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World Wide Tax News

1 North America and the Caribbean

1.1 Canada

1.1.1 Government acts on income trusts

Following the announcement that two large Canadian quoted companies, Bell Canada and Telus were intending to convert to income trusts, highlighting a growing trend in the corporate sector, the government felt prompted to act. The Finance Minister, Jim Flaherty, announced on the evening of October 31st, that he would be taking measures to neutralise the tax effect when a corporation converts to an income trust.

As reported in BDO *World Wide Tax News* 2005 Issue No.4, the income-trust structure has become very popular in Canada with both the investment and business communities. This is principally because it effectively allows investors to be taxed directly on an income trust's business income, which is not subject to corporate tax, resulting in a lower tax burden than would have been the case if the same income dis-

tributed to the investor had been earned by a corporation and then paid as a dividend. Of particular concern to the government was the large shareholdings in income trusts held by entities that were themselves exempt from tax, such as pension schemes and other retirement plans, and by non-residents. No tax would have been paid in such a case until the value of the plan is paid out in retirement. Measures already taken in the 2006 Budget (adopted from the proposals of the outgoing government) to reduce the tax on public-company dividends had done little to stem the tide of income trust conversions.

The new proposals, which will have effect from the date of the Finance Minister's announcement, will essentially subject income trusts to the general federal corporate tax rate, plus a proxy at 13% for provincial corporate taxes. The tax will apply to any distributed income from business carried on by the trust in Canada, income from non-portfolio investments in Canada and related

capital gains. Distributions and income allocations of this income to trust unitholders will not be deductible from the tax base. Other passive earnings – such as income and gains from portfolio investments and dividends received from Canadian corporations – are exempt from the tax. Resident unitholders will be taxed as if the income payment is an eligible dividend under the 2006 rules, unless they have tax-exempt status. Non-resident unitholders will face a 25% withholding tax (unless a double tax treaty applies to reduce the rate).

The tax, which will also be imposed on publicly traded partnerships and certain other flow-through entities, will apply in 2007 to all income trusts that were not publicly traded before October 31, 2006, so that the Bell Canada and Telus conversions, which will not now go ahead, would have been caught. Existing income trusts will not become subject to the new tax until 2011.

1.1.2 Imperial Oil case clarifies treatment of foreign-exchange losses

The Supreme Court of Canada has held that a corporation cannot deduct foreign-exchange losses arising from its financing activities from taxable income for the purposes of corporate income tax.

In *Imperial Oil Ltd v Canada*, the taxpayer had redeemed debentures denominated in US dollars and suffered an exchange loss owing to appreciation of the US dollar against the Canadian dollar. It maintained that at least 75% of the loss was deductible against income and that only the remaining 25% was a capital loss, not deductible from income. The Court upheld the Canada

Revenue Agency's position that the loss was predominantly a capital loss, and therefore deductible only against capital gains. A lower court had previously found in favour of the taxpayer.

1.2 United States of America

1.2.1 R&D credit extended and enhanced

On December 20, the President signed legislation enabling businesses paying tax in the U.S. to:

- claim Regular Research Credits against their regular income taxes for qualified research expenses ("QREs") incurred in 2006 and in 2007;
- claim (1) Alternative Incremental Research Credits ("AIRC") against those same taxes for QREs incurred in 2006 and (2) even larger AIRCs for QREs incurred in 2007; and
- elect an Alternative Simplified Credit ("ASC") against regular income taxes that is calculated without reference to a taxpayer's gross receipts.

Regular Research Credits and AIRCs were available under previous legislation, which expired at the end of 2005.

The Regular Research Credit is a tax credit equal to 20% of QREs in excess of a base amount, which is computed by reference to the taxpayer's gross receipts. The maximum tax benefit for this credit, net an add back required by the statute, is 6.5% of QREs.

The AIRC is a credit equal to 2.65%, 3.20% and 3.75% of the excess of

QREs over 1%, 1.5% and 2% of the taxpayer's average annual gross receipts. For tax years beginning after 2006, the rates are increased to 3%, 4% and 5%.

A major enhancement to the credit is the addition of the Alternative Simplified Credit ("ASC"). The ASC may be of considerable widespread benefit, because it is calculated without reference to the base amounts used to calculate either the Regular Credit or the AIRC. Instead, the ASC equals 12% of the amount by which QREs in the current period exceeds the average QREs over the preceding three taxable periods. If the taxpayer had no QREs in one or more of those periods, the ASC equals 6% of the current period's QREs. Taxpayers who elected the AIRC for a tax year including January 1, 2007 may elect the ASC for 2007, without needing approval from the Internal Revenue Service ("IRS").

1.2.2 US and UK tax authorities smooth application of double loss rules

An agreement between the US Internal Revenue Service and HM Revenue and Customs in the UK will help US corporations doing business in the UK and UK companies doing business in the US to avoid potential double taxation when making loss set-off claims.

The difficulties arise from the interaction of both countries' rules to prevent 'double dipping' of the loss in both jurisdictions. The US dual consolidated loss rules essentially provide that a loss of a foreign branch of a US corporation cannot be set off against the profits of any domestic affiliate. The equivalent UK rules provide that the loss of a foreign branch

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of a UK company may not be set off under the group relief rules against the profits of another group member if that loss is deductible against profits that are not subject to UK tax. A situation can thus arise when the application of both sets of rules prevents use of the loss in either the UK or the US.

In order to avoid this result, the two revenue authorities have agreed that taxpayers may make an annual election in which they opt to use a qualifying loss in either the UK or the US. The election cannot be made, however, in respect of the losses of dual-resident companies or certain hybrid entities, for example.

1.2.3 New US-Belgium treaty paves way for zero dividend tax

See under Belgium, item 2.3.3.

1.2.4 IRS acts against triangular reorganisations

The US Treasury and the IRS have given notice that they wish to issue regulations to counteract tax avoidance involved in certain triangular reorganisations. The regulations are aimed at limiting certain transactions including the "Killer B" transaction.

In a triangular reorganisation, a parent uses a subsidiary to acquire a target using its own (i.e. the parent company's) shares. For example, suppose Company A wishes to acquire a target, Company B. Company A will use an existing subsidiary or form a new company (Newco) to acquire the target but the consideration for the surrender of the target's shares will be the shares of Company A. Company B's (the target's) shareholders receive Company A shares in exchange for their own,

although they may have sold those shares to the subsidiary or to Newco. Typically, Company A then merges into the target (forward merger) or the subsidiary is merged into the target (reverse merger) after the share exchange.

In many transactions, in the cross-border context, the subsidiary acquires the parent's shares for debt rather than by means of a capital contribution by the parent to the subsidiary. Thus debt is inserted into transactions as a result of the drop-down of the parent company's shares to the subsidiary for use in the acquisition of the target.

The regulations will treat the transfer of property (including cash or a note) by a subsidiary to buy its parent's stock in connection with certain triangular mergers as distributions subject to IRC section 301(c), which may result in dividend treatment and the possibility of US withholding on such dividend. Affected transactions include various triangular transactions including forward triangular mergers, triangular "C" reorganisations, reverse triangular mergers and triangular "B" reorganisations. The regulations will apply if either the subsidiary or the parent (or both) is a foreign company

The effective date for the regulations will be for transactions occurring after September 21, 2006. A transition rule will apply to transactions that were entered into prior to September 22, 2006 and were subject to a written binding agreement at that time.

1.2.5 Regulations regarding partnership allocations of foreign tax credits.

The IRS has issued final regulations determining how foreign tax credits

may be allocated between the partners of a partnership. The final regulations were issued in October 2006, and are substantially the same as the provisions of the proposed and temporary regulations that they supersede. The regulations exclude allocations of credits for foreign tax paid from the substantial economic safe harbour of the section 704 regulations (which deal with partnership allocations and determination of a partner's distributive share of income, deductions, credits, etc). They instead provide a safe harbour under which foreign allocations will be deemed in accordance with the partners' interest in the partnership. The regulations generally apply for partnership tax years beginning after October 18, 2006.

The use of partnerships and special allocations has been used as a tax planning strategy by many US based companies. The IRS in recent years has raised concerns that special allocations may result in situations where excessive foreign tax credits are claimed by certain US partners in a partnership with foreign activities. The regulations attempt to reduce the potential for the perceived abuse. ■

2 Europe and the Mediterranean

2.1 European Union

2.1.1 French dividend withholding tax ruled out by European Court

The European Court (ECJ) has held that the French system subjecting dividends paid to non-resident parent companies to withholding tax whereas dividends paid to resident parent companies are not only not subject to withholding tax but almost fully exempt from tax altogether is in breach of the EC Treaty. Although the facts in the case precede the introduction of the EC Parent-Subsidiary Directive and concern France, the decision may still have repercussions across the EU and EEA.

The facts in the case (*Denkavit Internationaal BV & Denkavit France SARL v Ministre de l'Economie, des Finances et de l'Industrie*, Case C-170/05), concern the interaction of the French withholding tax system in the late 1980s and the France-Netherlands double tax treaty. At the time, the French subsidiary of the Netherlands parent paid French 5% withholding tax on dividends to the parent (had the treaty rate not applied, the rate would have been 25%). In the Netherlands, even though in principle the treaty allowed for a credit for the French withholding tax, that credit could not exceed the Netherlands tax payable on the dividend. Since the dividend was exempt from corporate tax under Netherlands domestic law, the parent was unable to claim the French tax as a credit against its Netherlands liability.

The ECJ has held not only that:

- a national tax law under which a tax is imposed on dividends paid to a non-resident parent whereas resident parent companies are almost wholly exempt from such a tax constitutes an unjustified restriction on the freedom of establishment

but also that:

- there is still such an unjustified restriction even where a double tax treaty provides for such a tax to be set off in the parent company's state of residence, if the practical effect of the treaty and the national law of the parent company's state is to prevent such a set-off

It is likely that such a fact pattern could be replicated between other Member States.

2.1.2 UK's former Foreign Income Dividend system was discriminatory

See under United Kingdom, item 2.10.2.

2.1.3 UK largely vindicated on treaty ACT refund system

See under United Kingdom, item 2.10.3.

2.2 Belgium

2.2.1 Withholding tax to be abolished on dividends to treaty countries

The Belgian government has announced that withholding tax on dividends paid by a Belgian com-

pany to another associated company resident in a country with which Belgium has a double tax treaty, will be abolished, subject to certain conditions.

This new exemption essentially extends the exemption from Belgian withholding tax currently available under the EC Parent-Subsidiary Directive for dividends paid to associated companies in other EU Member States to companies resident in third countries, provided that those countries have a tax treaty with Belgium. The company receiving the dividend will have to have held at least 15% of the capital of the Belgian company paying the dividend for an uninterrupted period of at least 12 months. The 15% minimum shareholding mirrors the 15% minimum that applies under the Parent-Subsidiary Directive from January 1, 2007.

Since Belgium has a wide network of double tax treaties, the exemption should enhance Belgium's attractiveness as a holding-company location. It is worth remembering also that the new exemption goes in most cases beyond what the respective treaty provides, nor is it subject to any anti treaty-shopping rules contained in the treaties.

The new exemption will enter into force on January 1, 2007.

2.2.2 VAT grouping to be introduced

Among other measures contained in the Belgian government's 2007 Budget was a proposal to introduce a VAT grouping regime, under which

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supplies made between companies in the group will not be liable to VAT. Although the final details are yet to be confirmed, it is understood that establishment and membership of a VAT group will be voluntary (except for entities in which the top company in the group structure has a direct interest of more than 50%, which will automatically be included in the group), and that membership must be for a minimum of three years. All Belgian-resident entities and registered Belgian branches of foreign entities will be eligible. Members of a group will have to be independent entities that are nevertheless closely linked economically, organisationally and financially.

The key features of a VAT group are that intra-group supplies are free of VAT (thus eliminating the partially or wholly non-recoverable input VAT on intra-group supplies which wholly or partly exempt group members would otherwise have had to bear) and that only a single VAT return need be made on behalf of the whole group.

Although the EU's VAT rules permit VAT grouping, only about half of the 25 Member States currently operate a grouping régime. Belgium will now be joining Austria, Cyprus, Denmark, Estonia, Finland, Germany, Hungary, Ireland, Italy, Malta, the Netherlands, Sweden and the UK.

It is expected that Belgium's group régime will take effect from April 1, 2007.

2.2.3 Belgian-US treaty paves way for zero dividend tax

Dividends paid by Belgian subsidiaries to US parent companies and by US subsidiaries to Belgian

parent companies may in future be payable in certain circumstances without deduction of withholding tax under a new double tax treaty signed between the two countries towards the end of November.

In place of the current 5% rate on some dividends and 15% on others, the new treaty provides for zero withholding tax on dividends paid:

- by a Belgian company to a US company, provided that the US company has directly held at least 10% of the share capital of the Belgian company for a period of at least 12 months preceding the date on which the dividend is declared or
- by a US company to a Belgian company, provided that the Belgian company has directly or indirectly owned at least 80% of the voting shares in the US company for a period of at least 12 months preceding the date on which entitlement to the dividend is established

As in all new US treaties, this benefit is made subject to passing one of a number of tests designed to limit possibilities for tax avoidance. The company receiving the dividend must either be a quoted company, be specially certified by its tax authority as qualifying or satisfy so-called 'base erosion', 'derivative benefits' or 'active trade or business' tests. The essential intention of these tests is to prevent the benefit of the zero rate accruing to passive conduit companies owned by shareholders who would not themselves qualify for benefits under the treaty.

Dividends that do not qualify for the zero rate will be subject to the existing 5% rate (where the recipient com-

pany directly owns at least 10% of the voting rights in the paying company) or 15% in other cases.

The new treaty also abolishes withholding tax on interest paid from one country to the other, except in the case of certain profit-based interest. Currently, both countries withhold tax at 15% on interest paid to a resident of the other in most cases.

The 10% threshold for dividends payable up to the US compares favourably with the equivalent threshold in other recent treaties negotiated by the US with both European countries such as Germany and with Japan, increasing Belgium's attractiveness as a location for US investment into Europe.

The new treaty will come into effect only once formal ratification procedures have been completed in both countries. A likely starting date is January 1, 2008.

2.3 France

2.3.1 New participation exemption not to apply on intra-group disposals

In BDO *World Wide Tax News* 2006 No. 3, we reported on France's new participation-exemption régime, which is due to take effect from January 1, 2007. Under the régime, capital gains from the sale of qualifying shareholdings will be exempt from tax to the extent of 95%. The remaining 5% of the gain will be included in taxable income. However, currently, capital gains arising from the disposal of shareholdings within a group of companies are wholly exempt from corporate income tax. Including intra-group disposals in the new régime would therefore have resulted in a tax charge where there had been

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none previously. In order to prevent this, the Finance Act 2006 Amendment Bill includes a provision excluding intra-group disposals of shareholdings from the new régime. It is made clear that the new régime will apply only where shareholdings are sold outside the group or where either the vendor company or the company whose shares are being sold leaves the group.

2.3.2 Advance corporate tax payments go up

A further measure in the Amendment Bill increases the proportion of corporate income tax that companies have to pay in advance. From January 1, 2007, companies with a turnover of between EUR 1000 million (USD 1322 million) and EUR 5000 million (USD 6610 million) will have to pay 80% of their final corporate tax liability for the year in advance payments, whereas companies with a turnover greater than EUR 5000 million will need to pay as much as 90% in advance.

ECJ rules against France in Denkavit case
See under European Union, item 2.1.1.

2.4 Germany

2.4.1 Shape of 2008 tax reform emerges

Negotiations at government level between the parties in the governing coalition on the precise shape of the 2008 tax reform have resulted in a consensus that has been submitted to the parties for their agreement.

The proposals take the following broad shape.

- Germany's 'headline' rate of corporate tax would be cut from 25%

to 15%. The 5.5% solidarity surcharge originally imposed to help fund the costs of reunification would remain, resulting in a combined rate of 15.825%

- The trade tax on income will be maintained but a number of changes made to the calculation of the tax base and to its relationship with corporate tax. The current rule under which 50% of long-term debt is added back in calculating income liable to the trade tax would be scrapped and replaced by an add-back of 25% or 30% of all interest payable (whether short-term or long-term, and whether paid to related parties or third parties). In addition, 25% of the deemed interest element in lease, rental and royalty payments would also be added back to the trade-tax base. The deemed interest element would be fixed at 25% of the payment in the case of leases or rentals of movable property; at 75% of the leases or rentals of immovable property; and at 25% of royalties paid on intellectual property. The trade-tax multiple applied to the rate of trade tax, which is set locally, would be reduced from 5 to 3.5. Finally, trade tax itself would cease to be a deductible expense for corporate tax purposes. The combined effect of the changes to trade tax and corporate tax would be to decrease the average combined corporate and trade tax rate from 38.65% to 29.8%
- The thin capitalisation rules would be abolished and replaced by a general earnings-stripping rule, under which a company could deduct net interest payments (i.e. interest payable less interest receivable) from its profits liable

to corporate tax only to the extent that its pre-tax earnings (ignoring interest) were not thereby reduced by more than 70%. The rule would not apply at all unless the interest payable exceeded EUR 1 million in any year. Any disallowed interest could be carried forward to future accounting periods.

- The declining-balance method of calculating tax depreciation would be abolished
- Dividends and capital gains received by individuals would be removed from progressive taxation and instead be taxed at a single flat rate of 25%. Private capital gains hitherto exempt from tax if sold after the end of the so-called 'speculative period' (for example, holdings of less than 1% in a company, if sold after 12 months) would become taxable, however, under these rules. It is possible that this aspect of the reforms would not take effect until 2009

2.4.2 Anti-treaty shopping rules tightened

Germany has significantly tightened its anti-avoidance rules by adding extra tests foreign companies must meet before they qualify for reduced withholding tax rates on outbound dividends or royalties they receive from German companies. The new measures are contained in the *Jahressteuergesetz 2007* (Finance Act 2007) recently signed into law by the Federal President, and will take effect from January 1, 2007.

Currently, domestic German law overrides treaty benefits (and the benefits of the EC Parent-Subsidiary Directive or of the EC Interest and Royalties Directive, as the case may be) granting reduced or zero with-

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holding tax rates for dividends or royalties paid to a foreign company where the shareholders in the foreign company would not themselves have qualified for those benefits if they had received the payment directly from the German company and there is no clear business reason for interposition of the foreign company. This second leg, the 'business purpose' test, has been strengthened and two further tests added. All three tests will have to be passed by the foreign company for it to benefit from the reduced withholding rates.

The new business purpose test will be failed if there is no relevant economic or business reason for the company's existence. The test will be applied at the level of the foreign company itself, and not at that of its shareholders or subsidiaries. The German tax authorities have already indicated that asset protection, inheritance planning and legal-liability protection will not normally be accepted as valid business reasons.

The business activities test requires the foreign company to generate more than 10% of its annual gross income from its own business activities. Business activities will not include passive asset management, so dividends and interest will not be classed as income from business activities, but management fees may qualify if active management of subsidiaries is carried on.

The substance test will be failed if the foreign company does not have sufficient substance in the terms of personnel and premises to carry on its business. Outsourced activities and simple administrative functions will be ignored.

Inbound investment structures into Germany will have to be reviewed to see if they satisfy the new rules.

2.5 Italy

2.5.1 Regional IRAP tax reprieved by European Court

Contrary to expectations, the European Court (ECJ) has held that Italy's regional tax on productive activities (IRAP – *imposta regionale sulle attività produttive*) is compatible with the EC Treaty. The decision will have come as a welcome boon to the centre-left Prodi government, in its attempt to reduce the budget deficit.

IRAP is levied at a rate of 4.25% on the net value of production and is payable by most corporate and non-corporate enterprises. It had been thought, following the opinions of not one but two Advocates-General (see *BDO World Wide Tax News* 2006 No. 1) that the court would outlaw IRAP as having too many characteristics of a value-added tax. However, the ECJ ruled that IRAP had only two of the four characteristics of a turnover tax, and it would have had to have all four to be in breach of EC law.

2.6 The Netherlands

2.6.1 Wide-ranging tax changes enacted

We reported in the last issue (*BDO World Wide Tax News* 2006 No. 3) on the extensive changes to the Netherlands tax system then under discussion in Parliament and on the likelihood that they would be enacted, whatever the result of the general election held on November 22nd. That has indeed come to pass, and the new measures generally come into effect on January 1, 2007.

The changes are as described previously. As a reminder, the most important changes are these:

- The corporate tax rate is cut to 25.5%. Lower rates of 20% and 23.5% will apply to the first EUR 25 000 and the next EUR 35 000 of profits respectively.
- Patent royalties and intra-group interest will be separately taxed at a flat rate of 10% and 5% respectively, in their own 'box' at the option of the company.
- The participation exemption has been simplified. Even if the investee company is located in a low-tax or zero-tax jurisdiction, dividends and gains will qualify for the exemption as long as the Netherlands investor company has a holding of at least 5% and the investee company is an active company. If the investee company is passive, the exemption will still apply if its profits (calculated under Netherlands rules) are subject to a tax of at least 10%
- Tax losses may now be carried back for one year only and forward for a maximum of nine (subject to transitional provisions)
- The general rate of dividend withholding tax is reduced from 25% to 15%

The treatment of patent royalties and intra-group interest needs to be approved by the European Commission, but this is expected to be a formality.

2.7 Poland

2.7.1 New residence rules for individuals

From January 1, 2007, individuals who are present in Poland for more

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than 183 days in any calendar year will be considered resident in Poland for tax purposes, thus becoming liable to Polish income tax on their world wide income. Those individuals who do not spend more than 183 days in Poland in any one year will nevertheless be resident if Poland is the centre of their personal and economic interests.

This new statutory rule replaces the previous provision in the Civil Code under which a person was considered resident in Poland only if he or she had a place of abode in Poland and his or her stay in the country was intended to be permanent. There was no separate definition of residence for tax purposes.

The top rate of income tax in Poland in 2007 is 40%, payable on the slice of taxable income exceeding PLN 85 528 (EUR 22 625; USD 29 800).

2.8 Portugal

2.8.1 Portuguese private residence exemption held to be unfair

Portugal's capital gains exemption for a disposal of a private residence has been held to be in breach of the EC Treaty by the European Court of Justice.

Under Portuguese law, an individual who sells his or her private residence (the home permanently used as a residence by the individual or the individual's family) will not be subject to income tax on any gain arising from the sale provided that the proceeds of the sale are used to reacquire another private residence in Portugal. The relief is not available if the taxpayer uses the proceeds to acquire a home abroad. A number of other conditions apply.

The European Court has held that this rule is in breach of the EC Treaty principle guaranteeing the free movement of persons within the EU, since it discriminates against both foreign nationals wishing to leave Portugal after a period of temporary residence and Portuguese nationals wishing to settle temporarily or permanently in another EU Member State.

It is not yet clear how Portugal will react to the decision.

2.9 Spain

2.9.1 Corporate tax rate cut

Spain is to reduce its rate of corporate tax, currently 35%, by two steps of 2.5% over the next two years. For the year 2007, the rate will be 32.5% and for 2008 and subsequent years, 30%. This two-year phased reduction replaces the original proposal (see BDO *World Wide Tax News* 2006 No. 1) to achieve the same reduction in 1% steps lasting until 2011.

However, the rate cut is mixed news for taxpayers, as Spain will progressively be abolishing certain tax credits, such as those for research and development, export activities and environmentally beneficial investments over the same time period.

2.9.2 Anti-avoidance measures enacted

The anti-avoidance measures foreshadowed in BDO *World Wide Tax News* 2006 No. 2 (June 2006) have been enacted. These include:

- New transfer pricing regulations requiring all related-party transactions to be valued at market value

- A deemed residence rule whereby companies resident in a tax haven whose assets are predominantly situated in Spain will be considered resident in Spain unless they have been established in the haven for *bona fide* business reasons and are effectively managed there
- Secondary liability for VAT for traders purchasing goods that they could reasonably have presumed are involved in a carousel fraud

2.9.3 Savings income to be taxed at flat 18%

Individual taxpayers will from 2007 be taxed at a single flat rate of 18% on dividends, interest and other savings income, and on capital gains from investments. Savings income and gains will no longer be subject to progressive rates of income tax.

By the same token, rates of withholding tax on savings income and gains paid to non-residents will be adjusted to 18% also. This means an increase in the withholding rate on dividends and interest (currently 15%), but a virtual halving of the withholding tax on capital gains (down from 35%). These general rates will remain subject to tax treaties, which may specify lower rates.

2.10 United Kingdom

2.10.1 Pre-Budget signals limited reform of CFC rules

In probably his last Pre-Budget Report as Chancellor of the Exchequer, Gordon Brown announced forthcoming changes in the UK's controlled foreign company (CFC) legislation, to take account of the European Court's judgment in the *Cadbury Schweppes* case (see BDO

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World Wide Tax News 2006 No. 3) but few other significant tax changes.

The Pre-Budget Report is in effect a foretaste of what the Chancellor intends to include in his Budget speech proper, which is normally delivered in March or April.

The proposed changes to the CFC legislation have disappointed business and advisers, but are clearly limited to the minimum that the Government believes is necessary to bring UK law into compliance with EU law as interpreted by the Court.

Under the new proposed rules, where a CFC has individuals working for it in an EU Member State or in another EEA state with which the UK has a tax enforcement agreement (i.e. only Iceland and Norway), and carries on genuine economic activity there, its UK parent would be able to claim a reduction in the CFC's profits otherwise chargeable to the UK parent in respect of the 'net economic value' directly attributable to the work of those individuals. 'Net economic value' would be strictly interpreted to exclude profits derived from capital or savings.

Other changes would replace the current definition of 'effectively managed' in the exempt activities exclusion from the CFC rules by one drawn from the *Cadbury Schweppes* judgment, but for EEA-located CFCs only. The exclusion from the CFC rules for CFCs publicly quoted on a foreign stock exchange is to be abolished. It is doubtful whether these changes go far enough to bring UK law into line with *Cadbury Schweppes*, and a further round of litigation cannot be ruled out if the legislation is enacted as currently drafted.

2.10.2 UK's system of taxing foreign dividends is partly discriminatory

Several, but not all, aspects of the way the UK taxes foreign dividends received by UK companies have been held by the European Court to be in breach of both the principles of freedom of establishment and free movement of capital of the EC Treaty. The Court came to this conclusion in a lengthy and at-times confusing judgment in the *Test Claimants in the FII Group Litigation* case (Case C-446/04). The judgment also dealt with aspects of the former ACT (advance corporation tax) and FID (foreign income dividend) schemes.

Essentially, the Court decided that:

- In the case of portfolio dividends (where the UK company has a holding of less than 10% in the distributing company), the UK system of taxing these dividends but not allowing credit for foreign underlying tax paid by the distributing company, whereas UK-to-UK intercorporate dividends are exempt, was not acceptable under EU law
- In the case of dividends from companies in which the recipient UK company has a holding of at least 10%, the UK system of taxing these dividends but allowing credit for foreign underlying tax paid by the distributing company was in principle acceptable under EU law, but it was for the UK courts to determine in each case whether in practice there were 'exceptional cases' where unfair treatment could be established

In our view, such cases, where the tax rate on the foreign dividend (effectively 30%) would have been

lower had the foreign company been UK-based, are far from exceptional. Examples include instances where the foreign company could have claimed research & development credits had it been UK-resident. It is disappointing that the Government has not recognised this, and prevented another costly round of litigation before, as we believe, it will be obliged to overhaul the whole way in which foreign dividends are taxed.

The case also involved aspects of the former ACT system. The Court found that both the system under which an ACT credit was available to UK companies on UK dividends but not on foreign dividends, and the system under which surplus ACT could be surrendered to UK subsidiaries but not to foreign subsidiaries were in breach of the EC Treaty. However, the rule requiring ACT to be set off against UK tax as reduced by double tax relief, was acceptable. It was for the UK to decide on the procedures under which companies claiming compensation for the effects of the unlawful system could be heard. ACT was abolished in 1999.

Finally, the Court also considered the former FID system, in operation between 1994 and 1999. Introduced to mitigate the effects of the interaction between ACT and foreign tax credits, the scheme allowed UK companies to recover ACT paid on dividends to shareholders to the extent that those dividends were matched by foreign dividends it had received. Such dividends were called 'foreign income dividends' (FIDs). However, individual shareholders receiving FIDs were not entitled to a tax credit corresponding to the ACT, whereas they were so entitled in respect of a normal UK dividend. The Court rules that this system was in breach of

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both the freedom of establishment and the free movement of capital. However, the question of whether the effect of the decision is limited to intra-EEA dividends or extends to foreign dividends from third countries is to be interpreted by the UK courts. If the FID régime was in effect only a relaxation of the system existing on December 31, 1993, dividends from third countries fall outside the scope of the judgment. If the courts decide it was a new restriction, the judgment will apply to third-country dividends also.

2.10.3 UK largely vindicated on ACT treaty refund system

In another case involving the former ACT, this time concerned with outbound dividends, the European Court has held that the UK was not obliged to extend equal treatment to all other EU Member States in its bilateral tax treaties with them on the question of ACT credits.

In *Test Claimants in Class IV of the Advance Corporation Tax Group Litigation v Commissioners of Inland Revenue* (Case C-374/04), the issue concerned the UK's double tax treaties with various other Member States. Before ACT was abolished in 1999, UK companies receiving UK dividends were entitled to a tax credit representing the ACT paid by the company distributing the dividend. Non-resident companies receiving UK dividends were not so entitled. In some of the UK's tax treaties with other Member States, however, the UK granted refunds of all or half of the ACT concerned to companies resident in the treaty-partner country, subject to a deduction of UK tax on the amount refunded. Treaties with other Member States did not provide for such a refund. The taxpayers claimed

that this was a form of discrimination in breach of the freedom of establishment and the free movement of capital articles of the EC Treaty.

The European Court, however, held that the EC Treaty did not oblige the UK to give equal treatment to each Member State.

2.10.4 Six-year time limit on tax claims

The UK will also be imposing a time limit of six years for all claims for repayment of direct taxes, according to the Pre-Budget report.

This action follows the decision of the House of Lords in October in the *Deutsche Morgan Grenfell* case, in which the Lords held that claims for restitution of tax paid under a mistake of law could be made up to six years after that mistake could reasonably be considered to have been discovered, and not, as the tax authorities had maintained, only up to six years after the tax had been paid. The case has its origins in the 2001 decision by the European Court in the *Metallgesellschaft* case that the UK had unlawfully denied EU parent companies the right to opt to receive dividends from their UK subsidiaries free of advance corporation tax (ACT), whereas that right existed for UK parents.

Concern on the part of the Government that the taxpayers might ultimately be successful had already resulted in legislation in 2004 imposing a six-year limit from the time of payment in respect of claims made after September 7, 2003. The new legislation, to feature in the 2007 Finance Act, is intended to apply to actions for rectifying a

mistake of law brought before September 8, 2003.

However, neither the existing legislation nor the proposed new legislation allows for a six-month transitional period during which taxpayers who may be affected may lodge claims, as an earlier decision of the European Court would clearly appear to suggest. It is distinctly possible therefore that both are in breach of the EC Treaty and may give rise to litigation in themselves. ■

3 Asia Pacific

3.1 Australia

3.1.1 Restructuring for foreign-owned groups to be made easier

The Government has announced measures to make it easier for groups of companies headed by a foreign parent to restructure without incurring significant tax consequences.

Under Australia's corporate tax system, it is possible for groups of companies to file a single consolidated return and be taxed as a single entity. A group in which all the companies are ultimately owned by a foreign parent and which has no intermediate Australian holding entity is known as a 'multiple-entry consolidated' (MEC) group. MECs qualify for group consolidation, but if an ordinary consolidated group converts to a MEC group, there are a number of tax consequences, such as:

- a possible cancellation of tax losses brought forward
- capital losses spread over five years may become immediately deductible
- the tax cost-setting rules apply to the assets of continuing group members
- the new group cannot take over the 'tax history' of the previous group

even though there may only be a minimal change to actual group membership.

Under the new proposals, conversion of a consolidated group to an MEC

group would not normally trigger any of the consequences above, thereby also reducing compliance costs.

3.2 Hong Kong

3.2.1 VAT not to come to Hong Kong

The seemingly inexorable spread of value-added tax world wide has been halted, at least in Hong Kong. After public consultation had produced an overwhelmingly negative response, the Government has decided not to proceed with the introduction of the Goods and Sales Tax, originally scheduled for 2010.

The search for alternative sources of finance (such as a capital gains tax, perhaps) continues.

3.3 India

3.3.1 Finance costs of share issue not deductible

The Indian Supreme Court has held that expenditure incurred by an insurance company in making an issue of bonus shares was deductible in computing its profits subject to income tax. The decision revolves around the distinction between revenue and capital expenditure.

In *Commissioner of Income Tax v General Insurance Corporation*, the company claimed a deduction for stamp duty and registration fees paid on the share issue. The tax authorities disallowed the claim on the grounds that the expenditure was not revenue expenditure, but capital expenditure (which is not deductible), since it was incurred in direct relation to a capital asset, namely the company's

share capital. The case eventually found its way to the Supreme Court for a final decision.

In the Supreme Court's opinion, issuing bonus shares by capitalising reserves constituted nothing more than a reallocation of the company's funds, without any influx of new cash or increase in the capital employed. Therefore, it could not be said that the company had thereby acquired any benefit or advantage of an enduring nature from the expenditure (one of the tests of what constitutes capital expenditure). The issue of bonus shares in this case did not result in any change in the capital structure of the company. Hence, the Supreme Court concluded that the expenditure incurred by the taxpayer on the issue of bonus shares in these circumstances was revenue expenditure and therefore deductible. ■

4 Latin America

4.1 Brazil

4.1.1 Individual income tax rates and bands adjusted

Income-tax bands will be adjusted by 3% for 2007, following agreement between the Government and the Budget Commission. A further 3% adjustment will also be made in 2008, amounting to an indexation of 6.09% over the two years.

All currency amounts are shown in Brazilian *reais*. At the time of going to press, the exchange rate for the *real* (BZR) against the euro was EUR 1 = BZR 2.8363 and against the US dollar was USD 1 = BZR 2.1536. The top income tax rate in 2007 will thus apply to the slice of monthly income above approximately EUR 912.25 or USD 1201.50.

The discount per dependant to which taxpayers are entitled will increase from BZR 126.36 to BZR 130.15.

There will also be an increase of 7.14% in the minimum wage in 2007, which will accordingly be fixed at BZR 375 (EUR 132; USD 174) per month.

4.1.2 Exchange control regime improved

A new Law on Foreign Exchange Transactions enacted on November 29, 2006, contains the following significant measures relating to both

the import and export of foreign currency.

Foreign exchange transactions

Foreign currency funds obtained from exports of goods and services from Brazil by legal entities or individuals may be kept with a financial institution abroad.

Funds kept abroad may only be invested or used to settle an obligation of the exporter. The funds may not be applied to make loans of any nature.

Income from services provided to an individual or legal entity domiciled abroad is exempt from PIS (income tax on profits) and COFINS (social security tax), regardless of the actual inflow of foreign currency.

The option to keep such funds with a financial institution abroad may be exercised if the financial institution or any other intervening party, or parties residing, domiciled or located abroad provide information about their use to the Brazilian Federal Revenue Service (SRF). The exact manner of providing this information is still to be confirmed.

These measures await regulation by government agencies.

Registration of foreign capital in Brazil

The new law provides that foreign capital invested in legal entities in Brazil and not yet registered or sub-

ject to any other type of registration must be registered in Brazilian *reais* with the Central Bank of Brazil (BACEN). That amount of foreign capital as registered must then be included in the accounting records of the Brazilian legal entity that receives the foreign capital, pursuant to prevailing legislation.

Foreign capital in Brazilian *reais* already in existence on 31 December 2005 must be regularised by June 30, 2007.

If the foreign capital is first recorded in the books during 2006, the accounting entry should be made by the last business day of the calendar year subsequent to that of the accounting year in which the legal entity has to register the capital.

BACEN will disclose data included in the registration addressed by the law and the National Monetary Council will rule such provision.

Violations of the rule on registration of foreign capital in Brazilian *reais* with BACEN will result in the imposition of a fine ranging from BZR 1000 to BZR 250 000 (EUR 350 – EUR 88 150; USD 465 – 116 075). The National Monetary Council will establish the amount of the fine and possible mitigation or waiver. ■

The changes result in the following rates and bands for 2007 as compared to 2006:

2007		2006	
Monthly taxable income	Rate	Monthly taxable income	Rate
0 – 1294.84	0%	0 – 1257.12	0%
1294.85 – 2587.46	15%	1257.13 – 2512.08	15%
2587.47 and above	27.5%	2512.09 and above	27.5%

Update on the 2007 Italian personal income tax rates

The 2007 Financial Law went into effect on January 2nd. One of the most significant changes to the tax code presented by this law is the new personal income tax rates and brackets, as shown in the below table.

From	To	Tax rate
0	15.000	23%
15.001	28.000	27%
28.001	55.000	38%
55.001	75.000	41%
75.001	and up	43%

In addition to the rate changes, personal deductions have changed to tax credits, and they are now subject to phase out. Not all of the proposed changes have been finalized yet, but we will include them in our regular Global Expatriate Newsletter when we have more information. To read the latest edition of the Global Expatriate Newsletter, please visit <http://www.bdo.com/about/publications/tax/expatnews/December%202006%20Expat%20Newsletter.pdf> If you would like to receive this newsletter delivered to your inbox, please send an email to bdoclientsand-contacts@bdo.com to request a subscription.

Coming Attractions

Webinars

January 9 Corporate Governance & Internal Controls for Equity-Based Compensation

Time:
12:00-1:00 PM EST + 30 minutes for
Questions & Answers

Place:
This interactive seminar will be held over the Internet using a combination of LearnLive University webinar platform for the visual presentation and a conference call for the audio portion.

Speakers:
Abe Hitti, Director, Risk Advisory Services Practice

Peter Klinger, Director, Compensation & Benefits Practice

CPE: 1 credit in the field of Taxation

Prerequisites and Advanced Preparation: None

Cost: There is no charge for this webcast.

Details:
This interactive, CPE-qualified discussion of the issues related to audit issues and FAS 123R will include such topics as:

Background & Current State

- Accounting Issues
- Disclosure
- Expense Recognition
- Settlement

- Tax Violations & Fas 109
- Software Tools
- Valuation

Sound Internal Controls

- Elements of a Sound Program
- Errors & Risks
- Comprehensive Framework
- Key Constituents
- Control Objectives
- Controls

Going Forward & Next Steps

Enrollment:

This webcast is being delivered from LearnLive University. Participants can enroll and attend from their own computer OR enroll and participate as part of a group in your office. Whether you are attending as part of a group or as an individual, ALL

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Coming Attractions continued

Webinars continued

participants MUST enroll themselves ONLINE before the day of the webcast.

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Individuals NOT affiliated with BDO, please visit: https://university.learnlive.com/content/public/1029/accessinstructions/bdoonlinecpenetwork_web.html

BDO International Member Firms, please go to: <https://university.learnlivetech.com/bdointernational>

After you register, you will receive an email confirmation and a reminder email approximately 24 hours before the webcast. If you have any questions on enrolling, canceling enrollment, other administrative policies or technical support issues, email BDOonline_support@learnlivetech.com or call 1-888-228-4188.

January 10, 2007 R&D Tax Credit Extended & Modified

Time:

1:30-2:30 PM EST + 30 minutes for Questions & Answers

Place:

This interactive seminar will be held over the Internet using a combination of LearnLive University webinar platform for the visual presentation and a conference call for the audio portion.

Speakers:

Chris Bard, R&D Tax Services, National Leader

Randy Friedman, R&D Tax Services, Western Regional Leader

Jonathan Forman, R&D Tax Services, East & Southwest Regional Leader

CPE: 1 credit in the field of Taxation

Prerequisites and Advanced Preparation:

None

Program Level:

Update

Details:

This interactive, CPE-qualified discussion arises from the recently passed legislation extending and modifying Section 41 of the Internal Revenue Code, "Credit for Increasing Research Activities." Among other things, the legislation enables companies to:

- Claim credits for expenses incurred in 2006 and 2007;
- Elect an Alternative Simplified Credit, potentially beneficial to companies subject to more than the minimum base amount; and
- Elect an increased Alternative Incremental Credit.

During this webinar we will discuss :

- These new credit opportunities, including their effective dates and transition rules;
- FAS109/FIN 48 and other financial statement reporting issues;
- Other recent IRS releases, including:
 - Final Regulations regarding the computation and allocation of the credit for controlled groups; and
 - Statistics regarding who's claiming the R&D credit.

Enrollment:

This webcast is being delivered from LearnLive University. Participants can enroll and attend from their own computer OR enroll and participate as part of a group in your office. Whether you are attending as part of a group or as an individual, ALL participants MUST enroll themselves ONLINE before the day of the webcast.

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Individuals NOT affiliated with BDO, please visit: https://university.learnlive.com/content/public/1029/accessinstructions/bdoonlinecpenetwork_web.html

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January 12 Ac'sense 2006 Year-End Technical Update

Time:

12:00 PM to approximately 2:30 PM EST (9:00 AM to approximately 11:30 AM PST).

Place:

This interactive webinar will be held over the Internet using the BDO Online CPE Network.

BDO Seidman, LLP Speakers and Topics:

Ben Neuhausen, Partner and National Director of Accounting
Accounting Update

Jeff Lenz, Partner, National SEC Department
SEC/Financial Reporting Matters

Liza Prossnitz, Director, National SEC Department
SEC/Financial Reporting Matters

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Coming Attractions continued

Webinars continued

Susan Lister, Partner and National Director of Audit Policy
Internal Control Update

Registration and Further Details:

Please go to the website below for further information and registration instructions:
<http://www.bdo.com/acsense/2006AnnualYETechnicalUpdate.asp>

To register directly, go to the website below and use company code **506201**.
<https://university.learnlivetech.com/bdoonline>

January 25

Mandatory E-File Is Here – Are You Ready?

Time:

1:30-2:30 PM EST + 30 minutes for Questions & Answers

Place:

This interactive seminar will be held over the Internet using a combination of LearnLive University webinar platform for the visual presentation and a conference call for the audio portion.

Speaker:

Steve Buschel, Tax Partner, New York

CPE: 1 credit in the field of Taxation

Prerequisites and Advanced Preparation:

None

Program Level: Advanced

Details:

During this webinar we will discuss:

- 1- Filing requirements
- 2- Attachments and disclosures
- 3- Rejected filings
- 4- Waivers

Enrollment:

This webcast is being delivered from LearnLive University. Participants can enroll and attend from their own computer OR enroll and participate as part of a group in your office. Whether you are attending as part of a group or as an individual, ALL participants MUST enroll themselves ONLINE before the day of the webcast.

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