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Keeping abreast of tax matters

Tax Times
December 2010

Our newsletter features a variety of practical guidelines, tax law updates, news briefs and definitions of local and international taxation

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Foreword

This new edition of Tax Times comes to you with a totally revamped look within our new visual identity. This change is about much more than our logo. Our brand includes our identity, what it's like to work with us, how we behave, as well as our capabilities. All together, this is the **value** we create for you.

In this edition, we bring to you a VAT perspective on the application of VAT R32, which deals with the taxability of a lump sum payment where we conclude that the VAT implications can be completely different if considered otherwise.

One of the purposes of Tax Times is to keep you abreast of fundamental issues and possible ambiguities that exist in the tax legislation in Mauritius. We analysed the fairness of Section 21 of the VAT Act which deals with the non-recoverability of certain types of input VAT. We also look at the hardship endured by the taxpayers in complying with the application of Tax Deduction at Source.

As regards to tax treaty issues, we comment on the application of the non-discrimination clause as per article 24 of the OECD model subject to a recent court case in India.

As always, our team of tax professionals are here to answer any of your queries in relation to the articles published in this newsletter. We also look forward to receiving your comments and suggestions on **tax.times@mu.pwc.com.**

Enjoy the reading!

Best regards

The Editorial Team

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Analysing VAT R 32

By Ryan Allas

Definition of supply

According to Section 4(1) of the Value Added Tax Act 1998 ('the Act'), a supply of services is defined as the performance of services for a consideration. A supply of goods means the transfer for a consideration of the right to dispose of the goods by the owner.

Anything which is not a supply of goods but is done for a consideration including, the granting, assignment or surrender of any right is a supply of services. The Third Schedule to the VAT Act gives further guidance as to what constitutes a supply of goods or services.

A taxable supply means a supply of goods in Mauritius, or a supply of services performed or utilised in Mauritius made by a taxable person in the course or furtherance of his business.

VAT R 32

Facts

A Ltd is engaged in the provision of management services, including financial and human resource services to related companies. B Ltd, which operates a Hotel, is a related company in which A Ltd owns 23% of the total share capital. A Ltd derives management fees from B Ltd as a consideration for the service it provides to this company under a management agreement.

There is, however, no formal written management agreement between the two companies.

Pursuant to a restructuring exercise, the arrangement between the two companies is terminated and consequently B Ltd compensates A Ltd for a sum of Rs 203 million, based on an independent valuation. The consideration for the compensation is by way of shares, so that B Ltd issues new shares to A Ltd.

Points of issue

Confirmation that-

(i) the compensation receivable by A Ltd is outside the scope of the VAT Act, as it is not a consideration for a supply of services but instead a receipt of capital nature, being compensation for the loss it will suffer subsequent to the termination of the management contract.

(ii) A Ltd would not be required to disclose the transaction in its VAT return as it is not a supply and is neither a zero-rated supply; nor an exempt supply.

(iii) Since A Ltd would not charge VAT on the compensation payment, the question of input tax does not arise.

Ruling

(i) On the basis of the fact that the compensation is not provided in any written contract between A Ltd and B Ltd, the amount receivable by A Ltd is a consideration for the surrender of a right and therefore constitutes a supply in accordance with the provisions of Section 4 (2) (b) of the VAT Act.

(ii) & (iii) The issues raised in the circumstance do not arise and A Ltd will therefore be required to disclose the transaction in its VAT return and also charge VAT at the appropriate rate in that respect.

Our View

In determining whether VAT must be applied on the compensation paid by B Ltd to A Ltd, we need to determine whether-

1. The amount received by A Ltd is actually for the surrender of a right; or
2. The compensation is for the supply of a service to B Ltd.

The VAT treatment for the compensation therefore depends on whether the payment made by B Ltd is for the breach of contract or the surrender of a right. As stated above, the surrender of a right falls under the purview of Section 4, and it is considered to be a taxable supply.

Since there was no management agreement between A Ltd and B Ltd, we cannot consider the payment by B Ltd to A Ltd as being a payment for the surrender of a right. In our view, the payment for the termination is more akin to a voluntary/consensual settlement. In the absence of a contractual relationship between A Ltd and B Ltd, the payment for the termination of the arrangement would be regarded as consensual, that is, an amount not provided for in any formal agreement and agreed by mutual consent between the parties concerned. In such a case, the amount received by A Ltd cannot be categorised as a payment for the surrender of a right and hence - in our view - there is no supply of services by A Ltd to B Ltd. Under our recommended treatment, the payment should be treated as an amount which falls outside the scope of VAT as A Ltd has not provided any services to earn that amount.

Did You Know?

With effect from 1 April 2010, diplomatic missions and agents are entitled to exemption from VAT on their purchases of taxable goods, provided that they hold a VAT exemption card issued jointly by Director-General MRA and Secretary for Foreign Affairs.

Tax Practice

Practical issues with the Application of Tax Deduction at Source

By Bobby Yerkiah

The Income Tax Act 1995 ("the Act") provides that a payer is required to deduct income tax from an amount that is being made available to a payee at a rate as provided below:

Amount or sum made available to the payee by way of -	Rate of tax
1. Interest	15 per cent
2. Royalties -	
(a) a resident	10 per cent
(b) a non-resident	15 per cent
3. Rent	5 per cent
4. Payments to contractors and sub-contractors	0.75 per cent
5. Payments to providers of services	3 per cent

Tax Deduction at Source ("TDS") is an advance payment on the gross receipts of a person pending the final submission of the annual tax return. The Act does not distinguish between a person who is taxable and someone who is not taxable. However, a non resident société, a company holding a Category 1 Global Business Licence and a non resident individual are not subject to TDS, while TDS on certain payments such as interest only applies to financial institutions.

It is worth pointing out that under Section 111H of the Income Tax Act, where the Director-General of the Mauritius Revenue Authority (" the Director-General") is satisfied that the payee would not be chargeable to tax on his income he may, on application by the payee, direct the payer not to withhold any tax on the payments made to the payee.

For example, if a person provides services in Mauritius he will be subject to TDS on any amount that he receives. However, if that same person provides the services from outside Mauritius and he is not taxable in Mauritius, the payer is still liable to withhold TDS on any amount paid to the service provider. As stated above, the service provider can however under the Act apply to the Director-General for a notice not to apply TDS.

Currently, there is no guidance in respect of the application procedures for the non deduction of TDS. It is not clear what documentary evidence is required to prove the non taxability of the person and there is no deadline within which such a direction would be given. Therefore, any delay in the above process would cause unnecessary hardship to the payee and it would be useful if the MRA could issue appropriate guidance.

Further, where a person has suffered TDS, it is understood that the Director-General should, after being satisfied that the person is not subject to tax, refund the amount withheld in a reasonable delay although the Act does not prescribe any specific deadline to do so. Thus, any person withholding TDS should, under Section 111K of the Act, issue the payee with a statement of tax withheld which should be sufficient and conclusive evidence for the payee to claim a refund of the tax withheld, should the payee find himself in a position of tax overpaid at close of his fiscal year.

In certain cases, it may happen that the payer does not, as required under the Act, remit the tax withheld to the Director-General. However, this should not be a condition for not refunding the tax if the claim is properly supported with a statement that the deduction has been made. The payee cannot be held responsible for the non compliance of the payer as the Director-General has other means to deal with this, such as the right to prosecute a non compliant payer and charge penalty and interest on any tax not remitted.

Since its introduction in October 2006, TDS has been instrumental in increasing the tax base and tax compliance in Mauritius. It has helped the Mauritius Revenue Authority to bring more taxpayers within the tax net as many taxpayers were not previously declaring such income. However, the TDS scheme should not be used as a tool for tax collection only and, where applicable, refunds should also be processed. A review of the current practices is required and this should enhance the quality of the tax service towards the compliant taxpayer.

Tax Treaties

Non-Discrimination Article in Tax Treaties - a practical analysis

By Cathie Hannelas

The Mumbai Income Tax Appellate Tribunal recently ruled, in the case of State Bank of Mauritius Ltd v. DDIT, that Article 24 – Non Discrimination ("the Article") of the Mauritius-India Double Tax Agreement ("DTA") did not prevent India from charging a higher tax rate on a Mauritian company operating through a branch in India compared to an Indian resident company.

Looking at the facts

During the year of assessment 1998-1999, the State Bank of Mauritius ("the State Bank") carried banking activities in India through its permanent establishment ("PE"). The tax rates for domestic companies and foreign companies were then at 35% and 48% respectively.

The State Bank relied on Article 24 of the Mauritius-India DTA and computed its tax liability at the rate of 35% when submitting its tax return. Paragraph 2 of Article 24 of the DTA reads as follows:

The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities in the same circumstances.

It was concluded during the tax audit of the State Bank that the tax rate to be applied was 48% and that Article 24 of the DTA was not applicable in the present case. The view was sustained by the Commissioner of Income Tax Appeal ("the Commissioner") and the State Bank lost its appeal.

On appeal by the State Bank against the decision of the Commissioner, the Tribunal was also of the opinion that the State Bank should be taxed at the rate of 48%. Its reasoning was based on the following-

- The State Bank did not meet the criteria of a domestic company as per the Indian Income Tax Act as it did not pay dividends within India out of income taxable in India.
- A domestic bank and a PE of a foreign bank are not subject to the same banking regulations and are therefore not considered as operating in the same circumstances as prescribed in Article 24.
- The wording "less favourably" in Article 24 did not refer to the application of a higher tax rate.
- The tax rate is prescribed by the Finance Act and not by the Income Tax Act. Thus, even if Article 24 of the DTA is more beneficial than the Income Tax Act to the taxpayer, the higher tax rate can still be applied as the rate is not set by the Income Tax Act.

Our analysis

Based on the above, the provisions of paragraph 2 shall apply only if the PE is carrying the same activities and under the same circumstances as a resident enterprise in that state.

It is not always easy to determine whether a PE is operating in the same circumstances as an enterprise resident in that state. The expression "in the same circumstances" refers to a taxpayer being subject to substantially the same laws and regulations. Therefore, to be considered as operating in the same conditions, a PE should operate in a similar legal structure as the resident enterprise. To illustrate what would not fall under the same circumstances, the OECD Model Tax Convention on Capital and Income ("the Model") may provide some guidance and gives the example of regulated activities as opposed to unregulated activities. The commentary in the Model refers to a PE involved in the borrowing and lending of money (not registered as a bank) as not being in the same circumstances as a registered bank doing banking business in the state. In the case of the State Bank, the Tribunal relied on the fact that the State Bank is not subject to the same banking regulations as a domestic bank in India. Therefore, the question is whether such "regulation gap" places the State Bank in a substantially different position compared to a resident bank in India which justifies imposing a higher tax rate on the State Bank. The Tribunal also emphasized the fact that the State Bank did not meet the criteria of a domestic bank as it did not pay any dividends within India out of its income in India. Paragraph 2 of Article 24 deals with the taxation of a PE and it does not mention rules such as distribution of profits, consolidation of accounts and transfer of losses. These rules are considered to fall outside the purview of Article 24 and besides, in most circumstances, we do not expect a PE to pay dividends. Therefore, the non distribution of dividends should not be a criterion to prevent the State Bank from availing itself of the provisions of the Article.

The taxation of a PE is dependent on the applicable tax rate. If a PE in India is taxed at a higher rate then the requirements of Paragraph 2 of Article 24 may not be fulfilled, since the taxation of the PE, operating under similar circumstance as a resident of India, would be taxed less favourably. The tax rate cannot be dissociated with the taxation of the PE.

Conclusion

In order to obtain protection under Article 24 of the DTA, a PE needs to carry out activities that are similar to and that are carried out in the same circumstances as an enterprise resident in the particular state. Whilst it may be argued that determining whether the PE is carrying the same activities as the resident enterprise poses less difficulties, it is acknowledged that determining whether these are carried out in the same circumstances may be more challenging. However, the Model in the present case gives sufficient guidance as to how to address that issue.

Tax Briefs

Russia

Ministry of Finance – deductibility of expenses for managing another company clarified

Deductibility of expenses for managing related company is clarified by the Ministry of Finance in its Letter dated 6 October 2010 (N 03-03-06/1/637).

Based on the general rule provided in the Tax Code, all justified and documented expenses incurred by a taxpayer are deductible.

According to the Ministry, if a company incurs expenses for managing a related company (e.g. expenses for representation and business trips for negotiations with potential contractors of such a related company) and no contract was concluded for such services, the expenses are treated as non-deductible. For such expenses to be deductible, the fact of their provision and their "onerous character" must be properly documented.

Romania

New tax introduced replacing AMT

On 29 September 2010, the Government announced that:

- as of 1 October 2010, the annual minimum tax is abolished; and
- with effect from 1 January 2011, a new tax will be introduced for companies operating in economic areas where tax evasion is prevalent.

China (People's Rep.)

Tax treatment of losses in respect of equity investment clarified

A Notice (SAT [2010] No. 6) was issued on 28 July 2010 by the State Administration of Taxation (SAT) to clarify the tax treatment of the losses incurred by an equity investor.

The Notice is applicable retroactively as from 1 January 2010. The losses incurred by an equity investor may be deducted on a one-off basis in determining the taxable income of an enterprise in the tax year in which the losses are recognized.

Any unsettled losses relating to such investments incurred ***before*** the issue date of the Notice (i.e. 28 July 2010) may be deducted on a one-off basis in 2010.

Australia

Discussion paper on taxation of Islamic Finance released

On 13 October 2010, the Board of Taxation released, for consultation, a Discussion Paper on the taxation of Islamic Finance.

The purpose of the paper is to identify issues associated with Australia's current approach to the taxation of Islamic Finance products, including income tax, withholding taxation, GST and state taxes.

The paper highlights a number of common Islamic Finance arrangements, such as *murabaha, sukuk, ijara, musharakah*, etc.; and provides an analysis of the economic substance of the arrangement together with possible Australian tax treatment of the parties to the arrangement under the current rules.

The paper also requests for the following:

- comments on the Australian taxation implications;
- input on the possible legislative changes that would be required to achieve tax neutrality between the treatment of Islamic Finance arrangements, and that of conventional financial arrangements of the same economic nature;
- a brief overview of taxation rules that deal with Islamic finance in selected foreign jurisdictions.

Belgium

Taxation of sportsmen clarified

Circular (CiRH 241/603.774) of 2 July 2010 issued by the Belgian Tax Administration clarifies the taxation of foreign sportsmen in Belgium.

- Currently, payments to non-resident sportsmen are subject to a final withholding tax of 18%, which is levied on the gross payments, including benefits and reimbursed costs.
- Non-resident sportsmen carrying out their sporting activities in Belgium for a period of more than 30 days over a continuous period of 12 months are, however, subject to income tax at the normal rates, based on Arts. 228(2)(8) and 232(1)(2)(c) of the Belgian Income Tax Code (ITC).

The Circular clarifies that:

- Training days in Belgium must be taken into account for the calculation of the above-mentioned 30-day period.
- Where a sportsman has several employers or principals, and he carries out his sporting activities in Belgium for more than 30 days for one employer or principal but for less than 30 days for another, his entire income is subject to income tax at the normal rates.
- The employer or principal for whom the activities are carried out for less than 30 days in Belgium may still withhold 18% withholding tax, but this tax is no longer final.

Tax Fundamentals
How fair is Section 21 of the VAT Act?

By Shameemah Raman-Sahebally

A fundamental concept of Value Added Tax ("VAT") is that a VAT registered person making taxable supplies is allowed to recover any input tax he has suffered against any output VAT he charges to his customer.

However, under most VAT legislations, there are specific circumstances where the registered person is not allowed to recover input VAT. The Mauritius VAT Act ("the Act") contains similar provisions under Section 21 and some examples are input tax on -

(a) Accommodation;
(b) Lodging and catering services;
(c) Reception; and
(d) Entertainment.

Although the input VAT on the above items may be incurred in making taxable supplies, the rationale for disallowing the input VAT might be understandable. In general, any input tax incurred in respect of private consumption should not be allowed as these do not relate directly to the taxable supplies. Moreover, Section 21 reduces any risk of abuse by the taxpayer.

For a VAT registered person, input tax is the amount he incurs in the course or furtherance of his business which is commonly referred to as the "business purpose rule"- a rule which is equally applicable under the UK VAT Act and which represents the guiding principles in respect of the recovery of input VAT. This principle is also applicable in Mauritius and is set out under Section 21(3)(a) which provides that where goods or services are used to make a taxable supply, the credit in respect of those goods or services shall be allowed in full.

Section 21 also provides that input tax should not be allowed on certain specific items as contained therein and as set out below:

(a) Motor cars for own use;
(b) Repairs of motor cars; and
(c) Gas oils used in engines, other than stationary engines, boilers and burners.

However, the rationale for disallowing the above items does not necessarily follow the "business purpose rule".

In many businesses, motor cars are used for making taxable supplies and therefore any input tax on the motor cars should be incurred for the purposes of making those taxable supplies. On the other hand, if the motor cars are used for private purposes the input VAT cannot be deemed to be for the furtherance of the business and therefore, disallowed.

However, section 21 does not follow the above principle and provides that input VAT on motor cars should be disallowed irrespective of whether these are used for the purpose of the business. This is unfair as any element of VAT on the motor cars, used for business purposes, will constitute a cost to the VAT registered person.

Under the Income Tax Act, motor cars used for business purposes are eligible for capital allowances. All repairs, leases and the cost of fuel in relation to motor cars are treated as deductible expenses. Such an approach is in line with the principle of taxation, that is, any expenses incurred to produce an income are allowed against that income.

It may be argued that somewhere in the mind of the legislator, it was clear that motor cars used for business purposes are allowable items. Therefore, the different approach for VAT as compared to income tax is without ground and is causing unnecessary hardship to the registered taxpayer.

Another example which goes against the principle of VAT recovery is the non eligibility to claim input VAT in respect of gas oils on engines that are not stationary, including gas oils on tractors, forklift, generators and purposely built vehicles such as collectors of wastes. This issue has, in recent years, been the subject of major litigations before the tax courts and it has been ruled that since the above plant and machinery are movable, input tax cannot be claimed by the registered person in accordance with the Act.

Gas oils, in the abovementioned cases, are exclusively used to make taxable supplies and the rationale for not allowing input VAT thereon is incomprehensible.

From a VAT registered person's standpoint, the non recovery of the input tax increases his cost and negatively affects his cash flow.

It is now over 12 years since VAT has been introduced in Mauritius and, in most countries, tax legislations are fine-tuned to cater for the evolving nature of economic transactions and circumstances. A review of section 21 of the VAT Act, particular addressing the above points would be necessary to align local practices with international norms.

Did you know?

Under section 124(1)(b) of the Income Tax Act, every person should furnish, on request by the MRA, such information as is demanded of him to enable the MRA to comply with any request for the exchange of information under a tax treaty. The provisions of this sub-section also apply to banks.

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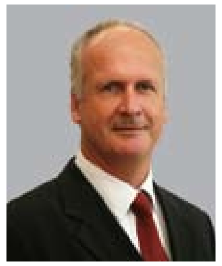

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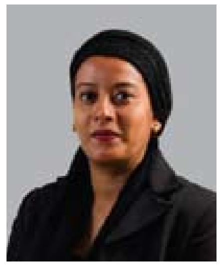

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