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LEGAL DEVELOPMENTS

LEGISLATION

1. CHILE

Chile, a platform for regional investment with a moderate tax impact

a) *Law No. 20154, published on 9 January 2007*

This Law modifies how Additional Tax is charged on payments made to persons or entities not domiciled or residing in Chile for the use or enjoyment of certain intangible goods by including the tax applicable to interest rates and professional services, reducing the applicable rate, and making certain rules more flexible.

In relation to patents, software, utility models, diagrams and designs, the applicable tax rate is halved from 30% to 15%, except in cases where the foreign entity is domiciled in a tax haven or is related to the Chilean entity.

As for the taxation of interest, the scope of the rules applying to cases in which interest paid abroad qualifies for a reduced 4% tax rate has been broadened. Note that, in general, the applicable tax rate is 35%.

Similarly, the Additional Tax rate applicable to fees paid for engineering or general technical advisory services has been cut from 20% to 15%, except in cases where the foreign entity is domiciled in a tax haven or is related to the Chilean entity.

b) *Law No. 20171, published on 16 February 2007*

This Law introduces modifications to unilaterally mitigate the effects of double taxation with a country that has not signed a tax treaty with Chile.

Accordingly, effective 1 January 2007, **dividends** received **or profits** withdrawn by a Chilean company from a foreign company will qualify for a credit against Chilean taxes, subject to a maximum limit of 30% for taxes paid abroad.

At corporate level, the tax credit limit is 17% (equal to the Chilean corporate income tax rate) and the 13% difference can be taken against the shareholders' personal taxes or the Additional Tax which affects foreign shareholders when profits are withdrawn.

This rule does not apply to other types of income, namely, capital gains or income from movable or immovable property.

It is worth mentioning that the Chilean tax authorities have not yet made any rulings in connection with this statutory modification.

2. CHINA

New Enterprise Income Tax Law

Rather unsurprisingly, the new PRC Enterprise Income Tax Law was enacted at the Fifth Session of the 10th National People's Congress on 16 March 2007 and will be effective 1 January 2008. Despite not having been publicly released before, most interest groups were already well aware of the main provisions of the new Law, since they had had sight of a draft version in December 2006 from various sources. There were no significant changes between the draft and final versions of the Law.

Although the new Law is very brief and many details have yet to be fleshed out in the upcoming Detailed Rules and Regulations (DRR) and subsequent circulars, there is no doubt the new Law will bring about fundamental change in China's corporate tax system and in the way in which enterprises structure their businesses in China. Having said this, the new EIT Law is still just a start.

a) *What are the main changes?*

The main changes introduced by the Law are summarized as follows:

- The new Law will apply to both domestic enterprises and foreign investment enterprises (FIEs). Historically there have been two separate corporate tax systems in China, with the system applicable to FIEs offering significant incentives, most of which were not applicable to domestic enterprises.
- Taxpayers are now defined as "Resident Enterprises" and "Nonresident Enterprises". The definition of "Enterprise" is not clear, but the chances are that the concept of "taxpayer" may be broader than under the two former Laws combined.
- The standard tax rate is 25%.
- Most of the incentives available to FIEs have been abolished, although a five-year grandfathering period will be provided. Incentives are still available in limited industries and ventures such as Hi-Tech, Infrastructure, Environmental Protection, etc., although the scope and significance of these incentives will be far smaller than under the former FIE rules.
- A new feature of the incentives is that many are not directly related to tax rates. Methods like special deduction allowances, special credits and special depreciation/amortization methods will be available.
- Certain prevailing international tax concepts are introduced, such as cost-sharing, thin cap rules, controlled foreign company ("CFC") rules, and arm's-length pricing.
- A five-year grandfathering period is allowed for "*pre-enterprises.*" However, the details still have to be given in the upcoming DRR.

b) *How will it affect my existing business?*

Given China's reputation for many years as a "low tax jurisdiction" for manufacturing FIEs, tax planning usually focuses on maximizing incentives and reducing local tax. There are numerous success stories where zero taxation has been achieved through a combination of tax holidays and reinvestment credit techniques. For many multinational companies, China generates foreign-source income taxed at low rates, something which has helped to push down the effective group tax rate. China will now become a country with an effective tax rate that is at the higher end of the scale and this will change the entire picture.

In the meantime, business costs in the coastal regions of China have risen significantly in recent years. This circumstance, coupled with an individual income tax rate capped at 45%, has led many business leaders to consider moving certain existing functions outside China for tax and nontax reasons. For instance, Vietnam is becoming highly competitive in the manufacturing sector and Hong Kong and Singapore are still competitive locations for regional headquarters and regional trade, especially from a tax standpoint. Furthermore, China's business, legal and foreign-exchange environment are far more relaxed than 10 years ago and the infrastructure (such as financial, logistics, IT and human resources) is much more developed. 10 years ago, a foreign investor had to go to China to do business with the Chinese, but now the Chinese can be found doing business anywhere in the world. Against this backdrop, the restructuring of the existing China-related supply chain on a regional scale becomes possible and can generate huge operating cost and tax savings.

Although not addressed in the new Law, it is possible that the Chinese Government may unveil certain policies relating to tax incentives for developing the manufacturing sector in the mid-western part of the country. The chances are that there will be a certain preference for basing regional headquarters in coastal areas such as those already earmarked by the Shanghai and Beijing regional authorities. The types of incentive envisaged are, however, still uncertain at this stage.

Historically, under China's tax incentive-based foreign investment model, the structure of a foreign investor's business in China had certain unique characteristics. It was common practice for many multinational groups to set up tens, if not hundreds, of legal entities in China. The reason for this is not hard to understand. Each new legal entity meant a new tax holiday for the multinational. There were also many tax and nontax considerations, such as regulatory complexity, controllership, transfer pricing, group consolidation (loss utilization), etc. With most, if not all, of the incentives having now disappeared, it is a good time for foreign investors to review their existing business structure and see what can be improved from both a business and a tax standpoint.

Many believe that the new Law is good news for enterprises in the services sector, which have historically been taxed at 33%, since they will see a significant cut in their tax rate. Having said that, China's business tax system is still problematic. Since it is a tax based on gross revenues, business tax may still, in fact, push up the effective tax rate significantly. Although business tax reform is also on the Chinese Government's agenda, it will take time.

The new Law has many positive aspects. The proposal to disallow the allocation of overheads was dropped at the last minute and cost-sharing is now allowed by law. Although detailed rules are not yet available and there are other considerations, such as business tax, these new developments should be important considerations when revisiting your China structure.

There are many other considerations for existing businesses in China. Should I change my holding structure in view of the uncertainty about the dividend WHT exemption policy? How can I maximize the grandfather benefits? Many of these questions will remain unanswered until more detailed rules emerge. However, as things stand today, it is not too late to revisit or rework your overall China tax strategy.

c) *What if I'm a newcomer? How do I structure a new business?*

In a TEI conference organized recently in Shanghai, many tax executives shared the view that although China would increase the tax rate (for FIEs), their respective multinational groups were still optimistic about their investment in China. The opportunities in the next ten years are enormous and investors are eager and anxious to seize them. The concern from a tax expert's perspective is how businesses can be structured in a tax-efficient way. In this regard, there are many new considerations following the enactment of the new EIT Law.

The "Resident Company" and "Effective Management" concepts, coupled with several rulings on PEs made recently by the Chinese Government, may change how a new business vehicle is structured in China. Transfer pricing will be another critical consideration.

In the past, foreign investors seemed to select their business vehicles by a process of "natural selection": Representative Office, service FIE, trading FIE, manufacturing FIE, Chinese Investment Holdco, etc. at different stages of development in China. The key consideration when choosing the right business vehicle was often not tax, but rather capital requirements and limitations on the scope of business. The tax implications were also closely related to the type of business vehicle selected.

The new Law, however, adopts more of a substance-over-form approach. In keeping with the spirit of the new Law, a Representative Office engaging in activities beyond its allowed scope may trigger a number of serious permanent establishment (PE) issues. A services company/sourcing company may help to reduce the PE risk, but the transfer pricing strategy needs to be carefully planned. Some statistics show that currently around 60%-80% of FIEs are in a loss-making situation, and many believe that things will be fine so long as a profit is being made. However, it is not necessary true that this will remain the case in the next 10 years as China is now entering into an era of international taxation.

It is advisable for newcomers to perform a thorough tax and functionality analysis before they decide on the appropriate business structure in China.

Another critical consideration is the appropriate holding vehicle. Historically, since all dividend remissions from a FIE are withholding ("WHT") exempt, it really doesn't matter whether a Cayman Islands or BVI company is being used. It is still not clear whether this preference will be kept or grandfathered. Even if it is retained, the preference will no longer be at state law level. Accordingly, it would be wise to seek a jurisdiction with an attractive tax treaty with China when designing the holding structure.

d) *Looking ahead*

The new EIT Law is just one of a series of changes in China's tax and legal system in the coming years. China will experience significant changes in the next ten years in relation to its civil law, foreign trade and investment regulations, stock market regulations, indirect tax regime, accounting rules, customs and the social security tax system, etc. This environment is much more dynamic than any well-developed western economy.

These changes will, however, move China into a more transparent market economy environment and lead to a level playing field for everybody. We suggest that an investor should take a proactive approach to planning its business in the context of such changes in order to achieve the best business and tax results.

3. FRANCE

Withholding tax on income distributed to nonresidents

Until 2006, withholding tax on dividends paid by French companies to nonresidents could only be deducted by the payors and by French paying banks.

The 2007 French Finance Act has provided for the possibility, from 1 January 2007 onwards, for foreign paying banks who pay dividends distributed by French companies listed on a regulated stock market to pay the relevant withholding tax to the French Treasury when the following conditions are met:

- the paying banks must be established in another EU Member State or a State which is a party to the European Economic Area Agreement and has signed a tax treaty with France aimed at combating tax fraud and tax evasion;
- the foreign banks must have concluded with the French tax administration an agreement drawn up in accordance with a model issued by the tax administration;
- the foreign banks must be authorized by the distributing company or the last French paying bank to report and pay over the withholding tax in its name and on its behalf.

A Decree is to be published to set forth the terms and conditions for applying this new system and will notably include a model agreement to be entered into by the foreign paying banks and the French tax administration.

4. GERMANY

Changes to German withholding tax rules[1]

a) *Introduction*

In November 2006 the German Federal Government adopted the 2007 Tax Bill. It was published in the Federal Law Gazette before year-end and entered into force on 1 January 2007.

The purpose of this brief article is to deal with a specific provision of the Bill, which deals with anti-abuse rules in relation to German withholding taxes.

b) *The essence of the changes*

The new version of section 50d, paragraph 3 (dealing with anti-abuse provisions) of the German Income Tax Act (*Einkommensteuergesetz*) stipulates that a full or partial reduction of German withholding taxes will no longer be available in certain cases, as outlined below.

Though the provision relates to withholding taxes on dividends, interest (if any) and royalties (and certain other payments), we will only examine the impact on dividends below. The same also holds true for other payments (mentioned above) that are subject to withholding tax.

The domestic withholding tax rate for dividends (and royalties) including the 5.5% solidarity surcharge, is 21.1%. This tax is reduced to a zero rate in the

[1] This submission has been contributed by Jan Kooi of the Dutch Taxand Member, Van Mens & Wisselink. Since neither Van Mens & Wisselink, nor Mr. Kooi are German tax specialists, the purpose of the note is simply to alert our readers to the issue and draw attention to the major international impact that the changes discussed here will have.

event of qualifying holdings under the EU Parent-Subsidiary Directive, and to rates ranging from 5%-15% under tax treaties.

Entitlement to this reduction will no longer apply if the ultimate shareholder(s) of the payee company would not have been entitled to the same reduction had the income been received by them directly, unless the payee company meets all of the following three tests:

- there are business or other good reasons (other than tax reasons) for interposing the payee company and the payee company has business activities of its own; and
- the payee company derives at least 10% of its **total gross revenues** from its own business activities; and
- the payee company carries on a general business activity with sufficient substance.

Note that it will not be necessary to meet all of the above three tests in order to avoid such reduction being disallowed if the (main classes of) shares of the payee company are **materially and regularly** traded on a recognized stock exchange or if the payee company is subject to the Investment Tax Act.

c) *Business activities*

The rationale behind all of the above tests is to make sure that payments to a foreign company that has virtually no business activities do not qualify for any reduction in withholding tax(es). The effect is that, unless all of the three tests referred to above are met, the standard rate of 21.1% would apply instead of the treaty rate applied to the shareholders of the interposed company, had they received the relevant income directly.

Example:

A Japanese company owns 100% of a Dutch holding company, which fails one (or all) of the above three tests. In turn, The Dutch company owns 100% of a German subsidiary. Currently there would be no withholding tax on dividends paid by the German subsidiary to the Dutch company and onward payment to the Japanese company would be subject to 5% withholding tax. Under the Germany-Japan tax treaty the direct withholding tax would also be 5%. However, since a direct payment by the German subsidiary to the Japanese company would not attract a zero tax rate, the German subsidiary must charge the standard domestic rate of 21.1%. Thus, there will be an effective additional tax burden of approximately 20%.

Based on our comments on the new provision, any business activity generating more than 10% of **gross revenues** of the payee company must be carried on at the payee company itself and also in its country (or territory) of residence. An "active" business carried on by a foreign permanent establishment or a subsidiary forming part of the consolidated tax group cannot be taken into account. In principle, a business activity can take the form of merely providing services to only one customer, even if the customer is a related party. However, the holding of shares or securities, the leasing of property or rights and proprietorship of intellectual property do not in themselves constitute an "active" business. It would seem that active management of and control over more than one subsidiary may be regarded as an "active" business. However, even if they did, some doubt still remains as to whether dividend income, capital gains or interest and royalty income can be taken into account when determining whether more than 10% of gross revenues are derived from an active business. Chargeable management fees and administration fees would seem to qualify, but it is also unclear whether the 10% threshold would be passed if such revenues accounted for 10% or less of total gross revenues including dividends, gains and interest.

Typical mailbox companies and so-called *base* companies, would, however, not be regarded as carrying on an active business.

Furthermore, there must be sufficient substance. The company that carries on a business activity must have its own premises and sufficient qualified staff to engage in active business activities. It would seem that the staff would have to be on the company payroll.

d) *Further information and regulations*

It is expected that the German tax administration will issue further written guidance in late March. From what has transpired so far, although no official documents are yet available, the German tax administration is adopting a very narrow interpretation of the substance requirements. Not only would the immediate payee need to have its own business, but also there would (definitely in the case of dividends) need to be a sound and strong business connection between the foreign company and the German subsidiary. It would appear that valid reasons (i.e., non-tax reasons at parent company level or in relation to affiliates) would not be sufficient to argue that the business test is met. Thus, the argument that the German company is owned by, say, a Dutch operating and holding/financing company, because the Dutch company acts as European/regional holding company for all of the subsidiaries in the region, is not a sufficiently strong reason to pass the substance and business purpose tests. It would seem that in such case the Dutch holding company would need to have *de facto* influence over the business of the German subsidiary. Moreover, the taxpayer would have the onus of proving such involvement. Undocumented involvement will not be accepted. The holding company must be involved with more than one subsidiary, if managerial involvement is the only real connection between it and the German company. Individual business functions, such as treasury or coordination of

purchasing would in themselves be insufficient involvement. The relationship must clearly go beyond the normal relationship of a shareholder.

Assuming that all tests, including the 10% test are met, a preliminary withholding exemption certificate will be issued. The burden of proof is on the party applying for the certificate to show that tests are met. If it becomes clear that a test will not be met, the applicant must inform the German authorities of this forthwith. Once the certificate has been issued, the German authorities will be entitled to demand further proof after the fact (i.e., in the years following the pertinent year). Furthermore, if circumstances change in the future, the certificate will be withdrawn. Based on currently available information, some leniency may be exercised if the 10% test has been met for a continuous period of three years, but is not in one year. Furthermore, it appears that in new cases, the certificate can even be applied for if in the first year the 10% test is not met but is likely to be met in each of the coming three years. Existing certificates for a reduction in withholding taxes will only remain valid to the extent that the taxpayer/beneficiary can prove that the three cumulative tests are met during the year of distribution.

Many issues are still extremely unclear. Similarly, no clarity exists as to whether or not the new rules (and the expected regulations) might conflict with EU law, especially as regards whether EU branches should be excluded from determining the existence of and the level of business activities.

Typical examples of groups that will be affected by these new regulations are groups whose ultimate shareholders are in China, Japan, Korea, the US, India and, obviously, places such as Hong Kong or Singapore.

e) *Final comment*

The new rule is not limited to related-party payments. Thus, particularly in the case of royalties, a situation can arise where 21.1% withholding tax suddenly becomes due despite it being completely beyond the control of the payor to (help) avoid the withholding. Only the payee will be able to reorganize its operations in order to meet the new tests.

5. INDIA

India Budget 2007

The Finance Minister of India presented the Union Budget for the 2007-08 fiscal year on 28 February 2007. As part of the Union Budget, the 2007 Finance Bill containing direct and indirect tax proposals was introduced.

Summarized below are some of the key tax proposals:

a) *Direct taxes*

- There have been no changes in the basic corporate tax rates. It continues to be 30% for domestic companies and 40% for foreign companies. However, marginal relief would be provided to companies with a taxable income of less than INR 1 Crore by removing the levying of a surcharge on tax (10% for domestic companies and 2.5% for foreign companies). Also, an additional cess of 1% would be introduced on all taxes (including the surcharge). The effective corporate tax rate would therefore be 33.99% for domestic companies (30.9% if taxable income were less than INR 1 Crore) and 42.23% for foreign companies (41.2% if taxable income were less than INR 1 Crore). Reduced-surcharge marginal relief would also apply across all withholding rates.
- Domestic companies providing Information Technology/Information Technology Enabled Services (IT/ITES) hitherto enjoyed a full tax holiday on their export revenues (currently, set to expire in 2009) under sections 10A and 10B of the 1961 Income Tax Act. It is proposed to eliminate the full tax holiday and require IT/ITES companies to now pay a Minimum Alternate Tax ("MAT") at an effective rate of 11.33% on their book profits (erstwhile MAT protection granted to such companies would be removed). The MAT paid could, however, be credited against future taxes (payable if the tax holiday were withdrawn in 2009). However, MAT would not apply to units located in Special Economic Zones ("SEZs"). These SEZ units would remain entitled to a tax holiday.
- The effective rate of Dividend Distribution Tax ("DDT") on companies would be increased from 14.025% to 16.995%.
- Concessions/benefits granted to employees under Employee Stock Option Plans ("ESOPs") or related plans would become subject to Fringe Benefit Tax ("FBT") in the hands of the employer when the employees in question exercised their options. The tax base for the FBT would be the fair market value of the options/shares granted under the ESOP (net of any amounts recovered from the employees). The tax rate would be 33.99%. The Government is expected to come up with detailed guidelines on valuation, percentage of benefit to be taxed, etc. Venture capital funds ("VCFs") providing seed capital to unlisted start-ups are currently tax exempt (pass-through entities), irrespective of the industry to which the capital is provided. The areas

targeted for investment by VCFs and continuing to enjoy tax-exempt status would be restricted. A limited list of areas has been specified. Among the key areas excluded are real estate and ITES (IT remains on the list of tax-exempt areas).

b) *Indirect taxes*

- The top rate of basic customs duty would be reduced to 10%, while the effective top rate of customs duty would be 34.13%.
- The top rate of excise duty would be 16.48%.
- Re-emphasis on the introduction of the converged Goods and Service Tax ("GST") by 2010.
- No changes in the service tax rate – effective rate of service tax would be 12.36% (including the 1% additional cess introduced).
- Seven new taxable services would be introduced, with the key new development being service tax on leases for commercial use (input credit would, however, be available against output service tax/excise duties).
- Clarity introduced in the definition of "export of services" from India–hitherto services "delivered outside India and used outside India" were considered "exports of services"–but, per the amendment, services "provided from India and used outside India" would now qualify as "exports of services" from India.

6. INDONESIA

6.1 Tax breaks for investments in selected business sectors and in selected regions

The Indonesian Government is offering tax breaks to certain taxpayers, namely, limited liability companies and cooperatives, making capital investments in selected business sectors and regions pursuant to Government Regulation No. 1 of 2007, which became effective 1 January 2007.

The tax breaks are as follows:

- A reduction in net income by a maximum of 30% of the total realized capital investment in Indonesia during the first six years from the date of commencement of commercial operations, or 5% per annum.
- Accelerated depreciation and amortization.
- Article 26 income tax charged at 10% on dividends paid to overseas shareholders or at the relevant tax treaty rate.
- Unused tax losses can be carried forward for longer than 5 years but not more than 10 years if certain requirements are fulfilled.

Enterprises engaging in the following business sectors or activities are eligible for the above tax breaks: the food processing industry, the agro-based natural resources processing industry, the packaging industry, the manufacture of paper and carton boxes, of goods made from plastic, and of cement, plaster, and gypsum, and the furniture-making and fishing industries, not to mention the processing of ocean fish, crustaceans and mollusks.

The tax breaks are being offered to taxpayers located on the island of Java and in the Indonesian provinces along the Indian Ocean coast.

6.2 VAT exemption for agricultural products

In its efforts to speed up development particularly in the agricultural industry, the Indonesian Government is offering a tax break in the form of classifying agricultural products as strategic taxable goods that are exempt from value added tax.

Effective 1 January 2007, imports and supplies of the following strategic agricultural products are exempt from value added tax pursuant to Government Regulation No. 7 of 2007: crop yields from agricultural land, estates and forests; products obtained from animal husbandry, hunting, catching or breeding; and farmed or non-farmed fish products collected or harvested directly from their sources, including products initially processed to prolong their shelf life or to simplify the process.

6.3 Ratification of tax treaty with Bangladesh

Indonesia ratified a Double Taxation Agreement (tax treaty) with the Republic of Bangladesh on 23 June 2006. The provisions under the newly-ratified Indonesia-Bangladesh tax treaty are applicable from 1 January 2007.

Under the Indonesia-Bangladesh tax treaty, the following are the maximum rates of tax that may be withheld by an Indonesian payor on:

- Dividends: 10% (if shareholding is more than 10%)
  15% (in any other cases)
- Branch profits: 10%
- Interest: 10%
- Royalties: 10%

7. LUXEMBOURG

Specialized Investment Funds regime enters into force

The Law creating Specialized Investment Funds ("SIFs") and superseding the Law on Institutional Investor Funds entered into force on 13 February 2007. From a regulatory standpoint, SIFs enjoy more flexibility than other Luxembourg undertakings for collective investments. Institutional investors, professional investors and well-informed investors (including high net-worth individuals) can make use of this new investment vehicle.

The SIF Law replaces the Law of 19 July 1991 (the "1991 Law") on undertakings for collective investment ("UCIs") the securities of which are not intended to be placed with the public.

SIFs enjoy more flexibility compared with other regulated funds in terms of the rules on investment restrictions (no restriction regarding eligible assets, risk-spreading rules set only in principle), company law, valuation rules, reporting requirements, approval process, etc.

The tax regime applicable to SIFs is almost identical to the one hitherto applicable to institutional funds: no tax on income or gains, flat amount of capital duty charged on incorporation of EUR 1,250, 0,01% subscription tax on net asset value, with some exemptions available, VAT exemption for management services rendered to SIFs.

For more details on the SIFs regime and its implications, please see the Luxembourg section of the previous issue of the Taxand Newsletter.

8. MALAYSIA

8.1 Real Property Gains Tax

It was announced on 22 March 2007 that Real Property Gains Tax (RPGT) will not be imposed with effect from 1 April 2007. Details of this proposal are not available yet, but the announcement has been broadly welcomed by the Property Development Sector and is also important to companies undertaking restructuring and reorganization transactions where transfers of real property are involved.

8.2 Islamic financial services industry

In its aggressive drive to promote the Islamic financial services industry, the Malaysian Government has announced several generous tax incentives in the 2007 Budget for Islamic banking, stockbroking, fund management, etc. The first of these incentives has recently been gazetted to allow a tax deduction for the costs of establishing a Malaysian-incorporated resident Islamic stockbroking company. Additionally, to encourage more consumers to source funds through Islamic banking facilities, a 20% reduction in stamp duty (a transaction tax) will apply to principal/primarily-approved Islamic financial instruments. A deduction will also be available for the costs involved in the issuance of certain approved Islamic securities.

9. MAURITIUS

Update on the Protocol to the China-Mauritius tax treaty on income

The protocol ('the Protocol') to the Double Taxation Avoidance Agreement of 1 August 1994 between Mauritius and the P.R.C. ("the tax treaty") which was signed on 5 September 2006 entered into force on 25 January 2007.

Under Article 3, the Protocol will take effect as follows:

a) in China – "in respect of income derived during the taxable year beginning on or after the first day of January next following the year in which the Protocol enters into force' that is, **on or after 1 January 2008**"; and

b) in Mauritius – "in respect of income derived during the taxable year beginning on or after the first day of July next following the date on which the Protocol enters into force', that is, **on or after 1 July 2007**."

Changes to the tax treaty were examined in the October 2006 issue of Taxand Newsletter. The main change relates to Article 13 (Capital gains). In short, a clause has been added to Article 13 of the tax treaty giving China the right to tax capital gains arising at a Mauritian holding company from the transfer of shares in a Chinese company in cases where the Mauritian company held, directly or indirectly, a stake of at least 25 percent in the Chinese company during the 12-month period preceding such transfer. Under Article 3 of the Protocol, only capital gains derived as from 1 January 2008 by a Mauritian holding company from the transfer of shares in a Chinese company will be affected by the change.

For Mauritian companies that may be affected by the aforementioned change in the capital gains tax provisions of the tax treaty, there are various planning opportunities that may be considered to preserve a tax efficient structure for holding investments in China. The most appropriate arrangement to be implemented would require a detailed consideration of each client's circumstances, commercial plans and various other relevant factors.

10. POLAND

10.1 New definition of "Polish tax resident"

Starting 1 January 2007, a new definition of "Polish tax resident" has been introduced into the Polish Personal Income Tax Law ("the PIT Law"). According to this definition, a natural person who:

(i) has his center of personal or economic interests (his center of vital interests) in Poland; <u>or</u>

(ii) is present in Poland for longer than 183 days in a tax year (Article 3.1a),

is deemed to be a person having a place of residence in Poland.

The fulfillment of just <u>one</u> of the above conditions is sufficient for a natural person to be considered a Polish tax resident.

Obviously, in order to determine the country of residence, the relevant tax treaty needs to be consulted. However, in practice, the change in the law may encourage the Polish tax administration to examine the status of expatriates staying in Poland on a permanent basis. For this reason, their personal circumstances should be carefully analyzed to avoid an *ex post* reclassification of their status by the tax authorities. In certain situations, tax planning may also be considered in this respect.

10.2 Corporate Income Tax Law – step-up on liquidation

As from January 2007, the opportunity for a step-up on the value for tax purposes of fixed assets contributed on an in-kind basis within an enterprise has been eliminated.

If the fixed assets are transferred to the shareholder as liquidation proceeds (bonus), their value for tax purposes may be adjusted to market value. Tax savings due to higher depreciation write-offs could thus be achieved.

The exception to this rule is where the fixed assets presently transferred as liquidation proceeds were originally contributed on an in-kind basis to the liquidated company as components of an enterprise / organized part of an enterprise.

11. PUERTO RICO

Real estate investment trusts

Major amendments were introduced to the Real Estate Investment Trust (REIT) provisions of the 1994 Puerto Rico Internal Revenue Code, as amended (the "Code"), by Act No. 226 of 26 December 2006 (the "Act").

a) *Background*

On 13 January 2000, Act No. 25 was enacted to create new REIT provisions which were codified under a new Subchapter P of the Code.

The objective of the new provisions was to promote economic activity and development normally associated with the real estate business. This initiative, however, totally failed as the new provisions were not properly focused and were full of limitations as to eligible real estate investments. For example, the following real estate investments were not eligible:

- Investments in hotel properties, shopping centers and shopping malls.
- Properties built prior to 1 July 1999 (except for those owned by the government and sold to the private sector).
- Substantial refurbishments made after 30 June 1999 to hotel properties, shopping centers and shopping malls built prior to 1 July 1999.

Moreover, the preferential income tax rate for beneficiaries or investors of REITs prior to the enactment of the Act was 17%, which was much higher than the preferential income tax rates under the Code for investors or holders of other investment instruments.

b) *The recently-enacted amendments*

The Act was enacted to amend the provisions of Subchapter P with the objective of removing the substantial limitations originally enacted in 2000. The consensus in the business community is that the amendments will certainly encourage the use of REITs to such an extent that they will finally begin to deliver growth to the Puerto Rican economy as was expected when the original provisions were enacted.

c) *The new REIT provisions*

After the amendments introduced to the Subchapter P provisions of the Code, the Puerto Rico REIT provisions now closely resemble the United States Internal Revenue Code's own REIT provisions (§§856-860). Nonetheless, certain differences still remain. The most significant amendments made are the following:

- A minimum of 50 investors (shareholders) are required.
- Subject to certain limitations, entities affiliated to a REIT are allowed to lease properties owned by the REIT.
- Dividends (distributions) paid by REITS are subject to a preferential income tax rate of 10%, instead of the former 17%.
- All properties acquired by REITs after 1 January 2007 must be acquired in a taxable transaction (not including eligible assets acquired from the Government of Puerto Rico) in Puerto Rico (i.e., purchases of assets, shares of stock or partnership participations). Accordingly, conversions of existing entities into nontaxable entities are not allowed.
- Wholly-owned subsidiaries of REITs are treated as disregarded entities. Therefore, the subsidiary's assets, liabilities, income items, deductions and receivables are considered those of the REIT.
- Old provisions dealing with ineligible properties have been repealed. Basically every real estate asset is now eligible to be owned by a REIT regardless of when it was built.

d) *Other considerations*

The election to be treated as a REIT can be made by any entity (corporation, company, partnership, trust or association) upon the filing of an income tax return for the year in which the election is to be effective. Once made, it may be revoked during the first 90 days of the taxable year in which the revocation is to be effective. A REIT will, in general, be treated as a nontaxable entity as long as it distributes every year 90% of its net income. Furthermore, five or fewer individuals cannot own more than 50% of the value of the shares of the REIT at any time. Lastly, income from certain prohibited transactions may be subject to a 100% penalty tax.

12. SINGAPORE

Singapore budget

The Singapore 2007 fiscal budget was announced on 15 February 2007. Details of some of the main changes to direct and indirect taxation are summarized below.

Please note that this article only provides an overview of some of the proposals made in the budget and is not intended to be a comprehensive analysis.

a) *Reduction in corporate tax rate*

It was announced that Singapore's corporate income tax rate will be reduced from 20 percent to 18 percent, effective from year of assessment ("YA") 2008, i.e., for any accounting year that ends in calendar year 2007.

b) *Partial tax exemption threshold*

The partial exemption threshold is set to rise from SGD 100,000 to SGD 300,000. 75% of the first SGD 10,000 of taxable profits remains exempt, as was the case previously, but the 50% exemption now applies to the next SGD 290,000 (previously, it only applied to the next SGD 90,000). The change takes effect from YA 2008 onwards.

c) *Full tax exemption for new companies*

A full tax exemption is currently granted for the first SGD 100,000 of normal chargeable income obtained by qualifying start-ups incorporated in Singapore for each company's first three consecutive YAs falling between YA 2005 and 2009. The scope of the relief is extended so that the exemption is available even if any of the first three YAs falls after YA 2009. In addition, start-ups qualify for a partial exemption for the next SGD 200,000 of chargeable income.

For such companies, the partial exemption mentioned in b) is then available from the 4th YA onwards.

d) *Tax deduction for borrowing costs*

Currently, a deduction is allowed only for interest payable on capital used in acquiring income; other borrowing costs do not qualify for any tax deduction. However, in the budget, the Minister announced that specified borrowing costs, other than interest, which are incurred on borrowings used to acquire income-producing capital assets will, subject to meeting certain criteria, qualify for tax deduction with effect from YA 2008 onwards.

e) *International arbitration tax incentive*

The Government is to introduce a tax incentive scheme that grants a 50 percent tax exemption for up to five years to approved law firms for their qualifying incremental income from international arbitration work. The scheme will be available from 1 July 2007 through 30 June 2012.

f) *Financial services*

Under Singapore's 80:20 rule, not more than 20 percent of funds managed by an approved fund manager in Singapore can be beneficially owned, directly or indirectly, by Singaporean citizens or residents, in order for it to qualify for the Singaporean tax exemption on specified income derived by the fund.

It was announced that the Government will remove this 80:20 restriction under the income tax exemption scheme for nonresident funds. The Monetary Authority of Singapore ("MAS") will release further details by May 2007.

g) *Singapore as a hub for philanthropy*

Currently, a charity's receipts are tax exempt provided that not less than 80% of its income is spent on charitable purposes in Singapore and within 2 years of receipt. From now on, registered charities will enjoy an income tax exemption without having to meet this 80 percent spending rule. There has also been a relaxation in fund-raising restrictions for financing charitable projects.

Further, individuals and companies that donate to foundations and institutions making grants will be eligible for double tax deductions if the donations are channeled to institutions of a public nature in Singapore within a specified timeframe.

h) *Goods and Services Tax ("GST")*

The GST rate will increase with effect from 1 July 2007 from 5% to 7%.

13. UNITED KINGDOM

13.1 Stop Press - Cut In Corporate Income Tax Announced

On 21 March 2007, the UK Government announced that the rate of UK corporate income tax would be reduced from 30% to 28% from 1 April 2008. Full details will be provided in the next issue.

13.2 Possible changes to the taxation of private equity deals

a) *Background and status of this issue*

On 8 March 2007, the UK Government announced a review of the tax treatment of highly leveraged private equity deals. The review is driven by the government's concern that "shareholder debt" is replacing the equity element in highly leveraged private equity deals, and that therefore it may be unfair for the interest on this debt to be deductible for UK tax purposes.

The results of the review will be announced in December 2007, and will be "consistent with the government's focus on ensuring that commercial decisions are taken on a level playing field".

By way of background, in April 2005, the UK transfer-pricing legislation was extended to include private equity funding structures. Under this legislation, a tax deduction for interest was only permitted if it could be shown that an independent, unrelated lender would have offered debt finance on the same terms. The UK Government expected to significantly increase its tax receipts from this measure. However, this did not turn out to be the case.

This was because the economic climate for funding was such that banks were prepared to accept greater risk. Therefore, using sophisticated analyses, it was possible for taxpayers and their advisers to support significant interest deductions in private equity deals by demonstrating that an independent, unrelated lender would have lent on the same terms. The tax authorities lack of success in applying the 2005 legislation has therefore led to this review announcement.

b) *Our view*

Any amendment to the existing regime for interest deductions should be very carefully considered as a negative outcome may seriously damage the UK private equity industry and its positive influence over the UK economy.

COURT CASES AND RULINGS

1. EUROPEAN UNION

1.1 ECJ judgment of 14 December 2006 in Case C-170/05, 1st Chamber, Denkavit International BV and SARL Denkavit France v Ministre de l'Économie, des Finances et de l'Industrie

The European Court of Justice has held that the deduction of withholding tax on dividends paid by a French company to its parent company resident in another EU Member State constitutes a discriminatory practice in contravention of Articles 43 EC and 48 EC, since the dividends paid by a French company to its parent company resident in France are tax exempt.

The France-Netherlands tax treaty, which makes it possible to offset a tax credit corresponding to the withholding tax levied in France against Dutch tax, does not call this solution into question. Indeed, Dutch parent companies may not offset the tax credit corresponding to the withholding tax levied on the dividends they receive from their French subsidiaries, since these dividends are tax exempt.

This solution was adopted with respect to a period prior to the entry into force of the Directive of 23 July 1990 concerning the parent-subsidiary tax regime. It nevertheless remains of interest where the nonresident parent company holds a stake of between 5% and 15% (10% on or after 1 January 2009) in the capital of the French company making the distribution. The percentage holding in the capital of the subsidiary required by French legislation in order to be entitled to benefit from the parent-subsidiary regime is 5%.

1.2 Excise duty in Poland – First preliminary ruling

Under Polish law, second-hand vehicles over two years old are subject to excise duty charged at a considerably increased rate. This measure was commonly regarded as being aimed at limiting the number of old passenger vehicles acquired in other Member States. As such, it raised doubts as to its compliance with the EC law.

When the dispute reached the District Administrative Court in Warsaw, it referred the case to the European Court of Justice, which requested a preliminary ruling.

In its judgment of 18 January 2007 (C-313/05) the ECJ ruled that Article 90 of the EC Treaty should be interpreted as precluding an excise duty, "*insofar as the amount of the duty imposed on second-hand vehicles acquired in a Member State other than that which introduced such a duty exceeds the residual amount of the same duty incorporated into the purchase price of similar vehicles already registered in the Member State which introduced that duty.*"

This means that the excise duty in excess of the amount paid on similar cars purchased in Poland at the time of their registration ('residual' meaning: adjusted to the present value of these cars) was not in fact due and should be refunded to the taxpayers.

Importantly, it was the first preliminary ruling by the ECJ in the case referred by the Polish court.

2. COUNTRIES

2.1 INDIA

Supreme Court ruling on taxability of offshore supplies and services in the hands of nonresidents in India

In relation to the taxability of supplies of goods and services from overseas locations ("offshore supplies" and "offshore services") for a large turnkey contract to be performed in India by a Japanese company (which was part of a consortium performing the contract), the Authority for Advance Rulings ("AAR") made a ruling that the income from offshore supplies and offshore services was taxable in India. The AAR held that since the offshore supplies were linked with the turnkey contract being performed in India, the income from the offshore supplies proportionally attributable to the Permanent Establishment ("PE)" in India was taxable in India. With regard to offshore services, the AAR held that the income arose in India as the source of the income was in India. An appeal was filed against the AAR's ruling by the Japanese company at the Supreme Court of India (the "SC").

In a landmark ruling, the SC recently held that offshore supplies were not taxable in India as they did not have any territorial nexus with India. It was observed by the SC that the permanent establishment ("PE") of the Japanese company did not have any role to play in the offshore supplies, the passing of title to which took place outside India. Further, with respect to the taxability of offshore services, the SC again applied the territorial nexus doctrine and observed that the offshore services could be taxed in India only if the services were rendered in India, in addition to being used in India. The SC therefore held that the offshore services were also not taxable in India, given that the services were rendered from outside India.

The observation of the SC was a welcome clarification on the taxability of offshore supplies. As for its observations on the taxability of offshore services, they had substantial revenue implications given that all payments for offshore services (viz, royalties, fees for technical services, etc) would not be taxed in India, if the services were rendered from outside India. In what is seen as a move to counteract the observations of the SC on the taxability of offshore services, in the recently-laid 2007 Finance Bill, the Government of India introduced amendments to the Indian Income Tax Law which seek to clarify (with retroactive effect) that in the case of interest, royalties and fees for technical services in India, the service provider does not need to have a territorial nexus with India, viz, a residence, place of business or business connection in India.

2.2 LUXEMBOURG

a) *Important change in the Luxembourg investment funds industry: new position of the Luxembourg VAT authorities*

On 29 December 2006, the VAT authorities issued a long-awaited circular regarding VAT changes in the investment funds industry. These changes follow two major VAT cases brought to the European Court of Justice; the *BBL* case (C-8/03) and the *Abbey National* case (C-169/04).

In particular, the new circular brings clarity to the Luxembourg authorities' position on the VAT status of investment funds. The new rules set out by this circular will be effective 1 April 2007.

The most important consequences of this circular can be summarized as follows:

- **Investment funds are taxable persons for VAT purposes**

  The VAT authorities take the view that investment funds should be considered taxable persons for VAT purposes.

  The VAT authorities are interpreting ECJ case law so that the economic activity performed by investment funds is VAT exempt. This activity does not give a right to deduct input VAT.

  From a practical perspective, investment funds are, in principle, relieved of the obligation to register for VAT. However, investment funds must register for VAT where they have to self-assess VAT on the receipt of taxable services (e.g. tax and legal services rendered by suppliers established outside Luxembourg). This should be welcome, since in many cases obtaining a VAT number should allow Luxembourg investment funds to save VAT on services engaged from foreign suppliers.

- **Scope of the VAT exemption**

  The second part of the circular deals with the scope of the exemption applicable to management services supplied to investment funds.

  In practice, the scope of this VAT exemption should be largely unchanged, with the notable exception of activities of control and supervision which become taxable at 12%. By implication, the question arises as to who (the custodian bank or its customer) will foot the bill.

  Custodian banks will have to determine the amount of services which become taxable based on objective criteria. In any case, legal and factual circumstances taken into account for the computation of the amount of the taxable services will have to be disclosed to the VAT authorities upon request.

  The new rules will not have retroactive effect.

- **Action required**

  Any parties involved in investment funds should at least:

  - consider the fund entities that may need to be VAT registered;
  - consider the custodial fees that become subject to VAT and amend contracts if required to clarify or to achieve VAT savings

b) *Luxembourg tax treatment of gains arising from French SCI*

The Luxembourg Administrative Tribunal (the "Tribunal") considered in a ruling of 20 December 2006 (hereafter referred to as "*C* case") that capital gains realized by a tax-transparent French Société Civile Immobilière ("SCI") on the sale of a real estate asset located in France could not be considered *participation income* ("*produit de participation*") within the meaning of Article 19, § 2 of the tax treaty taxable at the level of the Luxembourg shareholder. Instead, the income had to be considered income from immovable property within the meaning of Article 3 of the tax treaty (the Article on real estate in the tax treaty) and, therefore, only taxable in France. For net worth tax purposes, the shares held by the Luxembourg Company in the French SCI were considered only taxable in France based on a combined application of Articles 20 and 3 of the tax treaty.

In another earlier decision (in the *SOPARES/Malux* case: judgment of the Tribunal of 20 July 2005 and decision of the Administrative Court of 10 January 2006), the Tribunal and the Luxembourg Administrative Court (to which Administrative Tribunal decisions can be appealed) had decided that capital gains realized on the sale of shares of a SCI that elected to be subject to French corporate income tax (an opaque SCI) had to be considered fully taxable in Luxembourg without the possibility of any exemption based on 166 LIR or the Grand Duchy Regulation of 21 December 2001.

The Tribunal in that case considered that no distinction had to be made between current income and capital gains on the interests of the SCI and, therefore, took the view that both were covered by Article 19 § 2 of the tax treaty so that Luxembourg could tax the income.

Even though these two decisions do not address the same situations (the *Malux* case deals with an opaque SCI whereas the *C* case deals with a transparent SCI; also, the *Malux* case deals with the tax treatment of a capital gain on the shares of the SCI whereas the *C* case deals with capital gains realized by the SCI on the sale of its real estate), the stances taken by the Tribunal appear to conflict with the interpretation of Article 19 § 2 of the tax treaty.

When taken together, the decisions can lead to some surprising conclusions. The differences in outcome between opaqueness and transparency do not seem to be justified merely because of a French election. It will be interesting to see how the decisions are applied in practice and whether further litigation will ensue. What is sure is that any investments in French SCIs need to be handled with great care.

2.3 SPAIN

a) *Existence of a permanent establishment in a third country*

In a recently-publicized ruling dated 26 December 2006, the Directorate-General of Taxes (the "DGT") analyzed the tax consequences for a Spanish enterprise of renting a premises in France and of engaging salespersons there, in terms of the existence or otherwise of a permanent establishment.

The DGT took the view that under the Spain-France tax treaty, renting a premises to display and sell the Spanish enterprise's products fell within the definition of 'permanent establishment' in Article 5 of the treaty.

However, consideration was given to the possibility that since the activities engaged in on the premises were of a preparatory or auxiliary character, pursuant to Article 5(4), there would be no permanent establishment.

According to the DGT, if the activity engaged in on the premises was merely that of displaying goods, it could be considered to be one of the activities referred to in Article 5(4) as being of a preparatory or auxiliary character. However, since an activity identical to that carried on by the enterprise as a whole was being pursued on the premises, namely, the sale of goods, it could not be regarded as preparatory or auxiliary.

Coupled with the above reasons was the fact that the Spanish enterprise had engaged salespersons, who acted at all times under its direction and without any functional independence, which is why the salespersons per se could constitute a permanent establishment of the Spanish enterprise in France.

b) *Period of ownership of holdings and application of the Parent-Subsidiary Directive*

The Spanish legislation transposing the Parent-Subsidiary Directive treats as tax exempt income distributions by subsidiaries resident in Spain to their parent companies resident in other EU Member States (or to the permanent establishments of such parents situated in other states), where certain requirements are satisfied.

These requirements include the requisite that the holding must have been maintained uninterruptedly during the one-year period immediately prior to the date on which the income being distributed becomes claimable (the one-year period can be completed after the distribution, in which case, the tax originally withheld will be refunded to the taxpayer).

In this connection, the DGT has just made public its ruling dated 31 January 2007 in a case involving a German company which had owned a 100% holding in a Spanish company for a number of years. The company planned to transfer the holding to another German company under the tax neutrality regime in the Mergers Directive (Council Directive 90/434/EEC of July 23, 1990) and, after the transfer (but at all times before one year had elapsed), the Spanish subsidiary would distribute a dividend to its new shareholder.

The request for the ruling thus raised the issue of whether the new parent company could inherit the period during which the shares were held by the former shareholder.

In the DGT's opinion, provided that the transfer satisfied the requirements to qualify for the tax neutrality regime in Directive 90/434/EEC, the transferee would receive the shares with same period of ownership as previously existed at the transferor, for the purposes of Spanish law. Accordingly, the dividend distribution would meet the period-of-ownership requirement for holdings, for the purposes of the above-mentioned exemption.

OTHER NEWS

1. BRAZIL

Tax incentives as a source of funds for the development of sports

More than eight years after the enactment of Law no. 9,615 (the *Pelé* Law), which first introduced the possibility of creating tax incentives as a source of funds for the development of sports in Brazil, the Brazilian sports industry has finally succeeded in obtaining approval for legislation on sports tax incentives.

After intense debates between athletes and artists, sparked by the artists' contention that the original wording of the Proposed Bill on Tax Incentives for Sports would lead to competition between the sports and artistic communities for funds from tax incentives created to support cultural projects under the earlier *Rouanet* Law, Law no. 11,438 of 29 December 2006 was enacted at the same time as a Provisional Measure was published to amend the provisions giving rise to the disagreement.

Both athletes and artists were satisfied with the amendments to the Law, which allow corporate donors to deduct amounts spent on sponsorship and donations to directly support sports projects, including projects for disabled athletes, approved by the Ministry of Sports, albeit limited to 1% of corporate income tax for the 2007-2015 period. This deduction does not in any way affect the right to deduct up to 4% of corporate income tax for amounts spent on cultural projects and investments in audiovisual projects.

In the case of individual donors, however, the amounts spent on sponsorship and donations for sports events were merely included in the amounts deductible from individual income tax reported in their year-end tax returns, such as contributions to cultural projects and investments in audiovisual activities, among others, with no increase to the overall limit of 6% of the income tax payable by individual donors.

The maximum amount of these deductions will be set on an annual basis by the Federal Government, and the industry expects the limit for 2007 to be approximately BRL 300 million.

In order to benefit from the tax incentive, sports projects must be related to rehabilitation, educational or high-performance sports, and must comply with the limits and conditions to be established by regulations. In other words, the sports projects must be targeted at social integration, through educational or recreational activities, or must benefit unsponsored high-performance athletes, generally engaging in less popular or less known sports.

The funds generated by the tax incentive cannot be used to compensate professional athletes in any sport.

The regulations determining which sports will receive greater or lesser tax incentives are expected to be ready 45 days after publication of the Provisional Measure.

2. CANADA

CRA "clarifies" position on treaty residence

Canada's tax treaties offer significant benefits to foreign companies, such as preferential withholding tax rates on dividends, interest and other payments received from Canadian corporations, as well as allowing for a higher threshold level of presence in Canada before foreign companies can be taxed in Canada on their business profits. In order for a foreign company to qualify for treaty benefits, it must be considered to be a resident of the relevant Contracting State.

The residence article in Canada's tax treaties generally follows Article 4 of the OECD Model Tax Convention, which provides that a person (including a corporation) will be considered a resident of a Contracting State if that person is "liable to tax" therein by reason of domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature. Examples of entities which ordinarily do not meet these criteria to qualify for treaty protection include trusts, partnerships and hybrid entities such as limited liability corporations.

On 26 February 2007, the Canada Revenue Agency ("CRA") released *Income Tax Technical News No. 35* ("**ITTN 35**"), which is intended to clarify the CRA's position as to what level of taxation a Contracting State must levy on a foreign entity's income before that entity will be considered "liable to tax", and a resident of a Contracting State. ITTN 35 reiterates the CRA's long-standing position that, to be considered "liable to tax" for treaty purposes, a person must be subject to the most comprehensive form of taxation as exists in the relevant Contracting State. Based on the Supreme Court of Canada's decision in the *Crown Forest* case,[2] and the Commentary to the OECD Model Tax Convention, the CRA has generally interpreted this to mean full tax liability on worldwide income.

In ITTN 35, the CRA sets out its position on the meaning of the term "liable to tax" in the case of foreign entities which are either exempted from taxation or taxed at a very low rate under their domestic tax regime. The CRA's previous position was that such entities would not be subject to the most comprehensive form of taxation and, therefore, would not be "liable to tax" for treaty purposes. In ITTN 35, however, the CRA states that being subject to the most comprehensive form of taxation as exists in a Contracting State does not mean that a person must pay tax in that particular jurisdiction. For example, it is generally accepted that nontaxable entities such as charities or pension plans will be considered residents of a treaty country even though they are exempt from taxation in that country.

In fact, ITTN 35 recognizes that, in certain situations, a person's worldwide income may be subject to a Contracting State's full taxing jurisdiction, despite the fact

[2] *The Queen v. Crown Forest Industries Ltd. et al.*, [1995] 2 S.C.R. 802.

that the State's domestic law does not levy tax on that person's income, or taxes income at low rates. In these cases, the CRA will generally accept that the person is a resident of the other Contracting State unless the arrangement is abusive. This may be the case in certain "treaty shopping" transactions, whereby a person's presence in a Contracting State is part of an artificial structure designed to benefit from the provisions of a particular tax treaty. At the end of the day, the determination of treaty residence remains a predominantly fact-driven exercise, which can only be resolved based on the particular circumstances of any given case.

3. FRANCE

3.1 Article 209 B of the French Tax Code: Administrative circular 4 H-1-07 of 16 January 2007

Article 209 B of the French Tax Code is aimed at taxing French companies on the profits generated by companies and other enterprises in which they hold over 50% of the voting or dividend rights and which benefit from preferential tax treatment. A nonresident company is considered to benefit from preferential tax treatment where the amount of tax to which it is subject is less than half the tax for which it would have been liable had it been resident in France.

This provision had been called into question by the *Conseil d'Etat* (French Supreme Administrative Court) in a decision of 28 June 2002 (*Schneider Electric*), in which the *Conseil d'Etat* held that the provision was incompatible with the tax treaties entered into by France (unless they expressly authorized France to apply such provision).

The 2005 Finance Act changed the wording of Article 209 B in order to make it compatible with all the tax treaties entered into by France and with EU law. The Decree of 25 October 2006 clarified the conditions for application of these new provisions.

An administrative circular of 16 January 2007 (No. 4H-1-07) comments on these new provisions.

With regard, in particular, to countries established in another EU Member State, taxation in France is limited in cases where these companies are considered to constitute an artificial arrangement within the meaning of the decisions made by the European Court of Justice and, notably, the *Cadbury Schweppes Plc* decision of 12 September 2006.

3.2 Recent clarifications on the French regime for restricted stock units (RSUs)

Two years after the introduction into the French Commercial Code of the new regime for free grants of shares, an administrative circular dated 10 November 2006 and a recent Law enacted on 30 December 2006 have substantially clarified the tax and legal aspects of this new system.

This regime basically provides that French companies may grant shares at no charge to employees and company officers provided that the granting complies with a minimum 2-year vesting period followed by a minimum 2-year holding period. Subject to several conditions, the granting will benefit from a favorable regime whereby the gain (i.e., the fair market value of the shares on the vesting date) (i) is taxable only on the sale date at a global rate of 41%, and (ii) is not subject to social security contributions. This favorable regime was extended in July 2005 to Qualifying RSUs granted by foreign companies.

Until now, many questions remained unanswered in this regard. The recent Law and administrative circular address both inbound (i.e., foreign companies granting RSUs to French beneficiaries) and outbound (i.e., French companies granting RSUs to foreign beneficiaries) grants:

a) *Inbound RSU grants*

- French Qualifying RSUs must be granted under a French subplan complying with "substantive" conditions set forth in the French Commercial Code. In that respect, some obligations (specific to French companies) should not apply, such as closed periods (i.e., specific periods designed to prevent insider trading).
- The fact that a token subscription price is requested by the foreign grantor will not disqualify such a grant from the possibility of qualifying for "free shares."
- A foreign entity may grant French Qualifying RSUs, provided that its legal form is comparable to one of the forms of French corporation (i.e., partnerships are excluded).
- Qualifying RSUs require that the underlying securities are true equity instruments with an unpredictable yield. Furthermore, American Depository Receipts are eligible for the favorable French regime.
- During the vesting period, the beneficiary will not have any shareholder rights (i.e., no dividend equivalent).

b) *Outbound RSU grants*

The holding period may be waived, provided that the vesting period runs for at least 4 years (i.e., French RSU plans may be tailored to local conditions in foreign countries, where applicable).

c) *Both inbound and outbound RSU grants*

- The RSU plan must provide that beneficiaries who are company officers will not be entitled to sell a portion of RSUs before their term of office expires.
- Mergers or spin-offs of the grantors during the vesting and holding periods are tax neutral. In addition, a public exchange offer, stock split or reverse stock split during the holding period are also tax-neutral transactions.

- RSU costs incurred by the grantor (located in France or rebilled to the French subsidiary where applicable) are tax deductible. In addition, the grantor may take a corporate deduction equal to the fair market value of the shares on vesting only in case of treasury stock. For newly-issued shares, no capital loss is deducted unless RSUs are granted to all employees pro rata to salary and/or length of service.

As a result of these recent clarifications, it can be anticipated that RSU grants by non-French companies are expected to be placed on a more secure footing and will most likely increase when compared with stock option grants. With regard to outbound RSU grants, the new Law now authorizes French companies to tailor their plan to local regimes thus allowing foreign beneficiaries to benefit from any favorable tax and/or social security regime available locally, where applicable. In the future, administrative guidelines will be released on the mechanism for rebilling costs within a group or on the tax treatment of the gain on RSUs in the case of employee expatriation.

4. MALAYSIA

4.1 Tax administration

Following the 2007 Budget proposals in September last year and the enactment of the 2006 Finance Act at the end of last year, the tax administration system in Malaysia has undergone some important changes with the introduction of an Advance Rulings system. Draft Regulations on the scope of Advance Rulings, the costs and procedures involved, etc. have recently been issued by the tax authorities.

Essentially, Advance Rulings should only be sought where an issue requires an interpretation of the law or an interpretation on how a relevant provision would apply to an entity or a specified arrangement or scheme. The tax authorities have indicated that there are several situations for which they will not issue Advance Rulings, including Advance Pricing Arrangements and on anti-avoidance matters. While Advance Rulings are welcome, taxpayers are advised to be circumspect in seeking them as they will be binding and can only be challenged through the normal appeals process, which would be both costly and time-consuming.

The tax authorities have also recently released guidelines on tax audits and tax investigations. These set out the framework for tax audits and investigations and provide greater transparency and certainty on how such activities will be carried out by the authorities in Malaysia.

Additionally, the tax authorities have recently started to express their opinions publicly on decided tax cases by issuing 'Decision Impact Statements.' For taxpayers, this gives an insight into the tax authorities' views, which in the past has been difficult to ascertain.

4.2 Labuan – International Offshore Financial Centre

The island of Labuan operates a preferential tax regime for offshore companies located there. Expatriates (i.e., non-citizens) working in Labuan also enjoy a partial income tax exemption on salary income, i.e., a tax exemption on 50% of the gross income derived from employed work in a managerial capacity for a Labuan offshore trust company or a Labuan offshore company. The period for claiming this exemption has recently been extended to 2010.

Additionally, any person (including a company) which renders qualifying professional services to a Labuan offshore company will enjoy an exemption on 65% of statutory income (i.e., gross income after allowable deductions and tax depreciation) from the provision of such services in Labuan.

4.3 Fiscal and non-fiscal incentives for New Development Region

The Prime Minister announced fiscal and non-fiscal incentives for the Iskandar Development Region (IDR) in South Johor (i.e. the southern end of peninsular Malaysia adjacent to Singapore). This is a region which is being promoted to attract foreign investment into Malaysia into certain sectors of the economy. The proposed tax incentives include a 10-year exemption from corporate income tax for specific qualifying activities carried out within approved zones in the IDR and a withholding tax exemption on royalties and technical fees for 10 years upon commencement of operations. Key non-fiscal incentives include an exemption from local equity requirements which will allow companies to be 100% foreign owned, the freedom to source capital globally and unrestricted employment of foreign employees within the specific approved zones.

5. THE NETHERLANDS

Dutch participating loans in 2007

a) Introduction

As of 2007, new legislation further simplifies structures with participating or hybrid loans. The Netherlands has accepted that it cannot be the "world's tax inspector." The tax treatment of debt and equity abroad is no longer decisive in the Netherlands as from 1 January 2007. For instance, the (partial) deductibility or nondeductibility of "interest" abroad is no longer a test. Payments received are treated as interest or dividends in the Netherlands based upon Dutch case law. Dividends may qualify for the participation exemption. Perhaps confirmation can be obtained in advance from the tax authorities. Banking and financial products (ranking) that are not tax driven are easily accepted.

b) Requirements

The main rule is that when a loan is agreed on under such circumstances that, in fact, it functions as equity capital, it is wholly treated as equity for tax

purposes. In principle, the tax treatment follows the legal label – debt or equity. However, a loan is considered to be equity for Dutch tax purposes where the result of its conditions is that the lender "participates" to a certain extent in the borrower's enterprise. The Dutch courts have developed a number of cumulative tests for determining a qualifying 'participating loan,' namely:

- the interest is (almost entirely) profit-related;
- the loan is subordinated to all common creditors; and
- the loan has no stated maturity, or a term to maturity of more than 50 years, and otherwise matures upon bankruptcy, Chapter 11-type insolvency or liquidation of the borrower.

When a loan passes these tests, it is considered to be equity for Dutch tax purposes.

c) *Participation exemption in 2007*

Where a Dutch company holds at least 5 percent of the nominal paid-in capital[3] of a subsidiary whose capital is (partly) divided into shares, the subsidiary is an investee qualifying for the participation exemption. Participating loans from the Dutch parent to its investee benefit also from the participation exemption. (See the Dutch article in the "Special Features" section for a brief discussion on when the participation exemption applies).

In such a case, interest is treated as a tax-exempt dividend. Valuation differences and foreign exchange variations in the principal amount are not taxable/deductible. The Dutch tax treatment of the interest and the loan does not take into account whether or not the interest is deductible at the level of the foreign debtor.

The same criteria apply where a group company other than the lender itself has a qualifying participation (5 percent) in the debtor. The lender and the related party must be at least 33.33% directly or indirectly related. The loan may for instance also be granted to a parent or sister company. The required 1/3 relationship can exist via a nontaxable entity, a foreign entity or an individual.

Clearly, new opportunities will be available to mitigate the possible adverse effects of the thin capitalization rules in foreign jurisdictions, by financing through the Netherlands. Even if, perhaps, the thin-cap rules could not be avoided, at least there would be no taxation in the Netherlands.

d) *Change of conditions*

If the conditions of the loan are amended, a new determination is necessary. If the new conditions still meet the requirements for a qualifying participating loan, it will continue to be treated as equity. If, however, the new conditions cause the arrangement to become a loan for tax purposes, it will be treated as debt as of the amendment date and its amount will be equal to fair market value on that date. However, in the period running up to the amendment, the loan, its valuation differences, exchange variations and the interest accrued on it will still be treated as equity (income). Past interest will remain exempt, i.e., there is no clawback.

e) *Foreign withholding tax*

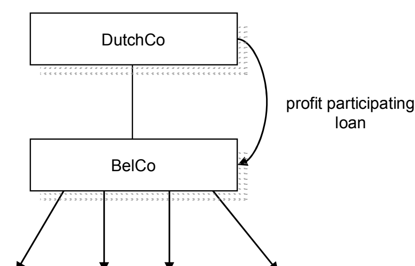
Foreign withholding tax levied on interest accruing on participating loans is not creditable or deductible at BV level. To obtain optimal benefit, it is thus important that the interest is not subject to withholding tax abroad at debtor level. Such withholding tax would be a net cost to the group.

f) *Some examples*

Many participating loans have historically been granted by Dutch companies to French subsidiaries (*prêt participatif* and *titre subordinée - durée indéterminée*). Structures with participating loans can, however, be set up in many countries all over the world, such as Russia or Belgium. Below are some examples where the overall effect is that interest can be offset against foreign operating or, say, rental income while being exempt at the level of the Dutch lender.

- Belgium borrower

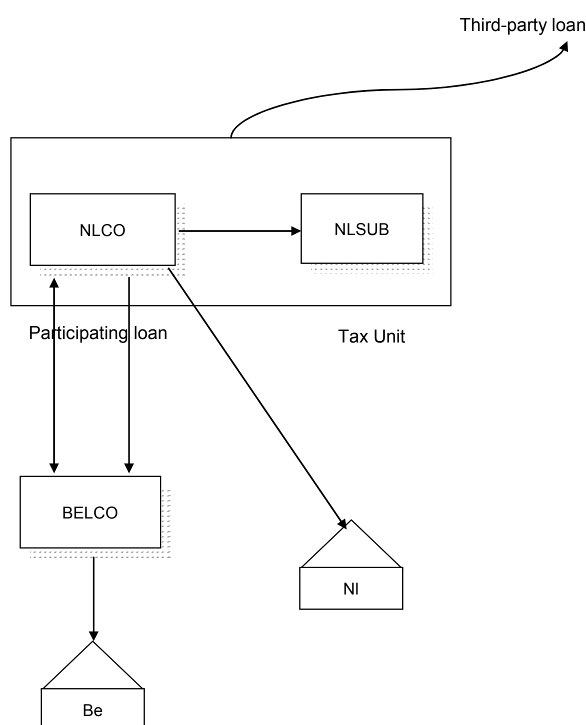
  A Dutch company ("BV") holds all the shares of a Belgian company ("SA"). BV grants a participating loan to SA. The interest received is treated as a tax-exempt dividend at the level of BV. Belgium does not levy withholding tax on the interest pursuant to the Belgium-Netherlands tax treaty. SA on-lends the funds to domestic and foreign operating (group) companies. SA reports an arm's-length taxable spread in Belgium. The operating companies offset interest against their local going-concern profit.



[3] A subsidiary in some treaty countries in the European Union is also regarded as an investee qualifying for the participation exemption where 5 percent of the voting rights is held.

- Belgian real estate

  BV grants a participating loan to a Belgian investee. The investee acquires real estate. The rent can (if properly structured, after maintenance, depreciation and interest deduction) effectively be absorbed. The interest due to BV is not subject to Belgian withholding tax. BV reports a tax-exempt dividend. The sale of the participation will be exempt for BV as well. The structure can even be further optimized if BV borrows from a group company or from third parties to finance the participating loan. Interest due from BV can be offset against Dutch taxable income. This can, for instance, be on BV's Dutch property or against the profit of a tax-consolidated company.



6. RUSSIA

6.1 Implementation in Russia of the main OECD principles

On 2 March 2006, the Government of the Russian Federation approved the Main Guidelines for Russian Tax Policy for 2008–2010. This document is devoted to implementing the main tax principles developed by the OECD. It introduces the following rules and principles into the Russian tax and legal system: transfer-pricing rules (the arm's-length principle and transaction methods); definition of interdependent (affiliated) and controlled companies, including the American rule for tax residence and the concept of consolidated tax reports; preliminary pricing agreements; partial exemption of dividends from taxation; the concept of an indexed tax unit and others. Within the 2008–2010 period, corresponding legislative proposals should be prepared and approved by the Russian Parliament. This trend is consistent with the intention of the Russian Federation to join the OECD and the WTO.

At the same time, many of the above rules and principles have already been applicable in Russian tax practice. For example, Russian tax legislation already provides for a thin capitalization rule for deducting interest for tax purposes. Furthermore, the Russian tax authorities have already issued a number of recommendations and regulations on determining of a company's tax residence. According to the position taken by the Russian tax authorities, formal state registration is not sufficient for a company to be deemed a tax resident of a foreign country. The test of tax residence should be the place of management and the place where the organization's owners are resident. The Russian courts have also held that the basic OECD tax principles and the commentaries on the OECD Model Tax Convention should be applicable in Russian enforcement practices.

On the other hand, some OECD tax rules are still not applicable in Russia.

For example, under International Financial Reporting Standards, financial instruments are classified as a financial liability or equity according to the substance of the contract rather than its legal form. A financial instrument is treated as an equity instrument only if 1) the instrument does not include a contractual obligation to deliver cash or another financial asset to another entity, or 2) the instrument will or may be settled in the issuer's own equity instruments. So, if a company issues preferred shares that pay a fixed dividend and that have a mandatory redemption feature at some future date, this means that the entity has a contractual obligation to pay cash. Therefore, the preferred shares should be recognized as a liability. In contrast, normal preference shares do not have a fixed maturity and the issuer has no contractual obligation to make any payment. Accordingly, they are treated as equity. Thus, dividends on preferred shares classified as financial liabilities are treated as deductible expenses (IAS 32).

Under the Russian tax legislation on preferred shares being treated as debt, dividends on such shares cannot be treated in Russia as expenses for tax purposes. The IFRS are not statutorily applicable in Russia and the Russian Financial Reporting Standards do not make provision for this possibility. Even if they did, it would not matter, as the Russian Tax Code prevails in tax issues. The Tax Code expressly stipulates that it considers even "income in the form of interest on preferred shares" as dividends. Moreover, no dividends are recognized as being a deductible cost. Quite the opposite, payment on debentures will be deductible, as they are considered a debt liability and, consequently, such payment is treated as interest. In the latter case, though, Russian thin capitalization rules will still apply to the interest paid.

6.2 Tax amnesty envisaged for individuals

A “tax amnesty” for individuals is coming into effect in Russia. Under the provisions of the corresponding law, from 1 March 2007 through 1 January 2008, all individuals have the right to submit a “declaration payment” to the Federal Treasury. This should be calculated on the basis of the sum of unpaid tax on personal income received before 1 January 2006 and a 13% tax rate, irrespective of the kind of income. Such a “declaration payment” releases individuals from any liability for the corresponding sum of unpaid tax. At the same time, an individual may still be held criminally liable for not paying taxes of more than RUB 770,000(approximately USD 30,000) for three years running.

7. UNITED KINGDOM

Binding pre-transaction rulings

The UK Government has announced that, from December 2007, the UK tax authorities will provide binding advance rulings on corporate reorganizations and significant investments, including proposed legal structures and proposed financing structures. The rulings will be available to those taxpayers that provide clear plans of their intentions.

The UK Government has also announced that, from March 2008, the UK tax authorities will provide binding pre- and post-transaction rulings on the tax consequences of *“genuine significant commercial issues whenever there is uncertainty.”* The proposal is that the tax authorities will issue a binding ruling within 28 days of a request, provided that the taxpayer makes full and transparent disclosure of the supporting facts and commercial intention.

We welcome the UK Government’s commitment to provide binding rulings on corporate transactions and areas of tax uncertainty. We await with interest, further details of the proposals, including details of the tax authorities’ response time for pre-transaction rulings, the definition of ‘significant,’ and whether the taxpayer will have the right of appeal against an adverse ruling.

SPECIAL FEATURES

THE RENEWAL OF THE US RESEARCH CREDIT TAX INCENTIVE: CHOICES OF A GLOBAL ORGANIZATION

The choices facing global organizations sometimes seem limitless. And often these choices are more like imperatives. A failure to make a choice may haunt an organization for years in the form of declining revenues, increasing costs, decrease in favorable standings among peer groups, and worse.

1. A new research credit choice

While we complained recently in a weekly article that the US Congress is acting on a modest tax relief package that uses an "Enronesque" gimmick to accomplish revenue neutrality, we should also pause to remember that, just this past December, Congress responsibly voted to extend certain tax incentives and to even add an incentive that is intended to help companies justify the continued use of the US as a sensible venue to conduct research activities.

Global economies provide new markets for products; they provide new labor pools that may be lower cost alternatives than legacy pools. Governments alter their tax base in ways to attract and retain businesses, and business processes and technology have made most business processes "portable." The upshot of all of this is that global companies sense that many different governments are vying for the privilege of "hosting" the research activities of a company by providing lucrative incentives to locate these activities within their jurisdiction. Canada, the UK and France are all reasonable alternatives to US research locations as each has an incentive that many companies find more attractive than those offered by the US.

Prior to December 2006, Congress had let the US incentive for research lapse. This incentive generally enjoys bipartisan support, so we were assured that it would be resuscitated. Yet several legislative initiatives that could have served as an appropriate vehicle for re-enactment were not used, as both political parties saw political gain by delaying or pairing an extender package with other legislative initiatives that were not supported by both parties.

One of, if not the last, legislative acts of the Republican-controlled "lame duck" congress, was the passage of an "Extender" package, which takes its name from the fact that many of its elements were merely "extending" certain existing incentives that expired on 31 December 2005. The Research and Experimentation credit was one such incentive that had expired. But, included in this Extender package, is a new research incentive that a taxpayer can elect to apply for years ending after 31 December 2006.

The new research incentive is merely a new way to calculate the credit for research activities. It is named the **Alternative Simplified Credit**. So, beginning in 2007, there are now three different methodologies for computing the credit: The **Regular Credit**; the **Alternative Incremental Research Credit**; and the new **Alternative Simplified Credit**.

2. A quick comparison

The **Regular Credit** rewards taxpayers that increase their historical domestic spending on research activities. The specific historical increase that Congress targeted was the ratio of research spending as compared with a company's domestic revenues. And Congress picked a reference period that remains constant, namely the five-year-period from 1984 through 1988. So, if a company was devoting, say, 2% of every domestic dollar of revenue to domestic research efforts during this reference period, any increase in this ratio for the current credit determination year would result in a research credit. So, if this same company devotes, say, 3% to research in 2006, then the credit is available for the research costs that comprise this 1% increment. The "before tax" credit rate is 20%.

The **Alternative Incremental Research Credit** was enacted in the mid-1990s because many companies found that their current spending was not exceeding their historical levels for a variety of reasons. Congress awarded something of a consolation prize to these companies by granting them a modest research credit, at varying credit percentages (depending on the degree to which the company's research exceeded statutory thresholds) beginning as low as 1% of a company's current revenue. The maximum "before tax" credit rate is 3.75%. This rate was increased to 5% for years ending after 31 December 2006.

The new **Alternative Simplified Credit** eliminates the historical intricacies of the **Regular Credit** in favor of a moving three-year average of domestic spending on research. Taxpayers electing this calculation methodology are entitled to claim a credit for those current year expenses that exceed 50% of this three-year moving average. The "before tax" credit rate is 12%.

3. Time for another choice

So taxpayers now need to decide which of these three methods it should choose. While you might think that such a choice should be as easy as picking the method that yields the most credit dollars, it isn't quite that simple. The first issue to complicate your decision making is that, as enacted, the new **Alternative Simplified Credit**, once elected, must be used by the taxpayer unless it receives permission to revoke this election by the Commissioner. The optimists among us are expecting guidance from the IRS that will make this revocation an automatic procedure, perhaps not unlike the current guidance for

the **Alternative Incremental Research Credit.** But we don't have that guidance yet, so caution in this regard is urged.

The second issue complicating your choice is the possibility that IRS audits of the **Alternative Simplified Credit** may be less burdensome on taxpayers, due to the elimination of the historical reference period mentioned above. While not always a problem, for some taxpayers, especially acquisitive ones, the difficulty of determining and documenting this historical period has led to inaction. If the **Alternative Simplified Credit** produces a credit that is reasonably close to the amount as determined by the **Regular Credit**, consideration should be given to the prospects of a less difficult IRS audit. Reduced IRS scrutiny may "pay" for the perceived shortfall in credit. And we also remind our readers that FIN 48 requires financial statement issuers to consider "the approach the enterprise anticipates that the taxing authority will take during an examination", when determining the appropriate unit of account for their R&E credit.

We expect every taxpayer to reconsider their prior decisions regarding this credit. And, while logic might suggest that many taxpayers will migrate away from the old **Alternative Incremental Research Credit**, we expect more than a few **Regular Credit** taxpayers to make the election as well.

4. Some final thoughts to keep in mind

Stock market indexes are at historical highs, so we should expect many more employees to exercise some options in order to "take some money off of the table". Generally the exercise event results in taxable wages in the year of exercise, so depending on how extensive your company's stock option plan is with respect to employees, you may experience an up-tick in the wage component of research expenses. Perhaps, for some, this means that your estimating technique may not be merely using SALY for the stock option component.

If it is clear that your choice of calculating method will be the new **Alternative Simplified Credit**, as opposed to the older **Alternative Incremental Research Credit**, you might find it wise to take a fresh look at qualifying activities. Because the older **Alternative Incremental Research Credit** was not that lucrative, is it possible that research credit opportunities were not even evaluated because the benefit didn't seem to outweigh the cost? Have many years passed since a comprehensive look at business activities was undertaken? Has there been employee turn-over that might have resulted in a slow erosion of claiming eligible activities?

If your answer is yes to any of these questions, then we suspect that you will find it appropriate to revisit current practices, take a fresh look at current business operations, and learn about new research activities. We also suggest that this review be conducted for the 2004-2006 years as well. We have heard some suggest that the IRS will be less inclined to enforce its consistency rules in this situation as it will only lead to more **Alternative Incremental Research Credit** for those three years. We are generally skeptical of this suggestion and believe that taxpayers need to be reminded of the results of a court case on a similar issue, called *Research, Inc.* Our read of this case causes us to conclude that a taxpayer has to at least attempt to reconstruct its base year activities—and don't expect the IRS to do this reconstruction for you.

5. Our conclusion

United States income tax incentives that result in a decrease in a company's financial statement effective tax rate (ETR) are dwindling. Many companies will find that their 2007 ETR will increase due to the elimination of the Extraterritorial Tax Incentive, and that its replacement, the Domestic Production Deduction, is still too small to help a company make up for this elimination. We suggest that US taxpayers should revisit their determination of the Research Credit for which it is entitled. Many qualifying activities may not have been determined by a taxpayer in its recent past due to the modest **Alternative Incremental Research Credit** rates. Now that Congress has granted every taxpayer the opportunity to increase its Research Credit, taxpayers should not overlook this area as a means to reduce its US tax burden.

CYPRUS: *SOCIETAS EUROPAEA,* THE BEGINNING OF A NEW ERA

Council Regulation (EC) No. 2157/2001 of 8 October 2001 on the Statute for a European company and Council Directive 2001/86/EC of 8 October 2001 supplementing the Statute for a European company with regard to the involvement of employees gave rise to a new legal form of company that can exist within the EU, namely, the European company ("SE" – *"Societas Europaea"*). These pieces of EU legislation facilitate the cross-border establishment of an SE and came into force on 8 October 2004. Consequently, the aim of the legislation is to provide a uniform set of EU corporate law rules that would be applicable to a company incorporated as an SE and seeking to operate across Europe.

According to the SE Regulation, *existing* public or private companies operating in different Member States will, provided that they meet the requirements of the Regulation, be given the opportunity to re-register as SEs, thereby yielding a number of certain advantages. Companies will be able to operate under a single legal structure and unified management and reporting system. They will be able to restructure speedily, and to transfer corporate head offices from one Member State to another, without having to first wind up (i.e., dissolve) the company in the Member State where its head office was originally established or re-register the company in a different Member State. Consequently, companies doing business in more than one Member State will have the opportunity to significantly save both time and money.

An SE may take the form of a European public limited-liability company, with share capital and limited liability for its shareholders. The registered office of an SE must be situated within the EU, and the same Member State

should host both the registered office and the head office. Although SEs and local companies are being registered on the same register, SE registrations must be published in the Official Journal of the EU. Accordingly, an SE will be treated in every Member State in the same way as a public limited liability company incorporated in that Member State. Its minimum subscribed capital will be EUR 120,000, and its name must be preceded or followed by the "SE" abbreviation. An SE that has been operating for two years can re-register as a public limited liability company in accordance with the provisions of the laws of the Member State where it is registered.

Companies can be re-registered as SEs, so long as they existed previously in a Member State. SEs are characterized by their ability to operate on a cross-border basis. Four ways of forming an SE can be identified. Public limited liability companies formed pursuant to the laws of a Member State and with registered offices and head offices in the EU can form an SE by way of a merger, so long as at least two of the merging parties are governed by the laws of different Member States. Public and private limited liability companies incorporated in accordance with the laws of a Member State and with registered offices and head offices in the EU can form a holding SE if each of at least two of them is governed by the laws of a different Member State or has, for at least two years, had a subsidiary governed by the laws of another Member State or a branch situated in another Member State. Companies and firms formed in accordance with the laws of a Member State and with registered offices and head offices in the EU, may form a subsidiary SE by subscribing for its shares, provided that each of at least two of them is governed by the laws of a different Member State, or has, for at least two years, had a subsidiary governed by the laws of another Member State or a branch situated in a different Member State. A public limited liability company formed under the laws of a Member State and with registered offices and head offices in the EU can re-register as an SE if, for *at least two years*, it had a subsidiary governed by the laws of a different Member State.

Accordingly, a Member State may allow a company with its head office located outside the EU, to take part in the formation of an SE so long as the company is formed according to the laws of a Member State, has its registered office in that Member State, and has a real and continuous link with that Member State's economy.

Since the Regulation does not address the fields of taxation, antitrust law, intellectual property law or insolvency law, the relevant provisions of the Member State's laws and EU law will be applicable to such areas.

Upon Cyprus's accession to the EU in 2004, the Cypriot Companies Law and all relevant subordinate legislation and forms had to be amended in order to include provisions on SEs. The necessary amendments have been made recently and it is now possible to register Cypriot SEs.

Cyprus is a well-known international business center and is surely set to become one of the most sought-after jurisdictions for hosting SEs. The key aspect to look for before choosing a location for an SE is the tax system of the host country. Consequently, the Cypriot tax system makes this jurisdiction an exceptionally smart and striking location for an SE, as it combines low tax rates with a vast network of tax treaties, not to mention a straightforward, simple and, most importantly, up-to-date body of tax laws. Nonetheless, following full implementation of the EU Merger Directive by Cyprus, pre-existing companies in other Member States can, through merger, re-register as a Cypriot SE without incurring any tax charge. **Thus, re-registration of an SE in Cyprus may prove to be most profitable, advantageous and beneficial option from a business perspective.**

2007 DUTCH CORPORATE TAX REFORM: A MAJOR OVERHAUL OF THE CORPORATE TAX SYSTEM IN THE NETHERLANDS

Several significant amendments to the Netherlands holding companies regime entered into force on 1 January 2007. The principal amendments affecting corporations and discussed in more detail below are:

- Reduction in the corporate tax (CT) rate to a maximum of 25.5%
- Significant amendments to the participation exemption regime, including the introduction of a credit system for ”low taxed passive investment subsidiaries” and changes in the treatment of “hybrid loans” (see also pages 14 and 15).
- Proposed introduction of a group interest box, resulting in an effective rate of 5% on profits from intercompany financing activities.
- Introduction of a patent/royalty box regime, resulting in a tax rate of 10% for income from self-developed intellectual property patented after 1 January 2007.
- Reduction in the dividend tax rate from 25% to 15%
- Restriction on depreciation/amortization of assets (goodwill: 10 years; other assets: 5 years).
- Limitation on the decline in value of real estate (the value of portfolio assets cannot be lower than their value under the Real Estate Survey Act; the value of real estate for own use cannot be lower than 50% of that value).
- Restriction on loss relief (1-year carryback, 9 year carryforward).
- Review of the anti-base erosion measures (interest deduction and thin cap rules).

1. Reduction in the corporate tax rate

At the time of the last major tax reform in 2001, the Netherlands lowered its CT rate to 35%. The rate was then gradually further reduced to 30.5% in 2005, 29.6% in 2006 and now a maximum rate of 25.5%. Profits up to EUR 25,000 are taxed at 20%, while profits from EUR 25,001 to EUR 60,000 bear tax at 23.5%.

2. Participation exemption

- ***Qualifying participations***

  A subsidiary qualifies for the participation exemption if the parent company holds at least 5% of the (nominal, paid-in) capital stock. This 5% test has been amended so that it is now a strict rule without exceptions. Transitional measures apply through December 31, 2009 in the case of participations of less than 5% that could have qualified under the former participation exemption rules. With respect to a shareholding in a corporation resident in an EU country that has a tax treaty with the Netherlands, the participation exemption also applies if the shareholder holds 5% or more of the voting rights in the subsidiary. Shareholdings that do not qualify because they fail to meet the 5% test, might nevertheless be eligible for the participation exemption if another corporation from the same group of companies *does* have a qualifying participation (i.e., 5% or more).

- ***Hybrid loans***

  Contrary to the pre-1 January 2007 position, the exemption on income derived from a hybrid loan is no longer restricted to hybrid loans on which the interest paid by the foreign subsidiary is not deductible. This creates opportunities for tax planning: if carefully drafted, the income on a hybrid loan from a Netherlands parent company to a foreign qualifying subsidiary may be exempt from corporate tax, even if the interest is deducted at the level of the subsidiary. Also, a hybrid loan could be used as a protective instrument against interest which is not deductible at the level of the subsidiary. (See also The Netherlands' article in the "Other News" section for a more detailed discussion).

- ***Expenses***

  Expenses incurred in the sale of a subsidiary can no longer be deducted under the participation exemption rules. The deduction of expenses incurred in the purchase has been disallowed since 2004.

- ***Portfolio investment test and 'subject-to-tax' test***

  In the case of foreign subsidiaries, in general, the portfolio investment test and the requirement that the subsidiary be subject to a profits tax, have been abandoned and replaced by a credit system for all subsidiaries (foreign and domestic) that can be considered to be "passive investment subsidiaries" (also known as "low-taxed portfolio subsidiaries"). The concept of "passive investment subsidiary" and the credit system will be explained further below.

3. Credit system for passive investment subsidiaries

The participation exemption regime does not apply to participations in so-called "passive investment subsidiaries." A credit system has been introduced for such participations. In order to determine whether a participation is considered a passive investment, two cumulative tests have to be met:

- The *portfolio investment* test: the subsidiary is considered to be "passive" if more than 50% of its assets consist of uncommitted portfolio investments. These include, for example, stock, bonds, real estate and bank deposits that are not considered to play a role in the company's business. The 50%-test has to be applied on an aggregate basis, meaning that the assets of investees of the subsidiary must also be attributed to the subsidiary.
- *The subject-to-tax test:* the subsidiary must be subject to a profits tax at an effective rate of less than 10%, calculated in accordance with Netherlands tax principles. This implies that the profit of the subsidiary has to be calculated in accordance with Netherlands tax law and at the local tax rate. Therefore, tax benefits such as tax holidays, fictitious costs (e.g. the Belgian *notional interest* regime), certain provisions, exemptions, etcetera, can lead to an effective tax rate of lower than 10%, while the formal rate is higher.

If both tests are met (and the parent company owns more than 5% of the shares), the participation credit system will apply, as opposed to the participation exemption regime.

Finally, although in some cases it could be argued that a subsidiary that invests in real estate qualifies as a portfolio investment subsidiary, a subsidiary is not considered a passive investment subsidiary if it qualifies as a real estate investee. This applies if at least 90% of the assets of the subsidiary consist of real estate. As in the case of the *portfolio investment* test, this test has to be applied on a *pro rata* basis.

4. Group interest box

In the case of intercompany financing activities, a special, optional regime has been introduced. In short, the (positive) balance of income from loans granted to group companies and the interest paid to group companies, is taxed at a rate of 5%. Capital gains and losses on intercompany loans do not fall within the scope of group interest relief. Further, third-party debt is not taken into account for the purpose of group interest relief. However, where a third-party loan has been used to finance a capital contribution to a group company that uses the funds for intercompany financing activities, the interest paid to the third party should be taken into account in

determining the basis for group interest relief. There is a limit on the amount of income that qualifies for group interest relief. The ceiling is calculated as the average annual equity of the company, multiplied by the percentage of interest on payments due to the Netherlands tax authorities (”*heffingsrente*”; currently 4.7%).This group interest relief is subject to approval by the European Commission. Once the Commission has confirmed that this tax relief is not classified as state aid, the relief regime will have retroactive effect from 1 January 2007. It should be noted that the Commission has indicated that part of the regime is incompatible with EU law. The fact that the regime is only of *de facto* interest to multinational groups that would use the Dutch company to finance foreign group companies and that it factually discriminates against the financing of Dutch related companies, since they would only be able to deduct the interest at the low rate (effectively 5%) will be a problem. We will report on further developments in relation to the Interest Box as and when the details become available.

5. Royalty/Patent box

Based on the general approval by the EU of incentives to stimulate R&D, the Netherlands has introduced a special tax regime for royalties. In brief, the regime provides that income from self-developed, patented (post-1 January 2007) intangible assets will be taxed at an effective rate of 10%. The assets must be patented after January 1, 2007 and trademarks are excluded, unlike, for instance, the French or Hungarian regime. Moreover, there is a cap. Up to 4 times the amount of the capitalized investment can benefit from the special regime. It should be noted, however, that one can “increase” the low-taxed basket by also including inventions that are currently patented, as yet unpatented, or never patented. Detailed rules apply on how and with which amount the “box” can be “filled”.

6. Dividend tax

The dividend tax rate has been reduced from 25% to 15%. This reduction will only affect shareholders of Dutch companies that do not benefit from the EC Parent-Subsidiary Directive or tax treaties which mitigate the dividend tax burden. Furthermore, the threshold for the exemption to withhold dividend tax has been lowered to a shareholding of 5% for EU-resident parent companies. In addition, foreign entities having a seat within the EU and not subject to a corporate tax (such as e.g. pension funds), can claim a refund of the dividend tax. Prior to 2007, this type of refund was only granted to Dutch entities.

7. Depreciation/amortization of assets (both movable and immovable)

New rules have been established for the depreciation/amortization of assets. “Ordinary” assets must now be depreciated/amortized over at least 5 years, regardless of their useful life, whereas the period for amortization of goodwill is 10 years as a rule.

From now on, real estate cannot be depreciated below the applicable value for real estate tax purposes (comparable to the French *taxe fonciere*). If the real estate is used in the business of the company, it can be depreciated down to 50% of this reference value. Very detailed regulations apply and taxpayers owning real estate in the Netherlands are strongly advised to contact their tax advisers.

8. Tax loss carryforwards

As indicated earlier, the carryforward of tax losses has now been restricted to 9 years (previously, there was no limit). Loss carrybacks have been limited to 1 year, compared with 3 years previously.

9. Anti-base erosion rules

In 1997 the Netherlands introduced substantial anti-base erosion rules. One of these rules related to loans taken up to finance the acquisition of a company, which was subsequently included in a fiscal unit. This specific provision has been abolished. The pertinent provision applied not only when funds were borrowed from a related party, but also in respect of third-party loans. The upshot of the new regime is basically that such loans may result in a limitation on the deductibility of interest, but only if funds are borrowed from a related party.

TAXAND NEWS

NEW FIRMS JOINING TAXAND

The Alliance is presently finalizing agreements with new member firms in Australia, Denmark and Finland.

SEMINARS FOR JUNIOR TAXAND PROFESSIONALS (AMSTERDAM AND KUALA LUMPUR)

A second international Tax Training Seminar for our junior colleagues took place in Amsterdam in February 2007.

40 junior tax professionals from 15 Taxand Firms spent a week at the IBFD's International Tax Academy for an intensive introduction to the principles of international taxation and transfer pricing.

In addition, another Seminar for junior Taxand professionals is taking place in Kuala Lumpur in April 2007, when 30 young tax advisers from the Taxand Asian Firms get the chance to meet to hone their skills in relation to advising on tax treaties and other relevant tax issues.

UPCOMING TAXAND CONFERENCES

On 11 and 12 June 2007 the 36 Taxand Firms will be meeting in Rome for the Sixth Taxand Conference.

During the conference, in addition to participating in numerous technical sessions on current developments of interest to our clients in different jurisdictions, we will have the opportunity to hold meetings between members of the different service lines (Real Estate, VAT, Transfer Pricing, Reward Consulting, BD & Marketing and Knowledge Management), and with several clients.

The next Taxand conference will take place in New Delhi in December 2007.

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