

WORLD WIDE TAX NEWS

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UNITED STATES

LOSS CARRY-BACK PROVISIONS EXTENDED

Among tax measures contained in the Worker, Homeownership and Business Assistance Act, signed by President Obama on 6 November, is an extension of the carry-back period for losses (net operating losses, or NOLs) incurred in 2008 or 2009.

An Act passed earlier in 2009 (the American Recovery and Reinvestment Act) allowed an 'eligible small business' to carry back a loss arising in 2008 for three, four or five years, rather than for the two-year period normally allowed. Under that provision, a taxpayer with an accounting period other than a calendar year, was entitled to choose the extended carry-back period for the taxable year that began or ended in 2008.

The new Act allows all taxpayers (regardless of gross receipts, hence no longer only small businesses) to carry back an NOL arising in either 2008 or 2009 (but not both) for three to five years. As under the earlier provision, a taxpayer with an accounting period not coincident with the calendar year may choose from among a taxable year beginning or ending in 2008 or 2009 for the extended carry-back period.

If the loss is carried back for five years, it may in that fifth year offset only 50% of taxable income. The remaining loss is then carried forward from that fifth preceding year until fully utilised, giving precedence to an earlier year before a later year. There is no limitation on the amount of income that may be offset in any preceding year except the fifth.

In addition, the new Act suspends the 90% limitation on the use of an NOL deduction against the alternative minimum tax normally attributable to amounts carried back for which the extended carry-back period is chosen.

An eligible small business (within the sense of the American Recovery and Reinvestment Act) that has made or makes a timely election to carry back a 2008 loss under that Act may also elect to carry back a 2009 loss under the new Act.

A similar extended carry-back period is available for an operating loss of a life-insurance company. The extended period may not be used by certain taxpayers who have received or will receive financial assistance under the Emergency Economic Stabilization Act 2008 in the form of an equity infusion or acquisition of a warrant or other right.

Elections to carry an NOL back for the extended period must be made by the due date (subject to extension) for filing the tax return for the taxpayer's last taxable year beginning in 2009. In addition, affected taxpayers have an identical period of time in which to revoke a prior election to forgo the entire NOL carry-back period for the loss year.

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EDITOR'S LETTER

Welcome to Issue 20 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 BDO Global Coordination BV in Brussels. If you have any comments or suggestions concerning *BDO World Wide Tax News*, please contact the Editor via the BDO International Executive Office at mderouane@bdoglobal.com or by telephone on +32 (0)2 778 0130.

We wish all our readers the Compliments of the Season and a peaceful and prosperous 2010.

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MEXICO

TAX INCREASES IN MEXICAN BUDGET MEASURES

Several tax increases, effective from the tax year 2010, were contained in the Budget Act signed by President Calderón in November.

RATE OF INCOME TAX

For the tax years 2010 to 2012, the rate of corporate income tax is increased from 28% to 30%. The rate is scheduled to decrease to 29% in 2013 and to revert to 28% in 2014.

RECAPTURE OF DEFERRED TAX UNDER CONSOLIDATION

A shorter period for enjoyment of the tax benefits of consolidation now applies. Tax deferred by consolidation becomes payable in the sixth tax year after the year in which the income is generated, beginning in 2010 with a phased recapture of pre-2005 tax benefits.

The rate of recapture will be 25% in both the sixth and seventh year; 20% in the eighth year, and 15% in both the ninth and tenth years. For tax deferred before 2005 and after 1998, recapture will begin with 25% in 2010, 25% in 2012, 20% in 2013 and 15% in 2014 and 2015.

VALUE ADDED TAX

The standard rate of VAT is increased from 15% to 16% in 2010 (the reduced rate in certain border areas increases from 10% to 11%).

CASH DEPOSITS TAX (IDE)

The rate of tax on cash deposits rises from 2% to 3% on deposits exceeding MXN 15 000 made in a single month.

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UNITED STATES OF AMERICA

WORLDWIDE INTEREST ALLOCATION DEFERRED

Under the American Jobs Creation Act 2004, taxpayers were to be allowed to elect to utilise a liberalised rule for allocating their interest expense among different sources of foreign income, in order to maximise the available foreign tax credit. This election was to be available for taxable years beginning after 31 December 2010. It will not now be available for a further seven years, i.e. first for taxable years beginning after 31 December 2017.

INCREASED PENALTIES FOR FAILURE TO FILE PARTNERSHIP AND S-CORPORATION RETURNS

The penalty for failure to file partnership returns or S-Corporation returns is currently USD 89 per partner or shareholder for each month or portion of a month for which the return is overdue, up to a maximum of 12 months. The Worker, Homeownership and Business Assistance Act increases the penalty to USD 159 per partner or shareholder, with effect for returns in respect of taxable years beginning after 31 December 2009.

ESTIMATED TAX PAYMENTS BY CORPORATIONS

Corporations with assets of at least USD 1000 million face an increase of 33 percentage points in the amount of estimated tax payments due in July, August or September 2014. These payments will now amount to 133.25% of the payment otherwise due for the quarter. The payment due in the following quarter is reduced by the same amount.

NEW PROTOCOL AMENDS UNITED STATES-SWITZERLAND TREATY

A new protocol to the double tax treaty with Switzerland, signed on 23 September 2009, provides for zero withholding tax on dividends paid to eligible individual retirement accounts (IRAs) and pension plans, new exchange-of-information provisions, and mandatory arbitration rules.

Readers may well remember the recent controversy surrounding demands by the Internal Revenue Service for bank-account details from the Swiss bank UBS in respect of suspected evaders of US tax, which has now been settled. The protocol replaces the previous article (Article 26) on exchange of information with a more extensive article. The new provisions comply with OECD requirements on the provision of information in individual cases when a specific and justified request has been made. As a result, US authorities will have easier access to information on US account holders with accounts at banks located in Switzerland.

However, the United States must be able clearly to identify the suspected account holder, the applicable period of time, the nature and format of the information to be received, and the tax purpose underlying the request. The level of detail required is intended to prevent 'fishing expeditions' for data irrelevant to tax matters.

Amendments to the dividend article ensure that US holders of IRAs that include Swiss companies in their portfolio will not be subject to Swiss withholding tax in respect of dividends from those companies. The exemption will not be available, however, where the IRA controls the company paying the dividend.

The protocol also provides binding-arbitration rules where the two states' tax authorities have been unable to resolve a dispute after the expiration of a reasonable period of time.

Before it enters into effect, the protocol must be ratified by both countries' legislatures and instruments of ratification exchanged

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EUROPEAN UNION

LISBON TREATY IN FORCE

On 1 December, the Lisbon Treaty entered into force, bringing with it many institutional changes. Some of these also have relevance to direct and indirect tax issues.

The EC Treaty, which contains the basic freedoms (freedom of establishment, free movement of capital, free movement of citizens etc), is renamed the Treaty on the Functioning of the European Union (TFEU) and some of the articles are renumbered. For example, Articles 43ff EC Treaty (freedom of establishment) become Articles 49ff TFEU; Articles 56ff (free movement of capital) become Articles 63ff. The European Union assumes full legal personality, and EC Directives become EU Directives.

In this issue alone, we shall continue to use the old designations, and refer to the treaty as the EC Treaty and use the previous article numbering for ease of reference. From Issue 21, however, the new designations will be used.

COMMISSION TACKLES VAT GROUPING RULES IN EIGHT STATES

The European Commission has formally requested no less than eight Member States to amend their legislation on VAT groups. The request, in the form of a Reasoned Opinion, was made on 20 November 2009, and addressed to the Czech Republic, Denmark, Finland, Ireland, the Netherlands, Spain, Sweden and the United Kingdom.

If the states concerned do not respond in a satisfactory way to the Opinion, the Commission may bring a case before the European Court.

For more details, see below under each country.



BELGIUM

COMMISSION ASKS FOR CHANGES IN THE PARENT-SUBSIDIARY RULES

The European Commission has asked Belgium in a 'reasoned opinion' to change the way it implements the Parent-Subsidiary Directive.

The Directive requires (a) dividends paid to associated companies resident in other EU Member States to be exempt from withholding tax and (b) dividends received from associated companies resident in other Member States to be exempt from corporation tax or for there to be a full tax credit for the foreign tax paid.

The Directive applies as between companies where one has a minimum holding of 10% in the capital of the other, but no other conditions are to be imposed. Currently, however, Belgium also requires the holding to be a 'fixed financial asset' before it applies the exemption stipulated by the Directive.

This additional condition is, in the opinion of the Commission, unlawful. Belgium has two months in which to comply with the Commission's opinion. If it fails to do so, a case may be brought before the European Court of Justice. In an earlier case (*Cobelfret*), the ECJ found Belgium to be in breach of the Directive in the method that it applied to exempt dividends qualifying under the Directive (see below).

EXCESS DIVIDEND-RECEIVED DEDUCTION EXTENDED BEYOND EEA

The Belgian tax authorities have issued a second Circular on how they intend to apply the *Cobelfret* decision. In previous issues of *BDO World Wide Tax News*, we have reported how the European Court of Justice held that the Belgian system of exempting foreign dividends where required by the EC Parent-Subsidiary Directive failed to do so in certain cases (Issue 2009 No 1) and on the first Circular issued by the tax authorities in response to the decision (Issue 2009 No 2).

In the first Circular, the authorities confirmed that where some part of the dividend received could not be deducted under the previous rules, the excess dividend-received deduction (DRD) could be carried forward to future years. It further specified that the carry-forward applied to qualifying dividends as follows:

- dividends received from other Belgian companies as from 1 January 1992
- dividends received from other EU Member States as from 1 January 1992 (or the later date of accession of that particular Member State)
- dividends received from Iceland or Norway from 1 January 1994

The first Circular maintained, however, that dividends received from Liechtenstein or outside the European Economic Area did not qualify for the excess DRD, since the European Court's judgment did not extend to third countries.

The second Circular, issued on 12 October 2009, reverses this position somewhat. The authorities now concede that the excess DRD may apply to dividends from third-country companies, provided that

- the relevant country has a double tax treaty with Belgium containing an 'equal treatment' clause effectively requiring dividends from that country to be treated as if they were Belgian dividends or
- where the EC Treaty guarantees free movement of capital

The Circular contains a list of 26 countries with which it is considered that the appropriate treaty is in existence. Broadly speaking, the free movement of capital would apply where the shareholding is not sufficient to confer any influence on decision-making and where no restrictions were already in place before 1 January 1993.

BUDGET TAX MEASURES

Among tax measures announced in the Government's Budget for 2010 were the following:

- the threshold for the alternative condition (capital invested) for applying the participation exemption is raised from EUR 1.2 million to EUR 2.5 million. This condition can be used to claim the exemption where the shareholding is below 10%
- 25% of fuel expenses will become non-deductible
- the percentage rate for the notional interest deduction is set at 3.8% for the tax years 2011 and 2012
- a reduced VAT rate of 12% is introduced for meals in restaurants and catering

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CYPRUS

FURTHER INCENTIVES FOR INVESTORS

Cyprus has enacted amendments to both income tax and the special defence contribution (SDC), designed to promote Cyprus as a jurisdiction for the establishment of collective investment schemes, and benefit corporate investors in Cypriot and foreign collective investment schemes.

The already minimal 1% holding requirement for a Cyprus company to benefit from the participation exemption from income tax on foreign-source dividends has been abolished, so that dividends from corporate holdings (however small) in foreign companies can now qualify for the exemption.

Interest earned by a Cyprus collective investment scheme (CIS) is subject (after deduction of allowable expenses) to income tax but is exempt from SDC. Hitherto, however, Cyprus-resident shareholders in a CIS have been subject to 15% SDC on any profit realised on the redemption of their units in the CIS. Under the amended legislation, a buy-back or redemption of units will not be considered to constitute a dividend and will therefore be free of SDC.

The third amendment concerns the treatment of Cyprus companies earning interest, such as deposit interest, other than in the ordinary course of business. This has previously been subject both to SDC and (to the extent of 50%) also to income tax, resulting in an effective rate of income tax of 15%. Under the law as amended, the interest will be liable solely to SDC at 10%.

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CZECH REPUBLIC

COMMISSION WANTS CHANGE TO VAT GROUPING RULES

The European Commission has formally requested the Czech Republic to amend its legislation on VAT groups, to prevent the inclusion of non-taxable persons in a VAT group.

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DENMARK

COMMISSION WANTS CHANGE TO VAT GROUPING RULES

The European Commission has formally requested Denmark to amend its legislation on VAT groups, to prevent the inclusion of non-taxable persons in a VAT group.

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a company may not deduct net interest expense exceeding 30% of 'EBITDA' (earnings before interest, tax, depreciation and amortisation). With retroactive effect from 2007, the Bill would in certain circumstances allow amounts by which the net interest expense is less than 30% of EBITDA to be carried forward for a maximum of five years as a form of allowance against excess interest expense in subsequent years. Such amounts carried forward will first be taken into account in 2010

- making permanent the relaxation in the loss-forfeiture rule on change of ownership. We reported in Issue 19 of *BDO World Wide Tax News* that the rule under which losses carried forward are forfeited on a change of ownership was to be disappplied on the occasion of certain company reorganisations necessitated by the financial crisis. This waiver of the rule applied solely to reorganisations carried out in 2008 or 2009. The Bill proposes to extend the waiver to qualifying reorganisations taking place in 2010 and subsequent years
- disapplication of the loss-forfeiture for reorganisations within a 100% group. Currently, losses carried forward in a German company could be lost even on the occasion

FINLAND

COMMISSION WANTS CHANGE TO VAT GROUPING RULES

The European Commission has formally requested Finland to amend its legislation on VAT groups in two respects.

First, to prevent the inclusion of non-taxable persons in a VAT group. Second, to extend the grouping facility to all taxable persons generally, and not limit it to the financial and insurance services sector as at present.

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of a reorganisation further up in the group involving a share transfer between two foreign companies. Under the Bill, there would be no forfeiture of losses if a wholly owned German company's shares are transferred within a group, and 100% of the shares in both the transferor and transferee companies are directly or indirectly held by the same person. Even a small third-party holding would disqualify the transfer. The new rule is intended to apply to reorganisations carried out after 31 December 2009

- introduction of a hidden-reserve exemption for the loss-forfeiture rule. The loss-forfeiture would not apply to the extent that the amount of losses carried forward did not exceed the German company's 'hidden reserves' located in Germany. For this purpose, 'hidden reserves' are the excess of the purchase price of the company's shares over the value of its equity for tax purposes (on a pro-rata basis where less than 100% of the shares are transferred). Hidden reserves located in foreign permanent establishments or in subsidiaries (whether domestic or foreign) would not be taken into account for this purpose
- introduction of an exemption from real property transfer tax (*Grunderwerbsteuer*) on corporate reorganisations. Under the Bill, there would be an exemption from real property transfer tax on certain reorganisations in compliance with the Reorganisations Act (*Umwandlungsgesetz*). The exemption would not apply to real property acquired in the five years preceding the reorganisation, nor to real property disposed of within the five years following the reorganisation

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GERMANY

NEW COALITION LEGISLATES FOR TAX CUTS

Following the October general election, the previous 'Grand Coalition' (Christian Democrat – Social Democrat) has been replaced by a centre-right coalition between the Christian Democrats (CDU) and their sister party, the Christian Social Union (CSU) on the one part and the Free Democrats (FDP) on the other. Angela Merkel continues as Chancellor.

The new government has introduced immediate tax relief measures and more tax cuts are promised for the future. A Bill containing the first measures has been passed by the lower house (*Bundestag*) and is due for consideration by the Upper House (*Bundesrat*) on 18 December. At the time of writing, the passage of the Bill, at least in its unamended form, was by no means certain.

Nevertheless, the measures contained in the Bill include:

- making permanent the temporary increase in the threshold for application of the restriction of the interest deduction at EUR 3 million of net interest expense. As reported in the last issue (Issue 19, October 2009) of *BDO World Wide Tax News*, the increase from the previous threshold of EUR 1 million was limited to accounting periods beginning after 25 May 2007 and ending before 1 January 2010
- an increase in the tolerance threshold for non-application of the interest restrictions. Currently, the interest restrictions do not apply where a group company can show that its own debt-equity ratio is not more than 1% greater than the debt-equity ratio of the group as a whole. This tolerance threshold is to be increased to 2%
- introduction of an excess 'EBITDA' carry-forward. Where the interest restrictions apply,

IRELAND

TOUGH BUDGET MAKES FEW TAX CHANGES

Few significant tax changes were announced in what has been widely billed as Ireland's 'harshest budget for decades', delivered by the Minister of Finance, Brian Lenihan TD, on 9 December.

The Budget focused mainly on cuts in welfare spending and public-sector pay, but among the tax measures was a half-point decrease in the standard rate of VAT, the introduction of a carbon tax and a planned simplification of the personal tax system.

VALUE ADDED TAX

The standard rate of VAT is to decrease from 21.5% to 21% with effect from 1 January 2010. The reduced rate of 13.5% remains unchanged.

REFORM OF PERSONAL TAX

The Minister announced he intends to replace the current personal tax system, under which individuals pay income tax (of which there are two rates – 20% and 41% – plus an income levy), and a double social security charge

(the health levy and PRSI – pay-related social insurance) with a simpler two-charge system, consisting of a progressive income tax and a single combined social security contribution (replacing the income levy, the health levy and PRSI). The new system will come into effect in 2011.

Meanwhile, those on the highest incomes will face a further restriction from 1 January 2010 on the reliefs they may claim, to ensure that their minimum effective rate of income tax is 30%. The entry-point to the restriction will occur at a level of adjusted income of EUR 125 000 (previously EUR 250 000), and the full restriction will now apply at income of EUR 400 000.

DOMICILE LEVY

Taxpayers who claim Irish domicile but are non-resident, and all non-resident Irish citizens (regardless of domicile) whose worldwide income exceeds EUR 1 million and who have capital of more than EUR 5 million situated in Ireland will pay a domicile levy of EUR 200 000 per year, beginning in 2010.

CUTS IN EXCISE DUTY

Excise duty on alcoholic drinks has been cut substantially, and there is no increase in the

excise duty on tobacco.

CARBON TAX

A carbon tax, amounting to EUR 15 per tonne, has been introduced on fossil fuels.

NO CHANGE TO CORPORATION TAX

In announcing no change in the 12.5% rate of corporation tax on trading income, the Minister affirmed the Government's commitment to this rate, one of the lowest in the European Union.

COMMISSION WANTS CHANGE TO VAT GROUPING RULES

The European Commission has formally requested Ireland to amend its legislation on VAT groups, to prevent the inclusion of non-taxable persons in a VAT group.

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ITALY

WITHHOLDING TAX ON EU DIVIDENDS UNLAWFUL

In the way that it applies withholding tax on dividends to companies resident in other EU Member States, Italy is in breach of the free movement of capital guaranteed by the EC Treaty. The European Court of Justice has so held, in a case brought by the European Commission.

Under current Italian law, when an Italian company receives a dividend from another Italian-resident company, the dividend is taxable, but the recipient may deduct 95% of the dividend received. The remaining 5% is taxed at a rate of 27.5% (33% in the years under review). The effective tax rate on the dividend is thus 1.375% (1.65% in the case before the court). By contrast, when a dividend is paid to a non-resident company and the EC Parent Subsidiary Directive does not apply, tax of 27% is withheld. Up to four-ninths of that tax may be reimbursed (on provision of proof that tax has been paid abroad on those dividends), leaving a minimum tax burden of 15%. Under an applicable tax treaty, the withholding tax may be reduced to 10% or 5%, but the net tax burden is still greater than for domestic dividends. It was this difference in treatment that the Commission considered to be in breach of Article 56 of the EC Treaty (free movement of capital) and the equivalent article (Article 40) in the EEA agreement. The Commission also considered that the situation was incompatible with Article 31 of the EEA Agreement (freedom of establishment).

In 2008, while the procedure before the Court was pending, Italy amended its legislation, to provide that for dividends declared on profits arising from 1 January 2008 and payable to companies resident elsewhere in the European Union or European Economic Area, withholding tax was to be reduced to 1.375%, but that it was to remain at 27% for dividends declared on profits arising before 1 January 2008.

The ECJ has upheld the Commission's contentions as regards the free movement of capital under the EC Treaty, and dismissed all of the Italian government's advanced justifications. Accordingly, EU companies that have suffered from the discriminatory level of taxation on Italian dividends should be entitled within the normal time limits for claims, to a

repayment of the excess tax. The normal time limit in such cases is 48 months from the date the dividends are paid.

However, the judgment was not entirely in favour of the Commission. The Court considered that as regards dividends paid to EEA-resident companies not within the European Union, the discrimination was justified on the grounds of the need to combat tax evasion.

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LATVIA

TAX INCREASES FOR 2010

The 2010 Budget passed by the *Saeima* (Parliament) on 1 December contained a series of tax increases. Among the more important measures are:

- An increase in the rate of personal income tax from 23% to 26%
 - Abolition of the special income tax rate of 15% on the business profits of individuals; as a result such profits will now be taxed at 26%
 - Introduction of income tax at 10% on previously exempt investment income such as dividends and most forms of deposit interest
 - Introduction of income tax at 15% on previously exempt capital gains on the disposal of e.g. shares and securities and immovable property
 - Introduction of a progressive property tax on residential property, at rates of between 0.1% and 0.3%
 - Increases in excise duties
- However, the rate of corporate income tax is unchanged at 15% and neither is there any change in the VAT rates (21% and 10%).

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VAT GROUPING INTRODUCED

As reported in *BDO World Wide Tax News Issue No 19* (October 2009), the VAT Act has been amended to allow for the registration of VAT groups.

As from 1 December 2009, a single registration may be entered on behalf of a VAT group. The group members must all be taxable persons who are either Latvian companies or the Latvian branches of foreign entities, on the proviso that those entities would under Latvian law be regarded as members of the same group of companies (*koncerns*). At least one member of the VAT group must have had a taxable turnover of no less than LVL 250 000 in the 12 preceding months.

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NETHERLANDS

PROSPECTIVE CHANGES TO CORPORATION TAX

Following the publication of a consultation document in June, the Netherlands government has issued a statement on the progress of proposed changes to corporation tax. As a result of the comments received, the government has decided to revise some of its plans. The new proposals include the following.

LIMITING THE INTEREST DEDUCTION ON ACQUISITIONS

Under current rules, a Netherlands holding company can deduct its interest expense against the profits of other companies in its tax group ('fiscal unity'). Where an acquisition is financed by borrowing, this permits the costs to be offset against the profits of the target company. Under the government's new proposals, interest payable by the holding company would be available for set-off only against the holding company's own profits (if any) where there was an excessive debt-equity ratio.

FOREIGN-BRANCH LOSSES

Although the profits of a Netherlands company's foreign branches are in principle subject to Netherlands corporation tax, they are largely exempt as a result of double tax relief rules. Foreign-branch losses, however, are available for set-off against the 'head office' profits. Should the branch become profitable, there is a recapture rule that prevents the application of double tax relief to those profits until the profits exceed the previously set-off losses.

Under the government's new proposals, a territorial principle would be applied to branch profits and losses, so that foreign-branch losses would cease to be available for set-off in the

Netherlands, while by the same token, foreign-branch profits would not be taxable as a matter of principle.

If both the above measures are to be implemented, they are likely to take effect from 1 January 2011.

INTEREST BOX POSTPONED

The proposed interest box, under which net interest income would be taxable at a reduced rate of 10%, may not now be introduced, at least in the near future, unless the climate for foreign investment in the Netherlands can be maintained.

EARNINGS-STRIPPING RULES TO BE REVIEWED

The June consultation document contained other measures aimed at limiting the interest deduction in excessive cases. The government is to review these measures against the possibility that they may be in breach of EC law.

COMMISSION WANTS CHANGE TO VAT GROUPING RULES

The European Commission has formally requested the Netherlands to amend its legislation on VAT groups in two respects.

First, to prevent the inclusion of non-taxable persons in a VAT group. Second, on a technical matter, with respect to its failure to notify changes to the fiscal-unity scheme to the European Union's VAT Committee.

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PORTUGAL

EXIT TAX TO BE EXAMINED BY ECJ

The European Commission has referred Portugal's imposition of an exit tax on companies moving their tax residence out of Portugal to the European Court. This follows Portugal's inaction following the Reasoned Opinion issued on this matter by the Commission in November 2008.

Under Portuguese law, a company transferring its residence from Portugal to another jurisdiction (this involves the transfer of the company's registered office (seat) and its place of effective management), or a Portuguese branch of a foreign company ceasing its activities in Portugal or transferring its assets abroad, is liable to an exit tax on capital gains both realised (where the assets concerned are actually disposed of) and unrealised (where there is only a deemed disposal due to emigration). In addition, the shareholders of an emigrating Portuguese company are taxed on the difference between the appropriate

proportion of the market value of the company's net assets at the time of migration and the cost of their participation.

The Commission considers that the tax on unrealised gains, which are not taxable in purely domestic circumstances, is an unjustified restriction on the freedom of establishment guaranteed by the EC Treaty. It bases its reasoning on the ECJ case of *De Lasteyrie du Saillant*, which concerned an individual emigrant's unrealised capital gains. The applicability of this decision to companies and other legal entities is not yet definitively established.

Since the case concerns the freedom of establishment, any adverse judgment would affect emigration to other EU or EEA states only. A similar action is being brought against Spain (see below).

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SPAIN

EXIT TAX TO BE EXAMINED BY ECJ

The European Commission has referred Spain's imposition of an exit tax on companies moving their tax residence out of Spain to the European Court. This follows Spain's inaction following the Reasoned Opinion issued on this matter by the Commission in November 2008.

Under Spanish law, a company transferring its residence from Spain to another jurisdiction, or a Spanish branch of a foreign company ceasing its activities in Spain or transferring its assets abroad, is liable to an exit tax on capital gains both realised (where the assets concerned are actually disposed of) and unrealised (where there is only a deemed disposal due to emigration).

The Commission considers that the tax on unrealised gains, which are not taxable in purely domestic circumstances, is an unjustified restriction on the freedom of establishment guaranteed by the EC Treaty. It bases its reasoning on the ECJ case of *De Lasteyrie du Saillant*, which concerned an individual emigrant's unrealised capital gains. The applicability of this decision to companies and other legal entities is not yet definitively established.

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UKRAINE

CRISIS MEASURES AFFECT FOREIGN INVESTMENT

A law enacted on 19 November to counteract the effects of the global financial crisis in Ukraine contains several tax measures, particularly in relation to banks and financial institutions. It is also provided that:

- Until 1 January 2011, all foreign investment must be registered. The previous procedure of registration by local authorities is now applicable to non-monetary investment. Foreign investment in property must now be registered within three days. Monetary investment is subject to registration procedures to be introduced by the National Bank of Ukraine. No such procedures have yet been announced, and until that time, monetary investment is not possible. Although the law prescribes no penalties for failure to register, investors who do not do so would probably face difficulties in realising their investment by selling their interest or redeeming their shares etc
- 'Ukrainianisation' of foreign investment. Foreign investors making monetary investments in Ukraine must now do so in Ukrainian currency (the hryvnia – UAH) and through an investment account opened with authorised Ukrainian banks
- The National Bank of Ukraine will not register any amendments to loan agreements with residents or credit agreements denominated in foreign currency with non-residents which reduce the repayment period of the loan. Resident borrowers may not make advance repayments of such loans even where the agreement was entered into before the law was passed

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UNITED KINGDOM

PRE-BUDGET REPORT BRINGS FURTHER NATIONAL INSURANCE CONTRIBUTION INCREASE

In what is the last pre-Budget report of this administration (a General Election must be held no later than early June), the Chancellor of the Exchequer kept the rates of corporation tax and income tax unchanged, but announced a further increase in national insurance (social security) contributions the year after next (beginning 6 April 2011).

The highlights are these:

- no change in the main corporation tax rate of 28%
- the one-point increase in the small companies rate (21% to 22%) postponed for a further year
- the government is to consult on the introduction of a Netherlands-style 'patent box' under which patent income would be taxed at a special low rate of 10%
- a paper early in the New Year on changes to the CFC (controlled foreign company) rules
- the top rate of income tax of 50% chargeable on incomes above GBP 150 000 will go ahead on 6 April 2010 as planned, as will the restriction of personal allowances for those with taxable incomes of over GBP 100 000
- the anti-forestalling cap on pension contributions in excess of the normal contributions pattern before 22 April 2009 will now apply to individuals with gross incomes above GBP 130 000 instead of above GBP 150 000 as originally legislated. The restrictions are meant to discourage excessive pension contributions in advance of the restrictions on contribution relief to take effect from 6 April 2011
- national insurance contributions will now increase by one percentage point across the board on 6 April 2011, not just by 0.5 of a point as previously announced. The employer rate will then be 13.8%, the employee rate 12% and the self-employed rate 9%. Lower-paid employees will be partially protected

SWEDEN

COMMISSION WANTS CHANGE TO VAT GROUPING RULES

The European Commission has formally requested Sweden to amend its legislation on VAT groups, to extend the grouping facility to all taxable persons generally, and not limit it to the financial and insurance services sector as at present.

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from the increase

- the standard rate of VAT will revert to 17.5% on 1 January 2010 as previously intended
- banks and other financial institutions paying discretionary bonuses above GBP 25 000 per employee will pay an additional bank payroll tax of 50%, and the tax will not be deductible in computing corporation tax profits. BDO's initial view is that the tax will extend beyond banks and building societies, and may include brokers and custodians. The new tax is scheduled to expire on 5 April 2010.

VAT ON SHARE SALES MAY BE RECOVERABLE

Companies may be able to claim for repayment of input VAT incurred on the sale of shares in a subsidiary, following a recent decision of the European Court of Justice (ECJ).

If a parent company sells a subsidiary, the UK VAT rules currently treat the sale to be an exempt supply. This means that the parent company is unable to recover any VAT on costs that it incurs wholly in relation to the sale, unless the purchaser belongs outside the European Union.

In a recent case involving a Swedish company (*Skatteverket v AB SKF*), however, the ECJ took a wider view. It held that costs relating to the sale of shares in a wholly owned and actively managed subsidiary can be seen as supporting a company's overall business activities. In that event, VAT may be partly or wholly recoverable, if the sale of the subsidiary forms part of a reorganisation of the parent company's business.

The ECJ also pointed out that the special rules for the transfer of a going concern (TOGC) allow for the recovery of VAT on sale costs to the same extent as they would on general overheads, and stated that it would be wrong to deny recovery in relation to the sale of shares in a subsidiary, where this was equivalent to a TOGC.

The ECJ held that it was for national courts to decide whether, in any particular case, the costs of selling a subsidiary support a company's overall business activities and/or whether the sale has an equivalent effect to an asset deal. For VAT to be recoverable, there must be an immediate and direct link to the company's economic activities.

Her Majesty's Revenue and Customs has yet to make any announcement on the decision, but any business that has incurred costs on a share sale relating to a wholly owned and actively managed subsidiary should now consider whether it is eligible to submit a claim for repayment of tax and interest. Businesses that are contemplating future disposals of subsidiaries should also consider how best to structure these in light of the European Court's decision.

COMPANY RESIDENCE MAY COME UNDER INCREASED CHALLENGE

There are indications that the new first-instance tax tribunal, the First-Tier Tribunal

(which replaced the former General and Special Commissioners in April 2009), is more likely to take a sceptical view of whether the location of board meetings is the decisive factor in determining company residence.

Under UK law, a foreign-incorporated company is resident in the United Kingdom if its central management and control is located there. Where board meetings that take substantive decisions are held outside the United Kingdom, that is a strong indication that the company is not UK-resident. If those board meetings merely rubber-stamp decisions taken elsewhere, however, the courts will look to see where decisive influence is exercised.

In the recent *Laerstate BV* case, a Netherlands company was held to be resident in the United Kingdom even though its board meetings were held abroad. The Tribunal noted that the company's UK-resident director exercised his powers of central management and control of the company from within the United Kingdom, and even after he had resigned (leaving a sole non-resident director), the Tribunal found that he continued to exercise control of the company by overriding the remaining director's powers.

The company advanced evidence that resolutions had been passed at board meetings outside the United Kingdom, but this evidence was insufficient to persuade the Tribunal that central management and control was exercised at those meetings. On the contrary, the Tribunal accepted evidence from HMRC that the UK-resident ex-director continued to make decisions on the company's behalf.

The taxpayers have lodged an appeal with the Upper-Tier Tribunal. It is possible that the case may proceed beyond that Tribunal to the courts.

THIN-CAP CASE DECIDED LARGELY IN FAVOUR OF THE TAXPAYER

In the ongoing litigation over the United Kingdom's thin capitalisation rules, the High Court has found largely in favour of the taxpayer in the *Test Claimants in the Thin Cap Group Litigation* case.

In March 2007, the European Court of Justice held that the rules, as they applied before 2004, did constitute a restriction on the freedom of establishment, but could be justified where they were targeted at wholly artificial arrangements and were not out of proportion to the mischief they were intended to counter. It was left to the UK courts to determine whether this was so in any particular case, but the ECJ set down two conditions that it considered would be decisive in the proportionality issue. They were that, in order to be proportional, the legislation had to:

- allow taxpayers the opportunity to provide evidence of commercial reasons for the lending structure and to do so without unnecessary administrative hurdles and
- where interest was recharacterised as a distribution because the arrangement was wholly artificial, provide that only the excess

interest over the arm's length rate be so recharacterised

The case concerned the rules that were in place between 1988 and 2004. The rules changed in 1995 and again in 1998 (when they were subsumed into the transfer pricing legislation).

It was found that the rules as they existed before 1995, where there was no double tax treaty in existence, recharacterised the whole of the interest as a distribution, and were thus disproportionate. Even where there was a double tax treaty, the judge in the High Court held, no opportunity was given to taxpayers to demonstrate commercial justification, so the rules there were also disproportionate.

As to the rules after the 1995 amendments, it was not possible, said the judge, to use the approach the Court of Appeal took in *Vodafone 2* (see *BDO World Wide Tax News 2009 Issue 2*) and read into the legislation a commercial-justification test, since the approach the thin capitalisation legislation took did not allow such a reading.

The judge therefore concluded that where there was a commercial justification, in whole or in part, for any transaction, the thin capitalisation rules, as they existed in the entire period under review, had to be disapplied in their entirety, and that the whole of the interest paid by the taxpayers should be allowed, including that part in excess of what would have been agreed by parties acting at arm's length. All the transactions in the test case where the lending company was either EU-resident or the subsidiary of an EU-resident parent, satisfied the commercial-justification test, and were thus allowable in full.

The judge made two further findings. First, he held that the 'clock' for restitution claims as a result of his judgment should run from the date of the ECJ judgment in *Lankhorst-Hohorst* (a case concerning German thin capitalisation legislation), which was delivered on 12 December 2002, and therefore only claims made before 13 December 2008 were in time. Second, he held that the ECJ's judgment and the consequent disapplication of the United Kingdom's thin capitalisation rules, did not extend where the lender was neither resident in the European Union nor a subsidiary of a company resident in the European Union.

The case is bound to go to appeal, but at this stage represents a considerable victory for taxpayers.

COMMISSION WANTS CHANGE TO VAT GROUPING RULES

The European Commission has formally requested the United Kingdom to amend its legislation on VAT groups, to prevent the inclusion of non-taxable persons in a VAT group.

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PEOPLE'S REPUBLIC OF CHINA

GUIDANCE FOR DETERMINING WHO IS THE 'BENEFICIAL OWNER' OF INCOME



The Chinese tax authorities have recently issued a tax circular, *Guoshuihan* [2009] No 601 (Circular 601) to provide guidance for determining who is the 'beneficial owner' of income for obtaining relief under a double tax treaty.

According to tax treaties entered into between China and foreign jurisdictions, persons who are tax-residents of the relevant jurisdiction may enjoy certain benefits under the treaty, e.g. preferential withholding-tax rates on passive income such as dividends, royalties and interest. Those persons must, however, be the beneficial owner of that income in order to obtain these benefits.

Under Circular 601, the general factors for determining whether a person is the 'beneficial owner' of the relevant income are as follows:

- does the person have ownership or control over the income or the rights or assets that generated such income?
- does the person engage in substantial business activities?

An agent or a conduit company, incorporated for the purpose of avoiding or reducing taxation, transferring or accumulating profit without any substantial business activities, is not a 'beneficial owner'.

The principle of 'substance over form' will be adopted by the Chinese tax authorities and the onus of proof is on the taxpayer when applying for relief under a treaty. The applicant should provide relevant supporting documents to the tax authorities to satisfy them that he is the

'beneficial owner' of the relevant income.

Circular 601 specifies that the following are factors that would suggest the applicant is not the beneficial owner:

- the applicant is obliged to distribute all or most of its income (e.g. more than 60%) to a resident of a third country within a prescribed time period (e.g. within 12 months from date of receipt);
- the applicant has no or almost no business activities;
- where the applicant is an entity e.g. a company, its assets, scale of operations and personnel are not commensurate with its income;
- the applicant has no or almost no control and decision-making rights and does not bear or bears very little risks;
- the income of the applicant is non-taxable or is subject to a very low effective tax rate;
- in the case of interest, there is a loan or deposit contract between the applicant and a third party, the terms of which (amount, interest rate, signing date) are similar to those of the loan contract under which the interest income is received;
- in the case of royalty income, there is a licence or transfer agreement between the applicant and a third party, the terms of which are similar to the terms under which the royalty income is received.

FOREIGN-INVESTED PARTNERSHIPS

The Chinese State Council has issued new measures allowing foreign investors to establish

partnerships in China as from 1 March 2010. Previously, foreign investors were obliged to use a company or joint-venture arrangement.

The measures were issued on 25 November 2009. The measures allow foreign investors to establish partnerships in China and provide the administrative rules and procedures in this regard. A foreign-invested partnership may be formed by two or more foreign partners or jointly by foreign partners and Chinese partners. The partners can be companies or individuals. The establishment of a foreign-invested partnership merely requires registration with the local branch of the State Administration of Industry and Commerce.

However, the measures have not addressed any tax matters and simply provide that foreign partnership-related tax matters should follow the prevailing applicable tax rules and regulations. In fact, currently there are no comprehensive partnership-related tax rules, and almost none specifically on tax treatments for foreign partnerships. Therefore, there are still many unclear tax issues, particularly with respect to foreign partnerships. It is likely that the Chinese tax authorities will issue tax circulars and guidance to clarify these issues.

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INDIA

PAYMENT FOR TECHNICAL SERVICES IS ROYALTY UNDER UK TREATY

In a recent case, the Madras Income Tax Appellate Tribunal (ITAT) has held that payments by an Indian company for technical services, including test documentation and staff training, constituted royalties under the India–United Kingdom double tax treaty, and were thus subject to withholding tax.

Under its agreement with the UK company, the Indian company received technical services, detailed documented test reports that could be used in future to test prototype services, and staff training. Royalties within the meaning of Article 13 of the India–United Kingdom treaty include payments for making technical knowledge available to the payee.

The ITAT held that in the circumstances, such knowledge had indeed been 'made available' and thus that withholding tax had to be deducted from the payments, but at the beneficial rate provided by the treaty.

PAYMENTS BY BROADCASTERS FOR SATELLITE USE HELD TO BE ROYALTIES

In another royalty case, this time before the Delhi ITAT, the Tribunal held that fees for the use of broadcast satellites by an Indian broadcaster constituted royalties and were thus taxable in India.

The facts were that the Indian broadcaster used the services of a Netherlands and a Thai satellite company that provided transponder services to the Indian payee, allowing it to make voice and data transmissions. The satellite companies had no presence in India and no control over the data transmitted from or to the satellite, but charged fees for the use of the transponder.

The satellite companies contended that since they had no permanent establishment in India, the fees were not taxable there since they did not constitute royalties. The company's justification for this contention was that no process was involved (a prerequisite for a royalty), and in any case if there was such a process, it was not secret. For a payment in return for making available a process to be a royalty, the companies argued, that process had to be secret.

The ITAT rejected the companies' arguments. It held that there was a process involved and that there was no requirement for such a process to be secret. The payments made by the Indian company were for the right to use, and for the use of, the predetermined process provided by the foreign companies, and thus the payments were royalties, subject to withholding tax in India.

ROYALTY CAP TO BE LIFTED

On the subject of royalties generally, the Indian government has announced that it intends to lift the royalty cap. Currently, payments for the inward transfer of technology from abroad have to receive prior approval where they exceed USD 2 million for lump sums, or, in the case of recurring payments, 5% of domestic sales and 8% of export sales. For trademarks and brand names, the cap is set at 1% of domestic sales and 2% of export sales.

In future, from a date yet to be specified, the intention is that no prior approval will be needed whatever the amount of the payment, but there will be a reporting mechanism to allow the authorities to monitor the size and nature of royalty payments. Any royalty payments will as now have to be at arm's length rates in order to satisfy the transfer pricing rules.

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MALAYSIA

BUDGET FAVOURS ISLAMIC FINANCE

The Malaysian government's Budget for 2010 included a raft of measures designed to increase Malaysia's attractiveness as a centre for Islamic financial services. These include a deduction for expenditure on establishing an Islamic stockbroking company and on the issue of Islamic securities approved by the regulatory authorities in Malaysia or Labuan, and a 20% stamp-duty exemption for Islamic financial instruments.

Among other tax measures included in the Budget were:

- a reduction in the top personal income tax rate (which is also the rate applied to the income of non-resident individuals) from 27% to 26%
- the reintroduction of the property gains tax (at a rate of 5%) on capital gains derived from a disposal of real property, as from 1 January 2010. These gains have been exempt from tax since April 2007

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MAURITIUS

FEW TAX CHANGES IN MAURITIUS BUDGET

The last pre-election Budget of the current administration was delivered in November, and contained few significant tax changes. Among the changes that were announced was an increase in the withholding tax on royalties payable to non-residents. This goes up from 10% to 15%, subject, of course, to any more favourable rates prescribed by tax treaties.

Mauritian residents paying income tax saw their exemption threshold rise by MUR 15 000 in most cases and by MUR 20 000 in others. These increases will result in tax savings of MUR 2250 and MUR 3000 respectively.

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CHILE

INVESTMENT COMPANIES MUST PAY LOCAL CAPITAL DUTY

In a decision modifying the results of previous cases, Chile's Supreme Court has held that an investment company is liable to the local capital duty chargeable by and payable to local authorities.

The duty, which varies between 0.25% and 0.5% of the taxpaying entity's equity capital, is payable by persons engaging in profitable activities or exercising a profession or occupation. Previous court decisions had held that a company's profitable activities had to be performed in a specific place for the local capital duty to be payable.

In its new decision, the Supreme Court has held that only not-for-profit organisations are exempt from the duty. In the case of investment companies, the court held that these perform 'tertiary activities' (neither extraction nor manufacturing). Since the statutes of the company provided for it to carry on profitable activities, it was liable to the duty. Although the company had not registered a commercial address, it was liable to duty in the local-government area that included its registered office.

In order to mitigate their liability, investment companies may choose to locate their registered office in an area with a lower rate of capital duty, or opt for a greater degree of debt financing. Loans are exempt from stamp duty in 2009.

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ARGENTINA

TAXES INCREASED ON TECHNOLOGY ASSETS

Congress has passed an Act increasing VAT and excise duty on certain assets, mostly those associated with IT and technological processes.

The increase affects assets such as answering machines, GPS equipment, VCRs, colour TV sets, and LCD monitors (group 1) and air conditioning, microwave ovens, audio equipment and compression refrigeration equipment (group 2).

For group 1 assets, the rate of VAT will be doubled, increasing from 10.5% to 21%. VAT

on group 2 assets is already payable at 21% and there will be no change in that respect. For both group 1 and group 2 assets, excise duty, from which they were previously exempt, will be imposed at 20.48%.

The Act has yet to be signed by the President, which is necessary for it to become law.

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CURRENCY COMPARISON TABLE

Below are illustrative exchange rates against the euro and the US dollar for the currencies mentioned in this issue, as at 16 December 2009.

Currency unit	Value in euros (EUR)	Value in US dollars (USD)
Euro (EUR)	1.0000	1.4347
Latvian lats (LVL)	1.4229	2.0421
Mauritian rupee (MUR)	0.02492	0.03578
Mexican peso (MXN)	0.05450	0.07818
Pound sterling (GBP)	1.1232	1.6115
Ukrainian hryvnia (UAH)	0.08741	0.1255
US dollar (USD)	0.6970	1.0000

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