

Border Crossing

Welcome to the seventh edition of Border Crossing - the electronic newsletter from RSM International covering technical developments in global taxation.

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Transfer Pricing Bulletin: New regulations limit intercompany allocations of service costs

The US Treasury has issued regulations on inter-company services, which limit taxpayers' ability to allocate the cost of services among related parties. This article is intended to help you understand and comply with these new regulations.

Background

The original transfer pricing services regulations (published in 1968) apply the arm's length standard to intercompany services, but provide no specific methods for determining appropriate transfer prices. Under these regulations, only those services which are "integral" to the taxpayer's business must be charged at fair market value (generally cost plus a mark-up); and all other services may be charged at cost. Many taxpayers have made a practice of allocating the cost of various US based functions among the foreign beneficiaries of such functions. Such functions often include management services, sales and marketing services, and various technical services. Under the new regulations, many of these services must be priced at fair market value.

Simplified cost method for services

The new regulations provide a new and exclusive method for allocating costs—the simplified cost method ("SCM")—and limits its use to only certain qualifying services. All services not qualifying for the SCM must be priced at fair market value. In order to qualify for the SCM, a service must satisfy the business judgment rule, must not be an "excluded transaction," and must either be included on the "white list" of specified covered services or be a low-margin service. The SCM is not mandatory, but rather elective by the taxpayer.

Business judgment rule

The SCM may not be used for services, which in the business judgment of the taxpayer, contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure in one or more trades or businesses of the renderer, the recipient, or both. Treasury intends that the taxpayer's judgment will be respected in "all but unreasonable cases."

Excluded transactions

The SCM may not be used for "excluded transactions," which are thought to be inherently high-value:

- > Manufacturing
- > Production
- > Extraction, exploration or processing of natural resources
- > Construction
- > Reselling, distribution, acting as a sales or purchasing agent, or acting under a commission or other similar arrangement
- > Research, development, or experimentation
- > Engineering or scientific
- > Financial transactions, including guarantees
- > Insurance or reinsurance



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Specified covered services—the 'white list'

Specified covered services included on the "white list," are eligible for the SCM; however, such services are still subject to the business judgment rule. The current "white list," issued in Rev. Proc. 2007-13, describes 101 specified covered services, which are summarized in the following general service categories:

- > Payroll
- > Premiums for unemployment, disability and workers compensation
- > Accounts receivable
- > Accounts payable
- > General administrative (limited to clerical and routine functions)
- > Corporate and public relations
- > Meeting coordination and travel planning
- > Accounting and auditing
- > Tax
- > Health, safety, environmental and regulatory affairs
- > Budgeting
- > Treasury activities
- > Statistical assistance
- > Staffing and recruiting
- > Training and employee development
- > Benefits
- > Information and technology services
- > Legal services
- > Insurance claims management
- > Purchasing

Low margin services

Finally, the SCM may be used for low-margin services, which the regulations define as services with a median arm's length mark-up of less than or equal to seven percent, provided that such services satisfy the business judgment rule. Generally, most executive level and strategic services would not qualify as low-margin services.

Other new developments

The new regulations provide for various other transfer pricing methods for services, certain documentation requirements related to shared services agreements and contingent payments, determination of allocable costs, and integration with other types of transactions—in particular those involving intangible property. These provisions may be of even more importance to some taxpayers than the SCM.

Effective dates and implications

Taxpayers should consider whether to comply with the current regulations or to elect to adopt the new temporary regulations for the 2007 tax year, taking into account penalty relief available to those taxpayers who elect to adopt the temporary regulations early and reasonably comply with the implementation. In either case, taxpayers should prepare contemporaneous transfer pricing documentation prior to filing their income tax returns because it is clear the Service is focusing on inter-company services.

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China: New Corporate Income Tax Law

The 10th National People's Congress passed the new Corporate Income Tax Law ("New Law") on 16 March 2007. The New Law provides a single income tax regime for both domestic and foreign investment enterprises ("FIEs"). The New Law will take effect on 1 January 2008. The following summarises the key aspects of the New Law and its impact on foreign investors.

New CIT Rate

The new standard corporate income tax ("CIT") rate is 25%. The reduced CIT rate of 20% would apply to small-scale and thin-profit enterprises and the preferential CIT rate of 15% is only available to high / new technology enterprises which require support from the State.

Taxpayers

The New Law introduces the concepts of "tax resident enterprise" and "non-tax resident enterprise" to differentiate taxpayers:

Taxpayers	Definition	Taxable Income
Resident Enterprise	<ul style="list-style-type: none"> Established in China under PRC laws Established under foreign laws but has its place of effective management in China 	Worldwide income
Non-resident Enterprise	Established under foreign laws, and has its place of effective management outside China	China-sourced income

Foreign enterprises established outside China without a "substantive presence" outside China will need to determine whether their place of effective management is based in China.

CIT Preferential Policies

The New Law grants tax preferential treatment on an industry basis rather than on a location basis. The main tax preferential policies in the New Law include:

- "Encouraged" high-tech enterprises are eligible for a reduced 15% CIT regardless of location in China;
- CIT exemption / reduction remains for specific technology transfer and investments in infrastructure, agriculture, forestry, animal husbandry and fishery industries;
- "Super deduction" is allowed for R&D expenses and salary expenses for employment of handicapped workers;
- CIT credit is granted to specific venture capital enterprises and investments in environmental protection, energy, water conservation and specific safety equipment.

Some CIT preferential policies currently available exclusively to FIEs will be revoked, including:

- Five-year tax holiday for manufacturing FIEs;
- Extension of tax holiday to export-oriented FIEs;
- Reduced 15% / 24% CIT rate applicable to FIEs in special zones;
- CIT refund on reinvestment;
- 50% CIT reduction for additional three years after the tax holiday for FIEs qualified as "technologically-advanced enterprises";
- CIT exemption for after-tax profit repatriation by foreign investors.



China: New Corporate Income Tax Law

Transition Period

The New Law allows for a five-year transition period. The transition arrangement is as follows:

- FIEs enjoying a 15% or 24% tax rate would be eligible for a 5-year transition period to move up to 25% tax rate. The New Law does not provide the details for the transition, but FIEs are expected to increase their 15% tax rate by 2% per year over the five-year transition period to reach 25%;
- Manufacturing FIEs which have not fully utilised the five-year tax holiday before the effective date of the new tax law will continue to enjoy the remaining holidays, e.g.
 - Y2007: First profit-making year and first CIT exemption year
 - Y2008: Second CIT exemption year
 - Y2009: First 50% CIT reduction year (with applicable new CIT rate applied)
 - Y2010: Second 50% CIT reduction year
 - Y2011: Third 50% CIT reduction year
 - Y2012: The full CIT rate will apply
- Manufacturing FIEs which have not started their tax holidays under the old law will have their tax holidays starting from the effective date of the New Law, e.g.

Year	Tax situation - Old Law	Tax situation - New Law
2007	No CIT liabilities due to accumulative loss	N/A
2008	No CIT liabilities due to accumulative loss	The first CIT exemption year even if it is still in loss
2009	First profit-making year and first CIT exemption year	First profit-making year and second CIT exemption year

Year	Tax situation - Old Law	Tax situation - New Law
2010	Second CIT exemption year	First 50% CIT reduction year with the applicable new CIT rate
2011	First 50% CIT reduction year	Second 50% CIT reduction year
2012	Second 50% CIT reduction year	Third 50% CIT reduction year
2013	Third 50% reduction year	The full CIT rate will apply

Withholding Tax Rate

The New Law provides a flat 20% tax rate for dividends, interest, royalties, rentals, capital gains or other income derived by non-resident enterprises from sources in China. However, it is still uncertain whether:

- Withholding tax on dividend remittance would continue to be exempted; and
- Withholding tax on other income, e.g. interests, royalty and capital gain, would continue to be reduced to 10%

It has been speculated that the current withholding tax exemption on dividends may be revoked and be taxed at 10%. The implementation rules may give the answer.

Anti-tax-avoidance Measures

Anti-tax-avoidance measures are tightened under the New Law as follows:

- An enterprise must report the details of related enterprise transactions together with its annual tax return filing;



China: New Corporate Income Tax Law

- An enterprise under tax audit with respect to transfer pricing must provide relevant documents as required, whether from the enterprise or its related parties. Otherwise, the tax authority has the right to determine the enterprise's taxable income;
- The advance pricing agreement can be negotiated with the tax authority. The enterprise will need to provide its pricing principles and computation methods in its business transactions with related enterprises.
- The tax authority is empowered to make tax adjustments and impose interest surcharges if a transaction between an enterprise and its related enterprise does not comply with the arm's length principle;
- Where the enterprise defers China tax on offshore profits parked in tax havens for non-operation purpose, the profits will be deemed to be attributed to the China resident enterprise even if profits have not been distributed or insufficient profits are allocated to the China resident enterprise;
- The ratio of loans to capital (both received from the enterprise's related parties) should be capped within a specific rate. Excess interest expense shall not be deductible.

The anti-tax-avoidance provisions above are very broad and general terms. More details are expected in the impending implementation rules.

Impact on Foreign Investors

As the detailed implementation rules have not been released by the State Council, many points remain to be clarified. However, the New Law has provided the general principles which may change future investment strategies for foreign investors in China. Foreign investors are advised to re-examine their tax planning schemes to optimise tax preferential policies available under the old law prior to the effective date of the New Law to ensure their eligibility for tax benefits under the New Law.

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Belgium: The new notional interest deduction in Belgium; a success story?

The Belgian Tax Law of 22 June 2005 introduced the notional interest deduction, which takes effect at the close of the financial year on 31 December 2006 or later. The impact of this measure will affect not only Belgian group companies, but also companies worldwide.

This notional interest deduction is a general measure, available to all Belgian companies and foreign companies with a Belgian permanent establishment that are liable to Belgian corporate income tax. The measure achieves (to a certain extent) that equity and loan capital are treated in an equal way from a tax perspective. Indeed, it implies a tax exemption/deduction of (currently) 3.781% (variable) of a company's equity. For small and medium sized companies the percentage is increased by 0.5 points.

A company's "risk capital" corresponds to its equity as it appears in its non-consolidated annual accounts of the preceding financial year-end. Based on Belgian accounting law and GAAP, the risk capital includes a company's paid in share capital, share premiums, re-evaluation surpluses, reserves, carried-forward results and capital subsidies. The notional interest deduction, however, is only applicable to the "adjusted" risk capital.

Therefore, the risk capital has to be reduced by certain items, e.g. the fiscal net value of financial fixed assets consisting of shareholdings and possibly own shares, the re-evaluation surpluses, the capital subsidies, the net equity of permanent establishments abroad and certain assets covered by specific anti-abuse measures.

Variations during the financial year of the paid in share capital and/or of the above mentioned items to be deducted will be taken into account on a pro rata basis, calculated per month.

If the notional interest deduction exceeds the taxable profit for the year, the excess can be carried forward for seven (calendar) years. Moreover, the deduction is not conditional upon any investments in tangible or intangible assets, neither upon an effective dividend distribution, nor an obligation to reserve the profits so obtained.

Companies will obviously consider equity optimization strategies in order to maximize the notional interest deduction. Certain interesting tax planning opportunities exist, including a double dip of finance costs or royalty, that do not require sophisticated structures (unless obviously substance as well as back up from an economic perspective).

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Indonesia: Changes to Article 23 Withholding Tax Rates

On 9 April, 2007 the Director-General of Taxation performed an 'about-face' with the issue of a revised regulation (Per-70/PJ/2007) regarding the rates of withholding tax under Article 23.

The previous regulation (Per-178/PJ/2006) stipulated that all services were subject to Article 23 withholding tax at a general rate of 4.5% unless listed at another rate. This was somewhat contradictory to the Income Tax Law, which suggests that only specified services should be subject to withholding tax.

Based on the new regulation, only the following services are subject to Article 23 withholding tax:

Type of Service	New Rate (per 9 April 2007)	Old rate (1 Jan - 8 April 2007)
Technical services and Management services	4.5%	4.5%
Construction planning & supervision/monitoring services ^(note 1)	4.0%	4.0%
Consulting services (except construction consulting services) ^(note 2)	4.5%	4.0%
Other services:	4.5%	4.5%
<ul style="list-style-type: none"> > Valuation services > Actuarial services > Accounting services > Design services > Drilling services in the oil & gas mining sector, except those performed by a Permanent Establishment > Supporting services in the oil & gas mining sector > Mining and supporting services in the non-oil & gas mining sector > Supporting services in airport/aeronautical sector > Tree felling services > Waste processing services > Manpower services > Agency services > Services in relation to traded securities, except those provided by the Stock Exchange, KSEI and KPEI > Custodial and storage services, except those provided by KSEI > Sound recording services > Film mixing services > Services in connection with computer software, including repairs and maintenance 		



Indonesia: Changes to Article 23 Withholding Tax Rates

Type of Service	New Rate (per 9 April 2007)	Old rate (1 Jan - 8 April 2007)
Installation services unless performed by a company operating in the construction sector that has a licence as a construction company	4.5%	4.5%
Repair and maintenance services for equipment, machines, transport equipment & vehicles, and buildings, unless performed by a company operating in the construction sector that has a licence as a construction company	4.5%	4.5%
Constructing contracting services, including: repairs & maintenance for buildings; installation of machines, electricity, telephones, water, gas, air-conditioning and cable TV, provided the company is operating in the construction sector and has a licence as a construction company ^(Note 1)	2.0%	2.0%
<ul style="list-style-type: none"> > Toll Manufacturing services; > Investigation and Security services; > Event Organiser services > Packing Services 	3.0%	3.0%
Media services	1.5%	4.5%
Catering ^(Note 1) , Pest Control & Cleaning services	1.5%	1.5%
Internet and Private Telecommunication services	0%	4.5%
<ul style="list-style-type: none"> > Travel/tourism services; > Freight forwarding services; > Courier services 	0%	3.0%
Other services, paid from the National or Regional Budget	0%	4.5%
Other, non-specified/listed services	0%	4.5%

Note 1: Withholding tax is due on the total contract value (i.e. services and materials) for catering and construction services.

Note 2: Previously consulting services (other than construction consulting, legal, business and tax consulting) were subject to 4.0% withholding tax. The 4.0% rate has now been replaced with 4.5% for all consulting services, except construction consulting.

Indonesia: Changes to Article 23 Withholding Tax Rates

Please note that there are several important changes when comparing the implementation of the new regulation to the previous regulations:

1. Previously the object for withholding tax was the entire value of the noncatering/ construction services if the contract/agreement did not specify the service/non-service components of the contract. This provision is deleted in the new regulation. However, to avoid future tax audit issues we recommend that companies continue to ensure that service/non-service components are clearly specified in contracts otherwise Article 23 should apply to the entire amount.

2. The previous regulation stipulated that the higher rate of withholding tax should apply if the contract/ invoice combines services that are subject to more than one rate of withholding tax. This stipulation no longer exists. Thus the rate of withholding tax is now based on the nature of each specific service.

Although there are no changes to the rates of withholding tax on payments for the rental of land and buildings, there is a reduction in the rate of withholding tax for the rental/use of assets other than land and buildings, and for land transportation vehicles.

	New Rate (per 9 April 2007)	Old Rate (1 January - 8 April 2007)
Payments for rental & other income related to the use of land and buildings	10.0%	10.0%
Payments for rental & other income related to the use of land transportation vehicles	1.5%	3.0%
Payments for rental & other income related to the use of other assets	4.5%	6.0%

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Singapore: Using Singapore as a base for investment in other countries, particularly in China and India

RSM Chio Lim, Singapore have published a briefing entitled 'Using Singapore as a base for investment in other countries, particularly in China and India'.

The newsletter provides a detailed overview of the current Singapore corporate income tax system, and explains the advantages of setting up holding companies in Singapore to invest in other tax jurisdictions, particularly in China and India.

It covers several major changes made by the Singapore Government over the past five years to the Singapore income tax system with the objective of enhancing Singapore's competitiveness. These changes have also made Singapore an attractive place to set up holding companies.

The publication can be downloaded from RSM Chio Lim's website <http://www.rsmchiolim.com.sg>.

Please note the information provided in the newsletter is reflective of the income tax treatments enacted in law to-date only.

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The next issue:

The next newsletter will be published in 4th quarter 2007.

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