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Global Tax Insights

Morison KSi

Editorial

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Automatic exchange of information (AEOI) is becoming a very potent tool against tax evasion. In my editorial for the quarter ended March 2017, I stated that AEOI was entering 'a critical phase, with the first exchanges scheduled to commence in September 2017'. I also mentioned that many countries were changing their domestic laws so that financial institutions would be required to report comprehensive information on the financial accounts and assets they hold for non-residents. Altogether, 53 jurisdictions had to undertake first exchange in 2017 and 47 countries had to exchange information in 2018.

From 20 to 22 November, the Global Forum on Transparency and Exchange of Information for Tax Purposes held its annual meeting in Punta del Este, Uruguay, bringing together over 200 delegates from more than 100 jurisdictions, international organisations and regional groups to reinforce the international community's fight against tax evasion. The meeting marked the rollout of automatic exchange of financial account information. Global Forum members took stock of progress made with AEOI implementation in 2018, which saw 4,500 successful bilateral exchanges by 86 jurisdictions under the new AEOI Standard. Each exchange contains detailed information about the financial accounts each jurisdiction's taxpayers hold abroad.

"The year 2019 will see further steps being taken by tax authorities across the globe to tackle tax avoidance"

The year 2019 will see further steps being taken by tax authorities across the globe to tackle tax avoidance – including the EU's anti-avoidance programme, the Anti Tax Avoidance Directorate (ATAD), which requires member states to enact BEPS requirements in the prescribed form with additional reporting requirements.

As I sign off, I take this opportunity to wish all the readers a Merry Christmas and a blessed and peaceful 2019.

Sachin Vasudeva

Country Focus

AUSTRALIA

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Accessing the lower corporate tax rate for small-to-medium Australian companies

In Australia, the general corporate tax rate is 30%. To assist smaller businesses in becoming more competitive with larger corporations, over the last few years the Australian Government has introduced various law changes (with only some passing into law) to allow small and medium Australian companies (or SMEs) to access a lower corporate tax rate. These changes have led to a multitude of new concepts, different tax rates and turnover thresholds, additional eligibility requirements and flow-on implications that need to be analysed and understood by corporate taxpayers and their advisers.

More recently, the new definition of a 'base rate entity' (BRE) passed into law on 31 August 2018 with effect from 1 July 2017. This new BRE definition effectively replaces the previous definition of a small business entity (SBE) for the purposes of accessing the lower corporate tax rate from the 2017/18 income year (see Table).

As the changes have caused significant confusion and uncertainty, we have summarised the latest position on accessing the lower corporate tax rate and potential flow on tax implications to franked dividends.

Broadly, if a company passes the following two tests then it should be able to access the lower corporate tax rate:

- BRE passive income test (replaces the 'carrying on a business' test from the 2017/18 income year); and
- Aggregated turnover is under the threshold for the relevant income year (aggregated turnover includes the annual turnover of connected entities and affiliates).

The new test: base rate entity passive income

The new BRE definition replaces the 'carrying on a business' test with a 'BRE passive income test' from 1 July 2017 (i.e. the 2017/18 income year onwards). Broadly, if less than 80% of a company's assessable income is BRE passive income, then this test is satisfied.

TABLE. Eligibility criteria for relevant income years impacted by changes to corporate tax (Au$)

Income year*	Classification	Test 1: SBE / BRE	Test 2: Aggregated turnover threshold	Lower corporate tax rate
2015/16	SBE	Carrying on a business test	Au$2 million	28.5%
2016/17	SBE	Carrying on a business test	Au$10 million	27.5%
2017/18	BRE	BREPI test	Au$25 million	27.5%
2018/19	BRE	BREPI test	Au$50 million	27.5%
2019/20	BRE	BREPI test	Au$50 million	27.5%
2020/21*	BRE	BREPI test	Au$50 million	26%
2021/22*	BRE	BREPI test	Au$50 million	25%

BRE, base rate entity; BREPI, base rate entity passive income; SBE, small business entity.
*Note: The standard income year in Australia ends on 30 June. The progressive reduction of the company tax rate to 25% has been brought forward to start from the 2021/22 income year (previously proposed to start from 2026/27) and only for SMEs. This change passed into law on 25 October 2018.

[1]A non-portfolio dividend is broadly a dividend from a company in which you have a voting interest of 10% or more.

BRE passive income includes (but is not limited to) the following amounts:

- Dividends, other than a non-portfolio dividend,[1] and franking credits attached to such a distribution
- Interest
- Royalties
- Rent
- Net capital gains
- Assessable income of a partner in a partnership or beneficiary of a trust estate to the extent the amount is referable to BRE passive income.

From the 2017/18 income year, an analysis of a company's assessable income is now required on an annual basis to determine whether a company passes the BRE passive income test. In some cases, identifying whether an amount of assessable income is BRE passive income or not requires tracing through specific components of income of the entity (or entities) making distributions to the recipient company.

Example 1: Determining the applicable corporate tax rate in 2017/18

For illustration purposes, a simple example of how the BRE passive income test is worked out is included below.

For the 2017/18 income year, a company's:

- Aggregated turnover is Au$26 m
- Total assessable income is Au$24 m
- BRE passive income is Au$19 m (i.e. 79.2%).

Although the company's BRE passive income is below 80%, its aggregated turnover is above the Au$25m threshold applicable for the 2017/18 income year. Therefore, the company in this example would not be eligible for the lower corporate tax rate of 27.5% for 2017/18 and its applicable corporate tax rate would be 30%.

Impact on dividend imputation and franking credits

Australia has a dividend imputation system in which some or all of the tax paid by a company may be attributed (or imputed) to shareholders by way of a tax credit (or franking credit) to reduce the income tax payable on a distribution. For the purposes of working out the corporate tax rate for dividend imputation purposes, the company must assume that its aggregated turnover, assessable income, and BRE passive income will be the same as the **previous** income year and compare this to the **current** year's aggregated turnover threshold.

Because of the way that the franking percentage is worked out based on previous year figures combined with the various changes to the corporate tax rate, situations could arise where a company's tax rate is different to its franking percentage for a particular year.

Importantly, taxpayers need to be aware of and plan for potential franking issues going forward whereby companies can only frank dividends at the lower corporate tax rate (i.e. 27.5% for 2017/18) on profits from previous years that have presumably been taxed at the higher 30%. While franking credits do not expire and may be carried forward indefinitely, the practical result is that the tax differential (2.5% for 2017/18) on historical franking credits taxed at 30% is effectively 'trapped' in the company.

Example 2: Determining the applicable franking percentage in 2018/19

Following from Example 1 above, for the 2018/19 income year the company's:

- Aggregated turnover is Au$32 m
- Total assessable income is Au$28 m
- BRE passive income is Au$22m (i.e. 78.6%).

As the company's BREPI is below 80% and aggregated turnover is below the 2018/19 threshold (i.e. Au$50 m), it would be eligible for the lower corporate tax rate of 27.5% in 2018/19. However, based on the company's prior (2017/18) income year results, it would only be able to frank dividends it pays in the 2018/19 year at 27.5% despite the fact that it would have paid corporate tax at 30% in 2017/18 (and presumably also in previous years).

Country Focus

GERMANY

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Expenses of a provident nature: Tax-related deductibility in the context of foreign assignments

German employees earning an income abroad as well as in Germany have often faced an unforeseen snag each financial year: when the foreign income was, in accordance with a relevant double tax agreement (DTA), tax-free in Germany, the resulting provident expenses (i.e., contributions to statutory health and pension insurance) could not be deducted from the taxable income to reduce the individual tax burden. A special expenditure deduction could only be considered if these were not 'directly economically related' to tax-free income. In the event that these also could not be assessed for tax purposes in the country the income was earned in, this could result in significant losses for the employee.

The latest developments

About a year ago, the European Court of Justice ruled on questions referred to it by a German court, which arose from a case in which a married couple (resident and fully taxable in Germany) assessed for income tax in Germany earned income from employment in France (ECJ judgement of 22 June 2017 – C-20/16 'Bechtel'). The local German tax office refused, technically in line with German tax law, to acknowledge provident expenses paid in France as special expenses in the income tax assessment. After dealing in great detail with European law and the German–French DTA, the European Court of Justice decided that the German rule on deduction of special expenses in connection with tax-free income infringes the free movement of workers within the EU referred to in Article 45 of the Treaty on the Functioning of the European Union.

It is worth noting that taxpayers can refer directly to the jurisdiction of the European Court of Justice. The new deduction possibilities apply to all employees who are subject to unlimited taxation in Germany and earn income that is tax-free according to a DTA with another EU Member State. This can either be a German working abroad in the EU who continues to pay contributions to their domestic social insurance during their secondment, or an employee seconded to Germany who continues to pay social insurance contributions in their home country.

The ruling of the European Court of Justice prompted the German Federal Ministry of Finance to publish a letter instructing tax offices to recognise provident expenses attributable to income earned within the EU as deductible special expenses in the future (letter dated 11 December 2017, IV C 3 – S 2221/14/10005 :003). It is required that:

- The contributions are directly related to income from dependent employment earned in a Member State of the EU or the European Economic Area
- The income is tax-free in Germany according to a DTA
- The state the income is earned in offers no possibility to deduct the contributions for taxation purposes
- The DTA does not allocate the consideration of personal deductions to the host country.

More recently, a German court dealt with a similar case (Düsseldorf Finance Court, judgement of 10 July 2018 – 10 K 1964/17 E). One big difference, however, was that the plaintiff had earned income from third countries (outside the EU/EEA; in particular in Brazil, China and Germany) in the same year

and requested a change of his income tax assessment, as only the domestic and no foreign income was considered as a measure for pension insurance contributions paid. As a result, there was a significant difference between pension contributions actually paid and the amount that was assessed as special expenses. The local tax office, as defendant, argued (similar to the case above) that according to income tax law, provident expenses could not be assessed as special expenses if they are directly related to tax-free income. Therefore, only the provident expenses attributable to the income earned in Germany could be deductible special expenses.

Roughly outlined, the court explained in its decision that the defendant's argument was basically right. But the lack of possibility to assert the remaining part of pension contributions in Brazil and China would make a difference. The plaintiff's full pension entitlement would serve as a tax base one day, and if the pension contributions were not wholly deductible from the individual's taxable income, that would be a violation of the net principle. This principle applies throughout German tax law and demands that only the actually available income of an individual is taxed. Therefore, the court reached the conclusion that the whole contributions are deductible.

The new deduction possibility can be worthwhile for taxpayers, but also for employers: many conclude net wage agreements with employees to be seconded in order to guarantee them, despite country-related taxation differences, the same net wage as in the home country. Due to the judgement in the latter case, the plaintiff could assess about €4,000 more for tax purposes in the respective year. Assuming that this would mean a tax saving of around €1,500, a fictious employer would save €15,000 a year on 10 similar assignments.

Good tidings for taxpayers

While the first-mentioned ECJ judgement was mainly justified by the freedom of movement of workers within the EU and, of course, only had consequences for secondments within the EU, the more recent judgement implies that from now on it could no longer matter for expatriates with unlimited tax liability in Germany whether they have earned income within the EU or elsewhere in the world.

Country Focus

GERMANY

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Limited tax liability on the sale of shares in foreign real estate corporations

Current situation

Income from investments in German real estate is regularly subject to full taxation in Germany in accordance with the relevant provisions of the double taxation agreements (DTA). For current rental or leasing income, the relevant article is Article 6 of the OECD Model Tax Convention; for profits from the sale of real estate, it is Article 13 para. 1 of the OECD Model.

For large commercial properties in particular, however, real estate is usually held not directly by the non-resident taxpayer but by a corporation. The current income and profit from the sale of the property will still be subject to limited tax liability in Germany. If, however, it is not the property but the shares in the corporation that are sold by the non-resident taxpayer, this profit is only subject to German taxation if the corporation has its registered office or place of management in Germany. By investing through a foreign corporation (often in Luxembourg), increase in value of German real estate can be finally realised without a German tax burden.

Even though Article 13 para. 4 of the OECD Model stipulates that profits from the sale of shares in corporations not resident in Germany, whose assets consist predominantly of German real estate, may be taxed in Germany, such profits cannot be taxed in Germany, as there is currently no corresponding provision in German national tax law.

EXAMPLE

Investor X, based in Beijing/ China, holds 100% of the shares in LuxPropCo Sarl, which he acquired in 2010 at a price of €10 million. The only asset of LuxPropCo Sarl was and is a rented office complex in Berlin. The sole managing director of LuxPropCo Sarl is Luxembourg-based Y. The company has no office or other entrepreneurial facilities in Germany. Investor X sells its shares in LuxPropCo Sarl in August 2018 for €17 million.

According to Article 13 para. 4 of the DTA with China, Germany is entitled to tax the profit from the sale of the shares in LuxPropCo Sarl. In the absence of a corresponding provision in German national tax law, however, the capital gain is not subject to tax liability in Germany and thus remains tax-free in Germany.

Planned new regulation

Within the framework of the recently completed legislative process, the German legislator has closed this supposed tax gap. In future, the sale of shares in foreign corporations will also be subject to limited tax liability in Germany if the shareholder holds at least 1% of the shares in the company and the share value is essentially determined by domestic real estate. According to the regulation contained in Article 13 para. 4 of the OECD Model since 2017, this should be the case if at any time during the 365 days before the sale more than 50% of the share value was based on domestic immovable assets based on the book values of the active assets. This regulation is to be applied to all share disposals after 31 December 2018. However, only increases in value after that date should be recognised.

Example modification

Investor X sells its shares in LuxPropCo Sarl in July 2019 for €20 million.

After implementation of the new regulation, the capital gain is subject to the so-called *Teileinkünfteverfahren* (partial income procedure) with a tax rate of up to 28.5%. However, only the increase in the value of the shares since 1 January 2019 will be taxed. Assuming that the share value as of 31 December 2018 amounts to €17 million, this results in a taxable capital gain of €3 million in Germany. Any tax levied in China on this profit can be offset against the German tax.

Effects of the new rules on foreign investors

Investors who invest in the German real estate market via a foreign corporation are thus threatened with a considerable additional burden. This primarily concerns cases in which the respective DTA with the shareholder's country of residence contains a real estate clause corresponding to the new provision (e.g. Austria, China, the Netherlands, Spain or UK) or in which the foreign investor is domiciled in a country with which Germany has not concluded a DTA (e.g. Brazil, Chile). It should be noted that none of the German DTAs currently contains the new provisions of the OECD Model 2017 regarding consideration of a 365-day period when determining the real estate quota, so that the amount of the real estate at the respective time of sale is always decisive here. In addition, the DTAs may be subject to other conditions in individual cases; for example, according to DBA Singapore, at least 75% of the share value must be based on German real estate. If the requirements of the respective DTA are not met or, in particular, in cases in which the DTA does not contain a corresponding real estate clause (e.g. France, Italy, Russia, or Switzerland), capital gains remain non-taxable in Germany even after implementation of the new regulation.

Variation example

Investor X is not based in China, but in Russia.

In contrast to the DTA with China, the DTA with Russia does not contain a clause on real estate corporations. Thus, the profit from the sale of shares in 2019 is subject to limited tax liability. According to the DTA, however, Germany cannot tax this profit, so it remains tax-free.

The amount of taxation on gains from the sale of shares in Germany depends on who is a shareholder in the foreign real estate corporation. In the case of a natural person, the *Teileinkünfteverfahren* applies, i.e. 60% of the profit is subject to the full income tax rate – resulting in a maximum tax burden of 28.5%. If, on the other hand, the shares are sold by a corporation, the capital gain is effectively 100% tax-free. It claims 5% of the profit as (fictitiously) non-deductible operating expenses and would in principle be subject to German taxation. However, according to the current case law of the Federal Finance Court, the tax cannot be levied. Only foreign financial and insurance institutions may, under certain conditions, be subject to taxation of the gain on the sale of shares in Germany.

Conclusion and possible reaction

For natural persons as shareholders of a German real estate corporation for whom the planned new regulation would lead to an additional tax burden, i.e. in particular for natural persons or financial and insurance institutions, there is still the possibility (until the end of 2018) of transferring their shares to another corporation and creating a double-storey structure. This way, an additional tax burden as a result of the new regulation is ultimately avoided. When transferring the shares to a corporation, however, the legal consequences in the country of residence of the shareholder and the country of residence of the company must also be taken into account, as well as any land transfer tax consequences in Germany.

Country Focus

HONG KONG

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Changes to individual income tax legislation in China

On 31 August 2018, China's Individual Income Tax Law (Amendment) was passed by the National People's Congress of the People's Republic of China (PRC). It will be effective from 1 January 2019, although some parts of it – including the minimum threshold for personal income tax exemption – are scheduled to come into force on 1 October 2018.

Redefinition of 'resident' and 'non-resident'

The new legislation redefines the criteria for being tax resident in mainland China as anyone who resides in PRC for ≥183 days in a calendar year (previously, 'resident' status required them to have lived there for 5 full consecutive years). Such individuals will be regarded as 'resident' and subject to individual income tax (IIT) on their global income.

A non-resident – who is not domiciled in mainland China, or who has lived in mainland China for <183 days in a calendar year – is subject to IIT only on their China-sourced income.

Inclusion of four types of income for consolidated tax computation

The new IIT Law includes four types of income in the scope of consolidated taxation, to be applied with standard progressive tax rates:

- Salaries and wages
- Income from personal services (20% deduction)
- Manuscript fees (20% deduction, plus a further 30%, up to a total of 44% of the manuscript fee income)
- Royalties (20% deduction).

Tax residents calculate IIT by consolidated income on an annual basis, while non-residents calculate it on a monthly or ad hoc basis.

Optimised tax rate structure

- *New consolidated income tax rate:* Residents must now report all their consolidated income on an annual basis.
- *Adjusted thresholds for lower tax rates:* Thresholds for the three lowest tax rates – 3%, 10% and 20% – have been expanded (those of the three highest tax rates – 30%, 35% and 45% – remain unchanged).
- *Business income tax rate (for sole proprietors):* Based on existing tax rates for manufacturing income, business income, contracting income and sole proprietorship leasing income, the five level tax rates of 5% to 35% remain unchanged. However, the levels between tax rates have been enlarged and the minimum threshold applicable to the tax rate of 35% will be increased from RMB 100,000 to RMB 500,000.

Increased minimum threshold for personal income tax exemption

The new IIT Law increases the minimum threshold for personal income tax exemption from RMB 3,500 to RMB 5,000 per month or RMB 60,000 per annum. The RMB 5,000 minimum threshold could be adjusted from time to time.

Additional special expense deductions

In addition to existing allowable deductions, such as basic pension insurance, basic medical insurance, unemployment insurance, housing provident fund, the new IIT Law introduces further special expense deductions, including children's

education, caring for the elderly, continuing education, treatment for serious diseases, housing loan interest and rental.

The State Council will later announce the criteria, amounts and execution procedures for these additional special expense deductions.

New anti-avoidance rules

For enterprise income tax, the new IIT Law introduces anti-avoidance rules that empower the tax authority to make tax adjustments in certain circumstances, such as:

- An individual's transactions are unreasonable and not on an arm's-length basis
- An individual reduces their tax burden by deploying a foreign tax haven
- An individual enjoys tax benefits by involving unreasonable commercial arrangements.

Apart from affecting Chinese residents, the new IIT Law will have a significant impact on foreign expatriates working in China and residents of Hong Kong, Macau and Taiwan who are working in or retiring to China. Under the new legislation, anyone residing in China for ≥183 days in a calendar year will now be regarded as tax resident and their global income – including salaries and wages, business profits, bank interest, dividend income, rental income, gain on disposal of properties, or even incidental income – will be subject to PRC IIT.

If foreign tax has already been paid on that income, the resident may be eligible to claim tax credit to offset part of the IIT.

On 20 October 2018, a Consultation Draft regarding the implementation of the New IIT Law was announced by the Ministry of Finance and the State Administration of Taxation.

According to the Consultation Draft, any individual not domiciled in mainland China but who has lived in mainland China for 183 days or more in a calendar year ('183 days' status), and this 183-days status continues for less than 5 consecutive years, or for 5 consecutive years during which the individual has left mainland China for ≥30 days in a single trip, then this individual would be subject to IIT on their China-sourced income only.

On the other hand, if the 183-days status continues for 5 consecutive years during which the individual has not left mainland China for ≥30 days in a single trip, then from the 6th year, then this individual will be subject to IIT on his or her global income.

The Consultation Draft means the continuation of the existing tax preferential policy for non-PRC domiciled residents working or retiring in mainland China (including the residents of foreign countries, Hong Kong, Macau and Taiwan) that their non–China-sourced income is tax exempt for 5 years.

Country Focus

INDIA

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Relevance of 'limitation of relief' clause in the context of the India–Singapore Tax Treaty

Singapore has emerged as a global hub for education, entertainment, finance, healthcare, human capital, innovation, logistics, manufacturing, technology, tourism, trade and transport. A proactive public tax policy has, in part, played a key role in helping Singapore achieve this remarkable success.

One example to illustrate how Singapore implemented this proactive tax pragmatism is the seemingly innocuous 'limitation of relief' (LOR) clause. Built on a base of 'anti-abuse' measures to prevent double non-taxation situations, a sizeable majority of Singapore's tax treaties contain this clause in some form. Essentially, the LOR clause seeks to make the elimination or reduction of tax at source conditional upon the income in question being remitted to and subject to tax in Singapore. For example, where a Singaporean company received shipping income from an Indian source and the money was received in a bank account in, say, France, Singapore could not tax this income owing to non-receipt, so the LOR clause could be invoked. Thus, Singapore has ensured that the income being evaluated based on established treaties would need to be received in and subject to tax in Singapore.

The *raison d'être* for this LOR clause is the territorial nature of Singaporean income tax, which is quite unique to the country. Whenever taxing rights to foreign-sourced income were allocated to Singapore in a treaty, the territorial nature of the tax system made it necessary to require that the income be remitted in order to be subject to Singapore tax. By linking the treaty relief to actual receipt and taxation in Singapore, the Singaporean tax regime has ensured that their tax base remained intact.

Of course, a fallout of the foreign-sourced income exemption could be that Singaporean tax residents may find themselves at a disadvantage in situations where tax rates in the source country are higher (as is generally the case, given that Singapore taxes are low). In acknowledgement of this – and recognising that economic dynamics in Singapore have also been dramatically altered, especially in last two or three decades, by the spurt in economic growth and the country's emergence as an investment hub – Singapore has discreetly omitted the LOR clause in fresh treaties and also seems to be intent on deleting this clause where opportunities manifest through renegotiations.

One treaty, amended recently, where (despite the chance to do so) Singapore did not choose to delete the LOR clause was with India. Article 24 of the India–Singapore tax treaty restricts the relief to so much of the amount as is remitted to or received in that other contracting state (Singapore), where:

- Any income is exempt from tax or taxed at a reduced rate in the contracting state (i.e. India); **and**
- The said income is subject to tax by reference of the amount thereof which is remitted to or received in Singapore and not by reference to the full amount.

The first condition under Article 24 provides that the LOR clause would apply only in case of income that was exempt or taxed at a reduced rate in the contracting state (India). Now, readers will be aware that Singapore could emerge as a credible entry-point for investing in India, owing to their well-developed economy and (perhaps especially) the favourable capital

gains tax regime in Singapore; a lot of European and US investors have routed their Indian investments through Singapore. Indeed, there is no capital gains tax in Singapore. And Article 13(4) gave the taxing rights on capital gains arising from the sales of shares in an Indian company exclusively to Singapore where the transferring shareholder was tax resident. As a result, there was lively debate – especially among Indian tax authorities – as to whether the LOR clause could be invoked to somehow deny the tax treaty benefits to that shareholder, in which case the Indian tax authorities could access the capital gains for tax purposes. However, this proposition was sharply rejected by an Indian Tax Appellate Tribunal,[1] which held (very reasonably) that once the income could not be taxed in India at all, the question of examining remittance and consequently, application of LOR became irrelevant.

But a counternarrative to this interpretation prevails... On the one hand, the Rajkot Tribunal[2] held that even in a situation where India had no taxing rights, LOR could still be invoked. Effectively, this ruling seeks to convey that in such a situation, the interpretation is that the context in which expression 'exempt from tax' was set out in Article 24 essentially implied that the treaty benefits of non-taxation of an income, or its being taxed at a lower rate in a contracting state (India), depended on the status of taxability in another contracting state (Singapore). On the other hand, in a recent ruling, the Mumbai Tribunal[3] has held that India did not have taxing rights to the impugned capital gains owing to Treaty application; therefore Article 24 was not satisfied, thus negating the LOR invocation.

An interesting pointer emanating from the Rajkot Tribunal ruling would be that in the facts of that case, the taxpayer produced a certificate from their tax advisers and the IRAS that 'gave the impression' that the *impugned* income was 'subject to tax' in Singapore, but it so turned out that the taxpayer had, in fact, claimed exemption on that income in Singapore. So the Tribunal concluded in that case that the income was never actually taxable in Singapore, thus clearing the path for invocation of the LOR clause.

On a separate note, the Indian tax tribunals have also had the opportunity to evaluate the application of LOR in situations where the income earned by a Singapore tax resident was taxable on an accrual basis, although no amount was actually received in Singapore. In such a case, the tribunal has held that the LOR clause, ideally, should not be triggered.[4] While doing so, the tribunals have relied on the certificate provided by the IRAS to establish the fact that the income was indeed taxed in Singapore on an accrual basis.

On balance, it seems that we have not yet heard the last word on the tax controversy surrounding the LOR clause applicability, especially in the context of those incomes whose taxability rights are assigned to Singapore exclusively under the tax treaty. In turn, this emphasises the need for planning tax affairs better – including exploring the possibility of an advance ruling on this issue, to defend such incomes; in many cases, there are high stakes involved. By way of other defences, we suggest that any payer (Indian or otherwise) making a payment to a Singaporean entity should adopt due caution from the Indian withholding tax perspective. If the income is not proposed to be remitted to Singapore and the benefits under the India–Singapore Tax Treaty are being contemplated, then the payer should obtain appropriate documents, such as a certificate from the Singaporean tax authorities stating that the appropriate income was indeed chargeable to tax in Singapore and suitable tax representations/ indemnities from the Singaporean payee.

As President Benjamin Franklin said, way back in 1789: 'In this world, nothing can be said to be certain, except death and taxes'.

1. India follows a four-tier tax grievance mechanism, with the first appellate authority being the Commissioner of Income Tax (Appeals). The next level of appeal goes before the Income Tax Appellate Tribunal ('Tribunal'), which happens to be the highest fact-finding authority under the Indian income-tax judiciary. Any appeals thereafter go before the High Court; and finally, before the Apex Court (the Supreme Court).
2. *BP Singapore Pte Ltd. v. ITO* in ITA no. 409/ RJT/2016, rendered on 28 November 2017 (Rajkot Tribunal).
3. *DCIT v. D.B. International (Asia) Ltd* in ITA No. 992/Mum/2015, rendered on 20 June 2018 (Mumbai Tribunal).
4. *M.t. Maersk Mikage v. DIT* (IT) (2016) 72 taxmann. com (Gujarat High Court); APL Co. Pte. Ltd. v. DCIT in ITA No. 4435/Mum/2013, rendered on 16 February 2017 (Mumbai Tribunal); *Alabra Shipping Pte. Ltd v. ITO* in ITA No. 392/RJT/2014, rendered on 19 October 2015 (Rajkot Tribunal); *Far Shipping Singapore Pte. Limited v. ITO* in ITA No. 399/Hyd/2017 rendered on 16 June 2017 (Hyderabad Tribunal).

Country Focus

MALTA

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The web of uncertainties shadowing the ATAD CFC rules (a primary EU law perspective)

In the wake of recent highly publicised tax scandals like those of Apple Inc. and Fiat,[1] the public has demanded a response from the governments, and the EU has become determined to establish itself as an efficient body against aggressive tax planning schemes. This is evidenced by the Anti-Tax Avoidance Directive (ATAD)[2] formulated a couple of years ago, which it now seeks to enforce in all EU Member States (MS) by no later than 1 January 2019.

One of the most noteworthy measures contemplated in the ATAD is the Controlled Foreign Corporation (CFC) rules contained in Articles 7 and 8. Essentially, these rules protect a country's domestic tax base from erosion by 're-attributing the income of a low-taxed controlled subsidiary to its parent company'.[3] Given that MS have retained sovereignty over their tax systems, the ATAD's intention to impose these rules across the EU could be considered somewhat ambitious. Indeed, the EU's impatience to implement rules to counter tax avoidance has left a number of grey areas for MS to deal with.

The first main uncertainty MS have been left to resolve is what may be called 'the artificiality rule dilemma'. As affirmed in CJEU jurisprudence like *Cadbury Schweppes*,[4] *Lankhorst-Hohorst*[5] and *De Lasteyrie du Saillant*,[6] a national measure limiting the freedom of establishment can only be condoned if it 'specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned'.[7] It is therefore surprising that the OECD has maintained that CFC rules can also be extended to partly artificial arrangements.[8] Even more extraordinary is the fact that the OECD based such a view on a case of thin capitalisation – *Thin Cap Group Litigation*[9] – rather than purely on CFC regimes, like *Cadbury Schweppes*.

Another hurdle that MS must overcome relates to ambiguity around the genuine economic activities test that emerged from *Cadbury Schweppes*. This test has been adopted in the ATAD through the transactional approach[10] – one of the two approaches[11] that MS can choose to establish which CFC income is to be included in the tax base of the controlling shareholders at the end of the controlled entity's tax year. Notwithstanding its significance, no clear-cut definition of what this test entails has been given; so MS have been granted discretion to adopt their own interpretation. This may prove problematic as without guidance, MS could end up creating excessive rules in breach of the freedom of establishment. Companies should not be compelled to devote more resources and employ more personnel to justify themselves as genuine business units. Otherwise this could negatively affect the internal market, which might end up suffering productivity losses that, in the worst-case scenario, could even result in the closure of certain businesses.[12]

Another fundamental freedom underlying CFC rules that should not be ignored is the free movement of capital. This was clarified in both the *Olsen case*[13] and in *Commission v. UK*,[14] where it was argued that the CFC rules that applied to financial investments should be considered incompatible with the free movement of capital.[15] If the CJEU confirms the conclusions reached in those cases, then the choice that EU MS currently have in Article 7(2)(a) ATAD to apply CFC

"The situation is aggravated by the fact that the ATAD provisions are solely de minimis *harmonisation rules, so MS may opt for stricter rules"*

rules to third countries without doing an economic activity test may be held to be invalid, because this fundamental freedom benefits both EU and third-country nationals alike.[16] Such an outcome is certainly possible because the CJEU, under Article 263 of the Treaty on the European Union, has the power to review the legality of legislative acts. This issue, which has yet to be fully clarified by the CJEU, presents something of a challenge to the MS when it comes to deciding how they should implement CFC rules.

Altogether, it is clear that although the ATAD strives to avoid legal uncertainty by maintaining uniformity in certain aspects, some elements of the directive remain ambiguous. Given that no ATAD impact assessment was conducted, it is likely that further uncertainties and challenges will become apparent once all MS adopt the CFC rules. Moreover, the situation is aggravated by the fact that the ATAD provisions are solely *de minimis* harmonisation rules, so MS may opt for stricter rules. Although there is nothing wrong with the notion of MS implementing stricter laws to secure greater protection for their domestic tax base, MS must be guided accordingly by the EU to ensure that they only do so within the limits established by primary EU law, particularly the EU fundamental freedoms. Such guidance will help the ATAD CFC rules to contribute to the prosperity of the internal market, rather than to its decline.

1. Alexander Albl, 'The new EU CFC Rules (Council Directive (EU) 2016/1164) and the US Subpart F Rules; A Comparative Study' (LL.M. Tilburg University, 2017), 4.
2. Council Directive (EU) 2016/1164 of 12 July 2016 on Rules against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market [2016] OJ L 193.
3. Ibid, para. 12 of Preamble.
4. Case C-196/04, *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue* [2006] ECR I-07995.
5. Case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt* [2002] ECR I-11779, para. 37.
6. Case C-9/02 *Hughes de Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie* [2004] ECR I-02409, para. 50.
7. *Cadbury Schweppes* (n. 4), para 51.
8. OECD, 'Designing Effective Controlled Foreign Company Rules, Action 3 –2015 Final Report' (OECD Publishing, 2015), para. 22.
9. Case C-524/04, *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue* [2007] ECR I-02107, para. 81.
10. Article 7(2)(b) ATAD.
11. The other approach is the entity approach where MS have to include in the tax base of the taxpayer various types of passive income that has accrued in the CFC; for a full list, see Article 7(2)(a) ATAD.
12. 'Anti-Tax Avoidance Directive and its Implications' (4Liberty.eu, 2016), http://4liberty.eu/antitax-avoidance-directive-and-its-implications/, accessed 2 September 2018.
13. Joined Cases E-3/13 and E-20/13, *Fred Olsen and Others and Petter Olsen and Others v. The Norwegian State* [2014] EFTA Court.
14. Case C-112/14, *European Commission v. United Kingdom of Great Britain and Northern Ireland* [2014] ECLI:EU:C:2014:2369.
15. Ana Paula Dourado, 'Free Movement of Capital and Brexit' in Nazaré da Costa Cabral, José Renato Gonçalves and Nuno Cunha Rodrigues, eds., *After Brexit: Consequences for the European Union* (Palgrave Macmillan, 2017), 334.
16. Ibid.

Country Focus

UK

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VAT implications of a 'no deal' Brexit for businesses selling digital services in the European Union

With the UK's exit from the EU fast approaching on 29 March 2019, uncertainty remains about the impact of Brexit on trade with the rest of the EU. One of the most significant areas to face changes will be tax, especially VAT. Although the UK will continue to operate a VAT system identical to the current EU VAT system, what remains to be seen is how supplies between the UK and the EU will be affected.

In what appears to be an attempt to allay some of these fears, HM Revenue & Customs (HMRC) has recently issued guidance on how UK VAT will be impacted if the UK leaves the EU without agreement (i.e., a 'no deal' scenario). The Mini One Stop Shop (MOSS) is one of several sectors that could be fundamentally impacted in such a scenario.

MOSS rules and how they apply to non-EU businesses

The MOSS regime was introduced on 1 January 2015 as a simplification mechanism for suppliers of 'e-services' to private individuals or organisations with no business activities (known as on a 'B2C' basis). The rules governing B2C e-services mandate that VAT must be accounted for in the EU Member State to which the customer belongs. Without MOSS, businesses could potentially have to register for VAT in all 28 Member States; clearly, this would be extremely cumbersome.

The B2C e-service rules apply to all businesses throughout the world, not just those established in the EU. As the requirements for MOSS registration differ slightly for non-EU established businesses (EU established business must be VAT registered in a Member State to use MOSS, whereas non-EU established businesses are not required to be VAT registered in the EU already), there are two regimes: **Union MOSS (for EU established businesses)** and **Non-Union MOSS (for non-EU established businesses)**.

It's worth noting that the MOSS regime was prompted by a change in the rules governing B2C e-services. Before 1 January 2015, the place of supply of B2C e-services for EU established businesses was where the supplier belonged. Historically, this allowed B2C e-service providers to establish themselves in Member States with lower rates of VAT (e.g. Luxembourg and Malta), thereby making their prices more competitive. The change in rules therefore prevented this distortion and levelled the playing field.

Importantly, the rules for non-EU established B2C e-service providers did not change on 1 January 2015; indeed, since their introduction on 1 July 2003, they have always imposed tax based on where the customer belongs. Until the introduction of MOSS, non-EU businesses used the VAT on e-Services (VOES) system, which is ostensibly the same as MOSS.

Non-EU businesses that are required to use the MOSS regime (i.e. the Non-Union MOSS regime) currently have the freedom to choose the Member State in which they register for MOSS. EU businesses do not have that luxury and are required to register for MOSS in a Member State in which they are established. There are many factors to consider for non-EU businesses when deciding where to register; in particular, language preference. Therefore, many businesses in English-speaking countries (e.g. Australia and the United States) choose to register in the UK. Unfortunately for these businesses, the impact of a 'no deal'

"A key aspect of MOSS is that there is no registration threshold; therefore, even a single sale covered by the B2C e-services rule will precipitate a MOSS/VAT registration requirement"

Brexit could be significant in respect of MOSS.

An obligation to register in the UK

HMRC's recent guidance outlines that, in the event of a 'no deal' Brexit, the MOSS system will effectively cease for businesses that use the portal in the UK. Non-EU MOSS users that provide B2C e-services to the rest of the EU will effectively have to re-register for MOSS in a Member State of their choosing, or can opt to register for VAT in each Member State individually. Again, language may be a decisive factor, in which case Ireland may be the best option for English-speakers. The effect on UK established businesses is similar: they too will require MOSS registration in an EU Member State.

Either way, as we edge closer to Brexit, our advice would be that affected businesses should start considering their options.

A key aspect of MOSS is that there is no registration threshold; therefore, even a single sale covered by the B2C e-services rule will precipitate a MOSS/VAT registration requirement. This is a point that is often overlooked by affected businesses. Indeed, in our experience, many non-EU businesses are completely oblivious to the fact that their supplies might be subject to EU VAT. While it is extremely difficult for EU Member States to enforce these rules on non-EU businesses, we are aware that HMRC is taking certain steps towards this. Although HMRC is unlikely to be able to collect any perceived VAT owed, it does have the power to make life difficult, as discussed in the following case study.

Case study

A US business (ABC LLC) provides various services in relation to websites, such as customisation to small-to-medium sized businesses, and can also offer generic packages and support to private individuals.

Altogether, 90% of ABC LLC's customers are based in North America; but, as there is no equivalent business currently operating in the EU, the remaining 10% of customers are UK-based (both businesses and private individuals).

The business is unaware of the rules governing B2C e-services and, in fact, has no idea what VAT is.

HMRC undertakes a project to catch non-EU businesses that should be accounting for VAT in the UK under the B2C e-services rules and finds ABC LLC's website. The website contains a free forum and many of the members appear to be based in the UK.

As the rules for non-EU businesses came into effect on 1 July 2003, HMRC decides that ABC LLC must be liable for VAT in the UK and it registers ABC LLC for VAT from this date. It then raises VAT assessments covering the years 2003–17 inclusive.

HMRC writes to ABC LLC numerous times, but does not receive a response. HMRC is unable to collect the debt as there is no formal agreement between the USA and the UK.

At some point in 2018, ABC LLC decides to sell the business to a third party. As part of the process, due diligence is undertaken and ABC LLC's debt with HMRC is discovered. The buyer then pulls out of the deal as it is concerned about ABC LLC's non-compliance and the possibility that it may have VAT obligations in other Member States, not just the UK.

Country Focus

US

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Taxation of cryptocurrency: Virtual transactions bring real-life tax implications

Cryptocurrency is digital currency using encryption techniques, rather than a central bank, to generate, exchange and transfer units of currency. Unlike cash transactions, no bank or government authority verifies the transfer of funds. Instead, these virtual transactions are recorded in a digitised public ledger called a blockchain.

IRS treatment of cryptocurrency

The IRS addressed the taxation of virtual currency transactions in Notice 2014-21, which provides that virtual currency is treated as property for federal tax purposes. Therefore, general tax principles that apply to property transactions must also be applied to exchanges of cryptocurrencies. Notice 2014-21 holds that taxpayers must recognise gain or loss on the exchange of cryptocurrency for cash or for other property. Accordingly, gain or loss is recognised every time that Bitcoin is sold or used to purchase goods or services.

How the gain or loss is recognised depends largely on the type of transaction conducted and the length of time the coin position was held.

Cryptocurrency trading

Settled for cash

Cryptocurrency gains from trading coins held as capital assets are treated as investment income by the IRS, and the same capital gains rules apply. A taxpayer who sells a coin position for cash must report a capital gain on Form 8949. A coin position held for 1 year or less is considered a *short-term capital gain*, taxed at ordinary tax rates. A coin position held for more than 1 year is considered a *long-term capital gain*, taxed at capital gains rates.

As with stock trades, capital losses offset capital gains in full, and a net capital loss is limited to US$1,500 ($3,000 for married taxpayers filing jointly) against other types of income on an individual tax return. An excess capital loss is carried forward to the subsequent tax year.

Under IRS rules, the default for stock transactions is the First In, First Out (FIFO) method of accounting. However, under certain circumstances, *specific identification* is allowed. The use of specific identification can drastically reduce the recognised gain on cryptocurrency transactions, since many traders have multiple transactions in the same form of cryptocurrency. However, the use of this method is considered very aggressive.

Exchanged for other coins

Taxpayers who make coin-to-coin trades (e.g. Bitcoin to Ethereum) may mistakenly assume there is no tax liability because they did not receive any actual funds. However, given the IRS's treatment of digital currency as property, cryptocurrency trades are subject to the same capital gains and losses rules as all other property exchanges.

Some taxpayers and preparers have attempted to delay capital gains income on coin-to-coin trades by classifying the trades as Section 1031 'like-kind' exchanges, whereby they can defer income to the replacement position's cost basis. While it is possible to argue that cryptocurrency can qualify, there are still problems inherent in the applicability of Section 1031 to coin-to-coin trades, since they may fail to meet certain requirements. The one requirement that the IRS is most likely to challenge if they decide to

reject the use of Section 1031 for cryptocurrency trades would be that the coins are not necessarily like-kind (i.e. Bitcoin may not be considered a like-kind property compared to Ethereum). It is also important that if the decision is made to report coin-to-coin trades using Code Section 1031, it must be reported properly using Form 8824 and listing every trade.

To date, the IRS still has not provided guidance on this matter so there is no guarantee that they will accept this treatment for 2017 and preceding years.

The Tax Cuts and Jobs Act of 2017 has eliminated this debate by limiting 1031 like-kind exchanges to real property, not for sale. Starting in tax year 2018, the ability to even consider like-kind exchange for cryptocurrency has been eradicated.

Cryptocurrency mining

Investors also earn cryptocurrency by using their computers to solve a complex mathematical puzzle. As a reward for solving the puzzle, they receive newly 'minted' cryptocurrencies.

The IRS in Notice 2014-21 states that when a taxpayer successfully 'mines' virtual currency, the fair market value of the virtual currency is includible in gross income. Furthermore, an individual who 'mines' virtual currency that constitutes a 'trade or business' is subject to self-employment tax on the income derived from those activities.

The amount of this income equals the market price of Bitcoin on the day it was awarded on the blockchain. This amount also becomes the miner's basis in the Bitcoin going forward and is used to calculate future gains and losses.

For example, assume an investor mines one Bitcoin in 2013. On the day it was mined, the market price of Bitcoin was US$1,000. The investor now has $1,000 of taxable income in 2013. Going forward, the basis in the Bitcoin is $1,000. If the investor later sells it for $1,200, there is a taxable gain of $200 ($1,200 – $1,000).

Payment for goods and services

Notice 2014-21 also provides guidance on the taxation of cryptocurrency that is received as employee wages, independent contractor payments for services provided, and other payments for goods or services.

Wages paid to employees in virtual currency instead of in US dollars are taxable to the employee and must be reported on Form W-2. The employee is taxed at the fair market value of the digital currency.

Payments made to independent contractors for services provided using virtual currency are subject to income tax and self-employment tax and must be reported on Form 1099. Again, the fair market value of the virtual currency establishes the taxable amount.

Any taxpayer who receives virtual currency as payment for goods or services must include the fair market value of the virtual currency in his or her reported taxable income.

Donating cryptocurrency

Instead of selling the cryptocurrency and donating the after-tax proceeds, a taxpayer can donate it directly to their favourite charity. This approach provides significant benefit. The tax deduction will be equal to the fair market value of the donated coin (as determined by a qualified appraisal), and the donor will not pay tax on the gain. This also results in a larger donation because, instead of paying capital gains taxes, the charity will receive the full value of the donation. Bear in mind that for this strategy to work, the coin must have been held more than one year.

Questions remain...

The IRS's guidance in Notice 2014-21 clarifies various aspects of the tax treatment of cryptocurrency transactions. However, many questions remain unanswered, such as how cryptocurrencies should be treated for international (FBAR and FATCA) tax reporting and whether cryptocurrencies (prior to 2018) are subject to the like-kind exchange rules.

Setting aside these questions, what's obvious is that cryptocurrency is here to stay, and that scrutiny surrounding its reporting will continue to intensify.

Regardless of market fluctuations, experts predict that the use of cryptocurrency will continue to rise, perhaps even to the point of becoming mainstream. Current technological advances, combined with the promise of lower transaction fees and decentralised authority, are sure to spur more growth in 2018 and beyond.

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