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# Border Crossing

1st Quarter 2012

Welcome to issue 20 of **Border Crossing** - RSM International's newsletter covering technical developments in taxation around the globe.

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# Malta: High Net Worth Individuals Rules

The High Net Worth Individuals Rules (the Rules) have recently been introduced to attract high net worth foreign individuals to take up residence in Malta and take advantage of the beneficial rate of tax. The Rules apply to both EU and third country nationals and will run in parallel to the current Residents Scheme Regulations. In fact, current holders of a valid permanent residence certificate will continue to fall under the old regulations, unless they wish to relinquish the certificate and apply under the new Rules.

## Nature of Incentive

Any foreign national may benefit from the special tax status, however, the Rules distinguish between EU/EEA/Swiss nationals and third country nationals.

## EU/EEA/Swiss nationals

Such individuals need to satisfy the Commissioner of Inland Revenue (CIR) that they meet all of the following:

- a) Individual acquires immovable property in Malta for not less than €400,000, or rents an immovable property in Malta for not less than €20,000 annually, and such individual and his family members have their habitual residence in such property as their principal place of residence. Furthermore, no other person may reside in such property and moreover it cannot be let or sub-let.
- b) Individual must not have applied for special tax benefits under the Residents Scheme Regulations or the Highly Qualified Persons Rules.
- c) Individual must be in receipt of stable and regular resources that are sufficient to maintain him/herself and dependents without recourse to the social assistance system in Malta.
- d) Individual is in possession of (a) a valid travel document, and (b) sickness insurance covering him/

herself and dependents in respect of all risks across the EU normally covered by Maltese nationals.

- e) Individual must not be domiciled in Malta and does not intend to establish his domicile in Malta within five years from the date of application.
- f) Individual is not a long-term resident, i.e. he is not holding long-term residence status in terms of the Status of Long-Term Residents (Third Country Nationals) Regulations, 2006.
- g) Individual is a fit and proper person. CIR will consider the individual's conduct and morals, reputation and character, and will take into consideration any criminal record, convictions for fraud or other dishonesty, disqualification by any professional or regulatory body, whether he/she was adjudged bankrupt or is the subject of any current investigations, proceedings or litigation, any offences connected to terrorism, money laundering, crimes against humanity, and whether in the past the individual had been candid and truthful in his dealings with the Maltese public administration.

EU/EEA/Swiss nationals who satisfy the above conditions can qualify for a flat tax rate of 15% on income received in Malta from foreign sources, provided that the minimum amount of tax payable (after any relief of double taxation) in any

year is €20,000 and an additional €2,500 for every dependent. Other income subject to tax in Malta of the individual or his/her spouse will be subject to tax at the rate of 35%.

## Third Country Nationals

Third country nationals have two options in relation to their entry requirements and stay in Malta:

**Option 1** - under this option the individual will not obtain any special rights to enter and reside freely in Malta, but would need to obtain a visa to enter and stay in Malta.

**Option 2** - under this option the individual will be able to obtain special rights to enter and reside in Malta, but would need to enter into a qualifying contract with the Government of Malta, whereby the individual would need to deliver €500,000 and an additional €150,000 ("the Bond") for every dependent to the latter, and the Government of Malta will hold such sums by title of gratuitous voluntary deposit.

The bond will be restored to the individual if the latter renounces the special tax status within four years from the date of signing of the qualifying contract. Moreover, any individual who becomes a long-term resident, or is already a long-term resident, he/she would be required to forfeit all the rights over the Bond. A long-term resident is defined as a person holding long-

term residence status in terms of the Status Long-Term Residents (Third Country Nationals) Regulations, 2006, or if he/she is a third country national who has resided legally and continuously in Malta for five years. Moreover, the Bond is also considered forfeited in the event of a serious crime being committed by the individual, or if the special tax status was obtained on the basis of fraud or omission on the part of the individual.

Any third country national must, in addition to satisfying the conditions mentioned in (a) to (g) above (under EU/EEA/Swiss nationals section), also prove that they are fluent in Maltese or English.

Third country nationals who satisfy the conditions should benefit from a flat tax rate of 15% on income received in Malta from foreign sources, provided that the minimum amount of tax payable (after any relief of double taxation) in any year is €25,000 and an additional €5,000 for every dependent. Other income subject to tax in Malta of the individual or his/her spouse will be subject to tax at the rate of 35%.

## Cessation of Special Tax Status

A beneficiary may opt to cease to possess the special tax status by informing the CIR accordingly. There are situations where the special tax status will cease in the case of default by the beneficiary of these tax compliance obligations and failure to reply to the CIR's requests. Moreover, if the following conditions are no longer met the beneficiary will also lose their special tax status:

- a) Does not hold a qualifying property holding at any time after acquiring the special tax status; or

- b) Is not in receipt of stable and regular resources that are sufficient to maintain him/herself and dependents without recourse to the social assistance system in Malta; or
- c) Is not in possession of sickness insurance covering him/herself and dependents in respect of all risks across the EU normally covered by Maltese nationals; or
- d) Becomes a citizen of Malta or establishes his domicile in Malta; or
- e) In the case of an EU/EEA/Swiss citizen, if he does not remain an EU/EEA/Swiss citizen, and in the case of a third country national, if he becomes an EU/EEA/Swiss national; or
- f) Resides in Malta for less than 90 days in a calendar year; or
- g) The beneficiary's stay is deemed not to be in the public interest by the Minister of Justice. This includes instances where the beneficiary's stay affects the interests of public safety, the protection of public order, national security, territorial public health or morals; or
- h) Stays in any one other jurisdiction for more than 183 days in a calendar year.

## Application Process

An application may only be submitted to the CIR through an Authorised Registered Mandatory accompanied by a non-refundable fee of €6,000.

## Current Holders of a Permanent Residents Scheme Certificate

No new certificates are to be issued under the Permanent Residents Scheme Regulations. Current holders may continue to benefit from the rights granted under those regulations, however, they have to satisfy the following additional conditions:

- a) Individual must be in receipt of stable and regular resources which are sufficient to maintain him/herself and dependents without recourse to the social assistance system in Malta;
- b) The holder must be in possession of sickness insurance coverage for him/herself and the members of their family in respect of all risks normally covered for Maltese nationals;
- c) The holder's place of residence in Malta cannot be occupied by any person other than the holder of the certificate and their family members.

If such individual sells their current property or terminates their current lease agreement, they must acquire a property for not less than €400,000, or rent an immovable property in Malta for not less than €20,000 annually (the same qualifying property requirements as per the new Rules).

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# USA: Foreign Investment in U.S. Real Estate

**Is there a "best" way for a foreign individual to own U.S. real estate? When planning to acquire U.S. real estate, foreign individuals have a number of ownership alternatives to consider each of which offers its own advantages and disadvantages. There are other items a foreign investor should consider when evaluating the most advantageous method for holding U.S. property title.**

When investing in U.S. real estate a number of important factors should be considered including risk, economic impacts and the income tax consequences in both the United States and the investor's home country.

This article briefly examines the five ownership options for those acquiring U.S. real estate:

- Direct ownership by foreign individual
- Investment in U.S. real estate via U.S. LLC (Limited Liability Company)
- Investment in U.S. real estate via foreign corporation
- Investment in U.S. real estate via foreign corporation and U.S. corporation or LLC
- Domestically-controlled REIT (Real Estate Investment Trust)

## Direct ownership by foreign individual

Some of the tax considerations include:

- If the foreign owner uses the property for personal purposes for more than either the greater of 14 days or 10% of the annual number of days rented (at fair rental value), the deductions

allowed for income tax purposes are substantially limited<sup>1</sup>. When the owner of U.S. rental property (e.g. rental of vacation home) uses that property in excess of these prescribed limits, the general rule is that tax deductions to be claimed will be substantially limited - generally no more than the income from the property. In other words, the owner usually cannot write off tax losses against other income for U.S. income tax purposes.

- One of the major benefits gained from owning the real estate directly is that the foreign person is generally entitled to the more favourable U.S. federal capital gains tax rates at the time of sale. For 2011, the U.S. federal capital gains rate is 15 percent<sup>2</sup>. Depending on the length of time the property is held, a portion of the capital gain may be taxed at a higher rate in connection with gains realised that are related to depreciation deductions. Each U.S. state will impose its own rates on capital gains. Of course, in evaluating the U.S. taxes on capital gains, the foreign investor must also consider the impact of the income taxes in their home country.
- The foreign individual will be required to file U.S. federal

and state individual income tax returns for each year of ownership, whether or not he/she actually has an income tax liability, in order to preserve any deductions for which the owner is entitled (including loss carry forwards). Alternatively, that individual could lose all deductions and be assessed income taxes based on the gross income received, if tax returns are not filed timely.

- Direct ownership of U.S. real estate generally results in that property being reportable and taxable for U.S. estate tax purposes. Furthermore, a foreign individual is not eligible for the more generous estate tax filing exemptions available to U.S. residents. The foreign person's exempt amount is significantly lower than what is permitted for U.S. residents<sup>3</sup>. In the case of a foreign decedent, all of the U.S. estate is subject to regular estate tax rates, less a credit of \$13,000<sup>4</sup>, and less any foreign estate taxes.

Transfers of U.S.-owned real estate by a foreign person will frequently result in U.S. withholding tax on the transfer price. (See additional discussion below regarding the Foreign Investment in Real Property Tax Act (FIRPTA) rules).

## Investment in U.S. real estate via U.S. LLC

Most of the issues associated with direct ownership also apply when a foreign individual owns U.S. real estate through a U.S. Limited Liability Company (LLC). Additional issues to consider include:

- Ownership through a U.S. LLC gives the individual "limited liability" on the same general basis as a corporation. This is one of the main advantages of using the U.S. LLC.
- The U.S. income tax treatment of a U.S. LLC is as a partnership (if there is more than one owner) or disregarded entity (if there is only one owner). The foreign individual's home country income tax treatment of the U.S. LLC, however, varies from country to country. Many foreign countries treat the U.S. LLC as a corporation, which often results in a mismatch of income taxation between that foreign country and the U.S. in any given year. Because of this difference in tax treatment, the use of a U.S. LLC is often not recommended for foreign investors.
- The same U.S. income tax reporting and U.S. estate tax issues apply to the individual investor, i.e. the foreign person must file a U.S. federal and state return each year.
- A transfer of the ownership interest in the U.S. LLC will result in the same U.S.

withholding tax under U.S. FIRPTA rules as a transfer of a direct interest. (See additional discussion of withholding below).

## Investment in U.S. real estate via foreign corporation

In this case, the U.S. income tax filing responsibilities fall to the foreign corporate entity. Following are some important considerations when using a foreign corporation as the vehicle for investment:

- The foreign corporation will not be entitled to the favourable U.S. capital gain rates (one of the principal disadvantages of this option).
- The foreign corporation will prevent the foreign individual from being liable for the U.S. estate tax (one of the principal advantages).
- The foreign corporation provides the owner with limited liability (another significant advantage).
- A sale of the foreign corporation's shares will generally be taxable in the U.S. due to its classification as a U.S. Real Property Holding Company (USRPHC). A sale of shares in a USRPHC will also be subject to U.S. withholding tax. Furthermore, a sale of the foreign corporation to a U.S. buyer would not likely be an alternative and the foreign corporation would first need to sell the real estate and then liquidate the corporation.

Because of the limitation on benefits provisions in most treaties, the foreign corporation should generally be incorporated in the same country as the owner/investor.

## Investment in U.S. real estate via foreign corporation and U.S. corporation or LLC

Why might one consider a double-entity approach to the U.S. investment? Frequently, when a foreign person is planning to invest in a large U.S. real estate fund, the fund has already decided that the U.S. structure is going to be the U.S. LLC. In that case, the foreign investor might decide to avoid risks associated with the U.S. estate tax compliance and/or the personal income tax filing requirements. In such cases, foreign investors often establish their own foreign corporation to own the U.S. real estate - thus giving up the potentially favourable U.S. capital gain rates in order to eliminate the U.S. estate tax issues.

## Domestically controlled REIT

A REIT is essentially an entity that is otherwise taxed as a corporation unless it meets certain technical requirements and affirmatively elects REIT status. The principal difference between a U.S. corporation and a REIT is that the REIT is allowed a special tax deduction for dividends paid to its shareholders. As one of the qualifications for this special treatment, a REIT must distribute at least 90% of its net taxable income exclusive of capital gains to its shareholders annually.

Continued >>>>

<sup>1</sup> IRC Section 280A <sup>2</sup> The U.S. tax rate on capital gains is scheduled to expire 31 December 2012. Because a change will require Congressional action, it is not known what, if any, a new favourable capital gain rate will be after this date. <sup>3</sup> Presently \$5m for US citizens, expiring 31 December 2012 absent additional legislation. <sup>4</sup> IRC Section 874 and Income Tax Regulation 1.874-1

## USA: Foreign Investment in U.S. Real Estate

Accordingly, this regime subjects investors to only one level of tax (as opposed to the general 'double-tax' U.S. tax regime that applies to corporations and their shareholders). This makes a REIT a unique holding vehicle designed specially to invest in real property assets.

REITs that invest into the U.S. are predominately investing in U.S. property. As a result, distributions from a REIT to non-U.S. investors, or gains such investors realise from the sale or exchange of REIT shares, are generally subject to FIRPTA taxation. However, there is an exception for domestically-controlled REITs.

A disposal of shares in a domestically-controlled REIT does not trigger FIRPTA tax or filing obligations. However, the disposal of the underlying REIT assets will likely trigger a FIRPTA tax and related filing obligation for the non-U.S. investors. Thus, it will be important for the non-U.S. investors to think carefully about the exit alternatives before moving forward with this REIT structure.

The REIT must be structured in a particular way to demonstrate domestic control. In general, as long as foreign investors own less than 50% of the value of the REIT for the lesser of five years or the time during which the REIT has been in existence, the REIT will qualify as a domestically-controlled REIT.

Although no FIRPTA tax will be due upon the sale or exchange of domestically-controlled REIT shares, distributions to all investors are taxable.

### U.S. FIRPTA

A withholding tax is imposed on the transfer of U.S. real estate by a non-resident alien generally equal to 10% of the fair market value at the time of transfer, regardless of the amount of gain<sup>5</sup>. Although the tax is referred to as a 'withholding tax' the non-resident must still file a U.S. income tax return and determine the correct amount of income tax on the gain, if any. If the withholding exceeds the actual tax, a refund is paid to the taxpayer following the filing of the annual income tax return. A reduced rate withholding certificate can be obtained when the 10% withholding is expected to exceed substantially the actual tax liability; however, this certificate should be requested well in advance of the closing of the transaction.

In general, this withholding tax applies to any foreign individual or corporation that transfers an ownership interest in U.S. real estate. In some cases, this can also include an indirect transfer where it involves the transfer of a U.S. corporation that holds 50% or more of its assets as U.S. real estate interests.

### Summary

There are numerous strategies for structuring an investment in U.S. real estate ranging from relatively simple to advanced. Determining the appropriate structure is very specific and depends on the goals, objectives and income tax situation of the particular foreign investor. To choose the most appropriate alternative, the foreign investor must consider a variety of factors, including:

- The filing of personal annual income tax returns
- The U.S. capital gain tax rate
- FIRPTA issues
- Tax treaty implications
- U.S. estate tax
- Administrative costs of multiple entities

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<sup>5</sup> With some exceptions for personal use property under \$300,000

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## Italy: Investment Funds Tax and Capital Gains Changes

### Introduction

A new investment funds tax regime has been enacted in Italy meaning investment funds are no longer subject to tax on an accrual basis. Investors are instead taxed on a cash basis. Furthermore, from 1 January 2012 withholding tax and substitutive tax on interest, dividends and capital gains will be set at 20%.

### New investment funds tax regime

A Law Decree<sup>1</sup> introduced a new tax regime for Italian and foreign investment funds. The new provisions have been in force since 1 July 2011. Investment funds established in Italy and historical Luxembourg funds are no longer subject to tax on an accrual basis, instead investors are taxed on a cash basis. A 12.5% (20% from 1 January 2012) withholding tax is applied on a final basis to individuals not engaged in business and to exempt entities; the same withholding tax is applied on an advance basis to other taxpayers.

Furthermore, the Law Decree provides for amendments to the Italian tax regime of foreign investment funds, compliant or not to EU Directives. Subject to conditions, Italian investors in European investment funds are also subject to tax on a cash basis at 12.5% (20% from 1 January 2012).

### Investment funds tax rate increased to 20%

From 1 January 2012 income from capital and capital gains derived from the participation in Undertakings for Collective Investment in Transferable Securities (UCITS), from portfolios of investments managed on a client-by-client basis and from capital distributed according to insurance contracts, will be subject to tax at 20%<sup>2</sup>.

Specific provisions apply to real estate investment funds whose regime has been recently subject to comprehensive amendments.

### Interest, dividends and capital gains tax rate set at 20%

From 1 January 2012 withholding tax and substitutive tax on interest, dividends, any other income from capital and capital gains will be set at 20%. Previously, a 12.5% or a 27% tax rate applied.

### Exception

Interest from state securities (and similar securities), from foreign state securities (only white list countries Art. 168-bis, par.1, TUIR) and from other special securities will be subject to a 12.5% withholding tax.

Net incomes derived from complementary pension plans will still be subject to a substitutive tax of 11%.

The increased withholding tax rate will not apply to dividends distributed by companies and other entities subject to company income tax in other member states of the European Union (EU) or of the European Economic Area (EEA) that allow an adequate information exchange (white list Art. 168-bis, par.1, TUIR). These incomes will still be subject to a final withholding tax of 1.375%.

### Treaty provisions and EC directives

Treaty provisions override statutory withholding tax rates when they are more favourable to the taxpayer. Therefore, lower treaty rates may apply.

Furthermore, subject to conditions, dividends distributed to a qualifying EU parent company are exempt from withholding tax under the EC Parent-Subsidiary Directive.

Finally, subject to conditions, interest payments to associated EU companies are exempt under the EC Interest and Royalties Directive.

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<sup>1</sup>(D.L. 225/2010) <sup>2</sup>(D.L. 138/2011)

# Australia: Removal of FBT Concessions for Foreign Executives

The Australian Government's latest revenue raising measures are again targeting international businesses. The 'Living away from home' allowance and other related benefits have been denied concessional tax treatment for international employees along with increased substantiation requirements for all others.

## Background

During November 2011 there were several media reports regarding changes the Australian Government were considering to the tax concessions available to foreign executives as a result of them living away from home and working in Australia.

The idea was initially raised at the October Tax Forum, with comments that foreign executives and workers were unfairly benefiting from the provision of these allowances at the taxpayer's expense. Senator Penny Wong further incited these rumours in a TV interview on 27 November 2011. In the mid-year Federal Budget review released on 29 November 2011, the Government confirmed there will be changes to the provision of 'living away from home allowances' (LAFHA) and other concessional tax LAFH benefits. Further details were contained in a Consultation Paper released on the same day. The issues subject to consultation will be limited to the impact on remote areas and some community sectors. There will be no transitional arrangements for business.

## Proposed changes

The changes will take effect from 1 July 2012, and will mainly affect "temporary residents" of Australia

i.e. those living and working in Australia on a temporary basis. (For instance an employee working in Australia on a 457 or similar temporary migration visa, although this may extend to New Zealand residents who have not been granted permanent residency in Australia.) From that date, cash allowances paid for LAFH accommodation and food costs will be removed from the FBT regime, and will be included as assessable income in the hands of the employee. Non cash LAFH benefits remain within the FBT system.

## Effect on temporary residents

For most temporary residents (i.e. those living and working in the same region), there will no longer be any support through the tax system to offset the additional costs of international assignments. They will not be entitled to claim deductions against cash allowances and an employer will be subject in full to FBT on any non-cash LAFH benefits provided. This will increase the cost to the sponsoring employer, with previous international experience suggesting a sharp reduction in expatriate numbers in the lead up to July 2012. Concessional benefits will remain available for temporary residents who live and work in different regions (i.e. for fly in, fly out).

## Effect on permanent residents

There will be no effective change to the current concessional treatment for permanent residents who live away from their home for work purposes (e.g. fly in, fly out workers assigned to another location within Australia). However, employees receiving a cash allowance to cover their food and/or accommodation costs as a result of LAFH will be required to report this as assessable income in their personal tax return. The employee would claim a tax deduction for the expenses incurred on food and accommodation above the statutory amount (which will be revised as part of the new legislation). Where the employer pays for the accommodation costs directly or reimburses the employee for the cost of accommodation, it will continue to be treated as a Fringe Benefit for FBT purposes, and will retain the current concessional FBT treatment.

## Unaffected employees

Australian permanent residents working offshore and who remain tax residents of Australia should not be affected by these changes, other than the obligation to support the amount of any deduction claimed against the

allowance paid to them under the new substantiation rules. Also, there is no intention to change the current FBT concessions available to employees receiving benefits as a result of living and working in a remote area. There is also no intention to change the record keeping concessions where a travel and meal allowance is provided in the course of an employee travelling in the course of employment.

## Affected benefits

It is intended that the changes will relate to the exempt food and accommodation components of the LAFHA and the provision of rental accommodation being provided direct to the employee. At this point, it is our understanding based on the Consultation Paper that there will be no change to other concessional benefits provided to employees who are relocating in the course of employment or other benefits provided to temporary residents, such as the foreign executive's children's school/university fees.

## Increased substantiation

Those who continue to qualify for concessional treatment, and receive a cash allowance in respect of LAFH, will be required to substantiate the accommodation and food costs above as a statutory amount in their personal tax return.

## Action

All employers currently providing LAFHA and related concessional benefits need to consider the cost of these changes. An early step will be a review of the employment contracts of all potentially affected employees.

Without remedial action, loss of concessional tax treatment will lead to an increase in the employer's FBT bill or may add a personal tax cost to the employees. For employees affected by the changes, options for the employer to consider will include:

- Maintenance of status quo, resulting in increased employment costs
- Seek to renegotiate remuneration arrangements to share the increased cost
- Early repatriation

## Employee communication

Given the anticipated high profile media attention this change is likely to attract, employers should consider early communication with affected employees, if only to acknowledge the matter is 'on the radar' and under review. Any foreign parent companies should also be alerted.

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## South Africa: Transfer Pricing - A Significant Change

With effect from 1 October 2011, South African Transfer Pricing legislation was significantly changed by the implementation of an amended Section 31 to the Income Tax Act 58 of 1962 ("the Act"). The section has now further been amended in terms of the Taxation Laws Amendment Bill 19 of 2011 introduced by the Minister of Finance on 25 October 2011. The revised wording, which is effective from 1 April 2012, has changed the structure of the section but not the fundamental principles which were addressed in the previous amendment to the Act. This article considers Section 31 in the light of the Taxation Laws Amendment Bill 19.

The objective of Transfer Pricing legislation in an international context is to implement anti-avoidance rules within taxation regimes. These rules are established to ensure that arm's length principles are applied to transactions, operations or schemes that have been entered into between connected persons. The underlying concept is that such transactions, operations or schemes are entered into, applying the same terms and conditions as would have been applied had the transaction been entered into between independent persons.

The objective of the amendments to Section 31 of the Act is to modernise South African transfer pricing and bring it in line with the latest transfer pricing guidelines issued by the Organisation for Economic Cooperation and Development ('OECD').

The new section has five subsections. Information for each is addressed below.

**Subsection 1** provides two new definitions; those of an "affected transaction" and "financial assistance".

In summary, an affected transaction constitutes any transaction, operation, scheme, agreement or understanding ('transaction') between connected persons where the terms and conditions of such transaction are different from any term or condition that would have existed had those persons been independent persons dealing at arm's length.

The definition of "financial assistance" is deemed to include the provision of any loan, advance or debt, or security or guarantee.

**Subsection 2** contains the most significant change from the previous Section 31.

The subsection first incorporates affected transaction as defined above. It further removes the concept of price which was used in the old section and replaces it with the wording "any term or condition". Thus the concept of arms length is no longer linked to price but the transaction, operation or scheme is required to be entered into on terms and conditions which would have been applied had the parties involved been independent persons dealing with each other at arm's length.

Secondly, in the old section the Commissioner for Inland Revenue had the power to adjust the consideration to that which reflected an arm's length consideration for the goods and services provided. This has been completely removed from the section, with the new section requiring that the taxable income of each person, that is a party to that transaction, that derives the tax benefit be calculated as if that transaction had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm's length.

It is clear from the new wording that the main focus of South African Transfer Pricing has shifted away from consideration, to one which now rather considers the terms and conditions which have been applied to a transaction.

**Subsection 3** deems the difference which arises from the calculation detailed in Subsection 2 to be a loan and such loan in turn constitutes an affected transaction as defined for the purposes of Subsection 2.

**Subsection 4** addresses the concept of thin capitalisation. Again, there has been a fundamental shift away from the old Section 31 which applied a fixed capital test when determining whether financial assistance, as defined, was considered excessive. The new section removes this fixed capital test in its entirety and applies the concept of thin capitalisation to the arm's length principles detailed in subsection 2.

**Subsection 5** deals with the impact of Transfer Pricing on Headquarter Companies.

It is, as always, important to note that the onus is on the taxpayer to evidence that a particular transaction, operation or scheme has been entered into on an arm's length basis.

The implementation of the new Section 31 is intended to bring South Africa's transfer pricing legislation in line with international norms. What is still unclear, however, is how South African Revenue Services ('SARS') intend to apply the legislation in

practice. To date, SARS have issued no guidance or interpretations to taxpayers on their intended application of the section. When such guidance will actually be issued is uncertain.

What is clear is that taxpayers must not only ensure that the arm's length principle is applied at all times but also that they are able to justify, in the form of relevant supporting documentation, that this principle has been applied to all transactions involving connected persons.

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# Netherlands:

## Tax Plan 2012 - Changes in the Dutch Tax Law

On 17 November 2011, the Tax Plan 2012 was approved by the Dutch Lower House with important amendments to the Dutch tax law that came into effect on 1 January 2012. The changes will certainly have an impact on tax planning opportunities and it is, therefore, important to follow the developments in this field closely. The major amendments are detailed below.

### The 30% tax ruling

Although overall the 30% tax ruling has become more restrictive, it is still a very attractive and internationally competitive facility. One of the important changes to the 30% ruling lies within the amendment of the 'specific expertise' requirement. This requirement will, under the new 30% ruling, be based on a minimum salary of €35,000, excluding the 30% reimbursement. Furthermore, it has been stipulated that the 30% ruling may be granted to young Masters students, provided that they receive a minimum salary of €26,605. In addition, a third category has been introduced that will not have a minimum salary requirement and applies to scientists and researchers who are employed through subsidised research or education institutions. In addition to this, the 30% tax ruling will, in principle, be granted for a period of eight years. Furthermore, it is the intention that the measure will no longer be applicable to the employees living in a frontier area (within 150km of the Dutch border).

### Research & Development

In addition to the existing regime of the innovation box and R&D wage tax credit, the Tax Plan 2012 introduced a new incentive for companies involved with Research & Development: R&D deduction.

The R&D deduction is designed as a deduction of a certain percentage of qualifying costs attributable to R&D activities. The R&D deduction will consist of an additional deduction in determining the taxable profit. The R&D deduction will be determined by multiplying the qualifying cost base (consisting of R&D costs and expenses, not being wage costs, and R&D investments) by an R&D percentage. The R&D percentage is set at 40%, which leads to an effective net benefit of 10% for companies which are subject to the standard Dutch corporate income tax rate of 25%.

As a result of the introduction of the R&D deduction, the climate for innovative companies will become even more attractive.

### Tax exemption for foreign permanent establishments (PEs)

As per 1 January 2012, profits and losses of foreign PEs are excluded from the Dutch taxable base as a result of the introduction of an object exemption method.

The new tax rules prevent that losses of foreign PEs being offset against other income of a Dutch taxpayer. This means that the cash flow advantage has disappeared. However, in accordance with EU law, permanent losses of a foreign PE that cannot be offset in the PE

country (e.g. in case of a wind-up of the PE) will remain deductible in the Netherlands. The 2012 Tax Plan also clarifies that the exemption will not apply to currency results from the determination of the profit of the foreign PE. In addition, passive foreign PEs may require special attention to apply the exemption method instead of the credit method. However, the object exemption method will not apply if a tax treaty dictates that the exemption method needs to be applied by the Netherlands.

### Dutch substantial interest taxation and Dutch dividend withholding tax

Up to 31 December 2011, foreign entities could be subject to 25% Dutch corporate income tax on dividends and capital gains derived from a so-called substantial interest (i.e. interest of more than 5%) held in a Dutch company, if the substantial interest cannot be attributed to an enterprise carried on by the foreign shareholder. The European Commission requested that the Netherlands change its substantial interest rules because it considers these rules to be in conflict with EU Law. Therefore, the Dutch Government has now limited the situations in which a foreign entity is subject to Dutch corporate income tax with regard to holding a substantial interest in a Dutch resident entity.

As per 1 January, 2012 an additional condition has been introduced stating that the main purpose (or one of the main purposes) of holding the substantial interest is to avoid the levy of Dutch personal income tax or dividend withholding tax. Thus, two conditions need to be fulfilled in order to be subject to 25% Dutch corporate income tax. The changes to the Dutch substantial interest regulations should, therefore, not affect existing structures which are in line with the Dutch substantial interest rules up to 31 December 2011.

Further to the above, a Dutch dividend withholding tax obligation for Dutch cooperatives has been introduced for distributions by Dutch cooperatives in case of abusive situations. A withholding tax obligation (at 15%) may arise if the cooperative holds shares with the main purpose of avoiding Dutch dividend withholding tax or foreign tax and the membership right of the cooperative is not attributable to the enterprise carried on by the particular member of the cooperative.

### Restriction of interest deduction on leveraged acquisition

The Tax Plan 2012 also introduces a measure in respect of the deduction of interest on leveraged acquisitions. This measure will retroactively take effect for Dutch fiscal unities formed as of 16 November 2011.

Currently, a Dutch entity with at least 95% of the equity interest in a Dutch subsidiary may form a fiscal unity with this entity. As a result, providing the existing anti abuse erosion and thin cap restrictions do not apply, interest paid or accrued on debt attracted by the Dutch acquisition company to finance the acquisition of a target company may be offset against taxable profits of the subsidiary. With the introduction of a further restriction on interest deduction, the deduction of interest on loans taken up to acquire or increase an investment in a Dutch company may be restricted when forming a fiscal unity.

The abovementioned limitation is applicable to the lower of (i) the annual interest expenses relating to the acquisition debt that exceeds the annual profit of the acquirer plus an additional threshold of €1,000,000, and (ii) the annual interest expenses on acquisition debt if considered excessive. The deduction of interest will be restricted if the amount of acquisition debt is higher than 60% of the purchase price of the acquired company at the end of the year in which the company is included in the fiscal unity. Subsequently, this percentage will be reduced by 5% each year over a seven year period to 25%.

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