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India: Indirect tax proposals in the 2013 Union Budget

Data Centres – Investments in an Emerging Asset Class

Deductibility of payments in intra company share transfers

Belgium: Status of the tax reforms and 2013 Budget

Cyprus: Recent changes to tax legislation

From the editor

India's Union Budget was unveiled on February 28, and we begin the March issue of *Tax Planning International Review* with an assessment of the indirect tax elements of the Budget, capably presented by Rajeev Dimri and Sudipta Bhattacharjee of BMR Advisors. Next month will see BMR's review of the Union Budget's treatment of direct taxes.

The transformation of our world over the last thirty years into one dependent upon secure online connections has led to the growth of data centres as a business sector and, in turn, as an investment opportunity. James Dodson and Prabhu Narasimhan of White & Case in London examine the tax issues inherent in investing in data centres.

In the second half of a two-part article from Dr. Rosemarie Portner, she analyses the corporate income tax implications of indemnity payments between subsidiary and parent companies to cover share offers at discounted rates.

At the end of 2012, the Belgian government announced a series of tax reforms of particular interest for corporations. Ariane Brohez, of Loyens & Loeff, discusses these proposals and their current status in detail.

In our final feature, we consider proposals made by the government of Cyprus to secure Troika support. This article was contributed before the recent proposals relating to the bank levy, but we hope to cover all developments relating to these proposals in a future issue.

In Brief this week covers news from Spain, Poland and Austria, with news of changes of Spanish Corporate Income Tax, the recent signing of Poland's double taxation treaty with the United States and a recent Austrian court decision on the deductibility of foreign losses for non-residents.

We continue our *Country Report* series with a report on Korea from Baker & McKenzie. Finally, the *Tax Treaties* section presents a report from Brian Loss, on a roundtable discussion of the United States — Chile tax treaty.

Should you have any suggestions or if you are interested in submitting an article or news story to *TPIR*, please don't hesitate to contact me by email at alexmiller@bna.com.

Alex Miller

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Data Centres – Investments in an emerging asset class

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The following article offers an outline of key tax considerations for private equity and institutional investors.

There are very few things more irritating or frustrating than a declined credit card. This direct assault on human dignity (as those prone to melodrama would say) results in a very dissatisfied customer for the credit card company. To the credit card company in question this represents more than just a dissatisfied customer base – a little glitch in their system means loss of millions in commissions and fees every second.

It is therefore not surprising that organisations across the world invest heavily in data centres. For such organisations, regardless of the industry or geographical location, data centres are at the heart of their business operations with direct impact on profitability.

The data centre industry therefore attracts significant levels of investment, including, in particular, London, Paris and Frankfurt, and demand currently outstrips supply globally. Significantly, in recent years, this industry has witnessed high-profile high value transactions worldwide which is indicative of the increasing maturity and consolidation in this real estate based sector.

In summary, the data centre market is, at its heart, one driven primarily by growing demand – which makes this one of the few sectors of real estate showing year on year growth!

Notwithstanding the above, the vast bulk of investors find the sector too complicated (in the UK and worldwide) and therefore tend to access this asset class through the listed markets (primarily LSE, NASDAQ or NYSE). However, an increasing number of private equity and institutional investors are looking closely at the data centre sector (in the UK and overseas) as an attractive direct investment asset class which has many of the characteristics of traditional real estate (i.e. long lease and recurring regular income) combined with better growth prospects.

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As with most investments, tax plays an important role in increasing or diminishing significantly the inherent attractiveness of the underlying real estate investments. In the case of the data centre sector, which falls between conventional commercial real estate (usually an appreciating asset) and infrastructure investment (marked by a disproportionate capital spend and significant depreciation with time), tax is a critical component that directly impacts bottom-line returns.

This article outlines some of the key UK tax considerations to be taken into account by private equity and institutional investors when undertaking direct investments in data centres located in the UK.

I. Tax considerations

In the context of the data centre sector, there are four broad categories of tax considerations which will impact the relative attractiveness of the underlying data centre asset and these are as follows:

A. Headline Tax Rates & Holding Structure
B. Tax Reliefs (on depreciation and financing)
C. VAT
D. Carbon Reduction Commitment Energy Efficiency Scheme (CRCs)

A. Headline tax rates & holding structure

Regardless of whether the underlying data centre assets are held by onshore or offshore companies, rental income generated from such data centre assets will be subject to UK tax.

Due to the very nature of the business, a data centre focussed corporate group is likely to have a company which provides a level of operational services (in addition to provision of data centre space). This of course means that such an operational company will (irre-

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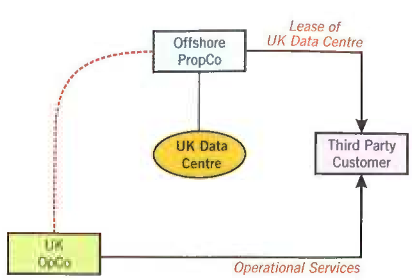
spective of where it is located) normally be treated as carrying on a trade (i.e. more than passively holding real estate) in the UK (if the data centre is located there) and will therefore generally be subject to corporate tax in the UK in respect of the income and gains of its UK data centre assets to the same extent (and in substantially the same manner) as a UK tax resident company.

A UK tax resident company is subject to UK corporate tax on its worldwide income and gains at the main rate of 24 percent (reducing to 23 percent from April 2013 and 21 percent from April 2014). Overseas companies trading in the UK (through a permanent establishment) are subject to UK corporate tax at the same rate as UK tax resident companies insofar as their UK income and gains are concerned. Overseas companies holding real estate in the UK as an investment are subject to UK income tax at the rate of 20 percent on UK rental income (for more – see further below).

In many jurisdictions (including the UK), the rate of tax applying to rental returns of overseas property holding companies is preferential to the rate of tax applicable to domestic property holding companies and for this reason, it is not entirely unusual for groups to structure affairs such that the data centre asset is separated from the operational functions and is held by an overseas property holding company which leases such asset and generates rental income. An associated domestic company provides the "unbundled" operational services to either the third party customers or to the connected property holding company. This PropCo-OpCo structure is not uncommon in the real estate industry (including the data centre industry) where separating the rental stream from the operational element means better access to the debt markets – in the boom years of real estate (and some would say even today), the debt that could be borrowed by a company on the strength of its real estate was more than the corporate debt that could be borrowed by that company on the strength of its business activities.

From a UK tax perspective, there are two tangible advantages of separating the UK data centre asset (from the operational activity) and holding it through an offshore company – first, the rental income will be subject to UK income tax at the basic rate of 20 percent (as opposed to corporation tax rate of 24 percent payable by domestic UK companies but reducing to 21 percent in 2014 as described earlier) and secondly (and more importantly), capital gains realised on the disposal of the UK data centre asset held as on investment by the offshore company are not, generally, subject to UK tax.

Figure 1



B. Tax reliefs (on depreciation and financing)

1. Revenue deductions & capital allowances

A UK company (whether carrying on a trade or a property letting business) will be able to deduct expenditure of a revenue nature it incurs wholly and exclusively for the purposes of its trade (where the UK company is trading) or its property letting business (where the UK company is in the property business). This principle also applies to non-UK companies carrying on a trade in the UK through a permanent establishment.

Where an overseas company holds property for investment in the UK, it is prima facie subject to UK income tax by way of withholding – that is, a tenant or a UK letting agent making a rental payment to an overseas company landlord is required to withhold UK income tax (at the current basic rate of 20 percent) from such payment and account for this amount to the UK tax authority directly.

However, it is possible for overseas landlords (including overseas companies) with UK real estate to register as a Non-Resident Landlord with the UK tax authority, in which case such overseas landlords are (a) able to receive property rental income in connection with UK real estate free of any withholding on account of UK income tax; and (b) able to account for UK income tax annually through the self-assessment mechanism – in calculating the UK income tax payable, such overseas landlords will be able to deduct certain expenses (that are not of a *"capital nature"*) which are *"wholly and exclusively"* incurred for the purpose of the UK property-letting business from their taxable UK property income.

It is an established principle of UK tax law that capital expenditure is not deductible in computing profits of a business (whether trading or property rental business) in the hands of a UK or non-UK company, notwithstanding the fact that such capital expenditure may be "wholly and exclusively" incurred for the purposes of such trading or property rental business.

Historically, no provision was made in the UK tax regime to take into account the accounting depreciation of capital assets. However, the UK tax regime has relaxed this strict approach by allowing relief for certain defined types of capital expenditure which, when claimed, displace the deductibility of expenditure and result in a broadly similar economic effect. This system of providing allowances for certain defined types of capital expenditure is known as "capital allowances".

As mentioned earlier, the data centre sector falls between commercial real estate and infrastructure investment and in many ways has features of both, thus making this sector somewhat of a new hybrid industry.

Ultimately, data centres are real estate assets marked by heavy build-up of infrastructure and, in that sense, constitute commercial real estate. Equally true is the fact that data centres are really infrastructure investments (no different from railways or toll roads) in that the investment is fundamentally on the build-up and maintenance of the infrastructure and returns are marked by use of the infrastructure (and less on the land that it is located).

In the above context therefore, capital allowances are an important factor to be considered carefully by data centre owners and investors (and for that matter tenants) as they allow a significant amount of investment expenditure to be recovered by way of tax relief. It is not unusual for 2/3rds of the total project cost of a new development to be eligible for capital allowances. In the case of refurbishment projects (where the expenditure is really on fit-out), this can be even higher (almost 4/5ths of the total project cost).

It is not within the purview of this article to focus in any detail on capital allowances but it is suggested that capital allowances experts are consulted at every stage of investment to ensure maximum benefit is obtained from this system. That said, summarised in the table below are the categories (and the corresponding rate) of capital allowances:

Category	Rate
General plant and machinery	18 percent (on a reducing balance basis)
Integral features	8 percent (on a reducing balance basis)
Long life assets	8 percent (on a reducing balance basis)
Enhanced capital allowances (ECA)	100 percent first year allowances

In addition to capital allowances, it is useful to consider land remediation relief which provides 150 percent tax relief on expenditure. As readers will be aware, a majority of new data centres in the UK are built on brownfield land which requires remediation. Costs incurred on such remediation are likely to qualify for land remediation relief.

2. Interest expenses

Given the level of infrastructure spend on new or existing data centres, it is likely that data centre owning entities will utilise external debt financing to undertake such activities (in addition to internal equity and debt funding).

The UK tax system provides for a generous system of tax deduction for interest expenditure incurred by UK property holding companies (whether located in the UK or overseas).

Any interest paid by a UK property holding company (whether located in the UK or overseas) to a third party financier should, in the absence of any tax mischief, be fully deductible in computing the profits of that entity.

Where internal financing is obtained by a UK property holding company (whether located in the UK or overseas) from a connected entity, the deductibility of the interest expense (in respect of such internal financing) will be to the extent that the interest being paid is not excessive (i.e. it does not represent more than a reasonable commercial return for the use of the principal secured) under the UK transfer pricing and thin capitalisation rules (which are subsumed within the general scope of the UK transfer pricing legislation).

There is no statutory debt/equity ratio applicable to UK property holding companies, nor is there any formal concession or safe harbour in this regard, with each case being considered on its own merits. In practice, the UK tax authorities should not (provided there is no tax mischief) challenge the deduction of interest (in connection with internal financing) if the following criteria are met:

- debt/equity ratio not exceeding 1:1; and
- interest cover ratio of 3:1.

HMRCgenerally accept a higher debt to equity ratio (of 3:1 and even 4:1 in some cases) in the case of property companies as long as the interest cover ratio remains at 3:1.

C. VAT

UK VAT applies (at the standard rate of 20 percent of the consideration) to most supplies of goods and services which take place in the UK. Given the level of infrastructure investment undertaken by data centre businesses, VAT represents a significant cost (being an additional 20 percent of the actual cost) for such businesses and directly impacts returns on investment in such businesses. Virtually every expense of the data centre business ranging from provision of power and electricity to build up (or refurbishment) of infrastructure and acquisition of plant and machinery is likely to be subject to UK VAT (at a rate of up to 20 percent of the underlying consideration). Therefore, it is imperative that careful VAT planning is undertaken to ensure the tax efficiency of data centre businesses.

Ultimately, VAT planning is bespoke and heavily reliant on specific facts and therefore it is impossible to delve any deeper into the issue of VAT in a general article of this nature. That said, summarised below are some areas in respect of VAT which may provide an insight into the kind of VAT issues data centre businesses are like to face.

VAT is a cascade tax that is intended to fall upon the final consumer. For a business making taxable supplies only (i.e. onward supplies on which VAT is chargeable), VAT should, at worst, only represent a cash flow cost. This is because VAT incurred by such a business can, generally, be reclaimed in full by that business.

However, given the inherent nature of the data centre business, which involves leasing of the underlying real estate together with some level of operational services, full VAT recovery cannot be taken for granted. This is because, whilst supplies of technological services (operational services such as the one provided by OpCo in the example referred to earlier) constitute taxable supplies for UK VAT purposes (i.e. supplies on which UK VAT is prima facie chargeable to end customers), supplies relating to commercial land and buildings are prima facie treated as exempt from UK VAT and therefore any supply of commercial land and/or building by a data centre owning company (e.g. leasing of a data centre by PropCo to end customers in the example referred to earlier) will not attract UK VAT. The effect of this is that VAT costs incurred by the OpCo (in the example referred to earlier) will be fully recoverable by the OpCo whereas VAT costs incurred by the PropCo will not be recoverable at all. Where the functions of the PropCo and the

OpCo are carried out by the same corporate entity, VAT costs of such entity may only be partially recoverable.

It is therefore common in the data centre sector for the data centre owner to make an *"option to tax"* in respect of all real estate held by such owner and elect for VAT to be charged on supplies of commercial land and buildings it makes (i.e. the leasing of the data centre is subject to UK VAT) where otherwise it would be exempt from UK VAT. This ensures full VAT recovery for such data centre owner.

However, where the end customers of such a data centre are banks or financial institutions (which are unable to recover VAT), making such an *"option to tax"* means that the VAT cost incurred by the data centre owner (in developing and operating the data centre) is simply passed on to the end customers for whom VAT constitutes a real cash cost. For that reason, making an *"option to tax"* may actually be a commercial *"put-off"* for banks and financial institutions customer who may consider an "un-opted" property to be more desirable. This *"to opt or not to opt"* dilemma is indicative of the typical VAT issues likely to be faced by data centre owners.

Another such issue (which many data centre owners are unlikely to notice in the absence of specialist advice) which has a direct impact on the bottom-line of a data centre owning business relates to statutory disapplication of an option to tax made by a data centre owner in certain "innocent" circumstances where upfront contribution for *"fit-out"* works to be undertaken by the data centre owner is made by a bank or other financial institution tenant at the onset of the lease. In such circumstances, any option to tax made by the data centre owner may be statutorily disapplied resulting in the data centre owner being unable to recover VAT (on costs it incurs) which is something that the data centre owner does not expect or intend.

In summary, the importance of early and ongoing VAT planning in the context of data centre businesses cannot be overemphasised given the direct impact it has on the bottom line of such businesses.

D. Carbon Reduction Commitment energy efficiency scheme (CRCs)

The CRC scheme is part of a UK government target seeking to cut carbon emissions by 80 percent of 1990 levels by 2050. The CRC is a mandatory emissions trading scheme, which applies to large businesses and public sector organisations in the UK. Although the ostensible objective of the CRC scheme is to make businesses more energy efficient and therefore reduce their CO2 emissions, many view this scheme as being in substance a carbon tax or a levy notwithstanding the UK government assertion that it is not supposed to be so.

The CRC scheme is particularly complex in its purview and operation and it is not within the purview of this note to consider this scheme. It is suffice to say that private equity and institutional investors obtaining a majority stake in data centre businesses should carefully consider the impact that this scheme would have on the bottom-line profitability of the underlying data centre business.

James Dodsworth is a Partner and is the head of the Data Centre Team at White & Case LLP which is a leading international legal advisor to the global data centre industry. James advises on all aspects of structuring, financing, acquisition, leasing and disposal in relation to this rapidly emerging asset class. He can be contacted at jdodsworth@whitecase.com.

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