

INTERNATIONAL TAX NEWS

3/2009

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International Tax News

Welcome to Issue No. 3 of WTS Alliance International Tax News which provides you with recent tax developments across the globe. If you seek more information about a specific topic raised in this issue please contact the person named under the respective article. International Tax News is published on a quarterly basis by WTS AG in Germany. If you have any comments or suggestions concerning WTS Alliance International Tax News, please contact Silke Koehler, by email at silke.koehler@wts.de or by phone on +49 (0) 89 2864 6224.

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El Salvador

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Directorate General of Treasury, Directorate General of Customs and Excise will be merged to combat avoidance, evasion and smuggling in El Salvador

The government of the Republic of El Salvador announced in June 2009 the creation of a Directorate General of Tax Administration (DGAT) which will administrate taxes, duties and taxes on exports and imports and the collection, storage, delivery, transfer and registration of financial resources from the public treasury, with the aim of coordinating the databases of the three existing directorates in an attempt to better combat circumvention, evasion and smuggling, in order to prevent the increase of tax rates and the creation of new taxes in times of economic crisis.

At present the Ministry of Treasury through each direction carries its own accounts and at the time to know the record of a taxpayer, they have to apply for up to three reports leading to a poor fiscal control. For the government the solution is to create a single account per taxpayer and thus, streamline their operations, providing access to their files, improving the control system, registration, administration of Human Resources, financial and customer service.

A similar case was tried in Chile, where the government in order to combat tax evasion considered merging the Internal Revenue Service with the Department of Treasury, which could not be merged because it was concluded that the best resources to combat tax evasion was to maintain a good coordination between the two services, invest in new technologies, improve infrastructure, improve the capacity, experience and professionalism of staff and improve the control and supervision of operations of the taxpayer.

With the new policy, the government hopes to begin recovering those funds to help sustain in a short term the fiscal deficit, which according to official estimates is 208.9 thousand million dollars at the end of the year, equivalent to 5.4% of GDP.

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Germany

3/2009

Rejection of tax exemption with regard to holding and investment companies acc. to Art. 8b KStG (Corporate Tax Act) possible

The provision of Art. 8b para 7 KStG (Corporate Tax Act) is an exception from the general tax exemption of distributions and capital gains and enables credit institutions and financial service providers to offset losses in connection with shares in corporate entities. Also finance companies in the meaning of Art. 1 para 3 KWG (German Banking Act) are subject to Art. 8b para 7 KStG; thus, with regard to those companies, both dividends and capital gains are completely subject to tax if the shares have been acquired with the intention of a short-term realization of a proprietary trading profit.

According to a judgment of the BFH (Federal Tax Court), holding and investment companies shall be regarded as finance companies in the meaning of Art. 1 para 3 KWG, in case their main activity is the acquisition of shares. Therefore, it is neither necessary for the company to constantly transact its shareholding in the market, nor that the shareholding constitutes "typically" tradable shares.

The tax exemption only persists if the shares have not been acquired with a short-term proprietary trading intention; i.e. if the short-term resale from the company's own stock was not the target of the transaction. An acquisition of shares with the intention of a short-term realization of a proprietary trading profit can be assumed if the shares are allocated to the current assets. Therefore, the acquisition date shall be decisive; subsequent rededications into the fixed assets would be irrelevant.

In practice, more importance should be attached to the first booking of shares of a corporation with regard to holding and investment companies.

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3/2009

Innovations regarding the earnings stripping rule

The treasury department of Schleswig-Holstein has issued a new statement on 12 March 2009 regarding the earnings stripping rule. The statement is based on an inquiry concerning the application of the earnings stripping rule with regard to foreign corporate entities with cash basis income subject to limited tax liability. Foreign entities acquire domestic real estate and lease it on a long-term basis without rendering commercial ancillary services. According to the opinion of the treasury department of Schleswig-Holstein, the foreign entities are establishments in the sense of the earnings stripping rule, where the establishment comprises both the domestic and the foreign sections.

For the assessment period of 2008, Art. 8a para 1 sentence 4 KStG (Corporate Income Tax Act) feigns the characteristic of establishment. After the amendment of Art. 49 para 1 no. 2 letter f EStG (Income Tax Act) by the Annual Tax Act 2009, corporate entities subject to limited tax liability generate commercial income. Thus, the earnings stripping rule continues to apply to corporate entities subject to limited tax liability for their rental or lease income domestically, unless one of the exceptions of Art. 4h para 2 sentence 1 letters a to c EStG applies.

Within the scope of the rectifications regarding the corporate tax reform, the chairmen of the coalition fractions agreed to increase the tax threshold of the earnings stripping rule (Art. 4h para 2 sentence 1 letter a EStG) from currently 1 million Euro to 3 million Euro. The amendment shall apply for the first time for fiscal years starting after 25 May 2007 and not ending before 1 January 2008, and ultimately for fiscal years ending prior to 1 January 2010.

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Deduction of cost for headquarter (or intra-group) services

In two recent decisions, namely, Decision 6532 of 18th March 2009 and Decision No. 5926 of 12th March 2009, the Italian Supreme Court has provided valuable directions with respect to the deductibility regime applicable in relation to cross - border headquarter (or intra – group) services.

The first decision dealt with the deductibility on the head of the Italian permanent establishment of a Belgian company of a portion of the R&D and administrative expenses sustained by the latter.

The second decision dealt with the deductibility on the head of the Italian permanent establishment of a Hong Kong airline of a portion of the general and administrative expenses as well as of the overhaul expenses sustained by the headquarter.

With reference to both cases, the Supreme Court has affirmed that the general inherence requisite (according to which, expenses are deductible only if they are related to the business activity performed) is met when expenses are in broad terms related to the business activity conducted by the company and not necessarily to the revenues or to the specific tasks of the Italian branch.

As a consequence, the Supreme Court has reputed as acceptable any apportionment criterion of general expenses based on specific accounting and technical indicators, such as, for instance, the turnover of the local branch or, in the case of the foreign airline, the so – called “*maritime formula*”, without the need to scrutinize the inherence of costs on an item per item basis.

The decisions also provide practical insights with respect to the documentation of the aforementioned expenses. In particular, according to the Court, it is not necessary that the provided documentation “*analytically covers each single item of expense separately detected and considered*” but, rather, pre-eminence shall be attributed to financial statements, if certified by Auditors.

The decisions are particularly remarkable as they confirm an interpretative standing already adopted by the Supreme Court in two similar decisions published in 2008 (Case No. 4416/2008 and Case 6939/2008) with respect to the interpretation of Art. 7, Para. 3 of the OECD Model Convention, concerning the deductibility of executive and general administrative expenses.

The recent orientation also appears to be in line with the prescriptions of the cost allocation and apportionment methods foreseen by the OECD Transfer Pricing Guidelines. Apportionment inevitably involves estimates and approximations, to the extent that it is sometimes difficult to evaluate the relationship between expenses and the services rendered. Nonetheless, such methodology may be considered as acceptable when based on a sound rationale and is consistent with the specific circumstances at stake.

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Poland

3/2009

Interest on loans granted for dividend payments

Tax deductibility of interest paid on loans granted for dividend payment remains a controversial issue. Polish tax authorities claim that such interest is not tax deductible since the cost born by the taxpayer is not related to the generated revenues.

The Supreme Administrative Court Ruling

A positive ruling was issued recently by the Polish Supreme Administrative Court supporting the possibility to recognize interest paid on loans granted for dividend payments. Main arguments referred to by the Supreme Administrative Court were as follows:

1. If getting a loan was reasonable from the economic point of view, the interest on such loans granted for dividend payment is tax deductible for corporate tax purposes;
2. Denial of right to deduct such costs is against the principle of free movement of goods, which has been defined in Article 56 Sec. 1 of the Treaty establishing the European Community.

The above ruling is of particular importance since for many companies nowadays it is essential to maintain an adequate cash-flow.

Possibility to claim excise duty refund on electricity paid by energy producers

The European Court of Justice issued a ruling (C-475/07) in February, in which it confirmed that Poland had not harmonized the excise regulations with the EU Directive 2003/96 with respect to the moment when the excise duty on electricity becomes due. In accordance with Polish regulations (Poland had not introduced new regulations until March 2009) excise duty was due at the moment of supply by the energy producer whereas the Directive defines it as a moment of supply by distributor or re-distributor. The consequences of the ruling are not limited in time. The ruling enables a refund of excise duty paid by energy producers in the period between January 2006 and February 2009.

The tax authorities in Poland refused the refund of excise duty based on the unjustified enrichment argument.

The Supreme Court Ruling on the excise duty refund

Polish Supreme Administrative Court (NSA) issued a ruling on 13 July 2009 according to which energy producers are entitled to claim an excise duty refund on electricity, since Polish tax regulations do not contain the "unjustified enrichment" clause.

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Obama Tax Proposals

In May 2009, the Obama administration released its “Green Book” - General Explanations of the Administration’s Fiscal Year 2010 Revenue Proposals - which outlines a number of significant proposed changes to US international and domestic tax law. Certain of these proposals are summarized below.

A. Select International Proposals

1. **Check-the-Box Rules.** Currently, an eligible foreign entity may elect its US tax classification as a corporation (i.e., taxable entity) or as a pass-through entity (i.e., partnership, or in the case of an entity with a single owner, disregarded entity). Strategies have evolved in which US multinationals use these rules to avoid the application of anti-deferral rules involving controlled foreign corporations (CFCs). Some strategies involve the use of financing companies formed in tax havens, which make loans to “disregarded” operating companies located in higher-tax countries. Under the proposal, a foreign entity may be treated as a disregarded entity only if it is organized in the same foreign country as its owner. Except in cases of U.S. tax avoidance, the proposal would generally not apply to a foreign entity directly wholly owned by a US person.

2. **Deferral of Deduction for Foreign-Related Expenses.** The Administration’s proposal calls for a deferral of deductions for expenses (other than qualifying R&D expenses), that are allocable to foreign-source income that is not subject to current US tax. The deferred expenses could generally be carried forward to future years. The proposal is designed to prevent US taxpayers from taking current deductions for expenses attributable to foreign investments until the income from such foreign investment becomes taxable in the US.

3. **Foreign Tax Credit Reform.** A US parent company may generally claim a “deemed paid” foreign tax credit when a dividend is received (or deemed received) from a foreign subsidiary in which it holds at least a 10% interest. The deemed paid credit is calculated separately for each foreign subsidiary. This often encourages US multinationals to maximize their tax deferral by repatriating earnings from high-tax subsidiaries while keeping lower-tax earnings offshore. The Administration’s proposal would require US taxpayers to determine their deemed paid foreign tax credit on a consolidated basis by pooling the foreign taxes and earnings of all foreign subsidiaries. Further, the Administration proposes a matching rule that would prevent the separation of creditable foreign taxes from the associated foreign income where certain hybrid arrangements are in place.

B. Select Domestic Proposals

1. **Codification of the Economic Substance Doctrine.** The IRS often challenges the validity of transactions that lack sufficient “economic substance” and which are motivated primarily by US tax avoidance. The standards for mounting such challenges have largely developed through case law and are somewhat uncertain. Under the proposal, in order to satisfy the economic substance doctrine: (i) the transaction must change in a meaningful way the taxpayer’s economic position (apart from federal tax consequences), and (ii) the taxpayer must have a substantial purpose (other than a federal tax purpose) for entering into the transaction. A nominal profit potential would not be sufficient to establish economic substance. Rather, the value of the expected pre-tax profit must be substantial in relation to the value of the federal tax benefits arising from the transaction.

2. **Repeal of LIFO Method.** Under current law, certain taxpayers may use the LIFO (last-in, first-out) method to determine inventory values. This may afford a benefit to taxpayers with rising inventory prices. The proposal would repeal use of the LIFO method and would require taxpayers to use the FIFO (first-in, first-out) method.

3. Tax Carried Interest as Ordinary Income

Under current investment fund structures, the general partner (and thereby the individual partners behind the general partner) earn the bulk of their profit through the receipt of a “carried interest” in the fund’s profits (e.g., often 20% of the total profit). One of the key tax objectives of fund principals is the treatment of this income as capital gains, which may allow for reduced federal income tax rates (e.g., 15%). Under the Administration’s proposal, a partner’s income from a “service partnership interest” (SPI) would be subject to tax as ordinary income (e.g., 35% federal tax). An SPI would typically include a carried interest held by a person who provides services to the partnership/fund. This would presumably sweep in most general partner principals in hedge funds and private equity funds.

Some of the Obama proposals are already embodied in proposed legislation sponsored by members of Congress. Other proposals are awaiting sponsorship and memorialization in draft legislation. Since many of the proposals are expected to generate significant revenue as part of the Administration’s 2010 budget, it is expected that they will have a high priority in the coming months.

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