“We’re the only nation in the world with a tax code that brings this much uncertainty. It’s so difficult for investors, employers and job creators to plan ahead, so that they can either build the plant, (which would mean that people would be hired and jobs created), or buy equipment, or grow their employment.”

Dave Camp,
House Ways and Means Committee Chairman

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One country particularly facing potential change is of course the United States, and with the Presidential election now complete, all eyes are now on the fiscal cliff and potential long term tax reform. We are very pleased to be able to include in this edition an interview with Dave Camp, House Ways and Means Chairman and one of the key influencers of US tax reform. Chairman Camp outlines the importance of dealing with the fiscal cliff issues as well as the critical challenge remaining ahead of the United States in reforming its international tax system. “We’re not competitive internationally and it’s a huge burden,” Chairman Camp told us. “We’re going to need to design a uniquely American tax system for us. But the only way to get to a territorial system is to have credible, workable base erosion rules.”

Base erosion and profit shifting

The issue of “Base erosion and profit shifting” has risen in prominence since our last edition, with the end-of-meeting G20 communiqué heralding a significant evolution of the G20 and OECD work in this area and accelerating their Base Erosion and Profit Shifting project – or BEPS. This represents the beginning of the G20 and the OECD taking a greater interest in multinationals and transfer pricing, with the OECD website indicating that the BEPS project “is looking at whether, and if so why, MNCs taxable profits are being allocated to locations different from those where the actual business activity takes place.” This new project ties together many different strands of OECD work – including intangibles transfer pricing, on which the OECD recently closed a comment period – and represents a real evolution in focus for this important body. You can read more about both BEPS and the OECD’s intangibles draft in this publication.

Transfer pricing has been a key generator of news in more recent weeks too, with the United Nations (UN) releasing a draft text of the Transfer Pricing Practical Manual for Developing Countries. Those awaiting the draft in order to see how it deviates from current OECD guidelines were not disappointed. A departure from those principles is seen by many commentators as driving additional uncertainty and potential double taxation, and the OECD and UN will need to work closely with one another if they are to minimize this risk. Notable by their absence were chapters on services, intangibles and business restructuring. Cost sharing and advance pricing agreements (APAs) were mentioned in passing, but are not yet detailed in any separate chapter. This indicates just how fast this manual is being produced, and although it provides some new insight for MNCs operating in developing markets, there remains much to be done.

Continuing country reform

Of course, supra-national organizations such as the OECD and United Nations are not the only ones influencing the tax landscape, and much has occurred at the national level since our last edition. After causing consternation in the international business community in their earlier Union Budget, the Indian government has since demonstrated a far higher level of willingness to engage with business. The recommendations of the Shome committee on the Indian GAAR proposals and the proposed 50-year retroactive measure on taxing the indirect transfer of assets have both been warmly welcomed as steps in the right direction. In the United Kingdom too, a recent consultation on implementing a GAAR has concluded, with revised draft legislation due out in December. While in Australia, draft legislation and an explanatory memorandum to implement the amendments to Australia’s general anti-avoidance rule foreshadowed on 1st March were released for public comment on 16th November. The draft legislation was met with relief that the effective date has been moved forward to that date.

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In the European theater, early October saw feverish activity as nearly half of all Member States lined up to request that the European Commission (EC) move to introduce (for themselves, at least) 2011’s Financial Transaction Tax (FTT) Directive via the rarely used enhanced cooperation mechanism. Whilst the FTT may have wide implications, impacting companies outside the financial sector, the use of these minority procedures (which have been used only twice before) to deliver the tax is groundbreaking. This may prompt other proposals that appear to be bound for deadlock, such as the Common Consolidated Corporate Tax Base proposal, to also be considered on this basis.

So once again we have a quarter with a lot of developments and the growth of both complexity and uncertainty in the tax system. With so much going on, we hope that the insights contained in this Briefing helps to place them all into context and allow focus on the matters of highest importance.
An interview with

House Ways and Means Committee Chairman Dave Camp

His quest for a uniquely American tax system

Dave Camp says Americans are demanding tax reform. The path to successful reform requires input from business, he tells Ernst & Young LLP.
Americans have been debating tax reform almost since the day the ink dried on the last comprehensive rewrite of the United States tax laws in 1986. Grassroots groups have championed fundamental changes without gaining traction, individual lawmakers have proposed legislation that never came to a vote and presidential commissions have made recommendations only to see them filed away in White House archives.

But today a confluence of factors is setting the course for real action. Where the US once had one of the world's lowest corporate tax rates following the 1986 reform, it now has the highest corporate tax rate of all major developed economies. The US still taxes its businesses on their global income in a world where capital and people cross borders more easily than at any time in history, while big trading partners like Japan and the United Kingdom have both shifted to territorial tax systems and lowered their top corporate tax rates. And a plethora of temporary provisions in the US tax code are getting harder and harder to address with stopgap measures because the budgetary impact of those annual repairs is growing exponentially at a time when lawmakers say eliminating deficits is a top priority.

Michigan Representative David Camp knows these things well. A member of the Republican Party, he has served in Congress since 1993. Since 2011, he has been chairman of the U.S. House of Representatives' Committee on Ways and Means, which is given explicit responsibility in the US Constitution to draft revenue measures.

That makes Chairman Camp one of the most important players involved with making tax reform in the US become a reality. Chairman Camp is taking this responsibility seriously.

During his two years in charge of the Ways and Means Committee, he has held more than 20 public hearings on tax reform, including several joint sessions with the Senate Finance Committee, which oversees tax legislation in the other chamber of Congress. In early 2011, he announced it was his goal to reduce the top corporate tax rate in the United States to 25%, down from 35% currently, and to similarly lower individual tax rates. And in October 2011, Chairman Camp released a comprehensive proposal outlining his vision for how the United States should tax its companies that operate globally. Chairman Camp’s ideas have sparked a substantive debate among policymakers and in the business community. President Barack Obama also has engaged, outlining his views on international tax policy in the framework for business tax reform released earlier this year.

In an exclusive interview with Ernst & Young LLP, Chairman Camp identifies tax reform as his top priority in the next two years shortly before the US elections. He makes the case for why tax reform is needed and discusses the tension he feels in designing a US tax system that is in sync with the rest of the world while maintaining a “uniquely American tax system for us.” He talks about his role in driving the tax reform agenda, the feedback he’s received from stakeholders on his proposals so far and the important role businesses must play in this ongoing process. And he also looks into his crystal ball and predicts success.

Ernst & Young commentary
The US legislative process

The formal legislative process is tricky and requires extensive negotiation. The US Constitution states that all revenue measures must originate in the House of Representatives, explicitly empowering the House Ways and Means Committee which Congressman Camp chairs. However that legislation must be reconciled with the US Senate. The joint House-Senate measure must then pass both chambers and gain approval from the President of the United States (or be supported by 2/3 of each of the House and Senate to override a presidential veto).

The legislative process in the US also differs significantly from other countries with parliamentary systems, where elected officials more routinely vote as a bloc along their party lines. American lawmakers generally have more individual rights and autonomy as legislators, creating more opportunities for small factions to build coalitions and affect votes. This is particularly true in the US Senate, where a single senator can block a vote by registering an objection, often anonymously.

Political party leaders in Congress do have some mechanisms to secure votes (a formal vote-counting process known as a “whipping” the vote); however they generally try to entice party members to support their positions while reserving heavy-handed whipping tactics for only the most critical and close votes.

Barbara Angus
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E: barbara.angus@ey.com
Barbara Angus (BA): Chairman Camp, thank you for spending time with us. I wanted to start today by talking a little bit about the fundamentals of tax reform. You’ve been an outspoken advocate of tax reform, and there seems to be a growing consensus on the need for real changes in our tax system. But at the same time, there’s an immediate crisis, with the “fiscal cliff” that looms ahead. How do you see the efforts to address these urgent tax and budget matters playing out over the coming months? And how does the need for more fundamental, long-term tax reform factor into the more immediate discussion?

Dave Camp (DC): Well, obviously we have not seen our economy recover like it should, with unemployment at over 8% for more than 40 months. I think that fundamental and comprehensive tax reform is a way to get a pro-growth tax system that will help strengthen our economy. Over the next couple of months, all of these things come together because, as you know, so much of our tax code expires at the end of the year and we have a set of extenders. But that’s not what I’m talking about. I’m talking about actual rates and estate tax and alternative minimum tax and all of these problems, and we have to deal with them. We’re the only nation in the world with a tax code that brings this much uncertainty. It’s so difficult for investors, employers and job creators to plan ahead, so that they can either build the plant, which would mean that people would be hired and jobs created, or buy equipment, or grow their employment.

The US system in the global context

“We’re the only nation in the world with a tax code that brings this much uncertainty. It’s so difficult for investors, employers and job creators to plan ahead, so that they can either build the plant, which would mean that people would be hired and jobs created, or buy equipment, or grow their employment.”

Dave Camp
House Ways and Means Committee Chairman
What is the fiscal cliff?

The expression, fiscal cliff, is Washington, DC jargon for the ultimate fiscal dilemma facing US lawmakers at the end of 2012. The metaphor itself is based on a movie cliché where the protagonist faces a choice between uncertain danger from jumping off a ledge or certain harm from incoming bullets, arrows or spears.

Before the US Congress can tackle comprehensive tax reform, it must first resolve what Chairman Camp referred to as this “immediate crisis.” Because of the expiration of existing provisions, taxes are scheduled to increase by some US$500 billion in 2013 alone unless the US Congress acts to stop it. Yet preventing the tax increase could add to the already high deficits, an equally unpalatable option for officials under pressure to reduce a US$16 trillion national debt.

The fiscal cliff negotiations are expected to be both intense and condensed. There are six major elements, four of which are tax-related:

- The scheduled expiration on 31 December 2012 of income, estate, and capital gains tax cuts proposed by President George W. Bush and enacted in 2001 and 2003
- The scheduled expiration on 31 December 2012 of a two percentage point temporary payroll tax cut championed by President Barack Obama and enacted in 2011
- The lapse of dozens of tax provisions benefiting businesses known colloquially as “extenders” because they are “temporary” provisions that in many cases have been renewed repeatedly
- The expiration of a temporary “patch” that indexes the alternative minimum tax for inflation. Absent this patch, more than 30 million American households will face unexpectedly higher tax bills when they file tax returns in early 2013

In addition to the tax issues, US lawmakers must negotiate two other contentious areas with enormous ramifications for the budget. The first is legislation that would sustain current reimbursement rates for doctors that participate in the Medicare health program benefiting elderly Americans, a policy that would add to the deficit unless the payments are offset with new sources of tax revenue. The second is addressing US$1 trillion in spending cuts known in Washington, DC as “sequestration” that are due to take effect in January. These cuts kicked in after a special House-Senate committee convened in 2011 failed to agree on a deficit-reduction plan.

While these issues have loomed for years, their convergence now means US lawmakers will be under pressure to find a solution in the final weeks of 2012. One possibility is that nothing is agreed, resulting in higher taxes and an economic shock but not adding to the deficit. Another possibility is a stopgap agreement to address the issues temporarily and postpone the debate for six months or a year. A third possibility is US lawmakers come to a grand agreement or use such a postponement as a catalyst to launch tax reform.
“We want to do this in a revenue-neutral way; you don’t want to take one aspect of corporate to fund personal rate reduction, and so I think in the general sense and in terms of business and personal, this should be revenue-neutral.”

BA: When you talk to your colleagues in other countries, what do they say about the current state of the US tax law and all the uncertainty? How do you explain it to them?

DC: They’re dumbfounded! And, see, they’ve made a lot of the reforms that we need to make, so they kind of look puzzled, like, “Why aren’t you doing this?!” So you’re trying to explain the lack of action here a lot of times. They’re doing it – they’re reforming their codes, they’re simplifying, they’re lowering rates because they know that if they can attract those high-paying jobs, their economies will do better, the government revenues will go up and they’re going to be able to meet the needs of their citizens.

BA: Right now, is this a case of dealing with the immediate crisis so something dramatic doesn’t happen on January 1, while also keeping the longer-term discussion of tax reform focused on dealing with the root of the problem?

DC: We’ve tried to do that this year. We’ve had more than 20 hearings in the Committee this session on tax reform, we’ve put a tax reform outline in our budget and I’ve released a draft in terms of international tax law. We’ve said, “How should we deal with the fiscal cliff? Let’s extend current law for a year.” We’ve addressed the sequester (the package of automatic spending cuts scheduled to take effect on 1 January 2013 as part of the Budget Control Act) in the House and Committee, as in past budgets, so we have put benchmarks out in terms of where we believe we should be addressing these issues. But we’ve not seen that kind of activity in the Senate – they’ve not passed a budget, they’ve not dealt with the sequester, they’ve not signaled where they’re really going with some of these very key areas – and so that’s going to be a real challenge.

So we’ll have that immediate crisis, as you’ve mentioned, of expiring provisions – for example, if the AMT issue is not dealt with by the end of the year, it could mean a delay of as many as 60 million refunds, and the expiration of all these policies would obviously be a big economic hit to the economy. (Editor’s note: The alternative minimum tax (AMT) was created in 1969 as a way to ensure that taxpayers who received the bulk of their income from dividends pay a fair share of taxes. In recent years, the federal government has created an AMT “patch,” which effectively adjusts the AMT for inflation. This helps exempt millions of Americans from getting caught in the AMT, but no such patch has yet been created for 2012). Those issues are going to have to be dealt with, we’re going to need to get some stability in terms of what tax policy is, and then I hope we can pivot very quickly to fundamental and comprehensive tax reform. For the obvious reasons we’re not competitive internationally – it’s a huge burden, compliance costs are out of sight, it’s very complex – and if we can address that, we can get a tax code that’s modernized, fair, simple and really grows the economy and creates jobs.

Building the case for change

BA: As people look at tax reform, there’s a natural tendency to think back to the experiences of other tax reform efforts here in the US, and the one that always gets mentioned is the 1986 Act. How do you think the challenges today differ? Are there particular factors that today are make-or-break in terms of advancing your objectives with respect to fundamental reform?

DC: I think one of the big differences is that the economy is in much worse shape now than it was then, and for a longer period of time. I think that means the compelling reason for doing it is actually stronger now. We do need presidential leadership on this issue. We haven’t had that to date and that would really be a difference. Obviously Ronald Reagan was committed to this, it was his number one priority, and we need that same kind of commitment out of the White House in order to push this. We’ve done a lot, with 20-plus hearings in the Ways and Means Committee, to try to move this issue forward – lots of good input, lots of good data, lots of good background work – but we’re going to need really that kind of leadership to continue to move it forward.

There are some similarities. I think that we want to do this in a revenue-neutral way. You don’t want to take one aspect of corporate to fund personal rate reduction, and so I think in the general sense and in terms of business and personal, this should be revenue-neutral.
“... we have had pretty strong unanimity around the 25% rate, that if we can get to 25% that they [companies] can see a path forward to that even though they may lose some of the deductions and provisions that they've taken advantage of in the past.”

BA: Mr. Chairman, what have you found particularly notable from the 20 hearings on tax reform conducted in your Committee?

DC: Well, just in a general sense, I'm very impressed with the member participation, and both Republicans and Democrats, and the seriousness with which they've approached the issue – I think that's been very encouraging. Also, the quality of the witnesses and their willingness to come forward. It's not easy to do, to take time out from a job and come to Washington and prepare testimony and be subject to all the questions that you might get.

I'm very grateful for this participation we've had, and the follow-ups to that have been helpful. I've known this is complicated. I've known that all along and I wouldn't say that surprised me, but I think it reinforced that we need to be very careful because if you make a mistake it could have a dramatic effect on a huge part of the economy.

So I think it's been about openness, it's been about transparency, it's been about trying to get the best information before the Committee that we can get and understanding that that isn't the be-all-and-end-all, that there are other ways that we can learn and understand and that we can then drive the agenda.

Probably the most surprising thing is we actually have driven the agenda. There really wasn't a lot of talk about tax reforms three years ago; there is now, and that's probably the biggest accomplishment that these 20 hearings have secured.

A 25% corporate tax rate

BA: Let's focus on the business tax side now. One area where there seems to be widespread agreement among policymakers and among business leaders is the need to reduce the US corporate tax rate. You've talked about reducing the corporate tax rate to 25%, which would bring our rate much more in line with the rates of our major trading partners, and you've just talked about the importance of revenue neutrality. How do you envision getting to a significant reduction in the corporate tax rate with a constraint of revenue neutrality?

DC: Well, the 25% rate is obviously our goal, and, as we did during Bowles-Simpson (The National Commission on Fiscal Responsibility and Reform, formed in 2010 to identify policies to improve the fiscal situation), we're going to have to go through and look at all of the various tax provisions and understand the impact of making those changes to the code. If we can get a tax code that meets that goal, we believe there will be a pro-growth element to that and you'll actually see revenue to the government. That's been the case in every tax reform that's occurred, whether it was the Kennedy years or the Reagan years, and I believe that could happen again.

BA: Some commentators have suggested that if the corporate tax rate can't be dropped dramatically, say well below 30%, perhaps corporate tax reform might not be worth the effort, the disruption to the status quo. Others think that there is much that needs to be done to make our code more efficient and that there are benefits from those kinds of changes as well as from rate reduction. Do you think there's some threshold level to which the rate must be dropped in order to get benefits from reform in the corporate area?

Table 1. Sharp reductions in G7 and BRIC corporate tax rates

<table>
<thead>
<tr>
<th>Country</th>
<th>2000 statutory corporate tax rate</th>
<th>2012 statutory corporate tax rate*</th>
<th>Percent change</th>
</tr>
</thead>
<tbody>
<tr>
<td>G7</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Canada</td>
<td>43.3</td>
<td>26.2</td>
<td>(39.5)</td>
</tr>
<tr>
<td>France</td>
<td>37.8</td>
<td>36.10**</td>
<td>(4.5)</td>
</tr>
<tr>
<td>Germany</td>
<td>52.0</td>
<td>33.0</td>
<td>(36.5)</td>
</tr>
<tr>
<td>Italy</td>
<td>39.5</td>
<td>31.4</td>
<td>(20.5)</td>
</tr>
<tr>
<td>Japan</td>
<td>43.3</td>
<td>38.01***</td>
<td>(12.2)</td>
</tr>
<tr>
<td>United kingdom</td>
<td>30.3</td>
<td>24.0</td>
<td>(20.0)</td>
</tr>
<tr>
<td>United States</td>
<td>39.4</td>
<td>39.0</td>
<td>(1.0)</td>
</tr>
<tr>
<td>BRIC</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>34.0</td>
<td>34.0</td>
<td>–</td>
</tr>
<tr>
<td>Russia</td>
<td>35.0</td>
<td>20.0</td>
<td>(42.9)</td>
</tr>
<tr>
<td>India</td>
<td>42.0</td>
<td>32.5</td>
<td>(22.6)</td>
</tr>
<tr>
<td>Foreign cos.</td>
<td>42.2</td>
<td>25.0</td>
<td>(24.2)</td>
</tr>
</tbody>
</table>

*Average of national and sub-national rates  
**Includes temporary two-year surtax in 2013-14  
***Includes temporary surtax. Tax rate will decline to 36.64% in 2015.
“In the case of international [taxation], the world has changed dramatically. There are a lot more viable places for investment around the world than 50 years ago. Fifty years ago the US was really the top place for a multinational to be headquartered; it was the top location for investment. But there are alternatives now.”
“... we have to understand and recognize that our international tax law is out of step and out of date with where the rest of the world is, and yet we’re competing with the rest of the world.”

**Table 2. Top 10 countries with most Fortune global headquarters: a shift towards territorial tax systems**

<table>
<thead>
<tr>
<th>Top 10 countries with most Fortune global headquarters</th>
<th>2012 statutory corporate tax rate*</th>
<th>Taxation of foreign-source income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Countries with worldwide tax regimes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>US</td>
<td>39.0%</td>
<td>Worldwide with deferral and foreign tax credit</td>
</tr>
<tr>
<td>China</td>
<td>25.0%</td>
<td>Worldwide with deferral and foreign tax credit</td>
</tr>
<tr>
<td>Korea</td>
<td>24.2%</td>
<td>Worldwide with deferral and foreign tax credit</td>
</tr>
<tr>
<td>Japan</td>
<td>38.01%</td>
<td>95% dividend exemption enacted in 2009</td>
</tr>
<tr>
<td>France</td>
<td>36.1%</td>
<td>95% dividend and branch exemption</td>
</tr>
<tr>
<td>Germany</td>
<td>33.0%</td>
<td>95% dividend exemption</td>
</tr>
<tr>
<td>Italy</td>
<td>31.4%</td>
<td>95% dividend exemption</td>
</tr>
<tr>
<td>UK</td>
<td>24.0%</td>
<td>100% dividend exemption enacted in 2009</td>
</tr>
<tr>
<td>Netherlands</td>
<td>25.0%</td>
<td>100% dividend and branch exemption</td>
</tr>
<tr>
<td>Switzerland</td>
<td>21.2%</td>
<td>Proportional dividend exemption</td>
</tr>
</tbody>
</table>

**Countries with territorial and exemption tax regimes**

| Japan                                                 | 38.01%                            | 95% dividend exemption enacted in 2009 |
| France                                                | 36.1%                             | 95% dividend and branch exemption |
| Germany                                               | 33.0%                             | 95% dividend exemption |
| Italy                                                 | 31.4%                             | 95% dividend exemption |
| UK                                                    | 24.0%                             | 100% dividend exemption enacted in 2009 |
| Netherlands                                           | 25.0%                             | 100% dividend and branch exemption |
| Switzerland                                           | 21.2%                             | Proportional dividend exemption |

**The international tax regime**

**BA:** Let’s shift now to international tax reform. October 2012 marks the 50th anniversary of the enactment of our subpart F regime governing the taxation of controlled foreign corporations, which is one of the basic building blocks of our international tax system and is the source of much complexity and much of the difference between our system and those of the rest of the world. The discussion draft that you released in October 2011 has focused attention on moving the current system to a more territorial tax approach. The 95% participation exemption, which is the centerpiece of your discussion draft, is quite similar in approach to many of our major trading partners, and that similarity is significant. What do you see as the key objectives of international tax reform in the United States?

**DC:** Well, as you mention, it’s the 50th anniversary, so it’s been a long time since we’ve looked at it. In an earlier discussion I was really thinking more on the personal side, but you asked, “What's the difference between now and ’86?” Well, in the case of international, the world has changed dramatically. There are a lot more viable places for investment around the world than 50 years ago. Fifty years ago the US was really the top place for a multinational to be headquartered; it was the top location for investment. But there are alternatives now. We have to understand and recognize that our international tax law is out of step and out of date with where the rest of the world is, and yet we’re competing with the rest of the world.

The other issue we have a difficulty with is that our US-based companies that earn revenue overseas actually are penalized if they bring it back to invest here, compared to their counterparts and competitors. So we want that to happen [the repatriation of profits] not just on a one-time basis but on a regular basis because we know that money left overseas is ultimately going into plant and equipment and jobs overseas, rather than here at home.

It is estimated that as much as a trillion dollars could come back. If we could bring that private sector money back here and invest it, I believe that’s another aspect that would help grow our economy. That’s why when our plan was evaluated as creating a million jobs in the first year, in connection with restrained spending in our budget, it was because we had items like transition designed to bring dollars back. So we need to move away from a worldwide system to a territorial system that more resembles what the rest of the world has.

**BA:** Thinking about the rest of the world, as you look at the design of what would be an optimal US international tax system not only for today’s economy but also for the future economy, are there particular insights that you see to be gained from the choices that other countries have made in their international tax approaches?
We do have to have some sense of what’s working, and why, in other parts of the world, but we’re going to need to design a uniquely American tax system for us.”

A revenue-neutral business tax reform

BA: Mr. Chairman, you referred a moment ago to revenue neutrality, and you’ve consistently talked about international tax reform on a stand-alone basis being revenue-neutral. What do you see are the benefits of doing international tax reform on a revenue-neutral basis, and why do you see that as so important?

DC: I think if you have a section of tax policy being used to pay for another section of tax policy, I think it would be very hard to get consensus on the sorts of reform you need.

This is all about “How do we get our economy moving again? How do we get job growth in the United States and how do we get people back to work?” And one of the ways you do that is not have an antiquated, outdated tax system that actually penalizes the kind of job growth that might occur in the United States by bringing dollars back. But we have to understand that not every country has our rules, so there does need to be some sense of dealing with the base erosion issues. We’ve got a number of ideas out there and we’ve not settled on one, and we’re still getting input; we got more feedback in the Committee as late as yesterday. So it’s a very important area – it’s an important area to get right – and that’s why I think it was very important to get out there early, in a more detailed way, and give those affected stakeholders an opportunity to come back with feedback.

BA: You mentioned base erosion, which is an area that’s received a lot of attention in the current debate. Your international tax discussion draft includes three alternative options for addressing the potential for base erosion through shifting of income, and those options have a particular emphasis on income from intangible property. Your discussion draft specifically seeks input from the business community on these alternatives or on other approaches. Do you have any suggestions as to the types of information that are most valuable for the business community to provide as you continue to work on this area?

DC: A lot of businesses have spent a lot of time modeling. We’ve not only had options A, B and C, but we’ve had options D and E coming in recently as well. We’re looking at those. I know others are looking at maybe not just the rate of tax and the jurisdiction but, again, seeing what income is earned there. But I think we have to keep in mind that there are low-tax jurisdictions and we’re going to have to deal with those and not have those be a magnet for reporting income.

BA: You mentioned getting input regarding other potential approaches as alternatives to the options included in your proposal. Where do you see developments going with respect to the approach to base erosion and the balance with the broader territorial principle?

DC: The only way to get to a territorial system is to have credible, workable base erosion rules. We’ve received very constructive feedback from businesses that compete in the global marketplace every day. That feedback is helping us to construct the best possible base erosion rule from both an economic perspective as well as a tax policy perspective.

BA: So information about the kinds of activities, the kinds of business that companies are doing around the world, how that business is structured, and how it fits in with the business they’re doing in the United States, is it that kind of input that’s most useful as you work toward a balance between the pro-competitive objectives you stress and the need to protect against base erosion?

DC: Yes, and of course, business transactions are very complex in an international setting. And whether that’s royalties or intellectual property, we know that those are used to enter other markets and be active in other markets and to make the profits that we’d like to see come back. But really the hallmark of it is the 95% threshold and we’re going to need to address base erosion in a robust fashion, and that’s what we’ve still been trying to get information around. But I look at all of this as being something that the Committee will deal with as we move forward on comprehensive reform, but the more information we get, the better we can do the job. So these 20 hearings that we have done have not just been about the hearing record, but they have triggered a lot of input, as have visits to the office and data being exchanged and a very open discussion draft.
Getting the business view

**BA:** Mr. Chairman, your international tax proposal has really advanced the debate by providing details that allow businesses to do both qualitative and quantitative analysis of the potential impact of the proposed changes to their operations. Your staff has been very receptive to comments of all types, from policy concerns, to business implications, to technical questions about the details of the discussion draft. That process certainly has been very important to the business community. What should businesses be doing to keep this constructive dialogue going as your work advances?

**DC:** Well, we want those evaluations and thoughts. Again, we've got really good people on the Committee – good members, great staff on the committee – but we can't possibly know the nuances and complexities of every business in America as those who own and operate them and are employed in them do. So we're trying to understand what's going to work. This is all about trying to get the best tax code in the world for the United States so that we can be the number one economy, we can have the best credit rating, we can have the highest job growth, we can have the highest GDP growth. And the result of that is that those benefits will extend to people, with more jobs, higher income and more prosperity. That's what this is all about.

**BA:** When you put out your discussion draft, you indicated you were focusing on the international tax area first because the changes being proposed are fundamental and feedback from a broad range of stakeholders would be valuable. What is the next step and when? Another international tax discussion draft that builds on the input received? A new discussion draft on another area of the tax code?

**DC:** I don't like to lay down artificial markers or timelines. Tax reform is tough enough on its own, and we have to remain nimble enough to adjust our strategy in the wake of new events. I released the discussion draft because I thought it would help move the entire effort forward. I think it did – the business community became more engaged and even the White House was forced to put forward some ideas. So, if in a couple of months another draft is the right move, that's what we will do. If it's something else, we'll do something else. But I can guarantee you, no coach is going to give their playbook to the opponent, and neither am I.

Delivering comprehensive tax reform

**BA:** Now some questions about the process for getting tax reform done. In thinking about the legislative path for tax reform, do you think that tax reform is separable from entitlement reform and deficit reduction?

“I think it [tax reform] needs to be comprehensive. ... In ‘86 you didn't have most of business organized as pass-through entities, and now you do. So if you do just corporate reform, you still don't impact the majority of the business economy in America, so you need to do both if you want to get that real economic jolt.”
“I think tax reform should move on its own, in a comprehensive way, and not be seen as a path to reducing the deficit or balancing the budget.”

“I think you need to do it [comprehensive tax reform] in one fell swoop, but as I said earlier, I think we need to take a step on extending because we’re in this very unique situation of everything expiring. I think we need to deal with that but then move in one fell swoop to kind of bring in some more fundamental reform.”

DC: I do. I think they’re all critical issues facing our nation, so I’m not trying to minimize the others, but I do think you can do tax reform on its own. I think if you try to make tax reform about reducing the deficit, I think it makes it much harder. That’s the exact testimony that we got from both [former Treasury Secretary] James Baker and [former House Majority Leader] Richard Gephardt when they testified in front of the Joint Committee on Taxation. So yes, you could address these other items, but I think the more you burden it with those other goals, the more difficult it is. I think tax reform should move on its own, in a comprehensive way, and not be seen as a path to reducing the deficit or balancing the budget.

BA: In terms of tax reform, do you think that reform needs to be comprehensive, or can individual and corporate tax reform move on separate paths?

DC: I think it needs to be comprehensive and the reason is … again, I didn’t respond completely when you asked first, ‘What’s the difference between now and ‘86?’ Well, in ‘86 you didn’t have most of business organized as pass-through entities and now you do. So if you do just corporate reform, you still don’t impact the majority of the business economy in America, so you need to do both if you want to get that real economic jolt.

The other thing is, they’re both problematic, they’re both in need of reform – on the personal side, not only just because the tax rates are all expiring but because of the complexity and the cost of compliance. Together, they combine to create the sense that your neighbor has a lower rate than you do simply because they engage in certain activities favored by the government.

On the business side, we’ve spent some time talking about that, particularly the high rate, the complexity in the international area, the fact that we’re out of step with the rest of the world. And we really need to move in a comprehensive way in order to get the kind of total economic benefit we want. The other things that have been tried haven’t worked, whether it’s quantitative easing or whether it’s stimulus, those things haven’t really moved the needle on getting people hired, getting people back to work or getting our GDP growing at a more rapid rate, and so I think we need to do all of it.

BA: How much progress have you made in dealing with the issues involving the treatment of corporate and pass-through business entities?

DC: Well, the theory is to have parity. Business entities are organized based on what’s best for their business, not necessarily what’s the best tax policy, and so that’s why in our proposals we say that both the individual and top corporate rates are 25%. For individuals we have two rates, 10% and 25% respectively. So we recognize there is a difference, but I think that it’s important to try to have parity between individual and corporate so that you don’t drive, just because of the tax rate, to a certain business model but instead they organize in a way that best meets the needs of whatever they’re producing or whatever service they’re providing.

BA: Is it necessarily a “one fell swoop” approach to comprehensive tax reform, or is there an incremental path?

DC: I think you need to do it in one fell swoop, but as I said earlier, I think we need to take a step on extending because we’re in this very unique situation of everything expiring at the end of the year. I think we need to deal with that but then move in one fell swoop to kind of bring in some more fundamental reform, and I think that there is support among many – Democrat and Republican – in the House and Senate to do that next year.
“...if we’re talking about stability from the government, there needs to be stability in our tax system so that business leaders and players in small businesses can plan and understand what their obligations are going to be...”

BA: Mr. Chairman, it’s interesting to hear you talk about what the rest of the world is doing and how we should consider some of those changes they have made. At the same time, you are clear on the need to create a uniquely American tax system. One of the tools that these other countries use is the value added tax (VAT). What is your thinking on that these days?

DC: I don’t see it having viability. Having said that, I’m not going to foreclose any discussion, but I don’t personally see it as a viable alternative. It’s been rejected 97-0 in the Senate, it’s never been popular and I don’t see it as really an alternative. But I’m not going to foreclose anyone else in terms of discussing that issue, and I think a good example of that is a 2011 hearing we had on alternative systems of taxation.

Getting to the finish line

BA: You’ve described tax reform as your “absolute highest priority.” What do you think it will take to get tax reform on the fast track?

DC: Presidential leadership would be nice. As I mentioned, it was Ronald Reagan who was critical to that, and administrations, when they want to, can do a lot to give the issue a real platform, and I think that whoever is President is going to be facing this issue, because the economy hasn’t recovered and because the need is so great. When I started on this a couple of years ago, there really weren’t that many people talking about tax reform, and now they are, so I think the United States public is ready for it and are demanding it.

As I’ve said, if we don’t do the AMT fix, 60 million refunds get delayed. To be facing this year in and year out, or every other year in and year out, is really not a way to have the most dynamic, growing, productive economy in the world. And if we’re talking about stability from the government, there needs to be stability in our tax system so that business leaders and players in small businesses can plan and understand what their obligations are going to be so they can make those very serious and big investments of hiring people or building plant or buying equipment.

When you talk to a lot of people – either young people themselves or their parents – when they’re in their 20s, they often get internships because businesses aren’t able to make a full commitment to an employee. Well, one of the reasons they can’t is that they can’t anticipate what their obligations are going to be. So if we can bring some certainty, some clarity, some simplicity and fairness to the tax code, both for businesses and individuals, I’m convinced we’ll see the economic engine that’s been idling in America really rev up and get people back to work, which is seriously a need.

BA: One final question, Mr. Chairman. The Tax Reform for the 21st Century Act – will we see the Rose Garden signing ceremony in 2013 or will it be in 2014?

DC: Well, having just watched the Olympics and seeing all these successful athletes, they always envision themselves standing on that podium, getting the gold medal. So yes, I think you’ve got to envision yourself standing there in the Rose Garden, watching the President of the United States (whoever that is) sign legislation for comprehensive and fundamental reform that will grow our economy and create jobs.
Access insights on US tax reform from Ernst & Young’s Center for Tax Policy

Tax, spending and fiscal reform – if not now, when?

Ernst & Young LLP’s Point of View series expresses our view on current public policy and regulatory matters of importance to our stakeholders, our profession and the capital markets.

We are at a pivotal point in the debate about US tax and fiscal policy reform. Economic indicators are troubling, the gap between spending and revenues is widening and a series of significant federal tax and spending shifts (commonly referred to as the “fiscal cliff”) are set to occur at the year’s end. With so much at stake, it is more important than ever to be an educated participant in the discussion.

*Tax, spending and fiscal reform – if not now, when?* poses a challenge to policymakers to take bold action to help get us back on a sustainable fiscal path. It presents Ernst & Young LLP’s point of view on the issues that have contributed to the current situation and on how to move the country forward. The data it includes demonstrates the need for US leaders to commit to spending and tax reform that will break the cycle of debt and deficits and secure the nation’s future in the global economy.

The Point of View series provides context for the critical policy debates currently taking place in Washington DC.


*Chairman Camp’s territorial tax plan: five things businesses should know*

This high-level piece explores five key issues businesses should consider when evaluating Chairman Camp’s proposal to move the US to a territorial tax system.

Access it at [www.ey.com/5things](http://www.ey.com/5things).

*Charting a course on tax reform: considerations of moving the US to a territorial tax system*

This article, the fourth in a series from our Center for Tax Policy, examines the options and trade-offs involved in reforming US taxation of foreign-source business income.


Visit Ernst & Young’s US Center for Tax Policy online at [www.ey.com/CTP](http://www.ey.com/CTP).
BorderCrossings with Ernst & Young’s transfer pricing and tax professionals

OECD Discussion Draft: Transfer pricing aspects of intangibles

Appropriate transfer pricing treatment of intangibles presents particular conceptual and practical challenges in comparison to the treatment of physical or financial assets. Accordingly, in 2010 the OECD announced the commencement of a project to address such challenges. During consultations held since that time, the business community suggested it would be helpful if the OECD were to periodically release a discussion draft for public comment as its work progresses.

Such a document, prepared by the OECD’s Working Party No. 6, was released for comment on 6 June 2012. It contains proposed revisions to Chapter VI of the OECD Transfer Pricing Guidelines, as well as annexed examples illustrating the application of the provisions of the proposed revised Chapter.

While the OECD’s Committee on Fiscal Affairs has not yet considered the draft, and the draft does not address all the topics that will eventually be covered, the scope of this initial draft paper is very comprehensive.

Access this webcast archive at www.ey.com/webcasts.
Base erosion and profit shifting: an evolving focus of the G20 and OECD

Four years have passed since the height of the financial crisis. In those four years, taxation has become front page news like never before; fiscal stimulus has been followed by fiscal austerity and tax now makes headlines the world over. But while the policy gyrations of the last few years have been fast, furious and a real challenge for the corporate tax function to monitor and assess, of equal interest is how rapidly and fundamentally the global enforcement landscape continues to be shaped in response to not only the uncertain global (not to mention European) economy, but to the changing dynamics of global business. A signal that the enforcement landscape is taking a brand new direction was indicated at the recent G20 meeting in Los Cabos, Mexico.

The large number of players trying to shape and influence the tax landscape continues to bring a real challenge at a time when business is already under significant stress. Tax used to be largely a local issue with the rules set by each country. Today for many multinationals, that model is over and the web of stakeholders influencing (or attempting to influence) how multinationals are taxed is more complex than ever.

For the corporate tax director, this shift in enforcement is key; financial and reputational risk related to tax is probably higher than ever. Monitoring the agenda of country, regional and global stakeholders can provide foresight of what enforcement issues will likely be a focus at the local level in the future. A new set of activities from the OECD means this is now more important than ever.

A crystallizing set of views

In the past there appeared to be little coordination behind the efforts by all of the various stakeholders – including the G20, OECD, EC, EU, IMF, UN, ATAF, CIOT and CIAT.
Some activities — particularly those launched at the height of the crisis, when virtually all stakeholders walked in lockstep — had a profound effect, such as the approach to growing the volume of information exchange and cooperation among countries. Some roared in like a lion but left like a lamb, however. Across the stakeholder groups there has been a lot to keep up to date on, little visibility of a cohesive strategy. The publication of one short sentence in recent months, though, seems to indicate that this is now changing.

**The Los Cabos communiqué**

When the G20 convened in Los Cabos, Mexico, in June of this year, not a great deal was expected to be communicated on the tax front — at least not in comparison to other G20 meetings of recent years where more sizable tax news had been made. Instead, the meeting was expected to focus almost exclusively on the European debt crisis. But the addition of one single sentence to the end-of-meeting communiqué in fact encapsulates what is occurring at the heart of global collaboration in the area of tax. That sentence read:

“We reiterate the need to prevent base erosion and profit shifting and we will follow with attention the ongoing work of the OECD in this area.”

That sentence concluded a longer tax section of the communiqué, which read:

“In the tax area, we reiterate our commitment to strengthen transparency and comprehensive exchange of information. We commend the progress made as reported by the Global Forum and urge all countries to fully comply with the standard and implement the recommendations identified in the course of the reviews, in particular the 13 jurisdictions whose framework does not allow them to qualify to phase 2 at this stage. We expect the Global Forum to quickly start examining the effectiveness of information exchange practices and to report to us and our finance ministers. We welcome the OECD report on the practice of automatic information exchange, where we will continue to lead by example in implementing this practice. We call on countries to join this growing practice as appropriate and strongly encourage all jurisdictions to sign the Multilateral Convention on Mutual Administrative Assistance. We also welcome the efforts to enhance interagency cooperation to tackle illicit flows including the outcomes of the Rome meeting of the Oslo Dialogue. We reiterate the need to prevent base erosion and profit shifting and we will follow with attention the ongoing work of the OECD in this area.”

Communiqué from G20 leaders meeting – Los Cabos, Mexico, 18-19 June 2012.

1 [http://www.g20.utoronto.ca/2012/2012-0619-loscabos.pdf](http://www.g20.utoronto.ca/2012/2012-0619-loscabos.pdf)
That last sentence, represents how the G20 – with the OECD providing day-to-day operational support – is shifting its focus. As with many political messages, the precise meaning of the sentence is representative of the tip of an iceberg, with many layers of detail yet to be seen under the surface.

**Deciphering the message**

Dr. Jeffrey Owens, recent director of the OECD’s Centre for Tax Policy and Administration and a new appointee to Ernst & Young’s global Tax Policy and Controversy network as Senior Policy Advisor to the Global Vice-Chair of Tax Services, has clear views as to the importance of this. “I think that this represents the beginning of the G20 taking a greater interest in multinationals and transfer pricing, even though they didn’t specifically include the words ‘transfer pricing’ in the communiqué,” said Owens. “This is an item that was pushed by India, South Africa and Brazil ahead of the G20 meeting, but interestingly with not that much enthusiasm on the part of the OECD countries, and also difficulties within the OECD,” said Saint-Amans. “One goal is to limit double taxation. Interest in transfer pricing has been growing for 20 years, and it’s still growing. So how do you best use transfer pricing to avoid double taxation? Which standard? Which practices? Which APAs? Which MAP? Which arbitration? I’m quite impatient with endless discussions, and I want to deliver some progress. So I would like to shake up that process so that we don’t merely reproduce the discussions we had on arbitration five years ago.”

It is interesting to note that Saint-Amann’s comments focused exclusively on the role of transfer pricing in limiting double taxation, which is a long-standing and critically important objective of the transfer pricing standards and the related provisions of bilateral tax treaties. Indeed, he made no reference to base erosion and profit shifting in those comments on transfer pricing.

This potential interest of the G20 in transfer pricing aligns closely to what readers of this publication saw in our June 2012 issue as Owen’s successor at the OECD, Pascal Saint-Amans, set out transfer pricing as one of his three key priority areas as he takes up the reins in his influential role: “My second priority is that we need to address transfer pricing, which is an undertaking that creates some difficulties in our relationship with non-OECD countries, and also difficulties within the OECD,” said Saint-Amans. “One goal is to limit double taxation. Interest in transfer pricing has been growing for 20 years, and it’s still growing. So how do you best use transfer pricing to avoid double taxation? Which standard? Which practices? Which APAs? Which MAP? Which arbitration? I’m quite impatient with endless discussions, and I want to deliver some progress. So I would like to shake up that process so that we don’t merely reproduce the discussions we had on arbitration five years ago.”

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**Shifting focus of the OECD and the emergence of the BEPS project**

During the course of the financial crisis, the OECD has been a central character in the global tax debate. In this recent period, the OECD has been particularly vocal with respect to the international cooperation area, including both the wider tax information exchange program and the “peer review” program within which countries assess the quality, ability and willingness to exchange such information, which have long been areas of focus for the OECD but which have come more to the fore in the last few years. The OECD also pursued some projects that were, perhaps, more reactionary in nature, dealing with specific topics and issues such as enhanced relationships between taxpayers and tax authorities, issues affecting high-net-worth individuals, bank losses and joint audits of taxpayers. Many of these projects reflect issues that had to be dealt with very quickly in the fallout from the financial crisis. During this period, the traditional core work of the OECD in the areas of tax treaties and transfer pricing has taken a bit of a back seat in relation to other more pressing requirements, but has continued uninterrupted.

2 See www.ey.com/tpc
The OECD’s Base Erosion and Profit Shifting project (hereafter referred to as the “BEPS” project) represents something of a joining up of the traditional focus areas of the OECD with the newer areas of focus, and, interestingly, did not actually attract a “formal” launch in the manner that is customary for OECD projects. This is interesting for a project of such seeming importance.

About the BEPS project

The OECD’s website indicates that the BEPS project “is looking at whether, and if so why, Multinational Enterprise’s (MNE’s) taxable profits are being allocated to locations different from those where the actual business activity takes place.” Based on the findings of an initial environmental scan, the OECD plans to implement what it describes as an “integrated and holistic approach to improve the concrete tools it has to address base erosion and profit shifting.” According to its website key areas of work of the OECD in which this is a current focus include:

- Harmful tax practices
- Aggressive tax planning
- Transfer pricing
- Tax treaties
- Tax policy and statistics
- Tax and development
- Tax compliance

The OECD has set out its aim as providing “comprehensive, balanced and effective strategies for countries concerned with base erosion and profit shifting.” The OECD states that essential elements of this framework include the arm’s length principle and the elimination of double taxation as well as the elimination of inappropriate double non-taxation, “whether that arises from aggressive strategies put in place by taxpayers or from tax policies introduced by national governments.”

Why now?

The OECD cites the pressures of economic recovery and the need to combine a focus on competitiveness with efforts to ensure that business bears its fair share of the tax burden in answer to the question “why now?” The OECD states that many (it does not say who) are questioning why so many multinational companies – and in particular those that are IP-intensive – have effective tax rates that seem to be dramatically lower than the statutory rates of the countries in which they operate. In this regard, the OECD acknowledges that certain items of income may be tax-exempt or taxed on a deferred basis, which is a main reason for the difference between effective tax rates and statutory tax rates. But, at the same time, it also states that “a number of MNEs are also using aggressive strategies to minimize their tax burden.”

This view is clearly shared by Masatsugu Asakawa, the Chair of the OECD Committee on Fiscal Affairs (to which the BEPS project will provide an interim report in 2013) and Deputy Vice-Minister of Finance for International Affairs, Japan. In a recent edition of World Commerce Review, Asakawa writes:

“... this gap [between an MNE’s effective tax rate and the statutory rate of the country in which they operate] has clearly broadened and this is largely due to aggressive positions taken by some MNEs. Many of these strategies can be entirely legal. In some cases they may be responses to the lack of effective countermeasures in the tax system. In other cases, they may be based on provisions wilfully put in place by governments. Nevertheless, the results of these strategies put a spotlight on the tax system and require reflection by policymakers and other stakeholders. At stake is the ongoing credibility of the domestic and international tax systems that are key foundations for long-term growth and for reducing inequalities.”

Intangibles in the spotlight

While the particular parameters of the BEPS project seem not to have been determined yet, it is clear that transfer pricing, and in particular those elements of transfer pricing addressing intangibles, will be an area of focus.

Transfer pricing, of course, represents one of the most significant compliance burdens and sources of tax risk for multinational companies. In fact, both taxpayers and tax administrators reported transfer pricing as their leading source of risk in our 2011–12 Tax risk and controversy survey.5

Transfer pricing is inherently complex because it can be very difficult to compare transactions between companies in a multinational corporation to deals between unrelated parties. As difficult as they are, and even though they can lead to significant disagreement and controversy because of the fact-intensive nature of the analysis, such hypothetical comparisons are the long-established, globally agreed standard for determining and evaluating transfer pricing.

What eventual impact the BEPS project might have on OECD transfer pricing guidelines is, at this point, not clear. Indeed the OECD is due to issue revised guidance on transfer pricing intangibles in 2013, following this summer’s comment process on the OECD discussion draft in this area and the upcoming public meeting on intangibles to be held at the OECD meeting center in Paris in November. (More can be read on the OECD intangibles project on page 28 of this publication.)

It seems that given the depth and complexity of carrying out an environmental scan on the perceived difference between MNC effective tax rates and actual statutory rates, reaching consensus on what causes the difference (assuming one is found) and then developing and implementing a consistent, manageable set of guidelines, regulations, and, not unlikely, penalties for infringements will be no easy or quick task.

Others join the debate

Of course, if the tax policymakers and tax administrators of the world were collaborating, coordinating and being influenced by a single multi-member entity (such as the OECD) that would be one thing; the truth is, of course, there are multiple such entities, each with its own stakeholders, all simultaneously seeking to influence the activity of not only governments but the taxpayers who ultimately foot the bill. This creates additional layers of complexity for tax directors who are trying to manage risk and support their business through effective (not to mention legal) tax planning.

Other sets of guidance and regulation often find their genesis in the European Union. Currently, 21 of 27 EU Member States also share membership with the OECD. Many of the tax coordination (for want of a better word) activities of the EU (or EC) are similar in nature to those of the OECD, although the relationship among EU members is very different than the status of OECD members.

A key example is the issue of double non-taxation; within just days of each other, the EC and the OECD issued papers dealing with so-called “double non-taxation” situations. On 29 February 2012, the EC launched its public consultation on factual examples of double non-taxation cases, while a week later, the OECD published a report that focuses on hybrid mismatch arrangements.6

Another example is the European Union activity in the area of aggressive tax planning. The EC in June 2012 published a communication on concrete ways to reinforce the fight against tax fraud and tax evasion. “Before the end of 2012, the Commission will also set out a ‘stick and carrots’ approach to dealing with tax havens, and measures to deal with aggressive tax planners,” said Algirdas Šemeta, European Commissioner responsible for taxation and customs union, audit and anti-fraud, when discussing the EC’s latest communication7 on the topic in late June 2012.

In our view, the occurrence of double taxation (especially in transfer pricing) and the implication by Asakawa that individual governments still have a road ahead of them to harmonize their systems should be the key focus area for G20, the OECD and all other supra-national organizations.

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6 See Global Tax Policy and Controversy Quarterly Briefing – June 2012: In the spotlight: OECD and European Union increase their focus on double non-taxation.
Information exchange — another example of “plates to be juggled”

The vast and growing array of taxpayer information exchange mechanisms in place around the world is another area that tax directors may feel does not impact them quite so directly, and in our view, this is a mistake. However, this is an area that business should be watching keenly. In that regard, building an understanding of the different information exchange mechanisms into pre-controversy strategy is increasingly important. Unfortunately, this is no easy task as the global information exchange model now operates on so many different dimensions.

On one dimension, the OECD’s Global Forum on Transparency and Exchange of Information for Tax Purposes reports that more than 800 bilateral tax information exchange agreements are now in place between countries. While few statistics are published, that these agreements are used on a regular basis is quite evident. Indeed, as recently as September 2012, the Australian Taxation Office (ATO) Assistant Deputy Commissioner, International, Large Business & International, Michael O’Neill, confirmed that the ATO expects to conduct several joint audits with the IRS this year; that information exchange is used within this context is undeniable.

Of course, country-to-country tax information exchange represents only one dimension. To gain the maximum leverage of such data, a multilateral instrument was needed by global tax authorities in order to make such data fully shareable. Two such vehicles now exist – again, one under the auspices of the OECD and another for the European Union. The OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters was originally developed by the OECD and the Council of Europe in 1988 and was refreshed in 2010 to enable three main things: the multilateral element of exchange that exists today, making the agreement available to non-OECD countries and aligning the agreement to the internationally agreed standard on exchange of information for tax purposes. In that regard, it provides that bank secrecy and a domestic tax interest requirement should not prevent a country from exchanging information for tax purposes. In addition, it is important to note that the agreement also provides for the automatic exchange of information as well as for information exchange on request. Since the 2011 Cannes G20 Summit, seven additional countries – Argentina, Colombia, Costa Rica, Greece, India, Ghana and Tunisia – have signed the agreement. The number of signatory countries now stands at 37 and, in the most recent news, July 2012 also saw the OECD announce that the agreement has been further modified to allow for group requests, meaning tax authorities are able to ask for information on a group of taxpayers (without naming them individually) as long as the request is not a “fishing expedition.”
Europe and Africa

In the European Union, meanwhile, political agreement was reached in 2010 on a draft of the Council Directive on administrative cooperation in the field of taxation, with this Directive effectively delivering a complete overhaul of the 1977 Directive 1977/799/EEC. The scope of the improved administrative cooperation Directive is widened over and above that of the 1977 Directive to include all taxes except those that are dealt with by separate EU legislation (for example, the VAT Directive), while a new set of common rules of procedure, forms and information channels allows the tax authorities of the Member State to make administrative enquiries in the territory of the other Member State.

In order to allay the risk of Member States making imprecise requests aimed at detecting irregularities (“fishing expeditions”), the Council of the European Union agreed to identify in the Directive certain details that must be specified in requests for information, namely the identity of the person under investigation and the tax purpose for which the information is sought. The Council also agreed on a step-by-step approach aimed at eventually ensuring unconditional exchange of information for eight categories of income and capital, and from 2015, Member States will automatically communicate information for a maximum of five categories, provided that that information is readily available.

Aside from the fact that the European Union mechanism of information exchange represents one more layer of detail for taxpayers to be aware of, a key question is whether information shared between country A and country B could be shared with country C given the multilateral nature of each mechanism. On this point there does not yet seem to be global agreement.

The global, multilateral web of information has now been created and continues to be built out month after month, with additional players, such as the African Tax Administration Forum (ATAF), joining the dialogue. “Gradually, more and more multilateral forms of cooperation are emerging” said Mr. Logan Wort, ATAF Executive Secretary, at a July 2012 ATAF conference. “... and we have taken to the global trend to develop one that is representative of the needs of African revenue authorities.” This is one of many areas in which business has to stay connected to multiple interested parties.

Countries have their say, too

The examples outlined above show how many different dimensions the corporate tax function now has to monitor and assess as new players enter the global tax landscape. Indeed, the examples do not take into account measures put in place by the countries themselves particularly those less willing to adopt standards developed by others. As 2012 has progressed, this dimension has become more and more evident, illustrated by the number of countries now either proposing a new General Anti-Avoidance Rule (India, United Kingdom) or strengthening existing GAAR (Australia, and, perhaps, soon, China), not to mention driving through new Specific Anti-Abuse Rules (SAAR) covering a range of tax issues. This shifting GAAR landscape – and what the corporate tax function may consider putting in place in direct response – will be covered in the next edition of this publication.

Adding it all up

In summary, the OECD, has embarked on a project that attempts to tie multiple strands of activity together. The BEPS project is still going and it impact not yet evident. Monitoring the BEPS project and similar activities by other interested parties should now be a line item on the “to do” list of tax directors. As outlined in our 2009 publication Tax administration without borders, “… by understanding the context in which tax policy and tax administration decisions are made, and assessing the potential impact of new legislation on existing and planned tax positions, companies can get a head start on implementing a pre-controversy strategy.”

An interim report from the BEPS project team is expected to be discussed by the Committee on Fiscal Affairs in 2013, though there is little visibility currently on when exactly and what the next steps might be thereafter.

The BEPS project is in its very early days, and it will be some time before more concrete impacts make themselves evident. The need to monitor the BEPS project – not to mention similar activities by other interested parties – should now be a line item on the “to do” list of tax directors.

Access the latest thought leadership from Ernst & Young

2012 global transfer pricing tax authority survey

The latest issue of our transfer pricing survey, 2012 global transfer pricing tax authority survey: perspectives, interpretations and regulatory change, provides the insights of tax authorities in a wide range of transfer pricing jurisdictions and gives practical suggestions on how organizations can deal with transfer pricing issues in the 48 countries covered.

OECD proposals for revised guidance of transfer pricing of intangibles: key issues, reactions

On 6 June 2012, OECD published its proposals for revised guidance on the transfer pricing of intangibles.¹ The draft, on which comments were sought by 14 September 2012, presents the results of the OECD’s work to date on two key issues relating to transfer pricing for intangibles:

- The definition of intangibles for transfer pricing purposes
- The determination of which entity(ies) should be entitled to the returns from an intangible

In addition, the draft contains a large number of examples – 22 – illustrating the application of the principles it sets out.

Unusually, the document has been issued as an interim draft that is identified as not necessarily reflecting OECD consensus.

Background

The existing guidance on the transfer pricing of intangibles was added to the OECD’s Guidelines in 1996. Since then tax authorities and taxpayers have gained considerable experience with transfer pricing issues, and transfer pricing for intangibles has raised some of the most complex issues. More particularly, in its work leading up to the publication of the revised Guidelines in July 2010, including the addition of a chapter on transfer pricing issues arising out of business restructurings, it became apparent to the OECD that further work on intangibles was needed.

In a scoping document issued in January 2011, the OECD announced an initiative to review and refine its guidance on issues such as those considered below. A consultation meeting on scoping issues was held in November 2010. A meeting on the valuation of intangibles took place in March 2011, and in November 2011, a further public consultation meeting took place, dealing with definitional and ownership issues.

¹ Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions, 6 June to 14 September 2012 (Discussion Draft). Available at: http://www.oecd.org/document/41/0,3746,en_2649_33753_50509929_1_1_1_1,00.html.
When the initiative was launched, it was anticipated that a Discussion Draft would be published in 2013. However, the OECD decided to publish a draft for a discussion somewhat earlier than planned in order to gain input from business as the Working Party continues its work. There is no consensus yet on a number of issues.

Set out in this article are a series of key points from the proposals, along with Ernst & Young's viewpoint on each. These viewpoints — along with supporting details — were submitted to the OECD by Ernst & Young on 13 September 2012.

Key issue 1: Legal and accounting definitions of intangibles are rejected in favor of one focusing on what unrelated parties would have agreed.

Having reviewed definitions of intangibles for legal and accounting purposes, the OECD has provisionally concluded that transfer pricing requires its own concept of what an intangible is:

“... the thrust of a transfer pricing analysis in a matter involving intangibles should be the determination of the conditions that would be agreed between independent parties for a comparable transaction.”

The OECD’s proposed definition of an intangible is therefore rooted in the fundamentals of Article 9 of the OECD Model Tax Convention. Although the enforceable rights that make up the legal definition of an intangible, such as patents and trademarks, are potentially encompassed by the transfer pricing definition, legal enforceability or separate transferability are not the focus of the OECD’s definition of intangibles for transfer pricing purposes. In addition, the draft calls for caution in use of accounting valuations for transfer pricing purposes generally and states specifically that purchase price allocations for accounting purposes are not relevant for transfer pricing.
The other key point in this section of the draft guidance is the distinction between attributes owned or controlled by a single entity and “comparability factors” that cannot be directly ascribed to a specific entity. These include group synergies and market characteristics such as low labor costs. These factors should be taken into account in the pricing (comparability) analysis for the relevant transaction rather than being treated as a separate transaction in intangibles. In this respect, it is indicated that workforce in place is such a comparability factor. However, it should be noted that, at the same time, it is mentioned that the transfer of an assembled workforce may provide a benefit and may affect the compensation required in connection with the transaction.

Overall, it appears that the OECD is striking a balance between the advocates of a narrow definition focusing on enforceability of property rights and attempts by some tax authorities to broaden the notion of an intangible to include almost any driver of profit such as access to low-cost labor.

Ernst & Young point of view

The Working Party’s work on the definition of intangibles is helpful, but we think there is a need:

1. To further sharpen the definition, and in that context, to clarify the distinction between comparability factors and intangibles, and to recognize that there may be factors too ill-defined to be useful for transfer pricing analysis (e.g., “good management”)
2. To recognize that in many countries, a definition that is not sufficiently concrete could be contrary to domestic law prohibitions, including constitutional prohibitions, on laws that are overly vague

As much as possible, differences in the definition of intangibles, e.g., between Article 9 and Article 12 (royalties); and if a difference is necessary, the distinction should be made clear.

Ernst & Young’s view is that an intangible should be capable of being owned or controlled, and be capable of being transferred on a stand-alone basis. Other aspects that do not meet these requirements (e.g., “synergy,” “location savings”) should be factored into the comparability analysis, but should not otherwise be considered a separate intangible.

It is our experience that in some jurisdictions, tax authorities feel they have an almost unlimited mandate to disaggregate common transactions into transfers of more and more discrete intangibles, each with its own, separately discoverable, arm’s length return. In other jurisdictions, the opposite tendency is common. We therefore think further attention also should be devoted to the issue of the level of disaggregation.

Key issue 2: Identification of the parties entitled to intangibles-related returns

In the second section of the new draft guidance, the OECD maintains and perhaps enhances the focus on economic substance already demonstrated in its commentary on profit attribution to permanent establishments under Article 7 of the Model Tax Convention 5 and, in particular, the first part of Chapter IX (Business Restructurings) of the OECD Guidelines on testing the contractual assignment of economically significant risks between the parties to a transaction.

The new guidance defines three criteria to be taken into account in determining which entity(ies) should have a claim on the returns to an intangible:

1. The terms of the legal agreement
2. The alignment of functional contributions and financial investment with legal rights
3. Whether “services rendered in connection with developing, enhancing, maintaining and protecting intangibles” are compensated on an arm’s length basis

It is quite clear that the OECD’s view is that the terms of the legal agreement are only a starting point for the analysis:

“Where the conduct of the parties is not aligned with the terms of legal registrations and contracts, it may be appropriate to allocate all or part of the intangible-related returns to the entity or entities that, as a matter of substance, perform the functions, bear the risks and bear the costs that relate to development, enhancement, maintenance and protection of the intangibles.” (Discussion Draft, paragraph 37)

As already suggested, the discussion of functional alignment explicitly and closely follows the framework set out in Chapter IX (Business Restructurings). Alignment requires that the entity contractually entitled to returns should either:

1. Develop, enhance, maintain and protect the intangible itself
2. Physically perform the important functions itself and “control” the supporting contribution of any service providers

Ernst & Young’s view is that an intangible should be capable of being owned or controlled, and be capable of being transferred on a stand-alone basis.
Ernst & Young point of view

We do not see the necessity for the new concept of “intangible-related returns.” If such a new concept is introduced, it should be clarified. In particular, although the Discussion Draft recognizes the issue, it needs to be made very clear that the profit attributable to drivers such as market circumstances and entrepreneurial activity should not be routinely allocated to the party entitled to intangible-related returns.

Financing and intangible-related returns

It is unclear whether the Discussion Draft’s definition of an intangible-related return would include the remuneration for the financing of the development of the intangible. We believe that at arm’s length and in line with the current transfer pricing guidelines, a party financing the development of an intangible can be entitled to take part of the “excess profits” in connection with an intangible.

Entitlement to the returns

Another major concern with this draft guidance concerns the emphasis placed on an assessment of whether the allocation of functions, assets, risks and costs is “in alignment” with the legal and contractual framework.

We agree that entities within an Multinational Enterprise (MNE) should have an appropriate level of substance to manage and control the development, enhancement, maintenance and/or protection (“DEMP” functions) related to intangibles, in order to claim entitlement to some or all of the intangible-related return. However, in our view, the level of substance and the level of control required should, wherever possible, be tested by reference to comparable transactions between third parties, rather than by a hypothesis about arm’s length behavior. Our view is that the guidance as currently drafted is too prescriptive about the behavior that is required in order for an entity to be entitled to intangible-related returns.

Such prescriptive guidance could not practically address the whole variety of arrangements that are seen at arm’s length, and this likely would lead to implementation problems and a risk of inappropriate deviation from the arm’s length standard.

Particular issues that we foresee arising in this regard include the following:

- There are undoubtedly arm’s length situations where third parties retain entitlement to intangible-related returns without themselves performing and controlling all the “important” functions to the extent that the guidance appears to require. MNEs should be free to adopt arrangements comparable to those observed between arm’s length parties in comparable circumstances without the risk of those arrangements being disregarded.

- Normal practice in many MNE groups is to allocate different DEMP functions to different entities within the group. (For example, group IP protection may be handled centrally, while development and enhancement of IP might be handled by entities in different jurisdictions.) In these cases, the entities that perform the protection functions may not exert control over the development or enhancement functions, or vice-versa. The guidance should be able to address this situation without the risk of intangible-related returns being reallocated around the group.

- There are arm’s length situations where a party will obtain the right to share in intangible-related returns by investing in the development of intangibles or purchasing intangible rights, but will perform little or no “control” activity other than due diligence at the outset, and will bear only risks associated with the loss of its initial investment and the volatility of intangible-related returns. Although we can see that this type of arrangement can fit in to the guidance (noting the references to paragraph 9.23-9.28), it would be helpful to confirm this.
Key issue 3: The perspectives of both parties, including the commercial alternatives they would have if they had been unrelated, should be taken into account in pricing.

Almost 20 pages of the draft guidance are devoted to pricing issues. Although for a large part, the guidance confirms what is now familiar practice (e.g., the use of discounted cash flow (DCF) analysis as a "tool" in pricing, particularly for transfers of intangibles), there are a number of points worth noting.

Two-sided perspective and application of ORA (options realistically available) concept to intangibles

Pricing analysis should be two-sided and consider the "realistic alternatives of both parties" as part of the comparability analysis. For example, a licensor or transferrer of an intangible would not accept a price less than it could realize by exploiting the intangible itself, and the licensee/transferee would not pay a price that leaves it less profitable.

Similarly, with respect to valuation, the calculation of the discounted present value of the streams of cash flows attributable to the intangible from the perspectives of both parties to the transaction will generally be necessary. In these cases, the arm's length price will fall somewhere within the range of both present values, after taking into account taxes required to be paid with respect to the transaction.

Ernst & Young point of view

We believe more guidance on the general notion of "options realistically available" would be very welcome, especially given the importance that is being put on this concept in the context of intangibles. For example, we think there should be more attention devoted to the issue of determining what options might be considered realistically available. Such discussion should consider such issues as, if a company has a certain risk appetite, is it a realistic option to invest in projects with a totally different risk profile?

In our view:

- The "next best alternative" cannot always be assessed by a simple NPV analysis. A wide variety of other factors need to be considered, such as the allocation of capital among different projects (e.g., although the NPV derived from project X might go down if project X is out-licensed, such an out-license might free up capital to exploit project Y in addition to royalties from project X).

- A tax authority’s view of what options are realistically available may be quite different from management’s view. Our opinion is that the way the guidance and example are currently drafted, with the reference to recharacterization, may encourage tax authorities to second-guess management decisions.

Key issue 4. Caution should be exercised in accepting valuations performed for accounting or other purposes when determining arm’s length prices; in particular, valuations contained in purchase price allocations are not relevant for transfer pricing purposes.

The draft guidance calls for caution to be exercised in accepting valuations performed for accounting or other purposes when determining arm’s length prices. It explicitly dismisses the use of valuations made for purchase price allocation purposes:

"... valuations of intangibles contained in purchase price allocations performed for accounting purposes are not relevant for transfer purposes."

Use of cost-based valuations and rules of thumb

Similarly, the OECD sees a limited role in transfer pricing for cost-based valuations except sometimes for non-unique intangibles used for internal business operations (e.g., internal software systems).
The use of rules of thumb (like the “25% rule of thumb,” a formulaic apportionment of the profit attributable to an intangible between its owner and the user) is “discouraged.”

Pricing of transfers of intangibles
This section of the Discussion Draft also contains guidance for determining arm’s length prices in a controlled transaction involving the transfer of intangibles or rights in intangibles. This is of particular importance in the context of business restructuring. It does not set out a prescriptive framework but makes a number of points on the details of pricing these transactions.

Ernst & Young point of view
We disagree with the suggestion that there is inherent conservatism in valuation assumptions adopted for accounting purposes. This is not consistent with fair value measurement requirements under IFRS, which are intended to reflect the fair value of an intangibles asset in an arm’s length sale between a willing buyer and seller, not a conservative estimate of value.

We also rebut the statement that “valuations of intangibles contained in purchase price allocations performed for accounting purposes are not relevant for transfer pricing purposes.” We believe this statement is drafted too broadly.

However, the asset to be valued for transfer pricing purposes is often different when looked at closely to the asset valued for purchase price allocation purposes. In this respect, broad definitions of assets or combinations of assets can be misleading.

We also think that the acquisition price may not be a good comparable because it can be expected to reflect the value to the group as a whole, not just the value to the acquiring entity, which would typically be lower.

We welcome the OECD’s application of discounted cash flow approaches in its examples and also the clear and consistent application of post-tax discount rates to post-tax cash flows. We suggest that further guidance and clarification be included with respect to the use of discounted cash flow techniques and the use of post-tax rather than pre-tax cash flows as the appropriate basis for value measurement.

However, we have concerns over the level of length and depth of discussion of the issues and concerns around valuation techniques. The articulation of the assumptions may add to the burden of documentation that is necessary for MNEs using valuation techniques in pricing intangibles, creating expectations of a level of detail that we feel is not appropriate.

Highly uncertain valuation
The Discussion Draft includes language on the pricing in case of highly uncertain situations. In our experience, renegotiation is seldom observed in practice, in particular in the situation of an outright sale of an intangible. We suggest making this explicit in the document. Hence, applying a renegotiation mechanism, by either the taxpayer or the tax administration, should be thoroughly documented and not be done lightly.

Next steps for the project?
A public consultation meeting will be held at the OECD Meeting Center in Paris on 13–14 November 2012. It is hoped that another draft will be released for further discussion, likely at some point in 2013.
Double non-taxation: responses to the European Commission’s public consultation on double non-taxation cases are published

On 29 February 2012, the European Commission (EC) launched a public consultation on factual examples of double non-taxation cases, i.e., cases where divergent national rules and/or inadequate national tax measures in two Member States lead to non-taxation.1

The EC invited interested parties to submit situations where double non-taxation is occurring, seeking to gauge the full scale of the problem and to determine where the main weaknesses lie. The deadline (30 May 2012) to provide contributions has expired and although the EC announced it will publish a policy response by the end of 2012, it has in the meantime published a Report2 summarizing the responses received.

Report details

The Report reveals that the number of contributions received was limited. Non-governmental organizations that contributed to the consultation welcomed the focus of the initiative but found it difficult to provide many factual examples of double non-taxation. The business community, meanwhile, expressed concerns on the scope of the consultation. Many of the contributors from the business community did not provide answers to the specific questions in the public consultation note, but instead provided broader and more general comments on the issues raised.

The following points are worth highlighting:

- Several found it important to make a clear distinction between actual double non-taxation (e.g., due to mismatches of hybrid entities and hybrid instruments) and tax competition (low taxation).
- Most organizations stressed that direct taxation falls within the competence of the Member States’ sovereignty. Several therefore found that any measures against double non-taxation should be handled at the Member State level, while others found some level of coordination may be appropriate.
- Many organizations felt that the issue of double non-taxation should not be addressed separately from that of double taxation.
- Some organizations stressed that measures against double non-taxation could adversely affect European economic competitiveness.
- Several organizations also called for coordination with other initiatives on EU and international levels that address aspects of double non-taxation, e.g., the EU Code of Conduct Group and the OECD report on Hybrid Mismatches.

Background to the current debate: EC and OECD efforts to tackle double non-taxation cases

Within just days of each other, the EC and the OECD issued papers dealing with so-called “double non-taxation” situations. On 29 February 2012, the EC launched its public consultation on factual examples of double non-taxation cases, while a week later the OECD published a report focusing on hybrid mismatch arrangements. Both papers aim at dealing with situations where, as a result of divergent national rules, transactions between two states lead to perceived non-taxation. This may, for instance, be the case if two states define financial instruments in a different way.

The OECD paper merely summarizes tax policy issues raised by the mismatch arrangements and describes, drawing on a survey of a few countries, the policy options available to address them. But the EC invited interested parties (including tax professionals from practice, business and academics) to submit situations where double non-taxation is occurring, seeking to gauge the full scale of the problem and to determine where the main weaknesses lie, as well as to provide possible solutions.

The EC's consultation paper is supported by the OECD report on mismatches between countries' tax systems. This is not surprising, given that a number of key EU countries were part of the OECD working group that prepared the report. The OECD observes, as does the EC, that market and equity distortions caused by double non-taxation are just as undesirable as distortions caused by double taxation. Both the OECD and the EU list a number of situations that they believe warrant a closer look and possible actions by policymakers. They also note that this list is non-exhaustive. It is peculiar that the two lists of potentially aggressive cross-border situations have only two situations in common, namely hybrid entities and hybrid instruments.

Work undertaken by the EU Code Group

Within the EU, the debate on double non-taxation is closely connected to the work of the EU Code of Conduct Group (the Group). In 2009, the Group determined that double non-taxation caused by mismatches is a problem that has to be addressed. So far the Group's work in this area particularly focused on mismatches between national law characterizations of payments made under hybrid loan arrangements. Two broad and rather obvious approaches have been identified: either the payer Member State follows the characterization in the recipient Member State (denial of deduction of the interest payment in the source Member State) or the inverse (denial of exemption of the interest payment received).

The Group is currently debating how the "agreed solution" should be implemented (hard law or soft law). In its most recent June 2012 Progress Report, the Group also announced that it started its work on other mismatches, specifically in the area of hybrid entities and permanent establishments.

Comments on the outcome of the consultation

As stated above, the EC stresses that the total number of 25 contributions could be perceived as limited. It states the main reasons as being the fact that the public consultation relates only to direct taxation (and not to taxation of individuals) and that the subject matter is quite complex. However, there may be another reason. The examples of double non-taxation, listed in the Commission's consultation document, occur frequently within the EU and are often confirmed by the courts and tax authorities. They are in many cases an integral part of a country's taxation system and, as with the reduction of corporate tax rates and Europe's wholesale move to dividend exemption, a part of building a sustainable fiscal climate by the different territories. This might explain the lack of response to the Commission's call for comments, particularly the request for details on any additional specific cases that may lead to double non-taxation. In this context, it is also not unexpected that most of the preferred solutions suggested by the business community were based on the premise that direct taxation falls within the competence of the Member States' sovereignty.

Only a few business community contributors found coordination or harmonization efforts at the EU level appropriate (for example, the Commission's Common Consolidated Corporate Tax Base (CCCTB) proposal) as a means to tackle double non-taxation.

Finally, several contributors called for avoidance of duplication of work already undertaken at the EU and OECD level.

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7 European Commission, 'Summary Report of the Responses Received on the Public Consultation on Factual Examples and Possible Ways to Tackle Double Non-Taxation Cases', 5 July 2012, TAXUD D1 D(2012).
The way forward: is the focus of the current debate holistic enough?

The EC’s Report summarizing the outcome of the public consultation is of course very welcome. However, far more interesting is that the EC is currently further analyzing the received contributions in order to identify and develop “appropriate policy responses.” The received contributions will be used as input for the EC’s communication on strengthening good governance in the tax area (“tax havens, uncooperative jurisdictions, and aggressive tax planning”), which it intends to publish at the end of 2012.

With a view to possible policy responses, it is notable to take into account that, as the EC implies in its consultation paper, it does not seek harmonization of taxation systems for purposes of combating mismatches. Instead, the EC seems to favor a more pragmatic legislative approach to be undertaken at different levels.

Apart from the traditional EU legislative approach (adoption of a directive at the EU level to be implemented by the Member States), the consultation paper mentions unilateral legislation in individual Member States, as well as bilaterally between Member States. The EC further suggested increased exchange of taxpayer information, especially mandatory advance disclosure of certain national tax planning schemes and also good governance as potentially very powerful tools; the latter, for example, could result in soft law agreements between Member States or in the sharing of leading practices.

The EC’s progress in this area is obviously deeply connected to the progress on the EC’s CCCTB proposal, which is still on the Council’s table and not yet finding consensus. Any solution on the CCCTB proposal would obviate the need for any legislation on mismatches, as would a further convergence of tax systems, such as that being proposed (and to some degree enacted) by Germany and France.

One of the remaining questions is how eager the various EU Member States will be to implement what might be seen as a further restriction on the ability to use tax as a national policy tool. Consider for example the Belgian Notional Interest Deduction and the recently introduced Italian Allowance for Corporate Equity. How do these Brussels-condoned measures stack up against this mismatch initiative? The same could be asked about the intellectual property regimes in various EU countries: clearly embraced by Brussels and clearly intended to attract business through a mismatch?

Another interesting question to ask is whether countries are becoming wary of the increasing complexity of their tax rules and the pressure it puts on their tax administrations and judicial systems. Certainly, many countries have established programs designed to simplify their tax code. However, the growing collaboration by the EU Member States continues to put this drive toward simplification under pressure. Of course, the effect of this complexity on companies where each tax change now means intricate IT changes and increased compliance costs has an even larger impact on companies themselves; migration of corporations or functions within companies may not be a new phenomenon, but it is becoming more common, especially by those corporations that feel overburdened by regulatory and administrative systems.

What therefore might be missing in the current debate is a thorough and detailed study of the various solutions and their form on the potential impact on taxpayers themselves. Currently, the vast majority of focus seems to be on the perceived income the potential EU policy responses could generate for government and the compliance cost to the Member States implementing them, not to the companies that have to deal with them and, most importantly of all, the impact the changes in tax law and the increased compliance burden may have on global trade.

As pointed out, the impact of (potential) policy responses on the ability of EU multinationals to remain competitive should be closely monitored and compared with multinationals with head offices in third countries, particularly those in OECD non-EU countries.

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The role of multinational companies in Africa’s development: the tax dimension

Over the last decade, Africa has experienced unprecedented growth, and it is expected to begin to match the growth rates seen in the BRICS markets.

This outstanding economic performance has been accompanied by political reform. For example, 2011 saw a record 28 nationwide elections, most of which were fair and peaceful. And the Arab Spring has spread democracy in the Middle East and North Africa (MENA) region. The Freedom House political freedom index, which measures political rights and civil liberties, now classifies almost one-fifth of the continent as “free,” two-fifths as being “partly free” and two-fifths as “not free.”1 Although corruption remains a problem in many African countries, there are exceptions, such as Botswana and Mauritius, and the overall business environment. In fact, the World Bank “Doing Business” indicators show that, in 2011, one-third of the economies that had experienced improvements were African.

The following forms the introduction of a report which looks at some of the specific challenges facing both business and tax administration in Africa today.

Download the full report at: www.ey.com/africarising

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Large multinational companies (MNCs) now recognize that Africa could be the next economic frontier. We have seen an inflow of both foreign direct investment (FDI) and portfolio investment into Africa, not just from OECD countries but also from other emerging economies, particularly China, Brazil and India. This inflow of investment is creating jobs, bringing new technologies, making domestic markets more competitive and generally contributing to rising living standards, disposable income and increasingly sophisticated tastes throughout the continent.

Africa’s population today totals more than one billion people, with combined consumer spending approaching US$1 trillion. And a sizable number of households are expected to move into a higher income band over the next 10 years. For example, in Ghana less than one-quarter of households had an income of more than US$5,000 in 2010. By 2020, more than one-third of households will enjoy an income above US$5,000. In Nigeria, 2020 will see nearly 56% of households enjoy an income in excess of US$5,000, up from 45% in 2010.

The tax dimension

As more capital flows into Africa, the nations involved want to make sure that any profits made are taxed accordingly and that the tax base is not eroded by tax abuse. But for many tax directors, operating in Africa can be a painful experience; because they are dealing with such rapid growth in inbound investment, these emerging countries tend to experience large volumes of tax policy and tax administration change as they develop the laws and processes to secure what they feel are the right levels of tax revenues from those capital flows and transactions. This is particularly prevalent in the complex area of transfer pricing, a concept that is experiencing significant global change.

It can take many years for a tax regime unaccustomed to policing cross-border commerce to mature, so some key nations rely on existing legislation and processes that globetrotting taxpayers may view as unsophisticated, complex and, without doubt, culturally different. But as emerging market countries become more confident in their own right, they are increasingly challenging commonly applied international standards.
Striking the right balance

Africa is no different in this regard; it is not easy for African governments to achieve the right balance between providing a business-friendly tax environment for investors while making sure that when foreign investors come into their countries, they pay a fair share of the tax burden. Around the world, many tax administrations – supported by collaborative efforts within the OECD – have accepted that securing high levels of tax compliance requires not only robust enforcement but also improved taxpayer service. They have therefore developed more sophisticated risk management tools, a greater willingness to group taxpayers into high- and low-risk groups and a “lighter touch” audit approach to those classified as low-risk. Indeed, many tax administrations are actively increasing levels of commercial awareness and industry specialization, and many auditors now have a better awareness of how business operates. These changes, taken together, take the form of what the OECD currently calls an “enhanced relationship” approach to tax compliance – in other words, cooperative compliance. This more open, transparent approach is typically accompanied by new pre-filing resolution programs and more robust domestic dispute settlement procedures.

“An enhanced relationship between a revenue authority and taxpayers is obviously beneficial to both parties” says Mr. Oupa Magashula, the South Africa Revenue Service Commissioner and Chairperson of the African Tax Administration Forum (ATAF), the grouping of tax commissioners, senior tax administrators and tax policymakers from 28 African countries. “It can and should lead to greater certainty and greater understanding of each party’s position. In this regard, the South African Revenue Service (SARS) was the first revenue administration in the world to enter into an accord with its banking industry, followed by Her Majesty’s Revenue and Customs (HMRC). This has resulted in a stronger relationship between SARS and the South African banking industry, but also in greater compliance, said Commissioner Magashula.”

2 Oupa Magashula, written statement to Ernst & Young, August 2012.
But such an enhanced relationship is unachievable when the underlying fundamentals to support it are missing, Commissioner Magashula explains. “There is not, however, always a fair and balanced approach to such ‘enhanced relationships,’” he says. “Frequently, corporations and industries appear to want to use such enhanced relationships for their own gain, but are less keen to accept the point of view of the revenue authority. In this regard, our experience has been sometimes that corporations seek a great deal of transparency, openness and clarity from the revenue authority, but are a lot less eager to show the same level of trust, openness and honesty with their information. Relationships between revenue authorities and taxpayers are like any other relationship – they must be equitable and both parties’ point of view should be taken into account. That doesn’t mean that the parties will not disagree on occasion. But in a strong and healthy relationship, these disagreements can be overcome through honest and open dialogue.”

Africa does not need to follow the same path of confrontation and conflict that characterizes the relationship between tax authorities and taxpayers in many OECD countries; there are better ways of structuring and managing this relationship. As Commissioner Magashula says, it is not easy, and it is a challenge to overcome a lack of trust. But the idea of a relationship that builds on openness and transparency is one that both tax administration and business would benefit from, especially in the complex area of transfer pricing. This balance must be found if Africa is to continue its stellar development and reap the ensuing rewards.

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United Nations Committee of Experts approves draft text of the Transfer Pricing Practical Manual for Developing Countries

On 4 October 2012, the United Nations (UN) released the draft text of the Transfer Pricing Practical Manual for Developing Countries (the Manual)1 and on 15 October 2012, the Committee of Experts approved it. The Manual reflects the thinking of developing countries – and also identifies the challenges faced by companies doing business within them – related to transfer pricing.

In 2009 the UN Committee of Experts on International Cooperation in Tax Matters instituted a Subcommittee on Transfer Pricing – Practical Issues, with the mandate to develop a practical manual on transfer pricing considering the arm’s length principle embodied in Article 9 of the UN Model Convention. The then envisaged Manual, in particular, had as its objective to consider and reflect the realities for developing countries at different stages of their capacity development, the specific experiences of developing countries and work done in other fora such as the OECD and African Tax Administration Forum (ATAF). The initial term of the mandate was extended to allow for presentation of a draft Manual for adoption during the eight annual session in October 2012.

The Subcommittee on Transfer Pricing – Practical Issues has met its goal and, on 4 October 2012, the UN released on its website a series of draft chapters of the Manual, which has now been approved.

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Purpose of the UN Manual on Transfer Pricing

The purpose of the UN Manual is to provide practical guidance to developing country governments, tax administrators and taxpayers. As such, the Manual has some notable differences compared to the OECD Guidelines. Like the OECD Guidelines, the Manual serves strictly as practical guidance, not as a legislative proposal or mandatory policy, and therefore much effort has been spent in trying to reflect complicated issues in a simple and clear fashion, in turn illustrated by many examples.

Considering its intended audience, the Manual serves mainly to educate its readers on a range of issues including:

- The business framework. How do MNEs operate and manage their transfer pricing?
- The general legal environment that needs to be considered when introducing transfer pricing legislation
- The importance of issues such as the burden of proof
- What considerations go into establishing transfer pricing capability in the administration of a country
- What transfer pricing methods are available and how they work in practice
- What system of transfer pricing documentation requirements can be used
- How transfer pricing audits and risk assessment can be conducted
- The importance of dispute avoidance and resolution options

The Manual’s chapter on comparability provides for extensive detail on how to conduct a functional analysis and how comparability screening should be conducted, including details as to how to apply adjustments. Obtaining comparables is seen in practice as one of the major challenges encountered in developing countries and therefore this issue is elaborated upon within the draft.
An additional notable aspect is the attention to location savings and location-specific advantages. From a developing country perspective, the Manual emphasizes that additional consideration should be given to the particular attractiveness that (developing country) markets offer companies doing business there and subsequent turnover generated from activities there. These items include the availability of relatively low labor costs and skilled people to render services but also the fact that there may be access to a large consumer force with spending power. This aspect is emphasized more specifically and as a particular developing country issue than currently included in the OECD Guidelines.

A significant difference from the OECD Guidelines is that the Manual includes a country-specific chapter, in which Brazil, China, India and South Africa all list either the transfer pricing system in place in their country (e.g., Brazil’s fixed margins system) or issues of particular concern for their respective jurisdiction (e.g., China’s location-specific advantages, India’s control over R&D activities and South Africa’s challenges with comparability and the high cost of foreign management services). According to the preamble to chapter 10, this chapter neither reflects input from the entire UN subcommittee nor overall consensus, but the country-specific subchapters are submitted by representatives of the respective country governments, as illustration of how they handle developing country-specific challenges under domestic law or under domestic audit approaches.

**Notable absences**

Notable by their absence are chapters on services, intangibles and business restructuring. Cost sharing and advance pricing agreements (APAs) are mentioned in passing, but are not yet detailed in any separate chapter(s). The Manual is seen as a work in progress, even now, after it has been adopted. It is expected that the Manual will be updated in a future phase and that services and intangibles will be high on the agenda to receive further guidance.

**Impact and considerations**

The whole issue of transfer pricing and the role of MNCs is high on the political agenda of many governments, as can be seen from the communiqué of the latest G20 summit (please see article on page 21) and the way that governments around the world are now focusing on how to help developing countries to build the capacity of their tax administration to deal with this and other tax issues.

The publication of the draft Manual undoubtedly heralds a fresh focus on transfer pricing by developing country revenue authorities themselves. Recent statements by a number of African commissioners also show that transfer pricing is high on their agenda. With their attention ranging from issuing new local legislation, building and refining auditing practices and capability and increasing enforcement resources generally, its existence – although a work in progress – provides taxpayers a new level of insight into the continuing evolution of transfer pricing practices in developing countries and offers a framework around which companies can continue to build their transfer pricing policies and administration in developing countries.

The Manual represents a most useful contribution to the transfer pricing debate and should help in encouraging governments to work together to find common solutions to practical problems that arise in the application of the arm’s length principle. The Manual may also assist in helping business to get more engaged in the transfer pricing debate, working with tax administrations in developing countries to help them overcome two important constraints that they face in auditing MNCs: finding sufficient information on comparables and auditing the transfer pricing of MNCs.
International tax quarterly update: the benefits to be gained from corporate simplification

The prevailing model of large and complex legal structures is under increasing pressure from a cost and efficiency perspective. Legacy structures lead to inefficient use of resources, value erosion and unnecessary direct and indirect carrying costs. Corporate simplification can remove costs and risks, helping companies in their transition to a higher value, more efficient legal structure.

Corporate simplification has a range of models. Legal entity reduction programs remove dormant and low value entities from the corporate structure. Legal entity rationalization involves a more strategic centralization of cost and profit centers into strategic hubs. The most significant target model is the move to a single entity structure in which a high value entity, with centralized control, profitability and management, operates in a geographic territory or area of business.

The transition and design of the target model involves multiple tax efficiency drivers. Detailed legal and tax analysis is a key part of the plan and tax optimization an important element of these projects. This webcast will discuss:

- Benefits of a corporate simplification program
- Potential target structures and issues arising on transition
- Tax and transfer pricing analysis required to achieve an improved target structure.

Access this webcast archive at www.ey.com/webcasts.
European Union update: quiet before the storm?

If 2011 was a year of resolute action and concrete proposals designed to bind the European Union (EU) around a set of shared goals in the area of taxation, 2012 could perhaps be characterized as a year when the best laid plans have been clouded by whether the EU would indeed exist in its current shape and form. Whether due to urgent and unplanned measures in individual countries, attempts at the center of the EU to create a platform of shared tax characteristics or the exhortations of leaders of the EU to pull together in a time of crisis, the status and direction of common tax policy is perhaps harder to discern than ever before. On the topic of Europe’s Financial Transactions Tax (FTT) though, recent events have shown that the FTT is now closer than ever to becoming a reality.

Frustration with the state of the union has not been lost on its leadership; at the Conclusions of the European Council of 28–29 June 2012, a communiqué stated:

“Tax policy should contribute to fiscal consolidation and sustainable growth. Work and discussions should be carried forward on the Commission proposals on energy taxation, on the common consolidated corporate tax base and on the revision of the Savings Tax Directive. As noted at the [Ecofin] Council on 22 June 2012, the proposal for a Financial Transaction Tax will not be adopted by the Council within a reasonable period. Several Member States therefore will launch a request for an enhanced cooperation in this area, with a view to its adoption by December 2012. The Commission is pursuing work on concrete ways to improve the fight against tax fraud and tax evasion and will soon present an Action Plan including options to that end. Rapid agreement must be reached on the negotiating directives for savings taxation agreements with third countries. Member States participating in the Euro Plus Pact will continue their structured discussions on tax policy issues, notably to ensure the exchanges of best practices.”
Deciphering the message

In concrete terms, this means that two of the major tax proposals on the Council table – the Common Consolidate Corporate Tax Base (CCCTB) and the Energy tax proposal – will continue to be discussed at length in the Council working group. Given their inherent complexity, the CCCTB discussions will likely continue for some considerable time. As for the energy tax proposal it appears that the ambitions of the EC proposal are being watered down, particularly because very few Member States appear to be in favor of splitting the tax base into two separate elements – one based on carbon emissions and the other on energy content.

Discussions are also getting underway in the Council on the EC’s recent and long-awaited proposal on the VAT treatment of vouchers – an area that has evolved considerably, and where there are no clear existing rules.

Financial Transactions Tax

The EU long-disputed FTT moved a step closer to introduction on 9 October 2012, as 11 EU Member States requested its introduction via the EU’s seldom-used “enhanced cooperation” process.

EU Taxation Commissioner Algirdas Šemeta said at the conclusion of the recent EU finance minister’s meeting in Luxembourg that the EC will make a proposal to the European Council for the enhanced cooperation procedure to be approved at the next meeting of EU finance ministers in November.

It is expected that the proposal will be largely based on the EU Commission’s Directive proposal published in September 2011 for a broad-based FTT, as opposed to a narrow-based tax like the UK stamp duty. Effectively, the levy would be introduced on the purchase and sale of financial assets and all derivative transactions.

Introduction of the Directive in all 27 European countries (including the 17 Eurozone countries) failed earlier this year after significant disagreement among Member States, most notably the United Kingdom and Sweden. Germany and France had been encouraging other Member States to support the enhanced cooperation process in recent weeks, including sending a joint letter to all countries. The days running up to the Luxembourg meeting saw a series of letters from individual Member States confirming their support, with a total of 11 Member States (exceeded the required nine) voicing their support. The 11 countries are Austria, Belgium, France, Estonia, Germany, Greece, Italy, Portugal, Slovenia, the Slovak Republic and Spain.
It should be noted that all Member States have a say in whether to authorize the enhanced cooperation process proposed by the EC, with a qualified majority of member country votes needed for that authorization to be granted. A number of Member States — importantly, with more than the 91 (of 345) votes required to constitute a ‘blocking minority’ under the EU’s qualified majority voting procedures — have already indicated that they will be looking carefully at the scope and potential impact of the proposed enhanced cooperation for the FTT before giving it authorization to proceed. Member States not satisfied that the conditions required to allow proposals to proceed under enhanced cooperation may choose to vote against the enhanced cooperation on those grounds, and it may be necessary for the terms or scope of the proposed FTT to be amended before it gains approval, even at this procedural stage.

A German EU diplomat close to the EU Finance Ministers’ consultations said: “We are hoping to achieve the enhanced cooperation by the end of this year.” Although more than a year has elapsed without major progress since the EC’s directive proposal in September 2011, an implementation of the FTT may yet be possible in January 2014 as originally envisaged. “One year as a period to prepare for the implementation seems not to be too short,” said Austrian Finance Minister Maria Fekter at the meeting’s conclusion.

This news means that the FTT is one step closer to becoming a reality. Accordingly, political developments now require close monitoring by the business community, and companies should revisit economic and fiscal scenario planning related to the potential implementation of the tax. The impact of an FTT, if introduced, can be expected to be felt beyond the financial services industry (as it could affect group treasury operations), as well as in countries outside of the Members States adopting the proposal – for example where a counterparty based outside one of the Member States enters into a transaction with a person/institution resident in one of the Member States.

**Procedure**

Now that these recent events have unfolded, it is well worth spending some time setting the procedure for adopting a legislative measure by enhanced cooperation. The procedure involves a number of steps not only confined to those countries who will participate in the eventual measure.

First, those Member States wishing to establish an enhanced cooperation between themselves are required to make a request to the EC (as France and Germany have now done) specifying the scope and objectives of the enhanced cooperation proposed, and there must be at least nine Member States signing up to such a request. The enhanced cooperation must fall within one of the areas covered by the European Treaties and must be used only as a “last resort” – i.e., it must be clear that the measure would not be adopted within a reasonable time by the EU as a whole. It cannot include areas that fall under the exclusive competence of the EU. This would already, for example, rule out any FTT proposal intended to raise resources for the EU Budget. The EC also has to be satisfied that a number of other conditions for enhanced cooperation laid down in the EU treaties are satisfied. These conditions are:

- It must not undermine the internal market or economic, social and territorial cohesion.
- It must not constitute a barrier to or discrimination in trade between Member States.
- It must not distort competition between Member States.
- It must respect the competences, rights and obligations of those Member States who do not participate in it.
If satisfied that the scope and objectives of the proposed enhanced cooperation meet those conditions, the second step is for the EC to make a proposal to the Council for the enhanced cooperation procedure to be approved. The EU Commissioner for taxation has already indicated he will give favorable consideration to a request for enhanced cooperation relating to an FTT, so it can be assumed that, if requested by sufficient Member Countries, the EC will indeed make this proposal to the Council, which is likely to come to the ECOFIN Council at the very earliest for its meeting on 9 October.

Third, all Member States have a say in whether or not to authorize the enhanced cooperation process proposed by the EC, with a qualified majority of member country votes needed for that authorization to be granted. A number of member countries – importantly, enough to constitute a blocking minority under the EU’s qualified majority voting procedures – have already indicated that they will be looking carefully at the scope and potential impact of the proposed enhanced cooperation FTT before giving it authorization to proceed. Member countries not satisfied that the conditions set out above are met may choose to vote against the enhanced cooperation on those grounds, and it may be necessary for the terms or scope of the proposed FTT to be amended before it gains approval, even at this procedural stage.

A further potential hurdle for an enhanced cooperation process to proceed is the choice of the Treaty area – the “legal base” – under which the eventual FTT will be adopted. The legal base for the EC’s 2011 FTT proposal was Article 113 of the Treaty on the Functioning of the European Union (TFEU), which covers harmonization of legislation concerning indirect taxes (such as the FTT has been categorized) to the extent that such harmonization is necessary to ensure the establishment and the functioning of the internal market and to avoid distortion of competition. It is, of course, arguable that an FTT adopted by less than the full 27 member countries cannot by definition be necessary for the functioning of the internal market or would avoid distortion of competition. An alternative suitable legal base in the European treaties is not obvious.

Non-participating countries have a say, too

Overall, the right of non-participating member countries to vote on whether, procedurally, an enhanced cooperation should go ahead gives them a certain degree of influence over the substance of any enhanced cooperation measure, even though they will not participate in it. In the context of the FTT proposal, this could, for example, lead non-participating Member States to insist on the removal of the “extraterritorial” elements of the EC’s 2011 FTT proposal, whereby financial institutions in non-EU countries would be deemed to be established in the EU, and subject to the Directive, as a result of transactions with financial institutions or other parties established in the EU in the ordinary sense of that test. It could also lead to calls for the FTT to be adopted by enhanced cooperation to be confined to the least potentially mobile transactions – such as stamp duties on shares levied by reference to the registered office of the company – in order to reduce the scope for potential distortion of competition between Member States. Additionally, there are likely concerns on the part of non-participating countries that an introduction via the enhanced cooperation route, when combined with national measures already in existence, would lead to double taxation, which could therefore have an impact on sovereign taxing rights. For example, it is possible that the introduction of an FTT – in broadly the form proposed by the EC in 2011 – among, say, Eurozone countries and combined with UK stamp duty reserve tax could lead to effective double (or multiple) taxation on trading in UK equities. This too could influence the detail of the measure to which the Council gives its approval.
Clearly, the timescale of such an enhanced cooperation process will very much depend on the nature of whatever FTT model is proposed and the scope of a European FTT will be shaped by a combination of legal and political pressures.

In reality it is highly unlikely that the demands of non-participating Member States will be sufficient to prevent some version of FTT going ahead by those wishing to participate, even though they may seek to restrict its scope or delay its introduction. It is also worth noting that Member States who are outvoted at the stage of approving an enhanced cooperation procedure may still continue to challenge the enhanced cooperation in proceedings before the European Court of Justice, as for example Spain and Italy have done in relation to the European patent enhanced cooperation.

The design of an FTT will also need to take into account the risk of legal challenge by disgruntled taxpayers. In this context, we note that, for example, the British Bankers’ Association (BBA) has already expressed doubts on whether imposing an FTT within a subset of EU Member States would be compatible with the EU treaty “fundamental freedoms” designed to maintain a single market.¹

The consent of the European Parliament is also required for the enhanced cooperation process to proceed. Although the European Parliament has strongly advocated a European FTT and has indicated a willingness to support enhanced cooperation, its consent could also depend on the scope of the proposed FTT envisaged by the enhanced cooperation countries.

On the assumption that the EC’s proposal wins Council approval – or does so subject to amendments in the scope and objectives of the proposed enhanced cooperation that have been agreed under the Council’s voting procedures – the fourth step will be for the EC to put forward a proposal for the enhanced cooperation measure itself. This substantive FTT proposal – which, for the reasons outlined above, is likely to be narrower in scope than the EC’s 2011 FTT proposal – would then be subject to the EU’s normal legislative processes, with the key difference that only participating member countries would have the right to vote.

This means that a legislative proposal would be made to the ECOFIN Council – likely to be in November 2012 at the absolute earliest – then discussed in the Council working group and at one or more meetings of the ECOFIN Council itself, as well as in the European Parliament, before being ready for adoption. These procedures take time, with the possibility of further revisions to the legislative proposal throughout the process, until a measure that satisfies all participating countries, the European Parliament and the EC is arrived at. Implementation of any measure adopted through this process therefore looks highly unlikely any time before late 2013 or early 2014, rather than by the end of 2012.

Clearly, the timescale of such an enhanced cooperation process will very much depend on the nature of whatever FTT model is proposed and the scope of a European FTT will be shaped by a combination of legal and political pressures. On one hand, a European FTT in the form of the 2011 proposal is likely to be supported by the EC, the European Parliament and others who favor a sweeping and hard-hitting tax. On the other hand, a European FTT that is more closely modeled on, say, a UK stamp duty reserve tax or the French financial transaction tax that came into force on 1 August 2012 may attract the support of a wider group of Member States and, in all likelihood, be more robust from an EU law perspective. At the time of writing, debate on the likely broad model for a European FTT, and on the precise tax base and exemptions of such a tax, is still ongoing. Even once these primary design issues are settled, there remain questions as to how any European FTT should take account of the different legal systems that govern the transfer of those securities potentially affected, as well as the practical and operational aspects, such as clearing and settlement, which vary between different Member States.

Tax fraud and evasion

In the midst of these discussions, the EC also recently published a communication on concrete ways to reinforce the fight against tax fraud and tax evasion. In itself, this communication contained little that was new or revolutionary, but it does come at a time when the G20 and OECD are also stepping up their fight against tax evasion. The communication does foresee as a next step the publication before the end of 2012 of an action plan that will have three distinct goals:

- To enhance administrative cooperation and support the development of the existing good governance policy within the EU
- To establish a set of measures, procedures and tools for coordinated action against tax havens that is likely to include a mixture of defensive measures or sanctions against countries that practice unfair tax competition and incentives for those countries to cease such practices
- To put forward proposals for tackling aggressive tax planning

Clearly this is an area within which much momentum is seen; indeed, witness the OECD and EU seemingly simultaneous reports on double non-taxation (about which you can read more on page 34) This promises to be an interesting trend that, along with deciphering messages around further harmonization, promises to be a key area that readers are advised to add to their bedside reading list.

Information reporting and withholding

The US Treasury and IRS continue to provide guidance on many of the specifics of the Foreign Account Tax Compliance Act (FATCA). When fully implemented, FATCA will apply to every company, yet will have widely disparate impact depending on the industry, business operations and corporate footprint of the company. Join our panelists as they discuss:

- FATCA framework from both the payor and payee perspective
- Methodology entities are using to understand the impact of FATCA on their organizations as well as plan for what they will need to do in the months ahead
- The practical impact of the anticipated convergence of FATCA and NRA/1441 rules on existing processes
- General discussion of timeline and open issues that the expected guidance will address

Access this webcast archive at www.ey.com/webcasts.
Around the world uncertainty continues to impact the tax landscape, overlaying and sometimes clouding broader tax trends. Whatever their source, these new uncertainties impact the global enterprise and the tax function, sometimes unexpectedly and dramatically, as demonstrated by the series of urgent and unplanned policy actions in the Eurozone.

Outside Europe, nations continue watch unfolding events with hawk-like vision, making efforts to reduce deficits in readiness for potential contagion by increasing the tax burden and improving collection. As a result, tax enforcement continues its dramatic rise, with the focus now onto perceived aggressive tax planning by corporations. Anti-abuse measures are proliferating as a result and countries are moving more rapidly to shore up tax base erosion caused by the rapid and profound globalization of business.

Underlying these rapid changes, longer term trends continue to play out and impact the enterprise; corporate tax rates continue to fall and countries look towards territoriality, increasing the pressure on the United States to execute an international tax reform package, while indirect taxes continue their seemingly inexorable rise, whether as an immediate policy tool of choice in some countries, or a new way to tax in others.

In his opening remarks, Stephan Kuhn, Ernst & Young’s Tax Leader for Europe, the Middle East, India and Africa, described a model which views the shifting landscape through the four lenses of globalization, shifting economy, rapid and significant tax legislative change and a changing model for tax administration. After covering the broader economic landscape and globalization trends, Stephan then turned the conversation over to a panel of Ernst & Young tax leaders – about whom you can read more in the box – who discussed the tax impacts in greater detail. What follows are some of the key remarks from this session.

**About our panel**

- **Stephan Kuhn** (moderator) is Ernst & Young's Europe, Middle East, India and Africa Tax Leader.
- **Chris Sanger** is Ernst & Young's Global and EMEIA Tax Policy Leader.
- **Jeffrey Owens** is senior policy advisor to Ernst & Young's Global Vice-Chair of Tax Services.
- **Debbie Nolan** is Ernst & Young's Americas Tax Controversy Leader.
- **Klaus von Brocke** is Ernst & Young’s EU Direct Tax Leader.

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**Selected comments from the opening plenary session at Ernst & Young’s European Tax Symposium**

Lisbon, Portugal – 14 June 2012
Stephan Kuhn: As capital flows are reshaped and cross-border transactions dramatically increase, the impact on taxation has been ground breaking. Governments, at the same time as they are dealing with massive economic and financial stresses, have to decide how to react to globalization from a tax policy perspective. They are “jockeying for position” in the new world order, and they are asking the people who police their policies – the tax administrators – to suddenly view the world through a global lens. So let us focus in more intently on these tax impacts and ask our panel to share with us their insights on what it all means. Jeffrey, can you help us start to make sense of how the world of tax is changing? Who are the winners and losers?

Jeffrey Owens: If I could identify who winners are going to be, I don’t think I’d be sitting here! But to answer your question of “What’s been driving policy?” I don’t think it’s very difficult to identify the drivers. Governments are facing a conflict. On one side, they need more competitive tax systems because they know the long-term answer to the crisis we are facing is growth, especially employment growth, because that will reduce the needs of public expenditure and it will increase tax. So the first thing they have to do is they have to produce a competitive tax system.

The second thing is, in the short term, they need money. That’s why we’ve seen a number of countries putting in revenue increasing measures, generally on the VAT side, and we’ve also seen higher earners paying more personal income taxes.

The third thing is more compliance. Governments have had to reconcile making a tax system competitive, raising revenue and also showing their citizens that the gains and the pains from globalization are being fairly shared. Because when you look at the figures today, the growing inequality in Europe, the United States, China and India, we can’t continue like that because inequality undermines social cohesion and when you don’t have social cohesion, your economies don’t function well. So there are a lot of conflicts that governments are facing.

There’s also the whole debate of what I call “How do we share the pie?” Who gets what? How do we share the multinational tax base? That’s a debate that’s become more difficult to handle because we’ve got new players around, newly influential countries. Stephan, you talked earlier of the BRICs, the next generation of BRICs, the Vietnamese, the Philippines, the other countries that are emerging. We’ve also got new organizations on the scene. A renewed, more active United Nations, the OECD’s Forum on Tax Administration and many others representing other regions. And we’ve got a new type of multinational company that is acting truly globally. So trying to address this question of how we actually share the tax base is going to be more difficult. So, I think, we are going into a period of flux. I think your lives (as tax directors) are going to be more stressful.

But there is good news. Governments can use this crisis to put in growth friendly tax reforms. To me, the test case is going to be the United States. If they can have fundamental reform next year that improves their competitiveness, that raises tax revenue – and they are going to have to raise tax revenues, because you can’t get the deficit down just by expenditure cuts – if they can do that, and produce a fair tax system, that would send such a strong signal to the rest of the world that it can be done if you have political support.

A three-year tax scorecard

Stephan Kuhn: That’s an interesting macro picture, Jeffrey. Let’s dig into the detail a little more; if we look back at the last three years – a scorecard, you might call it – what trends have we seen? And what do those trends tell us about where the world is heading next? Of course, a headline trend is that corporate tax rates have gone down. But at the same time, the corporate tax base is expanding, which increases the tax burden. We still see a shift towards territorial taxation, and we only have three large countries left who still insist on worldwide taxation. We see, in general – but with some notable exceptions – that CFC rules are being tightened. We can also see the shift to more indirect taxes playing out, with higher headline rates and fewer exemptions. Interest deductibility and thin capitalization also stand out as ways in which governments are tightening the reins. Klaus, give us your thoughts on what’s going on with corporate tax.

I don’t think it’s very difficult to identify the drivers [of policy]. Governments are facing a conflict. On one side, they need more competitive tax systems because they know the long-term answer to the crisis we are facing is growth, especially employment growth, because that will reduce the needs of public expenditure and it will increase tax.
“I think you’re right, the “easy move” has already happened. If I look to the UK, they have slashed their rate from 28 down to 22 eventually, and I personally think it will get further, probably about 20, but not much more than that. But to start with, they did it by widening the tax base, reducing reliefs, and therefore the total tax stayed the same. But that’s gone.”

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<td>United Kingdom</td>
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<td>24.0</td>
<td>(20.0)</td>
</tr>
<tr>
<td>United States</td>
<td>39.4</td>
<td>39.0</td>
<td>(1.0)</td>
</tr>
<tr>
<td>BRIC</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>34.0</td>
<td>34.0</td>
<td>–</td>
</tr>
<tr>
<td>Russia</td>
<td>35.0</td>
<td>20.0</td>
<td>(42.9)</td>
</tr>
<tr>
<td>India</td>
<td>42.0</td>
<td>32.5</td>
<td>(22.6)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Foreign cos. 42.2</td>
<td></td>
</tr>
<tr>
<td>China</td>
<td>33.0</td>
<td>25.0</td>
<td>(24.2)</td>
</tr>
</tbody>
</table>

**Klaus von Brocke:** We’ve seen a tremendous decline in headline corporate tax rates among the OECD and some other countries in the last few years. The chart speaks for itself. In fact, 90% of the OECD countries in the last 12 years have reduced their corporate tax rates and some quite dramatically. But of course, that’s only the newspaper headline, you need to read on into the detail to understand the whole picture of how the tax base is being expanded and how countries are becoming more and more territorial. That said, I think this trend of falling headlines rates may well be coming to an end, except for a few countries such as the UK who still seem to be traveling in that direction. From what I’ve heard recently from many countries is that we are now just starting to see a shift in the other direction. Sweden and Chile have both announced changes, and notably now one of the flat tax countries, the Slovak Republic, recently announced a tax increase.

**Jeffrey Owens:** The two countries you referred to are countries that already had relatively low corporate taxes, so I think what we are seeing is a hiccup. Competitive pressures will continue to push corporate taxes down, and people will be looking at what happens in the US. We have to watch what happens, because Europe will have to think about how it reacts if there’s a fundamental reform that makes the US more competitive, because by definition, that makes Europe less competitive.

**Chris Sanger:** This is going to be an interesting one to watch, because a lot of the rate reductions have almost been “free” for the governments because, at that same time, they’ve broadened the tax base. So I think you’re right, the “easy move” has already happened. If I look to the UK, they have slashed their rate from 28 down to 22 eventually and I personally think it will get further, probably about 20, but not much more than that. But to start with, they did it by widening the tax base, reducing reliefs, and therefore the total tax stayed the same. But that’s gone. The new prediction is that there’s a share of total tax, corporate taxes go down from 11% to 8% in the UK. So it’s now beginning to hurt, and I think that’s now getting to a question where governments will have to think twice about where tax rates go. The low-rate broad base is clearly the economic message that came from Jeffrey during his time at the OECD, and governments have understood it. But, that’s kind of the easy move and I think one that’s happened already.

**Top 10 countries with most Fortune global headquarters**

<table>
<thead>
<tr>
<th>Countries with worldwide tax regimes</th>
<th>2012 statutory corporate tax rate*</th>
<th>Taxation of foreign-source income</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>39.0%</td>
<td>Worldwide with deferral and foreign tax credit</td>
</tr>
<tr>
<td>China</td>
<td>25.0%</td>
<td>Worldwide with deferral and foreign tax credit</td>
</tr>
<tr>
<td>Korea</td>
<td>24.2%</td>
<td>Worldwide with deferral and foreign tax credit</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Countries with territorial + exemption tax regimes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
</tr>
<tr>
<td>France</td>
</tr>
<tr>
<td>Germany</td>
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<tr>
<td>Italy</td>
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<tr>
<td>UK</td>
</tr>
<tr>
<td>Netherlands</td>
</tr>
<tr>
<td>Switzerland</td>
</tr>
</tbody>
</table>

*Includes both national and sub-national statutory corporate tax rates
**Includes temporary two year surtax in 2013/14
***Includes temporary surtax. Tax rate will decline to 35.64% in 2015.
That means you've got to move to a territorial regime. It imposes a cost that is commensurate with the benefits it brings. Europe, or Japan into Asia Pacific, it needs to make sure that it is attractive and want to be the gateway, such as the UK into

and the UK full exemption, all is that if a country is going to be attractive and want to be the gateway, such as the UK into

in that country. What we've seen with Japan's partial exemption and the UK full exemption, all is that if a country is going to be attractive and want to be the gateway, such as the UK into Europe, or Japan into Asia Pacific, it needs to make sure that it is imposing a cost that is commensurate with the benefits it brings.

That means you've got to move to a territorial regime.

But what is territorial? You've got the question of dividends coming in. That's fine. But all the moves we are seeing around interest deductibility and CFC's are all part of this too. So there's a much bigger story, I think than just whether you are in a world-wide system or just taxing on an exemption basis.

It's a question of “where do you want to be on the spectrum?” It's not a choice of pure territorial or pure worldwide. It's where do you want to be, in the middle? To the left side or to the right?

And that's all intended to make people want to come to the UK. But the big thing that's going as a counter-trend to this, I think, is interest deductibility. The European master plan for a corporate tax system, the CCCTB, is now being proposed to have some restrictions on interest deductibility, very much akin to the ones we see in Germany. That's designed to make sure that you are only getting relief for interest against your activities that are undertaking in country. So it fits very much with the territorial regime.

But the UK approach is actually completely the opposite. One of the Ministers said he wants to make the tax system once again an asset to draw businesses to the UK. So the UK on interest deductibility is saying, “We can have your whole global interest deduction in the UK, even if it's funding activities outside of the UK”. So we are seeing two very different trends play out.

We've now got many European countries looking at a kind of austerity package, trying to control the deduction, perhaps using that to fund lower tax rates. But then you've got the UK at the edges of Europe saying, “We're going to use this as an attractive tool to bring business.” I think this will be really interesting to watch play out, because you have got two very different trends. The UK almost being the only outlier there, and whether more come to its side or whether they follow the recommendations of the European parliament and the CCCTB model, I think is something that's going to be really important for companies around Europe.

**GAAR rising**

**Stephan Kuhn:** Jeffrey, back to you, we see also a trend that there are more anti-avoidance rules being proposes and enacted, particularly in the area of General Anti-Abuse Rules (GAAR). What are you seeing?
Growing number of GAAR administered by the tax authority is in question and leaves a lot of uncertainty. So you might have about whether GAAR is anti-avoidance or anti-abuse lends uncertainty. Debbie Nolan: I think just the discussion and the debate that we are seeing in the context of offshore transfers. So this debate is not going to be limited to one country. I think that's where it is going to end up, as it happens. The second thing that's important to recognize is that there is a different group of countries coming on the scene now and saying, “Maybe we should do this.” You look at the diversity. You know, on the one side you have India and then on the other, the UK. Two very, very different countries. But my expectation is that we will see more and more countries actually going down this path, in part because they see this is the way to counter abusive schemes, in part because, I think, they are just afraid. They are afraid of whether they can keep up with tax planning or not.

The other thing that's important is to recognize, and this comes back, Chris, to a point you raised earlier, is public perception. The other thing that's important is to recognize, and this comes back, Chris, to a point you raised earlier, is public perception. Jeffrey Owens: You know, I can't resist it when someone says GAAR to me, it sounds aggressive already! A few points though; one, GAARs have been around for a long time. What's interesting is that there is a different group of countries coming on the scene now and saying, “Maybe we should do this.” You look at the diversity. You know, on the one side you have India and then on the other, the UK. Two very, very different countries. But my expectation is that we will see more and more countries actually going down this path, in part because they see this is the way to counter abusive schemes, in part because, I think, they are just afraid. They are afraid of whether they can keep up with tax planning or not.

The second thing that's important to recognize is that there is not one single, unique model for GAAR. You have other GAARs that are primarily directed at dealing with both tax evasion and tax avoidance. On the question of indirect transfers of assets, again we are all tending to focus on India, but let's get real – there are other countries. China has a very similar provision in Circular 698 and they are beginning to use it.

What's been interesting is that a number of OECD countries are looking at India and saying, “Maybe they have a point. What would I have done if I were the Indian tax authority?” It's actually surprising that they went it alone and didn't go to the OECD and said, “Let's have a general rule.” That way, you multi-lateralize it and I think that's where it is going to end up, as it happens.

So this debate is not going to be limited to one country. I think there's going to be a debate in how do we deal with these types of offshore transfers.

Debbie Nolan: I think just the discussion and the debate that we have about whether GAAR is anti-avoidance or anti-abuse lends itself to a considerable amount of uncertainty. So you might have legislation or even a policy that introduces a GAAR, but how it's administered by the tax authority is in question and leaves a lot to be desired as far as guidance and controls.

Jeffrey Owens: You know, I can't resist it when someone says GAAR to me, it sounds aggressive already! A few points though; one, GAARs have been around for a long time. What's interesting is that there is a different group of countries coming on the scene now and saying, “Maybe we should do this.” You look at the diversity. You know, on the one side you have India and then on the other, the UK. Two very, very different countries. But my expectation is that we will see more and more countries actually going down this path, in part because they see this is the way to counter abusive schemes, in part because, I think, they are just afraid. They are afraid of whether they can keep up with tax planning or not.

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Indirect taxes, transfer pricing

Stephan Kuhn: So, a lot of change is happening in a lot of different areas. I think to end up the discussion around what legislation changes will we see, I'll return to you, Jeffrey, and ask, How much of a further shift to indirect tax will we see? And of course, we'd be missing a hot topic if we didn't cover how the transfer pricing environment might change in the coming years.

Jeffrey Owens: In indirect taxes we have definitely gone through a revolution. In two generations, we've moved from six countries having a VAT to more than 160. It can't be that bad. It's not fool-proof but, for government, it's a money-making machine. So not only have you seen more and more countries actually putting in a VAT but, in terms of the way countries are responding to the crisis, the primary tax response has been to increase VAT. I think it's unfortunate that they have chosen to increase the rates, rather than look at the base, because I don't think it's viable to have VAT rates at 25% that puts enormous pressure on the system. One of the things I would like to see, and you as the business community can help us, just as the non-EU countries learnt from the experience of the EU in the design of VAT, why can't we reverse the process? Why can't we look at South Korea? Why can't we look at Chile? Why can't we look at New Zealand or Singapore and say, “What can we learn from them in the design of VAT?” Because if we did, we certainly wouldn't design the VAT as we have it today.

The other thing that's important is to recognize, and this comes back, Chris, to a point you raised earlier, is public perception. Because when you talk about VAT, you commonly hear the argument that “it's regressive.” But actually, it's not that that regressive, and you can design it in a way to reduce the regressivity. And secondly, that's probably the wrong point to make – or at least make first. If you are concerned about the way inequalities are growing, then the key question to ask is not whether a particular tax reduces inequality, not even whether the tax system reduces inequality, but does the tax benefit system do that? We need to shift the political debate because otherwise, we're going to be blocked in further progress on VAT.

Chris Sanger: Many people looking at VAT actually seem to assume this is a tax on the individual paying for the goods. Actually, it's just a tax on the production of the goods, much like corporation tax. I think the focus we're seeing on the global shift to indirect taxes is actually aggravating some of the tax activism we're seeing.
“So in a sense, I think you can hold the OECD responsible for the spread of the arms length principle, but now we need to follow that up by helping these countries to actually be able to apply it. And when I say “we” that means, I'm not slipping back into my former role at the OECD, but I mean we as the tax profession and you as taxpaying businesses.”

Stephan Kuhn: Let's turn to transfer pricing. Being fresh from the OECD, can you give us an overview of where things are heading and what the focus points are in this area, Jeffrey?

Jeffrey Owens: I think we've spent more than 25 years refining the guidelines. When we did the '79 guidelines, it was a publication of a relatively tiny size compared to where it is today. It was actually written in very nice English. Today I think very few people actually read the guidelines, because it just got too complex. I think what the OECD has decided is that the way to go isn't to simply keep on refining but, rather, to simplify. The discussion drafts that were put out ten days ago are taking us in that direction. It's saying, “Can we make it simpler? It's never going to be simple, but can we make it somewhat simpler? Can we put an emphasis on how we administer these rules? Can we strip out routine transactions? That would enable us to then focus on the really difficult things. Can we actually review the position and the guidelines on safe harbors? So from that perspective, I think there's some good news coming out of here. It should make your lives, as tax directors, a little bit easier, because the emphasis is shifting, not from refining the guidelines, but rather to making them easier to apply in practice.

On the second point you raise, and I think this is particularly relevant for economies in transition and developing countries, the OECD has done a great job in selling the idea of the arms' length principle. But you can’t go into a country and spend one day with them, trying to help them understand the rules and then walk away and then they say, “Ok, now we've got transfer pricing rules and we'll apply them.” Particularly when those countries don't have mechanisms in place to resolve disputes.

So in a sense, I think you can hold the OECD responsible for the spread of the arms' length principle, but now we need to be follow that up by helping these countries to actually be able to apply it. And when I say “we” I'm not slipping back into my former role at the OECD, but I mean we as the tax profession and you as taxpaying businesses. Business has to get engaged in the process of educating and helping tax administrations in developing countries to apply the arms length principle.

Debbie Nolan: We've seen that, too, in Latin America, exactly what you've described, where a country has now suddenly gained energy around transfer pricing. There’s recognition around the world that that's a revenue raiser for many countries but, if they don't have dispute resolution processes, or they don’t have tax treaties, then companies get caught in the middle. I think its incumbent on those tax authorities also to engage with external stakeholders to ensure that it's administered fairly. There are some countries that are willing to do that and other countries who are not.

But, you know, when you think about transfer pricing, you think about the OECD as being the key influencer over that, but there are many other organizations coming on the scene to influence transfer pricing. The U.N., IMF, World Bank, CIOT, CIAT ... .

Chris Sanger: But there does seem to be a growing perspective that the system isn't delivering for everybody, and possibly, for anyone. It's not really delivering for governments. It's not really delivering for corporates, because corporates are spending a lot of time focusing on doing transfer pricing reports for areas that are ultimately low risk. Governments are then looking at this then and thinking we need to go and investigate, I think that's going to be really a quite a seismic change over the next few years as we see this develop.

Debbie Nolan: One positive thing is that there are a lot of countries that are implementing advanced pricing agreement programs – perhaps even before they have created really robust transfer pricing administration, because they recognize that having rulings with large companies and agreements up front can be in the best interest of the government as well as the company. Even in the United States there's a reengineering of the advanced pricing agreement program, combining that with requests for competent authority assistance to make it more efficient. So there's a lot happening that's positive in this area.

In our next edition, follow a similar discussion from Ernst & Young’s 2012 Asia Pacific Tax Symposium where panelists will discuss the constantly changing tax administration and tax enforcement landscape.

How globalization, economy drive tax policy

Transfer pricing

- Transfer pricing as a leading risk by tax executives, policymakers and tax administrators in Ernst & Young's 2011-12 tax risk and controversy survey
- OECD transfer pricing guidelines long accepted as the “international standard” – but there is growing pressure from emerging markets concerned about base erosion
  - United Nations work
  - India’s letter to the United Nations
  - African Tax Administration Forum
- OECD shifts emphasis towards simplification of rules
On 26 July 2012, the US Treasury Department issued the first model for an intergovernmental agreement (IGA) for complying with the Foreign Account Tax Compliance Act (FATCA) provisions. The Model IGA, which includes a reciprocal version and a non-reciprocal version, was issued following negotiations between the United States and France, Germany, Italy, Spain and the United Kingdom. These countries had issued a Joint Statement on 8 February 2012, contemporaneous with the release of the proposed FATCA regulations, regarding their intention to develop an intergovernmental approach to implementing FATCA.

The Model IGA provides that an IGA between the United States and a FATCA Partner jurisdiction will take effect on the later of 1 January 2013 or the date the parties have notified each other that any required internal procedures for entry into force have been completed.

The Model IGA reflects the approach described in the joint statement whereby foreign financial institutions (FFIs) will report information on certain account holders to their national tax authorities, which in turn will provide such information to the United States under an automatic exchange of information.

Under the reciprocal version of the Model IGA, the United States will provide information to the tax authorities of the FATCA Partner jurisdiction on a reciprocal basis with respect to accounts of nationals of the FATCA Partner in the United States. In contrast, the non-reciprocal version of the Model IGA does not involve any provision of information by the United States to the FATCA Partner jurisdiction.

Read our full alert at http://www.ey.com/FATCAintergov.
International transfer pricing update: Ernst & Young global transfer pricing tax authority survey

In this webcast, we present an overview of our 2012 global transfer pricing tax authority survey, which provides insights of tax authorities in 48 transfer pricing jurisdictions. The survey presents trends and recommendations for dealing with your organization’s transfer pricing issues, addressing the following topics:

- The standards tax authorities currently apply to evaluate intercompany transactions
- The transactions and industries tax authorities target
- Tax authority attitudes to local versus regional comparables
- Tax authority approaches to comparables adjustments
- Coordination between transfer pricing and indirect tax enforcement
- Individual country developments of interest

Access this webcast archive at www.ey.com/webcasts.
In March 2011, Argentina formed a governmental commission to review the country’s existing treaties and their effects on taxation. Based on that review, Argentina recently decided to terminate three out of its existing 17 tax treaties, all of which have been in force for many years.

Until the end of 2011, Argentina had 17 comprehensive tax treaties in force, alongside many others that deal only with double taxation in international transportation. Of the 17 treaties, the ones with Chile and Bolivia were based on the Andean Pact Model. The remaining 15 – with certain variations based on the OECD and UN Models – were with Brazil, Canada, Australia and 12 European countries: Belgium, Denmark, Finland, France, Germany, Italy, Netherlands, Norway, Spain, Sweden, Switzerland and the United Kingdom.
The three treaties terminated in 2012 are those with Switzerland, Spain and Chile. Each treaty had particular benefits that the Argentine government believed had been excessively used to reduce taxes.

**Termination of treaty with Switzerland**

Among Argentina’s tax treaties, the treaty with Switzerland included some of the most beneficial clauses for foreign investors, such as an exemption from the personal assets tax on the holdings of Swiss residents in Argentine companies, and reduced withholding tax on royalty and interest payments from Argentine residents to Swiss residents.

This treaty was the only one in force on a provisional basis — since 1 January 2001 — because it had not been approved by the Argentine Congress. The Argentine government issued on 16 January 2012 a note to the Swiss Ambassador in Argentina communicating its intention of not being a party to the treaty. The decision to suspend the treaty’s provisional application was published in the Official Gazette on 31 January 2012.

The official intention appears to suspend the provisional application of the treaty as from 16 January 2012. This suspension disregards the treaty’s termination clause in light of the fact that it had never fully entered into force but was applicable on a provisional basis. However, this immediate termination is subject to controversy.

In the note, the Argentine government proposed to the Swiss government to enter into an Exchange of Information Agreement for tax purposes (following the OECD model) and an Exchange of Information Agreement for customs matters (based on the World Customs Organization model) to increase collaboration between the tax and customs authorities of both jurisdictions.

**Termination of treaty with Spain**

As published in the Official Gazette on 13 July 2012, the Argentine government terminated on 29 June 2012, the treaty signed between the Argentine Republic and the Kingdom of Spain to avoid double taxation and prevent fiscal evasion with respect to taxes on income and on capital.

Article 29 of the treaty regulated termination; under that article, either contracting state may terminate the treaty through diplomatic channels by giving notice of termination at least six months before the end of any calendar year.

In this particular case, the treaty will cease to be effective:

- As of 1 January 2013 for taxes withheld at source, levied on amounts paid to non-residents
- For tax periods beginning on or after 1 January 2013 for other taxes

**Termination of treaty with Chile**

As published in the Official Gazette on 16 July 2012, the Argentine government terminated its treaty with Chile on 29 June 2012. Based on the Andean Pact Model, the treaty was signed on 13 September 1976, approved by the Argentine Congress through Law 23,228 dated 5 September 1985, and entered into force on 19 December 1985. In addition, a Protocol was signed on 3 April 2003 introducing certain modifications.

Article 26 of the treaty establishes that either Argentina or Chile may, from 1 January until 30 June of any calendar year, notify the other contracting state in writing of its termination.
In such a case: The treaty shall cease to be effective:

- For individuals and the undivided estates thereof, with respect to income, earnings or profits received and capital owned from January 1 inclusive of the calendar year immediately following the calendar year in which notification was given of the termination of this treaty
- For enterprises, with respect to earnings, income, profits or capital corresponding to the fiscal or accounting years commencing after the date on which such notification was given

Considering that the notification of the termination was made on 29 June (i.e., within the term established by the treaty), it must be determined from which date the treaty provisions will cease to apply for every particular case, in accordance with the referred Article 26.

In addition, it will be of particular interest to determine the effect of the treaty’s termination on the following cases:

- Treatment of the Argentine personal assets tax by Chilean resident investors that own Argentine companies, as well as of Argentine residents with investments in Chile (the treaty had a variation to the general source principle and contained an exemption in the investment country from taxes applicable on shares owned by residents in the other country)
- Income tax treatment in Argentina applicable to royalties, interest or services income earned by Argentine residents, as well as the income tax withholding treatment of payments to be made to Chilean residents for such concepts
- Treatment of capital gains earned by residents of either country due to the disposition of investments in the other country
- Possibility of computing foreign tax credits for withholding performed in accordance with the rules of the other country

It is likely that, in the absence of the treaty certain services, licenses and royalties will become subject to income tax withholding in the source country, and the recipient of the payment will be subject to taxation of that income in its residence country. Moreover, according to the domestic rules of both Argentina and Chile, in some cases (e.g., technical assistance rendered in the country of the provider) the recipient will not be entitled to a credit for the withholding suffered abroad, thus creating double taxation.

Another issue of interest is the treatment of dividends and capital gains arising from investments that a resident in one of the countries has in the other country, during the period that the treaty continues to be in effect per the dispositions of Article 26.

Preliminary conclusions about the termination of the three treaties

One of the main benefits that these treaties had in common was the exemption from the tax on personal assets of foreign shareholders’ participation in shares in Argentine companies. These were the only treaties that contained such an exemption.

While this tax is usually aimed at Argentine and foreign individuals, a 2002 tax reform introduced a presumption (not admitting rebutting evidence) that any participation in Argentine companies owned by foreign entities should be treated as if indirectly owned by foreign individuals. As a result, all foreign companies started to pay 0.5% tax on their participation in Argentine subsidiaries, applicable on their proportional equity value in the Argentine entities.

The Argentine government believed that several multinational companies created holding entities in Chile, Spain and Switzerland to benefit from the exemptions in the countries’ respective tax treaties; therefore, it decided to denounce those particular treaties.

The treaties all also had additional issues that may have led to their termination. For example, the treaty with Switzerland was the only one that allowed the application of a 0% rate on the payment of royalties and technical assistance (such exemption was eliminated in a protocol signed in 2006 but was never entered into force).

Regarding the treaty with Chile, its basis on the Andean Pact Model meant that its main principle was the exclusive taxation of all income in the source country. This allowed the elimination of withholdings...
in certain cases and the non-taxation in the country of residence in many others. For example, several Argentine residents invested in Chilean bonds and securities that had total tax exemption in Argentina. In addition, a holding regime was created in Chile some years ago (known as “Plataforma”) that was totally free from taxes in Chile, with the related benefit of non-taxation for Argentine investors due to the treaty. The Argentine government said this regime was misused in order to avoid taxation in both countries.

Finally, Spain was reported as being used by many multinationals to establish holding companies, especially under a special holding regime known as “ETVE.” This typical holding regime was used by multinationals to invest in the region for several reasons, including the fact that Spain has the most extensive treaty network in Latin America. Although the EVTE regimes were not used in most cases for Argentine reasons, the Government understood that holding companies were being formed in Spain to avoid payment of the tax on personal assets, so it decided to terminate the treaty.

Finally, the existence of such treaties allowed shareholders from most Latin American countries to claim the application of the “non-discrimination clause” contained in the 1980 Montevideo Treaty that established the Latin American Integration Association (ALADI). This had become a controversial issue and is currently being discussed in court. But with the termination of the only three Treaties that contained an exemption, the possibility to claim discrimination has disappeared.
Governmental commission

According to a joint resolution published on 10 March 2011 (Resolution 56/2011 of the Ministry of Economy and Resolution 80/2011 of the Foreign Ministry), the Government created the Commission for the Evaluation and Review of Treaties to Avoid Double Taxation (the Commission). The Commission is made up of one officer from each ministry and is headed by the National Tax Authority Director.

According to the resolution, the Commission is in charge of evaluating the treaties in force or those planned to be entered into, based on:

- The impact on national taxation
- The adequate and effective relation between the tax sacrifice and the purposes followed when entering into each treaty
- The possibility that an improper application of each treaty generates an inadequate taxation
- The possibility that its application results in a double non-taxation as a result of the domestic legislation of the contracting countries

In addition, the Commission must perform periodic evaluations of the treaties’ tax implications and propose related courses of action that it considers appropriate, such as denunciation, renegotiation or maintenance of the treaties in force. According to Article 4 of the resolution, the Commission must issue periodic reports regarding its assigned tasks and one final report on proposals of related courses of action.

The above resolution and creation of the Commission clearly reflects the Government’s intention to review the treaties and terminate those that — according to its evaluation — may harm Argentine taxation. While no official report on the Commission’s work has become public, it is clear that the decision to terminate the treaties with Switzerland, Spain and Chile has been a result of this policy.

Final comments

The recent termination of three significant treaties for foreign investors has resulted in the loss of important instruments that granted tax neutrality to investments and transactions. Because these three terminated treaties contained particular benefits that were not contained by any other treaty, it is not likely that Argentina would begin to denounce other treaties that are still in force, but no final assumptions can be made.

It is likely that the Government will begin renegotiating the recently terminated treaties, as well as move forward with signing new treaties. Doing so would mean that Argentina continuing to keep pace with developed countries and its regional neighbors.
BorderCrossings with Ernst & Young’s transfer pricing and tax professionals

United Nations transfer pricing guidance: harmony or discord?

The UN Committee of Experts released its updated UN Model Convention (Convention) on 15 March 2012. In addition to an updated Commentary to the existing Convention, there are some updated or new Treaty articles put in place. In the background, there is also discussion on how to provide more guidance to developing countries related to the application of transfer pricing principles applicable under Article 9 of the Convention.

To accommodate developing country needs in this respect, the UN Committee of Experts has embarked on a project to draft a Transfer Pricing the Manual (the Manual). The Manual is intended to provide developing countries with an introduction to transfer pricing principles and methods and practical guidance on how these principles and methods can be implemented by a developing country’s tax authority. The webcast will address issues such as:

- The role of the Manual, in light of the existing OECD Transfer Pricing Guidelines
- The extent to which the Manual might differ from the OECD Guidelines in theory and in practice
- The timetable governing finalization of the Manual

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Australia recently formed the Business Tax Working Group (BTWG or the Working Group) had the potential to herald a new chapter of business tax reform for the country and set in motion a well-documented process for the development of reform proposals. The two years since the publication of the “Henry Review” have seen many political changes for Australia, with many key legislative changes also enacted. In a draft final report, however, the group has announced that, after the base broadening of recent years there is not enough potential for further base broadening to fund significant corporate tax rate cuts to meet Treasurer Wayne Swan’s terms of reference that any corporate rate cut be offset by business tax ‘saves’. 

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The Working Group released its first in a series of discussion papers on 13 August 2012, following the release of consultation paper in June 2012 which discussed ways in which Australia’s headline corporate tax rate may be reduced in the future.

The genesis of the BTWG can be traced back to October 2011, when Australia’s Federal Treasurer, Wayne Swan, announced the establishment of the BTWG and its terms of reference, which were to consider reform of Australia’s business tax system.

The objective of the Working Group is to make recommendations on improvements to Australia’s business tax system, while making the most of the challenges and opportunities arising from transformations in the broader economic environment, a theme common among many major markets in recent years. The recommendations must be revenue neutral, however and the Working Group must recommend offsetting business tax increases to fund its reform recommendations. These revenue-neutral reforms to the business tax system aim to increase productivity, while delivering tax relief to struggling businesses.

**Working Group terms of reference**

As detailed in the terms of reference, the scope of work that the Working Group is to focus on reducing taxes on new investment to encourage Australian businesses to undertake innovation and entrepreneurial activity. Furthermore, the terms of reference set out that they will focus on reform options that relieve the taxation of new investment by reforming the tax treatment of business losses (in the near term) and by reducing the corporate tax rate further or moving to a business expenditure tax system, particularly an allowance for corporate equity (ACE) (in the longer term).

For the final report, the Working Group was asked to provide specific analysis of a range of business tax reform options, including: (i) descriptions of how these reform options operate overseas and the evidence on their effectiveness; (ii) potential priorities for reform, including transitional paths; (iii) worked examples of how these options would affect business taxpayers, including their financial and tax accounts; (iv) revenue integrity provisions, such as measures necessary to limit the inappropriate claiming of tax losses, the equity allowance to new equity, and small and closely held businesses converting labor into business income; (v) how the reform options integrate with the rest of the tax system now and in the future; (vi) impacts on national income and macroeconomic risks; and (vii) costings.

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2 Ibid.
4 Ibid.
Principles for business tax reform

The Working Group set out six key principles for the tax and transfer system: equity, efficiency, simplicity, sustainability and policy consistency. These core principles serve as a foundation in developing the principles for business tax reform. The principles for business tax reform guided by the BTWG Consultation Guide, released June 2012, are as follows:

1. **Revenue adequacy:** The business tax system should raise revenue that, together with other taxes, helps to pay for public services on which the community relies.

2. **Economic efficiency:** The business tax system should raise revenue in a way that minimizes the effect of the tax system on business decisions, except where this is needed to correct for market failures.

3. **Distributional equity:** The business tax system and potential reforms should be understood in terms of where the final incidence falls among capital owners, workers and consumers.

4. **Competitiveness:** The business tax system should take into account Australia’s integration with the global economy.

5. **Simplicity:** Business tax reform should be aimed at making the system as simple and easy to comply with as possible, having regard to an often complex business environment, the need to maintain the integrity of the system and the costs and benefits of transitioning to any new rules.

6. **New investment focus:** Business tax reform should generally focus on new investment.

Further developments from the Henry Review

**Reduction of corporate headline tax rate**

A report to the Treasurer on Australia’s Future Tax System (also known as the Henry Review), publicly released in May 2010, contained a blueprint for a “root and branch” overhaul of Australia’s tax and transfer system over an extended period. The Henry Review initially proposed the reduction of the corporate tax rate to 25%, and the Working Group agreed on the proposed tax rate cut in its August 2012 discussion paper. The Working Group believes that the lower headline tax rate will bring benefits to the Australia economy as outlined below:

1. A lower tax rate will reduce the effective average tax rate (EATR), as well as the effective marginal tax rate (EMTR), which, along with the statutory tax rate, drive investment behaviors. The reduction of EATR and EMTR will lead to an increase of foreign direct investment (FDI) into Australia and an increase in investment scale. Reduction of such tax rates will increase pre-tax and after-tax return on investment encouraging higher investment activities.

2. Businesses will be able to attain higher productivity with a lower tax rate since it will allow businesses to make more investments into plant and equipment, product lines, work force and new markets.

3. A lower tax rate will reduce the potential distortions that result from business income measurement that are not neutral for certain types of investment, such as differences in the deductibility of debt and equity financing, and accelerated depreciation.

In order to finance the revenue lost from a corporate tax rate cut, the Working Group suggests measures to broaden the tax base. There are three broad categories of base-broadening options, as summarized below:

1. Interest deductibility and thin capitalism
2. Depreciating assets and capital expenditure
3. The R&D Tax Incentive

**Recommendations of the working group’s draft final report**

On 24 October 2012 the BTWG released its draft final report following its consideration of the benefits of a cut to the company tax rate accompanied by business tax measures that fully offset the cost of such a reduction.

The report makes understandable draft findings which support the perceived benefits of such a tax cut but the BTWG was unable to recommend a revenue neutral package to fund that cut.

**Their findings are in essence that:**

- After the base broadening of recent years there is not enough potential for further base broadening to fund significant corporate tax rate cuts to meet Treasurer Wayne Swan’s terms of reference that any corporate rate cut be offset by business tax ‘saves’, with an accompanying lack of support in the business community for such trade-offs.

- Changes to depreciation could have a significant impact on after-tax returns for investment in particular in resources and other sectors where there are long lead times before income production.

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5 “The Working Group believes that Australia should have an ambition to reduce its company tax rate over the medium term and that achieving a materially lower rate is a worthwhile reform objective.”, “Business Working Group Discussion Paper”, 13 August 2012.


7 According to AFTS Review, a 1% point increase in tax rate leads to a decrease in foreign direct investment of 3.72%, “Business Working Group Discussion Paper”, 13 August 2012.
Key findings also include:

- There could be economic benefits associated with a cut in the company tax rate. A reduced rate would lead to greater investment in Australia in the longer term, which would contribute to improved productivity and higher wages for Australians.

- A cut in the company tax rate of two to three percentage points would be needed to drive a significant investment response.

- The business tax base is broader than it was in the 1980s and 1990s and significant savings are now more difficult to identify and reach consensus on.

- There is considerable debate and uncertainty around the magnitude of the distortion associated with the remaining concessions in the business tax base, including concessions that promote important activity like investment in infrastructure and research and development.

- Many individual businesses asserted that they would be worse off as a result of the trade-offs canvassed; some submissions questioned whether there would be a net benefit for the economy as a whole from a combination of some of the base broadening measures canvassed and a cut in the company tax rate of between one and three percentage points; overall there is a lack of agreement in the business community to make such a trade off.

- An ACE should not be pursued in the short to medium term but may be worthy of further consideration and public debate in the longer term.

- The BTWG principles for business tax reform are a useful framework and the findings also supported the continuation of a consultative approach to business tax reform.

What next?

The BTWG’s August 2012 discussion paper set out a number of specific tax base broadening options that might have been used to offset the cost of a tax cut. Notwithstanding that the BTWG did not recommend any of these measures in this report, it would be open to the government to potentially implement any of these options independently of the review for example in the next federal budget (with or without any tax cut). We observe that the report notes that Treasury modeling on the base broadening options was not completed in time for its report.

The easiest option for the government to implement would be limiting interest deductibility and tightening the thin capitalization rules. (For completeness, the other groups of possible tax ‘saves’ were modifying rules for depreciating assets and capital expenditure, and reducing the R&D Tax Incentive.)

The government might now think tax reform is too hard given where we are in the political cycle with an election a year or less hence. There is, however, the need for ongoing tax reform in Australia, including the need to move ahead with reforms of state taxes, and consideration of GST reform along with other measures – businesses should encourage government to persist with these agendas.

**Loss carryback**

Previously, tax losses were only allowed to be carried forward to future years; however, the Henry Review initiated the idea of a loss carryback regime in 2009, stating “Companies should be allowed to carry back a revenue loss to offset it against the prior year’s taxable income, with the amount of any refund limited to a company’s franking account balance...”. The objective of this was to try and reduce the burden of taxation over time by promoting economic growth at a higher rate than public spending growth.

Following feedback on the Treasury discussion paper in May 2012, the Australian government took the recommendation of the Working Group and introduced the loss carryback regime designed to provide further opportunities with tax deductions. Effective as of 1 July 2012, businesses are allowed to elect loss carryback up to AUD$1 million of the tax paid during the previous year.

**ATO Compliance program 2012-13**

On 19 July 2012 the Australian Taxation Office (ATO) released the ATO Compliance Program 2012-13 which outlines key focus areas attracting ATO attention for the current year and is relevant for:

- Tax risk management and planning relating to potential controversies
- Planning areas of focus for 2012 tax returns and documentation and
- Highlighting unresolved issues, transactions or positions of potential interest to the ATO that need to be well documented in readiness for interaction with the ATO.

Whilst many themes generally remain the same every year, this year’s Compliance Program has a greater focus on new taxes such as new minerals resource rent tax (MRRT), the extended petroleum resource rent tax (PRRT), the carbon pricing mechanism and taxation of alternative fuels and clean energy measures such as fuel tax amendments that apply from 1 July 2012.

There is a theme of increasing focus on high yield initiatives and "doing more with less". The Compliance Program includes a section which evaluates outcomes from 2011-12 and in relation to the large business and SME sectors, it shows reducing volumes of review and audit activity, yet increased liabilities raised and cash collected from compliance activities in the SME sector.

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8 According to the ministers, “The introduction of the Loss Carry-back will encourage companies to adapt to changing economic conditions and take advantage of new opportunities through investment. It will help struggling companies adjust to the challenges and opportunities of the patchwork economy by improving cash flows and reduce disincentives for businesses to take sensible risks.”

Assistant Treasurer David Bradbury released a Treasury discussion paper on the design of the proposed new loss carry-back provisions on 18 July 2012. This was announced in the 2012/13 Federal Budget following recommendations of Business Tax Working Group’s final report on the tax treatment of losses. The proposals may provide eligible companies with up to AUD$1 million loss carry-back relief providing a cash benefit of up to AUD$300,000 a year. However the benefit of the proposals will not commence until after the 2012–13 year in respect of losses incurred from that year.

Briefly, companies will be able to carry-back up to AUD$1 million of revenue losses per annum for two years, phased in as follows:

1) For 2012–13, a one year carry-back of losses of that year to obtain a refund of tax paid (or reduction of tax due) in the 2011–12 year – so the cash benefit would not arise until FY2013

2) For 2013–14 and subsequent years, a carry-back of losses of a year against tax paid (or reduction of tax due) up to two years earlier

The paper sets out options for the design of the measures including limiting the carry-back to the company’s franking account balance, options for proposed integrity rules and various interaction issues.

Although of greatest benefit for small business, the measure applies to all companies.

The ATO will particularly focus on the following issues in 2012–13:

• taxation of financial arrangements (TOFA) 3 and 4 implementation
• profit shifting – transfer pricing and thin capitalization
• corporate restructures including mergers and acquisitions
• consolidation – inappropriate outcomes
• research and development claims
• GST integrity of business systems and also GST and financial supplies
• taxation of alternative fuels and clean energy fuel tax amendments

Additionally, this year the ATO will put under the microscope: tax fraud and avoidance schemes, the highly wealthy, property-related tax issues and employers who do not meet their superannuation obligations.

Top issues for large business including international tax issues

The large business segment consists of about 1,300 economic groups and entities, encompassing over 32,000 businesses, large government agencies and non-profit organizations, generally with an annual turnover of more than AUD$250 million. Around two-thirds of these groups are public companies. Over the coming year, the ATO compliance program for large businesses will focus on the following compliance risks (see pages 46-51 of the document):

“The Government’s initial response to the Henry Review was positioned as “the first wave” of an agenda to reform resource, company and small business taxes and superannuation. Though the initial response fell well short of the “root and branch” overhaul of Australia’s tax and transfer system originally intended, the Government has been forced to reassess its initial response as part of its bid to form Government. With the terms of reference of the Henry Review within the scope of the Tax Summit, there is potential for considerably more dramatic reform over the next decade than the Government’s initial response heralded.”

Ernst & Young Tax Policy & Controversy Quarterly Briefing – October 2010
TOFA 3 and 4 – implementation close monitoring including 35 reviews arising from TOFA questionnaires

Corporate restructures including mergers and acquisitions – ATO is planning 20 risk reviews

Consolidation – inappropriate outcomes. ATO will assist taxpayers to review claims relating to rights to future income and residual tax cost setting rules under 2012 amendments. ATO is examining the use of foreign partnerships in consolidated groups and interest deduction double dipping

Research and development claims – compliance focus on “tax concession” wrap-up claims

GST – integrity of business systems will be an area of focus as a result of many errors reported by large business. 500 reviews and audits are planned with a particular focus on mining, manufacturing, wholesale trade and financial and insurance services

GST and financial supplies is a key area of focus and 50 reviews and audits are planned for 2012-13

Taxation of alternative fuels

Clean energy measure – fuel tax amendments

International Tax issues of focus include:

Profit shifting – transfer pricing and thin capitalization – The ATO has concerns about the debt levels of entities that satisfy the safe harbor debt amount test but have significant asset revaluation values for thin capitalization purposes and entities that may not otherwise pass the safe harbour debt amount without such values. The ATO is also looking at the compliance with the arm’s length debt and worldwide gearing amount. In 2012-13 the ATO estimates it will undertake around 25 reviews and 29 audits. The ATO will also undertake 40 advance pricing arrangements and 15 mutual agreement procedures.

Continue to improve international transparency – the ATO will continue its involvement in global efforts, such as working with the Organisation for Economic Co-operation and Development (OECD) on arrangements for sharing offshore information and joint projects such as the Joint International Tax Shelter Information Centre (JITSIC) with other countries, and seeking details of offshore bank accounts from other revenue authorities and domestic banks withholdings of offshore accounts. The ATO continues to make extensive use of AUSTRAC data.

Large business corporate governance initiatives for 2012-13 will include continuing to invite companies to enter into an Annual Compliance Arrangement (35 invitations were issued in 2011-12) and the use of Pre-lodgment Compliance Reviews (93 PCRs are underway). The Reportable Tax Position schedule program will continue for 2012-13 and will involve about 170 taxpayers.

Further compliance issues for large businesses are outlined on page 45 of the Compliance Program:

Private equity holding arrangements structured using multiple entities, in treaty countries and tax havens to avoid Australian income tax on business profits

Transactions immediately prior to the disposal of a private equity target investment for the purpose of avoiding Australian tax on sale proceeds, or incorrectly characterizing the sale as a capital gain

Significant claims made for an immediate deduction for mining, quarrying or prospecting rights

700 reviews and audits to address GST risks associated with the sale, transfer and acquisition of real property, particularly in relation to the reporting of property sales and the incorrect application of the margin scheme provisions to reduce the GST payable on property sales
Transactions involving taxable Australian property by foreign residents who must report and are subject to capital gains tax on any such transactions. Focus on valuation outcomes designed to fail the principal asset test in relation to the disposal of indirect interests in Australian real property, as well as arrangements that seek to circumvent the non-portfolio interest test — including the use of non-share equity as part consideration for foreign resident acquisitions.

Use of hybrid financing arrangements and intellectual property contracts — including cross-industry sampling to identify the withholding tax risk and uncover uncollected and unpaid withholding tax.

Capital account treatment rules and withholding and related requirements on fund payments for managed investment trusts, as well as focusing on general tax governance processes associated with the trustee’s determination and calculation of net income.

Financing arrangements undertaken by stapled groups (such as the practice of some stapled groups to generate deductions for the company for what is effectively an equity return to investors via a stapled trust), with a ruling to be finalized this year.

Inspector-General of Taxation’s report on dispute resolution

On 31 July 2012 Assistant Treasurer David Bradbury released the IGT Report on its examination of the effectiveness of the ATO’s dispute resolution practices including early dispute resolution and Alternate Dispute Resolution (ADR). While the IGT found that, at a high level, the ATO is committed to early engagement with taxpayers to resolve disputes, he identified 22 recommendations for the ATO could improve and strengthen its practices — the ATO accepted 21 in whole or in part, and many immediately.

Selected recommendations that may affect current tax disputes include:

- Making sure the ATO and the taxpayer engage earlier to ascertain and agree on those matters that are agreed and those that remain in contention;
- Allowing ADR processes to commence early, without necessarily waiting for assessment;
- Streamlining of information exchange between the parties to make sure that the matters in dispute are understood;
- Making sure that disputes about valuations involve agreed terms of reference for independent valuers and ATO agreeing that all valuation disputes should go to ADR unless clear reasons to contrary (taxpayers can also refuse);
- Opening clear escalation channels to appropriate ATO personnel to engage in dispute resolution processes;
- Bringing early engagement and ADR to the forefront of ATO dispute resolution efforts and only litigating cases which turn on genuine and fundamental disputes as to law and where there is a public benefit in having the matters judicially determined;
- Enhancing the skills and understanding of both ATO staff and taxpayers of the different types of engagement available in ADR and the circumstances in which these may be appropriate through increased training and publication of information respectively; and
- Identifying opportunities for continuous improvement through implementing processes to enable feedback to be provided regarding the use of ADR in the tax dispute context.

The ATO disagreed on one major recommendation, the final recommendation (Recommendation 6.1), aimed at addressing the perceived lack of independence in the objection process and empowering the ATO’s in-house legal services function to assess matters independently of the audit arm.

The IGT also suggested the Government consider amending the tax laws to give the Commissioner of Taxation the power to extend the objection period, at the taxpayer’s request, prior to the expiry of this period for the purpose of engaging in ADR processes. The Government will give detailed consideration to this recommendation once it receives the IGT’s report from his current review into improving the self-assessment system.

These changes to the ATO’s dispute resolution process may improve outcomes for taxpayers.

Where next?

While Australia continues to experience a high pace of change across the policy and administration spectrum, the BTWG’s assertion that the tax base should not be widened any further in order to provide a corresponding headline rate cut aligns with the fact that many countries have already picked the “low hanging fruit” which allowed for easy expansions of the tax base. This, when coupled with the fact that the MRRT both failed to generate any tax revenues in its first three months of operation and has seen its longer terms revenue forecasts slashed, means that a headline corporate tax rate cut is an unlikely proposition for Australia – at least in the short term.
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On 5 September 2012, the Chilean Congress approved the Tax Reform Bill that was presented by the executive last July, itself the second, reduced version of a bill originally submitted in April 2012. Most of the provisions will be effective as of January 2013.

The bill was designed to increase corporate tax revenues (and to decrease personal income tax rates), with the revenue from corporate increases used to finance an overhaul of the Chilean education system, long a thorn in the side of the government and the source of riots in the Chilean capital in August 2011. Opposition members stated that the reform is “not enough” to satisfy the country’s needs, though the bill successfully passed through Congress.
The bill, which contains a raise in the corporate income tax rate, a whole new set of transfer pricing regulations and a new indirect transfer rule, among others, is primarily intended to raise revenue in order to finance several reforms in education, as well as modernizing the Chilean tax system bringing it closer to international OECD standards.

The main changes include:

1. **A rise in the statutory corporate tax rate:** from 18.5% to 20%, effective as of January 2013.

2. **Changes to the regulations on disallowed expenses:** when such expenses somehow benefit a company’s shareholders or partners, current regulations deem them as profit distributions (which trigger a tax credit at the individual’s level for paid corporate taxes). Under the new rule, the disallowed expense is not considered a profit distribution (and thus is taxed directly with no tax credit). Furthermore, the resulting payable tax is increased by 10% of the amount of the disallowed expense.

3. **Transfer of stock and other participation rights are assimilated:** current regulations contain different sets of rules for the transfer of stock and other participation rights, respectively. The bill assimilates all transfers under the regime applicable to stock (which, for example, allows for a different tax regime depending on different factors surrounding the operation).

4. **Regulations on tax “goodwill” and “badwill”:** the tax amortization of the goodwill embedded in the acquisition of a local entity through the merger of the acquired entity into the acquirer (calculated as the difference of tax basis of the shares against tax equity of the entity being absorbed) was only administratively regulated before the reform. The bill thus adopts the administrative criteria, with a few changes regarding the manner in which the amortization can be implemented, thereby providing legal certainty on the subject (which is a major issue for tax planning purposes).

5. **Changes in indirect transfer rules:** the bill introduces substantial changes in this subject. Whereas current regulation encompasses only indirect transfer of participation rights when the acquirer is a Chilean resident, the bill virtually extends the indirect transfer rule to any kind of Chilean asset that is indirectly transferred abroad, albeit introducing materiality thresholds and exceptions.

The new rules cover all indirect transfers where:

- At least 20% of the transferor’s ownership of the object of the transaction (e.g., a company, fund, permanent establishment) is represented by Chilean assets (at market value) and at least 10% of the foreign entity is transferred.

- The market value of the underlying Chilean assets equals or surpasses the amount of approximately USD 211,000, and at least 10% of the foreign entity is transferred.

- The assets that are transferred abroad were issued or are located in a tax haven (for Chilean purposes, which may differ from the OECD tax haven list), unless the taxpayer can prove that (1) no Chilean resident ultimately owns 5% or more of the transferred foreign entity, and (2) ultimate owners are all resident in non-tax haven countries.

Notwithstanding, if the operation abroad corresponds to part of a reorganization process, and no revenue is generated thereof, indirect transfer rules shall not apply.

6. **Transfer pricing:** the bill contains a whole new set of transfer pricing rules that have been more closely aligned to OECD recommendations, thereby establishing more familiar and more modern rules for foreign investors.
7. **Permanent establishments (PE):** the bill upgrades PE rules, establishing that the same must determine its results based on full accounts (as if it were a regular company), thereby considering its foreign income. The new rules set out a mechanism to determine a PE's taxable income when its effective revenue fails to be determined by the taxpayer.

8. **Withholding tax (WHT) administration:** though the WHT rate remains untouched (35% in general, with specific, differentiated rates for certain operations), the withholding procedure, which takes place when Chilean source income is remitted abroad, has been modified by the bill.

9. **WHT exemption for standard software:** payment of standard software licenses (as defined by the bill) is now exempt from WHT.

10. **Value Added Tax (VAT) exemption:** many remittances made abroad are currently VAT-exempt, insofar as they are also subject to WHT. The bill removes this exemption when by virtue of a double taxation treaty (or a legal exemption) the WHT rate is reduced or no WHT applies at all.

11. **Stamp tax:** the bill reduces stamp tax rates. The current 0.05% rate for each month or fraction of month between disbursement and maturity of the debt (with a maximum rate of 0.6%) is reduced to one-twelfth of 0.04% (with a maximum rate of 0.4%). In case of immediately payable operations, the stamp tax rate is reduced from 0.25% to one-sixth of 1%.

12. **Final taxes rate reduction:** all progressive rates applicable to the taxation of individuals (including employees) have been reduced, with the exemption of the top tier (of the eight current tiers).

The effects of the above modifications could significantly affect several companies, particularly foreign ones. While there has been special concern in regard to the indirect transfer rules (which undoubtedly increases their reach, raising questions about the tax administration's effective capability to enforce them) and transfer pricing, within which their further alignment to OECD standards has been mostly welcomed by specialists, we encourage taxpayers to carefully examine all modifications introduced by the bill in regard to each business' specific context.
Effective management of indirect taxes is essential to support growth and reduce costs and risk. If these taxes are left out of the picture, the expected benefits of a supply chain transformation may not be fully maximized or, in extreme cases, may not be realized at all. In our report, we look at seven common supply chain challenges that global companies face as they move into new markets and operate more effectively and sustainably. We outline leading practices to reduce risks and boost performance in VAT/GST, customs and international trade, excise duties and environmental taxes, export controls and incentives.

When investing into Asia-Pacific, as is the case in any market, all tax aspects should be considered as part of the decision making process. These include local country withholding taxes; access to double tax treaties; capital gains tax; transfer taxes; thin capitalization rules and deductibility of interest expense; the availability of incentives, including tax holidays or reduced tax rates; potential tax exposures, including permanent establishment and/or tax residency; and transfer pricing considerations. More recently, however, general anti-avoidance rules (GAARs) and other anti-treaty shopping measures have been becoming an increasingly important consideration. This is certainly no exception in China, as this detailed analysis of recent and upcoming policy sets out.
Asia’s shifting anti-abuse landscape

Jurisdictions in this region – Australia, the People’s Republic of China, India, Indonesia, Japan and South Korea, for example – are intensifying their review and adjustments on tax arrangements they view as artificial or consider abusive tax avoidance. Clear and consistent documentation of the business purpose and operational alignment of the tax strategy are increasingly important as tax benefits are often contingent on the satisfaction of varying business purposes and substance requirements being imposed that in many cases extend beyond internationally accepted tax practices.

Multinational corporations (MNCs) operating in the region and investors in the Asia-Pacific should be aware that the tax authorities are focused on tax-motivated structures and transactions that are considered to lack business purpose and commercial substance. They may deny the intended tax benefits, including the benefits of a relevant tax treaty in many cases despite having satisfied the conditions of the treaty. An important and growing element of the authorities’ increased enforcement efforts is the enactment of GAARs and specific anti-avoidance rules (SAARs) to counteract perceived abuse or the improper use of a double taxation agreement (DTA). These anti-avoidance rules are part of an effort to preserve and expand their taxing rights to prevent what they view as tax avoidance and protect their tax base. Alarming, there are instances where the use of either a general or specific anti-avoidance rule has been used to tax transactions that are not artificial or should not be viewed as abusive tax avoidance.

A statutory GAAR is in effect in Australia, Hong Kong, New Zealand and Singapore. Although India,1 Japan and South Korea do not currently have a GAAR, they are focused on tax-motivated transactions and the abuse of DTAs and will attack certain transactions or tax arrangements using a substance-over-form approach. Tax authorities in the region are increasingly using GAARs and substance-over-form principles to combat what they view as tax avoidance transactions, and there is an increasing concern that their approach has extended beyond internationally accepted standards, creating much uncertainty for taxpayers and deterring cross-border investment and deployment of capital as a result of the lack of certainty about the tax treatment of transactions.

China has a GAAR provision, and the substance-over-form principle was introduced into the tax regime in January 2009 when the State Administration of Taxation (SAT) issued Guoshui Fa (2009) No. 2 (Circular 2), the trial version of the Implementation Measures for Special Tax Adjustments. This article discusses the trend of GAAR enforcement and legislations in China and, importantly, what guidance may be forthcoming given the developing and very often uncertain tax landscape. It also provides our perspective on the Government’s and the SAT’s approach.

China’s GAAR

China introduced its first set of GAAR legislation in its 2008 corporate income tax reform. Since then, rules and enforcement efforts, aimed particularly at non-residents, have been introduced to combat tax avoidance and treaty shopping. The SAT’s increased enforcement efforts are strengthened by the GAAR provision of the new Unified Corporate Income Tax Law (CITL), which became effective 1 January 2008.

1 India introduced GAAR in its domestic tax law effective 1 April 2013, through the Finance Act 2012 and is in the process of formulating guidelines for its implementation. The Indian government formed an expert committee to address stakeholder apprehensions relating to the introduction of GAAR in the domestic tax law. The committee submitted a draft report to the Indian government on 1 September 2012 with a number of recommendations, including deferring GAAR to the tax year 2016–17, inserting overarching principles as a precondition to GAAR applicability, grandfathering existing investments, respecting income tax treaties with specific anti-avoidance rules and upholding the validity of the administrative circular issued in the context of Mauritius entities. Based on further comments and suggestions from stakeholders, a comprehensive final report is due for submission by 30 September 2012.
As part of the CITL, China adopted certain provisions that have broadened its tax net and tax enforcement abilities (including abusive tax situations). Of particular importance are the rules set forth within Chapter 6, the special tax adjustment section of the law, including the anti-avoidance rules under Article 47. The article gives the tax authorities the ability to adjust taxable income when enterprises make business arrangements that give rise to a reduction of taxable income and are not supported by a rational business purpose. Like previous legislation in China, the CITL only set forth the overall guiding principles of the law – further definition, guidance and clarification are needed to provide much more certainty about the tax treatment of transactions and for taxpayers to better understand how these anti-avoidance rules will be enforced in practice. The CITL was followed by the release of the Corporate Income Tax Law Implementation Regulations (CITLIR), issued by the State Council on 6 December 2007. The CITLIR provide that business arrangements without bona fide business purposes as cited in Article 47 are considered arrangements whose primary purpose is to reduce, avoid or defer tax payments.

Since the issuance of the CITL and the CITLIR, the SAT has issued important guidance to taxpayers regarding compliance with GAAR, including guidance published on 8 January 2009 with the release of Circular 2, the trial version of the Implementation Measures for Special Tax Adjustments. Circular 2 provides guidance on how taxpayers shall comply with and tax administrators shall enforce and administer the provisions contained in Chapter 6 of the CITL. More specifically, Chapter 10, Article 92 of Circular 2 instructs tax bureaus to apply this provision to enterprises that are abusing incentive tax policy, tax treaty provisions, legal vehicle form or structure, tax havens and other arrangements without bona fide business purposes. It also instructs tax bureaus to apply a substance-over-form principle in reviewing a particular arrangement's legal formality, timing, duration, potentially connected steps, and financial and tax implications for the relevant parties.

With a focus on substance-over-form, China tax authorities are increasingly willing to disregard or recast perceived tax-motivated structures, entities or transactions. This guidance appears to be very broad and provide authority to tax bureaus to make adjustments to transactions or the tax benefits enjoyed. Additionally, subject to limited safeguards, it allows tax bureaus to disregard legal entities deemed to lack substance while at the same time there is a lack of guidance as to what type of substance may be necessary to preclude a challenge under GAAR.

**Circulars 601 and 698 introduced**

On 27 October 2009, the SAT issued Guoshuihan (2009) No. 601 (Circular 601), setting out guidelines on the interpretation and determination of the term “beneficial owner” under tax treaties. The SAT’s interpretation of beneficial ownership determines whether a non-resident recipient is entitled to a reduced rate of withholding tax and applies to the dividend, interest and royalty articles of the tax treaties that China has entered into with other tax jurisdictions, including the Hong Kong and Macau Special Administrative Regions of China. Circular 601 provides guidance for the tax authorities to follow when processing applications from nonresident taxpayers for the benefits under a relevant DTA for such passive income (e.g., reduced withholding taxes).

In line with taking a substance-over-form approach, Circular 601 prescribes a list of seven factors that are considered disadvantageous to the nonresident recipient in recognition of its beneficial ownership for tax treaty purposes:

1. The recipient is under an obligation to distribute all or the majority (i.e., 60% or above) of the China-sourced income to a resident of a third jurisdiction within a specified period (i.e., 12 months).

2. Other than holding the properties or rights that generate the income received, the recipient conducts little or no business activities in China.

3. The recipient is a corporation or another type of business entity, and the assets, size of operations and human resources of the recipient are disproportionately small relative to the income received from China.

4. The recipient does not, or almost does not, have rights to control or dispose of the income or the properties or rights giving rise to the income, and bears little or no risks.

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2 The release of Circular 601 was preceded by the release of Guoshuihan (2009) No. 3 (Circular 3) on all passive incomes, Guoshuihan (2009) No. 81 (Circular 81) on dividends, Guoshuihan (2009) No. 124 (Circular 124) on all incomes covered by DTAs, and Guoshuihan (2009) No. 507 (Circular 507) on royalties. However, this series of circulars preceding Circular 601 was not the end of the story in the SAT’s continued guidance on the implementation of DTAs. In July 2010, Guoshuihan (2010) No. 75 (Circular 75) was issued, addressing, in a detailed and systematic way, all of the articles of the China Singapore DTA. The issuance of Circular 75 impressed many more commentators than any prior treaty guidance, not only because its effect goes well beyond the China-Singapore DTA, but also because it represents the SAT’s effort to standardize technical interpretations and practice guidance on the implementation of DTAs.

3 The term of “tax treaties” in this article refers to both tax agreements and tax arrangements.
5. The recipient is exempt from tax or is not subject to tax in the residence country with respect to the income received from China, or the recipient pays tax in the residence country but at an extremely low effective tax rate.

6. With respect to interest income from a loan agreement, the recipient has a loan or deposit agreement with another party with terms (e.g., amount, interest rate, execution date) resembling those in the primary loan agreement.4

7. With respect to royalty income arising from a copyright, patent or technical know-how (collectively intellectual property or IP) transfer agreement, the recipient has an agreement with another party regarding the same IP.5

Despite this list, in practice we have found that this is a controversial area where the application of the factors is unclear. In the absence of business substance, China tax authorities will likely question the application for treaty benefits, and the determination as to the availability of a reduced withholding tax may be called into question based on the facts and circumstances. Because this area has been largely within the control of the local in-charge tax authorities, we often see beneficial ownership denied by the in-charge tax authorities when only one or two unfavorable factors exist. Unfortunately, certain factors should be irrelevant to the determination of beneficial ownership, e.g., factor five above, which is most often unmet? This denial is particularly likely when the recipient lacks employees and substantive business activities or operations, despite that taxpayer’s view that the recipient is the beneficial owner applying the term as defined by the Organisation for Economic Co-operation and Development (OECD). However, the beneficial ownership matter is complex, and the determination or assessment is often a difficult issue as Circular 601 invokes a new anti-abuse dimension to the term “beneficial owner,” broadening the scope of the term outside the meaning as defined by the OECD.

Figure 1 shows reported Circular 601 cases as of August 2012.

Given the uncertainty this situation has created regarding whether a reduced treaty rate of withholding tax would apply, as provided in the dividend, interest and royalty articles of certain DTAs entered into by China, additional guidance has long been overdue. On 29 June 2012, after a series of consultations, the SAT released a supplementary notice to Circular 601, Notice (2012) No. 30 (Notice 30), which provides some guidance on how to assess beneficial ownership status in respect to passive income (i.e., dividends, interest and royalties). Notice 30 provides an important clarification stressing that all relevant factors should be considered “collectively” when assessing beneficial ownership status; status should not be denied simply because one of the seven factors exists, which is always the case. However, Notice 30 also clarified that beneficial owner status should not be granted purely because relevant arrangements were not put in place to evade or reduce tax or to transfer or accumulate profits. In other words, lack of a tax avoidance motive in itself is not sufficient to meet the requirements of beneficial ownership which is based on an analysis of the relevant factors.

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4 A back-to-back financing arrangement apparently could fall into this category.
5 A back-to-back licensing arrangement apparently could be covered by this factor. However, if the recipient is organized as an IP holding company that acquires the ownership of the IP through arm’s length transactions before licensing the IP to China, it is unclear whether this factor would be triggered.
China update
Landmark case concluded by competent authorities of China and a treaty country

In July 2012, China’s State Administration of Taxation (SAT) reached agreement in principle with the competent authority of a treaty country on a landmark case for transfer pricing matters. This case covers double tax relief under the mutual agreement procedure (MAP) and a forward-looking bilateral advance pricing arrangement (BAPA), as well as transfer pricing certainty for the time period under China’s follow-through investigation and the rollback of the BAPA. The covered transactions include the intercompany procurement, sales and license of intangibles and provision of various types of services. The total coverage of 15 years and the comprehensive nature of covered transactions for this case mark the advancement of competent authorities’ ability to reduce double taxation risks for enterprises operating in China.

This is the first MAP or BAPA case concluded for a Chinese entity located in Nanjing, the capital city of Jiangsu Province. This case was initiated by a global leading manufacturer of consumer electronics products and its manufacturing subsidiary supplying China and worldwide markets.

As China continues to strengthen the enforcement of tax laws regarding anti-tax avoidance and transfer pricing, the APA program is particularly valuable in helping enterprises attain tax certainty and increase business stability in China. In October 2011, the SAT published the China Advance Pricing Arrangement Annual Report (2010), in which the SAT emphasized support and encouragement toward eligible applicants of APAs.

Presently, taxpayers’ demand for the SAT’s support for APA application is overwhelming. If a taxpayer has the business need to apply for an APA, it is important to conduct thorough and unbiased transfer pricing analysis to examine the arm’s-length nature of planned transfer pricing policies. Attributes that may lead a taxpayer to a productive path toward BAPA acceptance and conclusion include supportable intercompany arrangements, timely and accurate presentation of the business facts and economic analysis, and a cooperative spirit to support the tax administration in its review and negotiation processes.

Read more at www.ey.com/bapa

While this clarification can be viewed as a favorable development, taxpayers should be aware that Notice 30 does not provide the local in-charge tax authorities or taxpayers with guidance as to what weight will be given to each of the factors, and it does not note which factors might be the most important. In practice, even though it should not be relevant, China tax authorities have placed a strong importance on substance, which appears to be among the most important factors. Further, it is uncertain as to what China tax authorities may require in any particular case. From our experience, no one factor will be viewed as conclusively important; instead, the totality of facts approach is adopted in each case. This is also in line with Article 1 of Notice 30 wherein it provides that “all factors specified under Circular 601 should be analyzed and determined in its totality.” It is for the taxpayer to articulate its facts and make the case officer understand, as much as possible, the circumstances upon which business decisions are made and other relevant facts.

Article 3 of Notice 30 introduced a new narrow safe harbor: the “same country publicly listed company” exception. In case the immediate holding company of a China tax resident company is in a DTA jurisdiction, and its parent company is a publicly listed company (Listco) resident in the same jurisdiction, it would be deemed that the Listco or the immediate holding company will satisfy the beneficial ownership test and that beneficial ownership status be granted. One additional condition is that the intervening companies along the ownership chain between the Listco and the immediate holding company be 100% held by Listco, and that the intervening companies can only be of the same jurisdiction of the beneficial ownership applicant, or be a China tax resident.
Under Article 2, the notice lists certain documents and evidence that will be examined when assessing beneficial ownership status. The list of documents suggests what is required to enable the tax official to assess whether the applicant can have the discretionary power to direct the money flow of the passive income recipient, which is very much in line with the OECD Discussion Draft, “Clarification of the Meaning of ‘Beneficial Owner’ in the OECD Model Tax Convention” (Sections 12.4, 12.5), as reinforced in the recent two Canadian tax cases Prevost Car paragraph 13 and Velcro paragraph 34. In addition, strong elements of anti-abuse language are embedded in Notice 30, beyond the tests for “discretionary use, enjoyment and control” as cited in Prevost Car or Velcro.

Additional difficulties could result from the fact that the provincial bureau is the in-charge determining bureau for beneficial ownership cases, and location variation could happen even though Article 8 of Notice 30 provides that the different tax bureaus should communicate with each other when determining a beneficial ownership for the same applicant covering different locations.

It is worth noting that even though a beneficial ownership case does not require the SAT’s approval (Article 7, Notice 30), it does not, however, disturb the normal Administrative Review procedures as laid down under the Tax Collection and Administration Law and Tax Administrative Review Rules in cases of disagreement by a taxpayer to the determination of the provincial tax bureau.

In China’s case, in practice, to pass the beneficial ownership test, an enterprise needs to pass the tax residence test, the beneficial ownership test itself and the GAAR test before beneficial ownership status can be granted. In reviewing the previously listed seven factors set forth in Circular 601, factors 2 and 3 focus on the business activities and operations of the recipient and appear to look at these not only in absolute terms but also in relative terms, creating uncertainty as to what might be sufficient substance in any particular case.

Despite the recent release of Notice 30, additional guidance and further clarification are still needed regarding the application of the seven factors in totality and determination of beneficial ownership. This is particularly true for the required substance and the nature of the substance, as they have in practice been among the most important factors. For example, what constitutes “substantive business operations”? Would management or holding functions be sufficient, or is commercial operational substance or both necessary? This determination is particularly important as the OECD commentary does not indicate substance is a requirement or view it as a distinguishing fact in determining beneficial ownership (even under the expanded definition set forth in the OECD Discussion Draft). In fact, outside of China domestic law definition of beneficial ownership, substance is not a relevant factor in the determination. The key and decisive factor, as set forth in the OECD Discussion Draft, is simply whether the recipient of, for example, a dividend “has the full right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass the payment received to another person.”

6 In April 2011, the OECD released a discussion draft titled “Clarification of the Meaning of ‘Beneficial Owner’ in the OECD Model Tax Convention” (the OECD Discussion Draft) that arguably expands the meaning of beneficial owner beyond its original meaning.

7 Prevost Car Inc. v. Canada, 2009 FCA 57.

8 Interestingly, in arriving at the decision, the Court concluded that the “beneficial owner” of dividends “is the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she received. The person who is the beneficial owner of the dividend is the person who enjoys and assumes all the attributes of ownership. In short, the dividend is for the owner’s benefit and this person is not accountable to anyone for how he or she deals with the dividend income.” The determination was not dependent on the recipient having substantive business operations or substance and is further supported by the taxpayer-favorable conclusion reached in the Velcro case.

9 Velcro Canada Inc. v. Her Majesty the Queen, 2012 TCC 57.


11 Article 16—Article. 18, Tax Administrative Review Rules (the SAT Order No. 21 (as revised in 2010)).
China update
Expansion of the VAT pilot program to cover 10 additional locations, including Beijing

On 25 July 2012 the Chinese State Council announced that the value added tax (VAT) pilot program will be expanded to eight more locations starting from August 2012, but with implementation occurring in phases from September through December 2012 and into 2013. Shortly after the State Council’s announcement, the Chinese Ministry of Finance and the State Administration of Taxation jointly issued Caishui (2012) No. 71 (Circular 71), which unveils the long-anticipated VAT pilot arrangements for Beijing and the VAT pilot expansion plan for other locations for the remainder of 2012. The new VAT pilot locations and start dates are:

- **Beijing** — 1 September 2012
- **Anhui and Jiangsu provinces** — 1 October 2012
- **Fujian (including Xiamen) and Guangdong (including Shenzhen) provinces** — 1 November 2012
- **Tianjin, Zhejiang (including Ningbo) and Hubei provinces** — 1 December 2012

The general rules of the existing Shanghai VAT pilot program will be adopted for the new VAT pilot locations.

What has been clear since 2009, when Circular 601 was issued, is that China tax authorities intend to curtail what they believe to be tax avoidance or abuse of tax treaties. They are proceeding cautiously in regard to further clarifying how to assess beneficial ownership, and they should consider a totality of facts. At the same time, as set forth in Notice 30, the SAT wants to have safeguards in place and has stipulated that only the provincial level tax authorities will have the authority to deny beneficial ownership status.

698 follows fast on the heels of 601

Subsequent to the issuance of Circular 601, on 10 December 2009 the SAT issued the now-famous Guoshuihan (2009) No. 698 (Circular 698). Circular 698 addresses gains from equity sales (i.e., capital gains) and is aimed at increasing the administration and taxation of direct and indirect capital gains derived by non-residents. Circular 698 stipulates the non-residents’ obligation to report such gains and China tax authorities’ jurisdiction over them. It also imposes an obligation on non-residents to supply information and documentation regarding indirect sales with a focus on potentially abusive transactions. Circular 698 had retroactive effect from 1 January 2008, the date China’s GAAR came into effect.

With the issuance of Circular 698, China tax authorities are clearly continuing to intensify their tax collection and administration efforts with respect to non-residents intending to combat tax avoidance. Circular 698 makes it clear that China tax authorities believe a substance-over-form approach should extend to capital gains derived indirectly by non-residents on equity transactions in abusive situations, and it highlights the SAT’s willingness to disregard certain entities under GAAR if they were established for tax avoidance purposes and lack business purpose and commercial activities.

Circular 698 asserts China tax authorities’ right to invoke the GAAR to disregard one or more intermediate holding companies if their existence serves no commercial purpose except the avoidance of tax liabilities. This right effectively re-characterizes the indirect sale as a direct disposition of China company or investment. The release of Circular 698 follows a number of high profile audit cases.
A common transaction may involve a multi-tier structure, as depicted in Figure 2.

Figure 2. A common multi-tier structure

With the issuance of Circular 698, China tax authorities are clearly continuing to intensify their tax collection and administration efforts with respect to nonresidents intending to combat tax avoidance. Circular 698 makes it clear that China tax authorities believe a substance-over-form approach should extend to capital gains derived indirectly by non-residents on equity transactions in abusive situations.

The Chongqing case

In a well-publicized audit case, the Chongqing Municipal Tax Bureau denied the intended tax benefits of an indirect sale by disregarding the existence of (or looking through) a Singapore Special Purpose Vehicle (SPV) that was established to hold the investment in a China company. In this case, the tax authority in Chongqing challenged the avoidance of China tax upon an indirect disposal of an investment in a China tax resident entity and looked through the most immediate holding company, taxing the Singapore parent as if there had been a direct disposal of China target. The tax authorities used a substance-over-form approach to reclassify the transaction as a direct transfer of the shares by disregarding the existence of the Singapore SPV. Further, the case was reviewed and approved by the SAT centrally and may have had an influence on the SAT’s issuance of Circular 698. As illustrated by this case, and now supported by Circular 698 and subsequent audit cases, if the foreign investor disposes the equity interest in China company by indirectly transferring the shares of an intermediate holding company that holds the shares in China company, such indirect disposition will likely be scrutinized. If the SPV’s jurisdiction imposes no tax or a low effective tax rate with respect to offshore income, the seller must make significant disclosures to the local China in-charge tax bureau — in other words, the filing “safe harbor” is not met.

12 A published case of the Chongqing Municipal Tax Bureau.
13 Article 5 of Circular 698 provides: “Where the foreign investing party (who is the actual controlling party) indirectly transfers the equity of Chinese resident enterprise it held and if the country (or region) in which the transferred offshore holding company locates levies no taxation on the foreign income of its residents or levies taxation on the foreign income of its residents of a percentage lower than 12.5%, such foreign investing party shall ... make the required disclosures under Circular 698.” On 18 March 2011, the SAT released SAT Announcement [2011] No. 24 (Announcement 24) to clarify, among other things, several issues related to Circular 698. In regards to the filing safe harbor (i.e., you meet the tax rate test and do not need to file), Announcement 24 states that the term “actual tax obligations” as specified in Article 5 of Circular 698 refers to the actual tax obligations for the income from equity transfer, and the term “income tax exemption” means the exemption of enterprise income tax for income from equity transfer.
Potential look-through in cases of indirect equity sales

Circular 698 requires the seller to submit the following information and documents to the in-charge tax authorities of a China resident company within 30 days of signing the equity transfer agreement:

- The equity transfer agreement/contract
- A statement describing the relationship between the seller and the intermediate holding company in the areas of finance, business and buy-sell transactions
- A statement describing the intermediate holding company's business operations, human resources, finance and assets
- A statement describing the relationship between the intermediate holding company and China resident company in the areas of finance, business and buy-sell transactions
- An explanation of the reasonable commercial purpose for the seller in establishing the intermediate holding company
- Other information as required by the in-charge tax authorities

Upon examination of the above information and documents, if the in-charge China tax authorities believe the establishment of an intermediate holding company by the foreign investor (i.e., the foreign entity that has actual control over China company) does not meet the business purpose and substance requirements and was created to avoid China corporate income tax, the in-charge tax authorities in China have, after obtaining approval from the SAT, re-characterized the share transfer transaction according to the substance-over-form doctrine and disregarded the existence of the intermediate holding company to impose China withholding tax on the capital gains realized. A summary of Circular 698 cases published through August 2012 is shown in Figure 3.

**Figure 3. Circular 698 indirect transfer cases as reported – August 2012**

**Total liabilities: CNY1,276m (USD201m)**

*The amount was converted based on the exchange rate of 1USD=6.3392 CNY announced by the People’s Bank of China on 2 August 2012 for reference.*
Practical considerations

With this in mind, taxpayers should pay special attention to having defendable commercial substance in the relevant tax treaty country or intermediary holding company location, and they should document the business purpose or commercial rationale of the holding company to reduce their exposure to China taxation on an indirect share transfer. They also should, due to the retroactive nature of Circular 698, consider the potential impact of having a lack of substance in the intermediary holding company on the taxation of any indirect sale transaction or transfer (including group reorganizations) occurring on or after 1 January 2008.

The substance-over-form principle stressed in Circulars 2, 601 and 698 has emerged as a major trend regarding the taxation of non-residents. While the guidance provided to date is helpful, many uncertainties still exist, particularly in how these rules will be developed and implemented in practice. The SAT has made it known that additional guidance on the implementation of GAAR should be forthcoming including supplemental guidance to Circular 698.

Beyond the determination of beneficial ownership and the many related open issues, further guidance is required regarding what level of substance is required or necessary in the intermediary holding company that is transferred to preclude a recast of an indirect equity transfer as a direct transfer of shares under GAAR in what would otherwise be a transaction not subject to taxation in China, given no China-source income arises. Would non-tax business purposes and operational substance in a lower-tier holding company below the transferred entity preclude a recast under GAAR?

Further, would related-party transactions or reorganizations be viewed differently? Absent such guidance, it is not possible to know with any certainty what equity transfer transactions may be subject to attack under GAAR.

The interaction between China’s anti-avoidance provisions and tax treaties

As of July 2012, China had signed 99 DTAs. Of these, a number include an anti-abuse provision within an article of the treaty. As an example, the protocol (2010) amending the 2000 China-Barbados DTA has an anti-abuse provision allowing China tax authorities to exercise a GAAR to override the DTA in certain cases. Under Article 4 of the protocol, the DTA provides:

“The provisions of this Agreement shall in no case prevent a contracting state from the application of the provisions of its domestic laws aiming at the prevention of fiscal evasion and avoidance, provided that the taxation in that State on the income concerned is not contrary to this Agreement.”

Importantly, it is worth noting that subsequent to amending the China-Barbados DTA, many (but not all) DTAs signed by the PRC after 1 January 2009 have included an article to apply a domestic GAAR treaty override. Therefore, we believe this will be a continuing trend in future DTA negotiations. Of the 11 DTAs entered into after 1 January 2009, more than 50% contain such a GAAR clause, as shown in Table 1 below.

Table 1. Double tax agreements entered into after 1 January 2009

<table>
<thead>
<tr>
<th>DTA country</th>
<th>Signed date</th>
<th>GAAR clause</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Ethiopia (not yet ratified)</td>
<td>14 May 2009</td>
<td>No</td>
</tr>
<tr>
<td>2. Czech Republic</td>
<td>28 August 2009</td>
<td>Yes – Article 21, Preventing improper use of the Agreement</td>
</tr>
<tr>
<td>3. Belgium* (not yet ratified)</td>
<td>7 October 2009</td>
<td>Yes – Article 23, Miscellaneous Rule</td>
</tr>
<tr>
<td>4. Turkmenistan</td>
<td>13 December 2009</td>
<td>No</td>
</tr>
<tr>
<td>5. Finland</td>
<td>25 May 2010</td>
<td>Yes – Article 23, Miscellaneous Rule</td>
</tr>
<tr>
<td>6. Zambia</td>
<td>26 July 2010</td>
<td>No</td>
</tr>
<tr>
<td>7. Malta*</td>
<td>18 October 2010</td>
<td>Yes – Article 24, Miscellaneous Rule</td>
</tr>
<tr>
<td>8. Syrian Arab Republic</td>
<td>31 October 2010</td>
<td>No</td>
</tr>
<tr>
<td>9. UK* (not yet ratified)</td>
<td>27 June 2011</td>
<td>Yes – Article 23, Miscellaneous Rule</td>
</tr>
<tr>
<td>10. Botswana (not yet ratified)</td>
<td>13 April 2012</td>
<td>No formal DTA published yet</td>
</tr>
<tr>
<td>11. Denmark* (not yet ratified)</td>
<td>16 June 2012</td>
<td>Yes – Article 23, Miscellaneous Rule</td>
</tr>
</tbody>
</table>

14 It is not clear whether a substance-over-form approach will apply to direct sales. This is because Circular 601 only addresses the definition of beneficial ownership (with respect to dividends, interest and royalties) under articles 9, 10 and 11 under the relevant tax treaty, and Circular 698 is silent on this point. However, given recent trends, it is possible that the SAT could apply a substance-over-form approach to direct sales under the GAAR.

15 As of the date this publication went to print, the SAT had not yet issued a supplementary notice to Circular 698, which we believe is imminent. Based on informal discussions with the SAT, we understand guidance should be provided on intergroup transfers or reorganizations that may not be subject to a complete Circular 698 filing and could be exempt from GAAR as long as certain requirements, e.g., business purpose, are met.
Given that this is a developing area, it is not clear when and how the SAT will exercise China's rights under the DTA and override the intended treaty benefit. Further, it is possible the SAT would apply GAAR or a substance-over-form approach if the specific DTA doesn't contain an anti-abuse clause.

It may be worth noting that China may be inclined to invoke exchange of information (EOI) privileges to assist the tax bureau in obtaining information on cases under review, and as noted under Article 5 of Notice 30,16 the tax bureau may revoke beneficial ownership status previously granted in cases where additional information obtained through EOI suggests justification to do so. This is not inconsistent with China tax authorities' use of the EOI in other cases. In the Xinjiang case,17 a published case involving the disposition of a China resident enterprise by a Barbados holding company (SPV), the Xinjiang State Tax Bureau denied in June 2008 tax treaty benefits on a capital gains tax exemption of a Barbados company based on the failure to substantiate tax residency in Barbados. In this regard, SAT employed the EOI provision of the treaty and ultimately concluded that the SPV was not a Barbados tax resident based on the limited information provided by the Barbados government.

Where next for China’s GAAR?

A circular issued in April 2012 indicated that the SAT intends to increasingly incorporate accepted international practices into GAAR’s legislative considerations and aim to improve the balance between domestic and international laws. At the same time, the SAT also set out that a panel review scheme for GAAR cases might be created in the near future to fairly and consistently implement GAAR across the nation.18 This panel review feature is also included in recent GAAR proposals from India and the UK,19 and it has long been a part of Australia’s GAAR administration.

The SAT plans to issue its updated GAAR implementation rules by the end of 2012. In designing its rules, GAARs of other jurisdictions with GAAR experience will no doubt be considered, as will the recommendations of ongoing consultations and refinements in Australia, India, the UK and other jurisdictions.

Ultimately, the goal of the SAT is to design a rule that could create more taxpayer certainty and more concrete guidelines to tax officials at field level.

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16 Article 5 states that if an applicant receives the passive income through an agent (or a designated person), the location of the agent may not affect the determination of the applicant’s beneficial ownership status, as long as the agents fill into a form (as an appendix to Announcement 30) to declare that it is not a beneficial ownership. However, if the Chinese tax authority subsequently discovers that relevant agent is in fact the beneficial ownership of the passive income through exchange of information, relevant treaty benefits originally granted would be clawed back and late payment surcharges would be imposed.

17 A published case of the Xinjiang State Tax Bureau.

18 See Guoshuifa [2012] No. 41, The work plan of strengthening China’s international tax administration system, for more information.

19 In India, it is proposed that the application of GAAR would require confirmation of an approving panel. The draft report of the expert committee constituted by the Indian Government recommends that an approving panel of GAAR should be a permanent independent body consisting of five members, and its chairman should be a retired High Court judge. This recommendation is in order to ensure objectivity and transparency at the time of the application of GAAR and provide taxpayer safeguards.
Circular 698 imposes an obligation on non-residents to supply information and documentation regarding the indirect transfer of China equity interests, with a focus on potentially abusive transactions. However, it is unclear from the Circular what constitutes an abusive transaction and under what circumstances would it be appropriate to disregard an intermediary and recast an indirect sale or transfer as a direct sale of the underlying China affiliate or investment. While there have been a number of published cases involving indirect sales, there is much uncertainty under what circumstances China tax authorities would challenge an indirect sale beyond situations involving SPVs lacking business purpose or substance. The SAT has made it known that additional guidance on the implementation of GAAR should be forthcoming including supplemental guidance to Circular 698 that should provide guidance on what is required to avoid a GAAR attack for transactions involving group reorganizations or transfers as well as third party sales. The supplemental guidance may also include an exemption for qualifying internal restructurings and details on circumstances subject to re-characterization under the look-through principles. There is an increasing concern that the SAT's approach would extend beyond internationally accepted standards, creating much uncertainty for taxpayers and deterring cross border investment and deployment of capital as a result of the lack of certainty about the tax treatment of transactions.

As at September 2012, there have been 11 tax cases where GAAR has been invoked. Although these cases have been publicly reported, the details available on them are limited. From the information available, it seems that the transaction has been characterized as an indirect transfer on the basis of the intermediate holding company lacking business substance.

### Under what circumstances may it be appropriate to apply GAAR as provided by Circular 698?

### Has China’s approach to beneficial ownership gone beyond the OECD guidelines and internationally accepted practice?

Although the main concept and principles of Circular 601 generally follow the mainstream international tax practice and the OECD’s definition of beneficial ownership in regards to conduit companies, the SAT’s guidance as set forth in Circular 601 would appear to go much further, creating significant uncertainty for non-resident taxpayers with respect to qualifying for treaty benefits. The determination of beneficial ownership under Circular 601 is a facts-and-circumstances analysis, and no one of the seven factors identified in Circular 698 seems to be conclusive of the outcome on its own as clarified in Notice 30. Notice 30 provides an important clarification stressing that all relevant factors should be considered “collectively” when assessing beneficial ownership status and such status should not be denied simply because one of the seven negative factors exists. Two other important features of Notice 30 include a same country safe harbor for intermediate holding companies in receipt of dividend income with no or little substance but held by a listco within the same country (similar to the US Limitation of Benefits provision under the 2006 US Model Treaty), and the beneficial owner of the income is still deemed to be; and a look-through provision for cases where legal ownership is held by an Agent.

However, some negative factors on the list appear to have been added by the SAT out of general anti-tax avoidance considerations as they are not generally important considerations in the determination of beneficial ownership outside of China. In other words, in defining beneficial ownership for purposes of reduced withholding tax rates on passive income, the SAT has expanded the term beyond its original meaning and used the beneficial ownership concept as an anti-treaty shopping test/anti-abuse rule, contrary to the OECD’s original meaning.

For instance, the factors focused on substance or whether the China-sourced income received is subject to little or no income taxation in the residence jurisdiction are listed as negative factors to the recipient’s claim as the beneficial owner. Including these factors into determining beneficial ownership appears to be unusual and overly restrictive. For example, a number of common holding company locations in Europe (e.g., Luxembourg) have adopted the so-called “participation exemption” regime, under which qualified dividend income is usually exempt from residence country taxation, while certain other jurisdictions have a territorial tax regime that would not tax foreign source income. Under Circular 601, this would be viewed as a negative factor and is one that is generally failed, often along with yet to be defined substance requirements that would not appear to be relevant in determining if the recipient is the beneficial owner under existing and proposed OECD commentary. In other words, the determination should not be dependent on the recipient having substantive business operations or substance.
The impact of anti-avoidance measures on investment models in China

MNCs and investors investing in China have many tax and non-tax considerations to manage when developing an efficient legal entity, tax and operational structure – and not just because of China’s changing tax treatment of foreign-owned enterprises. Going forward, structuring into China must take into account the existence, enforcement and development of China’s GAAR and the ongoing enforcement of Circulars 601 and 698, which has created much uncertainty. In practice, this will have a significant impact on common structures that lack substance or commercial activities. MNCs and investors are urged to review their group holding structures to make sure there is a sufficient degree of appropriate substance in the relevant holding company jurisdictions and document the non-China tax purposes for having established the holding company in the relevant jurisdiction (i.e., the business purposes of establishing an entity and operations in such as jurisdiction). This is not only important for determining beneficial ownership, but also for assessing whether an indirect sale or transfer may be re-characterized as a direct transfer under GAAR.

Prior to the Chongqing case and the release of Circular 698, it was believed that, unlike a limited number of jurisdictions that will look up the chain and tax an indirect disposition, China would only tax capital gains resulting from a direct disposition. Following the release of Circular 698, it is clear that this is no longer the situation. GAAR may be asserted on transactions required to be reported, and such indirect transfers may be taxed. Unless the taxpayer can demonstrate and document that it has adequate business purpose, substance and/or commercial activities in the relevant jurisdiction, it is likely GAAR will be asserted and China non-resident capital gains tax levied.

Conclusion

With an increasing amount of investment in the region and the continued use of multi-tiered investment structures to minimize local country taxes, tax authorities in China – and many other Asia-Pacific jurisdictions – are closely scrutinizing tax arrangements that they feel may have been used for tax avoidance. Whether a GAAR is designed to tackle anti-avoidance or anti-abuse, the growing number of similar measures arising globally creates a considerable amount of uncertainty for MNCs and investors. Past transactions require careful scrutiny, as do future transactions. Each case must be taken on its own merits, and the characteristics of local GAARs and SAARs – not to mention the known cultural approach of the local taxing authority – must be applied to specific fact patterns. MNCs and investors investing in China should carefully review their investment structures and investment strategies. With the increasing focus on treaty shopping, indirect share transfers and abusive tax arrangements, taxpayers should assess the potential tax risks that exist and consider steps that can be taken to mitigate such risks, including legal or operational restructuring.

Further, taxpayers should consider establishing protocols to monitor similar developments in key markets, as well as examine how any future guidance may affect their tax risk profile and exposure to China and other countries’ withholding or capital gains tax on prior or future transactions.

*This discussion was published in part by the IBFD in the Asia-Pacific Tax Bulletin in the September/October 2011 issue.*
Intercompany effectiveness: operationalizing transfer pricing

As multinationals expand their global footprint, the complex task of managing intercompany relationships and transfer pricing arrangements across multiple jurisdictions is increasingly challenging. CEOs and CFOs need to know that maximum value is derived from business operations. A lack of alignment of transfer pricing strategy with the operational side of the business can lead to an incorrect or suboptimal allocation of returns across the internal value chain, which can create transfer pricing risks with the fiscal authorities.

Accordingly, business executives want to control transfer pricing, especially to the extent that it can be a tool to increase efficiency, drive business value and manage compliance and risk. With proper steering of transfer pricing adjustments, the risk of delayed arrangements to correct or compensate inappropriate profit allocations is mitigated. Implementing a robust, commercially-aligned process for planning, setting and monitoring transfer prices can significantly reduce fiscal risks and also free up resources for more value-added activities.

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France

New proposals to limit financial expense deductions

France’s recent Finance the Bill for 2013 firmly cemented the country as one of a set of European nations putting in place stringent austerity measures in a bid to stave off further deterioration of their deficit which, projected at 4.6% of total GDP in 2012 is far beyond a 3% target.

Much news has circulated about the drastic step that François Hollande, the newly elected president of France, has taken in increasing the top marginal rate of personal income tax for the highest earners to 75%. Perhaps receiving less media coverage but of arguably more importance to corporate tax professionals are the proposals to limit financial expense deductions to 85% of interest for fiscal years ending on or after 31 December 2012, further reducing the deduction by 10% to 75% for years 2014 and beyond, aligning France even more to the widespread global trend in this area.
The immediate effect of the Bill would mean:

- The interest limitation would not apply if the net financial interest expenses of the financial year do not exceed €3 million.
- With regard to the acquisition of qualifying participants, an acquiring company will face a limitation to the deduction of interest if:
  - The company is established in France controlling the latter or it effectively makes decisions related to those shares
  - When it has control or influence over the shares of a company that is held or established in France
- Corporate income tax (CIT) would be applicable to 10% of the total gross capital gains without subtracting potential losses from the same fiscal year
- A reduced cap of net operating loss (NOL) carryforwards to €1 million plus 50% (a 10% reduction from previous years) of the taxable income of the fiscal year exceeding €1 million.
- An easing of conditions under which a company can request a tax ruling in order to secure the benefit of research and development (R&D) where the eligible company has already begun research
- Improved R&D tax credit for small- and mid-sized firms as defined by EU law
- Fourth installment of CIT extended for firms that have an estimated annual revenue exceeding €250M (reduced from €500M) for the current fiscal as well as an increase of the installment amount
- French firms with non-EU subsidiaries will only be eligible for the safe harbor clause and benefit from a tax favorable gain only if they can prove the absence of tax purpose or effect resulting in such an establishment (inversion of the burden of proof)
- Financial debt waivers would no longer be tax deductible

Additionally, companies are subject to a 3% additional surtax based on the dividends paid as of 4 July 2012 and as announced some time ago, the 2012 and 2013 CIT rate will include a 5% surtax on total corporate taxes due, which increases the effective corporate tax rate to 36.1%. However, this rate will decrease by a little less than 1.6% to 34.43 in the year 2014 and remain the same through 2015.

Policy context

While these changes have come to a fore within this single Bill, all have been under debate for some time. Considering the projected budget deficit of 4.6% of GDP and taking into account the overall European and global economic weakness, France has been under tremendous pressure from the European Commission as well as the financial markets to take action. Prior to Mr. Hollande’s election, the previous government had already started putting in place measures to reduce the deficit in 2011. Previously anticipated to reach 5.6% of GDP, the deficit was in fact reduced to 5.2% by the end of 2011.

Now, France is trying to speed up the process to further reduce the deficit to 3% of the GDP and to meet that goal by the end of 2013.

All in all, these drastic changes indicate difficult and somewhat tough times ahead for both taxpayers as well as France in the years to come.

Future predictions

France finds itself in a difficult predicament where, with a high corporate tax rate in place (although, to be fair, a smaller tax base than many European neighbors), it is most likely to have increased the tax burden of individuals over that of large multinational companies, as evidenced by the significant increase to the top rate of personal income — although that increase in fact impacts a relatively small number of taxpayers. What will be of greater interest — to the taxpaying public, at least — is whether the government takes advantage of the fact that it has only just been elected to play the “long game” by increasing the tax burden on the middle classes before reducing it in advance of the next election. As in many other countries, tax is now taking the stage as a core component of the political landscape in France.

It is anticipated that the main provisions of the Bill will pass in parliament with few amendments. Whether or not this challenges the overall tax competitiveness of France remains to be seen.
Indian tax policy has witnessed unprecedented action, particularly on the international taxation front, since the presentation of the Union Budget in March 2012. The Finance Act 2012 introduced a number of far-reaching amendments to Indian tax law, the most controversial being the introduction of a general anti-avoidance rule (GAAR) and the taxation of indirect transfers of assets (at the holding company level), the latter with a 50-year retroactive effect, putting many global multinationals into a situation where they were unwittingly taxed on transactions that would not formerly have attracted tax.\(^1\) In a series of recent events, the Indian government has demonstrated a real willingness to engage with and listen to business, with the signs showing that a more balanced approach is likely to be taken on both accounts.

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\(^1\) See article from edition 10 of this publication titled “2012 Union Budget raises specter of being taxed for deals past” at www.ey.com/TPC.
The provisions created a serious negative impact on the investors and the business community, raising doubts about India as a stable tax jurisdiction. The immediate month following the announcement of these provisions saw a sharp decline in Foreign Direct Investment (FDI) and investments by the Foreign Institutional Investors (FIIs) into India. This significant disquiet from the investor community triggered a serious review of the new provisions by the Indian government.

**GAAR rising**

The Finance Bill was amended in May 2012 to defer the applicability of the GAAR provisions by one year to 1 April 2013, and some added degree of comfort was offered to taxpayers by removing the onus of proof from them and putting it onto the Revenue Department as well as the introduction of an independent member in the GAAR approving panel to ensure objectivity and transparency. Advance rulings for GAAR were also proposed, and a committee was constituted under the Chairmanship of the Director General of Income Tax (DGIT) (International Taxation) to recommend guidelines for implementation of the GAAR and to suggest safeguards against the indiscriminate use of GAAR provisions.

The DGIT Committee published the Draft GAAR Guidelines for public comments on 28 June 2012. Though the DGIT Committee made some good recommendations, they did not provide the necessary comfort and clarity to taxpayers about the circumstances in which GAAR could be invoked.

In July 2012, the Prime Minister (who himself took interim charge of the Finance Ministry on the then Finance Minister’s appointment as the President of India), announced the formation of two important committees. An Expert Committee on GAAR was set up under the Chairmanship of Dr. Parthasarthi Shome to undertake stakeholder consultations and finalize the guidelines for GAAR. The Expert Committee’s mandate was later expanded to include making a series of recommendations regarding the issue of the taxation of indirect transfer of assets where the underlying asset is in India and bring clarity on the tax liability of portfolio investors and FIIs.

**Transfer pricing also a bone of contention**

India has the dubious distinction of having perhaps the greatest number of transfer pricing (TP) controversy cases compared to other jurisdictions, with TP cases under litigation numbering around 3,500 to 4,000 a year. To address the concerns about the rising number of disputes in transfer pricing, especially in the IT and IT-enabled services (ITeS) sector, the Prime Minister constituted another committee, under the Chairmanship of Mr. N. Rangachary, former Chairman of the Central Board of Direct Taxes, to finalize the safe harbor provisions sector-by-sector and suggest the approach to taxation of development centers in India. The safe harbor provisions were announced in the Budget 2010, but have been pending implementation since that time.

A significant aspect about both Committees was that they were headed by independent persons outside the Revenue Department. Given the urgent need to restore investors’ confidence, the Committees were given short deadlines to submit their recommendations. That the government is serious in its intent to reconsider the contentious international tax provisions announced earlier and reduce the anxiety of both inbound and domestic investors was made more evident by the following statement made by the new Finance Minister, Mr. P. Chidambaram, shortly after assuming office:

“The key to restarting the growth engine is to attract more investment, both from domestic investors and foreign investors. We intend to fine tune policies and procedures that will facilitate capital flows into India. Clarity in tax laws, a stable tax regime, a non-adversarial tax administration, a fair mechanism for dispute resolution and an independent judiciary will provide great assurance to the investors. We will take corrective measures where necessary.”

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2 Dr. Shome is Ernst & Young’s ITIC luminary and has taken a leave of absence to Chair the Expert Committee on GAAR.
The developments and the efforts made by the government are clearly indicative of the positive turnaround in the government’s thinking. They are a signal to the investors that the government is committed to providing better tax policies that are openly debated, well-considered and provide higher levels of certainty to taxpayer and tax authority alike.

**Key issues surrounding GAAR**

It is useful to understand the key issues under debate that guided the recommendations of the Committees constituted by the government on GAAR. Though the GAAR provisions were thoroughly discussed as a part of the Direct Taxes Code Bill 2010 (DTC), the form in which they were introduced in the recent Budget generated much controversy. The GAAR provisions proposed in the Finance Bill 2012 gave wide discretionary powers to the tax authorities to invoke GAAR and to declare an arrangement to be an “impermissible tax avoidance arrangement.” The main concern of the industry was that the provisions as they were worded were so open ended that even those transactions that are globally considered legitimate tax planning and are thus permissible, now became vulnerable to being treated as impermissible by the authorities.

Moreover, in the absence of any guidelines or rules to bring clarity in respect of the application of GAAR, business was concerned about the positions that may be taken by the tax authorities on various transactions.

The most fundamental issue raised was: “Is India ready for GAAR at the current juncture?” By its very nature, GAAR involves the use of discretion by the tax authorities and holds a strong danger of being misused or used indiscriminately. Other countries have put safeguards in place such that GAAR is invoked selectively in prima facie contrived or artificial transactions, and not against the “center ground” of tax planning. However, in a jurisdiction like India, where the tax administration has still to gain the requisite maturity and may arguably lack complete accountability, the degree of discretion that GAAR offers can be hazardous.

Secondly, if GAAR is introduced, under which circumstances should it be invoked? Given the complexity of transactions, there is a very thin line dividing tax mitigation and tax avoidance. If invoked inconsiderately, GAAR may affect even the transactions that are genuine and constitute legitimate tax planning.

The third aspect was the use of specific anti avoidance rules (SAAR) instead of GAAR. Having SAARs provide greater clarity and certainty in law as they communicate the clear intent of the government to not accept certain transactions. Thus, the avoidance transactions should be first checked through the use of SAARs and only the residual cases that are clearly abusive and contrived in nature should attract the attention of GAAR. GAAR should not be a substitute for SAAR. It should be invoked only as a residual, to fortify the SAARs, and only in the case of abusive transactions.

**DGIT Committee’s recommendations**

With the above key issues under debate, the DGIT Committee, constituted under the directive of the former Finance Minister, Mr. Pranab Mukherjee, issued draft guidelines on GAAR in order to obtain wider feedback. The guidelines reiterated the government’s assurances on many points:

- The assurance to taxpayers that GAAR would not be averse to tax mitigation.
- That where only a part of the arrangement is impermissible, the tax consequences would be limited to only that part of the arrangement.
- Treaty benefit could be availed by an investor who had adequate substance in the holding jurisdiction.
- Taxpayers were given a business choice of raising funds by mode of equity or capital.
- The guidelines also stated that in normal circumstances, SAAR would prevail over GAAR.

Finally, the guidelines included 21 examples of situations where GAAR could and could not be applicable.
The guidelines did not provide, however, the desired clarity around the application of the GAAR provisions or the comfort about their judicious use. For instance, some of the illustrative examples contained conclusions concerning denial of tax benefits, including treaty benefit, even where the fact pattern did not suggest abuse or artifice.

**Steps in the right direction**

The guidelines did not provide, however, the desired clarity around the application of the GAAR provisions or the comfort about their judicious use. For instance, some of the illustrative examples contained conclusions concerning denial of tax benefits, including treaty benefit, even where the fact pattern did not suggest abuse or artifice.

Interestingly, soon after the DGIT Committee gave its recommendations, the Prime Minister’s Office issued a statement that the guidelines had not been studied by the Prime Minister and that these were only draft guidelines for public comments. This was followed by another statement about the formation of the Shome Committee to study the guidelines, including having a more transparent and open debate with stakeholders before finalizing the guidelines.

After a month-long consultation, the Shome Committee submitted its first Report in August 2012 for public comments. The Committee made some path-breaking and positive suggestions.

Duly understanding business concerns and the immense challenges that the GAAR provisions in their current form could create, the Shome Committee recommended a three-year deferral of GAAR’s implementation. Cautioning against the use of GAAR as a revenue-generating tool, it suggested significant pruning of its scope by restricting its application only to abusive, contrived and artificial transactions. In the words of the Shome Committee itself, “GAAR is an extremely advanced instrument of tax administration – one of deterrence, rather than for revenue generation – for which intensive training of tax officers, who would specialize in the finer aspects of international taxation, is needed.” As a further safeguard, it recommended the invocation of GAAR to be subject to an approval by an independent Advisory Panel.3

An important suggestion by the Shome Committee was an exemption from GAAR for mutual funds and other pooling vehicles making investments through low-tax treaty jurisdictions such as Mauritius and Singapore, and the grandfathering of investments made prior to its implementation. One of the boldest suggestions made by the Shome Committee was to abolish the tax on short-term gains (long-term gains are already exempted), whether by way of capital gains or business income, from transfer of listed shares. Any revenue loss from such exemption could be offset, the panel recommended, by an increase in the rate of securities transaction tax (STT). The exemption would apply to both residents and non-residents of India.

The main benefit for the investments coming through Mauritius and Singapore is the exemption from capital gains. The Shome Committee seems to be of the view that the government of India should extend this benefit to all investments irrespective of the country from which they pertain, thus neutralizing the advantage under the treaty for the FIIs investing in India.

Set out briefly below are the key recommendations of the Report.

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3 Many of the caveats and restrictions on use of GAAR suggested by the Shome Committee are similar to those expressed by the Coalition on International Taxation in India, supported by Ernst & Young, in its interactions with the Shome Committee.
Key recommendations of Shome Committee

- The implementation of GAAR should be deferred by a further three years to financial year 2016-17.
- The tax on the transfer of listed securities for non-residents and residents should be abolished.
- Only arrangements having the main purpose of obtaining tax benefits should be covered by GAAR compared to arrangements having one of the main purposes being sufficient to trigger GAAR. In this vein, GAAR should be applicable only in cases of abusive, contrived and artificial arrangements.
- An approving panel committee should comprise five members headed by a retired High Court Judge.
- A monetary threshold of INR 30 million (approximately USD 5.5 million) is recommended for invoking GAAR.
- GAAR should be made subject to the overarching principle that tax mitigation is distinguished from tax avoidance; specify negative list where GAAR is not applicable (for e.g., payment of dividend versus buyback, funding through debt or equity, court-approved amalgamations and demergers).
- GAAR is not to be invoked in revenue-neutral intra-group transactions.
- All investments (not arrangements) made prior to the effective date of GAAR (1 April 2016) should be grandfathered.
- The period of time of existence of arrangement, payment of taxes, and the availability of exit route are relevant though not sufficient to prove commercial substance. These factors are to be considered, however, in determining whether an arrangement lacks commercial substance.
- SAAR in Indian DTL / limitation recast as sentence on benefits clauses in treaties to override GAAR.
- Where part of the arrangement is impermissible, GAAR consequences will be limited to that portion of the arrangement.
- Allow corresponding adjustment to taxpayers where GAAR is invoked recast as sentence. However, no such relief available to any other taxpayer.
- GAAR is not applicable to determine genuineness of residency of a Mauritius entity, where the administrative circular (Circular 789) providing for tax residency certificate as being sufficient evidence for residency continues to be applicable. It is also recommended to retain this circular (Circular 789) until the tax on listed securities is abolished.
- While applying for tax withholding certificate, GAAR may not be applicable on providing satisfactory undertaking to discharge any tax and interest liability in case GAAR was found to be applicable at audit stage.
- The Shome Committee Report acknowledges GAAR as an extremely advanced instrument of tax administration and one of deterrence rather than revenue generation. Towards this, it recommends training of tax officers to specialize in international taxation.

The Shome Committee was given the mandate of giving its final recommendations by 30 September 2012 and has duly submitted its final recommendations on GAAR (see box on left). Although the Finance Minister has indicated that the GAAR was to be finalized by the end of October 2012, we await the verdict of the government on which of the Shome Committee recommendations will be implemented. The finalization of the GAAR is likely to be followed by an amendment in the Income-tax Act, though the time frame for the legislative amendment is not known at the point in time at which this article was drafted.

India’s position on the indirect transfer of assets

Of course, GAAR was not the only source of distress to business earlier this year. Another significant legislative amendment was the taxation of all offshore indirect transfer of assets in India to capital gains tax, negating the well settled and time-tested interpretation of the relevant provisions of law. The law as it existed at the time did not apply to taxation of indirect transfer of capital assets in India as was clearly brought out by the Honorable Supreme Court in its recent judgment in the Vodafone case.

The amendment, expanding the source rule to activities that could have a limited nexus with India, was made with 50-year’s retrospectivity (i.e., affecting transactions back as far as 1962). Equally concerning was the validation clause in the Finance Bill, 2012 that provided for validation of demands raised under the Income-tax Act in certain cases and would operate “notwithstanding anything contained in any judgment, decree or order of the Court or tribunal or any authority.” The validation clause meant that irrespective of any Court judgment, the government could assert the right to collect tax demanded.
As in the case of GAAR, a severe backlash from business and the negative impact on the investor community spurred the government into reviewing these contentious provisions. The Shome Committee was therefore given the additional mandate of examining the issue of retrospective amendments and the taxation of indirect transfers.

The fundamental issue under debate has been whether income should be taxed on the basis of residence principle or the source principle. The difficulty in applying the source principle to capital gains is that the source of the share capital gains is very difficult to establish. The concerned corporate entity could be from any jurisdiction, and the change in the valuation of its shares will depend on an amalgam of factors. The valuation of shares may also reflect the contribution of the management, which may be located in the head office of the company, and not just the quantum of physical assets in a particular jurisdiction.

For this reason, the taxation of capital gains is limited to a narrow class of shares, representing interest in real property where is there is much greater correspondence between the valuation of shares and valuation of property.

Another key issue under discussion is whether the share capital gains should be taxable at all. Mr. Pranab Mukherjee had argued that the taxation of the Hutchison-Vodafone transaction was justified, as such income was not taxed anywhere and should therefore be taxed in India as it was derived from the assets located in India. The fact is, however, that capital gains on shares represent income that has been taxed previously in the country where the corporate assets are located. Capital gains tax is essentially a third tier tax over and above corporate income tax and a tax on dividends. Interestingly, the Shome Committee used the same argument as Mr. Mukherjee, but to reach an opposite conclusion in its Report on GAAR where it has recommended that the any gains on the transfer of shares should not be taxed.

The Shome Committee’s recommendation on doing away with taxation of capital gains was not expected, but it was consistent with the view expressed by Ernst & Young on the subject.

The following clarificatory amendments are included in the Finance Act, 2012:

- In the source rule, the expression “through” shall mean to include “by means of” or “in consequence of” or “by reason of” transfer of a capital asset in India.
- Any share or interest in a company or entity outside India shall be deemed to have been situated in India if the share or interest derives its value either directly or indirectly substantially from the assets located in India.
- In the definition of “capital asset,” the term “property” shall include any rights in or in relation to an Indian company it shall include rights of management or control or any other rights whatsoever.
- The definition of the term “transfer” is clarified to have a wide meaning by including disposition of an asset or any interest therein or creating any interest in any asset in any manner, directly or indirectly, absolutely or conditionally, voluntarily or involuntarily, by way of an agreement entered in or outside of India. Further, this definition will be irrespective of the fact that such transfer of rights has been characterized as being effected or dependent upon or flowing from the transfer of shares of a company incorporated outside India.
Business has been clear in its view that, should the government decide to retain the provisions on taxation of indirect transfers, they should apply with prospective effect only. The Shome Expert Committee on 09 October 2012 issued its second report. The Shome Expert Committee recommends that retrospective application of tax laws should occur only in exceptional or rarest of rare cases and with particular objectives, namely, first to correct apparent mistakes or anomalies in the statute, second to remove technical procedural defects which have vitiated the substantive laws and third to protect the tax base from highly abusive tax avoidance schemes. However, retrospective application of tax laws should never be used to expand the tax base as is the case in respect of taxation of indirect transfers.

The Shome Expert Committee has noted the objective of maintaining certainty, predictability and stability of tax laws in India so as to remove uncertainty in the minds of investors about shifting interpretations of the Indian Revenue seriously impacting the perception of safety of investing in India.

The Shome Expert Committee has further proceeded to consider the possibility of government retaining the retrospective amendments and even here has made some specific suggestions vis-a-vis both the purchaser of the foreign shares as also the seller thereof. Shome Expert Committee has recommended that the purchaser should never be treated as a taxpayer in default in relation to retrospective amendments as this would amount to imposition of burden of impossibility of performance. In other words, government could apply the retrospective provisions only on the taxpayers who earns capital gains from indirect transfers. Moreover, even for the seller, who earns capital gains, there should be no levy of interest and penalties on such back taxes.

The Shome Committee has also fully incorporated the recommendations made by the Parliamentary Standing Committee on Finance to clarify substantial value as 50% or more value derived from assets located in India and carve out exceptions for internal reorganizations.

The recommendations are truly salutary, and they align with the norms of certainty, predictability and stability of tax laws. A full analysis of the recommendations can be accessed at www.ey.com/shome_indirecttransfers.

The second Shome Committee recommendations: prospective application of indirect transfer amendments should be the norm, retrospective application “only in rarest of rare situations”
When compared with tax law of other large countries, the decision to push for such high levels of retroactivity (50 years) seems completely unaligned to practice among India’s peer group. In Brazil, for example, new tax legislation should only have prospective effects, although under very specific matters it may be possible to find tax legislation with retroactive effects – but certainly not past the five-year statute of limitations. In Russia, meanwhile, acts of tax- and levy legislation, which either establish or increase new taxes or levies or otherwise worsen the position of taxpayers or levy payers, do not have retroactive force.

It is perhaps China that provides the most easily comparable situation though; Circular 698 (which deals with beneficial ownership for treaty purposes and taxation of direct/indirect transfers of the shares of a Chinese company) was issued on 10 December 2009, but is retroactively effective to 1 January 2008 only. However, China’s provisions are far more limited in scope than those proposed in the Budget 2012 in India.

Even within India, the 50-year retroactive period – particularly given the nature of the very sizeable and sensitive issue it addresses – seems particularly unusual. That said, Finance Bill 2010 did contain a measure (that interest and fees for technical services and royalty would be taxable in India irrespective of the place where the services were provided, as opposed to formerly being taxable if the services were provided in India) that was retroactive for a period of 36 years, right back to when the tax was actually introduced.

India’s initiatives to reduce transfer pricing disputes

In India, transfer pricing (TP) disputes have emerged as a significant challenge faced by multinational enterprises, which significantly add uncertainty, compliance burden and costs to their businesses. As per the government’s own estimates, during 2011–12 more than 50% of the TP audit cases completed faced an adjustment, and the amount of adjustment during the period was as high as almost INR45,000 crores (over US$8.7 billion).

Existing dispute resolution mechanisms have not proved to be very successful. For instance, the mutual agreement procedures (MAP), being essentially negotiated settlements between the authorities of the countries involved, are time consuming and expensive. Dispute resolution panels (DRPs) were constituted by the government in 2009 with the objective of providing speedy resolution of disputes. Though the DRPs have the potential to be an effective mechanism to deal with transfer pricing controversy, significant implementation gaps have made their functioning ineffective.

Responding to the need to provide alternative channels for dispute resolution, the government has recently taken two significant steps in the right direction – the creation of an advance pricing agreement (APA) scheme and the constitution of a committee by the Prime Minister to review the taxation of development centers and the IT sector and to finalize the Safe Harbor provisions announced in Budget 2010, on a sector-by-sector basis.

APAs are expected to provide more certainty and predictability to the transfer pricing landscape by proactively avoiding controversy before it arises and offering a solution to the difficult and complex TP issues through discussions at the right level. In the Indian context, though the APAs are likely to take some years to gain maturity, their introduction is a step in the right direction and offers a window of opportunity for controversy management.
Safe harbor rules

Further evidence of the government's intent to provide comfort to investors can be found in their response to the long-standing demand from the IT industry to address the anomalies in the taxation of both the IT sector and development centers in other industries. A Committee was constituted by the Prime Minister under the chairmanship of Mr. N. Rangachary to address these issues, as well as the tax treatment of “onsite services” of domestic software firms and finalize the safe harbor rules individually, sector-by-sector, by December 2012. Recognizing that the safe harbor provisions have the advantage of being a good risk mitigation measure that could provide additional certainty to taxpayers, the government had announced the safe harbor provisions in its Budget 2010 but the rules for their implementation have been pending since then.

With the Indian IT sector suffering from fallout from the global financial crisis, clarity in taxation is important if India wants to remain an attractive destination for investment.

One of the key issues under discussion has been the identification of the legal and economic ownership of the IP of the work product of the development centers, and to determine who bears the cost and risks, and undertakes the critical functions in the entire process. The industry is of the view that given the “contract R&D” and “work for hire” arrangement between the IT development center and principal R&D company, the intangible-related returns belong to service recipients and not service providers. Most captive development entities are compensated on a cost-plus-mark-up basis wherein they are reimbursed for all of their costs (including costs of rework, hiring costs), and there is no real risk borne by these captive centers.
The development centers have also been facing aggressive audits for their transfer pricing, with the tax authority determining arm’s length markups in a much higher range. Indian companies forming part of a multinational corporation and rendering IT services and ITES to their related parties overseas generally earn a markup on total costs (“margin”) in the range of 12–18%6 for rendering these services. However, the indicative markup on total cost determined by tax authorities in various transfer pricing assessments has been as high as 25–35%. Such issues faced by the industry underscore the need for early implementation of the safe harbor provisions in order to bring greater certainty.

The Committee has been sympathetic to the industry concerns and has submitted its report to the Finance Minister but the recommendations have not yet been made public.

Where to next?

Returning to the Shome Committee recommendations on indirect asset transfers, the question now seems to be whether the Indian government has enough room on the expenditure side to allow itself the luxury of sacrificing income by way of tax revenues. Of course, they will be balancing this side of the equation with the possibility of damaging FDI flows if that choice is not taken.

The government may be tempted to adopt a balancing approach suggested by the Shome Committee, which centers on retaining the retrospective amendment but provide for waiver of interest and penalties. The dilemma for the government here would be that it might weaken its legal stance before the courts where it is already facing a challenge to the retrospective amendment in two cases. The fact of the matter is that these amendments are so complex in nature and so exhaustive in their reach that to justify them as mere clarificatory was by itself an unreasonable move by the government.

With its new found boldness and conviction, the government might spring a pleasant surprise and roll back the retrospective amendment in Parliament with a reasonably achievable assumption of attracting far greater investments in the remaining months to 2014 whereby both the fiscal deficit and political capital can be protected.

The recommendations are truly salutary and they align with the norms of certainty, predictability and stability of tax laws.

GAAR

If past international experience is any guide, the task of introduction of GAAR provisions through a consultative process and the formulation of guidelines for its implementation have always been a challenge, given the need to strike a fine balance between the desire to protect the tax base on one hand and tackling artificial and contrived schemes on the other, all while putting a check on the discretionary exercise of power so as not to create an environment of long-term uncertainty.

This is a delicate exercise because conferment of certain levels of discretion is always inherent in a GAAR. The ability to categorize tax arrangements as either permissible or impermissible in an objective, transparent and clear manner is yet another challenge.

In the midst of these challenges, the report by the Shome Committee nonetheless represents a positive step towards allaying the fears of investors and providing a policy direction to government and tax administration. The proposal to defer the introduction of GAAR to allow for change in the mindset of the taxpaying community and to prepare the tax administration is highly salutary. Likewise, the insertion of overarching principles as a precondition to GAAR applicability is reflective of the true intent of GAAR. Proposals to grandfather existing investments, to protect the tax efficiency of fund pooling vehicles, to respect double taxation avoidance agreements containing specific anti-avoidance rules and to uphold the validity of Circular No. 789 (which states that a tax residency certificate issued by Mauritius constitutes sufficient evidence) should allow go some way to starting the process of rehabilitating investor confidence in India.

The creation of a minimum threshold level of tax benefit for GAAR trigger is also likely, if enacted, to keep a large volume of taxpayers outside GAAR scrutiny, and the creation of an independent approving panel should have most bona fide GAAR cases happy with the proposals. But, as with any challenging change, some items remain open. For the business community, the comprehensive final report due on 30 September 2013 should provide more clarity.

Note: Events continue to develop in India. Parts of this article may be surpassed by the time this article is read and, readers are advised to secure timely and up to date professional advice.
The Netherlands, in common with other EU countries, recently further restricted the deductibility of interest expense. In its tax budget proposal for fiscal year 2013, on 4 June 2012, the Dutch Ministry of Finance proposed important changes for Dutch corporate taxpayers financed with net debt that currently generates tax-deductible interest. The move is taken in an effort to raise revenue, decrease the deficit and repair any “mismatching” of the Dutch tax benefit system.
The tax budget proposal contains a new provision that limits the deduction of excessive interest paid by a Dutch corporate taxpayer related to interest expense incurred with debts financed to generate income that is exempt under the Dutch participation exemption. On 21 June 2012, the Dutch Lower Chamber of Parliament adopted the proposal, and the new rule will be in effect as of 1 January 2013.

**Background**

The bill is in response to the ECJ/Bosal case, in which the court affirmed that the disallowance of the deductibility of the financing cost incurred by the Dutch corporation in connection to foreign participation was contradictory to the right to establish companies under the EC Treaty. The judgment of ECJ has decreed that interest expenses related to debts to finance a foreign subsidiary are, in principle, deductible at the level of Dutch (acquisition) entity. However, the decision resulted in the “mismatching” of Dutch tax benefits. Under the application of the participation exemption, the benefits (such as dividends and capital gains) are tax exempt, whereas the financing costs are deductible. In the explanatory memorandum to the new legislation, it is stated that the new bill was proposed to repair this “mismatching” by limiting the deductibility of “excessive interest” incurred with the acquisition of financing costs related to subsidiaries qualifying for the participation exemption.

**Key facts of the new rule**

Under the new rule, excessive interest is defined as the amount of interest and costs paid by a Dutch corporate taxpayer for both external and internal debt, times its average amount of participation debt divided by its average amount of total debt. Participation debt is considered present if the cost price of a taxpayer’s participation exceeds the taxpayer’s equity for tax purposes. The participation debt can never exceed the total amount of debt nor the total cost price of the participations. The participation debt is also lowered with the debt that is subject to other interest deduction limitations (i.e., Article 10a and Article 10b CITA).

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1 The participation exemption is one of the well-established features of the Dutch Corporate Income Tax Act of 1969 (CITA). It applies to income as well as capital gains related to qualifying participations.
2 Article 52 and 28 of the EC Treaty (recently renumbered as article 43 and 48).
3 Tax Analyst, Doc 2012-11412.
4 Mismatching is put between quotation marks, as it was an explicit choice of the Dutch legislator a couple of years ago not to repair the interest deductibility after the judgment of the ECJ.
5 These averages are calculated as the simple average of the relevant amounts per the first and last day of its fiscal year. Also, for the purpose of this calculation, the term of debt does not include tax payable, provisions, pension liabilities and non-interest-bearing debt related to which no deemed interest deduction is taken into account. Foreign exchange risk hedging costs and foreign exchange results related to interest (not related to loan principal) should be included in the interest and financing costs.
Exceptions to the rule

Expansion investment
An important exception relates to “expansion investments,” i.e., investments relating to the expansion of operational activities. If (i) the foreign participation has been acquired or expanded, or (ii) equity has been contributed to the participation for the expansion of operational activities, then the new rule does not apply to this participation. The expansion can take place at the moment of such acquisition, expansion or contribution as well as in the 12 preceding or following months. The expansion investment escape does not apply if the interest expenses related to the debt used to finance the expansion investment are deducted at the level of another entity within the taxpayer’s group (i.e., double dip) and certain other abusive situations.

Certain group financing activities
Active financing within the group will be excluded from the scope of the new rule. In order to apply for the active financing rule, the taxpayer should demonstrate that the payables and receivables held are related to the active financing activities. Financing activities are considered active if the activities, not being incidental activities, are carried out with regard to arranging and executing financial transactions, for the benefit of the taxpayer and related entities. In calculating the excessive interest, the interest expense and costs of payables related to any active financing will be excluded from the total amount of interest and cost. Payables related to the active financing will lower the average total amount of debt. As a result the amount of excessive interest will be lower.

Grandfathering rule
An optional grandfathering rule is introduced with respect to subsidiaries that are acquired, expanded or to which contribution was made in a tax year starting before or on 1 January 2006. In the grandfathering rule, 90% of the cost price of the taxpayer’s participation will not be taken into account when calculating the participation debt. The grandfathering rule does not apply in case of abusive situations, such as a double-dip structure.

Thin capitalization rule
The proposal mentions that the Dutch government is willing to abolish the current thin capitalization rule; however, the abolishment of the rule will occur only with the sufficiency and availability of additional budget.

Threshold
The new rule provides a threshold up to €750,000 in deducting the interest expense and related costs incurred with debts to finance the foreign subsidiary.

New rule in effect
The new rule on the limitation on the deduction of interest expense will apply for a fiscal year that starts on or after 1 January 2013.
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Indirect Tax Briefing – Issue 5 now available

In the latest issue of Indirect Tax Briefing, we look at how multinational companies are responding to changing global trends, how the management of indirect taxes can be improved and how the indirect tax landscape impacts the tax function and the role of the indirect tax executive.

The publication will be of interest to tax directors, indirect tax managers and C-suite executives of multinational companies. It provides valuable insights on how globalization is changing how business is done and how it impacts supply chains and the management of indirect taxes.

Sweden’s drive for tax competitiveness: proposed reduction in headline corporate income tax rate tempered with limitations on interest deductibility

Although their announcements were separated by some months, Sweden recently unveiled a pair of tax proposals that reflect a trend being seen in many countries elsewhere: that of a significant reduction in headline corporate income tax rates (from 26.3% to 22%, effective 1 January 2013), with a corresponding limit on the tax deductibility of interest payments that will cover roughly half the cost of the rate reduction.
Interest limitation — background
The Swedish government is currently proposing the tightening of Swedish tax rules limiting the tax deductibility of interest payments on loans. The objective of the proposal is to counteract certain types of tax planning using loans and interest payments, an approach that has been used in Sweden for some time and that the government feels has been eroding the Swedish tax base. The current proposal contains some radical changes to the rules currently in place since 2009. The proposed changes should also be seen in context of other changes to the Swedish Income Tax Act that the Swedish government would like to accomplish in coming years, including the proposed corporate income tax rate cut.

Government view of the Swedish corporate tax system
In an initiative to carry out a broad review of the Swedish corporate tax system, the government in 2011 appointed a special committee for this purpose. In the guidance to the committee, the Swedish government recognizes taxation of companies as being of central importance for both inbound and domestic investment, Swedish tax revenue growth and for competitiveness of companies. A dynamic and innovative business environment that is based on predictable rules, sound competition and development capability is widely seen as important for Sweden in order to support future economic development. The purpose of the review is, therefore, that the taxation of companies should be designed to favor entrepreneurship, investment and increased employment. Special attention shall be given to changes in tax legislation that can improve Sweden’s global competitiveness while protecting the tax base from erosion that has arisen from certain cross-border transactions.

Looking back
During the 1990s the Swedish corporate income tax system went through significant reform with the introduction of a much broader tax base and a reduction of the headline corporate income tax rate from 57% to 28% in just a few short years. From tax year 2009, the tax rate stands at 26.3%.

The reform contributed to a more neutral tax system where investment in different types of assets and where different means of financing and investment were treated more uniformly. As a result, Sweden was viewed as having one of the most competitive corporate tax systems within OECD; in 1995 the Swedish corporate tax rate was 28% while the average income tax rate of 27 EU Member States was 37.5%. Thereafter the income tax rate has decreased in many countries, and the average corporate tax rate within the EU is now 25.9% and for Euro countries, 23.5%. Despite the further reduction in 2009 to 26.3%, Sweden’s headline rate today is still above the average EU rate, and the country has consequently lost a significant competitive advantage compared with earlier years.

The rate cut to 22% mirrors that of a number of other European economies, all seemingly targeting a corporate income tax rate in the low-twenties. With all countries now driving these higher levels of tax competition, the Swedish Government now sees the need to carry out broader reform of the Swedish corporate tax system. Contributing to this is that in a more and more globalized economy, it is important that a corporate tax system is competitively neutral and contributes to a high level of investment and a quick development of productivity that will benefit the Swedish GDP. The Swedish government is consequently looking to create long-term changes to the tax system that promote investment and productivity, but at the same time introduce changes to the tax system that protect the Swedish tax base and prevent possible erosion of Swedish corporate income tax revenue.
Current areas of concern

In the current tax system there are some areas that are viewed as specific areas of concern by the Government, and the financing of investment is one key concern. In the current Swedish corporate tax system, there is what can be described as a “double asymmetry.” The first asymmetry comes from the fact that revenue from investment in certain kinds of assets, as for example business-related share investments, are tax free while interest expense on loans (that could be used to finance such an investment) are tax deductible. The second asymmetry comes from the diverging treatment of different sources of financing, where cost for borrowed capital (interest) may be deducted while cost of equity (dividend and value increase) is non-deductible. The asymmetries represent more and more of an issue as the world economy has become more and more globalized.

Other areas of concern and focus are:

- The lack of withholding tax (WHT) on interest payments made outside Sweden (while most other countries apply WHT), which may facilitate tax evasion attempts
- The lack of competitive research and development incentives, while other countries are introducing or reforming such systems
- Swedish rules on group contributions (the Swedish method of tax consolidation) that were designed to work in a closed economy (i.e., on a domestic level)

All of these areas will be addressed by the Government-appointed committee, and we will most likely see proposed changes to Swedish tax legislation. The more pressing concern, however, to the Government seems to be the Swedish rules on a tax deduction for interest costs. Despite that, rules governing interest deductibility are part of the broader review of the Swedish corporate tax system the Government has already now, in addition, proposed changes to the current rules effective already as from 1 January 2013.

Current legislation on interest deductibility

The Swedish Income Tax Act contains rules limiting the deductibility of interest expense on intra-group loans that have been used for intra-group acquisitions of shares or share-based instruments. Further, the rules apply to certain external financing related to internal acquisitions of shares, primarily with respect to so-called back-to-back financing.

Deductions are, however, allowed if the interest income corresponding to the expense would be taxed at a rate of at least 10% in the hands of the beneficial owner had the interest been the only income of the recipient/beneficial owner (the “10% rule”). Further, deductions are allowed if both the intra-group acquisition in question and the debt related to the interest expense are predominantly (approximately 75%) motivated by business reasons other than tax savings (the business reasons exemption).
Proposed legislation
The proposed legislation limits the deductibility of interest expense relating to all loans between related parties. Consequently, the application of the rules will no longer be limited to loans put into place as a result of an acquisition of shares between affiliated companies, but will apply to all inter-company loans – that is to say, it will be indifferent to the purpose of the loan. As an example, the rules will in the future apply also to loans put in place for the acquisition of assets such as machinery and equipment, or for the acquisition of intellectual property, as well as to loans resulting from group internal cash pool arrangements. Two entities are considered to be related if one of the entities has a substantial influence (through ownership or by other means) in the other entity, or if the entities are essentially under the same management.

Exemptions to limitation
Business reasons exemption
The proposed business reasons exemption provides that interest expense shall be deductible if the debt relationship related to the interest in question is predominantly motivated by business reasons.

The exemption is applicable only if the beneficial owner of the income corresponding to the expense is resident in a state within the European Economic Area (EEA) or, under certain conditions, in a state with which Sweden has a tax treaty.

If the debt relates to an acquisition of shares or share-based instruments from a related company, or to an acquisition of shares or share-based instruments in a company that becomes related after the acquisition, it is also required that the acquisition is motivated mainly by business reasons.

A specific rule is introduced providing that special consideration shall be paid to whether financing through contributions from either the lender or a company with a substantial influence over the borrower would have been possible instead of debt.

10% exemption
The 10% exemption provides that deductions for interest payments shall be allowed if the corresponding interest income would hypothetically be taxed at a rate of at least 10% in the hands of the beneficial owner had the interest been the only income of the recipient/beneficial owner.

However, a further requirement is that the debt relationship has not been created mainly to provide the group with a substantial tax advantage.

Legislative process
The interest limitation changes are proposed to come into force on 1 January 2013. The proposal has been referred for consideration to interested parties in a first round of consultation, and to the Council on Legislation in a second round, without undergoing any major changes. The proposal has also been accepted in the main by the Council on Legislation, although the Council has indicated that the rule providing that deductions shall not be allowed in situations where the 10% test is met if the debt has been put in place mainly for tax reasons, should not be applied by the Tax Agency at first instance. Instead, the Council indicates that the Tax Agency should apply to the first tier administrative court and request that the court tries whether the provision can be applied in a particular case. The reason for this is that the rule in fact is formulated as a general anti-avoidance rule.
Criticized proposal

The proposal has already been substantially criticized on a number of points. Introducing limitations to the interest deductibility in 2009, new restrictions in 2013 and the possibility for additional reform of the rules with potential effect from 2015 can of course be argued to be in conflict with the Government’s own intention of creating a business environment that is based on predictable rules.

The high pace of legislative change in itself creates uncertainty. Further, once rules are introduced, business would typically like to see rules that are clear and objective in their nature and where the tax effects of a transaction can easily be predicted. The proposed rules, however, open for uncertainty how some of the key definitions may be interpreted and also creates a situation where subjective assessments may be made by the tax authority and by the courts.

As an example, the newly proposed definition of affiliated companies makes it uncertain which companies will in fact be covered by the legislation. It will most likely be very difficult for the Swedish Tax Agency to assess whether a transaction is made for valid business reasons or not.

Further, it can be noted that the rules will restrict interest deduction for interest payments to a related entity located outside the EEA and in a country with which Sweden has no tax treaty, which is taxed below 10% even if there are valid business reasons behind the loan that can also be substantiated by the company. Consequently, even if there are valid business reasons for the loan, the interest deduction will still be restricted in these situations.

Corporate rate reduction

On 13 September 2012, the Swedish government, as part of the 2013 financial bill, presented a proposal for a reduction of the Swedish corporate income tax rate from 26.3% to 22% (a 16% reduction) effective from 1 January 2013.

As noted, during the 1990s, the Swedish corporate income tax system went through significant reform with the introduction of a much broader tax base and a reduction of the headline corporate income tax rate from 57% to 28% in just a few short years. While a further reduction in 2009 to 26.3% was welcomed by business, it remains around three percentage points ahead of the average for countries that have adopted the euro. With the downward pressure on headline corporate income tax rates remaining, and taking into account other recent moves by other countries, the government has decided that a significant reduction of 4.3 percentage points is necessary.

The proposal for the rate reduction is presented in the Government budget bill for 2013 and has an estimated cost of SEK16 billion (about US$2.44 billion) per year. The Government estimates that the proposed tightening of the Swedish interest limitation will result in SEK8.8 billion (US$1.34 billion) in revenue for the state. For corporations it is important to consider that if the proposed reduction of the corporate income tax rate is implemented, it will have a direct effect on potential deferred tax asset or liabilities booked on the balance sheet of the company.

What happens next?

At the time this article was published, the final form of the interest limitation proposal was still unclear. It is likely, however, that new rules will be adopted and that these new rules will have a significant impact on both existing and future internal debt relationships where Swedish entities are involved. Most likely we will see a final proposal during autumn 2012, and companies with arrangements in place that may be impacted are recommended to carry out impact assessments on the information known thus far.
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United Kingdom

General anti-avoidance rule (GAAR) process continues on schedule, consultation yields significant input and further questions

The United Kingdom was one of a group of countries that have announced in 2012 they propose to either introduce or strengthen general anti-avoidance rules. At the time this publication went to press, responses to the Government’s consultation process had just been submitted, no doubt providing ample viewpoints for policymakers to assess.

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Background
On 12 June 2012, the Government launched a formal consultation on a new general anti-avoidance rule (GAAR) to tackle artificial and abusive tax avoidance schemes. This follows the Budget 2012 announcement that such a rule will be introduced in Finance Act 2013 (but with a commencement date of 1 April 2013) which, in turn, followed the publication of a report by an independent study group led by Graham Aaronson QC. The purpose of the proposed GAAR is in line with the Aaronson Report's recommendation to introduce a rule targeted only at artificial and abusive arrangements and not "the centre ground of tax planning."

In line with the report’s recommendations, the proposed GAAR will apply to the main direct taxes (including bank levy) and national insurance. As announced at the Budget, it will be expanded to cover stamp duty land tax. The consultation also proposes an extension of the GAAR to inheritance tax and makes it clear that the Government will consider including further taxes if appropriate but not VAT due to complexities in its interaction with the abuse of law doctrine.

The consultation proposed the establishment of an Advisory Panel as recommended by Graham Aaronson. The Advisory Panel will advise on the application of the GAAR to a particular transaction and approve guidance produced by HMRC, which must be taken into account by a court in determining whether the GAAR applies in a particular scenario. This panel has significant influence over how the GAAR will apply in practice, and the composition and operational mechanics of the panel is, therefore, critical in determining whether the GAAR achieves its intended objectives and its impact on UK competitiveness. That level of detail is not covered in the consultation document.

The Government has proposed that there will be a further consultation on the draft legislation in the autumn but states that the guidance should be produced before the GAAR is enacted. It is suggested that HMRC would draft the guidance and the first act of the Panel will be to review and approve it. There is no suggestion that the guidance will be part of the consultation, although we consider this to be critical especially given that guidance must be taken into account by a court.

The consultation paper made it clear that HMRC believes that targeted anti-avoidance rules are still likely to be required, particularly until such time as the GAAR has proved effective in countering abusive schemes.

The Government acknowledges that the commencement rule for a GAAR will need careful consideration. A particular question is whether there should be a transitional rule dealing with arrangements straddling 1 April 2013. This means that the GAAR could potentially have an effect on transactions that began prior to the introduction of the legislation. The Government has invited representations on the issue.

The Government has proposed that the GAAR should apply to artificial and abusive arrangements where UK tax advantages have been obtained through rights or benefits under any double taxation agreements. Despite concerns that if the GAAR were to disapply the effect of DTAs this would conflict with the UK's duty to abide by the terms of its agreement with other countries, the Government believes that the GAAR would be consistent with the OECD commentary on the Model Tax Convention which states that:

"States do not have to grant the benefits of a double tax convention where an arrangement that constitute an abuse of the provision of the convention have been entered into."

The proposal is that the abusive tax advantage would be counteracted on a just and reasonable basis. However, the draft legislation does not contain the further provisions suggested by the study group that add detail as to what factors should be taken into account in determining what is just and reasonable. This matter has been the subject of judicial debate in the past, and the study group’s recommendation were intended to address this uncertainty.

The GAAR study group, headed by Graham Aaronson QC has now issued a supplementary report in response to the consultation issued by HMRC. Overall, the GAAR study group agreed that the consultation draft embodies all of the main principles that the study group considers need to be incorporated in, and to form the framework of, a GAAR that would be appropriate for the United Kingdom. The study group considers that the consultation GAAR is very well drafted and it does not recommend any amendments to the draft. The study group does comment on the differences between its suggestion and the consultation GAAR. In some cases it accepts the change, in others it highlights the need for care. In particular, the study group views it as essential that the guidance should be as impartial and objective as possible.

Our view of the GAAR proposal

Overall, Ernst & Young welcomes the approach taken with regard to the introduction of a GAAR; introducing a ‘broad spectrum’ general anti-avoidance rule of the type currently in place in Australia, New Zealand, Canada, South Africa and Hong Kong would not be beneficial for the UK tax system and so the proposal that the GAAR should be targeted only at artificial and abusive arrangements and not ‘the center ground of tax planning’ is also to be welcomed.

The concept of an Advisory Panel, whose opinion must be taken into account by a court or tribunal, is a novel one in UK tax law. However, we agree that this should, subject to the points made below, provide a helpful safeguard against the use of the GAAR in circumstances not covered by its stated purpose. Involving an independent member with experience in the relevant area will also reduce the chance that HMRC will misinterpret the nature of the transaction.

Given the key role that the Advisory Panel will play, it is vital to have considerably more detail on its composition and operation. The Advisory Panel will have significant influence over how the GAAR will apply in practice. The composition and operational mechanics of the Advisory Panel are therefore critical in determining whether the GAAR achieves its intended objectives and its impact on UK competitiveness.

Advisory panel

One area where there is still little detail is the composition and operation of the Advisory Panel.

It is proposed that the Advisory Panel will be established to advise on the application of the GAAR to a particular transaction and to approve guidance that must be taken into account by a court or tribunal in determining whether or not the GAAR applies in a particular scenario.
There is an urgent need for more detail as to how the crucial safeguard of the Advisory Panel will operate and for this to be consulted upon. Particular points that need to be addressed include:

- We understand that HMRC is considering a “double blind process” for the appointment of the Advisory Panel so that an independent chairman would be appointed who would be free to choose its members. While this has some benefits, in that it should reduce the risk associated with a panel appointed in its entirety by HMRC, there are some drawbacks of such a system as, in our view, it leaves too much discretion in one individual’s hands. If this route is followed, we would suggest that the Chair be given very clear guidance as to the broad composition of the Advisory Panel. So for example, while it would be for the Chair to select the Advisory Panel in any particular case, the wider Advisory Panel should include: tax advisors with experience of the relevant taxes; industry members taken from the corporate, small businesses and financial services sectors, and accountants with an understanding of the accounting treatment of complex transactions.

- At the launch event, it was suggested that a “shadow panel” would be in place before the commencement date (currently scheduled for 1 April 2013), but there was little detail on how this would work in practice. We would strongly encourage that this panel be established as soon as possible. Given the need to select members with a wide range of experience, this may take some considerable time.

- The consultation suggests that only written representations can be made to the Advisory Panel. To make sure that the transaction, its implications and purpose are fully understood by the Advisory Panel, we suggest the taxpayer be given the option to make oral representations.

Timing

The consultation document states that: “It would clearly be optimal for the first version of the guidance on the GAAR to be produced by the time the GAAR is enacted.” We consider this to be too late. The Draft GAAR states that the court or tribunal must take the guidance into account in considering any issue in connection with the GAAR. The guidance will therefore be fundamental to the operation of the GAAR. In our view it is therefore essential that the guidance is subject to consultation at an early stage as it goes to the heart of how the GAAR will apply in practice.

We consider that any GAAR should initially be restricted to the taxes contemplated in Aaronson’s Report and should not be extended to encompass inheritance tax (IHT). The application of the GAAR to IHT presents a number of significant difficulties arising from the different way in which this tax operates from the direct taxes. If the GAAR is to be extended to cover this tax, we suggest that there should be a delay so that due consideration can be given to these particular issues.

Next steps for the GAAR consultation

With responses to the GAAR consultation now lodged, it is likely that the government will bring forward legislation in Finance Bill 2013.
### Table 1. Global corporate tax rates — largest 50 “economies” or “jurisdictions” by GDP, sorted by tax rate

<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>GDP 2011 (US billions)</th>
<th>2012 Corporate income tax rate</th>
<th>Worldwide vs. territorial taxation</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>15,065</td>
<td>39.00%</td>
<td>Worldwide</td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td>5,855</td>
<td>38.01%</td>
<td>Territorial</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Effective for years ending on or after 1 April 2012. Includes recent 4.5 percentage point rate cut and temporary (three-year) corporate income tax surtax of 10%. Effective headline corporate tax rate will decline to 35.64% in 2015.</td>
</tr>
<tr>
<td>France</td>
<td>2,808</td>
<td>36.10%</td>
<td>Territorial</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Include five percentage point surtax on their corporate taxes in 2012 and 2013.</td>
</tr>
<tr>
<td>Argentina</td>
<td>435</td>
<td>35.00%</td>
<td>Worldwide</td>
<td></td>
</tr>
<tr>
<td>Pakistan</td>
<td>204</td>
<td>35.00%</td>
<td>Worldwide</td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>2,518</td>
<td>34.00%</td>
<td>Worldwide</td>
<td></td>
</tr>
<tr>
<td>Venezuela</td>
<td>310</td>
<td>34.00%</td>
<td>Worldwide</td>
<td></td>
</tr>
<tr>
<td>Belgium</td>
<td>529</td>
<td>33.99%</td>
<td>Territorial</td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>3,629</td>
<td>33.00%</td>
<td>Territorial</td>
<td></td>
</tr>
<tr>
<td>Colombia</td>
<td>321</td>
<td>33.00%</td>
<td>Worldwide</td>
<td></td>
</tr>
<tr>
<td>India</td>
<td>1,843</td>
<td>32.50%</td>
<td>Worldwide</td>
<td></td>
</tr>
<tr>
<td>Italy</td>
<td>2,246</td>
<td>31.40%</td>
<td>Territorial</td>
<td></td>
</tr>
<tr>
<td>Spain</td>
<td>1,536</td>
<td>30.00%</td>
<td>Territorial</td>
<td>As of 1 January-2012, the new Spanish government implemented tax rate changes as a result of austerity measures. However, these changes did not impact the corporate income tax rate.</td>
</tr>
</tbody>
</table>

1 IMF World Economic Outlook Database — September 2011
<table>
<thead>
<tr>
<th>Country</th>
<th>Tax Rate</th>
<th>Tax Type</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>30.00%</td>
<td>Territorial</td>
<td>Business Tax Working Group due to report on potential ways to reduce statutory corporate income tax rate in December 2012.</td>
</tr>
<tr>
<td>Mexico</td>
<td>30.00%</td>
<td>Worldwide</td>
<td></td>
</tr>
<tr>
<td>Nigeria</td>
<td>30.00%</td>
<td>Worldwide</td>
<td></td>
</tr>
<tr>
<td>Philippines</td>
<td>30.00%</td>
<td>Worldwide</td>
<td></td>
</tr>
<tr>
<td>Norway</td>
<td>28.00%</td>
<td>Territorial</td>
<td></td>
</tr>
<tr>
<td>South Africa</td>
<td>28.00%</td>
<td>Territorial</td>
<td></td>
</tr>
<tr>
<td>Egypt</td>
<td>26.50%</td>
<td>Worldwide</td>
<td></td>
</tr>
<tr>
<td>Sweden</td>
<td>26.30%</td>
<td>Territorial</td>
<td>Rate will be decreased to 22% on 1 January 2013.</td>
</tr>
<tr>
<td>Canada</td>
<td>26.23%</td>
<td>Territorial</td>
<td>Federal tax rate reduced from 16.5% to 15% in January 2012. Provincial tax rates remain between 10% and 16%.</td>
</tr>
<tr>
<td>China</td>
<td>25.00%</td>
<td>Worldwide</td>
<td></td>
</tr>
<tr>
<td>Netherlands</td>
<td>25.00%</td>
<td>Territorial</td>
<td>Rate for the first 200,000 Euro taxable basis is 20%.</td>
</tr>
<tr>
<td>Indonesia</td>
<td>25.00%</td>
<td>Worldwide</td>
<td></td>
</tr>
<tr>
<td>Islamic Republic of Iran</td>
<td>25.00%</td>
<td>Worldwide</td>
<td></td>
</tr>
<tr>
<td>Austria</td>
<td>25.00%</td>
<td>Territorial</td>
<td></td>
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<tr>
<td>Israel</td>
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<td>Rate increased to 25% for corporate profits and capital gains in 2012.</td>
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<tr>
<td>Algeria</td>
<td>25.00%</td>
<td>Worldwide</td>
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<tr>
<td>Finland</td>
<td>24.50%</td>
<td>Territorial</td>
<td>At the end of November 2011, a government bill was introduced to reduce the corporate income tax rate from 26% to 24.5% starting 1 January 2012.</td>
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<tr>
<td>Korea</td>
<td>24.20%</td>
<td>Worldwide</td>
<td>24.2% top tax rate includes a 10% surcharge applicable to taxable income in excess of KRW20 billion (USD18 million).</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>24.00%</td>
<td>Territorial</td>
<td>The Government will reduce the main rate of corporation tax to 24% from April 2012, rather than 25% as had been announced in Budget 2011. The rate will then be reduced by a further 1% in each of the following two years, and as a result will be 22% from April 2014.</td>
</tr>
<tr>
<td>Thailand</td>
<td>23.00%</td>
<td>Territorial</td>
<td>Thailand recently enacted a two-phased corporate tax rate reduction. Phase one reduction is from 30% to 23% and is effective for accounting periods beginning on or after 1 January 2012. Phase two reduces it down to 20% for accounting periods beginning on or after 1 January 2013 and 1 January 2014.</td>
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<td>21.17%</td>
<td>Territorial</td>
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<td>Russia</td>
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<td>Turkey</td>
<td>20.00%</td>
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<tr>
<td>Saudi Arabia</td>
<td>20.00%</td>
<td>Worldwide</td>
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<tr>
<td>Greece</td>
<td>20.00%</td>
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<td>Poland</td>
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<td>Worldwide</td>
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<tr>
<td>Czech Republic</td>
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<td>Territorial</td>
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<tr>
<td>Chile</td>
<td>18.50%</td>
<td>Worldwide</td>
<td>Rate will be increased to 20% on 1 January 2013.</td>
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<td>Taiwan</td>
<td>17.00%</td>
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<td>Territorial</td>
<td>17.00%</td>
<td>Worldwide</td>
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<tr>
<td>Hong Kong SAR</td>
<td>16.50%</td>
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<td>16.00%</td>
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<td>12.50%</td>
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<tr>
<td>United Arab Emirates</td>
<td>0.00%</td>
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2012 Corporate income tax rate
(The tax rate includes both national and local tax rates.)

Figure 1. 2012 Headline corporate income tax rates – largest 50 “economies” or “jurisdictions” by 2011 GDP

Figure 2. “Economies” or “Jurisdictions” taxing worldwide income

Figure 3. “Economies” or “Jurisdictions” taxing territorially
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