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Global Update

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EDITORIAL

Integra International – our fast growing network of accountants, auditors, tax and business consultants had their first Cross Border tax seminar on April 22nd in Vienna. About 20 tax experts from all over Europe discussed special tax cases and tax efficient structures.

Gerard Madec from Paris gave an overview about holding company privileges, financing and taxes and several other ideas; Francesc Bellavista showed the regulations of a Spanish ETV for international tax planning; Dirk Lehmann presented the actual tax implications of real estate investments in Germany; and I was pleased to show Austrias position as a location for headquarters and holding companies for investments in Eastern Europe. A lot of discussion about the different case studies showed us the importance of specialized tax seminars. Of course some events were also organized for the participants.

Integra International AAA section held their yearly meeting in San Francisco in mid may. More then 50 people attended the technical program of the conference with different topics on taxation (local US taxation as well as some International taxation issues in connection with US and Canada), marketing a CPA firm as well as internal Integra matters. The organization of the meeting was done by Brokstein & Rosen, thanks to Annise and Arnie Brokstein and Ken & Flavia Rosen for showing us wonderful San Francisco. We all will never forget such a marvellous event.

Integra International EMEIA section held their annual meeting in Malta in early June. Participants could learn about “Brand valuation”, international tax issues as well as IT and audit related topics. Thanks to Patrick Camillieri our Maltese member and his firm P C Corporate Services Ltd for organizing the wonderful event with a visit of historical places on the island of Malta and a beach and pool party.

The Integra World wide conference this year will take place in Hong Hong beginning of November. We are all looking for a next milestone in the Integra International world wide expansion with our first ever held meeting in Asia.

Integra International is proud to announce that it already can serve for its clients with members in 43 different countries with 85 members and more then 125 offices in the fields of accounting, tax consulting and auditing. New countries are in the focus of the global board and we are convinced to grow our network over 2007.

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INVESTMENT IN AFRICA-THINK ABOUT FRANCE

The relations between most of the industrialized countries depend upon a lot of bilateral treaties signed to prevent double taxations. It is more and more obvious that a lot of countries are handicapped by not having entered into a network of treaties. Many of those countries are tax heavens but not all of them.

It is now well known that HONG-KONG (in which there is a territoriality principle and foreign profits do not bear any taxation) has found a way to enter into EUROPE or to have EU companies investing abroad through HONG-KONG. The treaty, signed as December 10, 2003 between HONG-KONG and BELGIUM, became effective on October 7, 2004.

Any EU investor can have access to the HONG-KONG favorable tax regime by interposing a Belgian holding-company.

What happens with Africa?

A lot of African countries are not tax heavens (in principle) but might become tax heavens (since the computation of taxable profits and deduction of expenses are much easier that in the other countries).

Unfortunately, most of those countries have not entered into a developed network of treaties and the simple application of their internal tax laws may lead to double taxation.

MALI will be my illustration.

In MALI, profits are taxable at 35%, which is now a very high rate.
Dividends are bearing a 10% withholding tax, that is not creditable abroad where no treaty exists.

In some countries (Belgium, for example) dividends received are taxable.

It is quite easy to minimize the profit in MALI but fees paid by MALI to foreign parents or affiliates are suffering a 17,5% withholding tax in MALI (plus taxation abroad).

MALI has signed 2 treaties only (one with FRANCE, one with RUSSIA).

A Belgian investor will avoid the double taxation by interposing a French holding-company.

Think about FRANCE when you invest in Africa since FRANCE has signed treaties with most of the African countries.

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SPANISH HOLDING (ETVE)

1. ETVE TAX REGIME

The use of *Entidad de Tenencia de Valores Extranjeros* (ETVE) by international investors has increased a lot in the last years.

The reasons for this success are clear:

1.1 Full exemption for foreign-source dividends and capital gains from qualifying foreign subsidiaries;

1.2. Non-resident shareholders (except for low taxation and blacklisted jurisdictions) not taxed when the above-mentioned income is distributed. Capital gains derived by non-resident shareholders from the disposition of the Spanish ETVE shares are not subject to Spanish tax to the extent that the gains do not exceed undistributed profits of the ETVE from exempt dividends, capital gains, and the appreciated value of foreign qualifying subsidiaries (that themselves qualify for the “participation exemption”).

1.3. Almost no special restrictions on the deducibility of expenses, even if connected with exempt income, including interest, capital losses (with limitations when the participation was acquired to a related company), provisions for depreciation of the shares (except, in some cases, when it is due to the distribution of dividends), general expenses…

1.4. Tax amortization of financial goodwill disclosed in the acquisition of foreign subsidiaries;

1.5. Full access to Spanish tax treaty network (very extensive with respect to Latin American countries);

1.6. Full application of EU directives; (parent/subsidiaries on dividends; interest/royalties).

1.7. Flexibility for "checking the box" and other associated tax-planning formulas.

1.8. An ETVE can be a member of a tax group.

1.9. The contributions of shares (qualifying foreign subsidiaries) for setting up or increasing the capital of the ETVE, can benefit from the special “mergers & acquisitions” tax regime, even if it does not fulfill some of the requirements.

1.10. The thin capitalization rules are not applicable when the shareholder of the ETVE is an EU company. The debt/equity ratio is 3:1. for non EU residents.

1.11. Losses can be carried forward against future profits.

1.12. Stability: only improvements in the regime since its creation back in 1996.

The experience since 1996 has shown that most technical aspects of this regime are quite clear and that it works properly in practice.

2. ETVE REQUIREMENTS.

2.1. Use of Spanish Sociedad Anónima (S.A.) or Sociedad de Responsabilidad Limitada (S.L.)

2.2. Non bearer shares (nominatives).

2.3. Company object (non exclusive): The direction and management of the shares (participation) of the foreign subsidiaries. It is not necessary to manage the subsidiaries, only their shares (participation), performing the necessary activities as a shareholder.

2.4. Substance: to have personal and material means for doing this activity.

2.5. Domicile in Spain.

2.6. Accounting: Spanish accounting system.

2.7. Communication to the Spanish tax authorities the option to be on ETVE.

3. QUALIFYING FOREIGN SUBSIDIARIES (QFS):

3.1. Direct or indirect participation of 5% or more of the capital of the foreign companies or a minimum investment of 6 million Euros in the foreign company.

3.2. To hold the shares of the foreign company for an uninterrupted period of more than 1 year. The exemption is also granted if a distribution of a dividend is made to the ETVE before the one year period elapses, provided that the ETVE continues to hold the foreign participation for the one year period.

3.3. The foreign company ("participation") must be subject to a tax of an identical or similar nature to the Spanish corporate income tax. Foreign entities pass this test if there exists a Tax Treaty with a clause of information exchange.

3.4. The 85% of the foreign company's income, out of which dividends are paid to the ETVE, must have arisen from "active" business operations.

3.5. In case of capital gains coming from the transfer of QFS, the former requirements 3.3 and 3.4 have to be fulfilled during all the periods in which the participation have been held.

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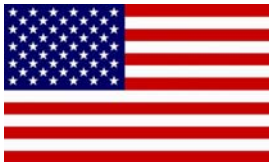

US INTERNATIONAL REPORTING REQUIREMENTS

The US has extensive reporting requirements designed to capture as much income as possible and to deter off shore harboring of income. In general, the US requires the filing of income tax or disclosure returns based on gross income rather than whether there is a tax due. With respect to Tax Treaty Exemption, the US requires the filing of an income tax return to disclose the treaty claim to give the Internal Revenue Service an opportunity to review and challenge the claim.

Outlined below are various special reporting requirements.

Controlled Foreign Corporations

A controlled foreign corporation (CFC) is a foreign corporation where over 50% of the shares or voting control are owned by US Shareholders which include US citizens, US corporations, US partnerships, and US trusts. A Form 5471 is required to be filed each year by the controlling shareholder. There are exceptions for US residents of US Territories including Puerto Rico, Virgin Islands, Guam, Northern Mariana Islands, and American Samoa. Additionally, exceptions apply for other shareholders where one has already filed Form 5471 for the same income and year. Form 5471 requires a full disclosure of income and balance sheet structure and is also designed to classify income as active or passive. Passive income is required to be reported currently and is taxed by the US even though the income has not been distributed by the corporation. There are special rules regarding what income is passive. Penalties can be assessed for failure to report within the prescribed period which is the normal due date for the shareholders income tax return ($10,000 for each failure to report). Additional penalties can be assessed for noncompliance after an IRS request for filings.

Foreign Trust Reporting

The US Congress assumed that any foreign trust established by a US individual must be established to improperly avoid US tax and created laws that are designed to be punitive to those who do not report virtually any transfer to or from a foreign trust. US persons are required to report the establishment of, and transfers to and from a foreign trust. US persons are the same as above but also include a US estate (trust which is established at the death of an individual that holds assets of the decedent until they are fully distributed). There are exceptions to the reporting requirements which include qualified US pension plans for their investments in foreign trusts, transfers at FMV to a foreign trust except where income or gain is not currently taxable, and transfers to or from a Canadian qualified pension plan including RRSP's and RRIF's.

US reporting is required via Form 3520. Generally speaking, the reporting is a disclosure although in many cases income within the trust may be currently taxable and the disclosure is designed to highlight that fact. Penalties for not reporting are severe starting with 35% of the gross assets transferred into the trust and / or 35% of the gross distribution from a foreign trust if the transfer or receipt is not timely and properly reported. Additional penalties can also apply.

US Income Tax Reporting for Foreign Nationals

Foreign nationals are required to file a US income tax return and report US source income if they have US effectively connected income or US source passive income that did not have the proper US nonresident withholding tax collected. Effectively connected income is income from a US trade or business income and includes the provision of personal services. Personal services are sourced to the location where the services are performed. Therefore business trips to the US almost always trigger a technical requirement to file an income tax return since US law has a very low de minimus threshold which is $3,000 or less than 90 days. The requirement to file a US income tax return is based on US source income not on whether a US tax will be due. This requires an income tax return be filed even where the individual may be exempt under a tax treaty with the US.

Nonresident are only taxable on US source income whereas US residents are taxable on world income.

US Tax Reporting for Foreign Corporations

Foreign corporations are required to report US income that is effectively connected with a US trade or business (ECI). There is no threshold and the requirement exists if they have any gross US ECI. US activity that would constitute a trade or business includes having an office or fixed base of operations, employees resident in the US, dependent agents in the US, or exercising management functions in the US such as concluding contracts in the US. Income Tax Treaties may allow a larger threshold of activity in the US without creating a US fixed base. A return is required to claim the treaty position.

Form 1120F is the required reporting and only income directly connected with the US business is taxable. Deductions are likewise limited to those directly connected to the US business.

US Nonresident Withholding Requirements

The US has a statutory Nonresident Withholding Tax (NRWT) that is set at 30% of gross US source not effectively connected income. ECI is taxed at the regular graduated tax rates with deductions allowed. US source not ECI includes dividends paid by a US corporation, interest paid by a US resident (with quite a few exceptions), rents on US real property or US sited personal property, US sited royalties, and US trust income. The payer of the income is liable to a penalty equal to the tax not collected if they fail to collect the NRWT and remit the same to the IRS. The law requires that the payer collect the full 30% unless they are provided official documents from the recipient documenting an exception from the withholding or an entitlement to a lower rate under an income tax treaty. Treaty claims require Form W-8BEN be filed.

US rental income paid to a nonresident of the US is subject to the 30% NRWT unless the individual files a US income tax return and makes an election to be taxed at graduated rates on net income.

Expatriation to Avoid Tax

The US has passed laws that require special tax reporting and establish a separate tax regime for individuals who are deemed to have expatriated to avoid US income and / or estate taxation. The rules apply to a US citizen who renounces their US citizenship or a Long Term Green Card holder who surrenders their Green Card after 5 years and departs the US.

The rules apply if the individuals net worth is $2,000,000 or more or if their average income tax in the 5 years up to departure were $124,000 or more. There are very limited exceptions.

Rules require the individual to file a US income tax return for 10 years after departure and subjects them to US tax on an expanded definition of US source income. The individual pays the higher of the US tax on a nonresident under normal rules including treaty relief or under the expanded rules with no treaty relief. The 10 year statute does not start until the individual has made an expatriation disclosure on their Form 1040NR. The law was specifically written to override all US Income Treaties in force in 1994. Newer treaties can lessen the impact of the rules but the vast majority of new treaties do not. More recent adjustments to the law include a provision to require an expatriated individual to file a US income tax return as a full year resident if they spend 30 days or more in a year within the 10 year window (with exceptions for days working for an employer which requires the US business trips).

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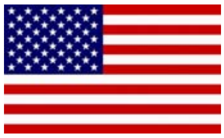

CAPITAL BUDGETING – A VALUE ADDED SERVICE

Most small to medium sized companies have no idea how to approach capital investments. They treat it as if it were an operating budget decision rather than a long-term, strategic decision that will impact their cash flow, efficiency of their daily operations, income statement, and taxable income for years to come. They need your help understanding the importance of and then making the right decisions.

Capital investment (or, expenditure) decisions relate to decisions on whether or not a client should invest in a long-term project, capital facilities and/or capital equipment/machinery. Capital investment decisions have a major effect on a firm's operations for years to come, and the smaller a firm is, the greater the potential impact, since the investment being made could represent a substantial percent of the firm's assets.

Capital projects are usually identified by functional needs or opportunities, although many are also identified as a result of risk evaluation or strategic planning. Some typical long-term decisions include whether or not to:

- Buy new office equipment, cars or trucks;
- Add to or renovate existing facilities, including the purchase of new capital equipment/machinery;
- Expand plant or process operations;
- Invest in facilities for a new product line or to expand services;
- Continue or discontinue an existing product line;
- Replace existing capital equipment/machinery with new equipment/machinery;
- Invest in software to meet technology-based needs or systems designed to help improve process and/or efficiency;
- Invest in R&D or intangible assets;
- Build or expanding a foreign or satellite operation;
- Reorganize assets or services; or,
- Acquire another company.

Capital investment (or, expenditure) decisions are more commonly referred to as capital budgeting decisions since they involve resource allocation, particularly for the production of future goods and services, and the determination of cash out-flows and cash-inflows, which need to be planned and budgeted over a long period of time. It is important that you get involved right from the start to guide them through this process since this is a very complicated accounting issue.

The phases of the capital budgeting process include:

- Description of the need or opportunity;
- Identification of alternatives;
- Evaluation of the options and the relevant cash flows of each;
- Selection of best alternative; and
- Conducting a post-completion audit of the projects.

The first step is to identify the need or opportunity. This is usually done at the mid-management level and is the result of a shared vision of company goals and strategies coupled with a "where the rubber meets the road" perspective of "local" clients needs, tastes and behavior. They see a need or opportunity and communicate it to senior management, usually in the form of proposals which both include identification of the need or opportunity, and potential solutions and/or recommendations. Senior management then evaluates the merit of each proposed opportunity and makes a determination of whether or not to look into it further.

While project need identification is usually a de-centralized function, capital initiation and allocation decisions tend to remain a highly centralized undertaking. The reason for this revolves around the need for capital rationing, especially when funds are limited and upper-management wishes to maximize its returns/benefits from any capital projects undertaken.

The information needed to make this determination usually comes from both internal and external sources, and is based on both financial and non-financial considerations. Interestingly enough, the factors examined in this process can be both firm-specific and market-based in nature. It is that this point that companies should be seeking qualified financial guidance since the consequences of both a poor decision and of the implementation of a good decision can be far-reaching.

Upper management must develop an objective methodology so that alternate capital projects can be evaluated on a reasonable basis. Both quantitative and qualitative issues must be considered and the whole organization should be used as a resource.

Marketing should provide data on sales trends, new demand and opportunities for new products. Managers at every level should be identifying resources that are available to upper-management that may lead to the use of existing facilities to resolve the need/take advantage of the opportunity. They should also be communicating any needs they/their departments or divisions have that should be part of the capital decision. Financial analysts, or in their absence, qualified external financial experts such as your firm, should be involved in identifying the target cost of capital, the evaluation of startup costs and the calculation of cash flows for those projects chosen for evaluation purposes. Calculating the appropriate discount rate and calculating conservative cash flows is a critical part of this process that is best served by an independent accounting firm that can look at the project/these issues impartially. Estimation bias can be dangerous.

The objective is to evaluate (predict) how well each capital asset alternative will do and to determine if the net benefits to the firm are consistent with the required capital allocation, given the scarcity of resources most firms are faced with.

The purpose of the evaluation phase is to predict how well a new asset will benefit the firm. Possible measures, which you should help the firm develop, that should be considered include:

- Net income -- managers evaluate the incremental increase in accounting net income between alternatives;
- Net cash flow -- this is the most widely used measure; this measure looks at the actual cash flows (out and then in) resulting from the capital investment for each alternative; these need to be evaluated for both overall value (several techniques will

be discussed next) and from the standpoint of the effect on daily cash flow and the ability of the firm to meet its financial obligations in a timely manner; projects with high projected future returns may not be as attractive when adjusted for the time value of money or the costs involved in borrowing funds to meet operating obligations such as payrolls and accounts payable;

- Cost savings -- many capital investments are not designed to generate revenues directly but are, instead, designed to save costs and increase productivity; these projects are best evaluated on the basis of incremental savings generated;
- Equality of cash flows -- cash flows tend to vary from year to year; the timing of cash flows may be an important consideration to the firm;
- Salvage value and functionality of an existing asset when replacing it with a new asset -- while the historical cost of an existing asset is not relevant to a capital budgeting decision, the net proceeds from disposal of the existing equipment is; so is the question of how well existing equipment operates given that capital budgeting decisions are only concerned with incremental costs and incremental savings/profits;
- Depreciation, earnings and income tax -- income tax effects need to be considered based on the form of the firm (sole proprietorship, partnership, corporation, etc.), and the differences in the financial and tax accounting treatments available to the firm, especially as they apply to salvage value, useful lives and allowed depreciation methods, and, consideration of the marginal tax rate (which may vary from country to country); most firms fail to consider this cost or choose a tax or financial accounting treatment that does not maximize the firm's return on invested capital;
- Inflation -- the effects of inflation need to be considered in estimating cash flows as well, especially if is projected to increase in future periods and varies between capital projects being considered;
- Risk considerations -- political risk, monetary risk, access to cash flows, economic stability, and inflation should all be considered in the evaluation process since all are hidden costs in the capital budgeting process; and,
- Interest and the cost of capital -- the venture has to have a return that is greater than its cost of capital, adjusted for tax benefits, if any.

The firm should also make a subjective decision as to its preferences in terms of characteristics of projects in addition to the regular selection criteria it has set. For example, does the firm prefer:

- Projects with small initial investments? Earlier cash flows? Or, perhaps, shorter payback times?
- New projects or expansion of the existing operations?
- Domestic projects or foreign operations?
- If the firm is risk neutral, would the prospects of additional potential cash flows in riskier investments make a capital project more attractive?

Risk also needs to be analyzed carefully, regardless of which valuation method is used to evaluate the project. The more popular risk-assessment techniques include Sensitivity Analysis, Simple Probability Analysis, Decision-Tree Analysis, Monte Carlo Simulations and Economic Value Added (EVA):

- Sensitivity Analysis considers what will happen if key assumptions change and identifies the range of change within which the project will remain profitable;
- Simple Profitability Analysis assesses risk by calculating an expected value for future cash flows based on their probability of success to future cash flows;
- Decision-tree Analysis builds on Simple Profitability Analysis by graphically outlining potential scenarios and then calculating each scenario's expected profitability based on the project's cash flow/net income; this technique allows managers to visualize the project and make more informed decisions, although decision trees can become very complicated considering all the scenarios that should be considered (e.g., inflation, regulation, interest rates, etc.);

- Monte Carlo Simulations use econometric/statistical probability analyses to calculate risk; and,
- EVA, which is growing in popularity, is a performance measure that adjusts residual income for "accounting distortions" that decrease short-term income but have long-term effects on shareholder wealth (e.g., marketing programs and R&D would be capitalized rather than expensed under EVA).

Once the risk has been assessed, which valuation method should the firm/you use for a project? The answer depends on considerations such the nature of the investment (the timing of its cash flows, for instance), uncertainty about the economy and the time value of money if it is a very long term capital project.

The four most popular methods are:

- The Payback Period Method, which favors earlier cash flows and selects projects based on the time it takes to recover the firm's investment; weaknesses in this method include the facts it does not consider cash flows after the payback period and it does not consider the time values of money; a common practice is to use this method to select from projects with similar rates of return that have been evaluated using a discounted cash flow (DCF) method (e.g., this is often referred to as the Payback Method based on Discounted Cash Flows or Break-Even Time Method);
- The Accounting Rate of Return (ARR) Method, which uses accounting income/GAAP information, is calculated as the average annual income divided by the initial or average investment; the projected return is normally compared to a target ARR based on the firm's cost of capital, the company's past performance and/or the riskiness of the project;
- The Net Present Value (NPV) Method, which is based on the time value of money and is a popular DCF method; the NPV Method discounts future cash flows (both in- and out-flows) using a minimum acceptable cost of capital (usually based on the weighted average cost of capital or WACC, adjusted for perceived risk) that is referred to as the "hurdle rate"; the NPV is as the difference between the present value of net cash inflows and cash outflows, and a $0 answer implies that the project is profitable and that the firm recovered its cost of capital; and,
- The Internal Rate of Return (IRR) Method, which is based on the time value of money, calculates the interest rate that equates the present value of cash outflows and cash inflows; this calculated rate of return is then compared to the required rate of return, or hurdle rate, to determine the viability of the capital projects.

Key differences between the most popular methods, the NPV and IRR Methods, include:

- NPV is calculated in terms of currency while IRR is expressed in terms of the percentage return a firm expects the capital project to return;
- Academic evidence suggests that the NPV Method is preferred over other methods since it calculates additional wealth and the IRR Method does not;
- The IRR Method cannot be used to evaluate projects where there are changing cash flows (e.g., an initial outflow followed by in-flows and a later out-flow, such as may be required in the case of land reclamation by a mining firm);
- However, the IRR Method does have one significant advantage -- managers tend to better understand the concept of returns stated in percentages and find it easy to compare to the required cost of capital; and, finally,
- While both the NPV Method and the IRR Method are both DCF models and can even reach similar conclusions about a single project, the use of the IRR Method can lead to the belief that a smaller project with a shorter life and earlier cash inflows, is preferable to a larger project that will generate more cash.

Recent variations of these methods include:

- The Adjusted Present Value (APV) Method is a flexible DCF method that takes into account interest related tax shields; it is designed for firms with active debt and a consistent market value leverage ratio;
- The Profitability Index (PI) Method, which is modeled after the NPV Method, is measured as the total present value of future net cash inflows divided by the initial investment; this method tends to favor smaller projects and is best used by firms with limited resources and high costs of capital;
- The Bailout Payback Method, which is a variation of the Payback Method, includes the salvage value of any equipment purchased in its calculations;
- The Real Options Approach allows for flexibility, encourages constant reassessment based on the riskiness of the project's cash flows and is based on the concept of creating a list of value-maximizing options to choose projects from; management can, and is encouraged, to react to changes that might affect the assumptions that were made about each project being considered prior to its commencement, including postponing the project if necessary; it is noteworthy that there is not a lot of support for this method among financial managers at this time.

Other considerations the firm/you should consider as part of the valuation process are "soft" costs and benefits. Soft costs and benefits are difficult to quantify by are real non-the-less. Examples of soft costs might be a capital investment in a manufacturing process that results in added pollution to the atmosphere. A soft benefit might be the enhancement of a firm's overall image as a result of investing in R&D for high-tech products. Ignoring soft benefits and costs can lead to strategic mistakes, especially if you are taking about investments in advanced manufacturing technology. Soft benefits and costs need to be estimated and then included as part of the method used to determine if a capital project is desirable.

Once the project has been chosen and put into operation, a post-completion audit of the project should be undertaken by a qualified financial services firm, such as yours, which can evaluate the project objectively. This audit by an independent party will function as a control mechanism to ensure that the capital project is performing as expected and, in the event it is not, to make it easier to terminate the project by eliminating any bias of those involved in the project. It will also serve as a learning mechanism for upper management as they compare actual performance to expected results, and improve the processes and estimates they use in future investment decisions.

It should be noted that this control mechanism, which can be expensive, is essential to the success of future capital investment decisions, especially considering the long life of most capital projects.

One final word regarding implementation of this control mechanism -- successful post-completion auditing processes require that upper management understand that the purpose of the audit is to learn from past experiences,. Managers should not be penalized for the decisions they made but should, instead, be given the opportunity to learn from them.

The **Global Update** is a quarterly publication of Integra International intended to keep its worldwide members and their clients informed about what's happening in business matters around the globe. The editor is Mag. Franz Schweiger and he can be contacted at: BF Consulting Wirtschaftsprüfungs-GmbH, Mariahilfer Strasse 32, AUSTRIA 1070 Wien, Tel. 0043 1 522 47 91, Fax. 0043 1 522 47 91 1, E-Mail: office@bf-consulting.at
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