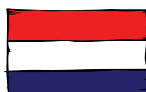
Corporate Tax Alliance

Corporate Tax Alliance | PO Box 17111, 2502 CC The Hague | www.corptax.org | info@corptax.org | November 2012

Recent developments re the tax concept of "substance"

by Jos Peters



'Substance' is a widely known tax concept, especially used in cross-border tax situations. Nonetheless the expression 'substance' does not normally appear in the actual text of tax treaties. There, a number of other tests are used, such as 'residency', 'beneficial ownership', 'qualifying persons', 'base erosion' and increasingly anti-avoidance articles such as a 'general purpose' tests. In addition, modern tax treaties increasingly contain a 'general anti-avoidance rule' (GAAR).

In my eighth consecutive contribution to the Euromoney Corporate Tax Handbook I will show that there are nonetheless a number of connections between the official treaty tests used to ensure tax payers qualify for the reduction of foreign withholding (w/h) taxes and the unofficial 'substance' test which is increasingly employed by the revenue services of the world.

General discussion

In many sectors, the use of Special Purpose Vehicles (SPVs) is common practice. The bulk of these entities does not employ the type of staff that would normally be required to manage the money flows which are being collected by MNCs via these SPVs, either from their foreign wholly-owned group companies or participations such as dividends, capital gains, interest payments or royalty payments, or from their foreign customers (interest and royalty payments). SPVs also do not usually employ significant assets and they are often under a contractual obligation to pay their income onwards (interest and royalties) or habitually do so (capital gains and dividends). So even if the term 'substance' lacks international definition, it is clear that SPVs often have no 'substance' at all. Yet they are very widely used but not many people, including tax advisers, seem to fully recognise the dangers connected to this 'loose' approach. This chapter is intended to raise a red flag, because on analysis it will turn out that the substance test does have meaningful connections with the official tax treaty tests, even if the word substance itself is very seldom used in a tax treaty context.

> "SPVs are widely used but not many people, including tax advisers, seem to fully recognise the dangers connected to 'substance'"

Nations are rapidly increasing their attacks on SPVs; in all major economical regions in the world, their tax authorities are taking a much closer look at substance issues than ever before. As a result, MNCs that employ SPVs should in my view reconsider their position, in order to avoid nasty surprises in the future. Not to mention that setting up new SPVs should no longer be done the 'old school' way, because there are better alternatives available.

For more information about these developments, visit *www.corptax.org/images/publicaties/merlyn-cth-2013.pdf*

INDEX

Developments re the tax concept of 'substance'	1
Major changes into force in Poland in 2013	2
New Intellectual Property Regime in Cyprus	3
New UK tax regime for Controlled Foreign Companies	4
Changes to Dutch tax law	4
Top eigth questions about taxation in Libya	5

Major changes to Polish tax law entering into force in 2013 *by MMR Consulting Sp*

1. Changes in the Corporate Income Tax Act

The Polish Ministry of Finance is working on major amendments to the CIT Act. At the moment it is not yet certain what the exact scope of these changes will be. The legislative process is at an early stage – the amendments are expected to come into force in 2014. However three major changes will concern rules regarding: thin capitalization, dividends in kind and the limited joint-stock partnerships which will become covered by the provision of the CIT Act. We will bring you updates on the developments in this area.

2. Amendments to tax treaty Poland-Cyprus

On 1 of January 2013 the protocol signed in March 2012 will come into force.

The major changes include:

2.1 End of tax-sparing clause
Currently a Polish tax resident receiving a dividend form a Cypriot company can deduct from the Polish tax (19%), the tax that could be imposed in Cyprus (10%). The deduction can be made even if no tax is imposed (withheld) in Cyprus. It means that in practice the dividends are taxed with a 9% rate. As of new year Cyprus can impose a 5% tax and the Polish tax resident can deduct it only if the tax is actually imposed (withheld)in Cyprus.

2.2 Remuneration of directors
From January the 1st 2013 the directors of Cypriot companies will be taxed in the country of their residence. This means that directors residing in Poland and receiving remuneration from a Cypriot company will be taxed (Personal Income Tax) in Poland (according to the scale).

3. Amendment of Polish VAT Act

It will be the most important amendment so far, changing significantly the way VAT will function in Poland. The legislative procedure is still at an early stage and the exact scope of these amendments is not yet certain. At the moment the main changes will concern:

1.1 Tax point
In its current form the Polish VAT Act provides many different moments when the tax point arises. As a result of the amendment these provisions will be significantly simplified. The general rule will be that the tax point arises when a supply of goods or services is executed. As a result the moment of issuing the invoice will no longer determine the moment when the tax point arises.

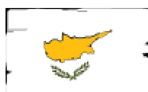
This change will mean that a taxpayer will be entitled to deduct input VAT when the tax point arises on the seller's side conditional upon the possession of an invoice. At the moment the Polish VAT Act provides a number of additional conditions such as for example the receipt of goods. The new rules will not include these conditions making life a lot easier for taxpayers. The exact date when these changes will come into force remains unclear and the legislative process is still underway. The predicted date is set for mid 2013.

1.2 Introduction of a completely new model for invoicing
As of January 2013 the ordinance implementing the Council Directive 2010/45/UE will come into force. One significant change will concern the invoices sent in electronic form. The new procedures will treat invoices in paper and electronic form in the same way. It means that the way in which invoices are given to the contractor will not affect the right to deduct input VAT.

Another change will concern the deadline for issuing the invoice. At the moment the deadline is 7 days from the supply of goods or services. The new deadline will be 15 days from the end of the month during which the supply of goods or services took place. As a result it will no longer be necessary to keep track of the exact date when the supply took place in order to issue an invoice within 7 days from the supply. This change results from the above mentioned changes regarding the tax point occurrence. The exact date when these changes will come into force remains unclear and the legislative process is still underway. The predicted date is set for mid 2013.

New Intellectual Property Regime in Cyprus

by the Aspen Trust Group



Cyprus has recently implemented, as from 1 January 2012, a new IP regime that is expected to stimulate the growth driving sectors of IP exploitation. Resting on a sound legal system based on Common Law principles, together with the conclusion of International Conventions on the Protection of Intellectual Property, Cyprus' new IP Regime guarantees maximum protection and certainty for IP owners. Below are the main points of the new IP regime:

1. **An 80% exemption on royalty income and capital gains upon disposal of IP**

Under the new rules 80% of the profit earned from the use of intangible assets is exempt for tax purposes. Since any dividend income generated and paid to non-resident shareholders is exempt from Cyprus tax of any sort, a Cyprus company can be used to generate royalties under licensing or similar arrangements with third parties and to distribute profits to its shareholders by way of dividends with minimal tax leakage.

> "the new regime provides very attractive opportunities for structuring exploitation of IP through Cyprus"

80% of any profit resulting from the disposal of relevant intangible assets is also exempt from tax purposes.

2. **No recapture system for previously generated losses – losses can be carried forward indefinitely**

3. **Gross IP income reduced by expenses incurred for the production of IP income with no limitations**

4. **Competitive amortization provisions over a 5 year period**

The cost of acquisition or development of an IP right may be capitalised and amortised on a straight line basis over five years, giving an annual writing down allowance of 20%.

This is a considerable acceleration compared to the previous amortisation regime, where rates were determined by reference to the estimated useful life of the underlying asset. For example, if a patent had a validity of 20 years its useful life would be deemed to be 20 years and the annual writing down allowance would be 5%. The acceleration of writing down allowances will result in substantial cash flow benefits by reason of the deferral of tax liabilities, especially where the value of the IP asset is substantial.

5. **Wide range of qualifying IP rights**

A Tax Circular is expected to be issued by the Cyprus Tax Authorities that will provide a detailed list of IP rights.

6. **Effective tax rate of 2% or less**

The amount subject to tax under the new rules is calculated by deducting the writing down allowance, the costs (including interest) of financing the acquisition or development of the assets and any other direct expenses from the revenue earned, and dividing the resulting amount by five. Applying the Cyprus corporate income tax rate of 10% produces an effective tax rate of two per cent of the net income. Given that generous deductions are available against gross income, the effective rate should generally be well below 2%. This rate compares very favourably with the competition: the United Kingdom's optional new "patent box" regime gives an effective rate of 10% on relevant income. The Irish scheme is more complex, and it is not possible to directly compare rates, but it will generally produce a rate close to the UK rate. The Luxembourg and Netherlands schemes are somewhat better, with effective tax rates of 5.76 % and 5 % respectively, but they are both considerably less beneficial than Cyprus.

The new regime provides very attractive opportunities for structuring the exploitation of IP assets through Cyprus and in particular through the use of Cyprus-resident IP owners, especially in the context of Cyprus's extensive network of double tax treaties under which foreign withholding taxes on royalty income are either eliminated altogether or substantially reduced.

The CTA member in Cyprus, the Aspen Trust Group can assist you and your clients to structure your IP holdings in the most beneficial way. We look forward to hearing from you and being of service.

New UK tax regime for Controlled Foreign Companies ("CFCs") *by Robert Newey*

From 1 January 2013 a new tax regime for CFCs will start to come into force in the UK. The regime will apply for accounting periods beginning on or after that date.

The UK has had a CFC regime since 1984. In 2006 the European Court of Justice held in *Cadbury Schweppes* that the original regime infringed European law. In response the UK made interim amendments to the CFC system. The old system will now be completely replaced by the new 2013 regime, which is outlined below.

The structure of the regime
A CFC is a non-UK resident company, which is controlled by a UK person or persons. Certain companies owned jointly by a UK resident and a non-UK resident may also qualify as CFCs. There are also provisions dealing with "cell" companies.

The "CFC charge" is chargeable in relation to a CFC's accounting period if the CFC has chargeable profits for the accounting period and none of the exemptions applies. "Chargeable profits" are profits that pass through the "CFC charge gateway".

Only chargeable companies are liable to the CFC charge. A "chargeable company" is a UK resident company to which at least 25% of the CFC's chargeable profits are apportioned.

Routes through the CFC charge gateway
As already mentioned, the CFC charge may apply to profits that pass through the gateway. These are:

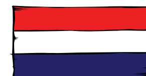
- Profits attributable to UK activities—the starting point is that all profits qualify, but profits are excluded if various conditions are satisfied
- Non-trading finance profits (but not—on certain conditions—if they are no more than 5% of the CFC's trading profits, business profits and/or exempt distribution income)
- Trading finance profits, if the CFC has funds or other assets that derive from UK connected capital contributions
- Profits from captive insurance business—but the conditions for passing through the CFC charge gateway are significantly tighter if the CFC is resident in the European Economic Area
- Where a "solo consolidation" waiver has been given to a company (e.g. a bank) and its subsidiaries for capital adequacy purposes, certain amounts included in the profits of the CFC subsidiary

Exemptions
There are exemptions for certain profits from "qualifying loan relationships".

A CFC may benefit from the following exemptions:

- Exempt period: a CFC may be exempted for a 12-month period.
- Excluded territories: a CFC may be exempted if a CFC is resident in a specified excluded territory, and the total of various types of income is not more than 10% of the CFC's accounting profits for a 12-month accounting period or (if more) £50,000.
- Low profits: a CFC may be exempt if for a 12-month period its profits or its non-trading income does not exceed £50,000.
- Low profit margin: a CFC may be exempt if its accounting profits are no more than 10% of "relevant operating expenditure".
- Tax exemption: a CFC may be exempt if its local tax rate is at least 75% of the corresponding UK tax. NB this does not apply if the local rate is determined under "designer tax provisions".

Changes to Dutch tax law
by Jan van Tilburg



The proposals for changes to the Dutch tax law as per 2013 are gradually crystalising out. In this newsletter we will highlight the most relevant changes for corporate taxpayers.

As a result of the ongoing economic crisis and the large government debts crated, there is hardly any room for introducing new tax facilities or tax cuts.

Already as per 1 October 2012, the standard VAT rate was increased to 21%. The reduced VAT rate remained at 6%.

> "An important change in the field of allowable interest deductions for holding companies"

With regard to the corporate income tax no rate changes are foreseen. The Dutch CIT rate will remain unchanged at 20% (for profits up to EUR 200,000) to 25% (applied to the part of the profit above EUR 200,000).

Continued on page 5>>

Continued from page 4 >> An important change will take place in the field of allowable interest deductions. New limitations will be applicable as from 1 January 2013. These new rules specifically target holding companies that are financed with loans. Until now all interest limitation rules were restricted to loans granted by affiliated parties (either directly or indirectly) but that is different this time. Also genuine third party loans (e.g. bank loans) might be affected by the new rules.

Basically the new rules stipulate that interest (and related costs) paid by a holding company is not deductible if the debts of that company are 'excessive'. For this purpose there is already an 'excessive debt' if the cost price of the subsidiaries is higher than the equity for tax purposes of the holding company. For the application of the new rule it is not relevant whether loans are used to finance Dutch or foreign participations. Also the rules apply regardless the capacity of the provider of the loan (e.g. affiliate of third party).

The interest on the excessive part of the holding company's debt (i.e. the difference between cost price of the subsidiaries and the tax equity) is not deductible for Dutch CIT purposes insofar that 'excessive acquisition interest' exceeds EUR 750,000.

The new rules determine more precise calculation rules for various situations that can complicate the principle calculation of excessive debt mentioned above.

On the positive side, the above rule will replace the thincap rules currently applied. Therefore, the thin capilation rules applied up to and including 2012 (allowing a debt:equity ratio of 3:1) will be abolished.

Top eight questions about taxation in Libya *by Tariq Almontaser*

Q1 Does the foreign company need to have a permanent establishment to supply only equipments in Libya?

No, any foreign company based outside Libya can supply equipments to companies inside Libya.

Q2 Does the foreign company need to have a permanent establishment to make an erection for projects inside Libya?

No, a foreign company can do the erection work as well.

Q3 Does any erection work inside Libya require paying taxes?

Yes, whether the erection work will be done by a foreign or local company, taxes have to be paid. The assumption is based on a separate erection contract and will be signed in addition to the supply contract:

Q4 In case an offshore company will sign the erection contract, what would the related due taxes?

- Stamp tax: 1% of total contract value(should be paid in Advance).
- Corporate tax: the assumption is based on net profit of 15% (± 20% of the net profit percentage itself) of total contract value, taxes is 24% of the net profit. (there are NO amnesties for companies that do not have an official branch)
- Corporate tax = 0.15 (approx.) x .24 = 3.6 % of total contract value.
- Salary Tax: the tax authorities may ask a foreign company to submit a pay roll for all personnel involved in the erection, including names; salary and duration of project. The tax authorities may also propose to assume a figure for the total salaries (if they are not convinced with the submitted pay roll) and then this figure for total salaries will be subjected to salary taxes. The amount of salary taxes is 15% (approximately) of the total value.
- The amount of taxes will be paid one at the time of signing the contract.

For the other four of the top eight questions about taxation in Libya, please visit: www.corptax.org/images/publicaties/lastrelease.pdf

CorporateTaxAlliance | PO Box 17111, 2502 CC The Hague | www.corptax.org | info@corptax.org