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International Comparison of Holding Companies – How Does Australia Match Up?

Prior to the Review of Australia’s International Taxation Arrangements (RITA) by the Board of Taxation (BOT) and its subsequent report to the Treasurer on 28 February 2003, Australia was not viewed as an attractive holding company location due to the wide reach of its tax net. Since then, however, a number of improvements to Australia’s international tax rules have greatly increased the competitiveness of Australian companies with offshore operations, which has promoted Australia as a holding company location for corporate groups with an international focus.

This article summarizes the key developments in Australia’s international tax rules since the release of the RITA report, as well as some anticipated future changes. It then compares Australia as a holding company location with a number of countries that are traditionally viewed as efficient holding company jurisdictions.

Key International Developments

In recent years, Australia has implemented a number of significant RITA and other reforms that have enhanced the country’s attractiveness as an international holding company location. The main reforms are outlined below.

Foreign Dividends – Since 1 July 2004, dividends received by an Australian resident company are treated as non-assessable, non-exempt income of the company to the extent the dividends are paid by a nonresident company in which the Australian resident company holds at least 10% of the voting power (i.e. a non-portfolio dividend). Before 1 July 2004, such non-portfolio dividends were only regarded as non-assessable, non-exempt income if those dividends were paid from
comparably taxed profits, i.e. paid by a company resident in a “listed country” (i.e. the U.S., Canada, France, Germany, the U.K., Japan or New Zealand).

This legislative change has clearly enhanced Australia’s attractiveness as an international holding company location since Australian holding companies that receive dividends from non-portfolio investments in nonresident companies are no longer subject to Australian income tax on those dividends.

**Foreign Branch Profits** – Similarly, since 1 July 2004, income and capital gains derived by Australian resident companies from foreign branches are regarded as non-assessable and non-exempt income in Australia, regardless of where those profits are sourced, provided those profits are derived from carrying on an active business. Previously, income and capital gains derived by Australian companies from foreign branches were generally subject to Australian income tax unless the profits were derived from a comparably taxed source country (i.e. a listed country).

In this regard, Australian holding companies can now broadly derive income and gains from foreign branches that carry on active businesses in a foreign country free from Australian income tax. From a practical perspective, this change provides an Australian holding company with tax efficient access to net foreign branch profits or gains, which the company may use to fund existing operations of the group or future acquisitions.

**Capital Gains Tax Participation Exemption** – Since 1 April 2004, capital gains or losses made by Australian resident companies or their controlled foreign companies (CFCs) on the disposal of non-portfolio interests in a foreign company may, broadly, be reduced to the extent the foreign company carries on an active business. However, this capital gains tax (CGT) participation exemption only applies where at least a 10% direct voting interest is held in the foreign company for a continuous period of 12 months in the two years before the disposal.

Where the CGT participation exemption applies, the gain or loss is reduced by a percentage that reflects the degree to which the assets of the foreign company are used in an active business (i.e. active foreign business asset percentage). Where the active foreign business asset percentage is 90% or more, capital gains or losses are reduced to nil. If the result is less than 10%, all capital gains will be taxable and all capital losses will be available. In all other cases, the gain or loss will be reduced by the active foreign business asset percentage.

Importantly, modified rules apply to foreign wholly owned groups under which a holding company can chose to calculate the active foreign business asset percentage of the top foreign company on a consolidated basis as part of determining the foreign company’s active foreign business asset percentage.

Prior to 1 April 2004, a disposal of shares in foreign companies was subject to CGT in Australia, while a disposal of active business assets by foreign companies was not subject to tax in Australia under the CFC rules. Clearly, this treatment created a bias towards asset sales rather than share sales and may have been viewed as a disincentive for foreign companies considering Australia as a possible holding company location.

A CGT participation exemption is an essential requirement of any country seeking to promote itself as an international holding company location. The introduction of the CGT participation exemption in Australia now places Australia on a par with countries such as the Netherlands and Singapore, which are traditionally viewed as favorable holding company locations.

The Australian CGT participation exemption provides Australian holding companies with greater flexibility in restructuring corporate groups, as the sale of shares or assets in foreign companies with active businesses should result in the same tax outcome.
Note that countries such as the Netherlands may still be viewed as a more favorable location than Australia due to the interaction between its CGT participation exemption regime and the capital gains article in some tax treaties, where gains from the alienation of property other than immovable property, movable property forming part of the business property of a permanent establishment (PE), and ships and aircraft operating in international traffic, will be taxable only in the contracting state of which the alienator is a resident. For example, if a company resident in the Netherlands disposes of its shares in its Korean subsidiary, no tax would be levied in the Netherlands due to the participation exemption and no tax would be levied in Korea because the Netherlands-Korea tax treaty provides that only the Netherlands can tax such a gain. This feature is not contained in Australia’s tax treaties.

**Income Attribution from Controlled Foreign Companies** – Broadly, Australia’s CFC rules require Australian companies to include in their assessable income passive and related party income derived by foreign companies that they control, even where the income has not been repatriated to Australia. Although these rules are complex, the RITA reforms have simplified them in some respects for Australian holding companies that have CFCs.

Since 1 July 2004, Australia has reduced the types of income derived by CFCs in listed countries that must be attributed to Australian controllers. Broadly, the categories of income that are attributable are now specifically identified for each listed country and, broadly, comprise income that is concessionally taxed in comparably taxed countries (e.g. capital gains in New Zealand).

In addition, the Australian government has proposed that CFCs controlled by CFCs in listed countries should not be subject to attribution under Australia’s CFC rules (known as the "push down proposal"). While legislation relating to this measure has not yet been introduced, the proposed measures should reduce CFC compliance costs for Australian holding companies with multiple tiers of CFCs.

Since 1 July 2004, income derived by CFCs from the provision of services to foreign associates is also no longer included in attributable income. This allows offshore service companies of Australian holding companies to provide services to non-Australian members of the group without triggering an Australian tax liability.

The government has also commenced a review of Australia’s anti-tax deferral rules, including the CFC rules. The push down proposal has not yet been discussed under this review. The anti-tax deferral rules review is discussed further below.

**Conduit Foreign Income** – The conduit foreign income (CFI) regime, broadly, allows Australian companies to distribute dividends to foreign resident shareholders free from Australian income tax to the extent those dividends are paid out of foreign-source income that is declared to be CFI. These rules have been in place since 1 July 2005.

While the CFI regime is an expansion of the previous foreign dividend account rules, the measures simplify the rules so that foreign dividend accounts are no longer required to be maintained. In addition, the CFI regime broadens the categories of foreign income that can be on-distributed to foreign resident shareholders free from Australian tax. Some examples of CFI include foreign non-portfolio dividends received by an Australian company, foreign branch profits, capital gains on the disposal of shares in a foreign company with an underlying active business, foreign income (e.g. royalties) and net capital gains included in the assessable income of a corporate tax entity where the Australian tax liability on that income is reduced by foreign tax credits or foreign income tax offsets.

When the CFI regime is taken together with the expansion of the rules regarding exempt foreign dividends and exempt foreign branch income and gains, Australia may be viewed as a country that has a tax efficient conduit regime. The ability to pass certain foreign income through a jurisdiction...
free from income tax in that jurisdiction is an important characteristic of any country promoting itself as an international holding company location, and should result in Australia being regarded as a viable alternative to other holding company locations.

**Taxation of Nonresidents on Disposal of Real Property and Branch Assets** – To further Australia’s aim to be considered a favorable location for conducting international business, Australia recently introduced another significant change to its tax laws by narrowing the CGT tax base for foreign residents. Under these new rules, foreign residents will only be subject to CGT on disposals of real property situated in Australia, indirect Australian real property interests (see the interposed entity integrity measure discussed below) and on business assets of an Australian branch. This will effectively abolish Australian CGT for foreign residents on a wide range of assets (e.g. disposal of non-portfolio interests in Australian companies provided these entities are not “land rich”).

The new rules include an interposed entity integrity measure, however, which may result in Australian CGT for a foreign resident selling shares in a foreign resident company, if the value of the company is derived wholly or principally from real property in Australia.

These changes bring Australia’s CGT rules and tax treaty practice closer in line with the OECD standards.

**Foreign Loss and Foreign Tax Credit Quarantining** – As foreshadowed in the 2005 federal budget, the government recently abolished the foreign loss and foreign tax credit quarantining rules for Australian companies. In the case of foreign losses, this means that, in utilizing deductions, no distinction is made between the foreign-source or domestic-source assessable income. When working out the entitlement to a foreign tax credit or the foreign income tax offset companies are no longer required to quarantine assessable foreign income into four classes and establish that a double taxed amount has a foreign source. The foreign income tax offset, however, is non-refundable and excess offset cannot be carried forward. The shift towards a participation exemption system diminished the need for these quarantining rules.

Under the foreign income tax offset rules, an attributable taxpayer of a CFC is still entitled to a credit for foreign income taxes and Australian taxes paid by the CFC; however a credit will be available for withholding tax paid on repatriation of previously attributed amounts only for first-tier CFCs.

These changes took effect from 1 July 2008 for June year-end entities.

**Review of Anti-Deferral Regimes** – On 10 October 2006, the government announced a review of the foreign-source income anti-tax deferral rules. The BOT released a discussion paper on 25 May 2007 and, following consultation, released a position paper on 12 March 2008 setting out the Board’s considered views on the high-level principles that should apply in the future design of the foreign-source income attribution rules. Particularly pleasing for taxpayers were the Board’s positions on potential exemptions for Australian listed companies and entities that tend to fully or substantially distribute their foreign income (such that no or minimal deferral advantage is obtained).

The BOT released specific Issues Papers on 19 May 2008 highlighting issues for further consultation, such as a listed public company exemption, the scope of the active investment exemption, a distribution exemption, identification of which interests are subject to attribution taxation and simplification of branch-equivalent calculations. It is expected that the Board’s review will, at the very least, result in further refinements to Australia’s CFC rules, although any changes may not be legislated for some time.

The current CFC rules represent the main drawback for Australia’s attractiveness as a holding company location. If the policy objective is to encourage the establishment in Australia of regional
headquarters for foreign groups, Australia’s anti-tax deferral rules need to adapt to the increasingly integrated global economy.

**Australia’s International Taxation Rules – Where Are We Now?**

This section provides an overview of Australia’s current international taxation rules with a view to facilitating a comparison with the rules of a number of other common holding company locations.

**Treatment of Inbound Dividends** – Broadly, dividends received by an Australian resident company from nonresident companies are assessable to income tax in Australia to the extent the dividends are paid by a nonresident company in which the Australian resident company holds less than 10% of the voting power (i.e. portfolio dividends). A foreign income tax offset may be available, however, for foreign tax paid in the source country.

As outlined above, non-portfolio dividends received by Australian resident companies from nonresident companies are non-assessable, non-exempt income.

Importantly, dividends received by Australian resident companies from eligible CFCs out of profits that have previously been attributed back to Australia under the CFC rules are exempt, to prevent double taxation of the same profits.

**Treatment of Outbound Dividends** – Franked dividends may be distributed free of withholding tax. Unfranked dividends paid by an Australian resident company to a resident of a country with which Australia does not have a double taxation agreement are subject to a 30% dividend withholding tax.

Where an Australian resident pays unfranked dividends to a resident of a country with which Australia has a treaty, such dividends are subject to the withholding tax rate specified in the treaty, which is generally 15%. The recently renegotiated tax treaties with the U.S., U.K., France, Norway, Finland, Japan and South Africa, however, provide for 0%, 5%, 10% and/or 15% withholding tax rates, subject to certain conditions being satisfied.

The CFI rules referred to above exempt unfranked dividends from Australian withholding tax where such dividends are paid from income that is declared to be CFI (broadly, foreign income).

**Capital Gains Tax on Sale of Shares in Foreign Companies** – As highlighted above, where an Australian resident company disposes of shares held in a foreign company, capital gains and losses arising from the disposal may be reduced to the extent a direct voting percentage of 10% or more was held in the company continuously for a 12-month period in the 24-month period leading up to the disposal, and the foreign company carries on an active underlying business.

**Capital Gains Tax on Sale of Assets by Nonresidents** – As explained above, nonresidents are only subject to CGT on gains derived from the disposal of real property situated in Australia (subject to an interposed entity integrity measure) or business assets of an Australian branch.

**Interest Withholding Tax** – Australian residents are broadly obliged to withhold 10% of gross interest payments made to nonresidents. Generally this 10% interest withholding tax rate is not reduced under Australia’s tax treaties. The recently renegotiated tax treaties with the U.S., U.K., France, Norway, Finland, Japan and South Africa, however, provide for 0% interest withholding tax in certain limited circumstances (e.g. where interest is paid to an unrelated financial institution or a government body).

It should also be noted that there is no interest withholding tax levied on certain publicly offered company or unit trust debentures or debt interests.
Interest Deducted for Borrowing Costs – Where an Australian resident incurs interest on monies borrowed to acquire shares in a foreign company that generates non-assessable, non-exempt dividend income for the Australian resident, such interest is generally deductible notwithstanding that it is incurred in deriving non-assessable non-exempt income.

Australia’s thin capitalization rules, however, may apply to limit the amount of debt deductions where the prescribed gearing limits are breached. The transfer pricing rules may also apply to adjust the cost of financing where the borrowing is from a related party.

Deductibility of interest expenses (within thin capitalization limits and subject to the transfer pricing rules) is a significant attraction of Australia’s holding company regime when compared to other jurisdictions, as investment decisions can take into account the existing Australian tax base of the investor group.

Controlled Foreign Company Rules – Broadly, under the CFC rules, Australian companies with controlling interests in foreign companies that are CFCs will be taxed on their share of a CFC’s “notional assessable income” as it is earned. If the CFC is resident in a listed country and does not pass the “active income test” (i.e. the CFC derives less than 95% of its income from active business activities), its notional assessable income is limited to income that is concessionally taxed in listed countries. If the CFC is resident in an unlisted country (i.e. countries other than listed countries) and fails the active income test, its notional assessable income include income derived from passive investments (e.g. dividends, interest, royalties) as well as specific sales and services income arising from related party transactions.

Australia’s CFC rules have often been cited as a significant disincentive to selecting Australia as a holding company location. The changes introduced in 2004 would appear to have alleviated the worst of those concerns. Where Australia is used as a holding company location for active business operations, there should be few adverse consequences from the perspective of Australia’s CFC rules.

Importantly, further amendments to the CFC rules are expected to be introduced as a result of the BOT’s review of Australia’s anti-tax deferral rules. These amendments should take into account the government’s goal of establishing Australia as a regional holding company hub in the Asian Pacific region.

Double Taxation Agreements – Australia has an extensive tax treaty network (more than 40), which typically provides for Australian withholding tax to be imposed at 15% for dividends, 10% for interest and 10% for royalties. As mentioned earlier, however, the new treaties with the U.S., U.K., France, Norway, Finland, Japan and South Africa, provide for 0%, 5%, 10% and/or 15% dividend withholding tax rates subject to satisfying certain conditions, and a 5% royalty withholding tax rate. These reductions in withholding tax rates subject to the renegotiation of the treaties with the U.S. and U.K. have imposed renegotiation of treaties with several countries whose existing treaties contain “most favoured nations” (MFN) clauses. Countries with a MFN clause include: Austria, France (new tax treaty awaiting ratification on the French side), Italy, Mexico, Republic of Korea, Spain, Switzerland, the Netherlands and Taiwan.

It is expected that Australia’s future treaties and re-negotiated treaties will follow the recent Australia-Finland treaty.

It should be noted that the Australia-U.S. treaty contains a limitation of benefits (LOB) provision (article 16) that may prevent foreign-owned holding companies from obtaining benefits under the treaty. Only foreign-owned companies that are considered to be “recognized headquarter companies” are generally able to access benefits of the treaty.
This LOB clause is similar to those existing in many U.S. tax treaties. The size and diversity of the Australian economy, in many instances, may result in Australian holding companies being able to access the benefits of treaty with the U.S. where holding companies in smaller jurisdictions may not because:

- Australia has a treaty with the U.S.; or
- The multinational group may have a sizeable business operation in Australia with headquarters’ personnel connected with existing businesses in Australia.

In contrast to the LOB article in the Australia-U.S. treaty that applies to all the articles of that treaty, the application of the LOB article (article 23) in the new Australia-Japan treaty is limited to the operation of the following articles: business profits, dividends, interest and alienation of property. Depending on the circumstances, this may also prevent foreign-owned holding companies obtaining treaty benefits under these provisions.

Since RITA, and as discussed previously, various provisions have been introduced to encourage the establishment of regional headquarters in Australia. These measures include narrowing the scope of capital gains tax for nonresidents, addressing conduit foreign income provisions, including a capital gains tax participation exemption, extending the scope of the non-portfolio dividend exemption, and abolishing foreign loss and foreign tax credit quarantine rules. The modernization of Australia’s treaty network should also encourage foreign groups to establish regional headquarters in Australia. The government is reviewing Australia’s tax treaty policy and program. Importantly, Australia’s trading relationships with Asian countries such as China, India, Singapore, Hong Kong, Indonesia, Malaysia and Thailand are rapidly expanding. Australia’s treaties with these countries have not kept pace, however, with its rapidly expanding trade relationships. To serve its best interests, Australia should modernize existing treaties with these countries and negotiate a treaty with Hong Kong (see “Australia’s Tax Treaty Policy Review Critical to Remaining Globally Competitive,” by Peter Madden and Isabelle MacInnes in *World Tax Advisor*, 12 September 2008).

**How Does Australia Compare with Other Holding Company Jurisdictions?**

In view of the new and proposed measures discussed above, Australia now appears to have the essential elements of a favorable international holding company location. To test this hypothesis, we have compared Australia’s international tax rules with those of some of the more popular holding company locations below.
Dividends Received from Nonresident Subsidiaries – Dividends received by each interposed holding company from Foreign Sub are treated as follows:

- **Australia** – Exempt if at least a 10% direct voting interest is held in Foreign Sub.
- **Netherlands** – Exempt if at least a 5% interest is directly held in Foreign Sub, and, if Foreign Sub primarily holds passive investments, the profits of Foreign Sub must be subject to an effective tax rate of at least 10% in the country of residence.
- **Singapore** – Exempt if the profits of Foreign Sub are subject to tax in the foreign jurisdiction and, at the time the dividend is received in Singapore, the headline tax rate in that jurisdiction is at least 15%.
- **Malta** – Exempt if the investment in Foreign Sub is a “participating holding.” A participating holding is generally a holding of at least 10% of the shares or an investment of at least EUR 1.2 million in the Foreign Sub, although alternative tests may apply. Furthermore, Foreign Sub must be either a resident of the EU, derive less than 50% of its income from passive interest or royalties or be subject to tax at a rate of at least 15%. If the conditions to qualify for the participation exemption are not satisfied, the dividends will be subject to tax in Malta at a rate of 35%, but Foreign Parent will receive a 100% credit for that Maltese tax paid when the dividends are distributed.
- **Bermuda** – No tax payable.
- **U.K.** – Taxable with a foreign tax credit. Direct or indirect control of at least 10% of the voting power of Foreign Sub would be required to receive a credit for foreign underlying tax. There is no minimum ownership threshold to receive a credit for withholding tax. Note that there is a proposal to introduce a participation exemption for dividends from April 2010.
- **Hong Kong** – Exempt.

Australia’s treatment of dividends received is broadly more favorable than the other comparable locations (apart from Bermuda and Hong Kong) as Australia has no subject to tax requirement. Bermuda, being a pure tax haven, does not tax income per se, but many companies may choose not to establish a holding company in Bermuda given its tax haven status in the eyes of many tax authorities across the globe. Furthermore, unlike the Netherlands and Malta, Australia’s dividend participation exemption does not depend on whether the underlying assets of a foreign subsidiary are active or passive.

Dividends Paid to Nonresident Company – Dividends paid by each interposed holding company to Foreign Parent are treated as follows:

- **Australia** – Exempt from dividend withholding tax if declared CFI (i.e. sourced from certain foreign profits) or if income tax is paid in Australia on the income. Alternatively, the withholding tax rate will depend on the terms of an applicable treaty, with a few exceptions, and the dividend withholding tax rate under Australia’s treaties generally varies between 0% and 15%. In the absence of a treaty, the domestic rate of dividend withholding tax is 30%.
- **Netherlands** – Under most Dutch treaties, the dividend withholding tax rate is 5%. In the absence of an applicable treaty, the withholding rate is 15%. The dividend withholding tax rate may be reduced, however, through the use of a Dutch co-operative. The EC Parent-Subsidiary Directive would reduce the withholding tax rate to 0% if Foreign Parent is also resident in the EU and holds at least 15% of Netherlands Hold Co.
- **Singapore** – No separate dividend withholding tax is levied in Singapore.
- **Malta** – No withholding tax is levied on dividends paid from Malta.
- **Bermuda** – No dividend withholding tax.
- **U.K.** – No withholding tax.
- **Hong Kong** – No withholding tax.

On the face of it, Australia does not appear to be as favorable as the other jurisdictions. Singapore, Malta, Bermuda, Hong Kong and the U.K., all do not impose dividend withholding tax regardless of
the source of the profits out of which the dividends are paid and whether income tax is paid in those jurisdictions on the profits. The domestic rate of withholding tax in the Netherlands is 15% compared to 30% in Australia, but this can be reduced to nil through the use of a Dutch co-operative.

The imposition of withholding tax on dividends paid to Foreign Parent should also be considered, however, together with the taxation of dividends received from Foreign Sub. Australia’s conduit foreign income rules mean that it will often be possible to pass dividend income received from Foreign Sub to Foreign Parent free from Australian tax. In contrast, the participation interest, the subject to tax and active asset requirements in the other jurisdictions outlined above mean that dividends received by holding companies in those jurisdictions will be taxed in those jurisdictions more frequently than would be the case for an Australian holding company. Hence, the overall tax burden on dividends received by Australia Hold Co from Foreign Sub and distributed to Foreign Parent is likely to be lower than that in other jurisdictions. Australia, therefore, appears to be more favorable than the other jurisdictions except for Hong Kong, which has a pure conduit regime. Our earlier comments about the tax status of Bermuda also apply here.

**Capital Gains on Disposal of Shares** – Capital gains arising from each interposed holding company’s disposal of shares in Foreign Sub are treated as follows:

- **Australia** – Reduced by the extent of Foreign Sub’s active underlying business, provided at least 10% direct voting interest is held in Foreign Sub for a continuous period of 12 months in the two years before disposal.
- **Netherlands** – Exempt if at least a 5% direct interest is held in Foreign Sub. There is no required holding period. If Foreign Sub primarily holds passive investments, profits of Foreign Sub must have been subject to tax in the country of residence at an effective tax rate of at least 10%.
- **Singapore** – No CGT provided the gains are capital in nature.
- **Malta** – Exempt if the investment in Foreign Sub is a “participating holding.” This is generally a holding of at least 10% of the shares, or an investment of at least EUR 1.2 million in Foreign Sub, although alternative tests may apply. Furthermore, Foreign Sub must be either a resident of the EU, derive less than 50% of its income from passive interest or royalties or be subject to tax at a rate of at least 15%. If the conditions for application of the participation exemption are not satisfied, the gain will be subject to tax in Malta at a rate of 35%, but Foreign Parent will receive a 100% credit for that Maltese tax paid when the gain is distributed.
- **Bermuda** – No CGT payable.
- **U.K.** – Exempt if the “substantial shareholding exemption” applies. There are various conditions required to meet the substantial shareholding exemption, including that Foreign Sub must be a trading company before and after the disposal. A minimum 10% ownership requirement is also applicable, and the shares in Foreign Sub must have been held for a 12-month period beginning not more than two years before the day on which the disposal takes place.
- **Hong Kong** – No CGT provided the gains are capital in nature.

At first glance, the Netherlands, Malta, Hong Kong, Singapore and Bermuda, appear to have the more favorable tax treatment. To the extent Foreign Sub carries on an active business, however, and the investment in Foreign Sub is for a continuous period of 12 months, Australia’s tax treatment of the disposal of the shares in Foreign Sub should be more favorable than the Netherlands, as Australia does not have a subject to tax requirement. The U.K. substantial shareholding exemption appears to be similar to Australia’s CGT participation exemption.

**Interest Paid to Nonresidents** – The withholding tax on interest paid by each interposed holding company to Foreign Parent will depend, in most cases, on the terms of the tax treaty between the jurisdictions in which Foreign Parent and the interposed holding company are resident:
• **Australia** – The domestic interest withholding tax rate is 10%. A 10% withholding tax rate also applies under most of Australia’s treaties with some exceptions, e.g. 0% for interest paid to Finnish, Norwegian, U.K. and U.S. resident unrelated and independent financial institutions.

• **Netherlands** – Nil withholding tax.

• **Singapore** – Where no treaty applies, a 15% withholding tax is imposed if the interest is not derived by Foreign Parent from any trade or business carried on in Singapore and the interest is not effectively connected with a PE in Australia. Otherwise, an 18% withholding tax rate applies. The interest withholding tax rate under Singapore’s treaties varies from 0% to 15%.

• **Malta** – Nil withholding tax.

• **Bermuda** – Nil withholding tax.

• **U.K.** – Where no treaty applies, a 20% withholding tax rate is imposed. The interest withholding tax rate under the U.K.’s treaties varies from 0% to 20%.

• **Hong Kong** – Nil withholding tax.

Broadly, a 10% interest withholding tax will be imposed on interest payments out of Australia, even taking the relevant tax treaty into account. In this regard, Australia appears to be a less favorable location than the other countries (with the exception of Singapore and the U.K.) for intercompany interest payments.

**Deductions for Interest Costs** – Interest paid by each interposed holding company to Foreign Parent for acquiring shares in Foreign Sub is treated as follows:

• **Australia** – Deductible if expect to derive dividend income from Foreign Sub (even if non-assessable, non-exempt under section 23AJ), limited by the thin capitalization ratio of 3:1 for debt-to-equity funding.

• **Netherlands** – Deductible but limited by thin capitalization ratio of 3:1 and further restrictions apply where the interest is due to group companies. Dutch anti-abuse provisions may deny or limit interest deductions.

• **Singapore** – Not deductible to the extent the interest relates to exempt income. Accordingly, interest on borrowings to acquire shares generating exempt dividend income would not be deductible.

• **Malta** – Deductible against dividend income generated and received in same year of expenditure.

• **Bermuda** – Not applicable.

• **U.K.** – Deductible but subject to thin capitalization rules. No safe harbor for thin capitalization purposes but, as a general guide, the U.K. tax authorities would generally look for a 1:1 debt-to-equity ratio.

• **Hong Kong** – Not deductible.

It appears that Australia’s treatment of interest is more beneficial than most countries and should be a significant advantage where there are other profitable operations in Australia and maximum allowable debt under the thin capitalization provisions is not exceeded.

**Controlled Foreign Company Rules** – Australia has a complex CFC regime that, broadly, operates to attribute certain income earned by foreign subsidiaries of Australian companies such that it is taxed in the hands of the Australian parent.

Holding companies located in the Netherlands, Singapore, Malta, Bermuda and Hong Kong, do not have to consider CFC rules, as there are no CFC rules in those countries. While the absence of CFC rules in the Netherlands, Singapore, Malta, Bermuda and Hong Kong, give them an advantage over Australia as a favorable international holding company location, the recent changes to Australia’s CFC rules now improve the ability to set up an efficient holding structure through Australia, although the CFC rules still need to be carefully considered. It is to be hoped that further
amendments to the CFC rules will be introduced as a result of the BOT’s review of Australia’s anti-tax deferral rules.

Furthermore, in the case of the Netherlands, there are general anti-avoidance measures that apply to direct or indirect shareholdings in non-EU subsidiaries.

**Other Tax Attributes** – While the major tax attributes of a holding company already discussed (i.e. dividend and interest flows, as well as taxation of assets on disposal) are important, there are many ancillary tax attributes that also need to be considered when determining the suitability of a particular jurisdiction as a holding company location.

**Treaty Network** – The country’s tax treaty network is an important consideration when determining where to establish a group holding company. The existence of a treaty in most instances will considerably lower the incidence of tax in relation to the remittance of profits, interest or royalties from the investment jurisdiction and can limit or remove any capital gains liabilities on the disposal of investments.

Australia’s treaty network is as comprehensive as most countries and certainly more extensive than countries such as Hong Kong, Singapore and Bermuda.

It should be noted that some jurisdictions may have broader treaty networks than Australia but have anti-abuse or anti-treaty shopping rules (e.g. Netherlands, Germany and France), which may apply to disregard holding companies that have insufficient economic substance. Jurisdictions with such rules are less attractive as holding company jurisdictions (discussed below).

**Tax Haven Status** – In recent years, the OECD has identified jurisdictions that are considered to have harmful tax practices. These countries have been threatened with prohibitive counter-measures by OECD member countries. Being listed as having harmful tax practices is clearly a negative feature for a jurisdiction when selecting a holding company location, especially if punitive measures are taken against transactions involving companies in those jurisdictions.

**Substance Requirements of Foreign Holding Companies** – Some European countries (e.g. Germany, France, the U.K.) apply anti-abuse rules negating tax treaty or EC directive benefits where the direct foreign parent company has no real substance in the country of residence. For instance, the substance requirements of foreign holding companies recently have been tightened under the German tax law and require that 10% of the foreign holding company’s gross income originate from its own economic activity. Care should therefore be taken to ensure that substance requirements are met (i.e. the direct parent company should perform an actual economic function within the group) before allowing access to tax treaty or EC directive benefits on payments made to that foreign parent.

Also, tax treaties commonly include “beneficial ownership” and LOB clauses to restrict access to treaty benefits. Recent court cases have considered the term “beneficial owner” in a tax treaty context. The U.K. courts considered this term in relation to the interest article in the 2006 decision in the *Indofood* case and the Canadian courts considered the term “beneficial ownership” in relation to the dividend article in the 2008 *Prevost* case. The critical element in establishing beneficial ownership seems to be the ability of the recipient to deal with the income as its own. Importantly, the reasoning adopted by the courts in *Prevost* and *Indofood* varies substantially. In the *Prevost* case, the court adopted a form versus a substance approach, whereas in *Indofood*, the substance approach was the preferred approach to establish beneficial ownership.

**Special Incentives/EU Benefits** – Consideration should also be given to whether the jurisdiction has any special benefits for holding companies such as low tax rates for headquarter activities, or has access to other benefits such as being an EU Member State.
Countries such as the U.K., the Netherlands and Malta clearly have an advantage over Australia as there is zero withholding tax on dividends and interest paid between EU member states (i.e. under the Parent-Subsidiary Directive and the Interest and Royalties Directive). These countries are, however, also subject to a Code of Conduct for business taxation and European Court of Justice decisions, which could equally work against them. The Code requires Member States to refrain from introducing any new harmful tax measures and amend any laws or practices that are deemed to be harmful in respect of the principles of the Code (e.g. repeal of Luxembourg’s preferential tax regime for financial holdings).

Singapore provides incentives for companies establishing headquarter operations in Singapore that, in some instances, could benefit a holding company established there.

**Other Taxes and Costs** – The actual costs of establishing and operating a holding company should be considered. For example, a number of countries have a capital subscription tax, which can be substantial if large amounts of capital are contributed. Also, annual registration and compliance costs can be relevant as well as the cost of having the appropriate directors/personnel present in a particular jurisdiction so that the holding company maintains its status as a resident of the jurisdiction.

**Certainty of Tax Law** – It is essential that a holding company jurisdiction have certainty of tax law and low risk of tax law changes. Also, it is a significant advantage if certainty can be obtained from the relevant tax authorities on the application of the tax laws through a ruling or advance opinion process.

**Is Australia Now the Place to Locate Your Holding Company?**

Australia has come a long way to establishing itself as a potential holding company jurisdiction. Based on the above, it appears that it can now be considered as favorable as other common holding company jurisdictions such as the Netherlands, Singapore, Malta, Bermuda, the U.K. or Hong Kong.

In many respects, Australia is actually more favorable than those countries as it does not have a subject to tax requirement for its dividend participation exemption, unlike Singapore, the Netherlands and Malta, in certain circumstances. Bermuda is viewed by most tax authorities as a tax haven. In this regard, Australia comes out ahead of those countries as an attractive holding company location. An appropriate holding company location will still depend, however, on the investment objectives of the particular investor.

For example, of the countries examined above, it could be beneficial to use a Netherlands holding company to invest into Europe as the Dutch company and its European subsidiaries can benefit from the EC Parent-Subsidiary Directive, which allows dividends to be passed from subsidiary to parent with no withholding tax. In contrast, it could be more favorable to use an Australian holding company as an investment vehicle into Asia as Australia does not have a subject to tax requirement for its participation exemptions, whereas the Netherlands and Singapore do.

In this regard, Australia may now be regarded as a competitive international holding company location that provides beneficial treatment of capital gains and dividends and has an extensive tax treaty network. Is Australia the place to locate your holding company? That depends on your investment objectives, but given the tax reforms in recent years, Australia is now a strong contender.
Denmark: Exit Tax Law Passed

Denmark’s Parliament approved revisions to the exit tax rule on 9 September 2008 that eliminate certain rights of taxpayers to mitigate the effect of exit taxation. The Minister of Taxation had introduced the bill in May to close a loophole in the tax law to ensure that capital gains on shares are subject to Danish taxation when a taxpayer moves abroad.

Previously, an individual that ceased to be a tax resident in Denmark was normally deemed to have disposed of all shareholdings at fair market value at the time tax residence was changed, which could trigger Danish taxation of unrealized capital gains. However, the taxpayer was able to postpone payment of the tax until actual disposition of the shares. Where a taxpayer requested such deferral and the gains derived on the sale of the shares were lower than the fair market value, the taxpayer could request that the capital gains be re-computed on the basis of the actual sales price. If the taxpayer subsequently re-established Danish tax residence and had not disposed of the shares, the taxes that were triggered at the time the taxpayer left Denmark were annulled. These rules allowed an entity controlled by a sole shareholder to move to a low tax country and pay out high dividends, thereby decreasing the fair market value of the company. Following such dividend payments, it was possible for a taxpayer to dispose of the shares or liquidate a company and request a re-assessment of the capital gains. This approach essentially made it possible to circumvent the legislative intent of the Danish tax regime, which provides that unrealized capital gains are subject to Danish taxation if a shareholder ceases to be a Danish tax resident.

The new legislation abolishes a taxpayer’s right to seek a post-sale capital gains re-computation and/or have previously assessed taxes annulled. The rules apply retroactively as from 30 May 2008, with certain grandfathering provisions for taxpayers who emigrated before that date.

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European Union: ECJ Rules on VAT Treatment of Public Authorities Competing with Private Sector

The European Court of Justice (ECJ) issued its decision in the Isle of Wight Council case on 16 September 2008, concluding that, when determining whether the VAT treatment of public authorities as non-taxable persons “would lead to significant distortions of competition” with private operators carrying on the same activity, it is necessary to examine the activity in the market as a whole and not merely in the local market where the relevant authority actually provides the relevant functions.

In a broader sense, the case is relevant for the VAT treatment of any functions carried out by public authorities (including local and regional government authorities and public law bodies).
Specifically, it looks at the issue of whether the authorities are acting as “taxable persons” when carrying out those functions and, hence, whether they need to charge VAT.

Facts

The Isle of Wight Council case involves off-street car-parking facilities operated by four local authorities in the U.K. The authorities had claimed a repayment of VAT they charged on receipts from the car parks on the grounds that the receipts should have been treated as outside the scope of VAT under article 13 of the principal VAT Directive (article 4(5) of the old Sixth VAT Directive). That article provides that government authorities and other public law bodies are not taxable persons – and therefore do not charge VAT – in respect of activities they engage in “as public authorities” unless such treatment “would lead to significant distortions of competition.” The U.K. tax authorities rejected the claims.

ECJ Decision

The ECJ held that, when considering actual or potential distortions of competition, it is necessary to view the activity as a whole, and not just the local market where the relevant authority actually provides its functions. Focusing only on the local market would be administratively unworkable because it would give rise to disputes over what the relevant local market actually is and would create a situation where the VAT treatment of an authority’s services would have to be re-evaluated any time there was a change in the status of that local market (such as private operators coming in and out of business). This result would jeopardize the Community law principles of fiscal neutrality and legal certainty.

According to the ECJ, both actual and potential distortions of competition need to be considered, provided the possibility of a private operator entering the market is real and not merely hypothetical. “Significant distortions” of competition mean actual or potential distortions that are more than negligible.

Implications

Although the Isle of Wight Council case itself relates only to off-street parking, the ECJ’s conclusions set out general principles of Community law that will have much wider application. As noted above, these principles will apply to any situation where a local authority (or any other government authority or public law body) carries out functions for individuals or businesses and receives payment in consideration.

To determine whether these functions fall within the scope of VAT (and, therefore, whether the authority will need to charge and account for VAT), it will be necessary to look at:

1. Whether any private businesses provide the same or similar functions as the authority that would compete with the authority. (It is irrelevant where the authority and the private businesses are located and carry out their functions.)
2. If the answer to (1) is no, whether there is a real possibility of private businesses providing such functions in the future.
3. If the answer to either (1) or (2) is yes, whether the VAT-free supply of such services by the authority would lead to distortions of competition that are more than negligible.

The Isle of Wight Council case will be referred back to the U.K. High Court to apply these tests to the facts of the case (unless the case is settled in the interim).
Japan:
Recommendations for 2009 Tax Reform Issued

Japan’s Ministry of Economy Trade and Industry (METI) and Financial Services Agency (FSA) each published a set of recommendations for the 2009 tax reform on 27 and 28 August 2008, respectively. The main objectives of the recommendations are to encourage inbound investment and improve the country’s capital markets.

Key proposals include the following:

- Excluding nonresident limited liability partners from being deemed to have a place of business in Japan;
- Abolishing the taxation of nonresidents and foreign companies on capital gains from the transfer of shares (i.e. the “25/5 rule”), or at least allowing for the calculation of the holding based on each partner’s separate participation, rather than on the partnership’s aggregate holding. Currently, the 25/5 rule applies if a shareholder (including related parties) has owned, directly or indirectly, 25% or more of the shares of a Japanese corporation at any time during the three years ending on the last day of the year in which the shares are sold and, during the year, sells at least 5% of the shares of the Japanese corporation;
- Eliminating Japanese taxation of dividends received by a Japanese parent from foreign subsidiaries; and
- Exempting Japanese taxation on dividends paid by listed companies for investments of up to a certain amount, such as JPY 1 million per year.

Currently, the risk of double taxation makes many overseas fund investors hesitant to invest in Japan. The measures proposed by METI and FSA attempt to put Japan in line with other major financial centers by eliminating double taxation of foreign investment funds and reducing the risk of investors being subject to capital gains tax and other taxes in Japan.

Foreign subsidiaries have also been reluctant to remit their profits back to their Japanese parent companies as dividends in order to avoid further taxation. METI’s recommendations would make Japan’s tax system similar to the systems in Canada, France and Germany, and should encourage foreign subsidiaries to remit their profits back to Japan.

Other recommendations put forward include:

- Extending the two-year limit for special depreciation rates, reducing registration and license tax, and reducing real estate acquisition tax for qualified enterprises;
- Expanding the offset of interest income against losses from futures transactions;
- Expanding the application of the defined-contribution pension plan regulations; and
- Extending and reforming the tax system applicable to R&D partnerships with a view to promoting innovation.

These recommendations and others will be considered by the Liberal Democratic Party Tax Committee, which will produce a tax reform proposal in December. Such proposals are “generally” passed into law by the end of March of the following year.
Malaysia:
**Budget 2009 Introduces New Transfer Pricing, Thin Cap Rules**

Malaysia’s Budget 2009, presented 29 August 2008, contains a variety of provisions that will affect both large and small companies. Most notably, Budget 2009 proposes that specific provisions be established to empower the tax authorities to make adjustments on transactions involving goods or services carried out between related companies and it introduces thin capitalization rules for the first time. Other measures that will impact companies doing business in Malaysia are changes to the group relief, withholding tax and reinvestment allowance rules. Additionally, a number of rules will limit the benefits currently available to small- and medium-size enterprises (SMEs). The bill must be passed by both houses of Parliament and receive royal assent, after which it will come into force. The measures will apply as from year of assessment 2009.

**Transfer Pricing**

Transfer pricing legislation is the most significant addition in Budget 2009. Malaysia introduced transfer pricing guidelines in 2003, but, since then, relatively few persons with related party transactions have prepared transfer pricing documentation. A new section 140A of the Income Tax Act places the onus squarely on the taxpayer by providing that any person with related party acquisitions or supplies of property or services is required to determine and apply the arm’s length price to such transactions.

Section 140A also provides that, where the Inland Revenue Board (IRB) has reason to believe that the pricing adopted is not at arm’s length, it may determine the taxable income of the person, making adjustments to reflect an arm’s length price. In this connection, it should be noted that the IRB has considerable data on the margins of taxpayers in various industries and it regularly uses this data to identify companies with apparent transfer pricing issues.

The IRB has been conducting transfer pricing audits since 2004 and these have increased in recent months. With the introduction of new section 140A, the level of transfer pricing audits is likely to be further escalated. Such audits yield considerable revenue to the government and, in the case of multinationals, taxes collected per case can be between MYR 10 million to MYR 100 million.

To defend against a transfer pricing audit, a taxpayer must prepare transfer pricing documentation that describes its activities, ownership structure with details of related party transactions, the pricing adopted and how such prices were determined. Among the items included in a transfer pricing report are functional, asset and risk analyses; the transfer pricing methodology adopted; and comparables.

Failure to prepare adequate transfer pricing documentation could expose the taxpayer to significant additional tax payments.

**Advance Pricing Arrangements**

As presaged in Budget 2009, beginning 1 January 2009, taxpayers will be able to apply for advance pricing agreements (APAs) with the tax authorities. APAs may be used to obtain certainty on transfer pricing methodologies on cross-border transactions with nonresidents and can be
concluded for three- to five-year periods. Such agreements may be unilateral, bilateral or multilateral.

**Thin Capitalization**

For the first time, Malaysia has introduced specific thin capitalization rules (also in section 140A of the Income Tax Act), which have the potential to bring about dramatic changes in the way taxpayers in Malaysia are financed. Under the new rules, which apply only to transactions between related parties, the IRB will be permitted to disallow a deduction for interest or other finance charges that are deemed to be excessive. It is likely that the IRB will permit a 3:1 debt-to-equity ratio, with interest expense exceeding this limit being nondeductible, thus increasing the taxes payable. The transfer pricing auditors are expected to aggressively pursue the disallowance of related party interest, etc., in excess of the 3:1 ratio. Since the thin capitalization provisions (and rules to be issued) are to be effective 1 January 2009, taxpayers should begin reviewing their debt-to-equity ratios immediately.

**Small- and Medium-Size Enterprises**

SMEs currently enjoy an array of tax benefits, including a 20% (instead of 26%) tax rate on the first MYR 500,000 of chargeable income. Further SMEs, are not required to make monthly corporate tax installments during their first two years of assessment. Under current rules, the tax advantages accruing to an SME apply regardless of whether the SME is owned by individuals or a listed company.

An SME is a company with a paid-up ordinary shares capital of MYR 2.5 million or less at the beginning of its financial year or, more accurately, basis period (the “SME threshold”). Finance Bill 2008 introduced through Budget 2009 seeks to narrow the definition of an SME from year of assessment 2009 and exclude those with more than 50% of their paid-up capital in ordinary shares directly or indirectly owned by a company that exceeds the SME threshold. Such a situation would normally arise where the SME is part of a group of companies and the ultimate holding company is a publicly listed company or one that breaches the SME threshold. The situation can be illustrated as follows:

![Diagram](image-url)
The Budget also proposes two other situations where a current SME would no longer be an SME from year of assessment 2009. The first is the converse of the above situation, i.e. where the holding company is currently an SME and the subsidiary’s paid-up ordinary shares exceeds MYR 2.5 million – the current SME will no longer qualify. The final situation arises where a current SME is held by a company that also owns a company with paid-up capital exceeding MYR 2.5 million. Thus, where a current SME is part of a group of companies that includes a non-SME, from year of assessment 2009, the current SME will no longer qualify for the 20% tax band and the exemption from submitting estimated tax and making monthly tax installments in the first two years of assessment will no longer apply.

SMEs are favored in Budget 2009 in that those that incur capital expenditure on plant and machinery acquired in financial years 2009 and 2010 will be entitled to depreciate them for tax purposes in the year the assets are fully acquired. Further, with respect to small value assets of up to MYR 1,000 each, a capital allowance equal to the amount of the expenditure may be claimed one year, i.e. in the year the expenditure was incurred. However, a current proviso restricts the allowance on small value assets to MYR 10,000 per year. It was proposed in Finance Bill 2008 that SMEs be exempt from the MYR 10,000 ceiling as from year of assessment 2009.

The proposed restricted definition of SMEs will apply in relation to both of these capital allowance benefits for SMEs.

SMEs should immediately review the shareholdings and paid-up capital of the group of companies of which they form a part.

**Other Changes**

**Group Relief** – The benefit of group relief, whereby companies are permitted to surrender up to 50% of current year losses to other companies in the group, will be increased to 70% of the losses from year of assessment 2009.

Under current legislation, SMEs are excluded from surrendering or claiming group relief. Despite the new definition of SMEs that denies some tax benefits (i.e. where there are certain related non-SMEs in the group structure), the revised meaning has not been adopted for group relief purposes, so that SMEs continue to be excluded from group relief. While this anomaly may be deliberate in view of the intricacies of group relief, it is hoped that it will be removed as Malaysia improves the benefits of group relief.

**Withholding Tax** – Finance Act 2008 introduced a new 10% withholding tax on “section 4(f) income,” i.e. income that is not business, employment, dividend, interest, discount, rent, royalty, premiums, pension, annuities or other periodical payments. The appendices to the 2009 Budget speech consider commission, “introducer’s” fees and guarantee fees as falling within the scope of section 4(f) income. This withholding tax is expected to produce considerable controversy, but the IRB wields significant power under a new provision that can prevent directors of controlled companies from leaving Malaysia if tax payable by the company (including tax on section 4(f) income) has not been settled.

**Reinvestment Allowance** – The reinvestment allowance (RA) is a very popular incentive in Malaysia and has resulted in decreased revenue to the government of MYR 5 billion. The RA is currently granted to manufacturing, processing and certain agricultural companies that expand, modernize, automate or diversify their operations. The RA is computed at 60% of qualifying capital expenditure. To limit revenue lost through the RA, the following changes will apply effective from year of assessment 2009:
Companies must be in operation for 36 months (currently 12 months) before being eligible to claim the RA;  
The RA will be clawed back if the assets concerned are disposed of within five years (currently two years) of the date of acquisition;  
The RA will be denied to the purchaser in respect of intragroup acquisitions of assets;  
Processing is not a qualifying activity for purposes of the RA; and  
“Manufacturing” would exclude simple processes.

Conclusion

Taxpayers cannot afford to be caught off guard by Budget 2009. For many companies, the budget will increase the tax cost of doing business through, among other measures, increased transfer pricing documentation requirements; increased costs of borrowing due to the thin capitalization rules; and lost or reduced benefits/incentives, e.g. from changes to the SME qualification rules and limitations on the reinvestment allowance. Companies should begin planning for the changes now to improve tax efficiencies and ensure they will be able to meet the additional compliance burdens.

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New Zealand:  
Tax Collection Article in Treaty with Australia in Effect

New Zealand and Australia are now able to assist each other in collecting tax debts. Under a new provision (article 27) included in the 2007 protocol to the New Zealand-Australia tax treaty, the New Zealand Inland Revenue Department (IRD) can transfer tax debt cases to the Australian Tax Office to recover outstanding tax debt owed by New Zealanders living in Australia, and vice versa. Article 27 came into force on 8 September 2008.

The IRD has issued a statement encouraging New Zealanders who owe tax debts and are planning on moving overseas or who are already living overseas to contact the IRD to discuss their payment options.

Article 27 will improve New Zealand’s ability to collect outstanding tax from individuals who have left the country and reinforces the cooperation between Australia and New Zealand in the enforcement of tax laws and the collection of tax.

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Hungary

Government Unveils Proposed Tax Changes
Parliament is considering various tax law changes, including the abolition of the solidarity tax, an increase in the corporate income tax rate, abolition of restrictions on interest deductions and an extension of the transfer pricing rules. [Issued: 22 September 2008]

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