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German BFH rules that dividends paid to US S Corp qualify for reduced withholding tax rate under treaty

In a decision dated 26 June 2013, Germany's Federal Tax Court (BFH) concluded that a US S corporation (S Corp) qualified for a reduced dividend withholding tax rate under the 1989 Germany-US tax treaty, as amended by the 2006 protocol. The BFH overruled a 2012 decision of the lower tax court of Cologne and rejected the German tax authorities' interpretation of the clause in the amended personal scope article (article 1(7)) addressing the applicability of the treaty to fiscally transparent entities.

The BFH held that the dividends at issue qualified for the reduced 5% withholding tax rate under the dividends article (article 10(2)(a)). The 0% rate did not apply because the US shareholder held only 50% of the shares in the German GmbH (the threshold for qualifying for the zero rate is 80%). The court based its decision on article 1(7).

The BFH decision resolves a long-standing dispute about the dividend tax treatment of payments to a US S Corp under the amended Germany-US treaty, and the decision should be relevant for other US outbound/German inbound structures involving hybrid entities.

Provisions in the treaty

According to article 1(7) of the amended treaty, income received by entities that are fiscally transparent under the laws of either contracting state will be treated as received by a resident of a contracting state if the laws of that state treat the income as income of a resident of that state.

Article 10 of the amended treaty provides for three withholding tax rates, depending on the extent of the recipient's participation in the distributing company. The rates are as follows:

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- 0% when the recipient holds directly at least 80% of the voting stock of the distributing company for 12 months on the date on which entitlement to the dividends is determined, if the taxpayer qualifies for treaty benefits under one of the tests in article 10(3) and the limitation on benefits article;
- 5% when the recipient holds directly at least 10%, but less than 80%, of the voting stock of the distributing company; and
- 15% in all other cases.

BFH decision

The case involved a US resident corporation that elected to be treated as a transparent entity for US tax purposes under subchapter S of the US Internal Revenue Code (sections 1361-1378) and, therefore, was not subject to income tax. In 2008, the US corporation held 50% of the shares in a German GmbH and received a dividend from this subsidiary. The German GmbH withheld a domestic dividend withholding tax of 21.1% (the applicable rate at the time) on the payment. The US corporation applied for a reduction of the withholding tax to the 5% rate based on article 10(2)(a) of the amended treaty, and requested a refund of the excess tax withheld. The German tax authorities denied the request, but granted a reduction to the 15% default rate under article 10(2)(b). The lower tax court of Cologne agreed with the tax authorities and denied the application of the 5% rate. The BFH, however, rejected the positions of both the tax authorities and the lower tax court and ruled in favor of the taxpayer.

To be entitled to the 5% rate on dividends, article 10(2)(a) of the amended treaty requires that the dividends be derived and beneficially owned by a company resident in the other contracting state. Article 4(1) defines a resident of a contracting state as ‘‘any person, who under the laws of that state, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature.’’ As a result, the application of the treaty is linked directly to the tax treatment of the recipient in its state of residence.

The lower tax court held that because an S Corp is treated as a transparent entity for US tax purposes and, therefore, is not subject to US income tax, it cannot be treated as a resident of a contracting state and cannot benefit from a reduced dividend withholding tax rate under the treaty. The BFH, however, took a different view. According to the BFH, article 1(7) of the amended treaty must be interpreted in a way such that it includes a “residence fiction” that results in the application of the treaty at the level of the transparent entity itself, and not at the level of the shareholders that are subject to tax in the US on their share of income from the entity. Thus, the BFH held that article 1(7) deems a transparent entity to have residence in a contracting state.

In reaching its conclusion, the BFH referred to its decision in a 2008 case regarding the treatment of an S Corp under the original text of the 1989 Germany-US treaty, and stated that the legal situation did not change as a result of the amendment to the treaty. The original text of the treaty did not contain a rule comparable to article 1(7); however, it contained a rule applicable to partnerships (and estates and trusts) (article 4(1)(b)) that provided that partnerships must be regarded as residents and must be granted treaty benefits to the extent that their partners qualify as resident persons under the treaty and the partnership income is subject to tax at the partner level. In the 2008 case, the BFH applied this same rule to an S Corp. However, since the treaty was amended, it had been disputed whether the “substitution” of article 4(1)(b) of the original text of the 1989 treaty with article 1(7) of the amended treaty led to different treatment for S Corporations. The BFH stated in the June 2013 case that it interprets both provisions in the same way and therefore reaches the same result (i.e. it considers S Corps to be residents if their partners qualify as resident persons under the treaty).

The BFH also explained that, in its opinion, article 1(7) cannot be interpreted as an income attribution rule; instead, the attribution of profits must be made based on the domestic principles of the source state. Based on German principles, a US S Corp should qualify as a corporation (which is not a transparent entity for German tax purposes), so the S Corp itself and not its shareholders should be treated as the recipient of the dividend and it must be analyzed whether the conditions for the reduced dividend withholding tax under article 10(2)(a) are met at the S Corp level. Based on its 50% ownership of the GmbH, the S Corp in this case qualified for the reduced 5% withholding tax rate.

Additionally, the BFH also mentioned that, in the case, the S Corp itself (rather than its shareholders) had the right to request a refund of the withholding tax under article 29 of the treaty and section 50d of the German Income Tax Code. However, the court pointed out that for payments made after 30 June 2013, the amended section 50d(1) sent. 11 of the Income Tax Code must be taken into account. Under the amended rule, only the person that qualifies as the taxpayer in the residence state (e.g. the shareholders of a US S Corp) can request a refund or apply for a withholding tax exemption certificate.

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Comments

The tax treatment of dividends paid by a German entity to a US S Corp (or an LLC that is treated as transparent for US tax purposes and nontransparent for German purposes) has been subject to considerable debate in Germany in light of the amendments made by article 1(7) of the 2006 protocol. The BFH decision should resolve this debate, at least with respect to the treatment of S Corps. The decision also may clarify the treatment of US LLCs that are hybrid entities, although it remains unclear how the German tax authorities will apply the BFH decision to LLCs.

The BFH also clarified that article 1(7) is not an attribution rule and, therefore, does not answer the question of which party derives the income for treaty purposes under article 1(7). This determination must be made based on the domestic law provisions of the country applying the treaty (i.e. the source country for withholding tax purposes).

The BFH decision should resolve some uncertainties about using a US S Corp for investments into Germany, even though it is unclear how the German tax authorities will apply the decision to other hybrid entities and how the newly applicable section 50d(1) sent. 11 of the Income Tax Code will affect such structures.

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China:
SAT clarifies meaning of technical services "inseparable" from transfer of technology

China's State Administration of Taxation (SAT) issued a circular on 29 October 2013 (Bulletin 62) that clarifies the enterprise income tax treatment of income from transfers of technology. Specifically, the bulletin provides guidance for determining whether certain technical services are "inseparable" from a transfer of technology, such that the tax incentive that applies to income from the transfer also should apply to income from the technical services provided. Bulletin 62 is effective as from 1 November 2013.

The 2008 Enterprise Income Tax Law introduced a tax incentive for income derived by a resident enterprise from the transfer of qualifying technology. (A "transfer of technology" for these purposes refers to a transfer of the ownership of the technology, or a global exclusive licensing of the technology for a period of five years or more. A transfer of technology to a related party that the transferor wholly owns, directly or indirectly, is specifically disqualified from benefiting from the tax incentive.) Under the incentive, the first RMB 5 million of income is exempt from enterprise income tax, and thereafter 50% of the income is exempt.

The SAT issued a circular in 2009 (Circular No. 212) stipulating that income from technical consulting, training services or other relevant services (collectively, "technical services") that are inseparable from the transfer of technology may be considered part of the technology transfer income eligible for the preferential treatment.

Bulletin 62 clarifies that technical services that are considered inseparable from a technology transfer include any technical assistance from the transferor that is necessary to enable the recipient to know how to put the technology into use and/or achieve commercialization. In addition, both of the following requirements must be met for the inseparable technical services to qualify for the tax incentive:

- The provision of the services must be agreed to in the technology transfer agreement for which the services are relevant; and
- The services income must be received along with the income from the technology transfer.

According to the interpretation notes accompanying Bulletin 62, it is the SAT's opinion that technical services provided *after* the technology has been put into use and/or commercialization has been achieved should not be considered inseparable. In particular, technical services provided in respect of product after-sales services, maintenance and upgrading will be considered separate and, therefore, ineligible for the preferential enterprise income tax treatment.

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Although Bulletin 62 clarifies which technical services will be considered inseparable, uncertainty remains because it is difficult in practice to clearly distinguish between services that are needed to enable the recipient to know how to put the technology into use and achieve commercialization and those that are not. It also is common for a transferor to provide ongoing technical assistance even after technology has been put into use and commercialization achieved.

Finally, the requirement that the services income be received along with the technology transfer income may be of concern to taxpayers because it is unclear whether separate pricing and/or invoicing for services provided would result in failure of this requirement.

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Hong Kong:
CFA holds unrealized gains not chargeable to profits tax

Hong Kong's Court of Final Appeal (CFA) ruled on 12 November 2013 that unrealized gains arising from the revaluation of trading securities that were recognized in accordance with ordinary commercial accounting principles were not chargeable to profits tax under section 14 of the Inland Revenue Ordinance or IRO (*Nice Cheer Investment Limited v. Commissioner of Inland Revenue* (CIR)). The CFA is the court with final adjudication power on the laws of Hong Kong.

Background

The taxpayer is a Hong Kong company principally engaged in the trading of securities quoted on the Hong Kong stock exchange. It prepared its financial statements in accordance with the prevailing accounting standards and recognized realized and unrealized gains and losses on trading stock in its financial statements for the relevant periods. The unrealized gains and losses were recognized on the changes in the fair value of the unsold trading stock held at year end.

The taxpayer treated the unrealized gains as nontaxable income, but claimed a tax deduction for the unrealized losses. The CIR took the position that the unrealized gains arising from the unsold stock should be treated as taxable. The CIR's reasoning was that profits tax should be assessed according to the applicable accounting principles.

The taxpayer appealed the CIR's tax assessments. The case went to the Court of First Instance (CFI) in 2011, the Court of Appeal in 2012 and finally the CFA in 2013. The taxpayer prevailed at all levels, with all courts concluding that the unrealized gains should not be recognized for profits tax purposes and thus were not chargeable to profits tax.

Decision of the CFA

The CFA held in favor of the taxpayer, concluding that the unrealized gains from revaluation of trading securities were not taxable, whereas unrealized losses may be deductible.

In accordance with the applicable statutory provision (section 14 of the IRO), the court stated that "profit" must derive from some trade, professional or business activity, and not merely result from a revaluation of assets held for the purpose of a trade, profession or business. As such, increases in the value of trading stock during the relevant period that represent unrealized profits should be excluded when computing assessable profits and are not chargeable to tax.

On the question of unrealized losses, the CFA noted two cardinal principles of tax law: (i) the word "profits" connotes actual or realized profits, not potential or anticipated profits; and (ii) neither profits nor losses may be anticipated. However, the court commented that the latter principle should not be interpreted to prohibit a taxpayer from using an unrealized loss to reduce its liability to tax; a taxpayer can "make a provision in the profit and loss account" for the diminution in the value of the trading stock, but this provision must be justifiable.

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Comments

The CFA decision is clear and unambiguous that unrealized gains on trading securities should be nontaxable. The court held that such gains are anticipated and are not "profits" for purposes of section 14 of the IRO. In preparing tax computations, a taxpayer should be entitled to remove the amounts of its unrealized profits as not chargeable to tax.

Additional observations on the CFA's decision in *Nice Cheer* are as follows:

Unrealized losses – Taxpayers should consider the tax treatment of unrealized losses. The CFA noted that neither profits nor losses may be anticipated, but it did not unambiguously prohibit the recognition of unrealized losses, as it did for unrealized gains. The court mentioned that a taxpayer may make a provision in the profit and loss account for the diminution in value of trading stock during the accounting period, but this provision must be justified.

The CFA's decision is not straightforward on the treatment of unrealized losses. It is not entirely clear in what situations a provision would be considered "justified." In particular, the court made no comment on section 19D, which requires that the amount of loss incurred by a person chargeable to tax for a year of assessment be computed in a like manner as the assessable profits for that year of assessment. Disputes between taxpayers and the IRD on the deductibility of unrealized losses are likely.

Other unrealized gains – The CFA's decision raises the issue of whether all unrealized gains recognized in financial statements should be treated as nontaxable under the same principle the court applied to unrealized gains from revaluation of trading securities in *Nice Cheer*. In particular, the court emphasized that the words "every person" in section 14 of the IRO mean that the section should be applied in the same way to every taxpayer to which the statute applies, regardless of the nature or size of the business. Accordingly, it seems the decision may be applied to other unrealized gains, such as those arising from the trading of debt securities (e.g. bonds) and other financial instruments. However, it is possible that the IRD may try to limit the application of *Nice Cheer*, e.g. to only situations involving the trading of equity securities, etc. It is yet to be seen how the IRD will interpret and apply the decision.

Exchange differences – The CFA did not comment on the treatment of foreign exchange transactions, as this was not at issue in the case. However, the CFI stated that the *Nice Cheer* decision should not be universally applied to foreign exchange transactions because unrealized gains and losses from foreign exchange transactions are different than those from trading securities; the underlying trading assets for foreign exchange transactions are currencies (money), i.e. fungible assets that have a ready market and a value against the reporting currency. In view of the above, it is unlikely that the IRD will accept the treatment of unrealized gains from foreign exchange transactions as nontaxable.

Tax follows accounting principle – It is interesting to note that Lord Millett, the judge in *Nice Cheer* and *Secan* (*CIR v. Secan Ltd. & Ranon Ltd.*), opined in *Nice Cheer* that the IRD had misread his decision in the *Secan* case. The *Secan* decision led the IRD to issue Departmental Interpretation and Practice Notes No. 40 – Prepaid or deferred revenue expenses (DIPN 40) and No. 42 – Taxation on financial instruments and foreign exchange differences (DIPN 42). In the IRD's view, the essence of the *Secan* case is that tax treatment should follow the treatment prescribed under the accounting rules unless the accounting rules are contrary to any provision of the tax statute, i.e. "tax follows accounting." However, the CFA stated that financial statements are prepared for investors' use in understanding the company's financial position and profitability, especially its future profitability; they are not prepared for tax purposes:

> *"It is clear beyond argument that accounts drawn up in accordance with the ordinary principles of commercial accounting must nevertheless be adjusted for tax purposes if they do not conform to the underlying principles of taxation enunciated by the courts even if these are not expressly stated in the statute."*

This raises the issue of to what extent "tax should follow accounting" and how this principle may evolve in the future. Following the judgment in the *Nice Cheer* case, it remains to be seen whether the IRD may revise DIPN 40 and DIPN 42.

***Sharkey v. Wernher* principle –** The *Sharkey v. Wernher* principle, based on a 1955 UK tax case, generally is applied when a taxpayer's intention of holding an asset changes from trading to long-term investment, or vice versa. When the principle applies, the fair market value of the asset at the time the intent is changed is taken into account in computing the taxpayer's assessable profits. In *Nice Cheer*, the CFI specifically rejected the application of the *Sharkey v. Wernher* principle in Hong Kong and expressed that a taxpayer cannot trade with itself and that notional profits should not be chargeable to

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tax. The CFA, however, did not comment on the applicability of the *Sharkey* principle, likely because this issue was not raised. It remains to be seen whether this principle will continue to apply in practice in Hong Kong.

Refiling prior year assessments – Section 70A of the IRO allows a taxpayer to apply for correction of an assessment within six years after the end of a year of assessment or within six months after the date on which the relative notice of assessment was served (whichever is later), if the assessment was excessive because of an error or omission in a return or statement. It is questionable if taxpayers will be allowed to reopen prior year assessments under section 70A based on the *Nice Cheer* decision. Technically, if an assessment was issued on the basis of, or in accordance with, general prevailing practice at the time the return or statement was made, no correction may be made under section 70A.

Conclusion

The *Nice Cheer* decision is welcome, as it reinstates the principle that unrealized profits are not taxable. Nevertheless, this decision also poses a challenge as to what extent "tax should follow accounting." In light of the growing complexity of accounting standards, professional judgment is needed. Taxpayers are advised to contact professional advisers on the possible tax impact this decision may have on their business.

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India:
Cyprus designated a noncooperative jurisdiction

On 1 November 2013, India's Central Board of Direct Taxes (CBDT) issued a press release in which it "notified" Cyprus as a jurisdiction that does not engage in the exchange of information under section 94A of the Income-tax Act, 1961 (ITA). This designation has consequences for Indian taxpayers engaging in transactions with persons in Cyprus.

Section 94A was introduced into the ITA in Finance Act 2011 to discourage transactions between Indian taxpayers and persons located in countries or jurisdictions that do not engage in an adequate information exchange with India. Under this provision, countries or jurisdictions that lack an effective exchange of information process can be designated as "notified jurisdictions."

The CBDT press release indicates that, because Cyprus has not been providing information requested by the Indian tax authorities under the exchange of information provisions in the India-Cyprus tax treaty, it was decided to notify Cyprus as a jurisdiction under ITA section 94A.

As a result, for Indian tax purposes, any transaction between a taxpayer and a person in Cyprus will be subject to the following treatment:

- All parties to the transaction will be deemed to be associated enterprises and, therefore, will be subject to India's transfer pricing regulations;
- A taxpayer may not deduct any payments made to a financial institution in Cyprus unless the taxpayer furnishes an authorization in a prescribed form authorizing the CBDT or other tax authorities to seek relevant information from the financial institution on behalf of the taxpayer;
- A taxpayer may not deduct any expenditure or allowances arising from transactions with persons in Cyprus unless the taxpayer maintains specified documentation and furnishes prescribed information;
- If a taxpayer receives funds from Cyprus, the burden is on the taxpayer to explain the source of the funds, and if it fails to do so, the funds will be deemed to be income of the taxpayer; and

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- Payments made to a person in Cyprus will be subject to a withholding tax of at least 30% where the payments are chargeable to tax in India.

It should be noted that the CBDT introduced rules on 26 June 2013 setting out the procedure and form (Form 10FC) to be used for a taxpayer to take the above-described deductions for payments to recipients in a notified jurisdiction and to allow the CBDT or other Indian tax authorities acting on its behalf to seek relevant information from a financial institution on behalf of the taxpayer.

Comments

Cyprus is the first country to be notified under ITA section 94A and the issuance of this notification sends a clear message that India will not tolerate any deviance from an exchange of information procedure. Affected taxpayers should assess the impact of Cyprus being notified as soon as possible and should take steps to mitigate the effects of section 94A, specifically by maintaining the prescribed documentation and submitting the authorization, as required. Finally, taxpayers making taxable payments to a person in Cyprus must ensure that tax is withheld at the appropriate rate.

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Mauritius:
2014 budget announced

The Mauritius budget 2014 presented by the Finance Minister on 8 November 2013 includes measures intended to invigorate growth, promote local investment and boost employment. The budget contains numerous tax-related measures covering a range of direct and indirect taxes. The main measures that have been proposed are as follows:

- The special levy on banks for "segment A banking activities" would be computed on 10% of chargeable income for years of assessment 2014 and 2015 (compared to the current basis of a proportion of turnover and book profits). The special levy, together with the 15% income tax and a 2% corporate social responsibility fee would give rise to an overall charge of 27% for segment A business for banks. Segment B banking activities would not be affected. (Segment A and B activities relate to banking transactions with residents and nonresidents or corporations holding a Global Business license issued under the Financial Services Act, respectively.)
- Fees derived by a nonresident would be subject to a withholding tax (at a rate yet to be specified) regardless of whether the services are provided within or outside Mauritius, subject to the provisions of an applicable tax treaty.
- A statutory exemption would apply to income derived from the charter of foreign-owned ships.
- The VAT exemption for debit or credit card services by banks would be extended to a company engaged wholly and exclusively in the provision of e-commerce to a person outside Mauritius.
- A single 5% rate of land transfer tax would apply as from 1 January 2014.
- The customs duty on specified goods imported from Southern African Development Countries would be removed as from 1 January 2014.
- The exemption from the payment to the Levy, National Pensions Fund and National Savings Fund for foreign employees in their first two years of employment would be eliminated, except for those working in export-oriented enterprises.

To become effective, proposed measures in budget 2014 must be enacted under a finance bill. The finance bill currently is being debated in the parliament and is expected to be finalized during the first week of December 2013.

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Peru:
New rules issued on indirect transfers of shares

Peru's Ministry of Economy and Finance published a decree on 6 November 2013 that includes long-awaited regulations to enable the tax authorities to better monitor indirect sales of shares of (or participating interests in) Peruvian companies. The guidance also should help taxpayers with their compliance obligations. Unless otherwise specified, the new rules apply as from 7 November 2013.

Background

Under rules introduced on 15 February 2011 (Law No. 29663), capital gains derived from certain indirect transfers of the shares of a Peruvian legal entity fall within the scope of Peruvian tax (generally taxed at a rate of 30%, although a lower rate of 5% may apply in certain cases). Law No. 29663 indicated that the Ministry of Economy and Finance would be issuing guidance to facilitate compliance with the new rules; however, no regulations were issued, which led to practical implementation issues and uncertainty for both taxpayers and the tax authorities.

On 21 July 2011, the Peruvian government enacted another law (Law No. 29757) that introduced measures to facilitate compliance by taxpayers and to enable the tax authorities to appropriately monitor relevant transactions and collect tax due. The regulations to be issued by the Ministry of Economy and Finance were then intended to provide guidance based on these updated capital gains tax (CGT) provisions.

On 26 June 2013, the government enacted the Securities Market Promotion Act (Law No. 30050), which contains rules for withholding CGT on indirect transfers that Peruvian Clearing and Settlement Institutions (ICVLs) must apply when they participate in cash settlements of relevant securities transactions. The withholding obligation will apply as from 1 January 2014.

Even with the subsequent provisions complementing the February 2011 law, the revised CGT rules have continued to give rise to practical implementation issues and, for this reason, additional regulations were needed to ensure compliance. The Ministry finally has issued these regulations.

Identifying an indirect transfer

Capital gains derived from an indirect transfer of the shares of a Peruvian legal entity currently fall within the scope of the Peruvian tax net if the following conditions are satisfied:

1. When the shares of a nonresident entity that owns, directly or indirectly, shares of a Peruvian company are transferred and either:
    a. The market value of the shares of the Peruvian company owned directly or indirectly by the nonresident entity is equal to 50% or more of the market value of all of the shares representing the equity capital of the nonresident entity ("50% market value rule") for the 12-month period before the transfer, and there has been a transfer (or transfers) of shares representing 10% or more of the equity capital of the nonresident entity within the relevant 12-month period (in the event of an audit, the tax authorities have the burden of demonstrating that these conditions are satisfied); or
    b. The nonresident entity is resident in a tax haven or low tax jurisdiction, unless it can be demonstrated that the conditions in the previous bullet are not satisfied (in the event of an audit, the taxpayer has the burden of demonstrating that these conditions are not satisfied).
2. When the nonresident entity directly or indirectly issues new shares as a result of a capital increase (generated by a new capital contribution, the capitalization of credits or a reorganization), and allocates the shares a value below their market value. This deeming provision will apply only if at least one of the circumstances described in 1) is present. Under this CGT anti-avoidance measure, the nonresident entity will be deemed to have transferred the shares issued as a result of the capital increase.

There also is a deemed foreign distribution provision (with tax withheld at a rate of 30%) when a capital reduction is made by a nonresident entity that owns, directly or indirectly, shares of a Peruvian entity. This residual anti-abuse provision is triggered when the conditions provided by the CGT anti-avoidance measure are not fulfilled. In addition to the conditions for the more-than-50% market value rule being satisfied within a 12-month period before a capital increase, the application of the deemed dividend rule requires the occurrence of two events: (i) a capital reduction within a 12-month period after

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the capital increase, and (ii) a payment in excess of the par value of the shares that are cancelled as a result of the capital reduction.

The pre-regulations rules did not explain how to determine the market value of the shares or the extent of a participation when there are different tiers of entities in the ownership structure. Even when the general provisions were used in practice to close the loopholes, it was unclear which approach would prevail in the event of an audit. The new regulations provide the market value rules that should be used to calculate the 50% market value (depending on whether there is a quoted price, audited financial statements or an appraisal value; any value expressed in foreign currency must be converted into local currency using specified guidelines), as well as the procedure for identifying the percentage participation of a nonresident in a Peruvian company when there are different tiers of entities. The regulations offer more certainty for determining whether a transaction falls within the scope of the reporting obligation, and allow taxpayers to anticipate which transactions are more likely to be scrutinized by the tax authorities and what documentation should be available.

Capital gains determination

Under the pre-regulations rules, the taxable base for purposes of the CGT on indirect transfers is determined by taking into account the market value of the shares in the nonresident legal entity that are transferred, multiplied by a percentage identified when applying the 50% market value rule. The regulations clarify that, once an indirect transfer has been identified, the taxable base will be determined as follows:

- By taking into account all transfers of shares representing the equity capital of the nonresident entity that took place within the 12-month period before the indirect transfer; and
- By taking into account the market value of the shares transferred:
    - Applying the highest of (i) the value agreed by the parties, (ii) the exchange valuation (if applicable) or (iii) the equity value at the time of each transfer. (For purposes of identifying the equity value, the most recent annual balance sheet issued by the foreign company before the transfer of its shares cannot be older than 12 months. If such a balance sheet is not available, the equity value of the shares will be their appraised value.)
    - Transfers between related parties or from, through or to a tax haven would be subject to Peru's transfer pricing rules.

The tax basis of the shares in the nonresident legal entity transferred would be the value obtained by applying the percentage determined when applying the 50% market value rule to the total tax basis available under Peruvian provisions. The tax basis available must be supported by documents issued abroad according to the tax rules of the relevant jurisdiction or by any other documents that would accurately support the amount claimed as tax basis.

On the other hand, for purposes of the CGT anti-avoidance measure when a nonresident is deemed to have transferred the shares issued as a result of a capital increase, the taxable amount would be the difference between the market value of the shares issued and the value allocated to them. Under the pre-regulations rules, no further guidelines on how to calculate the market value for this purpose were available. The regulations provide rules that define the market value the nonresident should take into account for purposes of quantifying the deemed taxable amount under the CGT anti-avoidance provision.

Withholding tax on certain indirect transfers

ICVLs currently are treated as withholding agents for CGT purposes when they participate in cash settlements of direct and indirect transfers of shares representing the equity capital of a Peruvian company (where the reduced rate of 5% applies).

Reporting obligations and rules facilitating the information-gathering process in connection with indirect transfers recently were provided by Law No. 30050, which from 1 January 2014 requires that CGT withholding on an indirect transfer of shares representing the equity capital of a Peruvian company by a nonresident entity is to be made at the time of the settlement and remittance of funds, if the taxpayer or an authorized third party notifies the ICVL of the indirect transfer and the amount subject to reporting and provides supporting documentation.

The regulations clarify that ICVLs must report the percentage determined when applying the 50% market value rule, as well as the tax basis and market value of the shares involved. The regulations also provide that an authorized third party for purposes of the reporting obligation includes a broker or any other ICVL participant.

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Joint and several liability of the issuer company

Under the CGT rules, a Peruvian company is jointly and severally liable with a nonresident transferor for the payment of any CGT that may arise from a transfer of its shares if the Peruvian company and the nonresident transferor were economically related within the 12-month period before the transfer. These rules do not apply to indirect transfers where the transferee is a Peruvian resident, but will continue to apply when an ICVL is acting as a withholding agent.

The regulations set out instances in which a nonresident transferor would be deemed to be economically related to the Peruvian issuer company. Until the regulations were issued, taxpayers had resorted to the general transfer pricing rule to determine whether an economic relationship existed. That rule requires a more-than-30% direct or indirect participation of one entity in the equity capital of another entity; the regulations set the threshold at 10%.

The new regulations should be examined closely when estimating the risk of a possible assessment by the tax authorities at the Peruvian level in connection with any potential CGT due by nonresident shareholders at the upper tiers of the economic group.

Reporting obligations

The CGT rules require the Peruvian issuer company to notify the tax authorities when its shares are indirectly transferred. General information on how to comply with this reporting obligation can be found on the website of the Peruvian tax authorities. However, where a Peruvian legal entity is not jointly and severally liable with a nonresident transferor for CGT due on an indirect transfer, tracking and gathering all the required information connected with all indirect transfers would be a substantial administrative burden. The regulations, therefore, exempt the Peruvian issuer company from this reporting obligation when there is no economic relationship with the nonresident transferor.

Comments

The new regulations complement Peru's CGT rules by introducing guidelines that should help taxpayers with their compliance obligations with respect to indirect transfers of shares of a Peruvian company, and should enable the tax authorities to better monitor such transactions. The Peruvian tax authorities will likely conduct audits to verify compliance with the CGT rules governing the direct or indirect transfer of shares. Potentially affected taxpayers should evaluate the risk of an information request and start designing a plan for appropriate compliance.

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Spain:
New rules on tax losses and temporary measures extended

A law published in Spain's official gazette on 30 October 2013 includes changes to the tax treatment of losses and extends the application of some provisions that were due to expire at the end of 2013.

The new law abolishes the deductions for impairment losses with respect to shares representing an equity participation in the capital of a Spanish or a foreign entity, losses incurred by foreign permanent establishments (except in case of a transfer or the cessation of business) and losses incurred by members of joint ventures operating abroad (except in case of a transfer or the cessation of business). These rules apply retroactively for taxable years beginning on or after 1 January 2013.

The temporary measures that were due to expire at the end of 2013 and have been extended to apply to taxable years 2014 and 2015 are as follows:

- The transitional regime introduced as a result of the abolition of the "free depreciation" regime applicable to the acquisition of new fixed assets, which allows companies to take depreciation on such assets to the extent of 20% to 40% of taxable income before taking net operating losses into account.

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- Companies whose annual turnover is between EUR 20 million and EUR 60 million may offset loss carryforwards up to a maximum amount equal to 50% of taxable income. If the company's turnover is more than EUR 60 million, the offset is limited to 25% of taxable income.
- The reduced amortization rates for goodwill and intangible assets with an indefinite useful life remain at 1% and 2%, respectively (reduced from 5% and 10%, respectively).
- The deductible tax credit available for certain promoted activities will remain at 25% (reduced from 35%) of the corporate income tax due, and the reinvestment tax credit will be taken into account in calculating this limit (previously not taken into account). The tax credit carryforward period is extended from 10 to 15 years.
- The minimum advance corporate income tax payment for taxpayers whose turnover exceeds EUR 20 million will continue to be 12% (rather than 8%) of total book net income, which may not be reduced by net operating losses.

For tax year 2014, the existing percentages for calculating the advance corporate income tax payment based on turnover are maintained (e.g. entities subject to the general tax rate whose turnover exceeds EUR 60 million still will use a percentage of 29%).

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In brief

Belgium – The Constitutional Court has issued a decision upholding the constitutionality of the general anti-avoidance rule (GAAR) that applies as from 2013 in respect of income tax, inheritance tax and registration duties. The court rejected three arguments that had been raised against the GAAR: (1) as regards inheritance tax and registration duties, the GAAR does not violate the allocation of powers between the federal and regional authorities; (2) the GAAR does not violate the legality principle because it is not a general authorization for the authorities to determine the taxable base, but rather is a procedural rule that allows the authorities to examine specific situations under the supervision of the court system; and (3) the GAAR does not violate the nondiscrimination principle because it applies to all taxpayers.

Japan – The Prime Minister officially announced on 1 October 2013 that the consumption tax rate will be increased to 8% from 1 April 2014 and to 10% from 1 October 2015.

OECD – The OECD held a public consultation on transfer pricing topics on 12-13 November 2013. The topics discussed included public comments on the revised discussion draft on transfer pricing aspects of intangibles and the white paper on transfer pricing documentation, the BEPS action plan requirement to adopt a system of country-by-country reporting of selected company financial data to tax administrations and the appropriate scope of other transfer pricing aspects of the BEPS action plan. After considering the discussion at the public consultation, the OECD Working Party No. 6 will finalize its revised guidance on intangibles and will pursue the various transfer pricing aspects of the BEPS action plan.

United States – The Large Business and International (LB&I) Division of the Internal Revenue Service (IRS) has issued a directive setting forth a mandatory three-step enforcement process that will be effective beginning 2 January 2014. LB&I examiners are instructed to follow this process when a taxpayer does not provide information by the due date for responding to an information document request (IDR), which is generally the primary tool the IRS uses to gather information from a taxpayer during the examination process. The three steps are: (1) a delinquency notice; (2) a pre-summons letter; and (3) a summons. The directive also sets forth strict time frames for each step of the process and reiterates prior guidance that all IDRs must be issue-focused, discussed with the taxpayer prior to issuance and provide for a reasonable deadline for the response.

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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

Austria-Liechtenstein – The 2013 protocol to the 1969 treaty will enter into force on 1 January 2014 and will apply as from the same date. When in effect, dividends will be exempt if paid to a company (other than a partnership) that holds directly at least 10% of the capital of the payer company for an uninterrupted period of at least one year; otherwise, the rate will be 15%. Interest will be taxable only in the state of residence of the recipient. The withholding tax rate on royalties will not be affected by the protocol.

Bulgaria-Switzerland – The 2012 treaty entered into force on 18 October 2013 and will apply as from 1 January 2014. When in effect, the treaty provides that dividends paid to a company that holds at least 10% of the payer company for one year before the dividends are paid will be exempt from withholding tax, as will dividends paid to pension funds and the reserve bank of the other contracting state. The rate in all other cases will be 10%. Interest paid between associated companies where the recipient has held a participation of at least 10% for at least one year will be exempt from withholding tax; otherwise, the rate will be 5%. The rate on royalties will be 5%.

Canada-Hong Kong – The 2012 tax agreement entered into force on 29 October 2013 and will apply generally from 1 January 2014 for Canada and from 1 April 2014 for Hong Kong. When in effect, dividends will be subject to a 5% withholding tax when paid to a company (other than a partnership) that controls directly or indirectly at least 10% of the capital of the payer company; otherwise, the rate will be 15%. The rate on interest and royalties will be 10%.

Canada-Poland – The 2012 treaty entered into force on 30 October 2013 and will apply as from 1 January 2014. When in effect, the withholding tax rate on dividends will be 5% if paid to a company that holds directly at least 10% of the capital of the payer company; otherwise, the rate will be 15%. The rate on interest will be 15% (with exemptions for interest paid on the sale of equipment, merchandise or services to an unrelated vendor). The rate on royalties will be 5% if paid for literary, dramatic, musical, or artistic work (excluding motion picture films or film or other means of reproduction for television broadcasting), patent royalties, and royalties paid for industrial, commercial, or scientific information (but excluding royalties paid in connection with a rental or franchise agreement); otherwise, the rate will be 10%.

Canada-Serbia – The 2012 treaty entered into force on 31 October 2013 and will apply as form 1 January 2014. When in effect, the treaty provides for a 5% withholding tax on dividends paid to a company (other than a partnership) that holds at least 25% of the voting power of the payer company; otherwise, the rate will be 15%. Interest and royalties will be subject to a 10% rate.

Chile – Chile signed the Multilateral Convention on Mutual Administrative Assistance in Tax Matters on 24 October 2013.

Cyprus-Estonia – The 2012 treaty entered into force on 8 October 2013 and will apply as from 1 January 2014. When in effect, the treaty provides that dividends, interest and royalties will be taxable only in the state of residence of the recipient.

Czech Republic-Panama – The 2012 treaty entered into force on 25 February 2013 and will apply as from 1 January 2014. When in effect, the treaty provides for a 10% withholding tax on dividends. Interest will be exempt from withholding tax if paid in connection with a loan or credit guaranteed by the government or a local authority, the central bank or any financial institution owned or controlled by the government if the period of the loan or credit is no less than four years; otherwise, the rate will be 5% on loans to banks and 10% in all other cases. The rate on royalties will be 10%.

Denmark-Kuwait – The 2010 treaty entered into force on 2 October 2013 and applies retroactively as from 1 January 2010. A 0% rate applies to dividends paid to the other contracting state, a government institution, political subdivision or local authority, or to a company (other than a partnership) that holds directly at least 25% of the capital of the payer company for an uninterrupted period of no less than one year and the dividends are declared within that period. However, where dividends are paid by a Danish company to a company resident in Kuwait, Denmark may withhold a tax at a rate of 15% if Kuwait would tax the dividends at a rate lower than 15% under its domestic law. A 5% rate applies where the

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dividends are paid to a recognized pension fund or similar institution. The rate in all other cases is 15%. Interest is taxable only in the state of residence of the recipient and the rate on royalties is 10%.

Ecuador-Korea – The 2012 treaty entered into force on 16 October 2013 and will apply as from 1 January 2014. 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 payer company; otherwise, the rate will be 10%. The rate on interest will be 12%. A 5% withholding tax rate will apply to royalties paid for the use of, or the right to use industrial, commercial or scientific equipment; otherwise, the rate will be 12%.

Estonia-Turkmenistan – The 2011 treaty entered into force on 15 March 2013 and will apply as from 1 January 2014. When in effect, dividends, interest and royalties will be taxed at a rate of 10%.

India – See article in this issue.
URL: http://newsletters.usdbriefs.com/2013/Tax/WTA/131122_4.html

Ireland-Thailand – When in effect, the treaty signed on 4 November 2013 provides for a 10% withholding tax rate on dividends. The rate on interest will be 10% if the interest is beneficially owned by a financial institution (including an insurance company), or by a resident of the other contracting state and paid with respect to indebtedness arising as a result of a sale on credit by a resident of that other state of equipment, merchandise or services, except where the sale is between persons not dealing with each other at arm's length. The rate in all other cases will be 15%. The rate on royalties for the use of or the right to use a copyright of literary, artistic or scientific work, including software, and motion pictures and works on film, tape or other means of reproduction for use in connection with radio or television broadcasting will be 5%; a 10% rate will apply to royalties paid for the use of or the right to use industrial, commercial or scientific equipment or a patent; and the rate will be 15% where royalties are paid for the use of or the right to use a trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

Korea-Poland – When in effect, the protocol signed on 22 October 2013 provides for a 5% withholding tax rate on royalties. The protocol does not amend rates under the dividends or interest articles.

Portugal-Switzerland – The 2012 protocol entered into force on 21 October 2013 and will apply as from 1 January 2014. When in effect, the protocol will amend the dividends article of the treaty as follows: a 0% rate will apply where dividends are paid to a company that holds directly at least 25% of the capital of the payer company for at least two years and certain other requirements are met; a 5% rate will apply where dividends are paid to a company (other than a partnership) that holds directly at least 25% of the capital of the payer company; otherwise, the rate will be 15%. The rate on interest generally will be 10%. The general rate of 5% on royalties will not change, but a 0% rate will apply where royalties are paid to an associated company and the companies are connected by a direct participation of at least 25% for at least two years or are both controlled by a third company that holds directly at least 25% of the capital of the first company and the second company for at least two years and certain other requirements are met.

Slovenia-Georgia – The 2012 treaty entered into force on 25 September 2013 and will apply as from 1 January 2014. When in effect, the treaty provides for a 5% withholding tax on dividends and royalties. A 0% rate will apply to interest paid on a loan made, approved, guaranteed or insured by an institution authorized by domestic law to insure or finance international business transactions; otherwise, the rate will be 5%.

Slovenia-Switzerland – The 2012 protocol entered into force on 14 October 2013 and will apply as from 1 January 2014. When in effect, the protocol provides that dividends will be exempt from withholding tax if paid to a pension fund or to a company that holds at least 25% of the capital of the payer company for an uninterrupted period of at least one year; otherwise, the rate will be 15%. Interest and royalties paid between associated enterprises will be exempt from withholding tax where a 25% participation has been held for at least two years; otherwise, the rate will be 5%.

Switzerland – Switzerland signed the Multilateral Convention on Mutual Administrative Assistance in Tax Matters on 15 October 2013.

United Kingdom – On 22 October 2013, Guernsey and Jersey simultaneously committed to the automatic disclosure of tax information on UK residents with assets held in their financial institutions. The agreements with the UK Exchequer follow the agreement announced with the Isle of Man on 10 October, expanding the UK government's plan to leverage the principles and methodologies developed by FATCA to compel disclosure of UK tax evaders with accounts in financial centers

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under the control of the British Crown. The program is referred to as "UK FATCA" or "Son of FATCA." These agreements may lead to FATCA IGAs between the US and the two Channel Islands.

United Kingdom – On 5 November 2013, the UK and Cayman Islands signed a "FATCA"-type intergovernmental agreement, preparing the way for Cayman to automatically share financial information with the UK on UK taxpayers who hold Cayman Islands accounts. Steps to establish the legislative and operational framework to implement the agreement are underway, and the Cayman Islands government also intends to issue guidance to assist with the implementation.

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Australia
Government announces plans for backlog of tax measures
On 6 November 2013, the recently elected Australian government presented its position regarding a backlog of 96 announced, but unlegislated tax measures, a number of which affect inbound investors into Australia. The announcement identifies the measures that will be implemented, those that will not be implemented and those that may be subject to further consultation.
URL: http://www2.deloitte.com/global/en/pages/tax/articles/global-tax-alerts.html?id=us:em:na:wta:eng:tax:112213
URL: http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/gx-tax-alert-australia-141113.pdf?id=us:em:na:wta:eng:tax:112213
Issue date: 14 November 2013

Brazil
RTT repealed, changes made to CFC and share premium allocation rules
The Brazilian government enacted Provisional Measure No. 627/13 on 12 November 2013, which introduces far-reaching changes to the country's tax rules. The most significant of the 100 articles included in PM No. 627 are those that repeal the transition tax regime and revise the controlled foreign company and allocation of share premium rules.
Issue date: 13 November 2013
URL: http://www2.deloitte.com/global/en/pages/tax/articles/global-tax-alerts.html?id=us:em:na:wta:eng:tax:112213
URL: http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/gx-tax-alert-brazil-131113.pdf?id=us:em:na:wta:eng:tax:112213

France
Bill to combat tax avoidance approved
On 5 November 2013, France's National Assembly and Senate approved a bill to combat tax fraud and major economic and financial crimes. The bill contains a number of targeted and highly technical measures against tax avoidance and evasion and also would amend France's transfer pricing rules and the rules on non-cooperative states and territories.
Issue date: 8 November 2013
URL: http://www2.deloitte.com/global/en/pages/tax/articles/global-tax-alerts.html?id=us:em:na:wta:eng:tax:112213
URL: http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/gx-tax-alert-france081113.pdf?id=us:em:na:wta:eng:tax:112213

Norway
New government makes minor change to interest deduction limit proposal
Norway's budget for 2014, presented by the resigning government on 14 October 2013, included a limit on the deduction of interest on related party debt to prevent earnings stripping via intercompany debt financing. The new government that took office on 16 October released one proposed amendment to the budget on 8 November: the net interest expense threshold for the interest deduction limitation to apply would be increased from NOK 3 million to NOK 5 million.
Issue date: 8 November 2013
URL: http://www2.deloitte.com/global/en/pages/tax/articles/global-tax-alerts.html?id=us:em:na:wta:eng:tax:112213
URL: http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/gx-tax-alert-norway081113.pdf?id=us:em:na:wta:eng:tax:112213

United States
Baucus tax reform discussion draft takes on international tax rules
Finance Committee Chairman Max Baucus released a staff-level discussion draft on 19 November 2013 that lays out his proposals to overhaul the tax rules governing US multinational corporations. Among other changes, the discussion draft

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includes proposals to eliminate deferral for CFCs on certain gross income while exempting all other CFC earnings; impose a minimum tax of 20% on previously deferred earnings in CFCs; eliminate check the box rules for offshore structures; and expand the definition of intangible property subject to IRC section 367.

Issue date: 20 November 2013

URL: http://www2.deloitte.com/global/en/pages/tax/articles/global-tax-alerts.html?id=us:em:na:wta:eng:tax:112213

URL: http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-alert-unitedstates-201113.pdf?id=us:em:na:wta:eng:tax:112213

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