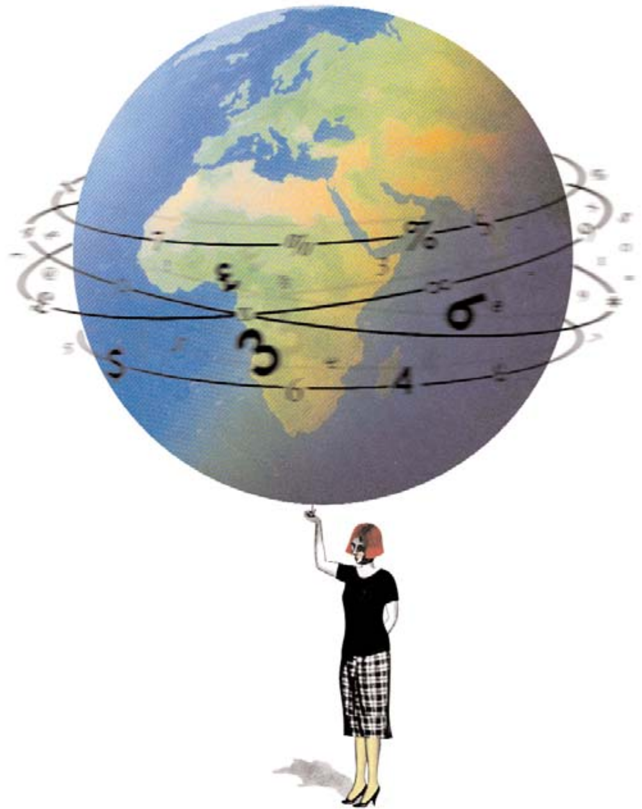
December 2006

BDO

BDO International

Expatriate News

The beginning of December saw the BDO International Expatriate Services Conference in London. Members of the International Expatriate Services team met to discuss the numerous changes which have taken place over recent months.They focussed on developing appropriate solutions to the challenges faced in general by employers of expatriates and by BDO's own Expatriate Services clients. Our next Expatriate Newsletter will report on the key outcomes of the Conference.



AUSTRALIA:

Proposals to simplify the system for taxing retirement savings were announced in the May 2006 Budget. Following public consultation, the Government has confirmed the following changes:

- Most payments (lump sums and pensions) from complying superannuation schemes to individuals aged at least 60 will be tax-free.
- The age-based employer deduction limits will be abolished, so that employers will be entitled to a full corporation tax deduction for their superannuation contributions. However, the onus not to transfer the new universal limit on deductible contributions will be transferred to the employee.
- The removal of the reasonable benefit limit (RBL) for end benefits. Instead, there are contributions limits from 1 July 2007 onwards and there are also certain restrictions from 9 May 2006. This applies both to tax-deductible contributions and after-tax (undeducted) contributions.

Deductible contributions

A limit of 50,000 Australian dollars (AUD) will generally apply to tax-deductible contributions and a maximum 15 per cent tax rate will apply to the contributions within this limit. The limit is increased to AUD 100,000 where the individual is aged at least 50 between 1 July 2007 and 30 June 2012. These deduction limits will be indexed annually, in increments of AUD 5,000.

Any contributions above the limits will be taxable at the highest individual marginal income tax rate plus Medicare Levy (a current maximum total rate of 46.5 per cent) instead of the 15 per cent applicable to contributions within the limit. The individual can meet his liability on the excess contributions out of the superannuation fund, but the tax treatment of the money released from the fund to pay the liability is not yet known.

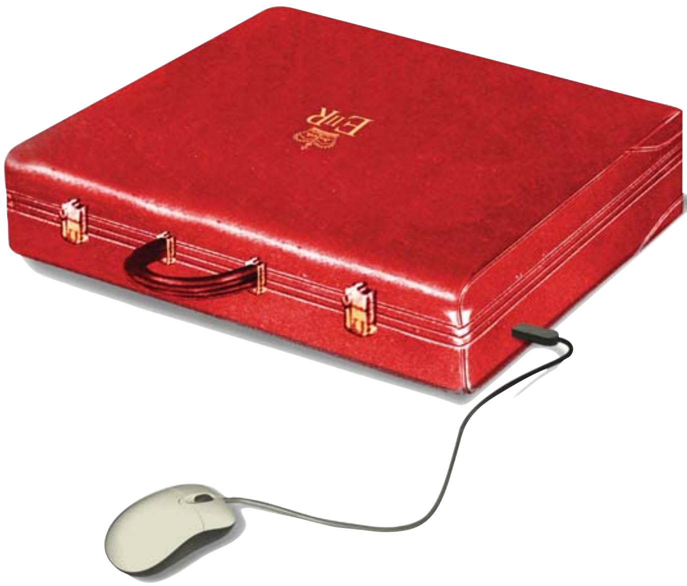
Undeducted contributions

Contributions from after-tax income (undeducted contributions) are also limited by a cap, which will be three times the deductible contribution cap (giving an undeducted contributions cap of AUD 150,000). Any contributions in excess of the deductible contribution cap will be counted towards the undeducted contributions cap.

Undeducted contributions made during the period 10 May 2006 to 30 June 2007 are limited to AUD 1m. The limit from 1 July 2007 will normally be AUD 150,000 per year or AUD 450,000 over three years. This averaging allowance only looks into the future, thus an allowance not used in one year is then lost. Therefore, an undeducted contribution of up to AUD

450,000 could be paid in year one with no further undeducted contributions in the next two years. However, individuals aged 65 or over will be limited to annual contributions of AUD 150,000 with no averaging allowance.

The Budget announcements were silent on whether amounts rolled over from an overseas pension plan would count towards the undeducted contribution cap. In the past there has been no limit on such amounts. As at the date of this newsletter, it is not entirely clear which of these amounts will be exempted from the contributions limits.



Currently, an individual who transfers their interest in a foreign pension plan to an Australian complying superannuation fund can elect to treat the taxable component of the rollover (normally the fund growth since the individual's arrival in Australia) as a taxable superannuation contribution which will be taxed within the Australian superannuation fund.

The growth on the transferred interest from the time the individual becomes a tax resident of Australia to the relevant transfer day is treated as a deductible contribution and is taxed at 15 per cent, whilst the remainder is classified as an undeducted contribution.

This election continues to be available under the new rules and the taxable component will not be counted for the purposes of the deductible contributions cap.

The remaining, non-taxable component of the foreign transfer (normally the capital value of the fund when the individual arrived in Australia) will be subject to the un-deducted contributions limit of AUD 1m until 30 June 2007 and AUD 150,000 thereafter. The excess will be taxed at the individual's marginal rate. This means that at least part of many large transfers from foreign pension funds will be taxed at 46.5 per cent.

Where the election for taxable superannuation contributions treatment is not made, the taxable rollover component will be taxed on the individual at their marginal rate.

The changes mean that individuals transferring foreign pension funds to Australia must normally decide between two alternatives:

(1) Taxed at their marginal tax rate (plus Medicare Levy of 1.5 per cent) on the growth in their foreign pension fund, with no tax on the balance.

(2) Taxed within the superannuation fund rules on the growth (at a maximum of 15 per cent), with the excess over the undeducted component (normally AUD 150,000, or AUD 450,000 under the three-year averaging rule) being taxed at their marginal rate. Individuals may wish to accelerate a transfer to utilise the higher undeducted contributions cap of AUD 1,000,000 which applies up to 30 June 2007.

The individual's decision may be further complicated by the foreign implications of the transfer. As an example, UK Revenue (HMRC) approval must be obtained for overseas transfers of UK approved pension funds in order to avoid UK tax charges. In addition, UK tax charges may apply when the recipient pension fund releases funds to the individual or to an unapproved fund in circumstances not permitted under the UK rules. This could arise, for example, where an Australian superannuation fund releases money to cover Australian taxes at a time when the individual has not reached the normal minimum UK pension age (currently age 50, rising to age 55 on 6 April 2010).

Where an individual who enters Australia on an eligible temporary resident visa leaves the country permanently, any superannuation benefits they have accumulated in an Australian superannuation fund before reaching retirement age and retiring can be withdrawn. The payment is known as the 'Departing Australian Superannuation Payment'.

The early withdrawal is subject to withholding tax of 0 per cent on the 'exempt component' and 30 per cent of the taxable component. The exempt component is generally the part of the accumulated benefits which relates to undeducted contributions.

Therefore, individuals who have not reached pension age and retired and who are leaving Australia need to consider the actions they should take regarding their Australian pension fund. Early withdrawal from a fund may result in a punitive tax charge, whereas a pension in payment to an individuals age 60 or over is tax-free. The tax treatment of pensions and early fund withdrawals in the individual's new country of residence and the provisions of any double tax treaty with Australia must also be taken into account.

DENMARK:

Legal versus economic employer

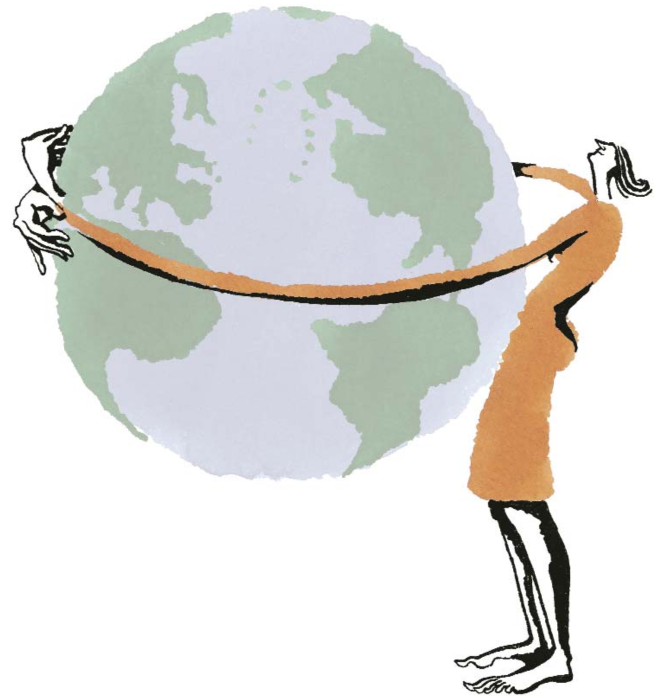
This issue arises constantly for expatriate employees, where an employee has a legal employer in one country (the company holding the employment contract), but works in another country in which there is an economic employer (which bears the salary or other employment costs). The specific issue is that, in addition to certain conditions regarding the periods spent by the employee in the host country, the tax exemption which is provided in most tax treaties requires the employer to be resident outside that host country. The fact that the individual is deemed to have an economic employer in the host country can result in the exemption being lost.

The Organisation for Economic Co-operation and Development (OECD) model tax treaty (on which most modern tax treaties are based) deals with taxing rights over employment income in Article 15 and allocates the right to tax earnings between the individual's country of residence (for treaty purposes) and the country in which the employee performs his duties. Most countries follow the OECD commentary by accepting the economic employer as a basis for taxation, but the way that this is applied varies from county to country.

A recent Supreme Court case in Denmark has ruled (ruling SKM2006.547) on the economic employer question for a Danish individual who was living in the UK. His salary derived from the UK group company, but he performed his work for the benefit of the Danish group com-pany (and the salary costs were fully reimbursed by the Danish company).

Although the employee and the UK company claimed that the employ-ment relationship was between the employee and the UK company, this could not be substantiated by an employment contract.

Consequently, the Supreme Court ruled that on this basis the UK com-pany could not be considered to be the true employer of the employee. Therefore, the employee was considered to be taxable in Denmark under the Danish domestic tax rules and it was correct that, ac-cording to Article 15 of the Denmark/UK tax treaty, Denmark could levy tax on the salary which was reimbursed by the Danish company for the work which the individual performed in Denmark.



Earnings for Danish functions

A recent ruling from the Supreme Court decided that earnings for work carried out by a pilot when on the ground in other countries are taxable in Denmark if the work is directly connected to the task of flying a Danish registered airplane.

As anticipated, this ruling has influenced another situation in which earnings potentially cover both work performed in and out-side Denmark. The first ruling by the Income Tax Commissioners (ruling number SKM2006.576) on this point has now been published.

The ruling concerned an Italian professor (a conductor) who lived in Italy, but was employed in Denmark at a public education centre. The professor argued that as he only spent 30 per cent of his working time in Denmark giving lessons and the remaining 70 per cent of his time was spent in Italy as preparation time, only 30 per cent of his earnings was taxable in Denmark.

The Income Tax Commissioners found that, since the salary for his job as a professor was paid for giving tuition in Denmark (and not for the preparation time in Italy), all the salary was taxable in Denmark. However, any part of his earnings which actually related to work performed outside Denmark and which did not relate to the tuition in Denmark cannot be taxed in Denmark.

This decision demonstrates the way that the Danish authorities have started to take the employee's functions into account in determining liability to tax, rather than simply looking at the time devoted to the duties inside and outside Denmark.

EUROPEAN COURT:

Belgium:

The European Court of Justice (ECJ) has found the Belgian legislation regarding foreign pension funds to be incompatible with the EC Treaty and the EEA Agreement.

On 3 October 2006 the Advocate General delivered her opinion in the case of Commission of the European Communities v Kingdom of Belgium (case C-522/04). The European Commission had referred Belgium to the ECJ with regard to an infringement procedure under Article 226(2) of the EC Treaty in respect of Belgium's rules which discriminate against foreign pension funds.

The following provisions in the Belgian tax law were subject to the infringement procedure:

- Contributions to domestic pension funds are deductible for tax purposes, but contributions to foreign pension funds are not.
- Personal supplementary pension and life insurance contributions which are paid by the employer to foreign insurance undertakings and foreign welfare funds are not tax-deductible, whilst contributions to domestic undertakings and welfare funds are allowed.
- Pensions paid to emigrating individuals remain taxable in Belgium, even where Belgium has ceded its taxation rights to another state under a double tax treaty.
- The transfer of the capital in a Belgian pension fund to a foreign pension fund results in a special Belgian tax charge, but where such a transfer is made to a Belgian pension fund or institution this does not constitute a taxable transaction.
- Foreign pension funds must appoint a tax representative in Belgium before offering their services in Belgium.

The Advocate General concluded that this Belgian legislation was incompatible with Articles 18, 39, 43 and 49 of the EC Treaty and Articles 28, 31 and 36 of the European Economic Area (EEA) Agreement, as well as Articles 4 and 11(2) of Directive 92/96/EEC (the Third Life Assurance Directive). The effect of this ruling will be reported in due course.

Germany:

The ECJ has held that the German rules for withholding tax from payments to non-resident service providers are generally not in breach of the European freedom to provide services.

The case of FKP Scorpio Konzertproduktionen GmbH v Finanzamt Hamburg-Eimsbüttel (case C-290/04) was heard on 3 October 2006, following a request from the German Federal Finance Court (Bundesfinanzhof) for a preliminary ruling by the Advocate General on 28 April 2004 (see BDO Expatriate News July 2006).

The ECJ agreed with the Advocate General's opinion and held that the freedom to provide services does not preclude national legislation which:

- provides an obligation on a service recipient to withhold tax at source on payments to non-resident service providers, where no such obligation is imposed in a purely domestic situation;
- only allows the deduction of directly linked business expenses in the withholding procedure and provides that any indirectly linked business expenses can only be deducted in a later refund procedure;
- only allows the tax exemption provided under the Netherlands/Germany double tax treaty if a certificate is provided, which has been issued by the competent tax authority in the other treaty country to indicate that the conditions for the exemption are satisfied.

However, the ECJ also held that the freedom to provide services does preclude national legislation which provides for a withholding tax on the gross amount paid by the service recipient (not allowing the deduction of directly linked business expenses reported by the non-resident service provider), whereas in a purely domestic situation the service provider is taxed on the net income after the deduction of such expenses.

EUROPEAN UNION: BULGARIA AND ROMANIA:

Bulgaria and Romania EU membership

On 17 October 2006 the Ministers of Foreign Affairs of the EU Member States formally approved the accession of Bulgaria and Romania to the European Union on 1 January 2007.

It should be noted that the date from which the EC social security regulations (Regulation 1408/71, to be replaced by Regulation 883/2004 in due course) will apply to nationals of Bulgaria and Romania will vary from country to country. Further details will be announced in a future Newsletter.

FRANCE:

Withholding tax on pensions

Guidance has been published by the French tax administration (Guideline 14 B-2-06 of 6 October 2006) on the application of withholding tax on pensions under the terms of tax treaties. Tax withholding applies to pension payments under Article 182 A of the French Tax Code (Code Général des Impôts or CGI).

Article 182 A of the CGI provides that pension payments to non-resident individuals are subject to a withholding tax if they are paid by a debtor established in France. The withholding tax only applies where either there is no tax treaty between France and the state in which the pension recipient is resident, or where the tax treaty between France and that state does not prevent France from taxing the pension payment at source.

The new Guideline indicates that, for all the tax treaties concluded by France which are in force from 1 January 2006 onwards, the withholding tax under Article 182 A of the CGI applies to:

(1) Pensions paid to non-resident individuals which are derived from a social security regime that is mandatory by law.

These pensions usually fall under Article 18 of the OECD Model Tax Treaty and Annex I to the Guideline indicates whether or not the withholding tax applies, depending on the treaty residence status of the pension recipient. Pensions derived from a social security regime are defined in Annex III to the Guideline as including social security pensions, mandatory complementary pensions, the social security regime for French expatriates, and supplementary retirement regimes concluded within the framework of a company or a branch.

(2) Pensions paid to non-resident individuals which are derived from rights acquired within the framework of government service for payment to non-resident individuals.

Annex II to the Guideline indicates whether or not pensions which are derived from government service rights (which generally fall within Article 19 of the OECD Model treaty) are subject to French withholding tax, based on the recipient's treaty residence position. In this respect, only a few tax treaties prevent France from applying the withholding tax at source and most of these treaties are with former French colonies.

FRANCE/GERMANY TAX TREATY:

France/Germany frontier workers

An agreement has been published on the application of the 183-day rule to frontier workers who are covered by the France/Germany tax treaty.

Guideline BOI 14 A-4-06 of 10 October 2006 abolishes and replaces the provisions in Guideline 14 B-1-82 of 22 January 1982. It contains an exchange of letters signed on 16 February 2006 between the French and German tax administrations, following . their agreement to clarify both the application of the 183-day rule in Article 13(4) of the treaty and the provisions which apply to frontier workers under Article 13(5).

Article 13(4) of the France/Germany treaty provides that income derived from an employment activity is taxable in the state in which the individual is resident if (amongst other conditions) he or she is present in the other state for a period or periods not exceeding in aggregate 183 days in the fiscal year concerned. The new Guideline confirms that in computing the 183 days, Sundays, bank holidays, holidays, sick days and brief periods linked to journeys to the residence state or in third states are included, to the extent that such days coincide with the period coved by an existing employment contract and may not be considered as ending the individual's temporary stay in the other state.

Article 13(5) of the treaty applies specific provisions to frontier workers, according to which income derived from employment activities in the other state is taxable exclusively in the state in which the employee is resident for the purposes of the treaty. In order for this to apply, the frontier worker must normally return on a daily basis to the state of residence and exercise the employment in the defined frontier zone.

However, if the frontier worker does not return to the state of residence every day, or exercises the activities in a workplace located outside the frontier zone, he or she may still be able to benefit from the special treatment for frontier workers. The situation differs, depending on whether or not the employee exercises the employment activities in the frontier zone for the entire civil year, as follows:

(1) If the employee exercises the activities in the frontier zone for the entire civil year, the number of days on which he or she does not return to the state of residence or on which he or she works outside the frontier zone cannot exceed 45 days.

(2) In any other situation, the number of days on which the employee does not return to the state of residence or on which he or she exercises the employment activities outside the frontier zone cannot exceed the lesser of 20 per cent of the period of the overall employment contract and 45 days.

LATVIA:

New personal income tax regulation

A new Regulation on the application of the rules in the Personal Income Tax Act has been adopted by the government and repeals most of the rules in the previous Regulation of 18 October 2000.

The new Regulation applies from 1 September 2006 and includes the following important clarifications.

Gains on disposal of immovable property

If a non-resident contributes immovable property which is situated in Latvia to the share capital of a company, the respective value of the company shares which are received is deemed to be the disposal value of the immovable property. The tax on this gain is only payable when the non-resident disposes of the shares.

The same rule applies to Latvian residents if the shares are disposed of within 12 months of the acquisition of the immovable property (where the shares are disposed of later than 12 months from the property acquisition date, the gain is exempt for a Latvian resident).

It has also been clarified that the costs of the renovation and improvement of immovable property can be taken into account in the calculation of the taxable gain arising from its disposal.

Advance payments of tax for individuals carrying out business activities.

The new Regulation sets out detailed rules for the calculation of the monthly advance tax payments by those individuals who are either obliged to pay them (where annual turnover exceeds 45,000 Latvian Lats) or who have chosen to compute their total business income according to the rules of the Corporate Income Tax Act.

Double tax relief procedures for employment income

As regards tax on income from an employment which is exercised abroad, under the new regulation a resident employer does not have to withhold tax from the salary of an employee working abroad, provided:

(1) the employment is exercised in a state with which Latvia has a tax treaty and;

(2) tax is paid on this income in that state and;

(3) the tax is certified by the competent authorities of that state.

This procedure ensures that employment income does not suffer effective double taxation. The employee must declare his income in Latvia under general rules and pay any tax which is due in Latvia, after applying the double tax provisions in the relevant tax treaty.

ITALY:

Tax and social security treatment of company cars

The Decreto Legge of 3 October 2006 which made significant changes to the tax treatment of stock options (see Expatriate News October 2006) has also made changes to the treatment of company cars.

Under previous legislation, it was possible to reduce the amount of tax and social security payable on a company car if the car was either owned or leased by the company for the employee's use and the employee used the car for both business and personal use.

Where these criteria were met, the amount of income that was included in the employee's employment income basis was determined as 30 per cent of the values published annually by the Italian Automobile Association for each make and model of automobile. As a result, a car that might cost €15,000 to lease would only result in employment income of about €3,000. The new legislation has changed the employment income basis by increasing the percentage from 30 to 50 per cent.

In addition, from a corporate point of view, previously the costs associated with the company car were fully deductible even if these amounts did not give rise to a personal income tax charge on the employee. The corporate tax deduction is now limited to the amount which is subject to personal income tax.

The Decreto Legge is currently in effect, but it must be converted into law within 60 days of issue or it will be cancelled.

USA:

The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) has effectively retrospectively increased the taxes of Americans who live abroad, by changing the application of the foreign earned income and housing cost exclusion provisions (broadly referred to as Section 911). The housing costs exclusion allows housing costs in excess of a base amount to be excluded in calculating the individual's taxable income.

The changes have the following distinct aspects:

- The new provisions enacted a ceiling on the amount of housing costs that can be excluded from the individual's taxable income. The maximum amount of housing costs that can be excluded is limited to 30 per cent of the foreign earned income exclusion amount, computed on a daily basis. Therefore, in a full calendar year, the maximum housing exclusion would be $24,720 ($82,400 x 0.3), with exceptions for certain locations.

  In high cost locations, the taxpayer is able to exclude a higher amount of housing costs. The adjustment of the 30 per cent limit on the basis of geographic differences in housing costs has been set out in detailed IRS guidance in IRS Notice 2006-87, which was issued on 6 October 2006.

- The base amount, over and above which housing expenses can be excluded has been revised to 16 per cent of the annual foreign earned income exclusion amount.

  The combined effect of the base amount and the new ceiling above is that normally a maximum housing exclusion of $11,536 applies for 2006 (30-16 per cent x $82,400).

- The tax rate structure for non-excluded income has been revised, so that the housing exclusion is disallowed in computing the tax on such income.

The table of high cost locations in Notice 2006-87 was derived from the Living Quarters Allowance table prepared by the Office of Allowances of the US Department of State, which will be updated each year by administrative pronouncement (for example, through a notice or amendment of Form 2555). As an example, a taxpayer living in Singapore throughout 2006 can exclude housing costs of $29,716 from his income (the higher $42,900 annual limit for Singapore in the table, less the base amount of 16 per cent x $82,400

Although the new higher housing expense amounts are welcome, for higher income taxpayers the exclusions are lower than the previous amount of relief, because the individual's non-excluded income is now taxed at much higher average rates.

It also appears that the IRS has adopted the highest allowances reflected by the Office of Allowances for employees who are in Group 2, with family. However, the family size contemplated by the U.S. Department of State for this information was a family of two, with suggested increments for additional family members. These family member increments are not included in the limits set by the IRS. Therefore, expatriates with children who have housing commensurate with their family size and those expatriate executives who have acquired housing in line with their normal standard of living, may find that the new housing expense limits are too low. Continuing the previous example, an expatriate living in Singapore with a family of four and a salary of $170,000 could spend an average of $68,000 annually on housing, but on the basis of the Notice the housing exclusion ceiling amount is $42,900.

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