

# WORLD WIDE TAX NEWS

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## UNITED STATES

### JOBS ACT PAID FOR BY INTERNATIONAL TAX RESTRICTIONS

On 10 August 2010, President Obama signed into law the so-called Education, Jobs and Medicaid Assistance Act (official title: Pub. L. No 111-226). In order to make the Act largely revenue-neutral, a number of restrictions concerning tax on the foreign operations of US corporations are included.

We provide below an extended summary of these important new rules affecting all US taxpayers with cross-border activities.

#### Splitting foreign tax credits

Under prior and current law, relief is provided from double taxation through a foreign tax credit. Subject to certain limitations, a US taxpayer may claim a credit against its US income tax liability for foreign income taxes that it has paid or accrued. A domestic C corporation that owns at least 10% of the voting stock of a foreign corporation is allowed a credit for foreign income taxes paid by the foreign corporation that the domestic corporation is deemed to have paid when the foreign corporation's earnings are either distributed or included in the domestic corporation's income under the provisions of Subpart-F (US CFC rules).

The Act introduces a matching rule to prevent the separation of creditable foreign taxes from the associated foreign income. Under this provision, a foreign-tax-credit splitting event occurs with respect to a foreign income tax if the related income is (or will be) taken into account for federal income tax purposes by a covered person.

In general, a taxpayer will be prevented from taking any foreign income tax into account for federal tax purposes until the taxable year in which the related income is taken into account by the taxpayer. This rule prevents the 'splitting' of any foreign income tax paid or accrued by the taxpayer. In addition, any foreign income tax paid or accrued by virtue of the 'deemed paid' provisions of Internal Revenue Code (IRC) section 902 will also not be taken into account before the taxable year in which the related income is taken into account for federal income tax purposes. Thus, such foreign income taxes are not added to the foreign corporation's foreign tax pool, and its earnings and profits are not reduced by such tax. In the case of a partnership, the matching rule will be determined at the partner level.

In general, the provision is effective with respect to foreign income taxes paid or accrued by US taxpayers and section 902 corporations in taxable years beginning after 31 December 2010.

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## EDITOR'S LETTER

Welcome to Issue 23 of *BDO World Wide Tax News*. This newsletter 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 Brussels Worldwide Services BVBA in Brussels. If you have any comments or suggestions concerning *BDO World Wide Tax News*, please contact the Editor via the BDO International Executive Office by e-mail at [mderouane@bwsbrussels.com](mailto:mderouane@bwsbrussels.com) or by telephone on +32 (0)2 778 0130.

### No foreign tax credit for covered asset acquisitions

Historically, taxpayers were permitted to consider US tax basis and not carry over foreign basis in certain actual or deemed asset-acquisition transactions if the asset transaction resulted in a basis adjustment under the operation of certain federal income tax provisions such as IRC sections 338 and 754. This rule allowed the direct or indirect US owner of the assets to amortise or depreciate any basis step-up related to the actual or deemed asset acquisition transaction. Such deductions reduced the earnings and profits of the acquired foreign business entity and increased the effective tax rate on such earnings, inasmuch as the basis step-up and subsequent amortisation were not considered in determining the foreign taxable income and foreign tax liability of the foreign entity.

The new Act denies a foreign tax credit for the disqualified portion of any foreign income tax paid or accrued in connection with a covered asset acquisition. For purposes of the provision, a 'covered asset acquisition' is defined as:

- a qualified stock purchase to which IRC section 338(a) applies;
- any transaction that is treated as an acquisition of assets for US tax purposes and as an acquisition of stock (or is disregarded) for purposes of the foreign income taxes of the relevant jurisdiction (i.e. the deemed liquidation of a controlled foreign corporation (CFC) as the result of making an entity-classification election may result in an IRC section 331 liquidation for US tax purposes that is disregarded for foreign income tax purposes);
- any acquisition of an interest in a partnership that has an election under IRC section 754 in effect; and
- (4) to the extent provided by the IRS, any other similar transaction.

The ratio (expressed as a percentage) of (a) the aggregate basis differences allocable to such taxable year with respect to all relevant foreign assets, divided by (b) the income on which the foreign income tax is determined, represents the disqualified portion of any foreign income taxes paid or accrued with respect to any covered asset acquisition. The law of the relevant foreign jurisdiction will determine the amount of income on which the foreign income tax is assessed.

Failure to substantiate such amount will result in a determination of the income by dividing the amount of such foreign income tax by the highest marginal tax rate applicable to that income in the respective jurisdictions.

The term 'basis difference' with respect to any relevant foreign asset, for purposes of determining the aggregate basis difference allocable to a taxable year, means the excess of (a) the adjusted basis of such asset immediately after the covered asset acquisition, over (b) the adjusted basis of such asset immediately before the covered asset acquisition.

Thus, the basis for US tax purposes is used rather than the basis as determined under the law of the foreign jurisdiction. If a relevant foreign asset (defined as an asset to which any income, deduction, gain, or loss attributable to the asset is taken into account in determining foreign income tax in the relevant jurisdiction) has a built-in loss, the loss is taken into account in determining the aggregate basis difference; however, a built-in loss cannot reduce the aggregate basis difference allocable to a taxable year below zero.

In general, subject to transitional provisions, the new rules are effective for covered asset acquisitions occurring after 31 December 2010.

The above provision raises issues with respect to income tax treaties and potential double taxation under those treaties. In addition to transactions subject to either IRC section 338 or section 754, other taxable asset acquisitions and taxable liquidation transactions are affected by this provision. Moreover, there will be an increase in taxpayer costs and administrative efforts associated with obtaining and maintaining carry-over asset basis information in order to comply with these new rules.





### Foreign tax credits for re-sourced items

Generally, the foreign tax credit is limited to the US tax liability related to a taxpayer's foreign-source income. This limitation allows the taxpayer to mitigate double taxation of foreign-source income without offsetting the US tax on US-source income. The applicable provisions establish various separate limitation categories (or baskets) of income. Amounts such as interest and dividends derived from a foreign corporation are generally treated as foreign-source income for US foreign tax credit limitation purposes. Special sourcing rules apply to these amounts when they are derived from a US-owned foreign corporation that is attributable to US-source income of the foreign corporation.

A coordination rule applies when an amount that would be treated as US-source income under special sourcing rules is treated as foreign-source income under a treaty. The coordination rule applies only to amounts derived from a US-owned foreign corporation, and not to amounts derived from a foreign branch or disregarded entity. The coordination rule creates a separate limitation category of income for foreign tax credit purposes for the resourced income.

Under the new Act, a separate foreign tax credit limitation will apply for each item (a) that is treated as derived from sources within the United States under US tax law without regard to a treaty obligation; (b) or that is treated as arising from sources outside the United States under a treaty obligation of the United States; and (c) for which the taxpayer chooses the benefits of the treaty.

The new provision does not apply to items of income to which the coordination rule applicable to US-owned foreign corporations currently applies. Similarly, the new provision will not apply when the rule for gains from the sale of certain stock or intangibles applies. This rule treats any such gain as foreign-source income while requiring the taxpayer to

assign any such gain and associated taxes to a separate limitation category for purposes of computing the foreign tax credit, and applies to the gain from the sale of stock in a foreign corporation or an intangible that would be US-source income but for a US-treaty obligation that treats it as foreign-source income.

The provision is effective for taxable years beginning after 10 August 2010.

### Limitation of taxes deemed paid for inclusions under IRC section 956

A foreign tax credit is allowed for any amount of income tax paid or accrued by a domestic corporation during the taxable year to any foreign country and for foreign income taxes deemed paid under the rules described above. In the case of qualified groups (i.e. certain foreign corporations within the first six tiers of a chain of foreign corporations if the product of the percentage ownership of voting stock at each level of the chain is at least 5%), the lower-tier corporations are also eligible for the deemed-paid credit for foreign income taxes paid or accrued. If the domestic corporation is a US shareholder of the CFC, foreign tax credits can follow from fourth-, fifth-, and sixth-tier subsidiaries of the US corporation, but only if the lower-tier corporation was a CFC during the period with respect to which the taxes were paid. The indirect credit does not extend to foreign subsidiaries below the sixth tier.

Earnings of a CFC may be includible in the gross income of a US shareholder under IRC section 951, if the income is subpart-F income or the CFC increases its investment of earnings in US property under IRC section 956.

The current inclusion of a US shareholder's share of controlled-foreign-corporation earnings is treated as a dividend paid directly to the parent. This treatment resulted in a foreign tax credit (under IRC section 960) related to a section 956 inclusion. The credit was determined as the amount of tax deemed paid by the CFC, rather than the amount that would

be deemed to have been paid if the inclusion amount had been distributed up the chain as cash to the US shareholder (the so-called 'hopscotch rule').

The new Act prevents taxpayers from maximising their foreign tax credits by using the hopscotch rule to repatriate income selectively from high-taxed foreign subsidiaries while continuing to defer US tax on income of low-taxed foreign intermediary subsidiaries. Thus, the new provision imposes a limitation on the amount of foreign taxes that a US shareholder is deemed to have paid under IRC section 960 with respect to any section 956 inclusions. In the case of US property acquired by a CFC after 31 December 2010, the amount of foreign taxes deemed paid in each separate category is determined by comparing the foreign taxes deemed paid with respect to the US shareholder's section 956 inclusion with the hypothetical amount of foreign taxes deemed paid as computed under the provision. For this purpose, the shareholder's hypothetical credit will be the amount of foreign taxes it would be deemed to have paid if cash in an amount equal to the section 956 inclusion had been distributed through the chain of ownership that begins with the foreign corporation that holds the investment in the US property and ends with the US shareholder. If the tentative credit is more than the hypothetical credit, then the amount of foreign taxes deemed paid with respect to the section 956 inclusion is limited to the hypothetical credit.

The provision generally applies to US property acquired by a CFC after 31 December 2010. Thus, for example, the provision would not apply to a section 956 inclusion resulting from a loan by a CFC to a US shareholder made before 1 January 2011. However, it should be noted that under the significant modification rules applicable to debt instruments, certain modifications of such a loan could be considered as the issuance of a new debt instrument.

### Certain redemptions by foreign subsidiaries

When a corporation purchases the stock of a related corporation in exchange for property (including money), the transaction is generally recharacterised as a redemption under IRC section 304. In many cases, the redemption will fail the requirements of IRC section 302(b) and be treated as a section 301 distribution. Under IRC section 301, a distribution is taxed as a dividend to the extent of current or accumulated earnings and profits of the distributing corporation. In the case of a transaction subject to section 304, however, the amount and the source of the dividend will be determined as if the property

In the case of a foreign acquiring corporation, the amount of the dividend to the transferor is limited to the portion of the foreign acquiring corporation's earnings and profits that (a) is attributable to stock for the foreign acquiring corporation held by a corporation or individual that is the transferor of the target corporation and that is a US shareholder of the foreign acquiring corporation and (b) was accumulated during the period such stock was owned by the transferor (or person related thereto) and during the period the foreign acquiring corporation was a CFC.

The new Act imposes an additional limitation on the earnings and profits of a foreign

As a result, the only earnings and profits taken into account to determine the amount constituting a dividend are the target corporation's earnings and profits. If the target is a US corporation, a 30% withholding tax applies on a gross basis to the amount constituting a dividend from the target, unless reduced or eliminated by treaty.

Future regulations are expected to provide rules to prevent the avoidance of the provision through the use of partnerships, options, or other arrangements to cause a foreign corporation to be treated as a CFC.

The provision is effective for acquisitions after 10 August 2010.



were distributed by the acquiring corporation to the extent of its earnings and profits, and then by the target corporation to the extent of its earnings and profits. The transferor of the target stock will then be considered to have received the dividend directly from the acquiring corporation to the extent that the dividend is sourced from the earnings and profits of the acquiring corporation (also known as 'hopscotching' because the dividend jumps or 'hopscotches' any intermediary shareholders).

acquiring corporation that is taken into account to determine the amount (and source) of the distribution treated as a dividend. The new law provides that if more than 50% of the dividends arising from acquisition would not be (a) subject to US tax in the year in which the dividend arises or (b) includible in the earnings and profits of a CFC, then the earnings and profits of the foreign acquiring corporation are not taken into account for purposes of determining the portion of the distribution that is treated as a dividend. Where the special rule applies, none of the foreign acquiring corporation's earnings and profits are taken into account.

### Affiliation rules and interest expense

To compute the foreign tax credit limitation, a taxpayer determines the amount of its taxable income from foreign sources by allocating and apportioning certain deductions between items of US-source gross income and items of foreign-source gross income. Specific provisions govern the allocation and apportionment of interest expense. For interest-expense allocation purposes, all members of an affiliated group of corporations are generally treated as a single corporation and allocations must be made on the basis of assets rather than gross income. For this purpose, the term 'affiliated group' is generally defined by reference to the rules for determining whether corporations are eligible to file consolidated returns. These rules exclude all foreign corporations from an affiliated group. Thus, while debt is generally considered fungible among the assets of a group of domestic affiliated corporations, the same rules do not apply as between the domestic and foreign members of a group with the same degree of common control as the domestic affiliated group.

Under Treasury regulations, however, certain foreign corporations are treated as affiliated corporations, in certain respects, if (a) at least 80% of either the voting power or value of the corporation's outstanding stock is owned directly or indirectly by members of an affiliated group and (b) more than 50% of the corporation's gross income for the taxable year is effectively connected with the conduct of a US trade or business (also known as 'effectively connected income'). In the case of a foreign corporation that is treated as an affiliated corporation for interest-expense allocation and apportionment purposes, the percentage of its assets and income that is taken into account varies depending on the percentage of the corporation's gross income that is effectively connected income. If 80% or more of the foreign corporation's gross income is effectively connected income, then all of the corporation's assets and interest expense are taken into account. If, instead, between 50% and 80% of the foreign corporation's gross income is effectively connected income, then only the corporation's assets that generate effectively connected income and a percentage of its interest expense equal to the percentage of its assets that generate effectively connected income are taken into account for the purposes of interest-expense allocation and apportionment purposes.

The new Act treats a foreign corporation as a member of an affiliated group, for interest-expense allocation and apportionment purposes, if (a) more than 50% of the gross income of that foreign corporation for the taxable year is effectively connected income and (b) at least 80% of either the voting power or value of all the outstanding stock of the foreign corporation is owned directly or indirectly by members of the affiliated group (determined with regard to this sentence). Thus, under the provision, if more than 50%

of a foreign corporation's gross income is effectively connected income and at least 80% of either the voting power or value of all the outstanding stock of the foreign corporation is owned directly or indirectly by members of the affiliated group, then all of the foreign corporation's assets and interest expense are taken into account for the purposes of allocating and apportioning the interest expense of the affiliated group.

The provision applies to taxable years beginning after 10 August 2010.

### Termination of special dividend and interest rules for 80/20 test

Generally, interest or dividend payments made by a US payor to a foreign person are treated as US-source income and subject to 30% US withholding tax. An exception applied to interest paid by certain US corporations or resident alien individuals. Under this exception, such interest was not US-source income if the payor met an 80% active foreign business requirement. This requirement is satisfied only where at least 80% of the resident alien individual's or domestic corporation's gross income from all sources during a three-year testing period was active business income (the '80/20 test'). Interest paid by a payor satisfying the 80/20 test was treated as foreign-source income and was completely exempt from the 30% withholding tax if paid to unrelated parties. If the interest was received by related parties, it was only foreign-source in the same proportion that the payor's total gross income during the testing period was from foreign sources.

Similar treatment applied with respect to a dividend paid to a foreign person by a domestic corporation that satisfied the 80/20 test. Such a payment would be partially exempt from US withholding tax but would remain US-source income.

The new Act repeals the rule treating as foreign-source income all or a portion of any interest paid by a resident alien individual or US corporation that meets the 80/20 test. In addition, the new law repeals the provision that treats all or a portion of any dividends paid by an 80/20 corporation as exempt from withholding tax. However, under a grandfather clause, the 30% withholding tax will not be imposed on the active foreign business percentage of interest and dividend income paid by an existing 80/20 corporation.

The provision is effective for taxable years beginning after 31 December 2010. The repeal of the 80/20 company provisions relating to the payment of interest does not apply to payments of interest to persons not related to the 80/20 company.

### Limitation extension on failure to notify certain transfers

There is an exception to the three-year period of limitations on assessment of tax due to failures to provide certain information reporting on cross-border transactions or foreign assets. Under this exception, introduced by the Hiring Incentives to Restore Employment (HIRE) Act earlier this year (see *BDO World Wide Tax News* Issue 22, July 2010), the period for assessment of tax does not expire any earlier than three years after the required information about certain cross-border transactions or foreign assets is actually provided to the Internal Revenue Service (IRS) by the person required to file the return. In general, such information reporting is due with the taxpayer's return; thus, the three-year period commences when a timely and complete return (including all information reporting) is filed. If the required information is not provided with the return, the period of limitations does not commence until such time as the information reports are ultimately provided to the IRS, even though the tax return has been filed. The taxes that may be assessed during this suspended or extended period are not limited to those attributable to the cross-border transactions or foreign assets.

The new Act modifies the scope of the exception where a failure to provide information reporting on cross-border transactions or foreign assets is shown to be due to reasonable cause and not wilful neglect. If a taxpayer meets this reasonable cause/wilful neglect standard, the running of the period of limitations is suspended only for the item or items related to the disclosure failure. If a taxpayer does not meet the reasonable cause/wilful neglect standard, the suspension of the limitations period and the commencement of the subsequent three-year period that begins after information is ultimately supplied will apply to all tax assessed with respect to the income tax return.

The provision is effective as if it had been included in the HIRE Act. Thus, the provision applies for returns filed after 18 March 2010, the date of enactment of the HIRE Act, as well as for any other return for which the assessment period specified in IRC section 6501 had not yet expired as of that date.

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# CHINA

## RANDOM SELECTION FOR TRANSFER-PRICING INSPECTION

In July, the State Administration of Taxation (SAT) issued a circular *Guoshihan* [2010] No 233, requesting all local tax offices nationwide to perform a review and an evaluation of taxpayers' transfer-pricing documentation. The circular requires the local tax offices to select randomly for evaluation at least 10% of taxpayers that are required to prepare transfer-pricing documentation for the tax years 2008 and 2009, based on information disclosed in annual enterprise income tax returns.

The evaluation has a fivefold focus:

- Organisational structure
- Modus operandi
- Related-party transactions
- Comparability analysis and
- Selected transfer-pricing methodology

From the review, the tax authorities have to rate the documentation in one of four categories – good, average, poor or very poor.

According to *Guoshifa* [2009] No 2 (previously reported on in *BDO World Wide Tax News*), transfer-pricing documentation must be prepared and kept by enterprises meeting any one of the following criteria:

- Annual related-party transactions in tangible goods of over RMB 200 million
- Annual amount of other related-party transactions of over RMB 40 million
- Loss-making enterprises performing limited functions and bearing limited risks
- Thinly capitalised enterprises
- Enterprises with cost-sharing agreements
- Enterprises having to prepare the documentation for other reasons

Failure to provide the documentation upon the request of the tax authorities incurs 5% penalty interest in addition to tax adjustments (with interest calculations based on a base interest rate) following a transfer-pricing audit. Local tax authorities are required to submit the review results to the SAT by 31 October 2010. The review process should thus already be coming to a conclusion. The evaluation of the documentation for large enterprises is being dealt with separately by the SAT.

### NEW RULES ON TAX TREATMENT OF ENTERPRISE REORGANISATIONS

The State Administration of Taxation has issued Bulletin [2010] No 4, giving guidance and clarification on matters contained in the 2009 Circular (*Caishui*) No 59, on the treatment of reorganisations for the purposes of enterprise income tax (EIT).

#### Same treatment

The Bulletin states that all parties involved in the reorganisation will have to choose the same tax treatment (i.e. 'ordinary reorganisation' or 'special reorganisation').

#### Definition of 'real operating asset'

Circular 59 defines an asset acquisition as a transaction in which an enterprise acquires the real operating assets of another enterprise. The Bulletin defines 'real operating asset' to mean an asset used by an enterprise in its manufacturing and business operations and which relates directly to the generation of income, including commercial information and technical know-how, account receivables, investments etc. It is still not clear what is meant by relating directly to the generation of income, and this may be interpreted differently by different local tax authorities.

#### Definition of 'controlled entity'

Circular 59 provides that consideration for the assets of the target enterprise may be provided in the form of the shares of the acquiring enterprise or a controlled entity of that enterprise. The Bulletin explains that a controlled entity is a company whose shares are owned directly by the acquiring enterprise. Further guidance from the SAT is still needed here.

#### Date of reorganisation

This term was undefined in Circular 59. The Bulletin provides the following definition:

- For debt restructuring: the date the restructuring contract or agreement is effective
- For equity acquisition: the date the equity-transfer agreement is effective and all statutory transfer procedures have been completed
- For asset acquisition: the date the asset-acquisition agreement is effective and all asset transfers have been completed
- In the case of a merger: the date all legal title to the assets of the enterprise being absorbed are transferred to the absorbing enterprise and registration with the State Administration of Industry and Commerce has been revised accordingly
- In the case of a demerger: the date all legal title to the assets of the surrendering enterprise have been separated and registration with the State Administration of Industry and Commerce has been revised accordingly

#### Forfeiture and carry-over of tax incentives

The Bulletin states that in a merger or separation (demerger) under an ordinary reorganisation, tax incentives awarded to the absorbed enterprise or the surrendering enterprise, as the case may be, are forfeited and cannot be carried over to the new enterprise(s) – the 'surviving entity'. Care should be taken to avoid the loss of tax incentives when planning a merger or separation so that the right entity is chosen as the surviving entity.

Under the special-reorganisation régime, however, tax incentives may be retained. Provided that the nature of the business of the surviving entity remains unchanged, that entity can continue to enjoy the incentive until its expiration. Where before the merger, the enterprises concerned had different unutilised tax-incentive periods, the surviving enterprise must allocate its taxable income according to the total proportion of total assets of the pre-merger enterprises to the total assets of the surviving enterprise(s) at the merger date to calculate the tax payable.

#### Meaning of common control

Under the special-reorganisation régime, deferred tax treatment can be applied when no consideration passes in a merger of enterprises under 'common control'. The Bulletin explains that common control exists where two or more enterprises are under the ultimate control of the same party or the same group of parties 12 months before and after the merger. The '12 months before' condition was not present in Circular 59 and is a new addition.

#### Net operating loss

The Bulletin also provides clarification on the maximum amount of the net operating loss that can be used by the absorbing enterprise and clarifies that this is the annual limit.

#### Other paragraphs

The other paragraphs of the Bulletin mainly deal with the types of documents or information that need to be provided to the tax authorities in support of the reorganisation.

One interesting item to note is an attempt in the Bulletin to provide guidance on the information that needs to be supplied to the tax authorities in support of a reorganisation with a *bona fide* business purpose. However, the guidance given is still fairly vague and the uncertainty as to what is meant by '*bona fide business purpose*' remains unsettled.

Even with the issue of Bulletin No 4, there are still many issues concerning reorganisations of enterprises in the People's Republic of China which remain unresolved, especially those involving foreign enterprises. Taxpayers need to consider their reorganisation plans carefully in order to avoid any uncertainties and pitfalls.

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# INDIA

## INDIA CAN TAX SALE OF NON-RESIDENT COMPANY'S SHARES

**T**he Mumbai High Court has held that India had jurisdiction to tax the purchase of shares by Vodafone International Holdings BV in another company, although neither company was resident in India.

In the transaction in question, Vodafone, which is resident in the Netherlands, purchased 100% of the shares in CGP (Holdings) Ltd, a Cayman Islands company, from Hutchison Telecommunications International Ltd, also resident in the Netherlands, for USD 11 200 million. By virtue of direct and indirect shareholdings and contractual arrangements, CGP Holdings controlled 67% of the shares of Hutchinson Essar Ltd, which is resident in India.

Following the transaction, the Indian tax authorities issued a show-cause notice to Vodafone, requiring it to justify its failure to withhold Indian tax on the purchase price under Income Tax Act 1961 s 201. That section requires tax to be withheld on account of capital gains tax on the transfer of a capital asset situated in India. Vodafone maintained that as the asset in question was shares in a Cayman Islands company, no Indian tax was due.

The Mumbai court has found for the tax authorities. Although it emphasised that there was no substance-over-form doctrine in India, and hence that it was unable to look through a genuine and legitimate transaction to the economic substance beneath, in this case several vital rights, with a direct nexus with India, were acquired by Vodafone, and it would be simplistic to assume that the entire transaction was fulfilled merely upon the transfer of the shares of CGP. These rights and entitlements themselves constituted a capital asset within the meaning of the Income Tax Act.

A non-resident is chargeable to tax on income that arises or accrues (or is deemed to arise or accrue) in India. It was for the tax authorities to apportion the income received by Hutchinson as a result of the transaction between that arising in India and that outside. However, the duty to withhold tax was not limited to residents, provided there was a nexus with India, which existed in this case. Vodafone was under the duty to deduct, therefore.

It is very likely that Vodafone will appeal to the Supreme Court.

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# EUROPEAN UNION

## MINIMUM 15% VAT RATE LIKELY TO BE PROLONGED

Under Article 97(1) of the VAT Directive (2006/112/EC, as amended), Member States may not levy a standard rate of VAT below 15%. This provision is set to expire on 31 December this year. The European Commission has proposed to the Council that the life of the provision be extended through to the end of 2015.

Currently, only Luxembourg has a standard rate of VAT as low as 15%.

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## COUNCIL TO ISSUE GUIDELINES ON CFC AND THIN CAP RULES

The European Council has published a preliminary resolution containing guidelines to Member States on how they should apply cross-border CFC (controlled foreign company) and thin capitalisation rules where these are not applicable in a purely domestic situation. CFC rules attribute the profits of a company controlled by domestic shareholders and resident in a foreign (normally low-tax) jurisdiction to those shareholders. Thin capitalisation rules restrict the deduction of interest expense on loans where e.g. loan capital exceeds equity capital by a defined amount, often where the interest is paid to a related party in a lower-taxed jurisdiction.

Recent judgments by the European Court have upheld CFC rules within the European Union only to the extent that they apply in cases where profits have been artificially diverted without economic justification. The resolution contains a non-exhaustive list of indicators of artificial diversion, such as:

- Insufficient valid economic or commercial reasons for the location of the CFC
- The CFC has significantly more capital than it needs for its activity
- A lack of proportionate correlation between the activities apparently carried on by the CFC and the size of its premises, staff and equipment

As regards thin capitalisation, the resolution suggests the rules should also be applied only where the loan has been issued in order to divert profits artificially. Indicators that this may be the case include:

- An excessive level of debt compared to equity
- The net interest paid exceeds a certain proportion of earnings before interest and tax (or before interest, tax and depreciation)

The resolution, once finalised, will only take the form of a recommendation, and will have no legislative authority. Nevertheless, it will probably form the basis of the Commission's submission to the European Court in cases involving a challenge to CFC or thin capitalisation rules.

### EUROPEAN COURT MAY FINALLY RULE ON CORPORATE EXIT TAX

As a case concerning Netherlands 'exit tax' on companies changing their residence from one Member State to another has been referred to the European Court of Justice, a definitive judgment on this controversial topic may perhaps be expected in the not too distant future.

Many countries in the European Union levy tax on the gains that a person (whether a natural person such as an individual or a legal person such as a company) is deemed to realise when that person removes himself from the tax jurisdiction of that country (i.e. becomes non-resident there). These gains may be unrealised (i.e. the emigrating person has not actually disposed of the assets in question) but tax – 'exit tax' – is nevertheless payable as if they had been realised.

In the case of individuals, the European Court has held, notably in the cases of *Lasteyrie de Saillant and N*, that to impose a tax on unrealised gains in these circumstances (and not allowing it to be deferred until an actual disposal) was a breach of the fundamental freedoms guaranteed by the Treaty on the Functioning of the European Union (TFEU), but a judgment in the case of legal persons is still awaited. Existing European case law may suggest that exit charges can be upheld as long as they are proportionate and targeted at cases where there is no commercial justification, but there are Member States (such as, for example, the United Kingdom) where taxpayers do not have the opportunity to demonstrate a commercial justification. The outcome of the case is therefore difficult to predict.

The case referred by the Netherlands is that of *National Grid Indus BV*, a Netherlands-resident company that transferred its place of effective management to the United Kingdom in 2000, thus becoming non-resident in the Netherlands under the law of that country. The company had a sterling-denominated loan, which had increased in value due to exchange movements. It is that increase in value that the Netherlands is attempting to tax. It should be noted that the Netherlands authorities also assessed the company on the grounds of abuse of law, which a lower Netherlands court held indeed to be present.

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# FRANCE

## GERMAN COURT RULES ON FRENCH BRANCH LOSSES

See under Germany – ‘When are foreign branch losses final?’

# GERMANY

## WHEN ARE FOREIGN BRANCH LOSSES FINAL?

The German Federal Financial Court (*Bundesfinanzhof*) has recently issued judgments on the ‘finality’ of cross-border losses, without referring the cases to the ECJ. It dismissed the possibility of importing time-barred losses but allowed the set-off in Germany of losses stranded by the incorporation of a foreign branch.

Where a foreign permanent establishment (PE) incurs a loss, the loss cannot normally be set off against taxable income if the state where the company whose PE it is is resident (‘the home state’) has concluded a double tax treaty with the state in which the PE is located which stipulates the exemption method as the means of avoiding double taxation. This means that in many cases, neither profits nor losses of the PE are recognised in the home state.

However, in its judgment of 15 May 2008 in the *Lidl Belgium* case, the European Court of Justice held – in line with its earlier decision in the landmark *Marks & Spencer* case – that foreign PE losses must under European law be recognised in the home state when these losses are ‘final’, i.e. there is no further possibility of their being taken into account in the foreign jurisdiction.

However, precisely when a loss can be considered to be final has been subject to dispute in several European countries. The

*Bundesfinanzhof* has now had the opportunity, in two decisions (both dated 9 June 2010), to take a position on this matter.

In one of the cases, a French PE incurred a loss that could partially no longer be utilised in France, since with respect to the year in question France limited the loss carry-forward period to five years. By mere passage of time, a part of the loss was for this reason virtually written off. In the opinion of the *Bundesfinanzhof*, this type of loss carry-forward, which is terminated simply by virtue of law, is not ‘final’ in the sense of its availability to the domestic entity. A limitation by the PE state of the ability to utilise the loss, e.g. by imposing a temporal limitation or similar, has no consequential effect on its recognition in the entity’s home state.

It is also the case that within the European Union, it is in principle a matter for the PE state to allow tax relief for losses incurred there and exempt in the home state. The latter is not obliged to compensate by a deduction against domestic tax to the extent of any remaining loss carry-forwards that it is no longer possible to take into account in the PE state.

In the other case, the loss-making PE – also French – was actually disposed of within the five-year period. The BFH recognised the losses as ‘final’ inasmuch as the losses remaining in

the hands of the PE up to the time of disposal could as a matter of fact no longer be taken into account, and allowed a corresponding deduction in Germany. These decisive factual grounds exist for example, in the case of an incorporation of the foreign PE, its transfer or of its final disposal, but not where the PE fails to utilise its losses in ways that is legally open to it, e.g. by carry-back or carry-forward or by means of a business transaction.

‘Final’ losses, in the above sense, are deductible domestically not only for income tax and corporation tax purposes but also for the purposes of trade tax. In all cases under German tax law, they first become available in the year of assessment in which their ‘finality’ becomes certain, and not in the year in which they arise.

However, there are different views in the Member States on the treatment of time-barred losses, and it is likely that this question will be raised again in other countries and then referred to the ECJ. It is distinctly possible, therefore, that this is not the end of the matter, even for Germany.

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# GIBRALTAR

## 2010 BUDGET MEASURES

### Economic summary

On 1 July 2010 the Chief Minister set out the budget for the 2010–11 tax year, which runs from 1 July 2010 to 30 June 2011. Below are some of the tax highlights.

### Corporate taxation

The Government confirmed the introduction of a 10% corporate tax rate for existing companies with effect from 1 January 2011, to coincide with the introduction of the new Income Tax Act – further information on this below. The 10% tax rate, however, is already available to any new companies that start up before that date, subject to certain conditions.

### PERSONAL TAXATION

The success of the economy has allowed the Government to continue with its programme of reducing personal tax in the jurisdiction. For the allowance-based system of personal taxation, allowances were increased by 2.8%, and the effective tax rate has been reduced on all income bands. This now means that anyone earning less than GBP 8000 will not pay any income tax. On the alternative gross-income based personal tax system, the top tax rate of 35% was abolished, so that the top tax rate is now 29%, which is paid on any income over GBP 25 000. The minimum tax payable by so-called 'Category Two' individuals increases by GBP 2000 to GBP 22 000 and the income of individuals categorised as 'High Executives Possessing Specialist Skills' (HEPSS) that is chargeable to tax increases from GBP 100 000 to GBP 120 000. Finally, the tax rate on incomes above GBP 353 000 reduces to 20%, and falls progressively to 5% on any income over GBP 1 million. The result of this is that the effective rate of tax on an income of GBP 1 million is now 20%, with any excess income taxed at 5%.

### Other areas

In other measures, social insurance contributions for both employers and employees increased by 10% and the statutory minimum wage increases by 8% to GBP 5.40 per hour with effect from 1 January 2011. The relief on contributions to retirement annuity contracts and personal pension schemes is reduced to the lower of 20% of earned income and GBP 35 000.

### NEW INCOME TAX ACT

#### The draft bill

On 16 June 2010, the Government published its first draft of the new Income Tax Act, which represents a significant change to the existing tax laws. The new Act is expected to come into effect on 1 January 2011, and the Government initially allowed for a six-week consultation period.

On 2 September the Government published a second draft of the proposed Income Tax Act, incorporating a significant number of the amendments proposed by the respondents. This second draft will form the basis of the bill that will be presented to Parliament shortly, so that it can be approved by Parliament in October before coming into effect on 1 January 2011.

### Territorial basis of taxation

The introduction of this Act will result in the repeal of the existing tax laws, including that allowing for tax-exempt companies. This means that from 1 January 2011 all companies doing business in Gibraltar will be subject to the new Act, and a corporation tax rate of 10% will apply to a company's profits – except if the company is a utility or telecommunications company, or a company benefiting from a dominant market position, where a corporate tax rate of 20% will apply.

Crucially however, the current territorial basis of taxation will remain, so that only income accruing in or derived from Gibraltar will be subject to Gibraltar corporation tax. The 'accruing in or derived from' criterion is defined by reference to the location of the activities that give rise to the profits, and the Income Tax Office will continue to base its interpretation on the principles established by the *Hang Sang* case, which has now been applied in Gibraltar for the past five years. This allows for significant tax-planning opportunities, as with the right structuring a company will continue to benefit from not paying any Gibraltar corporation tax on its profits. For example, a Gibraltar company owning and renting an overseas property will not pay any Gibraltar corporation tax on its rental income. The new Act does, however, stipulate that where a company carries out a licensable activity, i.e. an activity requiring a licence granted by the Gibraltar Financial Services Commission, the activities that give rise to the profits of the company will be deemed to take place in Gibraltar.

### Other exempt forms of income

The 10% (or 20%) corporation tax rate will only apply to a company's trading profits. There will still not be any capital gains tax in Gibraltar, and so any capital gains that a company (or individual) makes will be exempt from tax. For individuals, there will also continue not to be any inheritance tax. The proposed new Act also provides that for all companies other than banks or other money-lending institutions, interest income will also not be subject to tax, which means that the effective tax rate paid by companies other than banks, which are subject to tax in Gibraltar, will be lower than 10%.

### Submission of accounts and payment of tax

The proposed new Act requires that individuals submit their annual tax return to the Income Tax Office by 30 November for the previous tax year. This tax return would need to be submitted together with any final tax payment required in relation to that tax year. For companies, the existing preceding-year basis of taxation will be abolished and companies will be subject to tax on the basis of their current accounting period. Companies will need to submit unaudited accounts to the Income Tax Office within six months of the year-end, together with audited accounts by nine months after the year-end. Again, the submission of the tax return will need to be accompanied by any balancing tax payment in relation to that accounting period.

From 1 January 2011, companies and individuals will also be required to make half-yearly instalment payments to the Income Tax Office, based on the assessment for the prior year, with a final balancing payment made with the submission of the tax return. This represents a significant departure from the existing practice where no interim payments are required, and so companies will need to give more thought to managing their cashflow requirements to meet these payments.

### Benefits-in-kind and anti-avoidance

The proposed new Act includes a significant section on the taxation of benefits-in-kind, which again will be a significant change from current practice, given that the current Act is mainly silent on these matters. It also contains a number of anti-avoidance provisions, including the requirement to notify the Commissioner of Income Tax of any arrangements that enable a person to obtain an advantage in relation to taxation under the Act.

### Offences

In keeping with the Government's commitment to reduce the burden of personal taxation on those working in Gibraltar, the Government has emphasised the need to create a 'climate of compliance' in order to maintain its tax revenues, and the Act introduces a number of penalties and offences covering late filings to false declarations.

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# HUNGARY

## CORPORATE AND INHERITANCE TAXES REDUCED

Following the crushing election victory of the FIDESZ party, the new parliament has enacted several tax reduction measures, but also introduced an additional levy on banks and other financial institutions.

### Corporate taxes

Until July this year, a lower 10% rate of corporate income tax applied to the first HUF 50 million of taxable income, but only if certain stringent conditions were satisfied. As from 1 July, however, the 10% rate now applies, unconditionally, to the first HUF 250 million. Thereafter, the standard rate of 19% applies. Companies will be required to time-apportion their taxable income over the two periods 1 January – 30 June and 1 July – 31 December. For the first period, both the previous limit and the conditions for the 10% rate apply.

### Levy on financial institutions

A 'bank tax' will be imposed in the years 2010, 2011 and 2012.

For 2010, the levy will be charged on any financial institution with financial statements for at least one complete financial year as at 1 July 2010. For banks, the tax will be charged on the total balance-sheet value, at 0.15% on the first HUF 50 000 million and at 0.5% on the value above that amount. Insurance companies will be charged 6.2% on their income (excluding reinsurance). Other financial institutions (e.g. investment fund managers, risk-capital fund managers etc) will be subject to different rates on differing tax bases. Bank tax returns for 2010 had to be made by 10 September, and the tax is payable in two instalments, due on 10 September and 10 December 2010.

### Inheritance taxes

As from 1 July 2010, gifts and inheritances between transferors and transferees in the direct line (e.g. parents, children, grandchildren etc) are exempt from gift and inheritance taxes. Transfers to spouses remain taxable, under category 1.

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# IRELAND

## REDOMICILIATION OF FUNDS TO IRELAND

Due to a combination of regulatory issues (e.g. AIFMD) and the market conditions over the last number of years, there is ever increasing demand from investors and fund managers for regulated funds in onshore jurisdictions.

In a move aimed at consolidating Ireland's position as one of the world's leading jurisdictions in which to establish an investment fund, a new redomiciliation process was introduced by the Companies (Miscellaneous Provisions) Act 2009. The Act, which took effect in September 2010, now enables funds from the following jurisdictions to be redomiciliated to Ireland in a very efficient manner:

- The Cayman Islands
- Bermuda
- Jersey
- The British Virgin Islands
- Guernsey and
- The Isle of Man

Funds redomiciled can then be authorised as either UCITS or non-UCITS. A UCITS that is or becomes authorised in Ireland can be sold in all other EU Member States without further authorisation. UCITS are also sold in Asia, the Middle East and Latin and South America.

To augment the Act and the associated simplification of the legal steps to redomicile, there were a number of changes made to tax legislation including a stamp-duty exemption for redomiciliation and/or the creation of master-feeder structures as envisaged under UCITS IV. The requirement to submit non-residence declarations has also been relaxed where appropriate equivalent measures are adopted.

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# ISRAEL

## SOCIAL SECURITY INCREASE LEGAL

In a recent ruling, the Israeli Supreme Court has refused three petitions submitted regarding the legitimacy of changes to the Israeli social security rules that were approved by the Israeli Parliament last year within the framework of Israel's 2009-2010 budget.

One measure in the Budget raised the ceiling for social security contributions from five times the average wage to 10 times the average wage (which in 2010 is approximately ILS 8000 per month). As a result, the effective combined rate of income tax and social security contributions on the highest-paid taxpayers rose from 45% to 60%. The increase in the ceiling was enacted as a temporary measure, to apply to income derived between 1 August 2009 and 31 December 2010.

The petitions, filed by high-income individuals, claimed, *inter alia*, that social security contributions, as opposed to income tax, are intended to reflect future benefits to which the individual will become entitled (such as the state retirement pension). This being so, to the extent that these benefits were not increased as a result of the increased liability – nor was the income ceiling for calculating these future benefits – the ceiling increase for the social security liability should be deemed unconstitutional.

As stated, the Israeli Supreme Court refused the petitions and determined that no constitutional flaw was inherent in the new regulations. Moreover, the Supreme Court stressed that the said decision was in accordance with the norms of social ethics, which lean towards solidarity and mutual assistance, these being the basis of the Israeli social security system.

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# LATVIA

## MICRO-ENTERPRISE TAX INTRODUCED

In a move to simplify and reduce the tax burden on small businesses, Latvia has introduced a special tax régime for micro-enterprises. Enterprises that meet certain criteria can opt to pay micro-enterprise tax, which replaces corporate income tax or personal income tax (as the case may be) on the income of the enterprise and employer social security contributions, as far as the enterprise is concerned, and replaces personal income tax and employee social security contributions for the employees.

A micro-enterprise, which may be a limited-liability company (*sabiedrība ar ierobežotu atbildību*), individual trader, individual enterprise, a farming or fishing enterprise, or a natural person, is an enterprise meeting all the following criteria:

- its members (if any) consist entirely of natural persons, who must also be its directors
- its turnover does not exceed LVL 70 000 during the calendar year
- its number of employees is no greater than five at any time and
- the employees' and members' earnings from the enterprise must not exceed LVL 500 per month

Partnerships do not appear to be included.

Existing micro-enterprises may, beginning with 1 September 2010, opt for the micro-enterprise tax régime from the beginning of their next taxable period (i.e. 1 January 2011), provided certain further conditions are met. Newly incorporated companies may opt for the micro-enterprise tax régime on registration, if they expect to satisfy the necessary criteria.

Micro-enterprise tax is charged on the enterprise's turnover at a rate of 9%. An enterprise that is in the régime is exempt from corporate income tax or personal income tax (as the case may be) on its profits. Neither is it obliged to pay employer social security contributions nor to deduct employee social security contributions or salary tax from its employees or members.

Because of this latter exemption, the enterprise must obtain the written agreement of all its employees to apply for the micro-enterprise tax régime. Employees, members or proprietors (as the case may be) may opt to pay voluntary social security contributions to 'top up' the proportion of the micro-enterprise tax that is allocated to the social security fund on their behalf.

The LVL 500 earnings cap does not apply to dividends from the micro-enterprise.

Micro-enterprise tax is paid quarterly, on the turnover of that quarter. Payment is made with the micro-enterprise tax return, which must be filed by the 15th day following the end of the quarter.

If the turnover limit, employee limit or employee-remuneration limit is exceeded, additional tax is payable in respect of the relevant taxable period, and micro-enterprise tax status is lost from the next taxable period.

Latvia already has two other simplification schemes for small businesses. Individual entrepreneurs with no employees and a turnover of less than LVL 10 000 (the VAT registration threshold) in the previous tax year may opt to pay personal income tax on a 'lump-sum' basis varying with turnover rather than on an accounts basis. From 1 January 2011, there is a single rate of 5%, plus 7% (as now) on any turnover in excess of LVL 10 000. Tax paid on a lump-sum basis does not replace any other taxes or contributions.

A third option is open to individual entrepreneurs in certain specified trades, also having no employees and a turnover of no more than LVL 10 000. These taxpayers may opt to pay the so-called 'licence fee' (*patentmaksa*) instead of personal income tax. The amount of the licence fee varies between LVL 30 and LVL 120 per month, depending on the nature of the trade and location of the business. The licence fee replaces personal income tax and self-employed social security contributions.

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# LITHUANIA

## BINDING PRE-TRANSACTION RULINGS LIKELY

The Lithuanian Parliament (*Seimas*) is discussing the introduction of a pre-transaction rulings system in its current session. A scheme for such rulings, contained in a draft bill, was approved as long ago as March by the Government. In its current version, the bill provides for taxpayers to apply to the tax authorities for a ruling on a contemplated transaction. Taxpayers would have to indicate all the facts and circumstances, set out their understanding of how the law would apply to that transaction, and provide any other necessary information.

The tax authorities would be obliged to issue their ruling, in which they could agree or disagree with the interpretation sought by the taxpayer within 90 days of receiving the application, although a 150-day extension would apply if additional information is required by the tax authorities.

Once the ruling was issued, it would be binding on the tax authorities for the whole period of the transaction but not longer than five years. The ruling could still be overturned by a decision of the Supreme Administrative Court or the European Court of Justice, but the tax authorities could not for their part go back on the ruling unless the actual facts and conditions of the situation were not as described in taxpayer's application.

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# LUXEMBOURG

## FLAT INCOME TAX PLANNED FOR COMMERCIALLY INACTIVE COMPANIES

Luxembourg plans to introduce a minimum flat income tax of EUR 1500 on entities more than 90% of whose balance-sheet value consists of financial assets, transferable securities, and cash at bank and in hand. To fall under this régime, entities would also not be those requiring a business licence or the approval of a supervisory authority. Entities most likely to be affected are the SOPARFI (*société de participations financières* – financial holding company) and other entities holding investments but not carrying on a trade or business as such.

### INCREASES IN CORPORATE AND PERSONAL TAXES

Luxembourg charges a 21% corporate income tax, but an additional 4% of the corporate tax liability is payable as a contribution to the unemployment fund, making the effective rate of corporate tax 21.84%. It is intended to increase the unemployment contribution to 5%, making the overall effective rate 22.05%. Local income taxes may also apply.

However, on the other hand, the tax credit for additional investment in certain tangible fixed assets is set to increase by one percentage point to 13%.

On the personal tax side, the top rate of income tax is to rise by one percentage point to 39%, payable on the slice of income above EUR 41 793 (or EUR 83 586 for married couples filing jointly). A crisis surcharge of 0.8% is also planned on total taxable income, except for remuneration not exceeding the minimum wage. The unemployment fund surcharge payable by individuals is also to increase from 2.5% to 4% for income below EUR 150 000 (EUR 300 000 for married couples filing jointly) and to 6% for income in excess of those limits.

All these measures are included in the 2011 Budget Bill, still undergoing debate in Parliament, and are scheduled to take effect from 2011.

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# THE NETHERLANDS

## NETHERLANDS CORPORATE EXIT TAX REFERRED TO EUROPEAN COURT

See under European Union – 'European Court may finally rule on corporate exit tax'.



# POLAND

## VAT RATES SET TO INCREASE

Poland will be raising its VAT rates from 1 January 2011. The standard rate will increase from 22% to 23%; the reduced rate from 7% to 8%; and the super-reduced rate from 3% to 5%.

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# UNITED KINGDOM

## PENSION RELIEF CUT ANNOUNCED

The Government has announced its proposals to scale back tax relief on pension contributions to an annual limit of GBP 50 000. Contributions of up to this amount would continue to qualify for tax relief in full (i.e. at the individual's marginal rate of tax, up to 50% therefore).

The previous Government had already introduced complex provisions limiting the rate at which relief could be obtained to 20% (the basic rate of income tax) for individuals with income of over GBP 130 000, due to take effect from 6 April 2011. These rules were accompanied by equally complex rules to prevent forestalling by accelerating pension contributions to an earlier date. Subject to those provisions, relief is available for annual contributions of a maximum of GBP 255 000 within a lifetime limit of GBP 1.8 million.

Under the new proposals, the GBP 255 000 limit will be reduced to GBP 50 000, with effect from 6 April 2011 and the lifetime limit to GBP 1.5 million, with effect from 6 April 2012.

## THIRD FINANCE BILL LARGELY TECHNICAL

The United Kingdom's third Finance Bill this year, and the second under the Coalition government that took office in May, is largely technical in content, and contains politically non-controversial measures left over from the previous Parliament.

Among the more notable measures is the addition of corporation tax and petroleum revenue tax into the new harmonised regime for charging interest on late paid taxes and duties and for paying interest on overpaid taxes and duties contained in FA 2009 Sch 54. In a similar vein, a large number of indirect taxes (including VAT, excise duties and insurance premium tax) are brought into the harmonised régime of penalties for late filing of returns etc contained in FA 2009 Sch 55.

Neither régime yet has effect.

## TIME BAR ON EU TAX CLAIMS CHALLENGED

The European Commission has formally invited the United Kingdom to amend the time limitation imposed on claims for repayment of tax wrongly paid under EU law by FA 2007 s 107.

At the time, a claim for repayment of tax had to be made within six (now four) years of the date on which the tax was paid. However, where the claim could be treated as made under the common-law remedy of restitution for a payment made under a mistake of law, the six-year period ran from when the mistake was discovered (or could have been discovered). This meant that taxpayers could potentially make valid claims for tax overpaid many years previously (e.g. following a judgment of the European Court that a particular provision of UK tax law was incompatible with the treaties). In order to protect its revenue, the UK government first enacted FA 2004 s 320 and later, FA 2007 s 107, which overrides the more generous time limit in relation to claims that arose before 8 September 2003.

It is the Commission's view that FA 2007 s 107 makes it almost impossible for taxpayers to exercise the rights conferred on them by European law since it does not provide for any transition period (except in very limited circumstances).

In the absence of a satisfactory response within two months, the Commission may bring a case against the United Kingdom on this issue to the European Court.

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## VAT DUE ON SALARY-SACRIFICE VOUCHERS

The European Court has held that output tax is due on retail vouchers provided to employees in return for a salary sacrifice.

In *Astra Zeneca UK Ltd v Commissioners for Her Majesty's Revenue and Customs* (Case C 40/09), the company had offered employees retail vouchers exchangeable for retail goods at certain outlets in exchange for a reduction in salary. Participating employees received vouchers with a nominal value of GBP 10 in return for a reduction in their cash salary of between GBP 9.25 and GBP 9.55.

Astra Zeneca claimed input VAT on the purchase of the vouchers but maintained it did not have to charge output VAT on their supply since they were not provided for a consideration. The case was referred to the

European Court by the VAT and Duties Tribunal (then the tribunal of first instance for VAT cases) on the question of whether the supply of the vouchers was a supply of services for consideration.

On the basis that every supply that is not a supply of goods is a supply of services, and the vouchers did not immediately transfer the right to dispose of property (that being the criterion for a supply of goods), the issue of the vouchers was a supply of services and consideration for that supply was the amount of salary sacrificed.

Although the case specifically involved retail vouchers, it potentially affects all goods and services that are normally subject to VAT and are provided to staff under a salary-sacrifice scheme. In addition, there may be further VAT

implications if an employer provides 'VAT-exempt' services, such as childcare vouchers, through salary-sacrifice arrangements.

As this is a decision of the European Court, it could have an impact on all businesses across the European Union looking at tax-efficient ways of rewarding their staff. In summary, additional care needs to be taken by employers when setting up such schemes to ensure that they do not now incur an unexpected VAT cost.

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# BRAZIL

## FINANCIAL TRANSACTIONS TAX INCREASED

On 4 October, the Brazilian government issued a decree (Decree No 7323), increasing the tax on financial transactions from 2% to 4% on foreign investment in Brazilian fixed-interest securities. The increase is effective from 5 October, and is calculated on the amount of foreign currency converted into Brazilian *reais* for investment in the bonds.

Two days later, on 6 October, the decree was republished with clarifications and amendments. The new version of the decree makes it clear that the tax is payable on the settlement of exchange operations, and that the tax rate remains 2% on the following types of transaction:

- investment in variable-income instruments quoted on Brazilian stock exchanges and
- the acquisition of or subscription to public offerings registered with the CVM (the Securities and Exchange Commission of Brazil)

However, in order to avoid the influx of speculative foreign capital, the Brazilian government announced on 18 October an increase to 6% of the financial transactions tax on foreign capital invested in fixed-income instruments. The increased rate is also applicable to foreign-exchange market transactions.

Repatriation of the initial investment remains exempt from the tax.

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# ECUADOR

## WITHHOLDING TAX ON DIVIDENDS

As from 1 January 2010, dividends paid to individuals in Ecuador are subject to withholding tax at the following rates:

– First USD 100 000	1%
– Next USD 100 000	5%
– Balance above USD 200 000	10%

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# NETHERLANDS ANTILLES

EFFECTS OF THE DISSOLUTION OF THE CONSTITUTIONAL UNITY OF THE NETHERLANDS ANTILLES



**T**he Netherlands Antilles will be dissolved as a constitutional unity on 10 October 2010. The five islands will still, however, remain a part of the Kingdom of the Netherlands.

Until 10 October, the Kingdom of the Netherlands consists of the Netherlands themselves, the Netherlands Antilles and Aruba. The Netherlands Antilles is formed by five islands: Curaçao, St Maarten, Bonaire, Saba and St Eustatius.

The effects of the dissolution of the constitutional unity will be different per island. Curaçao and St Maarten will both have an autonomous status while Bonaire, St Eustatius and Saba will become part of the Netherlands

## **Curaçao and St Maarten**

The two larger islands in the Netherlands Antilles are Curaçao and St Maarten. These two islands will both have a more

independent position within the Kingdom of the Netherlands. In theory all the current legislation will remain relevant for these two islands after the dissolution. From a fiscal point of view there will be no changes to the legal entities, the current beneficial tax framework, any grandfathered structure, or to the expanding tax treaty network.

## **Bonaire, St Eustatius and Saba (BES Islands)**

These three smaller islands are also known as the BES Islands. They will become overseas public territories of the Netherlands. New tax legislation has been proposed, which will offer new opportunities for local activities. For example, the proposal contains the abolition of the profit tax legislation for companies that will be considered as resident on one of the BES Islands. To be resident on one of the BES Islands, certain conditions will have to be met. If this is not the case, the company will be

considered to be resident in the Netherlands proper. Consequently, Netherlands tax legislation will be applicable.

The new BES tax legislation that has been prepared in relation to the restructuring of the Kingdom of the Netherlands is yet to pass through all its stages in the Netherlands Parliament. It was passed by the Lower House on 7 October and is currently before the Upper House.

However, it is expected that the legislation will enter into force as at 1 January 2011.

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# UNITED STATES OF AMERICA

## UNCERTAIN TAX POSITION REPORTING REQUIREMENTS RELAXED

On 24 September 2010, the Internal Revenue Service (IRS) issued two Announcements providing welcome guidance concerning the recently proposed requirement for certain businesses with assets over USD 10 million to report their uncertain tax positions beginning in 2010. Announcement 2010-75, which was issued in response to public comments, eases much of the reporting required on a newly-drafted Schedule UTP and defers the requirement to begin filing Schedule UTP until 2012 or 2014 for certain taxpayers, depending on their total assets. Announcement 2010-76 provides modifications to the IRS's existing policy of restraint in requesting certain documents and working papers documenting the filing of Schedule UTP.

Following public announcements earlier this year proposing the reporting of uncertain tax positions, Announcements 2010-9 and 2010-17 detailed the IRS's proposed reporting regime. In Announcement 2010-9, the IRS noted that a new schedule would be required for taxpayers to disclose their uncertain tax positions annually, along with a concise description of those positions, and to specify for each position the amount of US federal income tax that would be due if the position were disallowed in its entirety on audit. Announcement 2010-17 provided that the IRS would require the filing of the new schedule for the 2010 taxable year.

The IRS indicated that it would continue its policy of restraint in requesting taxpayers' tax accrual working papers, but would consider future modifications as necessary.

Amid strong public comments concerning the new reporting régime, the IRS has made a number of significant changes to the April 2010 draft Schedule UTP and disclosure requirements. The significant changes include:

- Delayed reporting for certain corporations with audited financial statements, based on their total assets:
  - Corporations with at least USD 100 million in assets will be required to file Schedule UTP beginning with 2010 taxable years
  - Corporations with at least USD 50 million in assets will be required to file Schedule UTP beginning with 2012 taxable years
  - Corporations with at least USD 10 million in assets will be required to file Schedule UTP beginning with 2014 taxable years
- The maximum tax adjustment need not be reported, but the positions are required to be assigned a rank based on the amount of the reserve recorded for the position
- The rationale and nature of the uncertainty need not be reported
- Positions for which a reserve has not been recorded because it is considered an administrative practice need not be reported.

The final instructions to Schedule UTP make clear that corporations are not required to report tax positions that are either immaterial (under applicable financial accounting standards) or are sufficiently certain such that no reserve would be required.

Several additional issues were also clarified in the final instructions, including:

- Clarifying that Schedule UTP requires reporting of US federal income tax positions
  - not foreign or state positions. A corporation is, however, required to report a US federal income tax position taken in a return that arises out of uncertainty with regard to a foreign tax position if a reserve for US federal income tax was recorded to reflect that uncertainty
- Making clear that a tax position is reported on Schedule UTP only once, when (a) a reserve for the position is recorded and (b) the tax position is taken on a return (regardless of the order in which the two events occur)
- Clarifying that corporations report their own tax positions on Schedule UTP and not the tax positions of related parties
- Indicating that positions taken in years prior to 2010 need not be reported in any year, even if a reserve is recorded in audited financial statements issued in 2010 or a later year
- Addressing reporting of recurring tax positions taken in multiple years
- Making certain that Schedule UTP need not be filed for short periods ending in 2010.

To the extent the comments urged the proposal to be withdrawn altogether because of possible inconsistencies with the attorney-client and federally-authorised tax practitioner privileges and work-product doctrine, the IRS noted that the new Schedule UTP would not include information related to the corporation's assessment of the hazards of a tax position or analysis in support of or against the position. The potential application of the privileges and work-product doctrine did not, themselves, warrant departing from the reporting régime altogether.

Having received comments expressly requesting that penalties not be imposed either permanently or during a period of transition for failures associated with Schedule UTP, the IRS noted that it intends to review compliance and take appropriate enforcement action, including the possibility of opening an examination or other types of taxpayer contact.

The IRS had previously announced that it was considering ways to avoid duplicate reporting.

The final Schedule UTP instructions provide that a complete and accurate disclosure of a tax position on the appropriate year's Schedule UTP will be treated as if the corporation filed a Form 8275 or Form 8275-R regarding the tax position.

Accordingly, a separate Form 8275 or Form 8275-R need not be filed in order to avoid certain accuracy-related penalties with respect to that position. In contrast, reportable transactions must still be disclosed on Form 8886 even if they are also required to be disclosed on Schedule UTP.

The IRS has expanded its policy of restraint with its decision to require disclosure on Schedule UTP. In doing so, the IRS will refrain from requesting certain documents that relate to uncertain tax positions and the working papers that document the completion of Schedule UTP.

The IRS's new guidance concerning the filing of Schedule UTP is certain to be welcomed by taxpayers and practitioners. For those taxpayers with assets of less than USD 100 million, the time for filing Schedule UTP for the first time has been deferred to either 2012 or 2014, depending on the amount of their assets. It is clear that the IRS continues to consider less burdensome ways for taxpayers to make the kinds of disclosures sought by the reporting of uncertain tax positions. The IRS has also indicated that it will consider whether to extend all or a portion of Schedule UTP reporting to other taxpayers for 2011 or later taxable years, such as pass-through entities and tax-exempt entities.



### SMALL BUSINESS JOBS ACT

On 27 September 2010, President Obama signed the Small Business Jobs Act of 2010. The Act provides several tax incentives for business investment or access to capital, and makes other modifications primarily affecting small businesses. The tax incentives are temporary, primarily affecting 2010 and 2011 taxable years. Several revenue offsets have also been enacted. A summary of the principal provisions of the Act follows.

#### Bonus depreciation allowance

A bonus depreciation allowance had previously applied to certain property placed in service in 2008 and 2009. In order to qualify for bonus depreciation, the property must be (a) property to which the modified accelerated cost recovery system applies, with a recovery period of 20 years or less, (b) water-utility property, (c) most computer software, or (d) qualified leasehold improvement property. Certain other qualifications and limitations apply to this special allowance. The first-year allowance is 50% of the basis of qualifying property, with the remaining 50% being depreciated under generally applicable rules. Taxpayers may elect not to claim bonus depreciation on a class-by-class basis. The Act extends the allowance to property placed in service in 2010 (or 2011 for certain longer-lived and transportation property).

Congress did not extend one provision that had been closely associated with the bonus depreciation provision. Under this provision, a corporation with certain old alternative minimum tax (AMT) or research and development credits could elect to forgo bonus depreciation and convert a portion of these old credits to refundable credits. This provision expired for property placed in service after 31 December 2009.

#### Additional first-year expensing

Business taxpayers may elect to deduct the cost of certain fixed assets placed in service during the taxable year under the section 179 'expensing' provisions. For 2010, the allowance is limited to USD 250 000, but the limitation is phased out to the extent that the cost of qualifying property placed in service during the year exceeds USD 800 000. Most depreciable tangible personal property acquired for use in a trade or business is qualifying property for purposes of section 179 and, for taxable years beginning before 2011, off-the-shelf computer software is also qualifying property. The Act doubles the section 179 limitation for taxable years beginning in 2010 and 2011, and more than doubles the phase-out threshold. Thus, for these years, the section 179 election may apply to the first USD 500 000 of qualifying property placed in service in each year, but the limitation is phased out to the extent that the cost of qualifying property placed in service during the year exceeds USD 2 million. In addition, for the first time and for the same two taxable years, a taxpayer may elect to deduct the first USD 250 000 of the cost of certain real property, i.e. qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. The dollar limitations for real property acquisitions are not separate from the dollar limitations for all section 179 property. Thus, the deduction for tangible personal property will be limited to the excess of USD 500 000 (or the taxpayer's phased-down limitation) over the amount of real property that is deducted for the taxable year.

Congress had previously shortened the recovery period for these three types of real property — qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property — to 15 years. However, these provisions applied only to property placed in service before 1 January 2010. Thus, if the first-year expensing is not elected or does not apply to property placed in service after 2009, regular depreciation rules for real property will apply.

#### Exclusion of gain on certain small-business stock

Tax legislation enacted in 1993 permitted an individual to exclude 50% (in most cases) of any gain from the sale of certain small-business stock acquired at original issue and held for at least five years. The maximum amount of gain eligible for exclusion is the greater of 10 times the taxpayer's acquisition cost in the stock and USD 10 million. However, because of the combined effect of the special tax rates applicable to such gains and the application of the AMT to the excluded portion of the gain, the overall effective tax rate is not significantly lower than the maximum rate of tax generally applicable to the long-term capital gains of individuals.



The Act provides an effective tax exemption for gains from the sale of stock issued after the date of enactment and before 1 January 2011 (subject to the quantitative limitations described in the preceding paragraph). The effective exemption is achieved through the allowance of a 100% exclusion of the gain and the elimination of the AMT preference for the excluded gain. As a result, neither the regular tax nor the AMT will apply to such gains.

### **General business credits of eligible small businesses**

The Internal Revenue Code (IRC) provides for a variety of 'general business credits', which allow taxpayers a dollar-for-dollar reduction in their tax liability, subject to applicable limitations. With certain exceptions, such credits may not reduce a taxpayer's tax liability below the 'tentative minimum tax' of the taxpayer, a key determinant of the taxpayer's liability (if any) for the AMT. To the extent that the credits available to a taxpayer for a taxable year exceed the applicable limitation, the excess credits may be carried back one taxable year and carried forward 20 taxable years.

The Act provides two relief provisions for eligible small businesses, which are defined as taxpayers with average annual gross receipts not exceeding USD 50 million for the three immediately preceding taxable years. Certain special rules are provided for businesses conducted by S-corporations and partnerships, for sole proprietorships, and for aggregating the gross receipts of certain related taxpayers.

Under the first relief provision, in the case of the eligible small business taxpayer's first taxable year beginning after 31 December 2009, the general business credits may be carried back for five taxable years. Under the second relief provision, for the same taxpayers and for the same single taxable year, the general business credits are effectively permitted to offset both regular tax and AMT liability.



## Revenue provisions

The Act also contains a number of revenue-raising provisions in order to make it revenue-neutral over the relevant five and 10-year budget windows. However, unlike the tax-relief provisions, which are mostly temporary, the revenue-raising provisions are mostly permanent. The revenue-raising provisions include the following, and are generally effective beginning in 2011, unless noted:

- Extension of the Form 1099 information-reporting requirements to payments made by recipients of rental income to a service provider
- Increase in penalties for the failure to timely furnish correct information returns (payee statements)
- Permission to partially annuitise a non-qualified annuity contract
- Increase in the amount of estimated taxes otherwise required to be paid by certain large corporations in July, August, or September 2015.

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## CURRENCY COMPARISON TABLE

The table below shows comparative exchange rates against the euro and the US dollar for the currencies mentioned in this issue, as at 14 October 2010.

Currency unit	Value in euros (EUR)	Value in US dollars (USD)
Euro (EUR)	1.0000	1.4070
Hungarian forint (HUF)	0.0036	0.0051
Israeli [new] shekel (ILS)	0.1984	0.2791
Latvian lats (LVL)	1.4103	1.9847
Pound sterling (GBP)	1.1924	1.5369
US dollar (USD)	0.7107	1.0000

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