

Expatriate News

August 2005



As we publish this edition of BDO Expatriate News, the Centre of Excellence Committee is working on an exciting agenda for our Annual Conference which takes place in Orlando from 21-22 October 2005. On Friday 21 October we will host a day of presentations and discussions for our expatriate employer clients and contacts which will cover topical issues and end with dinner. We would very much like you to join us at the Conference. Please use the contact details below if you would like more information.

Australia

Meaning of foreign income

The Australian tax office (ATO) has provided further clarification (TR 2005/2) on what is meant by foreign income for Australian tax purposes. This is particularly important for the purposes of foreign tax credits if the income has been subject to tax in a foreign jurisdiction and also for applying the foreign loss quarantining rule.

The word 'income' in the phrase 'foreign income' is interpreted widely to include income according to ordinary concepts (for example, an individual's salary) and also statutory income (for example, personal services income and assessable income from a balancing adjustment on a depreciated asset).

Foreign income does not include net capital gains, except for the purposes of applying the foreign tax credit provisions. This means that although foreign income does not include a capital gain, it does not preclude the taxpayer from claiming a foreign tax credit on that capital gain.

Relocation consultants: fringe benefits tax

Proposed amendments to the Australian Fringe Benefits Tax Assessment Act 1986 will extend the employee benefits which are exempt from the Fringe Benefits Tax (FBT) charge on the employer. By way of

background, Australia is unique in comparison with other tax jurisdictions in that it has an FBT regime which taxes employers on the non-cash benefits provided to employees in relation to their employment.

The amendment to the FBT legislation introduces a further exempt employee benefit primarily affecting expatriate employees (but also domestic employees) who are relocated. This new exempt benefit applies where the employer engages a relocation consultant to assist in the relocation of an employee.

Cross-border taxation of employee share schemes

Significant changes are to be made to the rules governing the taxation of employee shares and share options. The current law has no specific source rules or exemptions for expatriate employees, which means that employees who are Australian resident when they exercise their options or the restrictions over their shares are lifted are taxed in full on their gains, even though part of the gain may have accrued outside the period of residence. In general, these changes mean that less Australian tax will be payable by employees who are either resident or working outside Australia at the time of grant of the employee shares or options, but who subsequently undertake services outside Australia.

However, it is likely that these measures will result in a greater Australian tax burden for employees performing services in Australia who were non-residents of Australia at the time of grant of the employee shares or options. In short, such employees may be subject to Australian tax on any unvested shares or options they hold at the time they first perform services as an employee in Australia. Importantly, the amendments to the law will result in an Australian income tax liability even in circumstances where the relevant employee is a non-resident of Australia at both the time of grant of the share or option and the time of its vesting or exercise.

The changes seek to align the Australian tax system with the international procedures developed by the Organisation for Economic Co-operation and Development (OECD) in order to prevent double or zero taxation of employee shares or rights, and thereby provide greater certainty for the individual. However, they will increase the potential Australian tax burden compared to the current one for some temporary resident employees who perform services in Australia. The changes will apply from the date of assent to the

New International Tax Arrangements (Foreign-owned Branches and Other Measures) Bill 2005.

Australian residents undertaking personal services in a foreign country

Taxation Ruling TR 2005/3 deals with the circumstances in which a resident taxpayer will be entitled to foreign tax credits where amounts are included in their assessable income under the personal service income (PSI) alienation measures. The ruling also explores the availability of the exemption concession for certain foreign income derived by employees.

Where an amount is subject to the PSI measures and such income is a reward for personal effort and/or skill exercised overseas, then broadly speaking it will be considered foreign income. Accordingly, where tax is levied on that income in the foreign jurisdiction, the individual taxpayer will be entitled to foreign tax credits to the extent of the tax that either he or the personal services entity has paid in respect of the income.

The exemption concession is considered not to extend to PSI, on the basis that PSI is not derived in the capacity as an employee in the strict meaning of the term employee. Rather, it is considered that PSI is a form of statutory income that is derived by virtue of an individual's personal effort and/or skill. If the income is paid to the taxpayer in the form of salary and wages, there is scope for the concession to apply.

Therefore, to the extent that PSI with a foreign source is included in an individual taxpayer's assessable income and tax has been levied on such income, foreign tax credits will be available. However, such income will not be entitled to the exemption concession, as it was not earned in the capacity of an employee.

Australian fixed base

The provision of services by a non-resident from a fixed base located in Australia and how such income is assessed under the Australia/UK Double Tax Agreement ('the DTA') is covered in ATO ID 2005/75.

The ATO ID deals with an individual who was non-resident for Australian income tax purposes and carried on a design business in the UK. The taxpayer provided services in the UK under a contract with an Australian company and for a continuous period of 111 days services were provided in Australia. The

services provided in Australia were performed in space which was made available in a studio of the Australian company. The space was not a defined area, nor did the individual use the same space for the entire 111 days.

The ID indicated that where a place of business has sufficient temporal permanence to be a permanent establishment (as it did in this case), the taxpayer will be considered to have a fixed base for the purposes of the DTA. Where there is a fixed base, the income attributable to that base will be deemed to have an Australian source and will therefore be assessable in Australia.

Australian Budget

The Australian Budget introduced a number of changes, as follows:

Tax rates: A reduction in the lowest tax rate from 17 per cent to 15 per cent with effect from 1 July 2005 and a widening of the thresholds for payment of the 42 per cent and 47 per cent tax rates. The surcharge payable on individual's superannuation payments and on termination payments has also been abolished.

Temporary residents: The temporary residents exemption, which has twice been defeated in the Australian Senate, is to be reintroduced. The exemption would provide a four-year tax exemption for first-time Australian temporary residents in respect of their foreign-source income, the capital gains on their foreign assets and any income attributed to them in respect of certain foreign companies and trusts. Temporary residents will also no longer be required to withhold tax from interest paid to non-residents (such as home loan interest paid to a lender in their country of origin).

These measures are designed to attract skilled migrants to Australia in order to address skills shortages and it is expected that they will come into force from 1 July 2006.

Belgium

Taxation of options

Guidelines regarding the taxation of 'late' options have been issued by the Belgian authorities. 'Late' options are options which are not accepted by the employee within 60 days of the date of offer. Where

options are accepted within 60 days, they are taxed in Belgium at the date of grant.

In early 2004 the Belgian Finance Ministry indicated that 'late' options would be considered as a discounted stock purchase for Belgian income tax purposes, which meant that these options would fall outside the OECD guidelines for employment income and a double tax charge could arise on options held by employees working cross-border.

The Belgian authorities have now confirmed if an individual is taxable in Belgium at the date of exercise of a 'late' option, the gain on exercise is Belgian-source income under the domestic law. However, the authorities have accepted that for the purposes of double tax treaties, the 'late' option income is stock option income within the OECD sourcing guidelines. This means that an individual who exercises a 'late' option when subject to Belgian taxation should only be taxable in Belgium on the proportion of the gain which relates to the period during which he was taxable on Belgian-source earnings from the date of grant to the date of vesting of the option. This stance ties in with changes over recent months in a number of countries (see Australia above and Ireland and UK below).

Denmark

Taxation of non-residents

The Danish Parliament has made changes to the taxation of non-resident individuals:

- The special 30 per cent tax on the Danish interest income of some emigrants has been abolished.
- The definition of income subject to tax has been widened and from 1 January 2006 will include not only income and earnings in cash, but also benefits in kind such as free telephones and company-paid housing. The inclusion of benefits in kind in the taxable income of non-residents will trigger higher taxation for some employees. In particular, individuals working in Denmark, but living in Sweden, are likely to be affected as benefits in kind have been widely provided because historically they have been tax-free in both countries.
- The possibility of some students obtaining support during their studies in Denmark has been extended. These study allowances are subject to tax on non-residents according to the new rules. As a consequence of the limited tax liability on

the study allowances, Danish employers should take care when they recruit candidates from outside Denmark to work in Denmark under the 25 per cent expatriate rule. This is because an employee does not qualify for the expatriate rule if he has received these study allowances as a non-resident within the three years up to the date of employment by the Danish company.

Full tax liability and Danish fiscal domicile

A recent ruling from the Danish High Court has stated that a taxpayer was taxable as a resident in Denmark and that he also had his fiscal domicile in Denmark, according to the Denmark/UK tax treaty.

The taxpayer had acquired a flat in the UK in June 1994 and according to the UK tax authorities he was considered taxable in the UK as a resident from July 1994. The taxpayer argued that he was only taxable on a world-wide basis in the UK, even though his spouse maintained their previous residence in Denmark.

The taxpayer was married from 1995 to the end of 1997 and the spouse maintained their previous home in Denmark. Mail to one of the taxpayer's UK companies was forwarded to the Danish address at least until the end of 1996. The taxpayer and his spouse were divorced in 1999, but the former spouse moved in with the taxpayer at his UK address and lived there until 2000.

The High Court referred to the fact that in an earlier tax year the Danish Supreme Court had considered the taxpayer to be taxable on a world-wide basis in Denmark and had also found that he had his centre of vital life interests in Denmark. The High Court found that the taxpayer had not proved any change to his tax position compared to the previous year, for which Supreme Court stated that he was subject to tax in full in Denmark.

This decision clearly shows how difficult it is to end world-wide Danish tax liability if the taxpayer's previous residence in Denmark is maintained after emigration from Denmark. In addition, it is also extremely difficult to change fiscal domicile under a tax treaty where the spouse stays on in the previous marital home in Denmark.

Estonia

Tax rate reductions

Estonia's parliament (Riigikogu) has passed an Act providing for a gradual reduction of the flat-rate tax on the income of individuals and companies from the current 24 per cent rate to 20 per cent in 2009 in single percentage point stages (thus the rate will be 23 per cent in 2006, 22 per cent in 2007 and so on).

European court

German deduction for foreign school fees

The EC has referred to the European Court of Justice (ECJ) the issue of the non-deductibility of school fees for attendance at foreign schools. Although the German law allows taxpayers who receive child allowance or child tax credit a tax deduction for fees paid to certain German private and supplementary schools providing public education, a deduction was denied by the German authorities to a German-resident couple who sent their children to a private school in Scotland. The EC Commission had previously requested that Germany change the rules which discriminate against foreign individuals who move to work in Germany and have children attending schools in their home country, as well as against German individuals working abroad who remain subject to world-wide taxation and have children attending foreign schools. The Commission also indicated that the law discriminated against foreign schools by comparison to German schools.

The ECJ has been asked to rule whether the fact that the German tax system does not allow a deduction for fees paid to schools in other EC countries is contrary to the principles of the rights to move and reside freely within the EU, to the freedom of establishment and freedom to provide services, as well as the free movement of workers.

German housing grants

In April 2005 the EC Commission brought an action against Germany, because under its domestic law individuals subject to worldwide income tax who have income within certain limits are entitled to a tax-free cash grant for the acquisition or construction of a new house for their own use.

The Commission argued that the non-availability of the housing grant to persons subject to unlimited income tax liability who live outside Germany and wish to acquire a new home there discriminates against employees working outside Germany in other EC states, frontier workers (at least 90 per cent of whom pay German income tax on their earnings) and German diplomats and EU officials. In the Commission's view, this means that the German law infringes the free movement of workers, freedom of establishment and the freedom of movement. Following the principles developed in the Schumacker case, the situation should be avoided where persons are denied advantages which are connected to their personal situation in either the EU state in which they reside or the state in which they work.

The abolition of the home-owner cash grant is being considered by the mediation committee of the German Federal Parliament.

German exit tax

Some time ago the EC Commission took action against Germany in regard to the law which imposes tax on the unrealised German share gains at emigration of certain individuals who had been subject to unlimited German taxation for the previous 10 years. The German Federal Ministry of Finance has now issued a letter in response, which provides transitional rules on the application of the exit tax for EU or EEA nationals who emigrate to another EU or EEA state.

The letter grants an interest-free deferral of the tax on the unrealised gains up to the time that the taxpayer either alienates all or part of the shares, or is no longer subject to taxation comparable to German unlimited liability in an EU or EA state, or fails to inform the German tax office on each 31 December of his address and the fact that he still owns the shares. The taxpayer must inform the tax office within one month when any of these conditions apply.

The letter rules will apply until the exit tax legislation is revised by the German legislator.

German deduction for home ownership losses

The ECJ Attorney General has decided in the Ritter case, which relates to a family residing in France. Mr Ritter is a German national and Mrs Ritter has dual German and French nationality. They are both subject to unlimited taxation in Germany, as they

both work in Germany as civil servants. The German/French tax treaty provides that the income from real estate is taxable in the country in which the real estate is situated. According to German income tax regulations, the Ritters were not entitled to deduct their home ownership losses from their German taxable income.

The Attorney General decided that it is incompatible with the free movement of employees for an EU Member State to deny a deduction for home ownership losses if (the majority of) their income is earned in that EU Member State. This is in line with standard ECJ jurisprudence which indicates that where (the majority of) his income is earned by a resident of one EU Member State while working in another EU Member State, the state in which the individual is working should take his personal and family situation into account if the state of residence is unable to do so.

Dutch exit tax regulations

The Dutch State Secretary of Finance issued a letter on 9 February 2005 in which he maintains his position that the Dutch exit tax regulations do not conflict with EC law. The June 2004 issue of this newsletter reported the ECJ De Lasteyrie case, which held that France was not in conformity with EC law when it assessed the unrealised capital gains of an individual who was emigrating within the EC. This case and more recent ECJ rulings have not altered the Dutch Secretary of Finance's opinion, which mentions Dutch regulations that indicate that where an entrepreneur decides to move his business abroad or a Dutch company decides to move out of the Netherlands, (corporate) income tax will be due on the profits derived up until the moment of emigration.

It should be noted that the question of the Dutch conservatory assessment that is levied when a Dutch tax resident with a substantial interest in a company emigrates from the Netherlands is currently being reviewed by the ECJ.

Finland

Non-resident athletes' income for the 2005 Helsinki World Championships

The Finnish Supreme Administrative Court has issued a ruling on the taxation position of the athletes who win an award as one of the eight best-performing athletes competing in the 2005 Helsinki

World Championships. The awards (which total c \$7 million) will be paid in early 2006 by a worldwide organisation which is established and resident in Monaco, but under the contract with the Finnish association organising the championships, that Finnish association is responsible for withholding and paying any taxes that are due.

The Court held that under the Finnish domestic law any income derived by non-resident athletes derives from Finnish sources and is taxable at a flat rate of 15 per cent. This contrasts with the advance ruling by the Central Tax Board that the rewards were not Finnish-sourced. No comment was made by the Court on the position under the various double tax treaties with Finland, many of which give the taxing right to the country in which the athlete is resident (and would correspondingly exempt the reward from tax in Finland).

France

Income tax and social security contributions rates

The new French Prime Minister has announced the continued suspension in 2006 of the income tax rate reductions which were promised in the 2002 presidential campaign. However, the new government will aim to combat unemployment by a reduction in the social security contributions payable for employees of small enterprises (less than 10 employees). In addition, a 1,000 bonus will be paid to long-term unemployed persons returning to work.

Deductible expenses of non-residents

The Court of Appeals in Paris has confirmed the Lower Court's decision and held that a non-resident individual should not be excluded from the benefits in the French Tax Code.

Although the French-source income of a non-resident is calculated in the same way as for a resident, the French tax administration considers that non-residents are not allowed to deduct from their French-source income the expenses which are normally deductible from worldwide income. A Swiss resident had French letting income and in his tax return he claimed relief available to taxpayers investing in new let property. The tax administration refused to give him tax relief, but the Lower Court allowed his claim. The Court of Appeal upheld this

decision and indicated that the individual was entitled to the tax benefit, provided he was taxable in France on French-source income.

Exempt remuneration for foreign employment activities

The French tax code exempts from income tax the additional salary paid to a French resident employee (including an expatriate) for non-French workdays. The exempt amount is the excess over the French salary that would be paid for the same duties. However, the French administration will normally not exempt additional remuneration for periodic meetings held outside France, where such meetings are either internal group company meetings (such as a visit to the parent company's head office), or are of a statutory nature (such as shareholders' meetings) or are internal training. This stance is taken on the basis that the remuneration does not encourage a secondment or temporary stay abroad.

The Supreme Court has rejected the tax administration's stance and held that the only condition which must be met in order to qualify for the exemption is that the employee is sent abroad by his French employer to exercise his employment activity and that this includes meeting activities organised by a group company to which the French employer belongs.

Exempt income of inbound expatriates

Certain employees of companies or other businesses resident outside France who are assigned to work in France from 1 January 2004 for a limited period can benefit from a special exemption for their additional assignment remuneration. In order to qualify, the employee must not have been domiciled (resident) in France at any time in the ten calendar years preceding the year of transfer to France and his salary (excluding share benefits) must be comparable to the French local salary for a similar position. If the rules are met, the employee's additional assignment remuneration can be tax-free in France for up to six years. The exemption covers allowances which are paid or reimbursed by the employer, such as cost of living allowance, relocation costs, tax equalisation. Deductions are also available for payments to foreign retirement and medical plans and home country social security contributions.

Guidance notes recently issued by the French tax authorities confirm that assignees who do not

become French resident cannot benefit from the exemption. There must also be a capital, legal or economic relationship between the assigning company and the French company prior to the employee's assignment. The extent of the deductions has also been clarified: private pension contribution deductions are restricted to secondments starting from 1 January 2004, but home country social security contributions can be deducted in the case of assignments which began before that date.

India

Exemption of earnings under the India/Austria tax treaty

The Gujarat High Court has recently made an interesting decision regarding the application of the employment income provisions in the India/Austria tax treaty. The treaty requires that, in addition to meeting other conditions, the employee must be liable to tax under the Austrian legislation on his earnings in order to be exempt from Indian tax on his employment income for Austrian duties under the 183-day rule.

The taxpayer was a foreign technician employed by an Austrian company to provide technical services to an Indian company. He was paid retention remuneration by his Austrian employer during his stay in India and this remuneration was not taxable in Austria. The individual claimed that the retention remuneration was also not taxable in India, because it was exempt under the employment article of the double tax treaty. The Indian authorities refused his claim, on the basis that he could only claim exemption in India if he could produce a tax assessment and proof of payment of tax in Austria on the relevant income.

The Gujarat High Court held that as long as the taxpayer was liable to tax in Austria on the earnings (and met the other treaty article conditions), he was eligible to tax treaty benefits in India. The treaty did not stipulate actual payment of tax on the income, therefore the fact that the Austrian domestic legislation exempted this income did preclude a successful exemption claim in India under the treaty.

Ireland

Residence status

This month the Irish Revenue Commissioners have issued guidance on individual residence status and the joint assessment of married couples where one of them is non-resident.

Where an individual both arrives in and departs from Ireland in the same tax year, the position will depend on the individual's residence status. In particular, residents are eligible for split-year treatment, so that they will only be resident for the period(s) that they are in Ireland (and taxed on their world-wide income for these period(s) accordingly). An individual who is non-resident for all or part of the year is only be taxable on their Irish-source income.

As regards married couples, the Commissioners have confirmed that although an election for joint assessment of a couple cannot normally be made where one spouse is resident in Ireland and the other is non-resident, where only the resident spouse has income and the non-resident spouse has no income, a joint assessment can apply.

Share schemes

The Irish Revenue has published an article on cross-border share options to outline its current practice in this area (which may be subject to change, see below).

The article considers the subject of the employee's residence status, confirming that an individual is taxable on any gain on the exercise, assignment or release of a share option which he obtained on or after 6 April 1986 as a director of a company or as an employee. Irish resident individuals who are not taxed on the remittance basis are chargeable to tax for the year of assessment in which the gain is realised. A charge arises even if the share option is granted before the employment commences or after the employment ceases, if it is granted by reason of the individual's employment. The gain is the difference between the market value of the shares at the time of exercise, assignment or release and the aggregate amount or value of any sums given for the shares and for the grant of the option.

Where a share option is capable of being exercised later than seven years after it is obtained, a tax charge may arise at the date of grant, calculated as the difference between the market value of the shares at the date the share option is obtained and the sum

for which the shares may be obtained on the exercise of the option. Tax is also charged when the share option is exercised, but any tax charged in respect of the grant of a share option is allowed as a credit against the tax charged on the later exercise.

Where the individual is resident at the time the option is granted, there is a charge to income tax at the date of grant (if appropriate) and at the date of exercise even if he is no longer resident in the Ireland at that time. However, there will not normally be a capital gains tax charge if the individual is neither resident nor ordinarily resident in Ireland at the date of disposal, unless the shares derive the greater part of their value from Irish assets, for example land and buildings.

Where an individual acquires a share option before arrival in Ireland and exercise the option when in Ireland, the Revenue has confirmed that no tax liability if there is no connection between the Irish employment and the granting of the option and there is no tax planning or avoidance involved. However, if the individual is resident but not domiciled in Ireland at the date of disposal of the shares acquired on the exercise of the option, he may be liable to capital gains. If the shares are registered outside Ireland and the United Kingdom, the tax charge is limited to the amounts remitted.

The 2005 Finance Bill included provisions to tax stock option gains by reference to the individual's Irish workdays in the period from the date of grant to the date of vesting, in line with the OECD guidelines. These changes are currently on hold, while the Department of Finance reviews the position. A Statement of Practice regarding the taxation of restricted stock awards is also expected later this year and new legislation may be introduced following a test case assessment, in which the Revenue assessed a tax charge at the date on which a stock award was granted, rather than their normal practice of assessment at the date of exercise.

Italy

Incentives for repatriating Italian researchers and inbound foreign researchers

The Italian authorities have issued further details of the application of the tax relief which was introduced in November 2003 to encourage both the repatriation of Italian researchers who have emigrated, and the transfer to Italy of researchers who have qualified abroad.

Researchers qualifying for the relief will only be subject to income tax in Italy on 10 per cent of their research activity income for a maximum of three years (the tax year in which the researcher becomes resident in Italy for tax purposes and the following two tax years). Employees and independent researchers can qualify. Companies employing qualifying researchers may also benefit from a reduction in the 4.25 per cent Regional Tax (IRAP) that they currently pay.

The relief applies to researchers who have a degree from a university or equivalent institution, have been resident outside Italy for some time, have performed professional research activities outside Italy for at least two consecutive years and who move to Italy between November 2003 and December 2008 to perform their research activities and become tax resident.

The tax authorities have not provided full details of the conditions that must be met, therefore each individual's position must be analysed by reference to the general criteria used in the Italian tax rules. In particular, the absence of a definition of the meaning of the term 'researcher' means that it is currently uncertain to which technical activities the tax relief may apply.

Korea

Expatriate exemptions apply to locally hired employees

Foreign individuals working in Korea can benefit from special tax rules. In particular, they can choose to either exempt 30 per cent of their gross earned income from tax or to pay a 18.7 per cent flat-rate tax (instead of the normal progressive rates of 8.8 per cent to 38.5 per cent).

A recent ruling by the Korean tax authorities confirms that the term "foreign worker" can include foreigners who are hired locally, as well as expatriate employees on assignment. This will help Korean companies which wish to recruit foreign employees to compete in the labour market on the same basis as foreign employers.

Luxembourg/Germany

Lorry drivers: employment article of the Luxembourg/Germany tax treaty

The Luxembourg administration has announced a mutual agreement on the application of the employment income article of the Luxembourg/Germany double tax treaty to lorry drivers, which applies to tax years commencing after 1 July 2005, or earlier years for German tax purposes where an application is made by 30 June 2006.

The agreement indicates that:

- The income earned for the lorry driver's workdays in his country of residence are taxable in that country.
- The income earned for the days on which the lorry driver only works in his employer's country (the country in which a company is resident or in which the permanent establishment paying the employee is situated) are taxable in that country.
- The income earned for the days on which the lorry driver only works in a third country, or on which he works both in a third country and in his country of residence, are taxable in his country of residence.
- The income earned for the days on which the lorry driver works partly in the employer's country and either partly in his country of residence or partly in one or more third countries or partly in both of these, is attributed equally to the various countries concerned and taxed accordingly.
- The lorry driver's earnings for non-working days will be attributed to the various countries in which he is taxable, based on the ratios of the income for his working days (as calculated under the rules above).
- Sickness payments are taxable in the country in which the lorry driver is subject to social security contributions.

The time that the lorry driver spends commuting from his home to work is not considered to be an employment activity and the lorry will be regarded as the employee's workplace.

Netherlands

183-day rule for employment income under the Netherlands/Belgium treaty

The Dutch Secretary for Finance issued a decree in June 2005 which clarifies the operation of the 183-day rule in the Netherlands/Belgium treaty which came into effect on 1 January 2003. The new treaty provides an exemption from Belgian income tax for earnings for duties performed in Belgium where certain conditions are met, including the condition that the employee is not present in Belgium for more than 183 days in any 12-month period commencing or ending in the Belgian tax year (the calendar year). In the previous treaty the test was more straightforward, being based on no more than 183 days in Belgium in the tax year.

The Dutch decree clarifies that where the employment relationship began before the new treaty came into force and continues after 1 January 2003, the employee's days in Belgium in the period up to 31 December 2002 must be taken into account for the purposes of the 183-day test in the new treaty, as applied to the earnings for the calendar year 2003. However, when applying the tests of the previous treaty to the employee's earnings for the calendar year 2002, the individual's visits to Belgium in 2003 should be ignored.

This decree is of wide interest because new treaties generally include the more stringent test of 183 days in any 12-month period commencing or ending in the tax year in the provisions for employment income.

Members of supervisory boards: the 30 per cent ruling

A lower court decided on 6 September 2004 that members of supervisory boards do not qualify for the Dutch 30 per cent ruling because these individuals are not actually employed by the company that they work for. As these members are supposed to be independent of the company, it has no power to instruct them. However, under the Dutch tax legislation, members of supervisory boards are deemed to be employed by the companies they work for. The lower court decided in line with standard jurisprudence from the Dutch Supreme Court that the 30 per cent ruling is only eligible for employees who are actually employed.

The court also decided that the Dutch 30 per cent ruling is not designed for situations in which the

connection between the Dutch employer and the employee is not very strong because the (deemed) employee concurrently or subsequently provides an equivalent level of services to other companies. This raises the question of whether a director or an employee who is working under separate contracts or a salary split arrangement can benefit from the Dutch 30 per cent ruling, since he is performing concurrent employment activities for more than one company.

Many advisers feel that the 30 per cent ruling does not exclude directors or employees who are working under separate contracts or a salary split arrangement. The Dutch State Secretary of Finance's comments are awaited regarding this issue and will be reported in a future issue of this Newsletter.

Social security contributions: Dutch-resident director of Turkish company

A Dutch resident with Dutch nationality was appointed director of the Turkish company in which he had a 40 per cent shareholding. He spent a considerable amount of time in Turkey, but was not subject to Turkish social security contributions. The question arose whether he was still subject to Dutch social security contributions.

A Dutch lower court decided that although the Dutch social security legislation stipulates that a resident who spends more than three months abroad when not employed by a Dutch employer is no longer subject to Dutch contributions, international social security legislation enables the employee's state of residence to subject its residents to domestic social security contributions. It was confirmed that EC regulation 1408/71 is not applicable in this situation, but the European social security treaty applies (which results in liability to Dutch social security contributions).

It should be noted that the Netherlands/Turkey social security agreement (which is overridden by the European social security treaty) would lead to the same result.

Social security contributions: Dutch resident working in Brazil for a Dutch employer

A Dutch resident who worked in Brazil questioned whether he was subject to Dutch social security contributions while he was working abroad.

In principle Dutch residents are subject to Dutch contributions, unless they spend a consecutive

period of three months abroad during which they are not employed by a Dutch employer. As the resident was employed by a Dutch employer he was subject to Dutch social security contributions.

Double tax adjustments following the ECJ De Groot case

In a decree of 15 April 2005 the Dutch State Secretary of Finance decided to adjust the double tax rules to fall in line with the ECJ De Groot case (see the November 2004 issue of this newsletter). The double tax decree prevents double taxation of Dutch-resident taxpayers in non-tax treaty situations. The decree is also often referred to when calculating the double tax relief in treaty situations.

The decree provides that where the tax exemption method applies, double taxation is prevented by applying the formula: foreign income/world-wide taxable income x Dutch income tax payable. Before the ECJ case and the Dutch Supreme Court ruling, the formula was: foreign income/world-wide total income x Dutch income tax payable. As a result, the amount of the exemption was lower because of the impact of non-employment deductions (such as alimony).

The revised decree includes a claw-back provision in case the non-employment deductions can be claimed both in the employee's country of residence and in the country in which he works.

Cross-border severance payments

An individual who was employed by a Dutch BV resides in Switzerland and his employment activities were performed in the Netherlands, Switzerland, the USA, Belgium and France. His employment contract was terminated soon after it commenced and a severance payment was made. According to the Dutch tax authorities, the entire severance payment was subject to Dutch tax, although the individual was non-resident.

The individual disputed this and the Dutch Supreme Court decided that the major part of the severance payment was taxable in the Netherlands, as the parties had intended that the majority of the employment activities would be carried out in the Netherlands.

It should be noted that in 2004 the Dutch Supreme Court decided that in principle a severance payment should be taxed in the countries in which the employment activities are performed in the year in

which the employment is terminated and the four preceding years (see the November 2004 issue of this newsletter). In the recent case the Court took a different position, mainly because of the application of the Netherlands/Switzerland tax treaty (which does not follow the OECD Model Tax Treaty) and the fact that the activities under the employment agreement were never performed as the parties had intended.

Late appeals and EC law

In the Netherlands the period in which to appeal against a tax assessment is generally six weeks. In certain situations where the taxpayer files a late appeal, the court may decide that a case cannot be brought before them for consideration of the late filing unless the late filing can be justified. The Dutch Supreme Court confirmed that where an appeal is filed late and this cannot be justified, the fact that the Dutch legislation is not in conformity with EC law will not be accepted as a justification for late filing. This decision is in keeping with the condition that the appeal period should not be unreasonably short, since ECJ rulings have indicated that a six-week appeal period is not considered to be unreasonably short.

Planning opportunity: mortgage interest

In the Netherlands home owners are obliged to declare a deemed income from home ownership in their annual income tax return (of EUR 8,175 for 2005). Taxpayers who are treated as Dutch-resident are entitled to deduct from the deemed income the interest paid on a loan to acquire their primary home.

A new regulation in the Dutch tax law indicates that with effect from 1 January 2005 an additional deduction can be claimed against the deemed income, even where the home owner paid no mortgage interest at all or only paid a small amount. The deduction is the deemed income less any interest paid, so that no deemed income has to be declared.

This creates a planning opportunity where the interest for the first six months of 2006 is pre-paid in 2005. According to Dutch tax, mortgage interest for the six months following the end of the tax year which is paid in advance can be deducted in the year in which payment is made (2005). In 2006 no mortgage interest is paid, therefore under the new regulation there is no net deemed home ownership income (because it is matched by the deduction). Finally, the interest for the last six months of 2006

can be paid in 2007 and it will be deductible in 2007.

It is important to note that the above scheme should be carefully structured in co-ordination with your Dutch tax advisor and that the co-operation of the loan provider will be required in order to set up this scheme and that not all lenders will agree to irregular interest payments. In addition, the Dutch Ministry for Finance could adjust the income tax calculation to remove this beneficial treatment.

People's Republic of China

Top-slicing of employee bonuses

Bonuses paid to both local and expatriate employees have benefited from top slicing relief from the beginning of 2005 in regard to their annual bonuses. The tax payable on the bonus is calculated by dividing the bonus by 12. The marginal tax rate applicable to this sum in the month of payment is then used to calculate the tax on the whole bonus.

It should be noted that this treatment only applies to annual bonuses. All other regular or special bonuses are taxed at the normal progressive tax rates for the month of payment.

UK

Dual Contracts

The UK Revenue has issued an article on the treatment of dual contract arrangements for non-domiciled employees working partly in the UK and partly outside the UK. This indicates that because the chargeable non-UK earnings under a separate contract wholly for non-UK work are taxed in the UK on the remittance basis, there is a clear incentive to ensure that such earnings are paid outside the UK and to minimise the amount of earnings remitted to the UK.

The article indicates that the Revenue may make formal enquiries into employees' tax returns in order to check whether there is in fact a single employment contract (regardless of the production of two written contracts) or whether there has been an attempt to split a single employment in order to exploit the legislation. It recognises that in many cases the contracts fairly represent the true employment relationships, they include a proper job description,

details of the remuneration package and other entitlements (annual leave etc) relating to each employment and the roles described in each contract are capable of independent existence with proper regard given to what would happen if one employment was terminated. The article does accept that where there are two genuine employments and the written contracts reflect this, dual contract arrangements provide a legitimate way to structure an individual's employment relationships.

If the Revenue is satisfied that the arrangements reflect the true employment relationships, they will then focus on whether an anti-avoidance adjustment is needed to address an imbalance between the earnings from the UK and non-UK contracts and whether the employee has performed substantive UK duties under the non-UK contract. The example is given of an employee who is responsible under his non-UK contract for servicing the business of non-UK clients and may have to respond to a telephone call or e-mail from one of those clients when he is in the UK. Responding while in the UK would be regarded by the UK Revenue as a fundamental duty under the non-UK contract and therefore all of the earnings under that contract would be assessable to UK tax (because the duties are not performed wholly outside the UK).

The article indicates that the Revenue do not consider that the existence of separate and distinct employments is determined by the terms of the written contracts where the main distinction between the duties required under each contract is geographical and in such cases they will fully investigate the facts and circumstances including the commercial rationale and context. The employee will be assessed to UK tax accordingly where the evidence shows that there is in fact a single employment.

The Revenue takes the view that a dual contract arrangement is unlikely to work unless there are two distinct jobs and gives the example of a French-resident employer which sends an employee to establish an office in London for its UK subsidiary and requires him to work three days per week in London in this capacity, but also requires him to work in its Paris office servicing their existing portfolio of French clients on two days per week.

The Revenue will also not accept that there are two genuine employments if the risks and rewards of work done both in the UK and outside the UK are substantially borne and received by a single employer.

The article confirms the following situations in which the Revenue will test whether the facts reflect commercial reality as regards separate contracts:

- (a) where a UK resident employee holding one employment with world-wide duties changes to dual contracts on becoming ordinarily resident;
- (b) where an individual who was self-employed before UK arrival becomes an employee with dual contract arrangements on attaining UK resident and ordinarily resident status without any significant change in the way in which he carries out his professional activities;
- (c) where recruitment material suggests that the employer had a single vacancy to fill and a dual contract arrangement is only implemented following the appointment of a non-domiciled individual.

In conclusion the article confirms that where dual contract arrangements fail because the facts indicate that there is in commercial reality only one employment contract, all of the employee's earnings will be taxable in the UK and the UK entity that receives the benefit of the individual's services will be obliged to apply tax withholding under the UK Pay As You Earn (PAYE) system to all payments of income made to the employee during the period that the employee works for that entity. However, where there are genuine separate employments, but the employee performs substantive duties in the UK for the non-UK employer (so that all the earnings from the overseas contract will be taxable in the UK), there is unlikely to be an obligation for the UK entity to operate PAYE on the earnings from the non-UK employer.

Cross-border share option gains

The UK Revenue has issued two articles which set out their views on the treatment of share options under double tax agreements and on the social security contributions position of cross-border options.

Tax: The tax article confirms the situations where a UK income tax charge applies on option gains and how this may be reduced where an employee has worked in a number of countries during the life of a share option. The Revenue follow the OECD model as it applies to share options, where the entitlement to benefit from the options accrues over a period of time and duties have been carried out in more than one country. The OECD identified two main types of options: American-style and European-style options. It is said that virtually all the options seen by the UK Revenue follow the American pattern, in that they are granted with a required period of future service in order to qualify to exercise the options, the first date that they can be exercised is known as the vesting date and the actual exercise takes place on that date

or later. The OECD concluded that up to the point that an option is exercised the gain derives from the employment (and is therefore within the employment article in a typical double taxation treaty) and after the date of exercise the gain is a capital gain within any capital gains article in the relevant treaty.

The OECD considers that the period of employment on which the exercise of an option is contingent will run only to the date that exercise can first take place (the vesting date) and the correct method of allocating taxing rights between countries is by straight-line time apportionment as the right to exercise is itself based on time spent in employment). The UK Revenue adopt the OECD approach from 6 April 2005 and apply apportionment between countries based on the period of employment from option grant to vesting (unless the agreement specifies another treatment, as in the case of the UK/US treaty). This will apply even where an option could have been exercised before 6th April 2005 but was not.

The option will normally be time-apportioned on a straight-line basis by reference to the UK and non-UK workdays in the period from grant to vesting (or grant to exercise for the US/UK treaty). The OECD suggested a typical year is 260 workdays. Periods where the individual was not in that particular employment are left out of account, so that apportionment is still made on the basis of the relative periods of employment in each country. If the employee changes contractual employer on being relocated, where the employers are in the same group of companies and the change did not affect the employee's stock option rights, the UK will normally regard this as one employment for the purposes of apportioning the option gain.

While it is not necessary for the country of residence to tax the option gain for the above reduction in the UK tax charge to apply, the normal Revenue expectation is that tax will actually be levied and any exchange of information powers in the relevant tax treaty may be used to ensure that the other country is aware of the option gain and they can tax it if their domestic legislation permits.

Where the individual is resident for tax purposes in the UK at the date of the option exercise, tax credit relief may apply, rather than exemption for periods of non-UK employment. Similarly, if the employee was resident and ordinarily resident at the date of grant, but resident in a non-treaty country at the date of exercise, the whole gain is taxable in the UK and the

UK will consider giving double tax credit relief for any non-UK tax.

Where a non-domiciled employee who is resident and ordinarily resident in the UK has more than one employment contract and an option is granted in respect of the non-UK employment (the earnings from which are taxable on the remittance basis), provided the contract arrangements are accepted the Revenue as genuine, they will also accept that the option was granted in respect of the non-UK employment and that any gains on exercise will also be taxable on the remittance basis.

Social security contributions: The social security article indicates that where a share option gain is chargeable to income tax in the UK, there is normally a UK social security contributions (national insurance contributions or NICs) liability on the same amount. However, it accepts that reference must be made to the specific UK and international social security provisions for persons working in the UK or working abroad. In particular, under the UK rules liability to NICs depends on whether the employee is present, resident or ordinarily resident in the UK when the option is acquired, whether the employee is in an overseas employment when a potential UK NICs liability arises, and whether the employee is covered by the EC social security legislation or a reciprocal social security agreement.

EC social security regulations: As regards the EC regulations, the article provides examples which indicate that where an option is granted in the UK to a UK-resident employee and exercised while that employee is on a short secondment to France, if he holds an E101 (so that he remains subject to the UK social security legislation) UK NICs will be payable on the full option gain, even if the gain is apportioned between UK and non-UK workdays for tax assessment purposes. However, if the employee is on a longer assignment and was subject to French contributions on his salary at the option exercise date, the UK Revenue consider that NICs arise on the option gain because the grant of the option relates to the UK employment. Again, even if the taxable gain is reduced to provide double tax relief, there would be no reduction in the UK NICs. The article accepts that this stance is the UK Revenue's view, that the treatment of share options is not yet an area where the EU Member States have a co-ordinated practice and that other States may not follow the same approach as the UK. It is indicated that the UK Revenue is working towards securing an agreement on this, but in the meantime in the case of conflict between the UK and another State in which contributions are required on the same income, the

UK Revenue will liaise with the other country concerned to prevent a double social security contributions charge.

Reciprocal social security agreements: In regard to employees who are covered by a reciprocal social security agreement, the article provides examples by reference to the UK/USA agreement. Social security contributions liability is determined by reference to the individual's status under the reciprocal agreement and the country where the duties to which the option relates are performed.

In particular, it is indicated that options granted in recognition of US service before the individual came to the UK and which are unconnected to future UK service, will not be subject to NICs on exercise when UK-resident, even where the individual pays UK NICs on his other earnings (because there is no US Certificate of Social Security Coverage in force).

In addition, where a US employee is granted options in recognition for his work while on assignment to the UK company, provided the individual was covered by the US system at the date of grant (by a valid Certificate of Social Security Coverage) there will be no UK NICs liability.

Other situations: In situations which are not covered by the EC regulations or a reciprocal social security agreement, the article refers to the 52-week period provided by the UK legislation to exempt certain employees from payment of UK NICs for the first 52 weeks of their UK assignment and which equally allows certain UK individuals to cease payment of NICs from week 53 of a foreign assignment.

It is made clear that liability to UK NICs on an option gain is dependent on whether the option exercise takes place in the relevant 52-week period. Options exercised before week 53 of the UK assignment of an inbound expatriate will not be subject to UK NICs, and equally a UK outbound employee will not pay NICs on options exercised after week 52 of his foreign assignment. In view of the high employer NICs charge on options gains (12.8 per cent with no upper limit), these UK rules may offer a significant planning opportunity in some situations.

USA

Final Regulations on the source of earnings

The Internal Revenue Service (IRS) has issued final regulations on how to determine the source of earnings for employees who work partly in the US and partly abroad, which is important in determining how much foreign earned income exclusion and foreign tax credit relief can be applied on the US return.

Background

The previous final regulations provided that if no accurate allocation or segregation of earnings can be made, the source should be determined on the basis that most correctly reflects the proper source of income based on the facts and circumstances of the particular case.

In an attempt to provide clearer guidance, the IRS issued proposed new regulations in 2000, which would have meant that all earnings (including fringe benefits) would be sourced on the basis of the employee's workdays. Rather than becoming final, however, those regulations were withdrawn and new proposed regulations were issued on 6 August 2004. These regulations retained the allocation of salary on the basis of workdays, but introduced a geographic basis for sourcing certain listed fringe benefits.

Final Regulations

The final regulations, issued on 13 July 2005, are largely similar to the proposed regulations issued in 2004. For most individuals, the rules will be effective for the 2006 tax (calendar) year. They provide two new bases for determining the proper sourcing of employment earnings that an individual receives for services performed. The basis for sourcing in the previous regulations is retained for determining the source of earnings received by persons other than individuals (for example, partnerships and corporations) and for persons who are not employees.

The source of wages and other non-fringe benefit earnings is to be determined on a time basis. Employees must allocate income to the US on the basis of the proportion of their US workdays to their total workdays in the period for which the earnings are paid.

The source of fringe benefits is to be determined on a geographical basis (generally, based on the location of the employee's principal place of work). Fringe benefits are defined as amounts paid specifically for housing, education, local transportation, tax reimbursement, hazardous or hardship duty pay, and moving expense reimbursement. These amounts must also be reasonable and substantiated by the taxpayer.

The IRS have also retained the proposed provision allowing employees to use an alternative method of determining the source of their earnings on the basis of the facts and circumstances. However, there are strict substantiation requirements for taxpayers wishing to use this method who earn more than \$250,000 per year. Although the forms have not yet been published, the IRS anticipates that these taxpayers will be required to attach written statements to their income tax returns that disclose:

- The specific earnings or fringe benefit for which the alternative method is being used;
- The alternative method used for each item;
- A computation to show how the allocation was determined for each item; and
- A comparison of the dollar amount of the US source and non-US source earnings determined under both the alternative method and the method that would have otherwise been used under the regulations.

The source of earnings which are earned over more than one year is determined on a time basis, based on the proportion of US workdays to total workdays for the period to which the earnings are attributable. As regard to stock options, the regulations make it clear that a typical nonqualified option gain is determined based on the workdays in the period from the date of grant to the date the option becomes exercisable by the employee (the vesting date). However, the alternative method described above is available to source stock option income, provided the facts and circumstances support it.

In the final regulations, the Commissioner specifically reserved the right to source an employee's earnings in accordance with the alternative method, provided that the earnings are either not received for a specific period or are in essence a fringe benefit (even if the substantiation requirements are not met). The alternative method may only be applied if it is determined that this basis is more reasonable than the basis used by the employee.

The IRS is continuing to reserve judgement on the issue of compensation and fringe benefits received by artists and athletes. Specific rules are expected to be issued, which will require the application of a basis that most correctly reflects the proper source of this income based on the facts and circumstances of each case and which is consistent with current law.

The new sourcing rules may impact employers by altering the US tax liabilities of their expatriate employees, with a consequent impact on the tax reimbursement costs of assignments.

More information

For more information, please contact your local expatriate contact or one of the Expatriate Services Centre of Excellence contacts below.

Chris Maddock	chris.maddock@bdo.co.uk	BDO Stoy Hayward LLP
Marc Verbeek	marc.verbeek@bdo.be	BDO Atrio G.I.E.
Amanda Sullivan	amanda.sullivan@bdo.co.uk	BDO Stoy Hayward LLP
Gerlinde Seinsche	gerlinde.seinsche@bdo.de	BDO Deutsche Warentreuhand AG
Jan Van Langendonck	jan.vanlangendonck@bdo.be	BDO Atrio G.I.E.
Armand Lahaije	armand.lahaije@bdo.nl	BDO CampsObers Accountants & Belastingadviseurs B.V
Stephen Healey	shealey@bdokendalls.com.au	BDO Melbourne Australia
Roslyn Innocent	r.innocent@advis.fr	BDO Marque & Gendrot SA
Carol-Ann Simon	csimon@bdo.com	BDO Seidman LLP

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