

ITS Global Dispatch

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Hungary

Hungarian Participation Exemption Rules Amended as of 2008

The Hungarian participation exemption rules effective as of 1 January 2008, have been made more favorable to taxpayers.

Participation Exemption on Capital Gains

Under the prior rules, capital gains from the sale of shares are exempt from both the 16 percent corporate income tax and the four percent solidarity surtax if the taxpayer holds the participation for at least two years before sale, the participation is registered with the tax authority, and certain other conditions are met.

The new law reduces the holding period to one year. Also, the registration of the participation is simplified because, in contrast to prior rules, the contract for the acquisition of the participation does not have to be filed with the authorities.

Otherwise, the main aspects of the rules remain the same – that is, only participations of at least 30 percent can be registered, and shares in companies that fall under the controlled foreign corporation definition cannot be registered.

Hungarian legislation uses the term ‘controlled foreign corporation’ to mean tainted entities; their shares, if held by a Hungarian taxpayer, cannot benefit from the participation exemption. Under the prior law, a foreign person was a CFC if its effective tax burden was less than 10.67 percent, unless the foreign person had a specific level of substance.

The new law introduces a ‘white list’ of countries. Companies with a presence in those jurisdictions cannot be CFCs. As of 1 January 2008, a corporation that has a registered seat, permanent establishment, or residence in the European Union, in an

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ITS Global Dispatch

is a monthly communication prepared by International Tax Services, Washington, DC summarizing recent worldwide developments pertinent to multinational companies. For additional information, please contact your local International Tax professional.

ITS Washington, DC

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OECD member state, or in a country that has an income tax treaty with Hungary can never be a CFC. Since Hungary has a treaty with every EU country and every member of the OECD except Mexico and New Zealand, the white list in effect consists of treaty countries, plus Mexico and New Zealand.

If they do not qualify under the white list, subsidiaries of Hungarian taxpayers are eligible for the participation exemption only if their effective tax rate is at least 10.67 percent; thus, the sufficient substance exemption from the CFC rules no longer exists as of 2008. There might be a need to interpose a holding company resident in a country on the white list for some Hungarian multinationals, especially those in the resource sector, if they have subsidiaries in nontreaty jurisdictions in the Middle East, Central Asia and so on that are not subject to a traditional corporate income tax, instead paying some kind of revenue-sharing or mining royalty to the host government.

[Participation Exemption on Dividends](#)

The amendment to the CFC definition has the same effect on the participation exemption for dividends as on the participation exemption for capital gains.

In order to exempt dividends received, the only criterion under both the prior and current rules has been that the subsidiary should not qualify as a CFC. There have been neither holding period nor ratio requirements, as contrasted with capital gains.

As of 1 January 2008, dividends derived from corporations that have a registered seat, permanent establishment, or residence in any country on the ‘white list’ are exempt without the need to meet any of the previous two tests (effective tax rate or certain level of substance).

On the other hand, dividends derived from entities that do not have a registered seat, permanent establishment, or residence in any country on the “white list” need only meet the effective tax rate test in order to be exempt.

[No Alternative Minimum Tax on Exempt Income](#)

Hungary has no real “Alternative Minimum Tax.” However, there is a “suggested minimum tax base” for corporate income tax purposes that effectively works similarly to an alternative minimum tax in certain instances (other than where the exemption is provided by law

or a treaty). The key difference is that in Hungary, the taxpayer does not have to pay tax on the minimum tax base if it files a supplementary form along with the tax return. The supplementary form is a questionnaire that examines various expenses of the company, with the aim of identifying possible tax evasion, mainly targeting local small- and medium-sized enterprises.

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Israel

Domestic Israeli Anti-Abuse Provision Can Deny Treaty Benefits, Court Rules

The Israeli district court has ruled in *Yanko-Weiss Holdings (1996) Ltd. v. Hulon Assessment Officer* (published on 30 December 2007) that the Israeli tax authority (ITA) can use a domestic anti-abuse provision to deny treaty benefits.

The court ruling allowed the ITA to use a domestic anti-abuse provision when the ITA is convinced that a taxpayer engaged in treaty abuse, even if there are no anti-abuse or tax avoidance provisions in the treaty.



The company in the case was incorporated in Israel. In 1999, the company's shareholders moved the registered office, management and activity to Belgium. Under Belgian tax law, the company was considered to be a resident of Belgium and was provided with a residency certificate from the tax authorities in Belgium.

The ITA denied the company benefits under the Belgium-Israel tax treaty, arguing that the company was an Israeli resident because it was actually managed and controlled from Israel and that the company's registration in Belgium should be viewed as a sham transaction because there was no economic purpose for its registration there other than tax avoidance.

Israeli tax law provides that a double tax treaty overrides the Israeli Income Tax Ordinance. Moreover, the Income Tax Ordinance empowers tax authorities to ignore transactions that are considered to be sham transactions. As a result, the company argued that the tax authorities cannot use a sham transaction argument that is based on domestic law because it contradicts the Belgium-Israel treaty.

The Court Decision

The court ruled that the ITA can use the sham transaction argument despite the treaty. The court based its decision on several arguments, including the OECD's position as reflected in the commentary to the OECD model income tax treaty and the Vienna Convention. The court noted that although the OECD's position does not bind Israel, it has a significant influence on the interpretation of tax treaties.

The court decision raises several issues. For example, it might be interpreted that the domestic anti-abuse provisions override the treaty tie-breaker rule. Therefore, even if a taxpayer were considered to be a Belgian resident under the tie-breaker provision, the tax authorities could still determine that the taxpayer is an Israeli resident and deny treaty benefits.

The court is aware of that issue and suggested that such issues would be settled as part of the competent authority procedures.

The court decision provides the ITA with a significant tool to challenge international tax planning. The decision also

underscores that investors who establish foreign holding companies should carefully examine the substance of those companies, as well as the purpose for establishing them.

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Mexico

Mexican Miscellaneous Tax Rules Address IETU

On 31 December 2007 and 15 February 2008, the Mexican tax authorities issued updates to the Temporary Tax Regulations (Resolución Miscelánea, or Miscelanea), which include the first regulations to the new Flat Rate Business Tax (IETU), which went into effect on 1 January 2008. The Miscelanea is a set of temporary regulations that are issued annually by the tax authorities. Since the Miscelanea does not require congressional or presidential approval, these rules generally cannot impose an additional obligation or higher liability on the taxpayer.

In general, these regulations provide guidance on implementation issues for the IETU, as well as the Presidential Decree that was issued in November. Although the regulations mainly address administrative processes, including estimated payments and credits, there is also a benefit for taxpayers seeking to recover assets tax, as well as certain beneficial regulations regarding withholding taxes on payments made abroad.

Recoverable Asset Tax

For taxpayers that have paid asset tax in the past, the Miscelanea provides three rules that should improve the ability to recover asset tax paid during 1998-2007. As background, given the fact that the IETU replaced the asset tax, transitory rules were also included in the IETU Law to allow for the recovery of asset tax paid in excess of income tax during the prior ten years, as would have otherwise been allowed under the asset tax law.

Pursuant to the now-eliminated asset tax law, asset tax paid in excess of income tax was recoverable in future years to the extent that income tax exceeded asset tax. Under the old asset tax rules, recovery of asset tax against income tax was allowed to the extent that income tax exceeded asset tax for the period.

The transition rules for IETU provide that taxpayers may request a refund of the unrecovered, inflation adjusted amounts of asset tax that were paid during the 10 preceding years, subject to certain limitations.

The transitory rules provide as a first step in the calculation of the amount of the recoverable asset tax each year, that taxpayers must compare the current annual income tax liability to a base period asset tax liability. To the extent the income tax liability is higher, the excess would be the maximum refunded amount for the period. For this purpose the base period asset tax liability was defined as the lowest asset tax liability for the taxpayer during the period of 2005, 2006 and 2007. The Miscelanea provides that if a taxpayer did not pay asset tax during these three years, then the lowest asset tax liability during the ten-year period of 1998-2007 should be used.

Under the IETU rules, the recoverable amount as determined above is further limited each year to 10% of the total asset tax paid during the prior ten years. As drafted, the original IETU law required the taxpayer to re-measure the total asset tax paid each year after 2008 and apply the 10% limit to the new total. Under

this rule, the number of years of possible asset tax recovery would decrease each year after 2008, since, for example, the asset tax paid in 1998 would have been dropped from the total in 2009. As such the 10% limit would be based on a lower amount (if asset tax were paid in the dropped years). This resulted in a severe limit on the recoverability of the asset tax for many taxpayers.

Interest Portion of Financial Lease

As a general rule, interest expense is not a deductible expense for IETU purposes and interest income is not subject to the IETU tax. Among the exceptions to this rule is the interest component when it is included as part of the sales price of goods and services.

There was some debate as to whether the financial cost component (i.e., interest) included in financial leasing payments was deductible for IETU purposes since the interest would be included as a component of the lease agreement, but separately stated.

A regulation in the Miscelanea was issued that clarifies the position of the tax authorities by stating that the interest component of a financial lease agreement will not be considered deductible



for IETU purposes. Likewise, the interest component of the financial lease will not be considered taxable income for the lessor. It can be expected that taxpayers may try to challenge the application of this provision.

[Withholding Tax on Payments Abroad](#)

Under Mexican income tax law (MITL), royalties paid abroad are subject to withholding tax. Royalties include payments for the *temporary use* of certain intangibles, but also the *alienation* of the intangible asset that generates the royalties. The Miscelanea establishes that the alienation of an intangible asset will only be treated as a royalty (for withholding tax purposes) if the sale of the asset or rights is conditioned upon the productivity or use thereof.

MITL provides for a 40% withholding tax rate applied to Mexican source income derived by foreign entities or vehicles that are subject to a preferential tax regime, and vehicles that are transparent for tax purposes. Certain specific exceptions to this rule exist, for instance for US Limited Liability Companies whose member(s) are (is) resident in the US for tax purposes. The Miscelanea now provides for a broader look-through rule for payments made to foreign transparent enti-

ties located or created in/under the laws of a jurisdiction with which Mexico has concluded a so-called broad exchange of information treaty. The transparency rules provide for look-through to the partners of the transparent vehicle in proportion to their equity participation therein, potentially resulting in reduced withholding tax on the Mexican source income derived by the transparent vehicle, depending on the residency and treaty access of the partners in the vehicle.

The Miscelanea also provides some additional new rules related to Mexican CFC legislation, as well as administrative clarifications.

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Singapore

Singapore Budget Includes Significant R&D and Maritime Incentives

On 15 February 2008, the Minister for Finance announced the Singapore Budget for the fiscal year beginning 1 April 2008. The Budget introduces a new package of R&D-related incentives that are intended

to enhance Singapore's position as a hub for both R&D activities and for IP ownership rights for companies operating in the burgeoning Asia Pacific region. There are also enhancements to the existing maritime incentives and financial services sector incentives intended to strengthen Singapore's status as a regional maritime and financial hub

[Business Tax](#)

Liberalization of R&D tax deductions — Under current tax law, only R&D expenses incurred in relation to a company's existing trade or business in Singapore would qualify for a tax deduction. Such R&D expenses may qualify for further tax deduction if certain conditions are met and they relate to an approved R&D project in Singapore. The Budget proposes to permit companies that carry out R&D activities in Singapore or outsource their R&D activities to an R&D organization in Singapore to qualify for a tax deduction of 150% of the amount of R&D expenses incurred from Year of Assessment¹ (YA) 2009 to YA2013.

¹ Singapore adopts a preceding year basis for its tax year. The basis period for Year of Assessment 2009 refers to the year ending in 2008. For example, if a company has an accounting year ending 30 June 2008, the basis period for its Year of Assessment 2009 is from 1 July 2007, to

There is no need for the R&D activities to be connected to the company's current trade or business. Further details will be introduced by September 2008.

R&D tax allowance — Companies with chargeable income² will be granted an R&D tax allowance for each year from YA2009 to YA2013, at a prescribed rate of up to 50% of the first S\$300,000 (US\$212,500) of the company's chargeable income. This allowance is to defray incremental qualifying R&D expenditure on in-house R&D activities carried out in Singapore. This allowance can be utilized to offset taxable income for the next three YAs following the YA in which it is granted. It is not transferable to related companies under group relief. Further details will also be introduced by September 2008.

Tax credit for foreign-sourced income — With effect from YA2009, Singapore residents will be able to claim unilateral tax credits³ on all types of foreign-sourced

30 June 2008.

2 Taxable income after tax depreciation (allowances) and applicable tax exemption.

3 Unilateral tax credits refer to foreign tax credits granted for foreign taxes paid by Singapore resident persons, subject to

income that are remitted to Singapore from countries with which Singapore does not yet have a tax treaty. This incentive may provide more flexibility to MNCs in their tax planning into Hong Kong through Singapore.

Maritime Sector Incentives

Enhancements to the Maritime Finance Incentive (MFI) — The MFI will be expanded to include leasing of sea containers. Specifically,

- an Approved Container Investment Enterprise (ACIE) will enjoy either a concessionary tax rate of 5% or 10% on its income from leasing sea containers to onshore and offshore lessees. The applicable rate will depend on the level of local business spending and headcount commitments;
- an approved container investment management company will enjoy a 10% concessionary tax rate on its management fee income derived in connection with the management of an ACIE;

certain restrictions (with respect to allowable credit amount), on foreign-sourced income from foreign jurisdictions with which Singapore does not currently have a tax treaty..

- MFI status will be granted to an ACIE and an approved container investment management company from 1 April 2008 to 28 February 2011.

More details will be released by May 2008.

MNCs have so far focused their R&D efforts in Singapore on projects related to their existing businesses in Singapore to secure a tax deduction. The potentially high exit costs to migrate IP ownership rights to Singapore has resulted in MNCs involving Singapore more in cost-sharing or contract R&D arrangements than as a hub for IP ownership rights. MNCs may now be able to look to Singapore beyond just the ability to perform contract R&D. They can potentially use a Singapore company to research and develop new IP that can be greenfield R&D and not related to the business the company is currently performing, own the rights, and obtain a 150% tax deduction on the R&D expenses incurred. Accordingly, there are more incentives for MNCs to innovate and develop IP in Singapore and reduce potentially high exit costs to migrate IP ownership rights to Singapore. The combination of these new R&D incentives, relevant existing tax measures and low corporate tax rate together with a

partial corporate income tax exemption should make Singapore more attractive as a hub for MNCs' R&D activities and for IP ownership rights for the Asia Pacific market.

The various maritime incentives will give shipping groups more flexibility to structure their businesses to suit their business needs.

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Singapore Budget Offers Enhancements Aimed At the Financial Services Industry

The Singapore Budget announced further enhancements to existing financial services sector incentives to promote activities in the financial services industry with a goal of strengthening Singapore's position as an Asia Pacific financial hub.

Financial Services

Extension of the Financial Sector Incentive (FSI) – The FSI, which offers a concessionary tax rate of 5% on income

from qualifying high growth and high value-added activities and 10% on income from qualifying financial activities that are important to Singapore's financial center development objectives will be extended for another five years from 1 January 2009 to 31 December 2013 if certain conditions are met.

A new Enhanced-Tier FSI award, FSI-Islamic Finance (FSI-IF) will be introduced to grant a concessionary tax rate of 5% on qualifying income from qualifying Shariah-compliant lending and related activities,⁴ as well as fund management and other investment advisory activities, subject to conditions. The incentive is subject to application and approval. The approval period is from 1 April 2008 to 31 March 2013. This is intended to encourage banks to offer Islamic financing, and increase Singapore's competitiveness vis-à-vis other countries aiming to become an Islamic financial hub (e.g., Malaysia). Further, US banking groups considering setting up an Islamic financial hub to tap into the increasing pool of "petro dollars" in the Middle East may consider Singapore as a potential jurisdiction.

⁴ This refers to financing activities permissible under Islamic law.

Enhancement to the Offshore Insurance Business (OIB) incentive — Subject to certain conditions, a 5% concessionary tax rate will be granted to an insurer (other than a captive insurer, a marine and hull liability insurer or an insurer underwriting specialized insurance risks) for offshore Islamic insurance (takaful⁵) or reinsurance (retakaful⁶) business for five years upon approval (granted between 1 April 2008 and 31 March 2013). This incentive complements the FSI-IF incentive discussed above.

The FSI-Bond Market incentive is expanded to include trading of Qualifying Debt Securities (QDS) and Qualifying Project Debt Securities (QPDS) with effect from 16 February 2008.

In an effort to encourage further growth of the derivatives market, the FSI-Derivatives Market award is expanded to include trading of exchange-traded financial derivatives with effect from 16 February 2008.

Enhancement of the Qualifying Debt Securities (QDS) incentive — The QDS incentive will be extended for another five

⁵ Islamic term for Islamic insurance.

⁶ Islamic term for Islamic reinsurance.

years to 31 December 2013. In addition, from 16 February 2008 to 31 December 2013, the incentive is enhanced to exempt all investors from income tax on qualifying income derived from QDS that are (a) debt securities with a term of at least 10 years; or (b) Islamic bonds (sukuks⁷), subject to conditions. Currently, debt securities in Singapore are generally issued with terms of less than 10 years. A borrower will prefer to finance a long-term asset with long-term debt. However, if long-term bonds are not available in the bond market, a borrower who financed a long-term asset with a series of short-term debt issues, could face a maturity mismatch scenario. With this enhancement to the QDS incentive, bankers and borrowers alike should have more flexibility in their financing products/arrangements.

Insurance and reinsurance brokers — Currently, the income of insurance and reinsurance brokers is subject to tax at the normal corporate tax rate of 18%. Under this Budget proposal, fees and commissions derived from the provision of insurance brokering and advisory services by qualifying licensed direct and reinsurance brokers to non-Singapore-based clients will enjoy a 10% concessionary rate

for up to 10 years. The window period for approval is from 1 April 2008 to 31 March 2013. With this incentive, US brokers may consider using Singapore as a base from which to operate in Asia.

Enhancement to tax incentives to promote project financing — The package of existing tax concessions is extended from 1 January 2009 to 31 December 2011. In addition, from 1 April 2008 to 31 December 2011, a 10% concessionary tax rate will apply for a period of up to 10 years on income derived by a company from the provision of management services to registered business trusts and funds that own offshore infrastructure assets and that list in Singapore.

Extension of tax exemption on income derived by primary dealers from trading in Singapore government securities — The tax exemption period is extended from 28 February 2008 to 31 December 2013.

Enhancement of Approved Special Purpose Vehicle (ASPV) incentive — The ASPV incentive will be renewed for another five years from 1 January 2009 to 31 December 2013. In addition, the condition requiring all debt securities issued by an ASPV to be Qualifying Debt

Securities will be lifted for the period from 16 February 2008 to 31 December 2013. This will enable SPVs that satisfy all other conditions except this condition to still apply for ASPV status.⁸

Tax exemption for family-owned investment holding company (FIHC) — This incentive grants a tax exemption to qualifying FIHCs to the extent that the

⁸ The following tax concessions are enjoyed by an ASPV engaged in asset securitization transactions:

- (a) tax exemption on income derived by an ASPV from approved asset securitization transactions entered into during the period from 27 February 2004 to 31 December 2008;
- (b) Goods and Services Tax recovery on its business expenses incurred during the incentive period, at a fixed rate of 76%;
- (c) remission of stamp duties on the instrument of transfer of assets to the ASPV for approved asset securitization transactions; and
- (d) tax exemption on payments made during the period from 27 February 2004 to 31 December 2008 to qualifying nonresidents on over-the-counter (OTC) financial derivatives in connection with an asset securitization transaction. Where the OTC financial derivatives contract took effect, was renewed or extended during the period from 15 February 2007 to 31 December 2008, any qualifying payment made to qualifying nonresidents under such contract is tax exempt.

⁷ Islamic term for Islamic bonds.



tax exemption mirrors the tax exemption on qualifying locally-sourced investment income and foreign-sourced income granted to individuals. The incentive is valid from 1 April 2008, to 31 March 2013. Currently, specified locally-sourced investment income and all foreign-sourced income (other than foreign-sourced income received through a partnership in Singapore) derived by individuals is tax exempt. This incentive should create fresh opportunities for private banking and wealth management professionals.

Further details on all the above incentives are expected to be released by the end of May 2008.

Implications

The enhancement of existing incentives for the financial services industry is aimed at strengthening Singapore's attractiveness as a location for a regional financial center. The Budget is expected to offer more flexibility to foreign-based financial institutions, hedge funds, and private

equity funds in their investment strategies and increase the potential range of product offerings by foreign-based financial institutions.

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Spain

Ruling Clarifies Application of Spanish Participation Exemption Tainted Income Test

The Spanish tax authorities recently issued a taxpayer-favorable binding ruling that clarifies the way in which the business activity test, also known as the tainted income test, must be performed. The tainted income test is among the requirements that have to be met in order to benefit from the Spanish participation exemption regime on foreign qualifying dividends and capital gains.

In the ruling, issued on 7 December 2007 (number V2628-07), the Spanish General Directorate of Taxes concluded that the fiscal years in which a foreign subsidiary has losses (either operating or non-operating losses) will not be considered for purposes of the tainted income test, irrespective of the passive nature of revenues derived during those years.

The business activity test requires that the gross revenues obtained by the foreign subsidiary of a Spanish parent must derive from "active" business activities conducted outside of Spain. In particular, this requirement will be deemed as met where at least 85% of the gross revenues obtained by the entity are not "passive" or "tainted" income under the Spanish CFC regime. In the case of sub-holding entities, the income obtained from their shareholdings (i.e., dividends and/or capital gains) is considered to be derived from business activities if it is sourced from lower-tier subsidiaries that in turn meet the participation exemption requirements. Similarly, group-financing entities



are deemed to have income derived from business activities provided the ultimate borrowers carry out a business activity.

In this respect, a controversial subject of debate has been that the participation exemption rules on capital gains only apply when the business activity test (and the subject-to-tax test) have been met in each and every year during which the relevant participation has been held. Deriving tainted income exceeding the 15% threshold during one particular fiscal year could jeopardize the participation exemption regime on capital gains.

In the case reviewed by the authorities, the Spanish parent owned two operating subsidiaries, in Romania and Portugal, both of which were engaged in the development of real estate projects. Both entities had been active since their respective incorporations, but, by following local GAAP, the only income they derived prior to the sale of the projects consisted of (tainted) interest from a bank account and minor foreign currency exchange gains. During those years, both entities had losses insofar as the sale of the projects had not yet begun to take place.

Under these circumstances, there is a concern that the rule could have been interpreted such that the participation exemption regime would not apply to a potential capital gain derived by the Spanish taxpayer upon the transfer of the participations as the 85% “business activity test,” literally, would have not been met in each and every year that the relevant participations were owned. However, the Spanish tax authorities concluded that the business activity test must be met only during fiscal years in which the relevant entity has derived profits. Therefore, the fiscal years in which the entity has losses will be disregarded for these purposes, irrespective of the nature of any income obtained during those years.

This binding tax ruling appears to be a positive development for all taxpayers potentially eligible for the Spanish participation exemption regime with regard to potential capital gains--including those utilizing the ETVE regime--since the Spanish tax authorities are obliged to apply the conclusion reached in the ruling to all taxpayers that are in the same situation.

Nevertheless, all facts and circumstances should be reviewed on a case-by-case basis in order to determine whether a particular taxpayer may rely on the ruling summarized herein, or rather should obtain further certainty from the Spanish tax authorities pursuant to a specific tax ruling.

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Switzerland

New Swiss Regional Policy Law Entered into Force on 1 January 2008 – Tax Holiday Regime Now Confirmed

Switzerland’s federal law on New Regional Policy (NRP) and its related ordinances entered into force on 1 January 2008.

The NRP replaces the Lex Bonny, otherwise known as the Bonny Decree, and its respective ordinances. As a consequence, the federal tax holiday regime has now been formally confirmed and codified in a law. Under the tax holiday provision of the NRP (art. 12), an existing or newly incorporated company may qualify for a partial or full tax holiday at the federal level — on top of a tax holiday at the cantonal/communal level — for a maximum period of 10 years. Details are regulated in two related ordinances newly issued by the Federal Council and the FDEA.

[Tax Holiday under the New Regional Policy Law](#)

The requirements to benefit from the federal tax holiday are very similar to those applied under the Bonny Decree. In general, a tax holiday at the federal level may only be granted in combination with and to the extent of a tax holiday granted at the cantonal/communal level. In other words, duration and extent of the federal tax holiday is directly linked to and dependent on the cantonal/communal tax holiday.

[New Development Areas](#)

The most significant change in the new regulations consists of redefining the areas entitled to the new federal tax

holiday regime. The ordinance redefines the perimeter of economic development areas. The regions listed extend over 11 cantons and represent an area where approximately 10% of the Swiss population resides. The new qualifying areas now better reflect the weaker economic regions of Switzerland whereas well-developed regions, particularly close to urban districts, are no longer listed under the NRP (specifically, regions in the cantons of Schaffhausen, Thurgau, Fribourg, and Vaud). Even though the qualifying areas have been reduced in terms of affected cantons and population covered, the total land area that qualifies under the new federal tax holiday regime has been increased.

[Transitional Rules](#)

Tax holiday rulings granted under the Bonny Decree should continue to be valid and applicable for the holiday's previously stated duration as long as the relevant facts and circumstances agreed to for the purpose of the tax holiday remain unchanged.

With reference to new tax holidays, the Swiss Confederation has decided to grant a three-year transition period for regions defined under the Bonny Decree but no longer listed under the NRP. During this

transition period (i.e., from 1 January 2008 until 31 December 2010), companies with investments in such regions may be eligible to a maximum 50% federal tax holiday for a period of up to 10 years.

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Taiwan

Taiwanese Tax Ruling May Adversely Affect Mergers

In January 2008, the Taiwanese tax authority unexpectedly issued a tax ruling that may have a negative tax impact on domestic and cross-border mergers. Under the tax ruling, a merged company would realize capital gains on deemed dispositions of fixed assets arising from a merger under a purchase method if the merger was effectuated on or after 1 January 2008.

Note that this ruling is not taxpayer specific but is binding on all taxpayers. The ruling does not apply, however, to



a subsidiary that merges into its parent, since such merger is considered as a restructuring transaction, and therefore, remains tax free.

Under the tax ruling, a surviving company may apply purchase accounting to the transaction. Under this scenario, the acquisition price is allocated to acquired fixed assets, resulting in assets being stepped up to their fair market values, provided that the acquisition price represents the fair market value of the assets, substantiated by documents such as a valuation report, merger agreement, a shareholder meeting resolution and other applicable supporting documents, and approved by the Taiwanese tax authority. As a result, the merged company would be deemed to have disposed of its assets at their fair market values, resulting in potential capital gains on its deemed disposition.

This is a significant departure from the current nontaxable treatment for Taiwanese tax purposes and potentially would cause the merged company to incur additional tax costs. The tax ruling itself covers fixed assets; however, based on an informal discussion with an official

in the Ministry of Finance, it appears the term "assets" may be sufficiently broad to include other assets such as intangible assets, depletable assets, and long-term investments. Without further guidance from the Taiwanese tax authority, it will remain uncertain what assets fall under the "covered asset" category.

The tax ruling may also have a significant impact on mergers that have already been negotiated (but not yet fully completed) prior to its issuance, unless the parties agree to renegotiate the purchase price, taking into account the ruling's impact.

While the new tax ruling provides an acquiring company with a potentially higher depreciable basis in acquired assets resulting from mergers occurring on or after 1 January 2008, a merged company could be subject to the 25% corporate income tax on capital gains from deemed disposition of assets.

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United States

US Customs Proposes to Eliminate First Sale Valuation

The US Bureau of Customs and Border Protection issued a Notice in the 24 January Federal Register proposing a new interpretation that would effectively eliminate "first sale" valuation. Currently, importers that purchase merchandise which has been subject to multiple sales prior to importation may declare the price paid in the earlier, or first sale, for Customs purposes. For example, there are many situations in which a contract manufacturer sells a product to a principal company, which resells the product to a US distributor, but the product is shipped directly from the manufacturer to the United States. Under the first sale rule, the manufacturer to principal sale is used for Customs valuation. Under Customs' proposed new interpretation, the second sale from the principal to the US distributor would be used, resulting in a higher dutiable value and more Customs duties.

The first sale rule was established in a series of court cases, with the seminal case being the Court of Appeals for the Federal Circuit 1992 decision in *Nissho Iwai America Corp. v. United States*.

IRS Issues Contract Manufacturing Regulations

The IRS and Treasury released long-awaited proposed regulations on contract manufacturing on 27 February 2007. The US government described the regulations as an attempt to “clarify” that in order for a controlled foreign corporation to not have foreign base company income on a sale otherwise described in Section 954(d), the CFC must itself either physically manufacture the property or “substantially contribute” to the manufacture of the property. The regulations then list factors that will be considered to determine if the CFC has, in fact, substantially contributed to the manufacture of the property.

As expected, the proposed regulations explicitly reject the so-called Its defense, and, in effect, turn the substantial transformation test into a more active one. The regulations also address what constitutes a branch and what happens when a CFC has multiple manufacturing branches.

In a nod to existing structures in place, the proposed regulations have a prospective effective date. The regulations will be effective when published as final in the Federal Register. However, the IRS notes that until the regulations are issued as final, taxpayers may choose to apply the proposed regulations in their entirety to all open years as if they were final regulations.

While providing welcome guidance, the issuance of the proposed regulations has specific implications for existing tax effective supply chain management (SCM) structures. Existing structures will need to be reviewed to determine whether a manufacturing branch exists under the proposed regulations. Other issues around SCM structures will likely require closer review and potential restructuring to conform to the new rules. ■

Customs subsequently issued its own guidance on meeting first sale requirements.

Based on its new assessment that *Nissho Iwai* was wrongly decided, the Federal Register Notice states that if the newly proposed interpretation is finally adopted, it will result in the revocation of Treasury Decision 96-87, the modification or revocation of all previously issued first sale rulings, and revocation of any first sale treatment previously given by Customs. Application of any prior court decisions would be limited to the facts of the case.

The new treatment would have only prospective application from the date of final adoption.

The Federal Register Notice solicits public comments on the newly proposed interpretation through 24 March 2008. Ernst & Young is actively working with taxpayers on comments, as well as other remedial measures. Additionally, it is important to note that there are often alternative structures which importers consider in situations where first sale qualifications are not met, which will remain viable

even if the newly proposed interpretation is adopted. While taxpayers may continue using first sale valuation prior to adoption of a final interpretation, it is important that any business using, or contemplating, a first sale structure be advised of the Notice and consider both submitting comments and potential alternative structures.

Ernst & Young, Customs and International Trade, US - Bill Methenitis (Dallas), Kristine Price (New York), Steve Gardon (Detroit), Michael Leightman (Houston) and Bob Schadt (Washington, DC)

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SCORE No. CM0889

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