

TAX LINK

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Australia Transfer pricing update

In a just released first tranche of draft Rulings and Practice Statements, the Australian Taxation Office (ATO) has set out its views and provided guidance on, the application of Australia's transfer pricing rules.

The draft Rulings and Practice Statements set out the ATO's views on:

- its power to reconstruct transactions between related parties
- the transfer pricing documentation an entity should prepare and keep to address matters that might give rise to a transfer pricing benefit
- the penalties applicable to transfer pricing adjustments and failure to meet transfer pricing documentation requirements.

Of concern to multinationals operating in Australia is the ATO's contention that it has the power to reconstruct transactions between related entities. One draft Ruling confirms the ATO's intention to disregard transactions entered into by entities where they are not commercially realistic or where, in the ATO's view, other entities operating independently would not have entered into them.

This means, of course, that an entity will be dependent upon the ATO's view of what happens in the normal course of business compared with what is happening between the entity and its related entities. As a consequence, there will be added pressure on an entity when it comes down to justifying their own particular transfer pricing model, where the ATO considers they can reconstruct it using their own ideas about what is "normal".

Under the new guidelines, an entity now also needs to prepare and keep documentation to support its offshore dealings with related parties more so than it ever had to under the old rules. This is so because the new rules operate on a self assessment basis with the onus resting upon the entity to show it has applied the new rules.

Where an entity gets it wrong and does not meet these requirements, penalties will apply as though the entity has adopted a position which is not reasonably arguable,

thereby giving rise to at least a penalty of 25% of the deemed tax shortfall amount. Where no supporting documentation actually exists an entity will have no chance of any remission of the penalty amount.

The documentation requirements specify that the records kept by an entity will meet the requirements if they enable that entity to take a reasonably arguable position and:

- are prepared before the time the entity lodges its income tax return for the income year relevant to the matter (or matters). For an entity to meet its self-assessment regime obligations, it is the ATO's view that the records need to exist and be kept by the relevant entity. This includes records in the entity's possession or ready and available to it before the income tax return is lodged
- explain that the cross-border conditions that operate between the entity and other related entities in connection with their commercial or financial relations and, in the case of attribution of profits, are consistent with the arm's length principle and show that the local entity did not obtain a transfer pricing benefit
- explain why the provisions were applied in a particular way to best achieve consistency with the relevant guidance material. The ATO considers the provisions require an entity to identify and record or reference relevant parts of the guidance material in their transfer pricing documentation. The documentation should also explain how the relevant guidance material has been taken into account by the entity in applying the provisions.

Importantly, an entity's records must allow a number of things to be readily ascertained, for example, the arm's length conditions relevant to the transaction and the particulars of the method used and the comparable circumstances relevant to identifying those arm's length conditions.

When the Rulings and Practice Statements are issued in their final form, it is proposed they apply to income tax years commencing on or after the 29 June 2013. Where any transactions are subject to withholding tax the new rules will apply to income derived in income years commencing on or after the 29 June 2013. This is designed to be consistent with the application of the new transfer pricing rules.

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India

Deputation of employees could result in permanent establishment (PE) and tax implications in India

The secondment of employees by foreign companies to Indian affiliates is a common practice. Seconded employees typically work under the direction, control and supervision of the Indian affiliate during their secondment. The foreign company pays the salary of the seconded employees abroad (i) to continue the social security contribution and (ii) for convenience purposes. The said salary paid is then recovered from the Indian affiliate on a cost-to-cost basis.

The Indian revenue authorities are closely monitoring these kinds of arrangements for possible Permanent Establishment (PE) exposure and for taxing the recharge of salary as Fees for Technical Services/Fees for Included Services (FTS/FIS).

Recently, the Delhi High Court (Delhi HC), in respect of the writ petition filed in the case of Centrica India Offshore Private Limited (CIO) [W.P. (C) No. 6807/2012 pronounced on 25 April 2014], had to decide whether the reimbursement of salary cost paid by CIO to the overseas entities is taxable in India; if yes, whether withholding of tax thereon was required under section 195 of the Income-Tax Act (the Act). A further issue raised was whether employees deputed to India created a Service PE of a foreign company in India or not.

Facts of the case:

- CIO, an Indian company, is a wholly owned subsidiary of Centrica plc, United Kingdom. Centrica plc along with its two other subsidiaries (one in Canada and one in the UK) (Overseas Entities), is engaged in the business of supplying gas and electricity to various consumers across the UK and Canada
- the overseas entities have outsourced their back office support functions such as consumers' billings/debt collections/monthly MIS to third party vendors in India. CIO was incorporated in order to ensure that the third party vendors comply with quality guidelines of the group. For these services, CIO received remuneration at cost plus 15% mark-up from the overseas entities
- a Secondment Agreement (SA) was simultaneously entered into between CIO and the overseas entities under which employees of the overseas entities were seconded to CIO to provide managerial support in its initial years. The seconded employees were to work under the control and supervision of CIO. CIO was to bear all the risks in respect of the work performed by the seconded employees ie the overseas entities were not responsible for the work and actions of the seconded employees
- the seconded employees would retain their entitlement to participate in the overseas entities' retirement and social security plans and other benefits
- CIO has withheld appropriate taxes under section 192

of the Act from the salary paid to the secondees. Further, service income received by CIO from overseas entities would be offered to tax in India under the Act

- on the above transaction, CIO sought a ruling from the Authority of Advance Rulings (AAR). The AAR held that the recharge of salary does not constitute FTS/FIS, however, the overseas entities constituted a Service PE in India on account of the secondment of employees to CIO.
- aggrieved by the said AAR ruling, CIO filed a writ petition before the Delhi HC challenging the AAR ruling.

Key issues before the Delhi HC:

- whether the overseas entities rendered technical services through seconded employees?
- whether overseas entities constituted a Service PE in India on account of the secondment of employees?
- whether the payments made were in the nature of reimbursement of expenses?

CIO's contention:

- the services rendered are 'managerial services' and the same are not within the scope of the meaning of FTS/FIS under the Double Taxation Avoidance Agreement (DTAA). Further, even if it is characterised as FTS/FIS, the same does not 'make available'
- the mere secondment of employees would not amount to the rendering of services by the overseas entities
- the payment made to overseas entities is a mere reimbursement, which does not form part of its income
- the seconded employees are under CIO's control and supervision. The roles and the duties were dictated by CIO and it bore all risks in relation to the work of the seconded employees and reaped the benefit
- CIO relied on Klaus Vogel and the Organisation of Economic Co-operation and Development (OECD) Commentary on model tax convention to explain that the right to terminate is with the legal employer (ie overseas entities) while supervision and control is with the economic employer (ie CIO)
- no Service PE is constituted as CIO is the economic employer and overseas entities are only legal employers
- substance of the transaction has to be looked at and not the form
- the overseas entities have outsourced their non-integral and non-revenue generating business to India. CIO is providing support services in relation to such business and hence, cannot be considered as carrying on business on behalf of the overseas entities
- the payments made to overseas entities is not income that accrues to the overseas entity but rather money that it is obligated to pay the secondees and the money is overridden by the obligation to pay the secondees and therefore, is not income.

Revenue's contention:

- managerial service is not included in the scope of technical services within the meaning of Article 13 of the DTAA. However, the services of the seconded employees should fall within the terms of technical services which includes 'make available'
- on a combined reading of the master service agreement and the SA, it can be inferred that the seconded

employees are being sent with technical knowledge and expertise of various processes and practices employed by overseas entities as well as the experience in managing and applying such processes and practices. From this, it is very clear that the employees were in possession of technical knowledge

- since CIO was in its start-up stage, the main objective of this arrangement was to train and familiarise the staff in India to the processes and practices of the group that could be applied by them once the seconded employees' term ended. Thus, the condition of 'make available' ie imparting technical knowledge to the employees of CIO would be satisfied. As a result, the same are in the nature of FTS/FIS under the DTAA with Canada and the UK
- these seconded employees retained their right to participate in the overseas retirement and social security plans. CIO could terminate only the secondment agreement and not the employment of the seconded employees. Further, the seconded employees could not sue CIO for default in payment of their salaries
- the Revenue further relied on OECD Commentary on Article 15 to state that the secondees were the regular employees of the overseas entities and that they had been seconded for a limited period. In the present case, on completion of the specified period of the secondment, the secondees will return to the overseas entities and will perform the usual state of affairs. This proves that the overseas entities were the economic employers of the secondees
- although the word 'reimbursement' is mentioned in the agreement, the nature of the payments under the secondment agreement has to satisfy the characteristic of reimbursement and that the term 'reimbursement' in the agreement will not be determinative of the nature of payments.

High Court's ruling:

- the overseas entities, through the seconded employees, have provided technical services to CIO, especially since the expression FTS/FIS includes provision of services of personnel
- the seconded employees who work for CIO are provided by the overseas entities and the work conducted by them ie assistance in conducting the business of CIO of quality control and management is through the overseas entities.

- the business support services provided by CIO would fall within technical and consultancy services. The secondees would oversee these services and the required application of technical knowledge and hence, their services would also fall within the meaning of technical services
- the distinction drawn by CIO between the provision of services by the overseas entities themselves and the mere secondment of employees does not make any difference, since the service provided by the overseas entities is a provision of technical services through the secondees
- the overseas entities required CIO to ensure quality control and management of their outsourced activities. In light of the same, the employees were seconded to impart their technical expertise and know-how, until the necessary skill set was acquired by the employees of CIO. Thus, this qualifies as FTS/FIS under the Act and the Double Taxation Agreements with Canada and the UK
- the seconded employees retained their rights to participate in the overseas entities' retirement and social security plans and other benefits
- CIO had the right only to terminate the secondment agreement and not the employment of the secondees. Also, the seconded employees could not sue CIO for default in payment of their salary. Thus, the employment relationship between the overseas entities and the secondees is, at no point of time, terminated nor is CIO given any authority to modify the same
- CIO may have operational control over the secondees for their daily work and may be responsible for their failure. However, these limited factors cannot displace the larger and established context of employment abroad
- the court further distinguished between the stewardship activities of employees and those of deputationists which have been highlighted in the decisions of Morgan Stanley and Co [2006 (284) ITR 260 (SC 3)] and M/s E-Funds IT Solutions [ITA 735/2011]. It said that activities such as back office support functions, overseeing quality control, etc. could not be characterised as mere stewardship. The activities which CIO was supposed to do were done through seconded employees through their expertise. Hence, the overseas entities continue to be their real employer. As a result, the seconded employees constitute a Service PE of the overseas entities
- The court observed that the term 'reimbursement of expenses' mentioned in the agreement could not

determine the nature of the payment. Similarly, the fact that the overseas entities do not charge a mark-up also could not determine the nature of the payment

SKP's Comments

Though this is a writ petition which applies only to the applicant ie CIO, it is important to note that:

- there are decisions which have accepted that reimbursement of salary is not taxable as Fees for Technical Services (FTS); however the same were not relied upon by the applicant
- typically as per the DTAA, a Service PE is not constituted when the amount paid to the overseas entities falls within the meaning of Fees for Technical Services/Fees for Included Services (FTS/FIS). In the present case, the Court has held that the payment to overseas entities is taxable as FTS/FIS. Based on this, logically, the overseas entities should not constitute a Service PE in India. However, this point has not been discussed in the present case.

In light of this decision, it would be pertinent that the current secondment agreement entered into by the Indian arm of foreign companies is reviewed, analysed and redrafted properly to mitigate the PE risk of the foreign entity in India.

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Malaysia Deemed interest income from loans or advances to director

The Budget 2014 proposed a new Section 140B of the Income Tax Act 1967 to expand the scope of corporate taxation by deeming interest income on loans or advances to directors as taxable income of the lending company. Where a company provides any loans or advances from its internal funds to its directors, the company shall be deemed to derive interest income from such loans or advances. The interest income for the basis period for a year of assessment shall be the aggregate sum of monthly interest in the basis period.

How is it calculated?

The sum of the monthly interest is determined in accordance with the following formula:

$$(1/12) \times A \times B$$

- where A is the total amount of loan or advances outstanding at the end of the calendar month
- B is the average lending rate of commercial banks published by the Central Bank at the end of the calendar

month, or where there is no such average lending rate, such other reference lending rate as may be prescribed by the Director General.

Where interest is charged by the company and the total interest charged and payable by the director is more than the aggregate sum of interest as determined based on the above formula, this provision of deemed interest income shall not apply.

Where the interest charged by the company is less than the aggregate sum of interest as determined based on the above formula, the actual interest charged shall be disregarded. The company shall be deemed to derive interest income based on the above formula.

When does Section 140B come into effect?

The above provision is effective for Year of Assessment 2014, which has a retrospective effect on companies with financial year-ends not ending on 31 December 2013. However, the Inland Revenue has through its dialogue with the Chartered Tax Institute of Malaysia (CTIM), recently confirmed that Section 140B will apply from 1 January 2014.

What is the tax treatment of deemed interest income?

The deemed interest income will be treated as non-business income of the lender unless there is interest income arising from the source of debentures, mortgages or other sources to which the interest relates and forms part of the stock in trade of a business carried on by the lender.

For the director, the deductibility of deemed interest expense will depend on the purposes of the loans or advances received. Interest would rank for deduction if the loans or advances are incurred in the production of assessable income.

Will the charging of deemed interest contravene the Moneylenders Act 1951?

Section 2A of the Moneylenders Act 1951 states: "The Act shall not apply to persons specified in the First Schedule, and such person shall be subject to any written law governing his business or activity." The First Schedule includes:

- 1) any company who lends money to its related corporation as defined under the Companies Act 1965
- 2) any company who lends money to its director, officer or employee as a benefit accorded to such person under his terms of employment.

The limited interpretation of the above definitions as regards "related corporation" and "as a benefit" restricts the question of whether the Moneylenders Act would apply for other scenarios. However, the second part of Section 2A allows the "person" which is the company to be subject to any written law which in this instance is Section 140B of the Income Tax Act 1967. Therefore, there will be no contravention.

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Malta Introduction of the Permanent establishment/ branch exemption in Malta

Malta has one of the most comprehensive participation exemption regimes in the European Union whereby dividends derived by a company registered in Malta from a participating holding or from the transfer of such holding is exempt from tax in Malta subject to certain conditions being satisfied.

An investment qualifies as a participating holding if the Maltese resident company holds equity shares in a non-resident company or a qualifying body of persons and it:

- i. has at least 10% of the equity shares in the non-resident company; or
- ii. is an equity shareholder in a non-resident company and the equity shareholder company is entitled at its option to call for and acquire the entire balance of the equity shares of the non-resident company and is entitled to the right to first refusal to purchase such shares; or
- iii. is an equity shareholder in a non-resident company and is entitled to sit on the Board or appoint a person to sit on the Board of that company as a director; or
- iv. is an equity shareholder in a non-resident company which invests a minimum sum of EUR1,164,000 and such investment is held for an uninterrupted period of 183 days; or
- v. holds the shares in the non-resident company for the furtherance of its own business and the holding is not held as trading stock for the purpose of a trade.

Furthermore, in order for the participation exemption to apply in the case of dividend income, the non-resident company in which the investment is held must either satisfy

any one of the following conditions:

- 1) it is resident or incorporated in the EU
- 2) it is subject to foreign tax of a minimum of 15%
- 3) it does not derive more than 50% of its income from passive interest and royalties;

or must satisfy both of the following conditions:

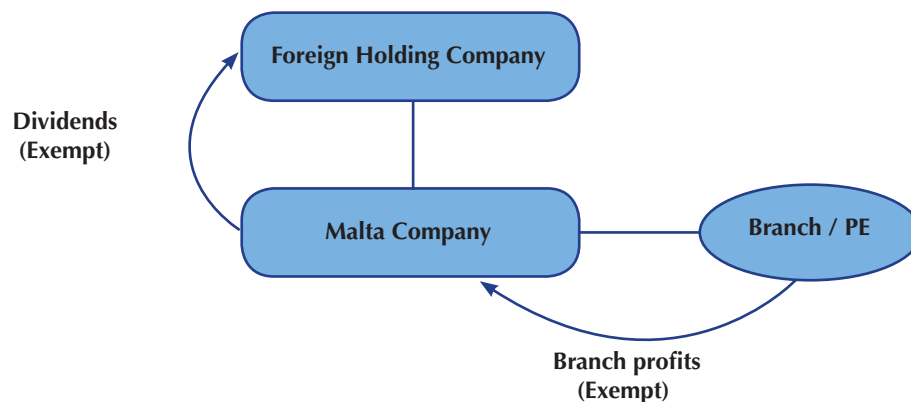
- 1) the shares in the non-resident company is not a portfolio investment
- 2) the non-resident company or its passive interest or royalties have been subject to tax at a rate which is not less than 5%.

Malta has a trustee regime and thus shares in Maltese companies may be held by licensed trustees in a fiduciary capacity for and on behalf of subscribers.

Recent amendments to income tax legislation in Malta have complemented the participation exemption regime by the introduction of an exemption in respect of income or gains attributable to a Permanent Establishment ("PE") situated outside Malta (including a branch). The exemption can be claimed on any profits attributable to a PE and any gains on the transfer thereof.

For the exemption to apply the PE has to be situated outside Malta and can be either wholly or partially owned by the Maltese company. The exemption also applies in respect of profits attributable to a PE (or arising from the transfer of the PE) when the PE is operated through any entity or relationship other than a company. There are no restrictions in respect of the country in which the PE is situated as long as it is outside Malta and there is no requirement for Malta to have a double taxation treaty with the country of establishment of the PE. The exemption applies irrespective of whether the branch is subject to tax in its country of establishment.

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Puerto Rico

A new aggressive economic and tax incentives programme

Puerto Rico (PR) has created an aggressive economic and tax incentives programme with the objective of helping those companies who manufacture or provide services on the island become more profitable. PR now offers a highly attractive incentives package that includes a very low fixed corporate income tax rate, various tax exemptions and special deductions.

Overview of incentives

Below is a brief overview of the incentives based on the following key business sectors: manufacturing, export services, individual investors, agriculture, international finance and insurers, film and creative services, hospitality and hotel development, education and training, foreign trade zones, and renewable energy.

Manufacturing

The manufacturing business sectors can request the following tax benefits:

- 4% income tax on industrial development income
- 0% to 1% tax rate on income for pioneer or novel products manufactured in PR
- up to 50% tax credit on purchases of products manufactured or recycled locally
- up to \$5,000 for each job created during first year of operation
- up to 50% tax credit on research and development activities
- special deductions on investments in structures, machinery and equipment
- a marketing incentives programme is available to qualified companies whose sales are greater than \$100,000 per year.

Export services

The Exportation of Services (Act 20-2012) looks to provide the appropriate environment and opportunities to make PR a center of international services, encouraging local service providers to expand their business by offering their services to clients who are located outside of PR and convincing foreign service providers to move their business to PR.

Tax benefits that apply to export services include:

- 4% corporate tax rate, which may be reduced to 3%
- 100% tax exemption on dividends or profit distributions from export services businesses
- 100% exemption on property taxes for certain export service businesses services
- decree of 20 years, renewable for an additional 10 years, guaranteeing these rates.

Almost all services for export are eligible services including but not limited to research and development, advertising and public relations, consulting, call centres, storage and distribution centres, telecommunication voice and data between persons located outside of PR, development of computer programmes, centres of electronic data processing, investment banking, asset management and other financial services, and professional services such as legal, accounting, architectural and engineering services.

Individual investors

The Individual Investors (Act 22 -2012) seeks to attract new residents to PR by providing a total exemption from PR income taxes on all passive income realised or accrued after such individuals become bona fide residents of PR. To qualify, the new resident must not have been a resident of PR at any time between 16 January 1997 and 16 January 2012.

Tax benefits for individual investors include:

- 100% tax exemption from Puerto Rico income taxes on all dividends
- 100% tax exemption from Puerto Rico income taxes on all interest
- 100% tax exemption from Puerto Rico income taxes on all short-term, and long-term capital gains accrued after the individual becomes a bona-fide resident of Puerto Rico ("Puerto Rico Gain").

Agriculture

The agriculture business sector can request the following tax benefits:

- 100% exemption on taxes for agricultural equipment
- 100% exemption on property taxes (land, buildings, vehicles, etc)
- 100% exemption on municipal taxes
- 100% exemption on stamp payments to PR's Treasury Department and fees to register a property
- 90% exemption on earnings from agricultural activity
- 50% tax credit for investment in eligible agricultural business
- annual bonus for agricultural workers
- wage subsidy programme to eligible farmers.

International finance and insurers

International insurers, branches, international insurer holding companies and international banking entities (IBE) receive attractive tax treatment:

- income tax - 0%
- branch profit tax - 0%
- dividends/other distributions of profits - 0%
- distributions in liquidation - 0%
- municipal license tax - 0%
- property tax - 0%

Film and creative services

PR's amazing locations, state-of-the-art equipment, post-production and sound recording facilities, along with one of the highest tax credit programmes in the world, allow you to produce your film in PR from start to finish.



Tax benefits that apply to the film and creative services sector includes:

- 40% tax credit on all payments to Puerto Rico Residents
- 20% tax credit on all payments to Non-Resident Talent (including stunt doubles)
- no principal photography requirements (full or partial development, pre-production and post-production may qualify)
- no per project or individual wage caps
- no cap on credits for payments to Non-Residential Talent.

Some requirements which are necessary to receive the 40% and 20% tax credit:

- spend a minimum of \$100,000 in payments per project to Puerto Rico Residents, including equipment, crew travel and accommodations (\$50,000 for short films)
- 20% tax credit payments made to Non-Resident Talent are subject to a 20% withholding over their PR income.

Any project in the development, pre-production, production, or post-production phase that is carried out in PR partially or fully is eligible. Qualifying media projects would be: feature films, short films, documentaries, television programmes, series in episodes, mini-series, music videos, national and international commercials; video games; recorded live performances; and original sound track recordings and dubbing.

Infrastructure incentives

- 25% tax credit on development or expansion costs of eligible infrastructure projects
- minimum investment of \$5 million per project
- maximum aggregate annual cap of \$10 million and lifetime cap of \$150 million for all infrastructure credits.

Preferential tax treatment

Persons engaged in qualifying media and infrastructure projects as well as operators of studios and other purpose-built media facilities with a budget equal to or greater than \$50 million (including their suppliers), are eligible for the following preferential tax rates or exemptions:

- fixed income tax rate of between 4% and 10%
- 100% exemption on dividend taxes
- 90% exemption from municipal and state taxes on property
- 100% exemption from municipal license taxes, excise taxes and other municipal taxes.

Film investment fund

- financing for locally produced short films, feature films and documentaries.

Hospitality and hotel development

Puerto Rico's tax incentives package offers hotel developers a competitive advantage over other destinations. The "Tourism Development Act of Puerto Rico" - (Act No. 74 of 2010) sets out the parameters of such benefits: benefits

under this law will remain valid for a period of 10 years from the starting date of the eligible

tourism-related project and the business operation will be entitled to a 10 year extension.

Tax benefits include:

- tax credit of 10% of the total project cost, or 50% of cash from investors (whichever is lowest)
- 100% exemption on municipal construction excise tax
- 100% exemption on taxes on imported goods and sales tax
- 100% exemption on municipal licenses
- 90% exemption on income tax
- 90% exemption on property tax

Education and training

The Workforce Investment Act offers workforce training Incentives to businesses through on-the-job-training, customised training, combined programmes, and retraining designed to meet the needs of the employers, people looking for jobs and those who want to improve their occupational careers:

- up to 50% of the salary of on-the-job training participants
- up to 50% of the salary of participants in customised training
- 100% of training costs and up to 50% of the participants salary for combined training programmes
- 100% of the cost of retraining employees to handle new tasks and up to 50% of the salary of the participant's during the retraining period.

Foreign Trade Zones

Puerto Rico has the largest non-contiguous Foreign Trade Zone (FTZ) system in the United States. The system allows companies to obtain significant financial savings, since raw material, components, and packaging can be transported tax-free throughout these zones and items shipped abroad after processing are exempt from U.S. taxes. The following incentives apply:

- deferment of federal customs duties
- deferment of Puerto Rico excise taxes
- 100% exemption on Municipal License Taxes on exports outside the United States
- 100% exemption on tangible property and equipment used
- 60% exemption on the value of the property that is designated intangible
- 100% exemption on exports from the zone and sub-zones.

Renewable energy (Green Energy Fund)

Puerto Rico created the Green Energy Fund (GEF) to increase green energy production and promote sustainability in Puerto Rico. The initiative is encouraged through:

- rebates of up to 60% of eligible costs for Tier 1 (0-100 kW) and up to 50% for Tier 2 (101 kW-1MW)
- 60% refund on acquisition and installation costs incurred during the installation of renewable energy equipment



for residential properties and small businesses (50% for other businesses).

Visas

Foreign investors visa

One of the “secrets” less known in immigration is the Visa category E or investors. Upon receiving this visa, a person can move to Puerto Rico for a period of time to directly manage an investment made in the country. This time period may be extended indefinitely as long as is necessary to keep the investors managing the investment.

Unlike the Immigrant Investor category (EB-5) – see below, there is no minimum initial investment amount and it is only required for it to be substantially in proportion to the business you want to open.

In addition to the requirement of substantiality, a prior commitment of money to be invested will be needed before applying for the visa E. This kind of visa can be obtained both within the U.S. (including Puerto Rico) and abroad.

Another important detail is that this visa, although it does not count as an immigrant visa, the same can be renewed indefinitely as long as the investment through which the visa was obtained initially, remains in force.

EB-5 Immigrant Investor

The programme was created by Congress in 1990 to stimulate the U.S. (including Puerto Rico) economy through job creation and capital investment by foreign investors. Under the Immigration Act of Congress of 1990, there have been 10,000 visas per year for investors that provide employment to 10 people or more. Investors under this programme must spend at least \$500,000 in rural areas, or areas of unemployment. Investors can get a green card through this scheme and for their spouse and unmarried children under 21 years.

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Spain Expert committee for tax reform report

Aside the euro area’s sovereign debt crisis and the generalised EU economies’ contraction observed during the last years, the Spanish economy is still suffering the particular effects determined by the well-known real estate bubble burst and wrong economics policies. These circumstances should be read together with a constant ageing of the population, the lowest rate of consumption and the subsequent fall of the tax revenue/Gross Domestic Product ratio, which is currently one of the lowest in the European Union.

In this scenario, in the light of the recommendations made by the European Union, IMF and OECD for tax reform and under the mandate received by the Spanish Government on 5 July 2013, the “Expert Committee for Tax Reform” has carried out an analysis focused on the Spanish Tax System.

As a result of such analysis, the committee suggested that the Spanish Government should act in a specific direction, in order to facilitate the ongoing adjustment of the economy and increase medium-term potential growth. The main areas are summarised below.

Personal income tax

Nowadays, the Spanish personal income tax is characterised by high marginal rates, an excessive number of income brackets, numerous exemptions and deductions and differences regarding the treatment of different capital gains.

The Committee proposal, in order to lessen the distorting effects of such a structure would entail:

- simplification of the current dual system for defining the tax base (standard base and saving base), on the one hand reconsidering the kind of income to be included in each base, and on the other hand, allowing offsetting among all kind of income arising from assets
- reduction of the existing exemptions, such as the partial exemption on dividends and profit-sharing, or the amounts paid by companies for employees’ health insurance
- lowering the existing reduction on irregular income or multi-year income generated over more than two years. Both are currently taxed after their reduction
- turning the current reduction for employment income into a fixed amount
- eliminating the deemed income for owning a non-rented property, and taxing rental income as the income from moveable property as part of the saving base and not subject to the highly progressive rate
- eliminating the “objective” method as a way of estimating the taxable income for some economic activities, in the light of the source of fraud that this method is causing
- eliminating the inflation adjustment on capital gains

arising from real estate, since such adjustment is not allowed for other capital gains on other assets

- increasing the minimum personal and family allowances in order to improve the low birth rate
- simplifying the different deductions stated by the different regional governments, in order to avoid distortion in the competition within the Spanish territory
- reducing the number of income brackets related to the standard base in accordance with the European trend and establishing a fix rate for the saving base.

Corporate income tax

Currently, Spanish corporate income tax is characterised by a high nominal tax rate, which exists alongside low or reduced effective rates. As such reduced rates depend on the turnover, it may generate a negative incentive for firms in terms of growth, as well as for the system itself. Moreover, there are some tax benefits in allowing a significant effective reduction in the legal nominal rate, which are not “visible” a priori.

The Committee proposal, with the aim of drawing effective rates closer to legal rates, would consist in:

- reduction of the legal rate from the current 30% to the 20%. Symmetrically, elimination of the current special regime for medium-sized companies
- elimination of some deductions or tax credits (such as R&D and technological innovation, for reinvested earnings, for environmental investments, for job creation for disabled employees etc) to make clear what the effective tax rate is in order to encourage domestic and foreign investment
- reduction of some deductible unrealised losses
- modification of the current rates of amortisation, with the aim of simplifying its application and aligning them to the real useful life of the assets.

Value Added Tax

Although the Spanish general VAT rate was raised in order to make it equal to the EU average rate, Spanish VAT revenue was the lowest in the EU, in terms of Gross Internal Product. The reason of such loss of revenues can be found in the combination of reduced rates and exemptions.

Considering that the VAT common system and the European community regulation provides only a narrow margin for changes regarding exemptions, and that raising the reduced VAT rates on staple goods does not seem to be viable, the Committee proposes:

- the elimination of the special retailer’s regime
- restriction in the use of the simplified VAT regime.

Wealth and inheritance taxation

Due to its negative effects on savings, and considering the unequal consequences of international tax planning for big wealth, the Committee suggests eliminating the wealth tax, in line with the observed trend in developed countries. On the other hand, with the aim of improving equality and fair wealth distribution, the Committee proposes a minimum tax on inheritance throughout Spain, eliminating the current differences observed between various regions. The proposal comprises exemptions up to a minimum amount, and the

only discrimination should be in the light of kinship. In order to preserve a certain level of progressivity, the rates should be set in a range from 4% to a maximum of 10%. In accordance with the aim of such proposal, all the reductions based on kinship (amongst others, rebate for acquisition of sole proprietorship, rebate for amounts received under life insurance contracts, professional services firms or equity holdings in entities known as family business, rebate for purchase of principal residence of the deceased person), should be either eliminated or reduced.

Transfer and Stamp Tax

In the Committee’s opinion, as Stamp Tax is levied on something that has been previously taxed, it should be eliminated or reduced until it disappears upon the introduction of a new real estate tax.

Social contributions

The Committee considers that not only is the social contribution paid in Spain higher than the EU average, but also that it is not equally distributed between employers and employees. Moreover, there are some groups of workers which are particularly underprivileged, so they would require particular attention at the time of planning a specific reform of the Social Security system and contributions in general.

The main point is to improve the competitiveness of firms, by means of reducing, as a first step, the cost of labour, but in a manner such that neither is the payroll affected by such a reduction in contributions, nor are the entity’s margins. Of course the contribution reduction should be compensated by an increase of some other taxes.

All the measures suggested seem to be coherent with the particular Spanish tax and economic system, but, of course, each of these measures will confront different interests, on whose related social pressure will its success depend.

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Notes



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