



BDO International

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BDO World Wide Tax News
Issue No. 3 / 08 - November 2008

Welcome to Issue 2008 No. 3 of BDO *World Wide Tax News*, which summarises important recent tax developments of international interest across the world. 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 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. BDO *World Wide Tax News* is published quarterly by BDO Global Coordination BV in Brussels. If you have any comments or suggestions concerning BDO *World Wide Tax News*, please contact the editor, Zigurds Kronbergs, by e-mail at zkronbergs@bdoglobal.com or by telephone on +32 (0)2 778 0141.



BDO International

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United Kingdom

UK may be taken to court on cross-border losses

The European Commission has put the United Kingdom on formal notice properly to implement the judgment of the European Court (ECJ) on cross-border losses in the *Marks & Spencer* case.

In December 2005, the ECJ held that Member States were obliged to allow the offset of losses incurred by subsidiaries in other Member States against the profits of the parent company in the home state, but only where there was no longer any possibility that the loss could be relieved in the subsidiary's own state.

As a result, the United Kingdom amended its group relief rules in Finance Act 2006, but at the time many commentators and the business community were of the opinion that the conditions set by the amended rules were so strict that they failed to comply properly with the judgment.

The European Commission is now of the same opinion. In its 'Reasoned Opinion' communicated to the UK Government on 18 September, the Commission finds that "the UK still imposes conditions on cross-border group relief which in practice make it impossible or virtually impossible for the taxpayer to benefit". In particular, it identifies four main faults with the legislation:

- There is an unnecessarily strict interpretation of the condition that there be no possibility that the loss may be used in the subsidiary's home state
- The date for determining that this condition is met is set immediately after the end of the accounting period in which the loss arises
- The time limit for claims to relief is set as early as 12 months after the filing date of the claimant company's tax return
- The legislation applies to losses incurred after (actually on or after) 1 April 2006 only

Under the Reasoned Opinion procedure, if the United Kingdom fails to respond satisfactorily within two months, the Commission may bring a case against the United Kingdom before the European Court. Based on our experience, that outcome seems quite likely.

If the ECJ were to agree with the analysis of the Commission, the UK legislation would have to be amended to allow cross-border loss relief in a wider set of circumstances. In particular, relief may become available where the use of the overseas losses becomes 'unlikely', rather than impossible. Furthermore, if the date for determining the foreign usability of the losses is extended, relief would become available for other years in addition to the losses arising in the 'terminal' year.

Consideration should therefore be given to making protective cross-border group relief claims in appropriate circumstances.



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North America and the Caribbean Canada

Distributions from ULCs not to benefit from revised US treaty

The Canadian Revenue Agency (CRA) has confirmed through a technical interpretation that distributions from an unlimited liability company to a US owner are not entitled to treaty benefits upon the effective date of the proposed Fifth Protocol amending the United States-Canada Income Tax Treaty.

In a technical interpretation dated 16 July 2008, the CRA has confirmed that new Article IV(7)(b) of the US-Canada treaty will subject distributions from a Canadian unlimited liability company (ULC) to its US owner to the Canadian domestic statutory dividend withholding rate of 25% once the Fifth Protocol is completely in force (possibly as early as 1 January 2010, see below).

The technical interpretation primarily addresses the new Limitation on Benefits (LOB) provisions regarding the active trade or business test in the Fifth Protocol. The interpretation provides that the reduced rate of withholding tax may apply for distributions paid after the effective date of the new LOB provisions but before the effective date of the hybrid-entity provisions of Article IV(7)(b), assuming the other requirements of the US-Canada Treaty are satisfied.

Certain of the provisions of the Fifth Protocol relating to taxes withheld at source will become effective on the first day of the second month that begins after the date on which the protocol enters into force. However, Article IV(7)(b) will become effective on the first day of the third calendar year that ends after the protocol enters into force.

The US Senate approved the Fifth Protocol on 23 September 2008. It will enter into force once the United States exchanges instruments of ratification with Canada. Canada's ratification procedures were completed on 14 December 2007. The procedures will be completed in the United States once the President and the Secretary of the Treasury sign the Protocol (which is expected to occur before the end of 2008). In that case, the effective date of Article IV(7)(b) will be 1 January 2010.

For distributions on or after that date, the technical interpretation indicates that the Canadian domestic 25% rate will apply to any dividend distributions instead of the reduced treaty withholding rate of 5%. In contrast, distributions between the two effective dates above may qualify for the reduced 5% rate under the treaty. The CRA's holding is consistent with the US Treasury Department's Technical Explanation of the Fifth Protocol dated 10 July 2008. The Canadian Department of Finance has issued a press release indicating that it agrees that the Technical Explanation reflects the understandings reached in the course of the treaty negotiations.

US taxpayers conducting business in Canada through ULCs will need to consider what planning or restructuring may be required to minimise the Canadian rate of withholding on distributions paid to the US owner of the ULC.

For more details on the Canadian aspects of this item, contact John Wonfor of BDO Dunwoody on +1 416 865 0111 or by e-mail at jwonfor@bdo.ca

United States of America

Stricter scrutiny of withholding agents

Stricter scrutiny and regulation of withholding agents and payments to foreign persons will result following publication of a new Internal Revenue Manual (IRM) by the US Internal Revenue Service (IRS).

Withholding agents are persons charged under Internal Revenue Code sections 1441 and 1442 with deducting and accounting for US withholding taxes on payments made to foreign persons.

The new manual instructs IRS agents to apply stricter scrutiny to a withholding agent's compliance with obligations imposed by IRC sections 1441 and 1442. As such, this same provision may be used as guidance as to what one may expect during an IRS audit.

Generally, a withholding agent is required to report payments of US-source, fixed or determinable, annual or periodic ("FDAP") income made to foreign persons on Form 1042-S and taxes withheld on such payments on Form 1042. The IRM categorises these withholding agents into two groups: financial institutions (banks, brokers, insurance companies, etc.) and multinational companies (non-financial institutions). Depending on the category, the IRS agents will primarily focus on different types of payments. For financial institutions, the focus will be on payments to foreign account-holding beneficial owners, intermediaries, and flow-through entities. For multinational companies, the focus will primarily be on vendor payments to foreign persons (e.g. dividends, pension payments, licensing fees, rents, compensation for services etc.).

In addition to focusing an audit on certain types of payments, the IRM sets forth some new rules. For example, the IRS agent must presume that any payment of FDAP income to a foreign person is US-sourced unless the withholding agent can establish by documentation that such payment is foreign-sourced. Furthermore, a foreign person claiming a reduced rate of withholding tax now must furnish a withholding agent with a tax identification number (TIN). These new requirements are significant since a withholding agent is liable for any underwithholding and penalties on the amount underwithheld.

The IRM also directs IRS agents to perform a 'functional review' of the withholding agent's internal procedures, due-diligence standards, and presumption rules. Finally, the IRS agent is instructed to review a sample of payments to determine whether the correct rate and form were used. The results of the functional review will determine the scope and result of each IRS audit with regard to withholding obligations.

The rules and procedures of the new manual are effective immediately and will be used to train IRS agents for future taxpayer examinations.

Any taxpayer subject to withholding obligations under IRC sections 1441 and 1442 should review its withholding procedures and documentation to ensure that they are accurate and up-to-date.

Proposed new regulations on asset-sale rule on share transactions

The Treasury Department has released proposed regulations under IRC section 336(e) relating to the election to treat sales, exchanges, and distributions of a target corporation's stock as sales of the target's assets.

The proposed regulations apply to domestic transactions but not to transactions in which the seller or the target is a foreign corporation.

Section 336(e) allows a corporation that owns stock in another corporation (the target) meeting certain requirements to elect to treat the sale, exchange, or distribution of all of the stock in the target as a sale of the target's underlying assets. This allows the base cost of the assets to the purchaser to be stepped up to their market value. Stock generally meets these requirements if it represents at least 80% of the voting power of all classes of stock entitled to vote and at least 80% of the value of all classes of stock.

The new proposed regulations will, when effective, provide for an election to treat sales, exchanges, and distributions of a target corporation's stock as a sale of its assets. Under the regulations, in order to be able to make the section 336(e) election, the corporation that

owns stock of the target meeting the requirements must make a qualified disposal of at least an amount of stock meeting those requirements. This proposal is a slight relaxation of the statutory requirement that the corporate shareholder must dispose of all of the target's stock that it owns. In general, all members of a seller's consolidated group will be treated as a single seller for purposes of determining whether section 336(e) applies. This election does not generally affect the tax consequences of the person or persons acquiring the stock of the target, but the target corporation itself may be entitled to a fair market value (cost) basis in its assets.

The regulations are proposed to be effective for transactions that are primarily domestic. Thus, the election is not proposed to be available where either the seller or the target is a foreign corporation. The preamble to the proposed regulations requests comments regarding how the rules of the proposed regulations should be modified to take into account the policies of international tax provisions should the proposed regulations be extended to apply to foreign sellers and/or targets.



Opportunity for refund of interest withholding under US-Canada protocol

Retroactive reductions in withholding tax on cross-border interest payments between the United States and Canada, to be introduced under the Fifth Protocol amending the United States–Canada double tax treaty may give rise to repayment claims for overdeducted tax.

The Protocol provides for a zero withholding tax on interest payments between qualifying parties, whereas the treaty currently stipulates a maximum 10% rate. For interest payments between related parties, the reduction to zero will be backdated to 1 January 2008. The same backdating is also likely for payments between unrelated parties, but this is not entirely certain.

There is also a two-year phase-out period for interest payments between related parties not exempt from withholding tax under the treaty as it stands. Interest paid during the first calendar year after the Protocol enters into force is liable to a reduced rate of 7%, falling to 4% in the second year and to nil thereafter.

As explained under Canada, both countries have already ratified the Protocol, which once signed by the President of the United States, needs only a formal exchange of instruments of ratification to come into force. This may be as early as 1 January 2009.

Scope of APA programme extended

The Advanced Pricing Agreement (APA) programme has now been formally expanded to consider determination of the proper amount of income from permanent establishments, income effectively connected with a US trade or business and income from US sources.

The APA programme was originally conceived to cover only transfer-pricing issues and was originally implemented in 1990. It has proven to be an effective means for both multinational taxpayers and tax officials in multiple jurisdictions to resolve double taxation associated with cross-border transactions giving rise to transfer-pricing issues. Experience with the APA programme has shown that often there are related non-transfer pricing issues that must be resolved in parallel to facilitate resolution of the transfer-pricing issues.

Under the new procedure, the scope of the APA programme has been increased to include: 1)

attribution of profits to a permanent establishment under an income tax treaty; 2) determination of the amount of income effectively connected with the conduct by the taxpayer of a trade or business within the United States; and 3) determination of the amounts of income derived from sources partly within and partly outside the United States. This Revenue Procedure will only apply to situations where a US tax treaty is in place, which is also a precondition for resolving double-tax issues arising from transfer pricing.

This revision is a welcome development as previously these areas have been outside the APA's authority and thus required taxpayers to seek additional relief in other advanced determination programmes such as the pre-filing agreement programme. This will facilitate more efficient resolution of all the issues now encompassed by the APA programme.

Temporary CFC exemption for loans

The Internal Revenue Service (IRS) has temporarily relaxed rules under which short-term loans to a US taxpayer from a controlled foreign corporation (CFC) could give rise to taxable US income to the US person.

Under Internal Revenue Code (IRC) section 956, an obligation of a US person to a CFC owned by that person (either alone or jointly with other US persons) – such as a loan from the CFC to the US person – could be deemed to be investment in US property and thus give rise to a corresponding charge to US tax on the US person.

The idea behind the relaxation (contained in Notice 2008-91) is to allow US taxpayers with short-term liquidity problems to access cash held abroad in CFCs without adverse tax consequences. It works by permitting the CFC to choose to exclude from the term 'obligation' loans that are collectable within 60 days.

Under previous administrative guidance, an exception was available for obligations collected within 30 days of being incurred, subject to an aggregate limitation of 60 calendar days for all such obligations during the taxable year.

Care must be undertaken if the exception is utilised, as Notice 2008-91 further provides that the exclusion is not to apply if the CFC holds for 180 or more calendar days during its taxable year obligations that would otherwise be taxable for the controlling US person(s). It is currently not clear how much time must elapse between successive 60-day loans. Regulations are expected to address this and other related issues.

Notice 2008-91 applies for only two taxable years of the CFC ending after 31 November 2008. For CFCs with calendar year-ends, these years are those ending on 31 December 2008 and 31 December 2009.

Distributions from ULCs not to benefit from revised Canada treaty

See under Canada.



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Europe and the Mediterranean European Union

CCCTB directive deferred

The European Commission will not now be issuing its draft directive on the European Common Consolidated Corporate Tax Base (CCCTB) this autumn. Taxation Commissioner László Kovács broke the news in a speech to the annual congress of the International Fiscal Association (IFA) in Brussels in September.

The CCCTB would form an EU-wide uniform set of rules to compute the taxable profits of companies with branches or subsidiaries operating in more than one Member State. The States would remain free to set their own corporate tax rates and there would be a pooling and redistribution mechanism to allocate tax revenues across the Member States. The CCCTB would be optional for companies but Member States would be obliged to offer them the CCCTB option.

Advocates of the CCCTB maintain it would end intra-EU transfer pricing and thin capitalisation issues as well as automatically allow for utilisation of cross-border losses. Several Member States, however, notably Ireland and the United Kingdom, are firmly opposed to the concept, although most have adopted a 'wait and see' attitude.

The delay, according to Kovács, is for technical reasons, and there is no sign that the Commission's resolve to proceed with the directive is in any way diminished.



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Parent-Subsidiary Directive should apply to usufruct holdings

If the European Court follows the Opinion of Advocate-General Sharpston, it will rule that the Parent-Subsidiary Directive must apply equally 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.

The present case involved a situation where the legal owner of the shares in the paying company had granted a usufruct to another company (the usufructuary). Normally, the usufructuary has the right to receive the income while legal ownership remains with the original owner.

Belgium applies the exemption method to dividends covered by the Directive. The case was referred to the European Court by the Appeal Court of Liège (*Cour d'appel de Liège*) to clarify whether the Directive applied to exempt the dividend even where it was received not by the legal owner who had the required holding in the paying company but by the usufructuary.

In fact, this case (*Les Vergers de Vieux Tauves*) involved a purely domestic situation, since both the recipient and the paying company were resident in Belgium, but the Court agreed to hear the case as the relevant law had been enacted specifically to implement the Directive.

During the time period covered by the case, the Belgian law was silent as to whether it applied also to cases of usufruct, but has subsequently been amended to exclude usufructuaries from exemption. If the European Court agrees with the Attorney-General, therefore, Belgium will be required to amend the law so as to comply; the judgment will apply to all Member States where usufruct is a recognised legal concept.

EC moves against Flanders registration duty

See under Belgium.

ECJ to examine Netherlands fiscal-unity rules

See under the Netherlands.

Commission says Portugal discriminates against foreign service providers

See under Portugal.

Swedish exit tax under EC fire

See under Sweden.

UK asked properly to implement *Marks & Spencer* decision

See under United Kingdom.

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, Netherlands, Portuguese, Swedish and UK aspects, respectively, see under the respective countries below.

Belgium

EC moves against Flanders registration duty

The European Commission has brought a case in the European Court of Justice (registered as C-250/08) against Belgium in connection with relief from registration duty as operated in the Flanders Region. Flanders imposes registration duty of 10% (lower than in other Regions of Belgium) on the purchase of residential property by private persons. If the property is intended to be the purchaser's principal residence, and the purchaser has purchased a previous principal residence in Flanders, he or she may deduct the registration duty paid on the previous residence, provided that it is sold within a certain period. However, if the purchaser's previous residence was in another Member State or indeed in another Region of Belgium (Wallonia or Brussels), the relief is not available.

The Commission considers this rule to be an unjustified restriction on the freedom of movement guaranteed by the EC Treaty. The Court has yet to hear the case.

It is of interest beyond Belgium as it illustrates again that the Commission does not limit itself to pursuing tax issues at the national level and that national governments can be held accountable for the actions of subsidiary regional or provincial governments with tax-raising powers.

Parent-Subsidiary Directive should 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

Denmark

Exit-tax regulations tightened retroactively

The rules charging an exit tax on shares held by individuals emigrating from Denmark have been tightened.

When an individual who has been tax-resident in Denmark for a number of years emigrates (ceases to be resident in Denmark) while holding shares, he or she is deemed to have disposed of the shares at their market value and is taxed on the notional capital gain so arising. As a starting point, the tax must be paid in the year following emigration. However, it is possible to obtain a deferment if the shares have not actually been alienated. If deferment is granted, a deferred exit tax account is established. The deferred tax then falls due in connection with subsequent disposals, dividend distributions, loans from the company and other transactions having the effect of decreasing the share value. Any Danish tax paid on dividends in respect of the shares is offset against the exit tax when a dividend is distributed. Under the new rules, however, any foreign tax paid on those dividends will not be taken into account.

The main change to the previous rules is that the exit tax will no longer be recomputed if the emigrating individual eventually disposes of the shares for a lower value than they had at the time of emigration.

Should the individual re-establish residence in Denmark, the previous rule was that any exit tax still deferred lapsed completely. Now, however, the shares will be accorded an 'entrance value' as the base cost for tax purposes. The base cost will be the market value of the shares on the day the individual returns to

Denmark but the value of any deferred exit tax will be factored in, resulting in a diminution of the base cost.

The new rules apply not only to individuals who emigrate on or after 30 May 2008, when the proposals were first announced, but also to individuals who emigrated previously, in respect of any shares still held on 30 May 2008 where the exit tax had not been paid in full at that date.

Individuals who emigrated before 30 May 2008 and have a deferred exit tax on their shares, must file two documents with the Danish tax authorities before 1 July 2009 if they wish to maintain the deferment. First an overview of shares still owned that have been subject to exit taxation, and second a calculation of the original exit tax on the shares owned at the date of emigration. The latter will be used as the account for offsetting taxes paid on dividends distributed after 30 May 2008. If these documents are not filed in due time, the deferment will lapse and the due exit tax will have to be paid in total immediately.

It is still the case that the exit tax itself may be in breach of Community law, following the case of *Lasteyrie du Saillant*. This issue has still to be addressed.

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Germany

Court at odds with anti-abuse guidance

A recent judgment of the Federal Financial Court (*Bundesfinanzhof*) takes a different view on the general anti-abuse rule than guidance issued by the tax authorities on the rule as newly amended.

BDO World Wide Tax News has reported (see Issue 2007 No. 4) that with effect from 1 January 2008, the rule (Article 42 of the *Abgabenordnung* – the Tax Ordinance) was amended so as to target transactions involving an ‘inappropriate’ legal structure.

Guidance recently issued by the tax authorities on the application of the amended rule indicates that in their view:

- The interposition of entities motivated only by tax reasons is an indication of a potentially inappropriate structure under the rule, as are structures that would not have been chosen by an informed third party had there been no tax advantage involved, and the tax-motivated transfer of income streams to other legal entities
- Whereas the new rule cannot be invoked where the transaction falls under specific anti-avoidance legislation, it can apply where the transaction is of a type to which a specific rule would have applied if all the relevant conditions had been satisfied
- Whereas the new rule allows taxpayers to escape its application where they can establish that there were genuine business reasons in choosing the structure, the business reasons given by the taxpayer in such circumstances would have to be substantial for the authorities to accept them as a justification

The case heard by the *Bundesfinanzhof*, although it involved the interposition of a company in fact involved individuals and related to the old rule. Nevertheless, the principles established by the Court could equally apply to companies and the amended rule.

In that case, in order to avoid restriction of capital losses on the sale of shares to 50% of their value following amendments to the law, individuals sold the shares to a newly formed holding company over which they had control. Overturning the decision of a lower court, the *Bundesfinanzhof* held that the mere fact that the interposed company was controlled by the same persons and had no other activity in its first year of existence than to hold the shares was in itself not enough to characterise the transaction as abusive and to disregard the enduring effects of the interposed company.

This judgment is therefore at odds with the above view of the tax authorities. Since, however, the authorities will apply the guidance in assessing transactions, taxpayers would be well advised to have proper and comprehensive documentation justifying the choice for sound reasons not connected with a tax advantage of a structure that may risk attack under the anti-abuse rule.

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Netherlands

Moves against excessive remuneration

The Netherlands government has submitted proposals to Parliament targeted at taxing so-called 'excessive remuneration'. In short the proposals involve:

- Introduction of a 30% penalty for employers in relation to excessive redundancy payments
- Introduction of a 15% charge on the employer for pension entitlements on the basis of final pay arrangements with a pensionable base in excess of EUR 500 000 (USD 678 250)
- Introduction of progressive taxation for managers of private equity and hedge funds for income derived from so-called profitable participations.

The changes are expected to enter into force on 1 January 2009, except for the changes related to the pension entitlement. These changes are to take effect from 1 January 2010. Below we will briefly elaborate on the changes for 2009.

Excessive redundancy payments

The 30% penalty tax applies to redundancy payments paid to employees having an annual salary in excess of EUR 500 000 where the redundancy payments exceed one year's salary. The penalty only applies to that part of the redundancy payment that exceeds one year's salary.

Profitable participations

The proposals state that the normal progressive rates (at up to 52%) of personal income tax will apply on income and gains derived from profitable participations. A profitable participation is an instrument that is held by the employee and provides a very high return.

The profitable participation can take many forms and these include:

- subordinated shares the total capital of which constitutes less than 10% of the total share capital of the company
- preferential shares with entitlement to a dividend of at least 15% per year
- debt claims having a value that is dependent on:
 - profit
 - turnover
 - cost reduction
 - attraction of financing sources
 - the preparation of (parts of) a company for sale or takeover
 - the acquisition or takeover of (parts of) a company or
 - a substantial increase in value in the case of sale or takeover of (parts of) a company, or a change of an interest in (parts of) a company.
- rights or other obligations that are (economically) similar to the shares and debt claims referred to above or whose value is dependent on similar factors to those referred to above.

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ECJ to examine fiscal-unity rules

As is the case with most EU Member States with special tax rules for groups of companies, in the Netherlands membership of a tax group (or 'fiscal unity' – *fiscale eenheid*) is restricted to companies resident in the Netherlands. This particular restriction is now to be examined by the European Court, following a reference by the Netherlands Supreme Court (*Hoge Raad*).

Membership of a fiscal unity enables tax losses to be set off against the profits of other members and the tax-free transfer of assets from one member to another.

The Netherlands allows permanent establishments in the Netherlands of foreign companies to be members of a fiscal unity but it is not possible for, say, a Netherlands parent company to form a fiscal unity with any of its foreign subsidiaries – the exception being, of course, where those subsidiaries have permanent establishments in the Netherlands, in which case those permanent establishments may be included in the unity.

The European Court will be asked to rule whether this restriction is in breach of the EC Treaty. The outcome of the case is uncertain. Whereas the restriction is undoubtedly discriminatory, it may be found to be justified on the grounds of fiscal cohesion and the need to prevent avoidance.

Nevertheless, Netherlands parent companies with EU or EEA subsidiaries may wish to consider claiming a fiscal unity in the event that the Court finds the current rules are incompatible with EU law.



For more details on the Netherlands aspects of this case, contact Hans Noordermeer of BDO CampsObers on +31 10 242 4600 or by e-mail at hans.noordermeer@bdo.nl

Poland

VAT refund delays for new taxpayers not justified

The European Court of Justice has held that Poland's rules imposing a longer delay on VAT refunds to 'new' taxpayers, who have not deposited a guarantee with the tax authorities, are in breach of Community law.

Under Polish law, repayments of VAT where a return shows an excess of input tax over output tax must be made within 60 days of the date on which the VAT return is filed. The maximum period for which 'new' taxpayers (persons who have been trading for less than 12 months) must wait for refunds is 180 days, however, unless they have deposited a guarantee of PLN 250 000 (EUR 72 275; USD 97 550) with the tax authorities.

The Court held that to impose a more onerous requirement on one class of taxable persons because of a presumed risk of evasion (which was the Polish authorities' justification) without permitting the taxable person concerned to establish that no risk of avoidance or evasion existed was disproportionate in relation to the supposed purpose and therefore contrary to the principles of the VAT Directive. Neither was the security deposit proportionate either to the refundable VAT or to the economic size of the taxable person.

The 180-day rule was therefore in breach of Community law. It is not yet known how the Polish authorities will respond to the judgment.

Corporate tax deduction rules do not apply to VAT

Recent judgments by the Polish administrative courts have held that the tax authorities may no longer deny a deduction of input VAT in respect of an expense that is not deductible for the purposes of corporate tax.

Polish law currently provides that if an item of expenditure is not deductible when computing profits for corporate tax purposes and does not represent capital expenditure on a fixed asset, the company concerned is also barred from seeking a deduction for the associated VAT in its VAT return.

The courts have held that this provision is too wide, and that any limits on deductibility of input VAT must be specifically provided in VAT legislation, and be compatible with the VAT Directive.

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Portugal

Commission says Portugal discriminates against foreign service providers

The European Commission has issued a Reasoned Opinion against Portugal for what it considers to be discrimination against foreign service providers.

Under Portuguese law, domestic service providers are taxed on their net profits whereas a non-resident service provider is subject to final withholding tax on gross income, without any deduction for expenses.

In its defence, Portugal argues that the final withholding tax does not apply where the foreign service provider is resident in a state with which Portugal has a tax treaty (Cyprus is the only EU Member State without a treaty with Portugal). Besides, it claims that the difference may be compensated by the lower rate

of the withholding tax (15%) compared to the tax applicable to residents (25%), and finally that the different treatment is necessary to combat fraud.

The Commission dismisses these arguments on the grounds that discrimination still exists with respect to Cyprus, that there is nothing to ensure that the differing tax rates bring about equal treatment, and that fraud could be combated with less disproportionate measures.

Under the Reasoned Opinion procedure, if Portugal fails to respond satisfactorily within two months, the Commission may bring a case against Portugal before the European Court.



For more details on the European aspects of this item, 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 Portuguese aspects, contact **Paulo Ferreira Alves** of BDO bdc & Associados on +351 21 799 0420 or by e-mail at paulo.alves@bdo.pt

Sweden

Swedish exit tax under EC fire

The European Commission is demanding that Sweden amend or abolish its exit tax on emigrating companies, at least with respect to migration to another EU Member State or EEA member. Several other EU Member States also have similar exit taxes on companies.

Currently, companies that move their registered office or place of effective management from Sweden to another jurisdiction (and thus cease to be liable to Swedish tax on their worldwide income) face a tax on any capital gain arising from a revaluation to market value of their assets, although the gain is not realised, and on recaptured deductions to untaxed reserves.

The Commission maintains that such a tax is incompatible with the freedom of establishment guaranteed by Article 43 of the EC Treaty. The case of *Lasteyrie du Saillant* (C 9/02) established that exit taxes on unrealised gains in those particular circumstances were incompatible with the EC Treaty with respect to individuals. Whether the same holds for companies has not yet been tested in the European Court of Justice, although the current *Cartesio* case – in which judgment is pending (see *BDO World Wide Tax News* 2008 No. 2) – is widely seen as a test of the applicability of these principles to the corporate environment. The reasoned opinion clarifies the view of the Commission in this area although its previous Communication on exit taxation in the EU published in December 2006 had previously implied the same.

Deferring the tax until the assets are actually disposed of (if at all) would be a possible solution. Exit taxes on emigration to third countries would be in breach of EC law only if they constituted a restriction on the free movement of capital under the EC Treaty.

Under the Reasoned Opinion procedure, if Sweden fails to respond satisfactorily within two months, the Commission may bring a case against Sweden before the European Court.

See also under Denmark.

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Switzerland

UK-Swiss tax reclaims for mutual funds

A simplified procedure for the refund of withholding taxes to collective investment vehicles as between the United Kingdom and Switzerland has been made available under a Memorandum of Understanding signed by the two countries.

In the case of Switzerland the relevant vehicles are contractual funds as defined in section 25, investment companies with variable capital as defined in section 36 and limited partnerships for collective capital investment schemes as defined in section 98 of the Federal Act on Collective Investment Schemes of 23 June 2006. In the case of the United Kingdom the relevant vehicles are authorised unit trusts, unauthorised unit trusts and open ended investment companies. The competent authorities may agree to include in the above other vehicles of identical or substantially similar economic or legal nature which are introduced by way of statute or legislation in either State.

The vehicles named may claim a refund of withholding tax limited to that proportion of units or shares beneficially owned by persons who, according to Article 4 of the treaty, are residents of the State in which the vehicle is organised.

Managers or authorised representatives of a vehicle organised in a State must indicate, based on data established at least once every year at a specific date, and to the best of their knowledge and belief, the percentage ownership of shares/units in a vehicle beneficially owned by residents of the State, as required by the claim form issued by the other State.

Each State may apply appropriate control mechanisms.

Where the percentage ownership by residents exceeds 95% a full refund may be claimed. Where the percentage ownership by residents does not exceed 95% a proportional refund may be claimed.

The above procedure will be applied to all pending and future claims for refunds if claimants provide an appropriately completed claim form.

Claims presented to the revenue authorities after 31 December 1999 that were subsequently refused may be resubmitted and the above procedures will apply.

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United Kingdom

Foreign-dividend exemption deferred

The UK Treasury has announced that the proposed reforms to the taxation of foreign profits will be delayed pending further consultation and are now unlikely to be enacted in 2009, as originally planned.

At the same time, the proposal to change the basis of taxing CFCs (controlled foreign companies) from an entity-based approach to an income-based approach (essentially, taxing all passive income) has been dropped.

It was in June 2007 that a discussion document was published by the Treasury. The document covered four main areas: the taxation of dividends from foreign subsidiaries (including a participation exemption); reform of the CFC rules; restriction on tax relief for interest expenses; and replacement of the requirements for Treasury Consent for certain transfers of capital abroad.

Adverse reaction to the proposed CFC reform and concern regarding the potential costs of introducing a dividend exemption without related revenue-protection measures were cited by the Treasury as the reasons for delaying the proposals for further consultation. The judgment of the court in the *Vodafone*

case (see under 'CFC rules held to be invalid before December 2006' below) may also have played a part.

In a technical note accompanying the announcement, the Treasury makes it clear that it remains attracted to moving to a wide exemption régime for the taxation of foreign dividends. The exemption may now include dividends from portfolio holdings, which would previously have been excluded. However, it seems that small groups may still remain in a credit régime.

Relief at the dropping of the CFC changes will be tempered by the continuing uncertainty regarding when and whether the exemption for foreign dividends will be introduced. As a result, where profits or cash need to be repatriated to the United Kingdom in the near future, alternative planning will be required instead of waiting for the exemption. The continuing uncertainty may also prompt some groups to review the merits of keeping their parent company or head office in the United Kingdom. A number of high-profile groups have already decided to transfer abroad (see also under 'Corporate migration' below).

CFC rules held to be invalid before December 2006

The High Court of England and Wales has held that the United Kingdom's controlled foreign company (CFC) rules (as they existed before December 2006) were invalid as respects subsidiaries in the European Union.

In *Vodafone 2 v The Commissioners of Her Majesty's Revenue and Customs*, the telecommunications group had applied for closure of an enquiry by Her Majesty's Revenue and Customs (HMRC) into its tax return for the year ended 31 March 2001. The point at issue was HMRC's contention that the loan interest received by a Luxembourg subsidiary of the group was taxable in the United Kingdom under the CFC rules. The subsidiary had been incorporated in connection with Vodafone's acquisition of the German Mannesmann group, and had made interest-bearing loans of EUR 35 000 million. Vodafone contended that the CFC rules represented an unlawful restriction of its freedom of establishment under the EC Treaty, as did the administrative burden arising from the extensive disclosure of documentation required by HMRC as part of the enquiry. Its application failed before the Special Commissioners (the tribunal of first instance).

In the *Cadbury Schweppes* decision (see *BDO World Wide Tax News* 2006 No. 3), the European Court held that the freedom of establishment guaranteed by the EC Treaty excluded the income of EU subsidiaries from exposure to a Member State's CFC rules, unless the effect of the rules was confined to wholly artificial arrangements. It was left to national courts (in this case, the UK courts) to determine whether their own country's CFC rules satisfied this criterion or not.

As far as the UK rules are concerned, most attention was centred on the so-called 'motive test'. Under this test, the CFC rules do not apply if the taxpayer can establish that tax avoidance was not the main or

one of the main purposes for incorporating the CFC. In the *Vodafone* case, the Special Commissioners had concluded that the motive test was compliant with *Cadbury Schweppes* because a second condition could be read into the legislation to the effect that the CFC rules would not apply where the CFC carried on genuine economic activities in its home country.

The High Court rejected this finding. Such an interpretation, the judge argued, would effectively amend the existing legislation to make it conform to the ECJ decision, and not interpret it as it actually stood. Following the decision of the House of Lords in *Condé Nast* (see *BDO World Wide Tax News* 2008 No. 1), which was issued after the Special Commissioners' hearing, it was for Parliament and not for the courts, to amend legislation so as to make it compliant with Community law. The appeal succeeded because the law as it stood was not compliant.

HMRC has already appealed to the Court of Appeal against this decision, but UK-based groups should continue to assert that CFC apportionments are inappropriate in relation to CFCs established in other Member States.

The CFC legislation was changed in December 2006, and the court did not have to consider the amended rules. Many consider that they are also defective, however.

If the decision is upheld, it disapplies the UK's CFC rules in relation to all EU subsidiaries, whether or not carrying on genuine economic activities. UK-based multinationals may therefore wish to resist any CFC apportionments or information requests in relation to their EU subsidiaries. Further, some groups may wish to review the use made of such subsidiaries.

HMRC concedes related-party interest rules may be non-EU compliant

The United Kingdom's tax authorities (HMRC) have conceded that the legislation requiring the deduction for interest paid by UK companies to foreign related parties to be deferred in certain circumstances may be in breach of Community law, and are suspending application of the rules until the issue is resolved.

Relief for interest payable by UK companies is generally available on an accruals basis. However, where the interest is payable to a related party that is not resident in the United Kingdom and remains unpaid more than 12 months after the end of the accounting period in respect of which the relief is claimed, the relief is deferred until the interest is actually paid.

Since this deferment rule does not apply where the recipient is another UK company, it appears to be in breach of Community law.

In its announcement, HMRC declared that it was consulting on options for changing the law so as to ensure it was compliant. In the meantime, it would not seek to apply the late-payment rules to any claims for relief that were still open until the law was changed.

UK companies should now therefore consider accelerating a claim for tax relief for connected-party interest where the expense is recognised in their accounts, rather than applying the late-payment rules, even where the recipient is resident outside the European Union. The possibility applies to all corporation tax returns filed after 28 July 2008 or to any other accounting period until the law is amended. Companies affected could also consider amending prior-year tax returns on the basis that the late-payment rules do not apply and claiming a refund of corporation tax previously paid; and renegotiating enquiries where returns are still open.



Corporate migration

A number of high-profile groups have recently announced their intention of moving their corporate headquarters out of the United Kingdom, and a recent YouGov survey commissioned by BDO Stoy Hayward shows that over one-third of large UK corporates are seriously considering this step.

The main concerns driving corporate migration stem from the United Kingdom's régime for the taxation of foreign profits, including the complex rules for the taxation of foreign dividends, the additional tax that arises on the repatriation of low-taxed foreign profits and the onerous controlled foreign company (CFC) rules that hamper the financing and structuring of operations abroad.

These concerns were being addressed through the review of the taxation of foreign profits begun by the Discussion Document issued by HMRC in June 2007, and more recently, the establishment of the Business-Government Forum on Tax and Globalisation. However, the planned date for the reform of April 2009 (which would have included the introduction of an exemption for some foreign dividends) has been postponed.

In evaluating whether to migrate from the United Kingdom, the potential tax savings need to be identified and compared to the commercial and other implications and costs. Benefits are likely to arise only if a group has low-taxed non-UK profits or significant finance or intellectual-property income. A major consideration will be the level of substance required in the new location and its implications for corporate governance, decision making, and the location of staff. A feasibility study would also need to evaluate:

- The optimal location for the new group parent company
- Whether shareholders will be able to obtain their shares in the new parent company on a tax-free basis
- Any other tax issues that arise, such as the change of control provisions relevant to German subsidiaries and the loss of full treaty benefits for US subsidiaries

Other important issues may include stock exchange, banking, pension and share-scheme implications.

Migration is not to be undertaken lightly, but is an option that has been evaluated and is being kept under review by many groups in the light of changing tax legislation and commercial circumstances.

UK-Swiss tax reclaims for mutual funds

See under Switzerland.

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Asia Pacific Australia

Rules eased on public trading trusts

Consistent with its policy of attracting further international investment into Australian managed funds, the Government has introduced into Parliament amendments to the rules governing public trading trusts.

Broadly, the rules currently apply to tax the income of widely held trusts that directly or indirectly carry on trading activities in the same way as a company. However, the rules are also designed to exclude from corporate taxation widely held trusts that exclusively carry on an 'eligible investment business'. This encompasses investing in land for the purpose of deriving rent and investing or trading in certain financial instruments.

The aim of the amendments was to remove some of the uncertainty regarding the meaning of 'eligible investment business' and to expand the activities that widely held trusts may participate in without being taxed as a company. The main amendments involve:

- clarifying the meaning of 'investing in land'
- introducing a 25% safe-harbour allowance for non-rental, non-trading income from investments in land
- expanding the scope of financial instruments in which the trust may invest without losing exempt status
- introducing an additional 2% safe-harbour allowance at trust level, which will allow the trust to earn up to 2% of its gross revenue from activities that are neither eligible investment business nor income from a separate business activity.



Thin capitalisation amendments introduced

Legislation has been introduced with the aim of allowing the treatment of certain items under international financial reporting standards (IFRS) to be ignored when assessing whether a company is thinly capitalised for the purposes of the thin capitalisation rules.

The thin capitalisation rules restrict the deductibility of interest expense where the ratio of a company's equity capital in relation to its loan capital falls below a certain amount. The way that accounting standards prescribe the valuation of assets, liabilities and equity affects the calculation of this ratio. Changes in this treatment followed from the adoption in 2005 of the Australian equivalent of IFRS (AIFRS).

Broadly, the move to AIFRS meant that intangible assets would have to be written down in the balance sheet of companies that are subject to AIFRS. The previous Government had introduced a transitional measure allowing taxpayers to use the previous accounting standards when applying thin capitalisation calculations for a transitional period of four years up to and including the 2009 income year.

The new amendments provide broadly that:

- Deferred-tax assets and liabilities will be excluded from thin capitalisation calculations
- Companies will be able under certain conditions to choose to recognise an intangible asset as internally generated (and hence not subject to compulsory amortisation) where recognition is currently prohibited under AIFRS on the basis that the asset cannot be reliably costed
- Companies will be able to choose under certain conditions to revalue an intangible asset where AIFRS would otherwise prevent this because of the absence of an active market

These amendments are positive for taxpayers and ensure that there will be certainty in relation to the impact of AIFRS on thin capitalisation calculations.

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Hong Kong

Import processing can benefit from 50/50 apportionment

The Hong Kong Court of First Instance has held that profits of a Hong Kong company from goods manufactured by its mainland Chinese subsidiary under an import-processing arrangement may benefit from a 50/50 concession operated by the Hong Kong tax authorities.

Hong Kong taxes on a territorial basis, so only income and profits deemed to be derived in Hong Kong are liable to Hong Kong tax. Under a concession referred to as DIPN 21, the Hong Kong Inland Revenue Department exempts 50% of the profits derived by a Hong Kong entity from the sale of goods manufactured outside Hong Kong under a contract-processing arrangement.

Under contract processing, raw materials are supplied to the manufacturer who manufactures the goods and then transfers the finished goods back to the supplier for sale to customers. Ownership of the materials and the goods remains with the supplier, who also typically provides machinery, training and technical support. Under an import-processing arrangement, the manufacturer purchases the raw materials from the supplier and then sells the finished goods back to the supplier for onward sale.

In this case (*Datatronic Ltd*), the taxpayer entered into an import-processing arrangement with a mainland manufacturer. It then claimed the benefit of the 50/50 concession on its profit from the sale of the finished goods to third parties. The tax authorities maintained that import processing did not qualify for the concession and that the taxpayer's profits were taxable in full.

The Court found for the taxpayer. According to the terms of the concession, it is said to apply to situations where the Hong Kong entity is 'involved' in manufacturing activities on the mainland. It held that the substance of the arrangement was one that fell within the concession, particularly in view of the fact that the taxpayer was actively involved in providing the manufacturer with training, designs, supply of plant and machinery etc.

Other taxpayers who are involved in import-processing arrangements under similar factual circumstances should consider filing claims for the concession, although the tax authorities will almost certainly appeal

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Malaysia

Budget increases group relief

In presenting the Budget for 2009 in August, the Prime Minister announced that in future, associated companies will be allowed to transfer 70% of losses between themselves, instead of the current 50%.

Other tax measures featured in the Budget include:

- A reduction in the top rate of personal income tax to 27%
- A corresponding reduction to 27% of the flat-rate tax on the income of non-residents
- Accelerated capital allowances (tax depreciation) for plant and machinery and small-value assets acquired by SMEs
- Revised transfer-pricing rules and the introduction of a thin-capitalisation rule

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Vietnam

Changes to corporate and personal income tax

Corporate tax

Significant changes, including a reduction of the standard corporate tax rate, are being made to Vietnamese corporate tax, following enactment of a new Corporate Income Tax Act, to take effect from 1 January 2009. Among the changes are the following:

- The standard rate of tax will be 25% instead of the current 28%
- Companies in the oil, gas and mineral sectors will be subject to special rates of between 32% and 50%, instead of at between 28% and 50% as at present
- The range of sectors eligible for incentive rates will be reduced and those rates will be either 10% or 20%. However, companies already entitled to incentives under the current law may continue to enjoy them if they would otherwise stand to lose
- The new Act abandons the prescriptive approach for deductible expenses in favour of a descriptive approach. In place of the current list of deductible expenses, the new Act provides that expenses are generally deductible if they are actually incurred and incurred for the purposes of the company's business, subject to specific exceptions. Advertising and promotion expenses, however, remain deductible only to the extent that they do not exceed 10% of total deductible expenses. This ceiling is increased to 15% for a new company's first three years of existence
- The surtax on income from the transfer of the right to use or rent land is to be abolished
- The tax will in future apply to corporate entities only; currently, certain individuals and households carrying on a business may also be liable to corporate tax

Personal tax

A new Personal Income Tax Act also takes effect from 1 January 2009. Among the changes made under this Act and its implementing Decrees:

- Income from business and income from employment will be taxed at progressive rates ranging from 5% to 35%. The 35% top rate will apply to that slice of income exceeding VND 80 million (EUR 3425; USD 4825) per month
- Several tax exemptions for expatriates are removed; for example, relocation and housing allowances will be revised; the exemption for home-leave allowances and certain school fees will be abolished

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Latin America Argentina

Tax-exemption for securitisation funds repealed

On 1 August 2008 the government of Argentina issued Decree 1207 terminating the nine-year exemption from income tax for mutual funds and financial trusts commonly used in the securitisation of distressed debt. The exemption will remain effective for financial trusts set up to fund public infrastructure works as implemented since 1998. Decree 1207 did not make

any changes regarding the tax exemption for trading with other financial instruments. Accordingly, mutual funds and financial trusts holding investments in Argentinian debt would become taxable at a rate of 35%.

New incentives for capital investment

Argentina has established a new favourable tax régime for investment in new capital goods (except for cars) for industrial activities and infrastructure works.

The highlights of the régime are as follows:

- It applies to resident individuals and companies authorised to do business in Argentina with ongoing investment projects in industrial activities or infrastructure works
- The benefits to be granted pursuant to a bidding process to allocate the available quota of benefits among taxpayers for every fiscal year; and for infrastructure works declared as critical by the Government

- The benefits consist of
 - VAT reimbursement or VAT credits to offset other tax liabilities, or
 - Accelerated depreciation of certain assets for income tax purposes.

Taxpayers must choose one of the benefits mentioned. Only projects that are intended entirely for export or involving environmentally-friendly manufacture as approved by the National Environment Secretary can take all the benefits.

Implementing regulations enabling the régime to take effect are still awaited.

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