

# WORLD WIDE TAX NEWS

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Offshore share transfers targeted

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## FRANCE

### CRISIS BUDGET MAKES WIDERANGING CHANGES

The Finance Act 2010 and the amended Finance Act 2009, incorporating the French government's Budget measures for 2010, labelled a 'crisis budget' by the Minister of Finance, made changes in four main areas:

- VAT place-of-supply rules
- Replacement of business tax
- Research and development credits
- Offshore tax avoidance

Meanwhile, the carbon tax, at first deferred to later in January after being held unconstitutional by the Constitutional Court, has now been postponed *sine die*.

#### VAT CHANGES

The changes to the VAT Act largely involve implementation of the 2008 VAT Directives of the European Union. These chiefly concern amendments to the place-of-supply rules for services. The new general rule for services supplied to business customers (B2B services) is that they take place where the customer is established, whereas supplies of services to private customers (B2C services) still generally take place where the supplier is established. Thus in the case of cross-border B2B services within the European Union, it is the customer who will have to account for the VAT under the reverse-charge mechanism. There are a number of important exceptions to the general rule. The supplier will have to declare such supplies in recapitulative sales statements (previously these applied solely to cross-border supplies of goods).

#### REPLACEMENT OF THE BUSINESS TAX

The long-awaited abolition of the business tax (*taxe professionnelle*) took effect from 1 January 2010, but given its importance as a source of revenue for local authorities, it has been replaced by two new taxes – the *cotisation foncière des entreprises* (business property contribution – CFE) and the *cotisation sur la valeur ajoutée des entreprises* (business value-added contribution – CVAE).

The *cotisation foncière* is a levy based on the rental value of buildings used by a business. The taxable base is largely identical to that of the immovable-property element of the business tax, but letting of unfurnished immovable property is brought into charge, subject to exemption for buildings let for residential purposes and the letting of other buildings for less than EUR 100 000 a year.

The *cotisation sur la valeur ajoutée* replaces the component of the business tax that was charged on plant and machinery. The value added by a business is broadly equal to the value of goods and services produced less the cost of acquiring or producing those goods or services plus the commercial margin on goods and services that are resold without further input by the business. For the purposes of the CVAE, there is a ceiling value added of 80% of turnover where the turnover is less than EUR 7.6 million, and 85% for larger turnovers. The CVAE is charged at progressive rates, ranging from 0% for businesses with a turnover of less than EUR 500 000 to 1.5% in respect of a turnover of more than EUR 50 million.

Taken together, the CFE and the CVAE must not exceed 3% of the value added of the business. Liberal professions, traders and highly profitable enterprises may be particularly badly affected by the new tax, and there is transitional relief available until 2013 for businesses whose effective tax burden has increased by the smaller of EUR 500 and 10%.

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## EDITOR'S LETTER

Welcome to Issue 21 of *BDO World Wide Tax News*. This newsletter summarises important recent tax developments of international interest across the world. If you would like more information on any of the items featured, or would like to discuss their implications for you or your business, please contact the person named under the item(s). The material discussed in this newsletter is meant to provide general information only and should not be acted upon without first obtaining professional advice tailored to your particular needs. *BDO World Wide Tax News* is published quarterly by Brussels Worldwide Services BVBA in Brussels. If you have any comments or suggestions concerning *BDO World Wide Tax News*, please contact the Editor by e-mail via Brussels at [mderouane@bwsbrussels.com](mailto:mderouane@bwsbrussels.com) or by calling +32 (0)2 778 0130.

### RESEARCH & DEVELOPMENT CREDIT REFUND RENEWED

Normally, research & development credits unused due to insufficient tax liability may be carried forward for up to three years. However, the Finance Act 2009 introduced an exceptional refund of unused credits for the years 2005 to 2008. The Finance Act 2010 extends the refund to unused credits for qualifying R&D expenditure incurred in 2009. Businesses can claim an immediate advance refund for 2009 based on an estimated of qualifying expenditure incurred in 2009.

### TARGETING OFFSHORE TAX AVOIDANCE

The amended Finance Act 2009 introduces an increased tax burden in respect of transactions with persons resident in so-called 'non-cooperative states or territories' (*états ou territoires non-coopératifs* (ETNCs)). A jurisdiction may be classified as an ETNC if it:

- Is not a member of the European Union and
- Is subject to a monitoring process by the OECD as regards transparency and exchange of information
- Has not implemented the OECD's standards on transparency and exchange of information by 1 January 2010 (to escape this definition, the jurisdiction must have signed at least 12 tax information exchange agreements) and
- Has not signed such an agreement with France

The first list of such jurisdictions (to be reviewed annually) has now been published (see below).

The particular tax measures that will be taken with respect to persons located in an ETNC are as follows:

- Dividends from an ETNC entity will not benefit from the French participation exemption
- A 50% withholding tax will be imposed on payments from France to persons resident

in an ETNC of dividends, life-assurance proceeds, interest and professional income (where there is no PE in France). The 50% rate will apply from 1 January 2011 for payments under agreements concluded before 1 January 2010; otherwise it applies from 1 January 2010

- Capital gains realised by an ETNC resident from the disposal of shares in a French company or from French immovable property will be subject to tax at 50%
- French taxpayers will in general not obtain a deduction for payments of interest, royalties or service fees to an ETNC resident, unless they can prove that the transaction related to the payment was real and effective, is not exaggeratedly large and not motivated by tax avoidance. This rule will apply from 1 January 2011
- French-resident individuals holding shares in an ETNC entity will automatically be deemed to hold the minimum 10% required to trigger the CFC (controlled foreign company) rules

### TRANSFER PRICING

Companies established in France if they or a member of a group of companies to which they belong have a turnover or balance-sheet total greater than EUR 400 million will have on the request of the tax authorities to provide further detailed transfer-pricing documentation relating to transactions with foreign affiliates. This requirement will also apply to transactions of all kinds with entities resident in an ETNC.

### THE ETNC LIST

The French government has now published the first list of ETNCs. It includes the 18 jurisdictions listed in Table 1 and is valid for the year 2010.

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Table 1

|              |                  |                               |
|--------------|------------------|-------------------------------|
| Anguilla     | Grenada          | Niue                          |
| Belize       | Guatemala        | Panama                        |
| Brunei       | Liberia          | The Philippines               |
| Cook Islands | Marshall Islands | St Kitts and Nevis            |
| Costa Rica   | Montserrat       | St Lucia                      |
| Dominica     | Nauru            | St Vincent and the Grenadines |



# AUSTRALIA

## TAX AMENDMENT MEASURES STALLED IN PARLIAMENT

An important tax amendment bill containing several measures favourable to taxpayers has been delayed in its passage through Parliament and will not now be considered again before May.

Among other important amendments in the Bill were provisions:

- Allowing eligible managed investment trusts (MITs) to make an irrevocable election to apply the capital gains régime as the primary code for the taxation of gains and losses on the disposal of certain assets and
- Clarifying the operation of the tax consolidation (group taxation) régime and its interaction with other parts of the law. The consolidation changes include amending the tax-cost setting rules (relating to the base cost of assets for capital gains purposes), modifying the choices to form or change a consolidated group and clarifying the rules surrounding conversion to a multiple-entry consolidated group

Although it was initially expected that the Bill would pass through Parliament relatively quickly, its progress has been delayed by referral to the Senate Economics Legislation Committee. The Committee concluded its report on 15 March 2010 and although the Bill was tabled for discussion in the Senate (the upper house of the Australian Parliament) during 16-18 March, the Senate failed to do so. Accordingly, the Bill has now been held over and will need to be reintroduced into the Senate during the Budget sittings scheduled to commence on 10 May.

Many of the provisions contained in the Bill have long been awaited by taxpayers and follow from extensive consultation processes between the Treasury and the tax profession. Many of its amendments will apply retrospectively and may have a material effect on the tax position of many taxpayers, several requiring taxpayers to make an election for certain provisions to apply. Further delays in the progress of the Bill will delay the ability of taxpayers to make a valid election, especially as 30 June (the end of the tax year) approaches.

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# PEOPLE'S REPUBLIC OF CHINA

## AUTHORITIES TARGET OFFSHORE SHARE TRANSFERS

China's tax authorities (the State Administration of Taxation – SAT) are targeting tax avoidance through the indirect transfer of ownership of Chinese companies using offshore vehicles.

In Circular (*Guoshuihan*) 698, issued on 10 December 2009, the SAT sets out the treatment of capital gains derived by non-resident companies from the transfer of shares in privately owned Chinese-resident companies.

Circular 698 states that a foreign investor who indirectly owns a Chinese company through a foreign holding company resident in a jurisdiction with an effective tax rate of less than 12.5% or one that does not levy income tax on foreign-source income and enters into a transaction that indirectly transfers the Chinese company's shares must disclose documents (as specified in paragraph 5 of the Circular) relating to the transfer to the competent local tax office for the Chinese company within 30 days of the signing of the transfer agreement. Furthermore, if the transfer lacks a reasonable commercial purpose and purports to avoid Chinese enterprise income tax (EIT) on the capital gain, the tax authorities may disregard the foreign holding company and recharacterise the transaction according to its economic substance.

In November 2008, a local office of the SAT released a tax case regarding an indirect transfer of the shares in a Chinese company. A significant (31.6%) holding in a Chinese company (CCo 1) was held by a Singaporean company (SCo 1) that was in turn wholly owned by another Singaporean company (SCo 2). Another Chinese company purchased 100% of the shares of SCo 1 from SCo 2, thereby acquiring the 31.6% holding in CCo 1. SCo 2 (and thereby its owner) realised a capital gain, which on the face of it was not taxable in China, since the direct shareholder of CCo 1 had not changed. However, it emerged that SCo 1 had a share capital of only SGD 100 and its sole activity was to hold the shares of CCo 1. The Chinese authorities therefore took the view that the transaction lacked any commercial purpose other than the avoidance of tax, disregarded SCo 1 and recharacterised the transaction as a direct sale of the 31.2% holding in CCo 1 by SCo 2, which is subject in China to enterprise income tax at 10% on the gain.

Since Circular 698 has retroactive effect from 1 January 2008, a non-resident entity meeting the disclosure criteria with respect to an indirect share transfer on or after that date must now submit the required documents to the competent Chinese tax authorities without delay. Non-resident entities liable to tax on the gains from a direct disposal of shares in a

Chinese company should also calculate and declare the tax in accordance with Circular 698.

### FOREIGN TAX CREDIT RULES CLARIFIED

The Chinese authorities have clarified the treatment of foreign tax credits for the purposes of the enterprise income tax (EIT).

The clarification was contained in Notice (*Caishui*) [2009] 125, issued on 25 December 2009.

Both resident and non-resident companies are entitled to claim credit for qualifying foreign taxes. To do so, they must separately calculate the amount of Chinese-source taxable income and foreign-source taxable income on a country-by-country basis and apply the foreign tax credits on the same basis. Qualifying foreign taxes are taxes of the character of income tax that are due and actually paid by a company on its foreign-source income in accordance with the relevant foreign laws and regulations. Notice 125 does, however, exclude some foreign taxes, e.g. taxes incorrectly paid or unlawfully imposed.

Foreign-source taxable income derived by a foreign branch of a Chinese-resident company and against which the foreign tax credit may be applied is defined as the branch's total foreign income less reasonable costs and expenses related to that income. The amount and nature of those costs is determined under the Law on EIT and implementing regulations. Foreign-branch income must be allocated to the current tax year, whether or not it is repatriated. Net operating losses incurred by a foreign branch are also computed according to the provisions of the Law on EIT and the relevant regulations. These foreign losses cannot, however, be set off against Chinese-source taxable income or against foreign income arising in any other jurisdiction. They are available only for carry-forward against future income in that jurisdiction.

Credit is also given for indirect foreign tax, i.e. foreign tax paid by a foreign entity but deemed to be borne by an immediate higher-tier entity. The credit is calculated using the formula

$$\frac{(A + B) \times C}{D}$$

where

**A** = taxes actually paid by the foreign entity on profits and dividend income

**B** = taxes indirectly borne by the foreign entity according to Notice 125

**C** = dividends distributed by the foreign entity to the immediately higher-tier entity and

**D** = the after-tax profits of the foreign entity



For the purposes of the indirect foreign tax credit, the foreign entity concerned must be one in which the Chinese company directly or indirectly holds at least 20% of the share capital and which falls into the first three tiers of the shareholding structure. Notice 125 sets different requirements for each tier.

Notice 125 also offers the opportunity for a credit for foreign tax spared. It stipulates that foreign tax that would otherwise have been borne by a Chinese company but in respect of which an exemption or reduction has been granted may be credited against Chinese tax due provided that the relevant tax treaty deems the tax to have been paid.

Finally, the Notice also contains guidance on the limitation of foreign tax credit. In respect of each jurisdiction, the maximum credit is given by the formula

$$\frac{(A \times B)}{C}$$

where

**A** = total EIT on worldwide income computed under Chinese law

**B** = taxable income arising in the foreign jurisdiction and

**C** = the aggregate of Chinese and foreign-source taxable income

Unused credits may be carried forward for a maximum of five years.

### THIN-CAPITALISATION RULES CLARIFIED

Circular (*Guoshuihan*) 777, issued on 31 December 2009, clarifies the thin-capitalisation rules for the deductibility of interest paid by a Chinese company to individuals.

The Circular identifies two types of loan. For loans from individual shareholders or other individuals who are related parties of the company, the maximum deductible interest is the amount calculated on the basis that the loan does not exceed the permissible debt-equity ratio, which is 5:1 for financial companies and 2:1 for others, and any other limitations in the Law on EIT and regulations. There are exceptions enabling companies to exceed these ratios in certain circumstances. Any excess interest is not deductible in the current or in subsequent years (i.e. there is no carry-forward).

As regards loans from employees and other unrelated individuals, interest will be deductible only where the company has signed a loan agreement, the loan is genuine, lawful and valid, and is not intended to provide illegal financing or contravene any other laws and regulations. The amount of deductible interest is limited to the amount that would have been charged by an independent financial institution on the same principal over the same period. The interest must also have actually accrued and be reasonable and relevant to the company's income. If these conditions are not satisfied, there will be no deduction

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# HONG KONG

## BUDGET AIMS TO CONSOLIDATE ECONOMIC RECOVERY

Against a backdrop of a surplus of HKD 13 800 million for the year 2009-10 instead of the forecast deficit of HKD 39 900 million, the Financial Secretary, John Tsang, in his 2010-11 Budget delivered on 24 February, stated that his aim was to consolidate the recovery, develop the economy and build a caring society.

Although there were no changes in any of the main tax rates for companies or individuals, measures announced included the following:

- An increase in stamp duty (from 3.75% to 4.25%) on the purchase of properties valued at over HKD 20 million
  - An extension of the 100% profits-tax deduction for the purchase of registered trademarks, copyrights and registered designs
  - An extension of the 100% profits-tax deduction for capital expenditure on environmentally friendly vehicles
  - An extension of the exemption from stamp duty for trading in exchange-traded funds (tracker funds) with portfolios including up to 40% of Hong Kong shares)
  - An extension of the concessionary profits tax rate to qualifying debt instruments with a maturity period of less than three years
- A one-off rebate of 75% of salaries tax and assessed individual income tax for 2009-10, capped at HKD 6000

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# INDIA

## BUDGET CONFIRMS GST SET FOR 1 APRIL 2011

The 2010 Budget delivered by the Minister of Finance in February confirmed that the nationwide Goods and Services Tax (VAT) is to be introduced on 1 April 2011. Meanwhile, the rate of service tax (which is to be replaced by the GST) remains at 10%, and eight new services have been added to those liable to the tax.

The Budget contained a number of tax reliefs for both businesses and individuals, although the Minister also included a few tax increases.

Among the Budget measures are the following:

- The rate of the income tax surcharge on companies with taxable income of over INR 10 million is reduced from 10% to 7.5%, and marginal relief will be made available
- An exemption from capital gains tax on the conversion of small private companies or unlisted public companies to limited-liability partnerships
- An increase in the weighted deduction for expenditure on in-house research & development, from 150% to 200%
- An increase from 125% to 175% in the deduction for payments for scientific research to specified institutions
- An increase of three percentage points in the minimum alternate tax payable by companies; this will now be 18%
- The interest on late accounting for tax withheld at source is increased from 12% to 18%
- A substantial increase in the threshold for the top rate of income tax for individuals. The 30% rate will now be paid on the slice of income above INR 800 000; the previous threshold was INR 500 000

### SINGLE SALE DURING TRIAL-RUN PERIOD CAN TRIGGER ASSESSMENT

The Delhi High Court has held that a single commercial transaction during a trial-run period can be sufficient to commence the initial assessment year for the purposes of income tax.

It is established under section 80-IA of the Income Tax Act that assessment to income tax does not begin while a taxpayer is engaged in trialling a product line, but only when commercial production commences.

In the case of *CIT v Nestor Pharmaceutical Ltd*, the taxpayer company began trial-run production of pharmaceutical products on 20 March 1998. In the same tax year (1998-99), it sold one water cooler and an air conditioner, but did not begin commercial production until the tax year 1999-2000. It appealed against the decision of the tax authorities that its initial assessment year under section 80-IA was 1998-99 and not 1999-2000.

The first-instance Tribunal found in favour of the tax authorities and the company appealed to the High Court. That court has now upheld the decision of the Tribunal. It confirmed that it is necessary for commercial production to commence for the initial assessment year to begin, but held that once goods are sold, the taxpayer has moved beyond the trial period and the initial assessment year has begun. The amount of commercial transactions or the quantum of goods sold was immaterial.

It is not known whether the taxpayer will appeal further.

### BAD DEBT CANNOT DETERMINE TRANSFER PRICE

The Income Tax Appellate Tribunal has held that the tax authorities may determine an arm's length price only by means of methods prescribed in the Transfer Pricing (TP) Regulations, and that a bad debt incurred by the taxpayer cannot be the determining factor for making an adjustment to a transfer price.

In the case concerned, the taxpayer company, a wholly owned subsidiary of a US company, was engaged in licensing software produced by its parent, in return for a royalty based on invoiced sales to third parties. During the tax year concerned, it had paid the royalty and also written off a debt owed by a third-party user of the software.

It was accepted that the royalty was set at an arm's length rate (determined by use of the comparable uncontrolled price (CUP) method). The tax authorities, however, disallowed part of the royalty by reference to the debt written off, on the grounds that an independent entity would have based royalty payments on amounts collected and not on amounts invoiced. There was no evidence that it had sought a waiver of the royalty on that part of its sales that it would be unable to collect.

The Tribunal upheld the taxpayer's contention that the jurisdiction of the tax authorities in transfer pricing cases was limited to determining the transfer price of international transactions within the framework of the TP Regulations; that a debt write-off was not a factor that could be taken into account by the authorities, and that since the royalty was based on goods sold, it should stand. The Tribunal agreed.

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# KOREA

## HIGHER CORPORATE TAX RATE UNCHANGED

Contrary to what had previously been announced, the 22% higher rate of corporate tax (payable on taxable profits of over KRW 200 million) remains in force for a further two years. The scheduled decrease to 20% will now take effect for financial years beginning after 31 December 2011, and not for financial years beginning after 31 December 2009, as originally intended.

### GROUP (CONSOLIDATED) TAXATION INTRODUCED

The scheduled introduction of consolidated tax accounting for groups of companies did, however, take effect for the fiscal year 2010 and subsequent years. Under the new system, a domestic company together with any number of its wholly owned subsidiaries may apply for consolidated taxation.

Where the application is successful, corporate tax will be payable on the combined profits and losses of the group as if it were a single taxable entity. Capital gains and losses arising from transfers of assets within a consolidated group will not be recognised until the assets are actually realised outside the group.

### INTRODUCTION OF ELECTRONIC VAT INVOICING POSTPONED

The use of electronic VAT invoices was due to become mandatory for all taxable persons with effect from 1 January 2010. However, 2010 is now to be a transition year, in which companies may continue to issue paper invoices. Mandatory electronic invoicing for companies will now take effect from 1 January 2011. Non-corporate taxable persons have a further year before electronic invoicing becomes mandatory for them, from 1 January 2012.

### TOP MARGINAL PERSONAL RATE REMAINS 35%

The highest rate of personal income tax is to remain at 35% in both 2010 and 2011, contrary to the previous intention to reduce it to 33% with effect from 1 January 2010. That reduction will now take effect from 1 January 2012. However, the planned reductions in the two intermediate rates did take effect as planned on 1 January 2010. Table 2 shows the new income tax rates for 2010, with 2009 rates in brackets.

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Table 2

| Band of taxable income (KRW) | Rate of tax (%) |
|------------------------------|-----------------|
| First 12 million             | 6 (6)           |
| Next 34 million              | 15 (16)         |
| Next 42 million              | 24 (25)         |
| Balance over 88 million      | 35 (35)         |

# SINGAPORE

## BUDGET BRINGS FURTHER RELIEF FOR RESEARCH & DEVELOPMENT

The 2010 Budget speech delivered by the Minister of Finance in February included the much awaited Productivity and Innovation tax credit and certain other relief measures for both businesses and individuals. The overall theme of the Budget was to boost skills, raise income levels, help Singaporean companies to deepen their capabilities and to make Singapore a distinctive global city.

### PRODUCTIVITY AND INNOVATION CREDIT

This new tax credit (PIC) is designed to encourage businesses, especially small and medium-sized enterprises (SMEs) to invest in activities promoting innovation and productivity. The favoured activities are:

- Research & development carried out in Singapore
- The registration of intellectual property (IP)
- The acquisition of IP
- Investment in design carried out in Singapore
- Expenditure on equipment or software aimed at process automation
- Training costs for employees

Research & development already qualifies for a variety of relief, including a 150% tax deduction. Under the PIC, there will be a 250% deduction on the first SGD 300 000 of qualifying R&D expenditure in any year and a 150% deduction for the remainder.

Existing reliefs will be phased out. There will be similar reliefs (a 250% deduction for the first SGD 300 000 and a 100% deduction for the remainder) under the PIC for the other qualifying activities. Businesses with at least three local employees will be able to convert the tax deductions or allowances into a non-taxable cash grant.

### OTHER MEASURES

Among other measures announced by the Minister were:

- A merger and acquisition allowance and stamp duty remission for the transfer of unlisted shares in a qualifying merger or acquisition
- The phasing-out of industrial buildings allowances for capital expenditure on industrial buildings, to be replaced by a new land intensification allowance
- Extension and enhancement of the tax concessions for REITs (real-estate investment trusts)
- Various incentives for the shipping industry
- Tax incentives for individuals acting as 'angel' investors in start-up companies

A reduction from 15% to 10% in the withholding tax on foreign entertainers and sportspeople

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# EUROPEAN UNION

## EUROPEAN COURT UPHOLDS BELGIAN TRANSFER-PRICING RULES

See under 'Belgium' below.

## BELGIAN EXIT TAX MAY BE REFERRED TO EUROPE

See under 'Belgium' below.

## DANISH EXIT TAX MAY BE REFERRED TO EUROPE

See under 'Denmark' below.

## FRENCH IMMOVABLE PROPERTY TAX REFERRED TO ECJ

See under 'France' below.

## EU LAUNCHES INVESTIGATION INTO GERMAN LOSS RULE FOR AILING COMPANIES

See under 'Germany' below.

## GERMAN TRADE-TAX INTEREST RULE TO BE SCRUTINISED BY ECJ

See under 'Germany' below.

## EUROPE TAKES GREECE TO COURT ON VAT AND INBOUND DIVIDENDS

See under 'Greece' below.

## LATVIA'S THREE-YEAR TIME LIMIT FOR VAT REFUND CLAIMS UPHOLD

See under 'Latvia' below.

## EUROPEAN COURT UPHOLDS NETHERLANDS GROUP RULES

See under 'The Netherlands' below.

## NETHERLANDS EXIT TAX MAY BE REFERRED TO EUROPE

See under 'The Netherlands' below.

## SELF-EMPLOYMENT HOURS CANNOT BE LIMITED TO NETHERLANDS

See under 'The Netherlands' below.

# DENMARK

## EXIT TAX MAY BE REFERRED TO EUROPE

The European Commission has issued a reasoned opinion formally requesting that Denmark change its exit tax on companies transferring their residence abroad.

When a Danish company transfers its residence out of Denmark, the Danish Corporation Tax Act charges an immediate tax ('exit tax') on the gain in asset values, whether or not there is an actual disposal of the company's assets.

According to the Commission, the charge to tax on unrealised gains is in contravention of the decisions of the European Court of Justice in the *Lasteyrie du Saillant* (Case C-9/02) and *N* (Case C-470/04) cases, which we have discussed on several occasions in *BDO World Wide Tax News*, as it infringes the freedom of establishment, unless collection of such exit taxes is deferred until there is an actual disposal of the assets concerned.

If in the Commission's view, Denmark does not react in a satisfactory manner to the opinion, the case may be referred to the European Court.

Similar action has been taken against Belgium and the Netherlands.

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# FRANCE

## IMMOVABLE PROPERTY TAX REFERRED TO ECJ

A case concerning the compatibility of France's 3% tax on immovable property owned directly or indirectly by companies has been referred to the European Court of Justice.

Since 1 January 2008, French and other EU-resident companies have been exempt from the tax, but companies established in third countries are exempt only if they are resident in a jurisdiction that has a tax treaty with France containing a suitable non-discrimination or administrative-assistance clause.

The European Court has been asked to rule on whether this extra hurdle is compatible with the free movement of capital guaranteed under Articles 63 and 65 TFEU. The case concerned is *Prunus* (Case C-384/09).

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# BELGIUM

## EUROPEAN COURT UPHOLDS TRANSFER-PRICING RULES



The European Court of Justice has recently held in the *Société de Gestion Industrielle* (SGI) case (Case C-311/08) that Belgian cross-border transfer-pricing rules are not in breach of European law.

The transfer-pricing provisions of the Belgian Income Tax Code allow the tax authorities to adjust a Belgian company's taxable profits to cancel the effect of an unusual or gratuitous (above arm's length) advantage granted to a related non-resident entity (such as an excessive purchase price or depressed sales price). In the present case, the advantage consisted of an interest-free loan. Such an adjustment would not be made where the other party to the transaction was a Belgian entity, since the benefit would be liable to Belgian tax in the other party's hands.

The taxpayers contended that this difference in treatment was an infringement of the freedom of establishment guaranteed under Article 49 TFEU (the Treaty on the Functioning of the European Union, as the EC Treaty is now called). The European Court agreed that the Belgian transfer-pricing rules did constitute a restriction on the freedom of establishment. Such restrictions can be justified, however, if they are proportionate, pursue a legitimate objective compatible with the Treaty and have overriding reasons in the public interest. The European Court found that the transfer-pricing rules in question were indeed justified by the need to ensure a balanced allocation of the power to tax between Member States, and to combat tax avoidance and abusive practices.

The ECJ also considered that the Belgian transfer-pricing rules did not go beyond what is necessary to achieve their objective, since any adjustment is restricted to the amount exceeding the arm's length compensation, and since the burden of proof lies with the tax authorities whereas the taxpayer has the right to demonstrate bona fide reasons for the price involved in the transaction.

Many Member States other than Belgium, in common with many third countries, of course, also have transfer-pricing regulations for cross-

border activities between related companies like Belgium. There was a considerable body of opinion that such rules were potentially incompatible with EU law. However, this ECJ judgment makes it clear that such an approach by EU Member States to preserve their tax base is generally justified. Only national regulations that go beyond what is necessary to achieve their objective might be in contradiction of EU law. This might be the case if the adjustments were not restricted to restoring an arm's length transfer price.

The Court's reasoning in the case is at one with its approach in *X Holding* (see under 'The Netherlands' below).

## EXIT TAX MAY BE REFERRED TO EUROPE

The European Commission has issued a reasoned opinion formally requesting that Belgium change its exit tax on companies transferring their residence abroad.

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If in the Commission's view, Belgium does not react in a satisfactory manner to the opinion, the case may be referred to the European Court.

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# GERMANY

## EU LAUNCHES INVESTIGATION INTO LOSS RULE FOR AILING COMPANIES

The European Commission has opened a formal investigation into the loss carry-forward exceptions granted by Germany to ailing companies undergoing significant restructuring (the so-called 'Sanierungsklausel').

Under section 8c of the Corporation Tax Act (*Körperschaftsteuergesetz*), where more than 50% of a company's share capital changes hands, the company loses any accumulated losses brought forward. Where there is a change of ownership of less than 50% but more than 25%, there is a pro rata deletion of losses brought forward.

However, in July 2009, an exception, the *Sanierungsklausel*, was introduced, with retroactive effect to January 2008. It provides that where the company concerned is in financial difficulties and can demonstrate that the restructuring will assist its recovery, it may preserve the losses going forward under new ownership, provided that certain other conditions are fulfilled. The *Sanierungsklausel* was originally intended to expire on 31 December 2009, it was made permanent by the Growth Acceleration Act (*Wachstumsbeschleunigungsgesetz*), which has been in effect since 1 January 2010.

In the opinion of the European Commission, this measure may constitute selective state aid, which is in general not allowable under EU law. It must be emphasised that a formal investigation of this nature allows for both sides to put their arguments and does not prejudice the conclusion.

For other measures included in the Growth Acceleration Act, see Issue No 20 of *World Wide Tax News* (Germany: New Coalition Legislates for Tax Cuts, p 5).

### TRADE-TAX INTEREST RULE TO BE SCRUTINISED BY ECJ

A case concerning inclusion of interest expense in Germany's trade tax has been referred to the European Court of Justice.

Interest paid by a German company to a related company may be added back to its income liable to trade tax (*Gewerbesteuer*). The taxpayers in the case (*Scheuten Solar Technology*, Case C-397/09) are contending that this rule is in breach of the Interest and Royalties Directive (2003/49/EC) that precludes a source state (in this case Germany) from taxing qualifying interest and royalty payments (whether by withholding or otherwise) made to an associated company within the European Union.

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# GREECE

## EUROPE TAKES GREECE TO COURT ON VAT AND INBOUND DIVIDENDS

The Greek government faces an attack on two fronts over its alleged failure fully to comply with previous decisions of the European Court on both the right to refunds or deductions of VAT and the taxation of inbound dividends.

As concerns VAT, there have been three previous decisions – *BP Supergas AE Geniki Emporiki-Viomichaniki kai Antiprossopeion v Greek State* (Case C-62/93), *Elliniko Dimosio v Maria Karageorgou et al* (joined Cases C-78/02, C-79/02 and C-80/02) and *Commission v Greece* (Case C-13/06) that found Greece to have incorrectly applied the [previous] VAT Directive, and requiring it to allow for refunds of unduly paid VAT or for a deduction.

According to the European Commission, in practice Greece has not made these refunds or deductions possible. Following a failure by Greece to take appropriate action following the issue of the Commission's reasoned opinion in February 2008, the Commission has now referred the matter to the European Court of Justice.

With respect to the taxation of inbound dividends, the European Court held in *Commission v Greece* (Case C-406/07) on 23 April 2009 that Greece had unjustifiably infringed what are now Articles 49 and 63 TFEU (the right to freedom of establishment and free movement of capital) by subjecting inbound foreign dividends to income tax while exempting domestic dividends from tax. According to the Commission, Greece has not notified it of tabling the necessary amendments to Greek legislation to remedy the infringement. Accordingly, the case has been referred to the European Court.

## FINANCIAL CRISIS: TAX MEASURES

Among the tax measures announced on 5 March by the Greek government as part of its austerity measures to combat the financial crisis are the following:

- An increase in the standard rate of VAT from 19% to 21%, an increase of one percentage point in the reduced rate (now to be 10%) and of half a percentage point in the super-reduced rate (up to 5%). There are corresponding increases in the rates applied in the Aegean Islands. In most cases, the new rates have effect from 15 March 2010
- A new top rate of income tax of 45% on individuals with income above EUR 100 000 and an easing of the burden on those with low incomes. The new rates are shown in Table 3 below
- A special 1% levy on individuals with actual or imputed net income (including exempt income) of more than EUR 100 000
- The flat-rate of tax payable by certain professionals is to be abolished
- Dividends will be aggregated with other taxable income subject to progressive rates and no longer taxed at only 10%. Interest income will remain subject to the final 10% withholding tax
- Bank bonuses to be taxed at 90%
- The tax on retained corporate profits will be gradually reduced to 20%; the rate to apply in 2010 will be 24%

Table 3 - Income tax rates applicable in 2010 (2009 income)

| Slice of taxable income (EUR) | Tax rate (%) |
|-------------------------------|--------------|
| First 12 000                  | 0            |
| Next 4000                     | 18           |
| Next 6000                     | 24           |
| Next 4000                     | 26           |
| Next 6000                     | 32           |
| Next 8000                     | 36           |
| Next 20 000                   | 38           |
| Next 40 000                   | 40           |
| Balance over 100 000          | 45           |

Several of these measures are contained in a Bill that is due to be debated in the Greek parliament as *BDO World Wide Tax News* was going to press, and may therefore be subject to amendment before becoming law.

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# HUNGARY

## INTEREST ON DIVIDEND LOAN NOT DEDUCTIBLE

A Hungarian company that borrowed in order to fund an extraordinary dividend has failed in an appeal against the denial of a tax deduction for the interest.

Under Hungarian law, expenditure is generally deductible where incurred for the purpose of an activity capable of generating income. However, after the shareholders had declared an extraordinary dividend that the company was unable to fund from retained earnings, it was forced to take out a loan from an independent bank to make the payments.

After the tax authorities denied a deduction for the interest and associated bank costs, the company appealed to the court. The court, however, upheld the disallowance on the grounds that the loan was not applied towards the company's business operations.

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# IRELAND

## NEW OPPORTUNITIES FOR FINANCIAL PRODUCTS

Ireland's Finance Bill 2010, which incorporates the Budget 2010 measures announced by the Minister of Finance in December, will shortly be signed into law.

Key highlights from the Bill are as follows:

### 12.5% CORPORATION TAX RATE

The Minister for Finance reaffirmed the importance of the 12.5% rate of corporation tax and his commitment to retaining this rate for trading profits indefinitely. The rate applying to non-trading income remains at 25%. The retention of the 12.5% rate is seen as very important in terms of attracting and retaining foreign investment into Ireland.

### TRANSFER PRICING

Transfer pricing legislation will become effective from 1 January 2011 (in respect of transactions agreed after 30 June 2010). Small and medium-sized enterprises (broadly defined as enterprises with fewer than 250 employees and either a turnover of less than EUR 50 million or assets or less than EUR 43 million on a global consolidation basis) are excluded from the scope of this legislation.

### COLLECTIVE INVESTMENT VEHICLES

The Bill introduces legislation that is aimed at enhancing Ireland as a leading location for the management of UCITS (undertakings for collective investment in transferable securities).

The UCITS IV Directive (approved by the European Parliament in January 2009) allows a management company in one EU jurisdiction to offer certain investment activities to UCITS funds in other EU jurisdictions. The tax changes in the Finance Bill include the protection of tax residence and tax exemption of any foreign UCITS that is to be managed by an Irish investment-management company. This is linked to recent company-law changes allowing corporate funds to migrate to Ireland through a re-registration process.

The Bill also includes provisions aimed at allowing for the consolidation of investment funds on a tax-effective basis. The compliance burden for non-Irish resident unitholders is also being reduced.

### ISLAMIC FINANCE

Islamic finance covers any financing arrangement that is compliant with the principles of Shari'a law.

The Bill contains provisions aimed at attracting Islamic-finance business to Ireland. Shari'a law forbids the making or receiving of interest payments. Essentially the changes proposed in the Finance Bill will facilitate Islamic financial

transactions by extending to this form of finance the relieving provisions that currently apply to their conventional counterparts. The Bill also proposes a stamp-duty exemption for the issue, transfer or redemption of *sukuk* (i.e. Islamic bonds) and an exemption from VAT on specified financial transactions.

### LEASING

An amendment has been made to allow one party only (lessor or lessee) to claim capital allowances on an asset that is leased.

Legislation in respect of accelerated capital allowances is being extended to cover both finance leases and operating leases.

Current legislation allows a company whose functional currency is a currency other than Euro to compute its capital allowances and loss relief in that functional currency. This is now being extended to non-trading lessors who are currently taxed under [Schedule D] Case IV principles (i.e. their income is taxable as miscellaneous income).



### DIVIDEND WITHHOLDING TAX

The Bill contains provisions to remove the requirement for non-resident companies to provide a tax-residence and/or auditor's certificate in order to obtain exemption from DWT at source.

### DIVIDENDS

The scope for taxing foreign dividends at 12.5% has been extended to dividends paid out of the underlying trading profits of a company resident in a non-treaty country where at least 75% of the foreign company is owned directly or indirectly by a publicly quoted company.

The Finance Bill permits unused credits in respect of foreign tax on branch profits

to be carried forward and credited against corporation tax in future accounting periods and in addition permits companies to carry forward losses of a foreign branch that were previously exempt from tax.

### WITHHOLDING TAX ON INTEREST

The Finance Bill introduces changes to confirm that the withholding-tax exemption is extended to interest paid to companies that are resident in countries with which Ireland has negotiated a tax treaty that is not yet in force.

### ROYALTIES

Foreign tax credit relief has been extended to royalty income from non-treaty countries generated from a company's trading income.

Provisions have been made to enable royalties payable by Irish-resident companies or branches to be paid free of withholding tax to persons resident or carrying on a trade in a jurisdiction with which Ireland has a double tax treaty.

### START-UP EXEMPTION

The exemption from corporation tax and capital gains tax for start-up companies introduced by Finance Act 2009 has been extended by the Finance Bill 2010 to include companies that start to trade in 2010. The Finance Bill 2009 introduced a provision exempting new start-up companies that began trading in 2009 from tax, including capital gains tax, in each of the first three years to the extent that their tax liability in the year does not exceed EUR 40 000. Marginal relief may apply where the tax liability is between EUR 40 000 and EUR 60 000 per annum.

### IP RÉGIME

The Bill further enhances the Intellectual Property régime that was introduced by Finance Act 2009. Amongst other changes, the Bill extends the list of specified intangible assets that qualify for the régime to include applications for the grant or registration of patents, copyright etc.

### DOUBLE-TAX AGREEMENTS

The Bill ratifies new double-tax agreements with Bahrain, Belarus, Bosnia and Herzegovina, Georgia, Moldova and Serbia. It also provides for the ratification of information-exchange agreements with eight other jurisdictions – namely Anguilla, Bermuda, the Cayman Islands, Gibraltar, Guernsey, Jersey, Liechtenstein and the Turks and Caicos Islands.

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# LATVIA

## THREE-YEAR TIME LIMIT FOR VAT REFUND CLAIMS UPHELD

The three-year time limit for the submission of repayment claims for excessive payment of VAT is compatible with European law, the European Court of Justice has held in *Alstom Power Hydro v Valsts ieņēmumu dienests* (Case C-472/08).

The former section 12(11) of the Latvian VAT Act (*likums Par pievienotās vērtības nodokli*) – repealed with effect from 1 January 2010 – provided that the tax authorities ('the VID') were required to make a refund of overpaid VAT within 30 days of the receipt of a reasoned application with supporting documents from the taxable person. However, the VID was entitled to defer payment on various grounds, including the necessity of an investigation where relevant further information was lacking.

Under section 16(10) of the Taxes and Duties Act (*likums Par nodokļiem un nodevām*), which applies equally to VAT, taxpayers must make claims for repayment of tax overpaid within three years of the due date for payment of the tax concerned.

The VID on the other hand is charged with controlling whether taxes have been properly and fully paid, and within the same three-year period may, following a tax audit, adjust the tax due where there has been a failure to pay the correct amount and, where the law allows, impose a penalty.

In *Alstom*, the company applied on 7 October 2004 for a repayment of VAT overpaid for the period from 1998 to 1 October 2004. The VID refused the claim for the greater part of the amount, on the grounds that it was out of time, and initiated an investigation into the remainder.

The company contended that the three-year time limit was in breach of what is now Article 183 of the VAT Directive (2006/112/EC), which requires (except in the case of insignificant amounts) Member States either to make a refund of overpaid tax or to allow the excess to be carried forward. Article 183 imposes no time limit on this requirement.

The Court held that it would be contrary to the principle of legal certainty to allow the right to a repayment claim to subsist indefinitely, and that with regard to the principle of effectiveness, it had previously held that the setting of reasonable time limits for bringing proceedings so as to protect both taxpayers and the tax authorities was perfectly compatible with European law. A two-year time limit had been upheld by the Court in previous jurisprudence.

In view of these considerations, the three-year time limit in question was not in breach of Article 183.

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# THE NETHERLANDS

## ECJ UPHOLDS GROUP TAXATION RULES

The Netherlands 'fiscal unity' or 'group taxation' rules, which limit membership of a tax group to Netherlands-resident companies, are not in breach of EU law, the European Court of Justice has held in its judgment in the *X Holding* case (Case C-337/08). In so doing, the Court concurred with the Opinion of the Advocate-General in the case.

Under the fiscal-unity rules, any Netherlands-resident parent company may form a fiscal unity with one or more of its Netherlands-resident subsidiaries in which it holds at least 95% of the shares. Within a fiscal unity, taxable profits and losses are aggregated.

The case concerned a Netherlands-resident holding company, which wished to form a Netherlands fiscal unity with its 100%-owned Belgian subsidiary. The request was refused by the Netherlands tax authorities on the grounds that the subsidiary was not resident in the Netherlands. The company appealed to the courts, arguing that the prohibition on the inclusion of foreign subsidiaries was in breach of the fundamental freedoms guaranteed by the Treaty on the Functioning of the European Union. The case was eventually referred to the European Court of Justice (ECJ).

In its judgment delivered on 25 February, the ECJ held that the situation of a resident parent company wishing to form a single tax group with a resident subsidiary and that of a resident parent company wishing to form a single tax group with a non-resident subsidiary were objectively comparable, and thus that the difference in treatment decreed by the Netherlands was in breach of the freedom of establishment guaranteed by Article 49 TFEU.

However, consistently with its previous jurisprudence, the Court then considered whether this breach of Article 49 could be justified on one of the recognised grounds. It came to the conclusion that in this case, the Netherlands law could be justified on the grounds of overriding general public interest, in order to preserve the balanced allocation of taxing powers among the Member States.

The Court took note that group taxation in the Netherlands was optional and that the fiscal unity could be dissolved and reconstituted from one year to the next. With such flexibility inherent in the system, allowing foreign subsidiaries into the unity would open the doors to tax optimisation by giving the parent company the chance "to choose freely the Member State in which the losses of that subsidiary are to be taken into account". The Court also rejected the argument that a foreign subsidiary could be compared to a foreign permanent establishment. A subsidiary was objectively different from a permanent establishment. The fact that a Member State decided to permit the temporary offset of

the losses incurred by a foreign permanent establishment of a resident company did not imply that the opportunity must be extended to non-resident subsidiaries.

While the judgment will undoubtedly also be welcomed by tax authorities elsewhere in the European Union (e.g. Cyprus, Finland, Germany, Ireland, Latvia, Luxembourg, Malta, Poland, Portugal, Slovenia, Spain) where tax-group membership is limited to resident companies, it is arguable whether the Court would necessarily come to the same conclusion in respect of the rules in each of those states. This would be especially open to doubt where the rules were a good deal less flexible (as is the case in Germany, for example) than in the Netherlands.

It is also not the case that *X Holding* represents a step back from the *Marks & Spencer* case, which requires that there must be a possibility in the home state to set off losses of a foreign subsidiary which are no longer capable of set-off in the subsidiary's state.

### EXIT TAX MAY BE REFERRED TO EUROPE

The European Commission has issued a reasoned opinion formally requesting that the Netherlands change its exit tax on businesses (both companies and non-incorporated businesses) transferring their residence abroad.

When a business established in the Netherlands transfers its residence abroad, the Netherlands charges an immediate tax ('exit tax') on the gain in asset values, whether or not there is an actual disposal of the company's assets.

According to the Commission, the charge to tax on unrealised gains is in contravention of the decisions of the European Court of Justice in the *Lasteyrie du Saillant* (Case C-9/02) and *N* (Case C-470/04) cases, which we have discussed on several occasions in *BDO World Wide Tax News*, as it infringes the freedom of establishment, unless collection of such exit taxes is deferred until there is an actual disposal of the assets concerned.

If in the Commission's view, the Netherlands does not react in a satisfactory manner to the opinion, the case may be referred to the European Court.

Similar action has been taken against Belgium and Denmark.

### SELF-EMPLOYMENT HOURS CANNOT BE LIMITED TO NETHERLANDS

The European Court has held that when taking into account hours worked in self-employment in order to qualify for the self-employed person's tax allowance, the Netherlands cannot exclude hours worked outside the country.

In *Gielen v Staatssecretaris van Financiën* (Case C-440/08), the taxpayer was a self-employed horticulturist who worked both in the Netherlands and Germany but was tax-resident in Germany. In the Netherlands, he was liable to tax on his income earned in that country. Under the Netherlands Income Tax Act (*Wet op de Inkomstenbelasting*) 2001, self-employed individuals are entitled to a special tax allowance, which varies from a minimum of EUR 2984 to a maximum of EUR 6084. One of the conditions for making the allowance available is that the individual concerned have worked for at least 1225 hours in his or her business. For resident taxpayers, it is irrelevant where the hours are worked. For non-resident taxpayers, however, only hours worked in a permanent establishment in the Netherlands count towards this total. Whereas the taxpayer had worked for over 1225 hours in total, he had not worked for 1225 hours in the Netherlands.

The taxpayer contended that the Netherlands-hours requirement was discriminatory and infringed his freedom of establishment under Article 49 TFEU, although, as the Netherlands tax authorities pointed out, non-resident taxpayers had the option in these circumstances to elect to be treated as resident taxpayers.

The Court held that by preventing non-residents from including hours worked in another Member State, the main rule constituted indirect discrimination on grounds of nationality, and was therefore in breach of Article 49. It also held that the option to be taxed as a resident was irrelevant to the question at issue, and was not in any case capable of remedying the discriminatory nature of the main rule.

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# UNITED KINGDOM

## FEW SURPRISES IN LAST BUDGET

Given that most of the measures were as usual trailed in the Pre-Budget Report in December, the Budget delivered on 24 March by Chancellor of the Exchequer Alistair Darling (his third and possibly last) contained few surprises. Inevitably also, with the imminence of the next general election (now confirmed for 6 May), the speech was heavier on political than technical content. The Chancellor did, however, pull two rabbits out of his hat – he announced a holiday from stamp duty land tax for first-time buyers of relatively modest properties and a doubling of the entrepreneurs' relief from capital gains tax.

### CORPORATE TAXATION

- No change to either the main rate (28%) or small-company rate (21%) of corporation tax
- A doubling of the annual investment allowance for capital expenditure on plant and machinery, from a maximum of GBP 50 000 to one of GBP 100 000 per year
- Extension of loss relief for consortia to include claims for unrelievable cross-border losses. This possibility is currently available only to groups of companies

### EMPLOYMENT TAXATION

- Confirmation of the one percentage point increase in national insurance (social security) contributions for employers and employees from 6 April 2011
- Confirmation of the bank payroll tax, with effect from 12:30 on 9 December 2009 to 5 April 2010. The tax is payable at a rate of 50% by banks and similar credit institutions on bonuses in excess of GBP 25 000 paid to employees

### INDIRECT TAXATION

- No change in the standard rate (17.5%) of VAT
- Increases of GBP 2000 in the VAT registration (to GBP 70 000) and deregistration (to GBP 68 000) thresholds from 1 April 2010
- Increases in landfill tax, aggregates levy, climate change levy and air passenger duty
- Increases in excise duty on alcohol and tobacco
- Staggering over a nine-month period of the increase in fuel duty

### PERSONAL TAXATION

- Confirmation of no increase in personal allowances for 2010-11 and of the tapered withdrawal of the personal allowance for individuals with taxable income in excess of GBP 100 000 (with effect from 6 April 2010)
- Confirmation of the restriction of relief for pension contributions for individuals with taxable income in excess of GBP 130 000 (with effect from 6 April 2011)
- Introduction of the 'additional rate' of income tax of 50% on the slice of taxable income above GBP 150 000 with effect from 2010-11
- No change in the rate of capital gains tax (18%)

- Doubling from GBP 1 million to GBP 2 million of the lifetime limit for entrepreneurs' relief from capital gains tax. From 6 April 2010, qualifying gains of up to GBP 2 million will be taxed at the lower rate of 10%
- Extension of relief for charitable donations to include a broader range of charitable organisations, including those based in other EU or EEA countries
- The threshold ('nil-rate band') for inheritance tax to remain at GBP 325 000 until 2014-15 at the earliest
- Further anti-avoidance measures to help combat schemes to reclassify income as capital gains
- Relief from stamp duty land tax (SDLT) for first-time buyers of residential property costing up to GBP 250 000. The relief will apply to purchases from 25 March 2010 to 25 March 2012. It will continue to be the case that no purchasers will pay SDLT on residential properties costing no more than GBP 125 000

- A new top rate of SDLT of 5% on properties costing over GBP 1 million with effect from 6 April 2011

### ADMINISTRATION AND ENFORCEMENT

- Tightening of the requirement to disclose tax avoidance schemes to the tax authorities, including enhanced penalties and information powers
- Harsher penalties for offshore tax evasion
- 'Naming and shaming' of serious tax evaders to start from 1 April 2010

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# BRAZIL

## AMENDMENTS TO TRANSFER-PRICING RULES

The so-called Provisional Measure 478, which became effective on 29 December 2009, has made several amendments to Brazil's transfer-pricing rules.

It revokes the resale price less profit-margin (*preço de revenda menos lucro*) method and replaces it by the sale price less profit-margin (*preço de venda menos lucro*) method, allows the Ministry of Finance to determine different profit margins for different sectors of business, and requires taxpayers to state the transfer-pricing method they have adopted on their annual tax returns.

## THIN-CAPITALISATION RULES INTRODUCED

Brazil has introduced rules restricting interest deductibility on loans from related parties or to legal persons resident in low-tax jurisdictions. The amount of interest deductible will be determined according to maximum debt-equity ratios.

Broadly speaking, where the loan is granted by a related party not resident in a low-tax jurisdiction, the interest is deductible only if the debt-equity ratio is no greater than 2:1 (i.e. the indebtedness must not exceed twice the equity interest held by the lender). Where the lender is a legal person resident in a low-tax jurisdiction, the permitted debt-equity ratio is no more than 3:10 (i.e. the indebtedness must not exceed 30% of the equity interest held by the lender).

Initially, these rules are effective for calculating liability for the social security contribution on net profits (*contribuição social sobre o lucro líquido* – CSLL), but the intention is to apply them also for the purposes of corporate income tax.

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# PANAMA

## SCOPE OF DIVIDEND WITHHOLDING TAX EXTENDED

Until a recent change in the law, dividend withholding tax in Panama was levied only on those dividend distributions that were made out of earnings taxable in Panama, i.e. from Panamanian-source income. Distributions made out of foreign earnings or out of otherwise tax-exempt income could be made free of dividend withholding tax. The rates of dividend withholding tax were 20% with respect to bearer shares and 10% with respect to registered shares.

However, Law No 49 of 17 September 2009 extended the scope of dividend withholding tax to previously exempt distributions.

Section 733 of the Tax Code as amended by Law No 49 now provides that any company that has to file a Notice of Operations (*Aviso de Operación*) – broadly speaking, any company that carries on at least part of its activities in Panama – will be required to withhold the related dividend withholding tax at the time that dividends are distributed to its shareholders at the following rates:

- 10%, where the dividends are derived from Panamanian-source earnings
- 5%, where the dividends are derived from:
  - foreign earnings
  - export or external earnings
  - exempt income related to
    - (a) earnings derived from international maritime commerce of Panamanian vessels;
    - (b) interest derived from securities issued by the Panamanian government and proceeds from the sale of such securities;
    - (c) interest derived from savings or time deposits and
    - (d) royalties paid by companies operating in the Colon Free Zone

Companies operating in the Colon Free Zone or in any other authorised free zones in the Republic of Panama are required to withhold a 5% dividend tax regardless of the source of the earnings or the type of operations. That is, if a company operates in a free zone, and reports local sales, export sales or offshore sales, all dividends derived from those operations will be subject to a 5% dividend tax.

If no dividends are paid, or if less than 20% of total retained earnings from the period are distributed, companies will be required to pay a 10% complementary tax on the difference, under amendments introduced by Law No 69 of 6 November 2009.

If Panama has a double tax treaty with the jurisdiction in which the beneficial owner of the dividend is resident, the rate fixed by the treaty will prevail.

The new provisions took effect on 17 September 2009 and apply to retained earnings at that time, even if these retained earnings pertain to fiscal periods generated before these changes were enacted.

## TREATMENT OF OFFSHORE COMPANIES

By an offshore Panamanian company is meant an entity that is incorporated in Panama to carry on business wholly outside Panamanian territory.

In that case, the company does not need to file a notice of operations. Accordingly, such companies will not be required to withhold tax on distributions, and are unaffected by the new Law.

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# CANADA

## BUDGET AIMS AT 'UNFAIR' LOOPHOLES



The Canadian government's Budget for 2010-11, tabled on 4 March, contains tax measures to close what are perceived as unfair tax loopholes. Hence, the stock (share) option rules will be amended to ensure that when an employee becomes eligible for a stock-option deduction as a result of a 'cash out' (cancellation of option in return for a cash payment), the employer cannot also obtain a deduction for the payment. In addition, current rules allowing for a deferment of the recognition of stock-option benefits of up to CAD 100 000 annually are being repealed. Certain loss-trading activities involving income trusts and partnerships have now been blocked, and there will be consultation on the introduction of disclosure rules for tax-avoidance transactions.

The stock-option rules will be amended so as to prevent a double deduction as described with effect from 16:00 EST on 4 March 2010. The current rules on recognition deferment allow employees to defer recognition (taxation as income from employment) of an option gain (the difference between the market price of the securities obtained on exercise of the option and the amount paid by the employee for the acquisition) until there is a disposal of the shares themselves. The deferment option is also to be removed with effect from 16:00 EST on 4 March 2010. However, deferment of stock-option benefits relating to the shares of most Canadian-controlled private corporations will continue to be available.

Among the measures of potential international interest are the following:

- Outstanding plans to amend the rules relating to foreign investment entities have been scrapped. Instead, the existing rules will continue with some modifications
- Plans to broaden the scope of the rules relating to certain non-resident trusts will be implemented, with modifications. The broadened rules are intended to make both resident contributors and resident beneficiaries jointly and severally, or solidarily, liable for tax payable by a non-resident trust that is deemed to be resident because it has a Canadian contributor and a related Canadian beneficiary. The modifications will ensure, inter alia, that pension funds and certain other exempt entities will not be jointly and severally, or solidarily, liable for a deemed resident trust's Canadian tax liabilities; investments in bona fide commercial trusts will not be caught by the new rules, and that a commercial trust will not be deemed resident if it satisfies certain criteria including that it not be a discretionary or personal trust and that each beneficiary be entitled to both the income and the capital of the trust
- Where an otherwise non-resident trust is deemed to be resident as just described, its property will in future be divided for tax purposes into a resident part and a non-resident part. The resident part will consist of property acquired by way of contributions from residents and certain former residents and any property substituted for such property. Income arising from the non-resident part will in general not be taxable in Canada. Distributions to residents will be deemed to be made first from the resident part of the trust property, whereas distributions to non-residents will be deemed to be made first out of the non-resident part. To the extent that the distributions to non-

residents are made out of the non-resident part, they will not be subject to Canadian withholding tax. It is intended that these measures apply retroactively, beginning with the 2007 taxation year. An election allowing a trust to be deemed resident from the 2001 taxation year will be available, but the attribution of trust income to resident contributors will apply to taxation years ending after 4 March 2010, only

- Certain Canadian corporations have been engaging in transactions referred to as 'foreign tax credit generators', designed to shelter tax otherwise payable in Canada in respect of interest received on loans made indirectly to foreign companies. These transactions artificially generate foreign taxes that the Canadian corporation can set off against the Canadian tax payable on the interest income. It is proposed that corporations engaging in these transactions be put on the same footing as if they had made a simple loan to the foreign company. Claims for offset of foreign tax would then be denied where the relevant foreign jurisdiction considers the Canadian corporation to have a smaller direct or indirect interest in the foreign entity than the Canadian corporation is considered to have under Canadian law. These anti-avoidance measures would take effect for taxation years ending after 4 March 2010
- A non-resident who disposes of an asset constituting 'taxable Canadian property' is liable to Canadian tax on any gain from the disposal. It is proposed that the definition of taxable Canadian property be changed to exclude shares of corporations and certain other interests that do not derive their value principally from real property situated in Canada, 'Canadian resource property' or 'timber resource property'. These amendments would bring Canadian domestic tax rules more into line with the provisions of Canada's tax treaties and the domestic law of Canada's major trading partners. This will relieve many non-residents from the need to file Canadian tax returns and from the so-called 'section 116 reporting requirements' for the obtaining of tax clearance certificates

All these measures require to be enacted and may be subject to amendment as they pass through Parliament.

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# UNITED STATES OF AMERICA

## INCENTIVES TO RESTORE EMPLOYMENT

On 18 March, President Obama signed the Hiring Incentives to Restore Employment Act. The Act contains a number of tax provisions intended to promote hiring of staff and to encourage business investment. The Act also contains substantial new compliance requirements related to foreign accounts.

Highlights of the major tax provisions follow.

### Payroll tax exemption

Employers who hire new employees after 3 February 2010 and before 1 January 2011 are exempted from paying the employer's share of social security contributions (amounting to 6.2% of the first USD 106 800 of salary) for each new employee. The employee must

- have been previously unemployed or worked no more than 40 hours during the preceding 60-day period and
- not replace another employee of the same employer, unless the former employee left of his or her own volition or for cause

### Employee retention incentive

A new business tax credit is created in respect of each new employee retained. The amount of the credit is the smaller of USD 1000 and 6.2% of the salary paid to the retained employee during the consecutive 52-week period

### Extension of enhanced small-business expenditure write-off

In 2009, small businesses were able to write off USD 250 000 of capital expenditure, with a phase-out if the amount of qualifying assets exceeded USD 800 000. This opportunity was due to expire on 31 December 2009 but has been extended for a further year.

### Worldwide interest allocation deferred further

In 2004, Congress provided multinationals with the opportunity of a one-off election to determine their foreign-source taxable income by allocating and apportioning interest payable as if all members of the group were a single taxable person. Originally intended to take effect for taxable years beginning with 2009, this provision has been repeatedly deferred, and was now due to take effect in 2018. It has again been deferred, for another three years, and is set to commence in 2021.

### Withholding tax on payments to foreign financial institutions

The Act imposes a 30% withholding tax on any 'withholdable payment' to a foreign financial institution, unless that institution agrees to report certain information regarding its 'United States accounts'. The payments involved include interest, dividends, rents, royalties, salaries, wages, premiums and other 'fixed or determinable annual or periodical gains, profits, and income' ('FDAP income'), and gross proceeds from the sale or exchange of any

property that can produce US-source interest or dividends.

A 'United States account' includes any account held by one or more US persons or by a foreign entity of which more than 10% is owned by a US person. There are exceptions for accounts held by publicly traded corporations, tax-exempt organisations, federal, state and local governments, banks, real-estate investment trusts (REITs), regulated investment companies and common trust funds.

A foreign financial institution can avoid the withholding tax by entering into an agreement with the Internal Revenue Service (IRS) in order to:

- determine whether any of its accounts is a United States account
  - comply with verification and due-diligence procedures with respect to its United States accounts
  - report annually the name, address, taxpayer identification number of the holder of the United States account and details concerning the balance and movements on the account
  - comply with requests from the IRS for information with respect to its United States accounts and
  - obtain a waiver from each holder of a United States account of any confidentiality provisions of foreign law in respect to the United States account or, in the absence of such a waiver, to close the account
- These provisions take effect for payments made after 31 December 2012.

### Withholding tax on dividend-equivalent payments

'Dividend-equivalent payments' determined by reference to an underlying US equity security and made as part of a securities-lending transaction, a sale and repurchase transaction or a 'specified notional principal contract' (as defined) will be treated as US-source income and subject to withholding tax of 30% (subject to treaty relief) in the same manner as dividend income. This provision is effective for payments made on or after 180 days after enactment.

### New reporting obligations

Any US individual who holds specified foreign financial assets with an aggregate value exceeding USD 50 000 must report ownership to the IRS on his or her tax return. Specified foreign financial assets are depository or custodial accounts with a foreign depository financial institution and, to the extent not held at a financial institution, shares or securities issued by a foreign person, any other financial instrument or contract held as an investment issued by (or having a counterparty who is) a non-US person, and any interest in a foreign entity. The reporting obligations are similar to those required with respect to foreign bank and financial accounts (FBAR reporting, for

which see below), but broader in scope. The penalty for non-compliance is USD 10 000. This provision is effective for taxable years beginning after enactment.

### Penalty for undisclosed foreign financial assets

A new accuracy-related penalty of 40% is imposed on any underpayment of tax attributable to an undisclosed foreign financial asset. The penalty takes effect for taxable years beginning after enactment.

### Presumption with respect to transfers to foreign trusts

The Act provides that if a US person directly or indirectly transfers property to a foreign trust (other than a deferred-compensation or charitable trust), the IRS may treat that trust as having a US beneficiary, unless the US person supplies such information as the IRS may require regarding the transfer, and demonstrates to the IRS's satisfaction that under the terms of the trust no part of the income or corpus can be paid or accumulated during the taxable year to or for the benefit of a US person, and that if the trust terminates during the taxable year no part of the income or corpus could be paid to or for the benefit of a US person. This provision has effect for transfers made after enactment.

### FBAR REPORTING GUIDANCE ISSUED

The US Treasury and the IRS have recently issued three items of guidance concerning FBAR reporting on Form TD F 90-22.1.

Notice 2010-23 provides guidance addressing comments received since the issue of Notice 2009-62, which generally extended the filing date for certain individuals with signature authority over (but no financial interest in) a foreign financial account or with signature authority or a financial interest in a foreign commingled fund. It further extends the filing date for persons in the former category by one year to 30 June 2011. With respect to persons in the latter category, it clarifies that only interests in foreign commingled funds that are mutual funds (excluding thereby foreign hedge funds and private equity funds, for instance) in the calendar year 2009 or previously need to be reported by the 30 June 2010 deadline.

IRS Announcement 2010-16 exempts persons who are not US citizens, US residents or domestic entities from FBAR filing obligations in respect of forms otherwise due on 30 June 2010.

Finally, the Treasury has issued proposed regulations clarifying who is required to file an FBAR report, exempting certain persons who have signature authority only over an account and providing rules intended to prevent avoidance by US persons of the filing obligations.

## ADMINISTRATION'S INTERNATIONAL TAX PROPOSALS

The Obama Administration's budget proposals for the fiscal year 2011 ('the Green Book') include the following measures relating to international tax:

- No change to check-the-box rules. The 2010 budget contained proposals to restrict the scope of the entity classification rules ('check the box'). These have not been enacted and no mention is made of them in this year's Green Book
- Extension of certain expiring provisions to 31 December 2011. These include the Subpart F (CFC) active financing and look-through exceptions
- Prevention of foreign tax credit abuse and matching rule. Currently, the foreign tax credit limitation is applied separately to foreign-source income in each of the separate income categories ('baskets') under IRC section 904(d). The proposal would instead determine the deemed-paid foreign tax credit for a taxable year based on the amount repatriated to the United States in that particular tax year. A matching rule would prevent separation of the creditable foreign taxes from the associated foreign-source income
- Non-arm's length transfers of intangible property abroad. Where a US person transfers intangibles at favourable rates to a related controlled foreign corporation subject to a low effective tax rate, in circumstances that suggest excessive income shifting, the excess amount of the transfer would be treated as Subpart-F income of that corporation, and hence be attributed to the US taxpayer in a separate foreign tax credit limitation basket
- Tightening of earnings-stripping limitation. Currently, certain interest paid by a US corporation to a related foreign person is limited where the US corporation's debt-equity ratio exceeds 1.5:1 and the net interest expense exceeds 50% of the corporation's adjusted net income. The proposed amendment to the rule would eliminate the 1.5:1 safe harbour and reduce the threshold net interest expense to 25% of a different base
- Tax-relieved repatriation of foreign earnings on a reorganisation. Currently, foreign earnings not previously taxed in the United States may be repatriated to US shareholders with minimal US tax consequences following certain cross-border reorganisations, such as under the 'boot-within-gain' limitation of IRC section 356(a)(1). The proposal would repeal the limitation for reorganisations where the acquiring company is foreign and the exchange of shareholders has the effect of a dividend distribution. This appears to affect certain so-called 'all-cash' or 'all-boot' reorganisations
- Repeal of 80/20 company rules. Where a US corporation derives at least 80% of its gross income over a three-year period from foreign sources and that income is attributable to the active conduct of a foreign trade or business, a

limited exception currently applies to prevent dividends and interest paid by the corporation from being treated as US-source income and thus subject to gross-basis withholding tax when paid to a foreign person. The Green Book would repeal this exception

- Avoidance of dividend withholding tax. Income earned by foreign persons from equity swaps that reference US equities would be treated as US-source income to the extent that the income is attributable to or calculated by reference to dividends paid by a US corporation. An exception to this rule would apply to swaps that are unlikely to reflect avoidance of US gross-basis (withholding) taxation

All such proposals will require passage by both houses of Congress before they are enacted into law. The legislative process may take significant time as the proposed changes affect many current provisions of the Internal Revenue Code, and members of Congress may not support the precise proposals made by the Administration.

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# SOUTH AFRICA

## TAX AVOIDANCE TARGETED BY BUDGET

The 2010-11 Budget delivered by the Minister of Finance on 17 February made no change to corporate tax rates, but increased reliefs for individuals and targeted what the Government perceives to be aggressive tax planning schemes. The Minister also announced that he will be considering easing exchange control and introducing tax relief for headquarter companies located in South Africa, but he failed to set a date for the replacement of the secondary tax on companies by the dividend tax.

Of the types of anti-avoidance scheme selected for action by the Minister, we would highlight:

- The interest-cost allocation for financial institutions
- Protected-cell companies
- Cross-border interest exemptions and
- Transfer pricing

### FINANCIAL INSTITUTIONS

The Minister considers that financial institutions are deducting interest costs to an extent beyond what should be allowed under normal tax principles. Accordingly, it is proposed to allocate interest expense incurred by these entities proportionately among different assets according to a taxable income/gross receipts and accruals formula, thereby intending a more accurate allocation of interest payable as between debt that finances the acquisition of assets that do not generate taxable income (the interest on which is generally non-deductible) on the one hand and debt that finances the acquisition of assets that do generate taxable income (the interest on which is generally deductible).

### PROTECTED-CELL COMPANIES

These are companies whose operations are effectively divided into different 'cells', each of which is protected from the others so as to limit shareholders' liabilities (and their control) to the appropriate cell. These cell companies when established abroad are often used to avoid the CFC (controlled foreign company) legislation, by ensuring that residents of South Africa hold no more than 50% of the share capital or voting rights of the company as a whole, their ownership being limited to the cell

or cells in which they participate. Legislation will be introduced to deem each cell to be a separate company, so that the CFC rules would apply, all other considerations being equal, to that cell. CFC rules generally attribute the income of a controlled foreign company to its domestic shareholders.

### CROSS-BORDER INTEREST EXEMPTION

Foreign companies and other foreign legal persons are exempt from South African tax on South African-source interest receivable, except where the interest is received by that foreign person's South African branch. The exemption is to be considerably restricted, but not so as to affect foreign investors in South African bonds, unit trusts or publicly available interest-bearing instruments.

### TRANSFER PRICING

A uniform set of transfer pricing rules is to be introduced to cover both domestic and cross-border transactions in order to combat artificial pricing or the deliberate misallocation of prices between related parties.

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## CURRENCY COMPARISON TABLE

The table below shows comparative exchange rates against the euro and the US dollar for the currencies mentioned in this issue, as at 31 March 2010.

| Currency unit          | Value in euros (EUR) | Value in US dollars (USD) |
|------------------------|----------------------|---------------------------|
| Canadian dollar (CAD)  | 0.7307               | 0.9850                    |
| Euro (EUR)             | 1.0000               | 1.3484                    |
| Hong Kong dollar (HKD) | 0.0955               | 0.1288                    |
| Indian rupee (INR)     | 0.0165               | 0.0223                    |
| Korean won (KRW)       | 0.0007               | 0.0009                    |
| Pound sterling (GBP)   | 1.1243               | 1.5162                    |
| Singapore dollar (SGD) | 0.5299               | 0.7147                    |
| US dollar (USD)        | 0.7416               | 1.0000                    |



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