



International Tax

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CANADA

Possible Changes in Interest Withholding Rules

The Canadian tax authorities have recently issued an interpretation concerning the application of the reduced withholding tax rate under the Canada - U.S Income Tax Treaty (“Treaty”) on interest payments made from a Canadian corporation to a Canadian partnership of two U.S corporations, where the partnership was treated as a corporation (or non-transparent entity) for foreign tax purposes.

Currently, the CRA’s position is that interest payments qualify for the reduced rate of withholding of 10% under the Treaty under the circumstance described above. However, this position is currently being reviewed as a result of being in conflict with the proposed changes in 2000 to the OECD model convention commentary relating to partnerships. Without the Treaty the withholding tax in Canada on interest paid to the non-resident partners would be 25%.

It is our understanding that the CRA is continuing to review this case, and will announce in the near future the results of the review. Though taxpayers should not rush to change their current financing structure if similar to that described above, it may be worth planning alternative financing structures should the CRA’s review result in disallowing the Treaty benefits to the interest payments in circumstances described above. ■

AUSTRALIA

Australia's foreign taxation system has been significantly overhauled recently. The purpose of this *International Tax Alert* is to provide a brief overview of the more important developments.

New participation exemption

Like many European countries, Australia now has a participation exemption which allows tax concessions for capital gains on sale of foreign subsidiaries as well as dividends received by Australian companies from their foreign subsidiaries.

Dividends

The previous dividend exemption (contained in section 23AJ) only applied to dividends received on non-portfolio (i.e. at least 10%) shareholdings in companies resident in listed countries. This exemption has now been widened and is available for all non-portfolio dividends regardless of the country of residence of the dividend-paying company. This exemption applies to all dividends received on or after July 1, 2004.

Branch Income

The current foreign branch income exemption has been expanded and now applies similarly to the dividend exemption mentioned above: no longer dependant upon the source country, nor whether taxable there. Some exemptions will apply so that the tax treatment of branch income will, broadly, be aligned to that of CFCs for income earned in

financial years commencing on or after July 1, 2004.

Capital Gains

A new exemption from CGT is available in respect of the disposal of shares in foreign companies. The exemption will only apply where the shareholder company held at least 10% of the voting rights in the foreign company for at least twelve months in the two years before the time of the disposal. This exemption applies to both Australian companies and their CFCs.

Where these conditions are satisfied, a percentage of any capital gain or loss is disregarded. This percentage (the "active foreign business asset percentage") is calculated at the taxpayer's choice either on the basis of market values or book values. Failure to make choice results in all losses being disregarded and all gains being fully taxable. Up to 10% (by gross value) of the foreign company's assets may be other than 'active foreign business assets' before the exemption percentage is reduced below 100%.

A foreign company's active business assets for these purposes are any assets (including goodwill) used in the course of carrying on a business.

Some assets are precluded from being 'active', such as:

- Financial instruments (e.g., loans to associates;
- Certain types of shares;
- Interests in partnerships or trusts;
- Life insurance policies;
- Cash or cash equivalents; and
- Certain assets used to produce passive income.

Listing of Foreign Countries

Instead of categorising countries into 'broad-exemption listed' (white), 'limited-exemption listed' (grey) and 'unlisted' (black), Australia's foreign taxation system now only recognises 'listed' (white) and 'unlisted' (black) countries.

The white list contains only:

- NZ
- UK
- USA
- Japan
- Canada
- France
- Germany

Income of CFCs resident in one of these white list countries continues to be exempt from CFC attribution provided it is not 'designated concession income'.

CGT and Non-residents

Under proposed amendments contained in the New International Tax Arrangements (Managed Funds and Other Measures) Bill, non-residents will no longer be subject to Australian CGT on some of their investments in Australian managed funds.

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Currently, non-residents are subject to CGT on

- Capital gains made on sale or redemption of units in an Australian unit trust;
- Capital gains made by the trust (regardless of whether the asset sold had the necessary connection with Australia) and distributed to the non-resident; and
- Deemed capital gains arising under CGT event E4 from the distribution by the trust of non-assessable amounts.

The proposed amendments will allow non-residents to

- Disregard capital gains or losses made on unit sales or redemptions provided the trust has a sufficient amount of assets without

the necessary connection with Australia;

- Disregard distributed capital gains made by the trust on assets without the necessary connection with Australia; and
- Be exempt from CGT event E4, but only in respect of distributions of foreign source income.

Non-residents will remain liable to Australian CGT on distributed capital gains made by the trust on assets which have the necessary connection with Australia. Australian unit trusts with non-resident unit holders will now need to work out which of their assets have the necessary connection and put in place procedures to produce annual distribution statements distinguishing between taxable and exempt capital gains. These amendments are

proposed to take effect from when the Bill receives Royal Assent.

Foreign Hybrid Entities

Under legislation which received Royal Assent on June 30, 2004, with effect from July 1, 2003 (and an opt-in choice from July 1, 2002), foreign entities such as UK LLPs and US LLCs will no longer be regarded as companies under Australia's CFC rules. Income of these entities will now be treated as that of their owners, along with credits for any foreign tax paid on it. Previously, such credits could have been lost. Further, the likes of shareholders of LLCs operating in Australia may now have an Australian tax liability on the LLC's Australian-sourced income. ■

UNITED KINGDOM

UK Disclosure Rules in Force

The UK's rules for disclosure of tax avoidance schemes to the Inland Revenue (and Customs and Excise, in respect of VAT) took effect on August 1, after the issue of Regulations and Inland Revenue guidance. The expectation is that firms will have made initial submissions to the tax authorities by September 30. However, in the case of innovative structures commanding premium fees, the Regulations appear to go much wider than expected. As a result, many firms may consider disclosing many more routine tax planning ideas by September 30 also. It remains to be seen how the rules will work in practice and whether the nature of disclosed schemes will result in changes in tax law.

When is a foreign company UK-resident and when is it not?

Although the recent Special Commissioners' decision in R and another v Holden establishes no new principles, it is interesting in that the Inland Revenue succeeded in its contention that whereas one non-UK company was in fact resident in the UK, another non-UK company was not.

The case concerned a complicated avoidance scheme for the major shareholders of a UK company wishing to sell their shares. The shares were eventually sold by a

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company (C Ltd) specially incorporated in the British Virgin Islands for the purpose to a previously dormant holding company (E BV) incorporated in the Netherlands, of which C Ltd was the sole shareholder. For the scheme to succeed, either both companies had to be UK-resident or neither had to be UK-resident.

For a foreign company to be UK-resident, its central management and control has to be in the UK. Although the sole shareholder of E BV was C Ltd, and its sole director a non-resident trust company, it was clear that the trust company took its instructions from the UK shareholder and thus that central management and control was exercised in the UK. On the other hand, it appeared to the Special Commissioners that the decisions carried out by X Ltd as director of E BV were in fact made in Geneva, and the taxpayers had failed to advance sufficient evidence to establish that they were in fact made in the UK.

The case emphasizes the importance of ensuring that a foreign company with an ultimate UK 'controlling hand' will only be regarded as non-resident if its non-resident directors are truly able to and do exercise proper discretion in strategic decision making.

Claims against the Inland Revenue under Group Litigation Orders

The UK courts and also the European Court of Justice are cur-

rently hearing or preparing to hear cases in which taxpayers are claiming that various existing or former provisions of UK tax law are in breach of the EC Treaty. Claims of a similar nature are grouped together in Group Litigation Orders, in which test cases are taken and the claimants share costs.

The current status of the various GLOs is shown in the table below.

Type of GLO	Explanation	Test Claimants	Current State
Loss Relief	In its simplest form, losses incurred abroad should be able to be offset against UK profits	Autologic, BNP Paribas, Caterpillar; Heinz, The Future Network	Revenue appealing to House of Lords, expected in October
Advanced Corporation Tax	In its simplest form, payment of ACT on dividends from UK subsidiaries to EU parents contrary to EU law	Deutsche Morgan Grenfell, Pirelli, NEC Semiconductors	Class 1 victory for taxpayer; Class 2 Revenue defeated twice, seeking leave to appeal to Lords Class 3 lost by taxpayers, appeal in April 2005; Class 4 referred to ECJ
Thin Capitalisation	Thin cap provisions are in breach of the EC Treaty	IBM, Pepsi, Lafarge, Volvo, Caterpillar	Trial date fixed for November 2004
Controlled Foreign Companies	Dividends received by UK corporations from European companies are subject to corporation tax - illegal under EC Treaty	Anglo-American, Cadbury Schweppes, Prudential	Trial date fixed for January 2005
Franked Investment Income	Payment of ACT by UK company groups on dividends from EU-based members of group contrary to EU law	British American Tobacco, Aegis	With ECJ
Foreign Income Dividends	Tax relief should have been available on dividends received on overseas investments between 1994 and 1997	BT Pension Scheme	Permission for GLO granted 21 July 2004

FRANCE

French Discuss CFC and Thin-Cap Changes

Following judgments in the European Court and France's own Supreme Administrative Court, France has had to consider revising its controlled foreign company (CFC) and thin capitalisation legislation.

In the case of thin capitalization, France's rules, like those of Germany (struck down by the European Court in the *Lankhorst* case and now revised), did not apply where the related-party lender was taxable in France. Since this rule discriminates against foreign lenders without a taxable presence in France, it was found to be in breach of the EC Treaty principle of freedom of establishment.

The proposed new rule would keep the existing safe-harbour 1.5:1 debt-equity ratio. Where related-party debt was in excess of 1.5 times equity, the excess interest would be disallowed if it exceeded both 25% of the borrower's adjusted operating profits and EUR 150,000. The rule would apply wherever the lender was resident.

In the case of the CFC rules, France's *Conseil d'Etat* held that they were in breach of the non-discrimination article in many of France's double tax treaties as well as of the freedom of establishment principle. The existing rules provide that a French corporate entity with a direct or indirect interest of 10% or more (or one worth at least EUR 22.8 million) in a non-resident entity would be taxable on the profits of that entity if

it enjoyed a tax rate on its profits of less than 22.22% (two-thirds of the French corporate tax rate of 33.33%). Foreign entities deriving more than 50% of their income from industrial or commercial activities conducted primarily in their local markets are excluded from the rules ('the local business test').

Under the proposed new rules, the CFC rules would be explicitly extended to all French entities (partnerships, associations and trusts, not merely companies) – regularising the current situation in which the rules are already applied to all such entities – but the threshold participation in the foreign entity raised to 35% (subject to various anti-avoidance provisions). The level of foreign tax considered to be low enough for the rules to apply would be reduced to 16.66% and the rules would not apply where the foreign entity was established in another EU member state (unless it was a wholly artificial arrangement set up to avoid French tax). Additionally, it would be enough to satisfy the local business test for the affairs of the foreign entity to be effectively conducted from its country of establishment. ■

UNITED STATES

Schedule M-3, Net Income (Loss) Reconciliation for Corporations With Total Assets of \$10 Million or More

Effective for taxable years ending on or after December 31, 2004, any corporation (or U.S. consolidated tax group) required to file Form 1120, U.S. Corporation Income Tax Return, that reports on Schedule L of Form 1120 total assets at the end of the corporation's (or U.S. consolidated tax group's) taxable year that equal or exceed \$10 million is required to include Schedule M-3 with its tax return.

On July 7, 2004 the Treasury Department and the Internal Revenue Service released a draft of the final version of the new Schedule M-3, Net Income (Loss) Reconciliation for Corporations With Total Assets of \$10 Million or More. The initial draft Schedule M-3 was unveiled January 28, 2004, and the IRS accepted comments through April 30, 2004. The draft Schedule M-3 instructions were issued March 11, 2004, and have yet to be finalized. The Service anticipates that the instructions to Schedule M-3 will be finalized in September 2004.

Acting Treasury Assistant Secretary for Tax Policy Greg Jenner stated, "The purpose of this project has been to make differences between financial accounting net income and taxable income more transparent. Schedule M-3 accomplishes this. Schedule M-3 provides information that will identify taxpayers that may have engaged in aggressive transactions and therefore should be audited."

The draft of the final version of the Schedule M-3 consists of three parts:

Part I, Financial Information and Net Income (Loss) Reconciliation, looks first to obtain information about the taxpayer's financial income statement and then to reconcile worldwide net income (loss) per income statement with the net income (loss) per income statement of includible corporations (either a single corporation or corporations that are included in a U.S. consolidated tax group);

Part II, Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return - Income (Loss) Items, reports differences between the net income (loss) per the financial income statement and taxable income per the tax return with respect to items usually considered to be income or (loss) items; and

Part III, Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return - Expense/Deduction Items, reports differences between the net income (loss) per the financial income statement and taxable income per the tax return with respect to items usually considered to be expense/deduction items.

Part II and III require the taxpayer to identify the portion of each difference that is a permanent difference and the portion that is a temporary difference. The specific differences listed in Part II and III are comprised of: 1) low risk differences that are reported for greater transparency; 2) high risk differences that may require attention; and 3) other areas of special concern such as emerging issues. IRS Commissioner Mark W. Everson said, "The new disclosures will help us target our examination efforts on high-risk areas, thereby improving and speeding the audit process." ■

THAILAND

Thailand Confirms Royalty Withholding Tax on Imported Shrink-Wrapped Software

The Thai Revenue Department has recently issued a private ruling to a software distributor in which it confirms that royalty withholding tax applies to the import of shrink-wrapped software.

The ruling was requested by a Singapore software distributor that had been granted the right to use and sell computer programs in the Asia Pacific region from its parent company in the United States. The company had numerous customers around the region that were either distributors or sales agents.

The computer programs sold by the company had the following characteristics:

1. The computer programs were not customized.
2. The programs were distributed in shrink-wrapped packaging, in the form of a CD or diskette.
3. The rights in the program were retained by the Singapore distributor.
4. The Singapore distributor would invoice the Thai customer, who would import the goods, arrange customs clearance and pay the import duty and VAT, if any.
5. The Thai customer would sell the goods to the end user who would receive the right to use the computer program under an end-user

license but not the right to reproduce the computer program.

The Singapore distributor viewed the income derived from the sale of computer programs to customers in Thailand as income under Section 40 (8) of the Revenue Code, which is income from business, commerce, agriculture, industry, transport or any other activities not specified in Sections 40 (1) through to 40 (7).

Withholding tax is only imposed on income paid under Sections 40 (2) through to 40 (6) and therefore no withholding tax would apply if the Revenue Department concurred with the distributor. The distributor took this view because the parties to the contract had intentionally agreed to enter into a contract in the form of a sale and purchase agreement and not a license agreement or a service agreement, which could otherwise give rise to a withholding tax liability.

The problem with adopting such a view is that computer programs are deemed a work of literature under Thailand's Copyright Act, 1994. Payments received for the use of computer programs are therefore deemed payments received for the

use of copyright, which fall under Section 40 (3) of the Revenue Code rather than Section 40 (8), as contested by the distributor. 15% withholding tax applies to the payment of assessable income under Section 40 (3) to a foreign company not carrying on business in Thailand.

No distinction is made in Thai tax legislation between payments made for granting a license that allows the simple use of the software by the end user, such as a shrink-wrapped product license, and other forms of licenses to use computer programs. There has also been no official announcement by the Revenue Department on whether it views shrink-wrapped product licenses differently from other forms of computer program licenses. In both cases, the license would be eligible for copyright protection under the Copyright Act.

It appears from the published summary of the ruling that the distributor went to great lengths to explain why no withholding tax should apply to payments for the software but it was all to no avail in the end. The Revenue Department ruled that the income received by the Singapore

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Thailand *Continued*

software distributor from the sale of computer programs was in the nature of copyright income under Section 40 (3) of the Revenue Code. The payer of the income therefore had a liability to withhold tax.

Singapore's double tax agreement with Thailand is of no assistance to the Singapore distributor in this situation because it allows Thailand to tax software royalties at the full rate of 15%. Thailand has however entered into double tax agreements with many other countries (including the United States) in which it has agreed to a lower tax rate for software royalties, in many cases as low as 5%.

If withholding tax is not deducted from payments to a foreign supplier of shrink-wrapped software, surcharges of 1.5% per month will accrue for late payment of the tax. The surcharges cannot exceed the amount of tax payable.

Many countries in the Asia Pacific region do not impose withholding tax on the import of shrink-wrapped software including Australia, New Zealand, Singapore, Hong Kong and Korea.

In Singapore for example, payments for software are classified as royalty payments for tax purposes and subject to withholding tax as high as 15% if paid to a non-resident. Since January 1, 2001 however, payments made to non-residents for shrink-wrapped software have been exempt from Singapore withholding tax. The exemption applies to end-consumers and resellers of shrink-wrapped software. The recent ruling by the Thai Revenue Department confirms that Thailand is not yet prepared however to give up its right to tax payments for imported shrink-wrapped software as royalties. ■

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