

**U.S.: Pending Legislation**  
**JOBS Act**  
**(S.1637/H.R.4520)**

Once the final shape of the currently pending repeal legislation is known, we will be announcing a Webex seminar to discuss all aspects of this landmark legislation and we will issue a tax alert.



# International Tax

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## CANADA:

### GAAR to Apply to Canada's Tax Treaties

Since 1988, Canadian domestic tax law has contained a general anti-avoidance rule (GAAR). The government's view is that the GAAR is intended to prevent abusive or artificial avoidance schemes, without interfering with legitimate commercial transactions. It does so by giving the Canadian tax authorities the ability to deny any tax benefit obtained as a result of the particular offensive avoidance transaction, or series of transactions.

The Canadian tax authorities (the Canada Revenue Agency or CRA) have always held the view that GAAR could also apply to the wording in Canada's bilateral tax treaties. Most experts in the Canadian tax community, however, have disagreed, noting that the wording in the Canadian law states that GAAR can only apply when there has been a misuse or abuse of the provisions of the Canadian Income Tax Act. As a bilateral tax treaty is not part of this Act, it was difficult to understand the CRA's position.

Faced with this uncertainty, the Canadian government has acted in its recent 2004 Federal Budget. The budget proposes that the GAAR will apply to a misuse or abuse of a tax treaty. The proposals state that this

chance will be retroactive to 1988, the year that GAAR was enacted.

This is a significant development for any taxpayer who is involved in international tax planning and plans on relying on a provision of one of Canada's bilateral tax treaties. Canadian GAAR will now have to be considered when determining the risks with any plan.

Do not neglect to consider the potential impact of GAAR in any tax plan involving Canada. It's now even more important if the recent proposals of the Canadian government are enacted. Contact your BDO member firm advisor if you want more information on how this proposal might affect you. ■

**AUSTRIA:**

## **Austria Cuts Corporation Tax and Introduces New Consolidation Régime**

**Austria is to reduce its rate of corporation tax from 34% to 25% effective January 1, 2005. It is also replacing its group tax consolidation régime from one closely modeled on the German *Organschaft* system to one more resembling the standard European model.**

Currently, in order to form a tax group, companies have to sign a profit-pooling agreement, under which they share profits and losses. The subsidiaries also have to be integrated on a financial, organizational and economic basis with their parent. The parent's minimum direct or indirect holding in each of the subsidiaries is 75%. Only Austrian-resident entities can form part of the group.

Under the new rules, there is no profit-pooling or integration require-

ment. Instead, the parent company needs to have a direct or indirect holding of more than 50% of the share capital and voting rights. Foreign subsidiaries may also be included in the group under certain conditions. The parent may be a resident company or cooperative or, in certain circumstances, a non-resident company. Non-resident companies may be parents of an Austrian group if they are comparable to a resident company or have their place of man-

agement in the EEA, or have a branch in Austria and the shareholdings in the subsidiaries are attributable to that branch. Partnerships, syndicates and other associations may be parents if their members are qualifying entities. As now with the *Organschaft*, the profits and losses of group members will be consolidated with the parent, which will be taxable on the consolidated profit or loss. ■

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**GERMANY:**

## **Germany Encourages Venture Capital And Private Equity Funds**

**The Lower House of the German parliament on June 18, 2004 approved a law, setting up what appears to be a boost for the German VC and Private Equity market. Taking effect retroactively, this law benefits funds that are set up after March 31, 2002, or investments sold or acquired after November 7, 2003.**

Subject to approval of the Upper House of parliament (widely expected shortly), a new provision provides a more favorable and internationally competitive capital gains tax treatment of management's carried interest – that is, the disproportionate (compared to the equity investment)

share of gains allocated as an incentive to the fund's management.

Rather than fully taxing the carried interest as consideration for services the funds executives/managers provide to the investors, the legislation proposes that the carried interest be

subject to the half-income method (i.e., only 50% of the carried interest will be taxable, provided the underlying profit consists of capital gains).

Together with two key regulatory decrees published in December 2003 on the income tax treatment of venture capital and private equity funds and the VAT treatment of the carried interest paid by a German private equity fund, this new law may allow the industry to enjoy a more favorable tax environment and make German funds competitive with funds established elsewhere. ■

**FINLAND:**

## Finnish Imputation System for Dividends Probably Unlawful

The European Court has been busy elsewhere too, and its forthcoming decision in another case is, in contrast to the *Sudholz* case, likely to be bad news again for Europe's tax authorities.

The latest case (*Petri Manninen*, Case C-319/02) has been brought by an individual resident in Finland receiving dividends from a Swedish company. Under Finland's imputation system, which is similar to that of other EC member states, individuals receiving dividends from Finnish companies are credited with a tax credit for

the Finnish corporation tax paid by the distributing company, while foreign dividends, where no Finnish corporation tax had already been paid, are more highly taxed than domestic dividends.

The taxpayer argued that the tax on foreign dividends constitutes a disincentive to the free movement of capi-

tal and is thus in breach of the EC Treaty. The Advocate-General in her opinion agrees, and contends that the Finnish system imposes double taxation on foreign dividends (looking at the EC as a whole), even though they are taxed only once in Finland.

The court has yet to give its final judgment, but it is rare for it to disagree fundamentally with the Advocate-General. This is yet another example of the European Court overturning national tax laws for the benefit of taxpayers. ■

**U.S.: Form TDF 90-22.1**

## Report of Foreign Bank and Financial Accounts

Taxpayers are responsible for filing Form TDF 90-22.1, by June 30, 2004. Subject to certain exceptions, any U.S. person (i.e., individual, corporation, partnership, trust or estate) who has a signature authority or direct/indirect financial interest in a foreign financial account (including bank, securities, or other types of financial accounts) in a foreign country that exceeds \$10,000 in the aggregate at any time during the calendar year, must report such accounts by filing TDF 90-22.1.

Notably, this disclosure also applies where the U.S. officer/shareholder/partner of the U.S. company has signature authority over a foreign subsidiary's foreign bank account. In addition, taxpayers who are currently filing Form 5471, Form 8865 or Form 3520 may also be subject to FBAR reporting requirements.

Willfully failing to file a FBAR report can be punished under both civil and criminal law. Civil penalties may result in a fine equal to the balance in the account at the time of violation up to a limit of \$100,000, or \$25,000, whichever is greater. Criminal penalties could, under certain circumstances, amount to a fine of up to

\$500,000 and imprisonment for up to 10 years.

Note that persons required to file federal income tax returns must also answer the question on the return as to whether or not they have a financial interest in or signature over a foreign account, and whether the aggregate value of the accounts is over \$10,000 during the whole year. Failing to respond to the foreign bank account question could violate IRC Section 7206(1) if the taxpayer signing such a return knew that the return was not "true and correct as to every material matter." ■

**U.S.: Form 8820**

## Residency Certification Update

The IRS has announced that beginning July 5, 2004, U.S. tax certification must be obtained by using Form 8802, Application for United States Residency Certification. This new date replaces the original effective date of March 17, 2004. An excerpt from our January 2004 International Tax Alert, set forth below, outlines these new rules (our January alert is still available at: (<http://www.bdo.com/about/publications/tax/index.asp>).

U.S. treaty partners routinely require proof of U.S. residency to secure the benefits of a U.S. tax treaty. Form 6166, U.S. Residency Certification Letter, is issued by the U.S. Department of Treasury and submitted to the foreign country's withholding agent or representative to certify such U.S. residency. Currently, a Form 6166 is secured upon written petition to the U.S. Treasury. Form 8802, Application for United States Residency Certification, has replaced this written petition. The IRS promises that a Form 6166 or a rejection

notification will be issued within 30 days of filing the Form 8802.

Form 8802 provides a uniform method of application for certification. Moreover, certain foreign countries (e.g., Spain and the U.K.) have requirements for proving U.S. residency that go beyond the "standard" requirements – Form 8802 addresses these additional requirements.

Form 8802 may also be used to apply for proof of tax status for other purposes, such as obtaining an exemption from a value added tax (VAT) imposed by a foreign country. ■

**U.S.:**

## Expatriate Taxation – A New Threat to IRC Section 911 Exclusion

Section 632(c) of the Jumpstart Our Business Strength (JOBS) Act, which was passed by the Senate on May 11, 2004, would limit the foreign earned income and housing exclusions permitted to Americans working overseas to a combined \$80,000 for both the housing and earned income amounts in total. Since almost all Americans working overseas have foreign earned income in excess of \$80,000, the practical effect of section 632© would be to preclude any housing cost from being excluded from gross income under section 911 of the Internal Revenue Code. Under

existing rules, Americans working overseas can exclude from gross income the cost of housing provided by their employers to the extent that the housing costs are reasonable and in excess of a certain threshold amount. A modification of the exclusion as set out in the JOBS Act would raise taxes on American workers abroad, as well as on their employers who frequently maintain tax equalization programs for their expatriate workforce. Given that the Senate and House bills will likely go to conference this summer, input from taxpayers may once again win the day. ■

**U.S.:**

## International Task Force to Tackle Avoidance

The tax authorities of four leading English-speaking countries – the U.K., the U.S., Canada and Australia – have announced the setting-up of a joint task force to tackle international tax avoidance. To be based in Washington, the force is charged with "addressing challenges arising from abusive tax transactions." Tax officers from the four countries will share experiences and exchange information on specific "abusive" transactions and their promoters. It is too early to tell what impact the task force will have. ■

**EUROPE:**

## VAT Recovery on Leased Cars

A European Court case, *Finanzamt Sulingen v Walter Sudholz* (C-17/01), has, contrary to expectations, confirmed that the 50% block on VAT recovery with respect to leased cars is lawful.

**BRAZIL:****Brazilian Tax Savings Opportunities: New COFINS & PIS Taxes**

The recently enacted changes to the Brazilian revenue-based COFINS (Contribution for the Financing of Social Security) and the PIS (Social Integration Program Contribution) taxes raise several opportunities for companies to restructure and rethink their Brazilian businesses going forward.

The original idea behind the changes to these taxes, initiated in 2002, was to make them non-cumulative, only levied on the mark-ups from the manufacturer through to the retailer. By raising the tax rates and allowing a credit system for listed expenses, the taxable basis was transformed from “gross revenue” to “adjusted net revenue.” In this way, expenses such as electricity, fuel, leases, interest, asset depreciation, etc. incurred by the taxpayer can be credited for the purposes of calculating monthly PIS and COFINS taxes.

The PIS tax had been raised from 0.65% to 1.65% in 2002 and the COFINS tax rate was raised from 3% to 7.6% as of February 1, 2004. Credits are not allowed for major ticket items such as labor costs. In addition, as per recently enacted rules, the COFINS and PIS will also be charged on the import of goods and services from overseas. In this case, the taxpayer is the importing company. For import companies, the rates are between 1.65% and 2% for the PIS tax purposes and between 7.6% and 10.3% for COFINS tax purposes depending on the product or service being imported.

Unfortunately, notwithstanding the noble objective of reducing the cascade effect these taxes had on all production phases, the credit system

adopted has more than doubled the tax burden of many companies for tax purposes (especially for service and import companies). This has significantly increased the tax cost of doing business in Brazil.

The legality of these tax changes is currently being challenged by taxpayers on the basis that these new rules treat taxpayers differently and that their enactment was illegal in view of the current constitution (they were brought about through provisional measures, whereas only complementary laws can increase tax and not provisional measures).

**Recommended Action:**

There are several situations in which the PIS and COFINS tax burden can be minimized for both Brazilian and U.S. purposes. For example: (i) the credit system adopted allows taxpayers to choose to outsource some non-core activities and to elect a lease instead of ownership of real estate or machinery and/or equipment; (ii) the local company can obtain a loan to generate interest expenses. In all, the changes invite a thorough examination of your company’s business activities in Brazil to analyze how best to take advantage of credit-generating opportunities and, at the same time, save on the newly transformed COFINS and PIS taxes. ■

**JAPAN:****New Laws Reduce Required Capital**

On June 9, agreement was reached among Japanese lawmakers to do away with the minimum capital requirement for incorporations, while generally increasing the amount of required financial disclosure. This liberalization is expected to be formalized next year in the regular session of the Diet.

Likewise, under the amendment in the Commercial Law, the requirement of increasing capital to 10 million yen within a 5-year period would be deleted, but a condition might still be imposed. A METI spokesperson explained that if the law is amended, the increase in capital would not be necessary, but there should be necessary financial disclosure requirements. The hope is that this will serve as an incentive for start-up companies. ■

## SPECIAL CHINA SECTION

China:

## Clarity Provided Regarding Taxation of China Representative Office

Under Chinese rules, foreign companies may establish branch companies in China. For lack of implementing guidelines, however, foreign companies (except foreign banks and a few insurance companies) have been unable to register a branch in China. Instead, foreign companies have been allowed to establish representative offices (ROs) in China since the early 1980s.

Most tax rules on ROs were formulated in the 1980s. Those rules established three methods for an RO to pay tax if it is not exempt from tax:

- Actual revenue and net income
- “Appraised” revenue and net income
- An “expenses-plus” formula.

The State Administration of Taxation (SAT) in 1996 issued tax Notice 165, listing which activities are taxable and which are tax-exempt, and confirmed that the tax authority should assess and decide the method of tax payment for an RO upon its establishment.

Because the power to decide an RO’s method of tax payment rested with the tax authority and the relevant rules provided only general standards, the decision process was very much discretionary, and to some extent chaotic. It was not unusual for a local tax bureau (in charge of business tax matters) and a state tax bureau (in charge of enterprise income tax matters) to have different assessments on the same RO’s method of tax payment. Also, if a foreign company had several ROs in different locations, the ROs, which engaged in the same business activi-

ties, could obtain different assessments from tax bureaus in different locations. In addition, once a tax bureau decided the applicable method of tax payment for an RO, that method would remain unchanged, notwithstanding that the RO may have substantially changed its activity model.

The SAT tried to clarify the administration of ROs through a circular (No. 249), effective July 1, 2003. The Notice sets out the tax administration policy for ROs, including filing and payment obligations.

This same circular also clarifies the tax treatment of ROs whose head offices are engaged in the “trading of self-manufactured products.” If the head office imports products into China, ROs that conduct market research and carry out other ancillary functions will be subject to tax on a cost-plus basis. If the head office exports products from China and the ROs’ activities are limited to market research and other ancillary functions, the ROs will be tax-exempt.

Many were confused by the circular, as it implied that all ROs of foreign trading companies, regardless of

whether the parent company was engaged in principal (direct) trading or agency trading, are taxed according to the cost-plus method.

With this most recent circular (No. 568), the SAT has clarified that an RO of a foreign company that engages in principal (direct) trading continues to qualify for a tax exemption, provided two conditions are satisfied.

First, the foreign company must engage in principal (direct) trading, which means its business activities are to purchase goods, take title to goods, and sell goods directly to its customers in China. In other words, the foreign company must purchase and sell on its own account and assume credit risk; it may not engage a third-party agent to sell its goods on its behalf.

Second, the RO must only carry out market research and perform other preparatory and auxiliary activities for its parent company.

With the issuance of the Circular, the SAT has made it clear that ROs of foreign companies that are engaged in principal (direct) trading activities will be exempt from tax in China. ■

## SPECIAL CHINA SECTION

### CHINA:

## June 30 Deadline for Individuals Filing for Amnesty

On March 11, 2004, China announced an amnesty program to encourage foreign individuals to comply with any past due filing requirements. The announced deadline for this amnesty program is June 30, 2004.

Foreign residents are subject to income tax in China on their employment income earned in that country if they are present for more than 90 days within a calendar year (183 days if they are covered under an income tax treaty such as the U.S./China treaty) or if their employment costs are borne by a P.R.C. entity or establishment. Also, individuals may be considered tax residents in China if they are present in China for an entire tax year and potentially are subject to worldwide taxation if they reside in China for five consecutive years. In determining whether a person is resident in China, temporary absences of 30 days or less consecutively or 90 days or less cumulatively in a calendar year are ignored.

Interest and penalties for failure to timely pay P.R.C. income tax can be onerous. Interest of 0.05 percent (0.2 percent for interest due before May 1, 2001) of the overdue tax may be levied per day on taxpayers who have not timely paid their taxes. Late filing of an individual tax return may be subject to fines of as much as CNY 10,000, and penalties for late payment or nonpayment of tax range from 50 percent to 500 percent of the

underpayment. Those penalties apply even in the absence of motives indicating tax evasion; when a tax evasion motive can be established, the consequences can be severe, ranging from imprisonment to the death penalty.

China's tax amnesty allows foreign residents or their withholding agents to remit overdue tax payments on or before June 30, 2004, without penalties.

Although penalties will be waived under the amnesty, interest will continue to apply to overdue taxes at the rate of 0.05 percent of the overdue tax per day. The SAT might have considered eliminating interest due under the amnesty to encourage participation; however, that approach likely would have caused equity concerns for taxpayers that have been complying with the law, and would have required new legislation. The SAT cautioned taxpayers that although interest on overdue taxes potentially could be reduced through negotiation with local tax authorities, any reduction in interest would technically cause the "deal" to fall outside the scope of the amnesty provisions, exposing the transaction to penalties

if and when it is revisited. In an effort to create a more cordial and conducive cross-border working environment for foreign residents, the SAT said that the primary purpose of the amnesty is to encourage delinquent foreign residents (or their employers) to come forward to clear their outstanding P.R.C. tax issues. With this in mind, the SAT left many details of the tax amnesty intentionally vague to allow foreign residents as much flexibility as possible to pay their outstanding P.R.C. tax liabilities. For example, although the amnesty period officially ends on June 30, the wording of the amnesty notice leaves open the possibility that taxpayers who notify the SAT of their outstanding liability by that deadline could be allowed to extend payments of tax and interest due through the end of the year. ■

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