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New U.S. excise tax hits foreign contractors

President Obama signed into law the James Zadroga 9/11 Health and Compensation Act of 2010 (Act) on 2 January 2011. The Act added to the Internal Revenue Code a 2% excise tax on certain payments received by foreign persons pursuant to contracts with the U.S. federal government (new Code section 5000C). The tax applies to payments received pursuant to contracts entered into on or after 2 January 2011.

Section 5000C had a whirlwind legislative history (it appears to have been drafted in the last five days of the 111th Congress), and its substance originated in trade policy, rather than tax policy. As a result, the Internal Revenue Service (IRS) and the Treasury Department's Office of Tax Policy (Treasury) probably had little pre-enactment opportunity to think about its implementation. This article describes the new law and the questions that must be addressed to apply it.

Specified Federal procurement payments

The new excise tax applies to "specified Federal procurement payments" received by foreign persons (section 5000C(a)). Section 5000C(b) defines the term "specified Federal procurement payment" as "any payment made pursuant to a contract with the Government of the United States for (1) the provision of goods, if such goods are manufactured or produced in any country which is not a party to an international procurement agreement with the United States, or (2) the provision of services, if such services are provided in any country which is not a party to an international procurement agreement with the United States."

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International procurement agreements

Although a payment can be received tax free if a relevant "international procurement agreement with the United States" applies, the Act does not provide any definition of that term. We understand, however, that it was intended to include the World Trade Organization's Agreement on Government Procurement (GPA), as well as free trade agreements (FTAs) between the U.S. and other countries that contain government procurement-related obligations.

- The GPA is a "plurilateral agreement" of the World Trade Organization (WTO) in which a signatory country agrees not to discriminate against suppliers of goods and services in other signatory countries in the area of government procurement. As a plurilateral agreement, some, but not all, of the WTO members have agreed to be bound by its provisions. To date, 40 WTO members have signed the GPA, including Canada, Israel, Japan, Korea, the 27 EU Member States and the U.S. However, many major trading partners of the U.S. have not signed the GPA, including China, Brazil, India and countries in the Middle East (although a number of these countries are currently negotiating accession).
- FTAs that contain government procurement obligations include the North American Free Trade Agreement (NAFTA), the Dominican Republic-Central America-U.S. Free Trade Agreement (CAFTA-DR), and bilateral FTAs between the U.S. and Australia, Bahrain, Chile, Israel, Morocco, Oman, Peru and Singapore.

Foreign person

Section 5000C(c) defines the term "foreign person" as "any person other than a United States person." The Code, under section 7701(a)(30), defines a "United States person" as meaning (i) a citizen or resident of the U.S.; (ii) a domestic partnership; (iii) a domestic corporation; (iv) any estate other than a foreign estate; and (v) certain trusts. Thus, for purposes of section 5000C, foreign persons will include nonresident alien individuals, foreign corporations and foreign partnerships.

Withholding obligation

The new excise tax will be collected by withholding. Section 5000C(d)(1) provides that "[t]he amount deducted and withheld under chapter 3 shall be increased by the amount of tax imposed by [section 5000C] on such payment." Chapter 3 of the Code (sections 1441-1464) imposes liabilities on all persons, in whatever capacity acting (including specifically all officers and employees of the U.S.), having the control, receipt, custody, disposal or payment of the items to which it applies (e.g. specified Federal procurement payments). Chapter 3 also describes information return and tax return filing obligations of withholding agents and the manner in which tax withheld is credited against the tax liability of the payment's owner.

Compliance with income tax procedures

For purposes of the procedural and administrative provisions of the Code (specifically, Code sections 6001 through 7874), any tax imposed by section 5000C will be treated as a tax imposed by Code sections 1 through 1563 (i.e. income tax). This seems to imply that, if no withholding agent collects the 2% excise tax, the payee is obligated to file a return in accordance with the income tax return filing rules and self-assess the tax.

Prohibition on reimbursement of the tax

Section 301(b) of the Act requires the head of each executive agency to "take any and all measures necessary to ensure that no funds are disbursed to any foreign contractor in order to reimburse the tax imposed under section 5000C" and provides for an annual review of the contracting activities of each executive agency to monitor compliance with this prohibition.

Open issues

Numerous unanswered questions are raised by the new excise tax, including:

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- Are the only payments subject to this new excise tax those received from the U.S. federal government? Under what circumstances might a payment received from a government contractor, in order for it to obtain the goods or services necessary to perform under its contract with the government, also be subject to the tax?
- How does a contractor determine, and when is a withholding agent entitled to assume, that goods are "manufactured" or "produced," or services are "provided," in a country that is a party to an international procurement agreement?
- Is the full amount of a payment received by a foreign partnership subject to the tax, even if some or all the partners are *not* foreign persons? In what cases will a payment's taxability be determined based on criteria such as its "beneficial owner," "ultimate owner" or similar or analogous criterion?
- What payments are considered to be made pursuant to a contract entered on or after the date of enactment (2 January 2011)? For example, do they include payments for goods or services ordered after 2 January 2011 if provided under a contract entered into before that date? Do they include payments for goods or services provided pursuant to a post-1 January 2011 extension of a contract entered into before 2 January?

Conversations have begun among government officials in several federal agencies having jurisdiction over various aspects of this new excise tax – including the IRS, Treasury and the Office of the U.S. Trade Representative. However, as of now, no express public statement as to the timeline for the promulgation of guidance has been made by any government agency.

Conclusion

We anticipate that the U.S. tax authorities will not leave these issues unresolved indefinitely. In the meantime, government contractors will need to be able to anticipate whether particular payments will or will not be subject to the new excise tax. They should not wait until they learn whether the federal government did or did not withhold on payments to them (especially if some payments will be subject to tax even if the payer is *not* the federal government or if a payer otherwise obligated to withhold fails to do so). Therefore, potentially affected taxpayers must begin to identify transactions that may be affected by this tax, evaluate whether or not to discuss these transactions with the federal government or other intermediary payers and remain alert to further developments in the coming months.

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Germany:
Pre-2004 thin capitalization rules violate nondiscrimination principle in relation to Switzerland

Germany's Federal Tax Court (BFH) recently ruled on whether the pre-2004 thin capitalization rules were compatible with the nondiscrimination principle in Germany's tax treaty with Switzerland. The European Court of Justice (ECJ) held in its 2002 decision in the *Lankhorst-Hohorst* case that the thin capitalization rules were incompatible with the freedom of establishment principle in relation to EU/EEA countries, but in 2007 the ECJ concluded in *Lasertec* that the rules were in compliance with the free movement of capital principle in relation to third countries.

The BFH has now held that, under the pre-2004 thin capitalization rules, German companies with Swiss resident shareholders were subject to taxation that was more burdensome than that of a similar German company with German resident shareholders, and this constitutes an infringement of the nondiscrimination principle in the Switzerland treaty. The fact that the treaty does not include a provision similar to article 24(4) of the OECD Model Treaty, which excludes payments made to nonresident shareholders from the application of the nondiscrimination principle, appeared to be an important factor in the BFH's analysis.

Although the German thin capitalization rules were extended to cover domestic situations as from 2004 following the *Lankhorst-Hohorst* decision and were completely revised and modified as from 2008, the decision still may be relevant. For example, it may be important in tax audit cases for years before 2004 where the thin capitalization rules are still applied in

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relation to Swiss shareholders (the applicability to other third country taxpayers would need to be analyzed on a case-by-case basis as it would depend on the actual wording of the applicable treaty (potentially relevant for countries such as Canada or Japan)). It remains to be seen whether the decision will have more far-reaching effects in other nondiscrimination cases where ECJ principles could be extended to third countries based on the BFH decision (e.g. potentially in the case of the old higher tax rate for permanent establishments).

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Iceland:
VAT treatment on sale of electronic services to be revised

As from 1 May 2011, the sale of electronically supplied services to parties that are not domiciled or operating in Iceland will be zero-rated turnover for purposes of Iceland's VAT law, provided the services are wholly used abroad. The zero rating also will apply to combined services provided by data centers to foreign customers.

Also applicable from 1 May 2011, the importation of servers and related equipment in certain circumstances will be exempt from VAT if the owner of the equipment is domiciled in the EEA, EFTA or Faroe Islands and does not have a permanent establishment in Iceland.

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Indonesia:
APA guidelines issued

Indonesia's Directorate General of Taxation (DGT) on 31 December 2010 issued Regulation PER-69/PJ/2010 (PER-69), providing long-awaited implementation guidance on advance pricing agreements (APAs) that hopefully will reduce the number of transfer pricing disputes.

Background

PER-69 was issued as an implementation guideline to Income Tax Law article 18(3a), which authorizes the DGT to enter into agreements with taxpayers for a specified period and to cooperate with foreign tax authorities to determine the price of transactions among related parties. The law also authorizes the DGT to supervise the implementation of such agreements and to renegotiate agreements following the end of their period. Given the increasing number of disputes between taxpayers and the DGT on taxpayers' transfer pricing practices, the DGT had long been urged to issue APA guidelines.

Taxpayers can use an APA to resolve transfer pricing issues in advance by entering into an agreement with the DGT that covers certain issues (for example, the transfer pricing methodology the taxpayer will use and the factors used in the analysis of critical assumptions) and determines the arm's length price or profit or arm's length range of price or profit on all or some of the taxpayer's transactions with related parties.

Guidelines

PER-69 outlines the steps for obtaining an APA as follows:

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1. Pre-filing discussion between the DGT and the taxpayer;
2. Taxpayer submission of a formal APA application (form APA-2) to the DGT based on the pre-filing agreement. The formal application must be on the prescribed form APA-2 with the required supporting information, including transfer pricing documentation;
3. Discussion of the APA between the taxpayer and the DGT;
4. Issuance of the APA letter by the DGT; and
5. Implementation and evaluation of the APA.

There are several important points to note in PER-69:

- PER-69 outlines the length of time (except for the discussion of the APA itself) as follows:
  - In step 1, within three months from submission of the pre-filing discussion request (form APA-1) and complete supporting documents, the DGT has to reply stating whether the process will be continued to the next step or is being rejected (if it is rejected, the taxpayer may reapply).
  - In step 4, APA documentation should be prepared within 20 working days following conclusion of the discussion between the DGT and the taxpayer.
  - Upon implementation, a compliance report should be submitted within four months after closing of the tax year.
- The supporting documents required during the process would include the following:
  - In step 1, articles of association, detailed description of the company's business operation, organizational structure, detailed description of the shareholders and related-party transactions, related-party transactions to be covered in the APA, transfer pricing methodology applied and its related comparables analysis, detailed functional analysis, accounting system, detailed production process, audit reports and annual corporate income tax returns for the last three years, etc.
  - In step 2, supporting documents (similar to the supporting documents in step 1) plus detailed analysis of critical assumptions (such as changes in the tax, customs, business law or economic conditions that affect sales volume, production or market share, etc.)
  - Other documents requested by the tax office during the APA discussion process.
- Conditions that will lead to the reassessment or cancellation of the APA by the Indonesian Tax Office (ITO) during the evaluation process include failure by the taxpayer to comply with the APA or a change in the critical assumptions used in applying the APA, among other factors.
- The maximum term of an APA is three tax years, starting with the tax year in which the APA is agreed. An APA also may be applied for a tax year before the APA is agreed if the annual income tax return for that year has not been audited, no objection or appeal on the return has been filed and there is no indication of any criminal conduct. The APA is applied to an earlier year by amending that year's tax return with a compensating adjustment.
- When an APA is requested for a transaction between a taxpayer and a domestic related party (domestic transfer pricing), a secondary adjustment for the other taxpayer may be made with the approval of the DGT.
- If a taxpayer is of the opinion that the APA could lead to double taxation, the taxpayer can submit a written request to the DGT to initiate a Mutual Agreement Procedure with the competent authority of the treaty partner country.
- An APA does not prevent the DGT from conducting a tax audit under the applicable tax law.
- Books, notes, documents or information submitted by the taxpayer for purposes of establishing the APA are treated as confidential and cannot be revealed to third parties. In the event that an APA is not agreed or the process is cancelled, then all taxpayer documents submitted during the process should be returned by the DGT and shall not be used as a basis to conduct a tax audit or investigation.

Conclusion

While PER-69 is generally in line with the OECD Transfer Pricing Guidelines on APAs, the following points require further clarification:

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- If the ITO cancels the APA and the taxpayer does not agree with the ITO's decision, the regulation does not mention an opportunity for the taxpayer to provide a response or explanation or to have a discussion with the ITO on the case; and
- It is not clear how the taxpayer can ensure that, if an APA is cancelled or is not completed, the data/information provided during the process will not be used by the DGT during the tax audit process.

Unlike mandatory transfer pricing documentation requirements, an APA is optional. Nevertheless, this voluntary alternative may provide taxpayers with the following advantages:

- An APA provides greater certainty to a taxpayer regarding the transfer pricing treatment of its related party transactions. This is a primary difference from providing the mandatory transfer pricing documentation, which is still subject to challenge by the ITO.
- It is expected that the APA process will be handled by a specific team in the DGT head office, who presumably have better knowledge of transfer pricing issues compared to the local tax office auditors charged with reviewing the taxpayer's transfer pricing documentation during a tax audit.
- The APA process provides an opportunity to discuss these complex tax issues in a less confrontational atmosphere than in a tax audit.

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Luxembourg:
Guidance issued on financing transactions

The Luxembourg tax authorities issued a circular on 28 January 2011 that addresses the tax treatment of intercompany financing transactions.

The circular defines intercompany financing transactions as loans made to associated enterprises refinanced through any type of financial instruments, such as public offerings, cash advances and private and bank loans. The definition of "associated enterprises" follows that in the OECD Model Treaty and includes cases in which an undertaking participates directly or indirectly in the management, control or capital of another undertaking, or when the same persons participate directly or indirectly in the management, control or capital of two undertakings.

Because Luxembourg law includes only general provisions regarding the arm's length principle, the circular confirms that the OECD's Transfer Pricing Guidelines must also be used for the determination of the arm's length spread to be earned on financing transactions.

Application of the arm's length principle to a transaction is based on a comparability analysis that must include the following indicators:

- Characteristics of the property or services;
- Functions performed by the parties;
- Contractual terms;
- Economic circumstances; and
- Business strategies.

This analysis also must take into account assets used and risks assumed. The circular also provides a further clarification of financing company substance requirements. Key criteria are as follows:

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- The majority of directors must be Luxembourg residents;
- Key decisions concerning the entity's management must be taken in Luxembourg;
- The company must have its own bank account in a Luxembourg credit institution or branch of a foreign credit institution; and
- The entity engaged in intragroup financing transactions must own sufficient equity (at least 1% of the nominal value of the credit granted, but without exceeding EUR 2 million) to hedge transaction risks.

Taxpayers may enter into an advance pricing agreement with the Luxembourg tax authorities on a spread; the APA will be binding for a five-year period, with an extension possible if the substantive characteristics of the transaction are unchanged at the end of the first five-year period.

The transfer pricing documentation and economic substance requirements will reinforce the robustness of Luxembourg financing structures and confirm the country's position as a prime location for conducting international business.

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Slovakia: New tax on emissions allowances introduced

Slovakia has introduced a new tax on emission allowances for allowances registered in 2011 and 2012. The tax, which applies as from 1 January 2011, is certain to create challenges for the financial management of companies involved in the assignment and trading of emissions allowances because the tax is imposed regardless of whether allowances are retained or sold.

The tax is imposed on mandatory participants in the trading scheme that carry out activities under the Emissions Allowances Trading Act. Greenhouse gas emissions allowances that are allocated free of charge and registered during 2011 and 2012 are subject to the tax.

The tax base for purposes of the tax is calculated as the amount of emission allowances transferred in the relevant calendar months and the average market prices for the prior calendar month (i.e. the month before the month of the transfer) and the unused allowances in the relevant calendar year multiplied by the average market price for the relevant calendar year. The tax rate is set at 80% of the tax base. The tax on emission allowances is not deductible for corporate income tax purposes.

The taxpayer is required to file a tax return on emission allowances by 30 June after the end of the relevant calendar year and pay advance tax on the estimated tax liability twice a year (by 30 June and 31 December of the relevant calendar year). For 2011, the estimated tax liability is calculated as the sum of multiples of the average market price of the emissions allowances in 2010 and the allocated emissions allowances in 2011 net of the amount of allowances used in 2010. Thus, companies should be prepared to make advance payments of tax in 2011, which will be calculated from the estimated amount of the excess allocation of emissions allowances in 2011 based on consumption in 2010. One option for financing the advance payments is to sell the emissions allowances, but a company opting to do so should first analyze the tax implications.

The tax on emissions allowances leaves open a number of issues that may impact a company's tax liability, such as the calculation of savings achieved as a result of investments in technology that reduces the released emissions (these are considered items that reduce the tax base of unused emissions allowances), what method should be used to write off emissions allowances for purposes of calculating the tax base (i.e. LIFO or FIFO) and the implications of swap transactions. The Ministry of the Environment is expected to issue a decree that addresses the practical application of the emissions tax that hopefully will clarify some of the uncertainties.

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Thailand:
Interest withholding tax exemption repealed for some government bonds

A decree issued on 14 December 2010 (Royal Decree No. 509) repeals the withholding tax exemption on certain interest paid to a foreign company or juristic partnership not carrying on business in Thailand. Interest affected by the decree is that on bonds issued by Thai government enterprises, including differences between the redemption and initial values of bonds (where bonds are issued at a price lower than the redemption value) and gains from the transfer of bonds issued by certain financial institutions established to promote agriculture, commerce and industry. The decree applies retroactively so that the exemption now applies only with respect to bonds acquired before 13 October 2010 that were actually issued or transferred before that date.

Exemptions from withholding tax on the payment of interest provided for under other sections of the tax law are not affected by the decree.

Absent the exemption, interest on such bonds is subject to Thailand withholding tax at a rate of 15%. This rate may be reduced or exempted under Thailand's tax treaties, with most treaties limiting the withholding tax rate on interest (including bond interest) to 10% if paid to a qualified bank or financial institution or providing an exemption for interest paid to qualified government agencies.

Because the decree is retroactive to 13 October 2010, late payment of the withholding tax is subject to interest at a rate of 1.5% per month, but the interest cannot exceed the amount of the withholding tax payable. The Thailand Revenue Department provided relief by extending the withholding tax reporting and filing deadlines to 7 February 2011 for bond interest payments made between 13 October 2010 and 14 December 2010, so that if the withholding tax was paid by 7 February no penalty interest would be applicable. The tax law does allow for a reduction of the penalty interest but this is not normally granted by the tax authorities.

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In brief

European Union – The European Commission has launched a consultation on taxation problems that arise when dividends are distributed across borders to portfolio and individual investors in the EU, which it says can sometimes be discriminatory and can lead to unrelieved double taxation. The deadline for comments is 30 April 2011.

OECD – The OECD has devised a "toolkit" for national tax administrations to help them counter aggressive tax planning by large corporations and wealthy individuals. The OECD defines aggressive tax planning as making tax avoidance transactions that comply with the letter of the law but abuse its spirit. The idea of the toolkit is to help tax administrations identify key risk areas and decide how to respond, by focusing on early disclosure schemes rules.

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