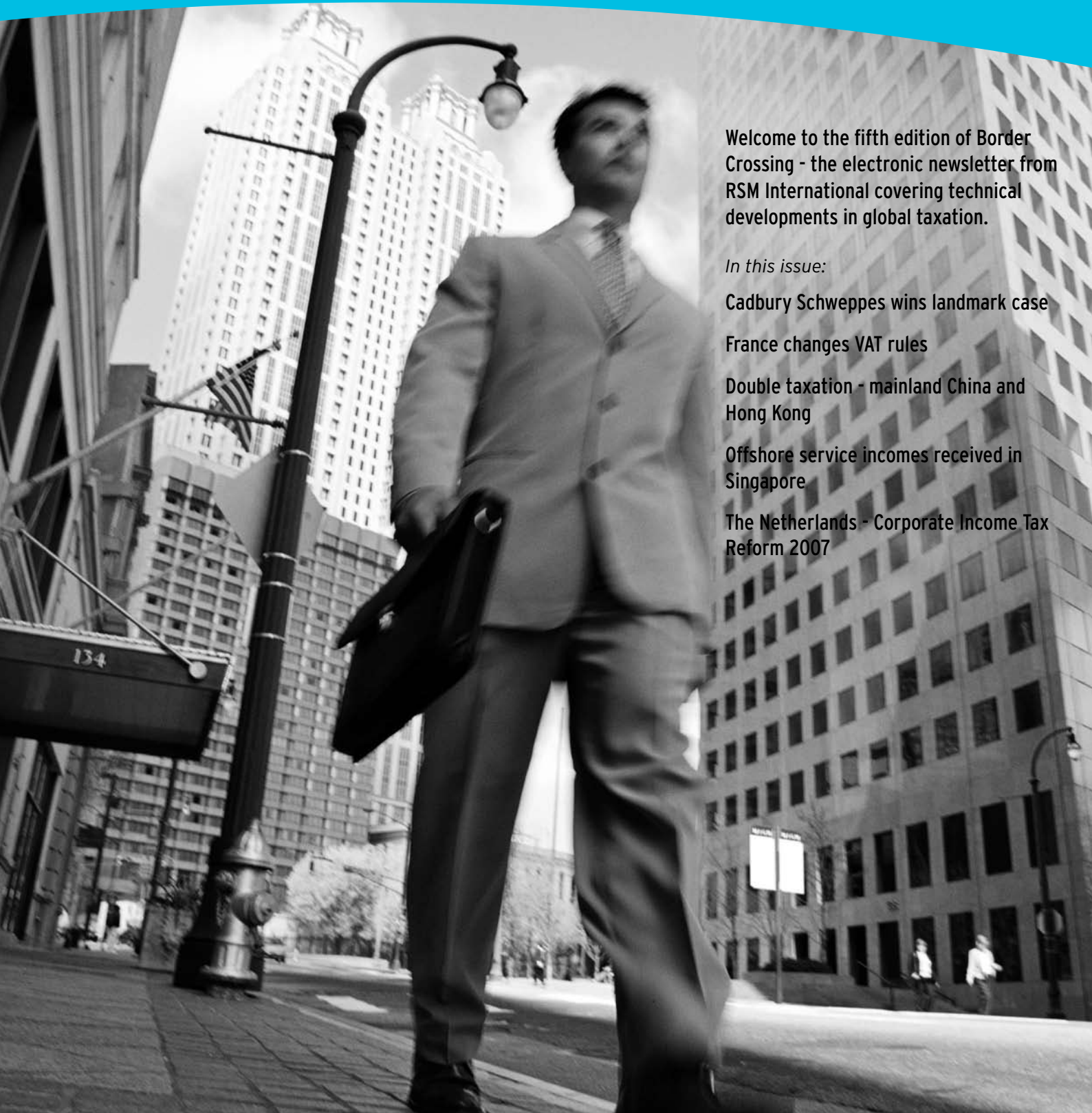


Border Crossing



Welcome to the fifth edition of **Border Crossing** - the electronic newsletter from RSM International covering technical developments in global taxation.

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Cadbury Schweppes wins landmark case

The decision on 12 September 2006 from the European Court of Justice (ECJ) on the 'Cadbury Schweppes' case confirmed the earlier opinion of the Advocate General of 2 May 2006, that the UK (CFC) rules restrict the freedom of establishment principle and are only justified to the extent that they relate to "wholly artificial" arrangements.

Cadbury Schweppes had two Irish subsidiaries whose business was to raise finance and to provide funding to subsidiaries of the Cadbury Schweppes Group. The two companies were established in the International Financial Services Centre (IFSC) in Dublin and were subject to a 10% tax rate which resulted in them being subject to a lower level of taxation than would have been applicable if they had been resident in the UK. UK domestic legislation on CFCs could have resulted in the Irish profits being subject to UK tax.

The ECJ considered whether the UK CFC legislation breached European law. It was held that Articles 43 and 48 preclude the profits subject to a lower level of taxation in one Member State, being included in another Member State's tax base by the CFC legislation, unless such inclusion relates to wholly artificial arrangements to escape the national tax normally payable. The CFC rules should not be applied where the controlled company is "actually established" in the host Member State and carries on "genuine" commercial activities there.

'Actually established' and 'genuine' activities are key here. This is not a licence to undertake artificial tax planning to erode the UK base.

This is very much a landmark case in terms of the principle of freedom of establishment in the EU and any EU Member State's countermeasures to competition within the EU could be significantly undermined.

There is already strong speculation that the UK Treasury are contemplating counteracting measures as they did following the Marks and Spencer case. It remains to be seen what, if any, such measures may be, and whether they would themselves comply with EU law. There have been discussions about restricting interest relief in the UK on overseas activities funded from the UK but this would have serious ramifications for the UK economy and its position in the global marketplace. The Netherlands and Germany both recently flirted with this idea but rejected it on the grounds of the negative impact it may have on their competitiveness.

To the extent not already done so, companies with controlled foreign subsidiaries in other Member States should urgently review the effects of this decision on their operations, including on any existing or potential disputes with the tax authorities and on their dividend policy. (A prior court ruling deemed UK taxation of overseas dividends to be discriminatory and hence illegal under the EC Treaty so the potential to remit CFC profits on a tax-free basis is now a distinct reality).

The decision should improve tax planning within the EU allowing companies to take advantage of lower rates within the EU, provided what is done is real, substantive and adds value to the group as a whole.

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France changes VAT rules

Important changes to the French VAT system have been introduced for foreign companies with effect from 1 September 2006.

Any foreign company doing business in France should immediately consult its VAT advisers as to how it will be affected, whether it is a customer or a supplier. The changes have been introduced to counteract the growing problem of VAT-related fraud, which is costing all governments in Europe billions of euros.

The new rules mean that, in certain circumstances, foreign companies not established in France will not be allowed to register for VAT in France. This is contrary to the previous requirement where they may have been liable for compulsory registration. For such companies, TVA (French VAT) will only be recoverable on the purchases of goods and services through the lengthy procedures of 8th or 13th Directive claims. Having to use the 8th or 13th Directive procedures will result in delays in getting TVA back from the French government. There are also much stricter time limits as to when the claims can be made.

Possible alternatives to this procedure allow businesses to register, or remain registered, for French VAT. However, to find out whether these alternatives can apply to you, you should consult your VAT advisers immediately.

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Arrangement between Mainland China and Hong Kong for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion

On 21 August 2006, the PRC Mainland Government and the Hong Kong Special Administrative Region Government signed a comprehensive Arrangement for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion. The arrangement will replace the old tax memorandum signed between the two governments in 1998. This article aims to provide an overview of this new arrangement and the advantages of using Hong Kong companies as an investment holding vehicle in Mainland China.

1. Background

Hong Kong adopts the territoriality basis of taxation and only income sourced in Hong Kong is subject to Hong Kong tax. In most cases, income derived from a source outside Hong Kong by local residents is not taxed in Hong Kong and therefore double taxation is generally not a concern. Nevertheless, the Hong Kong government recognises that there are merits in concluding double taxation agreements (DTAs) with its trading partners. To date, Hong Kong government has concluded 3 comprehensive DTAs (covering various types of income) with Belgium, Thailand and the Mainland China. In addition, Hong Kong government has also concluded up to 25 double taxation relief arrangements with its aviation and shipping partners for airline income, shipping income, or both.

2. General provisions

The general provisions of the new DTA between Mainland China and Hong Kong signed on 21 August 2006 are summarized below:

	Mainland China	Hong Kong
Article 1: Persons covered	Tax Resident ^(note 1)	Tax Resident ^(Note 2)
	Tax resident of both Mainland China and Hong Kong	
Article 2 & 3: Taxes Covered (Excluding tax penalty and interest)	<ul style="list-style-type: none"> - Individual Income Tax - Foreign Investment Enterprise Income Tax - Any other identical or substantially similar taxes imposed after the date of signature of the Arrangement 	<ul style="list-style-type: none"> - Profits Tax - Salaries Tax - Property Tax - Any other identical or substantially similar taxes imposed after the date of signature of the Arrangement



<p>Article 5: Permanent Establishment (“PE”)</p>	<p>A fixed place of business through which the business of an enterprise is wholly or partly carried on, including:</p> <ul style="list-style-type: none"> - A place of management - A branch - An office - A factory - A workshop - A mine, an oil or gas well, a quarry or any other place of extraction of natural resources. - A building site, a construction, assembly or installation project or supervisory activities that last for more than 6 months. - The furnishing of services, including consultancy services, by an enterprise of One Side directly or through employees or other personnel engaged by the enterprise and continues (for the same or a connected project) in the Other Side for a period or periods aggregating more than 6 months within any 12-month period. - A person other than an agent of an independent status, is acting in One Side on behalf of an enterprise of the Other Side, and the person has, and habitually exercises, an authority to conclude contracts in the name of the enterprise. 	
<p>Article 21: Elimination of Double Taxation</p>	<p>Tax paid in Hong Kong is allowed to claim as a credit against Mainland China tax imposed. However, the amount of the credit shall not exceed the amount of Mainland China tax in respect of that item of income computed in accordance with Mainland China tax laws and regulations.</p>	<p>Subject to the provision of the Hong Kong tax laws, tax paid in Mainland China is allowed to claim as a credit against the Hong Kong tax imposed. However, the amount of the credit shall not exceed the amount of Hong Kong tax in respect of that item of income computed in accordance with the Hong Kong tax laws and regulations.</p>
<p>Article 24: Exchange of Information</p>	<p>Mainland China and Hong Kong competent authorities may exchange information (in particular, information for the prevention of fiscal evasion) that is necessary for carrying out the provision of the DTA or of the domestic laws concerning taxes covered by the DTA.</p>	
<p>Article 26: Effective Date</p>	<p>Income derived in taxable years beginning on or after 1 January in the calendar year following the year in which the DTA enters into force.</p>	<p>Income derived in year of assessment beginning on or after 1 April in the calendar year following the year in which the DTA enters into force.</p>

Note

1. Pursuant to Article 4 of DTA, Mainland China tax resident refers to any person that is liable to Mainland China tax thereon by reason of his domicile, residence, place of head office, place of effective management or any other criterion of a similar nature.
2. Pursuant to Article 4 of DTA, Hong Kong tax resident refers to any individual who ordinarily resides in Hong Kong; or stays in Hong Kong for more than 180 days during a year of assessment or for more than 300 days in 2 consecutive years of assessment one of which is the relevant year of assessment; or a company incorporated / constituted in Hong Kong; or a company incorporated /constituted overseas but normally managed or controlled in Hong Kong.

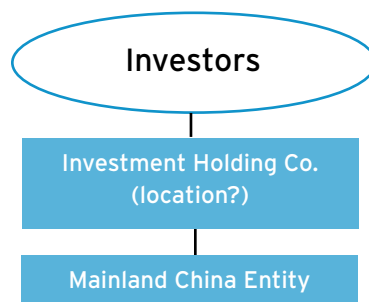
3. Right to Tax: Mainland China or Hong Kong?

The DTA establishes some guidelines to assign to one side or the other the primary right of taxation with respect to particular categories of income. We summarize below some common types of incomes' right of taxation from a Hong Kong tax resident's standpoint (i.e. a Hong Kong tax resident deriving such income from Mainland China):

Types of Income	Taxability in Mainland China
Income from Immovable Property (Article 6) Income derived by a Hong Kong tax resident from the direct use, letting, or used in any other forms from immovable property (including income from agriculture or forestry) situated in Mainland China.	- Withholding tax
Business Profits (Article 7) Profits (attributable to that PE) derived by a Hong Kong enterprise carrying on business in Mainland China through a PE.	- Enterprise Income Tax ("EIT") at 33% (or 15% if located in one of the five special economic zones or Pudong New Area in Shanghai) will be applied on the PE's taxable income (PE's taxable income = PE's gross income x deemed profit rate ranges from 10% to 40%). - Business Tax ("BT") at 5% of the total gross income.
Shipping, Air and Land Transport (Article 8) Income and profits derived by a Hong Kong enterprise from the operation of shipping, air and land transport in Mainland China.	- Exempt from any Mainland China taxes, including BT.
Dividends (Article 10) Dividends paid by a Mainland China company to a Hong Kong tax resident.	- Withholding tax (currently exempted for dividends paid by foreign investment enterprises)
Interest (Article 11) Interest arising in Mainland China and paid to a Hong Kong tax resident.	- Withholding tax

<p>Royalties (Article 12)</p> <p>Royalties arising in Mainland China and paid to a Hong Kong tax resident.</p>	<ul style="list-style-type: none"> - Withholding tax
<p>Capital Gains (Article 13)</p> <p>I. Gains derived by a Hong Kong tax resident from the alienation of immovable property situated in Mainland China.</p> <p>II. Gains derived from the alienation of movable property forming part of the business property of a PE which a Hong Kong enterprise has in Mainland China, including such gains from the alienation of such a PE (alone or with the whole enterprise).</p> <p>III. Gains derived by a Hong Kong enterprise from the alienation of ships or aircraft or land transport vehicles operated in shipping, air and land transport or movable property pertaining to the operation of such ships, aircraft or land transport vehicles.</p> <p>IV. Gains derived from the alienation of shares in a company situated in Mainland China.</p> <p>V. In other cases, gains derived from the alienation of any property.</p>	<p>Types (I), (II) and (IV)</p> <ul style="list-style-type: none"> - Withholding tax <p>Types (III) and (V)</p> <ul style="list-style-type: none"> - Exempt from Mainland China tax
<p>Income from Employment (Article 14)</p> <p>Remuneration derived by a Hong Kong tax resident in respect of an employment exercised in the PRC.</p>	<ul style="list-style-type: none"> - Mainland China individual income tax - Exempt if all the following 3 conditions are satisfied: <ul style="list-style-type: none"> · The recipient is present in the Mainland China for a period or periods not exceeding in the aggregate 183 days in any 12-month period commencing or ending in the taxable period concerned; and · The remuneration is paid by, or on behalf of, an employer who is not a Mainland China tax resident; and · The remuneration is not borne by a PE which the employer has in Mainland China.
<p>Directors' Fees (Article 15)</p> <p>Directors' fees and other similar payments derived by a Hong Kong tax resident from a Mainland China company.</p>	<ul style="list-style-type: none"> - Individual Income tax

4. Mainland China Investment Holding Structure



The government of Mainland China is planning to unify the corporate income tax rate for foreign and domestic enterprises as early as 2008. It has been noted that certain tax preferential treatments currently enjoyed by foreign investors may be eliminated. One of these preferences is the exemption of WHT on dividends paid by foreign investment enterprises to its foreign parent company. Certain practitioners have been advising clients to set up an investment holding company in Mauritius or Barbados to take advantage of the reduced withholding tax on dividend incomes as set out in the respective DTAs with China. In order to enjoy the treaty provisions, the companies set up in Mauritius or Barbados should be tax residents there. The effective corporate income tax rate for Mauritius and Barbados companies is 3% and 2.5% respectively.

With this new tax DTA and the fact that dividend income is exempted from tax in Hong Kong (exempt from profits tax at the Hong Kong company level and no withholding tax for dividend paid out from the Hong Kong company to its shareholder), Hong Kong is certainly the best choice for setting up a holding company for Mainland China investment, from a tax perspective.

The table overleaf summarizes the effective Mainland China withholding income tax rates with certain countries that have signed DTAs with Mainland China.



This is an edited version of an extensive article written by Dicky To of RSM Nelson Wheeler that deals at length with the DTA between China and Hong Kong. Interested readers should contact Dicky To for a copy of the full article or their local advisors for more information.

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	Effective Mainland China Withholding Tax Rate			
	Mauritius	Barbados	Singapore	Hong Kong
Income from Immovable Property	10% or 20%	10% or 20%	10% or 20%	10% or 20%
Dividends ^(Note 1)	5%	5%	7% or 12%	5% or 10%
Interest	10%	10%	7% or 10%	7%
Royalties	10%	10%	10%	7%
Capital Gains				
(a) Gains derived by a tax resident from the alienation of immovable property situated in Mainland China	10% or 20%	10% or 20%	10% or 20%	10% or 20%
(b) Gains derived from the alienation of movable property forming part of the business property of a PE which an enterprise has in Mainland China, including such gains from the alienation of such a PE (alone or with the whole enterprise)	10% or 20%	10% or 20%	10% or 20%	10% or 20%
(c) Alienation of shares in a company the assets of which are principally comprised, directly or indirectly, immovable property situated in Mainland China	10% or 20%	Exempted	10% or 20%	10% or 20%
(d) Alienation of shares (other than the shares referred to (c) above) of less than 25% of the entire shareholding of a Mainland China company	Exempted	Exempted	10% or 20%	Exempted
(e) Alienation of shares (other than the shares referred to (c) above) of more than 25% of the entire shareholding of a Mainland China company	Exempted	Exempted	10% or 20%	10% or 20%

Note 1: Under the prevailing PRC tax regulations, dividends payable by foreign investment enterprises in the PRC to their foreign investors are exempt from PRC withholding tax.

Offshore service incomes received in Singapore

Singapore taxation is based on territory concept and only incomes accrued in, earned from Singapore, or received in Singapore from outside Singapore are subject to tax.

Taxpayers who derive foreign-sourced incomes are not subject to tax when the incomes are not received or deemed as received in Singapore. The government is constantly reviewing the tax policy and has gradually removed the taxation of foreign-sourced incomes that are received or deemed as received in Singapore. However, as a general rule, foreign-sourced incomes are still taxable when received in Singapore.

The Misconception

The term "foreign-sourced income" is not defined anywhere in the Singapore Income Tax Act ("ITA"). Based on tax literature and case laws, sources of income are more certain in the case of royalty, interest, dividend and rental. The sources of these incomes are normally where the relevant assets are deployed or utilised. For royalty and rental income, it is usually the place where the properties are situated. Interest income is accrued at the location where the principal sum is utilised. Dividends are sourced from the country in which the dividend paying company is a tax resident.

In the case of service income, it should be the place of operation where the services are rendered. Owing to the lack of understanding of Singapore tax laws, foreign tax practitioners quite often share a common misconception that due to the territory tax concept, offshore service incomes derived by a Singapore resident company are not subject to tax in Singapore unless the incomes are remitted or deemed as remitted to Singapore.

Positions taken by the Inland Revenue Authority of Singapore

The above is a general misconception of some foreign tax practitioners. The Inland Revenue Authority of Singapore ("IRAS") will not regard service incomes as foreign-sourced unless they are derived from a fixed place of operation outside Singapore. Another important position the IRAS has taken is that all Singapore resident companies are deemed to be operating from Singapore unless they carry out their activities through a fixed place of operation outside Singapore. Consequently, service incomes derived by Singapore resident companies from the provision of services are normally deemed as sourced in Singapore unless proven otherwise.





The IRAS has clarified in its tax circular dated 30 July 2004 that service income is considered foreign-sourced if the service is rendered in the course of a person's trade, business or profession, through a fixed place of operation in a foreign jurisdiction. It also clarified that a fixed place of operation refers to a place of management, an office, or a certain amount of floor space ("premises or facility") at the disposal of a person carrying on a trade, business or profession of rendering services, through which he or his employees perform the activities that produce the profits of his trade, business or profession in the rendering of services. Such a place must also have features of permanence. Whether the premise or facility that is at the person's disposal has features of permanence is a question of fact. It is not of a temporary nature, but should be at the disposal of the person on an on-going basis and is being used regularly by the person to carry on his trade, business or profession of rendering services. A place of operation where only activities that are auxiliary or preparatory in character are performed does not qualify as a fixed place of operation.

Based on the above position, a team of auditors sent by a Singapore accounting firm for short-term overseas assignment outside Singapore will not be considered as rendering of foreign-sourced services unless the "features of permanence" as described above are met. As such, the audit fees derived from the services rendered outside Singapore are still deemed as sourced in Singapore.

For further clarification on offshore service incomes please contact your local expert or our Singapore office as listed below.

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The Netherlands - Corporate Income Tax Reform 2007

On 28 November 2006, the Upper House of the Netherlands Parliament adopted the Bill 'Work on Profit'. This Bill provides for significant changes to the Netherlands Corporate Income Tax Act 1969, as well to the Netherlands Income Tax Act 2001. The first proposals were published in a White Paper, issued earlier this year. It contained various proposals aimed at increasing the competitiveness of the Netherlands corporate tax system and to enhance the Netherlands investment climate.

Summary

The Corporate Income Tax Reform 2007 significantly reduces the tax rate but to broaden the taxable base. The reform involves numerous changes and the below overview focuses only on major changes and on changes relevant to international companies. The Bill will become effective on 1 January 2007. However, the Minister of Finance has requested the approval of the European Commission with respect to the compatibility with EU State aid rules of the provisions concerning the interest and patent box. These provisions will be effective with retroactive effect from the beginning of the year in which the approval has been granted.

Reduction of the corporate tax rate

The corporate tax rate will be further reduced from 29.6% to 25.5% with a lower rate of 20% for taxable profits up to € 25,000 and 23.5% for taxable profits between €25,000 and €60,000. The main corporate tax rate is deliberately kept above 25% to avoid Dutch subsidiaries triggering the application of CFC rules in some jurisdictions of their foreign parent company.

Reduction of dividend withholding tax rate

The domestic dividend withholding tax rate will be reduced from 25% to 15%. This impact may be limited since under most treaties concluded with the Netherlands the dividend withholding tax is reduced to 15% (or even lower). In many cross border EU situations it is questionable whether the dividend withholding tax is compatible with EU law anyway (Focus Bank Case E-1/104 and Denkavit C-170/05).

Restriction on loss compensation

The loss compensation will be limited to one year carry back and nine years carry forward. Currently carry back is allowed for three years whereas carry forward is indefinite. However, transitional rules are introduced, meaning that losses incurred in the calendar year 2002 and before, can be compensated with profits for the calendar years until 2011.

Boxes

A special tax rate is introduced for income derived from group loans, referred to as Group Interest Box. This box provides the balance of interest paid and received on intercompany loans will be taxed at an effective rate of approx. 5%. One of the conditions is that all group companies subject to Dutch corporation tax make a joint election.

An optional Patent Box is also proposed with an effective rate of approx. 10%. The income from a patent for the purpose of this box is defined as the benefit minus related R&D expenses, other charges and amortization of the IP. The Patent Box will only apply to patents that were first registered on or after 1 January 2007.





Participation exemption

The non-portfolio investment test for the application of the participation exemption to income derived from shares in foreign companies will be abolished. The revised participation exemption applies to any shareholding of at least 5% in both (i) active companies or ii) passive investments that are subject to an effective tax rate of at least 10%. The existing possibility to apply the participation exemption under certain conditions to interests of less than 5% will be abolished, however, transitional rules are introduced.

Depreciation

The depreciation of assets will be restricted. Real estate held as portfolio investment can only be depreciated to its fair market value (more precise, value according to the Law on Valuation of Real Estate (Wet Waardering Onroerende Zaken) (WOZ value); real estate owned for business purposes may be depreciated to 50% of its fair market value (WOZ value). Goodwill must be amortized over a minimum period of 10 years and other business assets must be depreciated over a minimum period of five years.

Restriction of interest deductions

The provisions limiting the deduction of interest, including thin capitalization, will be streamlined. In this respect, the clause in the CTA, which defines hybrid loans, will be abolished. Whether or not a loan must be treated as capital or as loan for tax aspects will be determined based on case law.

Capital Tax

Another important change has already been put through as the Netherlands Capital Tax has been abolished from 1 January 2006. Capital Tax used to be levied at a rate of 0.55% of the fair market value of all equity contributions to companies with a capital divided into shares that are resident in the Netherlands.

RSM Opinion

The Corporate Income Tax Reform 2007 is very good news for international operating companies who would like to use the Netherlands for its attractive tax environment and investment climate. The measures should make the Netherlands corporate tax system more competitive and attractive again for non-Dutch investors.

If you would like to discuss any of the matters raised by this article further, please contact your usual RSM expert or:

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