

# BDO World Wide Tax News

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Welcome to Issue 2007 No. 2 of *BDO World Wide Tax News*, which summarises important recent tax developments of international interest across the world. If you would like further 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 BDO Global Coordination BV in Brussels. If you have any comments or suggestions concerning *BDO World Wide Tax News*, please contact the editor, Zigurds Kronbergs, by e-mail at [zkronbergs@bdoglobal.com](mailto:zkronbergs@bdoglobal.com) or by telephone on +32 (0)2 778 0141.

## Germany

### Corporate tax reform on course

Germany's much-heralded and much-discussed corporate tax reform has now been approved by both the *Bundestag*, the lower house of the German parliament, and the upper house, the *Bundesrat*.

The main features of the reform are as described in *BDO World Wide Tax News* 2006 Issue No. 4 (December 2006), but important changes, particularly to the interest deductibility rules have been made. Most of the measures generally have effect from 1 January 2008.

### Corporate tax

The standard rate of the corporate income tax is reduced from 25% to 15%. The solidarity surcharge of 5.5% remains, so that the combined rate of tax is 15.825%, down from 26.375%. However, any consideration of the headline tax rate paid by German companies must also take account of trade tax (*Gewerbesteuer*), for which see below.

### Trade tax

Trade tax is payable by all German businesses on a base similar but not identical, to that used for corporate income tax. The main difference between the two taxes is the treatment of interest payments. Currently, 50% of interest payable on long-term debt deductible for corporate income tax is added back for trade tax purposes. The new rules replace this add-back with a broad 25% add-back for all short-term and long-term interest payable and equivalent expense (such as factoring discounts, with a specific exception for trade discounts granted in the normal course of business). These rules apply only to interest that is an allowable expense for corporate tax purposes. Where interest is disallowed for corporate

tax purposes (see below) it is also disallowed for trade tax purposes. Further add-backs will be made for specific proportions of royalties paid (6.25%) and asset leasing payments (up to 18.75% in the case of leases of immovable property).

While there is no minimum shareholding requirement for corporate tax purposes, dividends received from domestic or foreign companies are currently exempt for trade tax purposes only where the receiving company holds at least 10% of the paying company, or in the case of foreign dividends, also where the EC Parent-Subsidiary Directive or a double tax treaty provides for exemption. Under the new rules, where the Directive or a tax treaty do not apply, the participation threshold for exemption from trade tax will be raised to 15%.

Trade tax is a local tax. Federal law fixes the basic rate of the tax, but the effective rate is established by local authorities, which apply a multiplier that they may change annually. The basic federal rate is to be reduced from 5% to 3.5%.

Finally, trade tax has hitherto been a deductible expense for corporate tax purposes. From 2008, this is no longer to be the case.

The overall effect of the changes to corporate tax and trade tax is a combined effective average rate of tax in 2008 going forward of 29.8%, compared to about 39% currently. This brings Germany back into the mainstream of Western European corporate tax rates.

### Limitation of interest deductions

Under the original reform proposals, all existing restrictions on deduction of interest (such as thin capitalisation rules) were to be abolished and replaced by a rule that where net interest expense (interest payable less interest receivable) exceeded EUR 1 million (USD 1.36 million), it would be deductible only to the extent that it did not exceed 30% of the entity's net pre-tax earnings before interest payable, regardless of whether the interest was payable to related parties or not. The principle remains in the new Bill but there are important changes of detail.

The EUR 1 million threshold remains (calculated over a tax-consolidated group where appropriate). Where net interest expense does not exceed the threshold, it will be allowable, subject to general principles.

## Germany

Where the net interest expense exceeds the EUR 1 million threshold, any excess over 30% of pre-tax earnings before the deduction of interest payable and tax depreciation will be disallowed. Thus, tax depreciation will now also be ignored in applying the 30% test. There is an 'escape clause', in the sense that there will be no disallowance of interest if the German entity in question is a member of a group and can show that its 'equity ratio' (ratio of equity to total assets) is equal to or higher than that of the worldwide group of which it is part, as measured at the last balance-sheet date. A negative 1% difference on the German side in the equity-ratio comparison is considered acceptable.

Disallowed interest under this rule may be carried forward and deducted in subsequent years, subject to the overall 30% limitation.

Interest for the purposes of these rules includes payment on all instruments on which the holder is entitled to a return on capital, including discount instruments of which the company concerned is the original issuer.

The limitations apply to all German-resident entities

and German permanent establishments of foreign entities, and to partnerships as much as companies. They also apply to non-resident entities deriving non-trading income from Germany (such as property rentals and asset management fees).

### Changes of ownership

The rules concerning forfeiture of losses carried forward following a change in ownership have been tightened considerably.

Under the current rules, tax losses brought forward from previous years by an entity are forfeited where within a five-year period there is both a change of ownership of more than 50% and there is a contribution of predominantly new assets. The new rules stipulate that there will be a partial forfeiture of losses where during a period of five years, more than 25% of the entity's capital is transferred directly or indirectly to a single transferee or a person related to the transferee. Once more than 50% has been transferred in this way, there is a total forfeiture of the losses. To prevent avoidance in situations where four or more unrelated persons could acquire a share of 25% or less,

the forfeiture rules will apply where ownership is transferred to a group of persons having the same intentions and objectives with respect to the loss-making entity.

### Withholding tax rates

In line with the decrease in the corporate tax rate, the general rate of withholding tax on royalties will be reduced to 15% (15.825% inclusive of the solidarity surcharge).

However, from 1 January 2009, the general rate of withholding tax on dividends will increase from 20% to 25% (26.375% inclusive of the solidarity surcharge). Non-resident companies will be entitled to claim a refund of 40% of this tax, taking their effective rate back down to 15%/15.825%. Tax treaties or the EC Parent-Subsidiary Directive may, of course, stipulate lower or zero rates, and these have precedence.

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# 1. North America & the Caribbean

## 1.1 Canada

### 1.1.1 Government pulls back on interest-deductibility restrictions

The Canadian government has narrowed the scope of its proposed restrictions on deductibility of interest and extended the transition period for their implementation.

As we reported in *BDO World Wide Tax News* 2007 Issue No. 1 (April 2007), the government initially announced, as part of the 2007-08 Budget measures, its intention to disallow the deduction of interest on money borrowed to make investments in foreign affiliates except to the extent that income from those investments became taxable in Canada. Following considerable criticism of those proposals, the government withdrew them and announced a new set of proposals, known as the 'Anti-Tax Haven Initiative' some two months later.

In fact, the Initiative reflects a narrowing of the original proposals and allows for a longer phase-in period. In particular, despite the reference to tax havens, it would appear that the new measures are specifically targeting 'double dips', whether or not tax havens are involved. A 'double dip' is a structure to finance foreign investments in such a way that an interest

deduction becomes available twice (once in Canada and once in the foreign jurisdiction) for the same interest payment. The Canadian government views this sort of planning as inappropriate, even though, typically, only one deduction is actually claimed in Canada.

In broad terms, the new measures would disallow a deduction in Canada for interest that relates to investments in foreign affiliates where the Canadian corporation or corporate group is entitled to deduct the same or an equivalent expense in another jurisdiction. A deduction for such interest could only be claimed in Canada where it has not been, and could not in future be, claimed in any other jurisdiction. The measures appear to be aimed particularly but not exclusively at so-called 'tower structures', which involve Canadian and US entities to provide an interest deduction for both Canadian and US tax purposes.

The government also announced that the new measures will apply to interest payable after 31 December 2011, thus allowing Canadian corporations and groups 4½ years in which to restructure their foreign

investments where necessary. The original proposals would have been phased in gradually, but no later than 2009. Unlike the original proposals, the new measures make no distinction between arm's length and non-arm's length debt.

Nor is this necessarily the end of the matter. A panel of experts is to be set up to undertake further study and identify additional measures to improve the fairness and competitiveness of Canada's system of international taxation. The panel is to produce an interim report at the end of this year and a final report in 2008.

The new measures have yet to appear in a Bill, and unless and until they are finally enacted, may yet be subject to change. When the draft legislation becomes available, it would be advisable for all Canadian corporations with investments in foreign affiliates to review their borrowing structures.

It is worth keeping in mind that a number of other international proposals announced in the Budget (and reported on in the last issue of *BDO World Wide Tax News*) are unaffected by this development. They include:

## 1.2 United States

### 1.2.1 Interim guidance on REIT foreign-currency gains

- a redefinition of active business income under the foreign-affiliate rules
- improving the exchange of tax information with foreign tax authorities
- the elimination of withholding tax on interest paid to arm's length non-residents, regardless of their country of residence

#### 1.1.2 British Columbia introduces new hybrid entity

The Canadian province of British Columbia has joined Alberta and Nova Scotia in amending its company law to allow for the formation of a new form of corporate entity – the unlimited-liability company (ULC). A ULC is a form of corporate entity that exposes the shareholders to unlimited liability for the company's debts. However, the chief use of this type of entity is in cross-border investments, since the US, for example, treats a ULC as either a disregarded entity (if it has a single shareholder) or as a partnership (if it has more than one shareholder), whereas under Canadian law, a ULC is unequivocally a corporation. This difference in treatment offers planning opportunities.

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The Internal Revenue Service (IRS) has issued interim guidance on how US REITs (real estate investment trusts) may treat translations of certain foreign-currency gains.

The basic feature of a REIT is that it is a collective vehicle for investment into real estate, and provided that it meets certain requirements, both the income and gains it derives from its real-estate portfolio are exempt from income tax. Tax is charged when the REIT distributes the income and gains to investors (a minimum distribution requirement is a feature of most REIT régimes). REITs or similar tax-exempt vehicles are now available in an increasing number of countries (including, for example, Australia, Germany and the UK).

One of the requirements in the US is that the REIT's investment portfolio be sufficiently diversified. In the US, some REITs have invested in real estate situated abroad through entities that qualify as qualified business units (QBUs). QBUs are required to recognise currency gains in the manner prescribed by proposed IRS regulations issued in September 2006.

The new guidance concerns the circumstances in which REITs reporting QBU gains may nevertheless treat them as exempt from US tax on the grounds that they are derived from gross income satisfying the diversification requirements. The IRS has previously ruled that merely because real estate ultimately owned by a REIT may be situated abroad does not prevent its satisfying those requirements.

The IRS also intends to amend the September 2006 proposed regulations to cover gains remitted to REITs by a QBU.

In a separate but related move, the IRS has announced that it is to challenge tax exemptions claimed by foreign governments on certain distributions from REITs, the significance being that if the exemptions are upheld, no US tax will have been charged on the income at all.

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## 2. Europe and the Mediterranean

### 1.2 United States

#### 1.2.2 New Illinois franchise tax

The State of Illinois (which includes Chicago) is to replace its corporate income tax with a new gross receipts tax, with effect from 1 January 2008, if Budget proposals made by the Governor are enacted by the State legislature. The proposals also include a new payroll tax on businesses, to apply from 1 July 2008.

In the Governor's view, the Illinois corporate income tax contains too many 'loopholes' in the form of reliefs and allowable expenditures, which a tax on gross receipts (which takes no account of expenditures) would exclude.

The proposed rates of the new tax are 1.8% on service businesses and 0.5% on manufacturing, wholesaling, retailing and

construction businesses. Small businesses (with annual gross receipts of less than USD 1 million (EUR 735 000) would be exempt, as would not-for-profit organisations and certain other sectors. Revenue from goods and services exported from Illinois either to other states in the US or abroad would also be exempt from the new tax.

The gross receipts tax would apply both to all Illinois-based businesses and to receipts derived in Illinois by businesses based outside the state.

For further information on this item or other US state and local tax issues, contact Bevin Meade, Wallace Truesdale or Hani Sarji of BDO Seidman on +1 212 885 8000 or by e-mail at [bmeade@bdo.com](mailto:bmeade@bdo.com), [wtruesdale@bdo.com](mailto:wtruesdale@bdo.com) or [hsarji@bdo.com](mailto:hsarji@bdo.com).

### 2.1 European Union

#### 2.1.1 Germany likely to lose Belgian coordination-centre case

In a case involving the application of Germany's CFC (controlled foreign company) rules to a Belgian coordination centre owned by a German group, the European Court's Advocate-General has issued an opinion that if adopted by the Court, would seriously weaken Germany's ability to counteract German companies' tax-efficient structures in other EU countries (and possibly further afield).

Under Belgian law, an entity that qualifies as a coordination centre benefits from a special cost-plus method of taxation, under which financing and personnel costs are excluded from the cost base. In the case in question (*Columbus Containers*), a coordination centre in the form of a BVBA (a Belgian limited partnership) was held by a German group. A BVBA is treated for Belgian tax purposes as a company but is regarded as a partnership in Germany, so its profits are in principle taxable on the German partners. Under the tax treaty between Belgium and Germany, profits earned by the Belgian permanent establishment of German taxpayers are exempt from German tax, but due to the low effective tax rate enjoyed by a coordination centre, it falls within Germany's CFC rules, which in



## 2.1 European Union

this case replace the exemption method by a credit method (the so-called 'switch-over rule'). Accordingly, the German partners are taxable on their share of the BVBA's profits, with a credit for the (low) tax paid in Belgium.

The German group appealed against the resulting assessments on the grounds that this treatment was in breach of European law. At the first stage of the case in the European Court, the Advocate-General has substantially upheld the taxpayers' argument. In his view, the switch-over rule was in breach not only of the freedom of establishment principle but also of the free movement of capital principle (which can apply vis-à-vis third countries also). Because it operated only in cases where the effective rate of taxation in the foreign jurisdiction was lower than that in Germany, it discouraged German resident taxpayers from investing in such jurisdictions. This was so even if the result was as in this case that the burden of taxation on the German investors was no higher than it would have been if they had invested in a German limited partnership (in both cases, the effective rate of taxation was that prevailing in Germany). By reference to the Cadbury Schweppes case (see

*BDO World Wide Tax News* 2006 Issue No. 3, October 2006), the Advocate-General opined that although CFC rules as such were consistent with European law, they had to provide for an exemption mechanism for controlled companies that had actual substance in the foreign jurisdiction (which the German rules did not).

The Court is not obliged to follow the Advocate-General's opinion in a case, although it rarely differs substantially. If the Court does follow the Advocate-General in this case, Germany's CFC rules would potentially cease to apply to any Belgian coordination centre (since to qualify as such, they need to have premises in Belgium and a minimum number of employees), and further to any tax-efficient controlled foreign company elsewhere in the EU, provided it had a similar real economic presence. The application of such a judgment to controlled companies outside the EU is more problematic. The freedom of establishment principle applies only within the EU; the free movement of capital is also guaranteed as between the EU and third countries (subject to any contrary anti-avoidance rules already extant in 1993), but

the Court has tended to hold that only the freedom of establishment rule applies to an investment that gives the investing entity control or substantial influence.

The Court's judgment could also have an effect on similar CFC rules in other EU or EEA countries. For developments in the UK's CFC rules, see under United Kingdom, 2.8.1. It should be noted that the Belgian coordination centre régime is being phased out, as an unfair state aid.

For further information on the German context, contact Gerhard Engler of BDO Deutsche Warentreuhand on +49 69 959410 or by e-mail at [gerhard.engler@bdo.de](mailto:gerhard.engler@bdo.de). For the UK and European context, contact Anton Hume or David Simpson of BDO Stoy Hayward on +44 207 486 5888 or by e-mail at [anton.hume@bdo.co.uk](mailto:anton.hume@bdo.co.uk) or [david.simpson@bdo.co.uk](mailto:david.simpson@bdo.co.uk).

### 2.1.2 EU requires change to German taxation of foreign entertainers

See under Germany, item 2.4.2.

### 2.1.3 EU secures change in Irish treatment of patent royalties

See under Ireland, item 2.5.2.

### 2.1.4 EU requires UK to change 13th VAT Directive rule

See under United Kingdom, item 2.8.2.

## 2.2 Czech Republic

### 2.2.1 Corporate tax changes proposed

The centre-right coalition government of Prime Minister Mirek Topolánek has come forward with a package of reforms to the corporate and personal tax system.

#### Corporate tax

On the corporate tax side, the government is proposing to cut the rate but is combining this with a tightening of the thin capitalisation rules.

A phased reduction of the current 24% rate of corporate income tax is foreseen, to culminate in a 19% rate by 2010. As a first step, the rate would be reduced to 22% in 2008. Cuts in withholding tax rates applied to cross-border payments of royalties, management services and rental payments – from 25% to 15% – are also planned. The withholding tax exemption for dividends under the EC Parent-Subsidiary Directive would be extended to dividends paid by a company in liquidation.

With thin capitalisation, the current rule is that interest payable to related parties is deductible only to the extent that the debt-equity ratio for related-party debt does not exceed 4:1 (6:1 for banks and insurance companies). Under the new rules, all interest payable and

related costs such as guarantee and arrangement fees relating to debts owed third parties as much as to related parties would be covered. The maximum debt-equity ratio on related-party debt would be reduced to 2:1 generally and 3:1 for banks and insurance companies. For debt to third parties, a 6:1 ratio would be set initially, reducing to 4:1 in 2009. An overall cap would also be placed on deductible interest, which could not exceed 6% of the average amount of credits and loans outstanding during the accounting period. Interest payable on participating (profit-sharing) loans and subordinated loans would be disallowed altogether.

The new rules would not apply to companies with annual financing costs of no more than CZK 1 million (EUR 34 800; USD 47 400). Although generally applicable from 1 January 2008, the rules would apply to third-party debt taken before 31 December 2007 only as from 1 January 2010.

#### Personal tax

The government proposes to replace the current progressive-rate system (rates range from 12% to 32%) with a flat rate of 15%, and greatly increase a number

of personal tax credits. However, for employees, the 35% social security contributions payable by the employer would be added to the tax base, so that the 15% flat rate would effectively be charged on 135% of the employee's gross salary. The self-employed would no longer be able to deduct their social security contributions from taxable income.

It must be emphasised that the reform package is still to be approved by parliament, where the government has an extremely precarious majority. Its passage is therefore far from certain, at least in its present form.

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## 2.3 Denmark

### 2.3.1 Corporate tax changes enacted

Denmark has enacted a broad range of changes to its corporate tax system, including a reduction in the standard rate of tax from 28% to 25%, but also added restrictions on the deduction of interest. The package, which mostly has effect from 1 July 2007, also includes a reform of the CFC (controlled foreign company) rules to comply with European law.

#### Corporate tax rate

With retroactive effect from 1 January 2007, the rate of corporate tax in Denmark is 25%.

#### Interest deduction

For interest paid to be deductible for corporate tax purposes, it will have to meet three tests – the existing thin capitalisation test, a new asset test and a new net earnings test.

Under the thin capitalisation rules, the deductibility of interest paid to related parties is restricted to the extent that the company's related-party debt exceeds four times its equity. This test remains, but there are then two further tests, applied to net financing expenses (defined to include, broadly, interest payable less interest receivable on debt claims, financial leases and capital gains and losses

on debt claims and shares). Where net financial expenses exceed DKK 20 million (EUR 2.69 million; USD 3.66 million), they would be deductible only to the extent that they do not exceed a standard rate of return (initially set at 6.5%) on the company's assets (less shares, financial contracts, and cash, but inclusive of holdings in directly owned affiliated companies outside the tax-consolidated group). Both the DKK 20 million and the asset base are to be calculated on a group basis. Any net financial expenses restricted under this rule (with the exception of capital losses) would not be available for carry-forward.

Finally, to the extent that net financial expenses exceed 80% of net earnings before tax (again calculated on a group basis where there is a tax consolidation), the excess (but only beyond DKK 20 million) is not deductible in the current year, but may be carried forward to future years.

#### CFC rules

The controlled foreign company (CFC) rules have been amended in the light of the European Court's decision in the *Cadbury Schweppes* case (see *BDO World Wide Tax News* 2006, Issue No. 3).

Until now, where a Danish company controlled a company in a low-tax jurisdiction and more than 33% of the controlled company's income consisted of 'financial income' (broadly speaking, passive income from investments and loans), then the Danish company was taxable in Denmark on that financial income. The definition of 'control' was satisfied if the Danish company held either more than 50% of the voting rights or at least 25% of the capital. A low-tax jurisdiction was one in which the rate of tax on corporate profits was less than 75% of what it would have been in Denmark.

With effect from 1 July 2007, the low-tax test is abolished, and the CFC rules extended to all controlled companies, including those resident in Denmark and in jurisdictions other than low-tax. Control will now require ownership of more than 50% of the voting rights without reference to ownership of share capital. To fall within the CFC rules, however, the controlled company will have to have more than 50% of its income consist of financial income and the proportion by value of its 'financial assets' (the assets from which the financial income is derived) will require to be more

## 2.3 Denmark

than 10% of the value of its total assets. If the controlled company does fall within the rules, all of its income, and not just its financial income, will be taxable (in the appropriate proportion) in the hands of the controlling company.

The extension of the CFC rules to Danish controlled companies, while introduced to comply with European law, will have little practical effect, as such companies are already taxed in Denmark and are compulsorily included in a tax consolidation with the Danish controlling company.

### Other changes

Other changes include a restriction of the participation exemption for dividends from

foreign companies in which a Danish company has an interest of at least 20%. From 1 July 2007, the exemption is withdrawn where the foreign company is resident in a jurisdiction outside the EEA that does not have a tax treaty with Denmark, unless that company is included in a Danish tax-consolidated group. Furthermore, where previously only 66% of dividend income that did not qualify for the participation exemption was taxable for the Danish company, all of the income will now be taxable.

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## 2.4 Germany

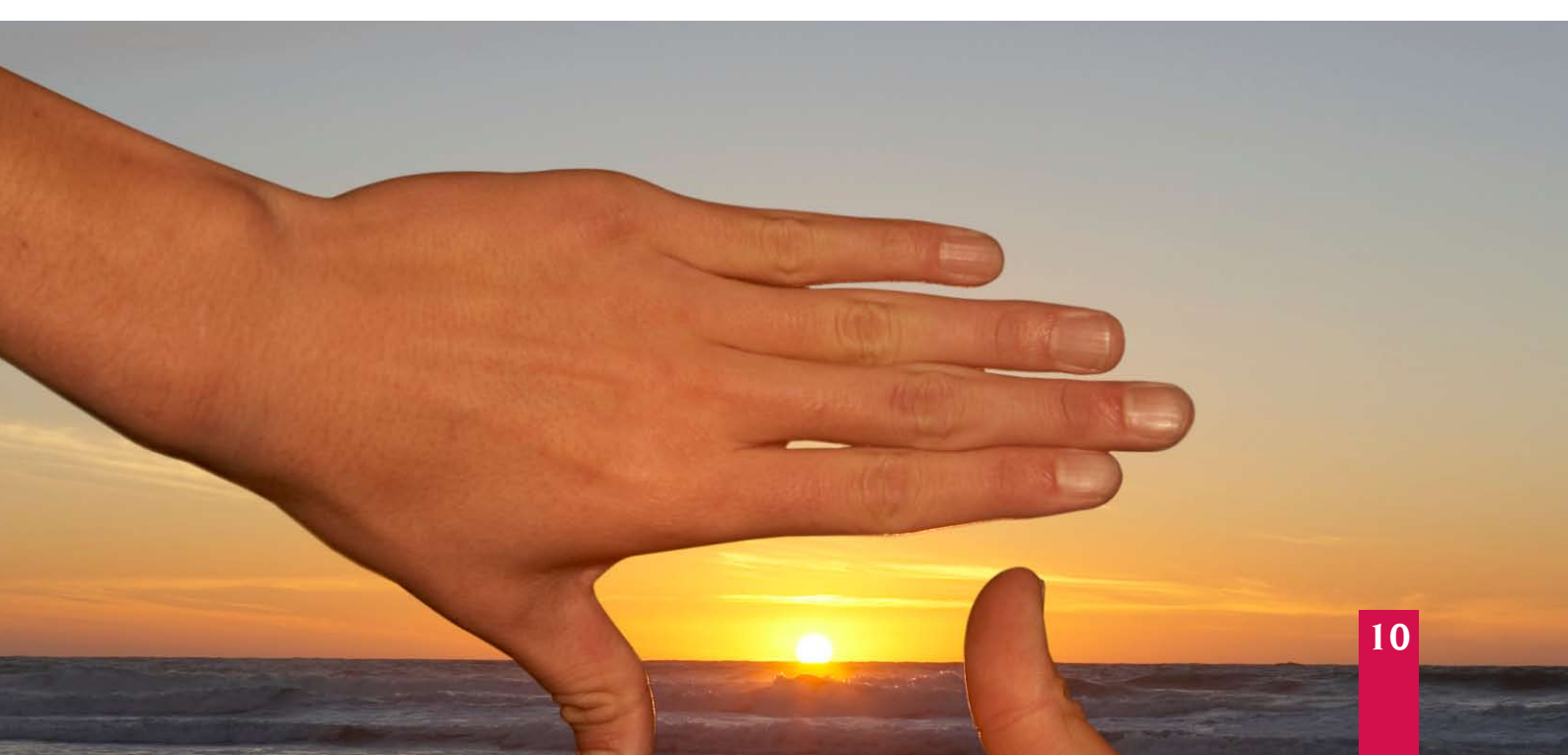
### 2.4.1 German tax reform

See leading article.

### 2.4.2 Commission requires changes in foreign entertainers rules

Following recent judgments in the European Court, the European Commission has issued a 'reasoned opinion' to the German government, requiring it to make certain changes to the tax treatment of non-resident artists, sportspeople, entertainers etc ('foreign entertainers').

Under existing German law, foreign entertainers must pay a withholding tax on their gross earnings in Germany, without the opportunity to deduct expenses from the base on which the withholding tax is charged. Although they may subsequently



## 2.4 Germany

file a refund claim, in which expenses may be set off against earnings, only those expenses with a direct economic link with the German earnings qualify for deduction. It is both the inability to deduct any expenses initially, and the subsequent restriction of the categories of deductible expense, neither of which apply to German residents, that the Commission considers discriminatory, on the basis of the European Court's findings.

If Germany does not accede to the Commission's request without due cause, the Commission may ultimately bring an action against Germany in the European Court.

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## 2.5 Ireland

### 2.5.1 Double tax relief extended

Ireland's Finance Act 2007 has introduced an extension of double tax relief for Irish companies and entities.

#### Branch profits

In Irish law, profits earned by a foreign branch of an Irish company are taxable in Ireland, under the worldwide basis of taxation. Where the branch is located in a jurisdiction with which Ireland has concluded a double tax treaty, Ireland grants a relief for the foreign tax paid by the branch, by way of credit against Irish tax due on the branch profits. Relief is granted on a per-country basis, so that, say, French tax paid by a French branch can be set off against the Irish tax on the French-branch profits only and is not available for set off against Irish tax on the same company's German branch, for example. Furthermore, if the

branch is located in a jurisdiction with which Ireland does not have a tax treaty, there is no relief for the foreign tax paid.

From 1 January 2007, however, Ireland will grant unilateral relief for foreign tax paid by branches in non-treaty jurisdictions, and operate a pooling mechanism for excess credits generally, so that in the above example, if the French tax paid by the French branch is more than sufficient to cover the Irish tax due on the French-branch profits, the excess may be set off against the Irish tax due on the German-branch profits (and the profits of any other foreign branch). The pooling mechanism will not, however, allow for any excess foreign tax credits to be carried forward to subsequent accounting periods. If they cannot all be set off in the current period, the excess will be forfeited.

## 2.5 Ireland

These new rules will also apply to the Irish branches of companies resident in other EU Member States, where the profits of some other foreign branch(es) are attributed to the Irish branch.

### Capital gains

A second extension to double tax relief involves capital gains. Currently, Ireland does not grant unilateral relief for foreign tax on capital gains, so that where an Irish resident makes a capital gain on which foreign tax is also payable, credit is given in Ireland for that foreign tax only where Ireland has a double tax treaty with the foreign country concerned, and that treaty specifically provides for the relief.

Because capital gains tax was introduced in Ireland comparatively recently (in 1975), there are a number of older treaties that do not cover capital gains. Until now, there has therefore been no relief for foreign tax in these cases. From 1 January 2007, this anomaly is removed. Countries involved include Belgium, France, Germany, Italy and the Netherlands.

For further information on either of these items, contact Frank Sheedy of BDO Simpson Xavier on +353 1 470 0000 or by e-mail at [fsheedy@bdosx.ie](mailto:fsheedy@bdosx.ie)

### 2.5.2 EU secures patent royalty changes

Following the issue of a 'reasoned opinion' from the European Commission, Ireland has amended its treatment of patent royalties.

Previously, patent royalties were exempt from tax if the research resulting in the patent was carried out in Ireland, but not exempt if the research was carried out elsewhere. The Commission considered this treatment to be in breach of the EC Treaty rights to freedom of establishment and the freedom to provide services, as it discouraged Irish residents from contracting out research to bodies located elsewhere in the EU or EEA. A recent judgment of the European Court, which found against a similar provision in French tax law, provides the justification for this move.

As part of the Finance Act 2007 measures (see 2.5.1 above), exemption will now be granted also where the underlying research was carried out in an EU or EEA country. However, a cap of EUR 5 million (USD 6.8 million) has been placed on the annual amount of patent royalties qualifying for exemption. In the case of a group of companies, the cap applies to the group as a whole. The rule change has effect from 1 January 2008.

### 2.5.3 Group relief extended to foreign losses

Ireland has also amended its rules on group relief to allow for losses made by foreign subsidiaries resident in another EU Member State to be set off against the profits of their Irish parent company. This change has been made in order to comply with the European Court judgment in the *Marks & Spencer* case (see *BDO World Wide Tax News* 2005 Issue 4 (December 2005)).

The new Irish rules closely follow those introduced by the UK in 2006, and apply retroactively as from 1 January 2006. Broadly, they stipulate that relief will be allowed for a loss incurred by a directly owned subsidiary in another EU Member State only where that loss is not otherwise available for set-off in Ireland and cannot be set off in the Member State of origin or anywhere else either in the current period or in any prior or subsequent period. A group-relief claim for the loss must be made within two years of the end of the accounting period in which it arose, but unlike the UK case, there is provision for a late claim when it becomes clear that the loss cannot be set off in any other jurisdiction.

For further information on the Irish context, contact Frank Sheedy of BDO Simpson Xavier on +353 1 470 0000 or by e-mail at [fsheedy@bdosx.ie](mailto:fsheedy@bdosx.ie). For the UK and European context, contact Anton Hume or David Simpson of BDO Stoy Hayward on +44 207 486 5888 or by e-mail at [anton.hume@bdo.co.uk](mailto:anton.hume@bdo.co.uk) or [david.simpson@bdo.co.uk](mailto:david.simpson@bdo.co.uk).

## 2.6 Latvia

### 2.6.1 Gains on property-company shares to be taxable

As part of its anti-inflation programme, in which property speculation is a particular target, the Latvian government has extended the tax on capital gains from the disposal of real property to gains on shares in companies whose assets consist predominantly of real property.

Previously, whereas gains on the disposal of directly held real property were taxable, gains on the disposal of shares in a company were exempt from tax. Most investment by both foreign and domestic real-estate investors was thus channelled through a company.

From 12 June 2007, however, the disposal of shares in a company more than 50% by value of whose assets consist (or in the immediately preceding taxable period consisted) of real property will be treated as if it were a disposal of the underlying real property, unless the shares are securities publicly quoted in an EU or EEA country. This will mean:

- for a non-resident corporate shareholder selling to a person liable to Latvian corporate income tax or a Latvian registered business, a final withholding tax of 2% on the proceeds of disposal

- for non-resident individual shareholders selling to a person liable to Latvian corporate income tax or a Latvian registered business, a final withholding tax of 2% on the proceeds of disposal; failing which, tax of 25% is payable on the gain after filing a tax return

### 2.6.2 Holding requirement for participation exemption abolished

From 12 June 2007, EU or EEA companies receiving dividends from a Latvian company are exempt from withholding tax on that dividend regardless of the size of their holding or the time for which it has been held, provided only that the foreign company is an entity qualifying for exemption under the EC Parent-Subsidiary Directive. Previously, a minimum holding of 15%, which had to have been held for an uninterrupted period of at least two years at the time of distribution, was necessary. Dividends paid to companies resident outside the EU/EEA remain liable to withholding tax of 10% (or 15% in the case of recipients resident in a tax haven).

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## 2.7 Russia

### 2.7.1 Participation exemption enacted

President Putin has signed into law a Bill that enacts a participation exemption for dividends. The draft Bill was discussed in the last issue of *BDO World Wide Tax News* (Issue 2007 No. 1, April 2007). While the essential features of the draft remain unchanged, there have been some changes to the criteria for the exemption to apply. In particular, in the final wording of the Act:

- there will be a participation exemption for dividends received by Russian companies, with effect from 1 January 2008. For the exemption to apply, the participation must have been held for an uninterrupted period of at least 365 days preceding the date of the distribution; the participation must amount to at least 50% and the acquisition value of the participation must exceed RUR 500 million (EUR 14.3 million; USD 19.5 million). If the participation is in a foreign company, the exemption will apply only if the distributing company is not resident in a blacklisted low-tax jurisdiction (according to the list maintained by the Ministry of Finance) or one with which Russia does not have an exchange of information agreement

## 2.7 Russia

- non-resident individuals not benefiting from a lower rate stipulated by a tax treaty will have the rate of withholding tax on Russian dividends reduced from 30% to 15%

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## 2.8 United Kingdom

### 2.8.1 Radical reform to taxation of foreign profits proposed

In a long-awaited consultation document, the UK government is proposing a radical reform of the way in which foreign income of UK companies is taxed. The reform includes an exemption for foreign dividend income and an overhaul of the CFC (controlled foreign company) régime. The proposals are made partly in response to the European Court judgments in *Cadbury Schweppes* and the *FII GLO* case and are partly the fruit of a long-standing review and consultations with business with the aim of maintaining the UK's competitiveness.

The proposals concentrate on four main areas:

- the taxation of foreign dividends
- the CFC rules
- the treatment of interest payable
- Treasury consents for movement of capital abroad

#### Foreign dividends

Currently, foreign dividends received by UK companies are always subject to corporation tax, but there is a difference in treatment between significant holdings (10% or more – called 'participation holdings' in

the document) and portfolio holdings. Relief is given by credit for foreign tax in both cases, but for participation holdings, credit is given for underlying tax (the foreign tax paid by the distributing company on the profits out of which the dividend distribution is made) as well as for foreign withholding tax, whereas for portfolio holdings, credit is given for withholding tax only. Furthermore, the treatment of foreign dividends (taxable, with credit) differs from that of domestic UK dividends (exempt). In its recent judgment in the *FII GLO* case, the European Court held that whereas the UK's treatment of participation holdings was in principle compliant with European law, the treatment of portfolio holdings was not.

With this background, the UK is now proposing that participation holdings should be exempt from UK tax for medium and large companies or groups (with the consequent loss of foreign tax credits) but a credit system would remain for small companies and groups, albeit in a simplified form. The proposed exemption for medium and large businesses would be linked to the inclusion of the distributing foreign

## 2.8 United Kingdom

companies in the proposed new controlled company régime (see below).

### **New controlled company (CC) régime**

In the *Cadbury Schweppes* case, the European Court held that a CFC régime such as the UK's was compatible with European law only to the extent that it allowed for controlled companies with genuine substance in the foreign jurisdiction to be exempt from the régime (i.e. the régime should apply to wholly artificial arrangements only). Although the Finance Bill 2007 (shortly to become law) contains changes to the CFC rules designed to comply with this judgment, the UK government concedes in the consultation document that they may still be open to challenge.

In short, the document proposes that in future:

- the entity-based, 'all or nothing' approach be replaced by a targeted income-based approach, dropping the low-tax test and the motive test
- the régime distinguish between 'active' income (largely exempt) and 'passive' income (largely taxable)

- in the case of passive income, the régime would apply to controlled UK companies as well as controlled foreign companies – hence the dropping of 'foreign' from the title of the régime
- small companies and groups would largely be exempt from the régime (as is currently the case with the UK's transfer pricing rules also)
- the threshold participation in a controlled company for the rules to apply be dropped to 10% (it is currently 25%).

Passive income would include dividends, interest, royalties, rents, and some capital gains. Certain intra-group interest and income from 'genuine active finance business' would, although qualified as passive, be exempt, as would dividends from significant holdings. On the other hand, certain active income of foreign controlled companies, such as intra-group sales and service income from wholesale, distributive, financial or service businesses and sales income from goods for delivery other than to the controlled company's territory of residence, would be taxable.

### **Interest deductibility**

The consultation document rejects the wholesale disallowance of interest linked to the acquisition of exempt foreign dividends, but proposes instead to broaden the scope of existing 'unallowable purpose' rules for loan relationships and derivative contracts. It also proposes that the interest deduction claimed by the UK members of a multinational group be restricted by reference to the group's total external finance costs.

### **Treasury consents**

Finally, the document proposes that section 765 of the Income and Corporation Taxes Act be repealed. This section requires that UK companies with foreign subsidiaries obtain the prior consent of the UK Treasury before carrying out certain capital movements and transactions, and carries a criminal sanction for non-compliance. It is already of no application to capital movements within the EEA, in respect of which there is instead a reporting requirement, and the proposal is that the same reporting requirement be applied to extra-EEA transactions.

## 2.8 United Kingdom

### 2.8.2 Commission requires UK to change 13th Directive VAT refund rule

#### Date of enactment

All proposals in the document are open to consultation. The legislative changes required would not be made until 2009.

#### Comment

The proposals should increase the attractiveness of the UK as a holding-company location, although the proposed exclusion of small groups from the foreign-dividend exemption would put them at a disadvantage when investing into medium and low-tax jurisdictions. This is one of the points that we shall include in our representations in the consultation process. UK-parented groups planning to repatriate foreign profits may well benefit from waiting for the introduction of the new régime.

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The European Commission has issued a 'reasoned opinion' requiring the UK to restore the right to a VAT refund to non-EU taxable persons in respect of insurance or financial services supplied to customers established outside the EU.

The 13th EC VAT Directive requires Member States to refund VAT incurred by businesses established outside the EU on a reciprocity basis. In December 2004, the UK amended its domestic VAT legislation transposing the 13th VAT Directive so that a taxable person established outside the EU was denied the right to recover VAT paid or due in the UK on goods or services in so far as they were used for the purpose of insurance or financial transactions supplied to customers established outside the EU. By contrast, a taxable person established in the EU (in

the UK or otherwise) is entitled, under UK domestic legislation, to recover VAT in such cases.

The Commission takes the view that the 13th VAT Directive, interpreted in connection with the relevant Community legislation, must be understood as allowing taxable persons established outside the Community to recover VAT in such cases. If the UK does not, without good cause, accede to the Commission's request within two months, the Commission may bring a case against the UK to the European Court.

For further information on this item, contact Emma Howard or Jim Pinder of BDO Stoy Hayward on +44 207 486 5888 or by e-mail at [emma.howard@bdo.co.uk](mailto:emma.howard@bdo.co.uk) or [jim.pinder@bdo.co.uk](mailto:jim.pinder@bdo.co.uk)

# 3 Asia Pacific

## 3.1 Australia

### 3.1.1 Partnership interests not exempt

The Australian tax authorities have ruled, in a draft Determination, that a partnership interest does not qualify as an 'active foreign business asset' for the purposes of the participation exemption from capital gains tax.

Under Australia's capital gains tax rules, gains on the disposal of shares in a foreign entity are exempt from capital gains tax to the extent that they represent the active business assets of the foreign company being disposed of (such as business goodwill, for example). The question arose as to whether an interest in a foreign partnership held by the foreign company was such an asset.

Tax authority rulings may be challenged in court, but in this case, there is little doubt that the ruling is correct, as there is a specific legislative provision to this effect. Australian businesses with offshore operations should ensure that they are structured correctly in order to take advantage of the participation exemption.

### 3.1.2 US tax debt not enforceable in Australia

Unpaid tax debts due to foreign revenue authorities are not in general enforceable in Australian courts, the New South Wales Supreme Court has affirmed in a recent judgment. The case concerned an executrix who obtained leave to distribute an estate without taking into account a claim for unpaid tax brought against the estate by the US Internal Revenue Service.

In most common-law countries such as Australia, it is a cardinal principle that foreign public laws cannot be enforced in the domestic courts, although this principle can be mitigated by specific agreements. In Australia, some double tax treaties such as those with France and Norway specifically override this principle, but that with the US does not.

With the growing globalisation of the world economy, the increase in cooperation between tax authorities and the clamping-down on international tax evasion, however, it is likely that future treaties and laws may abrogate this principle, so that less and less reliance may be placed on this principle in future.

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## 3.2 New Zealand

### 3.2.1 Business-friendly Budget brings corporate tax cut

In his 2007-08 Budget speech, the Minister of Finance, the Hon Dr Michael Cullen, announced a package of measures hailed as generally business-friendly by most commentators. The measures he proposed include:

- a decrease in the company tax rate from 33% to 30%, effective from 1 April 2008
- a 15% tax credit for expenditure on research and development
- a reduced 30% tax rate for certain savings vehicles
- an active-income exemption for controlled foreign companies
- significantly improved rebates for charitable donations
- compulsory employer contributions to KiwiSaver pension schemes

#### Company tax

The 3 percentage-point reduction in the rate of company tax will take effect in the 2008-09 income year. New Zealand operates an imputation system of dividend taxation, so that recipients of dividends obtain a tax credit matching the company tax rate with the dividend payment. Hitherto, the rate of the credit has been 33/67, corresponding to the 33% company tax rate. As

## 3.2 New Zealand

a transitional measure, dividends paid after 31 March 2008 and before 1 April 2010 will continue to bear a 33/67 tax credit despite the rate reduction. Thereafter, subject to any further rate change, the credit will be reduced to 3/7.

Unit trusts and most superannuation and group investment funds will also benefit from the 30% rate. In addition, the top rate of tax on investment income earned on behalf of individuals by a 'portfolio investment entity' (PIE) will be capped at 30%. A PIE is a managed fund that allocates its income to investors and pays tax on their behalf – normally at their marginal rate.

### R&D credit

A tax credit of 15% (equivalent to a 150% deduction) will be granted in respect of specific research and development (R&D) expenditure. To qualify for the credit, a business must control the R&D project, bear the financial and technical risk and own the project results. The R&D must be carried out predominantly in New Zealand. Eligible expenditure will include the cost of employee remuneration, depreciation of tangible assets used primarily in the conduct of R&D, overhead

costs (excluding interest), consumables and payments to R&D subcontractors.

The R&D credits will reduce the tax payable by the company but also give rise to matching imputation credits in the imputation-credit account, thus enabling companies to pass on the tax benefit to shareholders. Lossmaking companies will receive the credit in the form of a cash payment.

The credit will be available for software R&D. However, where software is developed for in-house use, the maximum eligible expenditure will be capped at NZD 2 million (EUR 1.15 million; USD 1.56 million). The minimum qualifying R&D expenditure in any one year will be NZD 20 000 (EUR 11 500; USD 15 625).

### CFC régime

New Zealand's current controlled foreign company (CFC) régime is regarded as overly complex and catches all the income, active or passive, of controlled companies. The government proposes to replace the current limited exemption for companies resident in the so-called 'grey list' countries (of which there are only eight) with a general exemption for all controlled foreign

companies whose proportion of passive income is less than 5%. Where a company's proportion of passive income is 5% or more, only the passive income will be taxable in New Zealand under the CFC rules. Passive income will be defined quite narrowly, to include interest, dividends, royalties and certain rents.

Once the new system is in place (expected to be from 1 April 2009), a domestic thin capitalisation régime will limit the extent to which New Zealand businesses can deduct interest costs relating to offshore investments outside the New Zealand tax base.

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## 4 Sub-Saharan Africa

### 3.3 Thailand

#### 3.3.1 VAT rate increase deferred

The Ministry of Finance has confirmed that the standard rate of VAT in Thailand, 7%, is to remain unchanged until September 2008. A previous Royal Decree had provided for a rise to 10% from 1 October 2007, but the government has decided that the increase should be postponed on economic grounds.

#### 3.3.2 Ruling on foreign employee's tax liability

A private ruling issued to a Japanese-owned company about the liability to income tax of its Japanese executives working in Thailand has confirmed that they are liable to Thai tax on that portion of their income derived in Thailand, regardless of the length of their stay or the location in which their remuneration was paid.

The executives in question were paid in yen in Japan by the Japanese company that was the 99%-plus owner of the Thai company.

In the ruling, the Thai Revenue Department also confirmed that if the Japanese company paid the Thai tax due on the executives' remuneration on their behalf, their taxable Thai income would have to be 'grossed up' so as to include the tax paid.

Were the executives to stay in Thailand for 180 days or more in a tax year, they would also become liable to Thai tax on non-Thai source income to the extent that it was remitted to Thailand in the year in which it was derived.

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### 4.1 Mauritius

#### 4.1.1 Budget announces new tax measures

Among the tax measures announced in the 2007-08 Budget speech by the Minister of Finance on 15 June 2007, are the following:

- A single flat corporate tax rate of 15% will apply from 1 July 2007, and not 1 July 2009 as originally envisaged
- A system of quarterly advance corporate tax payments will be introduced from 1 July 2008 for larger companies (those with a turnover exceeding MUR 100 million (EUR 2.36 million; USD 3.22 million)) and from 1 July 2009 for others. The payments will be based on the previous year's liability
- A special levy on banks of 0.5% of their turnover plus 1.7% of their accounting profits, to apply from 1 July 2007 (liability limited to 30% of the computed account for the year 2007-08)
- Personal income tax also to be charged at a single flat rate of 15% as from 1 July 2007

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# 4 Latin America

## 5.1 Uruguay

### 5.1.1 Major tax reform introduced

A major reform of both personal and corporate taxes took effect in Uruguay on 1 July. The main features of the new system are as follows.

#### Territoriality principle

The territoriality basis of taxation remains, so that Uruguay taxes only transactions taking place, and assets situated or used commercially in Uruguay. Transactions undertaken abroad by Uruguayan companies remain free of Uruguayan tax.

#### New personal income tax

The reform introduces a new personal income tax (*impuesto a las rentas de las personas físicas* – IRPF). Income from dependent and independent personal services is taxable at progressive rates from 0% to 25%, whereas income from capital and capital gains are taxed at various rates from 0% to 12%, depending on the type of income or gain.

#### New non-residents' income tax

A new tax on the income of non-residents (*impuesto a las rentas de los no residentes* – IRNR) applies to income derived in Uruguay by non-resident individuals and entities from commercial transactions, services rendered, income from capital and capital accretions – the rate of tax is variable according to the nature of the income and ranges from 0% to 12%.

#### New business income tax

A new tax on the income of businesses (*impuesto a las rentas de las actividades empresariales* – IRAE) replaces the former industrial and commercial income tax (IRIC), farming income tax (IRA) and the income tax on commissions (ICOM). It is a tax on the net Uruguayan-source profits of businesses, and is broadly similar to the taxes it replaces. The main new features are:

- the rate of the tax is 25%, compared to the previous 30%
- the carry-forward period for losses is extended to five years, compared to the previous three
- transfer pricing rules have been introduced

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