

Global Tax Report

Recent Tax Developments Around The World

Developments in Americas

Exchanging Distressed Debt for New Debt: US Tax Consequences to Debtors and Creditors

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Debt-for-debt exchanges are not new, but are worth revisiting given the current economic climate. Furthermore, the recently enacted "Stimulus Act"¹ provides some temporary relief to debtors from potentially harsh tax consequences of restructuring. The following discussion is relevant to issuers (also referred to as debtors) or holders (also referred to as creditors) of debt who are "US persons" (as defined in the US Internal Revenue Code).²

In order to illustrate some of the key US federal income tax consequences of a debt-for-debt exchange, consider the following example:

A US person ("Creditor") holds debt (bank debt or high yield debt) of Corporation A, organized in the United States ("Debtor"), with a stated principal amount (and stated redemption price at maturity) of US\$100x that is currently trading at 60 cents on the dollar ("Old Debt"). Creditor acquired the Old Debt for US\$100x upon its original issuance in 2002 and its adjusted tax basis is US\$100x. Debtor wants to issue new debt with a stated principal amount (and stated redemption price at maturity) of US\$70x ("New Debt") in exchange

for the Old Debt. The fair market value of the New Debt is US\$65x as of the issue date.

US Tax Consequences to a Debtor Exchanging Debt Instruments

Cancellation of debt income

A debtor is generally required to include income from the discharge of indebtedness (also known as cancellation of debt income or "COD" income) in gross income.³ There are some exceptions to this rule, including where debt is discharged in the debtor's bankruptcy proceeding, where the debtor is insolvent (to the extent of the insolvency) or where payment of the debt liability would have given rise to a deduction.⁴ The Stimulus Act also provides some relief from this rule (discussed below). For purposes of determining COD income of a debtor that issues a replacement debt instrument in satisfaction of its outstanding indebtedness, such debtor is treated as having satisfied the indebtedness with an amount of money equal to the "issue price" of such replacement debt instrument.⁵

If either the outstanding debt instrument or the replacement debt instrument is "publicly traded" (traded on an "established securities market"), the issue price of the replacement debt instrument is the fair market value.⁶ If neither the outstanding debt instrument nor the replacement debt instrument is publicly traded, the issue price of the replacement debt instrument is the stated principal amount if its terms provide for adequate stated interest.⁷

³ IRC §61(a)(12). All "\$" references are to the IRC and the Treasury Regulations promulgated thereunder.

⁴ IRC §108(a) and (e).

⁵ IRC §108(e)(10).

⁶ IRC §1273.

⁷ IRC §1274.

¹ The American Recovery and Reinvestment Tax Act of 2009 was enacted on February 17, 2009.

² US Internal Revenue Code of 1986, as amended ("IRC").



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As applied to the example:

If neither the Old Debt nor the New Debt is publicly traded, Debtor is deemed to satisfy the Old Debt (which has a stated principal amount of US\$100x) with US\$70x (the stated principal amount of the New Debt). Thus, in the absence of any exception to the COD rules, Debtor will have US\$30x of COD income.

If either the Old Debt or the New Debt is publicly traded, Debtor is deemed to satisfy the Old Debt (which has a stated principal amount of US\$100x) with US\$65x (the fair market value of the New Debt). Thus, in the absence of any exception to the COD rules, Debtor will have US\$35x of COD income.

Under the Stimulus Act, for a reacquisition (by issuer or a related party) of an “applicable debt instrument” (indebtedness of a C corporation or any other person in connection with the conduct of a trade or business) after December 31, 2008 and before January 1, 2011, the issuer may elect to include COD in income ratably during the period 2014-2018 rather than in the current year. This election is made on an instrument-by-instrument basis. The election is not available where the debt is purchased by a party unrelated to the issuer.⁸

Original issue discount

If the stated redemption price at maturity of the replacement debt instrument issued in the exchange exceeds the issue price, the debt will have original issue discount (“OID”). The debtor will amortize the OID over the term of the debt instrument.⁹

As applied to the example:

If either the Old Debt or the New Debt is publicly traded, the stated redemption price at maturity of the New Debt (US\$70x) will exceed the issue price (US\$65x) by US\$5x. Debtor will amortize the US\$5x of OID over the term of the New Debt.

⁸ IRC §108(i).

⁹ IRC §163(e).

If the issuer has elected to take COD into income from 2014-2018, there will be a corresponding deferral of deductions for OID.¹⁰

AHYDO Rules

If the new debt that is deemed to be issued constitutes an applicable high yield debt obligation (“AHYDO”), which is highly likely in the current economic climate, the issuer will not be allowed to deduct the non-cash interest, including any OID, until it is paid in cash, and a portion of the interest deduction may be permanently disallowed.¹¹

The Stimulus Act provides that if an AHYDO is issued during the period beginning September 1, 2008 and ending on December 31, 2009, in exchange for an obligation which is not an AHYDO, the AHYDO rules may be suspended (and therefore interest deductions are not limited by such rules). This AHYDO suspension rule does not apply to obligations issued to related parties or to obligations with contingent interest.¹²

US Tax Consequences to a Creditor Exchanging Debt Instruments

Exchange of debt

If both the outstanding debt instrument and the replacement debt instrument are “securities” for US federal income tax purposes, the exchange will be a tax-free recapitalization.¹³ If either the outstanding debt instrument or the replacement debt instrument are not securities, the exchange will be taxable.¹⁴

There is no definition in the US Internal Revenue Code or Treasury Regulations of a security, and accordingly there is some uncertainty surrounding this determination. Important factors to be considered include, among other things, the length

¹⁰ IRC §108(i).

¹¹ IRC §163(e)(5) and (i). The AHYDO rules apply to any debt instrument issued by a corporation with (i) a maturity date of more than 5 years from issuance; (ii) a yield to maturity that equals or exceeds the AFR plus 500 basis points; and (iii) significant OID features. If the yield to maturity exceeds the AFR plus 600 basis points, that portion of the yield in excess of the AFR plus 600 basis points will be disallowed permanently as a deduction.

¹² IRC §163(e)(5).

¹³ IRC §§354 and 368(a)(1)(E).

¹⁴ IRC §1001.

of time to maturity, the degree of continuing interest in the issuer, and the purpose of the borrowing. Generally, debt instruments that mature within five years of issuance are not considered securities and debt instruments that mature ten years or more from the time of issuance are considered securities.

If the outstanding debt instrument and the replacement debt instrument are securities and therefore the exchange is a tax-free recapitalization, a creditor will not recognize a loss and will only recognize a gain to the extent that the stated principal amount of the replacement debt instrument exceeds the stated principal amount of the outstanding debt instrument. However, if the outstanding debt instrument has accrued but unpaid interest (that accrued during the relevant creditor's holding period), a portion of the replacement debt instrument may be attributable to such interest and taxable as such.¹⁵ The creditor will have an initial tax basis in the replacement debt instrument equal to its tax basis in the outstanding debt instrument exchanged therefor, and the creditor's holding period for the replacement debt instrument will include the period during which it held the outstanding debt instrument.¹⁶

If either of the debt instruments are not securities, the creditor will recognize gain or loss in an amount equal to the difference between the issue price of the replacement debt instrument and its adjusted tax basis in the outstanding debt instrument.¹⁷ If the outstanding debt instrument was held as a capital asset, any gain or loss will be capital gain or loss.¹⁸ However, if the outstanding debt instrument has accrued but unpaid interest (that accrued during the relevant creditor's holding period), a portion of the replacement debt instrument may be attributable to such interest and taxable as such.

As applied to the example:

Assume the Old Debt was issued in 2002 with a maturity date of 2017, that the New Debt will be issued in 2009 with a maturity date of 2024, and that they are securities for US federal income tax purposes. Creditor will not recognize gain or loss on the exchange. Creditor will have an initial tax basis in the New Debt of US\$100x and will be deemed to have held the New Debt since 2002.

If instead we assume that either the Old Debt or the New Debt are not securities, Creditor will recognize a loss of US\$30x if the debt instruments are not publicly traded (the difference between the stated principal amount of the New Debt and Creditor's basis in the Old Debt) and will recognize a loss of US\$35x if the debt instruments are publicly traded (the difference between the fair market value of the New Debt and Creditor's basis in the Old Debt). Creditor's basis in the New Debt will be the issue price (either US\$65x or US\$70x) and its holding period will begin on the day following the exchange.

OID

If a debt instrument has more than a *de minimis* amount of OID, a creditor, regardless of its method of accounting, will be required to include such OID in income as it accrues, in accordance with a constant yield method based on a compounding of interest before the receipt of cash payments attributable to this income.¹⁹

As applied to the example:

If the Old Debt or the New Debt is publicly traded, the stated redemption price at maturity of the New Debt exceeds the issue price by US\$5x. Creditors will be required to include US\$5x in income as it accrues, in accordance with a constant yield method.

¹⁹ IRC §1272 and Treas. Reg. §1.1272-1.

¹⁵ IRC §354.

¹⁶ IRC §§358 and 1223.

¹⁷ IRC §1001.

¹⁸ IRC §1221.

Developments in Europe, Middle East, Africa

Reform of the French REITs (SIIC) Regime – SIIC 5



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The texts relating to the fifth part of the French tax regime of the “*Société d’Investissements Immobiliers Côtée*” (hereafter referred to as the “SIIC Regime”) have been adopted by the Commission of Finances of the Senat on November 12, 2008, in the form of several amendments to the draft finance bill for 2009.

The text was finally enacted on December 27, 2008 and affects (1) the SIIC regime but also (2) the tax regime of transfers of real estate.

Extension of the Scope of the SIIC Regime and Softening of the Condition to be met in terms of Shareholding

As a reminder, the SIIC Regime offers an option, for a minimum 10-year period, to certain listed real estate investment companies and their 95 percent direct or indirect subsidiaries, to benefit from a tax exemption on profits and gains derived from its real estate properties, if the entities meet the following conditions (Article 208 C of the French Tax Code):

- to be listed on the Paris Stock Exchange;
- a minimum share capital of €15 million;
- their main activity must consist of acquisition or erection of buildings for the purpose of their letting, or the direct holding of participations in partnerships or companies having the same activity (possibility of ancillary activity to a certain extent);
- to have less than 60 percent of their capital and voting rights held, directly or indirectly, by one shareholder or group of shareholders acting in concert. This condition must be complied with as from January 1, 2009 for pre-existing SIICs and

as from January 1, 2007 for newly created SIICs. However, please refer to our comments below;

- on the first day of the year in which they elect for the SIIC regime, a minimum floating requirement of 15 percent of their share capital must be held directly or indirectly by shareholders who own less than 2 percent of the share capital and voting rights.

Provided that these conditions are met, the SIIC and its appointed 95 percent subsidiaries may, upon election, benefit from a tax exemption from corporate income tax on the following profits:

- profits derived from the lease or sub-lease of real estate properties (which includes real estate purchased under a leasing agreement) provided that 85 percent of the exempt income is distributed before the end of the following fiscal year;
- capital gains derived from the sale to third parties of (i) real estate properties, (ii) shares in partnerships or subsidiaries subject to the SIIC regime and (iii) rights derived from real estate leasing agreements provided that 50 percent of the exempt gain is distributed before the end of the second following tax year; and
- distributions received from subsidiaries benefiting from the SIIC regime provided that 100 percent of the exempt distribution is redistributed before the end of the following financial year.

As a counterpart to this exemption, the SIIC is subject to an exit tax, payable over a four-year period, at a reduced rate of 16.5 percent (19 percent as of January 1, 2009) on latent capital gains derived from its real estate properties and shares.

Finally, please note that dividends paid out by a SIIC do not benefit from the French parent-subsidiary regime and that a specific 20 percent tax is levied on dividends paid by a SIIC to its corporate shareholders who (i) are not a SIIC or equivalent, (ii) hold directly or indirectly 10 percent or more

of its share capital and voting rights and (iii) are imposed at a low tax rate¹.

The Finance Bill for 2009 provides for an extension of the SIIC regime to:

- the whole real rights (“droits reels”) as mentioned in Article R 214-161 of the Monetary and financial code and in particular concessions, and
- the rental income arising from properties which possession is temporarily given to the SIIC by the State, its public institutions, the local authorities or one of their public establishments.

Regarding the 60 percent holding threshold, the Finance Bill for 2009 plans:

- to postpone until January 1, 2010 the entry into force of this 60 percent test;
- to amend the tax consequences of both definitive and temporary exit of the regime as follows.

In the event where the 60 percent test is not met, the stockholders can regularize the situation until the end of the fiscal year following the one in which the 60 percent threshold was exceeded.

During this period, the SIIC and its subsidiaries will be subject to standard corporate income tax, save that the computation of the taxable capital gains, in case of sale of real estate properties, will be decreased by the depreciation allowance recorded during the tax exemption period. SIIC qualifying subsidiaries would still be allowed to buy under the SIIC 3 regime during that period.

Upon the re-entry into the tax exemption regime, a 19 percent exit tax will become payable on the amount of the latent gains incurred during the temporary period of taxation.

If the situation is not regularized before the expiry of the above-mentioned period or if the test is not met for a second time², either during the ten years after the election for the SIIC regime or during the

ten following years, the consequences of the exit from the SIIC regime would be the following:

- retroactive payment of an additional exit tax of 17.93 percent or 15.43 percent³ assessed on the latent capital gains upon the entry into the tax exemption regime;
- standard CIT (34.43 percent) would become payable on the profits which have been exempted during the previous past fiscal years and which have not been distributed yet;
- 25 percent taxation on latent capital gains that have arisen during the application of the SIIC regime, reduced by a 10 percent annual depreciation;
- payment of an additional tax of 19 percent on the latent capital gains incurred during the temporary exit of the regime.

Deadline Extension of Incentives on Capital Gains Derived from the Transfer or Real Estate

In order to facilitate the transfer of real estate, the French legislator implemented in the Finance Bill for 2005 capital gains tax incentives that were supposed to last until December 31, 2008.

This so-called SIIC 3 regime allows companies to sell their real estate assets, shares in real estate companies or rights in real estate financial lease agreements to publicly traded companies (such as SIICs) or entities agreed by the Paris stock exchange authorities (such as SCPI or SPPICAV) having a long-term real estate investment activity, under a favourable tax regime. Under this regime, capital gains are taxed at a reduced rate of 16.5 percent provided that the acquiring company keeps the assets purchased for a minimum 5-year period.

The Finance Bill for 2009 extends the application of the SIIC 3 regime and plans the

1 Less than a third of French standard CIT; *i.e.*, circa 11.5 percent.

2 for a reason other than a stock exchange or restructuring operation.

3 *i.e.*, standard CIT 34.431/3 percent – reduced tax rate of 16.5 percent when the operation is realized before the 01/01/2009 or 34.431/3 percent – reduced tax rate of 19 percent when the operation is realized after the 01/01/2009.

following amendments:

- to extend the SIIC 3 regime until December 31, 2011;
- to increase from 16.5 percent to 19 percent the reduced tax rate for transactions realized as from January 1, 2009;
- to clarify the provisions relating to the acquisition of buildings aimed at being materially refurbished;
- to facilitate the financing of the acquisition of assets through financial lease ("Crédit-bail") in allowing lease-back operations without triggering the breach of the five-year commitment. Therefore, the SIIC or its subsidiaries having acquired the building within the framework of the SIIC 3 regime will be allowed to sell the acquired building to a financial institution under the form of a lease-back and still be deemed to comply with SIIC 3 regime.

Finally, please note that the French tax authorities are drafting administrative guidelines to comment on this specific regime. Based on the drafts disclosed so far, companies which will realize capital gains taxed at the reduced rate of 19 percent will be allowed to offset these gains against their ordinary tax losses.

Impact of the Recent Changes in the German Tax Laws on Debt to Equity Swaps



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Due to the ongoing financial crisis and the economic downturn accompanied therewith, many German

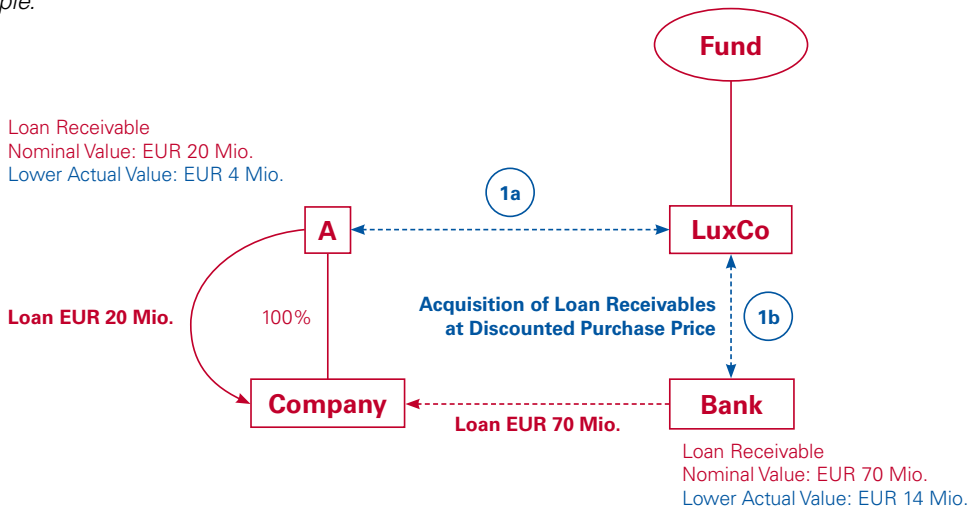
companies are or will be struggling with default and insolvency problems. The recently introduced so-called **Interest Barrier Rules** (*Zinsschranke*) within the course of the German Business Tax Reform Act 2008 (**BTRA**) will lead to additional problems for distressed companies as these rules will trigger additional tax payments caused by the non-deductibility of a major portion of any interest expenses payable by a company (for details see "Mitigation of the Tax Disadvantages arising from an application of the German Interest Barrier Rules" below). On the other hand, there are professional investors such as vulture funds which have an excess of money to invest and which specialize in turnaround strategies with respect to distressed companies. For such investors the current business environment offers opportunities to invest in or take over distressed companies, for instance by making use of debt to equity swaps.

In the following we will briefly outline selected German tax implications arising in connection with debt to equity swap transactions caused by recent changes in the German tax laws introduced by the BTRA effective since January 1, 2008.

Structure of a Debt to Equity Swap

A debt to equity swap is often structured in a manner that a third party creditor and/or shareholder sells its claim vis-à-vis a German company to an investor at a discount which intends to acquire a shareholding in the company and to benefit from the upside potential after a successful turnaround. In connection with some other typical recapitalization steps, the company then conducts a capital increase in the course of which the investor contributes the acquired claims into the capital of the company and thereby obtains the position of a new shareholder. As a further consequence the claims against the company expire.

Example:



Tax Effects at the Level of the Company

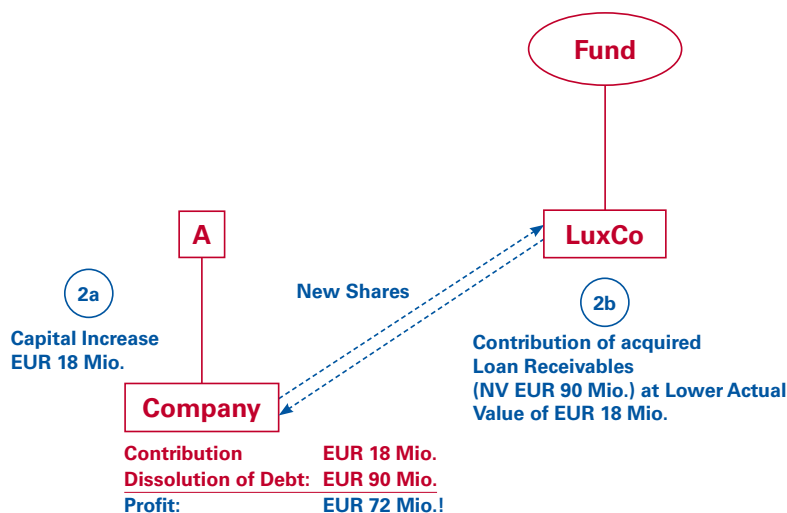
Realization of taxable income

The resulting increase of the stated capital at the level of the company, however, is only possible to the extent the amount of the capital increase is equivalent to the nominal value of the contributed receivable. As a rule, the value of the capital increase will, instead, be equivalent to the lower actual value of the contributed receivable. This is mandatory for corporations under the aspect of capital preservation (*Kapitalerhaltung*). Accordingly, the share capital increase will not amount to the nominal value of the contributed claims. As this is regarded to be an obstacle in German equity swap transactions there is some room for structuring alternatives depending on the economic goals

of the creditors which are, however, not further discussed within this article.

Correspondingly, for tax purposes the contribution is made by the investor (only) in the amount equal to the actual going concern value rather than the nominal value of the claim. As regards the amount of the valueless part, the claim will be considered as waived. Therefore, if and to the extent the capital increase and the contribution would be equivalent to the lower actual value of the receivable, the debt equity swap would result in taxable income for the company in the amount of the difference between the nominal value of the claims and their lower value.

Example:



Minimum taxation (“Mindestbesteuerung”) and tax remission on the basis of the recapitalization decree (“Sanierungserlass”)

As a result of the above, a debt to equity swap would lead to an additional taxable income of the company. In case the company has tax loss carryforwards available, such income could be offset with existing tax loss carryforwards of the company, however, subject to the restrictions of the German minimum taxation rule pursuant to Sec. 10 d German Income Tax Act (ITA). According to this provision, the taxable profits of the company arising from a debt to equity swap can be fully sheltered with available tax loss carry forwards up to an amount of €1 million only. With regard to any taxable income realized exceeding €1 million the offsetting with available tax losses carried forward would be limited to 60 percent of such income, *i.e.* 40 percent of the gain would be subject to tax and would lead to additional tax payments (“**Minimum Taxation**”, “**Mindestbesteuerung**”).

As such a result could be counterproductive and could jeopardize the willingness of investors or creditors to invest into distressed companies, in the past, recapitalization gains had been tax-free under the former sec. 3 No. 66 ITA. However, as this rule has been abolished without substitution, the German tax law currently does not provide for any tax exemption with respect to recapitalization gains.

Currently it is only possible to apply to the tax authorities for a deferral and remission of tax on recapitalization gains for reasons of equity (*Billigkeitsgründe*) on the basis of a decree of the Federal Ministry of Finance issued on 27 March 2003 (“**Recapitalization Decree**”, “**Sanierungserlass**”). A recapitalization gain would be any increase of the business property due to a full or partial debt forgiveness by a creditor of the company for the purposes of a recapitalization and restructuring of the company. However, according to the Recapitalization Decree, the benefit of a deferral and remission is only granted if the additional requirements of (i) a restructuring need of the company (ii) a restructuring capability of the company, (iii) a suitability of the debt forgiveness

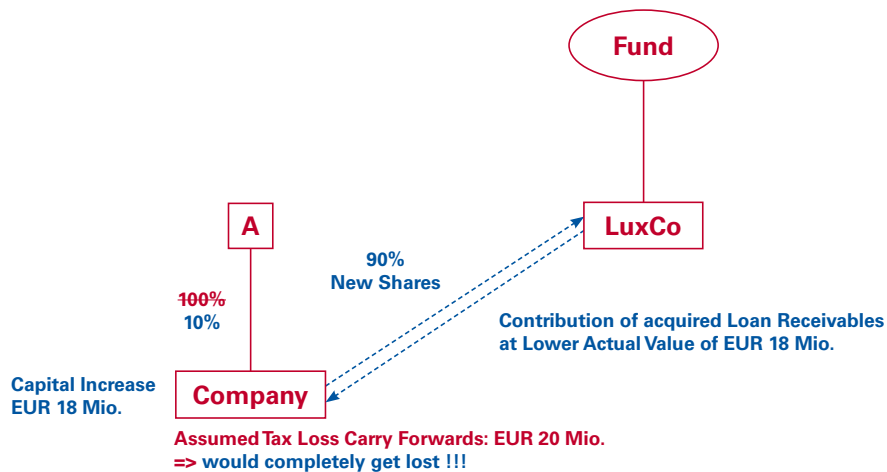
to achieve a restructuring of the company and (iv) the intention of the creditor to primarily support the corporation’s restructuring with the debt forgiveness, could be fulfilled. According to the Recapitalization Decree these requirements could be assumed as fulfilled, if the company provides for a restructuring plan (*Restrukturierungsplan*).

Risk of forfeiture of tax loss carried forwards

It must further be taken into account that a debt to equity swap will cause a risk of forfeiture of any existing tax loss carried forward of the company according to the revised rules, preventing **loss trafficking** in sec. 8 c Corporate Income Tax Act (CITA). According to this provision, the tax loss carried forwards of the company will be pro rata lost if more than 25 percent but no more than 50 percent of the shares or voting rights are transferred to (i) one acquirer or (ii) related parties to his acquirer, within a time period of five years, directly or indirectly. In case more than 50 percent of the shares or voting rights of the company are directly or indirectly transferred to (i) one acquirer or (ii) to related parties to the acquirer transferred within a time period of five years, the entire existing loss carry forward of the company will be lost.

According to the view of the German tax administration such a harmful transfer of shares or voting rights will also be assumed if, within the scope of a capital increase, a newly admitted shareholder will be granted a shareholding (or any other participation right) of more than 25 percent of the share capital of the company or an existing shareholding will be increased by more than 25 percent. Therefore, if and to the extent the investor will – as in our example assumed – be granted a shareholding of more than 50 percent within the scope of the debt to equity swap any available tax loss carry forwards of the company will entirely be lost. Of course such result is not in the interest of an investor and the German legislator has provided for an exception of the loss trafficking rule in case of specially defined German venture capital funds under certain circumstances. However, as foreign vulture funds will normally not be able to make use of this exception, again, there is need for tax planning in order to circumvent or mitigate the forfeiture of the loss carry forwards.

Example:



Mitigation of the tax disadvantages arising from an application of the German Interest Barrier Rules

Due to the Interest Barrier Rules (for a general description see below) most of the distressed companies will in future suffer further disadvantages as the interest expenses can not be fully deducted as business expenses for tax purposes. This will cause a further heavy negative impact on the cash flow and the financial situation of such companies.

The Interest Barrier Rules (Secs. 4h ITA, 8a CITA) limit the deductibility of interest payments for corporate tax purposes and trade tax purposes and applies irrespective of the nature of the creditor whether they be shareholders or third-party banks. The interest deductibility is generally limited to 30 percent of the taxable EBITDA (earnings before interest, tax, depreciation, and amortisation) plus the amount of interest received in the same fiscal year. Non-deductible interest expenses can only be carried forward and will generally be deductible in subsequent fiscal years, subject to limitations similar to those applicable in the current year.

Although there are some exemptions from the application of the Interest Barrier Rules ((a) net interest expenses are below €1 million; (b) relevant company is not part of a consolidated group (e.g. IFRS); (c) relevant company is part of a consolidated group but its equity ratio is higher than or equal to the equity ratio of the consolidated group to which

it belongs (missing that ratio by up to 1 percent is not harmful); additional requirement (counter exception) for cases (b) and (c): no more than 10 percent of the excess interest expense is paid on certain shareholder loans or intercompany loans other than from consolidated group companies), most of the distressed companies could not rely on one of the exemptions.

In the ordinary case the above described exemptions will therefore not be available so that a decrease of the debt volume by a debt to equity swap could provide for a relief insofar as it would lead to a reduction of the net interest expenses of the company enabling the company to escape or mitigate the Interest Barrier Rules. Instead, the improvement of the debt-ratio (being relevant for exemption (c)) will likely not be relevant in our example given the better debt-equity-ratio of the consolidated group.

Tax Effects at the Level of the Shareholder

As LuxCo is resident in Luxembourg under the Luxembourg/German double taxation treaty (DTT) and the EU Parent Subsidiary Directive it may receive dividend payments and capital gains without any German taxation.

However, in 2007 Germany introduced a Anti-Treaty-Shopping Rule (Sec. 50d ITA) according to which DTT or Directive benefits will not be granted to a shareholder of a German company if the shareholder would not be entitled to the benefit

if the income were earned directly (not through an intermediary company) and if at least one of the following three conditions is met:

- no economic or other sound reasons justify the interposition of the foreign entity; or
- the foreign entity does not earn more than 10 percent of its annual gross income from its own economic activities; or
- the foreign entity does not participate in the general market using a business establishment appropriate for its business purpose.



Dr. Janusz Fiszer

The Act defines that organisational or commercial circumstances of related entities will be disregarded. Neither the administration of assets nor activities which have been outsourced will be considered an “own economic activity” of the foreign entity.

The Anti-Treaty-Shopping Rule will, for example, apply to vulnerable structures of private equity funds which operate with a minimum amount of substance. Accordingly, vulture funds must consider whether they (i) may be able to realize return on investments only on a future exit by selling the German company, (ii) can delay dividends payments until necessary restructurings have been implemented or (iii) a different corporate investment set up is chosen (e.g. interposing a German partnership between the Fund and the LuxCo).

As regards the old shareholder, it should be noted that if such shareholder sells its shareholder loan to an investor, they will, as a rule, suffer a loss. According to the newly introduced provision of Sec. 8b para. 3 sentence CIT, since 2008 it must be taken into account that a loss occurring in connection with the sale of loan by (i) a shareholder holding directly or indirectly more than 25 percent of the capital of the corporation (“**Major Shareholder**”), (ii) a related party to a Major Shareholder or (iii) a third party creditor with recourse to a Major Shareholder is no longer tax deductible, unless it can be proven that an unrelated third party creditor would – under the same circumstances – have granted the loan as well and would not have reclaimed the loans in the meantime as well. It follows that a sale of shareholder etc.

loans, for tax purposes, has become less efficient compared to the past.

Significant Amendments to the VAT Law

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On October 20, 2008, numerous amendments to the 2004 VAT Law were passed by the Polish Parliament. The final version of the new amendments entered into force on January 1, 2009.

The most important changes to the VAT Law include:

- the possibility to file a quarterly tax statement instead of a monthly tax statement, as an option available upon the request of the taxpayer filed with the local tax office up to the 25th day of the second month of each quarter;
- the possibility to settle import VAT by direct filing of a tax statement, instead of paying the VAT due and then requesting a set-off based upon a tax return; again, this is an optional procedure, available upon the request of the taxpayer filed with the local tax office;
- a simplification of the VAT treatment of call-off stocks (so-called *consignment stock*);
- the introduction of a right to correct the tax statement in case the receivable is not collected within 180 days from the due date;
- the introduction of a right to deduct the input VAT from the output VAT in the two subsequent settlement periods;
- an exemption from VAT on the sale of an enterprise or of an organized part of an enterprise and the introduction of a revised definition of an organized part of an enterprise, consistent with the definition included in the 1992 Corporate Income Tax Law;

- the elimination of a 30 percent penalty for underdeclaring a VAT liability or overdeclaring a VAT refund; the only instance in which such a penalty could be levied on taxpayers who fail to obey the obligation to register their sales using the VAT cashiers;
- the elimination of the rule that the input VAT may be deducted from the output VAT only if a given expense was income tax-deductible, as such rule was inconsistent with EU law;
- a change to the VAT refund rules, including introducing a shorter refund period (60 days instead of 180 days) and the elimination of a so-called "preliminary VAT refund" applied to investment expenses made before commencing a taxable sale of goods or rendering of services; the major change here consists of the elimination of the rule that a VAT refund is related to a taxable sale;
- a regulation regarding the sale of real estate: sale of buildings, constructions or their parts will be, as a rule, exempt from VAT, however, the taxpayer may, under certain conditions, choose a VAT taxation regime; the establishment and sale of the perpetual usufruct rights to a real estate will become subject to VAT;
- an exemption from VAT on the donation of food products by manufacturers for charitable purposes (combined with a corresponding right to consider such donations as tax-deductible expenses for income tax purposes).

The new amendments also include a series of minor changes regarding:

- a higher limit for non-taxable gifts;
- a revised definition of the place of rendering so-called non-material services;
- a confirmation of a receipt of a correcting invoice, as well as numerous "technical" amendments to the existing regulations.

Anti-Crisis Tax Measures in Russia and Other Important Amendments to Russian Tax Legislation Effective in 2009

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As of 1 January 2009, a number of amendments have been introduced to the Russian Tax Code (the "**Tax Code**"). Some of these amendments contribute to the development of the Russian tax system, while others specifically address the consequences of the financial crisis.

Below we summarize the most important amendments that have come into effect as of 1 January 2009, or otherwise as indicated.

Profit tax

The profit tax rate has been reduced from 24% to 20% and regional legislatures are permitted, for certain categories of taxpayers, to decrease the rate still further, to 15.5%.

The scope of deductible expenses has been extended, including:

- for the period from 1 September 2008 to 31 December 2009, the threshold for deducting interest expense has been increased from 1.1 to 1.5 times the refinancing rate of the Russian Central Bank (*i.e.*, currently up to 19.5%) with respect to ruble loans and from 15% to 22% with respect to foreign currency loans;
- thresholds for deducting daily business trip allowances have been abolished;
- the threshold for deducting insurance premiums for employees' voluntary personal insurance has been increased from 3% to 6% of the total payroll expense;



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- deduction of expenses for voluntary property insurance is now available if the relevant insurance is required by law for particular types of activity;
- an increased ratio (1.5) is introduced for faster deduction of certain R&D expenses as per a list approved by the Russian Government, including those that did not yield any positive results; and
- limited deduction (with simultaneous exemption from individual income tax and unified social tax) is now allowed for certain benefits provided by the employer, including:
 - > compensation of interest on loans used for purchase or construction of residential premises;
 - > education in higher or specialized educational institutions; and
 - > voluntary pension insurance contributions.
- the VAT exemption for the importation of technological equipment, which was available where equipment was imported as an in-kind contribution to the capital of a company has now been extended to apply to any import. At the same time, this exemption is available for technological equipment where no equivalent equipment is produced in Russia, and which is included in a list which is to be approved by the Government;
- for the first time, purchasers are given the right to offset input VAT paid with advance payments, before the acquired goods (works, services) are actually received; and
- the requirement to pay VAT to the seller by wire transfer when completing barter transactions, offsetting counterclaims and using securities as a payment instrument, which had been introduced in 2007, is now abolished.

The depreciation rules have been altered as follows:

- the depreciation premium that permits a one-off deduction of a part of an acquisition cost has been increased from 10% to 30% for fixed assets with statutory life from 3 to 20 years (*i.e.* belonging to depreciation groups 3-7);
- the reducing depreciation ratio (0.5) for expensive cars and minibuses has been abolished, which permits faster depreciation of these assets;
- upon reorganization or liquidation, depreciation now accrues up to and including the month when such reorganization/liquidation is registered (previously, it was not possible to accrue depreciation in that month).

VAT

Important VAT amendments include the following:

- since the third quarter of 2008, for each tax period (which is a quarter for VAT purposes) VAT is to be remitted to the state budget in three equal installments over three subsequent months (by the 20th of each month). Taxpayers are effectively granted an "installment plan" for paying VAT;

Natural resources production tax ("NRPT") and export customs duty

The following amendments have been introduced to reduce the NRPT burden for oil producers:

- the tax rate was revised and the tax is now assessed on the oil price exceeding USD 15 per barrel (instead of USD 9 previously);
- zero rate (for a limited volume of oil produced) is extended to apply to oil fields north of the Arctic Circle, on the Azov and Caspian seas, in the Nenets Autonomous Area and the Yamal Peninsula.

In order to allow the more timely reflection of world crude oil prices, the export duty rate for crude oil is now adjusted monthly (instead of bi-monthly) based on world prices in the relevant previous month.

Taxation of concession agreements

- The Tax Code has been amended to regulate specifically the taxation of concession agreements *i.e.*, agreements on the creation and/or reconstruction and subsequent use of state or municipal property by private investors:
- concession agreements are to be treated for VAT purposes in the same way as simple partnership

and asset management agreements, so, among other features:

- > transfers of property or property rights under concession agreements is exempt from VAT; and
 - > the obligation to pay VAT and issue factura-invoices with respect to transactions made under a concession agreement lies with the concessioner, who is also entitled to offset input VAT on goods (works, and services) purchased for the purpose of executing the concession agreement;
- the concessioner is exempt from profit tax on the receipt of property and property rights under a concession agreement, and is allowed to deduct concession payments;

- the concessioner is now subject to property tax with respect to property received under concession agreements and accounted for on its balance sheet; and
- foreign companies without permanent establishments in Russia pay property tax only with respect to real estate received under concession agreements.

Tax administration

A decision of a tax authority issued on the basis of tax audit results can now be disputed in court only after it is disputed with the superior tax authority by filing an appellate or general complaint.

Developments in Asia-Pacific

Comprehensive Operating Manual of Anti-Avoidance Rules (including Transfer Pricing Documentation) Finally Released

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China's new 2007 Enterprise Income Tax Law, for the first time in Chinese tax history, introduced a set of anti-avoidance rules in its Special Tax Adjustments chapter, which include not only transfer pricing and advanced pricing agreement rules but also rules on cost sharing agreements, thin-capitalization, controlled foreign corporations, and general anti-avoidance.

On January 8, 2009, the SAT released long-awaited Circular Guoshuifa [2009] No 2, *Implementation Measures of Special Tax Adjustments (Trial)* that details rules on administering all the aspects of those anti-avoidance rules. If the Special Tax Adjustments chapter represents the first anti-avoidance legislation in China, Guoshuifa [2009] No 2 can be viewed as the first comprehensive operating manual of anti-avoidance administrations in China. All the provisions in Guoshuifa [2009] No 2 take retrospective effect from January 1, 2008. The most significant provisions of Guoshuifa [2009] No 2 are summarized and analyzed as follows.

Annual filing of related party disclosure forms

As the starting point of the anti-avoidance administration, Guoshuifa [2009] No 2 restates that all enterprises shall file the following nine forms annually to report related party transactions:

- Form 1 – Related party relationships
- Form 2 – Summary of related party transactions
- Form 3 – Purchases and sales



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- Form 4 – Labor services
- Form 5 – Intangible assets
- Form 6 – Fixed assets
- Form 7 – Financing
- Form 8 – Outbound investments
- Form 9 – Outbound payments

Those forms require enterprises to indicate whether they have contemporaneous transfer pricing documentation in place. The forms need to be filed together with the annual enterprise income tax return. For the tax year of 2008, the filing deadline is May 31, 2009.

Transfer pricing documentation

A significant new requirement in Guoshuifa [2009] No 2 is the annual contemporaneous documentation requirement that is in addition to the filing of the above nine forms. Enterprises are not required to submit the documentation to the tax authorities until receiving a formal notice. However, once receiving a notice, an enterprise must submit the documentation within 20 days. Failure to submit the documentation will result in a fine in the range of RMB 2,000 to 50,000. Also, if there is a TP adjustment, failure to submit the documentation will result in an additional interest levy of 5 percent.

Enterprise can be exempt from the annual documentation requirement if they meet the following criteria:

- The annual amount of related party purchases and sales of tangible goods is below RMB 200 million and the annual amount of all other related party transactions (services, royalties, interest, etc.) is below RMB 40 million;
- The related party transactions are covered under an advanced pricing agreement; or
- The foreign shareholding of the enterprise is below 50 percent and that enterprise only has related party transactions within China (*i.e.* with other Chinese enterprises).

The documentation shall cover 5 broad categories and 26 sub-categories of information and should be in Chinese. The 5 categories are:

- Organization structure
- Description of business operations
- Description of related party transactions
- Comparability analysis
- Transfer pricing method

The deadline for completing contemporaneous documentation is five months after the end of a tax year, *i.e.* May 31. For the year 2008, the deadline is extended to December 31, 2009. Contemporaneous documentation shall be kept for at least 10 years.

Transfer pricing methods

Under Guoshuifa [2009] No 2, enterprises can use one of the following six acceptable methods that are the same methods as under the OECD transfer pricing guidelines, to determine their transfer pricing:

- Comparable uncontrolled price method
- Resale price method
- Cost plus markup method
- Transactional net margin method
- Profit split method
- Other methods that are in accordance with the arm's length principle

Guoshuifa [2009] No 2 describes in details each of the methods but doesn't indicate any clear hierarchy for selecting transfer pricing methods, except saying that an enterprise or tax authorities shall choose a transfer pricing method that is most suitable in light of the following five comparability factors:

- Characteristics of the assets or labor services involved
- Functions and risks of each party involved

- Contract terms
- Economic circumstances
- Business strategies

Audit flags

Guoshuifa [2009] No 2 lists seven types of targets that may attract a transfer pricing audit. They are:

- Enterprises with significant amounts or numerous types of related party transactions
- Enterprises with long term losses, very low profits or fluctuating profits
- Enterprises with profitability lower than those in the same industry
- Enterprises with profitability that doesn't match their functions and risks
- Enterprises dealing with related parties in tax havens
- Enterprises failing to file annual related party disclose forms or prepare contemporaneous documentation
- Enterprises that obviously violate the arm's length principle

Based on the recent speech of a SAT official, the three major flags are long term low profitability or losses, noncompliance with the disclosure and documentation requirements and transacting with tax havens.

Advanced pricing agreement ("APA")

The APA rules in Guoshuifa [2009] No 2 are basically a restatement of the 2004 APA rules with certain modifications and amendments. Guoshuifa [2009] No 2 sets forth detailed requirements and procedures regarding applying for, negotiating, implementing and renewing APAs. To apply for an APA, an enterprise must have at least RMB 40 million of related party transactions. The term of an APA will cover transactions for 3 to 5 years.

Cost sharing agreement ("CSA")

The implementation rules on CSA are pretty much based on the OECD transfer pricing guidelines. However, in the service context, CSAs are limited to group procurement or group marketing strategies. A CSA, once entered into, shall be filed with the SAT within 30 days. Furthermore, by June 20 of every year, an enterprise shall submit a set of contemporaneous documentation to the tax authorities that includes key information on the implementation of the CSA and any changes to the CSA, participating parties and forecasts.

Controlled foreign corporation ("CFC")

Due to lack of experience and knowledge in this brand new area, the draft team of Guoshuifa [2009] No 2 managed to define only a few key items but failed to set forth detailed guidance on the implementation of CFC rules.

Guoshuifa [2009] No 2 provides that when determining a resident's shareholding percentage of an indirectly owned foreign subsidiary, the general rule is to multiply its shareholding percentage of the intermediate holding company by the holding company's shareholding percentage of that foreign subsidiary. However, if the intermediate holding company owns more than 50 percent of that foreign subsidiary, the intermediate holding company is treated as owning that foreign subsidiary 100 percent for the computation purposes.

The deemed dividends from a CFC attributable to its Chinese resident enterprise shareholder are calculated using the following formula:

$$\text{Reportable income} = \text{Deemed dividend distributions} \times \text{Number of holding days} / \text{Number of days in the CFC's tax year} \times \text{Shareholding percentage}$$

The foreign corporate income tax coming with deemed dividends can be credited against Chinese enterprise income tax.

Future cash distributions made by a CFC the income of which has been previously taxed as deemed dividends in China shall be exempt from Chinese enterprise income tax.

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Guoshuifa [2009] No 2 provides for three exceptions where CFC rules will not apply, which are:

- ❑ The CFC is established in a country or jurisdiction that doesn't have a low tax rate and is designated by the SAT;
- ❑ Its income is derived from active business operations; or
- ❑ It has annual profits of less than RMB 5 million.

Thin capitalization

In our Nov China tax update, we reported that Circular 121 sets out the prescribed debt-to-equity ratios – 2:1 for non-financial enterprises and 5:1 for financial enterprises. Guoshuifa [2009] No 2 provides for the mechanics for how to calculate the debt to equity ratio (on a monthly weighted average basis) and further provides that if an enterprise would like to claim deduction of excessive interest expenses, it should prepare and file contemporaneous documentation to the tax authorities.

Guoshuifa [2009] No 2 also clarifies that the non-deductible interest expenses, if paid to overseas related parties, shall be deemed as dividends and thus subject to dividend withholding tax if the dividend withholding tax rate is higher than the interest withholding tax rate.

General anti-avoidance rules

Guoshuifa [2009] No 2 provides that local tax authorities can, upon the approval of the SAT, launch a general anti-avoidance investigation on an enterprise if the enterprise is found to be engaged in any of the following activities:

- ❑ Abusing tax incentives
- ❑ Abusing tax treaties
- ❑ Abusing corporation forms and structures
- ❑ Avoiding taxes using tax havens
- ❑ Other tax arrangements that don't have a reasonable business purpose

In determining if an enterprise is engaged in a tax-avoidance arrangement, the tax authorities shall adopt the principle of substance over form. Furthermore, the tax authorities shall consider the following factors:

- ❑ Form and substance of the arrangement
- ❑ Conclusion time and duration of the arrangement
- ❑ How the arrangement is executed
- ❑ Connection between each step or part of the arrangement
- ❑ Changes of financial status of each party involved in the arrangement
- ❑ Tax consequences of the arrangement

The tax authorities can also require the tax planner to submit the materials relevant to the tax-avoidance arrangement under investigation.

The tax authorities are empowered to re-characterize transactions based on the true economic substance and disregard the intended tax benefits under a tax-avoidance arrangement. In particular, enterprises without any economic substance including those established in tax havens for the purpose of tax-avoidance, can be disregarded.

Corresponding adjustments and international negotiations

Guoshuifa [2009] No 2 provides that corresponding adjustments shall be allowed in the case of a transfer pricing adjustment in order to avoid taxable taxation. If this involves an overseas related party resident in a treaty country, the SAT will, upon the application of the enterprise, launch negotiations with the competent authorities of that treaty country based on the mutual agreement procedures in the treaty. The application of corresponding adjustments shall be made within 3 years after receiving the transfer pricing adjustment notice.

It should be noted that the corresponding adjustment rule shall not apply where the transfer pricing adjustment involves payments of interest, rental or royalty to overseas related parties. In other words, the excessive withholding tax in such a case is not refundable.

First Anti-Treaty-Abuse Case Publicized in China

Right before Guoshuifa [2009] No 2 was issued, the SAT issued Guoshuihan [2008] No 1076, endorsing an anti treaty-abuse case decided by the Xinjiang Uygur Autonomous Region tax authorities.

The issue was if the Barbados-incorporated company in question that derived capital gains from the sale of its equity interest in a Chinese joint venture company could qualify for the capital gains tax exemption under the China-Barbados treaty. The Xinjiang tax authorities denied the treaty based exemption in the end because they concluded the Barbados company didn't meet the residency requirement under the treaty and thus would not be considered a resident of Barbados.

The case initially caught the attention of the tax authorities because of the unusual arrangement entered into by the parties involved. Basically, the Barbados company purchased the equity interest in the Chinese JV only one month after the Barbados company was formed and sold the interest about one year after. The return on such an investment was 36 percent, which was pre-agreed by the parties. As such, in substance, the return could be arguably considered interest.

The case above clearly indicates that the tax authorities in China intend to seriously implement anti-avoidance rules and will scrutinize similar transactions closely going forward.

An interesting question is what if the Barbados company in question was indeed a Barbados resident even if it was just a holding company. Could the Chinese tax authorities still deny the treaty benefits based on Chinese domestic anti-avoidance rules? Our quick research shows that the answer should probably be NO because the China-Barbados treaty doesn't permit that. However, if the Barbados company in this case is a HK company, in theory, China should have the right to use domestic anti-avoidance rules to attack the arrangement because Article 25 of the China-HK treaty specifically permits that.

The take-way for companies that have similar offshore holding company structures is that they need to review their structures to determine if they

are vulnerable to scrutiny and, if so, what will be the best remedy.

The New Japan Independent Agent Exception

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Background

Prior to the 2008 tax reform act passed by the Japanese Diet, Japanese domestic tax law did not contain an independent agent exception within the legal definition of a contracting agent permanent establishment. Japan's extensive network of double tax agreements did contain the independent agent concept, as the tax treaties are predominantly based on the OECD model tax treaty. However, non-Japan resident taxpayers were often counseled by Japan tax practitioners that strong reliance upon the treaty based exception for purposes of avoiding having an agent permanent establishment (PE) status in Japan was somewhat risky because Japanese tax examiners, having no practical experience in applying the independent agent concept under the local tax law, may have difficulty applying the treaty based exception in accordance with the OECD commentary on permanent establishments.

The absence of an independent agent PE exception under the local law has made structuring the investments of non-Japan resident funds (Offshore Funds) into Japan who are relying on the expertise of related or unrelated Japan resident fund managers challenging, as many Offshore Funds and their investors are established or resident in jurisdictions which have not entered into a tax treaty with Japan. To protect against having a PE, most Offshore Funds structured their Japan resident investment advisor relationship to fall under the auxiliary and liaison exception contained in the local tax law definition of a PE. This meant that the Japan resident investment was limited to activities



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on behalf of the Offshore Fund in an advisory nature only, with no discretionary decision making authority. This factor was recognized by Japanese government policymakers a couple of years ago as a key reason why the total number of discretionary investment managers based in Japan remained virtually unchanged for the past twenty years.

At around the same time, the National Tax Administration (NTA) began to systematically audit Japan resident investment managers of Offshore Funds, focusing on the issue of whether the activities of the manager created an agent PE for the Offshore Fund and its non-Japan resident investors. Those audits were thought to be motivated in part by the large increase in hedge funds investing into Japan capital markets. Because of the high speed and large volume of sophisticated trades executed by offshore hedge funds in the Japanese markets, the sub-advisor structure was difficult for the funds and their advisors to implement in practice without creating PE risk to the hedge fund and its foreign investors. One consequence of the audit activities of the NTA was that many Japan resident fund managers, concerned about creating an agent PE for the Offshore Funds they were advising, began to move their operations from Japan elsewhere within Asia, primarily to Singapore or Hong Kong, whose tax laws not only made it easier to avoid creating PE status for the Offshore Funds, but which, at least in the case of Singapore, provide attractive tax incentives for fund managers to locate there.

Japanese government policymakers involved in the financial services sector believed that the flight of investment managers from Japan to other financial centers in Asia posed a serious national competitiveness issue. Not only was it contrary to Japan's long stated objective of making Tokyo a global financial center, but the fact that the managers were moving to Hong Kong and Singapore only worsened the perception, since both jurisdictions have the same objective of becoming the leading financial center in Asia.

To address this issue, the Ministry of Finance (MOF) and the Financial Services Agency (FSA), the regulatory body in Japan responsible for oversight of the capital markets and funds advisors, requested that the Japanese Diet adopt the independent

agent PE exception into the local law. The request was part of the plan announced by the FSA in its December 2007 report entitled "The Four Pillars of the Better Market Initiative". The report cited as its second pillar, to "put into place a business environment [in Japan] that vitalizes the Financial Services Industry and Promotes Competition". The report identified as an important objective in implementing the second pillar, "minimizing the PE risk to attract foreign fund managers to Japan's markets", and calls for measures that ensure "foreign funds or foreign investors are not deemed to have a PE in Japan under domestic tax law when they carry out their business in Japan through an independent agent".

The Independent Agent PE Exception

In response to the request by the FSA, the Japanese Diet, amended the Japan tax law to introduce the independent agent exception. Effective, April 1 of 2008, Article 186 of the Cabinet Order of the Corporation Tax Act, and Article 290 of the Cabinet Order of the Income Tax Act, were both amended to exclude from the definition of a contracting agent permanent establishment a "person who conducts business activities associated with the business of the foreign corporation independently of the foreign corporation.... and in the ordinary course of his business".

Generally, formal interpretations of the Japan income tax laws, as well as revisions to the laws, are set forth in tax circulars (Circulars) issued by the NTA. In the case of the new independent agent PE exception, the NTA, despite announcing earlier this year that it would issue guidance, has yet to issue a Circular interpreting the new tax rule. However, the FSA, which sponsored the law change, has issued guidance in the form of a document which sets forth a "safe-harbor" for investment fund managers, and also contains information on how the exception is to be interpreted more generally through case studies and Q&As.

FSA Guidelines

On June 27, 2008, the FSA issued two documents entitled "Reference Cases" and "Q&A" providing that agency's interpretation of the "independent agent exception" (collectively, the "Guidelines"). Although the FSA clearly consulted with the

NTA in drafting the Guidelines, it is important to note that the NTA is not officially a co-author of the documents. With that said, it is understood that the NTA is generally in agreement with the interpretation of the exception as set forth within the Guidelines for the reason that high level officials of the NTA participated in a public joint presentation on July 4, 2008, with officials of the FSA and the MOF, to explain the scope and application of the new exception (July Presentation). However, it is not clear that the views of the FSA and the NTA are completely aligned on every interpretive point. Some tax practitioners in attendance at the presentations noted that oral comments of tax officials sometimes seemed inconsistent with the oral comments of the FSA officials. Thus, the NTA may have its own views regarding how particular aspects of the independent agent exception are to be applied within a particular factual context. Only time will tell of course if that is the case. Hopefully, the NTA will soon issue a Circular interpreting the new independent agent exception to provide guidance and certainty to taxpayers.

The main purpose of the FSA issuing the Guidelines is to set forth how the new exception is to be applied to Offshore Fund portfolio management activities in Japan performed by Japan investment managers. The Guidelines also importantly set forth a “safe harbor” for determining the “independence” of a discretionary fund manager resident in Japan. Presumably, the FSA felt that, given the highly factual nature of an independent agent inquiry, creating a “safe harbor” under the tax law for Japan investment managers to structure within would provide certainty to Offshore Funds that they would avoid creating a PE for themselves and their investors in Japan. The Guidelines are also important in establishing that the exception is to be interpreted in line with the commentary to the OECD model tax treaty with regards to the independent agent exception.

Consistency with OECD commentary approach

Consistent with the OECD Model Tax treaty Commentary on Article 5 (concerning the definition of permanent establishments) (OECD Commentary), the Guidelines provide that for an agent to be considered as performing activities within the scope of the exception, it is necessary that the agent be “legally” and “economically”

independent from the principal, and that the business activities conducted by the agent for the principal are conducted in the “ordinary course of the agent’s ordinary business”.

Legal Independence

The Guidelines state that the question of whether an agent is “legally” independent from the principal depends upon the scope of the responsibility of the agent to the principal. If the commercial activities of the agent taken on behalf of the principal are under detailed instructions or comprehensive control of the principal, the agent is not considered to be independent. Legal independence of the agent therefore requires that the agent have sufficient discretionary authority to act as an agent.

The Guidelines note that the fact that the principal relies upon the special skills or knowledge of the agent is an indicia of independence.

The Guidelines also confirm the principal set forth in the OECD Commentary that the control exercised by a parent company to its subsidiary in its capacity as a shareholder is not a factor in determining the independence of a subsidiary acting as an agent for its parent company. In addition, the fact that the operations of the business of the subsidiary is managed by the parent company does not mean that the subsidiary is not independent from the parent company.

Economic Independence

Under the Guidelines, consistent with the OECD Commentary, for the agent to be independent they must have economic independence from the principal. This determination is based on all of the facts and circumstances. In determining such economic independence, relevant factors include the presence of entrepreneurial risk, and the number of principals the agent acts for.

Ordinary Course of Business

The Guidelines provide that the agent must perform activities within the ordinary course of its own business. In contrast, if an agent performs activities within the business field of the principal as opposed to its own course of business, the agent will fail to satisfy this condition. The comments in the Guidelines in this regard are consistent with the OECD Commentary.

Assuming the NTA is in agreement with this aspect of the Guidelines, it appears that in applying the independent agent PE exception, the tax authority will apply and interpret the exception consistently with the OECD Commentary. One hopes that is the case, as it will significantly reduce uncertainty and give taxpayers a well established body of written guidance to plan its affairs, and to use as support for positions in the case of a tax audit.

The safe harbor for fund industry independent agents

The Guidelines set forth in the Reference Cases document a “safe harbor” which allows a Japan resident investment manager (Japan Investment Manager) of the general partner (General Partner) of an Offshore Fund or of an offshore investment manager to the general partner of such Offshore Fund (Offshore Investment Manager) to be treated as an independent agent with respect to the Offshore Fund and the offshore investment manager as follows:

“Where an offshore general partner of an offshore fund established under a partnership agreement executes a discretionary investment contract with a domestic investment manager for non-residents, etc. who are members of such partnership agreement (including cases where an offshore general partner executes a discretionary investment contract indirectly with a domestic investment manager through an offshore investment manager), if such domestic investment manager conducts specific investment activities in Japan on behalf of such member, unless there are any of the following circumstances, such domestic investment manager is considered an independent agent....

- (a) The portion of the investment decisions entrusted to a domestic investment manager under a discretionary investment contract is small, and the offshore general partners (and members) or offshore investment managers are considered to be substantially conducting investment activities directly
- (b) One-half or more of the officers of the domestic investment manager concurrently serves as an officer or employee of the offshore general partner or offshore investment manager

- (c) The domestic investment manager does not receive compensation proportional to the total amount of management gains or managed assets entrusted from an offshore fund
- (d) Where a domestic investment manager places all or a considerable portion of its business activities on transactions with offshore general partners or offshore investment managers, such domestic investment manager is not capable of diversifying its business or acquiring other customers without changing its business activities radically or having a big impact on its profit.”

The four criteria of the safe-harbor are worded as negative conditions, meaning that, if the Japan Investment Manager does not satisfy any of these conditions, then it will be deemed to be an independent agent of the General Partner or the Offshore Investment Manager of the Offshore Fund, as the facts may be, under the Guidelines. It is important to note that the Guidelines do not suggest the opposite is true, meaning that the Japan Investment Manager is not automatically treated as a dependent agent if it satisfies any one of the conditions; rather, that the Japan Investment Manager will not be within the safe-harbor rule. In such case, presumably, the activities of the Japan Investment Manager on behalf of the General Partner or Offshore Investment Manager of the Offshore Fund are still tested under OECD commentary principles, and could, depending on the facts, still be treated as an independent agent.

Each of the four criteria is discussed in more detail below, and illustrated through case studies set forth in the Guidelines.

Detailed Instructions Test

The Guidelines provide that if the decision making authority of the Japan Investment Manager is limited in a manner such that decisions are in substance being made offshore by the General Partner or the Offshore Investment Manager, the Japan Investment Manager is not considered to be sufficiently independent of the General Partner. In determining whether the Japan Investment Manager meets this test, whether the manager applies specialist knowledge and expertise in

carrying out its activities on behalf of the General Partner is considered an important fact in measuring its independence.

Five case studies set forth in the Guidelines illustrate how the FSA, and possibly the NTA, interprets this factor, indicating its importance in the analysis.

In Case 1, the General Partner of the Offshore Fund enters into a discretionary investment contract with the Japan Investment Manager entrusted with the management of the funds of the Offshore Fund in the Japanese capital markets. The contract sets out certain parameters which the Japan Investment Manager must satisfy with regard to asset allocation ratios and risk limits, but leaves the investment decisions solely to the discretion of the Japan Investment Manager. The case concludes that because the General Partner does not give detailed instructions or comprehensively controls the Japan Investment Manager, the Japan Investment Manager satisfies the Detailed Instructions Test.

The facts of Case 2 are essentially the same in Case 1, except that the contracting party with the Japan Investment Manager is an Offshore Investment Manager which has entered into a discretionary investment contract with the General Partner. The case states that in determining the independence of the Japan Investment Manager from the Offshore Fund, it is necessary to analyze both (1) whether the Japan Investment Manager is independent from the Offshore Investment Manager, and (2) whether the Offshore Investment Manager is independent from the General Partner. The Guidelines conclude that because the Japan Investment Manager has been granted discretionary authority to invest in the Japan capital markets under its management contract, and the Offshore Investment Manager has been granted discretionary authority by the General Partner to manage the funds of the Offshore Fund globally, the Japan Investment Manager is considered to be an independent agent of the Offshore Investment Manager and the Offshore Fund.

Reading Case 2, it appears that as long as the Offshore Investment Manager is treated as an independent agent of the Offshore Fund, the Japan Investment Manager should automatically be treated as being independent from the

Offshore Fund, even if it is not independent from the Offshore Investment Manager. Even if the Offshore Investment Manager is not treated as being independent of the Offshore Fund, if the Japan Investment Manager is viewed as independent of the Offshore Investment Manager, the Japan Investment Manager is viewed as being independent of the Offshore Fund.

Case 3 illustrates a situation where the Detailed Instructions Test is not satisfied. In that case, the General Partner enters into an investment contract with a Japan Investment Manager which is considered to be discretionary under the Japan Financial Instruments and Enforcement Law (FIEL), and authorizes the General Partner to designate asset allocations, and give instructions to the Japan Investment Manager on the selection of investments and timing of trades. And in fact, the General Partner actually gives such instructions to the Japan Investment Manager. The Guidelines conclude that instructions regarding the selection of investments and timing of trades sufficiently limit the Japan Investment Manager's discretionary authority that they are to be considered "detailed instructions" which destroy the independence of the Japan Investment Manager.

Case 3 highlights that under the FIEL an investment contract may be classified as being a discretionary contract even if a part of the investment decisions are entrusted to the Japan Investment Manager. However, the fact that the contract is classified under the FIEL as being discretionary does not mean that the Detailed Instructions Test is also automatically satisfied.

Reading Case 1 and Case 3 together, it appears that the General Partner or Offshore Investment Manager may designate asset allocation limits without violating the Detailed Instructions Test, but selecting investments or timing the trades crosses the line.

Case 4 follows the facts of Case 1, except that the Japan Investment Manager is a 100 percent subsidiary of the General Partner. Consistent with the OECD Commentary, the Guidelines conclude that the fact that the Japan Investment Manager is a subsidiary of the General Partner does not make

it lose its independence. Further, the fact that the operations and business performed by the Japan Investment Manager is “managed” by the General Partner as its parent or is controlled by the General Partner in its capacity as a shareholder is viewed as “unrelated” to the question of independence.

Shared Officers Test

Under the Guidelines, if fifty percent or more of the officers of the Japan Investment Manager concurrently hold positions as an officer or employee of the General Partner or the Offshore Investment Manager, the Shared Officers Test is not satisfied. There is no indication in the Guidelines what type, level or functions of the officer or employee is relevant, and it appears that every type of position is counted for purposes of applying the test. At the July Presentation, an FSA official explained that the meaning of officer is as defined under the corporate laws. In that presentation, it was also confirmed by the FSA official that a member of the investment committee for an Offshore Fund would not be viewed as an officer of the general partner or offshore investment manager of the Offshore Fund unless the corporate law actually defined them as such. Since investment committee members are not officers within a corporate law context, this would seem to allow considerable leeway in structuring. One wonders, however, whether the NTA is of precisely the same view. At a presentation separate from the July Presentation with the FSA official, an NTA official stated that officers include “deemed officers”, suggesting that the definition of officers is broader than the FSA interpretation.

Remuneration of Investment Manager Test

The Guidelines note that the Japan Investment Manager must bear a degree of entrepreneurial risk to be considered independent, and the fact that it is compensated by reference to assets under its management and/or investment profits indicates that it bears such risk. The various cases in the Guidelines evidence that the FSA believes that payment of management fees to the Japan Investment Manager which are calculated as a percentage of assets under management combined with an incentive or performance fee calculated as a percentage of the gains satisfy the test. In contrast, one can presume that if the Japan Investment Manager is compensated on a cost

plus basis, the test would not be satisfied as they would be guaranteed to make a profit and therefore not bear any entrepreneurial risk.

How large of a percentage of assets under management or gains must the Japan Investment Manager be entitled to in order to satisfy the test? The Guidelines do not specifically state the appropriate amount of compensation, but provide useful guidance on the question. In Case 5, where the Japan Investment Manager is paid a performance fee and assets under management percentage-based management fee, the Guidelines provide that the compensation must not be less than an arm’s length amount, noting that compensation based on arm’s length pricing principles is an “important factor” indirectly supporting that the Japan Investment Manager is an independent agent.

Diversification Capacity Test

The Guidelines discuss the diversification capacity test in Case 5, which relates to whether the Japan Investment Manager is treated as being economically independent from the Offshore Fund. The case notes that the number of principals the agent acts on behalf of is a factor to be considered in determining economic independence. In discussing that factor, we are told that if the activities of the agent is conducted through the duration of the business or solely or mostly for just one principal, the Guidelines note that it is inconceivable that the agent has independent status. Further, all of the facts are to be considered, and in particular, whether the agent bears risk through entrepreneurial skills and knowledge and receives compensation.

On this first point, the case notes that if the Japan Investment Manager depends in considerable part of its business activities on transactions with the Offshore Fund, it is necessary that the Japan Investment Manager have special skills and knowledge, and the ability to diversify its business activities. The ability of the Japan Investment Manager to diversify its business activities or to acquire other customers without changing its business activities radically or without a big impact on its profitability indicates that it has special skills and knowledge. Regarding the second point, whether the agent bears entrepreneurial risk, the fact the amount of compensation of the Japan Investment Manager is based on the total managed assets and gains is cited as evidence

of entrepreneurial risk. Thus, even if the Japan Investment Manager only deals exclusively with one Offshore Fund, one FSA's official view is that it can still be treated as an independent agent if it has a DIM license, and receives a fee based on the total managed assets and gains. Whether the NTA shares the same view as the FSA official is unclear. At a presentation, one NTA official noted that whether an agent has special skills and bears entrepreneurial risk needs to be looked at based on all of the facts and circumstances.

Conclusion

The introduction of the independent agent exception into the definition of an agent permanent establishment under Japan domestic tax represents a significant policy shift by the Japanese government, and will prove useful to foreign taxpayers structuring their investments into Japan through non-treaty jurisdictions. In particular, offshore funds investing into the Japan capital markets can now structure their advisory relationships with Japanese discretionary investment managers without creating a PE under a new "safe-harbor" announced by the FSA. The Guidelines confirm that the new exception should be interpreted in line with the OECD Commentary, but formal guidance by the NTA on how to interpret the exception in other contexts would be welcomed.

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News Analysis: Singapore's Extraordinary 2009 Budget

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Singapore Minister for Finance Tharman Shanmugaratnam on January 22 announced an extraordinary fiscal 2009 budget.¹ For the first time, the government will tap its reserves to fund

a SGD 20.5 billion (US US\$13.7 billion) stimulus package, in response to a crisis.

"We are likely to experience the deepest recession in the Singapore economy since our independence, arising from the worst global economic decline in 60 years.... This is not a normal Budget. It is a not even a normal countercyclical Budget," Tharman said.²

Highlights of the fiscal 2009 budget include a reduction of Singapore's corporate income tax rate from 18 percent to 17 percent, to enable Singapore to stay competitive with archrival Hong Kong. The government also announced an enhanced tax incentive for fund management, with no restrictions on the residency status of fund vehicles or investors, to strengthen Singapore's position as a leading fund management hub in Asia. The budget includes other tax measures to improve business cash flow and competitiveness, such as a one-year tax holiday for the repatriation of all foreign-source income and a proposed simplification of the tax framework for corporate amalgamations.

Race to the Bottom: Part II

The government will reduce the corporate income tax rate by 1 percentage point, from 18 percent to 17 percent, effective from year of assessment 2010.³ That will bring Singapore's corporate income tax rate down to within a half percentage point of archrival Hong Kong's 16.5 percent corporate profits tax rate for the second time in three years. The tax cut underscores how serious the Singapore government is about staying competitive – it had to amend the Singapore Constitution to help pay for the tax cut in the middle of what likely will be Singapore's deepest recession since its independence in 1965. Under the new constitutional framework, the government has greater scope for drawing from investment returns on reserves for spending each year.⁴



Linda L. Ng

1 See "Budget Speech 2009," available at http://www.singaporebudget.gov.sg/speech_toc/downloads/index.html.

2 See *id.* at 1, paras. B.1-B.2 and H.1.

3 See *id.* at 1, paras E.29-E.30; and Annex C-1, "Enhancing Business Cashflow and Competitiveness," section 11.

4 Constitution of the Republic of Singapore (Amendment) Act 2008; see "Second Reading Speech for Constitution of Republic of Singapore (Amendment) Bill 2008 – Minister Tharman Shanmugaratnam," paras. 16.d, 19, 46, and 57, available at http://app.mof.gov.sg/data/Second_Reading_Speech_Constitution_Bill.pdf.

As a result, Singapore's corporate tax regime will be very competitive. Companies will continue to enjoy a partial tax exemption scheme for income up to SGD 300,000,⁵ together with the new 17 percent corporate tax rate. That means that Singapore's effective corporate tax rates for small and medium-size enterprises will be lower than in any competing jurisdiction.⁶ In addition, Singapore offers attractive tax incentives and an extensive network of 60 comprehensive income tax treaties.

History, however, suggests that this neck-and-neck phase of the race to the bottom may be only temporary. Two years ago, Tharman announced in the fiscal 2007 budget a reduction of Singapore's corporate income tax rate from 20 percent to 18 percent, a half percentage point above Hong Kong's then 17.5 percent profits tax rate. Hong Kong promptly responded in kind, by reducing its corporate profits tax rate by 1 percentage point, to 16.5 percent, in its fiscal 2008-2009 budget. Therefore, if history were to repeat itself, Hong Kong may widen the tax gap again by reducing its corporate profits tax rate in the next leg of the race to the bottom. That, however, may not happen any time soon. According to a recent news report, a Hong Kong government source has said that people should not expect any profits tax reduction, as Hong Kong's level is one of the lowest in the world. With further global financial turmoil on the horizon, Hong Kong Financial Secretary John Tsang is expected to sail a tight fiscal ship in his fiscal 2009-2010 budget speech on February 25.⁷

Fund Management

The fund management business contracted globally over the past year. However, the government still views fund management as a long-term growth area, especially in Asia, where wealth will be on an upward trajectory over the next 15 to 20 years. Therefore, it intends to enhance the current tax incentive schemes for fund management, to reinforce Singapore's position as a leading fund management hub in Asia.

The government will introduce an enhanced-tier tax incentive for funds with a minimum fund size of SGD 50 million at the point of application that meet prescribed conditions. The enhanced tier will be open to fund vehicles in the form of companies, trusts, and limited partnerships. There will be no restrictions on the residency status of the fund vehicles or the investors. The enhanced tier will be effective from April 1, 2009, through March 31, 2014. However, funds that are in the scheme on or before March 31, 2014, will continue to enjoy the tax exemption after March 31, 2014, if they continue to meet the scheme's conditions.⁸ In addition, the government has simplified the rules for recovering input goods and services tax for the fund management industry⁹ and expanded the list of specified income and the list of designated investments, effective from January 22 (see "Other Financial Sector Tax Changes" below).

The enhanced tier will be significantly better than the current tax incentives.¹⁰ Under the current incentives, specified income derived by qualifying funds from designated investments is exempt from Singapore income tax. Qualifying funds can be in the form of companies, trusts, or individual accounts. When a qualifying fund is in the form of a company or a trust, the fund must not be 100 percent beneficially owned by resident investors. Resident nonindividual investors of a qualifying fund are subject to a 30 percent or 50 percent investment limit, depending on the number of investors in the fund. If that limit is breached, the resident nonindividual investors would have to pay a financial penalty. Therefore, the current tax incentives inadvertently discourage resident companies from having their funds managed from Singapore because of the limits placed on their holdings in the funds. When the fund vehicle is a limited partnership, the incentive conditions are applied to each partner to determine whether the partner qualifies for a tax incentive.

The enhanced tier will be an improvement over the current tax incentives because it will apply to funds that are constituted in the form of

⁵ Singapore Income Tax Act, section 43(6).

⁶ See "Budget Speech 2009," *supra* note 1, at para. E.30.

⁷ See "No Budget Treats," *The Standard*, Jan. 30, 2009, available at http://www.thestandard.com.hk/news_detail.asp?pp_cat=30&art_id=77589&sid=22470996&con_type=1.

⁸ See "Budget Speech 2009," *supra* note 1, at para. E.35; and Annex C-1, section 15.

⁹ See "Budget Speech 2009," *supra* note 1, at para. E.36; and Annex C-1, section 16.

¹⁰ ITA sections 13C, 13CA, and 13R, and the related MAS Circulars.

limited partnerships, in addition to funds that are in the form of companies, trusts, or individual accounts; in other words, there will no longer be any need to look through to the partners' level to apply the incentive conditions. Moreover, the 30 percent or 50 percent investment limit on resident nonindividual investors will be lifted for funds that come under the enhanced tier. That will allow resident companies to enjoy the full benefits of tax exemption for qualifying income derived by funds, without any worries about being subject to financial penalties.

Singapore's enhanced-tier tax incentive also will be significantly better than Hong Kong's profits tax exemption for offshore funds. Singapore's enhanced tier will exempt both onshore and offshore funds from income tax, whereas Hong Kong's profits tax exemption is available only to offshore funds. Moreover, Singapore's enhanced tier will not impose any restrictions on the residency status of the investors, whereas Hong Kong's tax laws include deeming provisions to prevent abuse or round-tripping by Hong Kong resident persons disguising themselves as nonresident persons to take advantage of the profits tax exemption. A Hong Kong resident person who is subject to those provisions would be deemed to have derived assessable profits calculated under the prescribed formula, taking into account the percentage of the resident person's beneficial interest in the offshore fund and the length of ownership within the relevant year of assessment.¹¹

Singapore's announcement of the enhanced tier increases the pressure on the Hong Kong government to introduce a similar tax exemption for onshore funds. Historically, the Hong Kong government has rejected calls from the fund management industry to expand the scope of its profits tax exemption for offshore funds to also cover onshore funds. Its position has been that a Hong Kong-based fund with its directors and principal officers exercising central management and control of the fund in Hong Kong is no different from a normal resident company, which is not the intended beneficiary of the exemption for offshore funds. Widening the scope of exemption might

lead to abuse and open up the exemption to all local funds.¹² Moreover, when the Hong Kong government decided the scope of its profits tax exemption, it was not aware of any major financial center that offered a tax exemption to its onshore funds.¹³ However, it may need to reconsider its position because the situation clearly has changed.

Singapore still lags behind Hong Kong in terms of the total amount of assets under management. According to the latest official statistics available, in 2007, Singapore had SGD 1,173 billion (US US\$0.8 trillion) of assets under management,¹⁴ as compared with Hong Kong's HKD 9,631 billion (US US\$1.2 trillion) of assets under management.¹⁵ (The 2008 figures are expected to be lower for both jurisdictions because of the global financial crisis.) However, it is conceivable that Singapore could one day overtake Hong Kong because of Singapore's increasingly attractive tax incentives and its user-friendly regulatory framework for fund management.

Other Financial Sector Tax Changes

The government expanded the list of specified income and the list of designated investments for the foreign trust scheme, the fund management incentives, the approved trustee company scheme, the financial sector incentive standard-tier scheme, and the financial sector incentive fund management scheme. Designated investments now also include investments in structured products, units in business trusts, qualifying Islamic investments involving the Murabaha, Mudaraba, Ijara wa Igtina, Musharaka, Istisna, and Salam concepts, emissions derivatives,

11 Hong Kong Inland Revenue Ordinance (IRO), section 20AE and Schedule 15.

12 See LC Paper CB(1)44/05-06(24), October 2005, Appendix 1, Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005, Supplementary Notes/Responses to Industry's Concerns, paras. 8-9, available at <http://www.legco.gov.hk/yr04-05/english/bc/bc14/agenda/bc141128.htm>.

13 See LC Paper CB(1)150/05-06(01) (revised), "Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005 – Response to the Deputations by the Administration," Oct. 27, 2005, pp. 1-2, available at <http://www.legco.gov.hk/yr04-05/english/bc/bc14/agenda/bc141128.htm>.

14 See the Monetary Authority of Singapore's "2007 Singapore Asset Management Industry Survey," July 2008, p. 1, available at http://www.mas.gov.sg/resource/eco_research/surveys/AssetMgmt07.pdf.

15 See the Securities and Futures Commission's "Fund Management Activities Survey 2007," July 2008, p. 1, available at http://www.sfc.hk/sfc/doc/EN/speeches/public/surveys/08/fmas_080724.pdf.

stocks and shares of unlisted companies (whether resident in Singapore or nonresident) denominated in any currency, and adjudicated and nonadjudicated liquidation claims.¹⁶ The enhancements to the lists are effective from January 22.

The government also will enhance the Financial Sector Incentive-Headquarters Services scheme and the Commodity Derivatives Traders scheme.¹⁷

Easing Cash Flow

Foreign-source income exemption

The government announced a one-year tax holiday for the repatriation of all foreign-source income to Singapore, to ease business cash flow during the credit crunch. Resident nonindividuals and resident partners of partnerships in Singapore will be exempt from tax on remittances to Singapore of all their foreign-source income earned or accrued outside Singapore on or before January 21, 2009, if the remittances are made during the period from January 22, 2009, through January 21, 2010. The government also will temporarily lift the conditions that currently are required for foreign-source income to be exempt from tax when remitted to Singapore. The Inland Revenue Authority of Singapore (IRAS) will issue further details by April.¹⁸ Businesses may wish to take advantage of the temporary tax holiday to repatriate their foreign-source income to Singapore tax free.

Before the temporary tax holiday, resident nonindividuals and resident partners of partnerships in Singapore generally were taxed when they remitted their foreign-source income back to Singapore, under Singapore's semiterritorial tax system.¹⁹ There were some exceptions that allowed tax-free remittances of foreign-source dividends, branch profits, and income from professional consultancy and other services, subject to prescribed conditions and under specified scenarios.²⁰ However, the "Swiss cheese" approach to tax exemption was

complicated and increased compliance costs. Moreover, many types of income, such as interest and royalty income, generally did not qualify for tax exemption. That put some Singapore resident companies at a disadvantage vis-à-vis companies based in Hong Kong because Hong Kong has a pure territorial tax system that taxes only domestic-source profits.²¹

The temporary tax holiday for repatriated foreign-source income is a welcome relief for cash-strapped Singapore businesses. Businesses would be even happier if the government would permanently convert Singapore's tax system from a semiterritorial system to a pure territorial system like Hong Kong's.

Loss carryback

The government will enhance the loss carryback relief system for years of assessment 2009 and 2010 to allow businesses to receive a cash refund on taxes that they paid in previous years.

The government will raise the cap on losses that can be claimed against past taxable income from SGD 100,000 to SGD 200,000. It also will allow businesses to claim losses against their preceding three years of taxable income, instead of just the immediately preceding year under the current scheme. In addition, the IRAS will allow provisional claims for the tax refund to be based on estimated losses, instead of waiting for the finalization of their chargeable income and tax assessments.²²

Other measures

Other tax measures to ease business cash flow include property tax rebates and deferrals, and rebates and concessions on transport-related taxes and fees.²³

Corporate Amalgamations

The government will simplify the tax framework for qualifying corporate amalgamations because

¹⁶ See Annex C-1, section 19.

¹⁷ See "Budget Speech 2009," *supra* note 1, at para. E.36; and Annex C-1, sections 17-18.

¹⁸ See "Budget Speech 2009," *supra* note 1, at para. E.18; and Annex C-1, section 5.

¹⁹ ITA section 10(1).

²⁰ See, e.g., subsections (8)-(12) of ITA section 13 and the related IRAS tax guides.

²¹ IRO section 14(1).

²² See "Budget Speech 2009," *supra* note 1, at paras. E.16-E.17; and Annex C-1, section 4; IRAS Circular, "Enhanced Carry-back Relief System," first published on Jan. 23, 2009, and revised on Jan. 30, 2009, available at [http://www.iras.gov.sg/irasHome/uploadedFiles/Quick_Links/e-Tax_Guides/Enhanced%20Carry-back%20System%20\(23.1.09\)%20.pdf](http://www.iras.gov.sg/irasHome/uploadedFiles/Quick_Links/e-Tax_Guides/Enhanced%20Carry-back%20System%20(23.1.09)%20.pdf).

²³ See "Budget Speech 2009," *supra* note 1, at paras. E.11-E.15 and E.19-E.22; and Annex C-1, sections 1-3 and 6-10.

downturns typically provide opportunities for companies to merge, acquire, or restructure. To qualify, the amalgamated company must take over all the assets and liabilities of the amalgamating companies, the amalgamating companies must cease to exist, and other prescribed conditions must be met. The new tax scheme will significantly lower the tax burden on corporate amalgamations. The IRAS will release details of the new tax framework for public consultation in February.²⁴

It would be helpful if the government would consider adopting US-style provisions for all types of tax-free reorganizations,²⁵ not just amalgamations. It also would be helpful if the government would allow tax-free dropdowns of assets, by exempting contributions in kind to a company controlled by the transferor.²⁶ That would greatly facilitate business restructuring to improve efficiency.

Other Tax Changes

Jobs credits will automatically be granted to eligible employers, to encourage businesses to preserve jobs in the downturn.

Businesses that incur qualifying renovation and refurbishment expenses in the basis periods for years of assessment 2010 and 2011 can deduct those expenses in one year instead of over three years, subject to the cap of SGD 150,000 for each relevant three-year period.

Companies limited by guarantee may qualify for the tax exemption scheme for new start-up companies, effective from year of assessment 2010.

Accelerated capital allowances will be provided for plant and machinery acquired in the basis periods for years of assessment 2010 and 2011. Those investments can be written down over two years, with 75 percent of the write-down in the first year and 25 percent in the second year.

The period for writing down allowances under Income Tax Act section 19B will be reduced from five years to two years for the acquisition cost of intellectual property rights for media and digital entertainment content incurred by an approved company or partnership, subject to conditions.

Under the block transfer scheme, a withholding tax exemption can be granted for interest payable on a loan taken by a shipping enterprise from a lender outside Singapore to acquire a Singapore-flagged ship. The exemption is for ships registered with the Singapore Registry of Ships on any date from January 1, 2009, through December 31, 2013.

The tax deduction for collective impairment provisions made by banks, merchant banks, or finance companies under Monetary Authority of Singapore (MAS) notices 612, 811, and 1005 will be extended for a further three years, subject to conditions.

The government will increase the tax deduction for donations made in 2009 to institutions of a public character and other approved recipients (such as approved museums and prescribed schools) from 2 to 2 1/2 times.²⁷

The GST treatment of aircraft and aircraft-related supplies will be enhanced from April 1, 2009. GST will be suspended on goods temporarily removed from zero GST or licensed warehouses for auctions and exhibitions from April 1, 2009.

Other tax changes include a one-off income tax rebate of 20 percent for resident individual taxpayers, up to a cap of SGD 2,000, for the tax payable for the year of assessment 2009.

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²⁴ See "Budget Speech 2009," *supra* note 1, at paras. E.34; and Annex C-1, section 14.

²⁵ See U.S. Internal Revenue Code section 368.

²⁶ See IRC section 351.

²⁷ See IRAS, "Overview of Tax Changes Announced in Budget 2009," available at <http://www.iras.gov.sg/irasHome/page.aspx?id=7906>.

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