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Legal developments

LEGISLATION

1. CHINA

1.1 Memorandum between mainland China and Hong Kong

In August 2006, a new tax memorandum between the PRC Central Government and the Hong Kong Special Administrative Region Government was signed to replace the previous 1998 memorandum.

The new tax memo will be effective in 2007, subject to the fulfillment of legal procedures by both parties.

The main changes consist of the establishment of favorable withholding tax rates for payments from mainland China to Hong Kong:

	Interest	Royalty	Dividend [1]
China Domestic Rate	10%	10%	0% (FIE) 20% (domestic)
Memo Rate	0% (Government) [2] 7% (others)	7%	5% (FIE) 10% (domestic)

[1] FIE = foreign invested enterprises, with at least 25% foreign equity. Domestic = non-FIE

[2] The 7% withholding tax rate applies to interest payable from the mainland; the 0% rate applies to interest received by the Hong Kong Government or a recognized institution.

(There is no tax on gains from the sale of capital assets in Hong Kong).

Accordingly, Hong Kong becomes a better choice for holding mainland investments. In fact, it will be tax efficient to use a Hong Kong company:

- as a window company for holding investments on the mainland;
- to provide loans to mainland entities; and/or
- to license intellectual property to mainland entities.

1.2 Clarification on PEs in cases of projects lasting for several years in China, but with stays of less than 6 months

The China State Administration of Taxation issued a Circular (Guoshuihan [2006]694), clarifying

certain aspects of facts that determine the existence of, and the attribution of income to, a permanent establishments ("PE").

A Foreign Enterprise ("FE") will be deemed to have a PE in China if the project lasts for several years, but the FE's employees or consultants assigned to the China project stay in China for periods of less than six months. In this regard, the PE relates to all services provided by the FE for the relevant project in China, rather than just services provided during a particular period.

If a PE exists because the FE has provided services in China through its employees for a particular project, all profits derived from the services rendered by the FE in China for the project will be deemed to be profits of the PE and, thus, taxable in China.

2. CYPRUS

Tax treaty update

Cyprus became an attractive treaty partner for many countries after the implementation of the tax reform in 2003. The island has negotiated an extensive network of tax treaties and a number are still awaiting ratification. The latest tax treaties negotiated by Cyprus are summarized below.

In February 2003, an agreement for the avoidance of double taxation was signed between Cyprus and Lebanon in respect of taxes on income and capital.

In July 2005, the ratification of the tax treaty between Cyprus and Germany was agreed by both sides and is expected to take place in the near future. The new agreement clarifies the tax treatment in the shipping industry, where profit from international shipping and aircraft operations "shall be taxed only in the Contracting State in which the place of effective management of the enterprise is situated," and ships' crew will be taxed according to the residence of their employer rather than each crew member's residence, as was previously the case.

The new treaty has made Cyprus an attractive jurisdiction for German shipowners. Cyprus is already the third largest center for ship management in the world.

A significant step was taken by Cyprus and San Marino in November 2005, when a protocol leading to the future tax treaty between Cyprus and San Marino was signed. An agreement for the avoidance of double taxation between these two

countries will be very attractive to Italian companies using San Marino for their international investment and tax optimization structures.

In July 2006, a tax treaty was signed by Cyprus and Seychelles. This movement will make Seychelles a jurisdiction of keen interest in the Indian Ocean and will enhance Cyprus' attractiveness as a treaty partner.

The tax treaties between Cyprus and Armenia, Finland, Singapore, South Africa and Ukraine are awaiting ratification.

3. GERMANY

3.1 Corporate income tax reform

On 12 July 2006, the German Cabinet approved what will become milestones in the reform of corporate income tax:

- Corporate income tax and the trade tax on income are to be substituted by a federal and local/municipal corporation tax. Both taxes will have a common, single tax base.
- The effective tax rate for corporations of approximately 38.65 % (CIT and TTI) will be reduced below 30%, as will the rate for partnerships.

The decrease in the corporate tax rate to under 30% will also benefit small and medium-sized enterprises, that are partnerships. Two models are currently being considered: (i) Tax relief could be granted for recording reserves/retaining earnings that would later be used for investment; or (ii) to provide a general tax break for retained earnings.

- Measures to stem the outflow of income abroad through debt financing are to be reviewed, especially:
 - the adding back of all interest payments for local/municipal corporation tax (trade tax on income) purposes and for federal corporation tax (CIT) purposes;
 - limitation on the tax deductibility of interest payments (minimum taxation, minimum taxation of profits, limit on interest); and
 - tightening of thin capitalization rules (limitation on the tax deductibility of interest paid on shareholder loans).

- Introduction of a flat tax on capital investment income.

It will be necessary to wait for the draft legislation in order to resolve some issues that remain outstanding.

According to the current timeframe for implementation of the corporate income tax reform, the final Bill should be ready by the end of 2006 and the reform should enter into force by 1 January 2008.

3.2 Changes to tax law on German corporate reorganizations

On 12 July 2006, the German Cabinet approved a Bill on tax measures to accompany the introduction of the European company (*Societas Europaeae* or SE) and the amendment of other tax-related provisions.

The aim of the proposed Act is to bring the tax provisions on corporate reorganizations into line with current developments and EU law. This includes provisions for European companies (SEs) and European cooperative societies (SCEs), as well as the amended EC Merger Directive and the EC Directive on cross-border mergers of limited liability companies. The proposed Law is intended to establish uniform principles for domestic and cross-border reorganizations. The German Reorganization Tax Act will be applicable to reorganizations within the European Union and the European Economic Area (EEA). Rules on the emigration and immigration of individuals and legal entities will be introduced for cross-border migrations and general taxation on exit will be introduced if, as consequence of a transfer of assets abroad, Germany's right to tax unrealized built-in gains is excluded or restricted.

The current German Act on Alteration of Legal Form only addresses domestic mergers. The Law is silent on mergers involving a non-German entity. In contrast, it expressly stipulates that it applies exclusively to entities domiciled in Germany. This is about to change. On February 17, 2006, the German Federal Ministry of Justice published a Bill entitled "Second Act to Amend the Act on Alteration of Legal Form," which will add a new chapter on cross-border mergers to the German Act on Alteration of Legal Form. The proposed new provisions will make it possible to merge, for example, a German *GmbH* into a Luxembourg S.a.r.l. or vice versa.

3.3 German REIT legislation: status as of September 2006

REITs are set to be introduced in Germany at the beginning of 2007. An unofficial “working” draft dated 1 August 2006 on German REITs is available which includes a REIT Bill. The REIT Bill mainly lays down the requirements for REITs, the penalties for noncompliance, and exemptions from trade tax and corporate income tax. It should be stressed that it is unclear whether, and to what extent, the provisions of the Bill will be finally implemented into German law. In the meantime, the Federal Ministry of Finance published a first official draft bill of German REIT legislation on 25 September 2006.

According to the “working” draft of the REIT Bill, a REIT-Aktiengesellschaft or a REIT-AG (REIT stock corporation) is a stock corporation whose registered office is situated in Germany and whose core business is confined to buying, holding, selling and leasing domestic or foreign real estate or rights in rem. There are specific requirements that have to be observed for a company to qualify as a REIT stock corporation. If a German-resident corporation meets all the REIT requirements (admission to listing, shareholder structure, asset test, income test, distribution obligation, notarization, limitation of debt financing), it will be exempt from German trade tax on income and German corporate income tax, provided that it is subject to corporate income taxation without limitation and is not “resident” in another State within the meaning of a tax treaty.

Income distributions by domestic REIT stock corporations are taxable at the level of German-resident shareholders without any tax relief (no domestic dividend exemption, no half-income system). The same also holds true for income distributions by foreign REIT corporations whose gross assets consist of more than 2/3 of real estate and 2/3 of whose total gross revenues are obtained by leasing and selling real estate. The income distributions are subject to withholding tax (25% + 5.5% solidarity surcharge = 26.375%). In the case of nonresidents, the German withholding tax is basically a final tax. As a consequence of the 10% threshold (no shareholder is allowed to directly hold 10 percent or more of the shares) reductions and exemptions under tax treaties or the EU Parent-Subsidiary Directive may not be applicable. Capital gains on the disposal of shares in a REIT stock corporation are fully taxable.

The formation of a REIT stock corporation as a result of the re-registration of a stock corporation or

a German corporation limited by shares (GmbH) does not result in any entry tax charge. The transfer of real estate to REITs will qualify for favorable tax treatment (exit taxation). However, the details have not yet been specified.

4. INDONESIA

Proposed amendments to certain rules regarding international taxation

The Indonesian Government has submitted to parliament a draft amendment of the Indonesian Income Tax Law (thus far, the draft has been debated on a considerable number of occasions).

Taxpayers have, through a number of organizations such as the Indonesian Chamber of Commerce or the Indonesian Tax Consultants Association, complained that the amendment is detrimental to the foreign investment climate in Indonesia. It is not known whether, in the face of such opposition, parliament will finish complete its scrutiny of the draft legislation before the end of this year.

If the proposed amendments are accepted this year, they would enter into force in January 2007.

The following are examples of the proposed amendments:

a) *Proposed amendment to the definition of a PE:*

The definition of “permanent establishment” would now include a dedicated server owned or rented by a nonresident for doing business in Indonesia.

Normally, a server is used by internet users who pay the server’s owner directly, as well as other internet users who pay other ISPs. The question is how could the taxable income of the nonresident be calculated? Moreover, we consider that this proposed amendment would not be applicable to residents of countries with which Indonesia has a tax treaty, because the proposed amendment is not reflected in the Article on permanent establishments.

b) *Proposed amendment to the definition of “royalty”:*

Payment for the use of Internet bandwidth would be defined as a royalty.

Nonresidents would not bear Indonesian withholding tax in this connection. The withholding tax would, instead, have to be

borne by Indonesian ISPs. To offset this additional cost, Indonesian ISP providers would certainly raise their prices. Consequently, the cost of using the Internet could rise by at least 25%. In addition, this would create an issue with treaty countries.

c) *Proposed amendment to anti-avoidance rules (1):*

The Director General of Taxation would be authorized to determine “the actual taxpayer” that buys or sells shares or other assets through an SPV with a special relationship, or where there is an unrealistic transaction.

If the SPV were established in a tax haven, how would the Indonesian tax authorities know who is the beneficial owner of the SPV? Furthermore, how could they determine “the actual taxpayer”?

d) *Proposed amendment to anti-avoidance rules (2):*

The Director General of Taxation would be entitled to determine that a transfer of shares between a dummy corporation domiciled in a tax haven and having a special relationship with a company domiciled in Indonesia or a PE situated there, was actually a transfer of shares of a company domiciled in Indonesia.

If the buyer and seller were SPVs established in tax havens, how would the Indonesian tax authorities know who are the beneficial owners of the SPVs? Furthermore, how could they determine the “actual buyer and seller”? What would be the basis for determining that the transaction was “a transfer of shares of a company domiciled in Indonesia”? As in the case of the preceding anti-avoidance rule, this amendment would create uncertainty.

- ◆ leases to taxable persons who mainly or exclusively engage in business activities that allow no more than 25% of the input VAT to be deducted;
- ◆ leases to non-taxable persons;
- ◆ leases where the lessor has expressly opted in the lease agreement to charge VAT.

All other lease transactions not falling within the above scenarios, are VAT exempt.

- All residential lease transactions are VAT exempt.
- Registration tax
 - All commercial lease transactions are subject to ad valorem registration tax (1%), regardless to the applicable VAT treatment (exempt or taxable).
 - All residential lease transactions are subject to ad valorem registration tax equal to 2% of the rental income.

b) *Sales*

- VAT treatment
 - The following commercial real estate sales are subject to VAT:
 - ◆ sales by (i) the constructor of the building, on condition that the sale takes place within four years from the date of the completion of the building, or (ii) by a seller who has used contractors to carry out major refurbishment works on the property, on condition that the sale takes place within four years from the date of the completion of the refurbishment works;
 - ◆ sales to taxable persons who which mainly or exclusively engage in business activities that allow no more than 25% of the input VAT to be deducted;
 - ◆ sales to non-taxable persons;

5. ITALY

5.1 Indirect taxation: new regulations on real estate transactions

Law no. 248, of 4 August 2006,, establishes new regulations on the indirect taxation of real estate transactions (residential and commercial).

a) *Rental income*

- VAT treatment
 - The following types of rental income from commercial leases are subject to VAT:

- ◆ sales where the seller has expressly opted in the sale agreement to charge VAT.

All other sales of commercial real estate not falling within the above scenarios, are VAT exempt.

- Sales of residential real estate are subject to VAT if the sales are by (i) the constructor of the building, on condition that the sale takes place within four years from the date of the completion of the building, or (ii) by a seller who has used contractors to carry out major refurbishment works, on condition that the sale takes place within four years from the date of the completion of the refurbishment works.

All other residential real estate sales not falling within the above scenarios, are VAT exempt.

- Registration tax
 - In the case of commercial real estate, registration tax is charged at a flat rate of €168.
 - In the case of residential real estate:

In VATable sales, registration tax is charged at a flat rate of €168.

Sales of VAT exempt residential real estate are subject to the ad valorem registration tax regime, generally charged at 7% on the sale price, except for transactions qualifying for the so-called “*prima casa*” tax relief, which are subject to a rate of 3% instead.
- Mortgage and cadastral taxes
 - All sales of commercial real estate, whether VAT exempt or VATable, are subject ad valorem mortgage and cadastral taxes at a rate of 3% and 1%, respectively, on the sale price.
 - In the case of VATable sales of residential real estate, and transactions qualifying for “*prima casa*” tax relief, mortgage and cadastral taxes are each charged at a flat rate of €168.

All other VAT-exempt sales of residential real estate are subject to ad valorem mortgage and cadastral taxes, at a rate of 2% and 1%, respectively, on the sale price.

5.2 New anti-avoidance provisions

Law no. 248 of 4 August 2006 introduced several anti-avoidance provisions in the area of direct taxation.

Among other provisions, the Law establishes for new statutory presumptions in determining the tax residence of foreign entities controlling Italian subsidiaries.

In particular, the new provisions establish a rebuttable presumption that a nonresident entity holding a controlling interest in an Italian subsidiary is tax resident in Italy where

- it is directly or indirectly controlled by an Italian resident, or
- a majority of its board of directors (or a similar managing body) are Italian residents.

Consequently, the burden of proof that a foreign company is not resident for tax purposes in Italy is shifted to the foreign company. In this respect, the Government stressed that the place of effective management is decisive for determining whether or not the foreign company is resident in Italy for tax purposes.

Note that the above circumstances must exist at the fiscal year-end of the foreign entity.

6. LUXEMBOURG

Tax treaty update

a) *Real estate provisions of France-Luxembourg tax treaty amended*

Luxembourg and France have initialed a side letter amending the real estate income provisions of their tax treaty done on 1 April 1958.

The aim of the treaty amendments is to regulate the taxation of profits, income and gains arising from the management and sale of immovable property in the State in which the immovable property is located (amendment to Article 3 of the treaty). This will apply regardless of whether the immovable property is owned by an individual, a company or a flow-through

entity, and whether or not the immovable property is to be used by a permanent establishment. In other words, the characterization of the income as income from immovable property will prevail over the provisions dealing with the taxation of business profits attributed to a permanent establishment (amendment to Article 4 of the Treaty). The side letter also introduces an identical provision in respect of income derived from professional services, according to which the characterization of the income as "income from immovable property" within the meaning of Article 4 will prevail over its characterization as "income derived from professional services" within the meaning of Article 15 of the treaty.

The objective of the treaty amendments is to avoid situations like the *La Coasta* case (12831/14442c), where income from immovable property was characterized differently by the Contracting States (income from immovable property versus business profits), so that the income was finally considered as taxable in neither of the States: Luxembourg considered that the income realized by a Luxembourg company from a French immovable property was to be regarded as taxable in France under Article 3 of the treaty, whereas France considered that such income constituted business profits taxable in France only to the extent it was attributed to a French permanent establishment ("PE") of the Luxembourg company (Article 4 of the treaty). In the absence of such a PE, France considered that the income was not taxable in France. Ultimately, the income was neither taxed in France nor in Luxembourg.

The side letter does not include any provision whereby capital gains realized upon the sale of shares in a company, the assets of which mainly consist of real estate, will be considered as income from immovable property (i.e., will not be considered as income from movable property). Structures involving a fully taxable Luxembourg company investing in French immovable property through a French real estate company should therefore not be affected by the above treaty amendments: the income realized upon the sale of the shares in the French real estate company

should remain a capital gain that would only be taxable in Luxembourg.

The side letter will enter into force once each country has undergone its approval process and notified the other country that the process has been completed. Furthermore, the treaty amendments will apply to income in the calendar year (or any tax year starting after 1 January) following the entry into force of the side letter, which means that the amendments would apply at the earliest as from 1 January 2007, if France and Luxembourg approved the side letter before the end of 2006.

b) *New tax treaties*

At present, Luxembourg has signed 49 tax treaties that are already in force and a further 10 treaties are either about to be ratified or in the process of being negotiated.

Over the last few months, Luxembourg has signed tax treaties for the first time with Estonia, Azerbaijan and San Marino. The treaties with Lithuania and Latvia have entered into force and will apply as from 1 January 2007. A treaty with Israel has also just entered into force but applies retrospectively from 1 January 2004. These treaties generally follow the OECD Model Tax Convention on Income and Capital.

7. MALAYSIA

2007 budget highlights

We summarize below some of the most salient aspects of the 2007 Malaysian budget that was recently announced and laid before parliament by the Minister of Finance.

a) *Tax administration*

New provisions were introduced giving the tax authorities specific power to make public rulings. In addition, an advance rulings system is set to be introduced from 1 January 2007.

Guidelines are to be issued by the tax authorities on the framework for conducting tax audits and tax investigations so as to ensure transparency in the way the tax authorities carry out such activities.

An independent body in the form of a Customs Appeals Tribunal is to be set up from 1 March 2007 to decide on appeals against

the decisions of the Director General of Customs. A customs rulings system is to be introduced from 1 January 2007.

b) *Corporate tax*

- The corporate tax rate to be reduced from 28% to 26% by one percentage point each year over the next 2 years.
- The definition of an “investment holding company” has been revised so that companies deriving a source of business rental income may still be viewed as investment holding companies and thus subject to certain restrictions on the deductibility of expenses and use of losses.
- Review of tax treatment of Real Estate Investment Trusts: Where a REIT distributes 90% or more of its income for a particular year, the REIT will be exempt from tax in that year. The tax treatment of unit-holders in respect of dividend income from a REIT has also been made less onerous.
- Several new incentives to encourage the growth of Islamic banking and financing have been introduced.
- Incentives have been given to the banking industry to encourage overseas expansion: banks that are currently taxed at a worldwide level are to be encouraged to expand overseas with a new tax exemption on income derived from newly-established foreign branches and subsidiaries for a period of 5 years.
- The system of granting bilateral tax relief has been revised to allow for relief on foreign tax borne on Malaysian-source income.
- Property developers and contractors are now permitted to carry back losses to preceding years upon the completion of a project. They are also allowed to spread back profits to earlier years where the actual gross profit earned is less than the estimated profits computed (using the required percentage-of-completion accounting method).
- With the introduction of group relief (introduced in the previous budget), the surrendering company now has an avenue for appeal where it is penalized for the

overstatement of losses that have been claimed by another company within the group.

- Payments to nonresidents for chartering ships is no longer subject to withholding tax.

c) *Investment incentives*

- Additional tax incentives to promote the growth of the biotechnology industry have been introduced.
- The qualifying criteria for incentives provided for seed capital investment by venture capital firms in joint venture companies to qualify for a 10-year tax holiday have been relaxed so that the minimum required investment is reduced from 70% to 50% of its investment funds.
- A double deduction for advertising expenses incurred in the promotion of a Malaysian trademark is no longer restricted to the company holding proprietary rights to the trademark. The double deduction can now be claimed by another company in the same group so long as more than 50% of the company is owned by the registered proprietor of the trademark. This deduction is restricted to one company within the group per year.
- The existing tax-exemption incentives (for inbound and local tourists) granted to tour operators have been extended for a further 5 years. Furthermore, a 50% excise tax exemption is granted on locally assembled 4WD vehicles.
- The double deduction for allowances paid to participants of the Capital Market Graduate Training Scheme is extended to all companies which come within the purview of the Securities Commission and not just listed companies (as was announced in 2005). This incentive is effective for 3 years until 31 December 2008.
- The geographical areas receiving additional tax incentives (to promote their development) have been extended to include the Northern State of Perlis. (The other states currently listed as ‘promoted areas’ are Kelantan, Pahang, the Mersing district of Johor, Sabah and Sarawak.)

d) *Personal taxation*

The scope of certain tax reliefs and tax exemptions has been widened while other new reliefs and exemptions are envisaged. For instance, payments received by employees pursuant to a voluntary redundancy program (i.e., a program under which the employee is given the option to terminate his employment) will be tax exempt (to the extent of RM 6,000 per completed year of service), subject to fulfillment of certain conditions.

e) *Indirect taxation*

The qualifying period for claiming a refund of sales tax or service tax related to bad debts has been reduced from 12 to 6 months. Furthermore, refunds are allowed where debts have not been written off, but merely provided for, so long as all reasonable steps have been taken to recover the debt.

f) *Other issues and conclusion*

Overall, the 2007 budget was a wide-ranging affair, focusing on new growth areas such as Islamic banking and biotechnology and was well-received. The only real surprise was the reduction in the corporate tax rate.

It is expected that there may be some reductions in personal income tax rates in next year's budget.

No announcement has been made on the actual date for implementation of the proposed goods & services tax, which was postponed from the initially-envisaged date of 1 January 2007.

8. MALTA

2007 Pre-budget document

a) *Introduction*

On 5 August 2006, the Government published a pre-budget document entitled 'Securing Our Future' for the forthcoming budget for the 2007 calendar year. The document contains an action program, together with details of proposed changes to the tax system as agreed with the EU Commission.

Below are highlighted the proposed changes to the tax system.

b) *Tax system*

Malta's tax system is a full imputation system which treats residents and nonresidents in the same way and is therefore nondiscriminatory and does not fall foul of EU law on this count. The only feature in Malta's imputation system which requires amendment to be fully compliant with ECJ decisions on imputation systems is to allow a credit for foreign underlying corporate tax to individuals in addition to companies where such a credit is already available.

Such an amendment would strengthen the harmony of the tax system by not discriminating in favor of the corporate form.

c) *EU agreement*

Apart from the minor amendment to the full imputation system, other changes are necessary to reflect the agreement that Malta reached with the EU Commission as regards the tax rules as they apply to international trading companies and companies operating the Foreign Income Account.

While Malta did not agree with the Commission that these elements of the Maltese tax system constitute State aid, in the interests of stability and certainty, Malta sought to reach an agreement with the Commission on a revised tax system with appropriate transitional arrangements. The Commission agreed with the Maltese proposal on a revised tax system and in its decision the Commission invites Malta to implement this with effect from 1 January 2007.

In principle, this proposal extends the refundable tax credit system to dividend payments made by all Maltese companies to all of their shareholders.

d) *The proposal in detail*

The Maltese Government is proposing to retain the present imputation system of taxation whereby the tax paid by companies will essentially remain a tax prepaid on behalf of the shareholders, with the shareholder tier being the tier at which tax is finally determined. The Government is proposing to introduce the notion of an economic rent, as well as enhancing the distinction relating to how profits are derived, whereby income from immovable property will be excluded from the tax refund system agreed to with the EU

Commission. This income needs to be treated differently since land is not a mobile factor and such income does not only arise as a result of the inputs of capital and labor, but also because land has an inherent value relative to its location.

For this purpose such income will, for tax purposes, be allocated to an immovable property account and will be treated in the same manner as it has been treated to date.

As is also currently the case, company profits will be allocated to tax accounts in order to determine the tax treatment of such profits upon distribution to shareholders as dividends. Within the above conceptual economic framework, a distinction will be drawn in relation to company profits between profits on which tax will not be refundable since they are deemed to be the company's contribution to the country's provision of public goods, and profits which will be allocated to the Maltese Taxed Account and the Foreign Income Account on which tax is refundable. Upon the payment of a dividend from such profits, shareholders can, regardless of whether they are residents or nonresidents, claim a refund of all or part of the tax paid on the distributed profits. The refund will generally be equal to 6/7 of the Maltese tax paid on the distributed profits from such accounts.

Where the distributing company claims double taxation relief, the current provisions remain unchanged and a tax refund of 2/3 of the Maltese tax paid on the distributed profits is claimable. These changes will not affect local residents.

e) *Participating holding*

The tax refund is, however, increased to 100% where the profits distributed were derived by the distributing company from a participating holding. The definition of a "participating holding" will essentially remain the same as at present. However, as has been the case with other EU Member States, certain anti-abuse provisions will be introduced to target distributions received from companies having mainly passive income, where such income has not been taxed at more than 5%. Currently a shareholding in a nonresident company will qualify as a participating holding of a Maltese company if:

- The Maltese company holds equity shares in a nonresident company and it:

holds at least 10% of the equity shares in the nonresident company; or

is an equity shareholder in the nonresident company and is entitled to purchase the balance of the equity shares of the nonresident company, or has a right of first refusal to purchase such shares; or

is an equity shareholder in the nonresident company and is entitled to either sit on the Board or appoint a person on the Board of that subsidiary as a director; or

is an equity shareholder which invests a minimum of Lm 500,000 (or the equivalent in foreign currency) in the nonresident company; or

holds the shares in the nonresident company for the furtherance of its own business.

- The holding is not held as trading stock for the purpose of a trade.

It should be noted that the rules in (a) will remain applicable for participating holdings existing at 31 December 2006 until the end of 2010.

With regard to acquisitions of participating holdings made on or after 1 January 2007, where the nonresident company has mainly passive income and is not resident or incorporated in a tax-treaty, EU or EEA jurisdiction or in a country which levies a tax on corporate profits at a rate that is at least 50% of the Maltese corporate income tax rate, the following additional conditions must be satisfied:

the shares in the nonresident company must not be held as a portfolio investment. In any event a participation of at least 25% in the capital of a nonresident company, 90% of the assets of which consist of portfolio investments and nontrading financial assets, will be deemed to be a portfolio investment; and

the nonresident company or its passive income must have been taxed at a rate of not less than 5%.

f) *Participation exemption*

As from 1 January 2007 Malta will also introduce a participation exemption for dividends and capital gains derived from participating holdings.

g) *Effective date*

Under the agreement with the EU, the proposals will take effect on 1 January, 2007, and existing tax refunds will be retained up to 2010 for beneficiaries existing as at 31 December 2006. The tax refunds under the extended system will not be materially different from those currently applicable.

h) *Conclusion*

This is an important agreement for Malta and helps to secure its future ability to remain an attractive and competitive environment for international business and investment.

9. MAURITIUS

9.1 2006-07 budget

The 2006 Finance Act, approved by parliament on 26 July 2006, implements the measures announced in the budget. The Government's objective is to simplify tax administration and converge to a single income tax rate of 15% in four years' time. The following are some of the main changes brought by the budget in the area of income tax:

There has been a major overhaul of the 1995 Income Tax Act, both for individuals and for companies. As far as the global business sector¹ is concerned, there has been no major change as Category 1 Global Business Companies (GBL1 entities) are still taxed at 15% and will continue to benefit from the provisions of the 1996 Income Tax (Foreign Tax Credit) Regulations.

■ *Corporate income tax*

Tax losses: Only losses attributable to annual allowances can be carried forward indefinitely. For other types of losses, there will be a 5-year time limit for carry forward and offset against net income. Losses accumulated at 30 June 2006 can be carried forward and offset

against chargeable income for a maximum period of 5 years, that is, up to June 2011.

Trusts: Previously, the chargeable income of trusts was calculated by deducting distributions to beneficiaries and any amount distributed to beneficiaries was taxable in the hands of the beneficiaries. However, nonresident beneficiaries were exempt from income tax on their income. These provisions have now been repealed. Accordingly, distributions to beneficiaries can no longer be deducted from the chargeable income of the trust. Distributions to beneficiaries are tax exempt in Mauritius. This brings the taxation of trusts into line with that of companies.

Alternative Minimum Tax (AMT): This is a minimum tax imposed on a company that has paid out dividends. It is based on the lower of the following: 7.5% (previously 5%) of their book profit, or 10% of the dividend paid. It is unlikely that it will have any impact on GBL1 entities.

Only GBL1 entities are now exempt from income tax on revenues, gains or profits from the sale of securities.

Interest and royalties paid/payable to a nonresident not carrying on any business in Mauritius through a GBL1 entity are tax exempt.

Corporate income tax rate: The tax rate for Mauritian companies, which was 25% in income year 2005/06, will be progressively reduced by 2.5% in each of the following four income years, until it reaches 15% in 2009/10. Existing companies that are liable to 15% tax (including GBL1 entities) will continue to be taxed at such rate. Free port operators that currently are exempt from income tax will be subject to the 15% rate as from July 2009.

■ *Personal income tax*

As from income year 2006/07, the thresholds for all relief, allowances and deductions that have been granted in recent years are consolidated into a general exemption threshold for the following categories of taxpayer:

¹ Global business relates to activities that are carried on from within Mauritius with any person who is not resident in Mauritius and which are conducted in a currency other than the Mauritian currency.

- A Taxpayers without dependants: Rs 215,000
- B Taxpayers with one dependant: Rs 325,000
- C Taxpayers with two dependants: Rs 385,000
- D Taxpayers with three dependants: Rs 425,000

The tax rates have been reduced to two: the first Rs 500,000 of chargeable income will be at 15%, and the remainder (except interest income) at 22.5%. Chargeable income from interest will be capped at 15%. The top rate of 22.5% will be reduced annually by 2.5%, so that by income year 2009/10 there will be a single tax rate of 15%.

9.2 Protocol to treaty between China and Mauritius

A new protocol to the tax treaty of 1 August 1994 between Mauritius and China was signed on 5 September 2006. The protocol amends the capital gains Article and extends the scope of the exchange-of-information Article. It will enter into force once both countries complete the ratification procedures.

Under Article 13 of the current Mauritius-China tax treaty, gains derived from the alienation of shares, other than the shares of an immovable property company, are taxable only in Mauritius.

However, with the ratification of the Protocol, the current Article 13 has been amended and a clause has been added to the DTA giving the right to China to tax the capital gains arising to a Mauritian holding company from the transfer of shares in a Chinese company in cases where the Mauritian company held, directly or indirectly, at least 25 percent shareholding of the Chinese company during the 12-month period preceding such transfer.

10. PHILIPPINES

Draft transfer pricing regulations

In an effort to strengthen the enforcement of transfer pricing rules, the Bureau of Internal Revenue ("BIR") is set to release new transfer pricing regulations. The current Philippines transfer pricing regulations can be found in Section 179, Revenue Regulations No. 2 (the "Income Tax Regulations"). Based on these regulations, the standard to be adopted in determining the true net income of a controlled taxpayer is the arm's-length standard or the standard that would be applied by a party when dealing with an unrelated or

uncontrolled entity. Over the years, the BIR has also released several orders and circulars targeted at intercompany transactions and encouraging the application of the OECD transfer pricing principles.

The new regulations expand on the arm's-length standard in Section 179, Revenue Regulations No. 2 and contain the following general guidelines:

- The two primary factors to be considered in determining whether the uncontrolled transaction meets the arm's-length standard are the degree of comparability between the controlled transaction and/or taxpayer and any uncontrolled comparables and the quality of the data used in the analysis.
- The factors determining comparability are the characteristics of goods or services, functional analysis, contract terms, economic circumstances and business strategies. However, in no event can unadjusted industry-average returns be used alone to establish arm's-length prices.
- The arm's-length pricing methodologies that may be used are the comparable uncontrolled price, resale price, cost plus, profit split and transactional net margin methods. The BIR does not have a specific preference for any one method. Instead, the method that yields the most reliable results, taking into account the quality of the available data and the degree of accuracy of the adjustments, should be chosen.

A significant change that will be brought about by the new regulations is the introduction of advance pricing arrangements ("APAs"), which will minimize or help resolve transfer pricing disputes between taxpayers and the BIR and between the BIR and the tax administrations of other jurisdictions. The most significant features of the proposed APAs are as follows:

- The APA must formally be initiated by the taxpayer and requires negotiations between the taxpayer, one or more associated enterprises, and the BIR alone or with other tax administrations.
- The APA can cover all of the taxpayer's transfer pricing issues or be limited to specific affiliates and inter-company transactions.
- The APA will apply to future years, but cannot be for longer than three (3) years from the date on which it is made, subject to renewal if circumstances do not change. However, if the

BIR, the taxpayer, and where appropriate, the treaty partner agree, the agreed transfer pricing methodology can be applied to resolve similar transfer pricing issues that arose in prior years.

- When the APA process is completed, the BIR must confirm to the related enterprises in the Philippines that no transfer pricing adjustment will be made so long as the taxpayer complies with the terms of the APA.

No date has been set for the release of the regulations. In the meantime, public hearings continue to be held on the draft regulations.

11. POLAND

Changes to enter into force in 2007

As already reported, the Polish Government initially planned a comprehensive tax reform in Poland at the beginning of 2007. However, the draft tax regulations eventually made public offer solutions that should not be considered as far-reaching changes to the structure of the Polish tax system.

The changes set to be introduced as from 2007 and considered to be of particular interest from a business standpoint include:

- Corporate income tax amendments:
 - Full corporate income tax exemption for foreign dividends qualifying under the EU Parent-Subsidiary Directive. Domestic income tax will no longer be charged on dividends received from EU companies, where the Polish payee has held at least 10% of the shares of the payor for an uninterrupted period of two years (the latter condition can be met after the dividend has been received). This means that in some cases foreign dividends will be tax free (no withholding tax, no domestic tax), thereby yielding new planning opportunities.
 - Definition of “revenue earning costs” – the scope of the definition of “revenue earning costs” is to be broadened by including aspects that have been the subject of rulings by the authorities. As proposed, “revenue earning cost” will not only be the cost that was borne to generate the revenue, but also the cost of retaining or protecting the source of the revenue.

- VAT amendments:

- Call-off stock – a structure is introduced to allow for the shift in obligation to account for intra-Community acquisitions of goods from the foreign supplier of goods in Poland to the final purchaser of such goods when the goods are collected from the warehouse/stock available to the purchaser on demand.
- Deferred accounting system – the reporting of VAT on imports is facilitated. VAT due on imports will be reported in the VAT return filed for the month in which the tax point has arisen.
- Abolition of VAT penalty – the 30% tax penalty assessed on the tax deficiency/incorrect amount of input VAT refunded by the State is to be eliminated. The penalty had long been considered by Polish taxpayers as one of the main discrepancies between the 6th VAT Directive and the Polish VAT Law

12. PORTUGAL

Emigrant savings accounts

Based on disuse and on the absence of any current social or economic justification for it, the Emigrant Savings System has been recently abolished in Portugal (Decree-Law no. 169/2006). However, this change only applies to new contracts related to new banking transactions. Pre-existing savings accounts and loan applications submitted before the deadline of 18 August 2006 and set up before 30 October 2006, can still benefit from the system. Bearing in mind that the rules establishing exemptions from the municipal property tax and from the municipal property transfer tax (Tax Relief Regulations and Decree-Law no. 540/76) have not changed, such rules are still in force as regards real estate purchased under the recently abolished Emigrant Savings System.

13. PUERTO RICO

Merchant Registry and Exemption Certificate Regulations issued

On 4 July 2006, the Governor of Puerto Rico signed into law the “Tax Justice Act of 2006” (the “Act”) which amends the Puerto Rico Internal

Revenue Code of 1994, as amended, to establish, among other things, a Sales and Use Tax ("SUT"). As part of SUT obligations, all merchants are required to register with the Puerto Rico Treasury Department.

The P.R. Treasury Department has issued Regulations on the Merchants Registry and Exemption Certificates. Under SUT rules, an Exemption Certificate is the mechanism that will permit resellers and manufacturers to acquire certain goods free of tax. Following, we summarize the provisions of these Regulations.

a) *Who is required to register?*

Any person who is, or will be, engaged in a trade or business in Puerto Rico has to register with the P.R. Treasury Department.

For the purposes of the Act and its Regulations, a "merchant" is any person engaging in the business of selling taxable items (personal property, taxable services, admission rights and bundled sales), or required to file a monthly SUT return either to comply with the responsibility of collecting and remitting sales tax or to pay the use tax. Any person who is, or plans to be, engaged in a trade or business in Puerto Rico will be considered a merchant.

b) *When to register?*

All merchants must register with the P.R. Treasury Department on or before October 16, 2006 in order to obtain their Merchant's Certificate on or before November 15, 2006.

If the merchant has not yet commenced business in Puerto Rico, he must register at least 30 days before he does.

c) *What is the Merchant's Registry Certificate?*

The Merchant's Registry Certificate is an authorization to do business in Puerto Rico. It also serves to indicate to a potential buyer whether the merchant is authorized to collect sales tax on behalf of the Government of Puerto Rico.

The P.R. Treasury Department will issue a Merchant's Registry Certificate for each of the merchant's places of business. The merchant is required to display such certificates in a place where the general public can see it. Merchants who have no fixed place of business must to carry the certificate with them at all times.

d) *What types of Registry Certificates are available?*

There are four different types of Registry Certificates: (i) "merchant"; (ii) "merchants with no fixed place of business"; (iii) "temporary business"; and (iv) "tradeshow".

e) *What is an Exemption Certificate?*

An Exemption Certificate is a certificate issued by the P.R. Treasury Department to manufacturers and resellers of goods.

The Exemption Certificate allows manufacturers to purchase raw materials, machinery and equipment, and resellers to purchase goods for sale without paying SUT.

The Exemption Certificate will be issued for a three-year period. The P.R. Treasury Department has authority to revoke an Exemption Certificate when it is not used properly, or when there has been a change of ownership, or when the Merchant Registry Certificate has been revoked.

f) *What are the consequences of not having an Exemption Certificate?*

Manufacturers or resellers without an Exemption Certificate will be subject to SUT on their purchases, including purchases of raw materials, machinery and equipment (in the case of manufacturers) and goods for sale (in the case of resellers).

Manufacturers or resellers without an Exemption Certificate cannot request a refund of the SUT paid during the period in which they did not have the Exemption Certificate.

14. SPAIN

14.1 Current status of the tax reform

As we have commented in a previous issue of this Newsletter, the tax reform is undergoing passage through parliament, in the course of which certain changes have been made to the original wording reported on. Set forth below are the most relevant changes.

a) *Corporate income tax*

- The gradual reduction of the tax rate from 35% to 30% (or from 40% to 35% in the case of entities engaging in oil and gas exploration, research and exploitation)

will take place over two years (2.5 points annually), to leave the rate standing at 32.5% in 2007, and 30% in 2008.

- Contrary to what was originally envisaged, the tax credit for reinvestment of extraordinary income is retained, albeit at a rate of 14.5% for 2007 and 12% for 2008 (instead of 20%), therefore resulting in an 18% tax rate in both years.

Some additional requirements must be met in order to report the tax credit.

- The tax credit for R&D is retained for one further year. Accordingly, this tax credit will be eliminated for tax periods commencing in or after January 2012.

b) *Personal income tax*

- A 100% reduction is introduced for net income from immovable capital, provided that certain requirements established in the Law for lessees under 35 years old are met.
- The ceiling on reductions of taxable income as a result of contributions to employee welfare systems rises from €8,000 to €10,000, and from €10,000 to €12,000 where the taxpayer is over 50 years old.
- The possibility of switching economic rights between different employment welfare systems at no tax cost is introduced.

c) *Nonresident income tax*

As with corporate income tax, the tax rate applicable to permanent establishments will be cut over two years from 35% to 30%, and from 40% to 35% in the case of permanent establishments engaging in oil and gas exploration, research and exploitation.

14.2 New developments in the Bill on Measures to Prevent Tax Fraud

On 29 June 2006, the Lower House of the Spanish parliament passed the Bill on Measures to Prevent Tax Fraud. Detailed below are the main changes regarding transfer pricing to the wording of the Bill when compared with that initially unveiled by the Government.

- Corporate income tax modifications:

The valuation by the tax authorities will not give rise to taxation, for corporate income tax or, where appropriate, personal income tax or nonresident income tax purposes, of income/gains higher than that actually derived from the transaction by the persons who performed it as a whole.

- Value added tax amendments:

Two new situations are included, in which it will be deemed that the parties are related parties: (i) transactions between any of the not-for-profit entities referred to in Article 2 of Law 49/2002 and their founders, associates, trustees and representatives per the bylaws, members of the governing bodies, or the spouses or relatives up to and including the third degree of any of them; and (ii) transactions between an entity that is a trader or professional and any of its shareholders, associates, members or participation-holders.

Lastly, it is specified that there will be a manifestly anomalous price, not only where the price is appreciably lower than the price for such goods on the conditions pursuant to which the transaction was performed or the price paid in previous acquisitions of identical goods, but also where the price is appreciably lower than the acquisition cost to the supplier of the goods.

14.3 Tax regime for business reorganizations amended

A Bill to bring Spanish law into line with the recent amendments to the EU Merger Directive has been recently approved and its provisions came into force with retrospective effect as from 1 January 2005, the date on which the amendments to the EU Merger Directive should have been transposed into Spanish law.

15. TURKEY

15.1 New Turkish Corporate Tax Code

The Turkish Corporate Tax Code has been thoroughly revised and rewritten and the new Code (Law no. 5520) has entered into force following its promulgation in the Official Gazette dated 21 June 2006.

The basic amendments introduced by the new Code regarding the taxation of corporate profits can be outlined as follows:

- The most significant amendment is the 10-point reduction in the applicable corporate tax rate. With the entry into force of the Corporate Tax Code, the corporate tax rate is reduced from 30% to 20%. The 2006 earnings of corporations will be taxed at this reduced rate.
- The provisions regulating thin capitalization and transfer pricing have been revised to ensure their consistency with international standards. Objective thin capitalization rules (3:1 debt-equity ratio) are used. Generally accepted pricing methods have been defined in the transfer pricing regulations. Harmonization with the OECD transfer pricing guidelines has thus been ensured.
- As a mechanism for ensuring the taxation of corporate profits, except in certain special circumstances, all payments to countries or territories classed as tax havens are now subject to 30% withholding tax.
- Another mechanism for ensuring the collection of corporate taxes, namely, the concept of controlled foreign corporations, has been defined, and the relevant regulations have been prepared and put into effect.
- The exemptions applying under certain conditions to the sale of shareholdings and immovable property are been limited to 75% of the profits from such sale. The condition requiring this to be added to the company's capital however, has been dispensed with.
- Further regulations have been introduced to ensure the applicability of the provisions for the tax exemption of gains derived from transfers of holdings in the equity of entities resident abroad.

Most of the amendments were introduced by Law no. 5520 on the date of its promulgation, although their effects are backdated to 1 January 2006. The provisions on transfer pricing will not, however, enter into force until 1 January 2007, while the amendments relating to the exemption for profits derived from the sale of holdings and immovable property entered into force on the date of promulgation of the Law (21 June 2006).

15.2 A change of heart on the application of 15% withholding tax on portfolio earnings

Effective 1 January 2006, a new regime for the taxation of portfolio earnings was introduced. The new regime provided for the taxation of all kinds of portfolio income(*) obtained by investors (resident and nonresident) at the same rate, 15%, levied in the form of withholding tax, which would constitute the final tax liability for nonresidents.

However, the new regime has already been modified in order to attract more foreign portfolio investments into Turkey. Accordingly, the withholding tax rate for portfolio income derived by nonresident taxpayers has been reduced from 15% to zero (0), effective 7 July 2006. Note that the 0% rate applies to portfolio income excluding repo and deposit interest.

As a result of the new measures, the withholding tax rate on portfolio earnings (except for repo and deposit interest) for resident investors has been reduced to 10%, effective 23 July 2006.

After the recent amendments, the tax treatment of investment instruments is as follows:

In the case of resident investors:

- Repo and deposit interest income: 15%
- Gains derived from Treasury bills and Government and private sector Bonds*: 10%
- Capital gains derived from the Stock Exchange*: 10%
- Gains derived from mutual funds: 10%
- Gains from derivative Instruments (excluding individuals): 0%

In the case of foreign investors:

- Repo and deposit interest income: 15%
- Gains derived from all other investment instruments*: 0%

(*) Equities acquired before 1 January 2006 and bonds/treasury bills issued before that date do not fall within the scope of the withholding tax. Gains from such securities will be taxable pursuant to the rules applicable on 31 December 2005.

16. UNITED STATES

FIN 48, Accounting for Uncertainty in Income Taxes, is issued

The Financial Accounting Standards Board (the "Board") has issued its much anticipated FIN 48², *Accounting for Uncertainty in Income Taxes* (the "Interpretation"). This new Interpretation of *Statement of Financial Accounting Standards* ("SFAS") No. 109 establishes a new accounting model for income tax reserves and contingencies. For a copy of the new Interpretation, see the FASB website, www.FASB.org. This article discusses some of the Interpretation's significant implications as follows:

a) Key aspects of FIN 48:

- Tax position

FIN 48 applies to all tax positions accounted for in accordance with SFAS 109 (i.e., income taxes).
- Unit of account

The appropriate unit of account for determining what constitutes an individual tax position and whether the more-likely-than-not recognition threshold is met for such tax position is a matter of judgment based on individual facts and circumstances.
- Two-step approach
 - Recognition: A tax position is recognized in the financial statements when it is *more-likely-than-not*, based on the technical merits, the position will be sustained upon examination.
 - Measurement: A tax position that meets the more-likely-than-not recognition threshold is measured as the largest amount of tax benefit that is greater than fifty percent likely of being realized upon ultimate settlement with a tax authority that has full knowledge of all relevant information.

■ Change in judgment:

A change in judgment that results in subsequent recognition, derecognition, or change in measurement of a tax position taken in a prior period (including any related interest and penalties) shall be recognized as a discrete item in the period the change occurs.

■ Detection risk

Risk of detection shall not be taken into account in assessing the recognition or measurement of the financial statement benefits of a tax position.

■ Interest and penalties

Interest and penalties must be calculated and applied to the difference between the tax position recognized under FIN 48 and that reported (or not) on a tax return.

■ Disclosures

FIN 48 provides for additional disclosures, including:

- a tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period, including:
 - ◆ decreases in unrecognized tax benefits relating to settlements with taxing authorities during the period; and
 - ◆ reductions related to positions that are no longer uncertain because applicable statutes of limitations have expired.
- for positions for which it is reasonably possible (defined as more likely than a remote chance)³ that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date,

² FIN 48 was actually released by FASB on 13 July 2006 with a June issuance date.

³ This appears to be a rather low threshold and, as such, may lead to a rather broad interpretation of this aspect of the disclosures.

- ◆ the nature of the uncertainty and the event that could occur in the next 12 months that would cause the change;
 - ◆ an estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made.
- a description of tax years that remain subject to examination by major tax jurisdictions.
- Transition

The cumulative effect of the change in net assets resulting from the application of FIN 48 is charged to the opening balance of retained earnings.
 - Effective date

The Interpretation is effective for fiscal years beginning after 15 December 2006. Earlier adoption is allowed if financial statements for the period have not yet been issued.

b) *Significant implications*

While the true impact (both breadth and depth) of FIN 48 is still unclear, several significant implications that we anticipate, and which should be considered, include:

- Process requirements

Corporate tax departments will need to revisit their existing processes for identifying, measuring and disclosing uncertain tax positions. We anticipate that significant changes will need to be made to comply with FIN 48.
- Jurisdictional issues

Given the uncertainty typically associated with state nexus and permanent establishment issues, these areas should be a focal point of a FIN 48 analysis and will likely be the subject of considerable scrutiny by financial auditors. From a state income tax perspective, the jurisdictional issues could include an analysis of whether unitary tax filings should (or should not) have been made during all open years.

- Tax audits / controversy

Understanding how a company's tax audits have been (and will be) administered as well as their historical (or expected) results will have a significant impact on the analysis of uncertain tax positions and related disclosures.

- Real-time global tax knowledge

Given the requirement to disclose a remote chance that the amounts of unrecognized tax benefits will significantly increase/decrease within the next 12 months, there is an urgency for up-to-date knowledge of proposed changes in federal, state, and international tax laws (e.g., legislation, cases, regulations, notices, settlements of similar issues, etc.).

- Corporate business plans / strategy

Changes in corporate structure (and culture) could have a significant impact on tax positions and require revisions to FIN 48 liabilities and related disclosures.

- Tax opinions

In contrast to the current "probable" threshold (in accordance with SFAS 5), FIN 48 uses the more-likely-than-not threshold for recognition and derecognition of tax benefits from positions taken. The disclosure of a tax position could now depend on a 1%-2% change in the probability of success (i.e., 49% versus 51%). This presents companies with much less margin of error than under the "probable threshold." As a result, we anticipate an increased interest in more-likely-than-not tax opinions.

Clearly, getting ready for the adoption of FIN 48 will take careful advance planning. By year-end, you should be comfortable that you have identified the impact of FIN 48 on your organization and established your disclosure format with management and your financial auditors. Although FIN 48 will not apply until 2007, your company will, most likely, want to disclose the impact of this Interpretation in its 2006 10K. The actual dollar impact will then be reflected in the actual financial statements during the first quarter of 2007.

17. VENEZUELA

17.1 Value added tax rate will be reduced

The Government of Venezuela is considering different alternatives for economic measures, including a one-percent reduction in value added tax, from 14% to 13%, in order to temporarily control variations in the Consumer Price Index (CPI).

17.2 Partial reform of the Income Tax Law

A partial reform of the Income Tax Law was approved by the National Assembly in a second round of discussions. Under the reform, an oil and gas income tax rate of 50% (currently capped at 34%) must be levied on income generated by taxpayers engaging in extra-heavy crude oil activities and orimulsion production, except for refinement and enhancement. In contrast, the regular income tax rate (currently capped at 34%) will be levied on taxpayers engaging in unassociated upstream and downstream gas activities. In addition, the new investments tax credit of 10% for new investments in fixed assets in the hi-tech industry will remain in force for an additional 5 years after the publication of the reform.

17.3 Entry into force of Venezuela-Kuwait tax treaty

The Convention for the Avoidance of Double Taxation and Fiscal Evasion signed by Venezuela and Kuwait on 30 April 2004 entered into force on 26 April 2006, and will become effective on 1 January 2007.

COURT CASES AND RULINGS

A) EUROPEAN UNION

1. ECJ AND BETTING FIRMS

The ECJ judgment delivered on 13 July 2006 (in Case C-89/05) in connection with the case of *United Utilities plc v. Commissioners of Customs and Excise* which dealt with the Sixth VAT Directive – Article 13B(f) – Exemption for games of chance, may have far-reaching implications for the Maltese betting industry. This is since all service providers will now have to charge VAT when supplying a service to betting firms and since the latter are exempt they will not be able to recover any VAT.

This ECJ case will have relevant implications for betting companies established in an EU Member State such as Malta, which is one of the leading jurisdictions for this kind of activity. The Maltese VAT has not yet made any comments on past rulings or confirmations which were given to betting companies applying the reverse charge mechanism to a number of betting related services. Since the ECJ case has to be adopted in Malta, betting companies will find that some of their costs will be increased with the VAT element which they will not be able to recover.

2. THE UK'S CFC RULES ARE HELD TO BE CONTRARY TO EU LAW

On 12 September 2006, the ECJ published its findings regarding the dispute between Cadbury Schweppes plc (CS) and HM Revenue & Customs ("HMRC") over the UK's controlled foreign company ("CFC") rules. This follows from the opinion of the Advocate General Philippe Leger, which was delivered on 3 May this year, and was discussed in the previous edition of this Newsletter.

The case involved two Irish CS subsidiaries in the International Financial Services Centre (IFSC) in Dublin. The purpose of these companies was to raise and provide finance in respect of the worldwide CS group. The IFSC regime applied a 10% tax rate and therefore fell within the "lower level of taxation" test that triggered the operation of the UK's CFC rules. HMRC sought to tax the Irish profits at 30% by imputing them to the UK resident parent company. CS claimed that the UK's CFC legislation constituted discrimination and contravened the principle of freedom of

establishment enshrined within the EU treaty. This question was therefore referred to the ECJ.

The ECJ determined that, where a company establishes an overseas subsidiary in order to take advantage of a lower tax rate, then this does not in itself constitute an abuse of the freedom of establishment. Moreover, the ECJ went on to find that the UK CFC rules could constitute a restriction on freedom of establishment because the treatment of CFC's differed from those subsidiaries that were UK resident.

The ECJ nevertheless recognized that the UK CFC rules were justified where they specifically related to wholly artificial arrangements aimed at circumventing the tax legislation. However, the ECJ stated that where there is an actual pursuit of an economic activity through a fixed establishment for an indefinite period, then this is not regarded as a wholly artificial arrangement even if there was a tax motive for establishing the economic activity in the relevant territory.

The ECJ therefore concluded that the UK CFC rules should only apply to "a fictitious establishment not carrying out a genuine economic activity in the territory of the host member state."

In our view, the ECJ ruling should therefore mean that CFC rules in any EU country can only apply to EU subsidiaries where they are wholly artificial constructions with no economic reality, such as so-called "brass-plate" companies.

Going forward, in our view the ECJ ruling has a number of significant implications for corporate taxpayers.

Firstly, we recommend that any EU parented groups who have previously suffered CFC taxation on their EU subsidiaries should consider making an urgent claim to refund this tax.

Secondly, we recommend that any EU parented groups who have paid a dividend from an EU subsidiary in order to avoid CFC taxation, and has suffered a tax liability on the dividend as a result, should also consider making an urgent claim to refund this tax.

Finally, it may be thought that it is now easier for EU parented groups to take advantage of low tax regimes in other EU countries, such as Ireland's corporate tax system, the Belgian notional interest deduction regime, and the new Netherlands interest regime, provided that suitable economic substance is established in the low tax country.

B) COUNTRIES

1. CANADA

First tax case to consider limitation-of-benefits rules under Canada's tax treaties and domestic legislation

The first Canadian tax case to consider limitation of benefits or “treaty shopping” rules under Canada’s tax treaties and under Canadian domestic taxation rules was released in August of this year. In the case of *MIL (Investments) S.A.*, the Tax Court of Canada allowed the taxpayer’s claim of treaty protection under the *Canada-Luxembourg Tax Convention* (“Treaty”) in respect of a gain of over C\$ 425 million on the disposition of shares of a Canadian mining company. In that case, in general terms, an individual, Jean-Raymond Boule (“Boule”), and his wholly-owned corporation incorporated in the Cayman Islands, MIL (Investments) S.A. (“MIL”, the appellant in the case), owned shares of Diamond Field Resources Ltd. (“DFR”), a Canadian public corporation. MIL was then continued into Luxembourg (or, in other words, there was a change of jurisdiction of the governing law of the corporation). Within a few months of the continuance and after several offers from Inco Limited and another corporation, MIL entered into an agreement with Inco to sell its DFR shares (“Sale”) and realized a capital gain of approximately C\$ 425 million and claimed the protection of the Treaty in respect of that gain, which was the subject of the appeal.

The Canada Revenue Agency (“CRA”) challenged the application of the Treaty to MIL on the basis that the general anti-avoidance rule (“GAAR”) under the *Income Tax Act* (Canada) applied to deny the treaty benefit. In the alternative, the CRA argued that an anti-abuse rule inherent in the Treaty itself would deny the exemption. The CRA has contended for some time that Canada does not need to include limitation-of-benefits provisions in its tax treaties as the GAAR could be applied to deny the benefits of a particular tax treaty in circumstances of “inappropriate treaty shopping”.

In essence, the Court in the MIL case decided that the continuance of MIL to Luxembourg and the Sale were not part of the same series of transactions and, therefore, the GAAR could not apply in the circumstances to deny to the taxpayer the benefits of the Treaty. Although this constitutes the basis on which the case was decided, the Court went on to discuss the general applicability

of the GAAR to treaty shopping and stated that “the shopping or selection of a treaty to minimize tax on its own cannot be viewed as being abusive”, and that if Canada is concerned with the preferable tax rates of any of its treaty partners, it should seek recourse by attempting to renegotiate selected tax treaties rather than to apply the GAAR.

With regard to CRA’s alternative argument that an inherent anti-abuse rule would deny the treaty exemption, the Court stated that in light of the fact that there is no explicit reference to anti-avoidance rules in the Treaty, there was no ambiguity in the Treaty permitting it to be construed as containing an inherent anti-abuse rule. Therefore, the clear wording of the Treaty permitted the taxpayer to claim the protection of the Treaty.

While this decision may be viewed as encouraging from a tax planning perspective, it must be kept in mind that the Court’s comments on treaty shopping were not part of the actual disposition of the case (or, in other words, they were *obiter dicta*). Also, it is not clear yet whether the CRA will appeal this decision.

2. INDIA

2.1 Ruling of the Authority for Advance Rulings on requirement to withhold tax on cross-border software payments

An Indian company filed an application with the Authority for Advance Rulings (“AAR”) in India on a specific question of whether there was any legal obligation on the Indian company to withhold taxes on the proposed payment to a Singapore vendor for the purchase of packaged business software solutions by the Indian company.

In the course of the proceedings at the AAR it was argued by the Indian company that the payment was made towards purchase of a product and that it was not given any rights by the vendor over the copyright in the software. Arguing that the income was business profits in the hands of the vendor, the Indian company submitted that since the vendor did not have a Permanent Establishment (“PE”) in India, the payment was not taxable in India. The Indian Revenue however, argued that the payment constituted a royalty and was, therefore, taxable in India. With the Indian company being required to withhold taxes.

The AAR held that the question raised by the Indian company did not require it to rule on

whether any element of income was comprised in the payment made by the Indian company. The AAR was therefore of the view that the arguments by the Indian company that there was no royalty income or that there was no PE were beyond the scope of the subject-matter of the application and could not be considered. The AAR then proceeded to examine whether the payments to the vendor required tax to be withheld. In this context the AAR referred to a decision of the Supreme Court of India which had held that the requirement to withhold tax also applied to payments which may have an element of income embedded in them, even though the entire payment is not in the nature of income. The AAR concluded that such payments, which are of the nature of gross receipts, fall within the scope of the withholding tax requirement and therefore, there was a legal obligation on the Indian company to withhold taxes when paying towards the final purchase of the software.

The AAR ruling is binding on the Applicant and on the Indian Revenue and is not subject to further appeal, other than under a Constitutional remedy. Although the AAR ruling is not binding on the assessing authorities or the appellate authorities in the case of other taxpayers, such rulings do carry considerable persuasive weight in deciding similar cases, especially at lower instances.

While this ruling may cause considerable concern in the context of withholding tax requirements for cross-border business transactions, it should be noted that the AAR only ruled on the specific questions raised by the Applicant and that the AAR refrained from ruling on whether there is any element of income that arises in India in cases of cross-border payments for software. The recent findings of the Indian Tax Tribunal (which is the second appellate authority) in other cases (viz, *Motorola-Ericsson-Nokia*, *Samsung*, *Lucent*, etc) on the taxability of payments for purchase of software may, therefore, still be relevant.

2.2 Indian Revenue files petition with the Supreme Court against the Morgan Stanley Advance Ruling on PE

The AAR in India ruled on an application by Morgan Stanley and Co Incorporated, USA (“Morgan Stanley”) on whether its Indian captive BPO unit (a separate legal entity) in India would constitute a PE in India for Morgan Stanley. Given the assignment of Morgan Stanley employees to the Indian BPO, the AAR had ruled that Morgan

Stanley had a Service PE. However, the AAR also ruled that so long as the transactions between the Indian BPO and Morgan Stanley were at arm’s length, there would be no further income that could be attributed to the Service PE.

Since the rulings of the AAR are not ordinarily subject to further appeal, the Indian Revenue has filed a Special Leave Petition (“SLP”) with the Supreme Court of India contesting the AAR’s ruling.

This is an unprecedented move by the Indian Revenue and raises a question about the efficacy of Advance Rulings, which are ordinarily binding on the taxpayer and on the Revenue. The SLP also once again brings to the forefront an issue that has dogged the Indian BPO industry, namely, whether Indian BPOs constitute PEs for their parents. Note that the Indian Revenue has already issued an administrative circular on this issue (in 2004) and the industry is very keenly awaiting developments on this front.

OTHER NEWS

1. FRANCE

A code of conduct between France and the Netherlands to prevent double taxation

On 17 July 2006, the French Tax Administration published in circular no. 14 A-3-06 bilateral code of conduct with the Netherlands on the competent authority procedure set forth in Article 27 of the France-Netherlands tax treaty dated 16 March 1973.

This bilateral code of conduct follows a previous general tax circular issued by the French Tax Administration on 23 February 2006 commenting on, and clarifying the rules applicable from a French perspective to, the competent authority process established by tax treaties and by the European Convention dated 23 July 1990 on the elimination of double taxation (Circular no. 14 F-1-06 quoted in Taxand Newsletter issue 3, July 2006).

Both circulars have been issued pursuant to the Code of Conduct adopted by the European Commission on 23 April 2004. In this respect, France has clearly expressed its intention to comply with the recommendations of the Code of Conduct.

It must be noted that a competent authority procedure allows deferral of the collection of the adjusted tax (Section L 189 A of the Book of Tax Procedures) thereby giving this procedure a key strategic scope.

2. LUXEMBOURG

1929 Holding Companies regime must be abolished by the end of 2006 – grandfathering rules will apply until the end of 2010

After an in-depth investigation that opened on 8 February 2006, the European Commission concluded on 19 July 2006 that a preferential Luxembourg tax regime, the Exempt, Milliardaire and Financial Holdings of 1929, infringed the EC Treaty State aid rules (Article 87 of the EC Treaty).

The Luxembourg Government received notice of the decision on 20 July 2006 and the decision was published in the Luxembourg Official Gazette on 31 July 2006. The European Commission decision

requires the regime to be repealed by the end of 2006, while its effects for existing 1929 Holding Companies must be definitively eliminated by the end of 2010 (allowing existing beneficiaries to exit from the existing holding structures without incurring tax penalties).

Since the publication of the decision in the Luxembourg Official Gazette, it is no longer possible to create new 1929 Holding Companies (which means that it is neither possible to incorporate a 1929 Holding Company nor to convert a fully taxable company into a 1929 Holding Company).

While the regime as such will have to be abolished by the end of this year, existing 1929 Holding Companies have been granted a 4-year time period in which to change their tax status (until the end of 2010) and restructure their investments.

The European Commission decision states, however, that the share capital of existing 1929 Holding Companies cannot be sold during the transitional period ending on 31 December 2010, which should mean that if a sale takes place, the company will automatically lose the benefit of the regime and will become a fully taxable Luxembourg company.

The decision does not indicate when this transitional period started (date of notification of the decision – 20 July 2006, or date of publication in the Luxembourg Official Gazette) or will start (date from which the regime should be abolished, i.e., 1 January 2007). The Luxembourg Government has said, however, in an interview that the prohibition on selling would apply from 2007 onwards. The restriction could also give rise to severe practical problems in the case of quoted 1929 Holding entities as well as in the context of a group restructuring during the transitional period. The Luxembourg Government clarified, however, that this prohibition would not apply to existing quoted holding companies and that the sale of individual shares was not affected.

Even though, to the best of our knowledge, this interpretation has yet to be confirmed with the European Commission, this is at least the interpretation that should logically be reflected in the transitional provisions of the draft law to be passed in the coming weeks/months by the Luxembourg Government in order to abolish the current 1929 Holding Companies regime.

Today, the 1929 Holding Companies regime is mainly used for private wealth investments but is

no longer as attractive as it was seen to be in the past. The abolition of the regime will therefore mainly impact on existing 1929 Holding Company structures, but should not significantly affect Luxembourg's status as one of the most attractive financial centers in the world.

The decision of the European Commission to allow current 1929 Holding Companies a fairly long period of time to take appropriate action and undertake appropriate restructuring has been welcomed by the Luxembourg Government which is already working on some alternative legislation for private wealth management, which would be in line with EU legislation. A draft law is expected to come out by no later than this autumn.

3. MALTA

Share capital conversion

Guidelines aimed at ensuring a smooth transition to the conversion of company share capital from the Maltese Lira to the Euro were issued by the Malta Financial Services Authority (MFSA) on 29 May 2006, following approval by the National Euro Changeover Committee.

As a result of these guidelines, the planned conversion of company share capital to the Euro on 1 January 2008 is expected to require the least possible involvement and processing of documentation by all companies involved.

The relevant document, published as NECC/0006/2006, applies to all registered companies that have their share capital denominated in Maltese Lira on 31 December 2007. With effect from 1 January 2008, these companies will have their share value automatically denominated in the equivalent Euro amount at the irrevocable fixed rate of exchange. The Registry of Companies will convert its records in this respect without the need for any action to be taken by the companies themselves. The equivalent Euro amount will be stated to two decimal places. Any changes in company share capital after conversion will still need to be made by the company concerned following the normal procedures under the Companies Act.

All of the above is subject to the overriding condition that the Euro changeover will take place on 1 January 2008.

No other guidelines or tax guidelines have been issued so far and therefore it is not yet clear whether or not such a conversion (from the

Maltese Lira to the Euro) will have any tax effect resulting from realized or unrealized conversion amounts depending on whether or not the balance sheet items will be all converted using the same rate or else by applying the rules laid down in the Eighth Schedule of the Companies Act.

4. PORTUGAL

4.1 European Commission against tax regime for nonresident banks in force in Portugal

The European Commission has decided to refer Portugal to the European Court of Justice because the Portuguese Government has failed to amend its tax legislation (Article 80(2)(c) of the Portuguese Corporate Income Tax Code) concerning interest payments, as was requested in January 2006.

According to that regime, Portuguese resident borrowers must withhold tax on the gross interest paid to nonresident banks, while no such obligation exists for interest paid to resident financial institutions, even though they are subject to Portuguese corporate income tax. The consequence is that Portuguese lenders only pay tax on the interest they receive after deducting the cost incurred in raising the capital needed for the loans. Nonresident lenders, on the other hand, cannot deduct such costs, making their loans more expensive and less competitive in cross-border transactions.

The European Commission viewed this regime as a violation of nonresident lenders' freedom to provide services and a restriction on the free movement of capital.

4.2 European Commission requires Portugal to repeal Article 25 of the Portuguese Relief Regulations

The European Commission has formally required Portugal to repeal Article 25 of its Tax Relief Regulations (EBF), on the ground that the provision contravenes the bar in the EC Treaty on State aid liable to distort competition. Article 25 of the EBF establishes a corporate income tax exemption applicable to capital gains derived by state-owned business corporations from privatization and restructuring transactions.

Further to the investigation conducted on this matter, the European Commission found that Article 25 confers a selective tax advantage to certain companies, which is incompatible with the

Single Market. Therefore, the Commission concluded that Portugal must stop the relief and recover aid already granted under the provision in cases where the regime led to an effective distortion of competition.

5. UNITED KINGDOM

5.1 Large corporations are beginning to feel the strain of the UK's increasingly uncompetitive tax system

HM Revenue & Customs ("HMRC") is continuing its crackdown on tax avoidance, particularly against large corporations. This policy was initially articulated in an interview by HMRC's director-general during which he stated that HMRC's goal was to "make tax avoidance not worthwhile" by 2008.

However, the crackdown, together with the rate of UK corporation tax remaining at an increasingly uncompetitive level of 30%, is leading many UK companies to consider moving their headquarters to more accommodating tax jurisdictions overseas. This process is being aided by a number of recent EU tax cases that are gradually forcing the UK corporation tax system to harmonize with other tax systems in the EU, and thus make it easier for UK companies to migrate to other EU countries.

UK Government ministers are beginning to recognize this problem and have recently stated their aspiration that UK tax policies should do nothing to hinder the health and development of the UK economy and, in particular, London's importance as a global financial center. However, it remains to be seen whether these fine words will be translated into tangible action to make the UK tax system more competitive for corporations. The fundamental issue remains that the UK Government continues to try to collect greater amounts of tax from a potentially dwindling number of large UK corporations, whilst not offering any meaningful tax incentives to attract new businesses to the UK.

The danger of a complacent approach was illustrated most recently when GUS plc announced that it was splitting itself in two, with the data mining business Experian henceforth to be headquartered in Ireland. A reference in the public disclosures to the fact that Experian expects its pro forma tax rate to be in the low twenties (compared to the UK corporate tax rate of 30%) hints at a tax-

related reason for why a UK headquartered company might no longer be attractive.

5.2 Disclosure of tax avoidance schemes

The Disclosure of Tax Avoidance Scheme rules were introduced in 2004, and require a "promoter" of certain types of direct tax avoidance scheme to disclose the scheme to HMRC within five days of it being capable of implementation. It is now clear that HMRC regards the disclosure rules as their most successful weapon in countering tax avoidance by corporations. To date, HMRC has received over 1,000 direct tax disclosures. In addition, the separate disclosure regime which applies to VAT, which requires the taxpayer, as opposed to promoters, to make disclosures, has resulted in a further 800 disclosures. Together these disclosures have enabled HMRC to quickly close a large number of tax planning arrangements that they have perceived to be tantamount to tax avoidance.

The success of the disclosure regime has resulted in HMRC recently extending the rules to cover the whole of income tax, corporation tax, stamp duty, stamp duty land tax and capital gains tax. In addition, corporations who devise tax avoidance schemes in-house are required to disclose these schemes to HMRC within 30 days.

5.3 Tax risk profiling

HMRC also recently announced another key weapon for countering tax avoidance by UK corporations. HMRC now intends to evaluate the tax risk profile of every major UK corporation, and those corporations identified as being aggressive tax planners will be categorized as high risk, and will be subject to an intense level of scrutiny, including the presence of tax investigators at their offices for protracted periods.

To this end, HMRC has introduced the new Large Business Service in order to service its "customers" (large corporations). Customers are being assigned a Client Relationship Manager ("CRM") with responsibility for direct and indirect taxes. CRMs are then, as an initial step, arranging meetings with corporations, with the ultimate aim of examining their tax affairs on a 'real-time' basis.

This is worrying news because despite the customer-friendly face, HMRC appears to be moving towards the US model of tax compliance, which has many unwelcome features such as tax

audits without end, the permanent stationing of tax investigators at a corporation's premises, and the employment of staff whose only role is to handle the tax investigators.

The appointment of CRMs has inevitably created more "joined-up thinking" between HMRC staff dealing with corporate taxes and those responsible for VAT. This has manifested itself, in particular, in areas such as transfer pricing where transfer pricing policies are being reviewed routinely for VAT implications, particularly in the financial services sector. Furthermore, enhanced information flows between HMRC staff have resulted in an increase in investigations resulting, in some cases, in substantial tax assessments.

The increased levels of scrutiny that will be a natural consequence of Tax Risk Profiling will, inevitably, result in a significantly increased compliance burden to many large corporations that will be expensive to service. This, coupled with the increasingly bellicose statements emanating from HMRC regarding tax avoidance, and the backdrop of an increasingly uncompetitive tax regime, will do little to endear the UK to large taxpayers.

6. VENEZUELA

6.1 Customs audits that include transfer pricing matters

The Venezuelan customs authorities (the National Integrated Services of Customs and Tax Administration - SENIAT) have started to conduct customs and transfer pricing tax audits. They have sent taxpayers questionnaires and officially requested a long list of detailed information from them, including transfer pricing studies, for the purpose of determining the proper customs value of imported merchandise. The information requested must be filed by the taxpayer within 15 days following notification of the official request for information.

6.2 Venezuela to join Mercosur as a permanent member

With the withdrawal of Venezuela from the Andean Community in April, the Government entered in negotiations to bolster its participation in Mercosur, the South American Common Market. Venezuela has been an associated member of Mercosur since December 2004. On 4 July 2006, the Venezuelan President signed a Protocol of Accession to Mercosur with the Heads of State of the other member countries. The Protocol should enter into

force after the exchange of the corresponding diplomatic notes and provides that after 4 years Venezuela will join Mercosur as a permanent member.

6.3 Venezuela denounces the Cartagena Agreement

The withdrawal of Venezuela from the Andean Community has major fiscal consequences, although the Venezuelan Government has not yet issued any official communication on such effects. It could be interpreted that as soon as Venezuela terminated the Cartagena Agreement, Decision 578, which regulates the avoidance of double taxation between the member countries, was also terminated and, as a result, the benefits under the aforementioned Decision were not longer applicable. The Court of Justice of the Andean Community has held that it will not decide on claims to which Venezuela is party, because Venezuela has not been obligated to comply with the Court's judgments since its denunciation of the Cartagena Agreement; thus, as stated on the Venezuelan tax authorities website, Decision 578 has already been derogated.

Special features

1. CERTAIN CONSIDERATIONS TO BE ANALYZED BEFORE INVESTING IN ARGENTINA, BRAZIL AND MEXICO

1.1 ARGENTINA

In December 2001 and through most of 2002, Argentina experienced an unprecedented crisis that virtually paralyzed the country's economy and led to radical changes in government policies. Over the past three years, the Argentine economy has recovered significantly with real GDP growing nationwide at approximately 9% per year, and the business environment has largely stabilized.

After the crisis, Argentina embarked on a period of restructuring its public and private debt and established the two principles guiding its new economy: (i) the maintenance of a strong foreign exchange rate; and (ii) an increase in tax revenues with a significant fiscal surplus.

Although the conditions for investment are favorable, the legal environment does not attract foreign investment as it did in the '90s, basically because of certain foreign exchange regulations⁴, new corporate regulations and a distorting tax system. Focusing on the tax aspects, the two main problems faced by the current Argentine tax system are: (i) no adjustment for inflation rules are accepted for income tax purposes; and (ii) the short expiry period for tax loss carryforwards.

a) *No adjustment for inflation rules for income tax purposes*

In Argentina, the Government position is that adjustment for inflation rules are no longer in effect, despite a cumulative inflation rate of 178.7% from January 2002 to June 2006. Additionally, a recent judgment by the Argentine Supreme Court in the *Duggan* case (2005) initially disallowed the application by taxpayers of the adjustment

for inflation rules⁵ while the Government adjusted the tax base for several federal taxes. However, very recently, the Federal Supreme Court submitted in an adjustment for inflation case (*Juplast*) the so-called "amicus curiae" process by which experts and specialized entities can issue their non binding opinion on the matter. Therefore, the issue remains open and the decision of the *Juplast* case will be crucial for the market

The effects of the inapplicability of the adjustment for inflation rules will subsist even if inflation falls substantially or disappears (for example, asset depreciation and capital gains are currently calculated according to historic values and tax losses are not adjusted).

In an international context, while countries with much lower inflation apply index-linked adjustments⁶, Argentina, which has a considerably higher inflation rate, does not accept the application of such rules, thus creating an adverse environment for investment compared with other scenarios.

b) *Short expiry period for tax loss carryforwards*

The Argentine Income Tax Law provides that tax losses can be carried forward for up to 5 years. During such period, they can be offset against profits obtained by the company. Argentina has had this system for the past 21 years⁷, but, considering the shortness of the period, inapplicability of adjustments for inflation and the high inflation rate⁸, the situation faced by Argentina is currently the worst for the last 45 years. The situation is even more dramatic if the Argentine system

⁴ Capital inflows into Argentina are subject to (a) the creation of a mandatory named nontransferable deposit denominated in US dollars in an amount equal to 30% of the relevant transaction value (the "Mandatory Deposit"); and (b) a stay period of at least 365 calendar days. The Mandatory Deposit does not bear any interest or yield any return and cannot be used as collateral. These measures do not apply to certain specifically excluded transactions such as IPOs and foreign direct investment.

⁵ We would stress that the rules are supposed to apply in cases where the taxpayers prove that the applicable income tax becomes "confiscatory".

⁶ In this connection, Mexico (with a cumulative inflation rate of 19.5% from 2002 to 2005), Colombia (26.2% from 2002 to 2005), Chile (10.3% from 2002 to 2005), Venezuela (127.3% from 2002 to 2005), Bolivia (16.8% from 2002 to 2005) and Uruguay (103.9% from 2002 to 2005) allow adjustment for inflation.

⁷ In 1985, the period was reduced from 10 to 5 years.

⁸ As mentioned earlier, 178.7 from January 2002 to June 2006.

is contrasted with the systems in countries that have economic ties⁹ with Argentina.

This situation particularly affects banks and utilities, which have tax losses amounting to billions of Argentine pesos incurred in the 2002 crisis and set to expire in 2007. There are a number of initiatives promoted by chambers of commerce and other entities seeking a 10 years extension. Recently, a draft of bill proposing a 7 years period has been filed before the National Congress which has not been considered so far. We are of the opinion that chances for the bill to be passed without amendments are low.

c) *Conclusions*

In conclusion, although the current tax system may be effective for the Government's objectives, in the medium or long term it may result in Argentina losing competitiveness against other jurisdictions. Tax reform is thus urgently required, principally to resolve the adjustment for inflation rules and tax loss carryforward matters.

1.2 BRAZIL

On 27 July 2006, Provisional Measure (MP) #281, which created tax incentives for foreign investors and established the tax regime applicable to certain types of mutual funds, became Federal Law No. 11.312. We discuss the principal aspects of the changes below.

a) *Reduction to zero of the income tax (IRRF) withholding rate on income derived from federal public bonds held by persons who are resident or domiciled outside of Brazil*

Income from federal public bonds, acquired on or after 16 February 2006 by persons who are resident or domiciled outside of Brazil in countries that do not tax income, or in countries where the maximum tax rate is less than 20%, is subject to a zero income tax (IRRF) withholding rate.

In order to qualify for this tax incentive, the transactions with federal public bonds must

comply with the rules and conditions set by the Brazilian National Monetary Council (CMN). However, there is no tax relief if the federal public bonds are acquired by a purchaser who has entered into a resale commitment.

This tax relief also applies to the units of mutual funds dedicated to nonresident investors, where at least 98% of the portfolio consists of federal public bonds.

b) *Taxation of Private Equity Funds (FIPs), of Mutual Funds investing in Units of Private Equity Funds (FCFIPs) and of Mutual Funds investing in Emerging Companies (FIEEs)*

Law No. 11.312/06 consolidated the tax regime applicable to the Taxation of Private Equity Funds (FIPs), of Mutual Funds that invest in Units of Private Equity Funds (FCFIPs) and of Mutual Funds that invest in Emerging Companies (FIEEs). The Law established that the gains from redeeming units in FIPs, FCFIPs or FIEEs, including the gain on liquidation of the fund, is subject to IRRF at 15%, charged on the positive difference between the redemption value and the acquisition cost of the units.

In order to qualify for this tax treatment, the FIP, FCFIP or FIEE must comply with the diversity limits and investment rules contained in the regulations established by the Brazilian Securities Commission (CVM).

c) *Taxation of foreign investors who invest in FIPs, FCFIPs or FIEEs*

Income earned by foreign investors from investments in FIPs, FCFIPs or FIEEs are subject to a zero IRRF rate, so long as the following conditions are respected:

- the investments must be made in accordance with the rules and conditions set by the CMN;
- the foreign investor cannot hold, individually or together with associates, more than 40% of the sum of the units issued by the fund, or if the units held by the foreign investor give him the right to receive more than 40% of the total income generated by the fund;
- at no time may the net value of the FIP, FCFIP or FIEE portfolio contain more

⁹ For instance, in Mexico and Canada the period is 10 years; Spain, 15 years; United States, 20 years; and in Chile, Brazil (subject to certain limitations), Great Britain, Germany and France, tax losses can be carried forward indefinitely.

than 5% of bonds that are not federal public bonds;

- the foreign investor must not be resident in countries that do not tax income, or where the maximum tax rate is less than 20%.

d) *Zero rate for the provisional contribution on the movement or transfer of securities, credits and financial rights (CPMF) in acquiring shares offered to the public*

As a rule, the CPMF is charged on any withdrawal from bank accounts at a rate of 0.38%. In the case of acquisitions of shares by anyone who is resident or domiciled in Brazil or outside of Brazil in a public auction registered with the CVM and made outside stock exchange facilities or trading systems, bank account withdrawals for settling such transactions are subject to 0% CPMF, provided that the issuer is registered to trade shares on the Brazilian stock exchange.

1.3 MEXICO

a) *Tax rate reduction*

Since 2002, the Mexican Income Tax Law ("MITL") has included annual reductions in corporate and personal maximum marginal income tax rates. The current income tax rate for 2006 is 29% and will be further reduced to 28% in 2007.

b) *Thin capitalization – Safe Harbor*

Under the MITL, Mexican taxpayers cannot deduct interest accrued on debt exceeding three times shareholders' equity (3:1 debt-equity ratio), where the debt comes from loans from a related party or from independent parties who are foreign residents.

As from 1 January 2006, an amendment to the MITL provides that to determine the 3:1 debt-equity ratio, the taxpayer may not include loans that are subject to terms or conditions that limit the debtor to:

- distribute profits or dividends;
- resolve to make capital reductions;
- sell its fixed assets;
- take out new loans;

- transfer ownership of a majority of the capital stock; and
- allow the lender to be involved in determining the use of the proceeds from the loan.

Such restrictions (covenants) are generally found in financing transactions between unrelated parties.

A review of current loan agreements is recommended to determine whether they should be amended in order to comply with Mexican thin capitalization rules.

c) *Transparent entities - (US–Mexico tax treaty)*

On 22 December 2005, the competent US authorities and Mexico entered into a mutual agreement procedure ("MAP") under their tax treaty, which deals with cases where fiscally transparent entities are entitled to treaty benefits and clarifies the procedure for claiming benefits from Mexico.

In this connection, income from sources in one of the Contracting States received by an entity organized in either of the Contracting States, or a third country with which Mexico has in force a comprehensive exchange-of-information agreement (Belgium, Canada, Korea, Israel, Spain, France, Italy, Norway, Netherlands, Singapore, Sweden, Finland, Chile, Ecuador, Romania and Czech Republic), and treated as fiscally transparent under the laws of either Contracting State will be treated as income derived by a resident of the other Contracting State to the extent that such income is subject to tax as the income of a resident of the other Contracting State.

In view of the above, a fiscally transparent entity organized in the US (limited liability company, grantor trust, Subchapter S corporation) which has elected to be treated as a partnership for federal tax purposes will be treated as a US resident, and be entitled to claim treaty benefits, to the extent that the income it derives is subject to tax as the income of a US resident in the hands of its members, owners, partners or beneficiaries.

The application of the treaty benefits to US residents requires that the fiscally transparent entity provides a certificate of residence on Form 6166, which should

include a list of members that are US residents for US federal tax purposes.

Lastly, the MAP will be effective: (i) upon signature, with respect to Mexican-source payments made to Mexican or US entities, to the extent the Mexican statute of limitations has not expired for such payments, or (ii) on 1 January 2006, with respect to Mexican-source payments made to entities organized in third countries or jurisdictions identified in the MAP.

2. APPLICATION OF THE ANTI-ABUSE PROVISION IN THE PARENT-SUBSIDIARY DIRECTIVE IN FRANCE, GERMANY, ITALY AND SPAIN

Council Directive (90/435/EEC) of 23 July 1990 (the so-called “Parent-Subsidiary Directive”) establishes a broad provision (Article 1(2)) whereby the Directive will not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse. This general provision has been interpreted by different EU Member States in different ways. Some have incorporated into their national laws specific anti-abuse provisions as a result of the Parent-Subsidiary Directive. In this article we comment on some of these specific provisions.

2.1 FRANCE

With regard to the Parent-Subsidiary Directive, the withholding tax exemption does not apply where the parent company is directly or indirectly controlled by one or more residents of non-EU Member States, unless the parent company proves that the main purpose, or one of the main purposes, of the chain of shareholdings is not to take advantage of the exemption.

According to the French tax authorities, this is deemed to have been substantiated where the aggregate amount of the withholding taxes actually collected at the intermediate stages is at least equal to the amount that would have been levied in France had the dividends been distributed directly by the French resident company to residents of non-EU Member States.

Other proof may be provided. Thus, if the parent company can demonstrate that the dividends received from its French subsidiary are not redistributed to shareholders that are residents of non-EU Member States, but instead are reinvested

in other companies, this should make it possible to avoid triggering the anti-abuse provision.

2.2 GERMANY

According to German legislation, a foreign company cannot claim tax relief in whole or in part pursuant to a tax treaty or to the Parent-Subsidiary Directive insofar as its shareholders are persons who would not have been entitled to the reduction or exemption had they earned the income directly, and

- where business or other good reasons for interposing the foreign company are lacking; and
- the foreign company has no business activity of its own.

In this regard, in July 2006, the Federal Ministry of Finance published a Bill for the 2007 Annual Tax Act. Among other changes, it tightens the above-mentioned anti-abuse provision. Pursuant to the Bill, a foreign company is not entitled to treaty or Directive relief if:

- business or other good reasons for interposing the foreign company are lacking; or
- the foreign company does not obtain 10% or more of its total gross revenues for the relevant financial year through its own business activity; or
- the foreign company does not engage in general business activity with a business operation that is adequately equipped for its business purpose.

The amendment is a reaction to the decision of the Federal Tax Court dated 31 May 2005. This judgment relaxed the substance requirements where the group structure and strategic objective is to structure investments through a holding company, the structure put in place serves the long-term goals of the corporate group and is not implemented for the purpose of obtaining treaty benefit, and the domicile of the holding company is also the domicile for other group activities. The Federal Ministry of Finance reacted to this decision with a non-application order dated 30 January 2006. In the non-application order the Federal Ministry of Finance announced that section 50d subsection 3 of the Income Tax Act takes into account the features of the interposed corporation rather than those of other group members or the group structure. The interposed company must have substance (office, office equipment, human

resources) otherwise it cannot benefit from tax treaties or the EU Parent-Subsidiary Directive. The prerequisites for the provision, namely, “lack of business or other prudent reasons” and “no business activity of its own” are alternative rather than cumulative.

We will have to wait and see what form the final version of this amendment will take when it enters into force, what the practical implications will be, and how the European Commission will react to this new anti-abuse provision.

2.3 ITALY

The Italian anti-Directive shopping provision bars the application of the exemption under the Parent-Subsidiary Directive to companies controlled directly or indirectly by non-EU residents, unless it is evidenced that the structure was not set up with the exclusive or main purpose of taking advantage of the regime in the Directive. The rule applies only to outbound dividends, since Italy applies a 95% exemption regime to all inbound dividends, except those distributed by black-listed companies.

Evidence of the genuine purpose of the business structure could be adduced either to the payor of the dividends (which may apply the exemption under its own responsibility as the withholding tax agent), or to the tax authorities when the payee claims a refund of the withholding tax; moreover, proof could be adduced in an application to the competent tax authorities for a specific advance ruling; in such case, if the tax authorities express a positive opinion on the structure as proposed by the taxpayer in its application for the ruling, they would be precluded from subsequently assessing the matters agreed on in the ruling, subject to the *rebus sic stantibus* doctrine.

Such proof must show that the intermediate EU-resident company has some economic substance and business activity (a non-exhaustive list of examples in this respect might include the company's balance sheet, employment contracts, invoices and the like). However, given the scope of the provision, it will be necessary to prove that the intermediate EU-resident company was formed for sound business reasons, regardless of its current activities.

The anti-Directive shopping provision apparently complies with the principles affirmed by the ECJ with reference to national anti-avoidance rules (see, in particular, case C-28/95, *A. Leur-Bloem v. Inspecteur der Belastingdienst/Ondernemingen*

Amsterdam 2, [1997] ECR I-4161). However, as the advance ruling procedure is typically time-consuming and burdensome in Italy, certain doubts may still arise as to the compatibility of the provision with the proportionality principle as set forth by the ECJ.

2.4 SPAIN

The Spanish Nonresident Income Tax Law implements the Parent-Subsidiary Directive by introducing a specific anti-abuse provision: should the majority of the voting rights in the capital of the parent company be held directly or indirectly by individuals or entities not resident in a EU Member State, the exemption rule will not apply. The exceptions to this (i.e. the exemption still applies) are where:

- the parent entity engages in an economic activity that is directly related to the subsidiary's business; or
- the parent entity's business consists of managing the Spanish subsidiary through an adequate structure of human and material resources; or
- evidence can be provided that the EU parent entity was incorporated for sound economic reasons and not to unduly benefit from the exemption rule.

Based on tax rulings by the Directorate-General of Taxes and decisions of the Central Economic-Administrative Tribunal (part of the Tax Administration), our understanding is that the Spanish tax authorities have adopted an extremely broad approach towards the application of the anti-abuse provision. In this regard, the Decision rendered by the Central Economic-Administrative Tribunal on 15 October 2004 is a good example of this broad interpretation:

The facts on which the Tribunal made its Decision were that a Spanish subsidiary of a Dutch company had carried out R&D and management activities for its subsidiaries. The sole shareholder of the Dutch entity was another Dutch company which, in turn, was wholly owned by a US company.

According to the Tribunal's Decision, the tax exemption did not apply since:

- the relatedness between the parent's and the subsidiary's economic activities was not sufficient;

- the Spanish entity had incurred a substantial amount of expenses, which was evidence that it was managing itself.

As the above-mentioned reasons existed, the Tribunal concluded that it was not possible to adduce evidence that there had been sound economic reasons for incorporating the parent entity.

A parent entity with “economic substance” was not sufficient, per se, to qualify for the exemption rule. Furthermore, the Tribunal did not even enter into a consideration of the sound economic reasons adduced by the company for incorporating the parent entity.

Note that the European Commission has recently requested Spain to change its anti-abuse provision as the Commission considers that it infringes the Parent-Subsidiary Directive. The Commission has indicated that restrictive measures must be proportionate to the objective in question and that, in this case, the Spanish provision did not satisfy this requirement.

FIRST TAXAND SEMINAR FOR JUNIOR TAXAND PROFESSIONALS

The first International Tax Training Seminar for our junior colleagues took place in Amsterdam in July.

53 junior tax professionals from 14 Taxand Firms spent a successful week at the IBFD's International Tax Academy for an intensive introduction to the principles of international taxation and transfer pricing.

The next Seminar for junior Taxand professionals will take place in Kuala Lumpur in the spring of 2007.

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It is expected that 200 partners and tax professionals from more than 35 countries will attend the bi-annual conference. A good number of technical presentations and breakout sessions are being organized.

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