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Patent box regime included in package of Italian tax law changes

The Stability Law 2015 that became effective on 1 January 2015 includes a number of significant changes to Italy's tax rules, including the following:

- The introduction of a patent box regime;
- The introduction of a new research and development (R&D) tax credit available until 2019;
- An increase in the local tax on production activities (IRAP) rate to 3.9%, and a change to allow labor costs relating to employees hired on a permanent basis to be deducted in full;
- An authorization to the government to review “black-listed” countries;
- An opportunity for nonresident companies to “step-up” the tax basis of Italian participations; and
- An easing of the rules under the programs to correct tax violations and voluntarily disclose income.

Unless otherwise noted, the changes are effective as from 1 January 2015.

The Stability Law 2015 was followed by a decree (Law Decree No. 3/2015) published on 24 January to modify certain provisions of the patent box regime. It should be noted that, although a law decree enters into force upon its publication, it must be converted into law by the parliament within 60 days or it retroactively will become null and void.

Patent box regime

The patent box regime, designed to encourage the development of intellectual property (IP) in Italy, provides a partial exemption from corporate income tax (IRES) and the IRAP for income deriving from certain intangible assets. The regime is similar to existing patent box regimes in other EU member states (e.g. Belgium, France, Luxembourg, Netherlands, Spain and the UK) and, as indicated in the official explanatory report for the stability law, the patent box incentive is intended to be in line with the “nexus approach” described in the OECD report on base erosion and profit shifting (BEPS) Action 5, Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance. More precisely, the patent box regime is intended to be available only for “substantial activities” carried out in Italy.

The initial version of the patent box regime provided by the Stability Law 2015 covered only income deriving from patents, know-how, etc., with a specific exclusion for trademarks. However, the decree would expand the scope of the patent box to include trademarks, industrial designs and prototypes.

The patent box regime is available to Italian companies (and certain other bodies), as well as Italian permanent establishments (PEs) of nonresident entities that are resident in “white-listed” countries with an effective exchange of information with Italy.

The regime applies to certain income derived from the qualifying intangibles listed above, and to capital gains arising from the disposal of such assets.

- For 2015, an exemption equal to 30% of income deriving from the licensing (“indirect use”) or the direct exploitation (“direct use”) of such intangible assets is available; this will increase to 40% in 2016 and 50% in 2017. In the case of direct use, income eligible for the exemption generally must be determined in advance by the Italian tax authorities through a specific ruling; however, after the modifications provided by Law Decree No. 3/2015, a ruling would be optional in the case of intercompany royalties.

To support the link between the expenditure incurred in Italy and the income that may benefit from the patent box regime under the nexus approach, the amount of income subject to the partial exemption is determined based on the ratio of (i) the qualifying R&D costs for development, maintenance and improvement of the intangible asset, plus (ii) costs incurred to purchase the IP and R&D costs incurred by related companies, up to 30% of the amount in (i), to the total costs incurred to create the intangible asset.

- An exemption equal to 100% of capital gains arising from the disposal of such assets may be available, provided 90% of the sales proceeds are reinvested in R&D activities relating to intangibles eligible for the patent box regime by the end of the second fiscal year following the year of the disposal.

The patent box is an elective regime and, once chosen, it is irrevocable for five years.

A decree providing the implementation rules for the patent box regime is expected to be issued shortly.

R&D tax credit

The 2015 stability law introduced a new R&D tax credit to replace the credit provided in the 2014 law, as implementing rules were not issued and, therefore, the credit never entered into effect. The new measure, which applies from FY 2015 to FY 2019, allows Italian resident entities (i.e. Italian companies and Italian PEs of foreign companies) carrying out qualifying R&D activities to benefit from a tax credit up to a maximum of EUR 5 million, calculated on qualifying expenditure exceeding EUR 30,000. The tax credit ranges from 25% to 50% of the excess of qualifying expenditure in a given fiscal year over the average spending of the 2012-2014 period. Qualifying R&D expenditure for these purposes includes: (i) costs for highly qualified personnel; (ii) depreciation of laboratory equipment; (iii) costs for R&D activities outsourced to universities and similar establishments; and (iv) costs incurred for technical expertise related to industrial or biotech intellectual property. The credit is increased from 25% to 50% in connection with expenditure incurred under (i) and (iii).

IRAP

The stability law makes the following changes to the IRAP:

- The 3.5% ordinary IRAP rate introduced in 2014 is retroactively returned to the prior 3.9% rate as from FY 2014 (i.e. the reduced rate will never be effective). Similarly, the ordinary rates for banks and insurance companies are returned to the prior 4.65% and 5.9% rates, respectively. However, interest and penalties will not apply to underpayments of IRAP for FY 2014.
- For taxpayers with employees, labor costs incurred for employees hired on a permanent basis now are fully deductible for IRAP purposes.
- For taxpayers without employees, a tax credit equal to 10% of the gross IRAP due (tax before labor cost deductions) may be granted. The credit may be used to offset IRAP, as well as other potential tax payments (e.g. corporate income tax, VAT).

Potential changes to black-list jurisdictions

The stability law authorizes the Ministry of Economics and Finance and the tax authorities, respectively, to review and revise the black lists that apply for purposes of the deductibility of costs incurred in transactions with entities resident in such countries and the controlled foreign companies (CFC) regime. (Although the black lists were formally abolished, they will continue to be applied in practice until white lists are issued.)

An anti-avoidance rule in Italy's income tax code imposes an additional burden of proof on taxpayers seeking to deduct costs incurred in transactions with entities resident in black-listed countries (to date, identified as countries that have an inadequate exchange of information with Italy and low tax rates). The Ministry of Economics and Finance is authorized to review the black list and issue a new decree that would treat only those countries that do not provide an

adequate exchange of information with Italy as black listed, regardless of their effective tax rates. As a consequence, certain countries (e.g. Ecuador, Mauritius, Philippines, Singapore and United Arab Emirates) may be removed from the black list that applies in these cases.

For purposes of the CFC rules, a subsidiary of an Italian company is considered resident in a black-listed country (i.e. a country with a privileged tax regime) if the country's level of taxation is "significantly lower" than that in Italy. The implementing decree considers as "significantly lower" a level of taxation that is lower than 70% of the Italian level of tax. However, the stability law has introduced new criteria, under which a country will be considered to have a privileged tax regime only if the country has: (i) a level of taxation lower than 50% of the Italian tax rate (instead of the current 70%); or (ii) a level of taxation technically higher than 50% of the Italian tax rate, but that effectively is substantially lower than this threshold due to special privileged tax regimes (to be further identified by the Italian tax authorities). The stability law authorizes the tax authorities to modify and reissue the black list that applies for purposes of the CFC regime to reflect the new criteria.

Opportunity for nonresident companies to "step-up" tax basis of Italian participations

The stability law reopens the window for nonresident entities to elect to "step-up" the tax basis of participations in unlisted Italian companies held as of 1 January 2015, through the payment of a substitute tax. However, the substitute tax rates (4% for nonqualified participations and 8% for qualified participations) are double those provided in the past.

The substitute tax is calculated on the value of the participation as of 1 January 2015, which must be certified by a sworn appraisal completed by 30 June 2015. The substitute tax either may be paid in full by 30 June 2015 or paid in three annual installments starting from the same date (in this case, 3% annual interest is due on the second and third installments).

This provision may be of interest to foreign entities that potentially could realize a capital gain on the disposal of such participations that would be subject to tax in Italy (e.g. if no exemption under a tax treaty would apply).

Programs to correct tax violations and voluntarily disclose income

The stability law has made changes to the rules allowing taxpayers to correct previous tax violations (a permanent program) or declare previously undisclosed assets and funds (a temporary, one-time program).

- **Correction of tax violations:** This program allows taxpayers to correct a failure to meet most tax obligations, including failure to make a tax payment. The time limits for making a correction are extended under the stability law, and even if a violation already has been identified by the tax authorities, the taxpayer may self-correct it within the statute of limitations period and still pay reduced penalties. (However, the procedure will not be available if the taxpayer has received a "formal" notice of the violation.) The amount of the reduced penalty varies depending on when the violation is corrected, and ranges from one-ninth of the minimum penalty (for corrections within 90 days of the tax return submission date, or the date of the error or omission) to one-fifth of the minimum penalty (for corrections made after the tax authorities have identified the violation).

Taxpayers have the option to apply the new rules starting from FY 2015, which means that the new time limits also may apply to violations related to previous fiscal years, as long as the taxpayer has not been notified of a tax assessment.

- **Voluntary disclosure:** The voluntary disclosure regime (available until 30 September 2015) generally allows individual taxpayers to benefit from reduced penalties if they voluntarily disclose undeclared foreign income and assets. Under the new rules, it appears the program also may be used by Italian companies or PEs of foreign companies to report violations committed for corporate income tax, IRAP, VAT or withholding agent (taxes and social security contributions) purposes during years still open to tax assessment. The upcoming implementation rules to be issued by the tax authorities should confirm whether this is permissible.

To benefit from the voluntary disclosure program, taxpayers must disclose undeclared income before the beginning of any tax audit activity. In addition to a significant reduction of the applicable administrative penalties (similar to the program for correction of tax violations), the voluntary disclosure program provides taxpayers protection (with a few exceptions) from the criminal penalties potentially applicable for reported violations.

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China unveils draft of new foreign investment law

On 19 January 2015, China's Ministry of Commerce (MOFCOM) published a discussion draft of a new Foreign Investment Law (Draft FIL), along with explanatory notes, for public comment by 17 February 2015. If enacted in its current form, the Draft FIL would make fundamental and sweeping changes to the foreign investment landscape in China. For example, the distinctions between the wholly foreign-owned enterprise (WFOE), cooperative joint venture (CJV) and equity joint venture (EJV) would be eliminated for purposes of corporate governance and profit distribution mechanisms; foreign investors would be subject to fewer advance approval requirements; and the FIL would function as the main law governing foreign investment.

The Draft FIL clearly signals the government's intent to liberalize foreign investment in China, to bring it in line with prevailing best practices worldwide. Foreign investors that have invested, or that intend to invest, in China should monitor the progress of the Draft FIL through the various stages of the legislative process, so they are fully aware of its impact on their investment or potential investment.

Potentially affected legislation

If the Draft FIL is enacted, the three primary existing foreign investment laws (WFOE Law, CJV Law and EJV Law) and their implementation rules would be repealed and the Rules on Mergers/Acquisitions of Domestic Enterprises by Foreign Investors (Circular 10) likely would be amended to conform the rules to those in the new FIL.

The foreign exchange control policies would be adjusted to support the reform of the foreign investment regime.

Definitions relating to foreign investment

Foreign investor: As noted above, the WFOE, CJV and EJV forms of foreign entities would no longer exist. “Foreign investors” under the Draft FIL would include the following:

1. Non-Chinese individuals, enterprises incorporated under the laws of other countries or regions (foreign enterprises), foreign authorities and international organizations; and
2. Domestic enterprises that are “controlled” by entities listed in (1).

“Control” for these purposes would exist in any of the following circumstances:

- Where a person holds, directly or indirectly, more than 50% of the equity, assets, voting rights or similar interests in an enterprise;
- Where a person holds, directly or indirectly, less than 50% of the equity, assets, voting rights or similar interests in an enterprise, but the person (i) is entitled to nominate, directly or indirectly, more than 50% of the members of the board of directors; (ii) is able to secure more than 50% of the seats of on the board of directors or the equivalent decision-making body; or (iii) holds sufficient voting rights to significantly influence the resolutions of the shareholders’ meeting or the board of directors; or
- Where a person has a decisive influence on the management, finance, human resources or technologies of an enterprise through mechanisms such as contracts, trusts, etc.

Foreign investment: Foreign investment would be broadly defined to include activities carried out directly or indirectly by a foreign investor, including “greenfield” investments, mergers and acquisitions, long-term financing, the acquisition of real estate, concessions for the exploration or development of natural resources or for the construction or operation of infrastructure, control over a domestic enterprise via a variable interest equity (VIE) structure (discussed below) and any offshore transaction resulting in the transfer of de facto control of a domestic enterprise to a foreign investor(s). (If a foreign enterprise is de facto controlled by a Chinese investor, the enterprise may, when requesting market entry clearance for investment in restricted industries, ask to have its investment treated as a domestic investment, i.e. an investment by the Chinese investor.)

Fundamental changes under the Draft FIL

The following is a summary of some of the main changes that would be made by the Draft FIL:

National treatment: Foreign investment generally would be treated like domestic investment, except where the investment is made in certain industries. The government would publish a “negative list” of industries in which foreign investment would be prohibited or restricted (similar to the list that currently applies in the China (Shanghai) Pilot Free Trade Zone). Approval would be required only where a foreign investor proposes to invest in an industry on the negative list (currently, all foreign investors must obtain MOFCOM approval before setting up or acquiring an enterprise in China, and before registering the investment with the relevant

authorities). A foreign investor not operating in a restricted industry or whose investment amount does not exceed a prescribed threshold would be subject to the same treatment as a domestic investor (although an information reporting requirement would apply (see below)).

Market entry clearance: A limited entry clearance approach would replace the existing foreign investment approval requirement. Only foreign investment that falls within the scope of the negative list would need market entry clearance.

Information reporting: In lieu of the approval requirement, foreign investors not investing in a negative list industry would be subject to an information reporting requirement. Share transfers, capital increases and other changes to a foreign investment that currently require advance approval would need only to be reported via the online reporting system under the supervision of MOFCOM within 30 days of the transaction.

National security review: To counterbalance the elimination of the approval requirement, the Draft FIL would incorporate and broaden the existing national security review regime. Currently, national security reviews are limited to mergers and acquisitions of Chinese enterprises engaged in national defense and security industries, or mergers/acquisitions where de facto control is obtained over such companies. The Draft FIL would broaden the scope of reviews to include any foreign investment that “harms or is likely to endanger national security,” which potentially could encompass other forms of foreign investment, such as greenfields investment.

Corporate governance: The abolition of the WOFE, CJV and EJV laws would eliminate the different treatment of domestic and foreign-invested enterprises (FIEs) in terms of corporate governance, and would simplify the governance rules by subjecting FIEs to the same rules that apply to domestic enterprises under the PRC Company Law. Existing FIEs would have a three-year transition period to conform their corporate governance in accordance with the PRC Company Law (for example, to establish shareholder meetings for EJV, change the form of entity for CJVs, etc.).

“Control” and “de facto controller”: The concepts of control and a de facto controller would be introduced for determining whether investment activities fall within the scope of foreign investment (see above for the new definition of control).

Penalties: Criminal penalties would be imposed for violations of the information reporting rules.

Impact on existing FIEs

The Draft FIL would have the following effects on existing FIEs:

- Since the Draft FIL provides that entities registered in China but controlled by foreign investors would be treated as foreign investors, existing WOFEs and foreign-controlled JVs would be treated as foreign investors.
- If a foreign investor or an FIE uses a nominee shareholder, trust, multilevel reinvestment, lease, VIE structure or overseas transaction to operate in a prohibited or

restricted industry without market entry clearance, it would risk being deemed noncompliant.

- As noted above, existing FIEs would have a three-year transition period to adjust their corporate governance procedures.
- The treatment of long-term financing, the acquisition of real property and concessions for exploring or developing natural resources or for constructing or operating infrastructure during the transition period is unclear.
- Substantial reporting obligations would be imposed on FIEs under the Draft FIL, including requirements to submit an investment report, a change in investment (e.g. share transfer, shareholder change, capital increase, etc.) report, a quarterly report (in certain circumstances) and an annual report. Any reported changes that could trigger market entry clearance would require an application to MOFCOM.

Impact on VIE structures

The Draft FIL would have a significant impact on VIE structures. These structures typically are used by foreign investors to finance Chinese businesses in restricted industries: a wholly foreign-owned vehicle is used to control a Chinese entity that holds a relevant license, thus enabling it to operate in the “restricted” sector.

The FIL would not eliminate VIE structures. Instead, a VIE that is de facto controlled by a foreign investor(s) would be treated the same as other foreign investment, i.e. a VIE could not invest in an industry on the prohibited list and investment in an industry on the restricted list would require entry clearance. A VIE structure that is de facto controlled by Chinese investors would be allowed and would not be subject to the negative list restrictions, and a VIE structure set up by a foreign investor in an industry not on the negative list would be permitted. However, the Draft FIL does not contain any provisions on how to deal with existing VIEs where foreign investors use the structure to circumvent regulatory restrictions on foreign investment.

The potential impact of the new FIL (if enacted as currently drafted) on VIE structures would be as follows:

- The need to set up new VIE structures would be diminished because a VIE would not be able to be used to bypass negative list restrictions;
- VIE structures used in “red chip” structures (i.e. offshore listings) could attract the attention of overseas stock exchanges if the structure is effectively unnecessary; and
- VIE structures in existence before the enactment of the new FIL could be subject to challenge if they were set up for the purpose of circumventing regulatory restrictions on foreign investment.

Comments

There is no clear timeline for enactment of the new FIL, but, if enacted as currently drafted, the FIL would fundamentally change the foreign investment regulatory regime in China. In anticipation of enactment, affected foreign investors should consider the following actions:

- Reviewing the corporate governance structure of existing EJV/CJVs to identify items that should or could be adjusted;
- Preparing a strategy for the transition to the new regime, as well as a strategy to negotiate with Chinese JV partners;
- Assessing whether new options are needed where a foreign investor is relying on a VIE structure in “sensitive” industries;
- Restructuring any investments that could be perceived to have been designed to circumvent previously valid Chinese laws/regulations, to conform them to the new law; and
- Obtaining legal advice to better prepare for the new law.

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Belgium: Decision issued on fairness tax

Belgium’s Constitutional Court issued a decision on 28 January 2015 on a taxpayer request for the fairness tax introduced in the Law of 30 July 2013 to be annulled. The taxpayer took the position that the fairness tax should be annulled on several grounds, including that the tax violates the nondiscrimination principle in the Belgian constitution when read in conjunction with the EU freedom of establishment principle and the EU parent-subsidiary directive (according to the directive, dividends distributed by a Belgian subsidiary to its EU parent company should be exempt from dividend withholding tax, and double taxation of dividends received by a Belgian parent from its EU subsidiary must be avoided).

The fairness tax, introduced as from tax year 2014, is levied at a rate of 5.15% (5%, plus the 3% crisis surcharge) on resident and nonresident companies (other than small and medium-sized enterprises) if, for the same taxable period, a company distributes dividends and the taxable base is reduced by prior year tax losses and/or the current year notional interest deduction.

The Constitutional Court decided to refer three questions to the Court of Justice of the European Union for a preliminary ruling:

- Whether the application of the fairness tax to Belgian branches of EU resident companies violates the freedom of establishment principle;
- Whether the fairness tax is a prohibited withholding tax under article 5 of the parent-subsidiary directive because a declaration of dividends can trigger the application of the tax; and

- Whether article 4 of the parent-subsidiary directive allows dividends received from subsidiaries to affect the fairness tax liability of the parent company when these dividends are redistributed in a subsequent year.

It should be noted that the European Commission already has taken the position that the fairness tax violates the parent-subsidiary directive, as well as the freedom of establishment and free movement of capital principles in the Treaty on the Functioning of the European Union.

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Denmark: Government issues draft bill with anti-avoidance measures

The Danish government issued a draft bill on 25 January 2015 that would introduce two anti-avoidance provisions – general anti-avoidance rules (GAARs) and a rule applicable to foreign trusts – as well as limits on the duration and binding effect of rulings relating to the valuation of assets. Although the bill still is in draft form, the proposed measures are part of an agreement the government signed with the People’s Party, Socialist Party and Unity List in 2014 as an action step to combat the use of tax havens. Therefore, only minor adjustments are expected before a final bill is adopted (presumably during spring 2015).

Once passed, the proposed measures generally would be effective as from 1 July 2015; the GAAR, however, would apply as from 1 May 2015.

International GAAR

Denmark currently does not have a statutory GAAR, although the Danish courts have used basic principles to disregard certain transactions that are carried out for tax purposes and that have no, or limited, business purposes.

The draft bill would introduce two GAARs into Danish law: an EU tax directive anti-abuse provision and a tax treaty anti-abuse provision. The EU tax directive anti-abuse provision is an implementation of the updated EU parent-subsidiary directive (which must be implemented into domestic law by 31 December 2015), and the tax treaty anti-abuse provision is an implementation of the OECD recommendations under the base erosion and profit-shifting (BEPS) initiative on preventing the granting of treaty benefits in inappropriate circumstances.

The proposed GAAR that would implement the amended parent-subsidiary directive mirrors the wording of the amended directive, but it also would capture transactions covered by the EU merger and interest and royalties directives. Under the proposed GAAR, Denmark would not grant the benefit of, for example, the parent-subsidiary directive (i.e. no withholding tax) if obtaining such a benefit was the main purpose, or one of the main purposes, of any arrangement or series of arrangements resulting in that benefit.

The proposed tax treaty GAAR contains wording similar to the tax directive GAAR and would apply to transactions covered by an applicable tax treaty.

The scope of the proposed GAARs is unclear and the draft bill does not provide any additional guidance. The Danish tax authorities likely will rely on the interpretations of the Court of Justice of the European Union and the relevant OECD guidelines in determining the parameters of the GAARs.

Taxation of grantors of foreign trusts

The use of foreign trusts by Danish taxpayers has been under increased scrutiny in recent years, mainly because it is possible for the grantor of a trust to retain de facto control over the trust assets, as the assets are not irrevocably separated from the grantor's other assets.

Under the draft bill, the grantor of a foreign trust would be taxed on current income realized by the trust, in a way similar to taxation under the controlled foreign company regime; that is, the grantor would have to include the trust income in his/her own income. The rule would apply to foreign trusts regardless of whether the law in the foreign country requires the trust assets to be effectively and irrevocably separated from the grantor's assets.

If the trust has been subject to taxation in the foreign country, the tax paid would be able to be credited against the grantor's taxable income. The new rules would not apply to charitable or nonprofit trusts, or to commercial trusts used as collective investment funds or for retirement savings.

The rules would apply to trusts incorporated as from 1 July 2015, or where the grantor makes a contribution to the trust as from that date.

The draft bill would make it unattractive for Danish taxpayers to form and contribute to foreign family trusts. However, it is unclear from the draft bill how foreign trusts would be defined, and it is questionable whether the rules would be compatible with EU law, since grantors of foreign trusts that are similar to Danish foundations could be subject to the rules and be taxed more heavily than a comparable Danish foundation.

Limitations on binding rulings

Under the current rules, a ruling issued by the National Tax Assessment Board is binding on the Danish tax authorities, normally for a period of five years.

Obtaining a binding ruling on the tax value of assets, etc. may be desirable when transferring assets into and/or out of Denmark, or when transferring assets between related parties. The draft bill would reduce the effective period of a binding ruling on the tax value of assets from five years to six months.

The draft bill also would allow the tax authorities to disregard a binding ruling if the value of the assets – based on a subsequent sale or subsequent yield on the assets – exceeds the value determined in the binding ruling by at least 30%, and by at least DKK 1 million. A disregarded binding ruling would not automatically trigger taxation, since there may be justifiable reasons

for the higher value. In this case, the taxpayer would be treated as if no binding ruling had been issued.

The draft bill would create more tax uncertainty for Danish taxpayers that wish to move assets out of or into Denmark. It also is unclear from the proposal how the tax authorities would determine whether the value of assets exceeds the value determined in the binding ruling by more than 30% and more than DKK 1 million. Based on the draft bill, it is fully up to the tax authorities' discretion to make this determination.

The consequence of the new rules likely would be that binding rulings would no longer be a suitable method for clarifying the tax value of assets.

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Hong Kong: Tax resident certificate application forms revised

Hong Kong's Inland Revenue Department (IRD) has revised the application forms used to obtain a certificate of resident status under comprehensive arrangement/agreements for the avoidance of double taxation (DTA). The new forms must be used for applications submitted as from 1 February 2015.

During the annual meeting between the IRD and the Hong Kong Institute of Certified Public Accountants held in February 2014, the IRD mentioned that, when determining whether to issue a tax resident certificate to a company (regardless of whether the company was incorporated in Hong Kong or overseas), the IRD considers whether the person is *prima facie* entitled to treaty benefits, in addition to whether the person qualifies as a tax resident for purposes of the treaty. If the IRD has reason to believe a person would not be entitled to treaty benefits, it may request further information or exchange information with the treaty partner jurisdiction before deciding whether a tax resident certificate should be issued. The IRD looks at the beneficial ownership, whether there is any abuse of the relevant DTA and whether the company is a conduit company, and will refuse to issue a tax resident certificate to a "paper" company that was incorporated in Hong Kong merely to obtain treaty benefits.

The modifications to the application forms are consistent with the IRD's change in practice in determining whether to issue a tax resident certificate. The revised forms request more information to allow the IRD to consider the factors mentioned above. While different forms previously were used for applicant companies incorporated in Hong Kong and those incorporated outside Hong Kong for purposes of the DTA with Mainland China, the same form (IR1313A (1/2015)) now applies. In other words, Hong Kong-incorporated companies now must provide more detailed information in the application form.

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Luxembourg: Guidance on commercial activities provided for limited partnerships

Luxembourg's tax authorities published a circular on 9 January 2015 that provides guidance on when a common limited partnership (SCS) or special limited partnership (SCSp) is considered to carry out a commercial activity (as opposed to a private wealth management activity) for tax purposes.

Luxembourg used its implementation of the EU Alternative Investment Fund Managers Directive in July 2013 as an opportunity to modernize the legal regime for SCSs and to introduce the SCSp as a new form of limited partnership. (Most provisions applicable to these types of entities are similar; the main difference is that the SCSp does not have legal personality.) Since then, these vehicles, particularly the SCSp, have emerged as efficient fund or carried interest structures that are well-suited to an alternative asset manager's business model and comparable to the Anglo-American partnership model.

In light of the increasing use of the SCS and SCSp, the tax authorities published the new circular mainly to address the issue of the commerciality of these entities from a tax perspective. Briefly, when an SCS or SCSp is not viewed as carrying out a commercial activity for tax purposes and is not "commercially tainted" by its general partner, it is not subject to Luxembourg municipal business tax (e.g. 6.75% for Luxembourg City).

The circular confirms that, by reason of their corporate objective (i.e. asset management) and investment policy, alternative investment funds (within the meaning of the law dated 12 July 2013) established as an SCS or SCSp are deemed not to carry out a commercial activity when their general partner owns less than 5% of the interests in the SCS/SCSp.

The circular also confirms that, in light of specific provisions in various Luxembourg laws, the following types of entities also are deemed not to carry out a commercial activity for tax purposes, regardless of whether the general partner owns less than 5%:

- An investment company with variable capital (SICAV);
- A specialized investment fund (SIF);
- An investment company in risk capital (SICAR); and
- An alternative investment fund established outside Luxembourg that has an effective center of management or central administration in Luxembourg.

For other SCS/SCSp entities, the tax authorities refer to case law to clarify the distinction between commercial activity (defined in the income tax law as "an independent activity carried out on a permanent basis with the aim of being profit making and participating [in] the general economic activity") and private wealth management:

- The tax authorities place particular emphasis on the condition of “permanence.”
- Although the case law deals with real estate assets, the tax authorities indicate that the circular’s conclusions also can be applied to movable securities.
- The tax authorities will not consider an SCS/SCSp to carry out a commercial activity based solely on the fact that the SCS/SCSp holds significant assets or that it sells certain assets within a relatively short period of time after acquisition.
- The commerciality of an SCS/SCSp is to be determined based on the circumstances of each case, specifically based on the investment policy of each vehicle.

The clarifications in the new circular should provide more certainty regarding how the tax authorities will interpret the concept of a commercial activity versus a private wealth management activity for tax purposes. In the context of the alternative fund industry, the circular confirms the principle of “tax neutrality” and should make the SCS/SCSp a popular choice for fund or carried interest structuring.

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New Zealand: Mutual assistance convention should help fight tax evasion

The multilateral Convention on Mutual Administrative Assistance in Tax Matters entered into effect in New Zealand on 1 January 2015. The convention authorizes the tax authorities of the signatory countries to assist each other regarding the exchange of information, the recovery of unpaid tax and the service of documents. New Zealand is one of over 60 signatory countries.

The mutual assistance convention significantly increases New Zealand’s ability to detect and prevent tax avoidance. A key practical benefit for New Zealand is a reduction in the future resource and administrative costs of having to negotiate new bilateral treaties or update existing treaties. For example, at least 14 of the countries that have signed the convention are countries that have not signed a tax treaty or a tax information exchange agreement with New Zealand.

It should be noted, however, that the mutual assistance convention contains some mechanisms that allow a country to avoid working with particular countries on certain grounds, i.e. a country can refuse to comply with information requests on human rights grounds or if a request is at odds with its own laws.

There is growing importance of the exchange of information internationally, particularly against the backdrop of BEPS (base erosion and profit shifting) concerns. It is interesting to note that, in addition to specific requests by one country to another, automatic exchanges are becoming increasingly common, i.e. where certain tax authorities have made arrangements to provide another country with certain generic information, such as all nonresident withholding tax deducted from interest payments. Apparently, New Zealand Inland Revenue already receives

one million documents in bulk from the Australian Tax office each year in an automatic exchange arrangement, and Australia likely receives some reciprocation from New Zealand.

More spontaneous exchanges also are now taking place, where a tax authority will pass on information uncovered during an investigation that it considers of interest to another tax authority. Simultaneous exams, where two tax authorities investigate the affairs of a multinational company at the same time and share the information discovered, also are more common.

The mutual assistance convention is yet another tool in the Inland Revenue's armory to use to tackle international tax avoidance, evasion of tax through failure to declare overseas income and cases where taxpayers seek to escape paying debts by leaving the country.

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Taiwan: Draft amendments to transfer pricing guidelines released

Taiwan's Ministry of Finance (MOF) recently released draft amendments to the Rules Governing the Assessment of Income Tax for Profit-Seeking Enterprises on Non-Arm's-Length Transfer Pricing ("transfer pricing guidelines") that include a new definition of "business restructuring," a lowering of the threshold amount to obtain an advance pricing agreement (APA) and the introduction of an APA pre-filing conference and bilateral and multilateral APAs. The draft rules are expected to be finalized in the near future.

Definition of business restructuring

The definition of a business restructuring would be refined to mean a reorganization or reallocation of activities carried out by a multinational enterprise or group with respect to the functions, assets and risks of related parties, or the termination, renegotiation or transfer of business terms or arrangements between such parties. Business restructurings would include the following:

- A change of functions from a full-fledged distributor to a limited risk distributor;
- A change of functions from a full-fledged manufacturer to a contract or toll manufacturer;
- A transfer (i.e. centralizing or segregating) of intellectual property rights;
- A streamlining, winding up or liquidation of a business; and
- Other arrangements.

Any profit distribution resulting from a business restructuring must be on arm's length terms, as must any compensation for the reallocation of functions and risks, both before and after the restructuring. In determining whether the arm's length principle is met, the following must be taken into account:

- Consideration for the reallocation of risks:
 - Whether the reallocation of risks during the business restructuring conforms to the economic substance of the transactions;
 - Whether the allocation of functions/assets/risks/profits in the controlled transaction is on arm's length terms, both before and after the business restructuring; and
 - Whether the risk bearers have the control and financial capacity to assume such risks.
- Arm's length compensation for a business restructuring:
 - The business reasons and the expected benefits of a business restructuring;
 - The rights and obligations of the participants before and after the business restructuring;
 - Whether the allocation of potential profits is matched with the relevant risk allocation;
 - Whether the compensation for the transfer of tangible/intangible assets is appropriate; and
 - Whether compensation paid for losses suffered by one of the parties involved in the restructuring as a result of a termination or renegotiation of a contract is sufficient and appropriate.

The enterprise must carry out a comparability analysis of the controlled transactions after the business restructuring to determine the appropriate transfer pricing method, and it must compare the compensation to the operating profit both before and after the restructuring.

The Taiwan tax authorities will review all documents related to a business restructuring to determine whether the controlled transactions are "genuine," and if the economic substance of the controlled transactions differs from their form, the authorities will make the appropriate adjustments to ensure the transaction is on arm's length terms.

According to Taiwan's transfer pricing guidelines, the transfer pricing report should include a two-year analysis of functions and risks, since these tend to change following a business restructuring.

Advance pricing agreements

Under current rules, an APA may be obtained where the aggregate amount of the controlled transactions is at least NTD 1 billion or the annual total amount of the controlled transactions is at least NTD 500 million. It is proposed to reduce the threshold amount of the total controlled transactions to NTD 500 million and the threshold amount of controlled transactions per year to NTD 200 million. The period in which full documentation and the transfer pricing report would have to be submitted would be extended from one month to three months.

Additionally, a prefiling conference option would be introduced, under which the Taiwan tax authorities would be required to notify the applicant whether they are accepting or rejecting the APA application within one month after the prefiling conference. The draft also includes the possibility to apply for bilateral and multilateral APAs under a relevant income tax treaty or regulations.

Other changes

The draft amendments also include the following:

- The net cost plus (NCP) method, a common profit level indicator, would be added to the transfer pricing guidelines, following a ruling issued by the Ministry of Finance (MOF) (Ruling No. 09704541020).
- The profit split method could be used when “all participants in a controlled transaction make [a] unique and valuable contribution.”
- Transfer pricing documentation could be provided at the time the final tax return is submitted, following a 2009 ruling issued by the MOF (Ruling No. 09800470990).

Comments

The most significant proposed changes to the current transfer pricing guidelines are the new definition of business restructuring and the reduced threshold amount required for an APA.

Multinational enterprises should take the following into account when carrying out business restructurings:

- These types of transactions will be subject to scrutiny by the tax authorities and likely will be audited, with a focus on economic substance rather than form. The taxpayer should have sufficient supporting documentation available for the tax authorities to review.
- When an enterprise is carrying out structural or initial public offering planning, the compensation before and after the business restructuring should be on arm’s length terms.
- Enterprises should review a transfer of valuable intangible assets and the relevant income, both before and after the restructuring.

By lowering the threshold amount and adding the pre-filing conference option to the APA procedure, the MOF is encouraging enterprises to apply for APAs. If an enterprise has controlled transactions that involve large amounts or complicated types of controlled transactions, applying for an APA could help to mitigate transfer pricing audit risks. Finally, as Taiwan currently is discussing the possibility of signing tax treaties with a number of countries, including China and Japan, applying for a bilateral APA in the future could further reduce the risk of double taxation for enterprises.

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In brief

Albania: A new electronic tax filing system launched in January 2015 aims to maximize the effectiveness of communications between taxpayers and the tax administration. The tax

authorities have issued detailed guidance on the new system, including the new procedures for communicating with the tax administration.

China: The Ministry of Finance and the State Administration of Taxation have issued a circular that adjusts the export VAT refund rates for selected products. The circular increases and reduces some export VAT refund rates and cancels others.

Czech Republic: The tax authorities have clarified that Czech limited liability companies with nonresident statutory executives should have treated these executives as members of the statutory body of the corporate entity in 2014 (i.e. the executives' income should have been subject to withholding tax rather than advance income tax). An amendment to the income tax act provided that withholding tax treatment applies to statutory executives as from 2015, but the proper treatment for 2014 previously was unclear.

European Union: The European Parliament voted on 12 February 2015 to set up a special parliamentary committee to look into EU member states' tax rulings and other measures similar in nature or effect, and to make recommendations for the future. The committee will have 45 members and will be established for an initial period of six months. The committee will look into tax ruling practices as far back as 1 January 1991, but will review the way the European Commission treats state aid in member states and the extent to which they are transparent about their tax rulings. The committee also will seek to ascertain the negative impact of aggressive tax planning on public finances, and will come up with recommendations for the future. The committee is being set up in the wake of a series of investigations launched by the European Commission into tax rulings for multinational companies in Belgium, Ireland, Luxembourg and the Netherlands.

European Union: The European Commission has published "A Study on R&D Tax Incentives" on the effectiveness of research and development (R&D) tax incentives and what constitutes good practice. This includes a ranking of R&D tax incentives based on 20 best practice principles. According to the report, R&D tax incentive schemes are widely adopted in advanced economies. Within the EU, only Germany and Estonia currently do not have a tax policy aimed directly at stimulating innovation.

France: The tax authorities announced on 4 February 2015 that the additional 15 days previously granted to companies to electronically file their annual corporate income tax and CVAE (economic added value contribution) returns via the TDFC procedure (transfer of tax and accounting data procedure) is revoked as from 1 January 2015. However, a company may continue to benefit from the 15-day extension in 2015 if it makes a specific request when using the TDFC procedure. The request should be made in the appendix to the tax return.

Hong Kong: The Financial Secretary delivered the 2015/16 budget on 25 February 2015, which includes measures to support certain sectors, diversify economic development and reinforce long-term economic growth. More "sweeteners" and similar tax measures are offered to businesses and individuals than in the last few years' budgets, including an extension of the 75% tax rebate on profits tax (up to HKD 20,000). Other proposals would provide incentives for companies in the asset management sector, corporate treasury centers and intellectual property hubs. The government also has committed to the global effort in combatting cross-

border tax evasion arrangements, and proposes to implement the automatic exchange of specified financial account information with other jurisdictions from 2018.

Isle of Man: In the 2015 budget speech presented on 17 February 2015, the Treasury Minister stated that the 0% rate for companies will remain unchanged. However, with effect from 6 April 2015, the corporate income tax rate on companies receiving income from Isle of Man land and property will increase from 10% to 20%. Although no significant announcements were made in relation to international matters, mention was made of the growing global focus on tax transparency (in particular, with respect to the introduction of a centralized registry of beneficial ownership of companies, for which consultation responses currently are being reviewed), the automatic exchange of information based on the OECD common reporting standard and the emergence of new initiatives, such as the OECD's base erosion and profit shifting (BEPS) project.

Japan: With effect from 1 October 2015, Japanese consumption tax (JCT) will be due on digital services supplied to Japanese customers by overseas suppliers. For business-to-business supplies, the tax will be collected under a reverse charge mechanism, but suppliers that make business-to-consumer supplies will need to register and account for JCT. In both cases, there will be specific invoicing requirements. The forthcoming change raises a range of tax, business and systems implications that need to be addressed in the period leading to its implementation.

Singapore: The finance minister presented the budget for 2015 to parliament on 23 February 2015. The 17% corporate income tax rate is broadly unchanged but the minister announced that the top rate of personal income tax will rise from 20% to 22% in 2017.

Switzerland: The government has announced changes that will tighten the requirements for expatriate employees transferred to Switzerland to qualify for certain tax benefits as from 1 January 2016. The changes will impose additional requirements to qualify as an expatriate employee and to benefit from the lump-sum deduction for monthly expatriate expenses (rather than deducting actual expenses) and the deductions for certain housing, travel, moving and schooling expenses.

Taiwan: The Ministry of Finance has announced that a preliminary consensus has been reached on a real estate capital gains tax reform package that aims to rectify flaws in the current system, simplify the rules and make them more equitable. Although a complete bill has not yet been drafted, the proposed reform tentatively would include a flat rate of 17% on capital gains derived by legal entities and individuals from the disposal of both land and buildings. However, a 30% rate would apply to foreign investors, or if the real property was held for less than two years before the disposal.

Tax treaty round up

At the end of each month, *World Tax Advisor* provides an update on recent tax treaty developments, with a focus on items that directly affect the withholding tax rates of the key

jurisdictions covered by the Deloitte International Tax Source (DITS). Additional coverage may include stated negotiating priorities and other important tax treaty trends.

[URL: http://www.dits.deloitte.com?id=us:em:na:wta:eng:tax](http://www.dits.deloitte.com?id=us:em:na:wta:eng:tax)

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

Colombia-Portugal: The 2010 treaty entered into force on 30 January 2015 and will apply as from 1 January 2016. When in effect, the treaty provides for a 10% withholding tax rate on dividends, interest and royalties.

Croatia-India: The 2014 treaty entered into force on 11 February 2015 and will apply as from 1 January 2016 in Croatia and as from 1 April 2016 in India. When in effect, the treaty provides for a 5% withholding tax on dividends paid to a company (other than a partnership) that holds directly at least 10% of the capital of the distributing company; otherwise, the rate will be 15%. A 10% rate will apply to interest, royalties and fees for technical services.

Egypt-Mauritius: The 2012 treaty entered into force on 10 March 2014 and applies as from 1 January 2015 in Egypt and as from 1 July 2015 in Mauritius. A 5% withholding tax rate applies to dividends paid to a company that holds, directly or indirectly, at least 25% of the capital of the distributing company; otherwise, the rate is 10%. The rates on interest and royalties are 10% and 12%, respectively.

Germany-Norway: The 2013 protocol entered into force on 3 February 2015 and applies as from 1 January 2015. The protocol provides for a 0% withholding tax where dividends are paid to a company (other than a partnership) that holds directly at least 25% of the capital of the distributing company; otherwise, the rate is 15%. The protocol eliminates certain paragraphs in the dividends article addressing taxation when different rates apply to undistributed and distributed profits, and does not affect the treatment of interest or royalties.

Iceland-Albania: When in effect, the treaty signed on 26 September 2014 provides for a 5% withholding tax rate where dividends are paid to a company (other than a partnership) that holds directly at least 25% of the capital of the distributing company; otherwise, the rate will be 10%. The rate on interest and royalties will be 10%.

Japan-Qatar: When in effect, the treaty signed on 20 February 2015 provides for a 5% withholding tax rate where dividends are paid to a company that has owned, directly or indirectly, at least 10% of the voting power or of the total issued shares of the distributing company for the six-month period ending on the date on which entitlement to the dividends is determined (however, the 5% rate will not apply if the distributing company is entitled to a deduction for dividends paid to its beneficiaries in computing its taxable income in Japan); otherwise, the rate will be 10%. A 0% rate will apply to interest paid to banks, insurance companies, securities dealers, other enterprises that issue bonds in the financial markets or take deposits at interest and that meet certain requirements and pension funds that meet certain requirements; otherwise, the rate will be 10%. The rate on royalties will be 5%.

Luxembourg-Andorra: When in effect, the treaty signed on 2 June 2014 provides for a 0% rate where dividends are paid to a recipient that holds directly (1) at least 10% of the capital of the distributing company, or (2) a participation with an acquisition cost of at least EUR 1,200,000 in the distributing company, for an uninterrupted period of at least 12 months; the

5% rate will apply where dividends are paid to a company (other than a partnership) that holds directly at least 10% of the capital of the distributing company; otherwise, the rate will be 15%. Interest and royalties will be taxable only in the state of residence of the recipient.

New Zealand: See article in this issue.

URL: http://newsletters.usdbriefs.com/2015/Tax/WTA/150227_7.html

South Africa-Lesotho: When in effect, the treaty signed on 18 September 2014 to replace the 1995 treaty provides for a 10% withholding tax rate where dividends are paid to a company that holds at least 10% of the capital of the distributing company; otherwise, the rate will be 15%. The rate on interest and royalties will be 10%.

Spain-Andorra: When in effect, the treaty signed on 8 January 2015 provides for a 5% withholding tax rate where dividends are paid to a company (other than a partnership) that holds directly at least 25% of the capital of the distributing company; otherwise, the rate will be 15%. The 15% rate also will apply to dividends paid by a Spanish corporation listed on the Real Estate Investment Market to an Andorra resident. The rate on interest and royalties will be 5%.

UK-Algeria: When in effect, the treaty signed on 18 February 2015 provides for a 5% withholding tax rate where dividends are paid to a company (other than a partnership) that holds directly at least 25% of the capital of the distributing company; otherwise, the rate will be 15%. The rate on interest will be 7%, and the rate on royalties will be 10%.

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No new alerts were issued this period. Be sure to refer to the archives to ensure that you are up to date on the most recent releases.

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