

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: Recent Developments in China

During the year 2007, the People's Republic of China ("PRC") State Administration of Taxation ("SAT") has announced some new measures for the administration of the Transfer Pricing ("TP") in the PRC. In this article we provide an overview of these new measures.

Guo Shui Han [2007]236 ("CIRCULAR 236")

Circular 236 was issued by the PRC SAT on 28 February 2007 to clarify SAT's position on the level of profitability of those PRC Foreign Investment Enterprises ("FIEs") and Foreign Enterprises ("FEs") undertaking purely manufacturing functions for their overseas parent companies.

Following internationally accepted transfer pricing principles, SAT concluded that these FIEs/FEs should not sustain losses but should maintain a reasonable level of profitability if:

- > they carry out production activities based on orders placed by related parties in accordance with business plans of their overseas parent companies;
- > their overseas parent companies or affiliates are wholly responsible for strategic management, decision making, research and development, sales and marketing etc; and

- > they did not share the associated risks and losses SAT has instructed local tax officials to evaluate the profit levels of those FIEs/FEs sustaining losses or achieving low levels of profit using economic analysis and appropriate benchmarks set for each industry.

In view of the above it is likely that loss making FIEs/FEs undertaking purely manufacturing functions for their overseas parent companies will become targets for TP audits and investigations. The tax authorities are likely to examine the actual functions undertaken by, and associated risks associated with the FIEs/FEs, making reference to specific industry statistics to benchmark and assess the reasonableness of the profitability levels.

Guo Shui Han [2007]363 ("CIRCULAR 363")

Circular 363 was issued by the PRC SAT on 27 March 2007. It stipulates the specific documents to be submitted to the tax authorities during TP audits. The documentary requirements stipulated in Circular 363 place significant emphasis on functional and risk analysis in a TP audit whilst the exact information to be collated will depend on specific audit situations.



Transfer Pricing Bulletin: Recent Developments in the PRC

The New PRC Unified Corporate Income Tax Law

The New PRC Unified Corporate Income Tax Law ("New CIT Law") will take effect from 1 January 2008. Chapter 6 'Special Tax Adjustments' deals with tax avoidance and transfer pricing issues, including TP adjustments, cost sharing arrangements, advanced pricing arrangements, TP documentation, controlled foreign company rules, thin capitalisation, and late payment interest charges.

Observations In Relation To Major PRC Cities

In some major PRC cities such as Shanghai and Guangzhou FIEs/FEs are required to provide more detailed and comprehensive information about their related parties transactions (e.g. to provide information on similar transactions with both related and unrelated parties) when filing their 2006 annual CIT returns. We expect other PRC cities to follow this practice.

In addition we also note that some FIEs in Beijing and Tianjin have recently been requested by the tax authorities to furnish additional information such as group organization charts, details of their transfer pricing policy, financial reports, functional and risk analysis etc. In some instances, FIEs have even been requested to provide this information within 10 days, so clearly the PRC tax authorities are gearing up to obtain more information to enable them to assess TP structures and arrangements.

Conclusion

The developments mentioned above indicate that TP continues to be a key focus area for the SAT which in turn is putting a stronger emphasis on transfer pricing disclosure. Transfer pricing regulations in the PRC are evolving fairly rapidly. It is advisable for taxpayers to assess their TP risks and take precautionary measures if considered necessary. Taxpayers should review their transfer pricing policy, the underlying commercial rationale, and the supporting documentation.

A tailored solution-driven and commercially focused transfer pricing review should begin with the summary of the facts describing the company's product lines, intercompany flows, functions performed, risks assumed, and intangible assets employed. A functional analysis and benchmarking study will help to identify and document the risks and functions undertaken by the relevant group companies.

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UK Taxes and the Investment Manager

The summer months tend to be a quieter time for major policy changes in the UK. However, members of the investment manager community looked with interest at the revised Statement of Practice 1/01 ("the Statement"), released at the end of July earlier this year.

The Statement sets out the UK Revenue Services' view of how the law should be interpreted in relation to the taxation of both the investment manager and the profits of the non-resident.

It is worth noting that it is possible under UK tax law to bring the profits of a non-resident fund onshore, hence making them taxable by virtue of management and control. It is also possible to tax a fund manager based on the profits of the non-resident i.e. the manager is regarded as the non-resident's permanent establishment, and can be taxed in his name.

These are worst case scenarios and the Revenue's view of the application of the law in relation to the latter position is dealt with under the Statement, and discussed below.

Background

The UK Revenue has started to look very closely at the use of offshore vehicles over the last two years, including offshore funds and in particular the Hedge Fund community. It is our understanding that the review in relation to the funds was put on hold whilst this Statement was updated.

Tax on non-residents

As a general point of UK tax law, non-residents are not subject to tax here unless they are trading in the UK; the UK does not tax capital or investment profits unless they amount to a trade.

There is no given definition of trading but the Statement does state that the active management of an investment portfolio of shares does not amount to a trade, neither does putting money on deposit.

Where the Statement applies, the tax due on the non-resident will be limited to the tax deducted at source, if any, on any income it receives. It will have no further payment or compliance obligations in relation to the UK.

Qualifying conditions

The benefit of the Statement will apply when the manager meets certain tests. The main tests are; the independent capacity test, the 20 percent rule, and the customary rate test.

Independent capacity

This test seeks to show that the manager acts in an independent manner for the non-resident, having regard to a number of factors including their legal and economic relationship.

They will be regarded as independent if:

1. The non-resident is widely held i.e. it is held by more than five unconnected persons, and no one person owns more than 20%. A fund will have 18 months from commencement of trading in the UK to meet this test, or;
2. The provision of services to the non-resident is not a substantial part of the investment management business, for these purposes the services provided to the non-resident should not exceed 70% of the investment management business, or;
3. If the above are not satisfied the Revenue may look at all the circumstances of the relationship including legal, financial and commercial, to see if it is one of independence.



UK Taxes and the Investment Manager

20% Rule

This rule is broadly unchanged from the previous Statement, and provides that the investment manager and connected persons should not have an entitlement to more than 20% of the non residents profit for transactions carried out through the manager.

Where the 20% is exceeded, the excess is excluded from the limitation of charge. There are detailed rules on the operation of the test within the Statement.

Customary rate test

The UK Revenue will not regard the relationship as being one of independent entities unless the manager receives remuneration at a rate that is customary for his services.

Customary is not defined anywhere and one should expect the Revenue to apply the OECD Transfer Pricing Guidelines when looking at this. In particular they would expect to see documented transfer pricing policies where relevant.

This test is aimed to stop the use of offshore vehicles to shelter fees through the manipulation of inter-company pricing.

What now?

The new Statement is a welcome and superior document to its predecessor. However, it is not a substantive change in overall policy, merely a far clearer document with additional guidance that managers should welcome.

The problem is that if you fell foul of the previous Statement you may fall foul of this one. If this is the case, we would suggest that you review your structures and remuneration models quickly, as it is likely that this will be an area looked at closely by the UK Revenue.

We noted that we had seen Revenue activity in the Hedge Fund community slow down as consultations were taken. Similarly, it would not be surprising if this was on a Revenue official's radar during this change period.

The new Statement is effective immediately unless it requires a new arrangement to be altered, in which case its predecessor can be relied upon until 31 December 2009.

Suggested actions

1. Review your fund structure - it may be possible to avoid historic problems by quick action now.
2. Manage your future structure to avoid problems - can you meet the widely held test by combining funds?
3. Sort out your transfer pricing - those funds in compliance will be dealt with much more quickly by the UK Revenue.
4. Think carefully about offshore structures that lack substance, and either lose them or strengthen them.
5. Ensure that your funds are not managed and controlled in the UK.

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2008 Mexican Tax Reform

On 1 October 2007, the Mexican Government enacted sweeping tax changes in the Tax Reform Act, which will come into effect on 1 January 2008. The tax reform created a new tax called the "flat tax rate" or "IETU".

Below are some of the general features regarding the IETU.

- > This tax operates much like an "alternative minimum tax"
- > Taxpayers affected include all business taxpayers, corporate and non-corporate, including individuals with business activities on their worldwide income, and foreign residents with a permanent establishment in Mexico.
- > Generally, all business revenue is affected by this new IETU "alternative" income tax system, including independent personal services, and the rental of property.
- > Limited deductions (excluding compensation) are allowed to compute the tax base, although a direct tax credit is allowed for most of the compensation expense.
- > The IETU is calculated as an "alternative" tax, and the greater of the IETU or the regular income tax becomes the liability.
- > The IETU statutory rate is 16.5% for 2008, 17% for 2009 and 17.5% for 2010 and thereafter.
- > Companies operating under the IMMEX program (known as maquiladoras) may be allowed a tax incentive in the form of a tax credit that will reduce their IETU liability. The tax incentive may come from a presidential decree that is being negotiated by the National Maquiladora Association.

Note: The Assets Tax will be repealed on 1 January 2008. Many taxpayers may be able to minimize their first year IETU liability by taking action before 31 December 2007.

You can see further advice by contacting the RSM US-Mexico Cross Border Specialty Group to discuss your company's specific situation and the tax implications of the IETU impacting your Mexican operations. A white paper is available upon request.

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Malaysian Tax Reforms

Since the year 2000, Malaysia has implemented a number of tax reforms to the Malaysian Tax System.

It is proposed that effective from 1 January 2008, the present imputation system of taxation will be changed to a 'Single Tier Company Income Tax System'.

Under the new system, tax on the profit of a company is a final tax and dividends distributed will be exempted from Malaysian income tax in the hands of the shareholders.

There will be transitional provisions in the legislative amendments to allow companies to utilize the credit balances in the Section 108 account ("Memorandum account" for the purposes of franking dividends) over a period of six years from 1 January 2008 to 31 December 2013.

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New "Patent Royalties" Deduction in Belgian Tax law

A new 'patent royalties deduction' was introduced into Belgian tax law that allows Belgian companies, or Belgian branches of foreign companies, to deduct 80% of patent royalties from their taxable income.

The new tax measure is aimed at encouraging companies to play an effective role in patent research and development, as well as patent ownership. It comes into force in tax year 2008, i.e. as of the financial year ending on 31 December 2007.

The new tax deduction is more attractive than similar measures adopted in other countries. It will apply not only to patents owned and developed, entirely or partially, by the company or one of its 'branches of activity' (in Belgium or abroad). It will also apply to patents acquired from a third party. In such a case, the company or the Belgian branch of a foreign company, would have to improve entirely or partially the patent in one of its own research centers, in Belgium or abroad, in order to benefit from this incentive. For patents used by the Belgian company or establishment for the manufacture of patented products, the tax deduction will amount to 80% of the license fee that the Belgian company would have received if it had licensed the patents used in the manufacturing process to an unrelated party.

The patent royalties' exemption operates as follows. Companies will deduct from their taxable income 80% of the patent income. The 20% left from the patent income (after deduction) remains taxable, in effect decreasing the maximum effective tax rate from 33.99% to 6.8% of the patent income. The deduction has no cap but if the patent royalties' deduction exceeds the company's taxable income, it cannot be carried forward to the following tax year.

Companies can combine this new measure with the other already existing tax incentives, including the exemption of 95% of the dividends received by a Belgian company, and the Belgian notional interest deduction. It concerns only patent incomes, thereby excluding other IP rights or assets such as know-how, copyright or trademarks.

Because the tax patent income deduction applies irrespective of whether the patent has been developed or acquired, Belgium should be kept in mind as a good location for companies with a significant role in patent research and development and patent ownership.

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The Next Issue:

The next issue will be published in 1st quarter of 2008. This will include the following:

- > Singapore: The existing Singapore-China Double Tax Agreement will be replaced by a revised agreement which will take effect from 1 January 2008. We will detail the main changes in the revised agreement and how these changes impact Singapore investors.
- > Cyprus: We will explain how multinational groups with holding companies / or other operations in the Netherlands can benefit from tax planning opportunities through the use of Cypriot companies.

The next issue:

The next newsletter will be published in 1st quarter 2008.

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