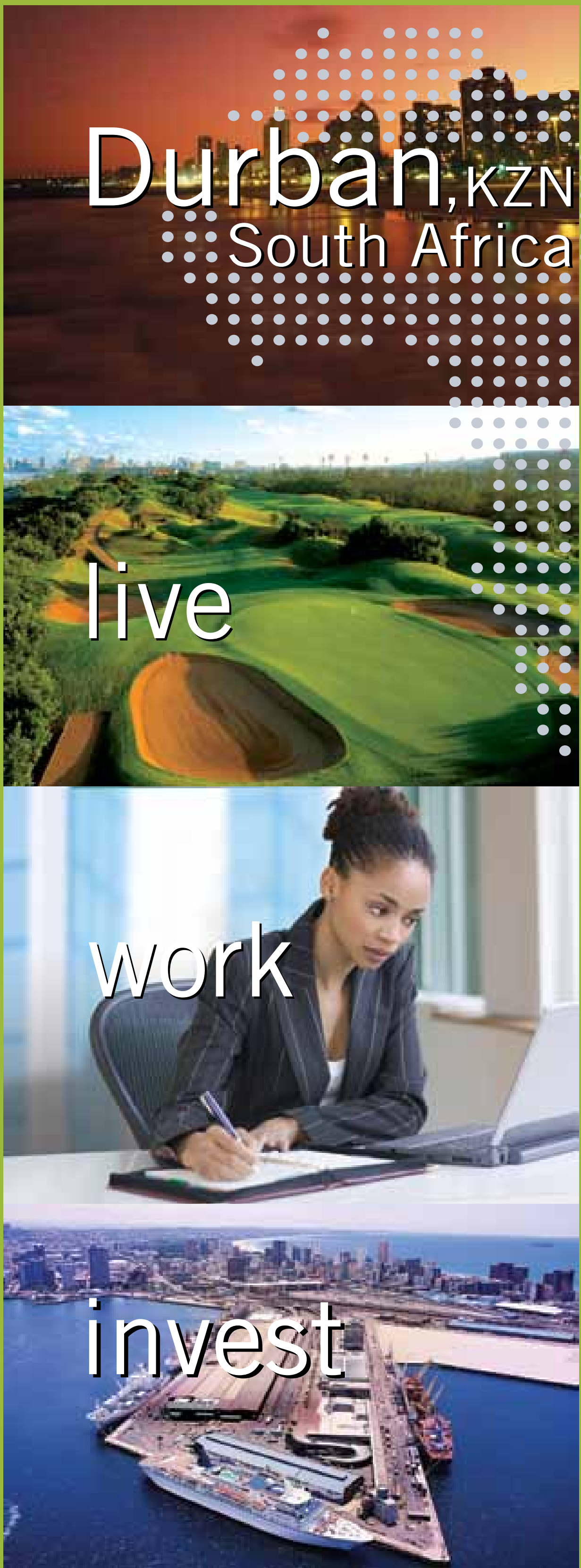
THE GLOBAL TRADE PLATFORM



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4. **H**ighest growth rates. Our economic growth rates are higher than the country's average, and that of the other major centres, historically being in the region of +/-6%. We're targeting in the range of 7,5% - 9%. This impacts positively on business confidence levels, fixed capital formation, etc. As most analysts would observe, "the trend is our friend" in Durban.

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7. **S**ubstantial, successful, sustainable business base already in place across the primary, secondary and tertiary sectors. It's a case of functional magnetism – companies like to be located synergistically, with more than 65% of the Province's GGP produced in Durban, along with the Durban Chamber of Commerce being the largest Metro Chamber nationally. Business is clustered around the manufacturing, tourism, services, maritime, logistics and agricultural industries. Having the second largest business and industrial base in SA provides many options for suppliers, support services, customers and employees, which are all important factors of production.

These are the 'ALL HITS' Super 7 key reasons that make Durban attractive to both residents and visitors alike.

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Choices for the eurozone

The eurozone, as conceived, has failed. It was based on a set of principles that have proved unworkable at the first major crisis. It has only two options: to move towards a closer union or to a partial dissolution.

The existence of this choice proves that an enduring union will at the very least need deeper financial integration and greater fiscal support than was originally envisaged. European monetary union has always been a halfway house – more than a fixed exchange rate system but less than a full economic union. Sometime soon, it will have to go one way or the other. Full fiscal integration would imply that the debts of one country are automatically shared by the others. But that is implausible without central control of spending, taxing and borrowing. And that is not acceptable without a political union. This is possible, but unlikely with euro-scepticism on the rise across the continent.

It would be more viable, though, for a smaller group. One option might be simply to accept that Greece was an integration too far and allow her to leave. Yet that is not an easy option either. Greece would still have to default, thereby threatening a financial crisis, while still having to maintain fiscal stringency and enact radical reforms.

The other option is for Germany to leave, taking with her those countries which are closely aligned. This group would include Austria, Finland and Benelux. This group could form a new currency, call it the 'new euro' (or perhaps the 'hard ecu' or the 'über euro'). The remaining countries would be left with the euro. The 'new euro' would be stronger than the euro, setting the stage for an export boom for countries that continue to use the euro. This would allow the remaining eurozone members to restore their competitiveness without having their financial systems go bankrupt; it also would allow Germany to sell the plan as saving Europe without breaking up the EU.

This has several advantages. The weaker countries are not picked off one by one (as with the ERM) but remain linked to other countries with which they have some close similarities. Weaker countries' debt would continue to be denominated in their own currency. It would be the stronger countries, led by Germany, that would have to face the difficult technical, legal and financial problems of forming a new currency. Lastly, these countries might be both able and willing to go the whole hog to fiscal and political union.

This solution isn't politically acceptable at the moment. The German business establishment wouldn't support it. The euro has contributed to Germany's export boom. But they, and the German public, may eventually change their tune after each bailout, and Berlin could ultimately make a simple calculation that extrication will be less costly than continuing the sacrifice needed to keep the euro.

Such choices are considered as fringe notions in Europe, but then who would have thought that the IMF would be bailing out the euro project? Eventually the policymakers will catch up with reality. ■

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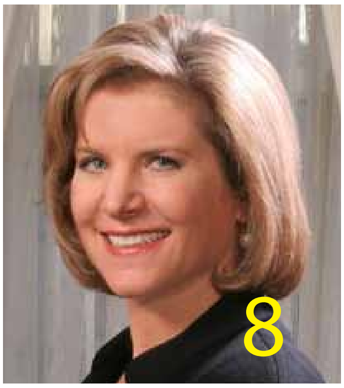

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Acknowledge Doha's demise and move on to save the WTO

Susan C Schwab is a Professor at the University of Maryland School of Public Policy, a strategic advisor to Mayer Brown, LLP, and is a former US Trade Representative

The Doha Round has failed. This article argues that prolonging Doha jeopardises the multilateral trading system and threatens future prospects for WTO-led liberalisation. Negotiators should salvage whatever partial agreements they can from Doha, and quickly drop the rest to ensure the December ministerial meeting focuses on future work plans rather than recriminations over Doha.

The Doha Round has failed. It is time for the international community to acknowledge this sad fact and move on. Prolonging the pretence that the Doha Round will succeed is now a greater threat to the WTO and the multilateral trading system than facing the truth.

A great many smart, hard-working and well-intentioned individuals have worked over many years to realise Doha's potential to contribute to global economic growth and development. But what is on the table in Geneva has failed to deliver any outcome, let alone a meaningful one. It is time for a swift, clean break from the past and to lay the groundwork for a future where the WTO and its members revive WTO-led liberalisation and reform.

End Doha's stranglehold and build towards near-term wins

To keep the multilateral trading system healthy, it is necessary to end the Doha Round's stranglehold on the system. This should happen quickly in order to ensure that the December 2011 ministerial meeting focuses on future work plans, rather than recriminations about a Doha Development Agenda that has struggled through one failed encounter after another.

Negotiators should refocus their efforts on near-term wins and on building the next Round – which need not be another behemoth, but perhaps a "rolling round" of reforms and new market access, or a few highest-common-denominator plurilateral, or WTO-plus deals. Ultimately, these should lead to a broader-based market access and rules agreement under the multilateral auspices of the WTO.

> **"The emerging economies have large markets, represent over half of global GDP growth, and stand to be the biggest winners from any major trade agreement"**

The small package possibility

In my recent Foreign Affairs article[1], I suggested that negotiators should try to salvage whatever partial agreements they can and then walk away from the rest. I mentioned a number of potential candidates, such as trade facilitation and the largely completed agricultural-export pillar (comprising proposed agreements on export credits, food aid, state-trading firms, and the elimination of export subsidies). Negotiators might also try to complete two environment-related agreements, one cutting subsidies to industrial fishing fleets that are overfishing the world's oceans, and the other ending tariff and nontariff barriers to "green" technologies in major producing and consuming countries. Taken together or individually, each of these would benefit countries across the spectrum of economic development.

I am, however, sceptical that even these small agreements are achievable in the current climate of mistrust and entrenched positions. A troubling development during the course of the Round has been how often countries seem to forget or forfeit their own economic interests – let alone the greater good – in the face of peer pressure and group-think. In the current environment, even these smaller deals might prove impossible to achieve.

It is certainly worth trying to achieve a few deliverables by taking a run at a small package, but negotiators should not spend too much time on it. They already know exactly what the options are; if they cannot get to "yes" in, say, two weeks, they should give up and move on to the real challenge of launching a new series of multilateral negotiations under WTO auspices.

Getting past Doha

How to conclude the Doha Round? One option would be for the Director-General and a representative sample of WTO Ambassadors to come together in the interest of the institution and to offer a declaration of Doha's demise, along with their pledge to begin building the future. That would enable leaders at the November G20 meeting to pledge their support for the rules-based trading system, the WTO and its next steps, rather than for the ever elusive "balanced and ambitious" Doha outcome.

After a short period of grieving over the death of Doha and an opportunity to get beyond the anger, lead trading nations should refocus on getting the WTO back into its mainstream business of negotiating mutually advantageous market opening, and updating the global "rules of the road". This approach offers the best promise of a meaningful "development" outcome as well.

How might this be achieved?

It seems unrealistic to think WTO members would agree to launch another massive all-or-nothing round in the near future. Such broad negotiations, however, will be necessary to tackle some of the world's most important market access challenges in services, manufacturing, and agriculture, along with such issues as farm subsidies. There are ways to build-up to the big-round model again, where countries once more see economic self-interest in the use of broad-based negotiations and trade-offs to achieve both new market access and market reforms. First, however, we must re-establish trust and regain momentum.

One way forward would be for ministers to agree to launch a number of confidence-building negotiations. For example, ministers in December could decide to open talks on expanding the 1997 Information Technology Agreement; a number of nations seem interested and the US Administration already has the authority to implement an enhanced agreement. If negotiators fail to work through the 850 brackets in the current Doha trade facilitation text, that could also be tackled as a stand-alone agreement, since each nation would benefit from more efficient movement of goods and services across borders.

Another confidence-building measure might be a merger of sectoral agreements geared toward a widely-shared objective, such as cheaper, better healthcare. A package that included pharmaceuticals, medical devices, and healthcare services might attract support from the broad array of WTO members across the development spectrum. Given the high-level of public interest in and awareness of environment issues, a sectoral negotiation on environmental goods and services might be another confidence-building deal, once it is removed from the straightjacket that Doha has become.

Lessons from Doha for next steps and the next round

Confidence building agreements would offer modest economic and social contributions, and serve to prepare the atmospherics for launch the next Round. This brings me to my last topic – the lessons we should draw from a decade of Doha talks.

One thing that is quite clear from years of struggling with the basic structure of Doha is that the combination of formula and self-selected flexibilities has not worked. It resulted in a situation where every negotiator had to assume the worst case – knowing the political costs they would pay for their own liberalisation, but expecting their trading partners to use flexibilities to negate any meaningful new market-access. It is possible to draw from the best of the Doha formulas – such as the higher the barrier, the greater the cut – while still creating real negotiations around them through requests and offers delivered using above- and below-formula cuts.

Another key lesson is that lumping the world's very diverse economies into three basic categories – developed, developing, and least developed – is a practice that no longer fits 21st century economic and trade realities. Nor is it a structure conducive to negotiations and real progress based on an exchange of market access among nations with large markets. Yes, the advanced economies should be expected to do more than those at lesser stages of economic development, but expectations should also reflect the fact that many emerging economies are characterised by both poverty and sectors where they are globally competitive trade powerhouses.

The emerging economies have large markets, represent over half of global GDP growth, and stand to be the biggest winners from any major trade agreement. They should be expected to contribute to the next Round accordingly. Major trade agreements generally take at least 12 years to implement from the time they are initially concluded. What should the world trading system look like in 2025 in terms of the absolute and relative responsibilities of key trading nations?

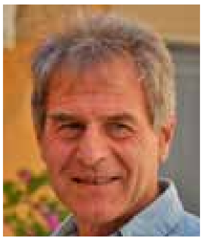
Concluding remarks

I am optimistic when it comes to the multilateral trading system and the WTO's central role in its governance. The optimistic scenario is that we put the Doha Round behind us. Facing facts can invigorate and strengthen the trading system. If we fail to act, the WTO risks losing its relevance.

The Doha Round – which in my view cannot be concluded as it is conceived today – should not be allowed to continue draining the WTO's credibility and potential progress on the multilateral front. Now is the time to liberate the would-be trade liberalisers from the Doha straightjacket and move on. ■

1. Schwab, Susan (2011). "After Doha: Why the negotiations are doomed and what we should do about it", Foreign Affairs, May/June.
A version of the editorial was previously published on www.VoxEU.org

A finance minister for Europe?



Charles Wyplosz is Professor of International Economics at the Graduate Institute, Geneva, where he is Director of the International Centre for Money and Banking Studies

The outgoing president of the European Central Bank has floated the idea of a finance minister for Europe. This column argues that such a statement from someone who has been in charge through the worst financial crisis in living memory is significant. It asks what the academic literature has to say on the matter.

Jean-Claude Trichet, president of the European Central Bank, has created a buzz by proposing to appoint a finance minister for Europe. In fact, he comes close to the idea of a fiscal policy committee, which has been advocated for a long time and with increasing frequency since the onset of the sovereign-debt crisis.

As befits a central banker, the proposal is couched in careful hypothetical terms. Maybe, in the future, when a country once again does not live up to its commitments,

> *...would it go too far if we envisaged giving euro area authorities a much deeper and authoritative say in the formation of the country's economic policies? […] Would it be too bold, in the economic field, with a single market, a single currency and a single central bank, to envisage a ministry of finance of the Union? Not necessarily a ministry of finance that administers a large federal budget. But a ministry of finance that would exert direct responsibilities in at least three domains.*

The first of his domains is fiscal policy oversight, the second is vaguely defined but concerns financial integration, and the third is external representation in international financial institutions, presumably a single Executive Director at the IMF.

It is of course of great significance that a departing ECB President – one who was in charge during the deepest crisis since the 1930s – has come to such a conclusion. Because the proposal is highly imprecise, it can be interpreted in a myriad of ways. The idea, it seems, is to let policymakers react as they see fit, to propose their own interpretations of a deliberately vague pronouncement, until something that is agreeable emerges.

Trichet's text includes countless references to great European philosophers of previous centuries and to Jean Monnet and other founding fathers of the EU, but not a single one to the academic literature, which has obviously considered many options. It may help, therefore, to consider what the literature has to say about the issues at stake.

Academic literature on centralising finance ministry functions

Trichet's call for institutional reform seems to be directly related to the current situation of Greece, so it is worth outlining how his thinking flows from Greece's problems before turning the scholarship on this.

We are dealing here with a country that has been bailed out by the other eurozone countries and the IMF under strict conditions, but also a country that fails to deliver. In such cases, the IMF normally suspends payments, letting the country deal with the consequences. This is, in fact, what the IMF recently threatened to do.

A consequence would have been default. In the current circumstances, the strategy of "teaching a good lesson" would directly hurt the other eurozone countries whose governments and banks are creditors, as is the ECB whose losses would have to be covered by member countries.

Indirectly, it could trigger a contagion of further defaults. For these reasons, the ECB is vehemently opposed to any default and pressure has been applied to keep the lending going.

Similar tactics have been applied in the past and, more than once, prompted the US to heavily weigh on the IMF to keep lending because the delinquent country was important, either economically (Mexico, Argentina) or politically (Egypt, Russia). This time it has led the eurozone countries to quickly put together a new programme with more public money, and to start thinking of a bailing-in of private creditors, ie. some form of default, causing enormous chagrin at the ECB.

Trichet's idea aims at avoiding such a situation in the future. Shunning the incentive approach of the IMF – threatening to punish in order to elicit the desired response – he proposes to assume control of the delinquent country in this "second stage" of bailout. The IMF clearly has no authority to do so, hence the idea to give control to the EU. "In the new concept, it would be not only possible, but in some cases compulsory, in a second stage for the European authorities – namely the Council on the basis of a proposal by the Commission, in liaison with the ECB – to take themselves decisions applicable in the economy concerned. One way this could be imagined is for European authorities to have the right to veto some national economic policy decisions. The remit could include in particular major fiscal spending items and elements essential for the country's competitiveness". The proposal intersects three issues:

- the link between monetary and political union;
- the need for fiscal policy coordination; and
- the need for fiscal discipline.

The first issue has long been debated. The empirical evidence is that currency and nationhood normally come together but with countless counterexamples, mostly small states.

Beyond symbolism, the main reason is that the "optimal currency area" criteria stands to be better satisfied within unitary states.[1] But then Frankel and Rose[2] observed that the mere existence of a monetary union stands to make a clearly suboptimal monetary union "more optimal" as time passes by. So we knew all along that bad things could happen because the eurozone is not (yet) an optimal currency area, and that they could be mishandled because we don't have the instruments of a unitary state.

It is logical, at this stage, to see the emergence of proposals that aim at giving the eurozone some attributes of a political union. Alongside Trichet's proposal, we have seen suggestions that Eurobonds be collectively issued, which is partly what the European System of Financial Supervisors has been doing. The largely unnoticed, but historically significant presence of the eurozone in IMF negotiations means that, in what Trichet calls the "first stage" of rescue operations, a country can find itself accepting conditions imposed by other. Because the first stage can fail, as is now happening with Greece, thinking about a second stage is unavoidable.

The second issue – the need for fiscal-policy coordination – harks back to the Delors Report:

In order to create an economic and monetary union the single market would have to be complemented with action in three interrelated areas: competition policy and other measures aimed at strengthening market mechanisms; common policies to enhance the process of resource allocation in those economic sectors and geographical areas where the working of market forces needed to be reinforced or complemented; macroeconomic coordination, including binding rules in the budgetary field; and other arrangements both to limit the scope for divergences between member countries and to design an overall economic policy framework for the Community as a whole.

The voluminous literature that followed the Delors Report in the late 1990s made two points.

- First, it would be desirable to have a way of achieving the right fiscal-monetary policy mix at the eurozone level.

This question has been set aside in academic work, perhaps because of theoretical uncertainties about the role and effects of fiscal policy, or because the problem had not yet materialised. The question, however, is very much alive at the political level where we hear periodic calls for "an economic government of Europe".

- Second, with the monetary instrument lost, fiscal would have to become the main countercyclical instrument.[3]

"It is of course of great significance that a departing ECB President – one who was in charge during the deepest crisis since the 1930s – has come to such a conclusion."

It then transpired that fiscal policies were mostly procyclical before the adoption of the euro and that they have become, at best, mildly procyclical afterwards.[4] The idea that some centralised benevolent dictator could direct national governments to do a better job is attractive and justified, but is it realistic? Now that the president of the ECB has formulated the proposal, at least, we can hope to have a debate.

The third issue, the need for fiscal discipline, is the heart of current preoccupations. We all know the long debate about the Stability and Growth Pact. The very fact that Trichet wants something new is comforting; it is in line with my long-held view that the Pact could not work as intended, and that it mostly focuses policymakers on the wrong criteria.[5]

Over recent years, following von Hagen and Harden,[6] a large literature has developed the view that fiscal discipline is a matter of adequate institutions and that different countries require different institutions. This has recently turned into a rich debate about the use of rule and of institutions, with increasing interest on independent fiscal councils.[7] Within the monetary union, national councils may not be enough because of the externality that arises when one country fails to deliver fiscal discipline. The current crisis is a potent reminder of the importance of this externality. It is therefore entirely reasonable that the president of the ECB goes in this direction.

Concluding remarks

President Trichet's proposal is original, it is remarkable, perhaps even historic, but not very clear. He envisions not a council but an individual. Yet, the decision to take over responsibility for fiscal discipline would come from "the Council on the basis of a proposal by the Commission, in liaison with the ECB". A number of questions arise:

- Would this "minister" just be the Commissioner for Economic and Monetary Affairs, like Baroness Ashton?
- Would this be a new position, like that of Herman van Rompuy?
- Would (s)he just be the head of an independent fiscal council?

The experience so far with a High Representative for Foreign Affairs and Security Policy and with a permanent President of the European Council is not very encouraging. It shows that member states are most unwilling to give up national sovereignty for the common collective good. Things change over time, however, and the EU's six decades are full of examples.

The idea of imposing fiscal policies on national governments and their respective parliaments, even in the "second stage" of a bailout programme is radical and sure to meet stiff resistance. It would require

a very strong personality to carry out such a task, perhaps a former President of the ECB? Member countries have shown no inclination for having strong personalities in Brussels, however. Perhaps, then, they might start with a European advisory fiscal council that would oversee national advisory fiscal councils, a proposal recently made by the Commission. That would be a useful step. ■

1. Optimal currency criteria are a list of economic features that make it likely that a group of countries would be better off sharing a common currency, eg. labour mobility among the nations, similarity of industrial structures, etc.
2. Frankel, Jeffrey A and Andrew K Rose (1998), "The Endogeneity of the Optimum Currency Area Criteria", Economic Journal, 108(449):1009-1025.
3. Melitz, Jacques and Frederic Zumer (1999), "Interregional and international risk-sharing and lessons for EMU", Carnegie-Rochester Conference Series on Public Policy, 51(1):149-188.
4. Fatas, Antonio and Ilian Mihov (2010), "The Euro and Fiscal Policy", in Alberto Alesina and Francesco Giavazzi (eds.), The First Ten Years of the Euro, University of Chicago Press.
5. Eichengreen, Barry and Charles Wyplosz (1997), "The Stability Pact: Minor Nuisance, Major Diversion?", Economic Policy, 26:65-114.
6. von Hagen, Jurgen and Ian J Harden (1995), "Budget Processes and Commitment to Fiscal Discipline", European Economic Review, 39(3-4):771-779.
7. http://www.voxeu.org/index.php?q=node/4680
A version of the editorial was previously published on www.VoxEU.org

A corporate tax scheme for the single market

Algirdas Šemeta is the European Commissioner for Taxation, Customs, Anti-fraud and Audit

Nearly 20 years after the creation of the single market, taxation of corporate income remains a domain where national rules essentially prevail. Companies doing business on the EU market have to deal with 27 different tax rulebooks and as many tax administrations. In this context the interaction of national tax systems often leads to over-taxation or even double taxation. It also means heavy administrative burdens and high tax compliance costs. This situation creates disincentives for investment in the EU and refrains businesses from expanding beyond their national borders.

This must change. The EU should become an attractive place to do business also from the corporate tax perspective. The Common Consolidated Corporate Tax Base (CCCTB) the Commission proposed last March will serve this purpose. It will make it easier, cheaper and more convenient to do business in the EU. It will also open doors for small and medium sized companies (SMEs) looking to grow beyond their domestic market.

"The Common Consolidated Corporate Tax Base... will make it easier, cheaper and more convenient to do business in the EU"

The CCCTB is a common system of rules for computing the tax base of companies which are tax resident in the EU and of EU-located branches of third-country companies. The CCCTB is an option for businesses. Under the CCCTB, groups of companies would have to apply a single set of tax rules across the union and deal with primarily one tax administration (one-stop-shop). A company that opts for the CCCTB ceases to be subject to the national corporate tax arrangements in respect of all matters regulated by the common rules. A company which does not qualify or does not opt for the CCCTB Directive remains subject to the national corporate tax rules.

The CCCTB will allow cross-border loss compensation. Immediate consolidation of profits and losses for computing the EU-wide taxable bases is a major step towards reducing over-taxation in cross-border situations and establishing neutrality of taxation in the single market. For companies opting for the CCCTB this means the end of transfer pricing issues at EU level.

Another major benefit of the introduction of the CCCTB will be a reduction in compliance costs for companies. The Impact assessment carried out by the Commission points to a reduction in the compliance costs for recurring tax related tasks in the range of 7% under CCCTB. The reduction in actual and perceived compliance costs is expected to exert a substantial influence on firms' ability and willingness to expand abroad in the medium and long term. The CCCTB is expected to translate into substantial savings in compliance time and expenditure in the case of a parent company setting up a new subsidiary in a different member state. On average, the tax experts participating in the study estimated that a large enterprise spends over €140,000 (0.23% of turnover) in tax related expenditure to open a new subsidiary in another Member State. The CCCTB will reduce these costs by €87,000 or 62%. The savings for small and medium sized enterprises are even more significant, as costs are expected to drop from €128,000 (0.55% of turnover) to €42,000 or a decrease of 67%.

The proposal will benefit companies of all sizes. However it is particularly relevant as part of the effort to support and encourage SMEs to benefit from the single market as set out in the review of the Small Business Act (SBA) for Europe. The CCCTB notably contributes to reducing tax obstacles and administrative burdens, making it simpler and cheaper for SMEs to expand their activities across the EU. The CCCTB will mean that SMEs operating across borders and opting into the system will only be required to calculate their corporate tax base according to one set of tax rules.

The CCCTB does not touch upon corporate tax rates. Each member state will continue to apply its own rate to its share of the tax base. Differences in rates allow a certain degree of tax competition to be maintained in the internal market. Fair tax competition based on rates offers more transparency and allows member states to consider both their market competitiveness and budgetary needs in fixing their tax rates. Harmonisation will only involve the computation of the tax base. It will not interfere with financial accounts. Member states will maintain their national rules on financial accounting while the CCCTB system will introduce independent rules for computing the tax base of companies. These rules will not affect the preparation of annual or consolidated accounts.

In these difficult budgetary times I also have been careful to ensure that, in as much as possible the CCCTB does not influence the tax revenues of member states. In preparing the proposal the impact on the distribution of the tax bases between the EU member states has been extensively analysed. In fact, the impact on the revenues of member states will ultimately depend on national policy choices with

regard to possible adaptations of the mix of different tax instruments or applied tax rates.

This is an initiative which is awaited by 80% of businesses. It is also supported by investors and academics. We now have a robust proposal on the table, I am confident that member states will see that its adoption is in the interest of the EU as a whole. The CCCTB will benefit – each and every EU citizen – by encouraging growth and employment, attracting foreign investment and allowing the EU to become a more competitive global player. ■

How the CCCTB can attract the interest and the support of the business community

Philippe de Buck is the Director General of BUSINESSEUROPE

Globalisation has changed the scope of economic relations, and as market integration has advanced, the internal organisation of firms operating in international markets has also changed. However, tax systems in the EU have not kept up with these developments, and remain highly fragmented, with 27 regimes that often clash.

Currently, companies cannot generally consolidate profits earned in some member states with losses incurred in others, in the same way as, for instance, an Italian company would offset the profits from its activities in its branch in Milan with losses of its operations in the Rome branch.

This often results in over-taxation – when cross-border activities create liabilities that would not have occurred in a purely domestic context-, double taxation - when the same income is taxed in more than one jurisdiction-, and transfer pricing disputes within the EU.

"The lack of cross-border profit and loss relief within the EU often results in over taxation, double taxation, and transfer pricing disputes"

The cost of compliance and the administrative burden on companies conducting cross-border business across the European Union is high. Tax-related compliance costs are estimated to be in the range of 2% to 4% of corporate income in the EU.

These factors are a significant obstacle to the single market, and create disincentives to investment, making the EU a less attractive place to do business compared with other economic blocs, such as the USA, Japan, or China, which are perceived as a single market by businesses.

On March 16, 2011, the European Commission presented its proposal for a directive on a Common Consolidated Corporate Tax Base (CCCTB). The proposed directive on a Common Consolidated Corporate Tax Base could provide a lasting solution to these problems. However, CCCTB must be a competitive option for companies and enhance the attractiveness of the single market as a location for investments.

What are the conditions that the CCCTB must meet?

In order to attract the interest and the support from the business community, the CCCTB needs to meet at least the following four key conditions:

1. It must be optional for companies

It is of utmost importance that the CCCTB is not made compulsory for companies. The purpose of a CCCTB is to provide for a competitive tax system which boosts business activity and strengthens the European economy.

For many companies a CCCTB would undoubtedly deal with key issues such as transfer pricing, cross-border loss relief and unresolved double taxation. However, if companies, for whatever reason, find it more efficient to operate within their current systems, they should be allowed to do so.

In addition, regardless of how competitive a new system may be, any shift from a domestic tax system to a common system within the EU will present significant costs. These costs may occasionally outweigh the benefits of a new system.

A compulsory shift could therefore prove to be contradictory in terms of economic growth and competitiveness. Furthermore, one should not underestimate the value of competing systems and institutional competition.

Ultimately, the success of the CCCTB is likely to be measured in terms of the number of companies that are willing to join in. An opt-in approach would provide additional political pressure on the CCCTB to be a truly competitive tax system.

For governments, an optional system entails the benefit of a gradual adoption by businesses, thereby ensuring a limited short-term impact on corporate tax revenue.

2. The system needs to allow for the consolidation of profits and losses from the outset (one-step process)

The current lack of cross-border consolidation and the administrative costs of complying with up to 27 different tax regimes constitute major obstacles to cross-border business activity in Europe.

A system with a common corporate tax base without consolidation would be of little or no interest for businesses. In order to remove cross-border tax obstacles, intra-group transactions should be disregarded for tax purposes. A common, but not consolidated, corporate tax base would suffer from the same transfer pricing problems and lack of loss relief as exist today within the EU. Consequently, consolidation must be allowed from the start.

3. The CCCTB needs to reduce compliance costs with a "one stop-shop" mechanism

Administrative simplification is an important factor in facilitating business activities and creating a competitive tax environment for the European market. A directive on the CCCTB should establish a tax system that allows for a single consolidated tax return. In other words, a CCCTB group operating in several member states should only have to file one (consolidated) tax return with the principal tax authority, preferably in the member state where the parent company is situated.

Such a system would not only reduce compliance costs but would also ensure a common tax treatment, as opposed to a system based on domestic compliance where the risk of inconsistent interpretation and application is evident.

Introducing a "one-stop-shop" would likely enforce better collaboration and exchange of information between national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here by chance...

tax authorities since this is necessary for the system to work. It could also lead to increased service level at tax authorities as a means to attract companies to locate their head quarters in their jurisdiction. Such institutional competition could also facilitate cooperation in other areas such as joint audits and VAT. However, for a "one-stop-shop" approach to work, there needs to be clear, common and consistently applied understanding of how the CCCTB rules will apply across all principal tax authorities.

4. The system must leave any decision on tax rates to national governments

The objective of the CCCTB is to create a more efficient tax treatment for companies within the EU, not to harmonise tax rates among Member States. Consequently, a CCCTB must not include any tax rate harmonisation or give rise to any minimum tax rates. The right to set the corporate tax rates must be kept at a national level. It is essential to maintain tax sovereignty with respect to tax rates.

This is important also from budgetary considerations, in particular for countries having a common monetary policy. Different tax rates may, in fact, actually encourage sound tax competition and thus stimulate efficiency, enabling Europe to be competitive. ■

New measures to bolster customs enforcement of intellectual property rights

Walter Deffaa is the Director General, Taxation and Customs Union, European Commission

Last month, the European Commission presented a comprehensive strategy on intellectual property rights (IPR) for the single market. This package included a proposal to reinforce customs actions to combat the trade of IPR infringing goods between third countries and the EU. Whilst a robust system of intellectual property rights is considered essential for the whole EU economy, the need for effective enforcement is also recognised. As Algirdas Šemeta the Commissioner responsible for customs has explained, customs are ideally placed at the border, to protect citizens and legitimate businesses and their contribution is highly valuable in fighting counterfeiting and piracy.

The enforcement of IPR is one of many tasks entrusted to customs in the EU and the impressive results over the years pay tribute to their commitment. In fact, the statistics relating to customs interceptions provide the only reliable data on the traffic in IPR infringing goods and from these we can see the growing complexity of the problem. The annual report covering customs activities in this domain for 2010 will be published shortly and will show an enormous increase in the number of consignments detained for possible IPR infringements. Nowadays, customs are faced with infringing goods in all product sectors, the infringements themselves have become far more sophisticated and of course the fraudsters are always a step ahead when it comes to concealing the goods from inquisitive customs eyes.

"With this new legislative proposal, the European Commission aims to give the legal framework an update, providing for more customs enforcement and better regulation"

With this new legislative proposal, the European Commission aims to give the legal framework an update, providing for more customs enforcement and better regulation. Current EU legislation already goes beyond the minimum standards set out in the relevant WTO instrument, the so-called TRIPS Agreement[1]. Nevertheless, areas where the rules could be further strengthened were identified; in particular, the types of infringements that customs are looking out for, as well as the types of rights.

Today, the only type of trade mark infringement upon which customs can act under EU legislation is the classic 'counterfeit' product, but there are several other variations, for example where the fraudster produces something similar to an original logo, such as a *"hike"* T-shirt, or where a well known brand is used for a completely different category of product. These would all be covered by the new rules. In addition to covering certain situations currently excluded, such as "lookalikes" and illegal parallel trade, it is now proposed that customs should enforce all types of rights recognized at the EU level. New rights include topographies of semi-conductors and utility models. Even if counterfeit products remain the core business for customs, these new rules will enable customs to take action where suspect shipments are identified.

One area of particular concern for customs is the dramatic increase of cases relating to the postal sector. Postal consignments arrive with little or no information and customs are unable to assess the potential risk of individual packages. With regard to IPR enforcement, where each suspect shipment is liable to a specific procedure, the administrative burden is disproportionate to the results achieved. The European Commission has therefore set up an expert group tasked with developing solutions to this problem. One possible cause for the rise in goods found in postal and courier traffic can be seen in the developments in e-commerce. Consumers are often unaware that they are buying fakes over the internet and the expert group will be looking for novel ways to disrupt this illicit traffic. However, the proposed new legislation also offers some salvation for customs and right holders. A specific procedure for handling small consignments would be introduced enabling recipients of counterfeit and pirated products to allow those goods to be abandoned for destruction without formal legal procedures.

The whole relationship between customs and the industry was reviewed. Overall, the current system of recordation was perceived positively by right holders and the customs authorities, though certain procedures had to be clarified. The proposal sets out clearly the obligations on customs and right holders concerning the timelines for detaining suspect shipments and the situations where information may be exchanged. As the information may be commercially sensitive, it was necessary to ensure the interests of all legitimate traders were taken into account and the new provisions should ensure a balanced approach towards the respective stakeholders.

Under the new legislative process laid down in the Lisbon Treaty, the European Parliament and the Council will now examine the proposal. Stakeholders will therefore have the opportunity to express their views on what has been proposed by the Commission and it is hoped that a new regulation could be in place during the course of 2012, further strengthening the integrity of the single market.

In parallel, the European Commission is working closely with customs authorities in the EU to improve operational capacity, as well as with third countries, notably China, which is the source of over half of all goods detained by customs. A dedicated customs action plan on IPR enforcement was developed with the Chinese counterparts, to tackle the problem at both ends of the supply chain. However, it is clear that customs will not solve the problem alone. A holistic approach to tackle all aspects of the supply and demand for such goods is required.

All product sectors are concerned and no one is immune from the negative impact and possible consequences of this illicit trade.

Certainly more still needs to be done to develop sufficient protection of IPR around the world. However, it is vitally important that emphasis is given to raising awareness. Counterfeit products do not respect any standards, they may be of poor quality or even dangerous, yet in many cases the purchaser is not aware that the goods are not genuine. Unless consumers face up to the negative consequences, counterfeit and pirated products will continue to be manufactured and offered for sale. ■

1. Agreement on Trade-Relate Aspects of Intellectual Property Rights, annexed to the Agreement establishing the WTO.

Icelandic tax law – amendments due to economic collapse

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Introduction

The economic status of the Icelandic government changed dramatically due to the fall of the Icelandic banks late 2008. In light of these happenings, the state treasury needed to reconsider its methods of revenue accumulation and also to find methods to reduce the blow to Icelandic taxpayers due to depreciation of capital and property followed by a rise in debt of individuals and legal entities. Since the year 2008, Alþingi has put into effect several amendments to the Income Tax Act and other statutes regarding taxes and other fees, for the purpose of solving problems which arose following these circumstances. The purpose of this article is to inform readers about the general changes made to the Income Tax Act since the economic collapse.

Novelties in the taxation of individuals

Tax rate increase

Significant changes were made to the income tax rates of individuals and legal entities. Income tax rates for individuals with low income were lowered but were increased for those with an income above ISK 700.000. The income tax rates of legal entities were raised considerably, in addition to the increases made to value added tax. Income tax rates for individuals now stand between 37.31% and 46.21%. An additional 8% surcharge is imposed on individuals with a high income, which is considered to be above ISK 700,000 per month. Taxes of capital income of individuals have been raised from 10% to 20% on income in excess of ISK 250,000.

> **"The purpose of this article is to inform readers about the general changes made to the Income Tax Act"**

Wealth tax

A special tax on wealth was enacted in 2010. This wealth tax is a temporary tax valid until the income tax year of 2013. The tax rate is 1.5% of net capital in excess of ISK 75,000,000 for unmarried individuals and in excess of ISK 100,000,000 for married couples. However, tax debts may be subtracted from net capital (which is the tax base) to form a new tax base. The arguments for this wealth tax are first and foremost based on the transfer of property and the condensation of ownership of capital in Icelandic society. This modification introduces the taxation of pure capital, however with a relatively high margin for tax-free capital.

The report of the wealth tax bill argued that 1,400 married couples were capital owners of property in excess of ISK 120,000,000, an amount which totalled ISK 208 billion or an average of ISK 270,000,000 per couple. These 2.2% of all married couples therefore owned a quarter of all property within the country according to tax returns of individuals. The report of the wealth tax bill furthermore argued that tax rates for capital income had been too low, in addition to other taxes being lenient. These rich couples therefore benefited due to the favourable taxes while the general public did not fare as well. For these reasons and due to the circumstances in general, it was not deemed unjust to levy further taxes on these individuals.

The taxation of interest of individuals with limited tax liability

Individuals and legal entities with limited tax liability in Iceland were once exempt from taxation of interest paid in Iceland. Legal entities with limited tax liability are now subject to an income tax of 18% on interest. Individuals with limited tax liability are subject to an income tax of 20% if their interests exceed ISK 100,000 per year. One of the reasons stated for the taxation of interest of individuals and legal entities with limited tax liability was that tax-free interest offered ways for possible tax evasion.

It was also noted that due to the fact that the Icelandic economy was heavily indebted a large portion of the domestic production was to be paid abroad in the form of interest to foreign parties. The taxation of interest would therefore ensure that a significant part of these amounts would end up in the state treasury of Iceland instead of the treasuries of other states. There are however exceptions to this rule, in cases where double taxation treaties state that withholding tax on interest shall not be retained.

Taxation due to debt relief

Temporary rules which allowed exceptions to the rule of having to declare debt relief as income were given legal effect in 2010. These rules apply to the income years of 2009, 2010 and 2011. These rules apply to individuals who receive debt relief and had not been able to benefit from debt relief before by payment adjustment negotiations or other means. These exceptions cover debt relief due to payment difficulties of mortgage debts outside of business activity and automobile financing contracts outside.

The maximum amounts exempt from the aforementioned declaration rule are ISK 15,000,000 for individuals during the income years of

2009, 2010 and 2011. Half of all amounts between ISK 15,000,000 and 30,000,000 received due to debt relief must be declared as income and a quarter of amounts exceeding ISK 30,000,000. The same rules apply to jointly taxed cohabitants and spouses, except all amounts are doubled. The aforementioned exceptions do not apply if the original principal of the debt is written off (with regard to payments made). According to the second paragraph of the provisional article, it is possible to delay the declaration of income received via debt relief for up to two years after the income year when the debt relief is received. It is also possible, after this two year delay, to declare the debt relief as income partially and equally over a five year period.

Changes to the taxation of legal entities

Tax rate increase

The tax rate for income tax of legal entities has been raised, as has been done with individuals. Until the end of 2008 the tax rate of legal entities was 18%. A lowering of this tax rate to 15% had been enacted and was supposed to take effect during assessment of the year 2010. This decrease however did never enter into effect. The tax rate of companies with limited liability is now 20%. Companies with unlimited liability have had tax rates increased from 32.7% to 36%.

"... the legislator deemed it just that the parties operating the financial market pay a larger sum in order to help rebuild the economy in the coming years"

In addition to increasing the tax rate, several changes have been made to the tax statutes which affect legal entities.

CFC rules

CFC rules were first enacted in Iceland in 2009. These rules provide that taxable entities which directly or indirectly own a part of any kind of company, fund or institution domiciled in a low tax country are to pay income tax from the profits of such parties pro rata to their ownership of share without regard to distribution. These laws are tailored to the Norwegian laws. This article applies when at least half of the shares in a company, fund or institution are owned by Icelandic tax entities.

Ownership by Icelandic entities is described as the collective ownership of all Icelandic parties which own shares in a company. Icelandic ownership of more than 50% of shares within the income year is therefore sufficient so that the ownership of a company, fund or institution falls within the article. States or jurisdictions are regarded as low tax countries when income tax from the profits of the company, fund, or institution in question is lower than two thirds of the income tax which the entity would have had to pay in Iceland.

It is assumed that these provisions do not apply to companies, funds or institutions which are subject to agreements between Iceland and low tax countries to prevent double taxation, provided that the income of those companies is not mainly property income. This means that more than half of the income needs to stem from actual operation or activity of the company in question, eg. via manufacture or sales of products or services.

It is also assumed that these double taxation treaties contain an article similar to the information-article no. 26 of the OECD model convention with respect to taxes on income and capital. It is however presupposed that the provisions of paragraph 1 do not apply to a company, fund or institution which has real operations, as has been defined above, in an EEA-state, provided that the company is subject to a double taxation treaty effective in Iceland, which contains an article similar to the aforementioned information-article.

Taxation in the case of debt relief

According to the principles of tax law and the Icelandic tax statutes, all income, however named, is subject to taxation, only with the exceptions and limitations stated by law. The definition of income in Icelandic tax law is very broad and this principle applies to individuals and legal entities alike. In accordance to this principle, all debt relief received by business operations is viewed as taxable income. The same applies to all gifts.

Temporary articles were enacted in 2010 which deviate from the aforementioned principle. These articles define how debt relief for legal entities and parties with independent business operations should be handled. According to the law, legal entities and individuals who run independent business operations are allowed to declare only 50% of income due to debt relief received in respect to operational and payment difficulties during the income years of 2009, 2010, and 2011 on amounts up to ISK 50,000,000. These parties must declare 75% of any income in this respect in excess of ISK 75,000,000. However, this applies only to debt relief received due to debts stemming from business operations.

Not all taxable entities were able to take advantage of the aforementioned article and therefore an additional article was enacted. The new article stated that business operations which received debt relief due to payment problems in the years 2010 and 2011 were able to transfer declarations of income due to debt relief between the assessment years of 2010 to (and including) 2014, if a part of the debt relief was in excess of transferrable operational losses, annual operational losses, depreciation or write-offs.

A condition for this right for taxable entities to transfer declarations for debt relief between years is that all possibilities for depreciation of property have been utilized and all available possibilities for writing-off claims and supplies been put to use. Furthermore, dividends may not be paid out during this time. A company which receives debt relief during 2010 or 2011 is allowed to transfer declarations between the assessment years of 2010 to and including 2014, all parts of declarable debt relief income exceeding losses. All undeclared debt relief remaining in late 2014, up to ISK 500,000,000, does not need to be declared as income. Any amounts received due to debt relief exceeding ISK 500,000,000 must be declared as income. These amounts may be declared in equal amounts between 2015 to and including 2019.

Banking tax

A new tax was introduced for declaration in 2011. This tax is only applicable to financial institutions. The tax rate of this new, so called banking tax is 0.041% and is levied on total debts at the end of the income year.

The tax base is the total debt as evident on the tax return. However, all insured deposits covered by The Depositors' and Investors' Guarantee Fund are subtracted from this amount.

It is assumed that the taxability of these financial institutions is directly linked to their operating license. Branches of foreign banks which receive deposits or trade in securities in Iceland are also subject to this tax, according to the bill, in the same way they are taxable according to the Income Tax Act. These branches may operate in Iceland on grounds of permits issued by other EEA states and therefore do not need a specific license from the Financial Supervisory Authority. There are two exceptions to this rule. First, the tax is not levied on companies established to be owned only by the government. Second, the rule does not apply to companies who are being wound-up.

This new tax is justified by pointing out the costs incurred on the Icelandic government following the economical collapse, which may largely be attributed to particularly risky behaviour on behalf of these financial institutions. Thus, the legislator deemed it just that the parties operating the financial market pay a larger sum in order to help rebuild the economy in the coming years. Furthermore, a stable financial system is key to ensure a continuing operation of a financial market and it is therefore feasible the costs resulting from improvements to this system be incurred on financial institutions.

An extensive discussion has been had among states within the EEA whether a particular tax pertaining financial institution shall be enacted. Many of the member states have either already enacted such legislation or have declared that these changes be made soon. The European Commission has also pointed out that it is rational that the financial institutions shoulder the burden which has mostly been incurred on governments of member states so far.

Support for innovation

At the end of 2009, Althingi passed a law regarding support for innovation. The purpose of this law is to improve the conditions for innovative businesses to operate in a competitive market. An environment which supports innovative companies is one of the stated objectives of the Icelandic authorities. It is hoped that by improving the conditions of these companies tax-wise, an increase in jobs in research and development within new and old Icelandic companies will occur.

These provisions apply to legal entities which have been confirmed by The Icelandic Centre for Research (RANNIS), where specialists evaluate whether or not applications for certain projects fall within the bill's definition of an innovative company.

The law assumes two ways to support innovation in Icelandic businesses. Firstly, a tax subtraction is available for taxable business operations in Iceland due to research and development projects approved by RANNIS. Innovative businesses which initiate projects relating to new knowledge, services, products or technologies receive particular subtractions from declared income tax. This particular subtraction is determined as a certain part of costs, totalling 15% of all costs directly related to the research and development projects. This right to subtraction is however only available in cases where R&D costs are between ISK 20,000,000 and 50,000,000 per year (ISK 75,000,000 if the costs are due to buying services from a third party). This means that subtractions according to these provisions may total between ISK 3 to 11 million per year.

Secondly, subtractions from income tax can be made due to individuals and legal entities investing in innovative businesses. This subtraction is meant to encourage such investments and as a result increase equity of innovative businesses since it is assumed that new shares will more likely be issued this way. It is also likely that increased equity will lead to easier access to credit markets.

The provisions stipulate a certain form of government aid to innovative businesses and therefore, in accordance to articles 61 and 62 of the EEA treaty, the EFTA Surveillance Authority has been notified. As stipulated by EEA statutes, these government aids cannot be granted unless EFTA has confirmed that they are legitimate and in accordance with the provisions of the treaty. This confirmation was received earlier this year.

Other changes

Provision of information and surveillance permissions

New provisions were enacted via law no. 46/2009, with paragraphs 4 and 5, article 94, respectively. The new provisions state that financial institutions, accountants, attorneys and other entities providing consultation and services on international tax affairs are now obliged to keep a record of all customers receiving such consultation and services. These records shall contain enough information to be able to identify each customer.

Consultation and services on international tax affairs refers to consultation provided by the aforementioned entities regarding, for example, the foundation and registration of legal entities abroad, movement of capital between countries or jurisdictions and transfer of ownership of Icelandic companies to foreign parties. Tax authorities shall whenever they wish be granted access to these records by the aforementioned entities. It was deemed necessary to enact an article stipulating that provisions of secrecy set forth by other statutes give way to the articles regarding this matter in the tax laws.

Increased enforcement powers of authorities

The Income Tax Act includes articles regarding collection of debt and securities. New articles were enacted in 2010, regarding the permission of authorities to sequester the properties of those under investigation by the director of tax investigations. It is now possible to sequester the properties of taxable entities to ensure the payment of possible tax debt, fines and court fees in cases under investigation by the director of tax investigations, where reasonable suspicion of punishable activity exists according to article 109 of law no. 46/2009. These activities however can only take place if there is any reason to believe that suspects may try to conceal or somehow diminish their properties. The same rules provide permission for authorities to sequester the properties of entities responsible for payment of tax.

These amendments were made to react to the increased likelihood of property concealment or diminishment due to the often long times of court procedures in tax investigation cases. For these reasons, it was believed necessary to increase the authority of government to be able to limit the likelihood of property concealment, by means of transferring assets to a third party or by other methods to exclude property from investigation.

"It has been suggested that tax rate increases for legal entities are one of the things which affect economic growth in the most negative fashion"

The article provides better means to ensure the payment of possible tax debt and fines to the state treasury. The permission to sequester is assumed to allow sequestering of properties owned by the taxable entity itself, other entities responsible for payment of tax and also those who are suspected of activity punishable by law and may therefore be subject to fines. The article is in accordance with the law on criminal cases, where police is allowed to sequester property. Any measures carried out due to this article must be ceased immediately when it is evident that the investigations of the Director of tax investigator will not lead to fines or other charges.

Summary

Opposing views have been expressed regarding the changes to the Icelandic tax law made in light of occurring economic events on whether or not tax authorities have reacted in an appropriate way. Articles deviating from the main principles of tax law regarding debt relief are very important and will alleviate the troubles of many who have had payment problems in light of recent conditions.

It is arguable whether tax rate increases for legal entities will affect the process of rebuilding taking place in the future, mainly in regard to possible economic growth. It has been suggested that tax rate increases for legal entities are one of the things which affect economic growth in the most negative fashion.

An income tax rate which is too high may reduce investment in industry, increase tax evasion and lead to financing with debt and discourage the issuing of shares. The new wealth tax is a property tax which has been considered unjust and was therefore repealed in 2006. It has been argued that this tax may distort the ability of Iceland to compete with neighbouring countries, since most of them have repealed this tax. Furthermore, this tax may catalyze the departure of wealthy individuals from Iceland. ■

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"Check the box" on China and The Netherlands even if you are not a US taxpayer! (The use of hybrid entities in international tax planning structures part V)

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Introduction

In several previous articles (WCR December 2009[1], WCR March 2010[2], WCR June 2010[3], WCR December 2010[4]) I believe I have demonstrated how the use of hybrid entities in international tax planning has changed over time, from somewhat obscure in the past to fully accepted today, as a means to save oneself considerable tax amounts in a fully legal fashion. The times of tax planning via the use of so-called special purpose companies for cross-border investments are almost over if you have kept a close look at the development of tax case law worldwide. Tax authorities have by now found all the weak spots:

1) lack of substance (an old problem);
2) lack of beneficial ownership (especially with the new OECD Model Treaty guidelines , just published);
3) the permanent establishment attack (spc's having a "place of management" in the home country of the multinational to which a large part of their profits can be allocated);
4) transfer pricing tax planning via shifting risks and intangibles to entities which do not have the knowledge to manage them.

However, the use of hybrid entities, if structured properly, will not fly in the face of any tax authority, because both of them, in a two country situation, will be confronted with a structure which to them is fairly "normal" ie. they know from their own tax viewpoint what the tax rules for these structures are and they usually show no interest in how they are treated abroad, because to them that is irrelevant anyway.

The topic for today: China

In this article I should like to focus on an excellent new tax planning opportunity for investments into China, offered by the introduction of the Chinese Partnerships Law per 1/7/2007 which deals with Chinese general and limited Partnerships. Such investments, in a Chinese LP, by multinationals from whatever country, via the Netherlands into China, offer these multinationals, even if they are not US-based, a "check the box" type of tax planning tool whereby they can freely choose to set up a Chinese LP structure which is tax wise treated as a subsidiary of its intermediate holding company in the Netherlands whilst in China it is seen as a tax transparent entity so the partners are subject to Chinese tax and not the LP itself.

This mismatch, in combination with the reverse mismatch that Dutch limited entities which invest abroad may also by characterized as a type of "check the box" tax planning, now under Dutch tax law, so they could be seen as tax transparent ("branches") under the Dutch CIT rules whilst abroad they are treated as foreign legal entities, can lead to a very tax efficient financing of the Chinese operations. This might be achieved either in the way of direct financing of the Chinese operations or via indirect financing: either the operational lease of equipment or the licensing of intangibles. The end result in all three cases being a tax deduction in China without any pick-up of the corresponding income in the Netherlands. This may sometimes even be further combined with a double dip: tax deductible interest in the Netherlands (even after the introduction of a new Bill of Law which was announced in May 2011 to reduce the tax deductibility of interest) and tax deductibility of that same interest (or an economically corresponding lease fee or licensing fee) in China.

This article has been written in close cooperation with several international tax specialists from Beijing University who have excellent access to the SAT, China's state administration for taxes. In fact the University of Beijing, today, is the only institution in China which has been able to enter into a number of "advance tax rulings" (ATR's) with the Chinese government, even though ATR's do not officially exist in China.

What does "check the box" mean?

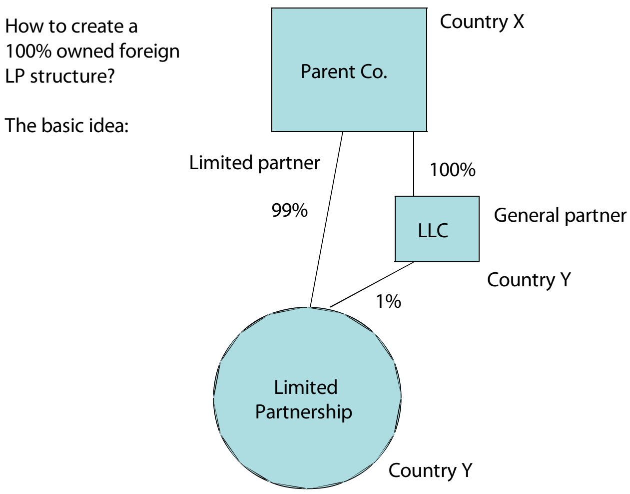
US-based tax payers have the option, for most types of foreign subsidiaries, to freely choose whether they will for US tax purposes be treated as tax entities (subsidiaries) or as tax transparent entities (branches). This can be done in the US tax return by checking a box on each foreign operation. When foreign entities are treated ("checked") as branches, any intercompany agreements with their direct parent companies become invisible for US tax purposes, a feature which has given rise to massive tax planning by US based multinationals since these rules were first introduced in 1994. Tax payers outside the US are not normally offered a choice on how to treat their foreign operations: their home country tax rules will decide whether such foreign operation is to be seen as a shareholding in a foreign entity (subsidiary) or as a foreign branch of the home country enterprise.

This article deals with a dual option right to treat subsidiaries as branches: one in the Netherlands where Dutch subsidiaries of Dutch tax payers may disappear for Dutch tax purposes when entering a tax consolidated group, and the Dutch rules to determine the taxation of a participation by a Dutch tax payer in a Dutch or foreign partnership. The Dutch fiscal unity rules are a real "election" almost like the US check the box procedure; with the partnerships interests the "checking" occurs when determining the details of the partnership agreement. The usual freedom of contract ensures that Dutch tax payers can elect to alter the Dutch tax treatment of a partnership share by merely adjusting a few words in the partnership contract; the insertion or deletion of just one word may be enough to go from tax transparency to full tax liability for a given partnership share. Therefore, as easy as "checking a box."

Why set up a Chinese LP or LLP if there is no joint venture?

Some readers of my previous articles have pointed out to me that they could not easily relate to my advice to set up hybrid LP's abroad because their company's foreign investment plans do not involve any cooperation with a third party: they just want to set up 100% owned foreign operations in case a foreign investment is being planned. To them the only tax question has always been "foreign branch or foreign legal entity?" So apparently it is quite a step already to realize that there is a third way to set up your wholly owned foreign business:

Exhibit 1



In this manner one combines the "foreign branch" tax rules with the "foreign subsidiary" tax rules. The difference is that usually neither a foreign branch nor a foreign subsidiary is capable of constituting a tax mismatch (other than in "check the box" elections made by US investors that are not the subject of this article). A branch is usually a branch in the tax view of the home country and in the tax view of the investment country. And a foreign subsidiary as seen from the home country is usually also a subsidiary in the tax view of the investment country. But an LP may give a tax payer the option to arrive at a tax mismatch at will. Such a mismatch can either be favourable (income elements not taxable in both countries or cost elements tax deductible in both countries) or unfavourable (income elements taxable in both countries or cost elements non-deductible in both countries) which obviously calls for prudence.

In fact, the tax planning around favourable mismatches (double tax deductions or income not taxable in either country) often has its roots in situations of double taxation: two tax authorities not willing (ie. not able) to take foreign tax aspects into account when deciding on the local tax aspects.

So I recommend that both tax payers and tax advisers, when looking at basic foreign investment scenarios, do not only take the usual branch versus subsidiary distinction into consideration but also spend some time on analyzing the tax effects of a fully owned foreign LP.

The Dutch "check the box" rule for foreign limited liability partnerships

The Netherlands is not officially known to have any "check the box" rule for taxation purposes and generally speaking there is no such rule, except for Dutch and foreign limited liability partnerships. Careful reading of the history of the Dutch CIT Act of 1969 reveals that the Dutch tax legislator has been struggling with the question of what forms of partnership should be treated as transparent for tax purposes and what forms should be subject to corporate income tax. This struggle has not been different from the struggle on exactly the same subject in other countries and each country has in the end taken its own decisions on this point, regardless of what other, even neighbouring, countries have done. They never really cared that this created a very high risk of double taxation, even under tax treaties!

The Dutch aim with defining the tax treatment of local partnerships has been to treat partnership forms which showed substantial resemblance with limited liability companies as subject to CIT and other partnership forms as tax transparent. The Netherlands' legal system knows a fairly large number of joint venture formats, so in the end a number of compromises found their way into the Dutch CIT Act. It should be kept in mind that in the days that these decisions were taken, Dutch limited liability companies were always joint ventures: a BV had to be incorporated by at least two incorporators, but each incorporator was free to sell his shares to a third party (albeit under a right of first refusal for the other existing shareholders) even seconds after the incorporation. But the JV aspect prevailed, back then.

"Tax authorities never really cared that their tax treatment proposals for LP's created a high risk of double taxation even under tax treaties"

Therefore the decision was taken to subject so-called "open" limited liability partnerships to Dutch corporate income tax. Whether a Dutch LP is "open" or "closed" has been defined as a situation where upon the entrance of a new partner this decision of the partners meeting would or would not be subject to unanimous approval from all partners. In case such unanimity was part of the document which established a Dutch LP (which used to be and can still be mere contractual arrangements in the Netherlands which can exist without any formal "founding" requirements), the partnership was considered as "closed" and not subject to Dutch CIT.

It follows that a Dutch LP (called a *"Commanditaire Vennootschap"* in Dutch, usually abbreviated to "CV") is in fact a check the box entity for Dutch CIT purposes: the founders may freely choose how to word their internal rules for the admission of new partners so they are free to create a CV which is not subject to CIT, if that suits them best, or to create a CV which is taxable for CIT.

It was not until the late nineties of the previous century that the Dutch tax authorities decided to use the same "open" versus "closed" criteria dating back to 1969 for participations of Dutch tax payers in foreign LP's: this was officially made public via a so-called resolution in which the Dutch Ministry of Finance has laid down the tax criteria for "participations in foreign joint venture formats including LP's".

The main criteria for a foreign LP to determine its Dutch tax status as "open" or "closed" and if "closed", as "comparable to a Dutch CV or not" (the check the box trigger) are:

1) Will the foreign LP own all business assets it uses in its enterprise or can some assets continue to belong to a partner even if used by the LP?
2) Is the capital of the foreign LP divided into shares or does the LP have a similar method to allocate profits to the partners?
3) Are all partners only liable for the debts of the LP for the amounts they have put in or are the partners or some partners liable for the debts of the LP without limitation?
4) Can new partners enter the LP or can partners sell their LP shares to other partners without the unanimous consent of all partners?

From a Dutch CIT viewpoint we will always need a foreign LP interest and not a foreign GP interest

This has to do with fairly old but still prevailing Dutch Supreme Court case law which held that a foreign interest as a GP in a Dutch LP structure must be regarded as directly accruing to the GP even if the Dutch LP is "open". This case law will then also apply to interests held by a Dutch tax payer as a foreign GP interest and this interest can consequently never be regarded as a subsidiary because the GP interest is then always deemed to stem from a "closed CV" from a Dutch CIT perspective. So in fact a Dutch Open CV is a hybrid all by itself: it is only "open" for the limited partners and not for the general partners; slightly confusing perhaps but something not to miss when structuring the set-up.

Country by country tax research is clearly indicated

In general, the question with regard to an investment by a Dutch tax payer into a foreign LP "is this foreign LP comparable to a Dutch CV and if so, is it "open" or "closed"?" cannot be answered without closely studying the LP rules on a per country basis. Each country has different rules as regards the above four "tax attributes" at stake.

It should be carefully noted that the question "is the foreign LP share subject to foreign CIT as a branch office or as a tax entity?" is not part of the criteria! The Netherlands will treat a foreign LP interest of a Dutch tax payer as a foreign branch if the Dutch rules say so, even if the foreign tax system treats that interest as a tax entity and vice versa.

When studying the Law of the People's Republic on Partnerships, it became apparent to me that Chinese LP's seem to have all the characteristics necessary for the Dutch "check the box" election: the partnership can own business assets all by itself, but can also use business assets owned by one of the partners, the managing partners of the LP have unlimited liability and the admission of new partners or the replacement of existing (exiting) partners by other existing (remaining) partners is, according to the Chinese Law, subject to the unanimous voting of the partners meeting "unless arranged otherwise in the LP agreement". So one can found a Chinese LLP where admission and replacement is subject to unanimous voting of all limited partners so the GP has no vote in this and this will turn the Chinese LP into an "open" LP so the interest in it qualifies under the Dutch rules for participations (ie. subsidiaries and the - in many ways different - Dutch tax rules for foreign branches do not apply.

What this might cause is depicted in three different case study scenarios, which show remarkable economical resemblance but are nonetheless treated differently under tax laws and tax treaties: intra-group financing, intra group operational leasing of equipment and intra-group licensing of an intangible. ■

Exhibit 2

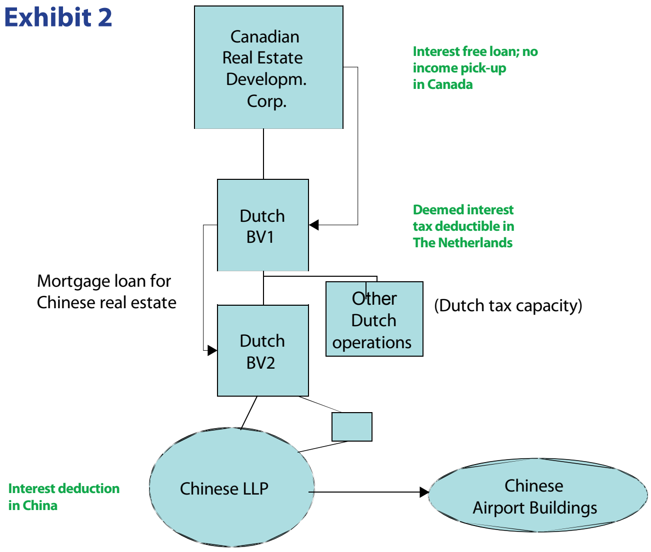


Exhibit 2 explanations

- The Netherlands sees a deemed loan to invest in a subsidiary; deemed interest is tax deductible (obeying thin cap constraints) under the Dutch "informal capital" rule;
- China sees a foreign limited partner in a Chinese LLP who has borrowed to finance the creation of Chinese real estate; interest tax deductible (obeying 1:2 thin cap constraints) in China;
- Equity is being transformed into a loan with interest deductions in two or even three countries

Exhibit 3

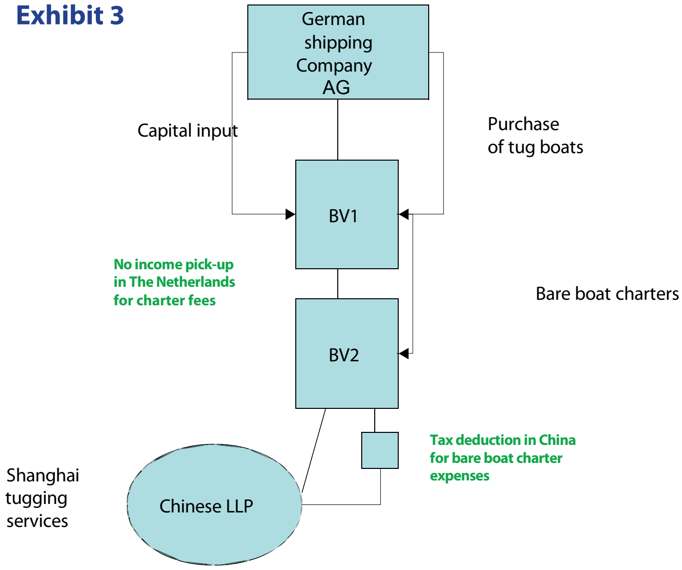


Exhibit 3 explanations

- The Netherlands sees BV2 as a local branch of BV1; the bare boat charter agreement does not exist (one cannot rent out boats to oneself); the income from this agreement is thus invisible and cannot be taxed; the Chinese LP is seen as a 99% subsidiary of BV1; interest to finance a subsidiary is tax deductible in The Netherlands;
- China sees BV2 as a limited partner in a Chinese LP who must rent boats to run the Shanghai business; charter fees tax deductible in China;
- China demands that the charter fees are "at arm's length"; if needed a ship mortgage bank can be put in between (back to back financing analogy)

Exhibit 4

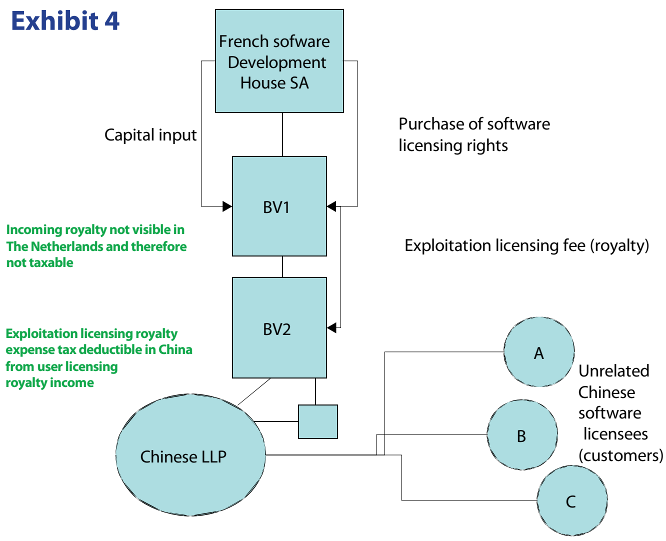
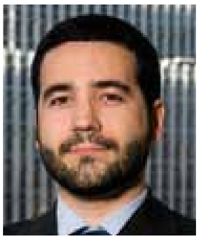


Exhibit 4 explanations

- The Netherlands sees BV2 as a Dutch permanent establishment of BV1; the software licensing agreement is invisible; the royalty income cannot be taxed;
- China sees BV2 as a foreign partner in a Chinese LP who may deduct the royalty it pays from the royalties it receives to compute taxable income in China; the royalty paid by BV2 to BV1 should be "at arm's length"

1. http://www.worldcommercereview.com/publications/article_pdf/202
2. http://www.worldcommercereview.com/publications/article_pdf/243
3. http://www.worldcommercereview.com/publications/article_pdf/273
4. http://www.worldcommercereview.com/publications/article_pdf/369

The international tax role - Spanish ETVE



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International tax is a key factor for multinational companies in choosing where to place their activities. It is a passionate item as it is complex. Tax planning is a must have for investors who want to develop sustainable projects.

One of the countries in which it is becoming increasingly attractive for foreign investor to have a holding company is Spain. It is well known that the ETVE[1] regime offers a wider range of vantage points compared with other jurisdictions in Europe. Essentially it is not different from any other company which takes part in economic or industrial activity in Spain and which amongst other assets, has ownership of foreign companies' share capital.

By virtue of the Spanish Double Taxation Treaty Network, which is currently being implemented in an increasing number of countries, the ETVE regime is currently regarded as a highly interesting channel for capital investments within these countries. Further to this the regime also offers an efficient channel for investors who are non-Spanish residents.

Spanish corporate tax

The average Spanish company faces a 30% taxation charge on their total income regardless of whether it is a limited liability company or a corporation with further representative investment vehicles. However there are specific lower tax rates which are applicable under certain circumstances. Medium to small sized companies can be taxed a 25% rate on €300,000 of its total benefits.

Withholding tax

A Spanish holding company, regardless of whether or not it is an ETVE regime, has to analyse the location of its subsidiaries. This enables one to ascertain whether or not the withholding of taxation will present problems in our ETVE tax plans regarding incoming dividends. If the subsidiary is a tax resident in:

- An EU member state: then any dividends remitted by the EU subsidiary to the Spanish holding company are free to withhold taxes

- A country with a Double Taxation Treaty signed with Spain: would result in a significant reduction or elimination of withholding tax rates on dividends remitted to Spain from the foreign subsidiary. Spain currently has 74 such treaties in its network.

- A tax haven or in other countries without an analogous corporate tax (similar to Spanish corporate tax rates). No withholding exemption or reduction is applicable; furthermore Spanish ordinary regimes or the ETVE regime cannot be applicable to any part of the ETVE income derived from dividends which originate from tax havens.

- Other jurisdictions: No withholding exemption or reduction is applicable, however Spanish ordinary regimes and the ETVE regime can be applicable to dividends which arise from these countries.

Therefore we must take into account which of the afore-mentioned situations will apply to withholding tax on incoming dividends.

Spanish taxation of incoming dividends

Under corporate tax law and according to the general regime, in order to avoid double international taxation of dividends (applicable also to ETVE regimes), it is necessary for us to evaluate the relevancy of the activity carried out by the foreign subsidiary. These activity's must consist of some actual business practices existing outside of Spanish jurisdiction, namely, manufacturing, bulk trading, rendering of services, financial and assurance services, copyrights, exploitation of patents, trademarks, including technical assistance. All those activities must exist under a structured organization of human and material resources with effects in a foreign market. Expressly, the activity cannot consist of:

- Income or gains which derive from ownership of immovable goods which do not belong to an actual business activity (ie, leases or house sales)

- Dividends, interests, gains or other type of income which derive from financial assets such as stocks, bonds, bank deposits or loans, etc, unless those financial assets which are related to an actual business activity, which means, the existence of a non-resident company with a structured organization of human and material resources whose 85% (the minimal percentage) income derives from actual business activities.

- Activities such as credit, financial, insurance or general render of services not related with an export activity, under the assumption that the costs for those activities are deemed as a deductible expense for a resident in Spain which is somehow linked to the non-resident according to tax laws (for example in a Spanish parent – foreign subsidiary relationship). However, those services can be accepted in case a non-resident carries out the major part of those specific activities with third independent parties; furthermore, when it comes to credit and financial services, such services can also be accepted in the regime to avoid double international taxation on dividends in case that more than 85% of the income of the non-resident lender is derived from actual business activity.

If one of these activities is able to meet the mentioned requirements, it would be commonly known as an "active" business activity. Conversely if the activity fails to meet the requirements then it would be considered a "passive" business activity. Notwithstanding the reasonably discriminatory treatment of tax havens, Spanish corporate taxation will not charge any incoming dividends received from the foreign subsidiary of a Spanish holding, provided that the subsidiary qualifies as an "active" business activity and furthermore the holding company has owned directly or indirectly a minimum of 5% of the share capital of the foreign subsidiary within a twelve month period.

Spanish corporate tax will not charge any capital gains which originate from the sale of shares that a Spanish holding company owned in the share capital of foreign subsidiaries under the same two provisions. Regardless of whether the holding company is a true ETVE or not, all those incomes are not charged. However the first difference between and ordinary regime and an ETVE can be presented as follows: under ETVE provisions the ETVE holding must directly or indirectly own 5% or more of the share capital of the subsidiary, or either own a lower percentage of the share capital whose acquisition cost exceeds that of six million euros.

Spanish taxation on outbound dividends

According to non-residents income tax law, ordinary Spanish regimes charges on outbound dividends at 19%; however the same law exempts all dividends that a holding remits to its EU parent which holds a minimum of 5% of its share capital within a minimum period of twelve months. Moreover through the applicable double taxation treaty a non-EU parent is entitled to a reduction or even elimination of the Spanish 19% tax imposition charged on its outbound dividends.

However, under ETVE provision, regardless of the tax residence status of the EU parent, no Spanish withholding tax will be applicable on the dividends that the ETVE remits to its foreign shareholder. Please note that this is only applicable if the recipient shareholder is not resident in Spain or a tax haven. In order to further fully understand this situation, we must take into account that this privilege is only applicable to dividends which are distributed out of exempt dividends or exempt capital gains obtained by the ETVE from its foreign subsidiaries. Therefore this privilege will never be applicable to outbound dividends which arise from ordinary activities (ie. industrial activities) that the ETVE might carry out in Spain. Moreover there exists a thin capitalisation rule for the Spanish holding company (regardless of its ETVE condition or not) and its lender or is other linked/associated companies. A 3:1 financing/equity ratio must not be exceeded so as to prevent interest being deemed as dividends (which are not deductible expenses according to Spanish corporate tax law). This provision however is not applicable on loans granted by linked/associated companies resident in an EU member state.

"The ETVE mechanism in Spain is a good example of what can be done by countries to attract and retain foreign investment, a critical antidote against lower investment in economic downturns"

Spanish taxation on capital gains

According to non-residents income tax law, ordinary Spanish regimes charge capital gains a 19% tax rate. However under the same ordinary regimes, Spanish non-residents income tax law declares non-chargeable capital gains which arise from the sale of participation in share capital of Spanish company, under the following circumstances:

- When the main assets of the Spanish company were not immovable ones, or,

- When the participation in the share capital of the Spanish company exceeded 25% within the 12 previous months

Moreover, when it comes to a non-EU parent, the applicable double taxation treaty may eliminate or reduce the Spanish 19% tax rate to be charged on those capital gains. In other circumstances, Spanish taxation would be applicable. If so: what happens if the foreign resident shareholder sells its participatory share capital of a Spanish company that exists as an ETVE?

Spanish ETVE regime states that the following types of income will not be charged in Spain:

1. The part of the capital gain which corresponds to non-distributed profits of the holding company, providing that those profits come from exempt dividends or capital gains already obtained by the holding company from its subsidiaries
2. The part of the capital gain corresponding to hypothetical capital gains which would have been declared exempt in the event that the holding company (both ETVE and an ordinary company) had sold its participation of share capital of its subsidiaries

The remaining part of the capital gain will be charged in accordance with the non-residents income tax regime: 19% of the resulting difference between the sale value and its theoretic value, unless applicable double taxation treaty settles otherwise.

If the subsidiaries do not meet all the requirements for them to enjoy the benefits of an ETVE regime (ie. non foreign residents, residents in tax haven, not actual business activity, etc.) dividends or capital gains will not be deemed exempt, however, a tax credit may apply under some circumstances. This tax credit will reach to the lowest of these two concepts: an amount equal to the actual taxes paid in the foreign jurisdiction or up to an amount equal to the tax which would have been paid in Spain for that income.

Requirements and incompatibilities for the ETVE:

- The ETVE statutory corporate purpose must include the management and control of participation's of non-resident subsidiaries.

- The shares of the ETVE must be nominative.

- A simple application for the ETVE regime must be filed to the Spanish tax authorities.

- There must be a person in charge in order to structure the shareholder's duties (voting rights, attending meetings, special fees for this performance, agreements in writing, description in the annual account memorandum, etc), a suitable candidate would be one of the directors with enough material resources at their disposal to meet those obligations.

- The ETVE cannot be a company whose main activity is the simple management of a movable or immovable asset, such as holding companies held by a family group with no actual business activity.

Conclusion

The combination of Spain's double tax treaty network and its ETVE regime means that there are currently a number of tax efficient routes for dividends through Spain. The broad tax treaty network (especially with Latin America countries) and the European features of the ETVE make this regime a tax-efficient channel for investments by non-EU companies provided they are not resident in a tax haven.

Furthermore, Spain has signed multilateral and bilateral investment treaties, especially with many Latin America countries, whose purpose is the protection of Spanish investments in those countries by settling that every Spanish investment will be treated in the same manner as domestic investments.

The ETVE mechanism in Spain is a good example of what can be done by countries to attract and retain foreign investment, a critical antidote against lower investment in economic downturns. ■

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15 years

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1. ETVE is the acronym for "Entidad de Tenencia de Valores Extranjeros" or Foreign Shares Holding Company

Poland simplifies double tax avoidance procedures

Paweł Jabłonowski is the Head of Tax Department at Chałas & Partners Law Firm

In response to parliamentary questions the Polish Ministry of Finance informs that it will seek to place a complete exchange of information clause into all treaties on double tax avoidance, in order to simplify the procedure of obtaining financial information on entrepreneurs.

It is intended to provide a tax administration on all bank accounts of Polish taxpayers, thus enabling verification of the declared tax base, particularly in cross-border income. The Polish tax administration does not currently have access to data on Poles operating in 'tax havens', which allows them to avoid tax. Following the introduction of full exchange of information clause Polish tax authorities will be able to get all the tax information about transactions made by Poles in those participating countries. The Treasury will be able to check if the income of these persons has been properly settled.

Work is ongoing on more than twenty agreements, including Jersey, Bermuda and San Marino. An agreement with the Isle of Man was signed in March. Agreements with Switzerland, Denmark and Malta have been renegotiated, and talks with Belgium are in the final stage.

> **"Work is ongoing on more than twenty agreements... "**

The Polish Finance Ministry also wants to remove unfavourable entries from the treaties. Work has begun on a contract with Luxembourg and Malaysia. Soon to be negotiated is the elimination of the tax-sparing clause from the agreements with Cyprus and Singapore. Cyprus is a key example here, as a company's tax planning is increasingly taking into account investments there. Why? The double taxation treaty includes the above mentioned tax-sparing clause. It is a tax incentive for mutual investment in countries through which the investor can save on tax. The source of the problem lies in the 1970s, when the reality was completely different and doesn't correspond with the current economic situation.

Based on this example the Cypriot tax, because of their internal regulations, is effectively not paid. As the Ministry of Finance explains, the dividend tax submitted by the Cypriot company is only 9% when the dividend paid by a Polish company to a Polish resident is 19%. Understandably there are Ministry actions focussed on addressing this.

It is obvious that such activities are complex and a long-term process, so changes will not come into force soon. Moreover, this type of amendment needs both sides to agree and Cyprus is not interested at the moment as this would lead to a reduction in Polish investment in Cyprus. Unofficial sources let it be known that negotiations would not be finished within three to five years.

It is important to point out that even if there were some changes to the treaty (with regards to the dividend payment) that there are a lot of benefits that are provided by Cypriot legislation that cannot be modified by negotiations between the polish and Cyprus governments. Even basic trade activity may benefit from the 10% corporate income tax levied in Cyprus, providing that the entrepreneur sets up the holding company in Cyprus. It should be pointed out that movement of goods does not have to follow a formal chain of transaction; goods are not required to be physically transferred to or from Cypriot territory.

Entrepreneurs should also remember that Cypriot legislation is very convenient in creating so called 'financing vehicles'. Cyprus has no 'thin capitalization rules', which would disallow interests deduction to the extent that debt/equity ratio exceeds a certain level, and also do not have withholding tax on interests paid to lender. Another benefit is the absence of withholding tax on interest payments to non-resident creditors, and the absence in general of any taxation over the profit upon the sale of securities makes Cyprus a highly interesting location for establishment of a subsidiary active in the financial field.

In Poland, capital gains realized by Polish individuals upon the sale of securities on the stock exchange will, in general, be fully taxable against a rate of 19%. Such taxation can be deferred by investing through a Cyprus company due to the exemptions stated above. The deferred income may not lead to a tax obligation due to the Parent/Subsidiary Directive that may apply in this case. The above Directive deals with the tax regime applicable to parent and subsidiary companies of the EU countries and eliminates any double taxation of dividends paid by a subsidiary in one member state to a parent company in another member state. A parent/subsidiary relationship is established where a parent holds 25% or more of the capital of the subsidiary company in question.

Cyprus also has a very favourable tax regime for companies active in the shipping or ship management industry. Again, this factor cannot be altered by changing the double tax avoidance treaties. A Cyprus-based company owning a ship under the Cyprus flag can benefit from a zero corporate income tax regime over its profit as well as a very low tonnage tax regime.

Interestingly, there are no changes in the tax treatment of members of the board. The agreement with Cyprus means that a director's salary is taxed only in Cyprus and not in the country in which the director has residence. The above regulation may be treated as key to effective tax optimisation.

Cyprus is not the only country that the Ministry wants to change the double tax avoidance treaty conditions with. Another example here is Luxembourg; dividends paid by companies with its residence in Luxemburg are exempt from tax in Poland. Luxembourg also provides a very low corporate income tax rate (at the level of 8.5%) that allows the establishment of an effective holding company.

One important issue should be stressed, taking advantage of 'tax havens' is legal, therefore simplifying the procedure of obtaining information from foreign tax administrations would not change anything in the activities performed in foreign legislation, from the Polish entrepreneurs perspective. The most interesting thing is that the Ministry of Finance has not specified the details of planned changes. It leads to the conclusion that the Ministry has already the instruments to check taxpayers, however they are either not effectively used or there is no tax avoidance to expose. ■

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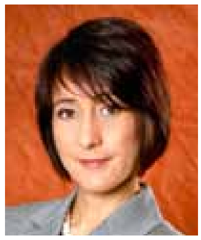
Panama in the international community: evolving to the future



Gisela Alvarez de Porras is a Partner at Arias & Muñoz, Panama Office[1]

Many years of diplomacy and goodwill have elapsed for us Panamanians, to begin restoring in 2000 the territories that since 1903 were controlled – by a voluntary assignment of Panama - by the United States for the construction, management and operation of the waterway that changed the form of running the international trade, and that has been an important part of what we are today as a nation and has turned us to be one of the leading countries of the region in economic growth.

The vision of those who devoted their lives to promote the Panamanian cause of the canal and the professional management carried out when the control of the Panama Canal was transferred to the Panamanian responsibility, as well as our innate commitment as a country to serve the world, have created an environment where the foreign investment is respected and valued, as our international oriented legislation shows.

All that effort kept us focused in the internal arena, and perhaps diverted our intention in understanding that something else was changing and we were somehow not taking advantage of our natural condition as facilitators and service providers. Thus, Panama was late in becoming part of the World Trade Organization and also behind in economic integration of the Central American Region, a prerequisite of the European Union to accept us as part of the commercial treaty with the region. Integration is critical to the region due to the small size of our economies which makes it difficult for each country to internationally participate separately, due to the cost-benefit relation in a multi-polar globalized world – economically – therefore, common effort imposes itself as the fundamental principle of integration.

At the end of the day, the commercial treaty with the European Union was signed – with Panama as part of the economic area, and the region now faces important challenges to benefit from the same. In this context, all Central American countries are called to jointly act: (i) to access new markets; (ii) to negotiate under variable and more flexible commercial schemes in different latitudes; (iii) to benefit from new technologies; and, (iv) to fight against the insecurity issues caused by crime and drug traffic.

Over the time, the bilateral commercial treaties existing between Panama and each Central American country will be superseded by the Economic Integration Treaty.

Besides the Central American Treaties, and all the consequences of an integrated region, the previous and the current Government have devoted time and effort to continue signing commercial treaties, again, with our main commercial partners, and with those countries with nearsighted trade opportunities. Keeping in mind that commercial treaties not only focus on import and export tariffs, but in creating better conditions for the protection of foreign investment, it seems that we have finally realized that we are more than a water way, and that such platform needs to be connected with what moves around it.

Despite of being late on the matter of international trade agreements, Panama has always been ahead in protecting foreign investment, and has been very active in promoting the signing of international treaties, giving special guarantees to foreign nationals vis-à-vis government avoiding acts which could lead to an inappropriate expropriation, for example.

Panama have treaties in force, and enforced, with the United States of America, Mexico, Italy, Singapore, Korea, Canada, and many other countries, which have been signed, aimed to attract the foreign investment, creating favourable conditions and guaranteeing title for the nationals of such countries. Basically, the treaties provide that the investment of such nationals would not be treated in a less favourable way than those of a Panamanian citizen.

And last, but not least, it is crucial to comment on the matter of being black listed by the OECD. The black (or gray) list has maintained us in the hit parade both, internally and internationally. The discussion centred in whether a level playing field was been applied (which I believe is not), and whether or not we should enter into Exchange of Information Treaties, not because there is an interest to protect tax fraud, but because there is a sound and solid banking centre that needs to maintain the confidentiality of the information (contrary to what is thought, we do not have bank secrecy legislation). There are good arguments on both sides, against and in favour of the treaties. But at the end, the common sense prevailed and it has been understood that (i) to maintain our competitiveness as a world class banking and financial center; and, (ii) to keep the levels of foreign investment required for an economic growth, the exchange of information is not an avoidable option.

As stated, those who oppose the treaties are thinking of the crash of the banking system. I am pretty sure it will not happen. Panama has solid financial institutions, run by expertise professionals who are clever enough to lead the centre through this new challenge (as well as the Basle's outlines which are being implemented.

Recent events have proven my theory that the exchange of information will be part of our daily living, whether we like it or not, and regardless of the existence of any exchange of information treaties in force. The tale is becoming reality: the Foreign Account Tax Compliance Act (FATCA), prepared by the US Treasury, would *"require overseas financial institutions to identify US account holders and report account information directly to the IRS, including the account balance…"* otherwise, economic sanctions would be applied to the banking institution. FACTA provisions are *"nothing less than financial imperialism by the US government, which is trying to regulate and prosecute foreign institutions that are abiding by their own countries' laws and have a presence in the United States."*[2]

Being inevitable, the Panamanian Government – wisely, in my opinion – negotiated treaties to avoid double taxation, instead of plain and simple exchange of information treaties (as the one the United States demanded from Panama). There are double taxation treaties (DTT) with Italy, Spain, Singapore, Mexico, Luxembourg, The Netherlands and other countries which are significant trade partners for the country, and, in addition, are key members of the OECD.

It is worth mentioning that the treaties do approve exchange of information, but under specific circumstances. Although Panama, with a territorial tax system, might not get a direct tangible gain from information received on the income made by its nationals outside its borders, it will certainly promote and attract foreign investment and therefore would prove to be an excellent vehicle for estate and tax planning since they all create lesser tax rates for beneficiaries resident in the party countries, to wit:

- Dividends: dividends may also be taxed in the contracting state of which the company paying the dividends is a resident, but if the beneficial owner of the dividends is a resident of the other contracting state, the tax so charged under the treaty usually does not exceed of 5% of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 10% per cent of the capital of the company paying the dividends, or 15% of the gross amount of the dividends in all other cases. To compare: the regular charge would be 10%, or 20% in case of corporations with bearer shares.

- Interests: interest may also be taxed in the contracting state in which it arises, but if the beneficial owner of the interest is a resident of the other contracting state, the tax so charged usually does not exceed 5% of the gross amount of the interest. The regular charge would be 12.5%.

- Royalties: royalties are also taxed in the contracting state in which they arise, but if the beneficial owner of the royalties is a resident of the other contracting state, the tax so charged is of 5% of the gross amount of the royalties. The regular charge would be 12.5%.

- Capital gains: gains derived by a resident of a contracting state from the alienation of immovable property covered by the treaty and situated in the other contracting state may be taxed in that other state.

- Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other contracting state, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), are taxable in that other state.

- Gains derived by an enterprise of a contracting state from the alienation of ships or aircraft operated in international traffic or movable property pertaining to the operation of such ships or aircraft shall be taxable only in that contracting state.

- Gains derived by a resident of a contracting state from the alienation of shares or comparable interests deriving more than 50% of their value directly or indirectly from immovable property situated in the other contracting state may be taxed in that other state.

- Gains from the alienation of any property other than that referred to in the above paragraphs are only taxable in the contracting state of which the alienator is a resident.

"... the Panamanian private sector has played a significant role in the development of the nation"

As a final remark, I must mention that the Panamanian private sector has played a significant role in the development of the nation. As an example, there is the logistic multimodal platform created around the canal waterway that competes with those of the first world countries. In this particular sector, investment protection treaties have been priceless, along with the existence of talented enterprises who negotiate the so called *"contratos leyes"* (a sort of a private contract solid as a law) that offer the fundamental scenario for the investment to make sense.

The above mentioned conditions, plus a specifically designed legislation, create the effervescence that it's been seen around: the Special Economic Area of Panama-Pacific, the new legislation on free zones (WTO approved), the Tourism Act, the Multiregional Offices Legislation – among others – are only a few rich examples.

It is my opinion, that upon having assumed its role in the international community Panama has been enabled to honour the tag of its coat of arms ... *"pro mundi beneficio"* and that should make us move onward the following level ... become an innovative country... a leit-motif for another article. ■

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1. Former Secretary of Trade and Industry of the Republic of Panama and Under Secretary of Finance.
2. Richard W Rahn, published May 24, 2011 – The Washington Times.

Data security and privacy

Keeping a company's IT systems secure was once fairly straightforward. IT managers adopted a 'castle and moat' approach. With a secure perimeter in place around the system, the computers inside were considered safe.

In a trade-off between security and productivity, firewalls, anti-virus software, locked-down desktops (to stop users installing their own software) and limits on email attachments are all today part of a sensible defence system. USB ports are often blocked to stop staff downloading data onto, or uploading viruses from, MP3 players or memory sticks.

Ultimately, though, corporate IT security is not just about better IT policies and compliance; it's also about protecting users and the data they access.

Security is not made any easier by the explosion of the quantity of data generated by companies and its interconnectedness. Locking down one system may have consequences across all data systems. Companies need to understand, with regard to their data, who provides and who may have access, and which digital assets require what levels of security.

The old 'castle-and-moat' perimeter mentality will probably not completely vanish, but if they wish to protect themselves and thus their customers, companies must become more aware of the importance of, and risks to, their data.

Bermuda's approach

As a jurisdiction, Bermuda was an early adopter of e-commerce and electronic communications. For more than 10 years, the Bermuda Government has worked closely with the companies in the island's e-commerce sector. The Government takes security seriously and is of the view that privacy and security go hand in hand. On the security side, the Government has a digital certificate programme in place and manages its own digital certificate authority.

Given that Bermuda is home to a meaningful number of multi-billion dollar insurance, banking and other ventures, data protection and security is critical to the jurisdiction and the companies that trade there.

"Bermuda has long been able to hit above its weight in the IT field due to the sophisticated international companies — largely information-driven — that are located here," explains Gavin Dent, chief executive officer CEO of QuoVadis Services, a managed data centre service. *"As the majority of these companies operate globally in regulated industries, they have wide-ranging obligations in terms of information security, business continuity, data integrity, and data protection. The island benefits from this activity as the skills cross over into local systems use,*

whether it's in technical skills or in the audit and legal support that goes along with them."

QuoVadis, a Bermuda success story, has two fields of interest. It is a provider of managed identity and encryption services (digital certificates), serving a global market and regulated in several international jurisdictions. *"Our certifications require us to deploy a wide variety of security controls over our physical and computing infrastructure, our personnel, as well as our operating policies,"* Dent says. *"This 'security and compliance mindset' has laid the groundwork for our second major business: managed data centres and cloud services for the Bermuda market."*

In the past, most major Bermuda businesses have preferred to keep all of their infrastructure in-house. *"But in today's competitive economy, and with their own global demands, many of those businesses are willing to consider outsourced IT for either their production or business continuity environments,"* Dent says. *"But this is not a simple trade-off made on pricing considerations alone; they demand confidence that the outsourced services provide the same — if not better — security and resilience that can be independently verified. For, after all, they are putting important pieces of their infrastructure under our control."*

"Bermuda is also working on developing comprehensive privacy legislation designed to protect personal information. Such legislation often goes a long way in helping to combat cybercrime"

In order to meet this changing market, QuoVadis has invested heavily in a new SecureCentre hosting facility in Bermuda which is tied into its operations in data centres overseas. With the critical mass of this managed facility, the company is able to provide the resilience in monitoring, power, cooling, computing platforms, and networking that a single enterprise may not wish to shoulder alone. *"In short, our customers want to be able to focus on the performance and security of the applications that are their core competence, but to outsource the raw platforms to a specialist provider,"* Dent says.

From an online safety perspective, the Bermuda Government also hosts a website, www.cybertips.bm. The aim of the site is to provide practical tips, resources and contact information to help parents, children and educators to use the internet safely and to be on guard against online predators and other inappropriate online content.

Bermuda is also working on developing comprehensive privacy legislation designed to protect personal information. Such legislation often goes a long way in helping to combat cybercrime.

Bermuda, known as "the wired island", has one of the highest cell phone penetrations in the world. It's sophisticated technology infrastructure includes several fibre optic cables connecting it to the rest of the word. But, in being an island in the middle of the Atlantic, disaster preparedness is a major focus. The availability of several disaster recovery and business continuity facilities, along with the multiple redundant international undersea cables, provides a significant comfort level to businesses operating in Bermuda.

Ask the experts

To assess further how security is regarded and treated in Bermuda, four other leading experts were asked a series of questions. Ronnie Viera is senior vice president of information technology and operations for First Atlantic Commerce. David Ciera is senior manager, advisory at KPMG Advisory Limited Bermuda. Nick Treasure is supervisor, IP and systems at North Rock Communications, and Chris Maiato is principal, advisory services at Ernst & Young Ltd.

Security is a key concern for us all, and ICT is no exception. What are the major ICT security concerns of your clients with respect to your interaction with their systems, and how do you address them?

Viera: As we are in the payment processing industry, the primary concern is the security of sensitive cardholder data. Data encryption, card number masking and several other layers of security are used to protect all data.

Ciera: Most of our clients' concerns are related to unauthorised access to their systems, ie. hacking. In order for us to address these concerns, we typically provide clients with penetration testing services and highlight weaknesses in the security of their networks.

Treasure: As an internet service provider, we rarely touch client systems. We do offer remote services such as corporate email and web hosting for clients. Security concerns here mean proper firewalling, server hardening and patch management.

Maiato: As the level of connectivity options and accessibility increases, the concept of security becomes a challenge. There has been a major trend towards anytime, anywhere access and adoption of new technologies such as cloud computing, social networking and personal (mobile) devices, coupled with an increase in the use of outside service providers. This has resulted in a rising level of risk and a new challenge for information security professionals to manage risk and protect their organisation's information assets, while providing the freedom of anytime anywhere access. To address these trends and despite the tough economic climate organizations are focusing more time on assessing the risks to their business and spending more to address the information security challenges. The response has been to implement new security technology and awareness programs across the organization. This has driven an increase in the spend on security.

What international security standards does the industry adhere to in Bermuda?

Ciera: Companies follow European and North American standards, given the nature of international business in Bermuda.

Maiato: With Bermuda's dynamic mix of international and domestic entities, we have seen the adoption of a number of various international standards, either fully- or right-sized. Many of the standards have a lot of overlap and are really founded in similar principles, so the choice depends on the company and the culture. Standards that we have seen include, the ISO27001/2, Cloud Security Alliance (CSA), and NIST, to name a few.

Treasure: In my experience, not one specific standard is adhered to. Businesses respect a variety of international standards as appropriate.

Viera: In our industry, it is the "Payment Card Industry — Data Security Standards" (PCI-DSS), which is mandated by the major card associations. This is an example of industry self-regulation, although in the US there is also legislation imposing specific standards of security for personal information (more broad than just card data), health related data (Health Insurance Portability and Accountability) and bank data (the Gramm-Leach-Bliley Act).

Is part of the approach, when assessing how well security is implemented, an external and independent audit?

Maiato: For clients that have the resources internally to assess their security eg. internal IT auditors, and chief information security officers, the approach tends to rely more on the assessments of these individuals as the first line of defence. Most organizations, small and large, are moving to annual security assessments from outside firms, such as EY, that have the skill sets to test all aspects of their security regime, right from their base security policies and procedures through to their awareness and training programmes. Over the past several years organisations of all sizes have increasingly wanted attack and penetration assessments to be performed by subject matter specialists in this area. This trend continues; however, the assessments have started to become more mature and to test a company's total security framework, not just its perimeter security.

Treasure: Yes, these are often implemented.

Viera: We are audited and have to be certified annually for PCI-DSS compliance. The audit must be conducted by a Qualified Security Assessor (QSA), who is a systems/security auditor who meets the qualification requirements and has passed an exam.

Ciera: Yes, we provide our clients with internal and external audit services that encompass assessing security. The scope of IT-related audits includes assessing security at the network and application layers.

How important is disaster recovery and business continuity (DR & BC) to your clients? How do you generally deal with the off-site storage and data synchronisation issues that this brings?
Viera: We consider DR & BC to be critical to our business. On occasion, clients will ask about these issues, but this usually happens only with our larger clients. We use real-time database synchronisation to a DR database in addition to disk-to-disk backup technology.

Ciera: DR & BC are very important to our clients, particularly as Bermuda is in a hurricane zone. Most of our clients mirror their systems, either on or off-island. We are seeing more mirroring of data, rather than traditional backup and off-site storage. This is particularly so, given that the costs of storage have come down significantly over the years.

Maiato: DR/BC is extremely important for all of our clients. Many of our clients have indicated to us that their clients are requesting additional information about their DR/BC plans as part of the due diligence process and simply saying you have one is no longer enough. Some companies choose to replicate between branch offices, others outsource to secure co-location data centres, while still some others leverage online replication services that are hosted.

Treasure: Yes, this is very important to our clients. We have redundant points of presence that allow us to seamlessly move clients, should there be a disaster in one area. We do not store client sensitive data, so off-island storage is not a concern for us.

Wi-Fi is now pervasive. How is security handled for this medium?
Ciera: Some use web keys or Wi-Fi Protected Access (WPA), which provide a more secure level of access.

Treasure: Private and enterprise wireless is handled differently. Private users should at least secure their network with WPA and enterprise should be using Extensible Authentication Protocol-Transport Layer Security (EAP-TLS), ie. secure certificates and Remote Authentication Dial-In User Service (RADIUS).

Viera: The first consideration is the risk and security profile of the business. Assuming data encryption (WPA or better) is used, the next concern is the segregation of public and private networks within a business/building. Specifically, an individual who has access to a company's internal network must be prevented from accessing that internal network at the same time as accessing the public internet via a Wi-Fi connection. There is a risk of creating a 'back door' to the company's network, whereby a perpetrator may gain access to the internal network via the public Wi-Fi network.

What happens if there is a security incident at one of your clients? How is it dealt with?
Treasure: We cannot control clients' security. However, the internet service may have caused the security incident, so we work closely with the client to diagnose cause and help to gather all the facts, so that they may proceed with charges if they see fit.

Maiato: Depending on the nature of the security incident, our clients react in various manners. Our more sophisticated clients typically have an incident response process that is defined to contain and recover from a security incident as quickly as possible.

Viera: It is difficult to go into detail in a short response. However, one of the key policies and procedures in a company's security manual should address 'incident response'. When an incident occurs, there is a lot of activity around securing the environment, so having a documented set of procedures to follow ensures that the proper steps are followed. In addition, if there is to be any type of criminal or other investigation, preservation of all evidence is critical, so having access to qualified forensics expertise is important.

Ciera: Such incidents are managed through predefined incident management procedures.

Intrusion Detection (IDS)has been superseded by Intrusion Prevention Systems (IPS). Are these widely deployed in Bermuda?
Viera: Newer versions of Windows, firewall software and anti-virus software provide a certain degree of IPS functionality. The risk profile of a business determines how much protection it needs to employ, so I suspect that more businesses have deployed industry-strength IPS devices/technology in their infrastructure.

Ciera: IDS is still more prevalent.

Maiato: Yes, we have seen both IDS and IPS deployed at our clients.

Security really starts with the physical aspect. Is this obvious in your client facilities?
Maiato: Physical security is a major concern; however, the majority of our clients have implemented key card systems to access their buildings, floors, and all technology rooms or cabinets. This has become the norm for even small businesses. We have seen an increase in the use of bio access readers in addition to swipe card access, to provide two-factor authentication at the physical level.

Treasure: Yes. Biometric/card access for all server rooms is observed. General workstations are not locked down, however, which could be seen as a risk.

Ciera: Yes, we see the full range, from a security guard at the entrance, man traps, surveillance cameras, card access and use of biometrics.

Viera: Once again, the degree of physical security depends on the risk profile of the company and the value and type of data it is trying to protect. For example, in a home setting, one would invest a significant amount of more money to secure an expensive painting or piece of jewellery, than, say, normal household possessions. Equally, a company will implement the level of security required to secure the data it is trying to protect. For a data centre, it is not unusual for physical security to now include as a minimum, eight-foot high barbed wire fencing around the perimeter, multi-layered door access, camera surveillance in all areas, manned security at all times, biological verification, accompanied access, detailed logging, etc.

If you were to list the top three items that your clients are asking about with respect to security — given the recent issues with global companies having data stolen from their systems — what would they be?
Viera: Availability; security of the cardholder data; and integrity.

Ciera: The effective use of data encryption; how to perform penetration tests; and implementing policies around the management of portable devices, including Blackberries and laptops.

Treasure: We are asked for security solutions, so it would be hard to list three items. It is apparent that many companies are desperate for good personnel with security skills.

Maiato: What are my risks and do we have any current exposures? What are the weaknesses in my security framework and how can we close them? How do I strike the balance between access and security?

Do any of your clients require that you comply with any international privacy/data protection standards or laws (ie. EU law)?
Ciera: Most of our clients are in international business and thus follow EU and North American standards.

Maiato: In Bermuda, our clients generally tend to be satisfied with our firm-wide data protection and confidentiality standards, as we have very robust and strict standards and therefore generally do not require us to comply with any others.

Do you make any special provision with regard to access to personal information held by your clients?

Maiato: Yes, we are very sensitive about access to and the protection of personal information. We always abide by the client's data privacy requirements, at a minimum. Our teams working on engagements only access that information that will allow them to perform their work. In addition all our employees are required to sign confidentiality agreements to safeguard and protect all client information (personal or otherwise) they come in contact with.

Treasure: No, we have no ability to access their personal information.

Viera: No. I have already stated the importance of security standards required in the payment card industry.

Ciera: We tend to hold client information, rather than the other way around, and this is treated with the highest security standards and in accordance with international best practice.

How important is the protection of personal information to your industry and why?

Treasure: Securing systems from external penetration is the one thing every company and home user is adamant about.

Maiato: Due to the nature of our business, we come into contact with a lot of confidential information, thus making protection of such information of utmost importance. We have put in place software (eg. data encryption), controls and policies that ensure that all information obtained from clients is kept confidential, in a secured format and is only known to individuals that have a need to know even within the organisation. Being able to appropriately protect our data and that of our clients, whether personal or corporate information, is key to ensuring our clients continue to have trust and confidence in us. Our brand and reputation is at stake. ■

Intensification of the remuneration requirements for credit institutions in the German and European legal areas

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The crisis that shocked the financial world three years ago seems to have vanished; the reconditioning of its causes is happening slowly but surely. One of the main reasons for the financial crisis was identified by politicians and the public as being the remuneration systems which caused misdirected incentives to take large risks. As a result, the parameters pertaining to supervisory law for the arrangement of the banks' remuneration systems and insurances were recently intensified in both the German and European legal areas.

In Germany, requirements pertaining to supervisory law for the payment systems of financial institutions and insurance companies were first implemented on December 21st, 2009 by two circular letters from the German Federal Financial Services Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*). They basically corresponded to the Principles for Sound Compensation Practices which had been published on September 25th, 2009 by the Financial Stability Board and subsequently endorsed by the G20-States during the summit in Pittsburgh. On July 27th, 2010, the German Banking Act (*Kreditwesengesetz*) was changed. On October 6th, 2010, the Institution Payment Regulation (*Institutsvergütungsverordnung*) came into effect. In correlation with the German Banking Act, the latter contains extensive guidelines regarding the arrangement of the payment systems of banks and credit institutions which go far beyond the requirements of the Principles given by the FSB. This is particularly remarkable because the range of the institutions affected by these regulations was made exceptionally broad. The new requirements apply to all credit and financial service institutions that are subject to the German Banking Act. These include not only domestic institutions, but also their foreign subsidiaries and branches as well as domestic district offices of companies based abroad (if not released by the European Banking Passport).

"The new requirements apply to all credit and financial service institutions that are subject to the German Banking Act"

The German regulations correspond to the new European remuneration requirements applicable since December 15th, 2010: The directive 2010/76/EC of November 24th, 2010 (CRD III) substantially expanded the bank directive and was amended with, inter alia, a part on "remuneration politics". Now the European law, as well as the German law given by the most recent changes in the German Banking Act and the Institution Payment Regulation, prohibits, for example, guaranteed variable remuneration payments, severance payments or personal hedging strategies which eliminate a payment's risk orientation. It also provides for detailed requirements in the award and payment process to align the variable remuneration with a sustainable company development by means of a combination of cash and stock payment components, each bound to deferral and retention periods. In addition, the *Committee of European Banking Supervisors* (CEBS), which has been part of the *European Banking Authority* (EBA) since January 1st, 2011, was ordered to release further guidelines, which were published on December 10th, 2010. The *CEBS-Guidelines on Remuneration Policies and Practices* consists of 86 pages and contains further detailed explanations of the directive requirements and their correct implementation.

This illustrates the European legislators' will to deliberately pursue the regulation of payment politics, and especially to take on a leading role in the discussion of world-wide standards for the arrangement of remuneration systems in the future, in particular with the new *European Banking Authority*. ■

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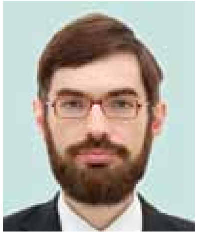
Quicksands: legal and enforcement rules affecting cross-border supply of financial products and services into the Gulf



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Introduction: a garden of rich pickings surrounded by (new) thorns

The attraction of the petroleum-derived capital richness of potential investors located in the Gulf States (which are united together in a union called the Gulf Cooperation Council (GCC)) has never gone unnoticed by international asset managers and international securities marketing and sales firms. These investors include both sovereign wealth funds and other investors but something important has changed and that is the degree of care needed in accessing this market. While in the past the nature of financial regulation in the Gulf countries was relatively weak, vague and non-enforced, this has been fast changing in recent years. Recently, all the GCC countries have new stricter rules on cross-border marketing and selling of funds and securities to investors located in those countries and they also have greater enforcement of those rules.

The old days, or the Wild East

Back in 2007, and in relation to the United Arab Emirates (UAE), an excellent article was written by the editor of the *International Financial Law Review* called *"Dubai and the UAE: Built on Shifting Sands"*[1]. The article stated that *"Theoretically, there are fairly strict selling restrictions for securities in the UAE... and prior approval of the central bank should be obtained. But practically, as long as the offering does not involve widespread solicitation to unsophisticated investors, the central bank does not pursue issuers who have not strictly complied with the law."* The article mentions that *"many in the region say this happens...speaking of "meetings with small groups in hotel rooms"."*

"... all the GCC countries have new stricter rules on cross-border marketing and selling of funds and securities"

The position now: a myriad of tougher regulatory rules and enforcement attitudes

If the rules in GCC countries on cross-border business funds and securities marketing and sales were shifting sands in 2007 then, by 2011, they are now treacherous quicksands of the first order. Those who wish to navigate the relevant rules and practices need guidance from lawyers who understand both international marketing practices and local laws and norms. The rules of the game have changed dramatically since 2007 – and in fact the winds of legal and regulatory change in this area had started blowing even before that.

A veritable revolution has occurred, and is still underway, in the financial regulatory laws and the enforcement attitudes the GCC countries. Legal, regulatory and enforcement reform has been an accelerating trend in these countries – but not necessarily along lines that are readily recognisable to those businesses based in western jurisdictions.

Why have laws and enforcement attitudes changed? Well, apart from the obvious reason that regulators benchmark each other and no regulator wants to be seen as undeveloped by their professional peers, there is a more fundamental reason. Regulators in the GCC countries were under pressure from their own financial institutions and their own citizens to tighten up their rules and systems to offer protection of one type to their own consumers and of another type to their own locally regulated financial institutions.

Against this backdrop, international fund marketers blatantly ignoring local laws and engaging in fly-in-fly-out salesmanship was understandably seen as an insult by local financial regulators who came in for increasing domestic criticism within their own countries particularly due to the periodic occurrence of boiler-room scandals where local nationals were sold fake or worthless securities by what was probably in fact a relatively small number of outright fraudsters.

Why is this important?

The challenge is that many international asset managers and investment firms are unaware of this - displaying a herd of sheep mentality that still harks back to the time when the prevalent sentiment amongst international investment salespersons was 'suitcase marketing into the Gulf - not be a problem – grey rules and no enforcement'.

A number of such behind-the-curve salespeople have been getting their employers into trouble recently. This may not have been intentional on the part of these marketers – often they either themselves conducted or their peers conducted fly-in fly-out marketing, or other forms of cross-border activity, into Gulf States for so long that it is hard for them to now adjust to the fact that the rules of the game have changed.

But Gulf financial regulators lenience towards excuses of the *"this was unintentional - please let us off this time"* type, from the international firms employing such marketers, has run thin.

The penalties for getting it wrong

The penalties for an international asset manager or investment adviser (including, as we will see below, DIFC or other single GCC jurisdiction based firms) in marketing or selling their products or services in a GCC jurisdiction where they have no local licence, in contravention of laws and regulations in that jurisdiction will vary according to the GCC country concerned and according to the nature of the contravention.

But there should be no doubt the state enforcement penalties could include imprisonment and fines for salespersons caught undertaking illegal activities in the GCC country concerned, through unlimited fines for international firms responsible for such activities, through loss of licences if any in that country, and perhaps most importantly, potentially global damage to the most important asset of any firm in today's marketplace - ie. damage to a firm's international reputation. Knock-on effects for firms regulated in other jurisdictions can involve investigations and penalties being imposed by their home regulators.

In cases where an international asset manager or investment firm has any type of regulated presence in the GCC country concerned, or indeed if any other company in the same group or run by the same people has interests in the GCC country concerned, violations attributable to one group company could result in enforcement actions being directed against the group as a whole, with potential

severe financial costs and reputational implications for the international firm.

Different legal and court systems: a whole different category of risk and penalties

There is a wholly different set of risks facing firms engaging in cross-border marketing of funds, securities and/or investment advisory services to potential customers located in GCC countries - and this is a second key risk area of which many international firms are, in this author's experience, often simply unaware. This relates to vast differences in the nature of the legal and court systems in the GCC countries as compared to legal systems in other countries.

For international asset managers and investment firms located in or run by persons with a US, UK or Commonwealth background, there is the fact that all of the GCC countries have legal systems that are based on varying implementations of, interpolations between and variations upon, European Civil Law. Unlike English Law sourced Common Law (found in the UK, the US and most Commonwealth countries), Civil Law provides relatively many more opportunities for judges to override the plain language intention of the parties as specified in written contracts between those parties.

Thus, in certain circumstances, the judge can do this because his country's Civil Law's may provide binding statutory protections and judicial discretion provisions that override what parties have agreed in writing. This is particularly dangerous for international suppliers of financial instruments and advice to nationals of GCC countries since nationals of GCC countries often benefit from both explicit constitutional preferential treatment and de facto preferential treatment from judges in cases before local courts in the GCC.

"... only a limited number of lawyers have an overview of the rules in all the GCC countries"

In many cases in the GCC, foreign choices of law or jurisdiction will be routinely ignored by local courts if a local national is involved, local courts may assert jurisdiction and local law may apply even if another law and court jurisdiction was specified in any contract – and the matter may be dealt with and disposed of in the manner deemed most fitting by the local judge, who may or may not speak full English.

As the reader will by now readily understand, if an international firm or their salesman has sold funds or investment advice to a local national and that investor then becomes dissatisfied with the performance of the securities or the advice then the local investor can go straight to their local court. Will their action against the international firm succeed?

Well, if the marketing or selling of the funds, securities or advice did not comply with the financial regulatory requirements of that country in the first place (and the judge is probably bringing in the regulator to take its own simultaneous enforcement action) then the defending salesperson and their firm are automatically on the back-foot from the start. There may not be any written or other record of exactly what went on between the salesperson and the investor before the product or the advice was sold. Accordingly the local national is in a position, whether honestly or dishonestly, to say that the promised returns were much, much higher than what actually materialised. So any such action brought by a local national against an international firm, in circumstances where the international firm's marketing and sales to that investor were illegal in the first place, has a good chance of success.

Therefore, in such circumstances, due to its own failure at head office level, ie. at senior management level, to make itself aware of the relevant GCC country's current marketing and selling laws and regulations, the asset manager or adviser may now face not only financial regulatory enforcement action in that GCC country and perhaps in their own home country, with unpredictable financial and regulatory penalties in both places, definite reputational damage both locally and globally – but it may also face financial judgements against it in the GCC court forcing it to recompense the local investor(s) to profit level that the investor(s) allege was promised in the sales pitch for the funds, securities or in the investment advice.

Another misunderstanding best avoided

No discussion of the marketing of funds and portfolio investment services in the Gulf would be complete without mentioning a further class of particularly persistent and increasingly incorrect misunderstandings: that there are particular jurisdictions in the Gulf where if a licence is obtained then that licence can be deployed as a valid licence for marketing throughout the rest of the Gulf – this is a completely erroneous notion.

Readers would be astonished if they knew the number of times this author has been approached by international clients who needed to be rapidly disabused of the notion that the GCC is a 'passporting' zone like the European Union, where a licence gained in one member jurisdiction can be used to undertake business in any other member jurisdiction. This is not the case. A licence issued in a particular GCC country to carry on financial services, whether it be securities marketing and sales, investment advice, or even a completely different type of financial services such as insurance marketing and sales, is of no use whatsoever in any other GCC country.

In the UAE, where the DIFC is located in part of Dubai, the situation is that there in fact two completely different and separate licensing jurisdictions for financial services within the UAE: the DIFC and the rest of the UAE. The DIFC is a small (approximately 100 acres) financial services free zone that is geographically onshore but legally offshore. It's financial regulation and laws are constitutionally carved out of and separate from the rest of the UAE - the important exception to this being the Federal Penal Code (criminal law) that applies throughout the UAE including the DIFC.

So let this author put readers in the picture. A financial services firm licence from the financial regulator in the DIFC, namely the Western-modelled Dubai Financial Services Authority (DFSA) is, in legal and regulatory terms, is no more valid in the rest of Dubai outside the DIFC, or in Abu Dhabi or anywhere else in the DIFC than would be a London or New York licence.

What can be done to reduce or avoid these types of risks in cross-border marketing and sales?

From working closely with local counsel in each and every country in the GCC, namely the UAE, Saudi Arabia, Bahrain, Qatar, Kuwait and Oman, this author can categorically state that the market practices referred to in the 2007 article cited above – which were not advisable even then (including for reasons that are outside of the purely regulatory system as are discussed elsewhere in this article) – are now outright inadvisable in each and every GCC country. The laws in each of these countries are very different from each other and the financial services regulatory and enforcement systems in each are at different (fast moving) stages of development.

So responsible and/or risk averse fund managers and others wishing to sell funds and other securities into the GCC states need to find out what are the rules and acceptable practices for cross-border marketing and sales into these countries. However, only a limited number of lawyers have an overview of the rules in all the GCC countries since this comes from deep involvement in this area and liaison with local counsel in each jurisdiction.

Fools rush in where angels fear to tread, or look before you leap

By obtaining guidance from lawyers who have familiarity with the financial regulations and enforcement rules are in all of the GCC countries, international asset managers and investment firms and investment advisors can get an early idea of which GCC countries where which they wish to target potential investors pose what marketing and selling problems and risks and what may be the techniques to reduce these risks to acceptable levels.

The right solution for internationally based firms targeting investors globally is highly unlikely to be applying for a licence in all the GCC countries where it wishes to target investors (though a licence in one jurisdiction may be well worth it just for the marketing advantages of showing a commitment to the region).

Rather, in most cases the solution will be, where possible, to find mechanisms that the international firm can use to give itself some credible claim that it has tried to follow practices that are legal and acceptable for each specific type of marketing and sales in each particular GCC country. In relation to marketing, for example, certain, but definitely not all GCC countries will treat more favourably marketing that can, using various techniques, be characterised as having taken place at the instigation of the local investor. In relation to sales, for example, in certain, but it must be stressed not all, GCC countries there is a relatively useful degree of protection from regulatory risk that can be obtained by ensuring that any transactions are at least technically consummated outside of the jurisdiction.

Final considerations for cross-border financial services into the GCC countries

Legally unregulated private placements do not exist as a concept in most GCC countries. Most GCC countries do not have any categories of sophisticated investors to whom marketing or sales of financial instruments or advice can be directed. Most GCC countries have the same rules for sales and marketing to their sovereign wealth funds as to their individual citizens. Lowering risk in these jurisdictions is possible if the right steps are taken. However, prior legal consultation is essential before marketing or selling any funds, securities or investment advice on a cross-border basis into any GCC country. ■

1. "Dubai and the UAE: Built on Shifting Sands", Simon Crompton, International Financial Law Review, July 2007.

Middle East Association celebrates 50th Anniversary

The Middle East Association held a reception to celebrate its 50th Anniversary at Lancaster House, London on Wednesday 11 May, in the presence of Alistair Burt MP, Parliamentary Undersecretary of State at the Foreign & Commonwealth Office. The reception, which was held with the generous support of Shell and the Foreign and Commonwealth Office (FCO), was attended by over 300 members and guests from business, government and public life, including many Arab Ambassadors to London, British Ambassadors to the Middle East, North Africa and Turkey, and Members of Parliament.

"The Middle East Association was founded in 1961 to promote and facilitate trade and to deepen understanding between the UK and the Middle East – an objective which remains the same today," said Terry Stone, Chairman of the Middle East Association. *"The MENA region is a vitally important market for British firms, accounting for almost £15 billion of UK exports in 2010. We will continue to build on our legacy as the leading organisation promoting trade and investment with the region – which is increasingly a two way relationship."*

"We will continue to build on our legacy as the leading organisation promoting trade and investment with the region – which is increasingly a two way relationship"

Alistair Burt MP commented that it had been an *"extraordinary"* few months in the MENA region, the outcome of which remains uncertain. He highlighted the importance of friendships at a time of uncertainty and the key role of trade and business in expanding economies, promoting prosperity and meeting aspirations.

"The Association plays a key role both in fostering these friendships and relationships and in providing the building blocks to develop new opportunities," he said. *"The revolutions in the Arab world mark the most important change in attitudes this century,"* he went on. *"The opportunities in the region are huge. This Government and the Association are keen to make the most of these opportunities, working together."*

Charles Hollis, Director General of the Middle East Association, thanked the Foreign & Commonwealth Office and Shell, as well as the Association's members and supporters.

"The wave of change in the region is having an impact on the Association and its members," he said. *"But it underlines the need for an organisation like the Middle East Association; understanding, networks, and expertise are at a premium. We will continue to provide a service that gives real value to members, and to assist and guide British companies in doing business with the region."* Referring to the new UK Trade & Investment Strategy and FCO Charter, he added, *"Anything we can do in cooperation with the British Government to promote UK exports, we will do."* ■

Alistair Burt MP is addressing the 50th Anniversary gathering, with Charles Hollis, Director General Middle East Association, to the left

The Middle East Association (MEA) is the UK's premier organisation for promoting trade and good relations with the Middle East, North Africa, Turkey and Iran. The MEA is an independent and non-profit making association founded in 1961 and based in London. It represents some 400 large and small companies from all business and industry sectors who together account for the majority of UK trade with the region. The Patron of the Association is HRH The Duke of York, UK Special Representative for International Trade & Investment. The MEA is currently playing a leading role in advising British companies on the implications of the current upheavals in the MENA region. www.the-mea.co.uk

21st century business challenges focus of 7th World Chambers Congress

Mexico City hosted the 7th World Chambers Congress on the 8-10 June 2011. Held for the first time in Latin America, the biennial Congress opened new doors to delegates and helped them keep pace with the latest issues affecting business and chamber leaders around the world.

MEXICO CITY
8-10 JUNE 2011
7th WORLD CHAMBERS CONGRESS

Mexican President Felipe Calderon officially opened the 7th World Chambers Congress on Wednesday 8 June in Mexico City.

Among the internationally renowned speakers who took part in the event were Muhtar Kent, Coca-Cola Chief Executive; Steve Killelea, Institute for Economics and Peace, Global Peace Index; Ekaterina Walter, Social Media Strategist, Intel; Martha Delgado Peralta, Head of the Mexico City Ministry of Environment and Secretary of the Environment for Mexico City; and environmental researcher Rajendra Pachauri, Chair of the Intergovernmental Panel on Climate Change and Director General of The Energy and Resources Institute.

"It's important to get back to the basic rules of economic growth, and especially to use open trade as a fundamental instrument for elevating the wellbeing of people and for stimulating the economy," Calderon told over 1,000 delegates during the inaugural ceremony of the Congress. *"The outcomes of this Congress will help us to address global challenges."*

Joining President Calderon in the opening ceremony line-up were Rona Yircali, World Chambers Federation Chairman and Arturo Mendicuti, Chairman of the Mexico City National Chamber of Commerce (CANACO).

Addressing delegates of the only gathering of global chambers, Yircali said: *"With insights from an impressive line-up of political and business leaders and world-renown experts, we can expect a superior level of analysis and discussion in our plenary sessions and workshops."*

More workshop than talkshop, the Congress provides chamber leaders with a unique opportunity to learn and interact with their peers from around the world. Delegates will also have the chance to develop new business opportunities and interact with the region's leading companies from the oil, agriculture, trade, and services sectors.

"For over 60 years the World Chambers Federation has been the backbone of the chamber community," Yircali said. *"As an essential intermediary between government, business and civil society we work tirelessly to address contemporary challenges, from climate change to rebalancing the global economy."*

The opening ceremony audience from the 6th World Chambers Congress which took place in 2009

Organized by the International Chamber of Commerce (ICC), the World Chambers Federation (WCF) and the Mexico City National Chamber of Commerce (CANACO), the Congress comprises four plenary sessions and a series of workshop sessions aimed at addressing topical issues under the event's overarching theme of *"Enterprise – Network – Prosperity".*

"Here we meet representatives from more than 105 countries, interested in enhancing the commercial and services sector worldwide from which a great number of people can benefit, no matter where they are," said Mendicuti.

The Congress also featured the final round of the 2011 World Chambers Competition. Open to all chambers, the Competition aims to encourage innovation by showcasing chamber projects that have had a positive impact on their respective communities, and that can potentially be adopted by others.

Entries were received from 72 chambers from 41 countries under the categories of *Best Unconventional* project; *Best Small Business* project; *Best International* project and *Best Corporate Social Responsibility* project. Twenty finalists will present their projects in designated Congress sessions. The winners in each category were:

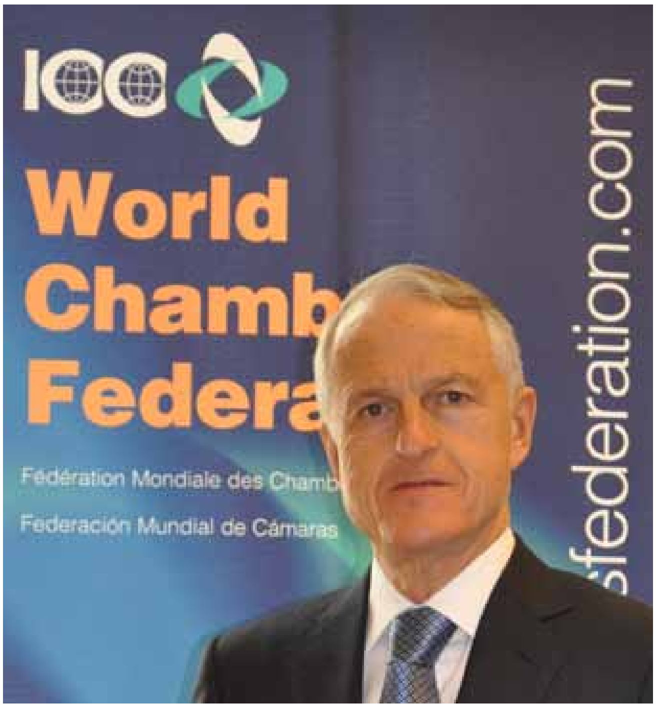
Best Unconventional project
Cambridge Chamber of Commerce (Canada) – Funny Money

Best International Project
Canterbury Employer's Chamber of Commerce (New Zealand) – Recover Canterbury, the role of a Chamber of Commerce when disaster strikes

Best Small Business Project
New South Wales (NSW) Business Chamber (Australia) – Online Growth Programme

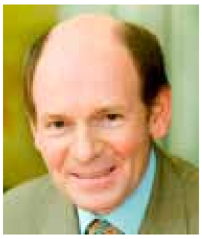
Best Corporate Social Responsibility Project
Istanbul Chamber of Commerce (Turkey) – Ozimek ■

For more information on the 7th World Chambers Congress please visit: www.worldchamberscongress.com



Rona Yircali, Chairman of WCF

Alternative Investment Fund Managers Directive – another regulatory overkill?



Dr Jürgen Brandstätter is Managing Partner at BMA Brandstätter Rechtsanwälte GmbH, Vienna, Austria

The financial and economic crisis which has peaked for the time being in the collapse of Lehmann Brothers in the fall of 2008, has led to numerous cries, mostly by politicians within the European Union, to subject the sector of international finance to a stricter regulatory scheme.

The area of finance where stricter regulations were considered necessary to replace the laissez-faire is the management of Alternative Investment Funds (AIF). Thus, two years ago a first draft of an Alternative Investment Fund Managers Directive (AIFM Directive) was presented to the Commission of the European Union. Having received approval from the European Parliament at the end of last year, the draft was approved by the Economic and Financial Affairs Council of the European Commission in June 2011.

Therefore, the member states of the European Union will have to transpose the AIFM Directive into national law within the next two years. This means that one has to be prepared for national regulation, in compliance with the AIFM Directive, by July 2013.

The content of the AIFM Directive shall be briefly summarized in the following:

- The AIFM Directive does not address Alternative Investment Funds as such but their management (Alternative Investment Fund Managers – AIFM), be it a natural person or a legal entity. An AIFM must henceforth obtain a concession for the management of such funds and the sale of participations in such funds from the national financial markets supervisory authority, which in Austria is the *Finanzmarktaufsicht* (FMA). It must be counted as an advantage that a concession, obtained in one member state of the European Union, entitles to conduct the same business activities in all other member states (the so called Passport Regulation).

"It must therefore be doubted, or at least questioned, whether the real aim of the directive, to stabilize the financial markets, will be achieved"

- The AIFM Directive applies to all AIFM with an official seat in the European Union which provide services to one or more Alternative Investment Funds. This applies irrespective of whether the AIF has its seat within the European Union, if the services are performed directly or through a third party, whether the AIF is an open-ended or close-ended fund and which structure the AIF and the AIFM have. This means that the management of funds which so far were not subject to regulatory oversight, like close-ended funds, will in future be supervised. This includes funds which have been regulated in Austria and in other member states by specific laws; for example the Austrian Investment Fund Act or the Austrian Real Estate Investment Fund Act, subjecting them to double the amount of regulations in future.

- Exempt from the AIFM Directive are funds which fall under the Directive governing Undertakings for Collective Investment in Transferable Securities (UCITS). Interestingly enough the AIFM also does not cover national, regional and local governments and bodies or other institutions which manage funds supporting social security and pension systems. Small AIFM on the other hand will be subject to less regulatory requirements according to the AIFM Directive.

- In order to be allowed to manage an AIF, one will have to fulfil certain qualifications. The AIFM Directive poses requirements with regard to the minimum capital, the reputation and experience of the directors, proof of appropriate risk and liquidity management, proof of adequate and legal prevention methods and the arrangement with a depositary bank.

- Special rules apply to Private Equity Funds which are the core of the AIFM Directive. They are subject to special transparency regulations and reporting requirements. The reasoning behind this is that companies where Private Equity Funds hold a share shall be protected from so called "asset stripping". Hence there is a duty to notify the authorities once the voting rights in a company, where a private Equity Fund holds participations, reaches or sinks below a certain threshold.

- Inspired by the political discussion regarding the remuneration of bankers, in particular their bonuses, the AIFM Directive contains regulations with regard to the remuneration of management and employees. For instance 40% of the to be paid bonuses have to be deferred between three and five years until it is clear whether a bonus would really be justified.

- The new European agency for the supervision of the financial markets, the European Securities and Markets Authority (ESMA) in Paris, has received special powers under the AIFM Directive, including the power to pass additional regulations with regard to the AIFM Directive.

Two years have passed since the idea of passing such a directive first came up. Now it seems clear that the real problem for the financial markets are the household debts of the public. It must therefore be doubted, or at least questioned, whether the real aim of the directive, to stabilize the financial markets, will be achieved. Any activities by private equity funds have nothing to do with the extreme budget deficits in almost all western countries. It must be feared that the directive will only lead to an increase in cost and more bureaucracy for the financial industry, which will in the end disadvantage European financial markets in competition for new investments. ■

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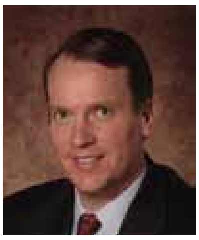
China embraces self-regulation of marketing



Jonathan Huneke is Vice President, Communications and Public Affairs at the United States Council for International Business (USCIB)

While the state in China is the key purveyor of law and regulation, the Chinese private sector often works on its own to enforce norms and expectations of government. So it is quite interesting to note that China has embraced self-regulation in the marketing and advertising sector.

In April, as part of the first Global Advertising Week to be held in Beijing in the event's 58-year history, the China Association of National Advertisers, the China Advertising Association and the China Advertising Association of Commerce jointly adopted the first set of ethical standards for the entire marketing industry in China.

"China is forecast to surpass Germany next year as the world's third-largest advertising market"

The China Responsible Marketing Code was developed by the three ad industry associations in close consultation with the World Federation of Advertisers, and multinational and Chinese companies. The Code is built on the global advertising code from the International Chamber of Commerce (ICC), USCIB's affiliate. The ICC code serves as baseline model for other countries, requiring that all marketing and advertising communications be legal, decent, honest and truthful. Brands must apply established principles of fair competition and recognize the special care required in marketing to children and young people. The Chinese Code also includes provisions for medical, health product, food, alcohol and cosmetics advertising.

"US business strongly supports Chinese efforts to develop an advertising self-regulatory system," said Brent Sanders, chair of USCIB's Marketing & Advertising Committee and associate general counsel at Microsoft. *"Building its code on global industry best practices set by ICC is a significant development in bringing the Chinese advertising market into greater coordination with the rest of the world. Furthermore, self-regulation enhances trust between businesses and customers, a vital concern for industry as Chinese consumer demand continues to grow."*

China is forecast to surpass Germany next year as the world's third-largest advertising market.

USCIB actively contributes to promoting advertising and marketing self-regulation around the world. Currently, USCIB's Marketing & Advertising Committee is in the final stages of helping to update the ICC's most recent marketing code. Key new provisions include transparency and control principles around online behavioural advertising for the first time at the global level. Once approved, the ICC's global standards can then be taken up by regional and national self-regulatory frameworks, as in the case of China and elsewhere.

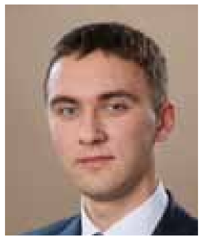
"The new Chinese Code is not only an opportunity for industry to demonstrate its commitment to ethical marketing practice, it will assist industry to engage the Chinese government as it updates and revises its current advertising laws, a process that has been ongoing," said Sanders. *"All self-regulatory frameworks build on core laws and regulation."*

Stephan Loerke, WFA's managing director, added: *"I congratulate the Chinese marketing industry on this important step. In a successful consumer-led economy, trust in brand communications is critical. This code is a significant first step towards establishing effective advertising standards in China."*

Self-regulation in marketing and advertising, whether in China or elsewhere in the world, is less about government versus industry than about finding ways to ensure principled commerce. Building trust between consumers and business is clearly on China's agenda, and that is a good thing. ■

USCIB Marketing Committee Chair Brett Sanders of Microsoft (centre) along with USCIB's Justine Badimon and Chris Martin (second and fourth from left) and members of the China Advertising Association at a 2010 meeting to promote self-regulation.

Joint implementation projects in Ukraine: tips for prospective investors



Artem Shyrkozhukhov and Oleksandr Polonyk are Associates at Avellum Partners

Introduction

On 4 February 2004 Ukraine ratified the Kyoto Protocol to the United Nations Framework Convention on Climate Change. This gave Ukraine an opportunity to engage in various types of projects purported at reduction of greenhouse gas emissions (the "GHG emissions"), in particular and especially joint implementation projects (the "JI projects"). JI projects involve participants who made commitments under the Kyoto Protocol and provide them with a possibility to meet emission reduction targets by earning emission reduction units (the "ERUs") from projects in other participating states, which made commitments.

Due to various reasons such as overall Ukraine's suitability for the implementation of JI projects (dominance of dirty and power-intensive industries, skilled and comparatively cheap labour, etc.), as well as the contraction of Ukrainian economy and fall of industrial production in the 1990's (which substantially reduced GHG emissions), Ukraine became a leader among the JI projects' host countries, and an essential partner for meeting emission targets by other parties to the Kyoto Protocol.

Ukrainian legal framework for JI projects

Implementation of JI projects in Ukraine is governed by the Procedure for Preparation, Examination, Approval and Registration of Projects Aimed at Reduction of Volumes of Anthropogenic Emissions of Greenhouse Gases, approved by Resolution of the Cabinet of Ministers of Ukraine No.206, dated 22 February 2006. The procedure is administered by the State Environmental Investment Agency (formerly known as the National Environmental Investment Agency) (the "SEIA") and includes the following steps:

- application for the support to the SEIA, which is completed upon issuance of a letter of endorsement by the SEIA;
- submission of a detailed description of the JI project along with a determination report to the SEIA. This stage completes when the SEIA issues a letter of approval and registers the JI project;
- implementation of the JI project;
- submission of a monitoring report of the JI project to the SEIA for registration; and
- transfer of ERUs to the account of the JI project owner held with the national carbon register. Further, the ERUs may be transferred to the account of any foreign entity held with a foreign carbon register.

Financing JI projects in Ukraine

Financing is an essential part of every JI project. Before engaging in a project, investors and project owners have to determine the best way to structure financing. More specifically, the structure of financing has to be determined and agreed upon before the beginning of the second step mentioned above. One of the documents that the project owner will need to submit to the SEIA to get the letter of approval is a financial plan. The financial plan must clearly specify the structure and feasibility of the planned financing, anticipated investment from the sale of ERUs, including any supporting documents.

Typical financing structures

For many Ukrainian project owners JI projects themselves represent an opportunity to get financing for the modernisation of their outdated and energy inefficient technologies and processes on reasonable terms. In the majority of JI projects the price of ERUs will cover only a certain, often a small, part of the overall project expenses. Therefore, some form of financing either by the project owner itself, or by investors, banks or other third parties will be inevitable for the project to go forward.

Financing structure is tailored to the specific situation of each JI project and there cannot be a one-size-fits-all advice. There are some projects that are financed by the project owners entirely, though they make up a small minority. More often, financing of Ukrainian JI projects falls into one of the following three structures: (1) technology transfers; (2) secured loans; and (3) payments under an Emission Reduction Purchase Agreement (the "ERPA"). Some projects may be able to benefit from governmental support of some sort.

Technology transfers

As mentioned above, most Ukrainian project owners require modernisation of their equipment and processes. Due to decline of Ukrainian engineering industry and science after the break-up of the USSR, new technologies often have to be imported from abroad. Typically, this is done under leasing or similar contracts.

Under Ukrainian law, leasing payments do not necessarily have to be monetary payments and, although not entirely clear, payments for ERUs in a form other than monetary form should also be possible in Ukraine. Investors in JI projects may transfer technology to Ukrainian project owners in consideration for the delivery of ERUs and possibly other monetary payments if the price of ERUs does not cover the price of the technology in full. Investors will retain title to the transferred technology until the project owner has performed its obligations to investors in full.

If structured this way, such cross-border contract for delivery of technology and ERUs would be subject to certain requirements of Ukrainian law for cross-border barter transactions. Among these, the most important are the denomination of payment obligations in hard currency (ie USD, EUR, JPY, CHF, etc.), no delivery of ERUs before the transfer of technology occurs, transfer pricing rules, etc.

Secured loans

Most JI projects require large-scale long-term financing which can be met by the price of ERUs only in a small part. Ukrainian internal market for financing is limited in its capacity to meet such financing demands of JI projects and, in general, there has been limited experience with project finance mechanisms in Ukraine. For a project owner to seek financing on its own at international markets may also be a problem due to business- and country-specific risks. Therefore, investors and/or parties that investors or project owners may bring into the project will need to extend loans to the project owner to cover most of the upfront project expenses. Repayment of the loan can be structured so that as soon as the delivery of ERUs takes place the parties will offset the price of ERUs against the same amount outstanding under the loan. Loans extended under JI projects are often secured with pledges of properties and property rights of the project owner, suretyships, etc. Under Ukrainian law, cross-border loans are subject to registration with the National Bank of Ukraine and compliance with certain other currency control and tax rules.

ERPA payments

As mentioned above, financing of some JI projects may rely on payments under ERPAs against the prospective delivery of ERUs, similar to other supply contracts. Some JI projects provide for a down payment in the amount of a percentage from the price of ERUs and subsequent payment of the outstanding amounts as soon as

ERUs become available. It is also possible for the investors to make a full upfront payment of the price of ERUs with the obligations of the project owner to deliver the ERUs being secured by a pledge of project owner's property or property rights. The project owner will then be responsible to bring the remainder of financing necessary to complete the project, if necessary. For some projects, especially those involving governmental or municipal authorities and other projects that generate no income on their own other than savings and efficiencies from emissions reductions, ERPA payments become the most common way of getting financing for their emissions reductions projects.

Governmental support

Environmental projects may benefit from state support in a number of ways: financial support (through direct funding, provision of state guarantees, interest reduction under loans attracted from commercial banks) as well as preferential regulation which incentivizes environmental and energy efficiency projects.

The major mechanisms for the provision of state financial support are (1) state support to public private partnerships and (2) financing under various state task programs. The former mechanism was introduced in 2010 with the adoption of the Law of Ukraine "On Public Private Partnership". It provides companies acting as private partners in the framework of public private partnership (through a concession agreement, joint activities agreement or otherwise) with an opportunity to seek funding from the budget or to apply for state guaranties. Although the mechanism is not fully effective yet, the Ukrainian government takes a proactive stance in its implementation.

"The price of ERUs will cover only a certain, often a small, part of the overall project expenses. Therefore, some form of financing either by the project owner itself, or by investors, banks or other third parties will be inevitable for the project to go forward."

Further state support may be acquired through specific state support mechanisms, such as task program for energy efficiency and development of renewable energy resources for 2010-2015 and mechanism of reimbursement of interest under loans attracted for projects in the sphere of energy efficiency.

Apart from financial support from the government, environmental projects may benefit from preferential regulation. For instance, the import of energy efficiency materials and equipment are exempt from customs duties and VAT.

Security interests under Ukrainian law

Ukrainian law provides for various tools for investors to protect their investment. These tools range from contractual penalties and security and quasi-security instruments such as mortgages, pledges of different types (eg, pledge of moveable property, pledge of shares, pledge of receivables), suretyships (sureties), etc.

Suretyships

A suretyship is an agreement whereby a third party guarantees to a creditor a debtor's performance of its obligations under a contract. If a debtor fails to perform its obligations, a surety is under an obligation to bear joint responsibility with a debtor under a contract. Suretyships in cross-border transactions should be used with caution due to a number of currency control rules that need to be taken into consideration.

Mortgages/pledges

Ukrainian law provides for obligatory notarisation and state registration of mortgage agreements. Restrictions under Ukrainian law make mortgages of some real estate objects difficult and, sometimes, impossible. Notably, this is the case with certain types of land plots.

The pledge (including mortgage) of objects of state property and municipal property is subject to substantial restrictions. In particular, the following categories of property may not be pledged/mortgaged: (i) objects of national, cultural and historic value that are or "intended to be" included in the state register of national and cultural heritage, (ii) objects that may not be privatized, (iii) property complexes of state and municipal enterprises that are in the process of corporatisation.

In addition, the availability of a specific asset (eg, as stock, inventories, shares in state or municipal enterprises, objects of real estate, etc.) of state and municipal enterprises for a pledge (mortgage) should be determined based on the authority of such enterprises to dispose such asset. Since Ukrainian law allows the use as collateral-only those assets which are freely disposal, due to existing moratorium on disposal of state-owned property, currently the use of such state property (assets) for purposes of creating security interests is problematic.

With the emergence of JI projects in Ukraine, a question of the ability to use ERUs and Assigned Amount Units (the "AAUs") as collateral arose. Applicable Ukrainian legislation envisages the transfer of AAUs in the amount correspondent to the projected amount of the ERUs as a collateral under JI projects as the security of the investments into JI projects. With respect to pledge of the ERUs, due to the fact that these units arise within the boundaries of a specific project after complex verification procedures, it should be possible for an investor in a particular project to take pledge over these ERUs, however, it may be difficult to pledge these units to a bank or other third party.

To obtain priority against subsequent security interests in a particular property or certain property rights, investors should take care of all necessary registrations in appropriate state registries of encumbrances.

Title to ERUs

One of the crucial issues that arise in all JI projects is the question of title to generated ERUs and, after conversion from AAUs, their transfer to a carbon register of the investor's country. In this respect, Ukraine is not unique in its approaches, as the concept of creating a commodity of value out of a reduction in GHGs is still a relatively new concept. The issue of how to assign legal title to this new commodity and, indeed, who is eligible to claim legal ownership has not been fully settled. Like many other countries, Ukraine does not have any special regulation of ownership of ERUs.

Based on Ukrainian regulations dealing with JI projects and practice of the SEIA, so far Ukraine has not taken any steps to override a *prima facie* assumption taken by the Kyoto Protocol parties and subsequently supported by practice that project owners have legal title to the emissions reductions and the resultant ERUs created on the basis of that project activity. In light of this legal uncertainty, all ERPAs should clearly provide for all aspects of legal title, including its creation and transfer. As a practical matter, a draft ERPA that a project owner has to submit to the SEIA to obtain a letter of approval should contain clear provisions on legal title to ERUs. This should mitigate the risk of challenging legal title to ERUs, though unlikely, should the Ukrainian government change its position on this matter.

There also an open question whether ERUs can be treated as property, property rights, licenses, etc. Although the debate on this matter is far from being settled with no clear guidance in the law, the practice shows that the status of emissions reductions tends to be closer to property rights, which means that ERUs can be treated as property rights and, thus, can be used as collateral.

Future of JI projects in Ukraine

Over its relatively short history, JI projects have proved to be very successful in Ukraine with Ukrainian companies and the Ukrainian government has realised their big potential and great benefit. However, developments on the international scene still leave a big question mark about the future of the Kyoto Protocol system and particularly, in absence of the Kyoto or similar framework, whether ERUs issued after 2012 will be recognised elsewhere.

Ukrainian government on a number of occasions expressed its support for JI projects and urged parties to the Kyoto Protocol to reach an agreement so that the international system of recognition of these projects goes forward after 2012. In light of little progress, Ukraine started looking for alternative ways to resolve this issue.

In 2010, Ukraine started negotiations with the European Union on a bilateral agreement recognising ERUs generated in Ukraine in the European Union Emissions Trading Scheme. For the time being, there has been little progress, which is largely due to differences between both parties as to the level of emissions reduction commitments that Ukraine should assume. It is also possible that the EU will impose eligibility criteria for Ukrainian JI projects before ERUs generated under these projects can be admitted into the European system.

Ukraine is also considering developing its internal emissions trading scheme in an effort to develop the internal carbon market and with hope that it will be easier to negotiate with other emissions trading systems in the post-2012 period. Currently, experts are sceptical about a fully operational Ukrainian carbon market, but welcome all efforts to bring more legal certainty to the legal framework of JI projects.

Although it is premature to predict the future of JI projects in Ukraine, the success and a lot of vested interest in these projects leave some room for optimism that an acceptable solution will be found in the near future. ■

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New challenges in German M&A transactions: the importance of vertical anti-trust rules

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Many European and German companies are currently experiencing difficulties with anti-trust authorities due to the dramatically increased fines for anti-trust violations and the high likelihood of exposure. Fines can amount to ten percent of a company's annual worldwide turnover. While it is important in a transaction process to take the general regulations of German merger control law into consideration, checking on anti-trust compliance becomes more and more crucial.

In practice, the target company's behaviour relevant to German anti-trust law can be exposed during the due diligence process. Such violations might then present an enormous obstacle in the transaction process since substantial fines may be imposed which would then have to be paid by the acquirer. These circumstances must be addressed, inter alia, in an agreement of risk allocation in the contract documents.

"These recent developments need to be on every investor's radar system"

Leniency programs are today the main reason for the abundance of the cartel exposures in Germany. These programs offer an immunity from fines or a reduction to companies that expose a cartel or work with the anti-trust authority in an ongoing anti-trust suit. As in the past, hardcore infringements are prosecuted with particular severity in Germany. They consist, for example, of price, territory, customer or quota arrangements between competitors.

As a new development, the German Federal Cartel Office (FCO) recently began to focus on vertical anti-trust violations. These include, notably, impermissible price maintenance agreements between suppliers and retailers, such as the fixing of resale prices. Unilateral price maintenance measures are also pursued with high priority by the authority. In principle, these resale price arrangements are prohibited since the 1970s. However, it was only in the course of the last few years that the FCO pursues them.

Two important decision of the German authority in 2009 laid the ground for these recent developments. In the case *Ciba Vision*, the FCO fined the leading company in the contact lenses business an amount of Euro 11.5m for having illegally restricted the internet trade and influenced the resale price of internet traders. A case relating to the sale of hearing aid devices (*Phonak*) dealt with similar anti-competitive behaviour and led to a substantial fine of €4.2m.

In 2010, the FCO conducted dawn raids at the premises of the major German retailers and several manufacturers of branded goods on suspicion of their colluding on end consumer prices. In the course of these and other cartel proceedings, the authority shows its willingness to firmly pursue anti-competitive vertical restraints. These recent developments need to be on every investor's radar system – for reasons of compliance, of due diligence, of contract drafting, of deal negotiation and, eventually, of proper defence in possible proceedings. ■

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Restoration of a BVI company following dissolution

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Introduction

The BVI company has enjoyed immense popularity and success in Asia as the offshore company of choice and enjoys an unrivalled reputation for cost effectiveness, flexibility, investor familiarity, ease of incorporation and low costs of maintenance.

A second wave of popularity is now being felt for the BVI's most famous export in the use of BVI companies for listing on the Hong Kong Stock Exchange. It is no wonder that the HKSE has allowed the BVI company to be listed in light of the significant use of BVI companies by the Asian market and the obvious role of Hong Kong as a financial centre for the region. The growth of equity capital markets has only served to bolster the potential use of a BVI company as a listing vehicle following pre-IPO restructuring.

However, the benefits of the BVI company is not the focus of this article. Instead, this article analyses recent BVI case law of the Commercial Court of the Eastern Caribbean Supreme Court concerning the test for restoring a dissolved company. Clients who use BVI companies will benefit from understanding the effect of these cases and managing risk and developing strategy accordingly.

What is the restoration of a BVI company?

Restoration of a company is a concept that will be familiar to common law practitioners. Different jurisdictions apply different statutory regimes to the striking off, dissolution and restoration of a company. At its simplest, a restoration is a Court process by which application is made seeking a declaration that a company, having been dissolved, be restored as a company. More precisely under BVI law it is a declaration that the dissolution of the company is void and is restored to the Company Register.

Under section 218 of the BVI Business Companies Act, 2004 ("BCA") an application for such a declaration can be made by the company, creditor, member or liquidator of the company. This section is concerned with restoration following dissolution and there are separate provisions for restoration following mere administrative striking off.

By virtue of the fact that restoration is a statutory process, careful regard has to be given to the precise terms of the legislation. Inevitably English common law guidance on restoration (which is persuasive in the BVI) is likely to be of limited assistance in understanding the true meaning of the specific BVI provisions.

Why should anyone need to restore a company?

The traditional, and by far the most obvious, reason for an application to the court to restore a company is where a creditor of the company wants the company restored so that it can sue the company on a debt. A company that has been dissolved has no capacity to be sued. Another reason to restore a company might be if, subsequent to the voluntary liquidation of a company, further and undistributed company assets are discovered. A dissolved company, no longer a juristic person, would have no capacity to distribute these newly discovered assets to shareholders. Occasionally, the company may wish to restore itself in order to tender performance for an obligation that crystallised when the company was in good standing, but which only fell due for performance following dissolution. In the normal course of events the counterparty to the obligation would likely move any application to restore the company and take action to enforce the obligation or sue for its breach. However, in the recent case of *YKM v Financial Services Commission* BVIHCM/2011/02 the application to restore was made by the company on the basis that it felt obliged to tender performance to the obligee, and in turn to do everything possible, including restoring itself, to do so. This will be a rare occurrence because: (i) strictly speaking, a dissolved company is no longer an obligor pursuant to the contract because following dissolution its debts and obligations are totally extinguished; and (ii) there would in principle be nothing to stop a third party from tendering performance on behalf of the dissolved company to the obligee. The Court in *YKM* did not grant restoration.

Some thorny questions

Substantial debate has occurred in the BVI as to the effect of a section 218 restoration of a company which had previously been voluntarily liquidated. Does the company become restored to the position it was immediately prior to dissolution (ie. in a state of voluntary liquidation) or is it restored to good standing and in the hands of the directors? In a recent case before Justice Bannister, head of the Commercial Division of the High Court, called *Dedyson Enterprises Limited v Registrar of Corporate Affairs* BVIHCM 2008/0011 it was held that a company that was in voluntary liquidation immediately before dissolution will not be in liquidation following restoration, but instead would be put back in good standing. The reasoning in summary terms was that unlike the provisions of the English Companies Act 1985 there was nothing in section 218 BCA to infer that the purpose of restoration was to enable a liquidation to be reopened so that unfinished business which had been identified subsequent to dissolution could be completed.

The scope of restoration

In *Dedyson Enterprises Limited* it was held that a restoration application following a voluntary winding up is to be granted in only very limited circumstances. The Judge held that where an application to restore is made by or in relation to a company whose liquidation had previously been reported to the Registrar as complete, it will generally be inappropriate for the application to be granted otherwise than for the purpose of enabling newly discovered assets to be distributed by the company or claims to be made against it which had not previously been made. There could, otherwise than in the most exceptional circumstances, be no good grounds for avoiding the dissolution of a company that had been wound up simply so that its owners could resume carrying on business through it as if nothing had happened.

Procedural clarification

It has also been recently clarified, following widespread variance in practice, that the proper defendant to a restoration application is the Registrar of Corporate Affairs. It would, after all, be the party bound by any restoration order. In turn, the Registrar will be awarded nominal costs in light of the public interest requirement for him to be in attendance at the hearing through Counsel.

Conclusion

It is of fundamental importance that the supervisory jurisdiction of the BVI Court over the companies incorporated within its territory is properly exercised. The Commercial Court in the BVI has substantially clarified the area of law relating to company restorations which will serve to give added confidence to users of BVI companies.

Further information

The foregoing is for general information purposes only and not intended to be relied upon for legal advice in any specific or individual situation. ■

For more information on the subject please contact Ian Mann (ian.mann@harneys.com) or your usual Harneys contact.

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