Spotlight on Foreign Taxes – China-India-LATAM

2019 U.S. Cross-Border Tax Conference
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# Today’s presenters

<table>
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<tr>
<th>Name</th>
<th>Title</th>
<th>Country/Region</th>
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<tbody>
<tr>
<td>Murilo Rodrigues de Mello</td>
<td>Partner, KPMG in Brazil</td>
<td>Brazil</td>
<td><a href="mailto:mrodriguesdemello@kpmg.com">mrodriguesdemello@kpmg.com</a></td>
</tr>
<tr>
<td>David Ling</td>
<td>Partner, KPMG in China</td>
<td>China</td>
<td><a href="mailto:davidxling@kpmg.com">davidxling@kpmg.com</a></td>
</tr>
<tr>
<td>Anjani Sharma</td>
<td>Partner, KPMG in India</td>
<td>India</td>
<td><a href="mailto:anjanisharma1@kpmg.com">anjanisharma1@kpmg.com</a></td>
</tr>
<tr>
<td>Alfonso Pallette</td>
<td>Principal, KPMG in U.S.</td>
<td>LATAM</td>
<td><a href="mailto:apallete@kpmg.com">apallete@kpmg.com</a></td>
</tr>
<tr>
<td>Alfredo Cobix</td>
<td>Partner, KPMG in Mexico</td>
<td>Mexico</td>
<td><a href="mailto:acobix@kpmg.com.mx">acobix@kpmg.com.mx</a></td>
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Agenda

01 Foreign country planning: the U.S. perspective

02 First things first: manage double taxation

03 Next step: review R&D incentives and withholding taxes

04 Country planning: financing & other

05 Discussion/questions
U.S. tax reform prompts foreign ETR planning

The United States has a worldwide tax system

— Annual determination of whether and how offshore income is taxed in the United States
  - GILTI is very broad; territoriality is very limited
  - More non-U.S. income is subject to immediate U.S. tax at varying statutory and effective rates

— Foreign tax credits remain the primary mechanism to address double taxation
More chances for foreign taxes to be a permanent cost

— Lower U.S. tax rates result in more “excess” foreign taxes from higher-tax jurisdictions

— Increased risk of double taxation
  - Numerous new and old limitations on the foreign tax credit
  - Mismatches between U.S. and non-U.S. timing rules can strand tax credits
The best way to avoid double taxation is not paying foreign taxes

— In light of BEPS/ATAD, there may be less reliance on offshore cross-border financing and IP planning and more reliance on:
  - In-country planning
  - Incentives

— Focus on both income and withholding taxes
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India – indirect transfer of assets (substance required and treaty protection)

**INDIA TAX IMPLICATIONS**

- **Capital gains tax on transfer of F Co. 2 shares** deriving substantial value from India assets
- **F Co. 2 shares deemed to derive substantial value** from India assets if:
  - Value of India assets > Rs. 100 Million ($ 1.5 Mn); and
  - India assets >= 50% value of all F Co. 2 assets
- **Exemption** if transferor has no mgt./control and voting power <5% in F Co.2
- **Reporting obligation** of I Co. if provision triggered *(penalty for nonreporting)*

**WAY FORWARD**

- **Analyze applicability of Indirect Tax Transfer rules**
- **Explore possibility of exemption / treaty benefits** by optimizing jurisdiction
- **Determine tax liability** and undertake necessary compliances

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<td>100%</td>
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<td>F Co. 2</td>
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<td>Indirect holding</td>
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<td>U.S.</td>
<td>India</td>
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<td>100%</td>
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<td>I Co.</td>
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Tax liability and reporting obligation on direct / indirect change in I Co. shareholding
Mexico – indirect capital gains tax

Tax considerations:
According to domestic tax law, an indirect capital gain is sourced in Mexico when:
— More than 50% of the book value of the shares derives directly or indirectly from real estate located in Mexico.

The tax is determined as follows:
a) Applying a 25% rate upon the sale price; or
b) Applying a 35% rate upon the net gain, subject to requirements:
   1. The seller is not subject to a preferential tax regime nor resident in a country with a territorial tax system;
   2. A Mexican representative is appointed; and
   3. A tax report prepared by a CPA is filed.
— Group restructuring tax deferral authorization may apply to certain cases, complying with requirements and filings. Authorization must be obtained prior to the restructuring taking place.
— DTT benefits may apply in certain cases. Case by case review required.
Brazil – nonresident capital gains

- Direct transfers or change in control => potential nonresident capital gains
- Progressive tax rates => 15% ~ 22.5%

- Indirect transfers are not taxable events => but “substance” analysis and risk assessment based on facts & circumstances needed

- Tax strategies => Specific tax-corporate structure (e.g. FIP)
  - Double tax treaties – limited application (Japan-Brazil Treaty)
China M&A tax – milestones (direct and indirect transfer)

Classification of enterprise reorganizations and the CIT treatment
Caishui [2009] No. 59

Supplementary Regulation on Circular 59
STA Announcement No. 4

Indirect Transfer
Guoshuihan [2009] No. 698

Supplementary rules for indirect transfer
STA Announcement No. 7
China indirect transfer – old circular 698

Circular 698 brings indirect transfers into China tax net

- Low tax
- No tax on offshore income
- Exemption for listed shares

Indirect transfer

- 30 days
- In-charge tax bureau of the PRC target

Reporting

- Commercial purposes
- GAAR
- Exception

Tax

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China indirect transfer – announcement 7

On 3 February 2015, the Chinese State Taxation Administration ("STA") issued Announcement 7 replacing the PRC’s indirect offshore equity disposal reporting and taxation rules in Circular 698

Comparison between the ‘old’ Circular 698 and ‘new’ Announcement 7

— Broader range of “Chinese taxable property”
  - Includes PE & immovable properties, in addition to equity interest
— Expanded scope of transactions falling within Announcement 7
  - Potentially includes share redemption
— Withholding tax ("WHT") mechanism
  - Affects both Buyer & Seller
— Extensive guidance on “reasonable business purposes”
  - Applies seven-factors test and introduction of “automatic deeming provision”
— “Safe harbor” rules
  - Open market trading, DTT relief and internal restructuring

Shuizongfa [2015] No.68

— Further clarified implementation of Announcement 7
— Clarified issuance of acknowledgment receipt upon reporting under Announcement 7
Mexico – CFC & hybrid mismatches

Payments made to foreign residents subject to a preferential tax regime, unless FMV under TP
• CIT rate < 22.5%

Deduction/No inclusion
• Interest, royalties and technical fees.
• Payments made to foreign related parties under common control:
  —Recipient is tax transparent (unless taxable at the level of its members);
  —Payment is disregarded by the recipient;
  —Payment is not taxable (not considered in computing the tax), unless taxable at the level of its members and residents in a country with broad exchange of information agreement.

Double Deduction
India – the GAAR web

**Trigger Event**

There is an arrangement

Such an arrangement results in Impermissible Avoidance Arrangement

There is a tax benefit

**Main purpose is to obtain a tax benefit**

Is entered into / carried out in a manner not ordinarily employed for bona fide purposes

Lacks / deems to lack commercial substance in whole / part

Gains on transfer of investments made prior April 01, 2017 - Grandfathered
Agenda

01  Foreign country planning: the U.S. perspective

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04  Country planning: financing & other

05  Discussion/questions
Next step: review R&D incentives
China - R&D super deduction

Increase in R&D super deduction rate
2018 expansion of the 75% R&D expense super deduction rate, which had previously been limited to smaller enterprises, to all qualifying enterprises nationwide; many of these had previously been limited to a 50% super deduction.

CIT super deduction for R&D outsourced overseas
2018 rule change, retroactive to January 2018, under which 80% of the amount of R&D activity-related payments, made to an overseas service provider, can now qualified for the super deduction. Companies who engages overseas subcontractors for R&D activities, due to lack of technical capacity or expertise in China, may benefit from this change and should review their existing arrangements.

Extension of loss carry-forward period
In 2018 was also clarified that, for High and New Technology Enterprises ("HNTE") and Science and Technology Small and Medium sized Enterprises ("STSMEs"), unused enterprise tax losses, incurred in the previous 5 years, are allowed to be carried forward for another 5 years. This includes losses incurred prior to the enterprises qualifying as a HNTE or STSME. In consequence, technology enterprises can now enjoy a relatively long tax loss carry-forward period (i.e., 10 years, vs the standard 5 years), which should encourage them to make upfront investment where necessary.
Mexico – tax incentive for technological research and development projects

30% of the expenditure and investments made during the FY.

Creditable against the income tax of the year – and in the following ten years.

Authorization granted by the Inter-Institutional Committee – not an automatic credit.

Establish commitments for the development of prototypes and equivalent deliverables, as well as the generation of patents that must be registered in Mexico.

Taxpayers requirements:

- Informative return - expenditures and investments made, validated by a registered CPA.
- Computer system to provide the application of the resources of the incentive in each expenditure and investment.
Next step: review withholding taxes
Brazilian WHT tax rates are in general standard 15% or 25% (beneficiaries located in a low tax jurisdiction).

— Potential WHT tax reductions alternatives:
  - Double tax treaties
  - WHT exemptions for specific type of loans
  - WHT exemptions for special type of bonds

— Currently dividends distributions are exempted (but Tax Reform discussions may impose taxation).
Mexico – use of DTT

OECD member since 1994

One of the largest DTT network in LATAM – 61 in force and 15 in negotiation
—OECD and UN models
—Latam, EU and Asia

Requirements:

- Beneficial owner analysis.
- Tax residency certificate or last Federal Income Tax Return filed.
- Statement signed under oath by legal representative crediting double taxation.
## India – treaty applicability on dividend distribution tax

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<th>Taxability of Dividends</th>
<th>DDT under Act</th>
<th>Tax rate for Dividend under the treaty</th>
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<td>20.56%</td>
<td>5% / 10% / 15%</td>
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### Arguments in Favor

- DDT is tax on dividends and is governed by Article 10 of the Treaties.
- SC decision in the case of Tata Tea Ltd.
- Legislative intent was to recover tax on dividend (which is income of the shareholders) from the Company.
- Possible to invoke treaty benefit by Indian residents for determining tax liability in India.

### Arguments Against

- DDT is a tax on the dividend paying company and not on the shareholder; there is no double taxation of dividends for the shareholder.
- A treaty applied where a resident of one Contracting State derives income from another Contracting State.

### Way Forward

**Approach 1** - Making a claim for refund of DDT by way of notes to the tax return / in the course of assessment / CIT(A) / ITAT proceedings and litigate in regular course.

**Approach 2** - Obtaining an advance ruling from the AAR – this approach would help in attaining certainty.
India – LLP - edge over company

Key Advantages of operating under LLP structure

- Not liable to Dividend Distribution Tax (DDT) @ 20.56% - Tax free profit repatriation
- Share of profit from LLP exempt from tax in hands of partners
- Change in profit sharing ratio / admission of new Partner does not restrict carry forward of losses (except in case of retirement of a partner)
- Not liable to MAT on book profits [subject to AMT - which is limited in scope as compared to MAT]

Possible to migrate existing Companies to LLPs in a tax efficient manner
Recent decision of Mumbai Tribunal in the case of Celerity Powers LLP
China – claiming DTT benefits to lower WHT

Non-resident enterprises repatriating profit from China

Dividend, Interest, Royalty
- 10% domestic WHT can be reduced under DTTs.
- Commercial substance based beneficial ownership assessment for DTT benefits – 5 negative factors.
- Dividend reinvestment in China to enjoy WHT deferral treatment.

Capital gains
- Direct disposal WHT 10% can be reduced (typically minority shareholdings).
- Indirect disposals caught if arrangements lack reasonable business purposes.
- Assess with 7 factors.
- Safe harbors
  - Open market trading
  - DTT relief
  - Internal restructuring

Service fee
- DTT PE article protects from tax – Service PE typically 183 days.
- Technical services, services involving know-how transfer risk royalty characterization.
- Local tax authority practices can impose WHT by default.

Ben. ownership safe harbor
- Government, Individual, listed enterprises of DTT partner state, and same country enterprises held 100% by the above
- Ben. Own. ‘derivative benefits’ test
  - If DTT relief claimant parent co:
    - Is tax resident in same country, or in country with same benefits DTT
    - Passes the negative factors tests then DTT relief granted
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Country planning: financing
Mexico – SOFOM

Summary
— Foreign ParentCo grants a loan to SOFOM, which finances to MexCo.

Tax Benefits
— 4.9% WHT applicable to interest paid by the SOFOM. ParentCo can reside in any country.
— Thin capitalization rules not applicable to interest paid to the SOFOM by the MexCo because payment is made to a Mexican entity.
— SOFOM considered as part of the financial system - thin capitalization rules would not apply to the SOFOM to interest payments made to foreign related party.
— No Value Added Tax (VAT) applicable to the interests paid to or from the SOFOM.
— Guarantees to mitigate back to back loan rules - application must be considered in the loan agreements.

Additional Comments
— Withholding tax on interest payment is triggered at the first to occur of due date or payment date.
Brazil – interest on net equity

Interest on net equity (INE)

— Tax deductible payment:
  - INE local legislation allows for yearly remuneration (interest) on capital. The amount of INE payable is **deductible for CIT purposes** in Brazil (at 34%).

— Withholding taxes
  - General rate of 15% WHT, 25% if shareholder is resident in a tax haven jurisdiction. Tax sparing credits may apply under DTTs.
  - Net benefit in Brazil will be **19% reduction**.

— Double tax treaties in force may optimize INE benefits.

— **Important**: Brazilian tax reform could impact INE computation and tax benefits
India

Various modes of financing Indian subsidiaries

**Equity**
- Dividend paid by the company shall be subject to dividend distribution tax (DDT) @ 20.56%. Dividend shall be exempt in the hands of recipient.
- Dividend paid shall not be tax deductible in the hands of company.
- Long term capital gains shall be taxable @ 10.92%. Short term capital gain shall be taxable @ 43.68%.
- Gain shall be taxable as long term, if held for > 24 months.

**CCD**
- Interest expense shall be tax deductible.
- Interest income shall be taxable @ 43.68%. However in case treaty benefit is available, then WHT may be around 7.5%-15% (As per India-US tax treaty applicable WHT rate is 15%)
- On conversion of CCD into equity, period of holding shall be available.
- Capital gains implications same as equity.

**ECB**
- DTT Interest shall be tax deductible.
- Reduced WHT on interest payment @ 5.46% as per S.194LC for loan agreements entered before 1st July 2020.
- No tax on repayment of ECB.
Country planning: other
Mexico – sale & lease back

Sale & lease back

Main benefits:

— Step up on the tax basis of the operative assets
— Higher Mexican deduction
— Lower foreign credit from a U.S. perspective

(1) Sale through a financial leasing

(2) Leasing

(3) Merger

AssetCos (Mexico) — SPV
Recognition of the inflationary effect as part of the deduction.

YEAR 1
- Acquisition of goods
- Raw material
- Finished and semi-finished products

Cost of Sales

Inflationary adjustment

YEAR 2

$ Sale of products

Mexico – tax deduction revaluation cost of sales
China – ETR reduction

- Increase R&D investment
- Group Losses utilization
- Transfer Pricing
- IP Structuring
- Extending loans for foreign related companies
Brazil – step-up and goodwill

**Step up and goodwill amortization**

— Reducing ETR:

  - **Step-up** on the basis of assets and **goodwill** could be tax amortized upon the merger of involved companies.

— Other aspects:

  - FIP “exit” strategy.

— Considerations:

  - PPA.
  - **Substance**
Brazil – reduce taxation on IP payments

Cross border IP payments

— **Transfer of IP** to Brazil (e.g. sale, capital contribution)

- **Reduction** on the tax burden of cross border payments (potential elimination of WHT, CIDE, PIS, COFINS, ISS, IOF taxes).

- Potential **tax amortization** (depending on IP characteristics).

- **Debt** for acquisition could generate tax deductible expenses (provided thin cap and other requirements are met).

— Case by Case analysis
Questions
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