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China, U.K. sign new tax agreement

The governments of China and the U.K. on 27 June 2011 signed a new comprehensive agreement for the avoidance of double taxation ("new DTA"). The key features of the new DTA include:

- A reduced 5% withholding tax rate on dividends (down from 10%);
- A reduction in the effective withholding tax rate from 7% to 6% in respect of royalties for the use of, or the right to use, industrial, commercial or scientific equipment;
- Measures to limit the double taxation of capital gains and "other income";
- Changes to the taxation of technical fees paid between the two countries;
- An updated definition of permanent establishment (PE), which now includes a service PE;
- A "miscellaneous rule" that specifically enables the Chinese tax authorities to apply the domestic general anti-avoidance rules notwithstanding the provisions of the DTA;
- Additional anti-treaty shopping measures; and
- Other changes to bring the new DTA more in line with the OECD model treaty.

The new DTA will enter into force after both parties have notified each other that their ratification procedures have been completed.

Summary of main provision: Permanent Establishment (article 5)

Under article 5(3), the PE definition now encompasses:

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1. a building site, construction, assembly or installation project *or supervisory activities in connection therewith*, but only where such site, project or activities continue for a period of ***more than 12 months***, *the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any twelve-month period commencing or ending in the fiscal year concerned*.

Comment – The PE definition under the new DTA introduces the concept of a service PE, which is absent under the current China-U.K. DTA, and which brings the PE definition in line with many of China's other DTAs. As a result, Chinese and U.K. enterprises will need to assess the risk of creating a taxable presence in the other state if they provide services (e.g. consultancy services) for an aggregate period of more than 183 days over a 12-month period.

A PE also will arise under the new DTA if construction, assembly and installation projects last for a period of more than 12 months (six months under the existing DTA). This brings the DTA in line with the OECD model treaty. Whilst this appears to be a more generous provision, it should be noted that the timeframe under the new DTA also includes time spent on connected "supervisory activities."

Summary of main provision: Business Profits (article 7)

The new DTA introduces two new paragraphs into the business profits article, while removing part of paragraph 3 (which relates, in part, to the treatment of amounts paid by a PE to its head office) from the current DTA, thus changing the methods for attributing profits to a PE.

Comment – The changes to article 7 appear to provide for a more flexible approach for determining the profits of a PE. Under the current DTA, specific items of income or expense (e.g. head office management expenses) are not allowed in calculating the profits of a PE, but the new DTA appears to allow the profits of a PE to be determined "by such an apportionment as may be customary." China's domestic law does not generally allow management fees to be deducted for tax purposes, although the wording of the new DTA may provide an opportunity for such expenses to be deducted in future in the context of management fees paid by a PE in China to its U.K. head office.

It will be important for businesses to choose an appropriate profit attribution from the outset, as paragraph 6 in the new DTA states that the same method should be used "year by year unless there is good and sufficient reason to the contrary." In practice (and following the guidance issued in Guoshuifa [2010] No. 19), the profits attributable to a PE in China are typically calculated using a deemed profit rate.

Summary of main provision: Dividends, Interest and Royalties (articles 10, 11 and 12)

The table below shows withholding rates for dividends, interest and royalties under the new DTA compared to the rates under the domestic law of China and the U.K. (i.e. in the absence of a DTA). Also included are the rates under the current DTA.

	U.K. domestic law	China domestic law	Current DTA	New DTA
Dividends	0%	10%	10%	5% (if the beneficial owner is a company that holds directly or indirectly at least 25% of the capital of the company paying the dividends)
				10% (in most other cases*)
Interest	20%	10%	10%	10%
Royalties	20%	10%	10% (in most cases)	10% (in most cases)
			7%** (industrial, commercial or scientific equipment)	6%** (industrial, commercial or scientific equipment)

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	U.K. domestic law	China domestic law	Current DTA	New DTA
* A separate dividend withholding tax rate is applicable to U.K. REITs (see comments below). ** Represents the effective rate of withholding for royalties for the use of, or the right to use, such equipment. The actual withholding tax rate is 10% but, under the existing and new DTA, the withholding tax applies to only 70% and 60%, respectively, of the gross amount of the royalty.				

Additionally, the following paragraph has been included in each of articles 10, 11 and 12 in an effort to prevent treaty shopping:

> *The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the [shares or other rights/debt claim/right] in respect of which the [dividend/interest/royalty] is paid to take advantage of this Article by means of that creation or assignment.*

Comments

5% withholding tax on dividends – Perhaps of most interest is the introduction of a 5% dividend withholding tax that will apply where the beneficial owner is a company that holds directly or indirectly at least 25% of the capital of the payer company. Although this will not impact dividends paid from the U.K. to China (i.e. the U.K. does not levy withholding tax on dividends under its domestic law), it will be of interest to companies investing into China directly from the U.K. The 5% reduced rate brings the U.K. in line with the China's treaty rates available to companies in, for example, Belgium, Hong Kong, Ireland, Luxembourg and Singapore. Consequently, we expect to see an increased number of multinational companies with substantial operations in the U.K. consider investing into China directly from the U.K., particularly as China's strict application of the beneficial owner requirement and general anti-avoidance rules can make the use of intermediate holding companies less favorable.

It also should be noted that the 5% rate should apply when the beneficial owner is a company that directly or *indirectly* holds at least 25% of the capital of the company paying the dividends. The term "indirectly" does not appear in most of China's tax treaties with other jurisdictions or in the OECD model treaty, and would be of interest in a number of scenarios:

1) UK Co directly holds less than 25% of the shares of China Co, but holds directly and indirectly 25% or more of the shares

All other things being equal, it would appear that the 5% rate would apply to dividends paid in respect of the direct holding in China Co. It is unclear, however, whether the use of the words "directly or indirectly," and not "directly, or directly and indirectly" was deliberate and intended to require the "indirect" ownership itself to be 25% or more. In our opinion, the better view is that this was not the intention.

The 5% rate would, prima facie, not apply to dividends paid in respect of the indirect holding of shares in China Co because they are not dividends paid by a Chinese tax resident company to a U.K. tax resident company, which itself is the beneficial owner of the dividends.

2) UK Co 1 wholly owns UK Co 2, which owns at least 25% of the capital of China Co, and UK Co 2 is regarded by the Chinese tax authorities as a "conduit company," such that UK Co 2 is not considered the beneficial owner of the dividends it receives from China Co

If the Chinese tax authorities agree to determine the tax treatment of the dividends on the basis that the dividends are "paid to" UK Co 1 and agree that UK Co 1 is the beneficial owner, the wording of the new dividends article would result in the 5% tax rate being applied to the dividends. It is unclear whether the Chinese tax authorities would agree to this treatment. Further, the OECD does not comment on whether dividends paid to a conduit company (UK Co 2) should be treated as "paid to" the company (UK Co 1) for which the conduit company is acting as the conduit.

The way in which the dividends article in the new DTA is constructed could, however, be read by some readers in the following way:

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- Dividends paid by a Chinese tax resident company to a U.K. tax resident company: Condition satisfied because the dividends are paid to UK Co 2.
- "Beneficial owner" of the dividend (UK Co 1) indirectly holds 25% or more of China Co: Condition satisfied subject to the facts.

Such a reading in our view would be in direct contradiction to the way in which the dividends article, if based on the OECD model treaty (which has no "indirectly" qualification), would almost certainly be read, i.e. "... dividends paid by a Chinese tax resident company to a U.K. tax resident company, which itself is the 'beneficial owner' of those dividends."

3) UK Co wholly owns a third country company (X Co) that owns at least 25% of the capital of China Co, and X Co is regarded by the Chinese tax authorities as a conduit company, such that X Co is not considered the beneficial owner of the dividends it receives from China Co

As noted above, if the Chinese tax authorities agree to determine the tax treatment of the dividend on the basis the dividends are "paid to" UK Co, and agree that UK Co is the beneficial owner, the wording of the new dividends article would result in the 5% tax rate being applied to the dividends.

As noted above, it is unclear whether the Chinese tax authorities would agree, and the OECD does not provide any commentary on this issue in the context of conduit companies.

4) UK Co holds its shares in China Co through an agent or a nominee, whether in the U.K. or a third country

The use of the word "indirectly" in the new dividends article makes it clear that in this situation UK Co should be entitled to the benefit of the 5% rate.

Dividends paid by U.K. REITs – U.K. Real Estate Investment Trusts should note that dividends paid to China will be subject to a 15% withholding tax under the new DTA, rather than the 20% rate under domestic law.

Anti-treaty shopping measures – The anti-treaty shopping measures that have been introduced reflect the U.K. and China tax authorities' increasingly aggressive stance towards tax avoidance. Companies should ensure that they have a bona fide commercial purpose when relying on any of the provisions of these articles.

Summary of main provision: Capital Gains/Technical Fees (article 13)

The capital gains article has been revised in line with the OECD model treaty. As a result, the new DTA provides that the alienation of property will be taxable only in the state of which the alienator is resident, except in certain situations, including:

- Gains derived from the alienation of immovable property in China by a U.K. resident (or vice versa);
- Gains derived by a U.K. resident from the alienation of shares deriving more than 50% of their value from immovable property in China (or vice versa);
- Gains derived by a U.K. resident from the alienation of shares in a company resident in China if, at any time during the 12-month period preceding the alienation, the U.K. resident owned at least 25% of the shares in the China resident company.

Article 13 of the current DTA refers to "Technical Fees" (article 14 is Capital Gains). There is no technical fees article in the new DTA. Under the current DTA, technical fees can be taxed in the state in which they are derived, at an effective rate not exceeding 7%. It appears that such technical fees will now be covered in part by the Royalties article and, if not considered to be business profits, in part by the Other Income article 21 (see discussion below).

Comments – Under the current DTA, capital gains generally are taxable in the country of residence, and also may be taxable where they arise. The new DTA provides for certain situations where, for example, there would be an exemption from China's 10% nonresident capital gains tax, including where a U.K. resident company holds less than 25% of the shares of a China company and disposes of those shares.

As noted above, the payment of technical fees is covered in part by the Royalties article, with the definition of "royalties" being broadened to include "*payments… for information (know-how) concerning industrial, commercial or scientific*

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knowledge." However, under the current DTA, "technical fees" are defined as "*payments… for any services of a technical, supervisory or consultancy nature, including the use of, or right to use, information concerning industrial, commercial or scientific experience*" and, therefore, it would seem that payments for technical, supervisory or consultancy services would, if not considered to be business profit, instead now be covered by the Other Income article. Technical fees covered by the Royalties article would appear to be subject to a 10% withholding tax under the new DTA, rather than an effective rate of 7% under the current DTA.

Summary of main provision: Other Income (article 21)

The Other Income article is new and broadly sets out the concept that any income not dealt with in the other articles of the DTA should be taxable only in the state in which the beneficial owner is resident.

The new DTA includes two paragraphs, which are not included in the OECD model treaty, that operate to limit the provisions of the Other Income article in cases where there is treaty shopping or the item of income is in excess of an arm's length amount.

Comment – This article is a welcome inclusion to the new DTA as it limits double taxation of Other Income such as income arising from technical, supervisory or consultancy fees, but with appropriate anti-avoidance measures in place.

Summary of main provision: Miscellaneous Rule (article 23)

The Miscellaneous Rule article is not included in the OECD model treaty, but it does appear in most of China's recently negotiated tax treaties (e.g. Hong Kong and Singapore). The article reads as follows:

> *Nothing in this Agreement shall prejudice the right of each Contracting State to apply its domestic laws and measures concerning the prevention of tax evasion and avoidance, whether or not described as such, insofar as they do not give rise to taxation contrary to this Agreement.*

Comments – The Miscellaneous Rule article appears to be a prerequisite for any new tax treaties entered into by the Chinese government in recent years. The article specifically allows the Chinese authorities to apply the domestic GAAR (which became effective in 2008) to the extent the resulting tax effect does not conflict with the intention of any of the articles in the treaty. As a result, treaty benefits are likely to be denied in cases of tax evasion or avoidance to counter tax structures that are considered abusive by the tax authorities.

While our view is that any transactions or agreements that have a bona fide commercial purpose should not be caught by the provisions of this article, it remains to be seen how the U.K. and Chinese tax authorities will interpret the rule and to what extent it will be applied in practice.

Summary of main provision: Other changes

Compared to the current China-U.K. DTA, the new DTA introduces significant changes to articles, such as: the Shipping and Air Transport article (article 8), the Associated Enterprises article (article 9), the Students article (article 20), the Elimination of Double Taxation article (article 22) and the Exchange of Information article (article 26).

Comments – A Chinese resident company receiving dividends from a U.K. resident company will, under the new DTA, only be able to take into account the U.K. tax payable (by the U.K. resident company) when calculating the tax credit available if it owns more than 20% of the shares of the U.K. resident company (according to the Elimination of Double Taxation article). This percentage has increased from 10% under the current DTA and is now in line with China's domestic law. We recommend that Chinese investors with minority shareholdings in U.K. companies assess the consequences of this change (if any).

The remaining changes largely operate to bring the DTA in line with the most recent version of the OECD model treaty.

Conclusion

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The signing of a new China-U.K. DTA is a welcome development since the existing DTA, signed in 1984, has not been updated since 1996. The new DTA brings the agreement generally in line with China's other, more recently re-negotiated, DTAs.

Further, we believe that the favorable terms provided by the new DTA will be welcomed by U.K. business, as this means that the U.K. should now be seen as a viable alternative to more traditional holding jurisdictions for Chinese investments, such as Luxembourg, Hong Kong and Singapore, particularly in light of the U.K.'s new dividend exemption regime, its substantial shareholding exemption rules and the expected changes to the U.K.'s controlled foreign company rules as set out in the U.K. government's recently published consultation document.

Both the Chinese and U.K. governments will be pleased with the additional anti-avoidance measures in the new DTA, particularly those addressing treaty shopping. It remains to be seen how aggressively these measures will be enforced by both the Chinese and the U.K. tax authorities.

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Details of Australia's carbon pricing mechanism announced

On 10 July 2011, Australia's Prime Minister announced the long-awaited details of the carbon pricing mechanism as part of its Clean Energy Future policy package. The Clean Energy Future package aims to dramatically reduce pollution by introducing a carbon price and expanding renewable energy, energy efficiency and land use policies and programs. The carbon price will create a fiscal incentive to reduce carbon pollution.

The carbon pricing mechanism will have a two-phased approach: a fixed price mechanism followed by an Emissions Trading Scheme (ETS). Under the carbon pricing mechanism, as from 1 July 2012, every ton of carbon dioxide equivalent (CO2-e) produced by approximately 500 of Australia's largest direct emitters will be priced at AUD 23 per ton. For the first three years, the carbon price will be fixed, rising annually by 2.5%. On 1 July 2015, the pricing mechanism will transition to the floating ETS. During the fixed price period, large emitters will be required to purchase a fixed price permit from the government in exchange for every ton of CO2-e produced. The market will determine the price under the floating ETS, although there will be a price floor and ceiling for the first three years: a floor price of AUD 15 and a ceiling price of AUD 20 above the international carbon prices, rising annually 4% and 5%, respectively.

The use of international credits will not be allowed during the fixed price period and companies will not be able to sell domestic permits overseas. International permits can be used in the floating price period with a 50% limit until 2020.

The sectors covered by the carbon pricing mechanism are stationary energy, industrial processes, fugitive processes (other than decommissioned coal mines), non-legacy waste and limited coverage of the transport sector. Agriculture and land use emissions are excluded. The carbon pricing mechanism will cover four of the six greenhouse gases under the Kyoto Protocol: carbon dioxide, methane, nitrous oxide and perfluorocarbons from aluminum smelting. The other two synthetic greenhouse gases under the Kyoto Protocol (hydrofluorocarbons and sulphur hexafluoride) are excluded.

The industry assistance mechanisms outlined in the policy include a number of complex measures, including the following:

Jobs and Competitiveness Program: Emission-Intensive Trade-Exposed (EITE) assistance

EITE industries will receive assistance worth AUD 9.2 billion over the period to 2014-2015. Assistance will be in the form of free permits set at two assistance levels (94.5% or 66%), and will be based on an activity level, with about 50 activities expected to be eligible, including aluminium smelting, zinc, steel and glass production. Assistance will be reduced by 1.3%

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each year as a "carbon productivity contribution" to act as an additional incentive to reduce emissions. Existing activities assessed under the deferred Carbon Pollution Reduction Scheme (CPRS) will continue to be eligible. The Liquefied Natural Gas (LNG) industry will receive a special 50% assistance level as a separate activity.

The government also has announced that special assistance of AUD 300 million over five years will be given to the steel industry to encourage innovation and efficiency in addition to EITE assistance received by the industry.

Manufacturing industries

An AUD 1.2 billion Clean Technology Fund will be set up to assist manufacturing industries improve energy efficiency and reduce emissions through grants and R&D incentives. Large users of electricity, gas or those directly impacted by the carbon pricing mechanism will be able to access AUD 800 million of the fund on a co-investment basis: every AUD 3 invested by industry will receive AUD 1 from the government. There is also AUD 200 million in special assistance for the food and foundries industries. There is also AUD 200 million to support investment in clean technology innovation.

Coal sector

The coal sector will receive assistance via the AUD 1.3 billion Coal Sector Jobs package over six years to assist the most emission-intensive coal mines manage transition to the carbon price mechanism. This may include the closure of such mines over time.

Electricity sector

An Energy Security Fund will be established to assist the electricity generation sector deal with the impact of the carbon price and assist in ensuring energy security for Australia. The fund has two key objectives:

- Payment for the closure of approximately 2,000 megawatts of very high emitting coal-fired generation capacity by 2020 (these are expected to be a number of existing brown-coal generators in Victoria and South Australia); and
- Limited transitional allocation of permits and cash estimated at AUD 5.5 billion over six years to assist high emitting coal-fired generators adjust to the introduction of a carbon price. This assistance may include government loans or loan guarantees to assist with refinancing obligations.

Carbon Farming Initiative (CFI)

Kyoto-compliant Australian carbon credit units (ACCUs) established under the CFI can be used in the fixed price period to meet up to 5% of the carbon price permit obligation. Once the floating ETS commences, there is no limit on the ability to use ACCUs to meet the carbon pricing obligations. This is expected to present significant opportunity for organizations in the land use and agricultural sectors.

Tax treatment of carbon permits – some details

Now that businesses have some clarity on the carbon pricing mechanism from a tax perspective, they need to prepare for two transition steps to adjust to a low-carbon economy: (1) assess the direct or indirect impact of the carbon tax beginning on 1 July 2012; and (2) prepare for the introduction of the ETS with international linkage.

Directly impacted companies need to start analyzing their liability and establish systems to correctly identify their carbon tax liability. The carbon tax payments are expected to be required in a way similar to the payment of company tax. The government has stated that "progressive" payments will be made throughout a compliance year (1 July to 30 June), with 75% of the carbon tax liability progressively satisfied by 15 June and a true-up payment due on 1 February. It is unclear when the first payment is expected during the 2012/2013 compliance year.

Subject to future guidance on the finer details, the government's announcement indicates that the tax treatment for permits is to largely reflect that under the prior Carbon Pollution Reduction Scheme, i.e. permits will be deductible under a "rolling balance" method, values can be elected by the taxpayer, the holder of the permit will be the beneficial owner and any cross-border trade results will constitute a deemed disposal acquisition (not relevant until the flexible price period starts).

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There will be deductions for expenditure incurred to become a permit holder, penalties will not be deductible and, importantly, assistance grants will be valued as zero under the rolling balance method for eligible emissions. Goods and Services Tax will not be levied on the permits, but the general rules will apply to any secondary market activity. The tax laws of other countries will need to be addressed because the consideration of a carbon tax under Australia's existing tax agreements is not clear and will need to be clarified.

Implications for business

The following issues should be priorities for management to consider as they evaluate the carbon price mechanism proposals:

- Review the direct emissions profile – With the carbon price impact directly related to the extent of emissions, organizations should assess their current measurement methodologies for robustness to ensure that all calculations and decisions are fully supported. The financial liability aspect means that is vital that a robust audit trail is maintained for the emission measurement process.
- Assess ability to access government assistance – The package details significant and specific assistance to various industries. Organizations should review the package to identify whether they are eligible for any assistance available: EITE assistance, access to grants under the Clean Technology Fund or other assistance to the coal or electricity sectors.
- Determine pass-through impacts in supply chain – The extent to which the permit cost can be passed through (to the next business in the supply chain or to the end user) will have a significant impact on the profitability of the organization. Contractual agreements should be reviewed to determine the extent of pass-through and, as new agreements are negotiated, consideration should be given to the treatment of the carbon price.
- Accounting for carbon permits – There is currently no guidance in Australian or international accounting standards on how to account for emissions permits. It is important that organizations review their accounting policies for any voluntary permit schemes they may be currently engaged in and consider the options with regard to accounting for the carbon price permits. Consistency in approach and clear disclosure will be important to help investors understand the accounting impacts.
- Tax implications – The announcement indicates that the tax treatment of permits is largely consistent with the previous CPRS, e.g. where permits will be deductible under a "rolling balance" method. As details are confirmed, organizations should ensure that they understand the timing and cash flow implications of permit payments. These permit payments are expected to be administered in a similar manner to company tax payments.
- Systems and processes – Managing carbon permits will be a new activity for most organizations and, therefore, appropriate governance, policies, procedures and systems need to be put in place to manage the process. Buying permits (and in later years, trading permits) can be complex, so planning should start now to ensure that adequate systems are in place for the 1 July 2012 start date.

Even if organizations do not have a direct carbon price liability, they will be impacted by the indirect flow-through of the carbon price, the extent of which will be different between products and industries. All organizations will need to have a good understanding of their current emissions and energy use to be able to properly assess and mitigate the financial impact.

Conclusion

A carbon price may present opportunities for many organizations. Those with activities in the renewable energy and innovative technologies sectors may face increased demand for their products. Within the policy package, significant funding was indentified for innovation or energy efficiency, the most significant of which is the establishment of the Clean Energy Finance Corporation (CEFC), which will be set up to increase investment in renewable energy, energy efficiency and other low-emissions technologies. The CEFC will have AUD 10 billion in funding over 10 years from 2013-2014 and will be focused on the commercialization and deployment of technologies, with funding split between renewable energy and clean energy streams. The CEFC may provide finance in the form of commercial loans, concessional loans, loan guarantees or equity. The CEFC will not invest in capture and storage technologies.

Draft legislation is expected to be released at the end of July, at which time more details will become known. The complete package of legislation for the Carbon Tax is expected to be passed both houses of Parliament before the end of calendar year 2011. That does not leave much time for consultation, so business needs to start understanding and preparing now for the introduction of a carbon price.

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Costa Rica:
Country now in compliance with OECD standards on EOI

The OECD announced on 7 July 2011 that Costa Rica has been moved into the category of jurisdictions considered to have substantially implemented the internationally agreed tax standard on transparency and exchange of information. The change in category was made possible based on the country's recently expanded network of tax information exchange agreements (TIEAs) – as of 1 July, Costa Rica has signed the minimum 12 TIEAs needed to be removed from the OECD "gray list":

- Argentina (23 November 2009);
- France (16 December 2010);
- Netherlands (29 March 2011);
- Mexico (25 April 2011);
- Denmark, Finland, Greenland, Iceland, Faroe Islands, Norway and Sweden (29 June 29 2011); and
- Australia (1 July 2011).

The TIEAs (none of which have entered into force) provide various forms of exchanges of tax information, including exchanges upon request, simultaneous and industry-wide, and exchanges for tax examinations abroad.

On 2 April 2009, Costa Rica was designated a jurisdiction that had not committed to meet internationally agreed tax standards, and in June, based on a promise made by the government, Costa Rica was moved to the gray list, a list of jurisdictions that had committed to the internationally agreed standard but had not yet substantially implemented it.

Costa Rica is aiming to further expand its TIEA network; it is negotiating TIEAs with Aruba, Canada, Colombia, Korea, Guernsey, India, Indonesia, Italy, Japan, Saint Martin (Sint Maarten) and South Africa.

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European Union:
European Commission probes tax benefits granted by Spain for purchase of ships

The European Commission announced on 1 July 2011 that it is launching an investigation into a Spanish tax and investment scheme for the purchase of ships to determine whether the scheme is compatible with EU rules on state aid.

While the Commission has provided very few details in its release announcing the investigation, the scheme being challenged appears to involve a combination of Spain's tonnage tax regime and its economic interest grouping (EIG) regime. Shipping companies managed and registered in Spain may elect to be taxed under the tonnage tax regime in respect of passenger or cargo ships. Under the tonnage tax regime, the computation of taxable income for corporate income tax purposes is based on the net tonnage per qualifying ship according to certain tables set out in the Corporate Income Tax Law.

Spanish EIGs are taxed under the fiscal transparency regime. The EIG does not pay corporate tax on the portion of taxable income allocable to members resident in Spanish territory (instead, the income is imputed directly to the members). There is no limitation on imputing losses generated by the EIG to its members.

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The special purchase structures used by shipping companies were generally set up by banks and involved a leasing company, an EIG and investors, who are the beneficiaries of the unidentified tax measures the Commission is targeting. Some of the tax measures necessary for the scheme must be approved in advance by the tax authorities. While no particulars were given in the Commission's release, we understand that the scheme basically consists of the following:

- A shipyard and a shipping company enter into a contract for construction of a vessel.
- The shipping company transfers the rights and obligations under the contract to a leasing company.
- A Spanish EIG is formed by investors.
- The EIG borrows from a bank.
- The leasing company enters into a financial lease agreement with the EIG.
- The EIG and shipping company enter into a bareboat charter agreement with a purchase option.

In the first stage, the EIG is taxable under the general tax regime, applying accelerated depreciation of the vessel, subject to an agreement with the Spanish tax authorities. The tax loss derived from the accelerated depreciation (potential deferred tax liability) of the vessel is imputed to the investors as EIG members. Once the vessel is built and enters into service, the EIG opts to be taxed under the tonnage tax regime. As a consequence of the application of the tonnage tax regime, the accelerated depreciation is treated as a permanent difference instead a timing difference.

According to the European Commission, the purchase structure scheme may comprise state aid for the EIGs, its investors and the shipping companies purchasing the vehicles, and possibly also for the shipyards and certain intermediaries.

Interested parties may submit comments to the Commission.

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Hungary:
Bill on regulated investment companies under review

A bill that would introduce the concept of a regulated investment company (RIC) was presented to the Hungarian Parliament on 14 June 2011. If approved, the bill would pave the way for Hungary to become a center for financial services in the Central and Eastern European region. According to the bill, a RIC (a special status company) would be exempt from corporate income tax and the local business tax and would be subject to a lower rate of property acquisitions tax.

Qualifications

To qualify as a RIC, a company would have to apply to the National Tax and Customs Office to be registered as such and would have to meet the following requirements:

- Be a publicly listed company limited by shares (with a free float of over 25%) with initial capital of at least HUF 10 billion;
- Limit its business in Hungary to the sale, lease, operation and management of freehold real estate, as well as asset management;
- Have no participations in companies other than Special Purpose Entities (SPEs), other RICs and companies engaged in the business of organizing building construction projects (a share of up to 10% is allowed in the latter two cases); and
- Pay out at least 90% of its profits to its shareholders.

The concept of an SPE is separately defined in the bill as a Hungarian entity that is wholly owned by a RIC and, like a RIC, is involved in the real estate business only (however, an SPE could not hold any participations). An SPE would be required to pay out 100% of its profits to the parent RIC.

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According to the bill, property owned by a RIC and its SPE(s) ("real estate portfolio") would have to be appraised at least quarterly, with any differences between the book value and the market value recognized for accounting purposes. Although not specifically stated in the bill, the appraisal would have to be carried out by an independent professional (the explanation to the bill mentions engaging third-party appraisers).

The following are some of the more important rules that would apply to the asset and liability portfolio of a RIC and an SPE:

- 70% of the balance sheet total (consolidated, if applicable) of a RIC would have to be invested in a real estate portfolio and the value of any single property would not be able to exceed 20% of the balance sheet total;
- Other assets held by a RIC would only be able to include bank deposits, government securities, stock market shares and the participations mentioned above; and
- A RIC would only be able to have debt of up to 65% of the aggregate value of the property it owned (70% for an SPE).

Tax liability of RICs

The rate of property acquisitions tax payable by a RIC and its SPE(s) would be 25% of the generally applicable rate. This preferential rate also would apply if the acquirer (or, in the case of an SPE, its owner) agreed to comply with the RIC registration rules at the end of the year in which the tax liability arises. However, if the qualification requirement was not met, twice the amount of the "tax benefit" would be charged.

A RIC would be subject to corporate income tax, although it would not have any liability provided the company refrained from entering into transactions with related parties not qualifying as RICs or SPEs resulting in transfer pricing adjustments and thereby increasing the pre-tax profit (in such cases, tax would be payable on the difference).

A RIC that was removed from the registry would become obligated to prepare an interim balance sheet and, based on this balance sheet, the amount of corporate income tax payable for the period in which the company had RIC status would have to be determined in part on the basis of special rules. However, for the remainder of the year, the general corporate income tax rules would apply.

A RIC and its SPE(s) would be exempt from the local business tax.

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India:
LLP form offers new business vehicle for foreign investors

India recently liberalized its foreign direct investment (FDI) policy to permit FDI in limited liability partnerships (LLP). An LLP, which is formed under the Limited Liability Partnership Act (notified in 2009), is a hybrid form of business having features of both a corporation and a traditional partnership.

As a business vehicle, the LLP offer a number of advantages:

- The liability of the partners is limited to the capital contributed by each partner to the LLP;
- An LLP is not subject to restrictions on the manner/frequency of holding board and shareholder meetings, as is the case with a company;
- Profits repatriated by an LLP are not subject to tax, unlike a company, which is subject to the Dividend Distribution Tax of 16.61% (while the profits of an LLP and a company are taxed at the same company tax rate);
- Loans/advances by an LLP to related entities are not subject to the deemed dividend provisions, as may be applicable in the case of a company; and
- While an LLP is subject to the Minimum Alternate Tax (MAT), the MAT may not have a significant impact, except in the case of LLPs enjoying tax holidays or having units in special economic zones.

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The key features of the policy relating to FDI in LLPs are set out below.

Sectors for investment

- FDI in LLPs is permitted only in "open" sectors, subject to the approval of the Indian government (e.g. sectors such as manufacturing, hospitality, services, etc.);
- No FDI in an LLP is allowed where there are FDI-linked performance related conditions. Thus, FDI is not permitted in sectors such as non-banking finance companies, the development of townships, housing, built-up infrastructure and construction-development projects, etc.; and
- FDI in LLPs is not allowed in the agricultural/plantation sector, print media or the real estate business, i.e. sectors that are not under the "automatic route" for investment (government approval of the investment is not required under the automatic route).

Funding of LLP

- Foreign capital participation in the capital structure of an LLP must be made via a cash inward remittance through the normal banking channels or by debit to the "nonresident (external)/foreign currency nonresident account" of the person concerned;
- Foreign institutional investors and foreign venture capital investors are not permitted to invest in LLPs; and
- LLPs are not permitted to avail External Commercial Borrowings.

Other restrictions

- An Indian company having FDI is permitted to make downstream investment in an LLP only if both the company and the LLP operate in sectors where 100% FDI is allowed through the automatic route and there are no FDI-linked performance related conditions;
- LLPs with FDI will not be eligible to make any downstream investments; and
- Conversion of a company with FDI into an LLP must be approved by the government.

FDI in LLPs has opened a new door for foreign investors wishing to enter the fast growing Indian market and also provides an opportunity for existing foreign investors to make their investments more tax-efficient by restructuring through an LLP.

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Liechtenstein:
Compatibility of IP regime with state aid rules confirmed

The Surveillance Authority of the European Free Trade Association (EFTA) announced on 1 June 2011 its decision to clear Liechtenstein's intellectual property (IP) regime under European Economic Area (EEA) state aid rules. (The EEA is comprised of EU Member States and three – Iceland, Liechtenstein, Norway – of the four EFTA Member States (Switzerland being the fourth EFTA country). Under the EEA Agreement, EFTA Member States are allowed to participate in the EU's internal market. The Surveillance Authority is responsible for the supervision of the application of EEA law in the EFTA states and monitors state aid granted by the three EFTA Member States to ensure compliance with the state aid rules in the EEA Agreement, which are generally equivalent to those under the Treaty on the Functioning of the EU.)

Introduced as part of a tax reform that became effective on 1 January 2011, Liechtenstein's IP regime allows a deduction of 80% of net positive income from IP prior to the imposition of corporation tax. Combined with a nominal corporate income tax rate of 12.5%, qualifying IP income is subject to an effective tax rate of only 2.5%. The ordinance to the tax act stipulates a rather broad definition of IP and IP income. Both developed and acquired IP qualify as IP. Similarly, income from IP used within the same group and income from IP licensed to a third party are within the scope of the IP regime. To calculate the net positive income from IP, all expenses connected to the IP (including amortization and depreciation of the IP) must be deducted from earnings, regardless of the fiscal year in which the expenses are incurred or the earnings are

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received. The IP regime applies in addition to, and independent of, the notional interest deduction. That regime allows a deduction of 4% of the modified equity when calculating the taxable base, resulting in an effective tax rate of less than the nominal 12.5% for regular income, depending on individual facts and circumstances.

According to the Surveillance Authority, the Liechtenstein IP regime does not constitute state aid because the tax deduction is available to all businesses, irrespective of size, legal structure or sector, and the regime does not favor any products or services.

With the Surveillance Authority's decision on the IP regime and its decision of 15 February 2011 clearing the tax status of the country's private investment structures, two main pillars of Liechtenstein's new tax code have been confirmed to be in line with state aid rules. Compatibility with EEA law was one of the main guidelines of the tax reform from the outset. The Surveillance Authority's approval of the tax law protects taxpayers from unpleasant surprises (e.g. recovery of unlawful state aid from taxpayers) and contributes to the long-term stability of Liechtenstein's tax environment.

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South Africa:
Court rules on exit tax on deemed disposal of shares under treaty with Luxembourg

South Africa's Tax Court has ruled that article 13(4) of the South Africa-Luxembourg tax treaty applies to eliminate capital gains taxation on the deemed disposal of shares in a subsidiary when a parent company ceases to be a resident of South Africa.

Facts

The taxpayer was an investment holding company incorporated in South Africa and listed on the Johannesburg stock exchange. The taxpayer's only significant asset was its wholly owned South African subsidiary (which, in turn, directly or indirectly owned shares in European companies). The taxpayer's board of directors decided on 2 July 2002 that all future board meetings would take place in Luxembourg. Consequently, the company became effectively managed in Luxembourg and, under Luxembourg law, became taxable in Luxembourg on its worldwide income.

One of the executive directors stayed in South Africa and continued to perform functions on the taxpayer's behalf until 29 January 2003, when the director moved to Europe. While the company continued to be considered tax resident in South Africa because it was incorporated there, South Africa added an exception to its definition of "resident" that same year providing that a taxpayer is not resident in South Africa if an income tax treaty between South Africa and another country exclusively allocates taxing rights with respect to that taxpayer to the other country. Thus, as from 26 February 2003, when the exception was added, the taxpayer ceased to be a tax resident of South Africa under domestic law.

Applicable law

South Africa's tax rules include provisions dealing with "events treated as disposals" (i.e. a situation in which there is no actual disposal of an asset). The deemed disposal is treated as if an amount is received that is equal to the market value of the asset at the time of the event. An asset (in this case, shares in the South African subsidiary) is deemed to be disposed of when a person ceases to be a resident of South Africa, unless an exception applies.

Article 13(4) of the South Africa-Luxembourg treaty, however, allocates taxing rights on capital gains solely to the contracting state of which the alienator is a resident, unless the gains are derived from the "alienation" of immovable property; movable property forming part of the business property of a permanent establishment (PE); or ships or aircraft operated in international traffic or movable property relating to the operation of such ships or aircraft.

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Arguments before the court

The Commissioner of the South African Revenue Service (SARS) assessed the taxpayer based on a taxable gain that, according to the Commissioner, arose from a "deemed disposal" of an asset under domestic legislation in the 2003 tax year. As to the application of treaty article 13(4), the Commissioner claimed that the article refers to the "alienation" of property and not to a "deemed disposal" as contemplated under domestic law, and, therefore, the gain that arose on the deemed disposal should not be protected under the treaty.

The taxpayer claimed that, under the treaty, the gain should be subject to tax only in Luxembourg. First, article 4(3) of the treaty provides that a company that is a resident of both contracting states is deemed to be a resident of the state in which its place of effective management is situated. In this case, the company was effectively managed from Luxembourg and was, therefore, resident in Luxembourg under the treaty. Second, the capital gains article, which is very similar to the equivalent article in the OECD Model Treaty, provides that capital gains (subject to exceptions that did not apply in this case) should be taxable only in the state of residence of the alienator, i.e. in this case, Luxembourg.

Court ruling

The court agreed with the taxpayer on the interpretation of article 13 and was unable to see any reason why a "deemed disposal" of property should not be treated as an "alienation" of property for purposes of article 13(4). The court also agreed with the taxpayer that it would be absurd if the treaty only protected actual disposals of property, rather than also protecting deemed disposals. Thus, gains from the alienation of property would only be taxable in Luxembourg on the basis of article 13(4) of the treaty.

Comments

Article 7 (business profits) allocates taxing rights with respect to business profits to the source state where the business activities constitute a PE. However, article 7 does not apply to allocate taxing rights with respect to items of income specifically dealt with under other articles of the treaty. Article 13 gives the residence state full taxing rights with respect to capital gains from the alienation of property (other than certain excepted property). Article 13 makes no distinction as to whether capital gains are derived by a resident company or by a PE in the other contracting state of such resident company. Thus, South Africa would have no taxing rights over gains from the deemed disposal of shares under the treaty once the company has changed country of residence, irrespective of any potential PE in South Africa.

In our opinion, however, in reaching its decision, the court omitted to discuss two important considerations. First, the court did not investigate in which country the company had its place of "effective management" under the tax treaty once the board of directors had resolved that all future board meetings would be held in Luxembourg. The court simply concluded that it is "common cause" that the appellant became effectively managed in Luxembourg.

Second, the court should have examined whether the company had a PE in South Africa under domestic law. Under domestic legislation, a taxpayer is deemed to have disposed of all of its assets at market value on the day before it ceases to be a resident in South Africa. Assets that are attributable to a PE in South Africa would not, however, be deemed to be disposed of in such circumstances because these assets would remain subject to capital gains tax in South Africa. Whether SARS assumed that the company still had a PE in South Africa until 29 January 2003 or that the company did not cease to be a tax resident in South Africa until the definition of a tax resident changed on 26 February 2003 is not clear from the case. What is clear, however, is that the exit tax was not charged to the company until the latter stage (i.e. a deemed disposal during the 2003 tax year). When the exit tax was finally assessed, the company was already a tax resident in Luxembourg and, therefore, protected by the treaty because of its tax residence. As a result, South Africa was never allowed to tax the accumulated profit in the shares held by the company.

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In brief

Austria – The Ministry of Finance (BMF) issued an opinion on 29 June on the April 2011 decision of the Administrative Supreme Court that the general anti-avoidance rule (GAAR) can be used to challenge the use of a trustee to avoid the Real Estate Transfer Tax (RETT) on a share transfer. The BMF points out that the court has not changed its general view that only a legal pooling of all of the shares in the hands of a single shareholder triggers RETT. In general, an economic pooling of all shares in a company via a trustee will not trigger RETT and a mere trustee agreement should not be considered an abuse that can be challenged by the GAAR. However, according to the BMF, trustee arrangements may still be challenged under the GAAR on an individual basis in specific (unidentified) cases.

Cook Islands – The 2011/2012 budget announced on 1 July 2011 includes the introduction of a 15% withholding tax on interest earned from registered banks. The new tax applies as from 1 September 2011.

European Union – The European Court of Justice (ECJ) has issued a decision on the availability of tax credits for foreign tax, concluding that the former German imputation system infringes the free movement of capital (*Meilicke 2*). The imputation tax credit must be calculated by reference to the rate of corporation tax on the distributed profits applicable to the dividend-paying company according to the law of the Member State of establishment. However, the credit is limited to the income tax payable in Germany on the dividends received. A tax credit should be given for the amount of tax actually paid up to the limit of the domestic corporation tax rate, and equality of treatment should extend to the level at which tax is credited. German rules that require a certificate for foreign corporation tax to be in the form prescribed by domestic law were ruled to be impermissible if it is, in fact, impossible or excessively difficult to obtain such a certificate. However, tax authorities are entitled to require the shareholder to provide appropriately detailed evidence.

European Union – The European Commission has updated its list of VAT rates in the EU (as of 1 July 2011). In addition to listing the VAT rates in use in each Member State, the document shows the broad categories of goods and services subject to each rate in each country and provides a history of rate changes.

Korea – The Ministry of Public Administration and Security announced on 1 June 2011 a proposal to transfer all of the local tax exemption provisions in the Tax Incentive Limitation Law (TILL) to the Local Tax Incentive Limitation Law (LTILL). The basic guidelines for the transfer of the exemption provisions would be as follows: (1) local tax exemptions would be available only in the LTILL; (2) there would be no changes in the tax benefits; and (3) the local tax exemptions to be transferred to the LTILL would have sunset clauses. The revisions are expected to be submitted to the National Assembly in mid-September 2011.

United Kingdom – The tax authorities (HMRC) issued a consultation document on 28 June 2011 on adopting the long-standing EU VAT exemption for shared costs on the supply of services by independent groups of persons who, among other criteria, merely claim from their members an exact reimbursement of their share of joint provisions. The consultation document: defines HMRC's view on "independent groups of persons"; questions whether an organization's activity be wholly exempt or non-business or whether a minimum level of taxable services can be made; outlines HMRC's preferred interpretation of the scope of "services directly necessary for the exercise of their activity"; explains HMRC's approach regarding "exact reimbursement" of costs and its application to overhead costs and management charges; summarizes tests for ascertaining the "distortion of competition"; and comments on cross-border issues and the exemption's impact. Comments are due by 30 September.

Tax treaty round up

At the end of each month, the World Tax Advisor provides an update on recent tax treaty developments, with a focus on items that directly affect the withholding tax rates of the key jurisdictions covered by the Deloitte International Tax Source (DITS). Additional coverage may include stated negotiating priorities and other important tax treaty trends. For updates on tax information exchange agreements, visit our DITS special feature.
URL: http://www.dits.deloitte.com
URL: http://www.dits.deloitte.com/Administration/ManageHomePage/Popup.aspx?ChildPage=InfoExchange

Unless otherwise noted, the developments discussed are not yet in force.

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Australia-Aruba – The 2009 treaty entered into force on 27 June 2011 and applies in Aruba as from 1 January 2012 and in Australia as from 1 July 2012. The treaty only covers payments to individuals and does not address dividends, interest or royalties, so domestic rates will continue to apply once the treaty is in effect.

Australia-Chile – The 2010 treaty entered into force on 27 June 2011. The treaty applies in Chile as from 1 January 2012, and in Australia as from 1 August 2011 for withholding tax, 1 April 2012 for fringe benefits tax and as from 1 July 2011 for other tax purposes. When in effect, the treaty provides for a 5% withholding tax on dividends paid to a company that holds directly at least 10% of the voting power of the payer; otherwise, the rate will be 15%. Interest derived by a financial institution that is unrelated to and dealing wholly independently with the payer will be taxed at a 15% rate; otherwise, the rate will be 10%. The rate on royalties paid for the use of industrial, commercial or scientific equipment will be 5%; in all other cases, the rate will be 10%.

Australia-Isle of Man – The 2008 treaty entered into force on 5 January 2010 and applies in Australia as from 1 July 2011 and in the Isle of Man as from 5 April 2011. The treaty only allocates taxing rights to certain income derived by individuals. It does not provide any withholding tax rates for dividends, interest or royalties, so the domestic rates apply.

Australia-Jersey – The 2009 treaty entered into force on 15 April 2010 and applies in Australia as from 1 July 2011 and in Jersey as from 1 January 2011. The treaty does not provide any withholding tax rates for dividends, interest or royalties, so the domestic rates apply.

Australia-Samoa – The 2009 treaty entered into force on 27 June 2011 and applies as from 1 July 2011. The treaty only covers payments to individuals and does not address dividends, interest or royalties, so domestic rates apply.

Australia-Turkey – The 2010 treaty entered into force on 27 June 2011. The treaty applies in Australia as from 1 January 2012 for withholding taxes and as from 1 July 2011 for other taxes; the treaty applies in Turkey as from 1 January 2012. When in effect, the treaty provides for a 5% withholding tax on dividends paid to a company that holds directly at least 25% of the voting power of the payer company; otherwise the rate will be 15%. The rate on interest and royalties will be 10%.

China-Hong Kong – The Hong Kong government announced on 4 July 2011 that it had received a reply from the PRC State Administration of Taxation that clarified the arrangements concerning the tax payable to the Mainland for dividends paid by Mainland companies to individual investors in Hong Kong. When non-foreign investment companies of the Mainland that are listed in Hong Kong distribute dividends to their shareholders, the individual shareholders generally will be subject to the 10% withholding tax under the Mainland China-Hong Kong Arrangement for the Avoidance of Double Taxation. No applications are required for entitlement to the 10% rate. Shareholders who are residents of other countries that have concluded a tax treaty with China on a withholding tax rate higher or lower than 10% must comply with the relevant agreement in paying tax in connection with dividends paid by Hong Kong-listed Mainland companies.

China-United Kingdom – See article this issue.
URL: http://newsletters.usdbriefs.com/2011/Tax/WTA/110715_1.html

Costa Rica – See article this issue.
URL: http://newsletters.usdbriefs.com/2011/Tax/WTA/110715_3.html

Denmark-Hungary – When in effect, the treaty signed on 27 April 2011 to replace the existing treaty dating from 1978 provides that dividends will be exempt from withholding tax if paid to a company (other than a partnership that is not liable to tax) that holds directly at least 10% of the capital of the paying company for an uninterrupted period of no less than one year. Dividends also will be exempt if paid to a qualifying pension fund or similar institution providing pension schemes; otherwise the rate will be 15%. Interest and royalties will be exempt.

India-Norway – When in effect, the treaty signed on 2 February 2011 to replace the treaty dating from 1986 provides for a 10% withholding tax on dividends, interest, royalties and fees for technical services.

Korea – Korea has concluded 12 Tax Information Exchange Agreements (TIEAs) since 2009 in an effort to adopt a more collective and cohesive approach to addressing issues relating to international speculative funds and offshore tax evasion, and in the first half of 2011, has signed draft TIEAs with the British Virgin Islands and Costa Rica.

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Luxembourg-South Africa – See article this issue.
URL: http://newsletters.usdbriefs.com/2011/Tax/WTA/110715_8.html

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United Kingdom
Consultation document on CFC rules issued
The government has published a consultation on the future shape of the controlled foreign company rules with an overall tone that is geared towards the taxation of income arising in or closely connected with the U.K. [Issued: 1 July 2011]
URL: http://www.deloitte.com/view/en_GX/global/services/tax/9c1c5f9cf36e0310VgnVCM3000001c56f00aRCRD.htm?id=us_email_Tax_WTA_071511
URL: http://www.deloitte.com/assets/Dcom-Global/Local%20Assets/Documents/Tax/Alerts/dtt_tax_alert_UnitedKingdom_010711.pdf?id=us_email_Tax_WTA_071511

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