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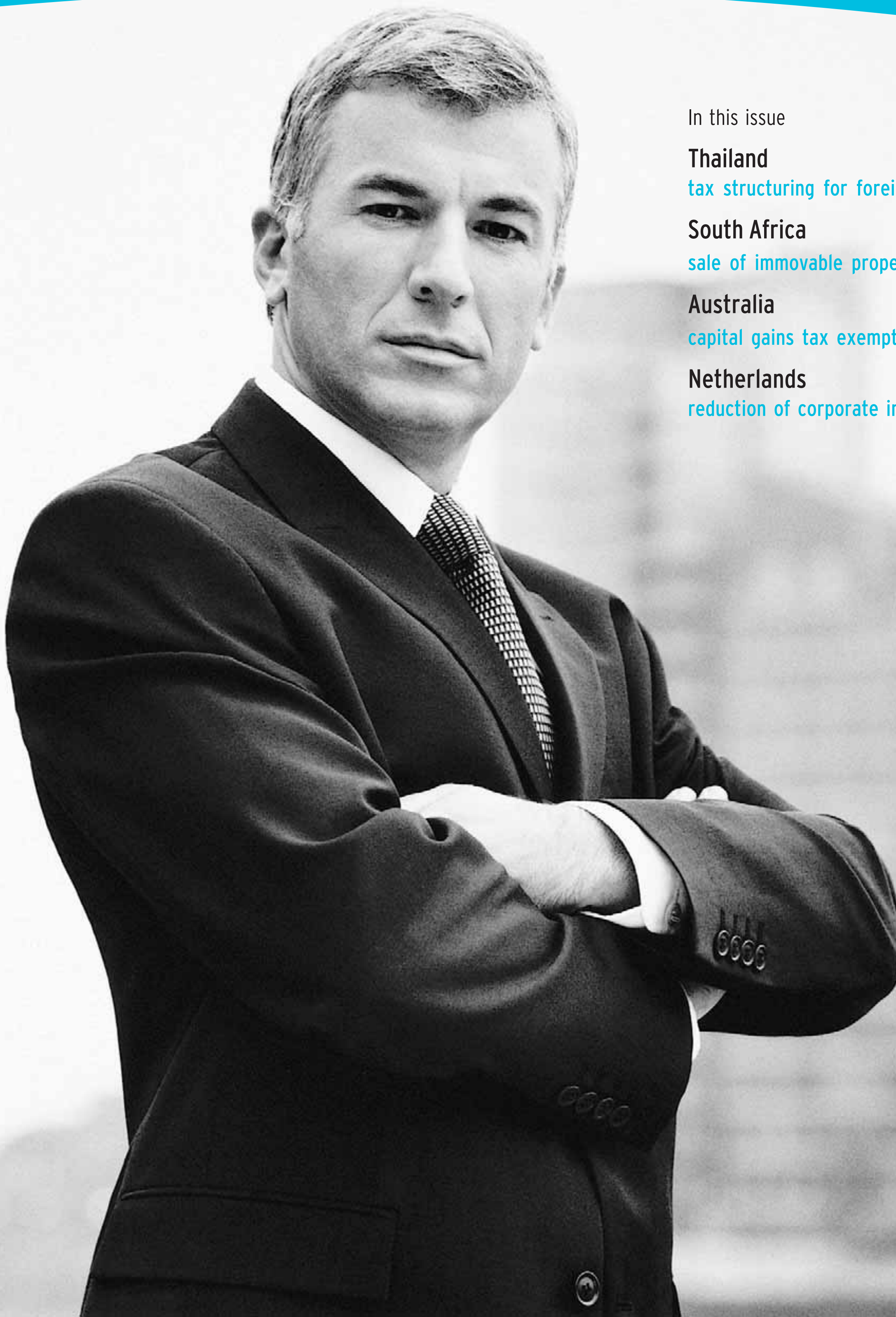

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Welcome

Welcome to the first issue of *Border Crossing*, a brand new electronic newsletter from RSM International covering technical developments in global taxation. Published quarterly, *Border Crossing* will draw on our knowledge of international tax matters to discuss their effect on our clients around the world.

RSM International is an affiliation of independent member firms located in over 70 countries. We are one of the world's largest full-service, assurance, tax and business advisory international network. Our member firms have expertise in all aspects of international taxation and, with a network of firms throughout the world, we can provide integrated services that meet the needs of our clients, using common standards, common approaches and teams of experienced professionals.

As you'll see from *Border Crossing*, we have truly global experience in transfer pricing; outbound and inbound investment structuring; worldwide effective tax rate planning; Intellectual Property related tax planning; cross-border cash planning; dividend repatriation, funding and currency issues; indirect tax; and workforce solutions for expats and inpats.

In this inaugural issue, we'll be taking a look at some of the tax structuring issues faced by foreign construction companies in Thailand. We'll also be considering the recent amendments to Australian law regarding capital gains tax exemptions for foreign residents investing in Australian trusts and discussing the new withholding tax on the sale of immovable property affecting non-residents in South Africa. This issue also features a look at the reduction in the rate of Dutch corporate income tax in 2007, which is set to improve radically the investment climate in the Netherlands.

But with our unparalleled breadth of expertise, future issues will focus on tax issues from many other parts of the world too. We are happy to respond to any other tax queries that you might have.

We hope you find this newsletter enlightening and useful. As always, we welcome your feedback so please feel free to send any comments or suggestions to Judit Petho, International Tax Executive Manager on T: +44 (0) 20 7251 1644 or E: judit.petho@rsmi.co.uk

Tax structuring for construction contracts in Thailand

This article outlines some of the tax issues foreign companies face operating in Thailand. It also discusses some tax planning considerations to help reduce the overall Thai tax bill.

To conduct construction business in Thailand, foreign companies normally have to apply for a Foreign Business License from the Business Development Department of the Ministry of Commerce and, in fact, set up a branch office in Thailand. Foreign companies that are deemed to be conducting business in Thailand through participation in a Thai construction contract are subject to the following Thai taxes:

- corporate income tax at 30% on the net profits derived from the contract;
- profits remittance tax at 10% on after-tax profits remitted (or deemed to have been remitted) to the head office;
- value added tax at the rate of 7% on the contract sum (the Thai government has announced that VAT will return to the 10% statutory rate from 1 October 2005);
- stamp duty at the rate of 0.1% of the construction or installation sum; and
- customs duty at various rates under the customs tariff regime on imported equipment and materials.

Generally, the Thai branch would be subject to all of the above taxes. In addition, for foreign companies conducting business in Thailand, the project owner will be required to withhold 5% withholding tax. This withholding tax represents an advance payment of the 30% corporate income tax liability on the annual net profits.

However, according to the Thai Revenue Code, this withholding tax can be reduced to 3% under the following conditions:

- if the foreign company has a permanent office in Thailand;
- if the foreign company has set up a provident fund for its employees in Thailand; or
- if the foreign company is engaging in other business activities such as sale of goods in Thailand in addition to the contract.

Where the project owner is a Thai government entity, and the above conditions are met, the rate of withholding tax can be further reduced to 1%.

Splitting arrangements and tax planning opportunities

To avoid a potentially heavy tax burden, an alternative is to negotiate an arrangement with the project owner in order to exclude foreign income from taxable income in Thailand.

If a contract between a foreign company and the Thai project owner is properly drawn up, only the income from the work performed in Thailand is subject to tax in Thailand.

For the supply of equipment and materials from abroad to be exempt from Thai tax, the contract should possess the following features:

- The supply of equipment and construction work must be clearly split.
- The title to the imported equipment should pass to the project owner outside of Thailand (ie, when it is shipped to the carrier).
- The project owner should be the importer of the equipment into Thailand.
- The project owner should pay for the shipped equipment, regardless of the construction or installation work.

Splitting has been legally accepted under the Thai Supreme Court ruling of case number 124/2540, provided both parties draw up two contracts (sales and hire of work) which feature all the required stipulations. If they abide by these rules, the Revenue Department should not seek to tax the offshore portion. However, if the correct taxes fail to be withheld the income payer is liable. For this reason, Thai project owners tend to be quite conservative in their approach, often withholding tax even if it may not be necessary to do so. Similarly, government entities tend to withhold where onshore and offshore elements are involved and usually refuse not to withhold unless there is a specific ruling.

This may sound confusing, but it needn't. So long as the project owner and foreign company stick to the Supreme Court's ruling and draw up two contracts – one covering the offshore work (supply of materials) and the other covering onshore work (construction or installation) they should avoid running into any problems with the Revenue Department. This risk can be further reduced by making sure the two contracts are performed by two different legal entities. For example, a foreign company could be the supplier of the equipment, while a related company would provide the services in Thailand.

Double Tax Treaties

If a foreign supplier of equipment does not reside in a country that has a Double Tax Treaty with Thailand, the supply contract should not be executed in Thailand. If such a foreign supplier sends employees into Thailand to sign the supply contract, there is a risk that the foreign company could be deemed to be conducting business in Thailand. In such a case, the income from the sale of equipment could become subject to tax in Thailand.

Joint venture v consortium

For large-scale construction ventures, further regulations apply, and these will depend on the type of arrangement the bidding contracts have been made under. Bidding contracts often comprise a group of companies looking to bid and in Thailand, three kinds of bidding arrangement exist. These are:

- an incorporated joint venture (IJV);
- an unincorporated joint venture (UJV); and
- a consortium.

An IJV is essentially a Thai-registered limited company. The taxation process is very straightforward, and, where complexities arise, they tend to be through UJV or consortium bids – particularly since the two can be difficult to differentiate from the other. A UJV is operated by two or more companies, and in the eyes of the Revenue Department, it is a taxable entity for corporate income tax purposes, even though the Ministry of Commerce does not recognise it as a legal entity.

The Thai Revenue Department often tries to class companies working together as a group under the heading of a UJV so that they can be treated as a separate taxable entity, rather than as joint venture partners.

Typically, UJVs are subject to the same tax as a Thai limited company except when they share their profits with companies registered in Thailand. In these cases, profits are exempt from tax. But it's not all necessarily plain sailing. UJVs need to be wary of negative tax implications surrounding subcontract work. Because UJVs generally subcontract work to joint venture partners in Thailand, a withholding tax may be imposed on it, and this could hit a UJV's bottom line.

A consortium, on the other hand, is neither a legal nor a tax entity. The suppliers are individual parties and pay tax separately on the income derived from their own portion of work.

To qualify as a consortium, a contract with a project owner needs to be drawn up, and abide with the following:

- The words "joint venture" should not be used at all.
- The price and scope of work of each consortium member should be clearly defined.
- There should be no sharing of any profits, losses or investments among the consortium members.
- The consortium members should issue their own invoices and receipts.
- The project owner should issue the applicable withholding tax certificates in the names of each consortium member separately.

Where the parties intend to create a consortium and not a UJV, all of the above should be made clear in the consortium agreement, amongst the consortium members, and with the project owner.

Under the provisions of Thailand's Double Tax Treaties, a foreign company may be able to enjoy the benefits under a Treaty only when it qualifies as a resident of a Treaty country.

Where a consortium is created its foreign company suppliers may be able to enjoy the benefits of a Double Tax Treaty because of their residency. UJV members, however may not.

Foreign construction contractors in Thailand can find themselves subject to onerous Thai and double taxation. But they needn't suffer unnecessarily. By conducting proper tax planning, by splitting contracts, by considering the legality of joint ventures and by utilising the benefits of double tax treaties, the tax drain can be substantially reduced.

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New withholding tax on sale of immovable property by non-residents in South Africa

A new withholding tax affecting non-residents is being levied on the sale of immovable properties in South Africa. The provisions, which will fall under Section 35A of the Income Tax Act, will be coming into force soon, although a specific date has not yet been confirmed.

Under current legislation, any non-resident that owns, has rights to, or shares in, an 'immovable property' in South Africa which they then sell, is liable to capital gains tax . However, if they hold less than 20% of the equity share capital of the company and if less than 80% of the net value of that company is attributable to immovable property (or an interest or right therein) capital gains tax does not apply.

The impact of the new withholding tax doesn't just affect the vendor: the buyer is impacted too. In fact, anyone that acquires an interest in a South African immovable property from a non-resident is subject to the following withholding tax:

- 5% if the non-resident is a sole trading individual;
- 7.5% if the non-resident is a company; or
- 10% if the non-resident is a trust.

Requirements state that monies owed because of this tax must be paid to the South African Revenue Service (SARS) within 14 days after the tax was withheld.

The following example may help explain this further: a foreign company sells a South African shopping centre to a domestic company for R50 million and specifies a closing date of 15 September 2006, and they must pay R20 million by this date, a further R20 million the following year, on 15 September 2007, and the final payment of R10 million on 15 September 2008. Each of these payments is subject to 7.5% withholding tax.

Result

Although the total proceeds accrue on 15 September 2006, the domestic company must withhold tax at 7.5% of the actual payment. Because the vendor selling the shopping centre is a non-resident company, the domestic company (the buyer) must withhold R1.5 million (7.5%) on the first R20 million, another R1.5 million on the second R20 million instalment and R750,000 (7.5%) of the final R10 million owed at the third instalment. They must pay these withheld amounts to SARS 14 days after each withholding date.

There are exceptions to this rule, and these apply in two specific cases.

1. If the person acquiring the property is a non-resident, they will have 28 days (rather than the usual 14) to pay over withheld amounts;
2. If the amounts withheld are denominated in foreign currency, payment to SARS must be transferred to Rand at the spot rate on the date of payment.

Advance against the seller's income tax liability

The amounts withheld then, serve as a credit against the non-resident's income tax liability for the year assessing when the property is sold. It could also result in a refund. However, the non-resident must still submit an income tax return.

R2 million exemption

The immovable property withholding mechanism does not apply if the total amount payable (eg, the total contract price) for the immovable property is less than R2 million. If the total amount payable exceeds R2 million, the withholding requirements apply in full, regardless of the R2 million exemption.

New withholding tax on sale of immovable property by non-residents in South Africa

Directives

The non-resident party selling their immovable property may seek withholding relief through a directive issued by SARS. This type of relief may come as a reduced withholding or without withholding at all. In order to obtain this relief, one of four conditions must exist:

- the non-resident party disposing of the immovable property provides adequate security;
- SARS may issue a directive based on the non-residents other assets within South Africa;
- the non-resident will not be subject to tax on the disposal; and
- the ultimate capital gains tax due is less than the withholding amount required.

Liabilities for the buyer

The person acquiring immovable property is personally liable for the withholding tax due and any resultant interest and penalties if that person "knows or should reasonably have known" that the transferor is a non-resident. Importantly, no withholding is required if the purchaser relies on an estate agent or conveyancer, and these parties fail to provide the purchaser with the required notification.

Any estate agents or conveyancers that are entitled to compensation following the transfer of an immovable property, they must notify the buyer of their obligation to withhold. This notification must be in writing before payment is made to the seller.

Recourse to the seller

It is the right of any person (purchaser, estate agent and conveyancer) subject to personal liability as a result of a failure to withhold, to recover any amounts paid to SARS against the non-resident selling the immovable property. This right of recovery exists only for the required withholding, not for any interest or penalties.

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Capital gains tax exemptions for foreign residents investing in Australian trusts

Recent amendments to Australia's tax laws have changed the tax treatment of foreign residents (non-Australian residents) who make a capital gain or loss in respect of an 'interest' in an Australian fixed trust (eg a unit in a unit trust).

The tax amendments are intended to give Australian managed funds a better competitive edge in the international markets by increasing their appeal to foreign investors. However, the amendments will also apply to foreign residents who have interests in closely held trusts and trusts that are not unit trusts subject to certain conditions.

Prior to the introduction of the new provisions, a foreign resident would make a capital gain or loss from the disposal of an interest in a trust if the *interest* had the necessary connection with Australia. (An interest had the necessary connection with Australia where the individual held at least 10% of the units in an Australian resident unit trust or an interest – of any size – in any other resident trust.) This still applied even if all of the underlying assets of the trust lacked the necessary connection with Australia. How do the new provisions affect this? Quite simply, it will not allow this to happen. The new provisions will disregard any capital gain or loss made in relation to an interest in a fixed trust if the underlying assets of the trust do not have the necessary connection with Australia.

However, the effects of the amendments are not confined to this one area. They also change the tax treatment of a foreign resident beneficiary of a trust. Previously, where a beneficiary was entitled to a share of the net income of a trust – including a capital gain – the beneficiary was liable to Australian tax if the income had an Australian source. Whether the asset had the necessary connection with Australia or not was irrelevant. Under the new provisions, these restrictions will disappear and a foreign resident beneficiary will not be liable to tax if the gain relates to an asset which lacks the necessary connection with Australia.

Finally, income of a trust that is foreign sourced can now flow through a trust to the foreign resident beneficiary without triggering any Australian capital gains tax consequences.

Interest withholding tax exemptions for interest paid to UK or US "financial institutions"

Australia's international tax agreements with the UK and the USA have been amended so that interest paid by an Australian resident to a financial institution resident in the UK or the USA is now exempt from withholding tax. Reciprocal exemptions also apply in respect of interest paid by a UK or USA resident to an Australian financial institution.

In all instances, the financial institution must be independent from the person paying the interest, and must deal with them on an arm's length basis. The term "financial institution" is defined to mean "a bank or other enterprise substantially deriving its profits by raising debt finance in the financial markets or by taking deposits at interest and using those funds in carrying on a business of providing finance". Back to back loan arrangements do not fall within the exemption.

The Australian Commissioner of Taxation has recently released a ruling which details how the exemption will be applied by the Australian Taxation Office. Australian resident taxpayers with offshore borrowings need to act now by investigating whether the cost of their capital can be reduced by refinancing their borrowings through a UK or USA financial institution. This may be the case where the interest withholding tax is added to the cost of finance or where the payee is not able to claim or use a foreign tax credit for the Australian withholding tax.

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Announced reduction of Dutch corporate income tax rate effective from 2007

A report and accompanying press release issued by the Dutch Ministry of Finance has sparked optimism that the investment climate in the Netherlands will improve. How? Through a number of innovative methods covering corporate income tax reduction, exemptions for private entrepreneurs, the abolition of capital duty and two new tax options for companies and patents. The report promises that these methods will "work on profit, towards a lower rate and a broad base".

From 1 January 2007, the standard corporate income tax rate will be reduced from 31.5% to 27.4%; this will be reduced further to 26.9% in 2008. And that's not all. The current 27% rate which applies to the first €27,689 income band would (from 1 January 2007) be reduced to 20% and apply to the first €41,000. This reduction would reduce the rate to below that of the average for the EU-15 Member States and in line with the average for all current Member States.

Private entrepreneurs will benefit through an exemption of at least 5% of their profits subject to personal income tax.

Group companies will be interested to know that the Ministry of Finance suggests introducing an optional box. Ultimately, this would mean that the difference between interest received on group company loans and the interest paid to third parties would be taxed at a low rate of, say, 10%. The regime would only apply to companies that have opted for it. Consequently, if the interest paid is higher than received, the taxpayer could, by not opting, deduct the difference against normal tax rates. There are areas which need to be reassessed – the anti-abuse provisions, for example. This option is intended to replace the group finance company regime, which was classified as a harmful tax regime by the European Union, and only applies until 31 December 2010 to companies that benefited from the regime on 11 July 2001 (the date on which the European Commission started the state aid investigation). The group interest box would apply for the entire group to interest from group loans and short-term investments for future acquisitions. The box would be available for all companies, ie not limited to internationally operating group finance companies. A confirmation from the European Commission that the measure is not incompatible state aid would be requested.

Group companies are not the only bodies that could benefit under the proposed methods. Patents too could benefit from a new optional box that allows a tax rate of 15%. However, because of the uncertainty of the effects of such measures, priority is presently given to a general reduction of the tax rate instead of the introduction of a special box for patents.

Capital duty, which currently stands at 0.55%, is to be abolished from 1 January 2006.

Announced reduction of Dutch corporate income tax rate effective from 2007

It is proposed that these measures be financed in a tax-neutral way. However, does this mean that they will be counter-financed? Apparently so. The Ministry's report highlights various ways for counter-financing dividing them up according to regime:

Amendments to the loss compensation regime

The carry-back possibilities would be reduced from three years to one year and the unlimited carry-forward possibility would be reduced to a carry-forward of eight years.

Due to the pending decision in ECJ Case C-446/03 *Marks & Spencer* the report suggests the introduction of a cross-border loss compensation regime and, whilst the government believe this will become possible in the EU, it's currently investigating how feasible it is through an extension of the current fiscal unity regime to foreign subsidiaries, combined with the introduction of restrictions to the current fiscal unity and the cross-border loss compensation regimes. Alternatively, they suggest disallowing cross-border loss relief, if the subsidiary has a possibility to compensate the loss in its own country.

Amendments to the participation exemption regime

Under the proposed measure, the participation exemption would apply to all participations of at least 5% in a Netherlands or foreign company. The requirements that this investment may not be held as a mere inventory and the so-called subject-to-tax condition, would be abolished. Shareholdings of less than 5% would never qualify for the participation exemption.

For any subsidiary conducting passive activities however, the subject-to-tax condition remains. The condition has to be met at the level of the subsidiary itself and would generally include investment companies and passive group finance companies. However, if such companies are subject to a low tax rate, a credit, rather than an exemption system, would apply.

The special regimes for temporary depreciation losses, which must be recaptured after five years, and for the deduction of losses sustained in the liquidation of a qualifying subsidiary would be abolished.

Depreciation of buildings

Depreciation of a building would no longer be possible if the book value of the building and land is below its fair market value. Only if the scenario is reversed – and the market value falls below the book value – would the allowance be possible.

To compensate real estate companies, a three-year transitional regime would be introduced. For example, buildings that are not yet depreciated when this regime is enforce, a maximum of three years would be introduced. This means that if the building has been depreciated for only one year, the current depreciation possibilities would be maintained for another two years.

Equalisation reserve

The equalisation reserve to cover insurance risks would be abolished for life insurance companies.

Mixed costs

Where companies pay out wages of more than €1m, mixed costs – costs which have both a business and a private character, such as food, representation, conferences, etc – would be fully deductible if 0.4% of the company's wages are added to their taxable base. Wages paid to major shareholders and directors are to be excluded from the calculation of the increase of the tax base. Under the current rules, only mixed costs exceeding €4,000 can be deducted unless the taxpayer opts for a deduction of 75% of the *actual* expenses; and this aspect of the current rules will not be modified.

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The next issue:

The next newsletter will be published in October 2005.

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