Deloitte.

International Tax

World Tax Advisor

14 September 2012

In this issue:

Choosing a gateway into Africa: Comparison of South Africa's headquarter company regime with the Mauritius Global Business License Category 1 Company regime

With Africa's abundant natural resources and population of nearly one billion, multinational companies have a growing recognition that expanding into the continent is a key driver for shareholder value. Traditionally, companies have widely accepted the Mauritius Global Business License Category 1 company (GBL1) regime as the standard investment route into Africa. However, despite the status of the GBL1, South Africa maintains one of the most extensive tax treaty networks with African jurisdictions and generally has been considered a desirable investment jurisdiction in its own right. Moreover, the steps South Africa has taken in recent years to establish itself as the "gateway into Africa" – particularly the introduction of its international headquarter company (HQC) regime – provide investors with an opportunity to re-evaluate their African investment routes.

This article examines South Africa's efforts and compares its HQC regime to the GBL1 company regime offered by Mauritius.

Background

South Africa introduced the HQC regime in 2010 to attract multinational companies wishing to invest in Africa. The regime, which applies as from 1 January 2011, is designed to eliminate fiscal and other regulatory barriers that have discouraged foreign investors from using South Africa as a holding company location and to allow South Africa to be more competitive with other established holding company/headquarter company jurisdictions. An HQC is subject to South African corporate income tax (currently 28%), but is exempt from the dividend tax and capital gains tax (in the latter case, provided certain requirements are met). It is excluded from the scope of South Africa's controlled foreign company (CFC) and thin capitalization rules, and, as a resident South African company, is entitled to benefit from the country's broad tax treaty network. An HQC also is entitled to various relaxations of South Africa's exchange control regulations.

In 2011, South Africa was admitted to the renamed "BRICS" association of leading emerging economies, joining the "BRIC" countries of Brazil, Russia, India and China. As a BRICS member, South Africa will represent its own interests and act as a proxy for the African continent.

Comparison of requirements under HQC and GBL1 regimes

The tests for qualification for HQC status under the South African regime include:

- Residence test – The company must be resident for tax purposes in South Africa;
- Shareholding test – Each shareholder (alone or together with another company that is part of the same group of companies) must hold at least 10% of the equity shares and voting rights of the HQC for the year of assessment concerned and all previous years of assessment;
- Asset test – At the end of the year of assessment concerned and all previous years of assessment, 80% or more of the cost of the HQC's total assets (excluding cash and bank deposits payable on demand) must represent investments (in the form of equity shares, amounts loaned or advanced, or intellectual property) in foreign subsidiaries in which the HQC holds (alone or together with any other company forming part of the same group of companies) at least 10% of the equity and voting rights; and
- Income test – Where the gross income of the HQC exceeds ZAR 5 million for the year of assessment, 50% or more of the gross income for that year must consist of (1) dividends, interest, rent, royalties or service fees paid or payable by a qualifying foreign company; or (2) proceeds from the disposal of an interest in equity shares in a foreign company or intellectual property licensed to a qualifying foreign company.

The company must submit an annual report setting out prescribed information demonstrating that the above requirements are met. An election to be classified as an HQC is made up front, although the above requirements are assessed on an annual basis. If a company fails to meet any of the requirements, it will forfeit its HQC status.

The Taxation Laws Amendment Bill released on 4 July 2012 would amend the HQC regime so that the 80% asset rule would not have to be met if the company does not hold assets worth more than ZAR 50,000 during a year of assessment. Another amendment would provide relief if a company did not trade during a specific year of assessment; this proposal would effectively allow a "shelf company" to be used as an HQC.

In contrast, the requirements for qualifying as a GBL1 company under the Mauritius regime are significantly less stringent:

- The company must be managed and controlled in Mauritius;
- The company must appoint two Mauritius directors and a Mauritius company secretary;
- The company must maintain a registered office in Mauritius;
- The company must open a bank account in Mauritius;
- The accounting records must be maintained in Mauritius;
- The audited annual financial statements must be filed in Mauritius; and
- A tax residence certificate must be applied for on an annual basis if tax treaty relief is to be requested.

Comparing these two sets of requirements leads to the conclusion that the heavier administrative burden associated with the HQC regime could be considered an impediment to using South Africa as an entry point into Africa.

Investment holding company structure considerations

When determining whether a jurisdiction offers the best environment for an investment holding structure, consideration needs to be given to a variety of factors, such as:

- Exchange controls affecting, and the tax consequences flowing from, the repatriation of funds to the parent company's jurisdiction;
- The ease of utilizing offshore funding for business growth; and
- The extent of the holding company country's tax treaty network and the coverage of the treaties.

An ideal investment holding company regime also would allow for the repatriation of income streams from the jurisdiction in which the holding company is located back to the shareholder without any exchange control restrictions and there should be no or limited adverse tax implications on any repatriation of income.

Since Mauritius does not impose any restriction on the remittance of income to or from that jurisdiction, an investment holding company located in Mauritius may transfer funds offshore and utilize offshore funds for business expansion purposes without limitation. Conversely, from a South African exchange control perspective, there are a number of restrictions that may apply to the introduction of income into, and the remittance of income from, South Africa. The HQC regime, however, grants relief from the exchange control restrictions. The criteria that need to be met to obtain exchange control relief generally are similar to those applying for the HQC regime in general. Even if these criteria are not met, however, an HQC still may benefit from relief from the exchange control restrictions if it is incorporated in another jurisdiction where no exchange control exists but is effectively managed within South Africa, thus allowing the company to qualify for the HQC regime while enjoying the benefit of a jurisdiction with no exchange control restrictions.

Access to a comprehensive tax treaty network is a critical requirement for expansion into Africa. South Africa has a much broader treaty network than Mauritius (South Africa has 70 treaties, 19 of which are with other African countries). It should be noted, however, that while Mauritius does not have such a wide network (36 agreements, 13 with other African countries), many of Mauritius' treaties with other African jurisdictions may provide more favorable withholding tax rates than South Africa's treaties. Mauritius also is in the processing of negotiating a number of additional treaties that are generally more favorable than those negotiated by South Africa.

Other considerations that can impact or affect the transactional flow of investment income are factors such as the rate at which dividends, interest and royalty receipts are taxed in the holding company jurisdiction, and the existence and nature of any transfer pricing, thin capitalization and CFC rules.

Rates and anti-avoidance rules – The table below illustrates the other primary differences between the Mauritius GBL1 and South Africa's HQC regime in terms of relevant tax rates and the presence of anti-avoidance regimes.

	Mauritius GBL1 regime	South Africa HQC regime
Effective corporate income tax rate	• Maximum of 3%	• 28%
Taxation of foreign dividends received by company	• Maximum of 3%, reduced by credits for withholding and underlying taxes paid or, alternatively, a deemed credit of 80%	• No taxes on foreign dividends received provided the recipient (South African) company holds at least 10% of the equity shares and voting rights of the distributing foreign company
Treatment of dividends declared by company and received by shareholders	• No withholding tax on dividend payments	• No withholding tax on dividend payments
Taxation of interest received	• Maximum of 3% • May be reduced by claiming foreign tax credit	• 28% • Interest received may be offset against interest paid in respect of funds borrowed and on-lent to foreign subsidiaries • Interest received by a nonresident shareholder on a loan to an HQC will not be subject to South African tax, provided the shareholder does not have a permanent establishment (PE) in South Africa
Treatment of interest declared by company and received by shareholders	• Interest is exempt from withholding tax in the hands of nonresidents if paid by a GBL1 company	• South Africa will impose a 10% withholding tax on interest as from 1 January 2013; however, HQC's will not be subject to the tax
Taxation of royalties received	• Maximum rate of 3%	• 28%

	Mauritius GBL1 regime	South Africa HQC regime
Withholding tax on royalties paid to nonresident	• Royalties exempt from withholding tax in the hands of nonresidents if paid by a GBL1 company	• 12% rate (to be increased to 15% in the near future), subject to tax treaty relief
Capital gains tax	• Mauritius does not tax capital gains • The disposal of shares in a Mauritian holding company may be subject to capital gains tax in the country in which the shareholder is resident	• In practice, a nonresident company is only subject to capital gains tax on the sale of assets if the sale relates to: o Immovable property or an interest in immovable property located in South Africa; or • Assets owned by a PE of the nonresident company in South Africa • If the shares in the HQC are sold by a nonresident, the transaction will not be subject to capital gains tax, subject to the above • The sale of shares in a foreign company by the HQC will be exempt from capital gains tax if the requirements of the participation exemption are met. The participation exemption allows a taxpayer to disregard the capital gains on the sale of shares in a foreign company where the taxpayer holds more than 10% of the shares and voting rights in that company. The exemption is subject to the following requirements: o The shares must have been held for more than 18 months before the sale; and o The foreign company may not be classified as a foreign financial instrument holding company (although the Taxation Laws Amendment Bill 2012 proposes to eliminate this requirement)
Securities transaction tax	• None	• 0.25% rate on the transfer of shares in an HQC • The Taxation Laws Amendment Bill 2012 proposes an exemption from the tax when the shares of an HQC are transferred to another shareholder
Thin capitalization regime	• None	• Not applicable, subject to certain requirements concerning the on-lending of borrowed funds to offshore subsidiaries
Transfer pricing rules	• No transfer pricing rules, but the arm's length principle applies	• The transfer pricing rules are generally applicable except, under legislation effective from 1 October 2011, for cases in which: o A company loans funds or provides security to a foreign company in respect of which it holds 10% or more equity and voting rights; and o A company obtains financial assistance from a nonresident for purposes of on-lending funds to a foreign company in which it holds 10% or more of the equity/voting rights
CFC rules	• Not applicable; underlying investment's profits will not be taxed in Mauritius	• Not applicable to an HQC, but CFC rules may apply to the shareholders of the HQC if they are South African resident and no exemptions apply

Application to private equity

Whether the HQC regime would be appropriate in a private equity scenario is debatable. Most private equity structures involve partnerships as opposed to corporate entities, and investors generally are looking for capital gains rather than foreign dividends. Interposing a corporate entity (such as a GBL1 company or HQC) below the partnership structure would result in investors ultimately receiving foreign dividends as opposed to capital gains on exit. To the extent the investors are U.S.-based, it is possible to interpose entities below the partnership structure as the U.S. tax regime allows for interposed entities to be disregarded in certain circumstances. In this regard, Mauritius has been the platform of choice for investment into Africa (including into South Africa). There is now no reason why the HQC regime could not be used in these circumstances. An HQC also could be an appropriate vehicle for asset managers looking to expand into Africa.

Efforts also have been made to relax existing impediments to private equity and nonresident funds operating in South Africa. These impediments include the effective management implications and PE exposure applicable to investing in South African funds. In many instances, foreign investment funds utilize the knowledge and expertise of fund managers within South Africa. Because this service is provided from South Africa, the fund may be viewed as being effectively managed in South Africa; alternatively, a PE could be viewed as having been created for the fund in South Africa. To mitigate this risk and establish South Africa as a serious competitor to Mauritius, amendments were made to the definition of a PE in the Income Tax Act to limit the circumstances in which a foreign investor has a taxable presence in South Africa. Additional amendments have been proposed in relation to the effective management of a foreign investment fund. The current wording of the legislation, however, is extremely restrictive and seems not to apply to the normal private equity fund structures. Therefore, it is still important to ensure the South African-based fund managers do not create an effective management risk for the offshore fund entities.

Conclusion

While South Africa's HQC regime appears to compete favorably in certain instances with the GBL1 regime, it seems unlikely overall that the HQC regime will be able to compete on a level playing field with the Mauritius regime for a number of reasons. The HQC legislation and its application are far more complicated than the GBL1 regime legislation. There also is a substantial gap in the applicable tax rates (although, if relatively little income is taxable in South Africa, this may not be of high relevance from the investors' perspective) and South Africa's Treasury does not wish the country to be viewed as a low tax or conduit jurisdiction for investment into Africa. In the narrower context of South Africa's well established and sophisticated private equity industry, however, the HQC regime could well prove attractive. The skill set of local fund managers compares favorably with those of their U.S. and European counterparts and, depending on the fund structure, it could make commercial sense to use South Africa and the HQC regime as a platform for funds investing in Africa.

— Anne Casey (Johannesburg)
Director
Deloitte South Africa
ancasey@deloitte.so.za

Indian AAR re-ignites controversy over applicability of Minimum Alternate Tax to foreign investors

The applicability of India's Minimum Alternate Tax (MAT) to foreign companies has been the subject of debate among tax practitioners for many years, and the Authority for Advance Rulings' decision dated 14 August 2012 in the case of *Castleton Investments Limited* is certain to add to the controversy.

The AAR held that an international transfer of the shares of an Indian company was subject to India's MAT (and transfer pricing rules) even though capital gains derived on the transfer were exempt from Indian tax under an applicable tax treaty. With respect to the MAT, the AAR deviated from its own previous ruling and determined that the MAT provisions in the Income Tax Act, 1961 (ITA) do not distinguish between domestic and foreign companies and, therefore, the MAT rules are applicable to foreign companies. The AAR also held that India's transfer pricing rules must be complied with in calculating income, even if that income may not be subject to tax under Indian tax law. The effect of the *Castleton* ruling is likely to increase the administrative burden on foreign companies and inject even more uncertainty into the debate on the MAT.

Background

The MAT was introduced in India to ensure that certain profitable, dividend-declaring companies that benefit from various incentives and exemptions under the tax rules still contribute a minimum tax (as a fixed percentage of book profits) to the government. A company is liable to MAT if the tax payable under the normal provisions of the ITA is less than 18.5% of its book profits. If MAT applies, the tax payable will be 18.5% of book profits. For the purpose of determining book profits, a profit and loss account must be prepared in accordance with the Indian Companies Act, 1956. The accounting policies and standards adopted for preparing the annual accounts should be the same as those adopted by the company at its annual general meeting in accordance with the Companies Act.

As noted above, the applicability of MAT to foreign companies is controversial. Because MAT liability is computed as a percentage of book profits determined by reference to a profit and loss account drawn up in accordance with the Companies Act, a question arises as to whether a foreign company that does not so prepare its accounts is liable for MAT. If the tax were to apply, every foreign company with Indian-source income would be required to compile its financial accounts in accordance with the Companies Act, 1956.

In the *Timken* ruling issued on 23 July 2010, the AAR held that the MAT is not designed to be applicable to a foreign company that does not have a presence or permanent establishment (PE) in India. The AAR distinguished a previous ruling in which it held that MAT applied to a foreign company where the foreign company was carrying on business and had a PE in India. The determination in *Timken* appeared to settle the issue and the Indian tax authorities did not go to any lengths to dispute the AAR's position in respect of foreign investors. In fact, the tax authorities had not disputed Castleton's claim that MAT should not apply in its case (the case primarily involved the capital gains tax provisions under the India-Mauritius tax treaty); however, the AAR ruled on the issue after observing that, when the question of the construction of a statute is involved, it cannot rely merely on the positions of the parties.

Castleton facts and AAR ruling

The case before the AAR involved a Mauritius-based company, Castleton Investments, that was part of the GlaxoSmithKline group and wanted to sell shares in an Indian listed company. Castleton requested a ruling from the AAR as to whether the share transfer would be exempt from capital gains tax under the India-Mauritius treaty and whether MAT would be applicable. The AAR held that the capital gains would not be taxed as per the provisions of the treaty, and thus Castleton would not be chargeable to tax in India. However, ignoring its own previous ruling, the AAR said that, since the ITA MAT provisions do not specifically address whether there is a distinction between a resident and a nonresident company, MAT applies to all companies with Indian-source income – even those that do not have a presence or PE in India (such as Castleton, which did not have a presence in India in terms of an office or employees, nor did it have a PE under the treaty).

In reaching its revised position on the applicability of MAT to foreign companies, the AAR relied on an unreported ruling issued in 2010 (AAR No. 1098 of 2010), and based its decision on the following:

- The definition of a company under Indian tax law means an Indian company or any company incorporated by or under the laws of a country outside India, i.e. it includes a nonresident company. The MAT provisions make no distinction between a resident company and a nonresident company, so *prima facie* the MAT provisions apply to all companies.
- If the MAT was interpreted so as to apply only to resident companies, this would lead to the illogical conclusion that the provisions in the ITA providing an exemption from certain long-term capital gains also would operate only in respect of a resident company since those rules simply refer to a "company."
- While there may be practical difficulties for foreign companies in preparing their accounts under Indian company law (which is the starting point for the computation of MAT), that is not a reason to truncate the scope of MAT. It is up to the legislature to consider and determine the scope of the MAT.

In view of the above, the AAR held that the MAT provisions apply equally to a foreign company.

Comments

While not completely on point, as it relates to the application of MAT to banking institutions (and not foreign companies generally), a decision of the Mumbai Income Tax Appellate Tribunal involving a Thai bank with branch offices in India (*Krung Thai Bank PCL v. JDIT*) is illustrative of the scope of the MAT. The Mumbai Tribunal held that the MAT can only come into play when the taxpayer is required to prepare its profit and loss account in accordance with Indian company law. Because banks are not subject to account preparation rules under the Indian company law, MAT cannot be applied to a banking institution. The analogy of this decision may equally apply to foreign companies as they are also not required to prepare accounts as per Indian company law rules.

Even assuming that the MAT is applicable to foreign investors, an issue that must be addressed is how the provision would operate in practice. Since the MAT provisions in the ITA provide that every company must prepare its profit and loss account in accordance with Indian company law, a foreign investor would be required to prepare accounts relating to its Indian operations/investments in accordance with Indian company law, which would be complicated and time-consuming.

Further, Indian tax law requires every taxpayer subject to the MAT to obtain a certificate from a chartered accountant in a prescribed format, which would further increase the compliance burden for foreign investors.

The key question to be answered is whether MAT applies where the income is not taxable in India under an applicable tax treaty. In such a case, should the taxability under the normal Indian tax law rules be compared with taxability under the relevant tax treaty and then the tax liability under MAT be computed? Or should the tax liability under the normal provisions of Indian tax law be compared with the MAT liability and the result compared with the taxability under the relevant tax treaty? The correct approach would be the latter because, once it is determined that the tax treaty provisions – being more beneficial – are to be applied, then it is a well-accepted principle that the tax treaty would override the provisions of Indian domestic tax law. Consequently, even if the MAT applies to a foreign investor that is exempt from tax under a tax treaty, there should not be any tax liability on the investor.

Nevertheless, the issue of how the MAT provisions would apply to different foreign entities, such as a foreign company with a PE in India, a foreign investor that does not have treaty protection, a foreign company earning income such as interest, royalties, technical service fees, etc., remains unresolved. We will have to wait until a higher court addresses this question or the Central Board of Direct Taxes (the body regulating direct taxes in India) issues guidance clarifying the applicability of MAT to foreign companies.

Applicability of transfer pricing rules

The AAR also held in the *Castleton* case that India's transfer pricing rules are applicable if the transaction falls within the scope of the transfer pricing rules, regardless of whether the ultimate gain or income is chargeable to tax. This will further increase the compliance burden for foreign investors that are exempt from tax in India under a tax treaty. In some of its earlier rulings, the AAR had held that the transfer pricing provisions are mechanical provisions and are not applicable if the income concerned is not chargeable to tax. However, in *Castleton*, the AAR noted that the concept of precedence may not have strict application in proceedings before the AAR; the AAR is bound only by the decisions of the Supreme Court, is not subordinate to any High Court and the decisions of High Courts only have persuasive value. It is interesting to note, however, that the Indian Supreme Court recently held in the case of *Columbia Sportswear Company* that all appeals against AAR rulings should be filed in High Courts, which indicates that the AAR is subordinate to High Courts.

Conclusion

Neither of the issues, i.e. the applicability of MAT to foreign investors and the applicability of the transfer pricing provisions to foreign investors, can be said to be finally settled and it is likely that foreign investors will challenge the applicability of these rules, which is likely to lead to protracted litigation and uncertainty.

— S.S. Palwe (Mumbai)
Partner
Deloitte Haskins & Sells
spalwe@deloitte.com

Pritin Kumar (Mumbai)
Director
Deloitte Haskins & Sells
pkumar@deloitte.com

Ashish Gogri (Mumbai)
Manager
Deloitte Haskins & Sells
agogri@deloitte.com

European Union:
ECJ holds Luxembourg's recapture of net worth tax relief contrary to EU law

The European Court of Justice (ECJ) issued a decision on 6 September 2012, concluding that Luxembourg's rules requiring a recapture of net worth tax relief when a taxpayer transfers its seat to another EU member state is contrary to the freedom of establishment principle under article 49 of the Treaty on the Functioning of the European Union (*Finanziaria di Diego della Valle* (FDV).

Under Luxembourg tax law, a net worth tax of 0.5% is levied annually on the adjusted net asset value of all resident companies. However, the tax may be reduced or eliminated entirely if the company creates and maintains for five years a specific reserve amounting to five times the amount of the net worth tax reduced. If the company transfers its seat outside Luxembourg during the five-year period, the benefit will be withdrawn.

The taxpayer in *FDV* is a private limited liability company (SARL) that had set up a blocked reserve and benefited from the reduction in net wealth tax liability for the 2004 tax year. In 2006, the company transferred its registered seat to Italy and the company subsequently merged with an Italian company. However, the net worth tax funds were still allocated to a reserve in the balance sheet. Following the taxpayer's migration to Italy, the Luxembourg tax authorities determined that it no longer met the requirements to benefit from the reduction in its net worth tax liability: the company was not a Luxembourg resident and was not subject to the tax for the five-year period. The tax authorities withdrew the relief granted and denied the tax reduction for 2005 and 2006. Following the taxpayer's appeal, the Luxembourg Administrative Court requested a preliminary ruling from the ECJ on 13 July 2011.

In concluding that Luxembourg law violated the freedom of establishment principle, the ECJ noted that a Luxembourg company transferring its seat outside the Grand-Duchy during the five-year period following the year in which tax relief was granted is subject to less favorable treatment than a company that continues to be Luxembourg resident. This difference in treatment could adversely impact the assets of companies wishing to transfer their seat to another EU member state and could discourage such companies from moving before the end of the five-year period.

The ECJ also rejected the Luxembourg government's arguments that the rule could be justified by overriding reasons in the public interest as the protection of the balanced powers of taxation between the member states and the need to ensure the coherence of the national tax system. The latter argument was rejected because there is no direct link between the tax relief concerned and the objectives of the Luxembourg legislation (in particular, offsetting the relief granted by additional revenue from corporate income tax and municipal business tax during the years in which the reserve is maintained). Finally, the court held that increasing and maintaining tax revenue is not an overriding reason in the public interest that justifies a measure contrary to a fundamental freedom.

The ECJ's decision that Luxembourg's net wealth tax reserve rule is incompatible with EU law is consistent with its jurisprudence, and given the court's statement that the freedom of establishment principle precludes similar legislation conditioning a reduction in capital tax upon remaining liable to tax "for the next five years," it is reasonable to assume that Luxembourg will amend the rule to generally preserve the net wealth tax reserve.

— Raymond Krawczykowski (Luxembourg City)
Partner
Deloitte Luxembourg
rkrawczykowski@deloitte.lu

India:
Review committee issues report on GAAR

Tasked with undertaking related stakeholder consultations and reviewing and finalizing guidelines for the implementation of the proposed general anti-avoidance rule (GAAR), India's "Shome Committee" issued its draft report on 1 September 2012. The committee has recommended that the scope of the GAAR be scaled back, implementation be delayed for three more years and investments made before implementation be grandfathered. Further, the committee recommended that tax on gains derived by both residents and nonresidents from the transfer of listed shares be abolished.

Background

The GAAR, introduced by Finance Act, 2012 and anticipated to be effective from 1 April 2013, is expected to target tax haven and holding company structures, as well as other types of tax avoidance strategies (some of which are illustrated in the Shome committee report). In its current form, the GAAR will codify the substance-over-form doctrine and is expected, in its application, to take into account the real intention of the parties, the purpose of the arrangement and the effect of the transactions (regardless of the legal structure used by the taxpayer) in order to determine the tax consequences of a particular transaction.

There is widespread concern that the GAAR will grant considerable administrative discretion to the tax authorities in applying the provision, potentially creating uncertainty as to where accepted tax planning ends and abusive tax avoidance begins.

In announcing the GAAR in the 2012 budget, India’s Finance Minister offered assurances that detailed guidance would be issued on the application of the provision to allay the concerns of foreign investors and ensure that the provision is not applied indiscriminately. Indeed, an earlier committee was set up to formulate guidance for implementing the GAAR, but that committee’s recommendations issued on 28 June 2012 were perceived to be insufficient and confusing by stakeholders, and led to the formation of the Shome Committee.The Shome report recommends changes to Income Tax Act, 1961 (ITA), the issuance of guidelines under the income tax rules and clarifying circulars that include examples.

Key recommendations of the Shome Committee are highlighted below.

Amendments to ITA

- Implementation of the GAAR should be delayed by three years (to 2016 rather than 2013) to train tax officers in the application of the provisions and establish appropriate procedures and processes.
- Only arrangements whose main purpose is obtaining tax benefits should fall within the scope of the GAAR.
- The term “commercial substance” should be defined in the ITA to mean a change in the economic position by altering the business risks or net cash flows.
- Tax on gains arising from the transfer of listed securities (whether in the nature of capital gains or business income) should be abolished for both residents and nonresidents. The government could consider increasing the rate of the Securities Transaction Tax (STT) to make the proposal tax neutral. (This recommendation appears to be designed to mitigate some of the uncertainties arising from the *Vodafone* decision and subsequent legislation and to encourage additional investment in the Indian market.)

Guidelines to be prescribed under income tax rules

- The GAAR should be subject to the overall principle that tax mitigation should be distinguished from tax avoidance, and there should be an illustrative list of tax mitigation scenarios or a negative list for purposes of invoking the GAAR. The Committee provided the following illustrations of tax mitigation strategies where GAAR should not be invoked:
  - Payment of dividends rather than a buyback of shares;
  - Setting up a branch office rather than a subsidiary;
  - Setting up a unit in a tax holiday zone rather than in another location;
  - Funding through debt rather than equity;
  - Purchase or lease of a capital asset; and
  - Amalgamations and spin offs as approved by the High Court.
- The GAAR should apply only in cases of abusive, contrived and artificial arrangements.
- The GAAR should not be invoked in intragroup transactions that could result in a tax benefit to one person, but in which overall tax revenue is not affected.
- A monetary threshold of approximately USD 600,000 in tax benefits per year (including tax, but not interest, etc.) should be used as a trigger for the applicability of the GAAR.
- Investments (but not arrangements) existing on the date the GAAR becomes effective should be grandfathered. (This arguably could provide protection for transactions routed through Mauritius until the GAAR is enacted.)

- Where anti-avoidance rules are provided in a tax treaty in the form of a limitation on benefits clause, etc., the GAAR provisions should not apply to override the treaty. If there is evidence that anti-avoidance provisions in a treaty have been contravened, the treaty should be revisited, but the GAAR should not override the treaty.
- Similarly, where specific anti-avoidance rules (such as rules on transfer pricing, dividend stripping, deemed dividends, etc.) are applicable to a particular transaction, the GAAR should not be invoked.
- Where a Foreign Institutional Investor (FII) opts to be subject to tax in accordance with domestic law, the GAAR should not apply to the FII. Regardless of whether an FII chooses to benefit from tax treaty provisions, the GAAR should not be invoked in the case of a nonresident that has invested directly or indirectly in the FII. However, this exemption should apply only in respect of investments in listed securities made by the FII in India.
- Where only part of an arrangement is impermissible, it should be clarified that the tax consequences of an "impermissible avoidance arrangement" will be limited to that portion of the arrangement.
- When determining the tax consequences of an impermissible avoidance arrangement, a corresponding adjustment should be allowed in respect of the same taxpayer in the same year, as well as in different years, if any. However, no relief by way of a corresponding adjustment should be allowed for any other taxpayer.
- The Indian tax officer should be required to provide detailed reasons for invoking the GAAR in the show cause notice to the taxpayer.
- The tax audit report should be amended to require the reporting of tax avoidance schemes exceeding a threshold tax benefit of approximately USD 600,000 that is considered by the tax auditor as more likely than not to be an impermissible avoidance arrangement.

Clarifications and illustrations

- The GAAR provisions in the statute and rules should be further explained through a circular and, in particular, should not apply to challenge the genuineness of the residence of an entity set up in Mauritius where Circular No. 789 is applicable, i.e. where a tax residence certificate has been issued by the Mauritius tax authorities.
- The guidelines contain 27 illustrations on the applicability of GAAR in various scenarios.

Other recommendations

- The administration of the Authority for Advance Ruling's should be strengthened so that a ruling can be obtained within six months.
- Circular 789, which requires the Indian tax authorities to accept a tax residence certificate issued by the Mauritius authorities, should be retained until the tax on gains arising on the transfer of listed securities (whether in the nature of capital gains or business income) is abolished for both residents and nonresidents.
- A targeted training program should be initiated for all tax officers specializing in international taxation.
- A Large Taxpayer Unit (LTU) should be made compulsory for a specified class of taxpayers to reflect international practice.

Conclusion

If accepted by the Indian government, the recommendations of the Shome Committee could substantially dilute the GAAR provisions and provide additional safeguards and certainty to protect taxpayers against the arbitrary use of GAAR by tax officers. However, taxpayers will need to wait for the government's reaction to the final report, which is scheduled to be submitted to the government by 30 September 2012.

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

Lakshit Desai (Mumbai)
Senior Manager
Deloitte Haskins & Sells
ldesai@deloitte.com

OECD: Update on PE Discussion Draft

The OECD's Working Party 1 held a meeting with commentators on 7 September 2012 on the discussion draft relating to the interpretation and application of the commentary to article 5 (permanent establishment or PE) of the OECD model tax treaty. In response to comments made to the draft, Working Party 1 has made some preliminary changes; further amendments are possible.

The concept of a permanent establishment is defined in article 5 of the OECD model treaty and is used to allocate taxing rights when an enterprise in one treaty partner country derives profits from the other treaty partner country. The OECD has been working to clarify the interpretation and application of article 5, and the discussion draft addresses a multitude of problems relating to the concept of a PE.

Some of the main points of interest are as follows:

- A preliminary clarification will be made in relation to contract manufacturing, so that intermittent and incidental visits by personnel of the principal to a contract/toll manufacturer (e.g. for quality control purposes) will not easily lead to the conclusion that premises are “at the disposal of” the principal. It became clear that on a literal reading of proposed paragraph (4.2) on contract manufacturing that the presence of inventory owned by the principal could lead to the conclusion that premises are “at the disposal of” the principal (with only article 5(4) of the model treaty mitigating the possibility that a PE will be created – although matters may be more complex if there is more than mere storage of inventory (article 5(4)(f)).
- In the proposed paragraph on activities of a recurrent nature (6.1), the example of a commercial fair taking place for 15 consecutive years (which was subject to considerable criticism) is replaced with an example concerning drilling operations that, due to seasonal circumstances, take place for four months in each of the five consecutive years.
- Working Party 1 is divided on the issue of the subcontracting of building projects. Specifically, it is Germany’s position that no PE will be created for the general contractor if all of the work is subcontracted and none of the general contractor’s own personnel are present on site. Conversely, most of the other OECD member countries believe that the presence of the general contractor’s own personnel is not required to give rise to a PE of the general contractor in these circumstances.
- No changes were made to the draft as it relates to an agency PE, so the OECD leaves open the possibility that an agent can bind its principal by other than purely legal means (i.e. economically or commercially). It should be noted that this seems to run counter to a number of domestic Supreme Court decisions in Europe, in which the courts have explained “binding” to mean legally binding.

The next Working Party 1 meeting will take place in February 2013 and a revised discussion draft is expected then. The final changes will be included in the next update of the model convention, currently scheduled for 2014.

— Hans Pijl (Amsterdam)
Partner
Deloitte Netherlands
hpijl@deloitte.nl

Russia:
Reporting obligations to be eased as from 2013

The Russian State Duma has amended the Tax Code with a view to easing compliance obligations as from 1 January 2013. The changes, which were published on 2 July 2012, provide that a Russian entity will only have to submit financial statements to the local tax authorities on an annual basis (within three months after the end of the tax year).

Currently, a Russian entity must submit quarterly financial statements (including a balance sheet and a profit and loss statement prepared under Russian Accounting Standards), within 30 days after the end of each quarter. This law will cease to be effective on 31 December 2012 and will be replaced by a new law, which sets the statutory reporting period as a calendar year (i.e. 1 January to 31 December) and does not contain any filing deadlines for interim reports. As a result of the new rules, Russian taxpayers will no longer be required to submit interim statutory financial statements to the tax authorities.

These changes evidence the efforts of the Russian government to generally eliminate red tape for both foreign investors and local businesses.

— Alexander Krylov (New York)
Senior Manager
Deloitte Tax LLP
alkrylov@deloitte.com

Shereen Chirambo (New York)
Senior
Deloitte Tax LLP
shchirambo@deloitte.com

Singapore:
IRAS stepping up enforcement of tax clearance for noncitizen employees

The Inland Revenue Authority of Singapore (IRAS) has been taking steps to ensure that tax clearance returns are submitted for non-Singapore citizen employees, and companies have been receiving letters from the IRAS to remind them of the filing requirement, as well as the penalties for failure to comply.

An employer in Singapore is required to notify the IRAS by filing the Form IR21 for an employee who is neither a Singapore citizen nor a Singapore Permanent Resident (SPR) under immigration rules or who is an SPR leaving Singapore permanently (including on an overseas posting for three months or more) upon the cessation of the Singapore employment. The notification must be made to the IRAS at least one month before the expected date of the cessation of employment or departure from Singapore, whichever is earlier. The employer also is required to withhold any monies due and payable to the employee until the expiry of 30 days after the IRAS receives the notification, unless earlier permission is granted to release the monies to the employee.

Late submission of the Form IR21 can give rise to the imposition of a "composition fee" of up to SGD 1,000 on the company and/or the company may be summoned to appear in court. A waiver of the composition fee by the IRAS is a concession and will only be granted once.

Extension of time to file tax clearance

In cases where tax is wholly borne by the company, the IRAS will grant an automatic two-month extension of time from the cessation date to file the Form IR21. It is not necessary for the company to request the extension or to provide estimated chargeable income (ECI) to the IRAS. However, where tax is partially borne by the employer, the company must submit the ECI together with the request for extension; approval of the extension will be granted on a case-by-case basis. The IRAS will issue an estimated Notice of Assessment upon receipt of the ECI to the relevant employee. The estimated tax assessed must be settled with the IRAS immediately, or by the due date as stated in the statement of account issued to the employee and the clearance directive issued to the company.

For a non-Singapore citizen who pays his/her own Singapore taxes, the company must comply with the statutory requirements by submitting Form IR21 within the one-month deadline.

Comments

In practice, when a company plans an international assignment transfer, there is usually little lead time between the time the transfer date is finalized by the business units and the actual transfer date, due to business and visa requirements at the receiving location. In addition, the company needs time to collate compensation data, including benefits-in-kind paid to the foreign employee through the employment cessation date. Where the foreign employee has been granted shares and/or stock options during his/her Singapore employment, which are yet to vest and/or be exercised, the company must report the unvested/unexercised gains based on the open market price of the shares one month before the employment cessation date, less the acquisition price, if applicable, under the deemed exercise rule. In view of these challenges, many companies are unable to comply with the filing deadline set by the IRAS.

Although the two-month extension generally should help prevent late filing, the extension will not be granted to a company for foreign employees who pay all of their own taxes or where the taxes are partially paid by the company.

Tax assessments for tax clearance must be settled by the payment due date to avoid the imposition of a late payment penalty and/or the issuance of a directive by the IRAS to the immigration department to prevent the foreign employee from leaving Singapore.

To mitigate the incidence of noncompliance, affected companies should take the following steps:

- File the tax clearance as soon as the company becomes aware of a non-Singapore citizen employee ceasing employment in Singapore;
- Emphasize the importance of timeliness to parties responsible for providing information for tax clearance purposes;
- Request an extension of time to file and provide the ECI to the IRAS before the cessation date where tax is partially borne by the employer; and
- Where less than one month's notice is given to the IRAS, indicate the reason on the Form IR21 for the IRAS' consideration to waive the composition fee.

— Sabrina Sia (Singapore)
Associate Director
Deloitte Singapore
ssia@deloitte.com

Ukraine:
New tax benefits for IT companies

A law granting tax benefits to IT companies entered into force in Ukraine on 3 August 2012. The special regime, which will apply from 1 January 2013 to 31 December 2022, will be available to companies engaged in a number of qualifying IT-related activities (including software development). Qualifying companies will be entitled to a 5% corporate income tax on IT-related activities and the supply of IT-related services will be exempt from VAT.

To benefit from the regime, a company must satisfy various requirements, the most important of which are the following:

- The company's income from qualifying IT activities comprises at least 70% of its total income; and
- The historic book value of tangible fixed assets and intangible assets exceeds 50 times the amount of the minimum monthly salary (the minimum monthly salary is currently equal to about USD 140).

The original version of the law provided for a 5% personal income tax rate (compared with the general 15%/17% rates), but this benefit was not included in the final version signed by the president. Considering that payroll costs usually constitute a significant proportion of the cost base of IT companies, the elimination of the personal income tax benefit could decrease the attractiveness of the special regime, and hence, some companies may elect not to apply for the regime. In addition, the list of activities that qualify for the regime is extensive and, in some respects, may be considered ambiguous, so companies will need to carefully analyze whether they qualify for the regime.

— Andriy Servetnyk (Kyiv)
Partner
Deloitte Ukraine
aservetnyk@deloitte.ua

Alexander Cherinko (Kyiv)
Senior Manager
Deloitte Ukraine
acherinko@deloitte.ua

In brief

India – The Central Board of Direct Taxes issued rules on 31 August 2012 regarding the advance pricing agreement (APA) scheme. The rules are effective 1 July 2012 and it is possible to enter into an APA for proposed transactions in the current year, but not for ongoing transactions. APAs may be unilateral, bilateral or multilateral, with a (renewable) term not to exceed five years. Filing fees are USD 20,000 if the international transactions value does not exceed USD 20 million, USD 30,000 for a value between USD 20 and 40 million and USD 40,000 for a value exceeding USD 40 million.

India – A new service tax system was implemented on 1 July 2012. Under the new rules, a 12% tax will be levied on all services not included on an exemption list.

Israel – The standard VAT rate increased from 16% to 17% on 1 September 2012.

Saint Lucia – Implementation of the VAT regime has been delayed to 1 October 2012. The standard rate of VAT will be 15% and the VAT registration threshold will be XCD 180,000.

Spain – The standard VAT rate increased from 18% to 21% on 1 September 2012.

Thailand – The Cabinet has approved a two-year extension of the existing 7% VAT rate, which was scheduled to revert to 10% on 1 October 2012. The 7% rate will now apply until 30 September 2014.

Are You Getting Your Global Tax Alerts?

Throughout the week, Deloitte provides commentary and analysis on developments affecting cross-border transactions on a free subscription basis delivered straight to your email. Read the recent alerts below or visit the archive.
Subscribe: http://www.deloitte.com/view/en_GX/global/insights/email-alerts/index.htm
Archives: http://www.deloitte.com/view/en_GX/global/services/tax/cross-border-tax/international-tax/69d28aca44ed2210VgnVCM200000bb42f00aRCRD.htm

Australia
Parliament passes Investment Manager Regime legislation
The parliament has passed amending legislation for Elements 1 and 2 of the Investment Manager Regime (IMR).
[Issued: 27 August 2012]
URL: http://www.deloitte.com/view/en_GX/global/services/tax/cross-border-tax/international-tax/1db838523c869310VgnVCM2000001b56f00aRCRD.htm
URL: http://www.deloitte.com/assets/Dcom-Global/Local%20Assets/Documents/Tax/Alerts/dttl_tax_alert_Australia_270812.pdf

Brazil
Government extends period to obtain federal tax incentives
The government has extended for an additional five years the term for companies to obtain approval to obtain tax benefits for projects in the north and northeast regions of the country that include a 10-year 75% reduction of federal corporate income tax, accelerated depreciation and tax credits for PIS/COFINS purposes and an exemption from the freight tax.
[Issued: 4 September 2012]
URL: http://www.deloitte.com/view/en_GX/global/services/tax/cross-border-tax/international-tax/6d86e9277e299310VgnVCM1000001a56f00aRCRD.htm
URL: http://www.deloitte.com/assets/Dcom-Global/Local%20Assets/Documents/Tax/Alerts/dttl_tax_alert_Brazil_040912.pdf

United States
IRS guidance addresses "legging out" of "qualified hedging transactions" under §988(d)
The tax authorities have issued regulations that amend certain aspects of the "legging out" rules applicable to nonfunctional currency denominated debt and one or more related hedging transactions treated as a qualified hedging transaction.
[Issued: 10 September 2012]
URL: http://www.deloitte.com/view/en_GX/global/services/tax/cross-border-tax/international-tax/8996e0d17f1b9310VgnVCM2000001b56f00aRCRD.htm
URL: http://www.deloitte.com/assets/Dcom-Global/Local%20Assets/Documents/Tax/Alerts/dttl_tax_alert_UnitedStates_100912.pdf

Have a question?
If you have needs specifically related to this newsletter's content, send us an email at **clientsandmarketsdeloittetax@deloitte.com** to have a Deloitte Tax professional contact you.