May 2022

WTS ICT Service Line Newsletter

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Argentina

Argentine Supreme Court rules on treaty shopping in the context of the Argentina-Chile Double Tax Treaty

The Argentine Supreme Court ("ASC") ruled on the *Molinos*[1] case, a milestone one related to treaty shopping. Here, the ASC - with the affirmative vote of three of its members - upheld the revenue service ("ARS") criterion, thus preventing the taxpayer from being entitled to tax treaty benefits under the double tax treaty Argentina - Chile ("DTT"). The DTT avoided double taxation by means of the exemption method, so that dividends distributed by a Chilean holding company to its Argentine-resident shareholder should not be taxed in Argentina. Chile, in turn, created the "exempt holding framework" (*"plataforma fiscal"*), aimed at exempting holding companies incorporated therein, which would invest outside of Chile. Molinos – an Argentine listed company – did have such a Chilean holding to invest in Uruguayan and Peruvian subs. Such dividends were not taxed either in Chile or in Argentina, an outcome that was not upheld by the ASC.

The majority vote was based, mainly, on the following considerations:

- The interpretation of the provisions of the DTT must be consistent with Argentine public law standards, recognised in the Argentine Constitution, among which, the standard of "reasonableness" can be found, so that taxpayer's rights are not absolute and cannot be invoked abusively, regardless of the inexistence of an anti-abuse rule in the treaty itself.
- According to the Vienna Convention on the Law of Treaties, applicable to the DTT[2], the terms of a treaty must be construed in *"good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose"*. Considering that the purpose of the DTT was to prevent double taxation, a good faith reading of its terms should not allow interpretations that would lead to the opposite result: i.e. a double non-taxation.
- The Argentine domestic law provides a General Anti Avoidance Rule ("GAAR") that allows the tax authorities to disregard inappropriate legal forms and structures and consider the real economic situation whenever there is a manifest discrepancy between the economic substance and the legal forms adopted by the taxpayers. In this sense, the ASC considered that evidence collected in the case was enough to conclude that the legal structure of the Chilean holding company and its Argentine shareholder had no substance. Therefore, such structure could be re-characterised by the ARS under the Argentine domestic GAAR.

  To reach such a conclusion, the ASC took into account a set of evidence and facts, such as: i) the Chilean holding was incorporated just one year after the unilateral amendment of the Chilean law - subsequent to the effective date of the DTT - which created the "platform entities"; (ii) that the Chilean holding company immediately remitted to its Argentine shareholder the income collected from the lower tier subsidiaries located out of Chile, so that the income did not remain in the holding company in order to fulfil its statutory objective; and (iii) there were no double tax treaties between Argentina and the countries from where the income came (i.e. Uruguay and Peru).

The *minority* vote of Judge Rosenkrantz concluded that the DTT clearly ruled this case, in accordance with the Andean Model Treaty, so that dividends paid by a Chilean holding company should not be taxed in Argentina. Having in the DTT no anti-avoidance provision that could jeopardise double non-taxation outcomes, taxpayer's criterion should prevail, for the revenue service intends to rewrite the DTT.

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1 Argentine Supreme Court, Molinos Rio de la Plata S.A. v. Dirección General Impositiva, 2 September 2021.
2 Law No. 19.865 (Argentina)

Brazil

Victory of taxpayers in the Federal Administrative Tax Court: overlapping of Double Tax Treaties and Brazilian CFC rules

Recently, the highest level of the Federal Administrative Tax Court (CSRF) changed its long-standing view on the overlapping of Article 7 of the Double Tax Treaty (DTT) and the Brazilian Controlled Foreign Corporation (CFC) rules, now favouring taxpayers.

Under the Brazilian CFC rules previously in force, profits accrued by foreign controlled entities were subject to corporate income tax (IRPJ) and social contribution on net profits (CSLL), at a combined rate of 34%, on an accrual basis, regardless of distribution. These rules applied to profits arising from all foreign controlled entities, including operational entities located in high-tax jurisdictions.

Historically, Brazilian tax authorities have tended to challenge the application of DTTs when they reduce the taxation imposed by Brazilian legislation, and CFC rules are no exception. In the tax authorities' opinion, Brazilian CFC rules aim to tax profits accrued by the Brazilian controlling company **by means** of its investment in the foreign controlled entities. This *rationale* heavily relies on the accounting method adopted by Brazilian GAAP for controlling companies to evaluate investments in controlled entities: the equity pick-up method. Using this method, profits accrued by controlled entities are automatically recognised in the P&L of the controlling entity.

Based on this interpretation, tax authorities sustained that CFC rules did not overlap with Article 7 of the DTTs signed by Brazil. According to them, whereas Article 7 prevents Brazil from taxing profits accrued by its foreign controlled entities, Brazilian CFC rules would not be limited by the DTTs as they target profits accrued by the Brazilian controlling company.

Despite strong questioning by taxpayers throughout the years, decisions issued by CSRF used to favour the tax authorities. In some cases, the decisions issued by the CSRF were tied and ultimately decided by the qualifying vote of a judge who represented the tax authorities.

The most recent decisions, issued by the court at the end of 2021, took a turn in the opposite direction. In the cases involving DTTs with Argentina, Ecuador, and Spain, CSRF understood that Article 7 of DTTs should prevail over Brazilian CFC rules, since both deal with profits earned by a company abroad.

This scenario was made possible due to an alteration promoted in 2020 to the way ties were treated in Brazilian administrative tax courts. As of this amendment, a tie in the votes of the counsellors now results in a decision favourable to the taxpayer. Even though the new understanding is very positive, taxpayers should be wary, given the fact that the constitutionality of this change to tiebreaker rules is still being evaluated.

This controversy is particularly relevant amidst the current talk on the implementation of Pillar 2 rules. Although there is as of yet no news as to how Brazil plans to deal with this matter, MNEs with Brazilian controlling entities would, technically, have to evaluate whether Brazilian CFC rules could be considered as being equivalent to qualified income inclusion rules in order to determine Pillar 2 effects.

Moreover, if no changes are made to Brazilian CFC rules currently in force, practical issues could arise for the offsetting of taxes paid abroad under Pillar 2 rules, considering that the taxation in Brazil is generally levied on profits accrued by each controlled entity individually.

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China

New challenges and impacts brought by Pillar Two to Chinese companies

The Pillar Two model has started a new chapter for international taxation when dealing with the challenges of globalisation and digitalisation. As the world's second-largest economy, China has actively participated in the discussion and implementation of the Pillar Two model.

By introducing a global minimum tax regime, the Pillar Two model has sent a clear message: MNEs shopping for tax benefits in lower-tax jurisdictions may end up bearing top-up taxes; it will make a dent in the tax advantages offered by some jurisdictions with low taxes.

For some years, China has been directing its investment attraction strategy away from the sole reliance on tax incentives. On the whole, China adopts a national standard CIT rate of 25%. Thus, most Chinese enterprises should not fall into the scope of the Pillar Two model, except some Chinese MNEs which may need to adapt to the new rules of the game.

→ Chinese MNEs with investments in other jurisdictions

Like their overseas counterparts, Chinese MNEs leveraging a global presence and region-specific privileges would also be affected by Pillar Two. They need to re-evaluate their situation per the core ideas of the model. If their tax burden in some jurisdictions falls under the minimum 15% level due to the use of tax incentives, they would also be taxed for the underpaid or saved tax sum in other jurisdictions.

By the same token, they need to assess whether they are covered by the Pillar Two model by measuring the breakpoint at which the minimum tax rule is applied and reviewing how Pillar Two would impact their multi-jurisdictional tax liabilities. Further, they need to evaluate whether any region-specific benefits or exemptions could backfire and result in a tax shortfall from the whole group's perspective.

→ Mega groups enjoying tax benefits in China

Some sector-specific and zone-specific tax incentives are still available in China. For example, a 15% CIT rate is offered to tech companies in software or integrated circuit business, encouraged sectors in the western regions, and to those companies based in Hainan Free Trade Port. In parallel, another CIT incentive is offered to R&D investments. With the tax incentives combined and enjoyed at the same time, some Chinese groups may see their effective CIT rate dropping below 15%. If so, they would end up bearing the top-up taxes using the Pillar Two model.

It is expected that some more guidance could be issued by the Chinese tax authority in due course regarding how to implement the Pillar Two model, as it will be effective globally in 2023. It is suggested that Chinese MNEs evaluate its impact and consider optimising the investment structure accordingly.

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Pillar Two

On 20 December 2021, the OECD published the model rules on global minimum taxation ("Pillar Two"), on which around 140 countries have agreed as part of the work of the OECD's Inclusive Framework. By the so-called GloBE rules (Global Anti-Base Erosion), the Inclusive Framework countries want to ensure that the profits of large MNE Groups are effectively taxed at a rate of at least 15%.

The EU has closely followed the development of Pillar Two and issued a draft directive already on 22 December 2021. As soon as the directive is unanimously approved by the EU member states, all of them will in principle be obliged to transpose the directive into domestic law.

Overview of the regulations

Theoretically, all MNE Groups with a consolidated turnover of at least €750 million in at least two of the last four consecutive financial years fall within the scope of the Pillar Two rules.

In a first step, the constituent entities need to be determined. Generally speaking, these are all fully consolidated entities as well as permanent establishments. Once the constituent entities have been determined, their respective GloBE income needs to be calculated on a stand-alone basis. The starting point is the financial result for group reporting purposes, but before any consolidation amendments. The entity's income is subsequently adjusted by numerous items and results in the qualifying income or loss for GloBE purposes.

The next step is to determine the adjusted covered taxes for each constituent entity. In principle, these are all taxes incurred on profit or income. Deferred taxes must also be taken into account, in particular as part of the total deferred tax adjustment amount.

The qualifying income or loss and the adjusted covered taxes of all constituent entities located in a jurisdiction are aggregated on a country-by-country basis to calculate the effective tax rate of this jurisdiction (jurisdictional blending).

If the effective tax rate in a country amounts to less than 15%, a top-up tax will be assessed to reach the 15% minimum taxation which is due by the Ultimate Parent Entity of the MNE group.

Need for action

The OECD has published an extensive commentary to facilitate the application of the complex GloBE rules. Nevertheless, there is still a long way to go before the rules will be implemented and become applicable. For example, there are still discussions on the administrative framework and potential safe harbour rules to reduce complexity for the taxpayers.

We expect that the Pillar Two directive will be agreed on by the EU Member States during the next months. Then, all member states including Germany will have to implement the directive into domestic law. For the taxpayers who have their Ultimate Parent Entity located in Germany, the German implementation law will be decisive to determine the top-up tax.

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However, in principle, within the EU, differences in the local implementation should rather be limited. This might be different outside the EU. Moreover, it needs to be seen whether domestic top-up taxes will be implemented in some states.

According to our experience from ongoing Pillar Two projects, the key issue is to identify the required data to conduct the Pillar Two compliance, the sources for the relevant data and a process to collect such data. As this process including the implementation in the local IT systems could take months, taxpayers should start the preparation in time as the entry-in-to-force of Pillar Two is envisaged for the year 2024.

India and Austria

International project business – India: Tax trap offshore supplies

Uncertainties relating to the determination of the profits attributable to a construction/installation permanent establishment (PE) are a substantial tax-related project risk for companies within the plant construction sector. To determine the profits of a PE, the OECD applies the two-stepped authorized OECD approach (AOA). In step 1, the functions and risks analysis attributes business functions and risks either to the head office or to the PE. Crucial factors for step 1 are the so-called "significant people functions" and the "risk follows function" principle. In step 2, an arm's length profit of the PE will be determined based on transfer pricing principles. In short, step 2 deals with the following question: what would be the profit of a separate legal entity with the same functions and risks as the PE?

Whilst many jurisdictions follow these principles of the OECD (e.g. Saudi Arabia recently abolished the force of attraction principal if a double taxation agreement [DTA] in accordance with the OECD model tax convention is applicable), India frequently taxes income with regard to the PE which should be attributable to the head office according to the AOA. In doing so, Indian tax officers often refer to a decision from the Income Tax Appellate Tribunal in Delhi in 2020 regarding an Austrian plant construction company (AUT-Co). In the following, we sum up the most important findings of the said decision in bullet point form:

- The common practice in international plant construction business to split the total project in an on- and offshore contract was seen as an artificial split to avoid taxes in India. The Indian tax authority additionally argued that the services performed by the PE are crucial to fulfil the obligations of the offshore contract.
- If the transfer of title, risk and peril takes place outside India, offshore supplies are generally not taxable in India. Even though it was agreed in the offshore contract that the transfer of title, risk and peril took place outside India, the Indian tax authority denied the non-taxability of the offshore supplies because AUT-Co was considered to owe a functional plant in India.
- Following the famous Rolls-Royce decision, the Indian tax authority attributed 35% of the offshore contract to the Indian PE.
- Based on a database analysis, a profit margin of 9.75% was applied to the offshore supplies contract. The Indian corporate tax rate for non-residents amounts to approx. 40%.

In a more recent tax assessment, an Indian tax officer – referring to the above-cited decision – attributed 100% of the profits from offshore supplies to the Indian PE. Furthermore, an objection highlighting the detailed price breakdown in the contract and the AOA principals was rejected by the Indian tax office. The Indian taxation approach led to a significant mismatch between the assessment basis for the taxation in India and the assessment basis for the tax exemption in Austria. The resulting double taxation directly impacts the profitability of the company/project.

How can a company deal with such a double taxation? Besides local Indian appeal procedures, concerned taxpayers will regularly have to initiate a mutual agreement procedure (MAP) in the state of residency. However, many jurisdictions will only initiate an MAP if a domestic appeal has been filed in the project state. As appeal procedures are lengthy, it is important to monitor related deadlines (e.g. filing deadlines for initiating MAP procedures).

Even though the above-cited cases refer to Austrian residents, the Indian taxation approach and the differing interpretation of DTA provisions constitute a serious tax trap for all plant construction companies resident in jurisdictions that apply the AOA. Besides India, we experienced an increasing number of jurisdictions around the globe trying to extend the taxation rights beyond the provisions in applicable DTAs. To avoid double taxation and lengthy tax disputes, it is advisable to have a tax safety check before signing international contracts.

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Italy

Italian rules on hybrid mismatches

On 26 January 2022, the Italian revenue agency published circular letter no. 2 concerning the tax discipline of the so-called "hybrid mismatches". The document analyses the provisions contained in the Articles 6 to 11 of the Legislative Decree 142/2018.

The circular examines, in Para. 1, the notion of "hybridism" which is essentially linked to financial instruments, direct and reverse hybrid entities, as well as permanent establishments.

With particular reference to financial instruments, hybrid financial instruments, hybrid transfers, as well as substitute payments of financial returns are analysed.

Para. 2 of the circular also examines the main profiles of the legislation at stake and, therefore, in addition to the subjective scope of application, the notions of mismatch, double inclusion income, hybrid entity, associated company, etc.

There follows an examination of the prevention rules (which operate ex ante) and the "reaction" rules (Paragraphs 3 and 4 of the circular), which operate on the occurrence of certain situations (double deduction, deduction without inclusion, transactions between companies associates, disregarded permanent establishments, etc.).

The prerequisites necessary for the use of the reaction rules are those provided for by Legislative Decree 142/2018, and therefore:

- the presence of a mismatch, i.e. an effect of double deduction (D/D) or deduction without inclusion (D/NI);
- the presence of a hybrid cause;

→ the subjective element, i.e. the fact that the mismatch occurs between associated companies, between a taxable person and an associated company, between the head office and the permanent establishment, between two or more PEs, or still within a "structured arrangement" to which the taxable person is a party.

Para. 5.2 of the circular is dedicated to mismatches arising from tax residence which, pursuant to Article 10 of the Legislative Decree 142/2018, come into existence when a taxable person is also resident in more than one state, and a cost is deductible in one state without being offset by a double inclusion income in the other state of residence.

Some procedural provisions on the investigation activities of the tax authorities and some coordination profiles with the provisions of the Italian corporate income tax code are then examined, in particular in connection with interest expense. The Italian revenue agency states that the "reaction rules" should be applied as a matter of priority with respect to Article 96 of the Italian corporate income tax code, as the former operate directly on individual negative income components, neutralising the effects of hybrid mismatches and, therefore, affecting the amount of potentially deductible interest expenses.

Furthermore, the agency states that the rules on mismatches are applied both for the purpose of verifying the condition of application of the CFC discipline (ETR test), and for the purpose of determining the income of the foreign subsidiary, to be attributed to the Italian shareholder by way of a look-through approach.

Finally, the examination of the revenue agency completes a review of the main cases of transactions and arrangements that fall within the scope of the aforementioned provisions.

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ATAD3

*On 22 December 2021, the European Commission ("**EC**") published a proposal for a directive to prevent the abuse of shell entities for improper tax purposes (hereafter: "**ATAD3 Directive**"). The ATAD3 Directive is expected to enter into force on 1 January 2024, whereby a two-year look-back rule is in place.*

At first sight, the directive seems to target substance-less shell entities, often managed by corporate service providers. However, upon closer inspection of the details of the proposal, the directive may have a broader scope and (unconsciously) target all kinds of businesses, applying more often than probably expected. For example, private equity as well as fund structures and multinationals that make use of central management companies (from which activities are performed for the rest of the group) may also be in scope. Is this an (unintended) overkill?

Here we further discuss the details of the ATAD3 Directive and our takeaways.

What are shell entities?

The draft ATAD3 Directive introduces the following three "gateway" criteria to determine whether a shell entity is in place:

- **Relevant income:** more than 75% of a company's revenue (in the previous two tax years) should consist of passive and mobile income, such as royalties, dividends and income from assets.
- **Cross-border activities:** at least 60% of the relevant income is received or paid via cross-border transactions.
- **Relevant functions/day-to-day management:** the entity has outsourced the administration of day-to-day operations **and** the decision making on significant functions.

If all three gateways are met, the entity is considered a shell entity and is subject to further reporting obligations. This reporting obligation requires the shell entity to include specific information about its substance in its tax return (e.g. own premises, own active EU account, a qualified director, employees).

If the minimum substance indicators are not met, the entity will qualify as a presumed abusive shell entity for the purposes of the ATAD3 Directive. In practice, this means that certain tax benefits may be denied. Furthermore, we note that in-scope entities can provide counter evidence in cases of assumed misuse.

Some further remarks and takeaways

For more details of the proposed ATAD3 Directive, we refer to a publication of our European Tax Law Center

We have listed below some questions and takeaways that we identified when discussing the possible impact of the ATAD3 Directive with our clients.

- It is currently uncertain how "outsourcing of administration and day-to-day management" should be interpreted. Does this only cover external outsourcing (e.g. corporate service providers), or also outsourcing to group companies? We note that the Netherlands has issued a formal response to the ATAD3 Directive in which only outsourcing to third parties was mentioned. However, looking at the preamble of the draft directive, this also seems to cover outsourcing to group companies. This may, under circumstances, lead to an overkill.
- Furthermore, we wonder how the ATAD3 Directive relates to existing tax treaties with non-EU countries; is there a treaty override? The fact that the EU intrudes into the tax treaties concluded between Member States and third countries appears to be a very liberal approach, going beyond what the EU is actually permitted to do under its own founding treaties.
- The next question is whether the ATAD3 Directive may have an impact on participation exemption regimes (e.g. in the Netherlands), in the case of insufficient substance at the level of the EU subsidiary/shell company. One may expect that the existing participation exemption regime in the EU will be re-examined (sharpened) for such cases.
- Moreover, some governments already expressed their concerns on the short deadline for the exchange of information (only 30 days).
- Finally, the proposal provides a 5% penalty (of the entity's turnover) for late (or false) filings. One may wonder whether such a penalty should be linked to an entity's turnover, instead of e.g. its income.

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Pakistan

ATIR rules on taxability of split contract arrangements under Pakistan-China Double Tax Treaty

Engineering, procurement and construction (EPC) contracts and split contract arrangements (involving offshore supply contracts and onshore service contracts) have remained a key focus of Pakistani tax authorities. The tax implications for these transactions are influenced by the design of the transaction in question and the provisions of the applicable Double Tax Treaties (DTTs).

Recently, Pakistan's Appellate Tribunal Inland Revenue (ATIR - second tier appeal forum) has allowed an appeal against the tax authority's order for recovery of withholding tax, deductible while making payment for the offshore supply of machinery (ITA 377/KB/2019). As per the facts, the appellant, a Pakistani renewable energy project, imported machinery and equipment from a Chinese manufacturer. The onshore contract (construction, assembly and installation services) was signed separately with an associate of the equipment supplier, also resident in China and executed through a branch office registered in Pakistan, constituting a permanent establishment (PE). The taxpayer was held assessee-in-default due to the following facts:

- The supplier of machinery and the provider of onshore service were associates.
- Both offshore and onshore agreements were similar in language and signed by the same person.
- The contract is essentially in the nature of an EPC contract and the location split of the EPC contract was made to avoid taxes due in Pakistan.

The tax authority inferred that the offshore supplier and onshore service provider, being PE of a separate company of the same group, must be considered a single entity for tax purposes. Lastly, the tax authority maintained that the offshore contract is subject to tax in Pakistan as per DTT between Pakistan and China, which is based on the UN Model Tax Convention (UN MTC) and contains a 'force of attraction' rule.

ATIR decided the appeal in favour of the taxpayer and relied on precedents involving DTTs with Germany and Italy to conclude that offshore supply contract/portion of composite contract cannot be subject to tax in Pakistan due to overriding effect of relevant DTTs. Moreover, ATIR held that:

- The requirement to obtain specific withholding tax exemption was inapplicable in case of payments for import of goods where title to goods is transferred outside Pakistan and supply is not made between associates.
- Tax authority was not authorised to discard the associated entity and treat Pakistani PE as the PE of offshore supplier for invoking force of attraction rule.
- The so-called force of attraction rule is not applicable for taxation of EPC contracts in view of the guidance provided under the UN MTC.
- The concept of Cohesive Business Operations (CBO) introduced in domestic tax law, including related amendments in the definition of PE and source rules for business income and restriction on exemption from withholding tax, may affect the tax position prospectively, i.e. from 1 July 2018 onwards.

- In case of any conflict between domestic law and a DTT provision, the latter overrides the former. DTT override is applicable insofar as it provides for tax relief otherwise not available under the domestic law. In the context of attribution of profits to a PE, existing DTT does not contain any specific reference to the concept of CBO in Article 5.

ATIR has addressed a key issue involved in the taxability of EPC/splitting of contracts under the Pakistan-China DTT. The amendments relating to CBO are not tested yet, however, the judgement may still apply insofar as it has been held that the definition of PE as per DTT supersedes the domestic law.

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Poland

Pay and refund – new WHT collection mechanism for passive payments

As of 1 January 2022, pay and refund has replaced previously effective relief at source mechanism as a way of withholding tax (WHT) collection for certain types of payments made from Polish entities.

According to amended regulations, the pay and refund mechanism applies to payments that collectively satisfy the following criteria:

- income has a passive character or should be treated this way, such as:
  - dividends and other corporate profit distributions;
  - interest, copyrights and related rights, rights (or sale of rights) to inventions, trademarks or industrial designs, royalties for the transfer of a secret formula or production process, or for the use of (or the right to use) an industrial device, including a means of transport, or a commercial or scientific device, or for the transfer of industrial, commercial or scientific know-how;
  - income which, for no valid commercial reasons, was not treated as any of the foregoing;
- income is paid to related parties, as defined by the TP regulations, which are non-tax residents in Poland,
- total amount of payments subject to Polish WHT in any way and made to the same taxpayer exceeds PLN 2 million (roughly EUR 420,000) within the WHT agent's tax year.

The pay and refund mechanism applies to excess payment over PLN 2 million. In general, it means that for such payments WHT is withheld mandatorily at the basic rate (19% for dividends and 20% for other types of payments) regardless of any preferences under double taxation treaties (DTT) or special regulations. Tax return is further possible only by means of an application for a declaration of overpayment supported by necessary documentation and carrying out a tax proceeding which can realistically equate to six months.

If criteria for the application of the pay and refund mechanism are met, WHT should usually be deducted, Polish CIT Act provides two simplification schemes under which the WHT agent may still apply preferences arising from DTT or special regulations even if the threshold of PLN 2 million is exceeded:

- **representation of the tax agent's Management Board** in which it states that it:
  - holds the documents required by tax law to substantiate the rightful application of a treaty rate or an exemption or the rightful forbearance of the withholding tax; and
  - is not aware of anything that could reasonably arise suspicion that any circumstances would preclude the application of the treaty rate or exemption or the right not to withhold the tax, or
- **preference opinion** issued by the tax office (statutory waiting period – up to six months) that confirms that the WHT tax agent is entitled to apply the preference indicated in the Polish CIT Act or prescribed in the respective DTT.

Irrespective of the type of simplification scheme, it should each time be preceded by an analysis with reference to the beneficial owner status of the recipient of payments.

The complexity of such an analysis varies depending on the nature of the payment, size of the parties of the transaction, and intercompany relations between them as defined in TP regulations.

In the case of planned payments, it is recommended to conduct a detailed audit of specific transactions (beneficial ownership incl. genuine business activity, proof of exercising due diligence), verify contracts for WHT clauses, establish if any of simplification schemes are applicable and advised, and implement a suitable WHT policy.

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Singapore and Indonesia

New Singapore-Indonesia Double Tax Agreement takes effect

The new Singapore-Indonesia Double Tax Agreement (**DTA**) took effect as of 1 January 2022, thirty years after the previous DTA entered into force. Singapore is a key hub for international investments into Indonesia, and has been Indonesia's largest foreign investor since 2014, while each country is also a top 10 trading partner to the other. The new DTA contains several changes that will benefit businesses in both Singapore and Indonesia and further boost bilateral trade and investment flows between both jurisdictions. Below is a summary of the key changes to the DTA from a corporate tax perspective.

New article on capital gains

Whereas the previous DTA was silent regarding the taxation of capital gains, the new DTA contains an article on capital gains which clarifies that the right to tax capital gains will generally be limited to the jurisdiction of residence of the seller. However, there are exceptions, including:

- Indonesia retains the right to tax capital gains arising from the alienation of shares in Indonesian-resident companies listed on the Indonesian stock exchange at 0.1% of the gross value (or 0.5% for founder's shares);
- Gains arising from the alienation of immovable property are taxed in the country where the property is located; and
- Gains arising from the alienation of shares in a company more than 50% of whose value is derived from real estate in a contracting state are taxable only in that contracting state, provided that the alienator resident in the other contracting states owns more than 50%

of the issued shares of the company. However, there are two exceptions: (a) where the immovable property is used to carry on the alienator's business; or (b) the alienation is the result of a corporate reorganisation, merger or other similar restructuring activity.

Lower tax rates on royalties and branch profits

The withholding tax (**WHT**) rate for royalties has been reduced from 15% to 8% (for use of, or right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience) or 10% (for other types of royalty payments). Moreover, the branch profit tax rate has been reduced from 15% to 10%, although this is not applicable to production sharing contracts for the oil and gas sector.

Corresponding Transfer Pricing adjustments

The new DTA expressly requires the other contracting state to make corresponding Transfer Pricing adjustments, unless there is a final judicial or legal proceeding under which one of the enterprises concerned is liable to penalty for fraud, gross negligence, or wilful default.

Removal of remittance requirement and introduction of the principal purpose test

Under the previous DTA, treaty relief is granted only if income that is taxable on a remittance basis has been remitted to or received in the other contracting state, which is generally the case in Singapore. This requirement has now been removed, and therefore, the reduced WHT under the new DTA for, say, interest income paid to a Singapore company, should apply even if the interest income is not remitted to or received in Singapore. However, the new DTA includes a new Article 28 (Entitlement of benefits) which essentially incorporates the treaty abuse principal purpose test as prescribed in Article 7 of the multilateral instrument.

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Vietnam

Tax exposure of the PE

According to Article 2 (1) (b) Law on Corporate Income Tax (CIT) a foreign enterprise (FE) is subject to CIT in Vietnam *"with or without a permanent establishment in Vietnam."*

Article 2 (2) specifies:
"(b) A foreign enterprise with a permanent establishment in Vietnam must pay tax on taxable income arising in Vietnam and on taxable income arising outside Vietnam and relating to the operation of such permanent establishment.

(c) A foreign enterprise with a permanent establishment in Vietnam must pay tax on taxable income arising in Vietnam and not relating to the operation of the permanent establishment.

(d) A foreign enterprise that does not have a permanent establishment in Vietnam must pay tax on taxable income arising in Vietnam."

Many of these activities of a FE are covered by the regime of the foreign contractor withholding tax (**FCWT**). The practical handling of the FCWT and the exemptions under the relevant double taxation agreement (**DTA**) are well established. If the contracts are prepared properly, the tax exposure is not high and most of the administrative procedures must be fulfilled by the Vietnamese partner.

Questionable is the tax exposure in cases where the FE has established a permanent establishment (**PE**) in Vietnam and that PE has income arising in Vietnam or outside Vietnam relating to the PE or the FE has income in Vietnam not related to the PE if this income is not matching the conditions of the FCWT. This will be the case if the income is not paid by an entity registered in Vietnam. If the PE is involved in a contract between the FE and a customer in a third country, this income is subject to CIT in Vietnam.

From our experience, not so few foreign companies with a presence in Vietnam are using this presence which can take the form of a rep. office or a subsidiary or other forms for operating the regional business. In the case of Bayer Vietnam Company Limited, the general department of taxation has decided in the official letter 1934/TCT-HTQT that even though it is a separate legal entity registered in Vietnam, the subsidiary constituted a PE of Bayer Hong Kong because of the way the subsidiary has been managed. All cases where the subsidiary is effectively managed by a foreign group company should therefore be analysed in detail.

Contrary to a widespread expectation, the FCWT regime will not be applied accordingly in these cases. The normal tax rate of 20% on the profit will be applied. Difficulties arise where the PE does not fulfil accounting in compliance with the regulations of Vietnam.

The Ministry of Finance tax department has instructed a local tax department in the official letter 3896/TCT-HTQT regarding the case of a PE having taxable income for which the FCWT is not applicable. The principles are:

→ The income of the FE is defined by the difference between revenue and expenses allocated to operations in Vietnam on the basis of the contracts and accounting books of FE.
→ If that is not possible, the ratio between the costs allocated to the operation in Vietnam and the total cost of the contract shall be used to determine the revenue.
→ If the FE cannot prove the relevant facts, the CIT will be charged on the revenue of the entire contract.

The local tax authorities are encouraged to enforce this tax obligation. FE operating in Vietnam should check their exposure.

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