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World Wide Tax News

Canada & the United States

Protocol amends Canada-US treaty

The US and Canada have signed a protocol amending the 1980 double tax treaty between the two countries. Although some of the changes are beneficial to taxpayers, others will have a significant impact on cross-border structures. The treaty changes potentially affect all taxpayers resident in one of the countries and having business interests, income or property in the other.

Eliminating withholding tax on interest

Withholding tax on cross-border interest will be eliminated. Currently, US or Canadian borrowers paying interest to a lender in the other country must deduct 10% tax and pay that over to their country's tax authorities. In future, there will be no withholding tax and the interest will be taxable in the lender's country only. Where the interest is paid between arm's length (i.e. non-related) parties, the change comes into effect two months after the protocol enters into force (at the earliest, from March 1, 2008). If the lender and borrower are related (e.g. corporations that are members of the same group, or parent and subsidiary), the reduction in

withholding tax will be phased in over three years.

Withholding tax on dividends

Unlike the tax on interest, this is not to be eliminated. Tax of 5% (where the beneficial owner of the dividend is a company owning at least 10% of the voting stock in the company paying the dividend) or 15% (in other cases) will still have to be deducted. A technical change is made, however, to the test that determines whether there is a minimum 10% interest. Where the dividend is ultimately owned by a company in the other country through a transparent entity (such as a partnership) that is not also tax-resident in the country

of the paying company, the authorities will look through the entity to test the percentage owned indirectly in that way.

Hybrid entities

These are entities such as US LLCs (limited-liability companies) that are regarded as look-through in one country (the US in this case) but as directly taxable corporations in the other (Canada in this example). Hybrids are frequently used in cross-border structures. Until now, hybrids have not been entitled to the benefits (such as reduced withholding taxes) conferred by the Canada – US treaty. This is because, in order to benefit from a treaty, a person or entity has to be both resident in one of the countries and liable to tax there. As look-through entities the hybrid themselves were not liable to tax in their home country.

In future, income earned by a resident of one country through a hybrid entity will be treated by the other country as earned directly by that resident when determining whether treaty benefits are due. For example, if US investors use a US LLC (which is a look-through vehicle for US purposes but a corporation for Canadian purposes) to invest in Canada, any Canadian income earned by the LLC will now be treated by Canada as owned directly by the US investors, entitling those investors to reduced withholding taxes under the treaty (assuming other conditions are satisfied). This change is due to come into effect two months after the protocol enters into force.

By the same token, however, if the income is not taxed directly in the hands of the investors, it will not be treated as having been earned by a resident of the other country and will not be entitled to treaty benefits.

The protocol also contains measures to deny treaty benefits altogether to certain hybrid entities frequently used in cross-border planning. This change will

become effective only on the first day of the third calendar year that ends after the protocol comes into force (1 January 2010 at the earliest). This gives time for cross-border structures using these entities to be reviewed and any necessary restructuring to be put into place.

Deemed cost step-up on emigration

Individuals emigrating from Canada to the US face potential double taxation if after becoming resident in the US they sell assets they held at the time of emigration. This is because when leaving Canada, they are deemed for Canadian tax purposes to dispose of assets at their market value. In the US, they would face tax on the gain calculated by reference to the original, and not the stepped-up, cost of the asset. Historically, to avoid this problem, Canadian emigrants would sell their investments when leaving Canada and then reacquire them once in the US.

The protocol finally codifies a relief that was first announced seven years ago which will resolve the problem. For any asset that is deemed to have been disposed of after September 17, 2000, Canadians emigrating to the US can elect to be treated for US tax purposes as having disposed of and reacquired those assets at their market value immediately before ceasing to be resident in Canada.

However, the election does not apply to assets held in RRSPs (registered retirement savings plans) and certain indirect holdings, so specific pre-emigration planning may still be required.

Other changes

Among other changes contained in the protocol are:

- a new deemed permanent-establishment rule for service providers
- a deduction in one country for pension contributions made in the other,

subject to certain conditions and limitations

- double tax relief for employee stock options
- mandatory arbitration for taxing disputes between the Canada Revenue Service and the IRS at the taxpayer's request over certain issues
- for the first time in a Canadian treaty, a comprehensive 'limitation of benefits' article to ensure treaty benefits are available to residents of Canada and the US only

See also under United States of America, item 1.2.1. ■

Continues on next page

1 North America and the Caribbean

1.1 Canada

1.1.1 New protocol to Canada – US treaty

See the lead item on page 1.

1.2 United States of America

1.2.1 US – Canada treaty changes

See principally the lead item on page 1.

More on hybrid entities

As already reported, the protocol denies benefits altogether to certain hybrid entities. There are two rules with which it does so.

The first rule denies treaty benefits on payments to, or amounts derived by, a resident of one country through a hybrid entity that is recognised by that country but is disregarded by the other country. The second rule denies treaty benefits on payments to, or amounts derived by, a resident of one country from a hybrid entity that is disregarded by that country but is recognised by the other country.

The intended application of these rules to cross-border structures used by US and Canadian investors is not clear. They may have wide application over many structures that have been used in recent years to take advantage of differences in US and Canadian taxation of entities and payments.

The rules are in force from the first day of the third year after the protocol comes into force, thus allowing some time to restructure certain outbound and inbound US-Canada tax planning.

More on mandatory arbitration

Under the current version of the treaty, various rules apply to determine which

country can levy tax, and when these rules do not eliminate double taxation, the final point of relief is a mutual agreement between the tax authorities of both countries on who will tax the item in question. However, this does not guarantee that such an agreement will in fact be reached and therefore, double tax may still arise.

Under the protocol changes, a new rule will be available to taxpayers. If the tax authorities of both countries fail to reach an agreement on a double tax issue and if a taxpayer so elects, he or she can ask for arbitration of the issue. However, it is not clear how beneficial this rule will be. First, it appears that the governments of each country can decide which articles of the treaty will be subject to arbitration. In addition, it would appear that arbitration on an issue can be denied if both countries agree, before the date on which arbitration proceedings would otherwise have begun, that the issue is not suitable for determination by arbitration.

This change applies to cases that are, when the protocol enters into force, already under consideration under the treaty's mutual agreement procedure, as well as cases that subsequently come under consideration.

Entry into force

In both the US and Canada, the protocol will enter into force on the first day of the calendar year immediately after that in which ratification procedures can be completed in both countries. The earliest date on which the protocol can enter into force is therefore January 1, 2008. Note, however, that several measures in the protocol do not have effect immediately, whereas others may be retroactive.

1.2.2 Disregarded entities must report for employment tax purposes

On August 16, 2007, the Internal Revenue Service (IRS) issued final regulations under which qualified Subchapter-S subsidiaries and eligible single-owner disregarded entities will be treated as separate entities for employment tax and reporting purposes.

A Subchapter-S subsidiary (or subsidiary 'S-corporation') is an entity that is a corporation but is disregarded for US federal tax purposes and treated as a division of its parent.

Under the Regulations (TD 9356), these entities, despite their general disregarded status, nevertheless be treated as corporations and required to calculate, report and pay all employment taxes in their own name and under their own employer identification number. This also holds true for certain excise tax purposes. Previously, they had the option of satisfying their employment tax obligations under their parent's name and identification number.

These disregarded entities will continue to be disregarded for all other federal tax purposes. The Regulations also make it clear that an individual owner of a disregarded entity that is treated as a sole proprietorship is subject to self-employment taxes.

1.2.3 Partnership mergers and built-in gain

The US Treasury has issued proposed regulations that would retroactively apply sections 704(c)(1)(B) and 737 of the Internal Revenue Code (IRC) to partnership mergers. These sections require certain unrealised gains to be brought into account for tax purposes.

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IRC section 704(c) provides that if property is contributed to a partnership, unrealised gains or losses associated with that property ('built-in' gain or loss) must be taken into account in allocating taxable income with respect to that property. Section 704(c)(1)(B) further provides that if the contributed property is distributed to another partner within seven years, any remaining built-in gain on the property is immediately recognised. Section 737 contains a companion rule under which a distribution of other property to the contributing partner may also cause recognition of built-in gain.

When two partnerships merge, one ('the transferor partnership') is generally treated as having contributed all its assets and liabilities to the other ('the transferee partnership') in exchange for an interest in the transferee partnership. The transferor partnership is then treated as having distributed its interests in the transferee partnership to its partners in liquidation. This type of merger is known as an 'assets-over' partnership merger.

In a previous ruling (Rev. Rul. 2004-43), the IRS concluded that sections 704(c)(1)(B) and 737 applied to the built-in gain associated with assets transferred in an assets-over partnership merger. This ruling attracted public criticism and was subsequently revoked, but the proposed regulations now issued by the IRS would enact the principles of the ruling.

The proposed regulations distinguish between pre-existing built-in gain subject to section 704(c) in the separate partnerships ('original section 704(c) gain') and any additional unrealised gain at the time of the merger ('new section 704(c) gain'). Both the original and new section 704(c) gain are made subject to sections 704(c)(1)(B) and 737, but the seven-year period during which the provisions are effective differs between the two classes of gain.

The regulations extend these rules to subsequent mergers, specify that any partial gain recognition is attributed proportionately to the original and new section 704(c) gain, and provide exceptions where ownership of the merged partnerships is identical or nearly identical. They would be effective for any distribution of property from a partnership made after January 19, 2005 if that property was contributed in the course of an 'assets-over' merger taking place after May 3, 2004.

1.3 Mexico

1.3.1 Reform brings in flat-rate business tax

Mexico has acted to increase the rate of tax collection, one of the lowest in the OECD, by introducing a flat-rate business tax of 17.5% on a broad income base, allowing for only limited deductions.

The new tax, abbreviated to IETU (*impuesto empresarial a tasa unica*), will replace the asset tax (*impuesto al activo*) and act as a minimum income tax for enterprises.

Both resident individuals and legal persons (including companies) carrying on a business (and taxable on their worldwide income) and the Mexican permanent establishments (branches) of non-residents (taxable on their Mexican-source income) will be liable to IETU.

IETU will be calculated on a cash-received basis on receipts from the sales of goods or property, the provision of independent services and the leasing of tangible goods (and any other grant of temporary use or enjoyment of goods), as reduced by a limited number of deductions. Royalties derived from transactions with non-related parties are also included in the tax base.

Deductions, also on a cash basis, will be permitted in respect of the purchase

of goods and property (including fixed assets); payment for independent services; and the leasing of tangible goods, provided that these expenses are all incurred for the purpose of generating taxable income; for the management of these activities and for expenditure on the production, sale and distribution of goods sold. Also deductible are insurance, and certain taxes and contributions. There is no deduction for depreciation (but the full cost of acquiring fixed assets, including land, is immediately deductible). Neither is there a deduction for payroll costs (but there is a tax credit at the IETU flat rate for the amount of salaries taxable in the hands of employees and for social security contributions). Dividends, interest and royalties paid for brands between related parties are neither taxable nor deductible.

Taxpayers will be required to make monthly advance payments of IETU (with a credit for advance payments of income tax) as well as of income tax. At the end of the tax year, the total amount of IETU due will be compared to the amount of income tax due. If the income tax liability is greater than the IETU liability, only income tax will be payable. If the IETU liability is greater than the income tax liability, the excess of IETU will be payable in addition to the income tax.

Where IETU deductions exceed the taxable income, a credit equal to the excess at the IETU rate will be eligible for carry-forward, adjusted for inflation, for a maximum of 10 years.

IETU will be due as from January 1, 2008. The rate of IETU will be 17.5%, effective from 2010, but the initial rate will be 16.5% in 2008 and 17% in 2009. ■

2 Europe and the Mediterranean

2.1 European Union

2.1.1 Losses from letting in other Member State must be recognised

The European Court has held that losses ('negative income') from let property in another Member State must be taken into account when determining a taxpayer's rate of tax in the state from which most of his taxable income is derived.

In *Lakebrink and Peters-Lakebrink v Grand Duchy of Luxembourg* (Case C-182/06), the taxpayers were a husband and wife resident in Germany but deriving most of their income from employment in Luxembourg. They owned property in Germany, from which they derived rental income, but the allowable expenditure on which exceeded the income. Had they been resident in Luxembourg, this 'negative income', while not establishing a deductible loss, would have been taken into account in reducing their overall tax rate ('negative progression'). Their claim for this reduction was refused by the Luxembourg tax authorities, because they were non-resident.

The European Court held that this unequal treatment of residents and non-residents, who were otherwise in a comparable situation, could not be justified. In the absence of taxable income in their own state (Germany), the taxpayers were in this way denied any possibility of making use of the loss to reduce their overall tax rate. In the circumstances, Luxembourg's refusal to extend negative progression to non-residents was in breach of article 39 of the EC Treaty (freedom of movement of workers).

The case is similar to the *Ritter-Coulais* case in Germany (see *BDO World Wide Tax News* 2006 Issue No. 1 (March 2006)), although there the taxpayers were suf-

fering negative income from owner-occupation, and had they had positive income, that income would have been taken into account in determining their rate of tax (unlike the situation in Luxembourg). The effect of the case is likely to be limited to situations where the facts are closely similar, but it demonstrates that the limit is yet to be reached in determining the extent of unallowable discrimination by Member States against non-residents.

2.1.2 Finnish group contribution system approved

See under Finland, item 2.5.1.

2.1.3 EU Commission acts against four Member States on outbound dividends

The EU Commission is taking action against Austria, Finland, Germany and Italy with respect to their treatment of outbound dividends.

The case against Austria and Germany concerns their treatment of outbound dividends generally. In both countries, dividends paid to domestic shareholders are effectively exempt from tax, whereas dividends paid to foreign shareholders are subject to withholding taxes ranging from 5% to 25% (except where the EC Parent Subsidiary Directive applies, or the relevant tax treaty eliminates withholding tax).

The Commission considers that this differential treatment is in breach of the free movement of capital and the freedom of establishment guaranteed by the EC Treaty, and it has formally requested Austria and Germany to amend their law accordingly. Failure to do so could lead to the Commission's bringing a case against those countries to the European Court. It has already decided to refer Belgium, Italy, the

Netherlands, Portugal and Spain to the Court on the same issue.

The European Court has already held, in the *Denkavit* case (see *BDO World Wide Tax News Issue* 2006 No. 4 (December 2006)), that outbound dividends from a subsidiary to a parent company in another Member State cannot be subject to a higher rate of tax in the subsidiary's home state than dividends paid to a parent company in the home state. However, it did leave open the possibility of taking into account whether the recipient's home state gave a credit for the withholding tax.

In the case of Finland and Italy, the issue concerns the specific treatment of outbound dividends paid to pension funds resident in other Member States. Whereas in those countries, domestic pension funds face some tax on dividends, the withholding taxes on outbound dividends to foreign pension funds appear higher to the Commission than the tax on domestic dividends. In the Commission's opinion, there is no justification for this apparent restriction on the free movement of capital. The Commission has already given formal notice on the same subject to the Czech Republic, Denmark, Lithuania, the Netherlands, Poland, Portugal, Slovenia, Spain and Sweden.

Pension funds resident in either the EU or the EEA who may in these circumstances become entitled to repayment of withholding tax should be filing protective claims within the periods allowed by their state of residence.

2.2 Austria

2.2.1 Commission to act against Austria on outbound dividends

See under European Union, item 2.1.3.

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2.3 Czech Republic

2.3.1 Corporate tax changes approved

The lower house of the Czech parliament has approved the corporate and personal income tax package we reported on in the last issue of *World Wide Tax News* (Issue 2007 No. 2; July 2007). It is now very likely that the measures will be enacted.

As a reminder, the main features of the package are:

- A reduction in the rate of corporate income tax from 24% to 21% in January 2008, followed by further reductions to 20% in January 2009, ending with a 19% rate from January 1, 2010
- Withholding tax on dividends, interest and royalties to be reduced from 25% to 15% in 2008 and to 12.5% in 2009. Lower rates than these prevail in any case if contained in a tax treaty or required by EC Directives
- An increase in the reduced rate of VAT from 5% to 9%, and the introduction of VAT grouping
- The replacement of the progressive-rate system of personal income tax by a flat rate of 15% in 2008 and 12.5% from 2009

2.4 Denmark

2.4.1 Foreign pension contributions to be deductible

Following a recent adverse decision of the European Court of Justice, Denmark is to extend tax deductibility for contributions to pension schemes established in other EU or EEA countries, subject to certain conditions. Until now, only contributions to Danish pension schemes have been deductible.

Generally speaking, the pension provider will have to be approved in its

home country to carry on life business or pensions business or must be an approved credit institution, and fulfil the conditions required under Danish law of Danish pension providers, including the same reporting, withholding and payment obligations. The pension scheme must also comply with the conditions required of Danish pension schemes, and the beneficiaries would have to accept to be taxed in Denmark on the pension if they left Denmark for residence elsewhere. Further, the special Danish 'PAL' tax on pension providers would be transferred down to (to be borne by) the beneficiary.

However, executives and others temporarily resident in Denmark and contributing to EU/EEA pension schemes would be entitled to deductions even if not all these conditions were satisfied, but for a maximum period of 60 months only.

These rules are contained in a draft Bill and may yet be subject to amendment. It is envisaged that contributions to foreign schemes would become deductible in 2008 and the PAL tax become payable by beneficiaries in 2009.

2.4.2 Treaties with France and Spain may be abrogated

Also in connection with the pensions issue, it is likely that Denmark will abrogate its double tax treaties with France and Spain, under which it has surrendered taxing rights to the treaty partner, and begin negotiations on other treaties to establish taxing rights for Denmark as country of source on both Danish and other EU/EEA pension payments.

If Denmark formally abrogates the treaties before January 1, 2008, they will most likely not cease to have effect before January 1, 2009. Although the reason for abrogation concerns only pensions, all treaty benefits (including reduced withholding taxes on divi-

dends, interest and royalties, where not also covered by EC Directives) will then cease to apply, unless a new treaty has been negotiated and is due to have effect by the same date.

2.5 Finland

2.5.1 ECJ approves Finnish group contribution system

In a judgment that surprised some commentators, the European Court of Justice has held that the group-contribution system in Finland is compatible with EC law. The judgment is of importance beyond Finland as Sweden and Norway also have similar systems. Although Norway is not a Member State of the EU, it is a member of EFTA (the European Free Trade Association) and the EFTA Court has tended to follow the precedent set by the European Court.

The group-contribution system is a form of group relief, in which a profitable member of a group of companies can make a tax-deductible 'contribution' to a loss-making group member wholly or partially to offset its losses. This achieves the same effect as a loss transfer the other way.

However, under Finnish law, a tax deduction by the transferor company can only be claimed if the transferee company is resident in Finland. In the case in question (*Oy AA*, Case C-231-05), a Finnish subsidiary wished to make a group contribution to its loss-making UK parent, but was denied the tax deduction because the parent was resident outside Finland. *Oy AA* claimed the law was in breach of the freedom of establishment guaranteed under article 43 of the EC Treaty.

The Court, while agreeing with the taxpayer that the discrimination in favour of domestic companies was indeed a restriction on the freedom of establishment, held that in this instance the restriction was justified, because it was necessary to safeguard the balanced allocation of taxing power between

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Member States and to counter tax avoidance. The objectives of the Finnish legislation were thus compatible with the EC Treaty and could be justified by overriding reasons in the public interest. Furthermore, even though the group-contribution rules were not specifically designed to counter only purely abusive arrangements, it was still proportionate to the objective. The Court also observed that without a restriction such as contained in the Finnish law, groups of companies would otherwise be able to move their income at will to whatever jurisdiction offered the most favourable tax treatment.

2.5.2 Commission to act against Finland on outbound pension dividends

See under European Union, item 2.1.3.

2.6 France

2.6.1 Denmark may abrogate its treaty with France

See under Denmark, item 2.4.1.

2.6.2 Companies to benefit from 2008 tax changes

The 2008 Finance Bill recently approved by the French government includes tax relief for companies in the area of research and development and intellectual property, but increases the tax payable on some real-estate gains.

R&D credits

The existing limit on this credit of EUR 16 million (USD 22.7 million) is to be removed altogether. Further, the component of the credit that is directly related to the amount of expenditure on eligible research and development is to be increased from the current 10% to 30% on the first EUR 100 million (USD 142 million) but would thereafter be limited to 5% of remaining eligible expenditure. Companies that have not yet benefited from the credit or not done so in the preceding five years will

be able to claim a credit of 50% of eligible expenditure.

Capital gains on patents

Capital gains from the disposal of patents and patentable inventions held for at least two years are to enjoy a reduced rate of tax of 15%, except where the disposal takes place to a related party, in which case the general corporate rate of 33.33% will continue to apply.

Shares in real-estate companies

The tax reduction on the sale of shares in companies more than 50% of whose assets consist of real property is to be withdrawn. Instead of the 15% rate currently payable on such gains, the standard 33.33% rate will apply as from September 26, 2007.

2.6.3 Dividend withholding tax rules clarified

The French tax authorities have issued further clarification of how EU or EEA parent companies of French subsidiaries are to benefit from exemption from French withholding tax on dividends. The exemption was introduced following the *Denkavit* decision of the European Court (see *BDO World Wide Tax News Issue 2006 No. 4*).

Changes announced in May 2007 mean that where a French subsidiary pays a dividend up to a company resident in another EU Member State or in Iceland or Norway, that dividend will be exempt from French withholding tax, whether or not the EU Parent Subsidiary Directive or a tax treaty applies, provided that:

- the recipient company owns at least 5% of the voting rights in the French company and has done so for at least two years and
- the recipient company is unable to obtain any credit or other benefit for French withholding tax otherwise payable in its home country and

- there is no artificiality in the arrangement

Further guidance has now made it clear that:

- the exemption applies both where there is a participation exemption in the recipient's home country or where losses would prevent utilisation of a withholding tax credit
- no specific documentary evidence has to be provided in order to claim the benefit of the exemption, although the French authorities may request the subsidiary to provide a letter or further documentation from the recipient attesting that it qualifies for the exemption
- the exemption also applies to distributions out of pre-2007 profits and liquidation proceeds

2.6.4 Consolidation rule referred to Europe

France's rules on tax consolidation have been referred to the European Court and may have to be changed as a result.

Currently, there is an optional tax consolidation regime, under which a group consisting of the parent company and its 95% subsidiaries may file a single consolidated tax return. However, both the parent and all the subsidiary companies must be resident in France or subject to French corporate tax. Although indirect as well as direct ownership is taken into account in the 95% test, indirect holdings can only be traced through other members of the group. This means that a subsidiary that is indirectly held through a non-resident company may not be included in the consolidation.

In the *Société Papillon* case, a French parent company owned several French subsidiaries to the required 95% extent, but via a Netherlands subsidiary. Its claim for consolidation of the indirectly

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held French subsidiaries was refused in the lower courts, but has now been referred to the European Court.

At first sight, it seems most probable that the Court will find that the French regime is in breach of the freedom of establishment, but it is less clear whether it will hold that this breach is justified.

2.7 Germany

2.7.1 German tax reform enacted

The comprehensive 2008 tax reform, the details of which were reported in the last issue of this newsletter (BDO *World Wide Tax News Issue 2007 No. 2* (July 2007)) has been formally enacted. As a reminder, the main changes were:

- the rate of corporate income tax is reduced from 25% to 15%
- trade tax ceases to be deductible against corporate income tax
- there will be a general 25% add-back for trade tax purposes of all long and short-term interest payments
- the federal trade tax multiplier is reduced from 5% to 3.5%
- as a result of these and other changes, the average tax burden on corporate income falls from approximately 38.65% to 29.8%
- for group companies whose net interest payable is EUR 1 million (USD 1.42 million) or more, the total interest deduction is limited to 30% of EDITBA (broadly, earnings before tax, interest and tax depreciation), unless the so-called 'escape clause' applies. Excess interest may be carried forward
- where during a period of five years, more than 25% of a company's capital is transferred directly or indirectly to a single shareholder, there will be a partial forfeiture of tax

losses brought forward. Where more than 50% is transferred in this way, the loss forfeiture will be complete

- the general withholding tax on royalties will be reduced from 21.1% (including solidarity surcharge) to 15.825% (lower rates will apply where stipulated by EC Directives or tax treaties) but the general withholding tax on dividends will increase from 21.1% to 26.375% (including solidarity surcharge, and again subject to lower rates stipulated by EC Directives or tax treaties). However, non-resident companies not subject to anti-abuse rules will be able to claim a refund of 40%.

All these changes will take effect from January 1, 2008, except the increased dividend withholding and refund, which will apply from January 1, 2009.

2.7.2 Further anti-avoidance measures

The German Cabinet has agreed on the draft of a Finance Bill for 2008, the main feature of which is a tightening of Germany's general anti-avoidance rule – article 42 of the *Abgabenordnung*, the Tax Code.

If the Bill is enacted in its present form, the tax authorities will be able to invoke article 42 to recharacterise a transaction if they can prove that there is an 'unusual legal structure' in place that leads to a tax advantage. A structure will be deemed unusual if it is considered to be out of line with generally accepted methods of achieving the same result. If the authorities establish that such a structure exists and has led to a tax advantage, the taxpayer may still avoid the application of article 42 if he can provide sufficient evidence of significant non-tax reasons for the choice of structure.

The Finance Ministry is also discussing the introduction of a disclosure regime for tax-avoidance schemes, under which promoters would be obliged to

notify the tax authorities of the nature of the scheme, the expected tax saving, and the number of clients to whom it has been made available. Taxpayers using those schemes would also have to declare this fact in their tax returns.

2.7.3 New flat-rate tax on savings income

With effect from January 1, 2009, a new flat rate of income tax of 25% (26.375% including solidarity surcharge) will apply for individuals in respect of savings income, i.e. interest, dividend and capital gains. Individuals may opt for normal progressive rates to apply if this would be beneficial. However, the exemption for gains on small portfolio shareholdings (less than 1%) held for more than one year has been abolished.

2.7.4 Commission to act against Germany on outbound dividends

See under European Union, item 2.1.3.

2.8 Gibraltar

2.8.1 Corporate and personal tax reductions

The 2007 Budget contains a number of tax-cutting measures. The headline rate of corporation tax has been reduced from 35% to 33% (from July 1, 2007), and will be further reduced to 30% in 2008-09 and 27% in 2009-10. The Government also confirmed that the unified corporate tax system to be introduced in 2010, replacing the current regular and exempt company regimes, will be based on a low headline rate, most probably 10%. Companies currently benefiting from the exempt regime may continue to do so until December 31, 2010. The scope of corporation tax will also remain limited to profits derived in Gibraltar (territorial system).

On the personal side, measures include a new regime for executives

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and senior managers possessing special skills, the HEPSS regime, will be introduced for those earning over GBP 100 000 (EUR 143 000; USD 201 000) a year. Qualifying individuals will have their taxable earnings capped at GBP 100 000, which will result in an effective income tax rate of no more than about 27.5%, but will be expected to maintain suitable accommodation in Gibraltar.

2.9 Italy

2.9.1 Commission to act against Italy on outbound pension dividends

See under European Union, item 2.1.3

2.10 Luxembourg

2.10.1 European Court rules against treatment of negative property income

See under European Union, item 2.1.1.

2.11 Spain

2.11.1 Record-Keeping Obligations in Transfer Pricing

In BDO *World Wide Tax News* 2006 No. 2 (June 2006), we reported that in Spain, the obligation to make transfer-pricing adjustments to ensure that transactions between related parties were always stated at arm's length prices for tax purposes was to pass to taxpayers themselves.

The record-keeping obligations in the new transfer pricing régime are contained in a new decree that is currently pending publication.

The decree generally follows OECD guidelines. In this sense, the main documents that Spanish companies should prepare are the following:

- The Masterfile Document, relating to the group or parent company, and including the group holding company's annual financial statements.

- The Country-Specific Document, relating to the [Spanish] subsidiary.
- Additional documentation relating to services or cost-sharing agreements.

These documents will have to be placed at the tax authorities' disposal.

In addition, the decree provides for complementary information that all companies with controlled transactions will have to include in their returns.

The new record-keeping obligations are due to have effect from a date three months after the day that the decree is published in the Official Gazette. Therefore, taking into account the current wording, if the decree is enacted after September 30, 2007 these measures will first affect fiscal year 2008.

With regard to fiscal years closed during 2007, the record-keeping obligations currently in force apply only to management fees, cost-sharing agreements and other service charges between related companies.

However, companies should take into account the following:

- The obligation to value at arm's length applies to fiscal year 2007.
- The new valuation methods, based on OECD guidelines, also apply to fiscal year 2007.
- Companies have the burden of proof of the correct value.

The law provides that if companies prove the correct value using the new valuation methods, no penalties will be imposed during the fiscal year 2007.

For this reason we recommend Spanish companies document their transfer pricing transactions taking into account the new record-keeping obligations provided in the decree and based on OECD guidelines.

2.11.2 Denmark may abrogate treaty with Spain

See under Denmark, item 2.4.2.

2.12 United Kingdom

2.12.1 Compound interest payable in tax compensation

The House of Lords has held that compensation for tax wrongly paid must be based on compound, and not simple, interest. The judgment was made in the *Sempre Metals* case, which arose from the *Metallgesellschaft* decision, in which the European Court held that the UK had been in breach of EC law in allowing only dividends to UK-resident parent companies to be paid free of ACT (advance corporation tax, now abolished). The Court also held that UK subsidiaries that had paid ACT in these circumstances should be entitled to compensation for the financial loss suffered. It was left to the UK courts to decide how that compensation should be paid.

It was agreed that the measure of the financial loss should be interest on the ACT paid from the date of payment to the date the ACT was recovered by set-off against the subsidiaries' corporation tax. The company had successfully argued before the lower courts that the interest should be calculated on a compound basis. The House of Lords agreed on that point but held that the rate of interest used should be the government, and not commercial, borrowing rate. The decision does not affect the rate of interest payable on the delayed compensation itself, which the law states to be simple interest.

The result of the judgment should be that claims for compensation in similar circumstances should now all be based on compound interest. Similar claims are also being lodged for VAT where HMRC have traditionally paid Statutory Interest only; HMRC are strongly resisting any such claims and further legal action as a consequence is possible. ■

3 Asia Pacific

3.1 Australia

3.1.1 Foreign-loss rules revised

The rules for offset of foreign losses and foreign tax credits are to be simplified from July 1, 2008.

Currently, foreign losses are 'quarantined', in the sense that they cannot be offset against domestic income, and both foreign losses and foreign tax credits are classified in 'baskets', meaning that losses and credits from one basket may not be set against income in another basket. The baskets consist of different types of income – capital gains, passive income, interest income and so on. Also, within the same basket, the amount of foreign tax credit that may be offset against income is limited to the Australian tax attributable to that income. Excess foreign tax credits may be carried forward in the same basket for up to five years. Foreign losses may be carried forward indefinitely.

Under the new rules, both quarantining and classification into baskets is swept away. Foreign losses will be available for offset against foreign income of any description and against domestic income. There will as now be no limitation on the carry-forward period for unutilised losses. Losses brought forward as at July 1, 2008 will be fully available for offset under the new rules, provided that they were incurred no earlier than 2001-02. Only 50% of losses incurred in the three years previous to that (i.e. in the years 1998-99, 1999-2000 and 2000-01) and still unutilised will be available, however. Any still earlier losses will be forfeited. Forfeiture will also take place to the extent that any of these old losses remain unutilised after five years (i.e. after the end of 2012-13).

As far as foreign tax credits are concerned, they will now become available for offset by non-residents (the Australian branches of non-resident entities) also, unlike the current situation, where only Australian residents may claim them. And, as already explained, they will no longer be classified into baskets, so that, for example, foreign tax credits on interest income may in future be set off against foreign passive income. However, there will be no carry-forward of excess foreign tax credits arising after June 30, 2008. To the extent that they cannot be utilised under the new rules in the current year, they will be forfeited. Old excess foreign tax credits may be carried forward for a maximum of five years as from July 1, 2008.

3.2 India

3.2.1 Arm's length remuneration to agent does not extinguish PE tax liability

In an interesting and highly controversial judgment, the Mumbai branch of the Indian Income Tax Appellate Tribunal has held that where a foreign principal is deemed to have a permanent establishment (PE) in India, the payment by the principal of arm's length remuneration to that agent does not extinguish any further tax liability the principal may have in India. The decision was made by reference to the India-Singapore tax treaty.

The case (*SET Satellite (Singapore) Pte. Ltd v Deputy Director of Income Tax*) involved a Singaporean broadcasting company marketing and distributing satellite television channels in India. It employed an agent in India to market airtime for commercials on its channels. The agent was paid an arm's length commission for its services. It was agreed that the agent was a

dependent agent, and thus that under article 5(8) of the India-Singapore tax treaty, the Singaporean company was deemed to have a permanent establishment in India. What was in dispute was whether the amount of arm's length commission paid to the dependent agent was the limit of the profits assessable on the Singaporean company in India (the so-called 'zero-sum approach') or whether some further profits over and above the commission could be attributed to it on an analysis of the functions performed, assets deployed and risks assumed.

The Tribunal ruled that the dependent agent and the permanent establishment of the foreign company deemed to exist due to the existence of the dependent agent were two separate things and that the mere payment by the company to the agent of an arm's length commission was not the limit of the company's income assessable in India. The Tribunal came to this conclusion after discussing and dismissing learned commentary to the contrary and an earlier contrary finding of the [Indian] Authority for Advance Rulings in a different case (*Morgan Stanley*). Significantly, the Morgan Stanley ruling has subsequently been upheld by the Indian Supreme Court.

The case is likely to go to appeal, but is pertinent in the light of discussion drafts issued by the OECD (on whose model double tax treaty many of the double tax treaties concluded in the world are based) that indicate the organisation's thinking is now moving in favour of the approach upheld by the Indian Tribunal.

3.3 Japan

3.3.1 CFC loss not deductible

A controlled foreign company's losses may not be set off against the control-

Continues on next page

ling Japanese company's income, the Japanese Supreme Court has held.

As in most countries' CFC legislation, Japanese controlled foreign company (CFC) rules attribute a proportionate share of the taxable profits of a CFC to the controlling Japanese shareholder. However, there is no provision allowing a Japanese company to claim losses suffered by a CFC against its own income.

The Takamatsu High Court has confirmed that such losses are not available for set-off in Japan, in a case involving losses incurred by a Panamanian subsidiary. Such losses may be taken into account, but only by set-off against subsequent profits of the subsidiary when calculating the CFC's attributable profits in such periods

3.4 Thailand

3.4.1 Tax changes in the air

Retirement funds

The Thai government has agreed to curb the tax benefits available to individuals who redeem their retirement mutual funds (RMFs) before reaching the age of 55. Under the new rules, only those individuals who hold their RMF for at least five years and do not sell it before reaching 55 will continue to enjoy full tax benefits, including personal income tax and capital gains tax exemptions. Individuals who hold an RMF for at least five years but sell it before they turn 55 will in future be entitled to partial tax exemptions only.

Inheritance tax mooted

When the new civilian government to be elected under the new constitution takes office, it is likely to be faced with a call from academics, advisers and the National Economic and Social Development Board to introduce an inheritance tax. Preliminary studies show that the tax rate could be 10% on

estates valued at THB 10 million (EUR 206 325; USD 291 975).

The introduction of the tax would be intended to reduce income inequality. Currently in Thailand, the highest-income group has 13.2 times the income of the lowest group. Supporters of the tax point out that Japan, Singapore, South Korea and Taiwan all have inheritance taxes, at progressive rates of between 2% and 50%.

Call for corporate tax cut for listed companies

Listed companies are to call for a reduction of corporate tax as a means of solving the so-called 'free-float problem'. Companies seeking a listing on the Thai stock exchange are currently required by the exchange to have a 'free float' of at least 25% on entry, and to maintain a free float of at least 15% thereafter. Several companies now face delisting because their free floats have fallen below the 15% minimum. The Association of Listed Companies points out that in Indonesia, a 5% reduction of corporation tax is available for listed companies maintaining a free float of 40%. ■

Continues on next page

4 Sub-Saharan Africa

4.1 South Africa

4.1.1 Government abandons windfall tax

The Government has announced that it will not now proceed with a windfall tax on synthetic-fuel producers, as mooted in the 2006 Budget. This decision was taken after consultation with key stake-

holders, despite a task-force report in February recommending the imposition of such a tax.

Two other recommendations made by the task force will also not be proceeded with. These are a progressive tax regime for upstream oil and gas companies and a tax on the 'must-have

volumes' supplied by Sasol (the state-owned oil company) to the domestic market. However, the government will investigate the possibility of a levy on refined products to finance the construction of excess capacity in relation to the planned Durban-Johannesburg pipeline. ■

5 Latin America

5.1 Brazil

5.1.1 Recent tax incentives revoked

Brazil has revoked reliefs relating to two social security taxes less than two months after a decree granting them had been published.

On July 25, 2007, Provisional Decree 382 allowed certain companies an immediate credit against PIS (*contribuição para o programa de integração social*) and COFINS (*contribuição para o financiamento da seguridade social*) paid on the acquisition of capital goods used in manufacturing vehicles, electronic products, wooden furniture and textiles. Normally, PIS and COFINS paid on the acquisition of assets is recoverable on a monthly basis over the depreciable life of the asset. The measure would also have reduced the percentage threshold for a company to be considered predominantly an exporter, which status entitles it to suspension of PIS and COFINS on acquisition of certain raw materials etc.

Before Provisional Decree 382 could become law, it had to be passed by

Congress. However, on September 19, a new Provisional Decree 392 was published, completely revoking Provisional Decree 382. Ostensibly, the reason given was that by deliberating whether to pass 382, Congress would be delayed in approving a constitutional amendment extending the life of another tax.

5.1.2 Companies may benefit from PIS and COFINS suspension regime

Companies with specially approved infrastructure projects in certain sectors of the economy can benefit from the suspension of PIS and COFINS (see item 5.1.1) when importing or acquiring certain assets and materials, under the new REIDI regime.

REIDI was instituted by Federal Law 11.488, of June 15, 2007, with the intention of benefiting companies that have received approval for the construction of infrastructure for the transport, ports, energy, basic sanitation and irrigation sectors.

Under REIDI legal persons may import or acquire in the domestic market

machines, rigs, instruments and new equipment, as well as construction materials for use or incorporation in the infrastructure works to result in fixed assets, under a PIS and COFINS suspension regime.

Accordingly, suppliers of the equipment and materials to the constructors can market them with suspension of PIS and COFINS contributions, and are also able, if they select the non-cumulative contributions system, keep the tax credits related to their own computation.

The benefit of suspension is also extended to sales or importation of services intended for the infrastructure works for incorporation in the fixed assets, where the requirement to pay PIS and Import COFINS is suspended on the imported services, as well on the incidental contributions on the supply of services provided to companies benefiting from the REIDI regime. ■

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To ensure compliance with Treasury Department regulations, we wish to inform you that any tax advice that may be contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or applicable state or local tax law provisions or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.

Expatriate Corner

IRS Determines Housing Costs Amounts Eligible for Section 911 Exclusion/Deduction for 2007

In September, the Internal Revenue Service issued an updated list for tax year 2007 of specific locations where it will allow more than the statutory limit for the Section 911 foreign housing expense exclusion due to the high cost of living in those areas. The adjustments are made on the basis of geographic differences in housing costs relative to housing costs in the United States. The new table with the adjusted housing expense limitations was published on September 10th in Notice 2007-77, *Determination of Housing Cost Amounts Eligible for Exclusion of Deduction for 2007*, and will appear in Internal Revenue Bulletin 2007-40 on October 1, 2007. Currently, the Notice with the full updated list of specific locations can be found at the website of the Department of Treasury at: <http://www.treas.gov/offices/tax-policy/library/N-07-77.pdf>. The Notice is effective for taxable years beginning on or after January 1, 2007.

History and Background

Section 911(a) of the Internal Revenue Code allows a qualified individual to elect to exclude from gross income his/her foreign earned income and housing cost amount. The maximum foreign earned income exclusion for tax year 2006 was \$82,400 and for tax year 2007 will be \$85,700. Prior to 2006, the foreign-based U.S. employees could exclude housing costs of "any reasonable" amount over a certain floor, i.e. there was a minimum limitation, but a maximum (ceiling) limitation never existed. Under the Tax Increase Prevention and Reconciliation Act (Pub. L. No. 109-222), enacted in May 2006, from an unlimited "reasonable" amount the maximum housing exclusion which could be claimed was reduced to \$24,720, i.e. a maximum for the exclusion was established. With the Act, Congress cut the housing deductions available to U.S. employees abroad, but it gave the IRS the authority to waive those limits in areas with high housing costs. The IRS utilized the authority granted by Congress and with Notice 2006-87 in 2006 (*Determination of Housing Cost Amount Eligible for Exclusion or Deduction*: <http://www.irs.gov/pub/irs-drop/n-06-87.pdf>) set a list with the 2006 ceiling limitations for various geographic locations. Now with Notice 2007-77 the IRS revised for 2007 the dollar limits for some of the areas and expanded the list of cities eligible for the higher housing exclusion.

Observations

The largest increases in the existing housing upper limits were to Calgary, Canada, Singapore, and Malaysia. New countries appearing for the first time on the adjusted limits listing were Australia, Philippines, and South Africa. The most expensive housing countries have been established as Hong Kong, with a limit of \$114,300 (unchanged from 2006), and Moscow with a new 2007 limit of \$90,900. The resulting tax savings from these limit increases are not that significant, however, since whenever you increase your exclusion claim you also give up some foreign tax credit relief. Foreign tax credits eligible for claim must be reduced commensurate with your exclusion claim, since the IRS will not let you claim exclusion and foreign tax credit on the same income (i.e. no double dipping).

Coming Events

Tax Executives Institute (TEI) 62nd Annual Conference

October 21-24
Gaylord Palms, Kissimmee, FL

BDO Seidman is proud to be a Gold sponsor of the Tax Executive Institute's Annual Conference. We invite you to stop by our Exhibit booth during the conference to meet many of our National Tax professionals. We look forward to seeing you there.

To register: Visit www.tei.org

Accounting for Income Tax Seminar – Spotting Red Flags

Seattle
Tuesday, October 30
The Red Lion at 5th Avenue
1415 5th Avenue
Seattle, WA 98101

San Francisco
Wednesday, October 31
Garden Court Hotel, 520 Cowper Ave,
Palo Alto, CA 94301

7:30 AM: Breakfast & Registration
8:00 AM -10:00 AM: Presentation, Q&A

Cost: Free

CPE: 2 hours of CPE credit in the field of Taxes

Pre-requisites/advanced preparation: None

Program Level: Intermediate

Panelists:

Robert Terpening, Tax Partner – National
BDO Seidman FAS 109 Team Leader
Scott Jaconetty, Tax Senior Manager

Details:

Join us for a live instructional and practical seminar as we discuss:

- income tax accounting, with an eye toward commonly made mistakes
- financial statement impact
- relevant implementation considerations

Learning Objectives: After this seminar, participants should be able to identify some of most critical “red flags” related to the complex issues surrounding calculation and disclosure related to income tax provisions.

To register: www.bdo.com/backtobasics

San Francisco questions, concerns, cancellations:
Contact **Leah Bravo** at 415-490-3259 or
BayAreaEvents@bdo.com

Seattle questions, concerns, cancellations:
Contact **Jessica Gomes** at 206-403-2445 or
GreaterSeattleEvents@bdo.com

Income Tax, Sales Tax & State Tax Incentives

Two Southern California
Locations/Dates:

Los Angeles
Tuesday, October 30
Luxe Hotel Sunset Boulevard
11461 Sunset Boulevard
Los Angeles, CA 90049

Orange County
Wednesday, October 31
Westin South Coast Plaza
686 Anton Boulevard
Costa Mesa, CA 92626

7:30 AM: Breakfast & Registration
8:00 AM -10:00 AM: Presentation, Q&A

Cost: Free

CPE: 2 hours of CPE credit in the field of Taxes

Pre-requisites/advanced preparation: None

Program Level: Intermediate

Topics to Include:

- FIN 48 Issues for State and Local Tax
- Legislative Updates: Illinois, Michigan, Texas
- Recent Judicial Developments
- New Sales and Use Tax Audit Programs

BDO Seidman Panelists:

Rocky Cummings, Tax Partner, State and Local Taxation
Steve Oldroyd, Tax Senior Director, State and Local Taxation
Jon Zefi, Tax Partner, State and Local Taxation, National Practice Leader

Questions, concerns or cancellations:
Contact **Bianca Bryner** at 310-557-8557
(LAEvents@bdo.com or OCEvents@bdo.com)

To Register: www.bdo.com/backtobasics

BDO Seidman's Annual Tax Clinic

Chicago
Wednesday, December 5
W Hotel – City Center
172 West Adams Street, Chicago

Detroit
Thursday, December 6
The Townsend Hotel
One Hundred Townsend Street
Birmingham, MI 48009

Come for all or select portions of the day:

7:30 AM: Breakfast and Registration

8:00 AM-9:30 AM: Plenary Session

10:00 AM-12:15 PM: Specialized Breakout Sessions

12:15 PM-1:30 PM: Luncheon and Keynote Speaker

1:45 PM-2:45 PM: Specialized Breakout Session

Topics to Include:

- State and Local Taxes
- International Taxation
- Research and Development Tax Credits and BLISS
- Compensation and Benefits
- Mergers and Acquisitions

Keynote Speaker (Chicago):

Carl Tannenbaum, Chief Economist,
LaSalle Bank

Early Registration and Additional

Information: chicagoevents@bdo.com or
312-233-1813

CPE Available

Complimentary Event

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