World Tax Advisor
Connecting you globally.
9 June 2017

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Japan's CFC rules tightened in line with BEPS action 3

The 2017 tax reform enacted by Japan's National Diet on 27 March 2017 makes fundamental changes to the country's controlled foreign company (CFC) rules (for prior coverage of the reform, see *World Tax Advisor*, 28 April 2017). The changes generally were made in light of the OECD's final report on action 3 of the BEPS project and to address aspects of the existing rules that potentially lead to the under- or over-inclusion of income. The new rules will become effective for accounting years of a foreign related company that begin on or after 1 April 2018.
URL: http://newsletters.usdbriefs.com/2017/Tax/WTA/170428_2.html

The key measures that may have potential tax implications for Japanese-owned groups are discussed below.

Current rules and background

Under Japan's CFC regime, income derived by certain foreign subsidiaries is taxed currently at the level of the Japanese parent. A foreign subsidiary of a Japanese company is considered a CFC if both of the following tests are met:

- The foreign company is more than 50% controlled, directly or indirectly, by Japanese shareholders. A foreign company is considered "controlled" for these purposes if Japanese shareholders own, directly or indirectly, more than 50% of the outstanding shares, the voting shares or the dividend rights of the foreign company; and
- The country in which the foreign company is resident does not impose income tax, or the effective tax rate (ETR) of the foreign company is "less than 20%." (The ETR is calculated by making certain adjustments to the local tax rate and is computed for each fiscal year.)

If a foreign subsidiary qualifies as a CFC, each Japanese shareholder that holds directly or indirectly 10% or more of the outstanding shares (or voting shares or dividend rights, if any) of the CFC is required to report its pro rata share of the taxable profits of the CFC, unless an exception under the rules applies (*e.g.* the active business exemption). All income of the CFC is apportioned – no distinction is made between active and passive income.

There has been considerable discussion about the need to update the CFC rules because they are both under-inclusive and over-inclusive. For example, if the ETR of a foreign subsidiary is 20% or more, the CFC rules do not apply (*i.e.* none of the foreign subsidiary's income is subject to taxation at the level of the Japanese parent company), even if the subsidiary lacks actual economic substance. This leads to the potential "under-inclusion" of income. On the other hand, where the ETR of the foreign subsidiary is less than 20%, income earned by the company may be subject to Japanese taxation in certain circumstances, even where the subsidiary has actual economic substance. This leads to the potential "over-inclusion" of income.

In line with the basic premise of the OECD BEPS project that tax should be imposed based on where the actual economic activities of foreign subsidiaries occur, the changes to the CFC rules aim to ensure that passive income arising in a foreign subsidiary without sufficient economic substance will be aggregated with the income of the Japanese parent company. Active income earned by businesses with sufficient economic substance, however, will not be included in the total income of the Japanese parent, regardless of the subsidiary's ETR.

Overview of new rules

The new rules make the following changes:

- The definition of a controlled foreign subsidiary is revised.
- Both an "entity approach" and an "income approach" will be used.
- The CFC regime generally will apply where a foreign subsidiary is considered a "paper company," a "cash box" or a "blacklist company" (collectively, a "specified foreign subsidiary"), even if the ETR of the foreign subsidiary is 20% or more (but less than 30%).
- Changes are made to the active business exemption.
- The scope of passive income is expanded.

Definition of controlled foreign subsidiary: The revised rules appear to focus on the purpose of the CFC rules as an anti-tax avoidance measure. They will introduce an additional substantive control test, under which a foreign company will be treated as a controlled foreign related company where certain conditions are fulfilled (*e.g.* where the Japanese company has a residual claim for "almost all" the assets of the foreign company), even if Japanese shareholders own 50% or less of the outstanding shares, the voting shares and the dividend rights of the foreign company.

Entity approach / income approach: The application of the revised CFC rules will be based on both an entity approach and an income approach. The entity approach is similar to the main framework under the current rules, and will look at certain characteristics of the company (*e.g.* the ETR of the subsidiary or the overall extent of active business undertaken in the subsidiary, etc.). Under the income approach, a determination will be made based on the details of income earned by the foreign subsidiary. The "less than 20%" tax rate test will be replaced by the following three ETR rules:

- A company that has an ETR of 30% or more will fall outside the scope of the CFC rules.
- The income of a company that is a "specified foreign subsidiary" will be subject to CFC taxation on an entity basis in the hands of the Japanese shareholder unless the specified foreign subsidiary's ETR is 30% or more.
- The income of a company that is not a specified foreign subsidiary and that has an ETR of less than 20% will be subject to CFC taxation on an entity basis in the hands of the Japanese shareholder unless the foreign subsidiary satisfies the "economic activity test," in which case only its passive income will be subject to CFC taxation.

Specified foreign subsidiaries: Under the current CFC rules, where the ETR of a foreign subsidiary is 20% or more, the income of the company is not subject to Japanese taxation in the hands of the Japanese shareholder. Under the new rules, the income of specified foreign subsidiaries that are considered a "paper company," a "cash box" or a "blacklist company" will be subject to Japanese taxation on an entity basis, even if the subsidiary's ETR is 20% or more (unless the ETR of the specified foreign subsidiary is 30% or more).

- A foreign related company will be considered a paper company if it fails to pass the following substance and management and control tests:
    - Substance test: The specified foreign company maintains an office or other fixed place of business necessary to conduct its main business; and
    - Management and control test: The specified foreign company functions with its own administration, management and control in the country where its head office is located.
- A foreign related company will be considered a cash box company if the total amount of certain types of passive income derived by the company during the year exceeds 30% of its total assets; and the sum of the company's securities, loan receivables, intangible assets, etc. exceeds 50% of its total assets. The types of passive income considered and the calculation mechanism will differ depending on whether the company is a financial subsidiary (*i.e.* a foreign subsidiary whose business is banking, financial services or insurance and that meets certain requirements) or a company other than a financial subsidiary.
- A foreign related company will be considered a blacklist company if its head office is located in a jurisdiction designated by Japan's finance minister as a noncooperative jurisdiction with respect to the exchange of tax information (a list of such jurisdictions has yet to be issued). In this case, the foreign company will automatically be considered a CFC, even if it has substance.

The changes relating to specified foreign subsidiaries may have major implications for minority investments, intellectual property management, group finance, etc. performed from countries where the subsidiary's ETR is 20% or more, but under 30%, which are not within the scope of the current CFC rules.

Economic activity test: Where the ETR of a foreign related company is less than 20%, its passive income will be subject to the Japanese CFC rules, even if the foreign subsidiary meets the "economic activity test" and does not fall within the definition of a paper company, cash box or blacklist company. If a foreign subsidiary with an ETR of less than 20% fails the economic activity test, its income will be subject to CFC taxation on an entity basis.

Economic substance currently is determined based on whether the company qualifies for the active business exemption by satisfying certain tests (the business purpose test; the substance test/administration and control test; and the country of location test or the unrelated party test). Under the revised rules, the active business exemption will be changed and renamed the economic activity test, with updates to each of the current tests that apply for purposes of the active business exemption. The main aim of the changes is to grant an exemption from the CFC rules only for certain business activities.

Among other changes, a foreign related company whose major business is aircraft leasing could be treated as satisfying the business purpose test if certain conditions are fulfilled. The current CFC rules clearly state that aircraft leasing does not satisfy the business purpose test. Under similar rules in other major countries, aircraft leasing businesses with sufficient business substance typically are excluded from equivalent CFC rules and, therefore, the tax reforms responded to complaints that Japan's aircraft leasing businesses are unfairly disadvantaged against their international competitors.

Passive income: The scope of income that is subject to the passive income inclusion rules will be expanded under the new CFC rules. The changes include the following:

- Dividends generally will be considered passive income unless they are paid by a company owned 25% or more by the foreign related company (increased from 10% or more under the current rules), except for dividends from certain oil and gas businesses in a country with which Japan has concluded a tax treaty, which will be subject to a 10% ownership requirement. Similarly, capital gains/losses on the disposal of securities generally will be considered passive income unless the foreign related company owns 25% or more of the company whose shares are sold (increased from 10% or more under the current rules) and certain conditions are fulfilled; the current provision under which capital gains are considered passive income only if the shares are disposed of through the open market will be eliminated.
- Interest, including interest received from loans to related companies, generally will be considered passive income unless certain conditions are fulfilled.
- The scope of certain other types of passive income, including royalties and income from leasing, will be expanded.
- New types of passive income will be added, including income from securities lending, profit and losses from derivative transactions, foreign exchange gains and losses, capital gains or losses on intangible assets and certain "irregular amount" income.
- Special rules will apply for financial subsidiaries, under which certain types of income that otherwise would be considered passive may be exempt from the CFC's taxable income in Japan if certain conditions are satisfied.
- Losses arising from certain types of passive income subject to CFC taxation may be carried forward to offset future passive income.

In practice, the extent to which a CFC taxation charge may arise on income from foreign subsidiaries that currently satisfy the active business exemption rule or the economic activity test under the new rules will be likely to increase. For example, Japanese-owned groups that have established regional headquarters in countries with lower tax rates, such as Hong Kong and Singapore, and that are investing in Asian countries through those regional headquarters, should review the nature of income received by such headquarters. In particular, dividend income and gains on disposals derived from shares where there is less than 25% ownership, interest income from group financing, gains and losses on derivative transactions and foreign exchange gains and losses, etc. often arise in the headquarters company from joint venture investment, fund management and similar activities.

Considerations for Japanese-owned groups

Given that the new rules are expected to potentially cause additional CFC income pickup with respect to the new "specified foreign subsidiary" rule and expanded passive income definition, for example, Japanese-owned groups should consider taking the following actions in view of the new CFC rules:

- Review/prepare relevant documentation and establish an ongoing reporting system to the Japanese headquarters for those companies not currently monitored for potential CFC treatment due to having an ETR of 20% or more, but that potentially may be categorized as a paper company, etc. under the new rules;
- For companies whose ETR is less than 20% but that pass the active business exemption test and that have no passive income under the current CFC rules, consider whether passive income will be deemed to exist under the expanded definition and establish a reporting system to the Japanese headquarters;
- Review the organizational structure based on potential risks identified from the steps above (*e.g.* consider the integration of companies where there is sufficient economic substance with a paper company in the same country, or consider reallocation of passive income to a subsidiary located in a country where the effective income tax rate is 20% or more, etc.); and
- Review business models based on potential risks identified from the steps above (*e.g.* for those businesses that are due to generate passive income on an ongoing basis or for businesses that are predicted to have a large amount of passive income in the future, consider reorganizing the business model so that it is more tax efficient, etc.).

— Kazumasa Yuki (Tokyo)
Partner
Deloitte Japan
kazumasa.yuki@tohmatsu.co.jp

Ryuta Tosaki (Tokyo)
Senior Manager
Deloitte Japan
ryuta.tosaki@tohmatsu.co.jp

Cyprus:
MOF revises CbC reporting decree

On 26 May 2017, the Cyprus Minister of Finance issued a revised decree on country-by-country (CbC) reporting, which replaces the decree issued on 30 December 2016. The main changes made by the new decree are as follows:

- The obligation of a Cyprus tax resident constituent entity of a multinational (MNE) group that is not the ultimate parent entity (UPE) or the surrogate parent entity (SPE) to file a CbC report with the Cyprus tax authorities under the "secondary mechanism," along with the corresponding notification obligation, will apply beginning with fiscal (accounting) years (FYs) starting on or after 1 January 2017.
- The concept of an "equivalent CbC report" is introduced to require a Cyprus tax resident constituent entity of an MNE group to file a partial CbC report under the secondary mechanism in cases where the UPE has refused to provide all information necessary for the Cyprus entity to file a complete report. Since the equivalent CbC report filing falls under the secondary mechanism, it also applies with respect to FYs beginning on or after 1 January 2017.
- A requirement to maintain books and records supporting the information disclosed in the CbC report is introduced.

The revised decree, together with the Multilateral Competent Authority Agreement on the Exchange of CbC Reports signed by Cyprus on 1 November 2016, establishes the legislative framework for the Cypriot tax authorities to collect and exchange information on MNE groups with a total consolidated group revenue of EUR 750 million or more.

CbC reporting obligation and notifications

The obligation to file a CbC report in Cyprus on behalf of an MNE group generally lies with the UPE of the MNE group, unless an SPE has been appointed by the group (where certain conditions are fulfilled). The CbC report must be filed with the Cyprus tax authorities if the UPE or SPE is tax resident in Cyprus. Under certain circumstances, a Cyprus tax resident constituent entity that is not the UPE or SPE will have to file a CbC report in Cyprus under the secondary mechanism (*e.g.* where the UPE is not required to file a CbC report in the jurisdiction in which it is tax resident, and the MNE group has not appointed an SPE).

In cases where the Cyprus tax resident constituent entity is the UPE or SPE, the first CbC report of an MNE group (to be filed by the UPE or SPE) is required to be filed for the FY beginning on or after 1 January 2016. However, in cases where the secondary mechanism applies, the revised decree provides that the first CbC report (to be filed by the Cyprus tax resident constituent entity) will be for the FY beginning on or after 1 January 2017.

A constituent entity of an MNE group that is tax resident in Cyprus will have to notify the Cyprus tax authorities whether it is the UPE or SPE (and thus will be filing a CbC report in Cyprus), or a constituent entity performing local CbC reporting in Cyprus under the secondary filing mechanism. If the Cyprus tax resident constituent entity is not acting in such a capacity, it must submit a notification to the Cyprus tax authorities containing the identity and tax residence of the UPE and the reporting entity of the MNE group. For FYs beginning between 1 January 2016 and 20 October 2016, the first notification is due by 20 October 2017; otherwise, the deadline will be the last day of the reporting FY of the MNE group.

Where a Cyprus tax resident constituent entity that is not the UPE or SPE files a report in Cyprus under the secondary mechanism, the revised decree provides that the corresponding notification obligation applies for FYs beginning on or after 1 January 2017.

Equivalent CbC report

If the UPE refuses to provide all required information to the Cyprus resident constituent entity to comply with its local filing requirement, the revised decree requires the Cyprus entity to file an "equivalent CbC report" containing all information in its possession, and to inform the Cyprus tax authorities that the UPE has refused to provide the information.

The required format of the equivalent CbC report described in the decree will follow the template provided in the OECD final report on BEPS action 13.

Maintenance of books and records

The decree provides that the Cyprus tax authorities may request books and records from the reporting entity that explain and support the information disclosed in the CbC report. The reporting entity is required to maintain the books and records for six years. Where such documents are located outside Cyprus, the reporting entity will be required to bring the information to Cyprus by the deadline set by the Cyprus tax authorities.

Exchange of CbC reports

According to the revised decree, the CbC report filed by the reporting entity on behalf of the MNE group should be exchanged automatically by the Cyprus tax authorities with other jurisdictions in which the MNE group has a presence (*i.e.* a tax resident entity or a permanent establishment) within 15 months from the last day of the FY of the MNE group to which the report relates. By exception, the first exchange of CbC reports in relation to FYs starting on or after 1 January 2016 will be made within 18 months from the last day of the reporting FY. CbC reports received by the Cyprus tax authorities under the secondary mechanism (*i.e.* via local constituent entity filing) are not mentioned in the revised decree as being subject to the automatic exchange of information.

Comments

The revised decree does not introduce specific penalties for noncompliance with CbC reporting obligations; therefore, the general fines in the Assessment and Collection of Taxes Law apply. Higher penalties are likely to be introduced to provide a more effective disincentive for noncompliance.

Following the issuance of the revised decree, MNE groups that are subject to CbC reporting in Cyprus should take steps to determine (i) which group entity will be the reporting entity and whether they have the necessary systems and procedures in place to collect the information to be included in the CbC report, and (ii) whether an equivalent CbC report is required. MNE groups also should consider the impact of the information that will be reported and take steps necessary to comply with global transfer pricing standards.

Further guidance on the application of the CbC reporting and exchange requirements is expected to be issued by the Cyprus tax authorities in the near future.

— Pieris Markou (Nicosia)
Partner
Deloitte Cyprus
pmarkou@deloitte.com

Harris Kleanthous (Nicosia)
Director
Deloitte Cyprus
hkleanthous@deloitte.com

European Union: CJEU rules on Luxembourg's implementation of IGP exemption

On 4 May 2017, the Court of Justice of the European Union (CJEU) issued the first of four decisions involving member states' implementation of the "independent group of persons" (IGP) exemption in the EU VAT directive. In this case, the CJEU held that Luxembourg's rules for determining the application of the exemption are too broad and, therefore, are not in line with the directive. The CJEU upheld the infringement proceedings brought by the European Commission against Luxembourg in 2011, and followed the 2016 opinion of Advocate General (AG) Kokott.

Background

Article 132(1)(f) of the VAT directive directs EU member states to grant a VAT exemption when two or more persons or organizations that carry out VAT-exempt activities (*e.g.* banks, insurance companies, hospitals) and/or nonbusiness activities (*e.g.* not-for-profit organizations, public bodies) join together to form an independent cost-sharing group to provide services to group members. To qualify for the IGP exemption:

- The members' activities must be exempt from VAT or be outside the scope of VAT;
- The shared services must be directly necessary for the members' activities; and
- The group must claim reimbursement of each member's share of the joint expenses.

The IGP exemption allows qualifying groups to share resources; in effect, VAT supplies made to group members at cost for the purpose of their own exempt or nontaxable activities are exempt from VAT. Without the IGP exemption, an external structure holding the centralized resources would have to charge VAT on its supplies of the resources to the group members, which, given their VAT-exempt or nonbusiness activities, could result in a final irrecoverable cost for the members.

The IGP exemption has been widely used by taxable persons operating in the financial sector and by not-for-profit organizations in several EU member states, but it also has been the subject of controversy.

The lack of specific details in the directive regarding the conditions for the application of the exemption has resulted in various EU member states imposing different conditions to qualify for the exemption in their implementation of the rules in their domestic law. The European Commission highlighted under-use of the IGP exemption in member states that have overly restrictive IGP regimes and those that have provided insufficient guidance for the application of the exemption in a document issued in 2010. Therefore, it was somewhat of a surprise when the commission challenged Luxembourg's IGP regime in 2011.

Luxembourg law and commission's challenge

Under Luxembourg's VAT law and administrative practice:

- Services supplied by an IGP for the benefit of its members are exempt from VAT, provided the taxed activities of the group member do not exceed 30% (45% in certain cases) of annual turnover, even if the services are used for the group members' VAT-taxable transactions. (This rule was introduced because many taxable persons in the financial and not-for-profit sectors undertake some activities that are subject to VAT).
- IGP group members that carry out taxable transactions may deduct the VAT charged to the group on purchases of goods and supplies of services from the VAT to which they are liable.
- Goods and services acquired in an IGP group member's own name, but on behalf of the IGP, are outside the scope of VAT and, therefore, are nontaxable.

The commission took the position that Luxembourg's rules on IGPs were incompatible with the VAT directive and, in 2011, it officially asked Luxembourg to revise the rules. Luxembourg did not amend the rules, so the commission referred the case to the CJEU on 8 June 2015. In an opinion issued on 6 October 2016, AG Kokott recommended that the CJEU conclude that Luxembourg has infringed the VAT directive by:

- Exempting services supplied by autonomous groups to their members in cases where the services are not directly necessary for the exempt activities of the members;
- Allowing an input tax deduction to members where supplies are made to the group; and
- Adopting an administrative practice that ignores for VAT purposes purchases that are made by a group member in its own name, but for the account of the group.

Decision of the CJEU

The CJEU followed the opinion of AG Kokott and found the three features of the Luxembourg IGP regime challenged by the commission were incompatible with the VAT directive:

- Based on the clear wording in the VAT directive, only services supplied by an IGP to its members that are directly necessary for the exercise of their exempt (or nonbusiness) activities qualify for the IGP exemption. Services related to VAT-taxable activities carried out by the group members should be subject to VAT.
- A group member may not recover the VAT on costs incurred by the IGP because the IGP – not the member – is the beneficiary of the supply. The IGP must be an independent taxable person to make supplies of services to its members, and VAT incurred on supplies rendered for the benefit of the IGP, therefore, cannot be deductible by its members.
- The Luxembourg IGP regime allows members of an IGP to purchase services in their own name but on behalf of the IGP, and then have a subsequent transfer of those services to the IGP be outside the scope of VAT. The CJEU stated that services acquired in the name of the members may not be transferred to the IGP without VAT being applied.

Comments

The court's ruling is a substantial narrowing of the scope of the application of the IGP exemption and likely will make the use of the exemption more cumbersome in some cases, or possibly unworkable. It is difficult to see how the decision could satisfy the European Commission's previously expressed wishes that the IGP exemption be more broadly used. For its part, Luxembourg will need to revise its rules so they are in line with the CJEU decision.

Decisions in the three other cases regarding the IGP exemption that are pending before the CJEU should be issued within the next few months.

— Christian DeGlas (Luxembourg)
Partner
Deloitte Luxembourg
cdeglas@deloitte.lu

Joaquim Bailly (Luxembourg)
Partner
Deloitte Luxembourg
jbailly@deloitte.lu

Germany:
Draft decree released on withholding tax treatment of software and database licensing arrangements

On 17 May 2017, Germany's Ministry of Finance (MOF) issued the first draft of guidance regarding the German withholding tax (WHT) treatment of payments made to nonresidents under software, cloud and/or database licensing arrangements. The draft decree, which is open for comment until 23 June 2017, provides useful guidance and numerous relevant examples.

Background

German domestic tax law generally imposes WHT at a rate of 15.825% (which includes the solidarity surcharge) on royalty payments made to nonresidents, unless a reduced rate or an exemption applies under a tax treaty, or relief from WHT is granted under the EU interest and royalties directive. Payments made to nonresidents that are properly classified as payments for services or for sales proceeds, on the other hand, generally are not subject to WHT in Germany.

For royalty payments that are subject to a reduced rate or are exempt from WHT under a treaty or the directive, the recipient is required to obtain a WHT certificate from the German federal tax authorities before the payment is made; otherwise, the tax must be withheld at the standard rate. The process required to obtain the certificate can be protracted and burdensome. The uncertainty and lack of guidance in this area have led to situations where German customers/recipients of software-based services have requested royalty WHT certificates even in situations where WHT should not be applicable (*e.g.* because the payment should be considered a payment for services), to mitigate the risk of incurring secondary liability for the WHT. The draft decree aims to provide more clarity and certainty to taxpayers in this area.

Payments for use of software

The draft decree provides that outbound payments for the use of software are royalties subject to German WHT only in cases where the user obtains, under the arrangement, a comprehensive right to economically exploit the software. A comprehensive right for these purposes would include the right to reproduce, modify, distribute or "publish" the software. The right to use a software program only for its "designated or intended use," without the right to further exploit or commercialize the software, would not be considered a royalty subject to WHT in Germany. A software program's designated or intended use would comprise:

- Installation of the software;
- Download of the software into user memory;
- Application of the software; and
- Necessary duplication of the software (*e.g.* so that a company's employees can use the software).

It would be irrelevant whether the software is provided via a physical data storage device or electronically by download or via a third-party server.

The draft decree provides that German WHT would not arise if only the result produced from using a software program is commercially exploited by the user. Nine specific examples describe circumstances in which payments for the use of software would and would not be subject to German WHT under the comprehensive right and designated or intended use principles.

Where, for example, a foreign company provides data storage capacity and data transfer capacity, as well as software (*i.e.* a "mixed" contract), the draft guidance clarifies that the various parts of the arrangement would have to be analyzed separately to determine the correct WHT treatment.

Payments for use of databases

The second part of the draft decree addresses the tax treatment of licenses to use databases, and provides four more examples illustrating when WHT would and would not apply. Similar to payments for the use of software, German WHT would apply to payments made to nonresidents for the use of databases and database content only where, as part of the arrangement, the user receives a comprehensive right to economically exploit the database, regardless of whether the right applies with respect to the entire database or is limited to specific content. German WHT would not apply where the rights of the payer are limited to typical rights of a database user (*e.g.* access, reading and printing rights).

Comments

The draft guidance provides a welcome clarification of the WHT treatment of outbound payments for the use of software and databases. If approved, the guidance should allow taxpayers to avoid the lengthy and burdensome process that is required to obtain a WHT certificate in cases where it is unnecessary, by making clear in which situations German WHT will apply to software and database use payments. The MOF has not announced a timeline for finalizing the decree.

— Andreas Maywald (New York)
Client Service Executive
Deloitte Tax LLP
anmaywald@deloitte.com

Mexico:
Rules for application of reduced interest withholding tax rates revised

The first amendments to the miscellaneous tax resolution for the 2017 fiscal year and annex 7 to the resolution were published on 15 and 16 May 2017, respectively, in Mexico's federal official gazette. The amendments include provisions that may restrict the application of the lower withholding tax rates on interest paid to nonresidents under certain circumstances.

The amendments introduce a rule that limits the application of the lower 4.9% and 10% withholding tax rates to interest payments that are deductible for the Mexican resident payer under the domestic provisions related to the OECD BEPS project (for prior coverage, see Mexico Tax Alert, 12 December 2013). A "nonbinding criterion" also is introduced that limits the preferential 4.9% withholding tax rate on interest paid by a SOFOM (a type of financing entity that, although part of the financial system, is subject to less stringent regulation by the financial authorities and is entitled to certain tax benefits). A nonbinding criterion is a rule that establishes the interpretation to be followed by the Mexican tax authorities in an audit, but that is not mandatory for taxpayers to apply in practice and may be challenged by the taxpayer.
URL: https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-alert-mexico-121213.pdf

The most relevant aspects of the new rule and nonbinding criterion published by the tax authorities are described below.

BEPS-related limitation

Under the Income Tax Law (ITL), interest payments made by a Mexican resident to a nonresident are subject to withholding tax at a rate that ranges from 4.9% to 40%, with the applicable rate depending on the identity of the parties, the form (*i.e.* the financial instrument used) and how the loan is used. In general, the 4.9% rate applies to interest paid to nonresident financial entities and banks and in respect of publicly traded securities in Mexico or abroad if certain conditions are satisfied; otherwise, the rate is 10%. A 15% rate applies to interest paid to reinsurance companies and a 21% rate applies if interest is paid to foreign suppliers of machinery and equipment. The rate is 40% where interest is paid to a related party located in a low-tax jurisdiction; otherwise, the rate is 35%. All of these rates may be reduced under an applicable tax treaty.

The new rule incorporated into the miscellaneous tax resolution for fiscal year 2017 provides that, in addition to meeting the requirements to apply the 4.9% and 10% rates, the interest payments must not fall within the scope of the BEPS-related provisions that limit the deductibility of certain interest expense for income tax purposes.

The BEPS-related provisions provide that, with some exceptions, interest payments will not be deductible for income tax purposes if the payments are made to a nonresident that controls or is controlled by the Mexican company that makes the payment, and:

- The nonresident is a transparent entity for tax purposes in its country of residence;
- The payment is disregarded for tax purposes in the nonresident's country of residence; or
- The payment is not considered taxable income in the nonresident's country of residence.

If the reduced 4.9% or 10% withholding tax rates are not applicable based on these provisions, the general 35% rate would apply (unless a reduced rate applies under an applicable tax treaty).

The new rule applies retroactively as from 10 March 2017.

Limitation on payments by SOFOMs

Under the ITL, SOFOMs may apply the 4.9% withholding tax rate to qualifying payments of interest to nonresidents.

Through the new nonbinding criterion, the Mexican tax authorities have clarified that SOFOMs may not apply the 4.9% rate if the effective beneficiary of the interest payment (direct or indirectly, individually or jointly with related parties) receives more than 5% of the interest derived from the relevant financial instrument and is:

- An owner (directly or indirectly, individually or jointly with related parties) of more than 10% of the shares with voting rights of the entity that issued the financial instrument (*i.e.* the entity paying the interest); or
- An entity whose shares are more than 20% owned (directly or indirectly, individually or jointly with related parties) by the entity that issued the financial instrument (*i.e.* the entity paying the interest).

The nonbinding criterion applies retroactively as from 10 March 2017, but since it clarifies the interpretation of provisions previously established in the ITL, the tax authorities can apply the criterion in any audit in progress or for fiscal years that are still open for purposes of Mexico's statute of limitations (*i.e.* the prior five fiscal years).

— Eduardo Barron (Mexico City)
Partner
Deloitte Mexico
edbarron@deloittemx.com

Josemaria Cabanillas (New York)
Client Service Executive
Deloitte Tax LLP
jmcabanillas@deloitte.com

OECD:
Peer review document released on treaty shopping minimum standard

On 29 May 2017, the OECD released a document that will form the basis of the peer review of the BEPS action 6 minimum standard on preventing the granting of treaty benefits in inappropriate circumstances.

The minimum standard on treaty shopping included in the final report on action 6 is one of the four BEPS minimum standards (the other three standards are countering harmful tax practices (action 5), transfer pricing documentation (action 13) and enhancing dispute resolution (action 14)). All members of the inclusive framework on BEPS have committed to implementing the four minimum standards and participating in a peer review process that is designed to ensure consistent, timely and effective implementation of each of the standards.

The new document includes the criteria for assessing implementation of the action 6 minimum standard, as well as the procedural mechanism for conducting the review. It also addresses the process that will be used to resolve interpretation and application issues that may arise during implementation of the minimum standard; the process to be followed by jurisdictions that encounter difficulties in obtaining agreement from another jurisdiction to implement the minimum standard; and the confidentiality of the review process.

OECD Working Party 1 and all jurisdictions that are members of the inclusive framework will conduct the peer reviews starting in 2018. Annual reports will outline whether and how the minimum standard on treaty shopping has been incorporated into the existing bilateral treaties of each jurisdiction in the inclusive framework, and will include any jurisdictions that fail to implement relevant measures. The first report on the implementation of the minimum standard is expected to be published in January 2019.

The minimum standard on treaty shopping is included in the multilateral instrument (MLI) that was signed on 7 June 2017 (see "in brief" in this issue), and will provide an effective way to quickly implement the standard. Members of the inclusive framework are encouraged to use the MLI for that purpose.
URL: http://newsletters.usdbriefs.com/2017/Tax/WTA/170609_ib.html

— Susan Lyons (Washington, DC)
Managing Director
Deloitte Tax LLP
slyons@deloitte.com

Sally Clurman (McLean)
Senior Manager
Deloitte Global
sclurman@deloitte.com

In brief

Brazil: The government released a provisional measure on 31 May 2017 announcing a new tax amnesty initiative, the "Special Tax Regularization Program" (PERT), that will allow taxpayers to settle their outstanding federal tax liabilities. The PERT, which offers several options for taxpayers to obtain reductions in interest and penalties and new conditions for payment plans, replaces the "Tax Regularization Program" (PRT) originally introduced in January 2017 (for prior coverage, see tax@hand, 6 January 2017). Under the PERT, taxpayers may settle their federal tax liabilities, provided they apply to participate in the regime by 31 August 2017.
URL: https://www.taxathand.com/article/5895/Brazil/2017/Federal-tax-amnesty-program-introduced?id=us:2em:3na:wta:awa:tax:060917

Brazil: The government presented a letter to the OECD on 29 May 2017, communicating its formal request to initiate the process to become an OECD member country. In addition, the congress commenced the formal process to approve and ratify a cooperation agreement signed on 3 June 2015 that aims to strengthen the relationship and participation of the Brazilian government in various OECD fora; establish a legal basis for the financial contribution made by Brazil to the OECD; and establish mechanisms to define future collaborations and efforts. The text of the cooperation agreement must be approved by the Brazilian Chamber of Deputies and Senate, and finally by the president, before it can enter into effect in Brazil.

Cambodia: The Ministry of Economy and Finance issued a regulation on 5 May 2017 on the application of withholding tax on dividends paid by Cambodian companies to their nonresident shareholders. The conversion of capital reserves/retained earnings into capital or equity will not be considered a dividend distribution and will not be subject to withholding tax if the conversion was approved by a resolution of the board of directors and a competent Cambodian authority (*e.g.* the Ministry of Commerce and/or the National Bank of Cambodia). However, a 14% withholding tax will be imposed on a dividend distribution to a nonresident in the course of normal business operations, or during a liquidation of the company, where the distribution arises from an equity or a capital conversion from retained earnings that was not subject to withholding tax on dividends.

Ecuador: The value added tax (VAT) rate reverted to 12% on 1 June 2017. The rate was increased to 14% in May 2016 to finance reconstruction activities related to the April 2016 earthquake. All taxable services supplied up to 31 May 2017 are subject to the 14% VAT, regardless of the date on which the invoice is issued (in other words, invoices issued in June for services provided in May must include the 14% VAT). The 14% rate also applies to credit notes affecting invoices issued through 31 May. Supplies made as from 1 June are subject to the 12% rate. It is possible that the tax authorities may issue further guidance on the application of both rates.

European Union: On 29 May 2017, the EU Economic and Financial Affairs Council adopted an anti-tax avoidance directive (ATAD 2) to prevent corporate tax avoidance through hybrid mismatches (for prior coverage, see *World Tax Advisor*, 24 February 2017). The ATAD 2 covers mismatches between EU member states and non-member states, and introduces new provisions on the use of hybrids involving permanent establishments, dual residents, imported mismatches and reverse hybrids. Member states must adopt the domestic legislation necessary to comply with the directive by 31 December 2019 (31 December 2021 for the reverse hybrid provisions), with the legislation to apply as from no later than 1 January 2020 (1 January 2022 for the measures addressing reverse hybrids).
URL: http://newsletters.usdbriefs.com/2017/Tax/WTA/170224_ib.html#EU

Hong Kong: The Legislative Council passed a bill on 25 May 2017, giving effect to the concessionary measures proposed in the 2017/18 budget (for prior coverage, see *World Tax Advisor*, 24 February 2017). On 26 May, a bill that introduces a flat rate ad valorem stamp duty of 15% and closes a loophole in the Stamp Duty Act was gazetted; legislation still must be enacted to for the stamp duty changes to become effective.
URL: http://newsletters.usdbriefs.com/2017/Tax/WTA/170224_ib.html#HK

India: On 3 June 2017, the Goods and Services Tax (GST) council unanimously agreed to 1 July 2017 as the implementation date for GST in India (for prior coverage, see *World Tax Advisor*, 27 January 2017). In addition to finalizing the tax rates for all items on which consensus had not been reached in its previous meetings, the council finalized the rules and format for GST returns and certain transition rules and, on 5 June 2017, published a list of exemptions and concessions that will be available under the GST regime. The council is scheduled to meet again on 11 June to review all published GST rates in light of industry comments and finalize all remaining pending items, including the rules on accounts and records.
URL: http://newsletters.usdbriefs.com/2017/Tax/WTA/170127_4.html

Peru: The tax authorities published a report on 5 May 2017, which clarifies that profits remitted to a Peruvian company by its foreign branch will be considered taxable income in Peru, even if withholding tax also is levied on the branch in the country in which the branch is established. However, a foreign tax credit will be available to the Peruvian company for the foreign tax withheld abroad.

BEPS corner

In each issue that provides updates on developments in the OECD BEPS initiative, the *World Tax Advisor* includes a "BEPS corner" covering these developments.

Brazil: The tax authorities have published guidance that amends the 2016 normative ruling that introduced the CbC reporting obligation in Brazil. See Global Transfer Pricing Alert 2017-023, 29 May 2017.
URL: https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-global-transfer-pricing-alert-17-023-29-may-2017.pdf

Cyprus: The Minister of Finance has issued a revised decree on CbC reporting, which replaces the decree issued on 30 December 2016. See the article in this issue.
URL: http://newsletters.usdbriefs.com/2017/Tax/WTA/170609_2.html

Japan: The scope of the controlled foreign company rules will be revised in 2018, in line with the OECD's final report on BEPS action 3. See the article in this issue.
URL: http://newsletters.usdbriefs.com/2017/Tax/WTA/170609_1.html

Mexico: Rules published in the official gazette restrict the application of reduced withholding tax rates on interest paid to nonresidents in certain cases involving BEPS concerns. See the article in this issue.
URL: http://newsletters.usdbriefs.com/2017/Tax/WTA/170609_5.html

OECD: In a joint ceremony held on 7 June 2017, the multilateral instrument (MLI) to implement the tax treaty-related measures to prevent BEPS was signed by 68 countries and jurisdictions, with eight additional countries expressing their intent to sign the MLI. The OECD announced that many more countries are expected to sign the MLI in the coming months. The MLI, the first of its kind, will automatically transpose the treaty-related measures resulting from the OECD BEPS initiative into more than 1,100 bilateral income tax treaties. The development of an MLI to efficiently implement the treaty-related BEPS measures was recommended in the final report on BEPS action 15 (for prior coverage, see OECD alert, 30 November 2016).
URL: https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-alert-oecd-30-november-2016.pdf

OECD: The OECD has announced that Djibouti and Thailand have become the 97th and 98th countries, respectively, to join the BEPS inclusive framework. Under the inclusive framework, all OECD member country and non-member jurisdictions that commit to the BEPS project will participate as BEPS associates of the OECD's Committee on Fiscal Affairs. Joining the BEPS inclusive framework means that Djibouti and Thailand must implement the four BEPS minimum standards: countering harmful tax practices, preventing treaty abuse, transfer pricing documentation and enhancing dispute resolution.

OECD: On 29 May 2017, the OECD released a document that will form the basis of the peer review of the BEPS action 6 minimum standard on preventing the granting of treaty benefits in inappropriate circumstances. See the article in this issue.
URL: http://newsletters.usdbriefs.com/2017/Tax/WTA/170609_6.html

OECD: On 23 May 2017, the inclusive framework released a discussion draft on The Approach to Hard-to-Value Intangibles: Implementation Guidance for Tax Administrations. See OECD alert, 26 May 2017.
URL: https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-alert-oecd-26-may-2017.pdf

Peru: The tax authorities published guidance on their website on 19 May 2017 to remind taxpayers that, effective from 1 January 2017, it is no longer necessary to file a transfer pricing information return and technical report (which normally would be due in June). These filing obligations were eliminated because the government introduced a requirement for taxpayers to submit a master file, local file and CbC report based on action 13 of the OECD BEPS project (for prior coverage, see *World Tax Advisor*, 10 February 2017). However, the legislative decree that will establish the content of the new obligations and due dates has not yet been published, and it is unclear when the decree will be issued.
URL: http://newsletters.usdbriefs.com/2017/Tax/WTA/170210_9.html

Portugal: The government has extended the deadline for filing the first notifications under Portugal's CbC reporting rules. See Global Transfer Pricing Alert 2017-024, 30 May 2017.
URL: https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-global-transfer-pricing-alert-17-024-30-may-2017.pdf

United States: The Internal Revenue Service has signed its initial bilateral CbC reporting competent authority arrangements. See Global Transfer Pricing Alert 2017-025, 30 May 2017.
URL: https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-global-transfer-pricing-alert-17-025-30-may-2017.pdf

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Global Tax Alerts

Brazil
Brazil issues additional guidance on CbC reporting rules
The Brazilian tax authorities published guidance on 25 May 2017 that amends the 2016 normative ruling that introduced CbC reporting in the country.

Issue date: 29 May 2017
URL: https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-global-transfer-pricing-alert-17-023-29-may-2017.pdf

European Union
ECOFIN agrees on new directive on tax dispute resolution mechanisms
On 23 May 2017, the European Council of Finance Ministers agreed on the terms of a proposed new council directive that aims to improve the existing mechanisms for resolving tax disputes between EU member states arising from the interpretation of tax treaties.
Issue date: 26 May 2017
URL: https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-alert-european-union-26-may-2017.pdf

OECD
BEPS action 8: Hard-to-value intangibles: Implementation guidance for tax administrations
On 23 May 2017, the inclusive framework on BEPS released a discussion draft on *The Approach to Hard-to-Value Intangibles: Implementation Guidance for Tax Administrations*, which supplements the approach set out in the final report on BEPS actions 8-10.
Issue date: 26 May 2017
URL: https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-alert-oecd-26-may-2017.pdf

Portugal
Portugal extends deadline for filing CbC notification
On 30 May 2017, Portugal's secretary of state for finance released a ministerial order extending the deadline for filing the first notifications required under Portugal's CbC reporting rules.
Issue date: 30 May 2017
URL: https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-global-transfer-pricing-alert-17-024-30-may-2017.pdf

Spain
Spain publishes draft order approving new form for reporting related-party and tax haven transactions
Spain's tax agency has published a draft order that would require taxpayers to use a new form to report information on related-party transactions and transactions and situations that involve tax havens, instead of reporting the information in the income tax return.
Issue date: 25 May 2017
URL: https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-global-transfer-pricing-alert-17-021-25-may-2017.pdf

United States
IRS enters into initial CbC reporting exchange agreements
The Internal Revenue Service has signed its initial bilateral CbC reporting competent authority arrangements, the government-to-government agreements under which CbC reporting information will be exchanged.
Issue date: 30 May 2017
URL: https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-global-transfer-pricing-alert-17-025-30-may-2017.pdf

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