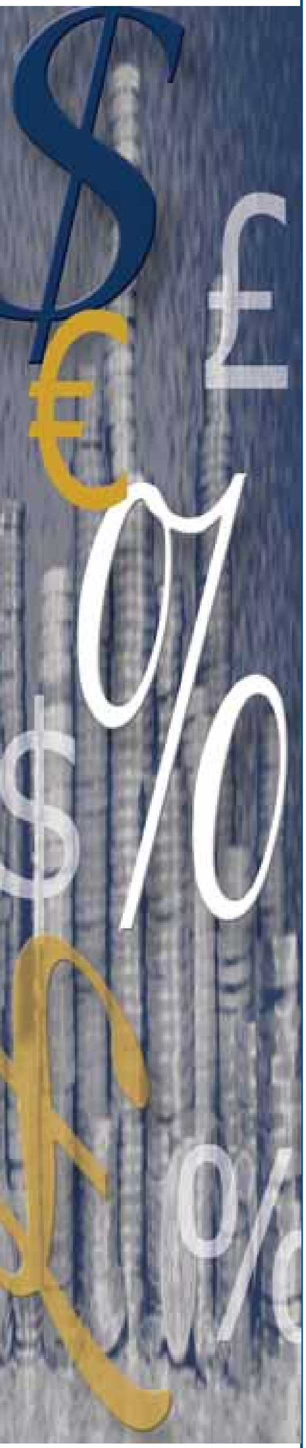
UHY

International Business

Issue 12



Transfer pricing: one step ahead

Companies' transfer pricing policies are expected to be challenged as governments increasingly seek to plug a widening hole in their corporation tax revenues.

UK, US and Japanese tax authorities have been the most active since 2000 in auditing transfer pricing policies. Challenges are also increasingly common in The Republic of Korea, India, Canada and Australia.

But one government's loss is another's gain – and some countries are increasingly promoting transfer pricing mechanisms to attract investment.

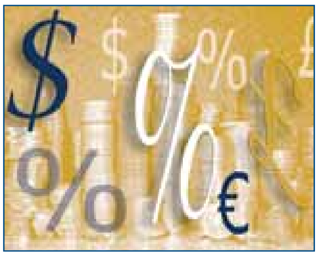
For example, there has been a big increase in the number of US and Japanese companies basing significant parts of their European operations in Ireland, which has a relatively low tax rate compared with many other countries in the European Union.

To attract inward investment, both Switzerland and Belgium have laws and practices that allow a reduction in profits to be subject to tax locally. The full tax rate is still applied but to a smaller amount of profits, resulting in a lower effective tax rate.

Transfer pricing - allocating profits between subsidiaries in different countries to take advantage of the most effective tax regimes - is an accepted part of compliance life and has become not only a major tax planning opportunity, but also an important consideration when streamlining and remodelling business structures.

The starting point for any remodelling has to be the most effective structure for the business. But, once that is identified, the question as to where to locate different parts of the structure should take tax issues into account – and there are opportunities particularly around intellectual property, procurement, manufacturing, distribution and sales.

But tax authorities do not enjoy seeing corporate tax on the decline from new business models and transfer pricing mechanisms. So it is important to seek cross-border advice specific to the countries in which you plan to operate.



In any international setting, transfer pricing issues arise where transactions are entered into between non-arm's length parties.

Without transfer pricing rules, a multinational group of corporations could set intercompany prices to unduly shift taxable income from high-tax to low-tax jurisdictions.

Many high-tax countries attempt to limit tax leakage through transfer pricing rules requiring taxpayers to charge a fair arm's length price for goods and services received from, or provided to, related non-resident parties.

Affected transactions

The transfer pricing policies of most countries are concerned with inter-company purchases and sales of goods and property; transfers of technology, rights, patents and intangibles; the rental of property; the use of intellectual property; and the provision of technical assistance.

Management fees and other payments for services, as well as payments resulting from research and development cost-sharing arrangements or expense allocations, are also areas of concern.

Arm's length principle

The arm's length principle is generally based on prices or margins obtained by arm's length parties engaged in the same or similar transactions. For price or margin comparisons to be useful, the economically relevant characteristics of the transactions being compared must be sufficiently similar so as to permit reasonably accurate adjustments to be made for any differences in such characteristics.

For example, where services are an integral part of the business activity, an arm's length charge would normally include an appropriate mark-up or profit element based on mark-ups charged by unrelated parties providing similar services.

In other words, the price to be charged to related parties should equal the price charged by unrelated parties rendering the same services. Simply charging for services based on cost plus a small mark-up - say 15% - does not meet the standard in many, or even most, situations.

In this issue

Transactional basis

In establishing transfer prices, generally taxpayers must set prices separately for each transaction they enter into with a non-arm's length party. This means that taxpayers cannot simply wait until year-end to 'true up' their inter-company transactions. Procedures must be in place to identify situations involving the cross-border transfer of goods and services to ensure the appropriate transfer pricing method has been determined, and to record each and every transaction using that method.

Documentation requirements

In addition to comprehensive rules addressing the quantum of the transfer prices, many countries require taxpayers to complete contemporaneous documentation setting out factors such as:

- The property or service to which the transaction relates.
- The terms and conditions of the transaction.
- The identity of the parties and their relationship.
- The functions performed, the property used or contributed and the risks assumed by the parties.
- The data and transfer pricing methods considered and the analysis performed to determine the transfer prices.
- The assumptions, strategies and policies, if any, that influenced the determination of the transfer prices.
- An overview of the taxpayer's business, including an analysis of the economic and legal factors that affect the pricing of its goods or services.

Severe penalties for failure to comply with these requirements may be imposed. Fortunately, it is normally possible to prepare a single analysis which can be used to satisfy the requirements in multiple jurisdictions. Many jurisdictions also require taxpayers to report annually the nature and amount of non-arm's length transactions. For example, the Canada Revenue Agency requires the filing of form T106 and the US Internal Revenue Service requires the filing of form 5472.

Support cross-border

The global presence of UHY is critical in assisting multinational clients deal with complicated, and sometimes conflicting, requirements.

Our goal is to reduce the potential for double tax, while taking advantage of appropriate planning measures to minimise the client's worldwide income tax burden.

We can work closely with clients to ensure that the transfer pricing methods selected comply with the requirements of the applicable jurisdictions, and provide the best overall result for the client.

We can also help to ensure that the contemporaneous documentation and reporting requirements are met. Should the need arise, we can assist at the time of audit by taxation authorities.

In situations where it is difficult to apply the arm's length standard, or where the dollars are significant, UHY firms can assist the client in applying to the applicable tax authorities to obtain a bilateral or multilateral Advance Pricing Agreement (APA).

An APA is a binding agreement between a taxpayer and the relevant taxation authorities setting out the transfer pricing method to be used in advance of the transactions. The obvious advantage of an APA is that it can provide certainty for the client and can avoid potential double taxation and penalties. However, the APA can be a time-consuming and expensive process – most tax authorities charge for this service.

Trans-national transfer pricing

UHY offices in Toronto, Canada, and London, UK, worked together to assist a Canadian client expanding to the UK.

Our Canadian client, a subsidiary of a Swiss conglomerate, was given the go-ahead by its Swiss management to acquire a substantial portfolio of UK commercial rental properties.

The UHY London office was instrumental in helping our client set up its UK operations. We worked together to determine the best structure for the UK ownership and to ensure transfer pricing rules were met in each jurisdiction – Canada, the UK and Switzerland.

Not only was it necessary to address the appropriate charges by the Canadian corporation for finding the properties, arranging the acquisition and managing the ongoing UK operations, but various related companies also provided financing and guarantees, which had to be considered.

Through the co-ordinated effort of both London and Toronto offices, we were able to help our client to establish the appropriate transfer pricing system, assist with documentation requirements, determine the optimal ownership structure and facilitate the set-up of the UK operations.

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Islamic banking: a growth market

Islamic banking is estimated to be managing funds exceeding 200 billion USD and growing at 15% per annum.

Islamic financial institutions - from commercial banks, investment banks, investment companies to leasing and insurance companies - are not confined to Muslim countries but spread over Europe, the US and the Far East, drawing funds from both Muslims and non-Muslims alike.

More than two-thirds of Islamic finance business currently originates in the Middle East. Bahrain has the largest number of offshore Islamic investment banks in the Muslim World. Other major markets for Islamic finance include Egypt, Malaysia, Turkey, Indonesia and Pakistan.

Malaysia operates a dual-banking system promoted by the government. It allows conventional financial institutions, investment banks, commercial banks and finance companies to launch separate Islamic banking divisions, competing alongside two Islamic banks - Bank Islam Malaysia and Bank Muamalat Malaysia. Bank Negara Malaysia (the central bank) has its own Shariah Advisory Board, which sets the rules for the entire Islamic banking sector, ensuring uniformity of products and services.

Islamic banking stemmed from economic growth in the Islamic world, fuelled primarily by oil wealth. A bigger, middle-wealth segment in society made banking a necessity for more of the population rather than a service for the few, as had been the case 10 to 15 years earlier.

Today, Islamic bankers keep pace with sophisticated techniques and latest developments, evolving investment instruments structured so that they are not only ethically motivated but also profitable.

Basic principles

The basic principle is the prohibition of Riba (Usury, or interest). It also prohibits dealing in liquor, pork, gambling, pornography and all else unlawful under Shariah law.

The goal is not equality but avoidance of gross inequality along with a tenet that wealth should not become 'a commodity between the rich among you'.

The Islamic financial system employs the concept of participation in the enterprise, utilising funds at risk on a profit-and-loss-sharing basis. Speculative activity is excluded by careful investment policy, diversification of risk and prudent management. The concept of profit-and-loss sharing, as a basis of financial transactions, distinguishes good performance from the bad and mediocre.

Equities have only comparatively recently been opened up as an asset to Islamic investors, following approval from the Islamic Fiqh (Islamic jurisprudence) Academy, Jeddah - one of the major legal bodies in the Muslim world. Islamic investors are now able to invest in equities subject to certain criteria and Islamic equity funds have been launched.

Research engine

The Institute of Islamic banking and Insurance was set up in London in 1991. It has made a significant contribution to the education and training of people in Islamic banking and insurance through a post graduate diploma course, publications, lectures, seminars, workshops, research, and Shariah advisory services.

The institute has come to be recognised as the world's leading research body in the field of Islamic banking and finance.

It has also taken up ethical issues – for example, it has called into question a claim by some that Islam prohibits investment in armament and cinema industries. 'Islam's stand on these issues is clear,' it says. 'Investment in these sectors is not only permissible but also essential.'

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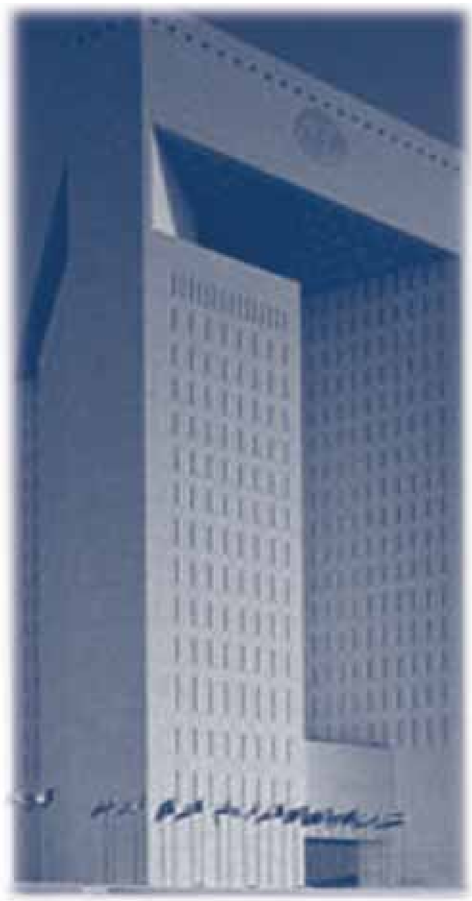
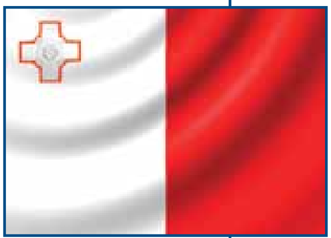


Malta: a land of opportunity

Keen and determined to attract foreign direct investment, Malta has restructured its fiscal legislation to provide tax incentives - particularly to companies manufacturing high value-added products, R&D and IT.



Malta has been described as the European Union's best-kept secret.

The islands have unique cost advantages and operate the imputation system for taxation.

With a company tax rate of 35%, non-resident shareholders setting up an International Trading Company (ITC) may benefit from a package of incentives and tax reductions which can take the tax rate down to as low as 4%.

ITCs are standard Maltese onshore limited liability companies with status specifically recognised only for tax purposes. They are:

- Companies registered in Malta.
- Engaged soley in carrying out trading activities from Malta.
- Trading with persons who are not resident in Malta (and with object clauses in their Memorandum of Association restricting them accordingly).

ITCs are taxed on gross dividend at 27.5%, but as the company would have already paid Malta's 35% company tax rate, the shareholder gets a refund of 7.5%. ITCs are also entitled to a refund equal to two-thirds of the tax paid by the company at 35% - which equals 23.3% of the company's taxable profits.

The resulting effective tax burden of 4.17% may be further reduced by double taxation agreements. Malta has treaties with 42 countries and is currently negotiating others.

Requirements for the formation of an ITC include a minimum authorised share capital equivalent to USD 1,500.

Foreign investment structure

Malta Enterprise (ME) is the government's agency focused on attracting foreign investment and supporting it. It promotes the islands as a competitive investment destination and offers attractive fiscal and non-fiscal benefits to companies intending to set up operations there.

Through ME, further incentives - such as Investment Tax Credits and investment allowances - may also be offered, subject to the investor meeting pre-determined criteria.

Malta's cost base is also lower than what would normally be expected from mainland Europe, particularly Luxembourg, which is one of the islands' major competitors.

The Maltese financial services sector accounts for 12% of GDP. Government projections expect this percentage to double over 10 years.

An important catalyst has been EU membership since May 2004 and with it the Malta Financial Services Authority (MFSA) which has a regulatory and supervisory role.

The MFSA has assumed most of the regulatory functions of the Central Bank of Malta. The adoption of one regulator is aimed at focusing on compliance requirements, while at the same time streamlining procedures and reducing bureaucracy.

Although the MFSA is demanding in compliance requirements, it is generally regarded as having a good relationship with the regulator that can, where possible, result in non-standardised approaches and custom-made solutions.

Malta has also received international recognition for its strong and stable regulatory framework which adopts EU standards on money laundering, professional secrecy, banking, insurance and company regulation.

Business climate

Malta offers a comfortable business climate to would-be investors in Southern Europe and the Mediterranean. With a European timezone and lifestyle, it has excellent connections to the European, North African and Middle East mainlands.

Benefits include:

- Government pro-business policy.
- Flexible and efficient 'can do' business environment.
- Dedicated, highly skilled and competitively priced workforce.
- Multilingual population - English, Maltese and Italian are spoken fluently and there are good numbers of French, German and Arabic speakers.
- Excellent distribution, freeport and telecommunications base from a strategic location.
- Social and economic stability.
- Modern, pleasant and safe country with a moderate climate for both business and to live in.
- Excellent business support services.
- Overall operating, training, retention and recruitment costs estimated to be one-third of EU average.

Following a revolution in communication technology, Malta has transformed its erstwhile insular handicap into a strength.

Another significant development is that Malta is fast gaining a strong foothold in the insurance market, particularly in captive insurance. The islands have been gearing up to take full advantage of pass-porting rights to sell services in the EU since accession. Industries related to oil and gas, manufacturing, pharmaceuticals etc, with typically high premiums, are particularly attracted to captive insurance.

And one further good reason for choosing Malta are the names of companies already doing business there - such as HSBC, ST Microelectronics, Lufthansa, De La Rue, Aventis and Microsoft.

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Investment vehicles bring tax plan benefits

Investors into Canada are making use of ‘flow-through’ vehicles in their tax planning strategies.

International businesses investing into Canada can sometimes use ‘flow-through entities’ (FTEs) in their tax planning strategies.

FTEs generally allow for a flow-through of profit or loss for tax purposes to the owner of the entity, while providing liability protection similar to that for corporations.

Combined with other tax planning strategies, FTEs may reduce the tax burden in the country where the operating business is located and/or in the foreign jurisdiction of the owner.

The challenge for tax planners is that FTEs may be treated differently under Canadian domestic law compared with the tax law in the foreign jurisdiction of the owner.

Canadian domestic FTE rules

Entities that provide a flow-through of income for Canadian domestic tax purposes are generally restricted to trusts and partnerships.

Canada has three types of partnership available (depending on the provincial law under which they are formed): general partnerships, limited partnerships (LPs) and limited liability partnerships (LLPs).

General partnerships are not often used as partners have unlimited joint and several liability for the obligations of the partnership, and partners may enter into binding contracts on behalf of the other partners.

LLPs are relatively new in Canada and allow a partner to fully participate in operating the business without losing limited liability status. Limited partners of LPs may not participate in managing the business without loss of limited liability protection.

It is thought LLPs will continue to be used more widely in Canada as advisors become more comfortable working with them. But LLP legislation varies from province to province and may not be available and/or appropriate in some Canadian jurisdictions.

Only partnerships provide for a flow-through of losses to owners. Losses incurred by a trust may not be claimed by beneficiaries but can be carried forward (subject to certain limitations) and applied to reduce income earned by the trust in subsequent years.

Canadian entities that are foreign FTEs

There are two corporate entities that may qualify as FTEs for foreign tax purposes - the Nova Scotia Unlimited Liability Corporation (NSULC) and Alberta Unlimited Liability Corporation (AULC).

While both are taxed as corporations for Canadian domestic tax purposes, some foreign jurisdictions may view them as FTEs.

In particular, the US Internal Revenue Service allows both entities to ‘check-the-box’ to determine whether they will be taxed as corporations, partnerships or disregarded entities for US tax purposes.

A recent case in UHY’s Vancouver office illustrates these rules:
A client of UHY’s Detroit office was considering setting up business in Canada and expected significant start-up losses. The client had other sources of income in the US against which losses could be deducted. The following structure was established:

The ultimate individual owners of the business in the US established S-Corporations. S-Corporations may be treated as FTEs for US income tax purposes.

The S-Corporations incorporated an AULC and funded it with a combination of debt and equity. The AULC ‘checked-the-box’ to be considered a partnership for US tax purposes.

The results were:
As the AULC and S-Corps were FTEs for US tax purposes, all start-up losses of the Canadian operations could be claimed by the individual owners in the US for US income tax purposes.

To reduce future exposure to Canadian corporate income tax in the AULC, interest-bearing debt formed part of the investment from the S-Corps. Note that Canada has ‘thin capitalisation’ rules that can deny interest deductions where the debt to equity ratio exceeds 2:1 and 25% or more shareholders have loaned funds to the Canadian entity.

As S-Corps are eligible for benefits under the Canada-US income tax treaty, dividends and interest paid to the S-Corps are subject to Canadian withholding tax of 5% and 10% respectively. Dividends paid to non-corporate entities would be subject to a 15% withholding tax rate.

There is no need for the ultimate US owners to file Canadian tax returns as the AULC is taxed as a corporation for Canadian income tax purposes.

There are alternatives to this structure that could have also provided a complete flow-through of start-up losses for US income tax purposes. For example, instead of using an AULC, the S-Corps could have used a Canadian LLP. However, in this alternative, the S-Corps would be required to file Canadian income tax returns.

This structure was a success for our clients because they had the foresight to look at their overall tax position in the US and Canada before deciding on how to proceed. Once they realised that the Canadian losses could be flowed through to them for US tax purposes, the decision on the appropriate structure was made.

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China: risks and opportunities

UHY's China Group principal Melanie Chen gives her insight into developing business in the Republic. Melanie has more than 10 years' experience in international tax and business advisory services. Her practice focuses on advising US multinational companies on the tax, financial and business aspects of doing business in China, Hong Kong and Taiwan - the so-called 'Greater China region'.

What are the risks attached to investing from abroad into China? What are the best ways to minimise these risks?

Risks are high in doing business in China because anything can happen, including political revolution, financial crisis, labour uproar, etc. However, the general return is high too – China is one of the fastest-growing markets with an annual growth rate approaching 10% in the past 10 consecutive quarters.

The key to success in China is to fully realise the risks and have a flexible action plan to minimise them. The following are, in my opinion, the most critical risks that may have a direct impact on foreign investment in China.

Undeveloped credit infrastructure

A common complaint of foreign companies doing business in China, or with Chinese companies, is about the difficulty of collecting full payment on time. China does not have a credit infrastructure that provides systematic and reliable resources to the credit history of companies and individuals.

Foreign companies should do good due diligence to minimise exposure to the risk of default on payment. It is worth investing time and money on extensive research and retaining a reliable third-party expert to find reputable partners and confirm the creditworthiness of partners or primary customers.

In addition, companies should pay close attention to the terms of payments and performance standards in contracts and verify the authority of Chinese people involved in negotiating and concluding these contracts. Make sure that contracts do not include provisions that violate Chinese law, even though the Chinese parties may promise not to enforce laws or regulations, and do not accept provisions that are beyond your control, such as visas for visits to your company in Europe or the US.

Poor legal environment

The existing Chinese legal system does not provide adequate and effective protection. The application of laws is inconsistent in different provinces and cities, and court verdicts are difficult to enforce. Cost of litigation is high, and penalties are low. Contracts are not fully respected and difficult to enforce. Bear in mind that the conclusion of a contract is just the beginning of real negotiation.

Verify the authority of the people you negotiate with and the ownership, permits, permissions, license and qualifications they claim that they have through independent sources. Find your own legal counsel and draft contracts in clear terms.

Do not rely on oral promises of business partners and government officials on local subsidies, incentives or special considerations that are not based on solid legal ground. Even if you have them in writing, you should treat these incentives as ways to augment profit (instead of counting on them to create profit) because they may be taken away at any time.

Lack of electric power supply

In recent years, more than two-thirds of China's provinces and municipalities have experienced chronic power shortages, with the most serious in the high-density industrial areas along the east coast.

In response, the Chinese government has approved several dozen new power plant projects, which are expected to add fresh capacity of about 35 million kilowatts, to come online in 2006 and 2007. However, there are concerns about the viability and sufficiency of such projects, because most of the approved new facilities are located in central China and it is in doubt whether the poor regional grid infrastructure can adequately transfer the added power to high-demand areas along the east coast.

Furthermore, it is expected that China's energy sector will have to be reformed from a controlled to a market pricing system, which calls for price deregulation. This means that prices of electric power may eventually be adjusted to meet the market demand.

Many foreign companies have started to shift manufacturing investment to smaller cities in central and west China, where power capacity for industrial use is more stable and adequate, and labour and land cost are lower than in large cities along the east coast. In addition, many companies have purchased diesel generators as a back-up to maintain production during peak power times.

As a result, foreign companies may want to include the expense of diesel generators as a fixed cost of investing in China and raise their estimate of costs to account for power supply uncertainties in east and south China.

Diverse and rapidly changing market

China is a very diverse market. With 1.3 billion in population, the consumer culture, cuisine and local languages are dramatically different in provinces from north to south and from east to west. The overall market has been growing rapidly but regional economy has developed at very different paces. In addition, China has a long history of strong regional protectionism where provincial and municipal governments impose barriers to the inward trade of goods and services from other regions to protect local businesses and tax revenue. It is challenging for foreign companies to penetrate regional markets because products that are well received in one city are not necessarily welcome in other areas in China.

Foreign companies need to be very sensitive to, and make marketing strategies taking into consideration, the regional differences and barriers. It is a mistake to assume that products popular in large cities or the east coast region will eventually find their ways into second-tier cities and the mid-west region.

Before jumping into these markets or launching a new product, it is critical that foreign companies do substantial and in-depth market research and keep close track of regional developments.

Difference in culture and management styles

The cultural differences between China and the West are striking. For example, in China telling a guest that he or she has gained weight recently is a compliment, and the honoured guests at a dinner party can expect to be given the head and tail of the fish to eat. To share and ask about personal matters is an expression by management of caring and respect for employees in Chinese companies, where the same questions may be seen as an invasion of privacy in the West.

Foreign companies doing business in China need to become familiar with basic Chinese culture and critical differences in business etiquette. Hiring managers who grew up in China and were trained overseas may help to smooth the potential conflicts in cultural and management styles.

What particular guidance can be given to smaller-sized to mid-market businesses looking to invest in China?

Find the right partner and make investments step by step. Small firms usually need a local Chinese business partner to make sales, deliver products and develop local markets. Companies may start by working with potential partners on low-cost products or under a consignment manufacturing arrangement to test their quality, capacity, efficiency and reliability before making substantial investment on forming joint ventures with a local partner or investing in factories and other capital expenditures.

Another approach is to set up liaison offices and hire a few Chinese employees to obtain first-hand market information and build customer relationships.

Alternatively, foreign companies may form joint ventures with Chinese partners with small amounts of investment and gradually increase the investment and eventually buy out these Chinese partners after they obtain a more solid market foothold.

Hire good local managers and advisors

Smaller firms tend to be cost sensitive. However, firms that are willing to pay for the best managers and advisors usually get significant return in the long run.

Advisors who have substantial experience in advising foreign companies doing business in China and in-depth familiarity with Western management and business models may help foreign companies identify the most cost-efficient market entry strategy and sustainable operating model for their Chinese investment. Smaller firms should invest in hiring and training the best local managers, instead of sending expatriates to work in China. Usually, periodic overseas training opportunities are very attractive to offer and an effective way of retaining and rewarding the best Chinese employees.

Be realistic and patient

Do not rely on the promises of subsidies and incentives of local government officials and partners to project your profitability. Use independent sources to verify your partners' claims of ownership, permits, permissions, licenses, and professional qualifications. Do a thorough risk analysis and have solutions for the worst situations in every phase of developments. Do not compromise on risk assessment standards just because the trend is to go to China. Be patient in waiting for acceptable terms and return on investment.

What incentives are offered?

China offers tremendous incentives. The basic tax incentive is the so-called 'five-year tax holiday', including a two-year income tax exemption followed by a three-year 50% income tax rate reduction starting from the first profit-making year to manufacturing-oriented foreign investment enterprises with a minimum 10-year business operation.

In addition, the regular corporate income tax rate is reduced from 33% to 24%, 15% or even 10% in various economic, technology or special development zones. There are incentives offered based on industries and transactions, incentives on business tax, value added tax, customs duty and other transactions tax. Local governments usually offer fiscal subsidies and tax refunds. The key is to identify what is on the table and verify incentives with independent advisors.

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