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TAXAND QUARTERLY

 YOUR GLOBAL NETWORK OF LEADING TAX ADVISORS



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LEGAL DEVELOPMENTS

LEGISLATION

1. BELGIUM

New circular confirms notional interest regime

The Belgian tax authorities have published a circular on the application of the “notional interest” regime (circular dated 3 April 2008). The notional interest regime was introduced into Belgian tax legislation by the Law of 22 June 2005 and allows corporate taxpayers to deduct a certain percentage of their accounting equity from their tax base. This percentage represents 4.307% for the current fiscal year.

In response to rumors that the notional interest regime was to undergo substantial changes, the new Circular confirms the continuing application of the notional interest deduction and provides certain comments on the regime from the viewpoint of the general anti-abuse rules applying in fiscal matters.

The tax authorities confirm that any deed or transaction which can be considered as “fictitious” shall not be binding. “Fictitious” deeds or transactions are those that do not reflect the real and true intention of the parties concerned. Accordingly, it is essential to assess whether the parties have fully and duly accepted and executed all consequences of their contractual engagements.

The circular also comments on several conditions and restrictions of the notional interest regime. For instance, participations held in other companies are excluded from the calculation of the notional interest deduction of the parent company

The circular also refers to certain types of transactions which are organized to combine the interest deduction on loans contracted in order to acquire shares, with the notional interest deduction on equity. From experience, the tax authorities claim that corporate taxpayers often contract a loan, deduct the related interest on the loan, and then contribute the funds concerned into a subsidiary which offsets the interest received on its invested capital with the notional interest deduction. The circular does not expressly prohibit such transactions, but refers to case law by stating that a company may only deduct costs if these are related to its corporate purpose and articles of association, or are incurred in connection with transactions carried out for the purpose of making a profit and not only a obtaining a tax advantage. It is unclear however how the application of these restrictions can and shall effectively limit the application of the notional interest deduction in similar cases.

The circular does not therefore implement any new rules, but essentially seems to stand as a “gentle reminder” that the notional interest regime should not be the cause of aggressive tax planning in a manner involving fictitious behavior.

2. DENMARK

Bill attacking reverse hybrid structures adopted by Danish Parliament

On 12 June the Danish Parliament adopted Bill L 181 (“the Bill”). The Bill will be enacted shortly and could affect the Danish tax classification of a number of Danish tax transparent entities and branches treated as non-transparent by their foreign owners. The Bill is primarily aimed at obstructing US check-the-box elections for Danish tax transparent entities (reverse hybrids) and reclassifies such entities as non-transparent corporations for Danish tax purposes.

The Bill may affect structures already in place as no “grandfathering” mechanisms will apply, and may also eliminate the future use of Danish tax transparent entities for tax planning purposes.

1. Pre-Bill regime

Under Danish law as applicable prior to the Bill, both limited and unlimited partnerships were treated as tax transparent entities, and partners were therefore taxed directly on the income generated by the partnership. Foreign partners were, however, only subject to Danish tax on income generated by the partnership if the partnership business constituted a permanent establishment in Denmark. The mere fact of holding a partnership interest did not constitute a permanent establishment.

2. New regime

Under the new Bill:

- Danish branches of foreign entities subject to registration in Denmark; and
- tax transparent entities which (a) are incorporated in Denmark or (b) have their registered office in Denmark or (c) have their effective seat of management in Denmark (together, the “Hybrid Entity”);

will be reclassified and treated as a non-transparent corporate entity for Danish tax purposes if:

- 1) more than 50% of the votes or the capital interest in the transparent entity/branch are held directly by foreign investors; and
- 2) these foreign investors are resident in a foreign state which (a) does not consider the Danish entity as tax transparent or (b) did not conclude any tax information agreement with the Danish tax authorities.

3. Carve-out for certain venture funds

Hybrid Entities which meet certain specific requirements to qualify as a venture fund for Danish tax purposes will be covered by a carve-out and will not therefore be subject to reclassification. The carve-out mainly applies to Hybrid Entities with a fairly diverse investor base investing solely in shares in small and mid cap companies with a view to participating in their operation and management.

4. Impact of the reclassification

- the Hybrid Entity assumes in certain respects the tax position of the investors;
- income generated by the Hybrid Entity will be subject to ordinary Danish corporation tax (flat rate of 25%);
- the disposal of an ownership interest in the Hybrid Entity will be treated as a sale of shares (NB: when the shareholder is not a Danish resident, such sales are always tax-exempt);
- payouts made by the Hybrid Entity to investors will be treated as dividends and may thus be liable for Danish withholding tax;
- subsequent discontinuance of the reclassification will be treated as a liquidation of the Hybrid Entity. This may result in the taxation of (i) capital gains realized by the Hybrid Entity and (ii) proceeds from the liquidation received by investors.

5. Effective date

The Bill is generally effective for fiscal years commencing on or after 15 April 2008. Depending on the circumstances, the Bill may also apply to fiscal years commencing before 15 April 2008. In this case, only the period of the fiscal year which falls after 15 April 2008 would be concerned.

6. Bech-Bruun comments

The Bill is the latest in a line of examples of the Danish tax authorities taking on extraterritorial authority to some extent in the field of corporate taxation in an effort to counter perceived tax abuse. However, as the structures targeted by this Bill have never been taxable in Denmark and as the income generated by the Hybrid Entities would generally be taxable upon repatriation, we find that the tax authorities have somewhat misunderstood or disregarded the concept of tax abuse in the matter at hand. Instead, they have created another technically complex tax regime which may negatively impact the investment environment in Denmark.

During the legislative process, the Danish Minister of Taxation indicated that he was considering introducing a patent box which could provide for reduced taxation of intellectual property rights provided that a political majority could be established (not currently the case). However, based on the statements made by the Minister in the run-up to the Bill, we believe that if such a patent box regime were to be introduced, there is a significant risk that it would not replace the reverse hybrid regime brought in by the Bill.

3. FINLAND

Government Bill for new CFC legislation issued

On 6 June 2008 the Finnish Government issued a Bill to amend existing CFC legislation. The Government Bill contains a proposal that would affect the application of the Finnish CFC regime. If adopted, the Bill would narrow

the scope of application of CFC legislation, and could also require reorganization of existing corporate structures.

The Bill proposes amendments to existing regulations especially with regard to the definition of a CFC entity. The Bill also proposes amendments to provisions concerning the calculation of taxable CFC income, CFC deductible losses, and the foreign tax credit.

Under the proposal, subject to certain exceptions, CFC legislation does not apply if the following conditions are met:

- the entity is resident in a Member State of the European Economic Area or in a tax treaty partner State; and
- on the basis of objective factors ascertainable by third parties, the controlled entity is actually established in the host State where it carries on genuine business activities.

Exceptions apply to entities established in countries that either feature on the black list provided by the Ministry of Finance or that do not exchange appropriate information with the Finnish tax authorities to ensure the entity's actual establishment and genuine business activities.

The proposed amendments would not affect the current exception from CFC legislation applying to a tax treaty State. Accordingly, an entity residing in a State with which Finland has a tax treaty would not be covered by CFC rules if:

- the tax burden under the general corporate tax system of that State is comparable to the corporate tax burden in Finland; and
- the entity has not been subject to a special tax benefit in its home country.

Provided these two requirements are met, an entity in a tax treaty State is not subject to CFC rules regardless of its level of establishment and actual tax burden. However, general anti-abuse rules apply.

Furthermore the Bill proposes to consider that foreign permanent establishments in low tax jurisdictions are comparable to foreign legal entities. Hence, in some cases a permanent establishment of a foreign subsidiary could be regarded as a CFC even though the subsidiary itself may not meet the definition of a CFC.

Currently, shareholders are liable for tax on CFC income if they hold an interest of at least 10% in the Finnish controlled foreign corporation's capital or if their interest entitles them to a 10% share in the corporation's return on assets. The Bill proposes raising the interest threshold to 25%. Accordingly, no CFC taxation would occur if the interest of separate shareholders does not exceed 25%.

The Bill is expected to be adopted by Parliament during Fall 2008 and would be effective for fiscal years commencing on or after 1 January 2009. However, a transitional period has been proposed for existing permanent establishments.

If the proposed Bill is approved in its current form, the amendments could affect admissible structures for Finnish-owned foreign entities. Restructuring measures

should be considered in order to ensure compliance with the new requirements.

4. FRANCE

New tax treaty between France and the UK

A new income tax treaty was signed between France and the United Kingdom on June 19, 2008. This new treaty should entry into force and become effective in 2009 and will replace the 1968 tax treaty currently in force. It should be noted that the treaty signed between France and the United Kingdom in January 2004 will never entry into force as it was superseded by the new treaty signed on June 19, 2008.

5. GERMANY

5.1 Draft 2009 Tax Act introduces changes for inbound investors into Germany

The Federal Ministry of Finance recently released its Draft 2009 Tax Act. This draft contains some important changes in tax law for inbound investors into Germany. The most important changes are summarized below.

- The 2008 Business Tax Reform Act introduced a tax rate of 15% for corporate entities. Accordingly, the domestic withholding tax rate on dividends paid by German corporations to foreign corporate shareholders will be reduced from the current rate of 20% to 15% beginning in 2009 (plus a solidarity surcharge in each case). However, the Draft 2009 Tax Act limits the reduction to those recipients that meet the strict substance requirements of the German anti-treaty and Directive shopping provisions that were introduced in 2007. In structures where the corporate shareholder of the German company does not meet these requirements and the upper-tier shareholder is an individual residing in a non-treaty country, the reduced withholding tax rate is not applicable and the domestic rate is actually raised to 25% (plus the solidarity surcharge).
- The current law prohibits German companies or German permanent establishments of foreign companies from locating their bookkeeping function outside Germany, except in the case of foreign permanent establishments. Under the Draft 2009 Tax Act, these companies may produce electronic bookkeeping records in other EU Member States and in certain cases in EEA-countries, provided they have met certain requirements and received permission from the tax authorities. No bookkeeping activities must be carried on in "third countries". The draft contains harsh penalties of up to EUR 250,000.00 if the taxpayer does not immediately relocate its electronic bookkeeping back to Germany, if it is considered to have failed to meet the necessary conditions precedent for establishing its bookkeeping in a foreign country.

- As from the 2009 tax assessment period, foreign corporate entities renting German properties will no longer generate rental income but trade income. Consequently, income will have to be determined on an accruals basis rather than on a cash basis as is presently the case. The positive impact of this reclassification will be a yearly depreciation charge for the building of 3% instead of 2%. The proposed change should not have an impact on the trade tax position of foreign special purpose vehicles deriving income from renting German real property. Neither should it impact the position of these vehicles with respect to the recently introduced German "interest barrier" limiting the tax deductibility of interest expenses, since the barrier is already applicable to foreign corporations earning rental income in Germany.

Although it is not included in an updated Draft published on June 18, discussions are also in progress to introduce a provision whereby all dividends and capital gains from the disposal of shares will be subject to corporate income tax if the company holds less than 10% of the shares ("widespread shareholding") at the beginning of the tax assessment period. This means that contrary to current law, dividends and capital gains from the disposal of shares received by corporate entities which only own such widespread shareholdings would no longer be 95% exempt under the participation exemption. A number of methods for calculating the shareholding percentage (e.g. in case of tax groups, security lending, etc) would be required. Moreover, expenses in connection with widespread shareholdings would be limited to income from these shareholdings.

5.2 Draft Decree Law interpreting the new transfer pricing provisions to be introduced

With beginning of 2008 amended transfer pricing regulations became effective in Germany. Amongst others a commensurate-with-income standard, the interquartile range, the prudent business manager concept as well as a provision requiring the tax payer to defend business restructurings were introduced.

On 23 May 2008 a draft decree Law passed the Federal Cabinet of Ministers which deals with the adequate transfer price for the transfer of functions/packages. This draft should pass the Federal Council until early July 2008 at the latest and shall become retroactively applicable from January 1, 2008 onwards.

The decree clarifies the interpretation of certain terms such as profit expectation/potential or hypothetical arm's length comparison. Highly controversial is the request that also advantages/disadvantages of the location as well as the total synergetic effects expected from the transfer are included regardless which of the entities is entitled to these advantages respectively how they have to be allocated among the parties involved.

Further the decree requires the use of appropriate capitalization rates based on a riskless investment plus a risk premium as well as capitalization periods when determining the profit expectation/potential. In case no credible proof exists with regard to the capitalization period applicable, an unlimited capitalization period has to be chosen. On first glance such regulations seem to ease the calculation of such transfer packages. However, the definition of an interest rate for riskless investments causes already problems as well as the definition of an appropriate capitalization period.

In addition, a duplication of functions is deemed to be a detrimental shifting of functions if within a period of five years the function of the enterprise that first did the activity is on the one hand reduced and on the other hand increased in another non-domestic enterprise. No duplication of functions shall be assumed if at a non-domestic enterprise a function is increased but the domestic enterprise that first did the activity does not reduce this function.

It is expected that the current version of the decree will lead to inevitably lead to intensive discussions due to the increased restrictiveness of the regulation itself as well as the lack of further guidelines providing further information on the practical implementation. .

6. GREECE

6.1 Export companies entitled to amortize exchange losses in three equal annual installments

Greek export companies that have claims denominated in foreign currencies were expected to incur extensive losses for fiscal year 2007 due to the significant depreciation of the US Dollar (USD) and Japanese Yen (JPY). In order to minimize the effect of such losses, the Greek Ministry of Finance has recently issued a circular (POL 1073/8.4.2008) providing that export companies which incur exchange losses:

- (i) on the collection of claims in USD or JPY from 1 January 2007 to 31 December 2007; or
- (ii) on the fiscal year-end valuation of claims denominated in USD or JPY generated from transactions performed up to 31 December 2007;

may amortize these exchange losses for tax purposes, either as a lump sum in the fiscal year ending 31 December 2007 or 30 June 2008, or in three consecutive equal annual installments, starting from the fiscal year ending 31 December 2007 or 30 June 2008.

6.2 Greece-Russia tax treaty

The instruments of ratification for the Greece-Russia tax treaty were exchanged on 20 December 2007. Accordingly, the treaty – signed in 2001 and ratified by Law 3047/2002 – is effective for income generated or capital owned as from 1 January 2008.

7. INDIA

Liberalization of existing external commercial borrowing policy

The Reserve Bank of India (RBI) has reviewed its existing policy on external commercial borrowings (ECB) and has made the following amendments:

- The ECB facility can now be utilized for rupee expenditure (for permissible end use) up to a maximum of USD 100 million for infrastructure projects and USD 50 million for other projects. This limit has been raised from the existing limit of USD 20 million. Prior approval is still needed from the RBI before using the ECB facility to undertake rupee expenditure.
- All-in-cost ceilings have been revised for both automatic and approval routes as follows:

Minimum Average Maturity Period	All-in-cost ceilings over six month LIBOR	
	Existing	Revised
Three years and up to five years	150 basis points	200 basis points
More than five years	250 basis points	350 basis points

- The policy has been relaxed for the services sector and specified businesses in the services sector. Hotels, hospitals and software companies can now access ECB facilities of up to USD 100 million per financial year, for the purpose of importing capital goods under the approval route.

8. INDONESIA

Indonesia reduces income tax rates

On 7 June 2008, the working committee on the amendment of the Income Tax Law composed of government representatives and legislators agreed to reduce the income tax rates as contained in the draft amendment to the Income Tax Law, in an attempt to make Indonesia more competitive in the region.

The new income tax rates are as follows:

1. The corporate income tax rate for corporate taxpayers will be a flat rate of 28% in 2009, falling to 25% in 2010 (from the maximum rate of 30% under the existing law).
2. The highest tax rate for individual taxpayers will be reduced to 30% (from 35%) in 2009. This rate may be further reduced to 25% by a Government Regulation upon the approval of the House of Representatives during the annual State budget hearing.

New Income Tax Rates for Individual Taxpayers			
Revised Tax Rates (effective 2009)		Current Tax Rates	
Annual income bracket	Rates	Annual income bracket	Rates
Up to INR 50 million	5%	Up to INR 25 million	5%
INR 50 million – INR 250 million	15%	INR 25 million – INR 50 million	10%
INR 250 million– INR 500 million	25%	INR 50 million – INR 100 million	15%
Over INR 500 million	30%	INR 100 million– INR 200 million	25%
		Over INR 200 million	35%

9. ITALY

New exemption rates on dividends and capital gains

In line with the reduction of corporate income tax from 33% to 27.5% introduced by the 2008 Budget Bill, the Ministerial Decree of 2 April 2008 modified the exemption rates with regard to dividends and capital gains.

Previously, 60% of the amount of dividends and capital gains from qualifying participations were exempt, with 40% of dividends and capital gains taxable at the ordinary progressive income tax rates.

In principle, a taxpayer's shareholding is deemed a qualifying participation when one of the following requirements is fulfilled: (a) in the case of securities traded on the stock market, the percentage of voting rights for the shareholders' general meeting is higher than 2% or the participation in the share capital is higher than 5%; (b) in other cases, the percentage of the voting rights for the shareholders' general meeting is higher than 20% or the participation in the share capital is higher than 25%.

The new taxation percentage is increased to 49.72% from 40%, with the new exemption rate reduced to 50.28% from 60%. These new rates apply to distributions of profits arising in the fiscal period beginning on or after 31 December 2007 and capital gains arising after 1 January 2009.

10. LUXEMBOURG

10.1 Abolition of the capital duty as from 2009

In his traditional "State of the nation" speech before Parliament on 22 May 2008, Prime Minister Jean-Claude Juncker announced various tax measures aimed at maintaining and improving an attractive tax environment in Luxembourg. The abolition of the 0.5% capital duty in 2009 is probably the most keenly awaited tax measure, and follows on from the reduction of the capital duty from 1% to 0.5% in 2008. Abolition of the capital duty in Luxembourg had been announced by the Government when the duty was reduced to 0.5% but uncertainties emerged following Council Directive 2008/7/EC of

February 12 2008, which no longer obliges EU Member States to abolish capital duty within a certain timeframe (contrary to its draft version).

Abolition of the capital duty will certainly make Luxembourg more attractive for foreign investors. Luxembourg was one of the few European Union countries still levying a tax on capital contributions. Even though the capital duty cost could be managed or at least reduced either by the use of alternative funding such as debt instruments or by carefully structuring investments, it was still a cost that had to be monitored by investors and their advisers. The definitive abolition of the capital duty will therefore make life easier for investors when investing in Luxembourg.

10.2 Decrease in corporate income tax rates

Overall corporate income taxation (corporate income tax and municipal business tax) is to be reduced from 29.63% to 25.5% in two phases. According to the Prime Minister, where appropriate, the reduction may be accompanied by a number of tax measures aimed at enlarging the taxable base of companies. The exact timing has not been confirmed but it can be expected that the reduction will happen within two years, with a first cut in the rate in 2009 followed by a second one in 2010.

The reduction in the overall corporate income tax rate ensures that Luxembourg remains competitive not only in the European Union but also on a worldwide basis. In 2007, Luxembourg's corporate income tax rate of 29.63% was approximately 3% higher than the EU average and approximately 4% higher than its competitors across the globe. The Luxembourg Government realized that something had to be done in this area and the Luxembourg market place welcomes the decision of the Government to act accordingly.

10.3 New Luxembourg-India tax treaty

On 2 June 2008, Luxembourg and India signed a tax treaty. The main provisions of the treaty are summarized below:

- Withholding tax on dividends, interest and royalties: the maximum withholding tax applicable to dividend distributions, interest payments and royalty payments is 10%. The rate applicable to dividend distributions applies regardless of the shareholding percentage.
- Capital gains: capital gains on sales of shares in companies whose assets mainly comprise immovable property, are taxable in the country in which the immovable property is located. Capital gains on shares other than the above are also taxable in the source country (country of residence of the company whose shares are sold). This latter provision is not in line with the OECD Model Tax Convention which provides for taxation only in the seller's country of residence.
- Entities excluded: the tax treaty does not apply to 1929 holdings and similar tax regimes. Luxembourg SICAV funds are not explicitly excluded but further clarification is needed to ascertain whether the tax regime applicable to SICAV/SICAF and SIF funds is

considered as similar to the 1929 holding tax regime, and therefore whether these entities may benefit from the tax treaty.

- Avoidance of double taxation: Luxembourg provides for the exemption-with-progression method to avoid double taxation and the credit method with respect to dividends, royalties, and income earned by artists and sportsmen.
- Limitation on benefits: the treaty includes a limitation on benefits ("LOB") clause according to which it will not apply to an entity if the entity's main objective, or one of its main objectives, is to benefit from provisions of the tax treaty which otherwise would not have applied. Since the wording of this clause is not specific, it leaves considerable room for interpretation and may create legal uncertainty for taxpayers.

11. MALAYSIA

11.1 Advance rulings

The Inland Revenue Board (IRB) has issued the 2008 Income Tax (Advance Ruling) Rules. Although only recently issued, these rules are effective from 1 January 2007. The draft rules were first released in early 2007, and present no significant differences with the definitive rules. The rules allow a taxpayer to seek an advance ruling on the tax treatment of a particular transaction/arrangement. The transaction/arrangement in question must be one that is seriously being considered when the ruling is sought. The IRB has also issued Guidelines on Advance Rulings which further explain the procedures and requirements involved in applying for an advance ruling. It should be noted that the matter on which the advance ruling is sought must not involve the interpretation of any foreign law or double taxation issues, etc.

There is no avenue to appeal against an advance ruling as such, but the normal appeal procedures for tax assessments would continue to apply to issues on which an advance ruling has been given. The Guidelines stipulate that advance rulings must be made within 60 days from the date of submission of (complete) requests.

11.2 Expatriates working for International Procurement Centres (IPCs) and Regional Distribution Centres (RDCs)

Expatriate employees who work for companies benefiting from the Operational Headquarters incentive are currently only taxed on the portion of chargeable employment income attributable to the number of days that they are in Malaysia. This tax treatment has now been extended to expatriate employees working for IPCs and RDCs as well, as such expatriates are typically required to travel extensively in the course of their employment. This provision has been enacted in the recently gazetted Income Tax (Exemption) (No. 2) Order 2008. Note that companies which qualify as IPCs and RDCs enjoy similar tax incentives to OHQs, namely a 10-year tax exemption on qualifying income.

11.3 Withholding tax exemption for non-resident experts in Islamic finance

Non-resident consultants who provide technical advice, assistance or services in Malaysia are generally subject to tax on the income earned thereon. The tax is levied via a withholding tax charge. To enhance skills in the Islamic financial sector and promote Malaysia as an Islamic financial hub, an exemption from withholding tax is given to non-resident individuals in respect of income arising from technical advice, assistance or services provided in relation to Islamic finance. To qualify for this withholding tax exemption, the non-resident individual must be vetted by the Malaysia International Islamic Financial Centre Secretariat as an expert in the field of Islamic finance. This exemption is in force from 8 September 2007 until 31 December 2016.

Liberalization of foreign exchange rules

The Central Bank of Malaysia recently relaxed the foreign exchange administration rules in respect of the following areas:

(i) Borrowing in foreign currency by residents

A resident company is now free to borrow any amount in foreign currency from its non-resident non-bank parent company, other resident companies within the same corporate group in Malaysia, as well as licensed onshore banks and licensed international Islamic banks.

Previously, the threshold for foreign currency borrowing was Malaysian ringgit (MYR) 100 million on aggregate on a corporate group basis.

Furthermore, a resident company is also free to obtain any amount of foreign currency supplier's credit for capital goods from non-resident suppliers and is free to refinance outstanding approved foreign currency borrowings.

(ii) MYR borrowing by residents from non-residents

A resident company is allowed to borrow in MYR, including through the issuance of MYR-denominated redeemable preference shares or loan stocks of any amount from its non-resident non-bank parent company to finance activities in the real sector in Malaysia and upto MYR 1 million from other non-resident non-bank companies or individuals (i.e. from a non-parent company) for use in Malaysia.

Previously, borrowing in MYR of any amount from non-residents required prior permission from the Central Bank.

(iii) MYR lending by residents to non-residents

A resident company or individual or licensed onshore bank is free to lend any amount of MYR to non-resident non-bank companies or individuals to finance activities in the real sector in Malaysia.

Further to the above, the Central Bank has also reclassified the definition of "credit facilities" to exclude the following transactions:

- operational leasing facilities;

- factoring facilities without recourse; and
- performance guarantees and financial guarantees.

Accordingly, the aforementioned transactions are no longer subject to the foreign exchange administration rules previously applicable.

12. MALTA

New legislation set to create more opportunities in the financial services sector

The new legislation (Civil Code (Amendment No. 2) Act XIII of 2007) provides for alternative structures in the form of foundations and associations, which may be used for investment purposes among others. According to the new Act, a foundation is "an organization consisting of a universality of things constituted in writing whereby assets are either destined for the fulfilment of a specified purpose or for the benefit of a named person or class of persons, and are entrusted to the administration of a designated person or persons".

The assets of the foundation may originate from any lawful business activity and may consist of present or future assets of any nature.

On the other hand, an association is an agreement between three or more persons to establish an organization with defined aims or purposes to be achieved through the dedication of efforts and resources by such persons and others who may join voluntarily. Even though associations are not bound by law to register as legal persons, they may elect to do so.

The patrimony of the foundation or of an association must be kept distinct from its founder, administrators or beneficiaries. The law also provides for hybrid associations which are established as a foundation but which have the features of an association or vice-versa. These qualify for registration both as foundations and as associations.

A foundation may be constituted by virtue of a public deed inter vivos or by a will. The deed of foundation must contain a minimum endowment of money or property of EUR 1,500, except for foundations established exclusively for a social purpose or as non-profit-making, in which case the minimum endowment is EUR 250.

A foundation may be formed for a maximum period of 100 years. The exception to this rule is in the case of a special purpose foundation (used as a collective investment vehicle or a foundation used in a securitization transaction), which may be established for an unlimited term. A foundation may not be established to trade or carry on commercial activities even if the proceeds of such efforts are destined for social purposes. A foundation would therefore qualify as a securitization vehicle under the terms of the Securitization Act. Thus, it may engage in transactions whereby it directly or indirectly:

- (a) acquires securitization assets from an originator by any means; or

- (b) assumes any risks from an originator by any means; or

- (c) grants secured loans or other secured facility or facilities to an originator; and finances any or all of the above, directly or indirectly, in whole or in part, through the issue of financial instruments, including any preparatory acts carried out in connection with the above.

The provisions of the Income Tax Act relating to trusts, settlers and beneficiaries will be extended to foundations, their founders and the beneficiaries thereof, as well as to any persons who donate property to the fund.

The Duty on Documents and Transfers Act in S.32C also provides that the administrators of a foundation may elect that the foundation be treated as a trust for an exemption of duty insofar as the founder transfers immovable property or any real right over immovable property to the foundation created for the purpose of a designated commercial transaction, including the securitization of assets.

13. PERU

Peru-Brazil tax treaty concerning income and capital has recently been approved by the Peruvian Congress, while the Peru-Spain treaty is still pending Congressional approval

The Peru-Brazil tax treaty (the "Treaty") signed on 17 February 2006 was recently approved by Legislative Resolution 29233, enacted by the Peruvian Congress on 21 May 2008. Following Congressional approval, the Treaty was ratified by Supreme Decree 019-2008-RE, enacted by the Peruvian Ministry for Foreign Affairs on 6 June 2008. The Treaty will be enforceable in Peru once the instruments of ratification have been exchanged between both States. The Treaty will be effective in Peru from 1 January of the calendar year immediately following the date in which it enters into force.

The Peruvian Congress is expected to approve the Peru-Spain tax treaty executed on 6 April 2006.

It should be noted that the only two tax treaties executed by Peru which are currently in force are those with Chile and Canada. These treaties follow the OECD Model Convention for the Avoidance of Double Taxation. However, Peru is also a member of the Andean Community (which also includes Ecuador, Colombia and Bolivia) which has its own double taxation rules set out in Decision 578, approved by the Commission of the Andean Community. This Decision essentially states that taxation is to be based on the source of income rather than on the residency principle.

14. POLAND

Changes to Polish Commercial Companies' Code

The Polish Commercial Companies' Code ("the CCC") was amended on 20 June 2008, implementing Directive

2005/56/EC of 26 October 2005 on cross-border mergers of limited liability companies ("the Directive").

The revised law provides the legal framework for cross-border mergers, i.e., involving companies or limited joint-stock partnerships referred to in article 2, clause 1 of the Directive, incorporated under the laws of the EU Member State or party to the European Economic Area and having its registered office therein. Joint-stock partnerships, however, may not be the acquiring or newly established company in a merger. The new regulation is not applicable to foreign cooperative societies whose object is the collective investment of capital raised from the public. These companies operate under the risk diversification principle and units in such companies are directly or indirectly repurchased or redeemed out of the assets of that company, at the holder's request.

The law sets out the detailed formal conditions which need to be fulfilled to complete the merger, along with provisions protecting the rights of minority shareholders and creditors. For example, the company's management board must obtain a certificate stating that the merger complies with Polish domestic law.

Other amendments to the CCC are also pending. The amendments will implement Directive 2006/68/EC of 6 September 2006 of the European Parliament and of the Council, amending Council Directive 77/91/EEC as regards the formation of public limited liability companies and the maintenance and alteration of their capital. These amendments will also facilitate the formation and operation of such companies. However, they are not yet in force.

15. PORTUGAL

15.1 VAT rate reduction effective 1 July 2008

The Portuguese Government has approved a reduction in the standard VAT rate from 21% to 20%, effective 1 July 2008. Following this reduction, it is expected that the lower standard rate applicable in Madeira and the Azores will also be reduced from 15% to 14%. No final decision concerning Madeira and the Azores has been issued to date.

If there is a decision to reduce the VAT rate in Madeira to 14%, companies established in the IBC of Madeira will benefit until 2015 from the lowest VAT rate in the European Union for B2C telecommunications, broadcasting and electronic services supplies.

15.2 Administrative guidelines on the deduction of input VAT

Following the 2008 budget law amendments to VAT deduction methods for mixed activities, the tax authorities have recently issued administrative guidelines designed to ensure uniform application of those rules.

The amendments to article 23 of the VAT Code established that VAT paid by taxpayers who, in the course of their activity, conduct operations which confer a right of deduction as well as operations which do not confer such right, may only be deducted by means of the pro rata or actual use method, when the goods or

services in respect of which the VAT has been paid have been used in the pursuit of both types of operations.

The new rules establish that the actual use method must be used to determine the tax deductible for the acquisition of goods and services partially used in conducting operations which do not arise from a business activity. In other cases, this method is optional. To apply the actual use method, the circular provides examples of allocation keys (e.g. area occupied or number of staff employed) that need to be adopted on a case-by-case basis. The taxpayer must be able to justify the methods and particular allocation key used. The criteria adopted by the taxpayer at the beginning of each calendar year must be applied consistently during that period, with the necessary adjustments made at year-end.

The new rules also establish that for the purposes of calculating the deduction under the pro rata method, only operations carried out in the course of a business activity may be used as the denominator of the equation. In addition, the guidelines clarify that subsidies resulting from a business activity subject to VAT are to be included in the denominator, with the exception of those which are intended to finance tax-exempt business activities or operations that do not arise from a business activity.

Finally, the guidelines also provide further information on transactions that may or may not represent a business activity for VAT purposes and on financial transactions that are considered ancillary despite meeting the definition of a business activity.

15.3 Disclosure rules on tax planning schemes enter into force

As reported in the previous Quarterly Issue, Portugal introduced disclosure rules on abusive tax planning schemes (Decree Law No. 29/2008). The disclosure rules, which entered into force on 15 May 2008, apply to all tax planning schemes still in progress on that date in which a promoter continues to provide any support, advice or assistance in the tax area for its implementation. Following Ordinance 364-A/2008, promoters or beneficiaries of qualified tax planning schemes are required to file a specific tax declaration available online.

In the meantime, interpretative guidelines have also been issued in order to provide uniform interpretation of the disclosure rules by the tax authorities. The guidelines include actual examples of transactions that the tax authorities consider to fall within the scope of the rules.

15.4 Portugal outbound interest withholding tax under ECJ scrutiny

The European Commission has recently referred Portugal to the ECJ (C-105/08) concerning the taxation of outbound interest payments. Under the current rules, non-resident financial lenders are generally subject to a 20% withholding tax levied on the gross interest paid by Portuguese-resident entities, whilst Portuguese-resident financial institutions benefit from an exemption from withholding tax on loans provided in the Portuguese territory.

According to the European Commission, the taxation of outbound interest payments to non-resident lenders may lead to a heavier tax burden than that borne by resident taxpayers in similar transactions. In this regard, the European Commission holds that by dissuading non-resident financial institutions from offering financial services in Portugal, these rules create discriminatory treatment in conflict with the freedom to provide services and the free movement of capital established in articles 49 and 56 of the EC Treaty.

In view of the above, we believe that foreign financial institutions having paid Portuguese withholding tax on outbound interest payments should consider filing an appeal with the Portuguese tax authorities against unlawful payments of interest withholding tax over the past four years.

16. PUERTO RICO

Summary of the relevant provisions of the new Puerto Rico Economic Incentives Act

On 28 May 2008, the Governor of Puerto Rico signed House Bill 4350, which became Act No. 73 of 2008: Economic Incentives Act for the Development of Puerto Rico.

I. Entities eligible for the incentives

Act 73 provides incentives for income, property, municipal license, municipal construction, excise, and sales and use taxes. In order to qualify for these incentives, the taxpayer must be an exempt business, i.e. an eligible business having obtained a grant under the Act (note however that in some instances, the incentives may be granted to exempt businesses having obtained a grant under prior Industrial Incentives or Tax Incentives Acts). Thus, to become an exempt business the entity must qualify as an eligible business. In general, the Act includes the following as eligible businesses:

- a. an industrial unit engaged in the production of a manufactured product on a commercial scale;
- b. an office that provides certain services in Puerto Rico on a commercial scale, such as:
 - i. services designated for foreign markets,
 - ii. the rendering of fundamental services as a subcontractor to an exempt business that is part of a high economic impact cluster (designated as such by the Puerto Rico Industrial Development Company and the Puerto Rico Planning Board), or
 - iii. the rendering of services as key supplier of an exempt business;
- c. property devoted to industrial development;
- d. an industrial unit for the production of energy;
- e. specified recycling activities;
- f. value added activities in connection with the operation of certain ports, including the ports of Las Americas and Roosevelt Roads;

- g. an industrial unit engaged in the production of bottled purified water; and
- h. the development of software for sale on a commercial scale.

To qualify as an eligible service provider (see b, above), 80% or more of the workforce of the business must be residents of Puerto Rico.

Designated services that would qualify under b.1. above include: distribution centers, marketing centers, regional corporate headquarters, air and maritime port facilities, shared services, production of engineering and architectural designs, and trading companies.

Services that can be provided by a key supplier include: specialized storage, inventory management, logistics related to the distribution of manufactured products, digitalization of documents, distribution of printed material, quality control services and services for the validation of processes, equipment and systems.

There are special rules for a business that intends to carry out an activity not classified as eligible under the 1998 Puerto Rico Tax Incentives Act) (the "1998 TIA") or that conducts an eligible activity prior to applying for a tax exemption grant under the Act.

II. Tax incentives

A. Income taxes

1. General rule

Under the Act, exempt businesses enjoy a fixed income tax rate of 4% throughout the exemption period on their industrial development income ("IDI"), excluding the income derived from IDI investments ("2(j) Income") which is totally exempt. However, businesses that are operating under a grant of tax exemption issued pursuant to the 1998 TIA, and that are taxed on income at a rate of between 2% and 4% inclusive, may maintain their existing rate if, among other requirements, they maintain an employment level of at least 80% of their average employment for the previous three years.

Exceptions

- a. Businesses located in the municipalities of Vieques or Culebra will be subject to an income tax rate of 0% during the first 10 years of the 15-year exemption period, and a 2% rate for the remaining 5-year period.
- b. Exempt businesses that carry out an "innovative activity" as defined in the Act (*actividad novedosa pionera*) are subject to an income tax rate of 1% throughout the exemption period. The fixed income tax rate is 0% in the case of innovative activities if the related intangible property is created or developed in Puerto Rico.
- c. An exempt business required to withhold Puerto Rico income taxes on royalty

payments to non-residents of Puerto Rico can, prior to the commencement of the exemption period, irrevocably elect to pay Puerto Rico income taxes on its IDI at a rate of 8% and make the required withholding at a rate of 2% (as opposed to the standard rate mentioned below).

- d. Exempt businesses that locate their operations in a designated low or intermediate industrial development zone can reduce their applicable income tax rate (4% (see 1, above), 1% (see b, above), or 8% (see c, above)) by 0.5%, resulting in a net income tax rate of 3.5%, 0.5%, or 7.5%, respectively.

B. Income tax withholding on royalty payments

Exempt businesses that make royalty payments to non-residents of Puerto Rico are required to withhold Puerto Rico income taxes thereon at a rate of 12%, subject to the alternative 2% rate mentioned in 2.c., above.

However, businesses operating under a grant of tax exemption issued pursuant to the 1998 TIA that are required to withhold at a lower rate may retain their existing rate if, among other requirements, they maintain an employment level of at least 80% of their average employment for the previous three years.

C. Taxation of dividends, liquidating distributions and gains on sales of shares of the exempt business

1. Dividends

Dividend distributions from an exempt business out of its current or accumulated IDI are fully exempt from Puerto Rico income taxes.

2. Liquidating distributions

In general, the liquidation of an exempt business prior to the expiration of the tax exemption grant will not be subject to any Puerto Rico income or withholding tax. This rule will also apply to the accumulated IDI of the exempt business when the tax exemption grant has been revoked or has expired before the liquidation takes place, or when the exempt business also carries out taxable operations.

3. Tax on gains from sales of shares of the exempt business

Any gain derived from the sale or exchange of shares of an exempt business prior to the expiration of the tax exemption grant will be subject to Puerto Rico income tax at a rate of 4%.

D. Special deduction

The Act provides a special deduction (instead of requiring capitalization of the expense) for the costs incurred by exempt businesses in buildings,

machinery and equipment that are used in the exempt operations. There are certain requirements that must be met if the property acquired has been used outside Puerto Rico.

The amount deducted can reduce the IDI by 100%. Any excess of the amount invested over the allowable deduction can be carried over to subsequent taxable years until it has been used in full.

E. Income tax credits

Under the Act, exempt businesses are entitled to various tax credits that are described below:

1. Credit for the purchase of products manufactured in Puerto Rico

The exempt business can use as a tax credit 25% of the cost of purchases of products manufactured in Puerto Rico by entities that are not related to the exempt business or 35% of such cost if the products purchased are recycled products. The credit can reduce by up to 50% the income tax liability for the taxable year in which the credit is used. Any excess of the available credit over the allowable amount can be carried over to subsequent taxable years until it has been used in full. However, this credit is non-transferable.

2. Credit for job creation

An exempt business that commences operations after 1 July 2008 will be granted a credit for each job it creates (as defined in the Act) during its first year of operation, depending on the industrial zone in which it is established. The maximum amount of the credit is USD 5,000 for each job created. The credit can reduce the income tax liability for the taxable year by up to 100%. This credit is non-transferable, but any unused amount can be carried over, subject to limitations.

3. Credit for investments in research and development

An exempt business is granted a transferable credit equal to 50% of the amount invested in "special eligible investments" (as defined in the Act). These include research and development. The credit can be applied against the entity's Puerto Rico income tax liability, or against its water or energy costs. If the credit is used to reduce the income tax liability, the amount available must be used in two or more installments, although the first installment cannot exceed 50% thereof.

4. Credit for investments in energy generation equipment

The Act also grants a credit equal to 50% of the amount placed by the exempt business in "eligible investments" (as defined in the Act), which can be used to reduce the tax liability of the exempt business by up to 25%.

5. Credit for industrial investment

The Act grants a transferable income tax credit to any person that makes an eligible industrial investment (as defined in section 6 of the Act). This includes the purchase of 50% or more of the stock of an exempt business.

The amount of the credit is equal to 50% of the amount placed by the investor in an "eligible industrial investment", and must be used in two or more installments, although the first installment cannot exceed 50% thereof.

6. Credit for payments made for the use of energy

An exempt business that makes payments to the Puerto Rico Electric Power Authority ("PREPA") is granted a non-transferable income tax credit of up to 10% of the payments made to PREPA for electricity, as follows:

- a. a standard credit equal to 3% of payments made;
- b. an additional credit of 3.5% of such payments if the business maintained an average of at least 25 employees during the taxable year; and
- c. another additional credit of 3.5% of such payments if the business maintained an average payroll of USD 500,000 during the taxable year.

Any unused credits can be carried over to subsequent taxable years, subject to certain limitations.

7. Intangible property credit (Credit for Puerto Rico income tax withheld on royalties)

The Act grants a non-transferable income tax credit to the exempt business equal to 12% of the royalty payments made to non-residents of Puerto Rico for the use of intangible property. However, if the exempt business is subject to the alternative withholding tax rate of 2% mentioned in sections I.e. 2.c. and II.B. above, then the credit is equal to 2% of the royalty payments made.

Any unused credit can be carried over until it has been used in full, subject to a limitation period of eight taxable years.

8. Credit for eligible investments in strategic projects

An exempt business is allowed a transferable credit equal to 50% of the "eligible investment made in a strategic project" (as defined in the Act). The credit can be used, at the taxpayer's election, to satisfy in whole or in part its electricity or water and sewer operational costs, or to reduce its income tax liability by up to 50%. Any unused credit can be carried over until it has been used in full.

9. Limitation on the use of tax credits

The Act establishes a minimum income tax payment on the net IDI of the business, after the application of the available credits, which varies depending on the type of business.

III. Property tax incentives

An exempt business will enjoy a 90% exemption on the property taxes levied on its real and personal property used in its exempt operations. It will also have a 100% exemption on its real property during the construction period.

The Act introduces a new concept of optional self-assessment of real property taxes for machinery and equipment classified as real property. If the business makes this election, it will be required to file a real property tax return.

IV. Municipal license taxes

In general, the exempt business will have a 60% municipal license tax exemption during the period the grant is in effect. The rate increases to 75% for small businesses, subject to certain limitations; 100% for corporate headquarters; and 90% if the operations are carried out in Vieques or Culebra. In addition, the business will be fully exempt for the first three half-yearly periods of operations.

V. Other matters

Every exempt business will have an exemption period of 15 years, and businesses that are presently carrying out exempt operations are allowed to renegotiate or convert their existing grants under the Act, subject to certain conditions.

The Act is effective on 1 July, 2008, and does not have an expiration date.

17. ROMANIA

17.1 Vehicle pollution tax to replace former car registration tax

Further to the EU infringement procedure initiated against Romania with respect to the discriminatory nature of its car registration tax, as from 1 July 2008 the tax will be replaced by a new pollution tax.

Like the previous car registration tax, the new pollution tax is payable when a car is first registered in Romania. However, the tax calculation formula has been brought into line with the full neutrality requirements of the EC Treaty.

Under the new calculation formula, the tax due on a second-hand car acquired from another EU Member State is equal to the tax due upon the registration of a similar vehicle acquired in Romania.

Any differences arising from tax payable under the new system and tax paid under the previous car registration system are to be reimbursed.

17.2 New Romanian cross-border merger regulations and introduction of the European Company concept

Romanian Company Law¹ has recently been amended² to bring it into line with the requirements of EU legislation on cross-border mergers and the status of European Companies (i.e. Council Directive 2005/56/EC and Council Directive 2007/63/EC amending Council Directives 78/555/EEC and 82/891/EEC). The recently adopted changes lay out the conditions precedent and legal procedures to be respected for cross-border mergers.

An important provision of Romanian law is that Romanian companies (including those meeting the definition of a European Company) owning land in Romania cannot be merged into a non-Romanian entity (e.g. a European Company based in another Member State) before five years have lapsed since the date of Romania's accession to the EU (1 January 2007). The restriction is extended to seven years if the land qualifies as agricultural land.

18. RUSSIA

Introduction of the main guidelines of Russian tax policy for 2009–2011

The Government of the Russian Federation is currently discussing the main guidelines of Russian tax policy for 2009–2011. This document specifies the chief measures undertaken during 2007 in the area of tax legislation, including the introduction of a Bill on significant changes in transfer pricing regulations, the introduction of a 0% CIT rate on dividends received by a Russian company from its foreign subsidiary (if certain requirements are met – see Taxand Quarterly Issue 7 for further details), and a new Bill on consolidated groups of taxpayers (see Taxand Quarterly Issue 10 for further details). It also describes significant changes in the current tax administration.

The main guidelines also contain several legal proposals that might influence multinational groups. For example, it is suggested that when a foreign company's business activity is established in the territory of the Russian Federation and not linked to a particular place of business (for example, field sales or client servicing), or when a foreign company participates in a Russian joint venture, this constitutes a permanent establishment. There is also a proposal to amend Russian tax legislation with regard to repo transactions and fiduciary management in the event that one of the parties to such transactions is a foreign company.

19. SPAIN

Tax measures aimed at boosting economic activity

To address the current adverse economic situation, the Spanish Government has considered it necessary to take

¹ Law 31/1990, as subsequently republished and amended.

² Emergency Ordinance 52/2008 amending Law 31/1990 (Company Law), and Law 26/1990 regarding the Trade Register.

action on various economic policy fronts. Royal Decree Law 2/2008 of 21 April 2008 on measures to boost economic activity contains a number of proposals in this respect. We take a closer look below at those with the most important tax implications.

1. First-time application of the new accounting standards and corporate income tax installment payments

The sole transitional provision of Law 16/2007 establishes that for the first-time application of the new accounting standards in fiscal years commencing on or after 1 January 2008, entities must prepare an opening balance sheet at the beginning of the fiscal year, in accordance with the standards established in Law 16/2007 and its implementing regulations (in particular, the transitional provisions of the new Spanish National Chart of Accounts, approved by Royal Decree 1514/2007).

In most cases, the first-time application of these new accounting principles will require entities to make a number of adjustments. The adjustments will, in many cases, be fully effective for tax purposes, and therefore will have to be taken into account to determine the corporate income tax base for 2008.

2. Concept of “refurbishment” of buildings for VAT and IGIC purposes

The Royal Decree Law modifies the concept of “refurbishment” of buildings provided for in the VAT Law and in Law 20/1991 amending the tax aspects of the Canary Islands Economic and Tax Regime.

Thus, as from 22 April 2008, the date the Royal Decree Law came into effect, the value of land must be excluded from the total value of the building when calculating whether or not a construction project exceeds 25% of its value (this is one of the requirements in determining which construction projects can be classified as building “refurbishment” projects for VAT purposes).

This legislative change is important because transfers of “refurbished” buildings subject to VAT or to IGIC (an indirect tax applicable in the Canary Islands, where VAT does not apply) are deemed to be first supplies of buildings. This means that in the case of VAT, these transactions are not exempt, and that in the case of IGIC, they are taxed at the reduced rate (refurbishment of government-subsidized housing under the general regime) or are zero-rated supplies (refurbishment of Community capital goods or of government-subsidized housing under the special regime), provided that the other requirements imposed are met.

3. Extension of the scope of the non-resident income tax exemption on Government debt securities

The Royal Decree Law extends the scope of non-resident income tax exemptions on Government debt securities and other fixed-income instruments to cover all non-residents wherever their place of residence may be.

In particular, it establishes that income from Government debt securities obtained in Spain other than through a permanent establishment will be exempt regardless of whether such income has been obtained via territories or countries classified by regulations as tax havens.

In addition, on June 13, 2008, a Preliminary Bill completing the above-mentioned measures was submitted to the Council of Ministers. Among other features, the Bill includes (i) establishing a 100% state reduction in wealth tax, as well as eliminating the obligation to file any return for this tax in the future, thereby making the wealth tax return for 2007 the last one; and (ii) implementing a new monthly VAT refund system, which will mainly benefit to newly-formed enterprises and enterprises that make investments. The Bill also includes other new developments in the corporate income tax area, such as the widening of the scope of application of R&D&I tax credits.

20. THE NETHERLANDS

New regime for partnerships

a) Introduction

Partnerships are associations between two or more parties that carry on a business for profit. Under current Dutch legislation, partnerships do not have a legal personality. Consequently, partners in a partnership are personally and severally liable for losses incurred by the partnership.

b) New regime for partnerships

The regime for partnerships will be amended drastically in the near future. The new regime was originally scheduled to enter into force as of 1 January 2008, but was subsequently postponed. The new regime is now expected to come into effect as of 1 January 2009.

The novelty of the new regime is that existing partnerships will be replaced with three new partnerships: the silent (non-public) partnership, the public partnership without legal personality (in Dutch: 'OV' and 'CV'), and the public partnership with legal personality (in Dutch: 'OVR' and 'CVR'). Existing partnerships will be automatically converted into either a limited partnership or a public partnership without legal personality (depending on their current legal form).

As mentioned above, the public partnership with legal personality is a legal form that does not exist under current legislation. In order to convert a partnership into this legal form, a number of legal requirements and formalities must be observed. As such, a public partnership with legal personality will have to be formed by notarial deed and are required to be registered with the Commercial Register (*Handelsregister*).

An important advantage of a public partnership with legal personality is that the partnership itself can

acquire title to goods. In the case of a public partnership without legal personality, title to goods cannot be acquired by the partnership itself but only by the partners.

The distinction between partnerships with legal personality and partnerships without legal personality is relevant in the event of admission or resignation of a partner. At present, the resigning partner must transfer his or her share in the partnership's assets to the remaining partner(s). This could have tax implications and for transfers of certain goods, a civil law notary would need to be involved. This would be different if the partnership had legal personality, since the public partnership itself and not the partners would be the owner of the goods. Therefore, no transfer of assets takes place when a partner resigns.

c) Tax treatment of partnerships under the new regime

Currently, an open limited partnership is subject to corporate income tax according to the general rules. Other partnerships are transparent for corporate income tax purposes.

Under the new regime, all partnerships to be created will be transparent for corporate tax purposes, regardless of whether they have a legal personality. The only exception to this rule applies to the open public partnership which will be 'partially transparent'. This partnership will be transparent with regard to the limited partners but not with regard to the managing partners.

The new regime also makes it easier for a partnership with legal personality to be converted into a BV and vice versa.

21. VENEZUELA

21.1 The Government of Venezuela terminates the agreement on encouragement and reciprocal protection of investments with the Netherlands

On 30 April 2008, the Government of Venezuela decided to terminate the agreement on the encouragement and reciprocal protection of investments between the Kingdom of the Netherlands and the Republic of Venezuela.

The treaty will be terminated as of 1 November 2008. However, investments made before 1 November 2008 shall continue to be effective for a further period of fifteen (15) years from that date.

21.2 The Venezuelan National Assembly approves the Law on special contributions over extraordinary prices of the international oil market

The Law on special contributions over extraordinary prices of the international oil market was published in Official Gazette No. 38910 dated 15 April 2008. Resolution No. 151 determining

how the special contribution must be calculated was published in Official Gazette No. 38939 of 27 May 2008.

The special contribution must be paid by those exporting or transporting abroad natural or upgraded liquid hydrocarbons and derivatives.

The tax applies when, in a given month, the average price for spot sales of crude oil in the North Sea ("Dated Brent") for free delivery on board at Sullom Voe, UK, as published in Platts Oilgram Price Report on working days, is more than USD 70 per barrel, based on the methodology established by the Ministry of People's Power for Energy and Oil.

The special contribution per barrel is equal to 50% of the excess of the average Brent price in a given month over USD 70. If the average Brent price exceeds USD 100, the excess will instead be subject to a 60% rate.

21.3 The Venezuelan National Assembly reviews the implications of the financial transactions tax (FTT)

The financial transactions tax has been in force in Venezuela since November 2007. The tax is paid by corporate entities at a rate of 1.5%.

The National Assembly's Finance Committee is currently reviewing the implications of this tax and the cost this creates for a legal person. If approved, the review could lead to a change in the current rate and in the exemptions provided for by law.

21.4 The National Foreign Exchange Commission (CADIVI) submits for public consultation the Regulation setting out the requirements and formalities concerning export-related transactions and defining key concepts and their impact on the implementation of the existing exchange regime

The most important issue in the Regulation (*Providencia*) put out to consultation relates to the definition of exports of services. If adopted, the Regulation will make it mandatory to report and sell to the Central Bank of Venezuela all foreign currencies derived from (i) services provided from Venezuela to another country, (ii) services provided in the territory of Venezuela to a foreign consumer, (iii) a Venezuelan service provider through a commercial presence in the territory of another country, and (iv) a Venezuelan service provider in the territory of another country, through persons residing in Venezuela.

To date, no pronouncements have been made by CADIVI in this respect.

RULINGS

1. FRANCE

Sale of French company shares and substantial participation provision: anticipating EU litigation, the French tax authorities have made the first move

The French tax authorities (FTA) have recently improved the situation of non-resident companies, especially Spanish entities, investing in French businesses. Spanish companies which sell their stake in French businesses remain taxable in France but will be able to obtain a partial refund of this initial taxation.

A number of tax treaties between France and other EU countries including Spain, provide for taxation in France of non-resident companies which sell their stake in a French business in which they hold at least 25% (the "substantial participation provision").

According to the French tax code (section 244 bis B), these capital gains realized by non-resident companies are subject to taxation in France at a rate of 18% (new rate applicable as from 1 January 2008).

This taxation for EU-resident companies was to be challenged on the grounds of EU principles, because in the same situation, capital gains derived by French companies on sales of interests in subsidiaries are 95% exempt, provided they have held at least 5% of the business concerned for a two-year period.

The French tax authorities recently issued new guidelines on this issue (4 B-1-08, 4 April 2008) – probably to avoid the aforementioned risk of EU litigation. The guidelines provide for a partial refund of the 18% taxation up to the amount that a French company would have paid in the same circumstances. As from 1 January 2007, this represents taxation at a rate of 1.67% (5% x 33.1/3%) under the French participation exemption regime (8% between 1 January 2006 and 31 December 2006).

To benefit from this refund, the non-resident company will have to prove that:

- the 18% taxation has been duly paid;
- it is subject to corporate income tax in its country of residence, without being exempt;
- the investment in the French company was sold after 1 January 2006;
- it had owned the shares for at least two years at the time of the sale.

The new position adopted by the French tax authorities must be taken into consideration in cross-border tax structures and will limit the tax risks related to previous structures set up in order to avoid the 18% taxation. The new guidelines also provide the possibility for a non-resident company to file a tax request relating to the tax paid as from 1 January 2006. It should be borne in mind that schemes may exist to postpone the taxation (and hence the payment) when it is possible to contribute the shares instead of selling them.

Finally, it should be noted that these provisions are not applicable to non-resident companies selling their stake in real estate companies. Capital gains arising on such transactions remain taxable at the normal CIT rate (same taxation as for a French seller).

Other countries with a substantial participation provision within the European Economic Area (EEA) are Austria, Bulgaria, Cyprus, Hungary, Iceland, Italy, Malta and Sweden.

2. INDIA

Ruling on taxability of intangibles in India

In a landmark ruling, the Authority for Advance Rulings (AAR) has laid down important principles relating to the taxability of intangibles in India.

The applicant was a non-resident company based in Australia and a wholly-owned subsidiary of Foster's Group Limited ("Foster's Group"), Australia. The applicant was in the business of brewing, processing, packaging, marketing, promoting and selling beer products, and owned Foster trade marks, logos, brand guidelines and know-how. In 1997, the applicant entered into a license agreement with Foster's India Limited ("Foster's India") for the right to brew, package and label Foster products and use its trademarks, know-how and logos ("license agreement"). Consideration received from Foster's India was taxed as royalties.

The applicant entered into an agreement with SAB Miller UK (SAB Miller) for the sale of intangibles ("sale agreement"). The sale agreement provided for the sale of trademarks, Foster's brand intellectual property ("marketing intangibles") and Foster's brewing intellectual property ("brewing intangibles") licensed by the applicant to Foster's India. The applicant was required to terminate the license agreement with Foster's India prior to its transfer. A separate assignment deed was signed pursuant to which SAB Miller assigned its rights in the entire intellectual property to an Indian company, SKL Breweries. The issue brought before the AAR was whether consideration received for the transfer of intangibles under the sale agreement was taxable in India.

The AAR held that under Indian tax laws, income arising from the transfer of capital assets situated in India is taxable in India. Based on existing case laws, it was held that trade marks, brand names, technical know-how would be treated as capital assets. The AAR held that the place in which intangibles are registered does not have a bearing in determining the location of such intangibles, which is taken to be wherever such assets are utilized. Further, as intangible assets could have multiple locations, the tax residency of the owner of the intangible cannot determine their location.

The AAR also observed that in the present case, the marketing intangibles were licensed to Foster's India and had been commercially exploited in India for a long time. Foster's India had undertaken extensive marketing activities during the period of the license agreement resulting in the generation of goodwill. The termination of the license agreement was a condition precedent under

the sale agreement and therefore was undertaken solely to give effect to the sale. Accordingly, the AAR ruled that marketing intangibles belonging to the applicant had their "tangible presence" in India and that consideration received on such transfers would be liable for Indian capital gains tax.

The AAR observed that the formula and technical aspects relating to the brewing intangibles were provided in the brewing manuals. Accordingly, it was held that the brewing intangibles, though in one sense trade intangibles, is also in the nature of goods. Upon termination of the license agreement, these manuals were returned to the applicant and the location of such intangibles moved from India to Australia. Accordingly, at the time of sale, the brewing intangibles were not located in India and the gains attributable to the transfer of such intangibles were not liable to be taxed in India.

Ruling on taxability of hardware and software maintenance services

In an important ruling, the AAR in India examined the issue of taxability of hardware maintenance contracts in which all contract-related activities were undertaken outside India.

In this ruling, the applicant proposed to enter into a contract for the supply of Air Traffic Systems with Raytheon, a US-based company. The contract involved the supply of certain hardware and software. Subsequently, the applicant entered into two separate contracts with Raytheon for the maintenance and repair of hardware and software, respectively. Under the hardware repair contract, the applicant was required to provide defective parts/components outside India to Raytheon at its workshop, with the repaired parts delivered by Raytheon to the applicant outside India. All of these activities were undertaken outside India. The contract for software maintenance involved resolving anomalies and modifying software supplied by Raytheon.

The issue for consideration was whether the applicant was required to withhold taxes on payments to Raytheon under both maintenance contracts.

The AAR held that hardware maintenance activities did not qualify as royalties or fees for technical services (FTS) under Article 12 of the India-US tax treaty. Further, no portion of the repair activity was undertaken in India. The hardware was delivered outside India for repairs and after repairs, was received by the applicant outside India. Accordingly, the AAR ruled that tax did not need to be withheld on payments made under the hardware maintenance contract. The software maintenance services were held to be FTS under the tax treaty, and therefore liable to withholding tax requirements.

Ruling on the constitution of a permanent establishment in the case of a foreign company office undertaking preparatory and auxiliary services in India

In a landmark ruling, the Delhi Tax Tribunal laid down important principles for ascertaining whether or not a liaison office (LO) engaged in activities of a preparatory

and auxiliary nature constitutes a permanent establishment (PE).

In this ruling, Japanese company Tokio Marine and Fire Insurance had set-up an LO in India. The LO was required to represent its parent company in India, and act as its communication channel. The Japanese company had also set up a joint venture (JV) for undertaking insurance business in India. The Revenue Authorities at the initial levels held that such LO would constitute a "fixed place of business" of the Japanese company in India. Also, since the LO's employees had signed as witnesses to the agreement with the JV partner, the LO was considered to be involved in concluding contracts and accordingly, undertaking income generating activities in India.

The Tribunal observed that the activities undertaken by the LO were preparatory and auxiliary in nature. It was neither engaged in contract negotiations nor had authority to conclude contracts in India. The fact that employees of LO were witness to the agreement signed by the Japanese company did not mean that the LO was undertaking income-generating activities in India. Hence, the tribunal ruled that the LO did not constitute a PE of the Japanese company in India.

3. ITALY

Reference for a preliminary ruling from the Italian Supreme Court (Corte di Cassazione)

On 25 February 2008, the Italian Supreme Court (*Corte di Cassazione*) asked the European Court of Justice to make a preliminary ruling on the following cases: *Ministero delle Finanze v. Michele Franchetto (C-80/08)* and *Amministrazione delle Finanze, Agenzia delle Entrate v. Paint Graphos Scarl (C-78/08)*.

The questions referred for ruling are as follows:

"Are the tax relief measures for cooperative societies, pursuant to articles 10, 11, 12, 13 and 14 of Presidential Decree No. 601 of 1973, compatible with the rules on competition and, in particular, are they classifiable as State aid within the meaning of article 87 EC, especially given that the system of monitoring and for the prevention of abuse provided for under Legislative Decree No. 1577 of 1947 is inadequate?"

In particular, for the purposes of determining whether the tax relief measures at issue are classifiable as state aid, can those measures be regarded as proportionate in relation to the objectives of cooperative undertakings; can the decision on proportionality take into consideration not only the individual measure but also the advantage conferred by the measures as a whole, with the resulting distortion of competition?"

For the purposes of the answer to the preceding questions, taking into account the fact that the system of monitoring has been seriously and further undermined by the reform of company law, above all in relation to cooperatives that are predominantly rather than fully mutual, under Law No. 311 of 2004, and regardless of whether the tax relief measures in question can be classified as State aid, can the use of the legal form of a

cooperative society, even in cases not involving fraud or deception, be regarded as an abuse of law, where that form is used solely or predominantly in order to achieve a tax saving?"

Ruling No. 83/E of 7 March 2008 – Italy-Tunisia tax treaty – Italian domestic tax credit on business income from a Tunisian PE – Availability of domestic tax credit on the Tunisian replacement tax (“prélèvement fiscal global forfaitaire”)

An Italian company (ALFA) carries gas to Tunisia through a pipeline which, pursuant to article 162 of the Italian Income Tax Code (ITC) and article 5 of the Italy-Tunisia tax treaty, constitutes a permanent establishment (PE). ALFA is subject to the *prélèvement fiscal global forfaitaire* tax on income generated in Tunisia through the PE. This tax replaces both direct and indirect taxes as well as customs duties. At the end of each tax year, the Tunisian tax authorities issue a certificate attesting final payment of the corporate income tax for which ALFA's PE is liable in Tunisia. The main issue is whether the portion of the replacement tax which corresponds to the Tunisian corporate income tax paid by ALFA's PE (*impôt sur les sociétés*) qualifies for the Italian tax credit set out in article 165 of the ITC.

Italian tax authorities specify that domestic tax credit is available for foreign taxes effectively paid abroad which are (i) similar to taxes levied in Italy and (ii) final. As far as the first requirement is concerned, the tax authorities observed that foreign tax qualifies for the tax credit pursuant to article 165 of the ITC when it falls within the scope of the existing tax treaty between Italy and the source State. Pursuant to the provisions of article 2 of the current Italy-Tunisia tax treaty, the *impôt sur les sociétés* is similar to taxes that are due in Italy. Hence the first requirement is met.

However, the tax authorities observed that in the case at hand, the *impôt sur les sociétés* is not autonomously levied and paid, because a replacement tax is paid. Therefore, only that part of the *prélèvement fiscal global forfaitaire* related to the *impôt sur les sociétés* meets the similarity criterion. The tax authorities also pointed out that as the *prélèvement fiscal global forfaitaire* is considered as a final payment pursuant to the certificate provided by the Tunisian tax authorities, the portion of it relating to the *impôt sur les sociétés* is also deemed to be final.

Ruling No. 167/E, 21 April 2008 – Italy-Netherlands tax treaty – Dutch pension fund – beneficial ownership – interpretation

A Dutch pension fund is a non-profit entity categorized as a “*stichting pensioenfond*”. The pension fund is exempt for income tax purposes because the income is taxed in the hands of the former Dutch employees. The fund entered into an agreement with other pension funds to set up a unit trust in Luxembourg (the FCP). The FCP is not subject to tax in Luxembourg and pursuant to domestic tax legislation, is categorized as a tax transparent entity. The FCP invests in Italian companies

and at least once a year is obliged to distribute all income to investors in the fund. The main issues involved in this case were the identification of the beneficial owner with regard to dividends and capital gains realized on the disposal of the investments in Italy, and the application of the relevant tax treaty (Italy-Luxembourg or Italy-Netherlands).

The Italian tax authorities took the view that as the FCP is not liable for tax under Luxembourg tax legislation, it cannot be qualified as a taxable person under the Italy-Luxembourg tax treaty. Therefore, this treaty cannot be applied. However the Italy-Netherlands tax treaty may apply if the FCP meets the principles set out in the Commentary to the OECD Model Convention on tax transparent entities, i.e. the FCP is a mere “flow-through” entity through which income flows directly to investors in the fund, and such income is effectively taxed each year in the hands of the fund's investors.

The first condition is fulfilled in the case at hand because the FCP is required to distribute its income at least once a year. Regarding the second condition, the tax authorities remarked that a pension fund can be considered to be the beneficial owner of dividends paid from Italy if, although exempt, it is considered to be subject to tax under domestic tax rules. In particular, the Italian tax authorities acknowledged that the Dutch pension fund is liable for tax within the meaning of paragraph 8.2 of the Commentary to the OECD Model Convention, which states that “a person is considered liable to comprehensive taxation even if the Contracting State does not in fact impose tax”.

4. PORTUGAL

Two recent tax rulings on restructuring transactions

Two recent rulings issued by the Portuguese tax authorities deal with restructuring transactions. The first ruling concerns the ability to carry forward losses in connection with certain intragroup restructuring transactions, whilst the second ruling deals with the definition of a branch of activity for the purposes of a demerger transaction.

Under the current regime, tax losses may be set off against future income and carried forward for six years as from the date on which they arise. The carry-forward of tax losses is not allowed if (i) the corporate purpose of the company is changed; or (ii) the nature of the former activities of the company is substantially altered; or (iii) 50% or more of the share capital or the majority of the voting rights are transferred. The Minister of Finance may nonetheless authorize the carry-forward for valid economic reasons, at the request of the taxpayer.

The first tax ruling clarifies that the restriction of the right to carry forward losses resulting from a substantial change in ownership shall not apply in situations where the new shareholders previously indirectly held the majority of the capital (intragroup restructuring) and where such change in ownership arises in the context of restructuring measures carried out under the tax neutrality regime.

For the purposes of the corporate tax neutrality regime, a branch of activity is defined as a set of elements of a company, which from an organizational point of view constitute an independent business, i.e. an entity capable of functioning by its own means. This may include the debts contracted for its organization and functioning. The concept of a branch of activity is also used for the purposes of the Tax Benefits Statute which provides for other specific tax exemptions (besides corporate tax), with the particularity that this latter definition expressly states that a portfolio of shares or a single asset do not meet the definition of a branch of activity and therefore do not qualify for the said tax exemptions.

The second tax ruling concerns a demerger involving the transfer of a branch of activity. After outlining the current definition of a branch of activity, the tax ruling clarifies that the sole transfer of a portfolio of shares does not qualify as a demerger for the purposes of the tax neutrality regime since it does not constitute a branch of activity. Nonetheless, the ruling acknowledges that if, in addition to the shareholding, there is a transfer of other assets that, taken as a whole, constitute infrastructure associated with the management of such shareholdings, such transaction may qualify as a simple demerger for purposes of the tax neutrality regime.

COURT CASES

1. EUROPEAN UNION

Referral to the ECJ

On 25 January 2008, the Swedish Supreme Administrative Court (SAC) made a referral to the ECJ (Case C-29/08, Skatteverket vs AB SKF).

The referral concerns an advance ruling given by the National Advance Rulings Board on indirect taxes on 12 January 2007. The facts of the case are set out below.

AB SKF is the Swedish parent company of an international industrial group, which provides management services to its subsidiaries and is therefore considered a taxable person for VAT purposes. A reorganization is planned within the group with the aim of selling part of the non-core business conducted by a wholly owned subsidiary to an external buyer. In addition, 26.5% of shares in a partly owned company are also to be sold.

During the reorganization process, SKF will incur transaction costs that will be subject to VAT. The question referred to the National Advance Rulings Board was whether SKF was entitled to a full VAT deduction on all costs incurred during the sale process.

The Board ruled that AB SKF was entitled to a full deduction for VAT in both cases (sale of fully owned subsidiary and partly owned company).

This represents an overhaul of Swedish case law regarding entitlement to a VAT deduction on costs relating to the sale of shares in a subsidiary. The sale of shares has usually been treated as a VAT-exempt transaction and consequently, any VAT deduction on costs incurred in these transactions has until recently been refused by the tax authorities as well as the Swedish courts. This being a hot topic, not only in Sweden but also in other Member States, the SAC asked the ECJ to rule on the case. In short, the questions referred for ruling were:

- 1) If a taxable person subject to tax on sales of services to a subsidiary sells the interests in that subsidiary, is this transaction subject to VAT?
- 2) If so, is the transaction as such covered by a VAT exemption under the EC VAT Directive?
- 3) Regardless of the answers to the questions above, does a right to deduct VAT on expenses directly attributable to the sale exist in the same way as for general expenses?
- 4) Do the answers to the questions above change if the sale of interests in a subsidiary takes place in stages?

From a Swedish VAT perspective, the answers to these questions will be of utmost importance, since there are numerous court cases within this field. The ECJ ruling would also hopefully put an end to disputes between the tax authorities and taxpayers in Sweden. Other Member States are likely to look forward to this ruling for similar reasons.

As tax lawyers, Skeppsbron Skatt is of the opinion that the ECJ will rule in favor of AB SKF. Unfortunately, we believe that the recently decided *Securenta* case will be a cause for further VAT deductibility disputes between the taxpayers and the tax authorities.

Case C-414/06 – Lidl Belgium Gmbh & Co. KG – freedom of establishment – direct taxation – losses incurred by a foreign permanent establishment

On 15 May 2008, the European Court of Justice (ECJ) ruled on whether a national tax regime which does not allow a resident company to deduct losses incurred in another Member State by its permanent establishment (PE), but allows losses incurred by a resident PE to be deducted, is compatible with articles 43 and 56 of the EC Treaty. First, the ECJ states that the domestic tax rule must be examined only in light of the freedom of establishment principle, because the creation and the outright ownership by a physical or legal person established in a Member State of a PE with no separate legal personality situated in another Member State falls within the scope of article 43 of the EC Treaty.

Based on a comparison between a company with a foreign PE and a company with a domestic PE, the ECJ considered that a tax regime which does not allow losses incurred by a foreign PE to be deducted represents a restriction of the freedom of establishment principle. However, the ECJ acknowledged that the restriction may be justified by the need to safeguard the balanced allocation of taxing rights between Member States and by the need to avoid the same losses being taken into account twice (so-called “rule of reason test”).

2. COUNTRIES

2.1 FRANCE

Case No. 06-3370, Paris Administrative Court of Appeal, Fondation Stichting Unilever Pensioenfonds Progress

On 6 December 2007, the Paris Administrative Court of Appeal ruled that a Dutch pension fund was not liable for the one-third withholding tax on capital gains derived from the sale of shares in a French real estate company, as provided for by article 244A of the French Tax Code.

The Paris Administrative Court of Appeal stated that the pension fund was entitled to claim for reimbursement of the tax paid, with respect to:

- applicable tax treaty nondiscrimination provisions; and
- European rules regarding the free movement of capital.

As regards the application of the tax treaty, the Court of Appeal considered that Dutch and French pension funds were in a comparable situation. Accordingly, the higher taxation levied on the Dutch pension fund was in conflict with the applicable tax treaty nondiscrimination provision.

The Court of Appeal also considered that the rules provided by the French Tax Code were in conflict with the

free movement of capital principle set out in the EC Treaty.

While the case at hand concerned capital gains derived from the sale of shares, the issue might also be raised in relation to dividends or interest paid to foreign pension funds.

In this respect, the European Commission has asked nine European countries to provide details of their respective regimes for taxing dividends and interest paid to foreign pension funds.

An appeal was filed with the French Administrative Supreme Court against the Paris Administrative Court of Appeal's decision, but no ruling has yet been issued.

2.2 MALAYSIA

Payments for assignment of rights and obligations – capital or revenue expense

In the **Juara Konsortium Sdn Bhd v. Director General of Inland Revenue** case (unreported), the issue arose as to whether payments made for the assignment of rights under a joint venture contract represented capital or revenue.

The case involved three contractors who set up a joint venture company (KPSJ) to undertake a road construction project worth MYR 62 million. One of the parties, Karun, then entered into a Deed of Assignment to assign its rights and obligations to one of its other joint venture partners, Juara, for MYR 2.6 million. Juara paid Karun the sum of MYR 2.6 million, for which it claimed a deduction in computing its tax. The tax authorities disallowed the deduction on the grounds that the payment related to the assignment of rights and thus amounted to capital expenditure. Juara argued that the payment represented sub-contractor fees and that no assignment of rights took place, since none of the three joint venture parties had any individual legal rights in the project, given that it was to be executed on a joint venture basis via KPSJ.

On appeal to the High Court, Juara's claim was dismissed on the grounds that there was no evidence to support that the payment represented sub-contractor fees. No sub-contracting agreement existed between the two parties, nor were there any supporting documents to evidence such an arrangement. Further, there was a clear Deed of Assignment between Juara and Karun. The Court concluded that the payments of MYR 2.6 million made by Juara and Karun were capital in nature and arose from an assignment of contractual rights. As such, they are not tax deductible.

Disposal of shares – capital or revenue receipts

In the **Director General of Inland Revenue v. Hypergrowth Sdn Bhd** case (unreported), the tax authorities appealed to the High Court against the decision of the Special Commissioners (SC) who held that the gain arising from the disposal of the shares in question was capital in nature and hence not taxable.

The respondent (Hypergrowth Sdn Bhd (HSB)) acquired shares in a company (NKB) in February 1997. HSB disposed of its NKB shares soon after the NKB's listing on the Kuala Lumpur Stock Exchange in June of that year. HSB was liquidated in 1999 pursuant to members' voluntary liquidation arrangements. The tax authorities sought to tax HSB on the gains arising from the sale of the NKB shares in 1997.

The SC had ruled that proceeds from such disposals of shares amounted to a capital gain for the following reasons:

- HSB did not carry on any trading in shares, and the case involved a one-off transaction consisting of acquiring and disposing of investment shares.
- The intention of the respondent at the share acquisition date was to hold the shares as a long-term investment; however, the shares were sold due to concerns arising from the unexpected deterioration in the local and regional economies.

The High Court dismissed the IRB's appeal. It found that the tax authorities had failed to demonstrate that the SC's decision was based on a misconception of law and that the conclusion was not supported by the primary facts. Based on the facts, the High Court ruled that the SC were right to draw the assumptions on which they based their conclusion.

Disposal of real property – investment or trading transaction

The issue of whether gains from the disposal of real property arose from an investment or a trading transaction was considered in the **Director General of Inland Revenue v Hock Lee Holdings Sdn Bhd** case (unreported). The taxpayer acquired nine land lots between 1975 and 1979. A few years later, the taxpayer entered into an agreement with its subsidiary to construct residential homes as well as commercial/industrial premises on the land. During the Asian financial crisis in the late 1990s (1997-1999), the taxpayer sold 85 property units to its subsidiary and nine units to third-party buyers. The tax authorities sought to assess the gain for income tax. The taxpayer appealed to the SC who held in favor of the taxpayer. The SC found that the taxpayer's intention to invest in the land on a long-term basis was established from the outset, and that there were no facts to indicate any trading activity or pattern or any other commercial characteristics associated with the sale of the properties. The tax authorities appealed to the High Court which upheld the SC's decision on the grounds that the tax authorities could not provide evidence of any fault or error in the SC's findings.

Lump-sum payment - compensation for loss of employment or gratuity

The SC addressed the question of whether a lump-sum payment received by an employee upon termination of employment as a result of a company takeover represented compensation for loss of employment or a gratuity in respect of exercising the employment. In the

THH v Director General of Inland Revenue case (unreported), the taxpayer's employment with Co A was terminated following a takeover by Co B. Consequently, the taxpayer lost his entitlement to retirement benefits. Co B paid a lump-sum gratuity to the taxpayer in consideration of the taxpayer's loss of retirement benefits. The taxpayer was also offered employment by Co B based on similar terms and conditions as his previous employment with Co A. The taxpayer was under no obligation to accept the offer of employment from Co B.

The tax authorities sought to tax the lump-sum amount paid to the taxpayer as a taxable gratuity rather than as compensation for loss of employment. The 1967 Malaysian Income Tax Act provides for a tax exemption of up to MYR 6,000 for each completed year of service in respect of which compensation is paid (subject to conditions). The tax authorities took this position on the grounds that Co A had reported the lump-sum payment as a 'gratuity'. The tax authorities also construed the employment offered by Co B as continuing from Co A and hence took the view that the taxpayer's employment had not been terminated.

The SC held that the real nature of a payment depended not on what the payment was actually called but on what the payment was actually for. The SC found that the lump-sum amount was in fact compensation for loss of employment received by the taxpayer as a result of the early termination of employment involving loss of entitlement to retirement benefits. Had the takeover which resulted in the termination of employment not taken place, the taxpayer was likely to have continued his employment with Co A until the compulsory age of retirement. Further, the employment with Co B could not be regarded as continuing from Co A as employment with the latter had been duly terminated.

2.3 RUSSIA

Russian Supreme Arbitration Court confirms the illegality of appropriation within tax disputes

On 10 April 2008, the Supreme Arbitration Court of the Russian Federation ruled that previous Russian judicial practice, under which the tax authorities would attempt to appropriate all consideration received by parties to a transaction aimed at tax avoidance, was illegal.

Before the abovementioned decision of the Russian Supreme Arbitration Court, the tax authorities attempted to apply article 169 of the Russian Civil Code in tax disputes. This article provides that a transaction may be considered void if executed for a purpose which intentionally contradicts the principles of the rule of law and morality. Under this article, in the worst-case scenario all consideration received by the parties on such transactions may be seized in favor of the State. The Russian tax authorities tend to assert that transactions aimed exclusively at tax avoidance contradict the tenets of the rule of law and morality, and are consequently void. Several court claims for appropriation of all consideration received by parties to such transactions were settled against the taxpayers.

Fortunately, the Supreme Arbitration Court has put a stop to this damaging judicial practice for taxpayers, and has

recognized that article 169 of the Russian Civil Code cannot be applied to tax disputes in this way.

2.4 SPAIN

Spanish thin cap provisions in force until 2003 contrary to EU law

According to Spanish tax legislation in force until 31 December 2003, interest paid to non-resident related parties was not deductible to the extent that the debt on which the interest was paid exceeded three times the capital of the company. Since this thin cap rule did not make any distinction between the lenders' countries of residence, it applied both to EU residents and to non-EU residents.

However, in the wake of the ECJ's ruling in the Lankhorst-Hohorst case on 12 December 2002, the legislation was amended to exclude other EU residents from this indebtedness rule with effect from 1 January 2004.

In a judgment handed down on 21 February 2008, the Spanish Supreme Court reversed a decision by the National Appellate Court which, in applying the abovementioned thin cap rule, had held that a portion of interest payments incurred by a Spanish subsidiary before 2004 and due to its Dutch parent company was not deductible.

The appellant claimed that the application of the thin cap legislation to this case contradicted the EU legal principles of nondiscrimination and freedom of establishment (since the lender was resident in another EU Member State), as well as the nondiscrimination provision of the Spain-Netherlands tax treaty, and that in both cases, supranational legislation and tax treaties prevail over domestic legislation.

In view of these arguments, the Supreme Court held that the principle of nondiscrimination by reason of nationality was directly applicable and could be directly relied on by private individuals before the national courts. Accordingly, the wording of the pre-2004 Spanish legislative provision represented a restriction to the freedom of establishment principle that was expressly prohibited by article 43 of the EC Treaty, as demonstrated by the legislative change effective since 1 January 2004.

For this reason, the Court ruled that (i) the National Appellate Court's decision should be reversed, and (ii) the interest paid on the loan from the Dutch company was fully deductible.

2.5 VENEZUELA

Political-Administrative Chamber ratifies criterion for late interest claim

On 7 May 2008, the Political-Administrative Chamber of the Supreme Court of Justice (the "Court") issued decision No. 00557 on the Pfizer de Venezuela SA case. In this decision, the Court decided that the late interest claimed was not payable because the liquidation act under revision was not final. The Court therefore ratified the criterion upheld by the Constitutional Court in its decision No. 1490 of 13 July 2007 (Telcel CA case).

Consequently, the Court confirmed the binding nature of the aforementioned criterion and ruled that it applied to both the 1994 and the current (2001) tax code.

Taxation of exports in municipal taxes on business activities

In the aforementioned decision, the Court held that income from export sales was to be included in the tax base for calculating the municipal tax on business activities, on the grounds that the exercise of that business activity is a tax event.

In this regard, the Court stated that the taxation of the business activity is based on the autonomy given to municipalities by the Venezuelan Constitution, and should not therefore be interpreted as a violation of the powers of the National Administration.

OTHER NEWS

1. COUNTRIES

1.1 MALTA

Consultation document on Islamic finance

The MFSA recently issued a public consultation document on applying Islamic finance in Malta to banking and securities.

Over the past decade, Islamic finance has grown rapidly across the world in general and Europe in particular. According to information released by the General Council for Islamic Banks and Financial Institutions (CIBAFI), the Islamic financial services industry includes 284 institutions offering Islamic financial services operating in some 38 countries. The institutions are estimated to manage some USD 250 billion.

These figures do not however include assets managed by Islamic window operations of conventional banks (CIBAFI estimates that a further USD 200 billion are managed by these operations), non-banking Islamic institutions, *takaful* and *re-takaful* insurers, and institutions involved in capital market activities.

The MFSA has been closely monitoring developments in this field. In this respect, there are a number of opportunities for setting up Malta-based Islamic institutions as either fully-fledged banking institutions in terms of the Banking Act or as financial institutions. There are also a number of opportunities for setting up Sharia-compliant funds in Malta.

The consultation document issued by the MFSA analyses conventional Islamic funding structures and financing vehicles vis-à-vis the Malta regime applicable to collective investment schemes, investment services providers, and credit and financial institutions.

Malta on list of IMF advanced economies

The International Monetary Fund's April 2008 World Economic Outlook Report has promoted Malta to the Advanced Economies Group, a status it now enjoys along with only 31 other countries in the world. The designation follows Malta's adoption of the euro in January 2008 and is a recognition of the country's success in meeting the criteria of the Maastricht Treaty and in aligning itself with the eurozone economies. Malta was the only one of the 12 most recent EU accession countries to be reclassified from the Emerging Europe Group to the Advanced Economies Group.

To view the full text of the IMF report, visit: www.imf.org/external/pubs/ft/weo/2008/01/pdf/text.pdf

1.2 ROMANIA

EU infringement procedure against Romania regarding taxation of outbound dividends

Romania recently received a formal notice from the European Commission alleging discriminatory practices in the taxation of dividends paid to EU/EEA resident legal entities other than Romanian residents compared with the taxation of dividends paid to Romanian resident legal entities.

Currently, the standard tax rate for dividends paid out to Romanian legal entities is 10%, while the tax rate applicable to dividends paid out to other EU residents is 16%. We note that the standard rate may be reduced to 0% both for dividends paid locally in Romania as well as for those paid to EU companies, under the conditions set out in the EU Parent-Subsidiary Directive.

The Romanian Ministry of Economy and Finance is considering amending Romanian law so as to eliminate the discrimination. The solution currently being analyzed is to reduce the tax to 10% for both dividends paid locally and those paid to EU/EEA shareholders. However, this matter is still under debate at the political level and no formal decisions have yet been made.

SPECIAL FEATURES

CANADA - PRÉVOST CAR DECISION – GUIDANCE ON BENEFICIAL OWNERSHIP AND ANOTHER SET-BACK

On April 22, 2008 the long awaited decision of the Tax Court of Canada (“TCC”) in the Prévost Car case was released. The sole issue in the case was whether a holding company located in the Netherlands was the “beneficial owner” of dividends received from the appellant, a Canadian corporation, thus allowing for a reduced rate of withholding tax under the Canada-Netherlands Tax Treaty (“Treaty”). In recent years the Canada Revenue Agency (“CRA”) has taken increasingly aggressive positions in respect of what it considers to be inappropriate use of Canada’s various bi-lateral tax treaties. The recent MIL case is another example of this. However, in both Prévost Car and MIL the CRA suffered set-backs in this regard.

The facts in Prévost Car are fairly straightforward. In 1995 Volvo Bussar A.B. of Sweden (“Volvo”) and Henlys Group PLC of the United Kingdom (“Henlys”) entered into an agreement to acquire all of the shares of Prévost Car (the “Appellant”), a Quebec corporation. Volvo incorporated Prévost Holding B.V. (“PH B.V.”) in the Netherlands and transferred all of the shares of the Appellant to PH B.V. Subsequently, Volvo transferred 49% of its shares in PH B.V. to Henlys. The resulting ownership structure was that 51% of the shares of PH B.V. were owned by Volvo and 49% by Henlys, while the Appellant was wholly-owned by PH B.V.

Volvo and Henlys entered into a shareholder’s agreement in which, among other things, they agreed that 80% of the profits of PH B.V. would be distributed to Volvo and Henlys. The terms of the shareholder’s agreement required the directors of PH B.V. to take reasonable steps to procure dividends from the Appellant and pay them out as soon as practicable. There were some additional facts that were adverse to the Appellant’s position in the case, namely, that the minutes of a shareholder meeting of the Appellant and a shareholder’s resolution referred to Volvo and Henlys as shareholders of the Appellant, rather than PH B.V. Further, “know your client” documentation provided to PH B.V.’s bank indicated Volvo and Henlys as the beneficial owners of the shares of the Appellant.

The Appellant paid dividends to PH B.V. during the taxation years in issue, and withheld tax pursuant to the provisions of the Income Tax Act (Canada). Under Article 10, paragraph 2 of the Treaty, withholding tax on dividends may be levied by the state in which the dividends arise, but if the recipient of the dividends is the “beneficial owner” of such dividends the withholding tax rate is limited to five percent (six percent for 1996). The appellant withheld tax from payments to PH B.V. on that basis.

The Minister of National Revenue (“Minister”) reassessed approximately \$78,000,000 of dividend payments on the basis that the beneficial owners of the dividends were the shareholders of PH B.V., namely, Volvo and Henlys and, accordingly, the applicable rate of withholding tax should have been 15% for Volvo (under the Canada-Sweden tax treaty) and 10% for Henlys (under the Canada-UK tax treaty). The Minister therefore argued that the TCC should “look through” PH B.V. to the entities that “benefit” from the payment of dividends.

The expression “beneficial owner” is not defined in the Treaty and there is little Canadian jurisprudence dealing with the meaning of this expression. In his analysis, Rip A.C.J. noted that the commentary to Article 10 of the OECD Model Convention states that “the limitation of tax in the State of source is not available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the other Contracting State.” However, the commentary also states that “states which wish to make this more explicit are free to do so during bilateral negotiations.” Rip A.C.J. noted that Canada and the Netherlands did not undertake negotiations to make this distinction more explicit.

During the trial expert evidence was adduced regarding Dutch corporate law. One expert testified that under Dutch law a recipient of a dividend would not be the “beneficial owner” of such dividend if it was obliged to pass on the dividend to its shareholders. A second expert indicated that the terms of the shareholder’s agreement between Volvo and Henlys did not limit the power or discretion of the directors in regards to any decision to pay dividends. The third and final expert testified on the use of conduit companies, and indicated that such companies are not categorized as mere agents or nominees simply because they just hold assets or rights. However, such a conduit company might not be the beneficial owner of income if it has very narrow powers and acts on account of a beneficiary.

Rip A.C.J. held that a “beneficial owner” of a dividend is an entity that receives a dividend for its own use and that assumes the risk and control of such dividend, without being accountable to any other person. In this regard Rip A.C.J. looked to a prior decision of the Supreme Court of Canada (the case of *Jodrey Estate v. Nova Scotia* (Minister of Finance), in interpreting “beneficial owner” to mean the person who could “ultimately” exercise the rights of ownership of the property. Rip A.C.J. concluded that the word “ultimately” did not imply that the corporate veil should be lifted to reveal the shareholders as beneficial owners of assets or income. Rip A.C.J. did note, however, that the corporate veil might be pierced in situations where a corporation is merely a conduit or agent for another person and lacks the discretion to use the funds it receives. In such a case, the beneficial owner of income may not be the conduit, but rather the ultimate recipient of the income that is flowed-through.

Ultimately Rip A.C.J. concluded that there was no evidence that PH B.V. was a conduit for Volvo or Henlys, nor was it a nominee or mere agent for them. Notwithstanding the fact that the directors of PH B.V. were to “procure” dividends for the appellant, Rip A.C.J.

held that there was no predetermined hard-and-fast obligation to funnel dividends to Volvo and Henlys. Further, since PH B.V. was not a party to the shareholder's agreement between Volvo and Henlys, any failure or refusal to pay dividends could not give rise to a cause of action against PH B.V. Consequently, Rip A.C.J. held that PH B.V. was the beneficial owner of the dividends and that the dividends in issue qualified for a reduced rate of withholding tax under the Treaty.

The TCC discussed briefly the English non-tax Indofood case, but did not analyze the reasoning in Indofood nor clearly distinguish between that case and the one before the Court. However, it seems clear that the general attitude and approach taken by the TCC was quite different from that of the Court in Indofood.

It remains an open question at this point whether the guidance in *Prévost Car* may be extended to other forms of payments such as royalties or interest, or whether its application may be limited to dividend payments, although there does not appear to be any reason to distinguish among these different types of receipts. Furthermore, it cannot be said with certainty how the Court might view a situation that is factually different from *Prévost Car*. For example, the outcome may have been different in *Prévost Car* if the conduit company was a party to the shareholder's agreement, or if the conduit company had less autonomy.

As mentioned above, this is the second significant recent set-back for the CRA at the TCC in treaty cases, the first being MIL where the CRA was unsuccessful in applying the "general anti-avoidance rule" to deny treaty benefits in what the CRA considered to be a case of aggressive and inappropriate treaty shopping. And while we have previously cautioned against putting too much reliance on the decision in MIL, principally because we did not find the reasoning of the Courts in that case to be particularly persuasive, we have fewer concerns in respect of the decision of the TCC in *Prévost Car*. Nevertheless, it is important to note that the CRA has appealed the decision of the TCC in *Prévost Car*.

TAX IMPLICATIONS IN SPAIN OF THE ECOTRADE SpA CASE

In a judgment handed down by the European Court of Justice (hereinafter "the Court" or "the ECJ") on 8 May 2008 in respect of *Ecotrade SpA* (joined cases C-95/07 and C-96/07), the Court addressed two issues relating to VAT that may be of notable interest for Spanish taxpayers.

Firstly, it considered whether the establishment of a limitation period on the right to deduct VAT (two years) that is shorter than the period available to the tax authorities to review returns filed by taxable persons (four years) is compatible with EU law.

Secondly, it considered whether the erroneous classification of a transaction subject to VAT under the reverse charge procedure that is not recorded in the registers as such, not stated in a reverse charge invoice, and not included in VAT returns, entitles the tax

authorities to claim the VAT chargeable and to disallow its deduction due to the expiry of the aforementioned limitation period.

Both issues were raised in relation to Italian VAT legislation. However, their similarity with Spanish legislation and administrative practice makes the judgment especially relevant for cases where VAT is not charged under the reverse charge procedure.

1. Facts of the dispute

In fiscal years 2000 and 2001, an Italian company (*Ecotrade*) received intra-Community transport services that its suppliers described in their invoices as "chartering of the vessel" or "shipping." These invoices did not indicate the amount of VAT, and some of them stated that the transactions were exempt.

Ecotrade therefore regarded the relevant transactions as being exempt from VAT and, accordingly, recorded the invoices relating to those transactions only in the register of purchases and not in the register of invoices issued. As a result, it did not charge the VAT subsequently chargeable, which understandably affected its VAT returns.

Following an inspection, the Italian tax authorities (the "Agenzia") took the view that the transactions in question were services in the intra-Community transport of goods subject to VAT, and that the reverse charge procedure was applicable to them. The Agenzia also found that *Ecotrade* had not complied with the accounting requirements relating to the reverse charge procedure. Therefore, the Agenzia claimed payment of undeclared taxes and imposed penalties.

The Agenzia also took the view that *Ecotrade* had lost its right to deduct the related VAT because it had not exercised that right within a period of two years from the time the VAT became chargeable.

2. The Court's view

2.1 On the limitation period

In accordance with EU legislation and VAT case law, the right to deduct must be exercised immediately in respect of all the taxes charged on transactions relating to inputs ("during the same period"). However, the taxable person may be entitled to a deduction, even if the right to deduct was not exercised during the period in which it arose, subject in this case to "certain conditions and procedures determined by the Member States."

These conditions reflect the fact that exercising the right to deduct without any temporal limit would be contrary to the principle of legal certainty. Consequently, Member States are entitled to establish a limitation period on the right to deduct, provided that, first, the limitation period applies in the same way to analogous rights in tax matters relating to domestic law and Community law (principle of equivalence), and second, that it does not render the exercise of the right to deduct

virtually impossible or excessively difficult (principle of effectiveness).

Since there was no dispute regarding the first principle, the ECJ considered that the limitation period of two years did not in itself render impossible or excessively difficult the exercise of the right to deduct merely because the tax authority has a longer period in which to recover unpaid VAT (four years). The tax authorities do not have the information needed to calculate the tax that has become chargeable and the deductions to be made until they receive the taxable person's tax return, so their position cannot be compared with that of a taxable person.

The Court underlined that this conclusion remained valid where, as in the cases in the main proceedings, the reverse charge procedure applies.

2.2 On the reassessment and recovery process

The second issue relates to whether non-compliance with accounting and formal obligations under the reverse charge procedure which affected the VAT returns, can be penalized by a denial of the right to deduct, taking into account the fact that under normal conditions, the reverse charge mechanism allows deduction of the VAT charged so that no tax is due to the tax authorities.

EU legislation allows Member States to establish the formalities with which the taxable person must comply in order to exercise the right to deduct under the reverse charge procedure. In the Italian case (as well as in Spain), these formalities consist of the taxable person invoicing itself and recording the invoice separately, together with the invoice issued by the supplier of the relevant services, in the register of invoices issued and in the register of purchases.

The Court considered that misapprehension of formalities cannot deprive the taxable person of his right to deduct given that the principle of fiscal neutrality requires deduction of input tax to be allowed if the substantive requirements are satisfied, even if the taxable person has failed to comply with some of the formal requirements. Consequently, reassessment and recovery practice which penalizes non-compliance on the part of the taxable person with obligations relating to accounts and tax returns by a denial of the right to deduct, clearly goes further than is necessary to attain the objectives of ensuring the correct application of such obligations. However, EU law does not prevent Member States from imposing, where necessary, a fine or a financial penalty proportionate to the seriousness of the offence in order to sanction misapprehension of those obligations.

The Court held that these conclusions apply even if the limitation period on the right to deduct has expired.

The Court considered that the good faith of a taxable person was relevant only in so far as there was, on account of the conduct of that taxable person, a risk of loss of tax revenues for the Member State concerned. This is not the case in these proceedings.

USA - TREASURY REFRESHES THE APPLICATION OF SUBPART F TO CONTRACT MANUFACTURING

For multinational taxpayers with suppliers, manufacturing and customers located around the globe, the U.S. Subpart F regulations have been a challenge since their enactment 40 years ago. One issue that has been particularly unsettled since the revocation of Revenue Ruling 75-7 in 1997 is how contract manufacturing arrangements are viewed under the manufacturing exception under Subpart F. On February 28, 2008, the Internal Revenue Service issued proposed regulations (Fed. Reg. Vol. 73, No. 40, p. 10716) to further define foreign base company sales income (FBCSI) and the applicable exceptions from this income.

Subpart F generally seeks to deny deferral of U.S. taxation for certain earnings of controlled foreign corporations (CFCs). One specific type of targeted transaction results in foreign base company sales income for the CFC and must be included in the taxable income of the CFC's U.S. shareholders. FBCSI typically results from a transaction flow where a CFC buys or sells personal property from a related person, and that personal property is manufactured outside the CFC's country of incorporation and sold for use outside the CFC's country of incorporation. For Subpart F to apply, in addition to the presence of at least three jurisdictions, the CFC must also purchase or sell the property to a related party. Essentially, the targeted transactions are ones where Congress found no significant reason for the CFC's participation in the transaction, other than tax reduction or avoidance, and where Congress felt that the purchase and resale, without appreciable value being added to the product by the selling corporation, was abusive.

Significant exceptions to FBCSI under these regulations include sales where:

1. Property is manufactured in the CFC's country of incorporation;
2. Property is sold for use in the CFC's country of incorporation; and
3. Property is manufactured or produced by the CFC.

Frequently referred to as the "manufacturing" exception, Regulation Section 1.954-3(a)(4) excludes income from the definition of FBCSI where a CFC manufactures property between the time when the materials are purchased and the products are sold. The regulations previously stated that a corporation was considered to have manufactured property if the property it sold was, in effect, not the property it purchased. If significant activities are conducted while the products are owned by

the CFC, there is arguably a valid reason for the participation of that entity in the transaction. To constitute “manufacturing,” the purchased products must either be substantially transformed or combined into an integrated product through assembly or other conversion of component parts. It is here that the confusion arises. If Congress was seeking to attack transactions where there is no valid reason for the CFC, then wouldn’t any performance of manufacturing during the ownership of the materials or products provide that validity? Based on the available exceptions, we hear a resounding “yes!”

Taxpayers believed they had fairly firm footing with the issuance of Revenue Ruling 75-7. The taxpayer in that situation was allowed to “claim” the manufacturing activity performed by a contract manufacturer it engaged to convert its materials into products. In that situation, the CFC engaged another party to carry out the actual manufacturing process because of the highly specialized skills required in the conversion process.

We know that contract manufacturing arrangements arise for a number of different reasons, including cost efficiencies and particular areas of expertise. Whether an entity hires employees to “turn the screws” or hires another firm that hires its own employees, the tax law should be applied the same way. However, in attempting to further tighten the requirements for CFCs achieving deferral of U.S. tax, branch rules were added to the mix. For this article, the branch rules are beyond the scope of our discussion. But it was in part the argument over how taxpayers and the IRS could apply the branch rules (see *Vetco, Inc. v. Commissioner*, 95 TC 579 (1990) and *Ashland Oil, Inc. v. Commissioner*, 95 TC 348 (1990)) that led the IRS to revoke Revenue Ruling 75-7 and replace it with Revenue Ruling 97-48. In Revenue Ruling 97-48, the IRS stated it would no longer allow a taxpayer to attribute the manufacturing conducted by a contract manufacturer to a CFC for purposes of qualifying for the exclusion from Subpart F (since the IRS lost the argument that in such arrangements the contract manufacturer should be viewed as a branch of the CFC).

Proposed Regulations Further Define Subpart F Exceptions

Out with the old and in with the new. The newly proposed regulations will allow a CFC to engage in transactions with renewed certainty (and perhaps the right answer). The manufacturing exception under the regulations has been both expanded and constricted. No longer will the income be exempt merely because the property is transformed during the period of ownership by the CFC. The qualifying activities must now occur through the hands of the CFC’s employees (constriction). However, the qualifying activities have been expanded to include three categories of eligible work done by those employees:

1. Substantial transformation of property (the prototypical manufacturing processes);
2. Assembly or conversion of component parts into a final product; and
3. Newly divined “substantial contribution to manufacturing of personal property.”

While the first two categories of activities have long been a part of the regulations, the new category is aimed at modernizing the regulations to reflect “current business structures and practices.” If a CFC provides a “substantial contribution” to the manufacture of goods while those goods are owned by the CFC, the activities of the CFC will qualify for the manufacturing exception. A substantial contribution is not necessarily defined (an almost impossibility), but Treasury has provided nine factors that will be viewed as indicative of a substantial contribution. These include the following:

1. Oversight and direction of the activities or process (including management of the risk of loss) pursuant to which the property is manufactured, produced or constructed;
2. Performance of activities that are considered in but that are insufficient to satisfy the tests provided in substantial transformation and assembly and conversion;
3. Control of the raw materials, work-in-process and finished goods;
4. Management of the manufacturing profits;
5. Material selection;
6. Vendor selection;
7. Control of logistics;
8. Quality control; and
9. Direction of the development, protection and use of trade secrets, technology, product design and design specifications, and other intellectual property used in manufacturing the product.

The presence or absence of certain factors is not intended to be determinative, and the fact that other people contribute to the manufacture of the property prior to sale does not prevent a CFC from making a “substantial contribution” to the property’s manufacture.

While the “substantial contribution” will not be viewed as equivalent to what Treasury and the IRS have termed “physical manufacture” in all respects (namely the branch rules alluded to previously), it will allow the taxpayer to engage in contract manufacturing arrangements and avoid the application of the Subpart F rules.

Commentators have already begun criticizing the new regulations for various faults (real and perceived). Some are wont to give up the “its” argument, that the sale of something other than what was purchased should be excluded from creating Subpart F income. Some are wary of the inclusion of consignment contracts in the examples, without any examples of “turnkey” arrangements (which are far more common today). Some insist that the proposed regulations somehow restrict the eligibility of the same country exception to the CFC itself (which would eliminate the need for two exceptions altogether).

For taxpayers whose employing entities are not involved in the sale of goods, there is still a nugget of insight to be gained from the proposed regulations. The IRS and Treasury are increasingly focused on denying beneficial

tax treatment to transactions without “real employees doing real work,” although they are willing to accept a broad definition of work.

The new proposed regulations will force taxpayers to readdress their supply chain in light of the newly defined manufacturing exception. To qualify for manufacturing, the CFC clearly has to be engaged in a substantial operation with oversight of the contract manufacturing process through its own employees. This change causes a re-evaluation of the relationship between the contract manufacturer and the CFC principle.

Given the current movement of manufacturing operations to jurisdictions like China and India, these new proposed regulations could have a large impact. It is therefore advisable to review current and planned supply chains in light of these proposed rules.

TAXAND NEWS

TAXAND RECOGNISED BY ITR FOR BEST-IN-CLASS TAX ADVICE

TAXAND achieved market recognition for its contribution to tax at this year's International Tax Review's (ITR) European Tax Awards. The "Best Newcomer Award 2008" was presented to TAXAND for delivering best-in-class tax advice across Europe.

The award, which was introduced this year to honour entrants to the market within the last five years, was determined by a panel from the Tax Executives Institute's European Chapter and ITR's editorial team following initial research canvassing the perspectives of tax executives, in-house counsel, tax advisors and private-practice lawyers.

TAXAND member firms were shortlisted for an impressive 15 awards in total, beating stiff competition in many territories. TAXAND winners on the night were DENMARK, Bech-Bruun, GREECE, Zepos & Yannopoulos, LUXEMBOURG, Atoz and SPAIN, Garrigues. All four firms picked up best national tax firm awards for their track record in delivering innovative international tax transactional work. DENMARK, Bech-Bruun, won the award for the third time, LUXEMBOURG, Atoz, scored a hat-trick, winning for the third consecutive year and SPAIN, Garrigues won for the fourth year in a row.

TAXAND GLOBAL ANNUAL CONFERENCE

From 8 to 10 June 2008, TAXAND member firms and a number of multinational TAXAND clients met in Maastricht for the eighth TAXAND conference, "Working together for our global future" organised by our Dutch and Belgium firms, Van Mens & Wisselink and AB Taxand.

The conference featured high profile external speakers including Professors Willem Buiter and Marius van Nieuwkerk who delivered engaging sessions on the current economic climate and what we can learn from historical downturns. Professor Frans Vanistandael also spoke about the free movement of capital between the EU and emerging markets and its impact on clients.

Sunday and Monday focused on TAXAND service lines sharing technical knowledge for the purpose of translating discussions into tangible advice to address our clients' latest tax issues. Nine groups met and out puts will be shared with our clients over the coming months.

Tuesday was dedicated to bespoke meetings for pre-selected clients who were introduced to key TAXANDERS across their operating territories. Specific discussions on each client's latest tax issues were held and actionable advice identified.

Networking sessions were enjoyed by all and solidified TAXANDERS' strong working relationships even further. We are all looking forward to TAXAND's next global conference in Miami in February 2009. If you would like to join us, just let your nearest TAXAND advisor know.

TAXAND'S GLOBAL TRANSFER PRICING TEAM SUBMITS RESPONSE TO OECD

The OECD Centre for Tax Policy and Administration called for comments, by 30th April 2008, on a series of draft issues notes in relation to transaction profit methods. TAXAND's Global Transfer Pricing Team worked together to submit its considered response to the OECD. To read TAXAND's response in full, please download it from www.taxand.com/services/transfer_pricing. To discuss our views further please contact the leader of TAXAND's Global Transfer Pricing Team:

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ITR'S ANNUAL POLL TO FIND THE WORLD'S LEADING TAX PRACTICES HIGHLIGHTS 26 TAXAND MEMBERS

In International Tax Review's first annual poll to find the world's leading tax transactional and planning practices, TAXAND members were highlighted. The poll, undertaken for the first time this year, was designed to focus on recognising tax firms in specific disciplines.

Readers of International Tax Review voted in the online poll for their top three tax planning and top three tax transactional firms in 43 jurisdictions (the same number of territories, that TAXAND now covers!). Tax transactional stars were published in the March edition of International Tax Review and tax planning stars ranked in the May issue – in total 26 TAXAND member firms were featured. Please visit http://www.taxand.com/media/articles/itr_annual_poll to find out more.

TAXAND LAUNCHES NEW TOOLS

More and more multinational clients are working with TAXAND and receiving actionable, responsive tax advice. To make our people more accessible, share our knowledge more widely and present clearly how we can help, we have redeveloped our website and brochureware. For your gateway to over 2,000 leading tax advisors, just visit www.taxand.com.

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