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EDITORIAL

Welcome to the January issue of International **TAX INSIGHT**, our quarterly publication highlighting cross border tax developments which may affect those doing business in global locations.

In this quarter's issue we feature news of tax developments in Australia, China, the European Union (EU), France, Indonesia, Ireland, Spain and the United Kingdom (UK).

The tax information given is intended as a brief overview and may not cover all circumstances. Readers should seek professional advice before taking any action. Baker Tilly International firms worldwide will be pleased to advise further. To locate your nearest firm, please see the Worldwide Directory at www.bakertillyinternational.com.

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AUSTRALIA

New Ruling on the Interaction of the Transfer Pricing and Thin Capitalisation Provisions

Multinational groups with an Australian resident member company which they finance through intra-group loans should note the issue by the Australian Taxation Office (ATO) of Taxation Ruling TR 2010/7 on how the transfer pricing rules and the thin capitalisation rules are to interact in determining whether there is to be any disallowance for tax purposes of interest paid abroad on related party borrowings.

The transfer pricing provisions are potentially applicable to all transactions for the supply of goods and services between Australian companies and foreign companies which are under the same ownership, and their coverage extends to include arrangements for the supply of finance. The provisions deny tax relief for prices paid to the extent that they are greater than those which would have been charged between parties acting at arm's length. In the context of intra-group finance this entitles the ATO to examine the rate of interest which is charged and to restrict the tax relief if the rate appears to be excessive.

The thin capitalisation provisions may also result in a disallowance of interest paid to the extent that the Australian company is considered to have excessive debt in relation to the amount of its adjusted equity, as defined. The question to be addressed is whether the company could have raised equivalent loan finance from external lenders, having regard to the amount of its equity. The provisions helpfully give a "safe harbour" gearing ratio, indicating that in most cases there will be no restriction of tax relief provided that interest-bearing debt does not exceed adjusted equity by more than 75%.

Ruling TR 2010/7 deals with the relationship between these two sets of rules, both of which are targeted at tax relief for loan

interest, and in particular it addresses the question of whether the transfer pricing provisions can be invoked against financing arrangements which are within the safe harbour for thin capitalisation purposes.

The directive is that the thin capitalisation rules govern the amount of allowable debt and the transfer pricing rules govern the allowable rate of interest on that allowable debt. However the ATO stresses that an intra-group financing arrangement must as a whole make "commercial sense", and that if it does not then the transfer pricing rules will be applied notwithstanding that the thin capitalisation safe harbour has been reached.

The example is given of an Australian company which borrows AU\$300m from its foreign parent at 15%, and the company's adjusted equity is such that the loan comes within the safe harbour parameters. The annual interest charge of AU\$45m however generates losses. The ATO may take the view that an independent lender would have advanced only AU\$250m in these circumstances, at 10%, and that the lender would have required the parent to contribute an additional AU\$50m in equity. The transfer pricing provisions would then be invoked to the effect that tax relief would be restricted to interest at 10% on the safe harbour loan of AU\$300m, giving relief on AU\$30m. Thus there would be a disallowance of AU\$15m.

Ruling 2010/7 has retrospective effect, so existing group financing arrangements may need to be reconsidered.

CHINA

Tax Incentives for Outsourcing Services

With the issue of two new circulars, Caishui [2010] No.64 and Caishui [2010] No.65, the authorities have amended and extended the tax incentives originally implemented in 2009 to encourage service enterprises registered in 21 designated cities to establish and develop offshore outsourcing services.

The main reliefs comprise an exemption from business tax, which is a sales tax on transactions which are not subject to VAT and which for the service industry is normally levied at 5% on income received, and a reduction in the rate of enterprise income tax (EIT) on corporate profits from the usual 25% to 15%.

In addition, expenditure on staff education is fully deductible for EIT purposes if it does not exceed 8% of the total wages and salaries paid. Any excess can be carried forward for possible relief in future periods.

The reliefs will apply from 1 July 2010 to 31 December 2013.

Service enterprises wishing to claim the reliefs must satisfy a number of conditions.

The designated cities are Beijing, Changsha, Chengdu, Chongqing, Daqing, Dalian, Guangzhou, Hangzhou, Harbin, Hefei, Jinan,

Nanchang, Nanjing, Shanghai, Shenzhen, Suzhou, Tianjin, Wuhan, Wuxi, Xiamen and Xian.

Income qualifying for the reliefs is that received from businesses located outside of China in return for the provision of qualifying outsourcing services, regardless of where the work is carried out. These can comprise information technology outsourcing (known as ITO), including software and other information technology development, or business process outsourcing (BPO), including management and operations services, or knowledge processing outsourcing (KPO), including research and development and industrial design services.

The responsibility for examining and approving claims for the reliefs is delegated to the science and technology departments of the provincial governments. We recommend that businesses operating in China which consider that they might qualify for the incentives should take advice on the conditions which are imposed and on the procedure for applications.

EU

Doubts Follow ECJ Judgement on Remuneration Paid in Vouchers

Some of the initial reactions to the judgement given last July by the European Court of Justice (ECJ) in the case of Astra Zeneca UK Ltd v. HMRC (case C-40/09) were that it would prove fatal to schemes used by some EU employers to pay their staff partly in vouchers which can then be exchanged for goods or services. A more considered view however is that it is necessary to look at the details of a scheme to see how it will be affected by the judgement.

Astra Zeneca UK Ltd offered its staff the option of sacrificing part of their salary in return for their receiving vouchers exchangeable at well-known retail stores. The benefit for the staff was that the salary sacrifice was less than the face value of the vouchers, since the company was able to acquire them at a discounted price. The company claimed that it was entitled to recover the input VAT it incurred on the cost of purchasing the vouchers, since this was a business expense. HMRC, the UK taxing authority, disputed this. However it also put forward the alternative argument that the company was indeed entitled to recover the input VAT but that it should also account for output VAT on the value of the vouchers given to the employees, on the grounds that this was a supply of services. Eventually the case was referred to the ECJ, which found in favour of HMRC's alternative argument.

The inference of the ECJ's verdict is that employers who use salary sacrifice schemes must either charge their staff with VAT on the discounted value of the vouchers or alternatively absorb this cost themselves. Neither outcome is conducive to the continued viability of the schemes. Evidence is emerging however that some EU member state governments which did not previously require

employers to charge VAT on the value of vouchers are proposing to continue with this policy, taking the view that case C-40/09 was decided on its own particular facts. Designers of remuneration packages are also contending that there are some types of benefits which are not affected by the judgement.

In this climate of uncertainty from country to country within the EU, employers continuing to offer voucher schemes, and those considering whether to introduce them, should take advice locally on the VAT position.

Minimum Standard Rate of VAT to Continue

The European Commission's Directive that EU member states must impose a standard rate of VAT of at least 15% was due to expire on 31 December 2010, but it has now been extended, unchanged, to 31 December 2015.

FRANCE

Extension to Thin Capitalisation Rules

International groups which include a French member company may need to review their financing arrangements in the light of a proposal now under discussion in Parliament to extend the thin capitalisation rules on interest deductibility to include external debt which is guaranteed by a related party.

The current rules potentially restrict tax relief for interest paid by French companies only in the case of loans from associated companies. For this purpose companies are deemed to be associated if one directly or indirectly owns 50% or more of the share capital of the other, or otherwise has *de facto* control of it, or if a third company owns 50% or more of the share capital of two other companies, or again has *de facto* control of them.

A French company is considered to be thinly capitalised if (1) the ratio of its associated company debt to its share capital is greater than 1.5 to 1, and (2) the interest paid to its associated companies is more than 25% of its pre-tax profits, and (3) the interest paid to its associated companies exceeds the interest it received from them. If any one of these limits is not exceeded then the company is not thinly capitalised and its interest payments should qualify in full for tax relief, provided the interest rate is reasonable. If all three of the limits are breached however then tax relief will generally be limited to the notional interest figure produced by the highest of them.

Some relief is provided in that if the disallowance of interest would be not more than €150,000 then it is ignored, and that disallowed interest can be carried forward for possible relief in future years, subject to an annual 5% reduction from the second year.

The important change now proposed for these rules, as set out in an amendment to the Finance Bill 2011, is that they will apply additionally to payments of bank interest in cases where the

borrowing is guaranteed by an associated company. Many groups with French subsidiaries will have financed them at least partially with bank loans secured by parent company or other associated companies guarantees, and for the first time now in such situations there is the threat of full tax relief for bank interest payments being denied.

Financing structures may need to be reviewed urgently. If adopted the new regulations are expected to apply for the fiscal year 2010 and onwards.

INDONESIA

Mandatory Requirement for Transfer Pricing Documentation

The release by the Directorate General of Taxation (DGT) on 6 September 2010 of Regulation No. 43/2010 entitled "Application of Common Business Practices and Arm's Length Principle in Transactions between Taxpayers and Parties who have a Special Relationship" is a significant development in the transfer pricing environment in Indonesia.

Although the DGT has for some years had the power to adjust companies' reported profits so that they reflect the arm's length principle in transactions between related parties the publishing of the new regulation can be seen as a declaration of intent that companies will now be required to do much more to justify their intra-group pricing policies and that the number and frequency of tax audits will increase.

The special relationship referred to in the title of the regulation occurs when two or more companies are under common ownership or control, directly or indirectly, or when one company owns 25% or more of the share capital of another, or when a company owns 25% or more of the share capital of two or more other companies.

The regulation sets out rules which follow basically the OECD's transfer pricing guidelines, but they are more prescriptive in that they set out a hierarchy of the transfer pricing methods which are to be adopted in the setting of prices for related party transactions. The comparable uncontrolled price (CUP) method is to take precedence, so groups must have regard to the market generally in fixing their inter-company prices. If comparables are hard to come by then the resale price (RP) or the cost plus (CP) methods are permissible. Only where circumstances are such that CUP, RP and CP are all inappropriate will other methods, such as the profit split method, and the transactional net margin method, become allowable.

A notable feature of this new regime is that Indonesian companies are now required to prepare transfer pricing documentation in respect of all their related party transactions and for every fiscal year. A declaration must be made with the filing of the annual tax return as to whether such documentation exists. An admission that it does not could be likely to increase the prospect of the DGT

conducting a tax audit. The new regulation is operable now, and Indonesian companies which trade internationally as part of a group have an urgent need to review and to document their transfer pricing policies in time for their fiscal year 2010 tax return filing.

IRELAND

Government Confirms Commitment to Low Corporate Tax Rate

The Government's four year national recovery plan, issued in response to Ireland's well publicised economic problems of late, includes a strongly worded commitment to the long term retention of the country's exceptionally low rate of corporation tax on trading profits.

There had been speculation that the 12.5% rate, one of the lowest in Europe and a key factor in attracting inward investment into Ireland in recent years, might have to be sacrificed in the interests of raising additional revenues, but this notion has been roundly dispelled.

The plan states that the highly competitive 12.5% rate "will not be increased under any circumstances", and there is all party support for this policy. Retaining the rate is seen as a main driver in developing economic growth through the continued inflow of investment by multinationals and the creation as a result of high value employment.

Personal taxes, and VAT on consumers, are set to rise.

Another boost for the corporate sector comes in the extension for a further year of the conditional three year exemption for start-up companies. Companies commencing to trade in 2009 or 2010 are exempt from corporation tax in any of their first three years of trading in which their liability would otherwise be not more than €40,000. This represents the potential to shelter taxable profits of €320,000 per year, or €960,000 over the three year period. A marginal relief applies in any of the years in which the tax liability would fall between €40,000 and €60,000.

This popular scheme will now apply also to companies commencing to trade in 2011. There will however be a potentially limiting factor in that the value of the relief will be restricted to the amount of employers' pay related social insurance paid by a company, subject to a maximum of €5,000 per employee.

SPAIN

Equity Contributions Now Exempt from Capital Duty

Contributions of capital to Spanish companies and to Spanish branches of foreign companies, whether on formation or on subsequent refinancing operations, have previously given rise to a capital duty liability of 1% of the amount involved.

The Government's Royal Decree Law 13/2010 however has now withdrawn this charge for contributions made from 3 December 2010.

The duty has previously applied also to the equity capital of foreign entities which transfer their registered address or their place of effective management from outside of the EU into Spain, and these actions too will now be exempt from capital duty.

These changes are designed to boost inward investment into Spain and investment through Spain into other countries. They bring the country into line with a number of other European jurisdictions which in recent years have abolished capital duty on subscriptions of equity capital.

In Spain the capital duty will remain for reductions of share capital and for the dissolution of companies. In these circumstances the charge is made on the company's shareholders.

UK

Favourable Tax Rate for Income from Patents

Following the Government's earlier announcement that the main rate of corporation tax will be reduced in incremental steps from 28% in the year to 31 March 2011 to 24% in the year to 31 March 2015 it has now set out provisional plans for the introduction of a "patent box" regime, under which net profits from patents will be taxed at a rate of only 10%.

The regime will apply for patents first commercialised after 29 November 2010, which is the date the announcement was made, and the reduced rate will take effect from the year ended 31 March 2014.

The move is clearly designed to enhance the reputation of the UK as a centre for technical innovation. Some manufacturing and pharmaceutical companies have already expressed interest in locating more of their research work in the UK. The reduced rate will apply to income from patents whether it is in the form of royalties or forms part of the sale price of patented products. Income from other types of intellectual property will not qualify however, and nor, probably, will the income of passive patent holding companies.

Changes are expected also in the UK's system of tax credits for research and development expenditure, now under government review.



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