



BDO International

BDO World Wide Tax News

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Contents: **United Kingdom** 2 • **North America and the Caribbean:**

Canada 4 • United States Of America 6 • **Europe and the Mediterranean:**

European Union 14 • Belgium 16 • Estonia 18 • France 19 • Germany 20 • Gibraltar 22 •

Israel 23 • Jersey 25 • Latvia 27 • Luxembourg 28 • Netherlands 29 • United Kingdom 31 •

Asia Pacific: People's Republic of China 35 • India 37 • Sri Lanka 39 •

Sub-Saharan Africa: South Africa 40 • **Latin America:** Brazil 41 • Chile 41

BDO World Wide Tax News

Issue No. 4 / 08/09 - January 2009

Welcome to Issue 2008/09

No. 4 of BDO World Wide Tax

News and a Happy New Year

to all readers! This newsletter

summarises important recent tax

developments of international

interest across the world,

including important judgments of

the European Court of Justice,

released just as 2008 was ending.

If you would like more information

on any of the items featured,

or would like to discuss their

implications for you or your

business, please contact myself or

the person named under the item(s).

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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United Kingdom

Foreign dividends to be exempt for larger companies

On 9 December 2008, the government issued draft Guidance Notes and legislation, confirming the introduction of an exemption system for foreign dividends received by larger UK companies. The legislation, which represents a major departure from the United Kingdom's worldwide taxation principle, is to be included in Finance Bill 2009, and likely to have effect from 1 April 2009 at the earliest. These proposals are still subject to consultation, which began with the publication of a discussion document in June 2007.

The exemption will apply to large and medium-sized companies only. Small companies, as defined by the European Commission (i.e. those with fewer than 50 employees, or turnover and assets of not more than EUR 10 million), will remain subject to the current régime, under which foreign dividends are taxed, with a credit for foreign withholding taxes and, for non-portfolio holdings, foreign underlying taxes (although the relief rules may be simplified).

For large and medium-sized companies, most foreign dividends will be exempt from corporation tax, whatever the extent of the shareholding and however short the holding period.

The proposals apply to all dividends received as from the commencement date, which is likely to be between April and July 2009. As a result, foreign profits earned prior to the commencement date are capable of repatriation as dividends free of UK tax.

There are complex provisions aimed at countering tax avoidance but there is no requirement that the paying company's profits be subject to tax.

Companies affected should therefore consider deferring dividends from foreign subsidiaries until the dividend exemption becomes available.

As a quid pro quo for exemption of the dividend, foreign withholding tax on the foreign distributing company's dividend payments will not be creditable in the United Kingdom and so will constitute a final tax. It will be reducible under the EC Parent / Subsidiary Directive or an appropriate tax treaty.

Some 33 of the United Kingdom's tax treaties with overseas jurisdictions

do not reduce withholding taxes where the dividend is not subject to UK tax. Fortunately, the most important of these, Germany, offers a zero withholding tax under the Directive. Of the other countries, the most important is probably Russia, where a 15% withholding rate will apply.

Thought could be given to reorganising the shareholding to obtain a more favourable withholding tax rate.

The exclusion of small companies from the exemption is, in our view, likely to be non-EU compliant.



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North America and the Caribbean Canada

Fifth Protocol to US treaty takes effect

The Fifth Protocol to the double tax treaty between Canada and the United States entered into force on 15 December 2008. It generally has effect from 1 January 2009, although some provisions take effect later and some have retroactive effect.

We discussed certain aspects of the Protocol in the last issue of *BDO World Wide Tax News*, but a summary of the main changes to which the Protocol gives effect is contained below. These include, but are not limited to, phased-in elimination of source-country withholding taxes on interest, relief for limited-liability companies (LLCs) and some other fiscally transparent entities, denial of benefits for hybrid entities, and deemed permanent establishments for service providers.

Interest

Taxpayers entitled to the benefits under the Fifth Protocol are eligible for reduced withholding rates on interest payments and a refund for over-withheld amounts. The reduced interest rates for related parties are effective for interest payments retroactive to 1 January 2008. Zero interest withholding on unrelated party interest will also likely result from the same retroactivity.

Fiscally transparent entities and LLCs

For US tax purposes, partnerships, certain investment trusts, grantor trusts, and business entities such as LLCs that are treated as partnerships or are disregarded as an entity will be considered fiscally transparent under the Treaty. For Canadian purposes the entities include partnerships and bare trusts.

The use of LLCs in cross-border investment is also

affected by the Fifth Protocol. Under the Fifth Protocol the use of an LLC by a US owner investing in Canada will also receive treaty benefits, provided the US member of the LLC is a qualified resident under the Treaty (including meeting the limitation-on-benefits provisions). However, Canadians conducting business in the United States through an LLC will be denied treaty benefits such as the reduced rate of tax for branch profit taxes. This could effectively increase the US tax rate on US branch distributions to Canada from 5% to 30% for Canadian corporations conducting US business through a US LLC. For source withholding tax purposes, this provision is effective on the first day of the second month after the Fifth Protocol enters into force, i.e. 1 February 2009. For other income tax purposes, this provision is effective for taxable years commencing after 31 December 2008.

Hybrid entities

The treatment of hybrid entities is one of the most widely discussed provisions of the Fifth Protocol. In general, if an entity is not treated in the same manner in both Canada and the United States, treaty benefits may be denied on interest, dividend, or other payments to which the Treaty may otherwise have applied. Thus, treaty benefits can be denied to a Canadian partnership that makes dividend payments to its US owner where the US owner treats the partnership as a corporation for US tax purposes, as well as to unlimited liability company (ULC) dividend payments made to a US owner if the ULC is treated as a flow-through entity for US tax purposes. Interest payments paid to Canadian limited partnerships that are treated

as corporations for US tax purposes, and commonly referred to as 'synthetic NROs' are also denied treaty benefits under application of the hybrid provisions. Furthermore, distributions (dividend payments) paid to its Canadian owners by a US limited partnership that is considered a corporation for US tax purposes will be denied treaty benefits. This provision is effective on 1 January 2010.

Permanent establishments

Service businesses performing services on both sides of the border are affected by the changes in the permanent establishment (PE) provisions. If services are provided over 183 days during any 12-month period, a PE may be deemed to exist and subject the service business to taxation in the country where the services are being provided, even if there is no office or fixed place of business. This provision is effective on 1 January 2010.

Other provisions

Other provisions of the Fifth Protocol include retirement benefits, stock-option continuances, pre- and post-emigration gains, the limitation-on-benefits provisions, and the new mutual-agreement procedure and arbitration processes.



For more details on the Canadian aspects of this item, contact John Herring of BDO Dunwoody on +1 604 688 5421 or by e-mail at jherring@bdo.ca

United States of America

Potential tax changes under new President

This issue of *BDO World Wide Tax News* is going to press shortly before the inauguration of Senator Barack Obama as 44th President of the United States on 20 January. Below we discuss some of the tax changes the new administration may make, based on the positions 'the plan' taken by the new President during the election campaign.

Business taxes

Among potential measures are:

- Elimination of capital gains for entrepreneurs and investors in small businesses. The plan would eliminate the capital gains tax for investments in small businesses, but does not define what will constitute a small business or what other requirements will apply
- Health-care credit for small businesses. Small businesses (to be defined) would receive a refundable tax credit equal to 50% of their costs of providing employee health insurance
- Reduced corporate tax rate. The plan supports lowering the 35% rate of corporate tax, but does not indicate what the new rate would be
- Permanent extension of the research tax credit
- Tax policies to encourage domestic creation and retention of jobs. Federal tax law includes many provisions oriented toward the imposition of US taxes on investment-type operations carried on offshore by US persons, but those provisions generally have not been extended to true operating businesses carried on offshore. In general, trade or business income earned offshore by controlled foreign corporations is not subject to US taxation

until the earnings are repatriated to the United States. Also, because of the availability of foreign tax credits, those provisions have not had a significant impact on the domestic taxation of operations carried on in non-tax haven countries. We would expect to see some combination of an expansion of the existing offshore tax provisions and targeted tax incentives for domestic employment. We do not expect the result to be a simplification of the tax law.

Personal taxes

President-elect Obama's plan would:

- reinstate the pre-2001 top two income-tax brackets of 36% and 39.6% (the top two brackets are currently 33% and 35%). Those rate increases would affect married couples with taxable income in excess of USD 250 000 (or single individuals with taxable income in excess of USD 200 000). For taxpayers in those top two brackets, the tax rate on dividends and capital gains would increase from 15% to 20%. The plan would also reinstate the phase-out of the personal exemption and itemised deductions at USD 250 000 for married couples and USD 200 000 for single individuals, and would index these amounts for inflation
- make permanent certain of the Bush tax cuts, including the child tax credit, marriage-penalty relief, and the first four tax rates of 10%, 15%, 25% and 28%
- target tax relief targeted at middle and lower-income taxpayers. While the plan does not include reductions of tax rates for middle and lower-income taxpayers, it includes various provisions intended to reduce their

overall tax burden. Those provisions include:

- A refundable credit of 6.2% on the first USD 8100 of earnings to offset the payroll tax.
 - Expansion of the earned-income tax credit and the child and dependant-care tax credits.
 - A refundable tax credit of up to USD 4000 for the costs of attending college.
 - Expanded tax credit for purchasing fuel-efficient vehicles and equipment.
 - Exemption from income tax for seniors earning less than USD 50 000.
- limit the estate tax to estates in excess of USD 7 million per couple, with a maximum estate-tax rate of 45%. Because the current temporarily low estate-tax rates and high exemption amounts are scheduled to expire soon, this proposal is considerably more generous to taxpayers than what current law provides
 - increase social security taxes beginning about a decade after enactment. If enacted, the increase could create a 'doughnut' phenomenon in which income below a certain limit would be subject to the taxes, the next level of income would not be (the 'donut hole'), and the top level would be subject to a combined (employer and employee) rate of tax of between 2 and 4 percent.

Combating tax avoidance

The plan contains a number of proposals to raise revenue to pay for some of the tax reductions mentioned above. Revenue-raising proposals include:

- Modifying the international tax rules to end the incentive for companies to move jobs overseas, and to close the 'offshore pension loophole'
- Taxing 'carried interest' as ordinary income rather than capital gain. A carried interest is a fund manager's right to a specified share of a fund's profits without contributing a proportionate share of the fund's capital

- Eliminating oil and gas tax incentives
- Closing the 'CEO pay loophole'
- Codifying the economic substance doctrine developed by the courts, under which the claimed tax benefits of certain transactions may be overridden because the transactions lack adequate economic reality
- 'Cracking down' on offshore tax havens.

Dealing with the economic crisis

An important part of the package aims to respond to the current economic crisis by, inter alia:

- Extending unemployment benefits and temporarily eliminating taxes on benefits received
- Allowing penalty-free hardship withdrawals from individual retirement accounts and tax-privileged savings ('401(k)') accounts of up to 15% or USD 10 000 for 2008 and 2009. The withdrawals would be subject to income tax.
- Temporarily suspending pension-fund minimum distribution requirements for retired persons over 70½, and exempting from tax the required minimum distribution amount
- Creating a refundable credit of USD 3000 to employers for each additional full-time employee hired in 2009 and 2010
- Increasing the small business expensing limit under Internal Revenue Code section 179 to USD 250 000 until 31 December 2009 (it was USD 250 000 in 2008 and has decreased as scheduled to USD 125 000 in 2009)

Fifth Canada protocol takes effect

See under Canada.

Automatic penalty assessments for late Forms 5471

Generally, any US person in control of a foreign corporation, who acquires a 10% interest in a foreign corporation, or is an officer or director in a foreign corporation is obliged to file a form 5471, which is an information return containing details of the person and the corporation (including its results for the financial year concerned). The form should be annexed to the relevant taxpayer's income tax return (Form 1120). Substantial penalties exist for late filing of this form.

The IRS has now announced that it will begin automatically assessing late-filing penalties against shareholders, officers, and directors who file late Forms 1120 with Forms 5471 attached. The automatic assessment will start for Forms 5471 received after 31 December 2008. The announcement follows a series of letters sent to taxpayers who may not have filed their corporate return and/or any required Form 5471 on time.

The IRS has the authority to assess a penalty of USD 10 000 for each occurrence of late or incomplete filing of the required information for the foreign corporation and its US shareholder, officer or director. In addition, under IRC section 6038, the IRS can assess

additional monetary penalties as well as reduce foreign tax credits to late filers by as much as 10% of the taxpayer's available foreign tax credits.

Under the new procedure, the IRS may no longer exercise discretion in asserting penalties upon the filing of any delinquent return. It does, however, maintain the ability to waive late-filing penalties for reasonable cause. In addition, the new procedures do not impact a taxpayer's ability to seek such relief after the IRS has proposed penalties.

The announcement does not specifically address other foreign-information reporting, where the IRS also has the authority to assess penalties for late filing. These forms include Forms 5472 (Information Return of a 25% Foreign-Owned US Corporation Engaged in a US Trade or Business), 8858 (Information Return of US Persons With Respect to Foreign Disregarded Entities), and 8865 (Return of US Persons With Respect to Certain Foreign Partnerships). However, as these returns are generally governed by the same rules as Form 5471, the automatic-assessment policy could theoretically be expanded to these required information filings as well.

New cost-sharing regulations

The long-anticipated final and temporary cost-sharing regulations were published on 5 January 2009 by the Internal Revenue Service (IRS). These regulations are effective as of that date, and contain very significant changes to the previously existing rules on methods to determine taxable income under the transfer-pricing rules in connection with a cost-sharing arrangement.

In August 2005, the IRS had issued proposed regulations on cost sharing that were considered by many to be quite onerous. These new final and

temporary regulations do consider comments of the taxpayer community made at that time, but the general thrust of the final and temporary regulations is the same. Any taxpayer contemplating transfer of intellectual property in the context of a cost-sharing arrangement is likely to face significantly higher buy-in payments under the final and temporary methods for determining taxable income in connection with a cost-sharing arrangement than under the previous cost-sharing regulations.

Loss carry-forward following change of ownership

The Internal Revenue Service has recently issued two Notices regarding the annual limitation on the use of net operating losses carried forward after an ownership change.

Capital contributions made within two years prior to an ownership change

The IRS has provided safe harbours for when capital contributions to a loss-making corporation made within two years prior to an ownership change may be taken into account for purposes of determining the annual section 382 limitation.

Section 382(a) of the Internal Revenue Code (IRC) provides that the amount of taxable income of a loss-making corporation that may be offset by net operating losses (NOLs) incurred before an ownership change may not exceed the annual section 382 limitation.

The section 382 limitation for a post-change year is generally equal to the fair market value of the loss-making corporation's stock immediately before the

ownership change multiplied by the long-term tax-exempt rate in effect for the month of the change or the two preceding months.

Any capital contributions received by the loss-making corporation within two years prior to an ownership change are presumed to be for the purpose of avoiding or increasing a section 382 limitation and therefore are not taken into account. This rule is commonly referred to as the 'anti-stuffing rule'. Although the authority to do so exists, no regulations have been issued to date to define certain exemptions from the rule.

On 26 September 2008, the IRS issued Notice 2008-78, which now allows capital contributions to be taken into account for purposes of determining the value of the loss-making corporation's stock under section 382, unless the contribution is part of a plan with a purpose of avoiding or increasing a section 382 limitation. Whether a capital contribution is part of a plan is determined based on all the facts and circumstances.

However, a capital contribution will be presumed to not be part of a plan if it meets any one or more of the following safe harbours:

- The contribution is made by a person who is neither a controlling shareholder nor a related party, where no more than 20% of the total value of the loss-making corporation's outstanding stock is issued in connection with the contribution, there was no agreement, understanding, arrangement, or substantial negotiations at the time of the contribution regarding a transaction that would result in an ownership change, and the ownership change occurs more than six months after the contribution
- The contribution is made by a related party but no more than 10% of the total value of the loss-making corporation's stock is issued in connection with the contribution, or the contribution is made by a person other than a related party, and in either case there was no agreement, understanding, arrangement, or substantial negotiations at the time of the contribution regarding a transaction that would result in an ownership change, and the ownership change occurs more than one year after the contribution.
- The contribution is made in exchange for stock issued in connection with the performance of services, or stock acquired by a retirement plan
- The contribution is received on the formation of a loss-making corporation (not accompanied by the incorporation of assets with a net unrealised built-in loss) or it is received before the first year from which there is a carry-forward of a net operating loss, capital loss, excess credit, or excess foreign taxes.

Taxpayers may rely on the above rules for ownership changes that occur in any taxable year that ends after 25 September 2008.

Bank losses and other bad debts

The IRS has clarified in Notice 2008-83 that banks experiencing an ownership change will not be considered as having built-in losses with respect to losses on loans or other bad debts.

IRC section 382(h) provides that if a loss-making corporation has a net unrealised built-in gain immediately before an ownership change, then the section 382 limitation will be increased by the amount of built-in gain recognised during the five-year period following the ownership change. However, if a loss-making corporation has a net unrealised built-in loss immediately before an ownership change, then the recognition of those built-in losses during the five-year recognition period will be subject to the section 382 limitation. A net unrealised built-in gain or loss is defined as the amount by which the fair market value of the assets of the loss-making corporation immediately before an ownership change are more or less than, respectively, the adjusted basis of those same assets. If, however, the net unrealised built-in gain or loss is not greater than the smaller of 15% of the fair market value of the assets and USD 10 million, then the net unrealised built-in gain or loss is presumed to be zero.

On 1 October 2008, the IRS issued Notice 2008-83, which provides favourable guidance on how loan losses and bad debts (including reasonable additions to bad-debt reserves) will be treated for purposes of determining a bank's net unrealised built-in losses immediately before an ownership change. As a result of this notice, losses incurred in connection with loans or other bad debts after an ownership change will not be considered recognised built-in losses subject to the section 382 limitation.

As the Notice does not specify a specific effective date, taxpayers may rely on this guidance retroactively or prospectively until further guidance is issued.

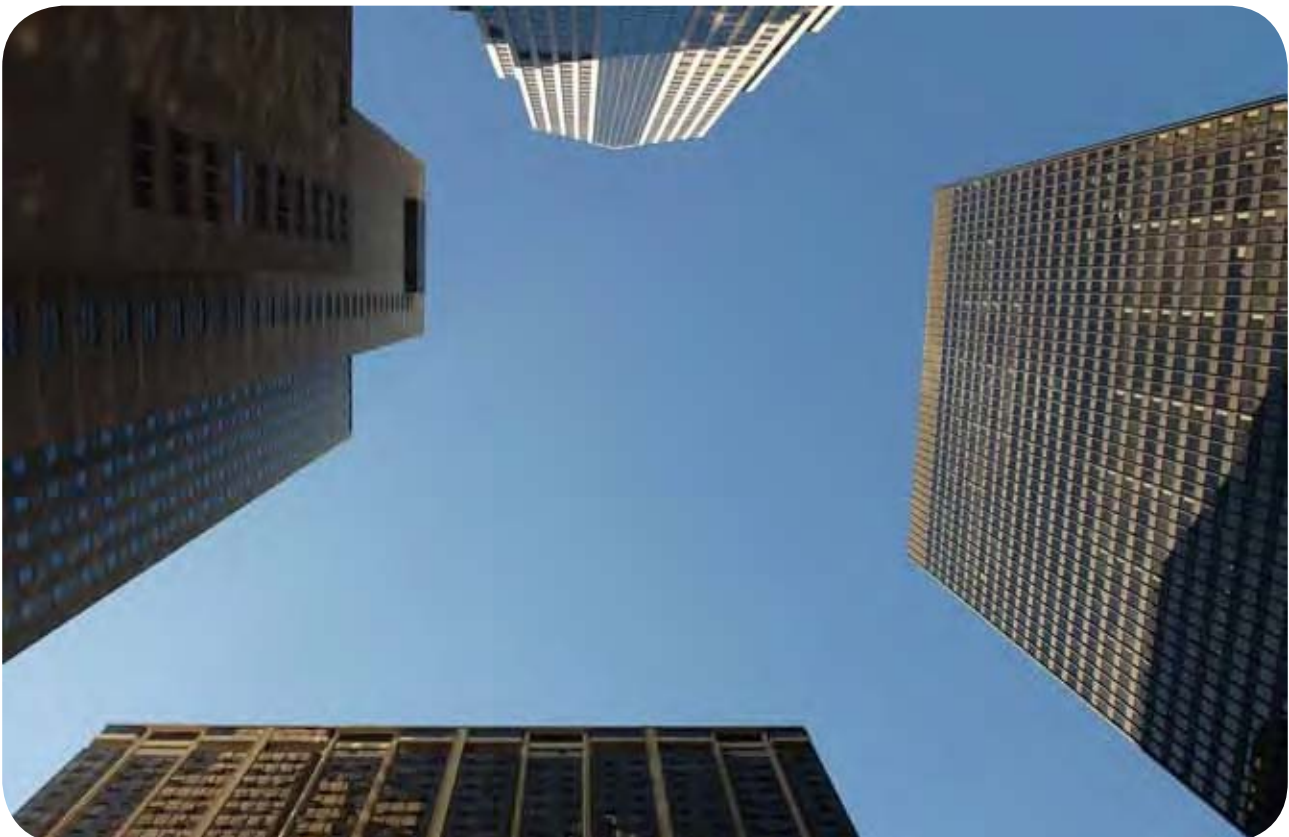
Definition of US real-property interest may change

The Internal Revenue Service and the Treasury Department have announced their intention to propose new regulations clarifying the treatment of certain government licences and similar rights as US real-property interests (USRPIs) under section 897 of the Internal Revenue Code.

This will potentially affect any foreign person holding an interest in a US partnership comprised of US corporations with foreign shareholders, investing within the United States and holding and selling a USRPI.

Section 897 and the regulations thereunder govern disposals of interests in USRPI by foreign persons. Generally, section 897(a)(1) treats any gain or loss of a

non-resident alien or foreign corporation of a USRPI as if the foreign person were engaged in a trade or business in the United States. A USRPI may take the form of direct ownership of real property in the United States (or the US Virgin Islands), and may also include shares of stock in any domestic US corporation. A domestic US corporation is presumed to be a USRPI unless it is established that the corporation was at no time a US real-property holding corporation (USRPHC) during the past five years. A USRPHC is generally defined as a corporation the fair market value of whose USRPIs is at least 50% of the fair market value of its worldwide interests in real property, including its USRPIs, plus its other assets used or held for use in a trade or business. Specific rules govern



the actual testing and determination of this status. For purposes of the test, a corporation's assets are deemed to include its rateable share of the assets of another entity, such as a partnership, by using certain look-through rules.

The IRS and the US Treasury have indicated that some taxpayers may be taking the position that a governmental permit, obtained from a governmental entity to operate certain infrastructure assets such as a toll road, toll bridge, or other assets, does not fall within a meaning of a USRPI under section 897(c). Rather, the taxpayers take the position that the permit or right is an asset used or held for use in a trade or business and that a significant part of the fair market value of the infrastructure assets is allocable to the permit or rights and not to the actual infrastructure (tangible) assets. According to the IRS, this treatment

of accounting for the permit or rights reduces the likelihood that the owner (in the case of a domestic corporation) is treated as a USRPHC under section 897(c)(2).

The proposed regulations would, when issued, provide clarification of the definition of an interest in real property and how the fair market value of licences, permits, franchises, or other similar rights granted by a governmental unit should be taken into account when determining the fair market value of a corporation's USRPIs and interests in real property located outside the United States.

Currently the IRS and the Treasury are seeking comments on the types of rights that should be included in the scope of the contemplated proposed regulations. Comments must be submitted by 29 January 2009.

New contract-manufacturing regulations

On 24 December 2008, the Internal Revenue Service and the Treasury Department issued final regulations on the application of subpart F (the US controlled foreign company – CFC – rules) to certain contract-manufacturing arrangements. These final regulations provide numerous changes and clarifications, some favourable to taxpayers, others not, in the application of the manufacturing exception under IRC section 954(d)(1) to contract manufacturers.

Some of the more important changes involve the liberalisation of the 'substantial contribution' test, which provides for an exception to subpart F income for CFCs whose business operations substantially contributed to the manufacturing process, even if the activities of the CFC's own employees did not reach the level of manufacturing.

The regulations expand the rules included in the liberalised standards for determining when automated processes may qualify as manufacturing, and clarify that there is no minimum level of activities performed by CFC employees before those activities will be taken into account.

Further, the regulations do not contain the rebuttable presumption (which had been included in the proposed regulations) that no branch of a CFC can meet the substantial-contribution test if another branch qualifies under the physical-manufacturing test.

In contrast to the above liberalised standards, the final regulations explicitly reject the 'its' defence, confirming the IRS and Treasury position set out in the proposed regulations (which were published in February 2008). The IRS position on this argument remains clear that

the manufacturing exception does not apply merely because the goods that are ultimately sold are in some way different from the goods purchased (i.e. the 'it' purchased is different from the 'it' sold), where the CFC is not involved in the transformation process.

The final regulations also clarify the rules regarding the application and quantification of the substantial-contribution test. The final and temporary regulations are effective for taxable years of controlled foreign corporations (CFCs) beginning after 30 June 2009, and for taxable years of US shareholders in which or with

which such taxable year of the CFC ends.

As a result, all US shareholders of CFCs should examine their manufacturing arrangements in light of the final regulations, and plan for the 1 July 2009 effective date, as appropriate. These final regulations should also be considered when documenting and quantifying income-tax exposures under FASB Interpretation No 48 (Accounting for Uncertainty in Income Taxes), an interpretation of FASB Statement No 109 (Accounting for Income Taxes).

New protocol with France

Zero withholding tax on royalties and certain dividends feature among the changes to be made to the existing double tax treaty between the United States and France contained in a Protocol signed by the two nations on 13 January.

The zero rate will apply to cross-border dividends paid within a qualifying 80% ownership structure, provided certain other conditions are met. Where the zero rate does not apply, but there is a holding of at least 10% by the recipient company in the distributing company, the withholding rate will be 5%, and 15% otherwise. There will also be zero withholding tax on cross-border royalties.

The Protocol also introduces mandatory arbitration where the two nations' competent authorities are unable to agree on a question referred to them, and strengthened limitation-of-benefit provisions to counter abuse.

The Protocol must be ratified by both nations before it comes into effect; this is unlikely to be before 2010 at the earliest



For more details on any of these items, contact Bob Pedersen of BDO Seidman on +1 212 885 8000 or by e-mail at rpetersen@bdo.com

Europe and the Mediterranean European Union

Restriction on company migration upheld

The European Court of Justice (ECJ) has upheld the Hungarian law that requires companies incorporated in Hungary to retain both their registered office and central administration in Hungary if they are to remain entities subject to Hungarian law. A company wishing to transfer its central administration to another country, therefore, would have to be wound up and then reincorporated in the new jurisdiction.

Whereas Hungarian law thus presupposes the dissolution of a company wishing to remove its central administration from Hungary, the company law of other Member States (such as Denmark, Germany, the Netherlands, Sweden and the United Kingdom) permits companies to transfer their central administration abroad without thereby losing their legal status, but certain of them make that right subject to restrictions, and the legal (and tax) consequences of a transfer vary from one Member State to another.

The case concerned *Cartesio*, a Hungarian limited partnership. Under Hungarian law, partnerships are for this purpose treated as companies. *Cartesio* wished to transfer its operational headquarters to Italy while retaining its legal personality and status in Hungary, but the Hungarian Commercial Court refused to allow it to do so, on the above grounds. *Cartesio*'s appeal against this decision, on the grounds that the law violated its freedom of establishment, was referred to the ECJ.

Going against the Opinion of its Advocate-General, the Court pointed out that Article 48 of the EC Treaty, in defining the companies that enjoy the right of establishment, places on the same footing as factors

connecting a company to the state under whose law it is governed, the registered office ('statutory seat'), the central administration ('real seat') and the principal place of business. In the absence of a harmonised Community definition of companies that may enjoy the right of establishment by virtue of a single connecting factor, Member States had the power to define both the connecting factor required of a company if it is to be regarded as incorporated under the law of that Member State and the factor or factors required if it is subsequently able to retain that status.

EU companies wishing to move their substantial operations outside their state of incorporation must thus in future check whether it is possible under the company law of their state for them simply to transfer their central administration abroad. Where this is not possible, and a dissolution is either impossible or undesirable, other ways must be sought. For example, they may consider a cross-border merger of the existing company into a company newly incorporated in the host country for that purpose. Such a procedure is possible under the EC Mergers Directive, and may also be carried out in a tax-neutral way where applicable. It is also worth noting that the European Company (*Societas Europaea*) was introduced in part precisely to allow a cross-border transfer of a company's seat without the legal and tax consequences of a dissolution and reincorporation.

Parent-Subsidiary Directive does not apply to usufruct holdings

The European Court has held, contrary to the Opinion of its Advocate-General, that the Parent-Subsidiary Directive does not apply to cases where the legal ownership of shares is separated from the right to enjoy the dividends.

Under the Parent-Subsidiary Directive, where a company is in receipt of a dividend from another company in another Member State, and has a minimum holding in the capital of the paying company, the home state of the recipient company must either exempt the dividend or give full credit for the corporate tax in the paying company's home state on the profits out of which the dividend is paid. Similarly, the paying company's state must not charge withholding tax on that dividend. Certain other conditions must also be satisfied.

The Court's judgment means that the Directive applies only to dividends received by the person having

the required legal-ownership relation to the paying company and not to cases where the dividend is actually received by a usufructuary to whom the legal owner has transferred the right to receive the income.

As we reported in the last issue of *BDO World Wide Tax News*, the case was referred to the European Court by a Belgian court. During the time period covered by the case, the Belgian law was silent as to whether the Directive applied to exempt dividends also in cases of usufruct, but was subsequently amended to exclude usufructuaries from exemption.

The Court did, however, point out that Member States that exempt domestic dividends received by usufructuaries as well as those received by companies holding the shares with full title, must extend the same favourable treatment to dividends received from companies in other Member States.

ECJ upholds non-resident interest withholding tax

See under Belgium.

Belgium's transfer-pricing rules to be tested in Europe

See under Belgium.

For more details on the European aspects of these items, contact **Andrea Bilitewski**, Chair of the BDO European Union Direct Taxes Centre of Excellence, on +49 40 302930 or by e-mail at andrea.bilitewski@bdo.de

For the Belgian aspects see under Belgium below.

For the Hungarian aspects of the *Cartesio Decision*, contact **Zoltán Gerendy** of BDO Forte on +36 1 235 3010 or by e-mail at zoltan.gerendy@bdo.hu

Belgium

ECJ upholds non-resident interest withholding tax

The European Court of Justice has held that it is not in breach of Community law for Belgium to impose a withholding tax on payments of interest to non-resident companies while exempting interest paid to resident companies from withholding tax.

In the case concerned, *Etat belge – SPF Finances v Truck Center SA* (Case C-272/07), the facts of which took place in the 1990s, a Belgian company was granted a loan by a Luxembourg company that owned 48% of the Belgian company's shares. Whereas Belgian domestic law exempted interest payments between Belgian companies from withholding tax, the exemption did not extend to interest paid to non-resident companies. The tax treaty between Belgium and Luxembourg allows for a withholding tax of up to 15% to be imposed in such circumstances.

The Belgian company did not deduct or pay over withholding tax on the accrued interest and appealed against an assessment to the withholding tax, maintaining that this difference in treatment between resident and non-resident companies was discriminatory and in breach of the freedom of establishment and the free movement of capital guaranteed by the EC Treaty. Whereas the freedom of establishment applies between EU and EEA states only, the free movement of capital may extend to third countries.

The Court held, however, that the position of resident and non-resident companies in these circumstances was not objectively comparable.

First, the position of the Belgian state was different between the two cases – in one it was the state of residence of both companies and in the other it was the state of source of the interest. Second, the payment of interest in the two cases gave rise to two distinct charges resting on separate legal bases. Interest paid to a Belgian-resident company was not subject to withholding tax, but was subject to corporate tax in the hands of the recipient company. Withholding tax on payments to non-residents was, on the other hand, deducted at source pursuant to a discretionary power agreed between Belgium and a treaty-partner, in this case Luxembourg. Third, Belgium had much less power of recovery over tax owed by non-residents than it had over tax owed by residents. Moreover, the absence of withholding tax on payments to residents did not necessarily result in an advantage. Resident companies had to make advance payments of corporate tax and were subject to higher rates of tax on the interest than the rate of withholding tax charged to non-residents.

It should be pointed out that payments of cross-border interest between qualifying affiliated companies within the European Union are now generally free of withholding tax under the EC Interest and Royalties Directive.

Belgium's transfer-pricing rules to be tested in Europe

As part of Belgium's transfer-pricing rules, article 26 of the Belgian Income Tax Code provides that where a Belgian-resident company grants an 'exceptional or gratuitous advantage' to a related non-resident company, the value of that advantage is added back to the taxable profits of the Belgian company.

Article 26 has now been referred to the European Court of Justice (ECJ). In the case concerned – *Société de Gestion Industrielle v Belgian State (C-311/08)* – the company ('SGI') granted such an exceptional and gratuitous advantage within the meaning of article 26 to an affiliated company resident in a low-tax jurisdiction. As a result, the Belgian tax authorities, applying article 26, increased SGI's tax base by the value of those advantages. SGI appealed and the case came before the

Court of First Instance (*Tribunal de Première Instance*) of Mons.

Observing that exceptional or gratuitous advantages granted to a related resident company are generally not included in the tax base of the Belgian company granting such benefits, the court referred the case to the ECJ, asking whether or not article 26 is compatible with articles 12 (non-discrimination), 43 (freedom of establishment) and 56 (free movement of capital) of the EC Treaty.

If the ECJ finds article 26 ITC to be incompatible with the EC Treaty, the legal base for preventing profit-shifting to related foreign companies would be gravely undermined. The Advocate-General's Opinion in the case is expected this Spring.

Parent-Subsidiary Directive does not apply to usufruct holdings

See under European Union.



For more details on the Belgian aspects of these items, contact Marc Verbeek of BDO Atrio on +32 2 778 0100 or by e-mail at marc.verbeek@bdo.be

Estonia

VAT increased, corporate deductions postponed

Estonia is unique among EU Member States in charging no corporate tax on retained profits. Distributed profits, non-business expenses and certain benefits-in-kind, are taxed at 21%. The rate of tax on distributions was scheduled to decrease by one percentage point from 2009 until 2011, to stabilise at 18%. Shortly before the end of the year, as a response to the economic crisis, these rate reductions were postponed for one year, so that the 2009 rate remains 21%, and the 18% rate will not be attained before 2012. Certain taxpayers are challenging the legality of the postponement, alleging that the postponement infringes their constitutional right of legitimate expectation.

As another crisis measure, the reduced rate of VAT was increased from 5% to 9%, and as in Latvia, the scope of supplies to which the reduced rate applies was significantly restricted.

However, measures were also enacted that are more favourable to taxpayers. From 1 January 2009, the minimum holding required by an Estonian company

in another company for the recipient company to be exempt from corporate distribution tax on a redistribution of dividends received from that other company is reduced from 15% to 10%. Where that other company is resident in Estonia or elsewhere in the European Union or European Economic Area or Switzerland, no further conditions are imposed. If the distributing company is resident in a third country, proof must be provided that it is subject to a tax on its income or that the dividend to the recipient Estonian company was subject to withholding tax.

Furthermore, from 1 January 2009, Estonia no longer imposes a withholding tax on any outbound dividends. Previously, withholding tax was charged at 21% (subject to reduced rates stipulated by tax treaties) on dividends payable to non-resident companies holding less than 15% of the share capital or voting power in the Estonian distributing company. The Estonian company must still pay the distribution tax, subject to the exemption discussed above.



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France

Refund of R&D credits

The French government has announced that any outstanding tax credits for research and development expenditure that companies have not yet been able to set off against corporate tax will be refunded

immediately in 2009. Normally, R&D credits are set off against corporate tax, but companies with insufficient tax liabilities to absorb the credits have them refunded after three years.

New Protocol to US treaty

See under United States.



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Germany

Taxation of outbound portfolio dividends

Germany's method of taxing dividends on shareholdings of less than 10% paid to non-resident companies has been challenged by the European Commission.

When a German company distributes dividends, a tax of 25% of the gross dividend is generally withheld at source. If the dividend is payable to another German company, this tax is effectively refunded, as it is considered to be an advance payment of corporate tax. However, if the dividend is payable to a non-resident company, the withholding tax is final (the rate may be reduced under a double tax treaty). If the dividend is payable to a company resident in another EU Member State in respect of a holding of 10% or more, the EC Parent Subsidiary Directive applies (provided that the other conditions are satisfied) to exempt the dividend from withholding tax.

Where the holding is less than 10%, however, the Directive does not apply, and in such situations, the European Commission regards the difference in treatment of domestic and other EU shareholders to be in violation of the EC Treaty. It has therefore initiated infringement proceedings against Germany on these grounds.

Germany could resolve the situation going forward either by also exempting outbound dividends on shareholding of less than 10% or by taxing domestic dividends on such shareholdings (as was discussed during the preparatory stages of the 2009 Finance Act). If Germany does not amend its tax legislation so as to eliminate the discrimination, the Commission's next step would be to bring a case before the European Court of Justice.



If such a case proceeds, we are of the firm opinion that the Commission would rule against Germany, and such a judgment would have retroactive effect, in whatever way Germany may amend its legislation in future. We therefore recommend that non-resident companies within the European Economic Area that have suffered German withholding tax on shareholdings of less than 10% file a protective refund claim with the Federal Central Tax Office (*Bundeszentralamt für Steuern*). Such claims can be made for dividends received after 31 December 2004.

It should be noted, however, that if the infringement proceedings are discontinued because Germany amends its tax law in the appropriate manner, taxpayers wishing to pursue their claims would have to take their own cases to court at their own expense.

This is only the latest of a series of infringement proceedings that the Commission has opened or has in view against Member States over the treatment of outbound dividends. In 2007, for example, the Commission announced that it would be referring Italy, the Netherlands, Portugal and Spain to the European Court on similar grounds.

Change in rate of withholding tax

As to the withholding tax itself, it should be noted that, until 1 January 2009, the rate was 20% (plus solidarity surcharge, so effectively 21.1%). It was increased to 25% (effectively 26.375%) from 1 January 2009, but, regardless of any treaty provisions, two-fifths of the tax is refunded to non-resident companies, so that they actually suffer tax of 15% (effectively 15.825%). Provisions in a double tax treaty may reduce this rate further.



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Gibraltar

Corporate tax reform cleared by ECJ

The European Court has held that Gibraltar's planned reform of corporate tax is not illegal State Aid, so reversing a European Commission decision of 2004.

The Commission had decided that the reform was both regionally selective (because Gibraltar is legally part of the European Community by virtue of the United Kingdom's membership) and materially selective (because it allegedly favoured some types of company over others).

In its judgment of 18 December 2008, however, the Court of First Instance of the European Communities found against the Commission on all counts. Basing itself on the precedent set in the *Azores* case, the court held that Gibraltar was sufficiently autonomous on all three grounds (institutional, procedural and economic and financial) established in that case, so that comparison with the rest of the United Kingdom was

not valid. As far as material selectivity was concerned, the Commission had failed to provide sufficient proof that the taxes forming part of the proposed reform were derogations from the common system to be established.

The Commission's decision was therefore annulled.

The Gibraltar government now feels free to proceed with the reform, which it believes will enhance Gibraltar's position as a leading international financial centre within the European Union. The legislation necessary to implement the new system is to be finalised by 1 July 2009, with a view to implementation by 1 July 2010. The new rate of tax for companies is anticipated to be 10%.

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Israel

Tax reform to encourage investment

A tax reform, effective as of 1 January 2009, is dedicated to encouraging foreign and domestic investment in Israel at a time of economic uncertainty in the worldwide markets. The following constitutes the main points of interest covered in the tax reform and pertaining to foreign investors.

Capital gains tax exemption upon the sale of non-traded securities

Despite the fact that certain tax treaties Israel has entered into may under certain conditions exempt foreign-resident shareholders from capital gains tax upon the sale of securities of Israeli-resident companies, these provisions are often dependent, inter alia, upon a minimal percentage holding. In 2006, a temporary measure was introduced (to end on 31 December 2008) providing a tax exemption upon the sale of non-traded securities in an Israeli-resident company. However, despite applying regardless of the percentage holding, this was still only applicable to treaty-country residents and subject to further conditions.

Under the new tax reform, the exemption from capital gains tax, now no longer only a temporary measure, has been expanded to include all foreign-resident shareholders and will apply upon the eventual sale of non-traded securities of an Israeli-resident company (or foreign company whose assets consist directly or indirectly mainly of Israeli situs assets), purchased after 31 December 2008. The exemption will not apply to the securities of an Israeli company whose assets consist mainly of Israeli *situs* real estate or Israeli real-estate companies.

Gains from the sale of traded securities are already exempt for all foreign-resident shareholders.

Temporary tax reduction on inbound dividends

A further measure included in the tax reform with an aim of increasing local investment is a temporary tax reduction on dividend income received by a local company in Israel from foreign sources, subject to, inter alia, the condition that the said income be 'used in Israel'. An Israeli company will be liable for a 5% tax only (as opposed to 25%) on the dividend income received from abroad during 2009 if that income is 'used in Israel' up to a year after being received. Foreign tax credit will be allowed for tax withheld upon the dividend distribution, but excess foreign tax (resulting from a withholding tax in excess of 5%) will not be eligible for carry-forward to future years. The income will be deemed as being 'used in Israel' if one of the following occurs:

- It is paid to an Israeli resident for work or services provided in Israel;
- It is used to purchase or lease assets (excl. securities) used in Israel or the payment thereof is to an Israeli resident;
- It is used for the improvement or maintenance of assets in Israel;
- It is invested in research and development in Israel;
- It is used for the repayment of a loan to an Israeli resident, should the loan be repaid to a related party – subject to the said party "using in Israel" the funds repaid;

- It is used for the payment of interest, discount or linkage differences on debentures traded on the Israeli Stock Exchange or for the repurchase of said debentures by the issuer;
- It is deposited in a bank in Israel for a period of at least one year, or used for the purchase of tradable securities held for a period of at least one year (ongoing sales and purchases of tradable securities is allowed if the full consideration received is used in the purchase).
- It is paid as a dividend to another Israeli resident company – subject to the recipient's "using in Israel" the dividend income received.

Certain anti-abuse measures are included with respect to the tax reduction and in addition should the recipient Israeli company be a transparent entity or where the source of the foreign income from which the dividend is distributed is in a Controlled Foreign Corporation the said dividend income is excluded from the said benefit.

Tax exemption for foreign debenture holders

Subject to certain conditions, no tax will be levied in Israel upon interest, discount, and inflation-difference payments made to a foreign-resident holder of debentures of an Israeli company issuer listed on the Tel Aviv Stock Exchange and made after 1 January 2009. These conditions include, inter alia, that the said payments are not attributable to a fixed enterprise in Israel of the foreign resident and that the foreign resident is not related to or a substantial shareholder in the Israeli company issuer. In addition, the foreign resident must not be an employee, service provider, or supplier nor have any special relationship with the Israeli company issuer (unless the payments were determined without the influence of the relationship between the issuer and the foreign resident).



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Jersey

Zero corporate tax

Jersey has introduced a zero general rate of corporation tax with effect from 2009. The new régime replaces the previous exempt-company régime regarded by the European Union as representing unfair tax competition. Jersey, although not part of the European Union, had agreed to withdraw it by 2009.

Previously in return for an annual fee of GBP 600, companies beneficially owned by non-Jersey resident shareholders would normally qualify as 'exempt companies'. This meant that they were deemed to be non-resident in Jersey for tax purposes, which in turn led them to suffer Jersey income tax only on any Jersey-source income received, excluding Jersey bank interest.

Under the new, so-called 'zero-ten' régime, Jersey companies incorporated after 3 June 2008, and existing exempt companies after 31 December 2008, are no longer able to claim exempt status. Instead, business profits of these companies are subject to Jersey income tax at either the general company rate of 0%, the higher rate of 10% for certain financial-services companies or the 20% rate if they operate a utilities business. Broadly, the 10% rate of tax applies to the profits of Jersey-based trust companies, banks, and certain custodians or fund-administrator businesses. Therefore there is an expectation that the vast majority of companies that currently benefit from exempt status will fall into the new 0% general company tax régime from 2009.

It should be noted that all companies will continue to suffer Jersey income tax at 20% in respect of profits earned from leasing out or trading in Jersey land and property, whether or not the company's other profits are taxed at 0%, 10% or 20%.

As well as the obvious benefit of suffering no Jersey tax on profits earned (unless those profits arise from Jersey land), a 0% taxpaying Jersey company is able to pay dividends and interest gross, subject to any EU Savings Tax Directive requirements. In addition, non-Jersey-resident directors of such companies will be exempt from Jersey income tax in respect of directors' fees they earn from the company.

Deemed rental income

Draft legislation has very recently been lodged with the States of Jersey which will affect companies owned more than 51% by non-Jersey shareholders that have an interest in Jersey-situs property. Very broadly, under this legislation, tax at 20% will be charged, based on the notional open market rental value of the company's property interest. It is unusual for a Jersey company forming part of an international structure to own Jersey property. However, some special purpose vehicles (SPVs) will rent office space. Provided that the rent charged against the SPV is market rent, this new law will have no impact. It is not yet clear when this new charge will begin to apply, but the better view is that it will be effective from 2010 and not 2009.

Shareholder taxation

The move to a general company rate of 0% has resulted in a loss of tax to the Jersey exchequer. To help fill some of this hole, the profits of Jersey companies are now apportioned among the company's shareholders and taxed at that level. However, this provision has effect only where the shareholder is a Jersey resident for tax purposes. As a result, a non-Jersey shareholder of a Jersey company subject to a 0% tax on all of its profits will not suffer any Jersey income tax over the life of that company.

Goods and services tax

Another way the Jersey authorities have sought to fill the fiscal deficit created by the move to a general company tax rate of 0% is by introducing a new indirect tax, goods and services tax (GST), which is closely similar to VAT, from 6 May 2008. The GST rate is 3% and a Jersey business only needs to charge GST on goods and services provided if the business turnover is more than GBP 300 000 per annum.

There are a number of exemptions from GST, among them the International Services Entity (ISE) exemption. Broadly, a company will be eligible to claim ISE status on an annual basis if either it is one of the prescribed businesses in the GST law (e.g. a regulated bank, trust company, Collective Investment Fund etc.) or it is a company the income or assets of which cannot be enjoyed by Jersey residents and at least 90% of the income of which is derived from non-Jersey customers/clients or another ISE. The prescribed annual fee varies depending on the type of business submitting the claim. It ranges from GBP 7500 for a bank down to GBP 100 for collective investment funds and most 'exempt'-type companies.

The practical effect of obtaining ISE status is that the company will not be directly affected by GST.

Corporate fund vehicles

Jersey has enjoyed an explosive growth in the number and value of Jersey-domiciled funds in recent years. The Jersey tax system has supported this industry and the new company tax régime continues this tradition.

Essentially, collective investment funds structured as Jersey companies will continue to benefit from a tax-neutral status, even after the exempt company is abolished. They should be eligible for the 0% company tax rate and ISE status for GST purposes and distributions will be payable gross, even to Jersey-resident investors, which is not the case under the exempt-company régime. An extra attractive feature of the new rules is that fund-manager companies located in Jersey will also be able to enjoy the 0% rate of tax.

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Latvia

VAT raised, income tax cut

As part of its reaction to the financial crisis, on 12 December the Latvian government secured the enactment of measures involving an increase in the standard and reduced rates of VAT, an increase in excise duties, and a decrease in the rate of income tax.

With effect from 1 January 2009, the single flat rate of income tax was reduced from 25% to 23%. The rate of income tax on an unincorporated business remains at 15%, in line with the corporate tax rate. At the same time, the standard rate of VAT was raised from 18% to 21% and the reduced rate from 5% to 10%. In addition, the range of supplies to which the reduced rate applies was significantly reduced, so that the rate of VAT on many supplies has been increased from 5% to 21%. The reduced rate now applies only to certain medicines and medical equipment, baby products, internal public transport, and supplies of domestic heating, electricity and natural gas. Books, magazines and newspapers have a one-year reprieve only. They continue to qualify for the reduced rate (doubled to 10%) for one year. From 1 January 2010, however, they will be taxable at the standard rate.

In earlier legislation, a deduction for notional interest, along the lines of the similar Belgian provision, was one of the chief amendments to the corporate tax. A company may, in respect of taxable periods beginning after 31 December 2008, claim a deduction in each taxable period equal to the aggregate of all its retained profits for any taxable period beginning after 31 December 2008 multiplied by the annual weighted average interest rate on loans denominated in Latvian currency and extended to non-financial enterprises in that year. The appropriate interest rate is to be published by the Bank of Latvia. Other amendments to corporate tax prolonged the life of the accelerated depreciation available to investment in certain fixed assets from 2010 to 2013, increased the carry-forward period for losses from five to eight years, and introduced a rollover relief for reinvestment in fixed assets.

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Luxembourg

Corporate tax cut; capital duty abolished

The tax reductions on which we reported in *BDO World Wide Tax News* Issue 2008 No 2 in July 2008 have been enacted. The main measures are as follows:

- the rate of corporate tax is reduced from 22% to 21%. Luxembourg companies also pay a local business tax and an unemployment fund contribution. For companies in Luxembourg City, the combined effective rate falls from 29.63% to 28.59%
- capital duty is abolished
- there will be a zero withholding tax on dividends paid to companies resident in jurisdictions with which Luxembourg has a tax treaty, provided that similar conditions to those applying to inbound dividends under the Luxembourg participation exemption are satisfied. These include the requirement that the recipient company hold at least 10% of the paying company or that its holding have an acquisition cost of at least EUR 1.2 million and that it have been held (or there be a commitment to hold it) for at least 12 months. The recipient company must also be subject to a tax similar to Luxembourg corporate tax

There have also been enhancements to the favourable intellectual property régime and an extension in the life of the tax credit to businesses hiring unemployed individuals.

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Netherlands

Interest deduction under review

The Netherlands government has announced that the tax treatment of inter-company interest is under review.

The government is under the opinion that the current tax treatment of interest encourages debt funding, leading to erosion of the corporate tax base. The way in which private equity funds finance certain acquisitions by debt was mentioned as an example of undesirable acquisition structures.

Any increased revenue arising from a possible change in treatment would be applied in reducing the rate of corporate tax, currently 25.5% (rates of 20% and 23% apply to the first EUR 200 000 of taxable income).

Among possible changes being considered are:

The exclusion of all interest income and interest expense from the corporation tax base

- The introduction of a comprehensive business income tax (CBIT). Companies taxed on a CBIT basis would exclude interest income from and interest expense paid to other companies taxed on the same basis; other interest would remain taxable and deductible
- Reduced deductibility of inter-company interest expense and reduced taxation of inter-company interest income (i.e. some kind of obligatory interest 'box', similar to the patent box currently in operation)



- An earnings-stripping rule, under which there would be restricted deductibility of both inter-company and third-party interest expense insofar as it was in excess of a certain percentage of income

Introduction of any of these proposals would also pave the way to repeal of several existing anti-abuse provisions aimed at countering planning schemes for optimisation of interest expense.

Another benefit in the eyes of the government of any exclusion of inter-company interest from the tax basis would be to enhance the attractiveness of the Netherlands as a jurisdiction for the treasury function of international groups.

The government expects to release a draft bill by the middle of this year, with implementation in 2010 at the earliest.

Accelerated discretionary depreciation

Accelerated depreciation of up to 50% on investments made in fixed assets during 2009 are available to taxpayers in the Netherlands from 1 January 2009, as a measure intended to provide businesses with additional liquidity during the credit crunch.

The accelerated rate (which may not exceed 50%) will be available on the expenditure incurred on the acquisition or production of fixed assets, both in the financial year of investment and in the following financial year. Expenditure on most types of asset will qualify, with the exception of real property, cars and intangible assets, among others. First use of the assets concerned must be made before 1 January 2012.

It will not be possible to combine this accelerated depreciation with other forms of discretionary depreciation, such as that applying to environmental assets or to expenditure by new businesses.

Companies with financial years other than the calendar year may thus claim the depreciation for investments made in 2008-09 as well as in 2009-10, on condition that the legal obligation to incur the expenditure is entered into in the 2009 calendar year.

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

United Kingdom

UK tax on foreign dividends unlawful

In a lengthy and complex judgment, the High Court of England and Wales has found the United Kingdom's taxation of foreign dividends received by companies holding 10% or more of the EU or EEA paying company unlawful. The judge further held that legislation introduced in 2004 and 2007 to limit the time period for claims for restitution of tax wrongly paid was unlawful. As a result, as explained below, UK companies having paid tax on foreign dividends may be able to claim repayment of that tax, with interest, dating right back to 1973.

The case (*The Test Claimants in the FII Group Litigation v Commissioners for Her Majesty's Revenue & Customs*) stems from the decision of the European Court of Justice in December 2006 relating to the same parties. The ECJ held that the United Kingdom's taxation of foreign portfolio dividends (holdings of less than 10%) was in breach of EC law, but that the question of whether the treatment of dividends from larger holdings was also unlawful was to be decided by the UK courts. The general principle, however, was that the treatment would be unlawful if it led to taxation in the United Kingdom of foreign dividends at a rate less favourable than that applying to domestic dividends.

From 1973 to 1999, the United Kingdom exempted domestic dividends from corporation tax. They gave rise, instead, to 'franked investment income' – FII. FII contained a tax credit that the company could set against the advance corporation tax (ACT) the company needed to pay on its own dividend distributions. ACT was an advance payment of corporation tax. Where ACT exceeded the corporation tax liability ('surplus ACT'), the excess

could be carried forward or back or surrendered to UK subsidiaries. In 1999, ACT was abolished but other features of the system remained. By contrast, foreign dividends were taxable, but with a credit for foreign withholding tax and foreign underlying tax. These foreign tax credits cannot exceed the UK tax payable on the dividends and do not give rise to UK tax credits, unlike FII. Furthermore, the ACT that the company could until 1999 set against its corporation tax was reduced by any credit given for foreign tax.

In the light of his interpretation of the ECJ's guidance and judgment, Mr Justice Henderson held in the High Court that:

- The charge to corporation tax on dividends from companies in EU and EEA states had at all material times infringed the freedom of establishment guaranteed by Article 43 of the EC Treaty and the EEA Agreement (which took effect from 1 January 1994)
- The charge to corporation tax on dividends from companies in third countries had at all material times infringed the free movement of capital guaranteed by Article 56 of the EC Treaty, but because the system had been in place at 31 December 1993, this was not unlawful
- The FID régime introduced in 1994 (and abolished in 1999) to alleviate the problem of surplus ACT on foreign dividends by permitting a repayment or set-off of ACT paid on further distributions of foreign-source dividends received was also in breach of Articles 43 and 57. Since it was introduced only in 1994, it was also unlawful in respect of dividends from third countries

- Legislation introduced in 2004 and 2007 to limit the time period for claims for restitution of tax wrongly paid to six years from the time of payment of the tax was unlawful, because it did not allow for any transition period

In view of the large sums involved, it is clear that the case will ultimately proceed to the House of Lords (and some aspects of it may again be referred to the ECJ).

However, our view is that:

- Any tax paid on foreign dividends paid to UK companies by companies established elsewhere in the European Union (tax paid since 1973) or the European Economic Area (tax paid since 1994) can in principle be recovered. For open periods, returns can be refiled to make such claims where this has not previously been done and it is beneficial to do so
- For groups with surplus ACT, where the surplus arose from the failure to rank the foreign EU/EEA

dividend as FII, a claim can in most cases be made in respect of open periods to recover the surplus ACT

- Claims made regarding tax on third-country dividends should be maintained pending clarification of the appeal process
- For closed periods, the judgment indicates that it is possible to bring claims for restitution before the High Court notwithstanding the legislative attempts to frustrate this remedy
- In both situations, UK companies that have received foreign dividends should review their position to determine the tax potentially at stake, so that a view can be formed on the potential avenues for redress. Interest on the tax due for repayment will itself be a significant consideration. Groups in receipt of such dividends also need to consider their ACT position where they have surplus ACT

Pre-Budget Report provides emergency fiscal stimulus

An urgent fiscal stimulus in view of the credit crunch and recession was the centre point of the Chancellor's Pre-Budget Report, delivered on 24 November. Among the measures announced by Alistair Darling were:

- An immediate cut in the standard rate of VAT to 15% (the minimum rate permitted in the European Union). The cut has effect from 1 December 2008 to 31 December 2009, after which date the standard rate is set to revert to 17.5%
- A postponement for one year of the one percentage point increase in the small companies rate of corporation tax, originally scheduled for 1 April 2009
- A temporary extension of the loss carry-back period for businesses from one year to three years. However, this extension applies only to losses incurred in accounting periods ending between 24

November 2008 and 23 November 2009 and the amount that may be carried back beyond one year is limited to GBP 50 000

- An above-inflation increase in the income tax personal allowance for taxpayers

However, the Chancellor of the Exchequer gave notice of fiscal tightening in future years, such as:

- An increase in the rate of employer's national insurance (social security) contributions from 12.8% to 13.3% from 6 April 2011;
- An increase in the rate of employee's national insurance contributions from 11% to 11.5% and an increase in the additional rate on high earnings from 1% to 1.5%, both from 6 April 2011;
- The introduction from 6 April 2011 of a top 45% rate of income tax

- From 6 April 2010, taxpayers with taxable income between GBP 100 000 and GBP 140 000 will face a progressive reduction in their personal allowance (currently set at GBP 6035) down to one-half of its full value. Those with taxable incomes above GBP 140 000 will have their personal allowance progressively reduced to zero where their income is sufficiently high

- A freeze in the maximum annual pension contribution limit and the lifetime pension allowance from 2010 to 2016

Worldwide debt cap to be introduced for multinational groups

As part of the reform of the taxation of foreign profits (see also 'Foreign dividends to be exempt for larger companies' on page 2), the UK Government has announced that the availability of relief from UK corporation tax for intra-group financing costs will be restricted for 'large' groups of companies at least one member of which is resident in the United Kingdom.

This restriction, known as the 'worldwide debt cap', represents a new set of rules that will limit the deductibility of the intra-group interest expense of UK companies in cases where the UK members of the group have more intra-group interest expense than the group's worldwide net external interest expense. These rules will be in addition to the existing rules that already potentially limit the deductibility of interest, such as the transfer-pricing, anti-arbitrage and unallowable-purpose rules.

The cap will apply only to groups with 250 or more employees and with turnover of EUR 50 million or more and/or net assets of EUR 43 million or more.

Groups affected will need to carry out a four-step process:

- 1 determine the gross UK intra-group finance expense (defined as the 'tested amount')

- 2 determine the worldwide group's net external finance expense (defined as the 'available amount')
- 3 where the tested amount exceeds the available amount, disallow the excess and allocate the disallowed amount between the relevant UK companies
- 4 apply compensating adjustments on a pro rata basis to reduce any intra-group finance income received by UK companies



As well as interest payable and receivable, net finance costs in this context are expected to include certain derivative contracts, finance-lease charges, debt factoring and foreign-exchange differences.

UK groups with upstream loans from their foreign subsidiaries and UK subsidiaries of foreign groups with debt financing provided by non-UK group members are potentially caught by the new rules, which will take effect on 1 April 2009 or possibly later. There will be exceptions to the cap for some financial-services businesses, notably banks and insurance companies. Other possible exclusions, for example where groups are temporarily cash-rich or where the REIT or securitisation régimes apply, are also being considered.

There will also be anti-abuse rules to prevent the externalisation of intra-group financing by, for example, back-to-back loans.

Groups will need to assess how these proposals could have an impact on them. The rules are not straightforward, as it will be necessary to compare the gross intra-group finance expense of UK companies with the net external finance expense of the group as a whole. The former is measured on a tax basis but the latter under IAS/IFRS. Well-capitalised groups may be penalised, and groups with no net external financing will not be able to obtain any deduction in the United Kingdom for intra-group financing costs.

Controlled foreign companies: consequential changes

A wholesale reform of the CFC régime is planned for 2010 or 2011 after further consultation with business. Until then, the existing CFC rules remain in place with consequential changes arising from the proposed dividend exemption:

- The acceptable distribution policy (ADP) exemption from the CFC charge is to be abolished for accounting periods of foreign subsidiaries beginning on or after the commencement date, as this would no longer make sense if the dividend income were exempt.
- For accounting periods of foreign subsidiaries beginning before the commencement date, the ADP route will continue to be available and the dividend will be taxed under the old rules with credit for foreign tax suffered.
- The exempt-activities test for foreign holding companies will be abolished, subject to a 24-month transitional period for existing holding companies, as most dividends received by a CFC will no longer form part of its chargeable profits.

Treasury Consents to go

As anticipated, the archaic requirement for prior Treasury Consent to be obtained for issue or transfers of shares and debentures of foreign subsidiaries is to be abolished. It will be replaced by requirements for the top UK holding company in a group to report specific transactions of over GBP 100 million (EUR 110.5 million; USD 146.7 million) within 14 days of the end of the quarter following the quarter during

which the transaction took place.

The present criminal sanctions are abolished to be replaced by monetary penalties.

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Asia Pacific

People's Republic of China

Reform of business tax and VAT

Businesses providing taxable labour services to Chinese customers are now liable to business tax, even if the suppliers of the service are not located in China and the service is rendered outside China, as a result of amendments to the business tax regulations effective from 1 January 2009.

The People's Republic of China has both a value added tax and a turnover-related business tax. VAT is charged on the importation of movable goods into China, the sale of movable goods in China and the provision of processing and repair services in China. The standard rate of VAT is 17%, although 'small-scale' taxpayers pay a rate of 3% under the amended VAT regulations. Business tax, on the other hand, is charged on the provision of services (other than processing or repair), the transfer of intangible assets and the sale of immovable property in China. The rate is normally 3% or 5%, although entertainment services may face a rate as high as 20%.

Business tax

Previously, labour services were liable to business tax if provided in China. The location of the supplier or of the customer was of no significance. From 1 January, however, these services are taxable if either the supplier or the customer are located in China, regardless of where the service is provided.

Chinese suppliers of taxable labour services are now required to file their business tax return at the location where they are registered or reside, and not as previously at the location where the services were

provided. There is an exception for construction services and certain other prescribed services, to which the old filing rule still applies.

For foreign enterprises or individuals supplying services liable to business tax but without a business establishment in China, it is their withholding agent who is responsible for withholding and paying over the business tax. Under the new rules, the withholding agent must be their general business agent or the customer or purchaser of the service, intangible or immovable property.

These changes may have a significant impact on many foreign service-providers supplying services in or outside China to Chinese customers. These service providers should review their business-tax exposure immediately to determine the appropriate course of action.

Value added tax

The current VAT system in China has been production-based, and generally disallowed the recovery of input VAT on the purchase of fixed assets. However, under a trial programme begun in 2004, certain industries in certain regions have been allowed to recover input VAT on fixed assets in a partial move towards a consumption-based system. From 1 January 2009, there are no further geographical or industry-specific restrictions on the recovery of input VAT on purchases of fixed assets. Where there is excess input VAT in any return period, it may be carried forward to set off against output VAT in future periods.

At the same time, the preferential treatment afforded to foreign-investment enterprises (FIEs), who have been able in certain circumstances to import equipment into China free of import VAT, has been withdrawn, in the light of the new ability to recover VAT incurred on fixed assets. However, the need to pay import VAT may cause cash-flow pressure and potentially hit the import costs of some businesses not registered as general taxpayers for VAT purposes, as it is only general taxpayers who are entitled to deduct input VAT. Also withdrawn, for the same reasons, is the facility for FIEs to claim a VAT refund

on the domestic purchase of Chinese-manufactured equipment. The replacement of a refund by a credit may also give rise to cash-flow issues.

Registration as a general taxpayer is dependent on turnover. Taxpayers with turnovers below the threshold are 'small-scale taxpayers', who cannot deduct input VAT but are compensated with a lower standard rate of VAT. From 1 January 2009, there is a single rate of 3% applicable to all small-scale taxpayers, replacing the previous 4% and 6% rates.

New transfer-pricing requirements

Under the new China Enterprise Income Tax Law and finalised Implementation Regulations, preparation of transfer-pricing documentation will become a compulsory compliance requirement in China this year. The deadline for the preparation of the documentation for the year 2008 will be 31 December 2009, and 31 May for subsequent years.

According to the Regulations, all enterprises in China undertaking transactions with related parties are obliged to prepare transfer-pricing documentation unless:

- Their total annual related-party purchases and sales of tangible goods are less than CNY 200 million (EUR 22.1 million; USD 29.3 million) and their total other related-party transactions (e.g. royalties, financing, services etc) are less than CNY 40 million or
- An advance pricing agreement is in place for the concerned related-party transactions or
- All related parties are within mainland China (i.e. excluding Hong Kong, Macau or Taiwan) and the enterprise has less than 50% foreign ownership

The documentation must contain information grouped under five main categories and no less than 26 subcategories, and must be provided in the Chinese language. The five main categories are organisational structure; overview of business operations; information

on related-party transactions; a comparability analysis and the transfer-pricing method adopted and reasons for its selection. Given the numerous subcategories, the information required is extensive.

Should an enterprise fail to prepare the documentation, the tax authorities may take the following actions:

- impose an administrative penalty of CNY 2000 (EUR 225; USD 300) to CNY 10 000 (EUR 1100; USD 1475)
- perform a transfer-pricing audit and make transfer-pricing adjustments to the taxable income of the enterprise. Afterwards, the tax authorities will closely review the situation of the enterprise for a further five years
- impose penalty interest based on the renminbi-loan base rate applicable to the relevant period of default as published by the People's Bank of China in the tax year to which the tax payment is related plus 5%. The penalty interest is non-deductible (if the enterprise has prepared the documentation, the additional 5% punitive interest is not charged).

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India

Taxability of sale of shares of an offshore company

On 3 December 2008, the Mumbai High Court pronounced a ruling in favour of the Indian Income Tax department upholding the Department's right to question the taxability of the sale of shares of an offshore company.

The brief facts of the case are that Vodafone International Holding BV (Vodafone), a Netherlands company, purchased the shares of a Cayman Islands company (which in turn held the shares of an Indian company, Hutch Essar) from another Cayman Islands company (HTIL). The Indian tax authorities issued a notice (a 'show-cause' notice) asking Vodafone why it should not be treated as an assessee in default for failure to deduct tax at source in India from the sale proceeds, since the Indian tax authorities maintained that the transaction between Vodafone and HTIL was a transfer of interest, tangible and intangible, in Indian companies rather than a mere acquisition of shares of a shell Cayman Islands company. Apart from its controlling interest Vodafone had also acquired other interests and intangible rights in India such as an interest in a joint venture between HTIL and the Essar group and became a co-licensee with the Essar group of the right to operate mobile phone services in India. Vodafone had filed a writ petition to challenge the show-cause notice issued by the Indian tax authorities.

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In its judgment, the High Court of Mumbai dismissed the writ petition and held as follows:

- Vodafone had wilfully failed to produce the original agreement and other prior and subsequent agreements and documents, which made it impossible

to analyse the true nature of the transaction and applicability of Indian income-tax provisions.

- It was settled law that a writ cannot be entertained against a mere show-cause notice unless the court is satisfied that the show-cause notice is totally contrary to the provisions of the law and causing undue hardship to the assessee.
- Vodafone had not used the alternative remedy available under the normal hierarchy of appellate authorities as provided under the Indian Income Tax Act.

This judgment is not about the taxability of the transaction as such, but is about whether the Indian Income Tax Department has a right to inspect or analyse an offshore transaction and documents related thereto. On this issue, the Mumbai High Court ruled in favour of the revenue authorities, stating that a transaction between two non-residents may be taxable in India; hence the Indian revenue authorities have the right to inspect or analyse the taxability of the transaction.

Therefore, it is pretty evident that this is a case-specific ruling and liability to tax will depend purely on the agreements between these parties i.e. HTIL & Vodafone. If this is 'merely a share purchase' arrangement then in our view the same should not be taxable. However, if in addition to the sale of shares there was a sale of Indian-based intangibles involved, then profits attributable to such a sale may be taxable in India.

Joint venture pitfall

An advance ruling in a case involving a joint venture between an Austrian company and two Indian parties to secure a construction project has highlighted the importance of the terms of arrangement and the actual implementation in avoiding undesirable tax consequences.

In *Geoconsult ZT GmbH (S) Pte Ltd*, the parties formed a joint venture and were awarded a tender by an agency of the State of Himachal Pradesh to provide consultancy services on a tunnel-construction project. The Authority for Advance Rulings concluded that the joint-venture partners had 'associated' themselves with a 'common design' within the terms of the Income Tax Act so as to constitute an 'association of persons', which is taxable at a maximum marginal rate of 42.23%. The Authority further observed that the contract between the agency and the joint venture was sufficient indication of the coming together of the three entities with the common purpose of executing the work entrusted to the joint venture. With respect to the division of profits, the Authority ruled that the payments must be deemed to have been made to and received by the joint venture as a unit, although the members had authorised the agency to make payments to them separately.

An alternative structure would have avoided some of these tax consequences.



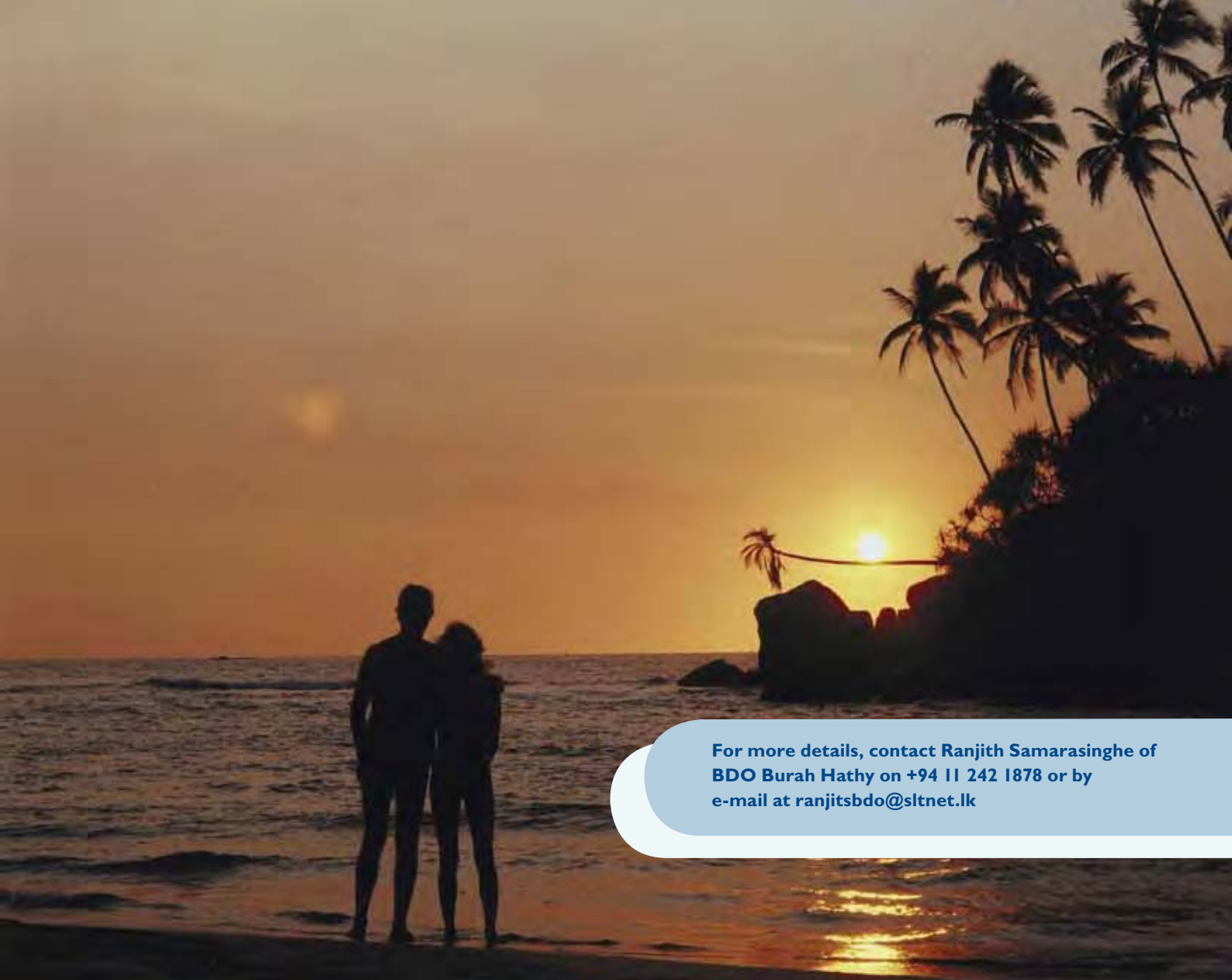
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Sri Lanka

Budget cuts VAT, introduces new turnover levy

Among measures announced by the President and Minister of Finance in his Budget speech on 6 November, are the following:

- A reduction in the standard rate of VAT from 15% to 12%, with effect from 1 January 2009 and a further restriction on the amount of input tax that may be deducted in relation to the 20% luxury rate from 15% to 10%
- The introduction with effect from 1 January 2009 of a new Nation Building Levy, at a rate of 1% of the quarterly turnover of importers, manufacturers and service providers. The levy would not be imposed where the quarter's turnover does not exceed LKR 100 000 (EUR 650; USD 875)
- A broadening of intermediate income tax bands. The top rate of income tax remains 35% and the top effective rate of corporate tax remains 35.525%



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Sub-Saharan Africa South Africa

New dividend withholding tax plans emerge

A draft Bill has been published outlining the basic principles of the dividend withholding tax that will be introduced later this year, to replace the existing secondary tax on companies (STC).

Currently, South Africa does not levy a withholding tax on companies, but instead charges the distributing company to STC of 10% on the dividend declared.

The new withholding tax will also be charged at 10%, but in line with practice throughout most of the world, would fall on the recipient of the dividend, but be collected by the company paying the dividend or by an intermediary. It is planned that dividends paid to other South Africa companies and certain tax-exempt bodies would be exempt from the withholding tax.



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Latin America

Brazil

Foreign investment in company bonds exempt from IOF tax

The Brazilian government has approved Presidential Decree 6.613, exempting investments (except for investments in stock or equities) by foreigners in fixed-income instruments issued by Brazilian companies from the *Imposto sobre Operações Financeiras* (IOF), or tax on financial operations. The IOF levies a tax of 0.38% on the cash inflows and outflows of money as well as other financial transactions. The rate of tax on all fixed-income investments was increased to 1.5% on 12 March 2008.

The decree also exempts certain foreign loans and foreign issues of corporate bonds from the IOF, a provision which was created in January 2008. Accordingly, foreign investors will no longer be required to pay the 1.5% tax when conducting or engaging in investment in Brazilian securities and derivatives instruments.

The decree was issued as a response to the current economic crisis and with the goal of expanding the inflow of dollars that has been reduced by the global economic crisis.

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Chile

Investment tax credit boost

Chile has temporarily increased its tax credit for investment in fixed assets from 6% to 8%.

The increased rate will apply to investment in the acquisition, production or leasing (with option to purchase) of fixed assets made in the calendar years 2008 to 2011 (inclusive). It is intended for micro, small and medium-sized businesses, which are defined for this purpose as businesses whose annual turnover in the two years previous to that for which the credit is claimed has not exceeded 100 000 'promotional units' (*unidades de fomento*). The *unidad de fomento* (UF) is

an inflation-adjusted unit of account used in Chile, and 100 000 UF is currently equivalent to about USD 3.373 million (EUR 2.542 million).

The tax credit, which may not exceed 650 monthly fiscal units (*unidades tributarias mensuales*) – equivalent to approximately USD 38 430 or EUR 28 950 – per year, is set against the taxpayer's liability to business income tax.

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