BDO International

BDO World Wide Tax News

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BDO World Wide Tax News

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Tax Partner

Welcome to the January Issue of BDO World Wide Tax News, which summarises important recent tax developments of international interest across the world. If you would like further information on any of the items featured, or would like to discuss their implications for you or your business, please contact me or one of the team. The material discussed in this newsletter is meant to provide general information only and should not be acted upon without first obtaining professional advice tailored to your particular needs.

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People's Republic of China

China introduces withholding tax

The existing Foreign Enterprise Income Tax Law of the People's Republic of China exempts non-residents from Chinese dividend withholding tax.

However, under the new Enterprise Income Tax Law, a withholding tax will apply as from 1 January 2008. The published rate is 20% but under the Implementation Rules issued on 11 December, just before we went to press, the rate was reduced to 10%. The 10% rate corresponds to the maximum withholding rate under several of China's double tax treaties (e.g. with Germany, the Netherlands, the UK and the US).

Below we outline some strategies for minimising the impact of the new rules.

Avoiding dividend withholding tax

Where this is still possible, companies should seriously consider paying up the maximum dividends prior to 1 January 2008, thus avoiding the new tax. However, interim dividends cannot be paid since annual audit and annual-settlement tax filing will not have been performed before the year-end. Dividends should therefore be paid out of profits that have arisen to 31 December 2006. Companies are basically free to arrange for funds to be remitted from China in payment of the dividend, provided that they submit certain documents to a designated bank for processing the remittance.

It should be noted that 10% of post-tax profits must be placed in a statutory reserve prior to dividend payment.

Although interim dividends for the year of 2007 cannot be paid, it may be beneficial for the company internally to declare but not pay an interim dividend with evidence of the board minute and record in its accounts before 31 December 2007. This declaration may be helpful and increase the possibility of paying the dividend free of withholding tax after 1 January 2008 once the accounts are finalised, although this depends on the terms of the new law.

It will be necessary for finance to be available to pay the dividend. It should be noted that interest on funds will be disallowed if the borrowings can be directly related to payment of the dividend.

Double tax relief under a tax-with-credit system

In countries that tax foreign dividends but give relief for some or all of the foreign tax suffered (e.g. Canada, UK, US), strategies need to be considered on how to preserve the maximum amount of double tax relief when receiving dividends from Chinese subsidiaries. Taking the UK as an example, and assuming the Chinese subsidiary is held directly from the UK, it will need to be calculated whether the dividend repatriation will provide sufficient double tax relief to extinguish the UK corporation tax liability. Where the subsidiary has benefited from a tax incentive it should be borne in mind that tax-sparing relief may be available under the terms of the double tax treaty between China and the home jurisdiction.

Participation exemption for foreign dividends

In countries that operate an exemption system for foreign dividends, double tax relief will not be an issue but it will be equally important to reduce if not eliminate the Chinese withholding tax, for which relief will not be available.

For dividends from 2008 onwards, parent companies in jurisdictions without a tax treaty with China will suffer the full 10% rate of withholding tax. For those countries with treaties providing for reduced rates, the reduced rate will apply. It is unlikely, incidentally, that this could be avoided by liquidating the company as the definition of distributions in China's tax law is wide.

A number of China's treaties provide for a 5% rate of dividend withholding tax. Given that the general rate is 10%, restructuring investment into China to take advantage of the 5% rate may be worth consideration.

Chinese capital gains tax

China will also be imposing a 10% withholding tax on capital gains from non-residents' disposals of shares in a Chinese company. Thus a company entitled in its home country to a capital gains exemption on the disposal of shares in a Chinese subsidiary will lose some of its benefit.

However, a considerable number of China's tax treaties currently reserve the taxing rights to the state of residence only and thus exempt the gain from Chinese tax. As a broad-brush approach it might be worth considering a transfer of the Chinese shares to a company resident in one of those jurisdictions. Care needs to be taken that a participation exemption will exempt the dividends and gains realised.

An alternative might be to transfer the shares to, say, a stand-alone Hong Kong subsidiary (5% dividend withholding), eventually selling the shares in that company and negotiating the CGT discount. Chinese CGT would not apply to the sale.

In principle, Chinese capital gains tax would apply to the transfer of the Chinese shares to the new holding company. However, under a PRC Tax Circular (*Guoshuihan* [1997] No. 207), the transfer, for group restructuring purposes, may be effected without incurring tax if the shares are sold to a 100% subsidiary or fellow-subsidiary, provided that the transfer is made at cost.

It is highly preferable that there be an underlying commercial purpose to the transfer, especially because the new Enterprise Income Tax Law has introduced a general anti-avoidance provision under which the tax authorities may make adjustments to arrangements executed without a commercial purpose. The Implementation Rules contain no guidance on this provision.

Chinese stamp duty at 0.05% would be payable on the transfer of value mentioned in the sale agreement. The new Implementation Rules do not appear to have made any change in this regard.

See also under China.

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North America and the Caribbean

Canada

Withholding tax eliminated on foreign arm's length loans

Under legislation that has just received Royal Assent, Canada will eliminate all withholding tax on interest paid to arm's length non-resident lenders, with effect from 1 January 2008. Originally, the intention was to take this measure once the protocol to the US-Canada treaty (see *BDO World Wide Tax News* 2007 Issue No. 3) took effect, but the Government brought it forward.

Under the Income Tax Act as it previously stood, withholding tax was levied at 25% (unless a tax treaty provided for a lower rate) on any interest on a loan that did not comply with the so-called '5/25 rule'. This stipulates that Canadian-resident corporations do not have to deduct withholding tax on interest under a loan from a foreign arm's length lender which is for a term of at least five years and does not require more than 25% of the principal to be repaid in the first five years.

The new rules apply to all loans other than participating loans, although there is doubt over the status of convertible loans and certain other debt instruments.

Related US lenders

The new rules will not apply to loans from related lenders. However, related US lenders will benefit from the new protocol to the US-Canada treaty, which will reduce the current 10% withholding rate to 7% in the first calendar year in which it is in force, 4% in the second year, and nil thereafter. The Protocol still needs to be ratified, and will not enter into force any earlier than 1 January 2008. Non-related US lenders will benefit from zero withholding under the protocol from a date two months after it comes into effect (from 1 March 2008 at the earliest, therefore), and of course also under the new Income Tax Act rules.

Tax cuts promised in Economic Statement

Corporate and personal tax reductions were promised by Canada's Minister of Finance, Jim Flaherty, in his Economic Statement recently.

On the corporate tax side, the Minister announced further reductions to be phased in over the next five years, in addition to those already scheduled. Currently, in the year 2007, the general rate of federal corporate income tax is 22.12%. It is already scheduled to be reduced gradually to 18.5% by 2012, but the Government now plans to reduce the rate to 15% by 2012. The proposed rate for 2008 is 19.5% (instead of the previously announced 20.5%). In addition to the federal corporate tax, Canadian corporations must also pay provincial corporate income taxes. The Minister also announced that he will try to obtain agreement from the provinces and territories on a combined corporate rate of no more than 25%. This promises to be difficult, as it would require all the provinces and territories bar one to reduce their corporate tax rates, in some instances substantially. Further reductions in the small business rate are also planned. This was scheduled to fall in two phases from 13.12% in 2007 to

11% in 2009. The reduction to 11% will no longer be staggered but take full effect from 1 January 2008.

When the current minority Conservative government came to power in 2006, one of its incoming pledges was to reduce the rate of GST (goods and services tax – Canada's equivalent of VAT) from 7% to 5%. A 1% cut took effect on 1 July last year (2006); the remaining 1% cut will now take effect from 1 January 2008.

On the personal tax side, Mr Flaherty announced that the lowest rate of federal income tax would be reduced retroactively from 1 January 2007 from 15.5% to 15%, while the 'basic personal amount' (deductible by all taxpayers from their taxable income would be increased to CAD 9600 (EUR 6425; USD 9475)) again backdated to 1 January, with further increases tabled for 2009.

For further information on either of these items, contact John Wonfor of BDO Dunwoody on +1 416 865 0111 or by e mail at jwonfor@bdo.ca

United States Of America

First notification under Mutual Agreement Procedure

The US and UK authorities have agreed on the definition of 'first notification' under the Mutual Agreement Procedure (MAP) of the UK-US double tax treaty. This is important for taxpayers who wish to invoke the MAP to redress what they perceive to be incorrect taxation under the terms of the treaty.

Article 26 of the treaty provides that taxpayers wishing to invoke the MAP must present their case to the appropriate competent authority within three years of the first notification of the action or non-action that in the taxpayer's opinion gives rise to taxation not in accordance with treaty provisions. 'First notification' means the date on which all domestic remedies have been exhausted. Alternatively, taxpayers have until six years from the end of the tax year or chargeable period in respect of which the relevant tax has been or is intended to be charged, if this is later.

The two tax authorities have now agreed that, in the case of the US, that first notification will be deemed to be the latest of:

- the date of an assessment issued under a notice of proposed adjustment or a statutory notice of deficiency and
- the acceptance of a closing agreement by the US Treasury Department and
- where the taxpayer is a party in a court action for redetermination of a tax liability or a refund of tax, the date when the action is finally resolved and all appeal processes exhausted

In the case of the UK, first notification occurs on the later of:

For US loans to Canada see under Canada

- the date of issue of a statutory notice concluding an assessment and any related appeal procedures for the period in question and
- the date on which an officer of HMRC (the UK tax authority) accepts settlement terms for the period in question

The agreement also makes it clear that these provisions in the article will be interpreted in the way most favourable to the taxpayer.

For further information on the US aspects of the protocol, contact Bob Pedersen of BDO Seidman on +1 212 885 8000 or by e-mail at rpedersen@bdo.com. For the UK aspects, contact Nick Udal of BDO Stoy Hayward on +44 207 486 5888 or by e-mail at nick.udal@bdo.co.uk

Mexican flat tax will attract US credit for now

The Internal Revenue Service (IRS) has announced that, at least for the time being, it will not challenge a claim by a US taxpayer for a foreign tax credit in respect of Mexico's new flat-rate business tax (*impuesto empresarial a tasa única* – IEUT).

The new tax, fuller details of which can be found in *BDO World Wide Tax News* Issue 2007 No. 3, functions as a minimum tax, and is payable only to the extent that it exceeds the taxpayer's normal income tax liability. It is charged at 17.5% on a cash-received basis, with limited deductions.

The IRS is conducting a study to determine whether, in its view, the IEUT is an income tax eligible for relief under the US-Mexico double tax treaty. In the meantime, however, taxpayers may claim a credit for any IEUT paid, within the normal rules. If the IRS eventually concludes that the IEUT is not an income tax for treaty purposes, there will be no retrospective clawback of the credit.

For further information on the IETU, contact Eduardo Díaz of BDO Hernández Marrón y Cía on +52 55 59 013930 or by e-mail at e.diaz@bdo.com.mx

FIN48 postponed for private companies

Non-public entities have been granted a one-year deferral by the Financial Accounting Standards Board (FASB) on implementing FASB Interpretation No. 48, *Guidance for Accounting for Uncertainty in Income Taxes*.

The Interpretation, known as FIN 48, will now take effect for periods beginning after 15 December 2007, to those non-public entities not already implementing it. The deferral applies to all such entities, including S-corporations and pass-through entities.

FIN 48 was issued in July 2006, to have effect for years beginning after 15 December 2006 (2007 for most non-public entities). It clarified how corporations and other entities should account for uncertainty in income taxes (e.g. in connection with positions taken by them as to the deductibility of certain expenditure or the non-recognition of certain income as taxable) recognised in their financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*.

In deciding to concede the postponement, the FASB conceded that certain entities, especially S-corporations and pass-through entities, might have genuine grounds for confusion as to whether FIN 48 applied to them or not, and might not have become aware of the true position until June this year. It emphasised, however, that its decision was not to be taken as an endorsement of failure by affected entities to become or stay informed.

Under the implementation delay, non-public entities will have the same 10-month window (assuming statements are issued for the first quarter of 2008) as public companies had when FIN 48 was issued in July 2006.

For further information on these items, contact Bob Pedersen of BDO Seidman on +1 212 885 8000 or by e-mail at rpedersen@bdo.com.

California adjusts LLC fee calculation

California has amended the calculation of its annual fee for LLCs doing business there, following an adverse court judgment.

LLCs (limited-liability companies) are hybrid entities incorporated under US state law, and are often used in tax planning. California has since 1994 charged a fee to all LLCs registered to carry on business in California. The relevant legislation provided that the fee (payable at graduated levels) was to be based on the 'total income' of the LLC from all sources, reportable to the state. The tax authorities interpreted 'total income' to mean worldwide income, without apportionment.

Following judgments in the California Superior Court that the fee was unconstitutional, because it was not based on income from Californian sources (thus violating the Commerce Clause and the Due Process Clause of the US Constitution), California has now amended the legislation so as to charge the fee on the basis of apportioned revenue earned within California, using the existing apportionment rules.

The amendment has effect for years beginning after 31 December 2006, but has the further effect of denying full refunds should the US Appellate Courts upheld the California court's judgment. Those taxpayers who have filed protective refund claims would, in that case, only obtain a refund for the difference between the fee that they have actually paid in prior years and what the fee would have been if the amendment had always had effect. Those taxpayers who have not filed a timely protective claim will not receive a refund at all.

For further information on this or other US state tax developments, contact John Zefi of BDO Seidman on +1 212 885 7488 or by e-mail at jzefi@bdo.com

For *Mexico: US will credit IETU for time being* - see under *US: Mexican flat tax will attract US credit for now*

Europe and the Mediterranean
European Union
German tax on Belgian limited partnership upheld

Germany's treatment of a Belgian limited partnership with German partners, involving an override of the Germany-Belgium tax treaty, has been upheld by the European Court of Justice (ECJ). In doing so, the ECJ has, unusually, gone against the earlier Opinion of the Advocate-General in the case, *Columbus Container Services* (Case C-298/05).

Columbus Container Services (CCS) was a limited partnership with another partnership as limited partner (BVBA & Co) established under Belgian law, but with German-resident partners. Its main business was managing passive investment income, and it qualified in Belgium for the coordination-centre régime, which meant it enjoyed a low effective rate of Belgian taxation.

Under Belgian law, the partnership was an entity taxable in its own right, but under German law, it was tax-transparent, so that its German-resident partners were taxable in Germany on their share of its profits, regarded as coming from a permanent establishment in Belgium. Under the Germany-Belgium tax treaty, profits of a Belgian permanent establishment are exempt (with progression) in Germany. However, German domestic law overrides the treaty, where, broadly speaking, such a permanent establishment enjoys an effective rate of tax below 30% and derives mostly passive income, which was the case here. In such a situation, the exemption method stipulated by the treaty is replaced by a credit method, under which the whole of the German partner's profit share is taxable in Germany, with a credit for the Belgian tax suffered. This treatment naturally resulted in a greater tax liability. CCS argued that this treatment was in breach of the EC Treaty principle of freedom of establishment.

Under ECJ procedure, before the judges give their final judgment in a case, they receive an Opinion from one of eight Advocates-General, senior lawyers who advise the Court. In most cases, the judges agree with the broad thrust of the Advocate-General's Opinion, although they may disagree with some of the detail or give differing arguments in support of the same conclusion. Here, however, although the Advocate-General's conclusion was in favour of the taxpayer, the ECJ held to the contrary.

The key to the ECJ's judgment was that there was no difference in the German tax treatment involved as between purely German partnerships and foreign partnerships. Both were treated equally. This equality of treatment was admitted by the Advocate-General, but his argument was that because Germany treated investment in different Member States differently (where the effective rate of taxation was not lower than 30%, the exemption method would apply, whereas where it was lower, as here, the credit method applied), this led to fragmentation of the single market, and was thus incompatible with the freedom of establishment. The ECJ, however, held that the only true comparison was Germany's treatment of partnerships established in Germany as opposed to partnerships established in another Member State with respect to comparable investments. In both cases, the same level of tax applied, so there was no discrimination and hence no breach of freedom of establishment. The difference in treatment between investment in different Member States, the ECJ held, was a result of the way Member States allocated taxing rights among themselves, which was within their competence.

The case is important beyond its immediate facts, because if the ECJ had agreed with the Advocate-General, EU Member States would effectively have been obliged to accord equal treatment in their tax treaties to all other Member States – and extend what is known as the 'most favoured nation' treatment to all fellow Member States. The ECJ also implicitly endorsed the use of the credit method for avoiding double taxation as equally valid in certain situations. It did not express an opinion on the validity of domestic law overrides of treaty provisions.

For further information on the German aspect, contact Gerhard Engler of BDO Deutsche Warentreuhand on +49 69 959410 or by e-mail at gerhard.engler@bdo.de. For the wider European aspect, contact David Simpson of BDO Stoy Hayward on +44 207 486 5888 or by e-mail at david.simpson@bdo.co.uk

For *Netherlands withholding tax rules incompatible* see under Netherlands.

EU agrees new VAT package

EU finance ministers have agreed on a package of amendments to the VAT Directive that will make major changes to the place-of-supply rules on cross-border services. The package also provides for simplified means of registration for businesses carrying out transactions liable to VAT in several EU Member States.

VAT is a harmonised tax within the EU, and its basic rules are contained in a number of Directives, principally Directive 2006/112/EC (called here the 'EC VAT Directive'). Member States must implement the Directives in their own laws, and it is in the implementation legislation and its interpretation that differences between VAT law in each Member State emerge. Member States may also apply to the European Commission to deviate ('derogate') from the Directives in specific ways for specific approved purposes.

One of the difficulties in cross-border transactions is to decide which Member State (that of the supplier or that of the customer) has the right to levy VAT on that transaction. This is particularly so in the case of services, and there are a number of rules (called the 'place-of-supply rules') to determine this. The state where the supply is deemed to take place is the state with the taxing right. The place of supply can depend on the nature of the service, the location within or outside the EU of either the customer or the supplier, and on whether the customer is another business or a private consumer. Although the general rule is that the supply takes place where the supplier is located, there are many exceptions, particularly in so called 'B2B' (business-to-business) services. For many types of service, the place of supply is where the customer is located, or where 'use and enjoyment' of the service takes place.

The principle of the new package, agreed on 4 December, is to shift the place of supply of B2B services decisively towards the place where the customer is located. However, where the customer is a private consumer, the place of supply will generally remain as the place where the supplier is located. Exceptions will remain. So, as regards services such as cultural or educational services or restaurant services, the place of supply will always be the place of consumption (i.e. where use and enjoyment takes place). This will also be the rule for business-to-consumer (B2C) supplies of telecommunications, electronic and broadcasting

services. Currently, this is already the rule only where the supplier is established outside the EU (to prevent an unfair advantage for non-EU suppliers).

Generally, the new place-of-supply rules must have effect in every Member State from 1 January 2010. However, in the case of B2C supplies of telecommunications etc services, the effective date is postponed to 1 January 2015. Until that date, a supply of these services by an EU supplier may continue to be taxed where the supplier is located. For three years after that, the Member State of the supplier will be entitled to reclaim a diminishing proportion of the VAT collected by the customer's state, by way of compensation.

The amendments will also ensure that where services (such as management services) are supplied cross-border between affiliated parties, the right to tax will rest with the state of the customer.

Other amendments address the right to recover VAT charged in another Member State (this procedure is governed by the so-called Eighth VAT Directive as regards businesses established within the EU). From 1 January 2010, businesses reclaiming VAT from a Member State where they are not established must have access to an electronic portal in their own Member State through which they may file their refund claim. Currently, forms have to be submitted completed in the language of the Member State where the VAT was incurred, and delays can be lengthy. This measure in particular should help to reduce these delays greatly and make the refund procedure less burdensome.

For further information, contact Ulrich Grünwald of the BDO VAT Centre of Excellence, on +49 30 885 7220 or by e-mail at ulrich.gruenwald@bdo.de.

Modernised European Customs Code expected in 2008

The European Customs Code provides a uniform customs régime for imports throughout the European Union. In the recent past, there has been a small customs-law reform. This reform introduced a so-called Authorised Economic Operator (AEO), a risk management system, and summary declarations before import and export. Now it is highly probable that a wholly new European Customs Code will be enacted in 2008, followed by appropriate implementing regulations by the end of 2008. In October 2007, a common position of the European Council regarding a Modernised Customs Code was published. This throws some light on a comprehensive process of new lawmaking in this area (cf. COM (2007) 647 final). The common position includes certain further modifications, made by the Council, which address both the concerns reflected in the European Parliament's proposed amendments, which took account of the opinions of European business interests, and those raised by the Member States' customs representation, centralised clearance and the 'single window' (for which political support was sought, and given, in the Council of Ministers), and several lesser issues, such as national simplifications, the application of guarantees and the right to be heard, for which practical solutions have been found within reason. Changes to the procedure for the adoption of implementing provisions have also had considerable implications for the Modernised Code. The end of the lawmaking process is in sight. Future issues of BDO World Wide Tax News will report on developments.

For further information on this item, contact Christoph Hölscher of BDO Deutsche Warentreuhand on +49 69 959410 or by e-mail at christoph.hoelscher@bdo.de

Belgium

Employment burden eased slightly

In an attempt to improve the heavy tax and social security burden on Belgian employers, a general reduction of 0.25% in the salary withholding tax owed to the state took effect on 1 October 2007.

Salary withholding tax (*précompte professionnel*) applies to all earnings, allowances, pensions and other employment income taxable in Belgium. Employers are obliged to deduct the tax (on account of the employee's final income tax liability) and account for it to the tax authorities. From 1 October, however, employers can deduct 0.25% of the gross employment income of all relevant employees from the amount that they must pay over to the state. Relevant employees are the employees on account of whom the employer pays over the précompte as at 1 October 2007. Entitlement to the reduction is conditional on the employer's falling within the scope of the Collective Bargaining Agreements and Joint Industrial Committees Law of 5 December 1968.

It must be emphasised that the reduction is meant to benefit employers only and is not a reduction in the tax burden of the employees. The employer still deducts the full amount of tax due from the employee, but is effectively able to retain 0.25% of that amount.

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Denmark

Withholding taxes to be cut on dividends, interest and royalties

Denmark is to reduce its rate of withholding tax on interest, royalties and certain dividends payable to non-residents.

Under a Bill presented to Parliament on 5 December 2007, withholding tax on non-residents' portfolio dividends would be reduced from 28% to 15%, under certain conditions. These are that the shareholder concerned (corporate or individual) must own less than 10% of the share capital of the Danish company paying the dividend and must be resident in a country that has concluded an agreement on exchange of information with Denmark. An additional condition applicable to shareholders outside the EU is that the shares held by affiliated persons would be taken into account in applying the 10% test. As regards interest and royalties, a straightforward reduction from 30% to 25% is proposed. All these reductions would come into effect on 1 April 2008.

None of these measures has any effect on lower withholding rates already provided to non-residents under Denmark's double tax treaties.

Social security tax qualifies for treaty relief

Denmark's social security tax on employees, the 8% 'labour market contribution' (*arbejdsmarkedsbidrag*) will from 1 January 2008 be classed as a tax on income for the purposes of double tax relief under Denmark's tax treaties. This means that individuals who are resident in a country with which Denmark has a tax treaty will be able to claim a credit for the labour market contribution they may have paid in Denmark against any income tax liability they have on the same earnings in their own country.

Relief will also be available in Denmark under Danish domestic law, whether or not a treaty is in effect. Employees liable to tax in Denmark on their earnings will be able to include the labour market contribution in the total of Danish tax against which they may set off foreign income tax paid, so increasing the amount of foreign tax credit potentially available.

Acquiring companies may deduct legal and accountancy costs

The right of Danish companies to claim a tax deduction for legal and accountancy expenses incurred in an acquisition of shares of another company has been confirmed by the Danish Supreme Court (*Højesteret*).

The expenses involved are those paid to lawyers and accountants, and are associated with due diligence investigations, advice, participation in negotiations and the drafting of contracts. The tax authorities had maintained these were capital expenses, forming part of the base cost of the acquired shares and so could not be deducted for corporate income tax purposes, except on a subsequent disposal of the shares.

As a result of the decision, it may be possible for companies that have previously been denied a deduction for these expenses to claim repayment in respect of income years going back as far as 1998.

For further details, contact Hans-Henrik Nilausen of BDO ScanRevision on +45 39 155200 or by e-mail at hhn@bdo.dk

France

3% tax on foreign-owned property in breach of EC Treaty

The European Court of Justice has held that France's annual 3% tax on the value of French real property held by non-resident companies and other legal entities is incompatible with the EC Treaty provisions on the free movement of capital.

Under the relevant French law, French-resident companies are exempt from the tax. Exemption is also extended to foreign companies, but only on the condition that the country in which the owner is resident has concluded with France either an agreement on administrative cooperation to combat tax avoidance and evasion or a double tax treaty containing an appropriate non-discrimination article binding on the taxpayer concerned.

The case involved a Luxembourg '1929 holding company', Elisa (Européenne et Luxembourgeoise d'investissements SA), which owned real estate in France. Although there is a double tax treaty between France and Luxembourg, which does contain a suitable non-discrimination article, Luxembourg 1929 holding companies (which enjoy broad exemption from tax in Luxembourg) are excluded from the scope of the treaty. Accordingly, Elisa was assessed to the 3% tax.

The Court held that the discriminatory treatment as between French and foreign entities owning property in France with regard to the tax was a restriction on the free movement of capital guaranteed by Article 56 of the EC Treaty. The prevention of tax evasion could provide sufficient justification for such a restriction on the grounds of overriding public interest, but only if the measures taken were proportionate to the intended objective. However, the fact that companies excluded from both an agreement on administrative cooperation or double tax treaty were given no opportunity to provide documentary evidence that no evasion or avoidance of tax was involved made the law disproportionate and therefore unlawful.

Companies in similar circumstances to Elisa could, therefore, be entitled to a refund of the tax if a claim for repayment would not now be out of time.

France has already adjusted its legislation to take account of the decision in Elisa.

For further information, contact Carine Duchemin on +33 1 70 690500 or by e-mail at c.duchemin@bdo-taxlegal.fr

For *Protocol with Luxembourg closes real-estate loophole* - see under Luxembourg,

Germany

Finance Act contains revised anti-avoidance measures

The Finance Act 2008 contains a variety of measures, including the expected tightening of Germany's general anti-avoidance rule – article 42 of the *Abgabenordnung*, the Tax Code.

We reported in BDO World Wide Tax News 2007 Issue 3 that it was proposed that the tax authorities would be able to invoke article 42 to recharacterise a transaction if they could prove that it involved an 'unusual legal structure' that led to a tax advantage. Under the final version of the Act, the offending structure must now be 'inappropriate' rather than simply 'unusual'. What is more, the tax authorities may only invoke article 42 if the transaction does not fall under a specific, targeted anti-avoidance rule. If article 42 is invoked, the authorities must establish that such a structure exists and has led to a tax advantage. The taxpayer may then still avoid the application of article 42 if he can provide sufficient evidence of significant non-tax reasons for the choice of structure.

The planned disclosure régime for tax-avoidance schemes, which we also reported on, has been dropped, at least for the time being.

Other measures contained in the Act include:

- disallowing losses or expenditure resulting from the write-down or transfer of an impaired unsecured loan granted by a shareholder holding more than 25% of the share capital or by a related party. To avoid disallowance, the entity would have to show that it could have obtained such a loan from an unrelated party under the same conditions
- a reduction in the trade-tax add-back for rental and lease payments in respect of immovable business assets, from 18.75% to 16.25%
- a reduction in the participation threshold for exemption from German withholding tax on outbound dividends qualifying under the EC Parent-Subsidiary Directive, from 25% to 15% (retroactive to 1 January 2007) – this is an EU-wide requirement

For *German rules on low-taxed foreign partnerships upheld* - see under European Union

For further information on any of these items, contact Dr Gerhard Engler of BDO Deutsche Warentreuhand on +49 69 959410 or by e-mail at gerhard.engler@bdo.de

German Draft Bill on Foreign Investment Controls

Following international practice, Germany is planning to tighten controls of foreign investment in German key industries. Meanwhile, a draft Bill has been drawn up to amend the German Foreign Trade Act [AWG] and the German Foreign Trade Regulations [AWV] providing for administrative controls of any foreign investment in domestic companies leading to control of 25% or more of the voting power. According to the draft Bill, in such a case, the transaction is deemed invalid without an appropriate licence from the German Government. Under the current proposal, the administration is given a period of three months for review. It remains

to be seen if these rules will be modified in the ongoing process of lawmaking. There is particular debate with regard to the length of the review period. Administrative review in any case will focus on a potential danger to public order or national security.

For further information on this item, contact Christoph Hölscher of BDO Deutsche Warentreuhand on +49 69 959410 or by e-mail at christoph.hoelscher@bdo.de

Italy

Important corporate tax changes in 2008

The Government's Budget for 2008 has been approved by both Chambers of Parliament. It includes significant changes to company taxation. Some of the more important new rules are described below.

Rate reduction

There are reductions in the rate of both corporate income tax (IRES) – from 33% to 27.5% – and in the regional tax on productive activities (IRAP) – from 4.25% to 3.90%.

Treatment of interest expense

Both the current thin capitalisation rules and the pro-rata restriction concerning interest incurred in connection with the acquisition of the right to receive exempt dividends are abolished and replaced by an overall interest cap, similar to that introduced in the German tax reform. The deduction for financial interest paid will be limited to the amount of financial interest received. Deduction of the remaining amount will be limited to no more than 30% of earnings before tax, interest and depreciation. Excess interest may be carried forward indefinitely, subject to the same cap each year.

Loss of tax-group advantages

Many of the tax advantages in having a consolidated group of companies will disappear. In future, the 100% exemption for dividends received from other group members will be replaced by the general 95% exemption that applies between unrelated entities. Nor will other transactions between group companies (such as asset transfers) any longer be tax-neutral. Intra-group interest will be subject to the interest cap. However, companies with excess post-entry interest will be able to pass the interest on to other members with spare interest capacity within the cap.

Increase in capital gains exemption

The participation exemption for capital gains, currently 84%, will be aligned with that for dividends, so that in future, 95% of the gain arising from the disposal of a qualifying shareholding will be exempt.

Withholding tax on intra-EU dividends slashed

The domestic rate of withholding tax on dividends paid to entities resident elsewhere in the EU will be slashed from 27% to 1.375%. Of course, dividends qualifying under the EC Parent-Subsidiary Directive (which require, among other things, a minimum participation of 15%) are already subject to zero withholding and most of Italy's tax treaties stipulate much lower rates than 27%. Nevertheless, the 1.375% rate will apply to any distribution to a corporate entity resident elsewhere in the EU, which does not qualify under the Parent-Subsidiary Directive, provided only that the recipient entity is subject to a corporate tax on income in its home state. The 1.375% rate will also apply to dividends payable to companies resident in the EEA but not in the EU, provided that the countries concerned (currently

Iceland, Liechtenstein and Norway) have a tax treaty with Italy containing an appropriate exchange of information article. Neither Iceland nor Liechtenstein currently has such a treaty.

Whitelist to replace blacklist

Under the law as it stands, transactions with countries on a 'blacklist' (generally comprised of low-tax countries) are subject to a range of anti-avoidance restrictions. The concept of a blacklist is to be replaced by a whitelist. The whitelist will comprise all jurisdictions allowing for an effective exchange of information with the Italian tax authorities. In future, all relevant transactions with countries not appearing in the whitelist will be subject to anti-avoidance restrictions.

Effective date

Most of the changes discussed above will be effective from 1 January 2008. Publication of the whitelist will have to await the relevant Ministerial Decree, and take effect from the taxable period following publication.

For further information, contact Giorgio Farina of BDO Sala Scelsi Farina on +39 02 290 62098 or by e-mail at giorgio.farina@bdo.it

Luxembourg

Luxembourg to abolish capital duty

Luxembourg is to cut the rate of capital duty from 1% to 0.5%, with effect from 1 January 2008 and abolish it altogether by the end of 2009.

Capital duty is a tax on the issue of share capital – in Luxembourg it is levied on subscriptions for share capital (in cash or in kind) and on any share premiums on incorporation, and on further issues of shares – and is a harmonised EU tax, subject, like VAT, to EC Directives. Only seven Member States currently charge capital duty, and the European Commission has recommended that it be abolished altogether by 1 January 2010. Luxembourg appears to be following this timetable.

The reduction of capital duty will lower the cost of company formation and raising of equity capital.

For further information, contact Guy Hornick of BDO Compagnie Fiduciaire on +352 451231 or by e-mail at guy.hornick@bdo-cf.lu.

Protocol with France closes real-estate loophole

A protocol to the tax treaty with France, recently ratified by both France and Luxembourg, closes a loophole in the taxation of income from French real estate owned by a Luxembourg company.

Under French law, income from French real estate owned by a Luxembourg company is treated as business income, taxable in France only if the Luxembourg company has a permanent establishment in France, which is usually not the case. Under Luxembourg law, the same income is treated as income from real estate, taxable only in the jurisdiction where the property is situated. Hence, neither state taxes the income.

The protocol makes it clear that such income is to be taxable in the situs state, i.e in this case, France. It takes effect from 1 January 2008.

For further information on the Luxembourg aspect of this item, contact Guy Hornick (as above). For the French aspect, contact Carine Duchemin (see under France).

The Netherlands

'Patent box' may be extended

Under the Netherlands' 'patent-box régime', corporate income tax on royalties received from patents held by a Netherlands company is charged at a special rate of 10%, at the company's option. The Government has indicated that it will give support to a proposal to extend the patent box to royalties and other income received in respect of intellectual property arising from an approved research and development project.

Interest base to be protected

Under the Budget Bill currently before Parliament, an additional restriction is to be placed on the deductibility of interest on certain loans between related parties, in order to guard against erosion of the Netherlands tax base.

In certain situations, where a Netherlands entity pays interest on a loan to a related foreign party, the interest is deductible only if the Netherlands entity can demonstrate that:

- the interest is taxed at an effective rate of at least 10% in the lender's state of residence or
- the loan and the transaction are incurred predominantly for sound business reasons

If the Bill is enacted as it stands, in essence both conditions, not just one, will need to be satisfied. The taxpayer will have to establish that the effective rate is no less than 10%. The tax authorities can then still deny the interest deduction if they demonstrate that the loan and the transaction are not incurred predominantly for sound business reasons.

The change would affect both existing and new structures as from 1 January 2008.

For information on either of these items, contact Hans Noordermeer of BDO CampsObers on +31 10 242 4600 or by e-mail at hans.noordermeer@bdo.nl

Withholding tax rules in breach of EC law

The European Court of Justice (ECJ) has held in the Amurta case (*Amurta v Inspecteur van de belastingdienst* (C-379/05)) that the Netherlands dividend withholding tax on outbound dividends as previously applied was incompatible with the free movement of capital guaranteed by article 56 of the EC Treaty.

Although the Netherlands has already amended its law with effect from 1 January 2007 to anticipate the negative decision, the result is still important in that it may have implications for taxpayers in other Member States. It is also the case that the law as amended may still be incompatible as it relates to shareholdings by companies resident in EEA countries outside the EU, Switzerland, and possibly third countries.

Amurta was a company incorporated under Portuguese law and resident in Portugal, which directly owned 14% of the shares in a Netherlands-resident company. The case revolved around the payment of a dividend from the Netherlands company to Amurta in 2002.

Under Netherlands tax law at that time, dividends distributed to an EU-parent were exempted from the 25% dividend withholding tax, if, amongst other things,

the recipient company held at least 25% of the shares of the Netherlands paying company. At the same time, in a purely domestic situation, exemption applied to a Netherlands recipient company holding no more than a minimum 5% of the shares of the Netherlands paying company.

For Amurta, the exemption from the 25% dividend withholding tax was not available under either Netherlands domestic law or under the EC Parent-Subsidiary Directive, since Amurta held only a 14% interest. If Amurta had been a resident of the Netherlands for tax purposes, or if its shares in the Netherlands company had been attributable to a permanent establishment that it had in the Netherlands, then the exemption would have been applicable.

Amurta contended that this distinctive treatment was a violation of the free movement of capital guaranteed by the EC Treaty. In the specific Portuguese case, the Netherlands tax administration filed as a ground for justification of a possible breach of the EC Treaty that Portugal applies a full tax credit. Since Portugal effectively repaid the Netherlands withholding tax, there was ultimately no discrimination or hindrance. The issue was referred to the ECJ.

The ECJ held that the free movement of capital guaranteed by the EC Treaty precludes a withholding tax on dividends distributed by a company established in one Member State to a company established in another Member State, while exempting from that tax the dividends paid to a domestic company or permanent establishment. The ECJ further concluded that this different treatment could not be justified on the basis of the coherence of the Netherlands tax system or of the allocation of taxing rights.

As regards the treaty issue, the ECJ held that the Netherlands could not rely on the existence of a full tax credit granted unilaterally by Portugal to a resident Portuguese company in order to escape the obligation to prevent economic double taxation of dividends. However, the Court did mention that it may be possible to act in accordance with the free movement of capital through the conclusion of a double tax treaty with the other Member State. Where a Member State relies on such a convention, it is for the national court to establish whether account should be taken, in the main proceedings, of that convention, and if so, to determine whether it enables the effects of the restriction on the free movement of capital to be neutralised. This specific question (the relevance of the double tax treaty) will have to be answered by the Court of Appeal in Amsterdam.

In the light of the judgment, it is possible that taxpayer companies in other Member States may be paying withholding tax where it is not due, if their legislation with respect to the taxation of cross-border dividend payments is similar to that formerly in existence in the Netherlands.

For further information, contact Niek de Haan of BDO CampsObers, Rotterdam, on +31 10 242 4600 or by e-mail at niek.de.haan@bdo.nl.

Portugal

Tax on non-residents' capital gains struck down by ECJ

Portugal's treatment of capital gains made by non-residents on the disposal of Portuguese real estate has been held to be in breach of EC law by the European Court of Justice.

If a Portuguese resident derives a capital gain from the disposal of Portuguese real estate, that gain is subject to progressive rates of income tax in Portugal, but a 50% reduction in net gains can be claimed. Where a non-resident make such a gain, on the other hand, no 50% reduction is available, but the gain is subject to a fixed 25% rate of income tax.

The case (*Hollmann v Fazenda Pública* – Case C-443/06) involved a sale of a house in Portugal by a German resident. She claimed and was denied the 50% reduction available to Portuguese-resident taxpayers. The European Court held that the availability of the 50% reduction resulted in a systematic benefit for residents that was unavailable for non-residents. It considered that this discriminatory treatment was a restriction on the right to free movement of capital guaranteed by Article 56 of the EC Treaty. The Court also considered that the restriction could not be justified on any of the normal grounds and was therefore unlawful.

The case illustrates quite clearly that any form of treatment of the same transaction that favours residents of a Member State over non-residents is likely except in specific and narrow circumstances to be held unlawful, and does not come as a surprise. It is expected that Portugal will amend its legislation in due course.

For further information on the Portuguese aspect of this item, contact Paulo Alves of BDO bdc & asociados on +351 21 799 0420 or by e-mail at paulo.alves@bdo.pt. For the European aspects, contact David Simpson of BDO Stoy Hayward on +44 207 486 5888 or by e-mail at david.simpson@bdo.co.uk.

Spain

Spain introduces VAT grouping

As from January 2008, Spanish tax law allows for voluntary VAT grouping for Spanish companies. Note, however, that foreign companies with Spanish subsidiaries cannot be part of a VAT group.

In order to apply the VAT grouping scheme, certain requirements should be met: a) the VAT group must be formed by Spanish taxpayers; b) one company in the group should be identified as the parent company that must hold, directly or indirectly, at least 50% of the shares of its subsidiaries during the calendar year; c) subsidiaries forming part of the group will have to have distinct legal personality – therefore the only way that a permanent establishment can be part of the group is as the parent company.

In order to qualify under the VAT grouping scheme, apart from other formalities, each of the companies involved in the VAT group will have to opt for membership individually. Once the decision is adopted and the relevant documentation has been submitted to the Spanish tax authorities, the VAT group will be in force for at least three years. This period will be automatically extended for another three years unless

the companies involved decide to dissolve the group or one of the requirements for grouping ceases to be met.

An election for VAT grouping must be completed before the month of December in the VAT period immediately preceding that in which the group is to take effect.

Two different VAT grouping procedures are available – known as the basic procedure and the advanced procedure respectively. Under the basic procedure, the group essentially makes an aggregated return of the VAT position of each company within the Group. The advanced procedure, on the other hand, is a tax-deferral system.

Under the advanced procedure, the group will be taxed only on the cost of services and goods supplied to and by third parties, as intra-group transactions are eliminated.

In a departure from what is the norm in most other EU Member States with a VAT grouping system, in Spain each company within the group will keep its own VAT number, although the parent company will act in the name of the group and will be considered as the representative member of the group.

One of the advantages of the VAT grouping scheme is that those companies that perform exempt activities and fall under the partial-exemption system can opt out of partial exemption and subject all their outputs to VAT. This possibility has been intended to benefit banks and other financial institutions as well as real estate companies, who will now be able to recover the whole of their input VAT and not merely a proportion.

Another advantage of this scheme is the possibility of compensating, without any limit, those repayment positions that accrued before the VAT group was created.

For more information, contact Marina Rincón of BDO Audiberia on +34 91 436 4190 or by e-mail at marina.rincon@bdo.es

Goodwill amortisation rule under EC scrutiny

The European Commission has launched a formal investigation into Spain's rules for the amortisation of purchased goodwill.

Under Spanish law, a Spanish-resident company or Spanish permanent establishment of a non-resident company that has acquired more than 5% of the issued share capital of a foreign company may for tax purposes amortise (depreciate) any financial goodwill on acquisition (the difference between the acquisition cost of the shares and the appropriate proportion of the fair market value of the target company's underlying assets) over a 20-year period, at 5% each year. No amortisation of goodwill is available, however, on the acquisition of a Spanish company.

The European Commission is to determine whether this rule constitutes illegal state aid. If it did so find, Spain may be required to recover aid previously granted, which in this case would mean a clawback of the amortisation dating back to 2002, when the rule was introduced. The Spanish Government is expected to defend the rule vigorously.

For further information, contact Carlos López of BDO Audiberia on +34 91 436 4190 or by e-mail at carlos.lopez@bdo.es

United Kingdom

Non-domiciliaries may face tax charge

Under measures announced by the Chancellor of the Exchequer in his Pre-Budget Report, delivered on 9 October, long-staying expatriates who wish to continue benefiting from the generous remittance basis of taxation available to individuals not 'domiciled' in the UK may have to pay an annual tax charge of GBP 30 000 (EUR 42 000; USD 60 400).

Under UK law, an individual is domiciled, broadly speaking, in the jurisdiction that he or she regards as a permanent or ultimate home. As regards foreigners coming to reside in the UK, as long as they retain links with their home country and intend ultimately to return there, no matter how far in the future, they will generally be regarded as having retained their foreign domicile and not have acquired UK domicile. As non-domiciliaries, they are taxed only on their UK-source income or capital gains and on any foreign income or gains that they remit to the UK (remittance is quite widely defined). This régime is known as the 'remittance basis'. Any foreign-source income or gains they keep outside the UK are not subject to UK tax. Normally, individuals who are resident or ordinarily (habitually) resident in the UK pay income tax and capital gains tax on their worldwide income and gains.

The UK Government had been reviewing these rules, which have come under a good deal of criticism, for a number of years. The new Chancellor, Alistair Darling, has now announced measures designed to come into effect on 6 April 2008 (for the tax year 2008-09). A consultation document has been published and draft legislation is expected both imminently and early in the New Year. As they currently stand, the proposals include the following:

- Individuals who are not domiciled in the UK but have been UK-resident for at least seven out of the last ten tax years will lose their right to the remittance basis, unless they agree to pay an annual charge of GBP 30 000. The 10-year period is retrospective, so it appears that any individual who has been resident in the UK for seven or more of the the ten tax years up to 2007-08 will be immediately affected from 6 April 2008. Individuals with unremitted income or gains of less than GBP 1000 (EUR 1400; USD 2025) will be exempt from the charge
- A higher charge may be introduced for individuals resident for ten or more years; alternatively, non-domiciliaries who have been resident for at least 17 out of the last 20 tax years may be deemed to have acquired a UK domicile (this is already the rule for inheritance tax)
- Payment of the charge will not exempt any foreign income or gains remitted to the UK from the normal charge to income tax or capital gains tax
- Individuals opting to keep the remittance basis and paying the charge will lose entitlement to personal income tax allowances (chiefly a deduction – in 2008-09 equal to GBP 5435 for those under 65 – in computing taxable income), subject to the GBP 1000 de minimis exception for unremitted income and gains

Days of arrival and departure no longer to be ignored

The non-statutory practice whereby days of arrival and departure have not been counted in determining whether an individual is resident or ordinarily resident in the UK is to be abandoned. From 6 April 2008, the day on which an individual arrives in the UK and the day on which he or she leaves the UK are both normally to be counted as days of presence, although there will continue to be an exception for UK days in exceptional circumstances beyond the individual's control (such as illness). There is also expected to be an exception for time spent in transit at UK airports.

An individual is generally regarded as resident in the UK in any tax year in which he or she is present in the UK for 183 days or more. Similarly, individuals averaging more than 90 days each tax year over a four-year period are regarded as resident and ordinarily resident. Until now, under a non-statutory practice of the tax authorities, days of arrival and departure have been ignored in applying this rule, so that only full days spent in the UK counted towards the total.

For further information on either of these items, contact Andrew Bailey of BDO Chiltern on +44 207 153 2391 or by e-mail at andrew.bailey@bdochiltern.co.uk

Single rate of capital gains tax to replace indexation and taper reliefs

Another measure announced by the Chancellor to take effect from 6 April 2008 involves the abolition, as regards individuals, of the indexation and taper reliefs for capital gains tax, and the replacement of the current progressive rates of the tax (linked to income tax, with a top rate of 40%) with a flat rate of 18%.

Currently, an individual who has held business assets (as defined) for at least one full tax year before disposing of them can reduce his or her capital gain by 50%. If the asset has been held for at least two tax years, the reduction is 75%. This relief is known as taper relief, which at current tax rates can reduce the effective rate of tax payable on the gain to 10%. Taper relief is also available on non-business assets, but on a longer timescale, with a maximum reduction of 40% where the asset has been held for at least ten tax years, and no reduction for the first three years. Where an asset was held at 5 April 1998, an inflation-linked relief, 'indexation relief', is also available for increases in value over the period from April 1982 to March 1998.

The Chancellor proposes to do away with these reliefs, and instead charge capital gains tax at 18% on the unadjusted gain, regardless of the type of asset, the period for which it has been held, and with no relief for inflation. The proposal has been widely criticised, largely because it appears to penalise the realisation of business assets in some cases (by increasing the rate of tax where relevant from 10% to 18%), while benefiting the realisation of non-business assets, such as second homes (in some cases reducing the rate of tax from 40% to 18%).

Draft legislation is expected in January, which will reveal to what extent, if any, the Chancellor has amended his initial proposals. One possibility is a reintroduction of a form of 'retirement relief', under which individuals above a certain age who disposed of most or all of their business were entitled to claim a time-related reduction in the capital gain.

For further information on this item, contact Wendy Walton of BDO Stoy Hayward on +44 207 893 2252 or by e-mail at wendy.walton@bdo.co.uk.

Asia Pacific
Australia
GST and cross-border transactions

The Australian tax authorities have released the final instalment of their detailed and lengthy rulings on the treatment of exports, in this case a ruling on the effective use or enjoyment provisions of GST (goods and services tax – Australia's equivalent of VAT). The area is complex and businesses face uncertainties in accurately accounting for GST on these transactions. The authorities intend to apply the rulings retroactively from 1 July 2000.

Most businesses assume that no GST is charged on services supplied to non-residents. However, this assumption is often incorrect and the decision whether to charge GST on such services requires a detailed analysis of the contractual and commercial nature of the services provided.

The Ruling indicates that subtle differences in arrangements may result in different GST characterisations for otherwise apparently similar transactions. For example, in circumstances where a non-resident business enters into a contract with a customer in Australia, under which it is obliged to provide certain services to that customer and subsequently subcontracts another Australian entity to provide those services to the customer, the Tax Office considers that both the supply from the non-resident to the customer and the supply from the Australian supplier to the non-resident will be subject to GST.

Broadly speaking, it is therefore not always appropriate to implement a single default GST classification for non-resident customers in business accounting systems. The same also applies to a taxpayer's customers who are Australian residents. For example, in some circumstances a supply made to an Australian resident by an Australian resident will be a GST-free export.

There is also a significant change in the final Ruling compared to the draft in respect of a supply provided both to an entity in Australia and an entity outside Australia. In the draft Ruling, it was the authorities' view that such a supply could not normally be apportioned on the basis the supply was made to an entity in Australia (and therefore no part of the supply could be treated as GST-free). In the final Ruling, they now consider suppliers may apportion such supplies on some fair and reasonable basis, so that part of the supply is treated as GST-free. Nevertheless, apportioning such supplies will not be an easy task.

Going forward, businesses will be expected to adopt a more consistent and technical approach to the characterisation of services for GST, particularly with respect to those services made to non-residents. The tax authorities' current attitude towards the imposition of penalties and interest may result in significant costs for businesses that fail to correctly account for GST on these types of supplies.

Taxation of financial arrangements

A Bill dealing with the taxation of financial arrangements was introduced into Parliament by the former Liberal-National government of John Howard, before its defeat in the November general election. The Bill deals with the taxation of gains and losses on financial instruments (TOFA), a topic that various papers and committees have been analysing since the 1980s.

The proposed rules cover a gain or loss from any 'financial arrangement'. This is defined as arising where there is a 'cash settlable' legal or equitable right or obligation to receive or provide a financial benefit. The clear intention is that the TOFA rules should only apply to arrangements considered to be financial arrangements by the market.

Equity interests are excluded from the TOFA rules, while foreign currency is specifically included as financial arrangements. There are a number of exemptions from the rules, including those for certain short-term arrangements where a non-money amount is involved, taking out certain trade receivables and similar accounts payable. There is also an exception for small businesses (that is, entities with a turnover of less than AUD 20 million (EUR 11.98 million; USD 17.275 million)) as well as for individuals, but only where the instrument provides no significant deferral of a gain. In this instance, any gain or loss on the instrument would only be taxed on redemption under existing rules relating to income, deductions and traditional securities.

Once it is determined that there is a financial arrangement, all gains and losses from the arrangement are characterised as ordinary income and deductions, removing them from the capital gains tax provisions. The calculation of the gain and loss from a financial arrangement is made under one of six different tax timing methods. The default methods are the 'compounding accruals method' and the 'realisation method'. The compounding accruals method allocates gains and losses from a financial arrangement to income years using the 'internal rate of return'. It can only be applied where the gains and losses can be calculated with reasonable certainty. Under the realisation method, gains and losses are allocated to income years when they are realised.

The four other, elective, methods allow a taxpayer to follow accounting standards if certain conditions are satisfied. Two of these conditions are that accounts be prepared in certain ways and that they be audited. Under the 'fair value method', gains/losses from financial instruments are based on changes in their fair value, which are allocated to each income year. The 'foreign exchange retranslation method' applies to the foreign currency component of a financial arrangement; gains and losses from changes in the value of foreign currency are allocated to the income year in which the change occurs. The 'financial reports method' ensures all gains and losses, except those from hedged transactions, follow the financial accounts; this method 'trumps' the previous two elective methods.

The last method, the tax-timing hedging method allocates gains and losses on a hedging (derivative) financial arrangement to match the timing of tax paid on the gains and losses of a hedged item.

There is an interesting point on the introduction of these rules that should be noted. The last Exposure Draft indicated that the rules would apply to income years commencing after 1 July 2007 (elective) or from 1 July 2008 (compulsory). The Bill defers this date by one year, so that the rules will now apply to income years commencing after 1 July 2008 (elective) or from 1 July 2009 (compulsory).

Deemed permanent establishment

The tax authorities recently issued two draft Taxation Determinations, TD 2007/D11 and TD 2007/D12. In the first draft Determination, D11, they consider whether the hire of substantial equipment in Australia under a hire-purchase agreement will create a deemed permanent establishment (PE) for a Singaporean-resident hirer under the Singapore-Australia double tax agreement. The answer is definitely 'yes', and the authorities note that this answer would be the same for several other double tax agreements, subject to conditions within those treaties. Notable exceptions are the UK and the US treaties, which specifically exclude hire-purchase arrangements from the definition of a deemed PE.

Draft Determination D12 considers whether withholding tax would be payable in respect of lease payments paid by a Singaporean sublessee to a non-resident head lessee for substantial equipment used in Australia. Again, the answer is 'yes', as the lease payments fall within the definition of royalties incurred in respect of an Australian PE.

In the case of *McDermott Industries (Aust) Pty Ltd v. Federal Commissioner of Taxation*, the Full Federal Court held that a Singaporean resident had a PE in Australia because it had leased equipment to an Australian resident for use in Australia. In that case, the decision actually worked in favour of the taxpayer, as this meant that there would be no royalty withholding tax payable on the leasing fees paid to Singapore. The authorities have accepted this decision but are now using it to their advantage, seeking to tax the Singaporean lessee (including where the lease is a hire-purchase arrangement) and also seeking withholding tax in respect of lease payments paid by a Singaporean sublessee to a head lessee. The authorities' approach is unsurprising, turning a losing case into a winning principle, and it will probably cause ripples through the Singaporean leasing industry.

For further information on any of these items, contact Vince Tropiano of BDO Kendalls on +61 2 92 865555 or by e-mail at vince.tropiano@bdo.com.au

People's Republic Of China

New Income Tax Law implementation rules

As mentioned in our leading item, the Chinese authorities have now issued the Implementation Rules for the new Enterprise Income Tax Law. The Rules, published on 6 December, provide interpretation, explanation and implementation details of and for the new Enterprise Income Tax Law ('the Law') effective on 1 January 2008, with a standard enterprise income tax rate of 25%.

The salient points of the Implementation Rules are summarised below.

Withholding tax rate

The withholding tax rate of 20% set by the Law on China-source passive income such as dividend, royalties, interest, rentals and capital gains derived by foreign companies is reduced to 10% under the Implementation Rules. This means that the 10% tax rate is applicable to all foreign companies, unless the relevant tax treaty stipulates a more favourable rate.

Tax-Resident Enterprise (TRE)

The new Law introduces the concept of a TRE. It provides that a foreign company that has its place of effective management in China shall be considered a TRE in China. A TRE in China is subject to enterprise income tax in China on its worldwide income.

The Implementation Rules define 'the place of effective management' as "the establishment that exercises, in

substance, the overall management and control over the production and operation, personnel, financial accounting, properties, etc of an enterprise".

Tax Incentives

The new Law removes the tax holiday consisting of a two-year exemption followed by a 50% reduction for three years granted to all manufacturing foreign-investment enterprises (FIEs) under the existing Foreign Enterprise Income Tax Law. However, it provides a five-year grandfathering relief to FIEs established before 17 March 2007.

The tax incentives granted under the new Law include mainly the following.

Preferential rate

The new Law grants a preferential tax rate of 15% to high-tech enterprises specifically supported by the state. The Implementation Rules define 'high-tech enterprises specifically supported by the State' as enterprises that own the core proprietary intellectual property rights and fulfil all of the following conditions:

- Products (services) fall within the prescribed scope of 'High-Tech Sectors Specifically Supported by the State'
- R&D expenses must not be less than the prescribed percentage of sales income;
- Income from high-tech products (services) must not be less than the prescribed percentage of total income;
- The number of technical people must not be less than the prescribed percentage of total employees; and
- Other conditions as prescribed in the administrative measures of the assessment of the high-tech enterprises.

The high-tech sectors to be specifically supported by the state are to be jointly formulated by the competent science technology, finance and tax department of the State Council.

Tax exemption or reduction

The new Law grants tax exemption or reduction to enterprises deriving income from the following activities or projects:

- Agricultural, forestry, husbandry, fishery activities;
- Public infrastructure, environmental protection, energy or water conservation projects;
- Technology transfer fulfilling certain conditions.

The Implementation Rules provide further details.

Tax deduction

The Implementation Rules set a deduction cap for some items of expenditure and specify certain disallowed expenses, some of which as below are new and not specified in the existing Foreign Enterprise Income Tax Law.

- Business entertainment expenses: only 60% of the actual expenses are deductible, with a cap of not more than 0.5% of annual sales income
- Advertising and business promotion expenses: the deductible amount is capped at 15% of annual sales income, and the excess can be carried forward to future years for deduction
- Commercial insurance expenses paid for employees are generally not deductible
- Management fees paid between enterprises are not deductible
- Sponsorship expenses of a non-advertising nature are not deductible

Contemporaneous Transfer Pricing Documentation Requirement

The new Law addresses the requirement for filing a related-party transactions report when filing annual tax returns with the tax authority. In addition, during a transfer-pricing investigation of an enterprise, the concerned enterprise and its related party, as well as other enterprises involved in the investigation, should provide the relevant information.

The Implementation Rules elaborate that the 'relevant information' includes:

- The relevant information documentation regarding the determination standards, computation methods and explanation of the prices and expenses in relation to the related-party transactions; and
- The relevant information regarding the resale (or transfer) prices or ultimate sale (transfer) prices of properties, rights to use of the properties and services in relation to the related-party transactions.

The Implementation Rules also specify that, where an enterprise conducts non-arm's length transactions with its related parties, the tax authority shall have the right to make tax adjustments within 10 years starting from the year during which such a transaction takes place.

Controlled foreign company rule (CFC Rule)

The new Law introduces a CFC rule, which is applicable to an enterprise controlled by Chinese-resident enterprises and established in a country (region) where the effective tax burden is substantially lower than the standard enterprise income tax rate in China, i.e. 25%.

The Implementation Rules clarify that the expression "the effective tax burden is substantially lower than the standard enterprise income tax rate in China" refers to the case where the effective tax rate is lower than 50% of the standard enterprise income tax rate, i.e. lower than 12.5%.

Thin-Capitalisation rule

The new Law introduces a thin-capitalisation rule that disallows an interest deduction on interest-bearing debts or loans from related parties if the ratio of debt to equity investment exceeds the prescribed ratio.

The Implementation Rules provide definitions for 'debt' and 'equity. Debt refers to financing directly or indirectly obtained by an enterprise from its related parties that requires repayment of principal and interest. 'Equity' refers to investment obtained by an enterprise without the need of to repay principal and interest, and in respect of which the investor has the entitlement to the appropriate proportion of the net assets of the enterprise.

General anti-avoidance rule

The new Law introduces a general anti-avoidance rule, which provides that, if an enterprise engages in an arrangement without a reasonable commercial purpose and which results in reducing its taxable income, the tax authority has the right to make adjustments based on reasonable methods.

The Implementation Rules clarify that 'without a reasonable commercial purpose' refers to the case where the main purpose is for the reduction, exemption or deferral of tax payments.

Conclusion

It is obvious that the Implementation Rules do not clarify all the uncertain issues in the new Law. There are still a lot of unclear issues and therefore further interpretation, explanation and implementation details on those issues from the authorities are necessary. Probably, the Chinese central government would like to leave those issues to lower-hierarchy authorities, namely the Ministry of Finance and the State Administration of Taxation. It is expected that supplementary Tax Circulars will be issued by the Ministry of Finance and the State Administration of Taxation from time to time in the coming period and the clarification process may possibly take months or even years.

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India

Transfer of Indian shares between two non-residents taxable in India

India's Authority for Advance Rulings (AAR) has ruled that the capital gain arising on a transfer taking place outside India of shares in an Indian company between two non-resident parties is nevertheless taxable in India.

The case involved shares in an Indian company that were transferred from a non-resident shareholder to a related US corporation. The transferee corporation applied for an advance ruling to determine whether Indian capital gains tax would apply to the gain realised by the transferor and whether it would be regarded as an agent required to deduct Indian tax at source from the sale proceeds.

Under section 9 of the Income Tax Act, all income accruing or arising, directly or indirectly, through, inter alia, "the transfer of a capital asset situated in India" is deemed to accrue or arise in India. The AAR noted that this provision of the Act had been specifically designed to tax any capital gains derived by a non-resident from the transfer of any capital assets situated in India. In this case, it was clear that the capital asset in question, the shares, were situated in India as that was where the company was registered. Since the India-US double tax treaty provided that capital gains (with the exception of gains from shipping and air transport) were to be taxable according to the domestic law of each state, the gains were taxable in India.

As to the question of agency, it was also clear that the transferee fell within the definition of 'representative assessee' (withholding agent) in the Income Tax Act, as it had acquired a capital asset in India by means of a transfer. Such an agent could be either resident or non-resident.

Use made of subsidiary premises gives rise to permanent establishment

In a case involving the UK company, Rolls Royce plc, an Appellate Tribunal in India has found that the extent to which the UK company made use of the premises of its Indian subsidiary gave rise to their constituting a permanent establishment in India of the parent company. This in turn meant that a proportion of the parent company's profits were taxable in India.

Under domestic Indian law, income can be taxed in India if it arises directly or indirectly through or from a 'business connection' in India. Litigation had established that for a non-resident to have a business connection in India, there had to be a relation between a business carried on by the non-resident and yielding profits or gains and some activity on Indian territory that contributed directly or indirectly to the generation of those profits or gains. There had also to be an element of continuity.

In the present case, the UK company sold engines and spare parts to the Indian defence forces and other Indian customers. It had a wholly owned subsidiary in India, which had agreed with the parent company to provide such services as organising events and conferences, managing air-show logistics, arranging visits to India by senior parent-company executives, liaising with the Indian media, conducting business development activities etc. The subsidiary maintained a permanent

office in India from which to provide these services. The office was frequently occupied and used by parent-company employees visiting India on business.

The Tribunal found that in these circumstances, the UK company did have a business connection in India. It then went on to consider whether the UK company had a permanent establishment (PE) in India under article 5 of the India-UK double tax treaty. If it had such a PE, it would be taxable in India on the profits attributable to that PE. The Tribunal ruled that the subsidiary's premises were occupied by the UK company for the purposes of its business operations and were thus a PE. It rejected a defence from the UK company that its activities were only of a preparatory or auxiliary nature (and so would not make the premises a PE). It was clear that the activities consisted of marketing its products and could not thus be solely preparatory or auxiliary.

In the absence of separate books of account for the Indian activities, the Tribunal ruled that 35% of the UK company's profits were attributable to its marketing activities in India and it was that proportion that was therefore taxable.

While the case will most probably go to appeal in the courts, it shows the importance to a non-resident company wishing to minimise exposure to Indian tax of limiting activities in India to those clearly falling within the treaty exclusions from the definition of a permanent establishment.

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New Zealand

New R&D régime

New Zealand is to make tax credits available for certain expenditure on research and development (R&D) from the beginning of the 2008-09 tax year (i.e. from 1 July 2008).

The expenditure must generally be incurred by a person carrying on or proposing to carry on business in New Zealand, bearing the financial risk of the R&D project and having effective control of the work and ownership of the results, although ownership of the ultimate intellectual property is not a requirement. The minimum expenditure in the tax year on which the credit may be claimed is NZD 20 000 (EUR 8450; USD 10 100), unless the R&D is outsourced to a listed service provider.

Two types of R&D activity qualify. The first is core R&D activities that are systematic, investigative and experimental, and are performed to acquire new knowledge or to create new or improved materials, products, devices, processes or services and that:

- are intended to achieve an advance in science and technology by resolving scientific or technological uncertainty or
- involve an appreciable element of novelty

The second type of qualifying activity is supporting activity. These are activities that are wholly or mainly for the purpose of, required for, and integral to, the performance of the R&D. These may include market research, making stylistic or cosmetic changes, quality control or routine testing, and routine collection of information.

Finally, the type of expenditure that qualifies falls into one of the following classes:

- employment costs relating to R&D personnel and activities
- depreciation of property used for R&D
- supporting costs such as overheads, administration, repairs, utility costs, insurance etc
- expenditure on prototypes or trial models and R&D consumables

The amount of the credit is 15% of the qualifying expenditure. Where the credit exceeds the claimant's tax liability, the excess may be set off against other tax liabilities or may be refunded.

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Sub-Saharan Africa

South Africa

Liability to tax of interest-free loans

A recent judgment in the Supreme Court of Appeal of South Africa (*SARS v Brummeria Renaissance (Pty) Ltd*) suggests that the beneficiaries of interest-free loans may, at least in certain circumstances, face an income tax liability on the benefit of not paying interest.

The case involved a company that received advanced an interest-free loan from certain parties, to whom it provided in return the free use of some residential units. The company was assessed to tax on the benefit derived by non-payment of interest. The case eventually came before the highest court in South Africa.

The court came to the conclusion that a deemed accrual took place because of the fact that the taxpayer had the benefit of not paying any interest on amounts it had received as an interest-free loan.

However, it is not thought that the judgment can be applied to all persons to whom interest-free loans are made. Although the judgment was wide-ranging, what distinguishes the facts in the case from those in most situations where an interest-free loan is made is that there was a quid pro quo – the company provided the lender a benefit in return. In essence the transaction was a barter transaction. In most cases where an interest-free loan is made (e.g. between family members or to related parties such as investment trusts or family businesses), no consideration is provided in return for the use of the capital on loan-account, free of interest. It is to be hoped, however, that the tax authorities will issue a statement in clarification of their position.

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Latin America

Argentina

Wealth tax amendments proposed

The outgoing government of President Ernesto Kirchner recently submitted a Bill to the Parliament proposing amendments to net wealth tax, to take account of inflationary increases in value. The Bill would increase the nil-rate band from ARS 102 300 (EUR 22 625; USD 32 600) to ARS 300 000 (EUR 66 350; USD 95 575) and adjust the progressive rate bands (the top rate being 1.25%). Non-residents are also assessable to wealth tax, in their case on the value of their property situated in Argentina. They would be taxed at a flat rate of 1.25% (currently 0.75%), without the benefit of a nil-rate band. However, shares and other participations remain liable at a 0.5% rate. Some double tax treaties waive Argentina's taxing rights in this respect.

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Brazil

Congress refuses to renew CPMF tax

The Brazilian Congress has defeated a constitutional amendment Bill to renew the term of the financial transactions tax, CPMF.

CPMF (*contribuição provisória sobre a movimentação ou transmissão de valores e de créditos e direitos de natureza financeira*) is a tax, levied at 0.38%, on domestic financial transactions involving the debiting of a Brazilian bank account. It is payable by both individuals and legal entities.

It was introduced in 1996 as a temporary measure, but its life has been extended by means of constitutional amendments. It is the latest such amendment, which would have prolonged the life of the tax beyond the end of 2007 to the end of 2010, that has been turned down by Congress.

The government is already considering alternative revenue-raising measures, including a possible reintroduction of CPMF in a modified guise.

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