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In this issue:

Need for integrated handling of South African transfer pricing, VAT and customs issues

Many multinational entities approach and manage different types of tax issues in isolation from one another. This segregated approach creates unwarranted and avoidable risks in tax areas that, despite views to the contrary, are interconnected. For example, groups of companies commonly set up subsidiaries in various countries and transact on an intracompany basis in terms of the export and import of goods. Any adjustment made to the margins affecting the price of goods supplied across borders between group companies can impact not only the customs valuation of the imported goods, but also value added taxes (VAT).

While the South African Revenue Service (SARS) historically has taken a segregated approach by auditing only one type of tax, SARS has now expanded its spectrum and is carrying out integrated audits where a specialist of each type of tax is involved in the entire assessment process. Taxpayers also can expect a more challenging environment with enacted changes to SARS' discretion regarding transfer pricing adjustments and changes to further limit the waiver of interest on VAT underpayments.

This article highlights the interconnected nature of transfer pricing, customs valuation and VAT and how management of each area can impact the others.

Areas of overlap

These three tax issues interact in such a way that they do not overlap exactly. For example, VAT applies to almost every type of transaction, whereas the transfer pricing rules only apply to intragroup transactions. Customs duty is generally only relevant to transactions involving goods, whereas the transfer pricing and VAT rules also apply to services.

The potential traps may also lie in different areas. For example, South African customs duty generally does not present an issue for exports of goods, whereas exports represent one of the largest exposure areas from a VAT perspective, in particular because a South African company may incorrectly use the zero VAT rate while falling short for compliance purposes. The application of the zero rate to exports is subject to stringent requirements. In addition, where the documentation requirements are not met within the required time frame, the seller is obliged to declare and pay output tax to SARS.

Notwithstanding these differences, there is a substantial degree of overlap between VAT, customs and transfer pricing, as shown below. Therefore, a coherent risk management strategy must take all three into account. The most significant cause of risk is generally that different personnel in an organization bear responsibility for administering the company's affairs and they make decisions in their own areas without appreciating the associated consequences and risks.

Transfer pricing

Transfer pricing rules apply when there is a cross-border transaction between related parties. When such transactions involve the supply of goods, VAT and customs duty also apply. In practice, transfer pricing tends to be administered differently from the other types of taxation. For example, transfer pricing often operates not by looking at specific transactions but at the overall profitability of a tested entity (which may or may not be the South African group company). Pricing adjustments are frequently made at specific points during the year (e.g. quarterly, semi-annually or at year end) to ensure that the tested entity makes a predetermined gross margin or operating margin.

These adjustments invariably will have both VAT and customs duty implications, so it is critical that all implications of a pricing adjustment be fully considered. An adjustment of the price of imported goods in favor of a South African company often will result in a potential refund for overpaid customs duty. An outbound transfer pricing adjustment payment generally means that the customs duty and VAT paid on importation were understated and must be adjusted. This situation requires careful managing to reduce the risk of penalties and interest on the additional customs duty and VAT payable. Moreover, outbound payments usually require exchange control approval.

The interaction between customs duty and transfer pricing creates anomalies: what is beneficial for transfer pricing purposes is often detrimental from a customs duty perspective, and vice versa. For example, a transfer pricing adjustment in favor of a South African company generally will increase the income tax the company pays in South Africa, while reducing the customs duty payable.

The nature and extent of transfer pricing risk carried by South African taxpayers is set to change with effect from 1 October 2011, when the SARS' discretion to make transfer pricing adjustments will be amended dramatically. As from October, any potential transfer pricing exposure will be automatically triggered at year end and will not be suspended until, and unless, the SARS exercises its discretion. This will result in a fundamental change to the calculation of penalties and interest with respect to transfer pricing adjustments.

VAT

Where the customs value is adjusted to a higher value, the VAT impact may seem inconsequential at first glance because any additional VAT that is payable as a result of the upward adjustment generally will be claimed back. However, the SARS will levy penalties and interest on the underpayment of VAT. Although the seller generally will be able to obtain a waiver of the penalty because it can demonstrate there was no intent to avoid the payment of VAT, the SARS recently introduced new rules relating to the waiver of interest. To be successful in this regard, the seller will have to prove that the underpayment was due to circumstances beyond its control (i.e. circumstances that are external, unforeseeable and unavoidable, or in the nature of an emergency, such as an accident, disaster or illness that resulted in the person being unable to make payment of VAT due).

Where the customs value is adjusted to a value that is lower, there has been a practice not to require a VAT adjustment (i.e. no refund from SARS Customs and no VAT payment through the VAT return) provided the recipient is entitled to claim a full VAT deduction. A refund of the customs duty, however, still may be possible.

Customs

When any adjustment to the value of imported goods is made, it is important to consider the impact on the customs value that was declared to SARS and on which customs duty was paid. The facts of each case must be studied to determine the impact.

In most cases, a transfer pricing adjustment that relates to the value of imported goods will have an impact on the customs value. The problem arising is that the transfer pricing adjustment is normally a one-off adjustment to the collective price of the imported goods (e.g. an adjustment of 10% of the cost of the goods imported). This will increase the cost of sales and, hence, reduce the net profit and income tax payable by that company. On the customs side, additional customs duty and VAT must be paid. This is a challenge because the company will need to attribute the overall adjustment of 10% against the basket of goods imported and adjust each import bill of entry with a voucher of correction. In certain circumstances, SARS will allow for a one-off department bill of entry, but this must be supported by a reconciliation of each import bill of entry.

Conclusion

The above discussion illustrates the need for an integrated approach to mitigate and/or tax risk. The move by SARS towards integrated audits, as well as enacted and proposed legislation, means that all companies need to take into account that a decision relating to one tax may directly impact another – clearly, any decision made based solely on transfer pricing considerations can have a direct negative impact on VAT and customs.

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Austria:
Administrative Supreme Court rules on Real Estate Transfer Tax planning

Austria's Administrative Supreme Court issued a decision on 5 April 2011, concluding that the general anti-avoidance rule can be used to challenge the use of a trustee to avoid the Real Estate Transfer Tax (RETT) on a share transfer.

According to section 1 paragraph 1 of the Real Estate Transfer Tax Act (RETT Act), the transfer of Austrian real estate triggers RETT liability. In general, the RETT is 3.5% of the consideration received in the transfer or, if no consideration is provided or the consideration cannot be determined, the tax base is three times the tax assessed value of the property (which usually is approximately 10%-20% of the fair market value, but is determined on a case-by-case basis). Under paragraph 3 of section 1, RETT also is triggered on the transfer of shares in a company that holds Austrian real estate if all of the shares in the company are in the hands of a single shareholder (or held by several shareholders that meet the criteria for forming a VAT group). In that case, RETT is 3.5% of three times the tax assessed value of the real estate held by the company.

Until the April 2011 decision of the Administrative Supreme Court, paragraph 3 was interpreted to mean that RETT liability would be triggered only if 100% of the shares were legally pooled in the hands of a single shareholder (or VAT group) because the Court used a form-over-substance approach when applying the provision. Thus, in practice RETT often could be avoided by using a trustee to hold an insignificant share; in other words, a minority share was not transferred to the purchaser but remained in the hands of the seller or a third party acting as a trustee for the purchaser.

In a decision dated 25 June 2010, the Court of Appeal of Innsbruck held that the "trustee solution" to avoid RETT on a share transfer constituted an abuse of the law because the sole purpose of the structure was to avoid the tax. The case involved an individual that held all of the shares in an Austrian GmbH that held Austrian real estate. The individual transferred 25% of his shares in the GmbH to his son and, two years later, transferred 74% of the shares to the son, but kept the remaining 1% in trust for the son. The father and son entered into a sale and purchase agreement on the 74% share transfer and into a trustee and sale and purchase agreement on the 1% share transfer on the same date. The Administrative Supreme Court has now confirmed the conclusion reached by the Court of Appeal.

Although the Administrative Supreme Court reconfirmed its position that, in general, only a legal pooling of all of the shares in the hands of a single shareholder triggers RETT, even if a minority share is held by a trustee, the court agreed with the Court of Appeal that the trustee solution could be challenged under the general anti-abuse rule on a case-by-case basis if there are no justifiable business reasons, other than tax planning, for the use of the trustee structure.

It is now possible that the Austrian tax authorities might mount an anti-abuse challenge on the use of a trustee in share transfers. The Ministry of Finance is expected to respond to the decision, but, until that time, a trustee should not be used in a share transfer if no valid business reasons for the structure can be demonstrated.

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European Union:
AG considers German Trade Tax rules on add-back of interest payments compatible with IRD

European Court of Justice (ECJ) Advocate General Sharpston issued her opinion in the *Scheuten Solar Technology* case on 12 May 2011, recommending that the ECJ rule that the (old) rules on interest add-back in the Trade Tax Act are compatible with the EU Interest and Royalties Directive (IRD). The IRD provides for a source-state tax exemption for interest and royalty payments in certain intragroup situations, regardless of whether tax is levied by way of assessment or withholding. The main issue in *Scheuten Solar Technology* is whether a German rule that limited the deductibility of interest payments is in line with the IRD. AG Sharpston opined that it was permissible to limit the deductions. The German Federal Tax Court (BFH) had requested a preliminary ruling from the ECJ in 2009.

Scheuten Solar Technology, a German company, obtained a loan from its Dutch parent company, which qualified as a long-term loan. Under the rules governing the determination of the trade tax base in the year at issue, 50% of the interest payments on long-term loans had to be added back to the trade tax base of the debtor (i.e. were treated as nondeductible). Scheuten Solar Technology brought the case to court, arguing that an increase of its trade tax base due to the interest payment to its direct EU parent is not in line with the IRD because the tax burden resulting from the increase in the tax base constitutes taxation of the interest payment, which is prohibited by the IRD.

AG Sharpston disagreed with the company, concluding that the limit on the deductibility of interest under the trade tax rules is compatible with the IRD. In her view, the IRD only applies to tax imposed on the interest payment itself. Rules governing the determination of the debtor’s tax base, such as the trade tax add-back rules, do not fall within the scope of the IRD.

If the ECJ does not follow AG Sharpston’s opinion and instead rules in favor of Scheuten Solar Technology, the consequences could be far-reaching, potentially affecting the interest deduction limitation rules in various EU Member States. Although the trade tax rules have since been amended, the case will continue to be relevant for post-amendment years because a portion of the interest expense still gives rise to an increase in the trade tax base of a debtor.

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Germany:
Draft guidance issued on reorganizations under Reorganization Tax Act

The German tax authorities issued 177 pages of draft guidance on 2 May 2011 in which they comment on issues related to the taxation of reorganizations in the context of the 2006 reform of the Reorganization Tax Act. The changes in the Act were aimed primarily at facilitating new possibilities for cross-border reorganizations (mergers, spin-offs, split-offs and hive-downs). The draft guidance also addresses situations that were common practice even before the 2006 reform. Only a few of the positions taken by the tax authorities in the draft guidance would benefit taxpayers.

Reorganizations at book value for tax purposes and at fair market value (FMV) for GAAP purposes

Under the Reorganization Tax Act, reorganizations generally are possible on a no gain/no loss basis if certain conditions are satisfied. The wording of the Act allows for a tax neutral rollover even in situations in which assets are stepped up to FMV for German GAAP purposes. In the past, the tax authorities have attempted to limit this planning tool by arguing that, although the difference in the valuation in the GAAP and the tax balance sheets may be permissible on the date the reorganization becomes effective, that difference is not allowed on the following balance sheet date because the German GAAP accounts form the basis for the tax balance sheet, unless specifically stated otherwise. This position would effectively lead to a taxable profit in the year following the year of the reorganization.

The draft guidance now confirms the taxpayers' view: a tax neutral rollover would be available in the year of the reorganization and in subsequent years even if the assets are stepped up to the FMV for GAAP purposes in the course of the reorganization.

Definition of branch of activity (as prerequisite for tax neutral reorganizations)

Spin-offs, split-offs and hive-downs are tax neutral only if the transferred assets at least have the quality of a branch of activity. The draft guidance generally uses the same definition of a branch of activity as is found in the EU Merger Directive.

The tax treatment of "neutral" assets, i.e. assets that are not essential for the business (such as liabilities, certain accruals and other assets) is not entirely clear. The guidance includes specific rules for spin-offs that may limit a taxpayer's options when allocating such assets in these transactions. It is not entirely clear whether similar restrictions would apply for hive-downs, because the guidance does not make a specific reference to the tax treatment of "neutral assets" in the section on hive-downs.

In line with previous guidance and jurisprudence, all assets that are necessary to continue the transferred business will have to be legally owned by the entity to which the branch of activity is transferred in the reorganization. The "possibility" to use the assets would not be considered sufficient (e.g. under rental agreements).

In contrast to previous practice, the branch of activity would need to be in existence on the tax effective date; a branch of activity that is "under construction" would no longer be sufficient.

Downstream merger with nonresident shareholders

Under the 2006 reorganization tax rules, downstream mergers generally are possible on a no gain/no loss basis. Whether such a downstream merger would be possible in a tax neutral way if the parent company had nonresident shareholders has been controversial since the Reorganization Tax Act was amended.

When acquiring a German target entity, foreign acquirers frequently use a German company that is subsequently merged downstream (e.g. to push down the acquisition financing). According to the draft guidance, the shares in the German target entity could not be transferred at book value to the foreign acquirer following the downstream merger (thus, a transfer at FMV would be deemed to take place, which may lead to a fully taxable or a 95% tax-exempt capital gain if the FMV of the shares in the subsidiary exceeds their book value.

The tax authorities do not comment on the tax treatment of situations in which, after the merger, the liabilities exceed the receiving subsidiaries' equity, which also is a controversial issue.

Holding periods for shares received in tax neutral contribution of branch of activity

A seven-year holding period generally applies for new shares received in a contribution of a branch of activity at below FMV. Any sale of the shares received should lead to retroactive taxation of the capital gain deferred upon contribution, with the taxable gain reduced by 1/7 each year. Because the law does not mention certain types of reorganizations as permitted transfers, even if made at book value, the tax authorities have included further guidance as to which reorganizations can trigger a harmful retroactive taxation of built-in gains and which transactions should not be harmful.

According to the draft, a reorganization at book value would not be harmful for the parties involved if:

- The capital gain derived from the contribution, in principle, remains subject to tax;
- No built-in gains are shifted to the shares of a third party;
- Germany's right to tax will not be restricted; and
- The taxpayer agrees that the new shares also will be subject to the same restrictions as the shares received in the first reorganization.

The following transactions would always be considered harmful and would lead to retroactive taxation of capital gains:

- A merger of the receiving company back into the parent company that made the contribution (because the shares received will be eliminated); and
- A reorganization into a partnership or a contribution into a partnership.

Under these rules, a distribution that is sourced out of the capital contribution account for tax purposes could be considered a harmful event and could trigger a retroactively taxable capital gain of the original contribution. Under the wording of the draft guidance, it would not be decisive whether the capital contribution account was created in the reorganization or whether it previously existed. A retroactively taxable capital gain would be presumed to the extent the distribution out of the capital contribution account exceeds the book value of the shares received in the reorganization.

Tax groups and reorganizations

One of the requirements to establish a German tax group is that the parent company holds the majority of the voting rights in the subsidiary ("financial integration") from the beginning of the subsidiary's fiscal year.

In cases where the parent is reorganized and the participation in the subsidiary transferred to the legal successor of the parent, it has been unclear whether the tax group could be continued without interruption.

The draft guidance takes the position that the tax group could be continued without interruption only if the subsidiary in the group was financially integrated into the transferring entity before the reorganization and (under the retroactivity principle for tax purposes) the shares in the subsidiary were deemed to be owned by the receiving entity (i.e. the new parent) from the beginning of the subsidiary's fiscal year. A tax group could not be formed from the (retroactive) tax effective date of the reorganization where the financial integration is made possible only by the reorganization (even if the reorganization has retroactive effect to the beginning of the subsidiary's fiscal year).

Given that share-for-share exchanges are generally no longer possible with retroactive effect under the 2006 rules, a retroactive formation of a tax group will not be possible in these situations.

The draft guidance also includes rules on the tax treatment of mergers into entities that are controlled entities of a tax group. Under the guidance, there may be adverse tax consequences where a merger is carried out at book value for tax purposes and at FMV for GAAP purposes, or if the effective dates for GAAP and tax purposes fall into different years (which is usually the case for mergers carried out by calendar year taxpayers with a tax effect as of 31 December), because deemed distributions (subject to the 5% inclusion and dividend withholding tax) may arise.

According to the draft guidance, the guidance would apply to all cases not yet finally assessed. However, since the guidance is still in draft form and may be subject to change, no reliance should be placed on it. Final rules are anticipated to be released by September 2011.

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Thailand:
Tax incentives granted to International Procurement Centers

The Thai government issued Royal Decree No. 518 on 4 May 2011 to provide tax benefits for income earned by an International Procurement Center (IPC).

An IPC is a company incorporated under Thai law to carry on the business of procuring goods, raw materials and spare parts for resale to an associated enterprise. An associated enterprise for these purposes is a company or juristic partnership: (1) that holds shares representing 25% or more of the total capital of the IPC; (2) respectively, that has shares representing 25% or more of its total capital or 25% held by the IPC or in which the IPC has a partnership interest of 25% or more; (3) that, respectively, holds shares representing 25% or more of the capital of a company referred to in (1) or has a 25% or more partnership interest in a juristic partnership referred to in (1); (4) that has controlling power over or supervision of the business operation and management of the IPC; (5) over which the IPC has controlling power or of whose business operation and management the IPC has supervision; or (6) that has controlling power over or supervision of the business operation and management of a company or juristic partnership referred to in (4).

The following incentives are available to an IPC:

- A reduced corporate income tax rate of 15% (rather than the normal 30% rate) for five consecutive accounting periods for procurement revenue that is: (i) income earned from goods purchased in foreign countries that are resold to associated enterprises in foreign countries without the goods being physically imported into Thailand; and (ii) income from procuring raw materials or parts purchased in or outside Thailand that are resold to associated enterprises in foreign countries for production in foreign countries; and
- A reduced personal income tax rate of 15% (the normal progressive rate is 5% to 37%) for employment income paid by an IPC to no more than three expatriates working in Thailand, provided the IPC meets qualifying criteria. The reduced rate for expatriates will be disallowed retroactively if the procurement revenue earned by the IPC is less than 50% of the total revenue from the procurement under (i) and (ii) above, including revenue from the purchase of goods in or outside of Thailand that are subsequently resold to an associated enterprise in Thailand.

To qualify for the tax benefits, an IPC must meet the following criteria:

- Have paid-up registered capital of at least THB 10 million on the last day of each accounting period;
- Have incurred either (i) operating expenses paid to a Thai recipient of at least THB 15 million in each accounting period (excluding depreciation expense, overseas operating expenses, cost of goods purchased, raw materials or parts, costs of goodwill, copyrights or other rights, etc.); or (ii) capital expenditure paid to a Thai recipient of at least THB 30 million in each accounting period, excluding any investment in securities according to the Securities and Stock Exchange Law;
- Have an associated enterprise that carries on business in accordance with its objectives and that has executives and employees actually working in the enterprise as notified to the Revenue Department;
- Have skilled employees that have a minimum knowledge and who carry out work in the IPC in accordance with the notification of the Director General of Revenue; and
- Have, by the third accounting period, revenue of at least THB 1 billion for each accounting period and have at least three employees who receive a salary of at least THB 2.5 million per person per year.

The IPC must register its status as such with the tax authorities within two years from the date the Director General of Revenue allows registration.

If an IPC fails to meet the registered capital or operating expense criteria in any accounting period, the reduced corporate income tax rate will be disallowed retroactively as from the first accounting period the entity attained IPC status.

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In brief

Israel – The Finance Committee of the Parliament has announced that the planned reduction of the corporate income tax rate from the current rate of 24% to 18% in 2016 will be postponed (with the time period still to be determined).

United States – The Financial Crimes Enforcement Network (FinCEN) released Notice 2011-1 on 31 May 2011, providing a one-year filing extension to the 30 June 2011 foreign bank account reporting (FBAR) filing deadline for certain individuals. The extension applies to (1) an employee or officer of a "regulated entity" who has signature or other authority over, and no financial interest in, a foreign financial account of another entity (a "controlled person") more than 50% owned, directly or indirectly, by the regulated entity; and (2) an employee or officer of a controlled person with signature or other authority over, and no financial interest in, a foreign financial account of the regulated entity or another controlled person of the regulated entity.

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United States
IRS issues final "Killer B" regulations under §367(b)
The tax authorities have issued final regulations under §367(b) addressing cross-border triangular reorganizations popularly known as "Killer B" transactions. The regulations finalize with certain modifications proposed and temporary regulations issued in 2008. [Issued: 31 May 2011]
URL: http://www.deloitte.com/view/en_GX/global/services/tax/international-tax/689bc57783740310VgnVCM2000001b56f00aRCRD.htm?id=us_email_Tax_WTA_060311
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