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China (Shanghai) Pilot Free Trade Zone opens for business

The State Council has released the Framework Plan for the China (Shanghai) Pilot Free Trade Zone ("the Shanghai Pilot FTZ") and officially launched the pilot zone on 29 September 2013. The Shanghai Pilot FTZ, located in Shanghai's Pudong New Area, will test fundamental reforms to the financial sector and will further open the economy to foreign investment. Financial sector changes include liberalization of interest rates, free convertibility of the *renminbi* (RMB) and removal of limits on foreign participation in the financial industry and offshore banking business. Pre-approval requirements for foreign investors will be relaxed and streamlined.

The potential impact of the pilot zone on the Chinese economy is being compared to the launch of the Shenzhen Special Economic Zone by Deng Xiaoping in 1980. The Shanghai Pilot FTZ is expected to be accompanied by radical economic reforms, principally to further open and rebalance the economy. The package of economic measures under consideration is expected to be rolled out in the Shanghai Pilot FTZ, and if successful, later implemented throughout the country. The success of the pilot measures also will directly inform the position that Chinese negotiators take during free trade agreement negotiations.

While the Shenzhen Special Economic Zone and similar zones focus on "incentives" (mainly income tax, customs and VAT incentives), the Shanghai Pilot FTZ is expected to create – as measured by international standards – a largely free and open economy for the pilot area. As noted above, the zone will operate as a platform for testing full convertibility of the RMB and the opening up of financial services, in addition to operating as a typical FTZ in which goods can be imported, processed and exported free from customs duties. Many foreign investors are expected to take advantage of the Shanghai Pilot FTZ reforms as the pilot rules take shape.

The framework plan for the Shanghai Pilot FTZ includes the following:

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- **A significant relaxation and streamlining of the approval requirements for foreign investors** – Broadly, foreign investors will be able to obtain "national treatment" and be allowed to invest in any activities other than those included on the "Negative List." Pre-approval will no longer be required for a broad range of foreign investment-related matters; instead, filing (i.e. reporting) requirements will apply. Foreign investors gradually will be allowed to invest freely in six modern service sectors: financial services, shipping and logistics services, commerce and trade services, professional services, cultural services and public sector services.
- **Elimination of the pre-approval requirement for certain domestic investors** – Domestic investors wishing to make outbound investments below a stipulated threshold (likely the threshold currently requiring approval by only the municipal authorities) will be able to do so simply by reporting the investment. Pre-approval will no longer be required.
- **Measures aimed at promoting the zone as a center for international trade and shipping and logistics** – Relevant customs procedures will be updated and streamlined by reference to internationally accepted best practices.
- **Measures aimed at promoting the zone as a financial center** – An overhaul of the financial system will include interest rate liberalization and full convertibility of the RMB. The development of specified financial products and instruments, particularly in relation to commodities and shipping and trading will be encouraged, as will the establishment of global/regional settlement and treasury centers and fund management businesses.
- **Competitive tax regime** – Although not the principal focus of the Shanghai Pilot FTZ, a competitive tax regime is expected to be introduced.
- **Alignment of rules with zone objectives** – The Shanghai Pilot FTZ is expected to be administered by the Shanghai municipal government. Laws and regulations that create obstacles to the achievement of the objectives of the zone likely will be suspended in the zone, and regulations that have specific application to zone activities likely will be introduced.

Immediately following the launch of the Shanghai Pilot FTZ, the Shanghai municipal government issued six sets of regulations for the zone, all of which are effective as from 1 October 2013. The regulations contain general administrative measures; filing procedures for foreign investment projects, outbound investment projects and foreign-invested enterprises and for setting up overseas enterprises; and special rules where approval of foreign investment is required (Negative List (2013)).

Comments

In launching the Shanghai Pilot FTZ, the Chinese government appears to be intent on "changing the game." The reforms are fundamental and far-reaching and, if fully implemented nationwide, will dramatically change China's foreign investment landscape. It remains to be seen whether the reforms can be implemented successfully in the Shanghai Pilot FTZ and, eventually, nationwide. However, as the government is committed to moving forward, the launch of the Shanghai Pilot FTZ seems set to herald a new era in the development of the Chinese economy.

Details on many of the proposed reform measures are not yet finalized, and some are to be rolled out gradually. However, the relevant authorities appear to be taking a fresh approach to potential investors. Currently, the government sets the rules and investors are left to fit their business models within the confines of those rules. The proposed reform measures are expected to lead to more business-friendly and market-driven rules. The government is inviting investors to ask: "what business model," "what's in it for the investor and the industry" and "what's in it for China," and appears to be keeping an open mind for constructive discussions with investors.

Interested investors should engage in discussions with the relevant authorities about their proposed investments and desired business models.

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Brazil:
Tax authorities retreat on retroactive application of new tax rules and reporting requirement

Brazil's Ministry of Finance and the tax authorities have announced that the double accounting requirement and related taxation consequences (including dividend taxation consequences) and the new reporting requirement for companies set out in the recently-issued Normative Instruction (NI) No. 1,397/2013 will not be applied on a retroactive basis.

The tax authorities issued NI 1,397 on 17 September 2013 on the Transition Tax Regime (RTT), which is the regime enacted in 2009 to ensure the tax neutrality of changes in criteria for income recognition and the computation of costs and expenses in light of Brazil's implementation of IFRS. Under the RTT, taxpayers are required to follow the accounting criteria and methods in effect on 31 December 2007.

The NI introduced several new – and controversial – rules that could have a significant impact on the mechanisms for calculating the corporate income tax, the social contribution on profits and the social contributions on revenue (PIS/COFINS), as well as a new reporting requirement (ECF) that likely will increase compliance costs for companies. The issuance of the NI generated a storm of criticism from the business community.

In response, the authorities have announced that the RTT will be abolished and that a new provisional measure designed to regulate the tax consequences of IFRS will be issued in the near future that will apply during the next couple of years. The authorities seem to have acknowledged that the retroactive provisions for dividends (and potentially interest on net equity) would create significant uncertainty and difficulty for taxpayers (for example, listed entities would need to re-compute their dividend distributions for the last five years to determine the tax implications). In addition, the tax authorities have retreated from their original intention of requiring companies to maintain an additional set of accounting records for tax purposes through the filing of the ECF, although it is not entirely clear what alternative will be substituted.

The business community is hoping that further clarification will be provided in the upcoming provisional measure and that the revocation of the retroactive measures contained in the NI will be confirmed.

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Germany:
Federal Tax Court rules on application of participation exemption for stock option premiums

The Federal Tax Court (BFH) recently issued a decision in which it concluded that income from stock option premiums or capital gains derived from the sale of stock options do not qualify for benefits under Germany's participation exemption. Under the participation exemption regime, dividends received by a corporation and capital gains derived from the sale of shares generally are 95% tax-exempt. Losses incurred on the sale of shares are not tax deductible.

The case involved a German GmbH that regularly entered into stock put/call option agreements with different parties, for which it received option premiums from the relevant counterparties. The tax authorities did not challenge the applicability of the participation exemption on capital gains realized upon the actual exercise of the underlying stock options, but they questioned its applicability to option premiums that were paid regardless of whether the stock options were exercised.

The BFH ruled in favor of the tax authorities, holding that stock option premiums are not covered by the participation exemption. This decision is in line with a previous ruling that disallowed the application of the participation exemption on

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gains realized on the sale (as opposed to the exercise) of stock options. The participation exemption is designed to prevent double taxation at the level of a subsidiary (taxation of its ordinary business profits) and its shareholder once the previously taxed profits are either distributed (participation exemption for dividends) or the appreciated shares in the subsidiary are sold (participation exemption for capital gains). According to the BFH, there is nothing in the wording or the intent of the law that would bring stock options within the scope of the exemption.

While the decision clarifies the tax treatment of stock option premiums at the level of the recipient (to the disadvantage of the taxpayer), the tax treatment at the level of the person incurring the expenses is still somewhat unclear. In practice, where the option right actually has been exercised, such expenses have had to be capitalized as incidental acquisition costs of the acquired stock and, therefore, treated as nondeductible. The BFH decision may provide a basis on which to argue for the tax deductibility of such expenses in these cases. However, where the option is not ultimately exercised, the decision supports the prevailing view that stock option premiums constitute a deductible expense.

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India: ITAT rules on tax treatment of subscription fees paid to nonresident

The Mumbai Income Tax Appellate Tribunal (ITAT) has ruled that subscription fees paid by Indian subscribers to an Irish company for accessing an online commercial database are subject to tax in India as royalties under section 9(1)(vi) of the Income Tax Act, 1961 (ITA) and article 12 of the India-Ireland tax treaty (*Gartner Ireland Ltd vs. DDIT*, dated 24 July 2013).

Background

Gartner Ireland Ltd (Gartner), an Irish tax resident company, offers subscriptions to online research products, including reports on qualitative research and analysis in the information technology sector, to subscribers in India. Subscribers receive access to the research products over the Internet from Gartner's server, which is located outside India. Gartner does not have a permanent establishment (PE) in India.

India has the right to tax Indian-source income of a nonresident, subject to the provisions of an applicable tax treaty. ITA section 9(1)(vi) deems royalties paid by an Indian resident to be Indian-source income. Article 12 of the India-Ireland tax treaty defines royalties as payments "for the use of, or the right to use, any copyright of literary, artistic, or scientific work, any patent, trademark, design or model, plan, secret formula, or process, or for the use of or right to use industrial, commercial, or scientific equipment (other than aircraft), or for information concerning industrial, commercial, or scientific experience."

In its tax filings in India, Gartner treated the income received from the Indian subscription fees as business profits and claimed an exemption from tax in India on the grounds that it did not have a PE in India. However, during a tax audit of Gartner's income tax return, the Indian tax authorities characterized the subscription income as royalties, taxable in India under section 9(1)(vi) of the ITA and article 12 of the tax treaty.

Ruling

The ITAT concluded that the subscription fees paid by Indian subscribers to an Irish company for accessing an online commercial database are subject to tax in India as royalties. In reaching its decision, the ITAT referred to earlier rulings of various Indian courts, in which similar payments were treated as business profits. However, the ITAT ruled that the right conferred on subscribers to access and use the information was merely a transfer of the right to use the copyright in the data owned by Gartner and, therefore, the related income was taxable as royalties.

The ITAT relied, in particular, on a 2011 decision of the Karnataka High Court (*CIT(IT) v. Wipro Ltd*), in which the court classified subscription fees paid by Wipro to Gartner (the same recipient as in this case) as royalties and held that Wipro was required to withhold tax from payments of the fees. Since the *Wipro* decision also involved payments to Gartner, the ITAT preferred not to issue a ruling that contradicted the earlier decision. Accordingly, the ITAT rejected Gartner's argument that

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subscription fees are akin to magazine subscriptions and instead concluded that the income in question falls within the definition of royalties under the ITA and the India-Ireland tax treaty.

Comments

The ITAT ruling in *Gartner* is inconsistent with certain other precedent, under which payments for subscriptions to online databases were not considered royalties on the grounds that there was no access to a copyright, i.e. that the subscription was for the use of a copyrighted article, not for the transfer of a right in respect of the copyright.

The *Wipro* decision referred to above followed an earlier decision of the Karnataka High Court (*Samsung Electronics*), in which the court failed to make the internationally-accepted distinction between a copyright and a copyrighted product in the case of a software license. In *Wipro*, the court observed that, while a subscription allowing access to a journal may seem different from a software license, it is simply a license to use (i.e. the "right to use") the journal and, thus, fees paid for the subscription should be characterized as royalties.

To address the conflicting decisions of the courts on the characterization of royalties and to clarify the legislative intent, Finance Act, 2012 contained a measure that broadens the definition of royalties in the ITA retroactively as from 1 June 1976. Royalties now include payments for the right to use, or for the transfer of the right to use, computer software (including payments for the granting of a license). Royalties also include consideration paid by an Indian resident in respect of a right, property or information (regardless of whether that right, property or information is in the possession of the payer) used directly by the payer or located in India.

The ITAT ruling comes at a time when Indian companies and individuals are actively pursuing access to new technology and innovations overseas and the government is exploring measures to reduce the country's dependence on foreign technology and to curb foreign currency volatility (including exchange control regulations). The ruling will have substantial implications for subscription fees paid to nonresidents and could open a Pandora's box of withholding tax obligations in relation to payments made for accessing other forms of information from overseas and domestic vendors. Ironically, the provisions in Finance Act, 2012 may not be the final word on the issue, since arguably the change in the domestic definition of royalties will not override the royalty definitions in India's tax treaties. Finality on the issue may not be achieved until the Indian Supreme Court is asked to rule on this specific issue. In the interim, Indian parties making such payments may have to re-examine their tax positions in light of the uncertainty created by the decisions in *Wipro* and *Garnter*.

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Slovenia:
Scope of thin cap rules expanded

Amendments to Slovenia's corporate income tax adopted by the parliament on 24 September 2013 include changes to the thin capitalization rules. The revised law was published in the official gazette on 4 October 2013 and will apply as from 1 January 2014.

Slovenia's thin capitalization rules currently apply to interest on loans granted by shareholders that hold directly or indirectly (at any time during the tax year) at least 25% of the capital or voting rights of the taxpayer if, at any time during that period, the shareholder loans exceed a debt-to-equity ratio of 4:1. Such interest is nondeductible and will be recharacterized as a dividend. The rules will not apply, however, if the taxpayer can demonstrate that the loan would have been granted on similar terms by an unrelated third party.

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The revised rules provide that a loan granted by a related company will be deemed to be a loan granted by a shareholder. For these purposes, a company granting a loan will be regarded as related to the company receiving the loan if shareholders (and in the case of shareholders that are individuals, their family members and related legal persons) hold directly or indirectly at least 25% of the capital or voting rights of both companies. As a result, a loan granted by a sister company of the taxpayer may be considered a loan granted by a shareholder of the taxpayer for purposes of the thin cap rules.

To calculate the debt-to-equity ratio under the revised rules, equity will include all categories of equity according to accounting standards (i.e. net profits and losses for the year will not be included in the calculation of equity for these purposes). Equity will be calculated as the average of equity at the beginning and the end of the tax period (currently, equity is calculated as the average of equity as of the last day of each month of the tax period).

In addition to the changes to the thin cap rules, the revised corporate tax rules abandon the previously-announced annual reduction of the corporate income tax rate, so the corporate income tax rate will remain at 17%.

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In brief

Argentina – A new tax on the payment of dividends and profit distributions by Argentine entities and on gains derived from certain sales of shares, bonds and securities was enacted on 23 September 2013 and applies to taxable events taking place after this date. These measures will affect both foreign investors and Argentine resident individuals. Additionally, Argentine payers of dividends and profit distributions to nonresidents will be required to act as a withholding agent.

Italy – The standard VAT rate increased from 21% to 22% as from 1 October 2013. Special rules apply from October to December 2013 to allow taxpayers to update their accounting systems without incurring penalties. The reduced (10%) and super-reduced (4%) rates have not changed. The increase in the standard rate had been postponed from July 2013, and the government did not approve a second postponement.

OECD – The tax committee of the Business and Industry Advisory Committee to the OECD (BIAC) had a meeting with the OECD on 1 October 2013 to discuss the Base Erosion and Profit Shifting (BEPS) project. The work is being carried out by two of the OECD's existing working parties: Working Party (WP) 1, which handles tax treaties, and WP 6, which is responsible for transfer pricing and intangibles. A new working party, WP 11, has been set up to cover interest, controlled foreign companies, hybrids and harmful tax measures. This WP will hold its first meeting in November. There is also a digital taskforce that will report directly to the Committee on Fiscal Affairs. The first consultations will take place in spring 2014, but several of the proposed actions are not expected to materialize until the end of 2014.

Portugal – The Court of Justice of the European Union (CJEU) has gone straight to judgment on a reference for a preliminary ruling on Portugal's rules on the deduction of interest. The rules provide that interest applied to the part of an overall debt categorized as "excessive" that is paid by a resident company to a lending company established in a non-EU country with which the borrowing company has "special relations" is not deductible for tax purposes. However, such interest is deductible where it is paid to a Portugal resident lending company with which the borrowing company has special relations. The CJEU decided that Portugal's rules infringe the free movement of capital. The Portuguese government's arguments that the rules were intended to combat tax evasion and avoidance could, in principle, be a justification, but the CJEU held that the rules in question were too broad to be proportionate.

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France

Finance Bill 2014 includes new taxes on large companies

The French government announced a package of measures on 25 September 2013 that would impact large companies. The measures are part of the draft finance bill for 2014 and include an exceptional tax on high remuneration paid by companies, a 1% tax on gross operating profit, a restriction on the deduction of interest paid between related parties and a new transfer pricing reporting obligation for certain business restructurings. If enacted, some of the proposals would be applicable as from the current financial year.

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