

Global Dispatch

Hong Kong

Hong Kong denies tax deduction for plant or machinery used under import processing arrangements

The Hong Kong Inland Revenue Department (IRD) has denied tax deductions on costs incurred by a Hong Kong taxpayer on the acquisition of plant or machinery which they make available on a rent-free basis to their subcontractors in mainland China under import processing arrangements.

The IRD generally treats profits derived by taxpayers from the sale of goods made from Hong Kong through import processing arrangements as trading rather than manufacturing profits. While the profits are generally 100% chargeable to tax in Hong Kong, the IRD has been denying taxpayers' claims for tax deductions in respect of the costs incurred on the relevant plant or machinery either (i) as being prescribed fixed assets under Section 16G of the Inland Revenue Ordinance (IRO) thus qualifying for a 100% one-off write-off of the acquisition cost in the year of acquisition; or (ii) as being general fixed assets qualifying for normal tax depreciation allowances.

The IRD's denial was based on its view that a rent-free provision of plant or machinery by a Hong Kong taxpayer to its sub-contractor in mainland China constitutes a "lease" arrangement as defined in the IRO. As such, on the basis that assets subject to a lease term are excluded from the definition of prescribed fixed assets, the IRD has been denying claims by taxpayers for tax deductions under Section 16G of the IRO.

As regards claims by taxpayers for tax depreciation allowances on the relevant plant or machinery, the IRD has been invoking Section 39E of the IRO to deny such claims. Briefly, under Section 39E, where an asset is subject to a lease term and used outside Hong Kong by a person other than the Hong Kong owner of the asset, the Hong Kong owner will be denied tax depreciation allowances on the asset. As such, on the basis that (i) a rent-free provision of plant or machinery by a Hong Kong taxpayer to its subcontractor in mainland China constitutes a lease term; and (ii) the plant or machinery is used outside Hong Kong by a person other than the Hong Kong taxpayer, namely the sub-contractor in mainland China, the IRD has also

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been denying claims by taxpayers for tax depreciation allowances under Section 39E of the IRO.

Taxpayers, however, do not consider that the arrangement constitutes a lease term nor that Section 39E should be interpreted in that manner by the IRD.

Some commentators note that if the IRD is to abide by transfer pricing principles, it should increase the cost of goods purchased by a Hong Kong taxpayer from its subcontractor by the amount representing deemed rental charges, but the deemed rental charges would be excluded from Hong Kong's tax base since the charges are deemed to be received outside Hong Kong.

Ernst & Young LLP, Greater China Tax Desk - Sandy Chu (*New York*)

Ernst & Young LLP, Asia Pacific Business Group - Kaz Parsch and Jeff Hongo (*New York*)

Ernst & Young Tax Services Limited - Tracy Ho and Jo An Yee (*Hong Kong*)

India

India releases Union Budget 2011-2012

The Indian Finance Minister presented the Union Budget for 2011-12 on 28 February 2011 against the backdrop of the swift and broad-based growth achieved in 2010-2011. In view of the proposed Direct Taxes Code (DTC), it was

widely expected that the Finance Minister would limit his direct tax proposals to initiatives that require immediate attention. The Finance Minister confirmed that the DTC would be finalized for enactment during the financial year 2010-11 and will become effective on 1 April 2012.

Regarding indirect tax, although the Finance Minister stated some progress was made drafting the model goods and services tax (GST) legislation in the current year, no date for proposed implementation was provided.

Direct tax proposals

Income tax rates

- ▶ The surcharge on income tax rates for domestic companies is reduced from 7.5% to 5%, and for foreign companies, from 2.5% to 2%, resulting in effective tax rates for domestic and foreign companies of 32.445% (from 33.22%) and 42.024% (from 42.23%), respectively.

Minimum Alternate Tax (MAT)

- ▶ The MAT rate increased from 18% to 18.5%. The MAT exemption to Special Economic Zone (SEZ) developers and units in the SEZ is proposed to be repealed.

Alternate Minimum Tax (AMT)

- ▶ An 18.5% AMT on adjusted total income will be applicable to limited liability partnerships where regular income tax on total income is less

than the AMT. The provisions for a ten-year AMT credit carryforward and set off similar to those under MAT have been proposed.

Dividend Distribution Tax (DDT)

- ▶ The DDT exemption available to special economic zone (SEZ) developers is proposed to be repealed for dividends paid on or after 1 June 2011.

Other incentives

- ▶ Investment linked deductions associated with capital expenditure (other than on land, goodwill and financial instruments) will be extended to certain housing project developers and companies engaged in the production of fertilizers. The tax holiday sunset clause for the power sector is extended to 31 March 2012. An income tax exemption is proposed on the income of specified infrastructure debt funds. Interest received by nonresidents on investments in these funds will be subject to a 5% withholding tax.

Transfer pricing

- ▶ The current fixed 5% variation in determining a cross-border arm's length pricing is proposed to be replaced with norms that the government may consider more relevant based on the nature of the industry or transaction. A transfer pricing officer's jurisdiction will be extended to include controlled transactions not referred by the examining officer.

India's Union Budget 2011-2012 proposes annual reporting requirements for liaison offices

The taxability of a liaison office in India has been a matter of debate especially due to the limited activities permitted to be conducted by a liaison office under Indian exchange control regulations.

Under Indian exchange control regulations, a foreign incorporated company may establish a liaison office in India with the specific approval of the Reserve Bank of India (RBI). The role of a liaison office is limited to undertaking the following activities in India: (1) representing the headquarters company/group companies in India; (2) promoting export/import from/to India; (3) promoting technical/financial collaborations between headquarters/group companies and companies in India; and (4) acting as a communication channel between the headquarters company and Indian companies. A liaison office is not allowed to undertake any commercial activity, directly or indirectly, and cannot earn income in India.

There is a specific "purchase exclusion" available for activities which are confined to the purchase of goods in India for export purposes. In addition, most Indian tax treaties exclude from the definition of permanent establishment, activities undertaken by foreign entity's employees that are preparatory or auxiliary in nature.

A recent Indian tax ruling held that, if the liaison office was carrying out real and substantive business operations of the nonresident company in India, the liaison office would become taxable in India. Consequently, the purchase exclusion will be denied to the nonresident company. Moreover, depending on the facts and the nature of activities undertaken by liaison offices, the Indian tax authorities have been adopting a position that the liaison offices in India could constitute a taxable presence for the foreign headquarters company.

Also worth noting, some foreign companies which have set up liaison offices in India do not file income tax returns in India on the ground that no business activity is allowed to be carried out by such liaison offices in India.

The Union Budget 2011-2012 has now proposed that nonresidents who have set up liaison offices in India will be required to file an annual statement, providing details of activities carried out in India, although a required form has not yet been issued by the tax authority. The current requirement for a liaison office to file an annual activity certificate from a Chartered Accountant with the RBI would continue. The due date for filing the above statement will be 60 days from the end of the financial year of the headquarters company. This amendment is proposed to become effective 1 June 2011.

The proposed filing requirements seek to monitor the activities of a liaison office and ensure better enforcement when the activities create a taxable presence in India. With the backdrop of the recent ruling on the taxability of a liaison office in India, the proposed disclosure requirements highlight the need for multinational entities to review their existing arrangements, and the nature and level of activities conducted by their liaison office and assess compliance requirements.

Compliance

- ▶ The filing due date for income tax returns by domestic and foreign entities, which are also required to report controlled transactions under the transfer pricing regime, is proposed to be extended to 30 November. Liaison offices would be required to file an annual information return within 60 days from the end of the financial year. (For more details on the Budget's liaison office proposal, see page 4 of this issue of the *Global Dispatch*.)

Anti-avoidance

- ▶ Anti-avoidance measures have been introduced to discourage transactions with entities located in notified jurisdictional areas (NJA). A list of the NJAs has not yet been released.

- ▶ The proposed anti-avoidance measures include deeming all transactions with entities located in the NJA to be controlled transactions subject to transfer pricing provisions, restricted deductions for specified transactions, and increased withholding tax rate on payments made to entities in the NJA.

Cooperation with international revenue authorities

- ▶ The Central Board of Direct Taxes will notify tax officers to collect information on request received from tax authorities outside India.
- ▶ Indian revenue authorities are empowered to make inquiries and collect information on requests received from revenue authorities outside India in accordance with the respective income tax treaty.

The government appears to have adopted a balanced approach while framing the budget proposals. The current proposals have focused on anti-avoidance measures and information gathering rather than any radical change to the current tax system. More activity on the tax and regulatory reforms may be expected in the coming months because of the government's intention to implement the DTC and the GST.

Ernst & Young LLP, Indian Tax Desk - Himanshu Bhatia and Brenden Saldanha (*New York*); Hitesh Sawhney (*San Jose*)

Ernst & Young LLP, Asia Pacific Business Group - Kaz Parsch and Jeff Hongo (*New York*)

Ernst & Young Private Limited - KT Chandy, Rajendra Nayak and Riad Joseph (*Bangalore*)


Japan

Japan's transfer pricing assessments rise, tracking increase in APAs

Increase in average TP assessments

In November 2010, Japan's National Tax Agency (NTA) released its annual Audit Report, containing the results of tax audits conducted during the 2009 tax year (covering the period through 30 June 2010).

The NTA has revealed some interesting changes in transfer pricing (TP) audit activity in Japan as compared with the previous tax year. The number of TP cases ending with a finding of under-reported income decreased 25 percent, from 134 cases to 100. However, the total TP assessment amount over the same year rose 138 percent, from 29 billion yen to 69 billion yen. The



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average transfer pricing assessment per under-reported income case increased from 213 million yen to 678 million yen. While the last three years have seen a general decline in audit activity in Japan, this increase in total assessments and average assessments per case could signal a return to previous trends of increasing transfer pricing enforcement.

At the beginning of the Audit Report, the NTA outlines its intent during the year to focus on tax cases with a potential for “high impact” on taxpayers. Therefore, it might be reasonable to infer that in tax year 2009, the NTA chose audit targets selectively in order to achieve larger assessments. In the coming year, a continued audit focus on high-profile cases is likely.

EY expects NTA to pay greater attention to companies that have undergone business restructurings, given the introduction of new guidance in this area in the OECD Guidelines. Companies whose profit levels have fallen significantly due to such restructurings are especially likely to attract attention.

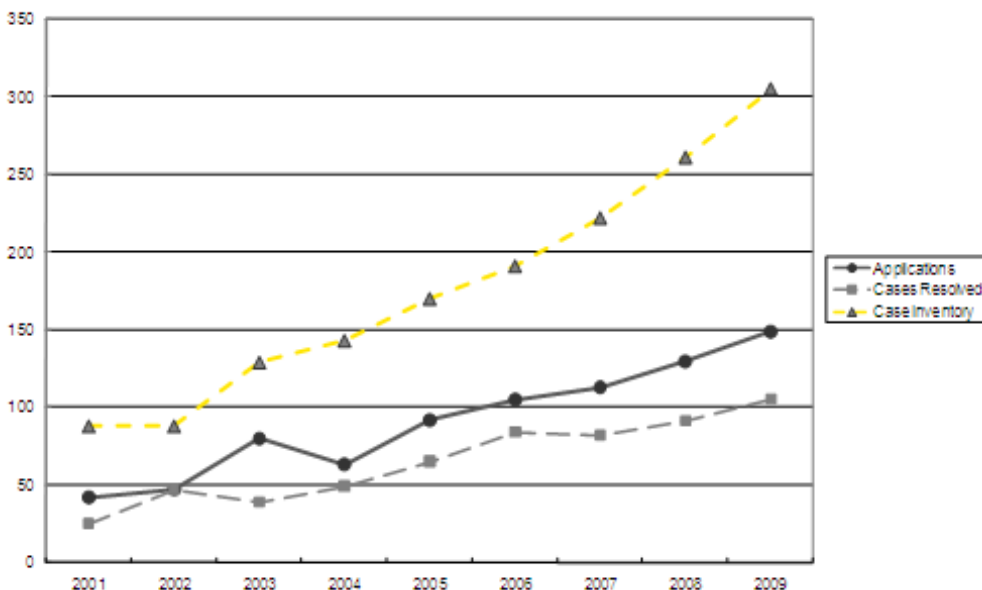
In a further development, the NTA’s annual Advanced Pricing Agreement Program Report for the 2009 tax year shows increased use of APAs to manage TP audit risk.

During the 2009 tax year, the NTA received 183 Mutual Agreement Procedure (MAP) applications, of which 149 were related to bilateral or multilateral APAs, an increase in APA applications of almost 15 percent from the previous tax year (statistics on unilateral APA applications were not included). The majority of newly initiated APAs involve the United States and Australia; however the total number of countries with which NTA holds MAP discussions has increased to 18 from 6 over a period of 10 years. Relatively recent additions to MAP discussions with NTA regarding APAs are Ireland and Spain.

The steady increase in APA applications indicates that companies in Japan recognize and are attempting to manage potential TP exposure. Given the jump in transfer pricing assessments in the last tax year, corporations with extensive foreign related-party transactions should consider the potential benefit of an APA to manage TP assessment risk.

Figure 1: Comparison of APA applications, cases resolved and cases carried over

(Source: *The NRT 2011*)



Ernst & Young Shinnihon Tax - Kai Hielscher, Chris Newman, Jon Jenni and Megumi Nakao (*Tokyo*)



Japan's proposed 2011 tax reform follows OECD Transfer Pricing Guidelines

Japan's Tax Commission of the Cabinet Office on 16 December 2010 released its tax reform proposal for 2011. The proposal includes a section specifically addressing transfer pricing, which is intended to provide greater clarity to multinational corporations on their transfer pricing in Japan. The proposal is currently under review at the National Tax Agency and may be adopted in phases starting as early as April 2011.

Three specific changes relating to transfer pricing are to be included in the tax reform package:

- ▶ Elimination of Japan's hierarchy of transfer pricing methods: the hierarchy is to be replaced with a "most appropriate method" analysis;

- ▶ Amplification of the use of the arm's length range and the appropriate central measure: the role of a range (rather than a single point) in determining the arm's length standard is to be confirmed, although the definition of the term range is not addressed. Further, where actual results fall outside the range, the proposed reforms authorize the use of a value other than the simple average of the data points constituting the full range in calculating the arm's length result if that alternative value is considered to be a more reliable measure than the average; and

- ▶ Clarification of the use of secret comparables (comparable data obtained from audits of third parties engaging in similar transactions): the specific situations in which secret comparables can be used are to be more clearly explained. When secret comparables are used, the

authorities are to disclose as much non-confidential information as possible, while still maintaining third party confidentiality.

No specific details are discussed in the proposal package. However, these proposals are described as being based on the 2010 revision to the OECD Transfer Pricing Guidelines.

In addition to these changes, the reforms will formalize the use of variations of the profit split method (i.e., the comparable, contribution, and residual profit split methods) by clarifying them in the tax regulations. The proposed changes will also specify how arbitration will operate under Japan's tax treaties. Other, unspecified revisions to Japan's transfer pricing rules also are planned in order to bring the rules in-line with the revised OECD Transfer Pricing Guidelines.

If these proposed reforms are passed, multinationals should have greater flexibility in managing their transfer pricing in Japan and should be able to pursue a more consistent global transfer pricing policy as Japanese transfer pricing rules move closer to the OECD standard.

Ernst & Young Shinnihon Tax - Kai Hielscher, Chris Newman, Jon Jenni and Jonathan Tapp (*Tokyo*)

Mexico

Proposed tax reform submitted to Mexican Congress

A comprehensive tax reform bill was submitted by a senator from the Partido Revolucionario Institucional political party (PRI) to the Mexican Congress on 10 March 2011. If enacted into law, the tax reform bill could simplify certain aspects of the tax system, but would increase the overall tax burden of businesses in Mexico.

To simplify the corporate tax, the current Flat Rate Business Tax (IETU) would be eliminated. However, the proposed reform would adopt certain of the characteristics of the IETU into the income tax by changing the basis for recognizing income and expenses to a cash basis as well as by making salary payment relief through a credit and denying deductions for royalty payments. The proposed reform also puts pressure on the informal economy by

providing a benefit to individuals for requiring that their transactions with a business be reported.

The corporate income tax would be paid annually at a rate of 25%, which would be a reduction to the current 30% rate (currently scheduled to be reduced to 28% by the year 2014). However, upon distribution, an additional tax at a rate of 10% would be due.

In this regard, earnings coming from previously taxed earnings ("CUFIN" by the Spanish acronym) would be subject to a tax of 10% on a grossed up basis. Distributions in excess of CUFIN would be subject to a 35% rate. The proposed reform does not include transition rules for earnings, so it would appear that distributions or pre-reform earnings would also be subject to this tax on distribution.

This proposed reform is just beginning the process required for enactment and, as currently drafted, would become effective 1 January 2013. Congressional approval from both houses is needed before it is submitted to President Calderon for approval. Since the law would become effective in 2013, the impact will not be felt until after the next presidential election in July of 2012.

Ernst & Young LLP, Latin American Business Center - Manuel Solano (*New York*); Terri Grosselin (*Miami*)

Mancera, S.C. - Koen van 't Hek and Santiago Chacon (*Mexico City*)

Netherlands

Dutch Decree on attribution of profits to permanent establishments

On 27 January 2011, a new Dutch Decree (the Decree) was published in the Government Gazette concerning the attribution of profits to permanent establishments. This Decree provides further insights into the position of the Dutch Tax Administration (DTA) regarding this important topic, following the publication of the 2010 OECD report on the attribution of profits to permanent establishments (PE Report) and the OECD work on article 7 of the OECD Model Tax Convention (MTC), including commentary, in recent years.

The Decree, applicable as of 28 January 2011, provides that Dutch policy concurs with the conclusions laid down in the PE Report. It also clarifies the DTA's position regarding certain issues, including the endorsement of the conclusions of the PE Report, the dynamic approach in interpreting tax treaties, the preference for the capital allocation approach, certain issues regarding dealings involving group services, intangible assets and financial assets, and certain specific topics, including advance certainty. This Decree is particularly important for those multinational enterprises that operate through a permanent establishment (PE) in the Netherlands.

The following are some of the highlights of the Decree:

Arm's length principle

- ▶ The DTA endorses the conclusions of the PE Report, which provides guidance on how to apply the arm's length principle in the framework of Article 7 MTC while applying the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations by analogy.
- ▶ The Decree provides that dealings between the PE and another part of the same enterprise of which the PE is a part should be remunerated

at an arm's length price unless a restriction was made on such a remuneration by the commentary on Article 7, the Dutch Decree on the prevention of double taxation 2001 (Bvdb) and / or Dutch case law.

Dynamic approach

- ▶ The guidance in the PE report can partly be characterized as an elaboration of the existing commentary and partly as new guidance as a consequence of which the OECD changed the language of Article 7.

- ▶ With respect to the guidance that can be seen as an elaboration of the existing OECD commentary, the DTA applies the "dynamic approach" in interpreting treaties entered into before the subject amendments were made.

Preference for capital allocation approach

- ▶ The Decree provides that the DTA has a preference for the "capital allocation" approach (rather than the "thin capitalization" approach) when allocating "free" capital to a PE.

OECD publishes scoping paper on transfer pricing and intangibles

On 27 January 2011 the Organization for Economic Cooperation and Development (OECD) released a scoping paper for a project that will examine various issues related to transfer pricing for intangible property. The full paper can be accessed at: <http://www.oecd.org/dataoecd/10/50/46987988.pdf>.

According to the scoping paper, the need for this project became apparent during the OECD's 2010 revision of the Transfer Pricing Guidelines (the TPG). During that process, "transfer pricing issues pertaining to intangibles were identified as a key area of concern to governments and taxpayers, due to insufficient international guidance in particular on the definition, identification and valuation of intangibles for transfer pricing purposes."

The stated intention of the new intangibles project is to provide guidance on issues specific to intangibles; it is expected that this project will result in an update of Chapter VI of the TPG (Special Considerations for Intangible Property) and may also involve some updating of Chapter VIII (Cost Contribution Arrangements).

The project will be carried out by Working Party No. 6 of the Committee on Fiscal Affairs on the Taxation of Multinational Enterprises, through a Special Session on the Transfer Pricing Aspects of Intangibles. The OECD is planning to involve non-OECD countries in pursuit of global consistency. The OECD's plan is to publish a discussion draft at the end of 2013.

This OECD project on intangibles is of great importance for the development of transfer pricing over the next decade. In order to succeed, the OECD will need successfully to deal with the complex issues outlined in its scoping statement and summarized above. EY will be closely following the project and will issue further information as it develops.

- ▶ The PE requires a certain amount of funding, made up of both free capital and interest-bearing debt. Once the amount of capital is determined, as well as the amount of free capital, the balance is therefore the amount by reference to which the interest deduction is calculated. For the allocation of the amount of interest, the Decree expresses a preference for the “fungibility” approach (rather than the “tracing” approach). It is noted that for the attribution of interest to the PE, a risk-weighted share of the total interest expense should be taken into account.

“Significant people function” versus “control”

- ▶ The concepts of “significant people function” (in the context of Article 7 MTC) and “control” (in the context of Article 9 MTC) could be interpreted differently in their application. However, the DTA is of the view that a large overlap can be recognized in the activities of parties who have control over the risks and the “day-to-day” activities of the significant people function.

Dealings

- ▶ With respect to dealings involving group services, a profit markup should be considered. However, the DTA will be flexible in applying treaties based on the old Article 7 MTC. The policy laid down in a 2004 transfer pricing decree, allowing a charge of only the

relevant actual costs without a profit markup for certain types of supporting activities, is also applicable to internal dealings.

- ▶ With respect to dealings involving intangible assets, the DTA is of the view that it is possible under certain circumstances to charge a royalty between the headquarters and the PE in interpreting Article 7 MTC 2008.

Ernst & Young Belastingadviseurs LLP - Ronald van den Brekel and Bernard Damsma (*Rotterdam*); Clive Jie-A-Joen and Danny Oosterhoff (*Amsterdam*)

Singapore

2011 Singapore Budget contains pro-business tax measures

On 18 February 2011, the Minister for Finance delivered the 2011 Singapore Budget for the fiscal year 1 April 2011 to 31 March 2012. The Budget introduces significant enhancements to the Productivity and Innovation Credit incentive which was announced last year. The Budget also introduces a new foreign tax credit pooling system to give companies greater flexibility in managing the remittance of their foreign income and the use of their foreign tax credits. In addition, the Budget provides refinements to the pre-commencement expenses claim.

The following are some of the Budget’s highlights.

- ▶ Foreign tax credit (FTC) pooling system: A new FTC pooling system will be introduced effective from accounting years ending in 2011 and thereafter. Under this proposal, Singapore tax resident companies can elect to compute their FTC on a pooled basis, rather than on a source-by-source and country-by-country basis, if the following conditions are fulfilled:
 - foreign income tax is paid on the foreign income in the foreign jurisdiction from which the foreign income is remitted;
 - the headline tax rate of the foreign jurisdiction from which the foreign income is remitted is at least 15%; and
 - there is Singapore tax payable on the foreign income.

This will allow greater flexibility for companies in their use of FTCs, reduce taxes payable and simplify tax compliance, especially for companies with significant regional or global investment holding, licensing and/or financing activities.

- ▶ Enhancing pre-commencement expenses claim: It is proposed that companies be allowed to claim pre-commencement revenue expenses incurred in the accounting year immediately preceding the accounting year in which they earn the first dollar of trade receipts.

The change is effective from accounting years ending in 2011 and thereafter.

- ▶ Financial sector liberalization of the withholding tax exemption regime: Effective on or after 1 April 2011, a withholding tax exemption will be granted on interest and other qualifying payments received by all nonresident persons (excluding permanent establishments in Singapore) from licensed banks, licensed finance companies

and other approved financial institutions, if the payments are made for the purpose of their trade or business. This will strengthen Singapore's position as a regional funding center and facilitate the banks' access to a wider range of funding sources.

Other changes proposed in the budget would affect the biomedical sector, maritime sector, and trading sector (enhancement of the Global Trader Program).

The Singapore tax authority will release more details on these tax proposals in due course and the legislation to enact the tax changes is likely to be published in the latter half of 2011.

Ernst & Young LLP, Singapore Tax Desk - Ching Khee Tan (*New York*)

Ernst & Young LLP, Asia Pacific Business Group - Kaz Parsch and Jeff Hongo (*New York*)

Ernst & Young Solutions LLP - Russell Aubrey, Andy Baik and Lim Joo Hiang (*Singapore*)

Ernst & Young LLP, Singapore Tax Desk - Sandie Wun (*London*)

Spain/Germany

Spain, Germany sign new tax treaty

On 3 February 2011 the Spanish and German governments signed a new comprehensive tax treaty that will replace the treaty currently in force that was signed in 1966. The structure and content of the new treaty is based mostly on the OECD's current model tax convention.

The most relevant change in the new treaty allows Spain to tax capital gains derived from the transfer of shares in an entity which is directly or indirectly mainly composed of real property.

The 1966 treaty did not allow the state of source to impose tax on capital gains deriving from portfolio investments. Article 13, paragraphs



2 and 3, of the new treaty sets forth that the following capital gains from portfolio investments will be subject to capital gains tax in the source country:

- ▶ Capital gains deriving from the transfer of shares (or similar rights) of an entity when at least 50% of the assets of the entity consists, directly or indirectly, of real estate located in such country; or
- ▶ Capital gains deriving from the transfer of shares (or similar rights) that, directly or indirectly, grant to the holder of such shares (or rights) the right to use real estate located in such country.

The change is relevant to German groups looking to dispose of their real estate investments in Spain since, under the new wording of the treaty, their capital gain will be subject to Spanish capital gains tax at a 19% rate.

This may provide an opportunity for German corporations and individuals as well as to German investment funds as there may be a need to reorganize current German investment structures into Spanish real estate while the (old) tax treaty is still in force.

The new treaty also reduces the withholding tax rate on certain dividends from 10% to 5% and provides that interest and royalties are not subject to tax in the state of the payee. There are also other changes in respect to the taxation of individuals.

Ernst & Young LLP, Spanish Tax Desk
- Inigo Alonso Salcedo (*New York*)

Ernst & Young LLP, German Tax Desk
- Thomas Eckhardt and Jorg Menger (*New York*)

Ernst & Young Abogados - Laura Ezquerro (*Madrid*); Carlos Gabarró (*Barcelona*)

Taiwan

Taiwan issues draft bill on thin capitalization rules

A recently issued draft bill provides clarifications and explanations of Taiwan's new thin capitalization rules that were introduced on 10 January 2011. The thin capitalization rules include a 3-to-1 debt-to-equity ratio, computation of nondeductible interest expense, definitions of related-party debts, equity and interest expense, and tax return disclosure requirements.

Highlights of the draft bill

Debt-to-equity ratio of 3 to 1 and computation of nondeductible interest expense

If the related-party debt-to-equity ratio exceeds 3 to 1, a portion of related-party interest expense will be disallowed based on the formula provided in the draft bill.



The related-party debt-to-equity ratio is determined by taking the current year sum of monthly average related-party debt amounts and dividing by the current year sum of monthly average equity amounts.

Related-party debt

The term related-party debt refers to a direct or indirect interest bearing loan or any other type of interest bearing debt from a related party, including, but not limited to, the following:

- ▶ Borrowing from a related party
- ▶ Back-to-back borrowing indirectly through an unrelated party
- ▶ Borrowing from an unrelated party for which a related party issues a guarantee, or
- ▶ Other type of financing arrangement involving a related party directly or indirectly

Equity

For a Taiwanese entity, the term equity refers to a capital amount, including registered paid-in capital on a balance sheet, and additional paid-in capital. For a branch of a foreign entity, the term means a registered working capital amount.

Interest paid to a related party

The term interest paid to a related party for thin capitalization purposes means actual interest and any other costs equivalent or similar to interest in nature paid to a related party, including interest paid or accrued on direct or indirect debts, default interest, guarantee fees, mortgage charges, loan commitment fees, financing charges, fees on participation loans and other fees equivalent or similar to interest.

Disclosure requirements

If a related-party debt-to-equity ratio exceeds 3 to 1 or an entity has been engaged in related party funding

transactions, unless certain criteria to waive the disclosure requirement are met, the entity is generally required to disclose information on changes in capital, equity, and other accounts, currency denomination, interest rate, terms and conditions of the related-party debt, etc.

The draft bill is subject to public hearing and discussions before it is finalized.

Ernst & Young LLP, Greater China Tax Desk - Sandy Chu (*New York*)

Ernst & Young LLP, Asia Pacific Business Group - Jeff Hongo and Kaz Parsch (*New York*)

Ernst & Young - Milly Liu, Sophie Chou, Alice Chung and Anna Tsai (*Taipei*)

Foreign Tax Desks in the United States

- ▶ **Foreign Desks, Director**
Gerrit Groen, *New York*
+1 212 773 8627 / fax +1 212 773 5547
- ▶ **Argentina**
Pablo Wejcman, *New York*
+1 212 773 5129 / fax +1 212 773 5547
- ▶ **Australia**
Michael Anderson, *New York*
+1 212 773 9692 / fax +1 212 773 0826
- ▶ **Austria**
Peter Grau, *New York*
+1 212 773 7120 / fax +1 212 773 5119
- ▶ **Belgium**
Hans van Haelst, *New York*
+1 212 773 7907 / fax +1 212 977 0298
- ▶ **Brazil**
Simone Frizzo, *New York*
+1 212 773 2583 / fax +1 212 977 5547
- ▶ **Canada**
Nik Diksic, *New York*
+1 212 773 3330 / fax +1 212 773 5583
- ▶ **France**
Frédéric Vallat, *New York*
+1 212 773 5889 / fax +1 212 773 0826
- ▶ **Germany**
Jörg Menger, *New York*
+1 212 773 5250 / fax +1 212 773 5119
- ▶ **Greater China**
Lucy Wang, *New York*
+1 212 773 4330 / fax +1 212 773 5584

Sandy Chu, *New York*
+1 212 773 6721 / fax +1 212 773 5584
- ▶ **Hungary**
Miklos Santa, *New York*
+1 212 773 1395 / fax +1 212 773 6883
- ▶ **India**
Himanshu Bhatia, *New York*
+1 212 773 4496 / fax +1 212 773 5584
- ▶ **Ireland**
Paul Fleming, *New York*
+1 212 773 8744 / fax +1 212 773 7186
- ▶ **Israel**
Motti Tagar, *New York*
+1 212 773 1984 / fax +1 212 773 5562
- ▶ **Italy**
Emiliano Zanotti, *New York*
+1 212 773 6516 / fax +1 212 773 0298
- ▶ **Japan**
Hideyuki Ebihara, *New York*
+1 212 773 8435 / fax +1 212 773 5584
- ▶ **Luxembourg**
Jurjan Wouda Kuipers, *New York*
+1 212 773 6464 / fax +1 212 773 0298

Serge Huysmans, *Chicago*
+1 312 879 3899 / fax +1 312 879 4055
- ▶ **Netherlands**
Roderik Rademakers, *New York*
+1 212 773 3390 / fax +1 212 977 1567
- ▶ **Pan-Africa**
Dele Olaogun, *New York*
+1 212 773 2546 / fax +1 212 773 1570
- ▶ **Poland**
Lukasz Strzelec, *New York*
+1 212 773 7012
- ▶ **Russia**
Maria Gubina, *New York*
+1 212 773 3343
- ▶ **Scandinavia (Denmark, Finland, Norway, Sweden)**
Thomas Iversen, *New York*
+1 212 773 1069 / fax +1 212 773 6883
- ▶ **Singapore**
Ching Khee Tan, *New York*
+1 212 773 0012 / fax +1 212 773 5584
- ▶ **Spain**
Inigo Alonso Salcedo, *New York*
+1 212 773 8692 / fax +1 212 773 6760
- ▶ **Switzerland**
Alfred Preisig, *New York*
+1 212 773 6475 / fax +1 212 773 5562
- ▶ **United Kingdom**
Ian Beer, *New York*
+1 212 773 5185 / fax +1 212 773 5562
- ▶ **Asia Business Group**
Jeff Hongo, *New York*
+1 212 773 6143 / fax +1 212 773 5584
- ▶ **Central European Business Group**
Miklos Santa, *New York*
+1 212 773 1395 / fax +1 212 773 6883
- ▶ **EMEIA Financial Services**
Mark Semple, *New York*
+1 212 773 5943 / fax +1 866 433 2882
- ▶ **Latin American Business Center**
Alberto Lopez, *New York*
+1 212 773 0770 / fax +1 212 773 5547

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