



# International Tax

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## U.S. Gives One-Time Repatriation Bonus for CFC Income

On October 22, the American Jobs Creation Act of 2004 was signed into law, creating a host of changes to U.S. corporate tax law. The highlights of the Act are reviewed in BDO's *Washington Tax Report* of November, a link to which is available at <http://www.bdo.com/services/tax/>. We review here only selected highlights of this landmark legislation.

The immediate cause for the Act was the ruling by the World Trade Organisation (WTO) that the U.S. Foreign Sales Corporation (FSC) regime and its successor, the Extra-Territorial Income (ETI) Exclusion, was an illegal export subsidy under the General Agreement on Tariffs and Trade (GATT). However, the Act goes a great deal further than the repeal of the ETI Exclusion. It provides for:

- A phased-in 9 percent deduction for domestic production activities
- An 85 percent deduction for one year only for extra dividends repatriated from controlled foreign corporations (CFCs) and invested

in an approved 'domestic reinvestment plan'

- The reduction of foreign tax-credit 'baskets' from nine to two
- New 'anti-inversion' provisions

Under the ETI Exclusion, a U.S. corporation was entitled to an exemption from U.S. tax of 'qualified foreign trade income.' Under the new Act, income from transactions entered into after 31 December 2004 will no longer qualify for ETI treatment, subject to transitional provisions.

### Qualified production activities income

By way of compensation, the U.S. will phase in a 9 percent deduction

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**Repatriation Bonus** *Continued*

for 'qualified production activities income' earned within the U.S. and give a one-off deduction for 85 percent of dividends repatriated from CFCs above a baseline figure, provided that the income so repatriated is invested in an approved reinvestment plan.

'Qualified production activities income' is the net income from production property wholly or mainly manufactured, grown, produced or extracted within the U.S., subject to certain limitations. It is thought that a wide variety of sectors, not just manufacturing but also, for example, the agricultural sector, software companies, film-production companies, utility companies and engineering firms, will qualify for the deduction. The deduction will be

introduced at a rate of 3 percent in 2005 and 2006, rising to 9 percent in 2010 and thereafter until 2015, when it is due to lapse.

**CFC dividend deduction**

The one-off CFC dividend deduction will apply either to the profits of the last accounting year beginning before 22 October 2004 or to the first accounting period beginning in the year after that date. U.S. corporations receiving dividends from their controlled foreign corporation subsidiaries will be able to claim an 85 percent deduction (equivalent to a tax rate of 5.25 percent) on the dividends received, but on two main conditions. First, the deduction applies only to the excess over the average dividends repatriated over

three of the last five accounting years. Second, the cash repatriated must be invested within the U.S. as provided by a 'domestic reinvestment plan'. There are certain other limitations. Operating losses may not be deducted from the 15 percent of the dividend remaining in charge to tax, and foreign tax credits may not be set against the U.S. tax on the non-exempt dividends.

The CFC dividend deduction provides a massive potential tax break for U.S. companies with low-tax foreign subsidiaries. Assessing whether to take advantage of the new one-year window is extremely difficult however, due to the risk of falling outside the necessary conditions. Many groups are therefore waiting for further guidance from the IRS. ■

## Hungary Abolishes Withholding Tax on Outbound Dividends

Hungary, a member of the EU since May 1, 2004, has further enhanced its position as a location for a European holding company by abolishing withholding tax on all outbound dividends to foreign parent companies from January 1, 2006.

Under the EC Parent Subsidiary Directive, Hungary was already bound not to withhold tax on dividends to associated companies in other EU Member States, but the new rules apply to dividends to all parent companies wherever established, and whether or not the foreign recipient company is resident in a country with which Hungary has a double tax treaty.

Hungary's low rate of corporation tax (16 percent) is coupled with a provision which allows companies in certain circumstances to deduct 50 percent of interest and royalty income from taxable profits, bringing the effective tax rate on such income to 8 percent. Furthermore, Hungary has no withholding tax on outbound interest and royalties, making it an attractive EU location for tax efficient financing. ■

## Selecting a Holding Company Location

The measures adopted by Hungary, Ireland and Netherlands may be attractive in themselves, but the entry on May 1, 2004 of 10 new member states into the European Union has made competition in this area even stiffer than previously. (For example Turkey, although outside the EU, has just implemented new holding company legislation.) The latest edition of the BDO Stoy Hayward European Holding Company Table contains a summary of relevant tax information on 12 European jurisdictions. Copies are available on request. ■

## Exit Charge on Companies

Companies incorporated in France wishing to transfer their registered office (or ‘seat’ – *siège*) abroad will no longer be treated as if they had been liquidated, thus facing immediate corporation tax on untaxed profits and gains. The change, contained in a clause of the 2005 Finance Bill, currently being considered by the French Parliament, was probably introduced to facilitate the creation and use of the new European Company (SE), but also brings French companies into line with the European Court’s judgment in the *de Lasteyrie* case. Tax remains chargeable on assets that are actually transferred to the new country of residence, or disposed of.

Although the judgement in the *de Lasteyrie* case referred to ‘taxpayers’ and is thus, on the face of it, not limited to individuals, there is little or no sign that those Member States who levy an exit charge on companies are contemplating its removal, with the exception of France and Austria. Under a Bill cur-

rently being considered by the Austrian Parliament, unrealised gains on assets being transferred by a company from Austria to a permanent establishment elsewhere in the EU will no longer be taxed immediately, if the transferor taxpayer makes an election for deferral. The tax charge would be deferred in

such cases, and would crystallise when the assets were disposed of or transferred on to a third country.

By contrast, the UK, which taxes emigrating companies under Section 185, the Taxation of Chargeable Gains Act, on a deemed disposal of their chargeable assets for example, does not appear to be about to amend its law. However, the Government is reviewing all the legislation that is potentially in breach of European law with a view to protecting revenues as far as possible. Action in the UK will probably have to wait until the final outcome of the various Group Litigation Orders against the Inland Revenue are known, and it may well take another European Court judgment, either from that or some other source, before other Member States take any corresponding action. ■

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## Irish Holding Company Regime Gets Go-Ahead

Ireland’s new capital gains exemption has been approved by the European Commission after Ireland agreed to drop the monetary threshold; it was announced on September 23.

In its original form, as it appears in Ireland’s Finance Act 2004, the regime specified a minimum qualifying shareholding of 10 percent (for shareholdings valued at no less than EUR 15 million) or 5 percent (where the shareholding was valued at no less than EUR 50 million). The final version of the rules will drop mention of the monetary thresholds altogether and specifies the lower 5

percent participation threshold for all qualifying shareholdings. As in the UK, both the investor and investee companies have to satisfy certain activity criteria.

The amendments to the law will be made in the Finance Act 2005, which should also reduce Ireland’s capital duty rate from 1 percent to .5 percent, but the intention is for

the rules to be applied retroactively from February 2, 2004, which is the starting date for the regime as a whole.

The new exemption, which brings Ireland into line with the UK and many other European countries, will undoubtedly increase Ireland’s attraction as a holding company location, especially when coupled with its 12.5 percent rate of corporate income tax on trading profits. ■

## UK Companies: Are Foreign Dividends Taxable?

Another judgment of the European Court of Justice (ECJ) with potentially far-reaching implications for the UK is that in the case of *Petri Manninen*. Here, as in *de Lasteyrie*, the case was brought by an individual, but also has implications for companies. Essentially, in *Manninen*, the ECJ held that Finland was in breach of European law by taxing foreign dividends received by a Finnish-resident individual less favourably than Finnish dividends.

In the UK, this is potentially true not only for individuals (who do not receive a tax credit on foreign dividends, only a credit for foreign tax withheld from the dividend) but also for companies. Dividends received by a UK company from another UK company are exempt from corpora-

tion tax, whereas foreign dividends are liable to corporation tax, with a credit for foreign tax paid. There is current litigation to establish whether this treatment is in breach of European law with respect to dividends from subsidiaries and related companies in other Member States.

The UK tax treatment of foreign dividends is also potentially unlawful in respect of dividends from outside the EU.

UK companies in receipt of foreign dividends should consider treating those dividends in their tax return as exempt from UK corporation tax, in the same way as UK dividends, but make full disclosure. The Inland Revenue is likely to resist such a position, and may change the UK tax rules once they consider a loss of UK tax likely. The case could also lead to claims in other EU jurisdictions. ■

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## EU Arbitration Convention

The European Commission has welcomed the adoption by the Council of the EU of a Code of Conduct to eliminate the double taxation that can arise where an EU Member State, by making a transfer pricing adjustment, increases the taxable profits of a company from its cross-border intra-group transactions. The Code will ensure a more effective and uniform application by EU Member States of the 1990 Arbitration Convention that is designed to deal with such double taxation.

The Code establishes rules such as the starting points of time limits for dealing with complaints and practical arrangements concerning the mutual agreement and arbitration phases of the Convention. It recommends the suspension of tax collection during the dispute resolution period. The Code is based on a Commission proposal of April,

2004 arising from the work of the EU Joint Transfer Pricing Forum. The Council also welcomed the Commission's decision to prolong the work of the Forum for a further two years and agreed on an Accession Convention that will, when ratified, allow the ten new Member States to adhere to the Arbitration Convention. ■

## Netherlands to Cut Corporate Taxes

The Netherlands Government has announced plans to reduce the rate of corporate income tax from the current 34.5 percent to 30 percent over a three-year period. The intention is to apply a rate of 31.5 percent in 2005 and of 30.5 percent in 2006 before introducing the ultimate 30 percent rate from 2007. The reduction, which is intended to be revenue-neutral, will be financed largely by increasing energy taxes and by an increase in employers' social security contributions. ■

## EFTA Case Adds Weight to Tax Credit Refund Claims

**A ruling by the EFTA Court in a Norwegian case may add weight to claims being made against the UK Inland Revenue for full tax credit refunds by EU parent companies of UK subsidiaries.**

The European Economic Area (EEA) encompasses the 25 Member States of the EU plus Iceland, Liechtenstein and Norway. These last three countries are the only remaining members of EFTA (the European Free Trade Association). The EEA Agreement incorporates the greater part of the EC Treaty, including the 'four freedoms', such as the freedom of establishment. The EFTA Court is the body parallel to the European Court of Justice (ECJ), and gives advisory opinions on matters relating to the obligations of the EFTA countries under the EEA Agreement.

The case concerned dividends paid to non-resident shareholders of Fokus Bank, which was resident in Norway. Norway operates an imputation system (in the course of being replaced) for the taxation of dividends, under which a full tax credit for income tax is given to resident shareholders which eliminates their tax liability on the dividend they receive. However, non-resident shareholders remain liable to tax on the dividend, but the tax rate is normally reduced by treaty and collected by a withholding tax. They are not entitled to the tax credit.

The bank argued that it should not have had to withhold tax from the dividend, because the discrimina-

tion inherent in the absence of a Norwegian tax credit for the non-resident shareholders was in breach of the freedom of establishment rule of the EEA Agreement. The EFTA Court agreed, and ruled furthermore that it was irrelevant that the shareholders were entitled in their home country to a credit for the Norwegian withholding tax.

The Fokus Bank case is analogous to the Manninen case before the ECJ, but whereas Manninen involved (Finnish) resident shareholders in receipt of foreign dividends, Fokus

represents the other side of the coin (non-residents receiving domestic dividends). Although the opinions of the EFTA Court are not binding on the ECJ, the decision in Fokus Bank is bound to carry some weight there. The ECJ has yet to hear a case on the same footing as Fokus Bank, but the reasoning of the EFTA Court may influence the ECJ in its decision on one of the claims being made in the UK under the Group Litigation Order relating to the Hoechst case where claimants are arguing that they are entitled to a refund of a tax credit. ■

### UK's Pre-Budget Statement

A number of tax planning techniques used by UK-based international groups were closed down in the Pre-Budget Report on December 2, 2004. These techniques have become known to the Government following the introduction of the disclosure rules earlier this year, which oblige tax advisers to send the Inland Revenue details of remuneration and financial schemes within five days of them becoming available for implementation.

In addition to a blitz on remuneration planning for employees, international groups may be affected by detailed changes to the rules for double tax relief, repos, and controlled foreign companies (CFCs).

While most of the changes close down specific tax planning techniques, of particular concern is a new provision withdrawing the availability of the Excluded Countries exemption where a foreign subsidiary has been involved in a tax avoidance arrangement. This introduces considerable uncertainty to the availability of the most widely used CFC exemption, as eligibility will no longer be based solely on objective criteria. ■

## Mexican Approved Tax Bill

### Date\Timing:

As predicted in our October Tax Alert on Mexico's proposed new tax bill for 2005 (<http://www.bdo.com/about/publications/tax/alerts/TaxAlert-Mexican2.pdf>), the Mexican Congress approved the 2005 tax bill on November 12, with effect from January 1, 2005, involving significant changes to corporate taxes in Mexico.

The final, approved tax bill involved changes beyond those indicated in our October Alert including:

1. An increase in the consolidation percentage allowed to Mexican parent companies.
2. Inclusion of a new definition of Business Profits.
3. An increase in the debt-equity ratio for the Thin Capitalization Rules.
4. Inclusion of the deduction for asset tax purposes of the debt maintained with foreign residents and financial institutions.
5. A reduction of the income tax rate for individuals.

### Details:

1. *Corporate Tax Rate*: The Tax Bill reduces the Mexican corporate income tax rate from 33 percent to 30 percent in 2005. This rate would be reduced by 1 percent each of the following tax years until it becomes 28 percent in 2007.
2. *Profit Sharing Deduction*: The Tax Bill allows Mexican Companies to deduct the 10 percent mandatory profit sharing paid to employees, which was effectively impossible under the old rules.
3. *Cost Of Sales v Purchase Deduction*: The Tax Bill restores a system (which was previously adopted in Mexico in 1986) requiring Mexican companies to deduct their cost of sales instead of the inventory purchases made in a given year. Also, the tax bill sets forth specific rules to calculate the cost of sales for each given industry, as well as includes special transition rules.
4. *Tax Consolidation Regime*: Mexican parent companies will be able to consolidate 100 percent of the taxable income or loss of their Mexican controlled subsidiaries. Under current law, the maximum consolidated percentage is 60 percent.
5. *Thin Cap Rules*: The Bill includes Thin Capitalization Rules, which in general terms allow the deduction of interest payments as long as the debt-equity ratio of 3 to 1 is not exceeded. A five-year transition period is established to comply with this debt-equity ratio. These thin capitalization rules will not apply to financial institutions and Mexican companies with an Advanced Pricing Agreement supporting associated debt and interest charges compliant with the Arm's Length Principle.
6. *CFC Rules for Jurisdictions with Preferential Tax Regimes*: The Tax Bill eliminates the so-called "Black List" and defines preferential tax regimes as those jurisdictions in which taxes are lower than 75 percent of the tax that would have been paid in Mexico. Also, foreign transparent entities in which a Mexican individual or corporation is a shareholder will be subject to the CFC Rules.
7. *Definition of Business Profits*: A new definition of Business Profits is introduced in the Tax Bill imposing withholding taxes on certain types of income not subject to taxation under the Tax Treaty's provisions.

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8. *Independent Services*: The Bill establishes a new assumption to determine whether the source of income for independent services is located in Mexico. This assumption establishes that a service will be deemed rendered in Mexico if the payer of the service is a Mexican resident or foreign resident with a permanent establishment in Mexico and if the payment is made to a foreign related party.
9. *Credit Rights*: The Bill establishes that the gain obtained by a foreign resident from the sale of credit rights issued by a Mexican resident or a foreign resident with a Permanent Establishment in Mexico should be subject to taxation in Mexico as interest income, when these rights are acquired by a Mexican resident or a foreign resident with a Permanent Establishment in Mexico.
10. *Income Tax Rate for Individuals*: The income tax rate for individuals will be reduced from 33 percent to 30 percent in 2005. This rate would be reduced by 1 percent each of the following tax years until it becomes 28 percent in 2007.
11. *Mexican Asset Tax*: The Tax bill allows Mexican companies to deduct from the Asset Tax base debts maintained with foreign residents and banks. ■

### In the Expatriate Corner: U.S.–Swiss Agreement Exempts Pension Plans From Double Taxation

The United States and Switzerland have reached agreement on the qualification of certain Swiss and U.S. pensions for treaty benefits under paragraph 3 of Article 10 (Dividends) of the U.S.-Switzerland income tax treaty. The agreement also specifies the procedures for claiming treaty benefits in each country and the methods each country uses to grant treaty benefits. The full text of the IRS release is available at:

[http://www.irs.gov/pub/irs-utl/us-swiss\\_pensions.pdf](http://www.irs.gov/pub/irs-utl/us-swiss_pensions.pdf)

## Potential Refund of the Italian Regional Tax (IRAP)

The European Court of Justice (ECJ) is now reviewing a case (Case C-475/03) on behalf of a Provincial Tax Court in Italy for a ruling on whether the Italian Regional Tax (IRAP) contravenes the EU law holding that no tax may be levied that impairs the workings of the common VAT system. If the ECJ rules that IRAP is unlawful, the Italian subsidiaries of multinational companies may be entitled to refunds.

The core of the argument is that IRAP shares the essential characteristics of a VAT tax in that it is levied as a function of the added value of an Italian enterprise, calculated on the difference between revenue and costs. If the ECJ agrees with the view that IRAP is similar to a VAT tax, it will be held unlawful

under Article 33 of Directive 77/388/EEC (the Directive). A claim for a refund of IRAP had to have been made within 48 months of its payment, such that payments made in November 2000 forward could be subject to a request for refund. Normally, these claims would be filed and handled at the appropriate

local or regional office of the Italian tax authorities. However, there is some uncertainty in this case due to its potential size. It may be necessary to file a formal litigation claim, the filing of which will trigger a 90-day clock within which time the tax authorities must respond, or an appeal to the Italian Tax Court can be made.

Even if the ECJ determines that IRAP is unlawful, the Court could still impose limitations on the effectiveness of the decision, though all initiated or vested litigation rights/claims would likely be respected. ■

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