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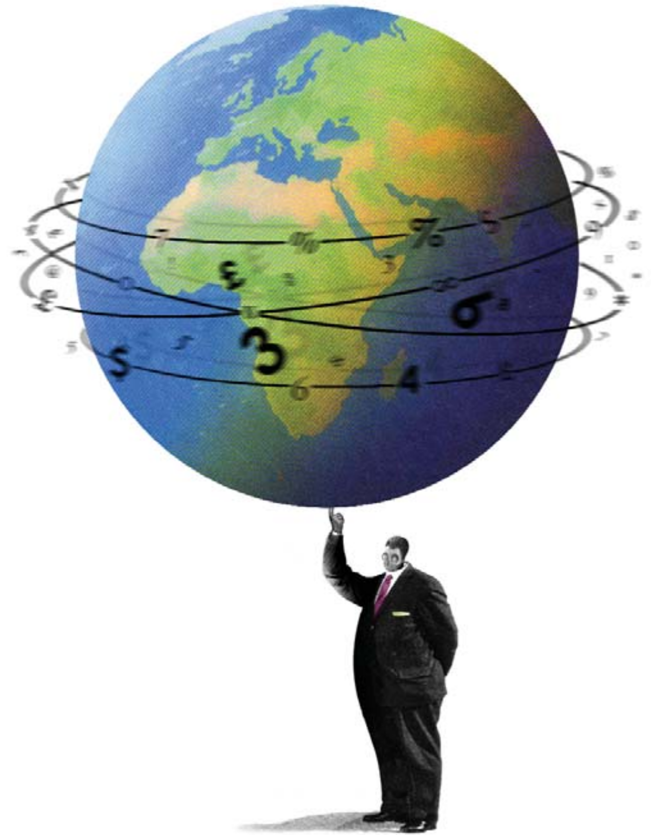
Expatriate News

At the start of a new year the BDO International Expatriate Services team send greetings and best wishes for a successful 2006.

Our first round-up of expatriate news for 2006 highlights a number of important legislative and administrative changes. In particular time sensitive information relating to simplified US Federal Income tax return filing extension procedures as well as those affected by Hurricane Rita.

Also highlighted are some key appeal decisions relating to the determination of residence and permanent establishment status resulting from the application of double tax agreements and the European Court of Justice.



Argentina:

Change in social security tax legislation

Argentina's government has removed the cap on employer's social security contributions with effect from 1 October 2005. This will require certain Argentine employers to calculate social security contributions on the total employment income received by the employee, including benefits-in-kind. However, the employer contributions for Health Service and Labor Risk Insurance continue to be capped at monthly earnings of 4,800 Argentine pesos (ARS).

The cap on the employee's contributions remains in place. Currently, employee contributions are capped at monthly earnings of ARS 4,800.

The employee social security contribution rates are:

Pension	11 per cent (reduced to 7 per cent if private pension regime opted)
Health care	3 per cent
Disability	3 per cent

The employer's social security contribution rates are:

Pension Fund	12.71 per cent
Health Service for the Pensioned	1.62 per cent
Health Service monthly	6.00 per cent (on maximum earnings of ARS 4,800)
Family Compensation Fund	5.56 per cent
Unemployment Fund	1.11 per cent
Labour Risk Insurance	ARS 1.50 + 0.22 per cent (capped at ARS 4,800; rate may vary)
Total Annual Percentage	27.22 per cent

Brazil:

Capital gains taxation remains unchanged

The Brazilian government enacted Provisional Measure 252/2005 for two months from 15 June 2005 and then extended it to 13 October 2005.The expiration of the legally required timeframe for approval by Congress means that this provision is no longer valid. Its aim was partly to stimulate the real estate industry and to simplify the sale of assets with a maximum value of 20,000 Brazilian Reals (BRL) by raising this ceiling to BRL 35,000 per month.

Consequently, the previous legislation is once more in effect and transactions involving monthly sales of low value assets not exceeding BRL 20,000 per month are in general exempt from taxation.

Individuals who are tax resident in Brazil continue to be exempt from capital gains tax on the sale of real property in Brazil with a sale price of less than BRL 440,000, provided the individual has not sold other real property within the last five years. The provisional measure would have exempted the sale of a personal residence from capital gains tax.

Change in immigration requirements relating to local contract temporary visas

New criteria announced by the Brazilian National Immigration Council ease the experience requirements for candidates applying for a temporary local labour contract visa.

The new requirements are as follows:

a) two years of work experience in a technical college level profession, with a minimum nine-year school education or;

b) one year of work experience in a university level profession following graduation from university or;

c) a master's or higher degree, compatible with the activities the candidate will perform in Brazil or;

d) three years of experience in a profession, in which artistic or cultural activities do not require a minimum education.

In addition to the reduction in minimum work experience, documents issued outside of Brazil will no longer be required to be translated by an official public translator. They will only need to be certified by the Brazilian consulate.

Canada:

Government Economic and Fiscal Update

Canada's Finance Minister Ralph Goodale presented his government's economic and fiscal update, which included the following personal tax measures:

- An increase in the basic personal tax-free amount by 500 Canadian dollars (Can$) with effect from 1 January 2005
- A reduction in the lowest personal income tax rate from 16 per cent to 15 per cent with effect from 1 January 2005 and subsequent reductions of 1 percentage point to each of the two middle tax rates by 2010

It should be noted that due to the dissolution of the current parliament, the upcoming election may impact the passage of this bill into law.

Determination of a permanent establishment for Canadian income tax treaties

In the case of Dudney (2000) 2 CTC 56, the Federal Court of Appeals (FCA) held that the premises of a US resident consultant's Canadian client did not constitute a fixed base or permanent establishment (PE) for the purposes of the double tax treaty. As a result, the consultant was not liable for Canadian tax in respect of his work at his Canadian client's premises.

In making this determination, the FCA considered the following factors:

- The actual use made of the premises that are alleged to be the person's fixed base
- Whether, and by what legal right, the person exercised or could exercise control over the premises
- The degree to which the premises were objectively identified with the person's business

The factor of legal control was only one of the three factors listed by the FCA in support of its decision and it was indicated that these factors were not intended to form an exhaustive list. Therefore, the legal right to exercise control over a place of business does not of itself mean that a person has a PE in Canada, but is one factor among others. The Canada Revenue Agency (CRA) has clarified its intent that the PE analysis will not stop at concluding that there is no legal control, but other factors will also be evaluated.

The CRA has indicated that in making a PE determination, many factors must be considered that are outlined in the OECD Model Treaty Commentary and derived from jurisprudence, some of which are:

- There must be a place of business
- The place of business must be fixed
- The non-resident must carry on their business wholly or partly through this fixed place of business.

The CRA believes these three conditions form an appropriate framework for a PE analysis and that any relevant factor in a PE determination must revolve around one of these three conditions. Income Tax Technical News 33 provides examples of factors that may be relevant to determining whether these three conditions are met.

Residence under the Canada/US tax treaty

The Tax Court of Canada (TCC) decided on 8 April 2005 in the case of Allchin v The Queen that a taxpayer was not a resident of Canada under the tie-breaker rules in the Canada/US tax treaty of 26 September 1980. Initially, the TCC had found that the taxpayer was Canadian resident, but following an appeal before the Federal Court of Appeal, the case was sent back to the TCC for re-determination on the basis that the judge had failed to consider that the taxpayer might be dual resident.

The facts

The taxpayer was born in Canada, but in 1967 moved with her parents to the USA where she obtained a resident visa ("Green Card"). She moved back to Canada in 1969, but maintained her Green Card status through her employment as a registered nurse in the USA. She was employed in Canada from 1983, but after educational study in the USA she began selling hospital supplies throughout the USA. In 1991, her Green Card status changed from commuter to permanent resident and she moved from Canada to the USA, living in her cousin's house until 1993. In 1992, she had a US state (Michigan) driver's licence and filed her tax returns in Canada. She became a member of a professional nurses' association in the US and gave up her equivalent membership in Canada.

The taxpayer was told by an immigration lawyer to break all ties with Canada in order to petition for her family to become permanent residents, therefore the family home was sold and by September 1992 there were no Canadian bank accounts. The taxpayer did have a Canadian state (Ontario) driving licence, a Canadian telephone and she sent money to Canada to support her husband and children. A houseboat was stored in Canada, the taxpayer and her husband purchased an investment property in Canada to renovate and rent out, and in the years under appeal, the taxpayer had Canadian health care and visited her dentist in Canada. She spent on average 100 days in Canada in each year, however her family received Green Cards in 1995 with the plan that the family would settle in the USA for better jobs and US universities for the children.

In the years under appeal (1993-1995), the taxpayer filed US returns and paid tax as a US resident on her worldwide income. The Canadian Minister of National Revenue determined that the taxpayer had not severed her ties with Canada and must report and pay tax on her worldwide income.

Decision

The TCC determined that the taxpayer was a dual resident of Canada and the USA in the years under appeal and went on to consider the tie-breaker rules in Article IV(2) of the Canada/US tax treaty. It found that in the years concerned the taxpayer had a permanent home in either both or neither country and therefore it was not possible to say that she had a permanent home in one country and not the other. The taxpayer's centre of vital interests was in both Canada and the United States, in particular almost all of taxpayer's economic activities (her work and professional organisation memberships) were in the USA and almost all of her personal relations (her family, doctor and dentist) were in Canada. A combination of the evidence of her US lifestyle and activities and the fact that in each year she spent approximately 100 days in Canada and 265 days in the United States, lead to the conclusion that her habitual abode was in the United States. Accordingly, the taxpayer was not taxable in Canada under Section 2 of the Income Tax Act for the relevant years.

The taxpayer was told by an immigration lawyer to break all ties with Canada in order to petition for her family to become permanent residents.

European Court:

Dutch levy rebates compatible with EU law

The European Court of Justice (ECJ) has ruled in the Blanckaert case. This relates to a family of Belgian nationality residing in Belgium which owned a holiday house in the Netherlands. The Blanckaerts had no Dutch income or other property.

Dutch income tax is reduced by "levy rebates", which consist of a tax part and a social security part. As Mr Blanckaert was not subject to the Dutch social security system, he was not entitled to the social security part of the levy rebates. However, if he had been a Dutch tax resident, then he would have been entitled to the social security part of the rebates (even if he paid no Dutch social security contributions, for example because he had no income at all). The Blanckaerts felt discriminated against, as they felt their position was comparable to a Dutch resident taxpayer with no income.

The ECJ ruled on 8 September 2005 that because the Blanckaerts were not in the same position as a Dutch resident taxpayer (who is normally subject to the Dutch social security system), they cannot be protected by the EC treaty.

Swedish capital gains tax

On 14 July 2005 the Attorney General gave her opinion in the Bouanich case. According to Swedish tax regulations, if a Swedish company buys shares from its shareholders the shareholder's gain (calculated as sale price less acquisition value) is treated as a capital gain. Capital gains are subject to Swedish tax at 30 per cent. The Bouanich case concerned a French tax resident who owned shares in a Swedish company, which the company decided to buy back. According to the Sweden/France Double Tax Agreement (DTA), the capital gain was designated as a dividend distribution subject to 15 per cent Swedish dividend tax and the acquisition value of the shares was not taken into account to determine the amount of the dividend distribution.

Attorney General Kokott decided that the fact that the acquisition value of the shares is not taken into account leads to Swedish non-resident taxpayers being discriminated against by comparison to Swedish resident taxpayers. However, the fact that the 30 per cent Swedish capital gains tax rate is lowered to 15 pert cent under the DTA leads to the conclusion that a Swedish non resident taxpayer is not worse off in net terms compared to a Swedish resident taxpayer in every situation. Therefore, in every case a Swedish court needs to decide whether the Swedish non-resident taxpayer is being treated disadvantageously compared to a Swedish resident taxpayer. If the non-resident taxpayer pays more Swedish tax than a Swedish resident taxpayer, the DTA provisions should be ignored and the non-resident should be treated as if he was resident in Sweden.

The Netherlands:

Deemed alienation of substantial interest

In a case in which a Dutch resident taxpayer emigrated on 2 November 1998 from the Netherlands to Belgium, the Dutch tax authorities issued a "conservatory assessment" on the deemed alienation of the taxpayer's substantial interest.

A lower court in the Netherlands decided that the issue of the conservatory assessment was not allowed under the Netherlands/Belgium 1970 DTA, since the DTA provides that the right for the Netherlands to levy tax on the capital gain derived from the alienation of a substantial interest is limited to a five-year period. As from 1 January 1997, a conservatory assessment is issued when a substantial shareholder emigrates on the deemed alienation of his substantial interest and the conservatory assessment is issued for a ten-year period.

In this case, an extension from a five-year treaty period to a ten-year period was not allowed and by issuing the conservatory assessment, the Netherlands had unilaterally reclassified a potential dividend distribution as a capital gain under the DTA. Therefore, the conservatory assessment was terminated by the Court.

It is expected that the Dutch state secretary of finance will dispute this court ruling. It is also anticipated that if the Dutch Supreme Court confirms the ruling, then conservatory assessments issued under DTAs that pre-date 1 January 1997 may be challenged.

It should be noted that from 1 January 2003 a new DTA between the Netherlands and Belgium is in force, which specifically includes the use of ten-year conservatory assessments.

New health insurance system from 1 January 2006

In the Netherlands employees who earn less than 33,000 Euros (EUR) per year are compulsorily insured for health care under the sickness insurance act (ZfW). Employees who earn more must take out private sickness insurance.

As from 1 January 2006, the distinction between the two categories of employee will cease to exist, since all employees aged 18 years or older will pay a standard health care contribution averaging approximately EUR 1,100 per year. In addition, an income-related contribution will be required. Employees on a small income will be entitled to receive government compensation.

Expatriates who remain subject to their home country social security system while employed in the Netherlands will continue to be entitled to medical care in the Netherlands. The situation remains unchanged for these employees.

New decree on the Dutch 30 per cent ruling

The Dutch State Secretary of Finance published a new decree on 24 August 2005 on the Dutch 30 per cent ruling, which has clarified a number of issues.

General: The 30 per cent income tax regime is a tax facility for foreign employees who work temporarily in the Netherlands and meet certain conditions. These employees are considered to bear extra expenses because they are working outside their own country. Therefore, it is possible for them to receive an exempt reimbursement for these extra expenses (extraterritorial costs).

Effective date: If an employee first works abroad for a period of time prior to becoming employed in the Netherlands, the question arises when the 30 per cent income tax regime becomes effective. The decree states that the period of the 30 per cent income tax regime begins when the employment commences with the Dutch entity which is responsible for tax and social security contributions withholding, whether or not this employment is carried out in the Netherlands.

The 30 per cent regime can apply to benefits in kind: In the past it was questioned whether the 30 per cent income tax regime could be applied to a benefit in kind. The new decree confirms that this is possible in regard to non-cash earnings from the current employment. The benefit in kind may also be an exempt reimbursement, in which case it should be recorded separately in the employment contract. The tax authorities provided a draft text in the decree to demonstrate how to implement this in the contract.

Additional salary and the 30 per cent ruling: The 30 per cent ruling aims to reimburse the extraterritorial costs that the employee incurs due to taking up employment in the Netherlands. If the employer, in addition to the 30 per cent ruling, also reimburses the employee for actual extraterritorial costs or provides the employee with benefits in kind that have an extraterritorial nature (such as housing in the Netherlands), the value of the benefit should be deducted from the 30 per cent ruling as a cash amount. If the Dutch tax authorities levy an additional wage tax assessment on any excess net salary paid, then the 30 per cent ruling may be applied on the additional salary.

Final taxable salary (eindheffing): The 30 per cent income tax regime can be applied to the final taxable salary, if this is applied by the employer. A condition for this is that the final taxable salary is determined separately for each employee.

Payments outside the ruling period: If an employee who benefited from the 30 per cent income tax regime receives a bonus after the application period has expired, the regime may still be applied under certain conditions. The bonus should relate to the period for which the 30 per cent income tax regime was applicable. Therefore it is necessary to pinpoint the time when entitlement to the bonus becomes unconditional, since entitlement to the bonus should be unconditional by the end of the period for which the 30 per cent income tax regime is applicable.

New application on a change of employer: If an employee utilises the 30 per cent income tax regime and then takes up a new employment, the 30 per cent income tax regime must be re-applied for by the new employer within four months from the start of the new employment. It had previously been clarified that the 30 per cent ruling can be transferred from one employment to the next, providing no more than three months have expired between the end of the first employment and the start of the new employment.

US royalties and Dutch double tax relief

An American national, who was Dutch tax resident in 2000, was employed in the Netherlands. He received royalties from the US for books which he wrote. As he was a Dutch tax resident he was subject to Dutch tax on his Dutch employment income and on the US royalties. The individual was also subject to US income tax, as he was a US national and he received a tax credit in the US for the Dutch income tax payable on his employment income. The balance of the US income tax payable amounted to approximately EUR 15,000.

In the Netherlands foreign tax can be deducted as costs from Dutch taxable income, provided that there is no other relief to avoid double taxation.

The taxpayer claimed that he could deduct the US income tax payable as costs in calculating his Dutch taxable income. The Dutch Supreme Court ruled that as relief to avoid double taxation is provided in the Netherlands/US DTA, the US tax could not be deducted from the Dutch taxable income as costs.

Norway:

Change to 15 per cent expatriate deduction

There will be changes to the tax position of expatriates working in Norway from 1 January 2006. Stricter rules will apply to the use of the 15 per cent expatriate allowance (standard fradrag). Up to 2005, 15 per cent of gross income earned in Norway could be deducted if the intention was to stay in Norway for a maximum of four years.

The deduction will be reduced to 10 per cent for 2006 onwards, there will be a maximum overall deduction of 40 000 Norwegian Krone (NOK) and the deduction will only normally only apply for the two first years that the expatriate is living in Norway. However, an individual who is not resident in Norway for tax purposes (because their stay in Norway is either less than 183 days in any 12-month period, or less than 270 days in any 36-month period) can continue to claim the 10 per cent standard deduction after the first two years of assessment.

It appears that the Norwegian Government may not have considered the effect that this change to the expatriate deduction will have on the ability to attract the necessary specialists in various occupations.

On the other hand, an adjustment will be made to the EEA agreement, so that individuals from other EEA countries will be given tax deductions on an equal footing with Norwegian individuals, provided that the major part of the individual's income (at least 90 per cent, in principle) is earned in Norway.

Exit tax

The 2006 tax reform has introduced an Tax Exemption Model (TEM) for limited companies and other entities, by which dividends and capital gains from shares are tax-free provided the income or gain is derived from investment in a Norwegian limited company or similar company resident within the EEA area. As regards investment outside the EEA, a 10 per cent or two-year ownership requirement applies for exemption. From 2006 onwards, similar rules will apply to investment income and gains derived by limited companies from investment in partnerships.

On the other hand, from 2006 onwards dividends and capital gains (that exceed a tax-free basic amount) which are derived by the individual owners of a limited company or partnerships will be taxed with 28 per cent (in addition to the 28 per cent tax on the net profit of the business). Therefore, in order to avoid tax-motivated emigration a new exit tax has been introduced with effect from 1 January 2006.

The provisions will apply to investments both in Norwegian and in foreign companies. The taxable gain on shares will be calculated at the time the individual ceases to be a Norwegian tax resident under Norwegian domestic law and tax will be levied when the total unrealised gain exceeds NOK 200,000. In order to avoid liquidity problems, the calculated tax will not be payable until the shares are actually sold. For individuals moving outside the EEA, however, a guarantee for the amount of tax is required in order to postpone payment. By adoption of the EEA treaty, Norway will not require this type of guarantee for individuals moving to EEA counties. .

It should also be noted that tax on the unrealised gains will only be payable if the shares are sold or disposed of within five years of the date that Norwegian tax residence ceases. The tax liability ceases if the shares are sold outside this time limit, but because of the Norwegian emigration rules (below), the time limit may in reality be more than eight years. Further regulations with more detail will follow and it is not clear at this stage whether these regulations will include employee share options.

Emigration rules

When moving to a permanent home outside Norway, an individual will still be considered resident in Norway for tax purposes if he stays for at least 61 days in Norway during the income tax year (after moving) or as long as he or someone closely related to him (spouse, cohabitant, minor age children) maintains a home in Norway. An individual who has been resident in Norway for more than 10 years will normally remain resident for a three-year period after emigration. However, residence will not cease as long as he (or someone closely related to him) maintains a home in Norway, or if he has stayed in Norway for more than 61 days in any of the three years after emigration.

Surtax

The surtax rates have been reduced for 2006. The lowest rate (for personal income between NOK 394,000 and 750,000) has been reduced from 12 per cent to 9 per cent and the highest rate (personal income exceeding NOK 750,000) has been reduced from 15.5 per cent to 12 per cent.

Spain:

Optional regime where Spanish residence results from an employment contract

A provision was established in the Personal Income Tax Law 40/1998 (PITL) from 1 January 2004, so that individuals who become tax resident in Spain are able to apply to be taxed as non-residents if several requirements are met. A regulation approved on 11 June 2005 develops the process for exercising this option and clarifies several questions that were not clear in PITL.

This new optional regime for individuals who acquire Spanish tax residence can be very beneficial, especially for those who have high taxable incomes. In this respect it is important to note that the maximum Non-Resident Income Tax rate is 25 per cent, but the maximum Resident Income Tax rates is 45 per cent, so that this special regime could mean a tax saving of 20 per cent.

Special Requirements

Individuals who acquire tax residence in Spain as a result of moving to Spanish territory may choose to be subject to Individual Income Tax as a resident (IRPF) or to the Non Resident Income Tax (IRNR) in the tax period in which the change of residence takes place and in the following five tax years if all of the following conditions are met:

- The individual has not been resident in Spain in the ten-year period up to the date on which the change of residence takes place.
- The move to Spain is a consequence of an employment contract. This requirement will be satisfied where a labour relationship is initiated with a Spanish entity or where the transfer to Spain is required by the employing entity.
- The work involved is effectively carried out in Spain. It is possible to satisfy this condition even though the individual works part of the year outside Spain, provided the total payroll received outside Spain does not represent more than the 15% of the total worldwide payroll (this percentage increases to 30 per cent for an international group of entities).
- The individual is employed by an entity resident in Spain or by a permanent establishment of a body corporate that is not a resident in Spanish territory.
- Employees of an international group of entities who move to Spain must be in possession an employment contract issued by the Spanish subsidiary at which they are going to work. A specific transfer document from a non-resident company can be also enable this requirement to be met.
- Income deriving from the employment relationship must not be exempt from the Non Resident Income Tax Regime (IRNR).

Taxable income under the special regime

The main benefit of being taxed in Spain as non-resident is that tax is only levied on Spanish-source income, whereas a Spanish tax resident is taxed on worldwide income. The tax rate is 25 per cent for a non-resident's earnings, such as salary. However, the personal deductions for children, contributions for pension plans, etc are not applicable.

In general, the items of Spanish-source income which will be taxable in Spain on a non-resident will be those obtained from employment, self-employment, real estate property, dividends, interest, pensions and capital gains. The special non residence option applies both for Individual Income Tax and for Wealth Tax.

This special option will apply for the tax year that Spanish residence is acquired and can be maintained for the following five tax years if the individual continues to meet the conditions above.

Communication and tax returns

Residents in Spain who want to exercise the special non-resident option must submit an application to the Spanish tax authorities (Form 149) within six months of the date of commencement of the employment activity, as stated in the social security documents.

However, residents who became Spanish tax resident in the period 2004 or before 11 June 2005 and wished to apply for this special regime were required to submit their applications to the tax authorities within two months of 11 June 2005.

The communication to the tax authorities must enclose a supporting document issued by the employer which contains the following items:

- Acknowledgement of the employment or professional service contract.
- The employment commencement date.
- The employer's name and address.
- The length of the employment contract.

It is possible to renounce this special non-resident regime by submitting renunciation communications to the tax authorities in the months of November and December of the tax year for which the renunciation will be effective. Individuals can also be excluded from this special regime by the authorities if they are not in compliance with some of the conditions outlined above.

Once an individual resigns, or is excluded, from the special regime there is no possibility of re-applying for it.

UK:

Residence status

The Shepherd case concerned an airline pilot who flew long haul flights out of the UK and was resident and ordinarily resident in the UK up to October 1998. He then rented accommodation in Cyprus, continued to fly from the UK and prior to his retirement in April 2000, spent his off-duty time either in the UK, in Cyprus, engaging in sporting activities, or on holidays in Europe.

The pilot was granted an immigration permit by the Cypriot authorities, filed Cypriot tax returns and joined several clubs in Cyprus. However, he retained membership of his UK clubs and usually stayed in the UK, either at his former family home or with his parents. He continued to receive correspondence at his former home address (including flight rosters, UK tax authority correspondence, bank and credit card statements) and he maintained his voting rights.

The UK authorities assessed the individual's earnings for the tax years 1998/99 and 1999/00, on the basis that he had continued to be ordinarily resident in the UK. It was held that he was resident and ordinarily resident in the UK for both years under the occasional residence abroad legislation. This was based on the taxpayer's past and present habits of life, which showed no distinct break evidencing a move abroad. There was little or no change in his life or in his financial arrangements after October 1998. His residence in the UK was part of the regular and habitual pattern of his mode of life. The taxpayer had made regular and frequent visits to the UK, for personal reasons and not simply for reasons of his work. At best, it could be accepted that he resided in both Cyprus and the UK, but this would still make him resident in the UK for tax purposes. He was a British subject and had a presence in the UK which was not considered to be casual or temporary, but substantial and continuous. He had a fixed residence in the UK and was not a mere traveller in the UK, whereas his attachments abroad were more of a temporary nature.

Termination payments under the UK/US tax treaty

A recent case examined the application of the UK/US tax treaty to a payment made to an employee by his employer on the termination of his employment.

At the date of receipt of the payment, the taxpayer was resident and ordinarily resident in the UK and also resident in the US for tax purposes, which meant that it was necessary to determine his residence status for the purposes of the treaty and then establish the taxing rights over the payment.

Irrespective of whether the taxpayer was treaty resident in the UK or the USA, the termination payment was taxable in the UK because the relevant employment was not exercised in the USA (therefore treaty Article 15(1) gave sole taxing rights to the UK). Even if the taxpayer had been treaty resident in the USA, the UK had the right to tax the earnings because the employment was exercised in the UK.

In this situation, the US must give credit for the UK tax by reason of treaty Article 23.

If the taxpayer had been treaty resident in the USA, Article 15(2) could not give sole taxing rights to the USA because the employer was a UK resident and the taxpayer was in the UK for more than 183 days in the tax year.

If the taxpayer's treaty residence at the payment date was the UK, the US would have had no right to tax the termination payment. Conversely, if his treaty residence at that date was the USA, the UK would still have the right to tax the payment (because the employment was exercised in the UK), but the US would have to give credit for the UK tax.

The overall conclusion of the case was that the taxpayer's UK liability had been correctly determined and that a claim should be pursued with the US Internal Revenue Service for a credit for the UK tax paid on the termination payment.

USA:

Simplified federal income tax return filing extension procedures

The Treasury and Internal Revenue Service (IRS) have released final and temporary regulations (and also proposed regulations) to simplify the procedures for individuals and other taxpayers to obtain an automatic extension of time to file tax returns.

The new regulations provide streamlined and simplified procedures that will enable most individuals and businesses to request a full six-month tax filing extension without a reason or even a signature, with effect from 1 January 2006 for 2005 income tax returns.

The new procedures replace the existing two-step process under which an automatic extension was only allowed for four months, generally until 15 August. If more time was needed, a taxpayer had to file a second extension request form (Form 2688) explaining the reasons the extension was needed.

Beginning with 2005 returns which are due in 2006, individuals will be able to use a single IRS form (Form 4868) to get an automatic six-month extension of time to file. Form 2688 will be eliminated. As under the existing regulations, the new automatic extension will not extend the time for payment of tax.

Proposed nonqualified deferred compensation plan regulations

The IRS has issued proposed regulations to implement the nonqualified deferred compensation plan (NQDC) rules enacted under the American Jobs Creation Act (AJCA) of 2004. These regulations would apply to tax years beginning on or after 1 January 2007 and may be relied upon until finalised.

Background

The AJCA added new section 409A to the Internal Revenue Code, which provides that unless the new requirements under this Section are met, amounts deferred under a nonqualified deferred compensation plan or arrangement on or after 1 January 2005 will be includible in current income and subject to interest and tax penalties from the date on which such amounts are no longer subject to a substantial risk of forfeiture.

Amounts deferred prior to 1 January 2005 are generally not subject to the new requirements and tax treatment, provided that no material modifications are made after 3 October 2004 to the deferred compensation arrangements which were in place when the plan payments were effected or the compensation was deferred. The definition of a nonqualified deferred compensation plan in section 409A is sweeping and includes any plan or arrangement that provides for the deferral of employment income (whether voluntary or not), other than a tax-qualified retirement plan or a bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plan.

Some of the new requirements which must be met for nonqualified deferred compensation to avoid current taxation are:

Initial Deferral Election. The initial deferral election, if applicable, must be made no later than the end of the calendar year preceding the calendar year in which the participant performs the services giving rise to the compensation to be deferred. In the first year of participation, the election may be made within 30 days after the date the participant first becomes eligible under the plan. For performance-based compensation based on services performed over a period of at least 12 months, the election may be made no later than six months before the end of the performance period. The time and form of distribution must be specified at the time of the initial deferral.

Subsequent Deferral Election. If the plan permits a subsequent election to delay payment or change the form of payment, the election cannot take effect until at least 12 months after the date of the election. Except in the case of elections relating to distributions on death, disability or unforeseeable emergency, the first payment with respect to which the election is made must be deferred for at least five years from the date payment would otherwise have been made under the initial election. An election related to a distribution scheduled to be made at a specified time may not be made less than 12 months prior to the date of the first scheduled payment.

Restrictions on Distributions. The plan must provide that compensation deferred may not be distributed earlier than the time of:

- separation from service, as determined under Treasury Department regulations
- disability
- death
- a specific time (or pursuant to a fixed schedule) specified under the plan at the time of the initial deferral election
- a change in ownership or effective control of a corporation, or in the ownership of a substantial portion of the corporation's assets, to the extent provided in Treasury Department regulations
- the occurrence of an unforeseeable emergency (i.e. a severe financial hardship to the participant), in which case the amount of the distribution must be limited to the amount needed to satisfy the emergency and may include amounts needed to pay resulting taxes.

No Acceleration of Payments. The plan cannot permit the acceleration of distributions, except as otherwise provided in Treasury Department regulations.

Guidance

The proposed regulations recently issued provide guidance on applying the rules of Section 409A to various situations, including guidance with regard to various foreign arrangements. The following are examples of the exemptions for various foreign arrangements under the Section 409A rules:

Nonresident Aliens

Compensation deferred and vested by a nonresident alien while working in a foreign country generally will not be subject to Section 409A. This provision applies if the compensation would not be includible in income for US federal income tax purposes, if it had been paid at the time the legally binding right to the compensation first arose, or (if later) at the time the right was no longer subject to a substantial risk of forfeiture. The regulations also exempt up to US $10,000 of deferred compensation for a given calendar year.

US Citizens and Resident Aliens

If the compensation constituted foreign earned income under Section 911 and the amount of the compensation

deferred does not exceed the difference between the maximum Section 911 exclusion and the amount actually excludable under Sec 911 for the taxable year, the arrangement is not subject to Section 409A.

Resident Non US citizens who are not Green Card holders
Amounts deferred under certain broad based foreign retirement plans are not subject to Section 409A.

Other exemptions
Tax equalisation payments are exempt, provided the payments are made no later than the end of the second calendar year beginning after the calendar year in which the individual's US federal income tax return is required to be filed for the year to which the payment relates.

Section 409A will not override any specific tax treaty provisions which relate to foreign plans. Contributions to foreign social security systems which are either covered by a totalisation agreement or a government-mandated system, are not subject to Section 409A.

The proposed regulations also provide relief for individuals who become resident aliens during the year.

New wage withholding rules for some Nonresident Alien employees

In Notice 2005-76 the IRS has issued new rules for determining the amount of income tax employers must withholding from wages paid for services performed within the United States by nonresident alien employees. When completing form W-4, nonresident alien employees will be required to:

- Claim no exemptions from withholding
- Request withholding as if single, regardless of their marital status
- Claim one allowance (except aliens from certain countries)
- Write "NRA" on the form

Employers will be required to calculate income tax withholding based on adding an amount to a nonresident alien employee's wages solely for the purpose of calculating the income tax withholding for each payroll period. The additional amount will not be income or wages to the employee, will not affect income tax, social security tax (FICA) or unemployment tax liability for either the employer or the employee and will not be reported as income or wages.

The new rules are effective for wages paid to nonresident alien employees on or after 1 January 2006.

Updated per diem rate rules for reimbursing employee for business travel expenses.

In Revenue Procedure 2005-67 (which supersedes Procedure 2005-10), the IRS published revisions to the list of high cost locations and the per diem rates for high-cost and other locations. The IRS also provided rules under which the amount of the ordinary and necessary business expenses of an employee for lodging, a meal and incidental expenses (or for a meal and incidental expenses) incurred while travelling away from home are deemed to be substantiated under the relevant regulations.

The use of the methods described in the procedure is not mandatory. A taxpayer may use actual allowable expenses if adequate records or other sufficient substantiating evidence are retained.

The Revenue Procedure also provides an optional method for employees and self-employed individuals who pay or incur meal costs to use in computing the deductible costs of business meals and incidental expenses paid or incurred while travelling away from home. In addition, the Procedure elaborates on the deductibility of incidental expenses paid or incurred while travelling away from home by employees who do not pay or incur meal costs and who are not reimbursed for the incidental expenses.

Additional guidance and extension of hurricane relief to those affected by Hurricane Rita
IRS Notice 2005-81 supplements Notice 2005-66 which relates to certain taxpayers affected by Hurricane Katrina. In particular the notice:

- expands the definition of "covered disaster area" to include additional counties and parishes that the Federal Emergency Management Agency (FEMA) determined were eligible for federal assistance after the IRS issued Notice 2005-66;
- extends the deadlines for the IRS to perform certain acts to 28 February 2006 to match the deadlines for affected taxpayers to file, pay, and perform certain acts;
- expands the definition of affected taxpayer to match the definition of affected taxpayers in Notice 2005-73 and now includes all workers assisting in the relief activities in the covered disaster area (regardless of whether they are affiliated with recognised government or philanthropic organisations), any individual whose principal residence, and any business entity whose principal place of business, is not located in the covered disaster area but whose tax professional or tax practitioner's office is located in the covered disaster area, and individuals visiting the covered disaster area who were killed or injured as a result of Hurricane Katrina and its aftermath. The estate of an individual visiting the covered disaster area who was killed as a result of the hurricane is also considered to be an affected taxpayer and;
- grants the IRS a postponement of time to perform an act not previously identified in Notice 2005-66.

In Notice 2005-82 the IRS extends the period for the government to take certain actions to 28 February 2006 with respect to certain taxpayers affected by Hurricane Rita.

More information

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

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If you have any feedback or comments regarding this newsletter, including features that you would like to see in the future, please contact **helen.jerrold@bdo.co.uk**

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