International Tax Update[1]

December 2014 Issue

In our year-end newsletter we cover two recent tax cases and two notable developments in tax policies. In terms of geographies our topics span from China through Delaware in the US to the United Arab Emirate of Ras al-Khaimah ('RAK'). These stories are a remarkable sign of how tax policies of countries of diverse economic, political and cultural background go in the same direction. Enhanced tax transparency and enforcement of ever stringent tax laws put an end to "traditional" offshore tax planning sooner than we ever thought.

We wish all our readers and their families the joys of the holiday season and a New Year of good health, happiness and prosperity.

1) Leading US multinational's Chinese tax evasion case

State owned Chinese media company Xinhua News reported that 'M Corporation', a top 500 American company had been caught for evading Chinese taxes and had agreed to pay 840 million yuan ($137 million) of taxes and interest. Many claim Microsoft's identity in the case is a public secret. **The case was labeled as the first major Chinese anti-avoidance case involving a US multinational.** Many expect others will follow.

What is known of the case is that M applied for a bilateral advance pricing agreement with the US and Chinese tax authorities in 2012 with regards to its Chinese operations. The case relates to prior periods, when M in China paid high research & development and franchise fees to its affiliated companies outside China, hence accumulating huge losses at the level of the Chinese entity, while it performed well in China. The case is therefore likely **a transfer pricing case,** where the State Administration of Taxation ('SAT'), the Chinese central **tax authority, adjusted the Chinese tax base of M and assessed its Chinese tax liabilities on the grounds of challenging the levels of these inter-company payments.** This measure fits well into recent Chinese tax policies aimed at protecting Chinese taxing power and tax revenues.

China is committed to end tax evasion, is a recent signatory to the OECD's Convention on Mutual Administrative Assistance in Tax Matters and is gradually revising and reviewing its domestic anti-avoidance measures and double tax treaties **in line with the action plan points of the BEPS project** (Base Erosion and Profit Shifting) driven by the OECD and the G20. These **special tax adjustment rules include transfer pricing and transfer pricing documentation rules, thin capitalization rules and general anti-avoidance rules.**

1, This newsletter is based on articles published in Worldwide Tax Daily (WTD) and International Tax Review (ITR). (1) Microsoft Identified in Chinese Tax Evasion Case – WTD, 28 November 2014; (2) China Releases GAAR Administrative Measures – WTD, 15 December 2014; (3) China's Tax Jurisdiction Goes Global – WTD, 19 November 2014; (4) U.A.E., Ras al-Khaimah Free Trade Zone Sign MOU – WTD, 17 November 2014 (5) Top 500 American company 'M Corporation' owes China $137 million after tax evasion – ITR, 26 November 2014

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2) China broadens its general anti-avoidance legislation – Disclosure of tax planning schemes?

A noteworthy sign of the above initiatives is Decree 32, issued by the SAT on 12 December, introducing administrative measures for **applying the domestic general anti-avoidance rules ('GAARs') to allegedly abusive tax arrangements.** The measures will come into effect on 1 February 2015.

According to the new administrative measures **tax avoidance will be established where the sole or main purpose of an arrangement is to obtain tax benefits.** This approach is in line with GAARs already applied by many major and developed economies.

Chinese tax authorities have the right to adjust a taxpayer's tax liabilities where **an arrangement lacks a reasonable business purpose** and it brought tax benefits to the enterprise. Decree 32 defines the term tax benefit as the reduction, avoidance or deferral of Enterprise Income Tax. The **characteristics of a tax avoidance arrangement** are also set by the decree as follows:

- it's **sole or main purpose is to obtain tax benefits;** and
- it complies with tax laws formally, however, **lacks economic substance.**

Special tax adjustments may be done by the tax authorities under any reasonable methods, including in particular the following:

- recharacterization of part or all of the arrangement;
- **disregarding the existence of a party to the transaction for tax purposes** or treating all parties to the transaction as the same entity; and
- recharacterization of the income, deductions, preferential tax treatment, or foreign tax credit, or reallocation of those items between or among the parties to the transaction.

Although at this stage taxpayers will not be routinely required to submit communications with their tax advisers to the tax authorities, under the decree competent tax authorities will have the power to demand relevant information and supporting documents from entities or individuals that provided the investigated taxpayers with tax planning services regarding the arrangement. **In this respect Decree 32 can also be interpreted as a very first step taken by China towards disclosure rules of many jurisdictions that require full disclosure of tax planning schemes and arrangements to tax authorities.**

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It is worth noting that extending general anti-avoidance rules under the decree are secondary to specific anti-avoidance rules, such as those applying to transfer pricing, cost sharing agreements, controlled foreign corporations, beneficial ownership or economic substance, and can be considered an additional set of rules to be invoked by the Chinese tax authorities.

3) Delaware LLC ignored in a Chinese indirect share transfer case

Challenging tax arrangements under specific anti-avoidance rules does already have a history in China. Several cases are known where indirect share transfers have been investigated under the substance over form principle implemented in Circular 698, which empowers Chinese tax authorities to **ignore or look through offshore special purpose vehicles ('SPVs') for tax purposes** in the case of non-resident enterprises transferring offshore holding companies with underlying Chinese resident companies. If the transferor is found to **have set up a holding company without a business purpose so as to indirectly transfer the underlying Chinese enterprise without paying Chinese taxes, the competent tax authority can, with the approval of SAT, recharacterize the transaction. If the competent tax authority is successful in challenging the transaction, the existence of the offshore holding company is disregarded and the offshore transfer is treated as a transfer of the underlying target, which is taxable in China.**

The rules set out in Circular 698 were so far applied to SPVs in traditional tax havens only, such as the British Virgin Islands or the Cayman Islands.

In a recent case of the Zhejiang tax bureau, the SAT confirmed, in Circular 38, the application of Circular 698 to an SPV incorporated in the US state of Delaware. **Circular 38 effectively expands the scope of Circular 698, possibly disregarding exit transactions or even legitimate tax-free reorganizations in any jurisdiction.**

In the Zhejiang case, East Balt Inc., an international bakery incorporated in Delaware, held East Balt LLC, a holding company also incorporated in Delaware. East Balt LLC in turn invested in a subsidiary in Hangzhou ('Hangzhou WFOE'). East Balt Inc. transferred East Balt LLC to OEP East Balt B.V., a company registered in the Netherlands.

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The Zhejiang tax bureau challenged this transaction and found that:

- the effective tax rate of East Balt Inc. was lower than 12.5 percent for the share transfer;
- the holding vehicle, East Balt LLC, **had no full-time employees and no substantive business activities such as manufacturing, sales, or management;** and
- **East Balt LLC does not have any assets other than the equity interest in Hangzhou WFOE,** and the share transfer price was based mainly on the valuation of Hangzhou WFOE.

The SAT concluded that the transfer of East Balt LLC was, in essence, a transfer of Hangzhou WFOE, and thus, **East Balt LLC should be ignored for Chinese tax purposes and East Balt Inc. must pay Chinese withholding taxes on the transaction.**

The case suggests that Chinese tax authorities aim to further expand their jurisdiction in indirect share transfer cases as long as the underlying assets comprise of Chinese target companies.

4) Ras al-Khaimah Free Trade Zone in the UAE implementing international standards of information exchange

The Ras al-Khaimah Free Trade Zone ('RAK FTZ') is the Delaware of the UAE, one of the major offshore centres in the Emirates. Scholars and practitioners will agree that a main feature of a jurisdiction labeled 'offshore' is privacy and the lack of information on fiscal matters, shareholders and beneficial owners of companies. **Transparency is** therefore, not surprisingly, **in the focus of governments around the globe fighting against tax evasion and the inappropriate use of offshore arrangements and entities.**

The Ministry of Finance of the UAE has signed a memorandum of understanding with the RAK FTZ aimed at ensuring international standards of transparency in the exchange of information for tax purposes. **The agreement will implement exchange of information between the MoF of the UAE and RAK FTZ, affecting both individuals and companies.**

This measure will facilitate information exchange between the UAE and its double tax treaty partners and extend it to RAK nationals and companies incorporated there. **The days of absolute privacy for those operating businesses in RAK FTZ are therefore numbered.**

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This step will bring RAK FTZ in line with numerous offshore centers and jurisdictions around the world that have recently concluded double tax treaties with extensive exchange of information articles or tax information exchange agreements that will facilitate information exchange in fiscal matters at a global scale. Operating companies and doing business in RAK FTZ, as in other offshore centers, may still be legitimate; however, full transparency will be assumed and required.

We update our clients and business partners on a regular basis about tax, legal, regulatory and other developments in the Middle East and Asia.

We are an independent advisory firm with the focus on helping clients to “de-offshorize” their international structures and to implement substance in various jurisdictions around the globe where we provide significant know-how when it comes to the implementation of onshore solutions.

We are proud to say that the background of our associates is very diverse, ranging from legal, tax, banking, economists and to even medical which allows us to cover various industries. Hence, we are comfortable to say that we can work with our clients in a number of different industries, ensuring that not only the tax and legal structure is put in place in compliance with the rapidly changing regulatory environment but also the various industry specific functions are carried out appropriately.

Furthermore, through our presence in the Middle East (Bahrain) and Asia (Hong Kong) we gained significant insight in the current developments in these striving markets. We also serve as an intermediary for investors from both parts of the world to establish them and also identify investment opportunities.

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