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In this issue:

Italy offers election to reduce capital gains on nonresidents' sale of unlisted participations

Legislation has been enacted to allow taxpayers not engaged in Italian business or entrepreneurial activities (e.g. nonresidents without an Italian permanent establishment) to elect a step-up in the tax basis of participations held in unlisted Italian companies. The election, which is an extension of prior step-up provisions, may be exercised only for participations in unlisted Italian companies held on 1 July 2011.

The step-up will be achieved by paying a reduced "substitute tax" of 4% (for qualifying participations) or 2% (for non-qualifying participations) up to the fair market value of the participation on the basis of a valuation appraisal made by an Italian expert by 30 June 2012. The step-up also may be partial, on a value lower than the fair market value of the participation. The new tax basis (up to the fair market value) will be recognized immediately and will reduce the gain on the sale of the participation.

An election to step-up the tax basis will provide foreign shareholders with an arbitrage opportunity with respect to taxable gains derived from:

- Participations in real estate companies, which often are not protected by tax treaties;
- Participations exceeding certain percentages, which also may fall outside the scope of treaty protection; and
- Any participation where the seller is not entitled to treaty benefits (as may be the case with hedge funds and other investment vehicles).

Background

Under Italian law, gain is calculated as the difference between the sale price and the tax base of the participation (generally the price paid at the time of the initial purchase of the shares). Capital gains derived by a nonresident from the sale of a participation held in an unlisted Italian company are taxed as follows:

- **Qualifying participation** – If the participation exceeds 20% of the voting rights or 25% of the capital or profit rights (a "qualifying participation"), 49.72% of the gain is subject to the 27.5% ordinary corporate income tax rate, resulting in an effective rate of 13.67% on the entire gain;
- **Non-qualifying participation (non-white-list country)** – If the participation is less than 20% of the voting rights or 25% of the capital or profit rights (a "non-qualifying participation") and the seller is not resident in a country on Italy's white list (i.e. the list of countries to which certain income can be paid free from Italian withholding tax), the entire gain is subject to a 12.5% substitute tax; and
- **Non-qualifying participation (white-list country)** – If the participation is a non-qualifying participation and the seller is resident in a white-list country, the entire gain is exempt.

A gain also is not subject to tax in Italy if the nonresident seller is entitled to claim an exemption under a tax treaty between Italy and the seller's country of residence because tax treaty provisions will apply if they are more favorable to a taxpayer than domestic rules.

Article 13 of the OECD Model Treaty provides that, if a foreign seller does not have a permanent establishment in the source country to which the sold participation is related, the gain generally is taxable only in the country where the seller is resident. Nevertheless, many of Italy's treaties do not prevent the source country from taxing gains from the sale of participations that meet specific requirements, such as participations exceeding a certain percentage (e.g. participations exceeding 25% in the Italy-France treaty and those exceeding 10% in the Italy-Israel treaty) and participations in real estate companies (e.g. in Italy's treaties with Canada, France, Israel and the U.S.).

Step-up provision

Under the new provisions, the substitute tax will be computed by applying a 4% rate to the fair market value of qualified participations and a 2% rate to the fair market value of non-qualifying participations. The substitute tax must be paid in a single installment by 30 June 2012 or in three equal annual installments (with a 3% interest charge levied on the second and third installments). The foreign shareholder also must file a tax return in Italy.

The fair market value of the participation must be based on a valuation appraisal made (and officially sworn) by an Italian CPA/auditor by 30 June 2012. The Italian appraiser can be appointed by the Italian company or the foreign shareholder. If the appraiser is appointed by the Italian company, the cost of the appraisal is deductible from the Italian company's taxable base over a five-year period; if the appraiser is appointed by the foreign shareholder, the cost of the appraisal will increase the shareholder's participation tax basis.

The new tax basis will be recognized immediately. No claw-back mechanism will apply and the participation can be sold any time after 1 July 2011, even before the date of the appraisal and before the substitute tax is paid.

Opportunity for foreign shareholders

The election for the step-up in the tax basis of participations held in unlisted Italian companies provides foreign shareholders with an arbitrage opportunity with respect to taxable gains that are expected to be realized (or that have been realized) after 1 July 2011 from the sale of such participations.

If the participation is a qualifying participation, the calculation of the benefit is as follows:

Tax base before election	100
Appraised FMV	1,000
Substitute tax	4% x 1,000 = 40
Sales price	1,000
Gain without election	1,000 - 100 = 900
Income tax on gain	13.6% x 900 = 122.4
Gain with election	0
Income tax on gain	0
Tax saving with election	122.4 - 40 = 82.4

If the participation is a non-qualifying participation, the benefit is calculated as follows:

Tax base before election	100
Appraised FMV	1,000
Substitute tax	2% x 1,000 = 20
Sales price	1,000
Gain without election	1,000 - 100 = 900
Income tax on gain	12.5% x 900 = 112.5
Gain with election	0
Income tax on gain	0
Tax saving with election	112.5 - 20 = 92.5

Comments

The appraisal of the participation must be completed and the substitute tax paid (in full or at least a first installment) by 30 June 2012. All nonresidents owning participations in unlisted Italian companies as of 1 July 2011 should immediately determine whether a tax treaty is applicable to exclude any liability to Italian tax on potential capital gains. If a capital gain is anticipated and the Italian tax liability is not excluded by a tax treaty (e.g. the seller is not entitled to treaty protection or the participation sold gives rise to a gain not covered by the treaty), the election for the tax base step-up should be considered.

— Stefano Schiavello (New York)
Client Service Executive
Deloitte Tax LLP
stschiavello@deloitte.com

Olderigo Fantacci (New York)
Client Service Executive
Deloitte Tax LLP
ofantacci@deloitte.com

European Union:
ECJ considers OCTs third countries for free movement of capital purposes

The European Court of Justice (ECJ) issued a decision on 5 May 2011 upholding a French real property tax that exempts companies having their effective management either in France or an EU Member State, but requires those situated in a non-Member State to pay the tax, unless there is a treaty or convention on administrative assistance to combat fraud and evasion (*Prunus*). In its decision, the ECJ also ruled that an Overseas Territory (OCT) of an EU Member State qualifies as a "third country" for purposes of the application of the free movement of capital principle.

Prunus, a French resident company, directly and indirectly held immovable property in France. Prunus was directly held by a Luxembourg company that was held by two companies resident in the British Virgin Islands, an OCT of the U.K. Under French law, every company directly or indirectly holding French immovable property is subject to a 3% levy on the market value of the property. Companies resident in France or in countries that had concluded a treaty with France on administrative assistance in the field of tax fraud and evasion, however, were exempt from the 3% levy. For EU situations, the ECJ already determined that the French legislation was incompatible with the free movement of capital, so that the tax exemption should be extended to companies resident in other EU/EEA Member States that directly or indirectly hold immovable property in France.

In *Prunus*, the ECJ was requested to determine whether the exemption from the 3% levy would be applicable to a company resident in an OCT. France does not have an administrative assistance treaty with the BVI. According to *Prunus*, the free movement of capital prohibits all restrictions on capital movements between EU Member States and in relation between a Member State and a third country.

The ECJ concluded that an OCT, such as the BVI, would qualify as a third country under the free movement of capital since it cannot be considered a Member State and the Treaty on the Functioning of the EU does not provide any specific arrangements relating to the free movement of capital between Member States and an OCT. Thus, the denial of the tax exemption in relation to the BVI company, in principle, constitutes a restriction on the free movement of capital. However, because the French tax exemption entered into force on 1 January 1993, the standstill provision under the free movement of capital principle applies. Under that provision, a restriction in relation to the free movement of capital concerning third countries can be upheld if it already existed on 31 December 1993. As a consequence, the French tax exemption is not extended to an OCT directly or indirectly holding French immovable property.

The *Prunus* decision is significant in that it is the first case in which the ECJ has specifically held that an OCT qualifies as a third country for purposes of the application of the free movement of capital. One issue that does remain, however, is whether the free movement of capital would apply in relation to an OCT and its parent country (e.g. the U.K. and the BVI) or whether that situation would qualify as internal.

— Hans van den Hurk (Eindhoven)
Partner
Deloitte Netherlands
hvandenhurk@deloitte.nl

Jasper Korving (Eindhoven)
Manager
Deloitte Netherlands
jkorving@deloitte.nl

India:
AAR rules on taxability of communications management services

The Indian Authority for Advance Rulings (AAR) held on 16 May 2011 that a payment made by an Indian company to an associated U.K. resident company for communications management services provided by the U.K. company is not in the nature of fees for technical services (FTS) under the India-U.K. tax treaty and, therefore, is not chargeable to tax in India (*R. R. Donnelley India Outsource Private Limited (RRD India)*). This ruling is the latest in a string of taxpayer favorable rulings on the restricted definition of FTS under some of India's tax treaties.

The scope of FTS under India's domestic law is broad, with FTS defined to mean consideration for the provision of any managerial, technical or consultancy services, as well as consideration for the provision of services of technical or other personnel. In contrast, some of India's tax treaties (including the treaties with the U.K. and the U.S.) provide for a truncated definition of FTS, such that FTS is defined to include payments for technical or consultancy services that "make available" technical knowledge, experience, skill, etc., or consist of the development and transfer of a technical plan or design. To the extent services do not fall within the scope of FTS under such treaties, they can escape tax in India provided the nonresident does not have a permanent establishment (PE) in India. The issue as to whether services fall under the FTS clause has been the subject of considerable litigation.

The case involves RRD India (applicant), which provides a range of services in the field of print management, data capture and processing services, as well as high-end support services to customers identified by its associated concerns. RRD India entered into a data capturing and processing contract with a U.K. bank, and, in connection with the contract, RRD India concluded a Data Processing Services agreement with its U.K. affiliate (RRD UK) to scan and send the relevant data to India. RRD UK was to provide the following services: routine data entry, application sorting, document handling and data capturing, such as sorting the hardcopy applications received from the client, forwarding scanned images of the applications in batches to RRD India for further processing and thereafter loading the completed information onto CDs to be sent to clients.

RRD India requested a ruling from the AAR on whether the amount received by RRD UK under the service agreement is taxable as FTS under the Indian Income tax Act, 1961 (ITA) and the India-U.K. tax treaty. RRD India also asked the AAR to rule on whether, in the absence of a PE of RRD UK in India, such income would be taxable in India and whether RRD India was required to withhold tax under the ITA on the remittances to RRD UK.

RRD India took the position that the payment to RRD UK is not taxable under the treaty because no technology was transferred, nor were know-how or skills "made available" by RRD UK to the Indian company. It also was contended that the services were not taxable as FTS under the ITA because they were routine data processing services, not technical services. While the Indian tax authorities admitted that RRD UK did not have a PE in India because none of RRD UK's personnel visiting India stayed in the country for more than 30 days, the authorities did argue that, regardless of whether there was a PE, the services were taxable as managerial and technical services based on the amended source rule. India's domestic source rule was amended by Finance Act 2010 (applying retroactively as from 1 June 1976) to provide that specified income earned by nonresidents will be deemed to accrue or arise in India regardless of whether the nonresident has rendered services in India.

The AAR agreed with RRD India and held that there is no transfer of technology, skill or technical know-how by RRD UK, so the payment was not taxable under the treaty. The AAR observed that, had there been a transfer of technology in this case, the very purpose of entering into the services agreement would be defeated. In reaching this conclusion, the AAR relied on earlier rulings (e.g. *Invensys Systems Inc.* and *Intertek Testing Services*) in which the AAR held that services will be considered to "make available" technology if they result in transmitting technical knowledge, skills, etc., so that the service recipient can utilize the knowledge in future on its own without the assistance of the service provider. The AAR further concluded that the services to be rendered by RRD UK cannot be said to be technical, managerial or consultancy services within the definition of FTS under the ITA. Finally, the AAR referred to the Indian Supreme Court's decision in the case of *Ishikawajima-Harima Heavy Industries Ltd.* for the proposition that services rendered outside India will not be taxable in India.

Consequently, the AAR held that the amount received by RRD UK would not be liable to tax in India under the India-U.K. treaty or under the ITA and, therefore, there was no requirement for tax to be withheld on the remittance to be made to RRD UK. Interestingly, the AAR referred to one aspect of the *Ishikawajima* decision that was nullified by India's retroactive amendment to the source rule. Specifically, the Supreme Court ruled that the services must be rendered in India to be taxable in India. The retroactively amended source rule, however, provides that income of a nonresident is deemed to accrue or arise in India regardless of whether the nonresident rendered services in India. Therefore, the Supreme Court ruling is no longer good law in that respect. The AAR nevertheless referred to the Supreme Court ruling for the proposition that services rendered outside India will not be taxable in India.

— Rajesh H. Gandhi (New York)
Client Service Executive
Deloitte Tax LLP
rajegandhi@deloitte.com

Smita Parulkar (New York)
Senior Manager
Deloitte Tax LLP
sparulkar@deloitte.com

India:
One step closer to GST

A constitutional amendment bill has been introduced into the Indian Parliament to help prepare for the introduction of the Goods and Services Tax (GST), specifically to include provisions relating to GST. The major proposals are as follows:

- Consolidate various central and state indirect taxes and levies into GST;
- Levy integrated GST on interstate transactions;
- Confer simultaneous power upon the Parliament and state legislatures to make laws governing GST;
- Create a GST Council to examine issues relating to GST and make recommendations to the Union and states on rates, exemptions and other parameters;
- Set up a GST Dispute Settlement Authority to adjudicate disputes or complaints referred by a state government or the government of India;
- Permit the local municipalities and Panchayats to levy and collect tax on the entry of goods in a local area; and
- Include all goods within the purview of GST (other than crude petroleum, diesel, petrol, aviation turbine fuel, natural gas and alcohol for human consumption) and empower the states to levy tax on the intrastate sale of such goods.

— Prashant Deshpande (Mumbai)
Senior Director
Deloitte Haskins & Sells
pdeshpande@deloitte.com

Malaysia:
Authorities issue guidance on residence status of companies and bodies of persons

The Malaysian Inland Revenue Board issued Public Ruling No. 5/2011 on 16 May 2011 on the determination of the residence status of companies and bodies of persons carrying on a business or a non-business activity in Malaysia. The ruling, which sets out the interpretation of the Director General of Inland Revenue in respect of the tax law, and the policy and procedure that are to be applied, is effective as from year of assessment 2011.

In addition to explaining the differences in tax treatment of a resident and a nonresident company and body of persons and the interaction of the residence rule with the dual residence article in Malaysia's tax treaties, the ruling addresses the following:

Carrying on a business

A company or body of persons carrying on a trade or business is resident in Malaysia for a basis year for a year of assessment if at any time in that basis year the management and control of its business is exercised in Malaysia. If it carries on several businesses, the management and control of one of its businesses should be exercised in Malaysia.

The term "management and control" is used in referring to the controlling authority which determines the policies that are to be followed by the company. Management and control is exercised at the place where the directors meet to conduct the company's business/affairs. If one of several meetings of the board of directors of the company is held in Malaysia and that meeting concerns the management and control of the company, the company is resident in Malaysia in that basis year.

Where management and control are exercised outside Malaysia, but certain director's meetings are held within the country, the following documentation may be required to determine the company's residence status:

- Articles and memorandum of association to ascertain where the company is registered and whether the articles contain any provisions regarding residence;
- If the articles do give a place of management and control, whether they are being implemented;
- The company's letterhead;
- Minutes of the meetings that indicate where the meetings were held and what decisions relating to management and control were taken; and
- Minutes of general meetings that show where such meetings have been held and what transpired.

Other company or body of persons

Any other company or body of persons is resident in Malaysia for the basis year for a year of assessment if the management and control of its affairs are exercised in Malaysia by its directors or other controlling authority such as a board of management.

Subsidiary or branch of a foreign corporation

The residence status of a Malaysian-incorporated subsidiary of a foreign corporation will be determined in accordance with the above paragraphs. However, a branch of a foreign corporation is generally treated as a nonresident in Malaysia unless it can be established that the management and control of its business/affairs is exercised in Malaysia.

Residence status of trust bodies

A trust body is resident in Malaysia for the basis year for a year of assessment if any trustee of the trust is resident in that basis year. However, that trust body will not be regarded as a resident if:

- The trust was created outside Malaysia by a person who was not a Malaysian;
- The income of the trust body is wholly derived from outside Malaysia;
- The trust is administered for the whole basis year outside Malaysia; and
- At least one-half of the trustees are not resident in Malaysia.

— Tham Lih Jiun (Kuala Lumpur)
Executive Director
Deloitte Malaysia
ljtham@deloitte.com

Joseph Teoh (Kuala Lumpur)
Manager
Deloitte Malaysia
jhmteoh@deloitte.com

Saudi Arabia: System-based tax and customs audits on the rise

Over the last few years, we have seen a pattern developing in that the Saudi Arabian tax authorities have adopted a new inspection methodology, whereby import purchases disclosed in the tax return are compared with data contained in the Saudi Arabian customs authorities' customs database. The tax authorities will seek to penalize taxpayers, through additional tax liability, where differences are noted.

Thus far, it appears that the quality of the databases and the information they contain may not be complete and reliable, which makes effective inspections based on this methodology difficult. In several cases, information from the database did not correspond to the supporting documentation presented by the taxpayers. However, from a customs perspective, once the databases are fine-tuned and procedures are up to speed, it is likely that the above "data matching" may lead to an increased potential for uncovering customs infringements, such as in cases where companies (partially) avoid customs duties by under-valuing goods at the time of their importation.

For compliance purposes, it is advisable for Saudi Arabian companies to obtain printouts of their import declarations on a regular basis, and reconcile these to their books and records before finalizing their corporate tax returns. This might require close cooperation with customs brokers by those companies that make use of their services.

— Justin Whitehouse (Dubai)
Managing Director
Deloitte United Arab Emirates
jmwhitehouse@deloitte.com

Daan de Vlieger (Dubai)
Associate
Deloitte United Arab Emirates
ddevlieger@deloitte.com

In brief

European Union – The European Court of Justice (ECJ) has issued its decision in a case involving the VAT treatment of goods supplied between connected parties at less than market value and Spain's failure to obtain a derogation for its treatment of the supplies (*Campsa Estaciones de Servicio S.A.*). The case specifically concerned the valuation for VAT purposes of a sale of a chain of service stations in Spain. The sale was between connected persons and the Spanish tax authorities wanted to base the VAT accounting on an amount higher than that passing between the parties, alleging that the price paid was below market value. Since there was no derogation allowing Spain to adopt an "open market" valuation at the time the transaction took place, the Spanish authorities argued that the rules on the application of goods and services to private use permitted the adoption of a higher amount. The ECJ disagreed and held that the general rule on the value of a supply for VAT purposes – the price paid – had to be applied. Under the current VAT Directive, EU Member States are permitted to adopt measures applying "open market value" in situations such as that in question, but must inform the EU VAT Committee of such national legislative provisions. A failure to do so is likely to render such laws ineffective.

OECD – The OECD released its Multi-Country Analysis of Existing Transfer Pricing Simplification Measures on 10 June 2011 as part of a project launched in 2010 on the administrative aspects of transfer pricing. The Analysis presents the main findings from 33 OECD and non-OECD countries concerning their existing domestic law measures to simplify the application of their transfer pricing rules, to include safe harbors, less stringent documentation requirements, alleviated penalties and streamlined procedures. The OECD states the survey will help inform the Committee on Fiscal Affairs as it works to improve transfer pricing administration, to include revisiting the existing OECD guidance on safe harbors and analyzing the advantages and disadvantages of various forms of transfer pricing administrative simplification. Comments may be submitted to the OECD before 30 June 2011.

United Kingdom – On 10 June 2011, the government published new consultation documents on the Patent Box and Research and Development (R&D) tax credits. The patent box will apply a 10% corporation tax rate to profits attributed to patents as from April 2013. This consultation, which builds on the initial review, consults on detailed proposals for implementation of the patent box, and provides more information about which patents and associated intellectual property types and which income will be eligible. The consultation will run for 12 weeks and close on 2 September 2011.

United Kingdom – The latest version of the U.K. tax authorities' (HMRC) internal Business Income Manual (intended for its own officers but also available publically) contains guidance on the direct tax treatment of VAT refunds, and the interest payments that are sometimes associated with them. HMRC's position, almost without exception, is that such refunds will be subject to income/corporation tax and that interest always will be taxable. This is an area where there has been a great deal of uncertainty and while the manual sets out HMRC's view, affected taxpayers should consult with their advisors.

United States – The Internal Revenue Service released temporary regulations 9 June 2011 that remove the duplicate filing requirement for Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. The form addresses certain transactions with related parties and, under the duplicate filing requirement, affected entities were required to file the form (1) with their annual income tax return (or at the service center where the return would be due in the case of untimely returns), and (2) separately with the Internal Revenue Service Center in Philadelphia.

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Susan Lyons, Director	**-or-**	**Connie Angle**
Washington International Tax Services		**Washington International Tax Services**
Deloitte Tax LLP		**Deloitte Tax LLP**
slyons@deloitte.com		**cangle@deloitte.com**