www.taxbites.be

Practical European
Tax Strategies

WorldTrade Executive, Inc.
The International
Business Information
Source™

Report on Tax Planning for International Companies Operating in Europe

May 2005
Volume 7, Number 5

The Gateway Between Europe And the Far East

BY MARC QUAGHEBEUR
(VANDENDIJK & PARTNERS, BRUSSELS)

This article explores various strategies using the current income tax treaty in force between Belgium and Hong Kong. Those strategies include creating holding company structures and other arrangements to repatriate profits between Europe and Hong Kong and to finance investments in both Europe and the Far East.

The double taxation agreement signed between Belgium and Hong Kong in 2003 is a good conduit for repatriating profits between Europe and Hong Kong, or for financing investments in Europe or in the Far East. With the publishing of an administrative note, the Belgian tax authorities have highlighted the strengths of the treaty, and Belgian Finance Minister Reynders is proud to present this new link as the "gateway" between Europe and the Far East.

continued on page 14

EU Cross-Border Loss Relief

BY BILL CAPORIZZO, SIMON COURT,
JAMES HILL, CHRISTOPHER PROUT, AND BOB STACK
(WILMER CUTLER PICKERING HALE AND DORR)

In this article, the authors explain the potential impact of a forthcoming European court decision on the ability of groups of companies with operations in more than one EU member state to offset losses suffered in one member state against profits made in another. The article also suggests steps groups could take now to take full advantage of the expected favorable decision.

An Opportunity to Reclaim Tax

Tax relief for trading losses is a fundamental part of most corporate tax systems, but the rules allowing this relief are often narrowly drawn. The UK food and clothing retailer Marks & Spencer looks likely to score a significant victory that should increase the ability of businesses with operations in more than one EU member state to offset losses suffered in one member state against profits made in another, thus reducing their overall effective EU tax rate.

continued on page 2

IN THIS ISSUE

Tax Treaties
We begin with an article that describes strategies using the current income tax treaty between Belgium and Hong Kong as a tool for repatriating profits and financing investments. *Page 1.*

Cross-Border Losses
A European court decision on the ability of consolidated corporate groups to make full tax use of their cross-border losses is likely to have a significant impact on their effective EU tax rates. *Page 1.*

Legislative Developments
We bring you an update on significant tax law changes included in the UK's 2005 Finance Bill. *Page 3.*

Country Focus
Far-reaching corporate tax law changes in the Netherlands will cause many multinational groups to rethink how they structure their activities in Europe. *Page 5.*

Transfer Pricing
New German transfer pricing guidelines give direction to auditors and taxpayers on establishing arm's-length prices and help taxpayers comply with extensive new German documentation rules. *Page 9.*

Tax Penalties
Recent decisions from the Dutch Supreme Court on certain tax penalties could substantially affect the bottom lines of enterprises that have made the Netherlands their European home. *Page 12.*

Snapshots
Pages 4 and 19.

 © WorldTrade Executive, Inc. 2005

www.taxbites.be

Gateway from page 1

The Double Taxation Agreement

The double taxation agreement with Belgium was the first comprehensive double taxation agreement signed by the Chinese "Special Administrative Region" of Hong Kong. The Special Administrative Region has not signed any other comprehensive double taxation agreements, yet.

First rounds of treaty discussions with Italy and with the Netherlands were held at the end of 2004. Hong Kong's discussions with France and Denmark are in an advanced stage, but Hong Kong is reluctant to apply the 2004 version of the Organization for Economic Cooperation and Development (OECD) model tax convention regarding the exchange of information. A treaty with Thailand may be expected soon.

Hong Kong had signed a Memorandum of Understanding (MOU) on the Arrangement for Avoidance of Double Taxation with the People's Republic of China, but this MOU does not address the treatment of dividends, interest, or royalties.

Hong Kong's discussions with France and Denmark are in an advanced stage, but Hong Kong is reluctant to apply the 2004 version of the OECD model tax convention regarding the exchange of information.

Therefore, the double taxation agreement between Belgium and Hong Kong gives Belgium a competitive advantage. Moreover, it is a good conduit for repatriating profits between Europe and Hong Kong or for financing investments. The following provisions are relevant in this respect.

Dividends

The treaty allows a limited taxation of dividends in the source country. The standard withholding tax rate is 15 percent. The rate is reduced to five percent if the beneficiary of the dividends is a company holding a direct participation of at least 10 percent.

There is no withholding tax if the parent company has kept a 25-percent participation for 12 months without interruption.

Interest

As for interest, the Belgium-Hong Kong treaty allows a withholding rate of 10 percent. However, no withholding tax is due on interest paid on commercial paper, purchase financing, export financing by a government entity, loans from banks or financial entities, *etc.* Any excessive interest remains taxable in accordance with the domestic law of the country from which the interest was paid.

Royalties

While Belgian companies paying out royalties typically must withhold tax at a rate of 15 percent, this rate is reduced to five percent under the Belgium-Hong Kong treaty.

To eliminate double taxation, Hong Kong uses the credit method. Belgium has opted for a variation of the "exemption with progression" method for income that is liable to tax in Belgium and in Hong Kong.

Permanent Establishments in Hong Kong

In practice, the exemption with progression method of eliminating double taxation means that Belgian companies will not pay Belgian income tax on profits that have been taxed in Hong Kong. However, Hong Kong applies the "territorial principle" when it taxes Hong Kong companies and permanent establishments. It exempts foreign (*i.e.,* non-Hong Kong) source income.

This means that Belgium could refuse to exempt non-Hong Kong-source income, such as profits from the People's Republic of China, for example. In this respect Article 7 of the protocol explicitly states that elements of income which are considered not taxable or tax-exempt in Hong Kong do not qualify for exemption in Belgium.

In an administrative note dated March 31, 2005, the Belgian tax authorities confirmed that they will exempt all profits realized by a permanent establishment if the branch has paid some income tax in Hong Kong. This also applies to profits that are not liable to tax in Hong Kong because they are not arising in, or derived from, the Special Administrative Region.

This administrative note explicitly refers to the protocol that grants an exemption from taxation for dividends paid in connection with a holding that is effectively connected with a permanent establishment in Hong Kong, interest paid on a debt claim effectively connected with the permanent establishment, and royalties paid for a right or property effectively connected with this permanent establishment.

 © WorldTrade Executive, Inc. 2005

www.taxbites.be

The Participation Exemption in Belgium

To prevent the double taxation of dividends received, Belgium grants a participation exemption for certain dividends received by a parent company. The dividends are eligible for a 95-percent exemption if the parent company holds a participation of at least five percent of the subsidiary's nominal share capital or, alternatively, with an acquisition value of at least €1,200,000. Further, the subsidiary must not fall within a specific anti-avoidance exclusion. In practice, this means that the subsidiary must meet a "subject-to-tax" condition.

Generally speaking, a foreign subsidiary must be subject to a corporate income tax that is equivalent to the Belgian corporate income tax. Dividends from foreign subsidiaries are also excluded in a five specific situations. Several of these exclusions could apply to the dividends received from a Hong Kong subsidiary:

(1) The subsidiary must have its residence in a country in which the ordinary corporate income tax regime is considerably more favorable than that of Belgium. The criterion is that the nominal tax rate, or the tax burden under the ordinary tax regime, is not less than 15 percent. To ensure legal certainty, a Royal Decree of 13 February 2003 lists the countries that have a substantially more advantageous corporate income tax regime than Belgium.

(2) If the subsidiary is a financing, treasury, or investment company, it can be excluded to the extent that it enjoys a special tax regime deviating from the general tax regime of its state of residence (with certain exceptions).

The administrative note confirms that the dividends paid out by a Hong Kong subsidiary will generally qualify for the participation exemption in Belgium.

(3) If the subsidiary derives its income (other than dividend income) from sources outside its state of residence, that income from offshore activities must not benefit from a special tax regime in that state.

(4) If the subsidiary derives profits through a foreign permanent establishment, the tax regime applicable to this permanent establishment must not be considerably more favorable than the one that would apply to

continued on page 16

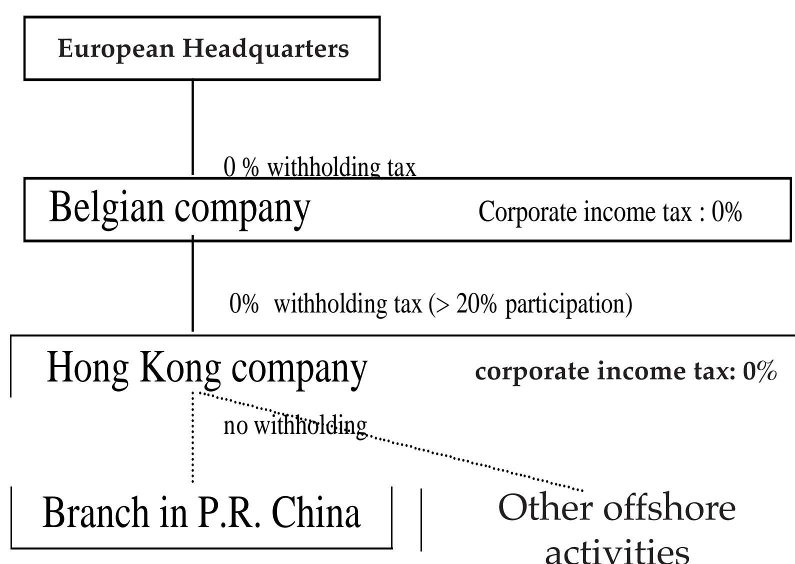

Table 1. Tax efficient repatriation of profits from the Far East

© WorldTrade Executive, Inc. 2005

www.taxbites.be

Gateway from page 15

those profits in Belgium. This exclusion does not apply if Belgium has a tax treaty with the country of the permanent establishment, or if the foreign tax actually paid on the profits of the permanent establishment is at least 15 percent (as computed by using Belgian standards).

The double taxation agreement between Belgium and Hong Kong offers an interesting channel through which to repatriate profits between the Far East and Europe and to set up financing and licensing operations.

(5) Finally, if the subsidiary is a conduit company that passes on dividends from other companies, at least 90 percent of those dividends must qualify for the participation exemption.

The administrative note confirms that the dividends paid out by a Hong Kong subsidiary will generally qualify for the participation exemption in Belgium.

In the first place, even if Hong Kong's 17.5-percent tax rate is more advantageous than the Belgian corporate income tax rate, it is not substantially more advantageous (*see* exclusion 1). However, because Hong Kong only charges a 17.5-percent profits tax on income from onshore activities, the tax burden of a Hong Kong subsidiary can be very low if it has substantial offshore profits. The tax authorities confirm that this does not jeopardize the participation exemption.

This position will normally apply to a subsidiary that derives its profits from a permanent establishment that is subject to a considerably more favorable tax regime than the one that would apply to such profits covered by exclusion 4.

In any event, these dividends could not be excluded if the permanent establishment is located in a country that has signed a double taxation agreement with Belgium. This is the case for Australia, Bangladesh, the People's Republic of China, India, Indonesia, Japan, Malaysia, New Zealand, Pakistan, the Philippines, Singapore, South Korea, Sri Lanka, Thailand, and Vietnam. A double taxation agreement with Taiwan awaits ratification.

The administrative note also confirms that dividends from a Hong Kong subsidiary that is either a financing, treasury, or investment company, or that has income from offshore activities (exclusions 2 and 3) cannot be excluded from the participation exemption.

The administrative note acknowledges that the territorial principle is the ordinary tax regime in Hong Kong and not a special tax regime that deviates from the ordinary tax regime.

Generally speaking, the only situation in which a Hong Kong subsidiary cannot be used is when it is used as a conduit company for dividends from a third country, which would not qualify for the participation exemption.

Using the Agreement to Invest

The double taxation agreement between Belgium and Hong Kong offers an interesting channel through which to repatriate profits between the Far East and Europe and to set up financing and licensing operations.

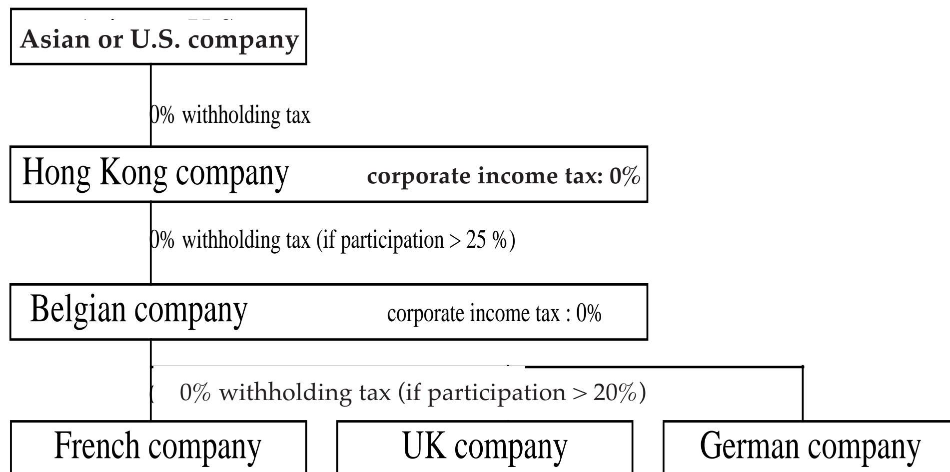

Table 2. Tax efficient repatriation of profits from Europe

 © WorldTrade Executive, Inc. 2005

www.taxbites.be

Investing in the Far East through Belgium

A Belgian company can repatriate profits without any major withholding tax in Belgium or Hong Kong.

Profits realized through a Hong Kong branch do not attract any further tax in Belgium if the branch has paid some income tax in Hong Kong.

As for a Hong Kong subsidiary, it will not be liable for the profits arising outside of or derived from outside the Hong Kong Special Administrative Region. These profits do not incur any withholding tax when they are paid out from Hong Kong. There is no withholding tax on dividends or on interest. Moreover, the current 5.25-percent withholding tax on royalties is reduced to five percent under the Belgium-Hong Kong treaty.

Dividends received from a Hong Kong subsidiary qualify for the 95-percent participation exemption if the recipient holds a participation of at least 10 percent of the subsidiary's capital, or if it is a participation with an acquisition value of at least €1,200,000. Only five percent of the dividend is subject to corporate income tax at the 33.99 percent. However, the holding company can set off a number of expenses against this taxable basis, including its interest expenses.

Capital gains realized by Belgian companies on the sale of shareholdings in Hong Kong subsidiaries are fully tax exempt.

Finally, the European Union (EU) Parent-Subsidiary Directive prevents Belgium from imposing withholding tax on any dividends paid out to a parent company that holds at least 20 percent of the share capital (or voting rights) of the company paying the dividend for an uninterrupted period of at least 12 months. This shareholding requirement will be gradually reduced to 10 percent by January 1, 2009.

For dividends paid out to a non-EU parent company, one must rely on Belgium's extensive treaty network, which reduces the tax rate to 15 percent, 10 percent, or even as low as five percent.

Capital gains realized by Belgian companies on the sale of shareholdings in Hong Kong subsidiaries are fully tax exempt.

Investing in Europe through Hong Kong

The double taxation agreement between Belgium and Hong Kong does not include a limitation on benefits provision. Non-Hong Kong investors can use this double taxation agreement to gain access to other EU jurisdictions through a Belgian holding company under a Hong Kong parent company.

Under the EU Parent-Subsidiary Directive, a subsidiary in one of the 24 other EU member states can pay out a dividend that will not attract withholding tax if the Belgian parent company holds at least 20 percent in the share capital of the subsidiary. In the worst case scenario, the Belgian company will have to pay 33.99 percent

continued on page 18

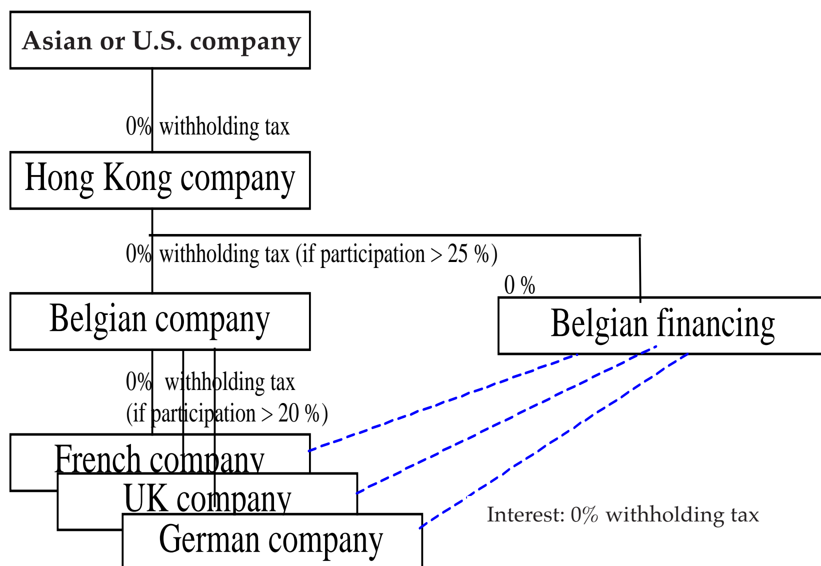

Table 3. Tax efficient financing in Europe

 © WorldTrade Executive, Inc. 2005

www.taxblog.be

Gateway from page 17

corporate income tax on five percent of the dividend (*i.e.*, 1.7 percent) -- that is, assuming it does not have any expenses to set off against the taxable basis.

Further, if the Hong Kong parent company holds 25 percent or more of the Belgian company's share capital, there will be no withholding tax. The dividends will not attract any profits tax or withholding tax in Hong Kong.

As mentioned above, capital gains realized by a Belgian company on the sale of a shareholding in a Hong Kong subsidiary are fully tax exempt.

The EU Parent-Subsidiary Directive prevents Belgium from imposing withholding tax on any dividends paid out to a parent company that holds at least 20 percent of the share capital (or voting rights) of the company paying the dividend for an uninterrupted period of at least 12 months. (This will fall to 10 percent in 2009.) A non-EU parent company will have to find a channel through Belgium's extensive treaty network with which to reduce the tax rate to 15 percent, 10 percent, or even five percent.

The Belgian government has presented a legislative bill to the Belgian Parliament, which would make Belgium an attractive place again for investing in Europe -- as of 2006.

A Belgian company can be used to finance the group in a tax-efficient manner. EC Directive 2003/49/EC of 9 June 2003 has introduced a common system of taxation applicable to interest and royalty payments made between associated EU companies. In so far as the companies are held within one group with a 25-percent shareholding, no tax is withheld at the source on the payment of interest. A bill introduced before the Belgian Parliament will make this even more interesting. (*See* Table 3.)

Other Benefits of the Belgian Tax System

The Belgian government has presented a legislative bill to the Belgian Parliament, which would make Belgium an attractive place again for investing in Europe -- as of 2006. The new measures in the legislation could also offer a solution to the problem of the ending of the Belgian coordination center regime by the end of 2010.

Over the last 20 years, Belgium has established a reputation as a tax-attractive location for finance centres of multinational groups. Belgian coordination centres were an attractive vehicle for the centralization of shared functions (including finance) on a pan-European basis.

The first measure is the abolition of the 0.5-percent capital duty on share capital increases and contributions to a company's share capital. These capital contributions and increases will only attract a fixed duty of €25, which is generally tax deductible for Belgian income tax purposes.

Denmark, France, and Germany may have a zero-percent capital duty, but they have controlled foreign corporation (CFC) rules. Further, among the countries that do not have CFC rules, most of them have a capital duty ranging from 0.50 percent (Ireland) to 0.55 percent (the Netherlands, although this may be abolished soon), and 0.6 (Austria, Luxembourg, and Switzerland).

More important, there is the risk capital tax deduction. This is a standard deduction to which all Belgian companies will be entitled as an enticement to "auto-finance" their investments, and to strengthen their capital structure compensation. The deduction will be compensation for the economic cost of using the company's equity, at a rate that reflects the cost of long-term, risk-free financing. The deduction will be based on the interest rate paid on 10-year linear bonds issued by the Belgian state (currently around 3.70 percent). This interest rate would be calculated on the company's share capital and reserved profits, with certain adjustments to prevent double deductions and abuses.

Advance Rulings

Belgium recently modernized its advance ruling practice to enable the ruling committee to provide more legal certainty with respect to tax due.

In the past, the Belgian ruling system was limited to a specific number of tax issues, such as anti-abuse provisions, the tax consequences attached to certain investments, the applicability of tax incentives, and certain transfer pricing issues. The ruling committee can now grant unilateral rulings on the tax consequences of intended transactions, although it cannot grant tax exemptions or reductions.

Under the new ruling practice, a taxpayer would be able to request a ruling on all tax queries, unless:

- the tax law specifically indicates that a ruling cannot be requested;
- the activity does not have a sufficient economic substance in Belgium, or the transaction or situation does not have any practical economic effect, with the exception of the tax savings; or

 © WorldTrade Executive, Inc. 2005

www.taxbites.be

- a tax haven is involved, which does not cooperate with the OECD.

Further, rulings cannot be given for disputed transactions or situations, or if the taxpayer has already implemented identical transactions or situations.

A ruling would generally be valid for five years, but could be granted for a longer time period in certain cases. Moreover, it would be possible to request a renewal of a ruling.

Rulings are also published anonymously. The Belgian tax authorities are bound by a ruling unless: (a) the facts were incorrectly described; (b) the taxpayer does not abide by the conditions set forth in the ruling; (c) the ruling is in conflict with a tax treaty, or domestic or EU law; or (d) the law has been changed subsequently.

A combination of these elements can, indeed, be used to optimize any investment and financing structure between Europe and the Far East, and they can even give non-Hong Kong investors an opportunity to venture into Europe. ❑

Marc Quaghebeur is an international tax lawyer and partner with Vandendijk & Partners Avocats/Advocaten, Tax Lawyers, in Brussels. Mr. Quaghebeur can be contacted by telephone at 32-2-343-3345, or by email at marc.quaghebeur@vandendijk-taxlaw.be.

Value-Added Taxes

New Report Out on "B2C" VAT Regime

The European Commission's Directorate-General for Taxation and Customs Union (DG TAXUD) launched an online consultation in February on problem areas the Commission identified in Article 9 of the Sixth VAT Directive (Directive 77/388/EEC of 17 May 1977) with respect to services supplied to nontaxable persons or final consumers (B2C supplies). The document also provided an overview of possible changes in the rules to solve the problems. The Commission sought reactions and input on the proposed changes. The consultation period officially ended in April, but contributions received during April were also considered.

Key Results

A total of 71 external contributions were received in response to the consultation. Of that total, 47 were from national and European federations or associations, 22 were from business and two were from individuals.

A total of 71 external contributions were received in response to the consultation. Of that total, 47 were from national and European federations or associations, 22 were from business and two were from individuals.

The main industry sectors reacting to the consultation were the telecommunications and e-commerce sectors, the transport sector, consultants and law firms, the restaurant and travel agents sector, car leasing companies, the entertainment and publishers' sector, and financial institutions.

The majority of respondents were supportive of the proposed changes with respect to the place of taxation of services supplied to final consumers. However, there were various comments that called for continuing the place of origin system and for maintaining the current general rule.

Most replies related to the part of the proposal that changes the place of supply of services supplied at a distance, which would see these services taxed in the customer's European Union (EU) member state. A number of comments opposed the proposed changes, asserting that they would result in additional administrative burdens and practical problems and the respondents that agreed with the proposed changes said that they could only accept them if, before any changes were made, the proposed "one-stop" VAT collection mechanism was put into place.

For access to the full text of the report, and information about the DG TAXUD's one-stop mechanism, visit the organization's website at *europa.eu.int/comm/taxation_customs*.

Source: European Commission, Directorate-General Taxation and Customs Union. ❑

 © WorldTrade Executive, Inc. 2005