Advisory Panel on
Canada's System of
International Taxation

Tax Treatment of Expenses Attributable to Foreign Source Income in Selected Countries

Deloitte & Touche LLP

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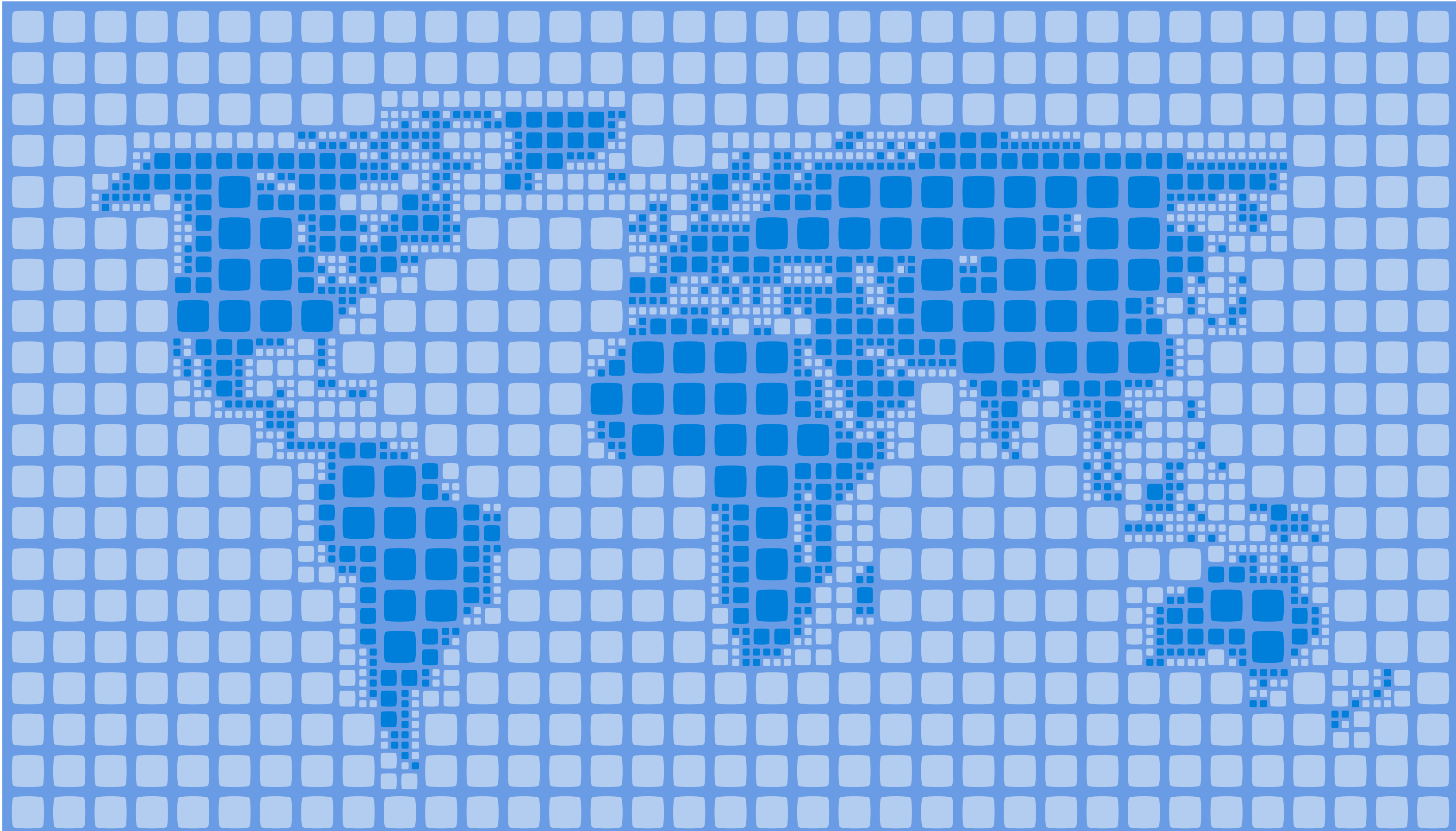

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Australia

System for taxing foreign income

Australian residents generally are taxed on income derived from all sources, including foreign source income. However, certain categories of foreign source income are excluded from Australian taxation through a combination of an exemption system and a foreign tax credit system.[1]

Exemption system

The exemption system applies to:

- dividends derived from a foreign corporation where the Australian corporation holds 10 percent or more of the voting shares in the foreign corporation ("non-portfolio interests");[2]
- "active" foreign branch income derived by an Australian corporation;[3]
- distributions paid out of income previously attributed through the accruals regime;[4] and
- capital gains in respect of non-portfolio interests in a foreign corporation that carries on an "active foreign business".[5]

The exemption system was introduced in 1991, but it has been subject to a myriad of changes in recent years. Previously, an exemption was provided for non-portfolio dividends paid by a corporation that was resident in a "listed country" (countries considered to tax profits comparably to Australia) or by a corporation that was resident in an unlisted country the profits of which were taxed in a listed country. Non-portfolio dividends from corporations that were resident in unlisted countries were generally subject to Australian income tax with a credit for underlying foreign tax and withholding tax.

1 It is noted that the foreign tax credit system will be replaced with a foreign tax offset system generally starting from July 1, 2008.

2 Section 23AJ *Income Tax Assessment Act 1936*.

3 Section 23AH *Income Tax Assessment Act 1936*. In broad terms, where a taxpayer fails the "active income test" in respect of income attributable to its foreign branch, passive income and capital gains from the sale of "tainted assets" are excluded from this exemption.

4 For example, section 23AI and 23AK *Income Tax Assessment Act 1936*.

5 Subdivision 768-G *Income Tax Assessment Act 1997*. To be eligible for the exemption (either full exemption or partial exemption), the Australian company generally must have held the non-portfolio interest for at least 12 months. A specific calculation is required to determine whether or not the foreign company carries on an active foreign business.

The exemption system was broadened in 2004 to include non-portfolio dividends from unlisted countries following recommendations from the Australian Board of Taxation[6] and after extensive public consultation.[7] The purpose of the measure was to improve the competitiveness of Australian companies investing in foreign countries and to encourage the repatriation of profits from unlisted countries.[8] The extension of the exemption system to cover all non-portfolio dividends meant that foreign tax credits for underlying foreign tax paid by the foreign company[9] were no longer required. It also meant that the management of foreign tax credits/foreign losses became less important, particularly for corporate taxpayers.

The extension of the non-portfolio dividend exemption to cover non-portfolio dividends from all foreign companies (not only those resident in listed countries) has increased the attractiveness for corporate taxpayers to use low tax jurisdictions to undertake active businesses (inactive business/passive income are likely to attract taxation under Australia's accruals regimes). Low tax profits could potentially be repatriated to Australia and reinvested or paid onto foreign shareholders free of Australian withholding tax pursuant to Australia's "conduit foreign income" regime.

In 2005, the "conduit foreign income" rules were introduced in order to further bolster Australia's effectiveness as a holding company location. These rules exempt Australian dividend withholding tax applying to distributions by Australian corporate entities to the extent that the income from which the distribution is paid is declared to be "conduit foreign income". "Conduit foreign income" essentially consists of foreign source income that is not subject to tax in Australia at the entity level (e.g., non-portfolio dividends, exempt foreign branch income, etc.). These rules allow profits from offshore to be repatriated to Australia and passed on to non-resident shareholders free from Australian dividend withholding tax.

There is currently a slight bias for Australian investors to invest offshore via a foreign subsidiary rather than a foreign branch, particularly if the foreign operations will be funded by debt in Australia. As discussed below, interest on debt used to derive non-portfolio foreign dividends can be deductible, subject to thin capitalization limits, while interest expense attributable to an exempt foreign branch would not be deductible.

One of the reasons for recent legislative changes was to increase Australia's attractiveness as a regional holding company location. Multinational corporations may be enticed to realign some of their foreign operations below Australia. Subject to thin capitalization and other relevant considerations outlined below, interest expense on debt funding used to acquire foreign subsidiaries can potentially be deductible.

6 The Board of Taxation is an advisory body to the Treasurer and the Australian Government. It was established in response to the Ralph Review of Business Taxation.

7 Paragraph 2.5, *Explanatory Memorandum to the New International Arrangements (Participation Exemption and Other Measures) Bill 2004*. The changes to the law were a result of the report by the Board of Taxation, *International Taxation — A Report to the Treasurer* and at paragraph 1.64 in the 1998 discussion paper, *An International Perspective — Information Paper: Examining how other countries approach business taxation*. This change was implemented to encourage multinationals to use Australia as a regional holding company base, by allowing non-portfolio dividends to flow through Australia tax-free.

8 Explanatory Memorandum to the *New International Taxation Arrangements (Participation Exemption and Other Measures) Bill 2004*.

9 Former section 160AFC *Income Tax Assessment Act 1936*.

Foreign tax credit system

Currently, a foreign tax credit system applies to foreign source income that is subject to tax in Australia (generally, foreign income that does not fall within the exemptions above). Foreign income includes:

- dividends derived from a portfolio investment where the Australian corporation holds less than 10 percent of the voting shares in the foreign corporation;[10]
- foreign source interest income;
- foreign source rental income;
- foreign source royalties; and
- non-exempt income of a foreign branch.

Amounts made assessable under Australia's accrual taxation rules are also specifically deemed to be foreign income for the purposes of the foreign tax credit rules to eliminate double taxation.

Under this system, a credit is generally available for the lesser of the Australian tax payable on the foreign income and the foreign tax actually paid on that income. Excess foreign tax credits may be carried forward for five years but may not be carried back. Tax credits are quarantined according to four classes of foreign source income, the general rationale being to prevent mobile income from being shifted offshore to use up excess foreign tax credits.[11]

The existing foreign tax credit system will be replaced with new foreign tax offset rules, generally effective for taxation years beginning on or after July 1, 2008. Broadly, the foreign tax offset rules will allow Australian taxpayers to claim a tax offset against Australian tax payable for foreign income tax paid, subject to a cap.[12] The cap will essentially be based on the amount of Australian tax payable on all foreign income, not just foreign income on which foreign tax has been paid. This differs from the existing situation where foreign tax credits are quarantined and effectively can only be used against foreign income of the same class. The explanatory memorandum to the new measures suggests that the removal of quarantining is justified when weighing the cost of compliance versus the low risk to Australian revenue, particularly in light of the gradual broadening of the exemption system.[13]

10 As noted above, foreign tax credits for underlying foreign tax paid have been abolished. The foreign tax credit is limited to withholding tax.

11 Paragraph 1.6 of the Explanatory Memorandum to the *Tax Laws Amendment (2007 Measures No. 4) Act 2007*.

12 Australian Taxation Office, *Changes to foreign loss quarantining and foreign tax credit calculation rules — Updated September 2007 — Fact Sheet*.

13 Paragraph 1.4-1.17 of the Explanatory Memorandum to the *Tax Laws Amendment (2007 Measures No. 4) Act 2007* (Section 770-135 of the new rules).

Taxation on an accrual basis

Australia has controlled foreign company (CFC) rules, foreign investment fund rules and transferor trust rules which tax income on an accrual basis broadly where passive income is derived.[14] Generally, income of a foreign entity such as rent, royalties and interest would be considered passive in nature. Australia also has "deemed present entitlement rules" that can apply to bring forward the taxing point for beneficiaries of foreign trusts.[15]

The Board of Taxation is currently reviewing these separate accrual regimes with a view to simplifying and harmonizing these into a single regime. Their report to the government is expected around mid-2008.[16]

The tax rate for 2008 is 30 percent. No future tax rate changes are expected for corporations at this time.

Tax treatment of expenses attributable to earning foreign income

Generally, an Australian corporation cannot claim a deduction for expenses incurred in producing income which is not assessable in Australia.[17] For example, expenses incurred to derive active income attributable to a foreign branch would not be deductible, as the income would not be subject to tax in Australia. Similarly, expenses other than certain debt deductions incurred to derive non-assessable foreign dividend income will not be deductible.

An important exception relates to "debt deductions" (e.g., interest expense and other borrowing costs). Since 2001, subject to the thin capitalization rules, an Australian corporation may claim debt deductions incurred to derive exempt non-portfolio dividends and certain other foreign income which is not taxable in Australia[18] (e.g., dividends paid out of previously attributed income[19]).

Australia's rules on interest deductibility for outbound investments differed prior to 2001. Prior to 2001, interest incurred to derive non-assessable foreign dividends was not deductible (e.g., non-portfolio dividends from a foreign company resident in a listed country). This restriction was removed with the expansion of the thin capitalization rules to apply to Australian multinational investors, in addition to certain inbound investors into Australia. As a broad statement, the gearing limits under the thin capitalization rules are calculated only by reference to assets that generate income that is taxable in Australia. For example, shares in a controlled foreign subsidiary would generally be excluded from total assets in calculating an entity's thin capitalization "safe harbour" (non-portfolio dividend returns from the controlled

14 The CFC rules also apply to income derived from certain related party transactions.

15 Section 96B and 96C *Income Tax Assessment Act 1936*.

16 Refer to the Board of Taxation website at www.taxboard.gov.au/content/anti_tax_deferral.asp.

17 Section 8-1(2)(c) *Income Tax Assessment Act 1997*. Although section 40-880 *Income Tax Assessment Act 1997* generally allows a deduction over five years for expenses which are considered "business related costs", section 40-880(5)(j) *Income Tax Assessment Act 1997* does not allow a deduction for business related costs incurred to derive either exempt foreign branch income or non-portfolio dividends.

18 The deduction is available pursuant to section 25-90 *Income Tax Assessment Act 1997*. This section does not extend to debt deductions incurred to derive exempt foreign branch income.

19 Section 23AI, section 23AK *Income Tax Assessment Act 1936*.

foreign subsidiary would generally be non-assessable). Consequently, the thin capitalization rules would in most cases effectively apply to restrict debt deductions incurred to fund foreign assets that generate exempt income. This is subject to cases where, for example, the entity's Australian assets are not fully geared to their thin capitalization limits.

Expenses incurred to derive non-exempt foreign income such as portfolio dividends, interest income, rental income and royalties are generally deductible subject to Australia's general deductibility rules. However, such expenses are quarantined (into four classes) and only deductible against foreign income of that same class.[20] Note that these quarantining rules have in general been removed for income years starting on or after July 1, 2008.

Since 2001 when the new thin capitalization rules were introduced, quarantining of foreign deductions was considered unnecessary with respect to debt deductions and therefore debt deductions were removed from the scope of the quarantining provisions. Under recent changes applicable to taxation years beginning on or after July 1, 2008, the quarantining of foreign deductions will be removed entirely. Following these changes, such deductions can be used to offset Australian source income and there will be no distinction between domestic and foreign losses going forward.

There are no comprehensive rules in Australian tax legislation concerning the method of sourcing expenses. Moreover, there is no specific allocation formula used to determine the portion of an expense that relates to foreign source income.

In the case of companies, the issue of apportionment typically arises in relation to the allocation of expenses to a foreign branch the income from which is exempt. The sourcing and apportionment of expenses incurred to earn foreign source income is determined based on principles developed in case law. The general principle is that income is deemed to arise at the place where the substantial elements of production of income occur, but will depend on the particular facts and circumstances. Consequently, a tracing of expenses is generally required to determine the source of the profits.[21] However, the courts have indicated that a rigid application of the tracing principle is not always appropriate.[22] Where an expense has been incurred that is not specifically traceable to assessable income or non-taxable income, a "fair apportionment" must be made as to how much of the expenditure is deductible and how much is non-deductible.[23] However, there is no discussion as to what constitutes a "fair apportionment".

Since 2001 when the changes affecting debt deductions were introduced and debt deductions in respect of exempt non-portfolio share investments ceased to be restricted, the allocation of expenses between domestic and foreign sources became less relevant. The apportionment of expenses will become even less of an issue after the foreign loss and foreign tax credit

20 Section 79D *Income Tax Assessment Act 1936.*

21 For example, the Australian Taxation Office (ATO) notes, in Taxation Ruling TR2004/4, paragraph 16–17 that, in the case of interest expense, the use to which funds are put and the subjective purpose of the taxpayer are useful in determining the deductibility of interest as "tools to assist in the resolution of what is essentially a question of fact" (Hill J, *Kidston Goldmines Ltd v. Federal Commissioner of Taxation,* 91 ATC 4538, at 4545). [*TR2000/D3 has been replaced by TR2004/4.*]

22 In *FC of T v. JD Roberts; FC of T v. Smith,* 92 ATC 4380, at 4388; (1992) 23 ATR 494 at 504, Hill J. later observed that "...a rigid tracing of funds will not always be necessary or appropriate..."

23 *Ronpibon Tin NL and Tongkah Compound NL v Federal Commissioner of Taxation* (1949), 78 CLR 47.

quarantining rules are eliminated in 2008. Apportionment will still be relevant in various contexts such as working out the cap for foreign tax credit purposes (the allocation of expenses between Australian source and foreign source income).

From the ATO's perspective, the apportionment method must be "fair and reasonable" in all circumstances. There is no allocation formula enunciated by the ATO.[24]

General limitations on the deductibility of expenses

Australia's thin capitalization rules were formerly similar to Canada's current thin capitalization rules. Broadly, under Australia's former thin capitalization rules:

- there was a general safe harbour debt-to-equity ratio of 2:1;
- the rules generally did not apply to Australian multinationals investing offshore;[25] and
- the rules generally only applied to foreign related-party debt and foreign debt guaranteed by foreign related parties.

As a result of the Ralph Report, the Australian Government concluded that the old interest deductibility and thin capitalization rules were ineffective in achieving their objective — to ensure that multinational entities did not allocate excessive amounts of debt to their Australian operations. The following problems with the rules were identified:[26]

- because the rules relied on tracing the use of borrowed funds, it was relatively easy to establish a use of funds that ensured deductibility to circumvent the rules;
- there were opportunities for Australian corporations to avoid tax which arose from the complexities and anomalies in the thin capitalization regime;[27]
- because the rules applied on a single-entity basis, the rules could be circumvented by interposing entities to separate the foreign income from the expenditure;
- the old rules were not adequate to prevent multinational entities from taking advantage of the differential tax treatment of debt and equity to reduce their Australian tax.

24 In Taxation Ruling IT 2684 and ATO Interpretative Decision 2004/175, it was considered appropriate in those circumstances to apportion interest expense incurred for both assessable and non-assessable purposes based on the proportion of total distributions from the unit trust that was assessable. TR 2001/11 considers the attribution of profits to permanent establishments. At paragraphs 3.41–3.44, the Commissioner identifies various approaches to allocating interest expense to a permanent establishment but again highlights that the appropriate method depends on facts and circumstances.

25 The former thin capitalization rules only applied where there was a "foreign controller" with respect to the Australian company. Generally, a "foreign controller" is a foreign resident that can control at least 15 percent of the voting power of a company or a foreign resident that is entitled to at least 15 percent of the dividend/capital distributions a company may make.

26 Explanatory Memorandum to the *New Business Tax System (Thin Capitalisation) Bill 2001*.

27 General outline and financial impact section, Explanatory Memorandum, *New Business Tax System (Thin Capitalisation) Bill 2001*.

New thin capitalization rules were introduced in 2001. The following are a number of distinguishing features of Australia's current thin capitalization rules:

- they apply to all debt — related or unrelated, from both foreign and domestic sources;
- they apply to both inbound (e.g., where an Australian entity is controlled by a non-resident) and outbound (e.g., where an Australian entity controls a foreign subsidiary) contexts;
- there are three tests, one of which must be satisfied:[28]
  - the safe harbour test (broadly based on a 3:1 ratio);[29]
  - the worldwide gearing test;[30] and
  - the arm's-length test;[31]
- there is significant interaction with the debt/equity classification rules (described below) when applying the thin capitalization rules.

The thin capitalization rules will not apply when the interest deduction and other debt financing expense of an entity is not more than AUD 250,000 in a taxation year.[32] Additionally, certain outward investing entities whose average "Australian assets" represent 90 percent or more of the average value of their "total assets" are not subject to the thin capitalization rules.[33]

The deductibility of interest expense can also be affected by Australia's debt/equity classification rules.[34] In broad terms, the debt/equity rules classify financing arrangements based on economic substance, rather than purely based on legal form. Returns on a financial instrument that is classified as an equity interest are not deductible.

Previously Australia had "debt creation" rules targeting the introduction of debt into Australia via the transfer of assets within a corporate group.[35] Since the introduction of the current thin capitalization rules in 2001, the debt creation rules were considered unnecessary and were therefore repealed at the same time.

28 Specific thin capitalization rules apply to financial entities and to authorized deposit taking institutions.

29 In broad terms, the safe harbour is calculated as 75 percent of an entity's total Australian assets less associated non-debt liabilities (such as payables, provisions).

30 The worldwide gearing test looks at the Australian entity's worldwide leverage. Under this test, the Australian operations can be leveraged up to 120 percent of the leverage of the worldwide group. However, this test is not available to foreign entities and Australian entities controlled by foreign entities.

31 Under the arm's-length test, a determination is made of the amount of debt that could be borrowed from an independent party, and the level of debt that the entity could reasonably be expected to have, if the Australian entity's operations were independent from the foreign operations.

32 Debt deductions of "associate entities" are included in determining whether this de minimis threshold is satisfied.

33 "Australian assets" and "total assets" include those of an entity's associates.

34 Division 974 *Income Tax Assessment Act 1997*.

35 Former Division 16G *Income Tax Assessment Act 1936*.

As noted above, an Australian corporation may claim an interest deduction, subject to the thin capitalization rules, relating to interest incurred to derive non-portfolio dividends. There are two main reasons why there is no general denial of interest deductibility in such circumstances according to the Australian government: (1) the benefit of including a rule of this nature did not outweigh the concern about compliance costs for corporations to determine whether the interest expense related to the derivation of Australian or foreign source income, particularly given the fungibility of debt; and (2) it is thought that the thin capitalization rules, which have been broadened to apply to all types of debt, should adequately address the policy concerns regarding the diminishment of the Australian tax revenue base through excessive debt loading.[36]

There are currently no specific anti-avoidance rules other than those described above.[37] Australia does have a general income tax anti-avoidance rule (commonly referred to as "Part IVA").[38] Part IVA applies to schemes entered into with the sole or dominant purpose of obtaining a tax benefit. Part IVA was enacted to operate against artificial or contrived arrangements but was not intended to cast unnecessary inhibitions on normal commercial transactions by which Australian taxpayers legitimately take advantage of opportunities available for the arrangement of their affairs.

36 Paragraph 22.6, "A System Redesigned — Review of Business Taxation".

37 There are other specific provisions that may affect the availability/timing of deductions in particular circumstances (e.g., payments that trigger a withholding tax liability where the tax has not been withheld and remitted: section 26-25 *Income Tax Assessment Act 1997*).

38 Part IVA *Income Tax Assessment Act 1936*.

France

System for taxing foreign income

The French corporate income tax system is based on the principle of territoriality.[39]

Foreign branches

A company incorporated in France and governed by the laws of France is subject to corporate income tax in France on both its French source and foreign source income, except for the income derived from an "enterprise operated outside of France."

Unless the income relates to an enterprise operated outside of France, the French company is taxable in France on the foreign source income net of the foreign tax validly due and paid abroad on that income. Generally, a foreign tax credit is only available under a tax treaty.

When the income is derived from an enterprise operated outside of France, it is simply exempt from French income tax.

There is no positive definition in the statute of an "enterprise operated outside of France". To decide whether there is an enterprise operated outside of France, the French tax administration, under the control of the French courts, will apply the same criteria that apply to determine whether income derived by a non-French company from an enterprise operated in France will be subject to French income tax. Accordingly, an enterprise operated outside of France will be determined to exist in any of the three following situations:

- the French company operates an autonomous establishment outside of France;
- the French company operates outside of France through an autonomous agent; or
- the French company has derived income from a complete cycle of commercial operations that has been entirely performed abroad, and which is disconnected from the French operations (a so-called "cycle commercial complet et détachable").

The first two situations are very similar, although not completely identical, to the traditional concepts of "fixed place of business" and "dependent/independent agent" used by the Organisation for Economic Co-operation and Development (OECD) to define a "permanent establishment" in its treaty model. The third situation is unique to French domestic international law.

When one of the above situations is met, the French company must file a separate set of accounts (balance sheet and P/L) and a separate tax return for the enterprise operated outside of France. See the discussion, below, concerning the tax treatment of expenses incurred to earn foreign branch income.

39 There is a regime ("bénéfice mondial consolidé") only accessible in practice to very large French multinational companies, pursuant to which, subject to certain very strict conditions, French tax authorities may permit the consolidation of income of a French parent company with that of local and foreign subsidiaries in which it holds a 50 percent share or more.

Foreign-source passive income (e.g., dividends, interests, royalties and capital gains) will also be exempt from French tax if it can be established that the income is connected to an enterprise operated outside of France. In practice, this connection will be established with a formal allocation of the asset generating the passive income (shares, intellectual property, etc.) to the foreign branch on its separate balance sheet.

Foreign subsidiaries

When the French company operates abroad through a separate legal entity (a subsidiary), the income of this separate entity is generally not taxable in France. Only when this entity distributes its profits to the French parent company will this profit become taxable in France as dividend income (subject to the application of the participation exemption regime).

Participation exemption regime

To the extent the French parent company owns at least five percent of both the capital and the voting rights of the subsidiary from which income is derived, such income will be eligible for the participation exemption regime.

Pursuant to the participation exemption regime, dividends received from the foreign subsidiary will be 100 percent exempt from French income tax. However, as discussed below, the exemption will trigger a deduction disallowance of part of the expenses of the French parent company (if any).

The dividend exemption is conditional upon the French parent owning the participation for at least 24 consecutive months from the date of acquisition (i.e., the dividend will be exempt from day one but there will be a claw-back if the participation is not kept for two years).

Finally, when the income benefits from the participation exemption regime, the French parent company is denied the right to use any tax credit attached to the income to reduce its income tax liability (i.e., if the country where the subsidiary is established has levied a withholding tax on the dividend payment, the withholding tax is not creditable to reduce French income tax).

However, if the French parent company re-distributes the income up to its foreign parent and the distribution is subject to a French withholding tax, the French company can offset the tax credit corresponding to the withholding suffered on the "input" dividend against the French withholding tax payable on the "output" dividend.

For the participation in a subsidiary to qualify for the capital gain exemption, one of the following conditions must be met:

- the participation qualifies for the exemption in respect of dividends pursuant to the above conditions;
- the participation qualifies as a long-term investment for statutory book purposes (i.e., the shares are held durably as a strategic investment and they allow the holder to exercise influence or control over the subsidiary); or
- the shares were acquired through a public offering.

The shares of real estate companies (i.e., companies whose assets are predominantly composed of real properties) are never eligible for the participation exemption on capital gains.

Provided that the French parent has owned the shares for at least 24 months at the date of the disposal, the gain should be 95 percent exempt with a residual five percent taxed at the ordinary French CIT rate (34.42 percent including surtaxes), which means an effective tax rate of 1.7 percent. As discussed below, the five percent is a proxy for deemed disallowed expenses relating to the gain. Due to the fact that the French tax suffered on five percent of the gain is not legally construed as an actual capital gain tax but is the result of a disallowance of deemed expenses, the French parent would not be authorized to claim a tax credit in respect of the tax, if any, payable to the source country.

Controlled foreign corporation rules

In the French tax system, a controlled foreign corporation is not taxable in France unless it is located in a "low tax country" or a country where it benefits from a favourable income tax regime (see below).

The profit of a foreign branch or of a foreign subsidiary will be taxable in France (in proportion to the dividend rights of the French parent with respect to the profit of the subsidiary) if such branch or subsidiary pays an income tax that is less than 50 percent of the income tax that would have been paid in France pursuant to French tax rules (i.e., lower than 17 percent approximately).[40]

With respect to subsidiaries, the rule generally applies only when the French parent company has a participation of more than 50 percent.

The tax paid in the country where the branch is established or where the subsidiary is resident is creditable in calculating the tax due in France.

There are two important exceptions to the application of these anti-avoidance rules:

- the rules do not apply when the branch is established in or the subsidiary is a resident of the European Union, unless the establishment in the other EU member state is an artificial scheme, the purpose of which is to avoid French tax; and
- the rules do not apply when the branch or subsidiary is genuinely engaged in a trade or business in the foreign jurisdiction (subject to certain exceptions).

Tax treaties

Most tax treaties signed by France are based on the OECD tax treaty model.

As noted above, the French corporate income tax system is built around a principle of territoriality which derives from concepts very similar to the ones underlying the OECD definition of a permanent establishment (concept of fixed place of business and dependent agent).

40 Sections 209 B and 238 A of the French Tax Code.

As a result, in most cases, the application of the domestic rules and the application of the treaty provisions will lead to the same result as regards when France will be precluded from the right to tax foreign-source income (with the exception of the "cycle commercial complet et détachable").

Traditionally, tax treaties signed by France would provide for an exemption mechanism to eliminate the consequences of double taxation, similar to the domestic rules. However, in most recent treaties or on the occasion of the amendment of existing treaties, it is a foreign tax credit mechanism that is adopted.

EU law

The influence of the EU law on the tax system of EU member states is growing every day and experience shows that it is impossible to predict how far it will extend its grip in tax matters.

In relation to the tax treatment of foreign-source income in France, EU law has shaped part of the recently amended CFC rules. France was obliged to provide an exception to the application of its CFC rules when the subsidiary is established in another EU member state.

Following a recent ruling of the European Court of Justice, the EU member states, including France, are currently under pressure to extend the territorial scope of their tax consolidation system (tax-grouping) to include all subsidiaries established within the EU.

Rates

The standard corporate income tax rate is 33 ⅓ percent.

In addition, large companies, i.e., companies with a turnover exceeding €7,630,000, are subject to a surcharge, resulting in an effective rate of 34.43 percent.

Although the question of reducing the corporate income tax rate has been recently discussed by the French government, there is at this point no specific and official rate change expected in the future.

Tax treatment of expenses attributable to earning foreign income

Foreign branches

As provided in the French tax code, expenses incurred to earn or maintain business income are deductible from this income for tax purposes.[41] Based on a negative application of the above provision, it is generally considered that expenses incurred to earn or maintain foreign source business income that is not taxable in France should not be deductible by the French taxpayer.

In practice, as explained above, the French company will file a separate set of accounts (balance sheet and P/L) and a separate tax return for its branch when it constitutes a presence abroad that is not taxable in France. Accordingly, the French company must identify which of its expenses should be allocated to its foreign branch and not deducted from its taxable income in France.

In addition, in consideration of the fact that a branch does not have any legal personality separate from the company from which it emanates, France does not recognize the deductibility of expenses (nor the taxation of income) deemed to be paid to (earned from) the foreign branch by the French head office.

However, as an exception to the above, it has been ruled that a French company can, under certain conditions, deduct for tax purposes accrued losses or depreciation allowances relating to advance payments made to a foreign branch, provided (i) the advance payments were made in the course of a commercial relationship between the French head office and its foreign branch, and (ii) the purpose of the advance payments was the continuity and/or development of a business carried out in France by the head office (as it then indirectly contributes to the realization of income taxable in France).[42]

Foreign subsidiaries

There is no general limitation rule regarding the deductibility of expenses connected to the acquisition or maintenance of a shareholding in a foreign subsidiary.

However, when a participation in a subsidiary is eligible for the French participation exemption regime, a small portion of the total expenses of the French parent company, generally equal to five percent of the exempt income or gain, is recaptured when a dividend is received from the subsidiary or the shares are sold. The amount of disallowed expenses cannot exceed five percent of the dividend (e.g., a dividend will be 100 percent exempt only if the French parent company has no expenses and it will be at least 95 percent exempt if the parent company has a lot of expenses). The five percent recapture is not capped in the case of a capital gain.

41 Article 13 of the French Tax Code.

42 Conseil d'Etat, 16 mai 2003, nº 222956, Sté Télécoise.

Restrictions on the deductibility of capital losses realized upon the disposal of a participation in a subsidiary exist but, whether the subsidiary concerned is resident in France or not is irrelevant. The same comments apply to the deductibility of a provision for depreciation of a participation in a subsidiary.

In general

French tax law does not provide any detailed tracing rule or allocation formula to determine whether and to what extent expenses relate to foreign source income not taxable in France and accordingly not deductible for French tax purposes.

The only test is whether the expense was incurred to earn or maintain an income taxable in France. This is determined on a case by case basis.

However, as a starting point, the allocation will have to be made in compliance with the arm's length principle as if the head office and the branch were two separate entities.

The filing position of the French company will be reviewed by the French tax authorities and may, in certain cases, be reviewed by a court. In doing so, the French tax authorities and the courts will very often accept references made by the taxpayer to the OECD principles and guidelines even though those authorities have no legal status in the French tax system.

General limitations on the deductibility of expenses

Maximum interest rate when interest paid to shareholders

As a general rule, interest paid by a French company on a debt owed to a related party is tax deductible to the extent the interest rate is arm's length.

The French tax code contains a safe harbour provision with respect to the arm's-length nature of the interest rate. Every quarter, the French tax authorities publish the interest rate that will be deemed to be arm's length for interest paid to related parties in the previous quarter.

For instance, for the 12-month financial year closed on December 31, 2007, the interest rate was deemed to be arm's length if it did not exceed 5.41 percent.

A French company may still deduct an interest at a higher rate provided it can prove that it is an arm's-length rate.

Thin capitalization rules

Interest paid to related parties is not fully deductible if it simultaneously exceeds all of the three following thresholds:

(a) A related party debt-to-equity ratio of 1.5:1, calculated as:

$$\frac{\text{Interest paid x 1.5 x net equity (capitaux propres)}}{\text{Average amount of related party debt}}$$

(b) 25 percent of adjusted current profits (i.e., pretax operating and financial profits, increased by items such as interest paid to related parties and depreciation) for the year; and

(c) Interest income received from related parties.

If the interest exceeds all three limitations, the interest deduction is limited, although the excess may be carried forward as discussed below.

Excess interest will equal the difference between interest paid to related parties and the higher of the limit in (a), (b) or (c).

The new thin capitalization rules include a safe harbour provision so that the rules will not apply if the French company demonstrates that the debt-to-equity ratio of the group to which it belongs is equal or higher than its own debt-to-equity ratio (worldwide consolidated approach whether the French company is a French MNC or a subsidiary of a foreign company).

Also, the interest limitations do not apply to certain financial transactions (involving for example, group cash pools and credit institutions) or when the portion of excess interest is less than €150,000.

Excess interest may be carried forward indefinitely and deducted from taxable profits of subsequent tax years (after deduction of the interest expense of the year and to the extent there is room for an additional deduction based on the above thin capitalization rules). However, the amount of excess interest available to carry forward will be reduced by five percent per taxable year as from the second subsequent year.

Specific rules apply when the French company paying the interest belongs to a consolidated group for French tax purposes.

Arm's length principle

The arm's length principle is of general application in the French tax system (e.g., royalties, management fees and interest paid to or received from a related party must comply with the arm's length principle).

The arm's length principle is particularly important in the French tax system, as all tax rules must generally be complied with on a standalone basis, entity by entity, as opposed to on a group level.

Anti-avoidance

While this is no specific anti-avoidance rule aimed at restricting the deductibility of expenses related to foreign source income, there is a general rule, enforced by the French tax courts, according to which the French tax authorities can always reassess the tax consequences of any legal arrangement, any legal structure, any contractual obligation or right based on a "substance over form" analysis, if the existence of a fraud or an abuse of law is found. The two terms can be viewed as essentially synonymous today, the difference being mainly a question of procedure.

For a fraud or an abuse of law to be found, one of the two following conditions must be met:

i) the legal situation of the taxpayer has been created by means of fictitious deeds or agreements; or

ii) the legal situation of the taxpayer results from a transaction or set of transactions which can have no other purpose than accessing a tax benefit and this tax benefit results from a mere literal application of the law to the legal situation of the taxpayer in a way which is clearly in contradiction with the goals pursued by the lawmakers.

As a rule, the burden of proving that one of the above conditions is met rests with the French tax authorities.

However, when the tax consequence that is challenged consists in an erosion of a tax base, some specific procedural rules apply, codified under Section L64 of the Fiscal Code of Procedures and commonly referred to as the "abuse of law" procedure. Under this procedure, the burden of proof can be reversed in certain circumstances and the taxpayer incurs an 80 percent penalty on the amount of the tax unduly avoided.

Germany

System for taxing foreign income

Corporate income tax

German resident corporations are subject to corporate income tax on their worldwide income except that dividend income and income derived from the alienation of shares in other corporations is tax exempt, regardless of how long the participation has been held and regardless of the extent of the participation. However, five percent of the gross dividend is added back to taxable income as deemed non-deductible business expenses, resulting in an effective tax rate of approximately 1.5 percent from fiscal year 2008 (five percent taxed at a combined corporate income tax and trade tax rate of approximately 30 percent). The same treatment applies to capital gains from the alienation of shares. Please note that the exemption does not apply to deemed dividend distributions where the respective payments were treated as a deductible business expense at the level of the distributing company.

An exception from the general tax exemption for the abovementioned income is in place for financial institutions. Under the "shares held for trading" principle, both dividend income and gains derived upon the alienation of shares are fully taxable.

Due to the 95-percent exemption for dividends and capital gains, German companies generally borrow to the extent possible to buy or invest in foreign subsidiaries (subject to the new interest limitation rule, discussed below).

With respect to foreign branch income, Germany's double taxation treaties frequently provide that income generated in a foreign country will be taxed only in the country of source and remain tax-free in Germany. In non-treaty situations or in treaty situations where the treaty provides for a tax credit, German corporations with foreign source income are subject to tax under domestic law and may claim a foreign tax credit; alternatively, the taxpayer may choose to deduct foreign taxes paid as a business expense.

A foreign tax credit is also provided for other foreign source income that is subject to withholding tax and is not exempt from German taxation, such as interest and royalties.

Generally, foreign tax on foreign profits is creditable against the portion of German corporate income tax relating to that foreign income (but not trade tax). Foreign taxes exceeding the amount of German corporate income taxes relating to that income are not refunded. The foreign tax credit is computed on a country-by-country basis.

Trade tax

For trade tax purposes, profits derived from foreign permanent establishments are not taxable. Dividends received from non-portfolio shareholdings in other companies, both domestic and foreign are 95-percent exempt (an activity clause applies for foreign dividends, unless the Parent Subsidiary Directive applies). The 95 percent exemption will only apply for trade tax purposes if certain minimum holding and minimum ownership requirements are met. In addition, certain activity requirements apply for shareholdings in companies which are resident outside the EU.

Controlled foreign company regime

Under the Foreign Tax Act, certain passive income of controlled foreign companies (CFCs) resident in a low-tax jurisdiction controlled by German resident shareholders may be attributed proportionally to those shareholders and included in their taxable income. Such an attribution requires in particular that:

- one or more German residents hold, directly or indirectly, more than 50 percent of the shares or voting power in the CFC at the end of the respective fiscal year for which an income attribution occurs;
- the CFC receives passive income; and
- the passive income is subject to tax at an effective rate below 25 percent.

If the CFC rules apply, the income of the foreign subsidiary is taxable in Germany as though the income was earned by the German parent company.

Active income generally includes income derived from:

- agriculture and forestry;
- exploitation of natural resources, energy generation, manufacturing, and processing of goods;
- banking or insurance business (unless captive);
- trading (unless captive);
- services (unless captive);
- leasing of movable and immovable assets and licensing (only of self-developed intangibles);
- the taking on of debt and on-lending to a German business or to a foreign active business;
- profit distributions of corporations; and
- the sale of shares to another corporation as well as the dissolution or reduction of its capital.

Exceptions to the definition of active income mainly apply if the activities are carried out with the assistance of or support by a German related company and if the foreign intermediary company does not have sufficient economic substance.

In the case of low taxed partnerships or permanent establishments which earn passive income as described above, Germany will switch unilaterally from the exemption method to the credit method.

Tax rates

The corporate income tax rate is 15 percent. The solidarity surcharge of 5.5 percent is levied on the corporate income tax so that the combined rate is 15.825 percent. Trade tax is levied by the municipal authorities and therefore tax rates vary regionally. The trade tax burden averages from 14 to 15 percent of income. As of the 2008 fiscal year, the municipal trade tax is no longer deductible as a business expense. The combined tax rate including corporate income tax, trade tax and solidarity surcharge amounts to approximately 30 percent. The rates for corporate income and trade taxes have just been changed in 2008; further changes are not expected.

Tax treatment of expenses attributable to earning foreign income

Non-deductibility of business expenses related to tax-exempt income

As a general principle, business expenses are deductible except in cases where these expenses are economically directly related to the earning of tax-exempt income.

Business expenses related to foreign branch income that is tax-exempt under the exemption method of an applicable tax treaty are therefore not deductible from the taxpayer's tax base. Business expenses relate to tax-exempt branch income if there is a direct economic relation to that income. Business expenses are generally considered as related to exempt branch income if these expenses are causal and directly linked to activities generating the income. If expenses are not linked in this way to tax-exempt income, these expenses remain fully deductible.

Business expenses related to foreign income that is (fully) taxable (either under the credit method of an applicable tax treaty or in a non-treaty situation) are deductible from the taxpayers' tax base.

There is a special rule for situations where a corporate taxpayer receives (German or foreign) dividend income and/or income from the alienation of shares in participations in other (resident or non-resident) corporations. Business expenses related to that income are generally deductible; however, as discussed above, an add-back of five percent of that income applies.

The taxation of five percent of dividend income and capital gains derived from the sale of other corporations is intended to avoid certain "ballooning strategies". According to settled case law of the German Federal Fiscal Court, under the general rule which provides that expenses are deductible unless there is a direct economic link to tax-exempt income, expenses are only linked to such income to the extent the shareholder actually receives dividend income in the year the expense is incurred. To avoid the classification of expenses as non deductible under this general rule, corporations accumulated earnings in subsidiaries for several years and paid out those earnings in one distribution. Business expenses incurred in a year when no distribution was made were fully deductible. The approach to declare five percent of the dividend income as non deductible business income was aimed at countering such ballooning strategies. The approach is also backed by the EC Parent Subsidiaries Directive.

The extension of the five percent add-back to capital gains from the alienation of shares in other corporations was due to the view that capital gains arising upon the sale of shares in a company are economically equivalent to dividend distributions. The more dividends are distributed to shareholders, the less capital gain will arise upon the sale of the shares. Consequently, the five percent add-back is also applied to such capital gains. According to the legislative history, the government intended to prevent taxpayers from avoiding the five percent add-back due upon dividend distributions by accumulating profits in the corporation and later selling the stake in the corporation for an exempt capital gain.

Non-deductibility of losses related to tax-exempt income

Corporations may not deduct capital losses from the alienation of shares in other resident or non-resident companies or from the liquidation of or capital reduction of such companies.

Deduction of business expenses/losses resulting from the write-down or transfer of unsecured loans granted by a substantial (i.e., more than 25 percent) shareholder or related party in the case of impairment is not allowed unless the taxpayer can show that it could have obtained the loan under the same conditions from an unrelated third party (i.e., an arm's-length test). For example, where a German parent company has made a loan to a foreign subsidiary and the parent company writes down or disposes of the loan at a loss, the deduction of the loss may be denied unless the arm's-length test is met. That restriction applies from 2008 onward.

Borrowing to acquire shares of a related company

Germany formerly had a rule which denied the deductibility of interest on borrowings related to intercompany share acquisitions. However, this rule was recently repealed upon the introduction of a new general restriction on interest deductibility (described below).

General limitations on the deductibility of expenses

Thin capitalization

Germany's thin capitalization rules were replaced as of 2008 by the interest deduction limitation rule (see below).

Corporate income tax: interest deduction limitation rule

As of the 2008 fiscal year, a taxpayer will only be able to immediately deduct (net) interest expense up to 30 percent of annual pre-interest, pre-loss carryforward profits for tax purposes, increased by the tax depreciation incurred (taxable EBITDA). The 30 percent limitation will apply to all interest, regardless of whether the debt is owed to a shareholder, related party or third party.

The 30 percent limitation will not apply where:

(a) the annual (net) interest burden is less than €1 million;

(b) the taxpayer is not part of a group of companies;[43] or

(c) under the "group clause", the taxpayer demonstrates that the equity ratio of the German borrower (equity divided by total balance sheet assets) does not fall short by more than one percentage point from the worldwide group's equity ratio.

The EBITDA threshold is calculated on the basis of the current year tax EBITDA of the German "business" (i.e., the year for which interest deductions should be claimed). An Organschaft is treated as one business. Interest expense exceeding the 30 percent limitation will be non-deductible for German corporate income tax and trade tax purposes (unless one of the exceptions listed above can be met).

Excess interest can be carried forward indefinitely. However, the carryforward is subject to change-in-ownership rules. In the case of an ownership change of 25–50 percent, a partial forfeiture applies. In case of a change of ownership of more than 50 percent, a 100 percent forfeiture of the carryforward balance applies. These rules apply equally to related party transfers of shares.

Unlike under the previous thin capitalization rules, interest expense disallowed under the interest deduction limitation will not trigger withholding taxes as a deemed dividend, but may lead to double taxation as the lender will be taxed on the income and the deduction will be denied.

43 A taxpayer is part of a group if his business is (or if it could be) included in consolidated accounts under IFRS, any EU GAAP or U.S. GAAP. A taxpayer's business may also be seen as a part of a group (even though not actually being consolidated with any other business) if the financial and business policies of the business and other businesses can be commonly determined by a controlling shareholder. A German consolidated tax group ("Organschaft") is treated as one business: the Organschaft may qualify for the stand-alone exception if there is no controlling shareholder at the level of the Organschaft-parent and if there is no controlled, but non-tax grouped, subsidiary.

Under the group clause test, the 30 percent limitation does not apply where the borrowing business can show that its equity ratio does not fall short by more than one percentage point from the worldwide group's equity ratio. The test applies to both German subsidiaries of foreign parent companies and German parent companies with foreign subsidiaries. As an example, in a case where a business (not being able to invoke the stand-alone exception) has an equity ratio of 5 percent and the worldwide group of which it is part has an equity ratio of 5.5 percent (i.e., the worldwide group is slightly less leveraged but within the one percent permissible margin), no limitation on the deductibility of interest applies. However, in practice, this equity ratio exception may not be available in many situations, since it is necessary to deduct the book value of shares in group subsidiaries that are not part of a German tax group from the borrower's equity for the purpose of the calculation.

Under the "10 percent harmful financing test", the group clause test is not available if more than 10 percent of net interest is paid/accrued by any group entity to any substantial shareholder or related party outside of the worldwide group or on third party debt which is guaranteed by a substantial shareholder/related party outside of the consolidated group. For example, if ForeignCo owns German Subsidiary and Foreign Co pays interest to a 30 percent shareholder of ForeignCo that is not part of the group, this test may apply to prevent the use of the group clause test by German Subsidiary.

The group clause test is applied based on financial statements for the German business at the end of the previous fiscal year. A uniform accounting standard has to be used for the German business and the group financial statements (primarily IFRS, but if no IFRS accounts are available, any European GAAP or U.S. GAAP). Many uncertainties currently exist, e.g., the definition of a "group" in private equity scenarios and the definition of "guarantee".

The new rules apply as of the 2008 fiscal year, i.e., from January 1, 2008 for calendar year taxpayers. For taxpayers with a non-calendar fiscal year, they apply for all fiscal years starting after May 25, 2007 (and not ending before January 1, 2008), i.e., the 2007–2008 fiscal year.

There are many interpretive issues associated with the new rules. Draft guidance on the rules was released by the German tax authorities on February 20, 2008 and is now the subject of consultations with taxpayers.[44]

As noted, the former thin capitalization rule and the rule which denied the deductibility of interest on certain intercompany share acquisitions were repealed as a consequence of the introduction of the new interest limitation rule. The government considered that these rules did not adequately protect the German tax base, and the government wanted to broaden the tax base in order to finance a reduction of tax rates. The new interest limitation rule is broader than the old rules since it targets not only interest payments to shareholders, persons related to shareholders and third parties (where supported by a parent guarantee) but all interest payments.

44 See Christian Ehlermann and Andreas Kowallik (2008), "Germany Issues Guidance on Interest Limitation Rule", vol. 49, no. 9, *Tax Notes International,* at p. 716.

The explanatory statement released with the draft legislation mentions a number of concerns which led to the introduction of the new rule:

- German companies have a relatively high debt-to-equity ratio in the international context;
- the interest limitation rule aims at making excessive debt financing less attractive and preventing corporations from increasing debt merely for tax reasons;
- the interest limitation rule should especially prevent groups from transferring profits made in Germany abroad by intra-group financing; and
- the interest limitation rule should avoid debt financing schemes where German group members raise loans in the capital markets and thus reduce their German tax base.[45]

Trade tax

The trade tax base is derived from the corporate tax base by applying certain adjustments. For purposes of determining the tax base for trade tax, certain add-backs of items that are deductible for corporate tax purposes are required. The following amounts may be subject to the add-back:

- 100 percent of the interest paid on debts;
- 100 percent of business related annuities;
- 20 percent of rental expenses for movable property;
- 100 percent of the share in profit of a silent partner;
- 65 percent of rental expenses for immovable property;
- 25 percent of royalty payments and/or other expenses paid as consideration for the use of rights.

If the total of such amounts exceeds €100,000, an add-back of 25 percent of the total amount is required for purposes of the determination of the trade tax base. If the total is less than €100,000, no add-back is required.

Arm's length approach

Business income may be adjusted in circumstances where business transactions between related parties do not meet the arm's length approach.

Standard methods for transfer pricing are the comparable uncontrolled price method, the resale price method and the cost-plus method. Profit based methods are not officially accepted. Advance pricing agreements are, as a matter of principle, possible but not very common.

45 This is a general summary of the Explanatory Statement, which is not available in English.

Miscellaneous restrictions

Further restrictions apply for certain expenses like gifts, 30 percent of expenses relating to business meals, guest houses, expenses for the lease or use of hunting or fishing rights, sailing or motor yachts, half of fees paid to members of the supervisory board[46] and corporate taxes (from 2008 including trade tax).

Where corporate taxpayers hold an interest in (transparent) partnerships, the deductibility of interest on loans raised by the partnership to finance excessive withdrawals of the partners is restricted. A withdrawal is deemed to be excessive if it exceeds the amount of profits and contributions of the partners in a fiscal year.

Business expenses may be non-deductible in circumstances where the payor does not reveal the identity of the payee to the tax authorities upon a special request from the tax authorities. The intent of this policy is to encourage disclosure of the payee to ensure appropriate tax has been paid at the payee level.

46 The German Stock Corporation Act requires German Aktiengesellschaften (public limited companies) to have a board of directors and a supervisory board controlling the board of directors ("two-tier" system). Only remuneration for members of the supervisory board is subject to the 50 percent restriction.

Hong Kong

System for taxing foreign income

Hong Kong has a territorial tax system. In general, tax is only levied on Hong Kong source profits derived from a trade, profession or business carried on in Hong Kong. Profits from a source outside of Hong Kong (e.g., dividends from a foreign subsidiary, income from a foreign branch or property income such as interest and royalties from a foreign source) are not taxable in Hong Kong, even if remitted to Hong Kong. Hong Kong does not have CFC legislation.

The profits tax is currently levied at a rate of 17.5 percent for corporations. The February 27, 2008 budget stated that the rate will be reduced to 16.5 percent, effective from the 2008-2009 year of assessment (i.e., starting April 1, 2008).

Tax treatment of expenses attributable to earning foreign income

Expenses attributable to profits earned outside of Hong Kong are not deductible. Expenses are deductible only to the extent that they are incurred to earn taxable profits (i.e., profits derived from Hong Kong). The policy rationale is that only expenses incurred in the production of taxable income should be deductible.

To the extent possible, expenses should be traced (i.e., to identify the expenses directly incurred in generating non-taxable foreign source income) and disallowed as appropriate. However, a direct tracing method is often difficult to apply in practice. An allocation formula may then be used particularly when both taxable income and non-taxable income are significant. There are no hard and fast rules as to which allocation formula should be used. An apportionment based on income (disallowance based on the ratio of non-taxable income over total income) or assets (disallowance based on the ratio of assets generating non-taxable income over total assets) may be used. In circumstances where it is practically difficult to trace the actual usage of expenses to the earning of taxable income, the different possible apportionment methods for expenses (e.g., income basis or asset basis) are typically computed to determine the most favourable method.

It is important to have documentation in the event of a challenge by the tax authorities, to prove that expenses can be traced through fund flows to the production of taxable income, in particular where the taxpayer has non-taxable income like foreign source income.

General limitations on the deductibility of expenses

For interest to be deductible, it must satisfy the general requirements for interest deductibility as provided under domestic law. More specifically, interest is deductible if it was incurred to earn taxable income and the expense is not capital in nature.

There are no thin capitalization rules; however, there are a number of other rules that can deny the deductibility of interest expense, even where the borrowing does not relate to the earning of foreign source income.

Where the taxpayer is not a financial institution, in order for interest expense to be deductible it has to meet one of the following additional three tests:

(a) if the funds are borrowed from a non-financial institution, the interest is subject to tax in Hong Kong in the hands of the recipient;

(b) the funds are borrowed from a non-associate and are used to finance the acquisition of machinery, plant, or trading stock used to produce taxable profits; or

(c) the money is borrowed by way of debentures or other marketable instruments where the debentures are listed on a recognized stock exchange or the instruments are marketed in a recognized major financial centre.

As an example, if a Hong Kong subsidiary borrowed from its foreign parent company the interest would not be deductible since it would not generally be subject to Hong Kong tax in the hands of the parent company. Hong Kong has no withholding tax on interest.

In addition to meeting the above tests, the interest is only deductible if it is not disallowed by the "secured loan test" or the "interest flow back test". Under the secured loan test, the loan cannot be secured by a deposit or loan made by the borrower or his associate where the interest generated by such deposit or loan is not taxable in Hong Kong. Under the interest flow back test, there cannot be an arrangement in place such that the interest is ultimately paid back to the borrower or a person connected with the borrower (except where the connected person is subject to tax in Hong Kong in respect of the interest in question).

General anti-avoidance rules may also have application in certain circumstances.

The general restrictive rules on interest deductibility are anti-avoidance measures intended to counteract arrangements to allow an interest deduction to the borrower in circumstances where the interest is not taxable in the hands of the recipient.

Italy

System for taxing foreign income

Italian resident companies are subject to tax on their worldwide income including income from foreign branches and direct foreign source income, subject to foreign tax credits.

Foreign subsidiaries

Italy has a 95 percent exemption from corporate income tax for domestic and foreign source dividends paid by subsidiaries to Italian resident corporate taxpayers. The exemption does not apply if the subsidiary is resident in a listed tax haven country, if the dividends can be traced back to a tax haven country, or if the dividend is deductible to the payor. These tax haven countries are considered "black list" countries. There is no holding period or minimum ownership percentage required to qualify for the 95 percent dividend exemption.

Capital gains on the disposition of shares of a foreign subsidiary are also 95-percent (formerly 84 percent) exempt subject to a 12-month holding period and other requirements (e.g., the subsidiary must be classified as a fixed asset for accounting purposes, have tax residence in a country that is not a black list country and be considered "operative" for Italian tax purposes).

The Italian government has acknowledged that the five percent taxable portion of dividends and capital gains is designed to recognize an amount of expenses associated with the ownership of the investment.

Italy also has a controlled foreign companies (CFC) regime. Under the CFC regime, profits of a non-resident entity are attributed to an Italian resident where the resident directly or indirectly controls the non-resident entity and the non-resident is resident in a tax haven on Italy's black list.[47] If a company is not resident in a tax haven country, the CFC rules do not apply, even if the company earns passive income. Similar rules apply to certain other investments where the Italian shareholder does not control the company.

Foreign branches

Income from foreign branches is subject to taxation in Italy due to the principle of worldwide taxation. The income of the branch is calculated using the same rules applicable to Italian resident companies. The tax credit for foreign taxes is generally allowed on the basis of the formula:

$$\frac{\text{Foreign income}}{\text{Worldwide income (net of tax losses carried forward)}} \times \text{Income tax liability}$$

47 Foreign underlying tax is creditable. The rules do not apply if the Italian resident controlling entity can demonstrate that the CFC carries on actual industrial or commercial activities as its main business in the black-list jurisdiction and that it is not trying to avoid high tax rates by allocating income to the entity in the black-list jurisdiction. The CFC is taxed in the hands of the Italian resident at its average tax rate, as long as the rate is at least 27 percent.

The Italian tax system allows the foreign tax credit on the basis of the requirement of "reciprocity" meaning that, in order to credit the foreign taxes, the type of foreign income would have to have been taxable if it had been received by an Italian taxpayer. Should the foreign income not have been taxable in Italy if it had been received by an Italian taxpayer (because there was no taxable event or income for Italian tax purposes), the foreign tax credit would not be allowed.

Tax treaties

The existence of a tax treaty applicable between Italy and the source country may limit the right of the source country to tax the income (granting the exclusive right to tax to Italy). However, the application of a tax treaty does not influence the "reciprocity" criterion which is based on domestic rules. In most circumstances the ability to use the foreign tax credit is not restricted.

Rates

The corporate tax (IRES) rate is 27.5 percent (formerly 33 percent). There is also a regional tax on productivity (IRAP) of generally 3.9 percent (formerly generally 4.2 percent) which has a broader base. While there is a current proposal to reduce or eliminate the IRAP, it is too soon to determine whether this will occur.

Tax treatment of expenses attributable to earning foreign income

There are no specific rules which limit the deductibility of interest expense and other expenses that relate to the earning of foreign source income. The ability to deduct an expense does not generally depend on the source of the expense (domestic or foreign).

Expenses relating to foreign income which is taxable in Italy must be allocated to foreign income for the purpose of computing the foreign tax credit.

There are no rules which dictate which expenses should be allocated to foreign income and how the allocation should be made. In 1980 the Ministry of Finance issued a guideline for allocating expenses to foreign branches for the purpose of exempting the branch income from a local tax applicable only to income sourced in Italy (called "ILOR"). The Ministry of Finance suggested the allocation of interest expense and overhead costs should be determined on the basis of the ratio between the foreign revenues and total revenues. However, this is not a mandatory indication and it is possible to apply another criterion if it leads to a more accurate allocation.

General limitations on the deductibility of expenses

Italy's former thin capitalization rules were repealed as of 2008. When these rules applied, interest paid on related-party financing in excess of a certain threshold was disallowed and generally treated like the payment of a dividend. There was a safe harbour debt-to-equity ratio of 4:1.

The former "pro-rata patrimoniale" rule has also recently been abolished. Under this rule, a portion of interest expense could be denied if the book value of foreign subsidiaries qualifying for the participation exemption exceeded the book net equity of the parent company.

With respect to the repeal of the thin capitalization rules and the pro-rata patrimoniale rules, the Italian government has stated that the application of these rules was extremely complex and led to many difficult interpretative issues:

> In many cases the current rules trigger effects that are not logical and systematic. Currently entrepreneurs must apply in sequence three provisions, two of which, the pro-rata patrimoniale and the thin capitalization rules, offer substantial interpretative difficulties. The amendment that is proposed replaces the three provisions with only one which is of more straightforward application and whose scope is more clear.[48]

Instead of these rules (and similar to changes adopted in Germany), beginning in 2008 interest expense (net of interest income) will be deductible only up to an amount equal to 30 percent of earnings before interest, taxes, depreciation, and amortization (EBITDA) except for financial institutions. Any excess non-deductible interest will be available for unlimited carryforward to offset 30 percent of EBITDA of another year that is not fully absorbed by interest expense in the same year. From 2010, carryforward will be allowed for the portion of EBITDA not fully used to absorb net interest expense in the same year. The notional EBITDA of subsequent years will be increased by the excess capacity in a given year.

The non-deductible excess amount of one company can be offset against the 30-percent EBITDA not used by other entities within the same consolidated group.

In order to calculate the 30-percent EBITDA restriction, the new rules will allow the "virtual" consolidation of a foreign subsidiary of an Italian company. In this case the EBITDA not used by the foreign company to absorb its interest expense will increase the EBITDA of the Italian (virtual) consolidating entity. The rationale of this provision appears to be avoiding discrimination between the acquisition of Italian subsidiaries and the acquisition of foreign subsidiaries. It is still unclear whether virtual consolidation will be allowed only when an Italian company is tax consolidated with another Italian company, or irrespective of any Italian tax consolidation. The second interpretation appears to be more reasonable, but the first interpretation appears to be more consistent with the literal interpretation of the tax rule.

The benefits of virtual consolidation can be illustrated by a numerical example. Assume that Italco 1 owns Italco 2 and together they form a consolidated group for Italian tax purposes. Italco 1 also owns a foreign subsidiary, Forco. Assume the following EBITDA and interest expense for each of the three entities:

	EBITDA	Interest	As percent of EBITDA
Italco 1	100	35	35.0
Italco 2	200	80	40.0
Actual Consolidation	300	115	38.3
Forco	250	45	18.0
"Virtual" Consolidation	550	160	29.0

48 2007 explanatory notes of the government to the proposed legislation (translation). The legislation was approved in December 2007.

The amount of interest expense deductible by the Italian consolidated group is increased to 160 from 90 (being this the 30-percent EBITDA threshold at group level) by including Forco in the calculation since Forco is less highly leveraged than the Italian group, and enables the excess of 25 at the actual consolidation level as a deductible interest expense.

In order to be part of the virtual consolidation, the non-resident company must:

- be directly or indirectly owned for more than 50 percent (capital and profits) by an Italian (consolidated) entity;
- have accounts audited locally; and
- have the same fiscal year as the Italian entity.

The new restrictions described above only apply to corporations, and not to Italian partnerships. The 30 percent interest limitation rules are relatively recent and therefore the actual impact on the taxable base of Italian entities is still unclear.

Arm's length principle

In addition to the restriction outlined above, interest expense payable to related parties is only deductible to the extent it is determined on an arm's-length basis.

Anti-avoidance rules

Expense deductibility is limited if the expenses relate to transactions between resident entities and certain non-resident entities (related or unrelated) in tax haven jurisdictions, unless it can be shown that the non-resident carries on a real business activity, or that the relevant transactions have a real business purpose.

Japan

System for taxing foreign income

General

As a general rule, corporations established in Japan are subject to income taxation on worldwide income. As such, foreign source income including dividends, foreign branch income and taxable undistributed profits of tax haven subsidiaries (discussed below) of corporations established in Japan is also subject to taxation in Japan.[49]

In principle, a foreign tax credit is available for a Japanese corporation in respect of any foreign income taxes paid up to a statutory limit.

Direct foreign tax credit

A Japanese corporation may take a direct foreign tax credit to the extent of the limitation computed in the formula below. Excess foreign tax credits can be carried forward to the following three fiscal years.

$$A \times \frac{B}{C}$$

where:

A = Japanese tax (national and local corporate income taxes)
B = total foreign income
C = total worldwide income

The overall limit on the foreign tax credit described above is applied on a worldwide basis, not on a country-by-country or source-by-source basis. The maximum ratio of foreign income to worldwide income in the above formula (B/C) is generally capped at 90 percent. Moreover, foreign taxes levied at a high tax rate may not be fully creditable. Foreign taxes in excess of 50 percent of the tax base are not creditable against Japanese taxes but are generally treated as deductible expenses for corporate tax purposes.

It should be noted that under Japanese tax law, "foreign source income" is defined as income which does not fall under Japanese source income provided under the article 138 of Corporate Income Tax law. Total foreign income in the formula above is net of related expenses.

49 The Japanese Trade Ministry announced on May 9, 2008 that it will propose the introduction of an exemption system for repatriated foreign earnings in order to boost the country's international competitiveness and encourage the repatriation of foreign earnings. The plan will be included in tax reform proposals to be submitted to the Ministry of Finance for fiscal year 2009.

Deemed paid (indirect) foreign tax credits

A deemed paid foreign tax credit is available to Japanese corporations in respect of dividends received from certain foreign subsidiaries. This credit is available in respect of taxes paid by first-tier subsidiaries, and also granted to taxes paid by second-tier subsidiaries where the second-tier subsidiary has paid a dividend to a first-tier subsidiary which has in turn paid a dividend to the Japanese parent company.

In order to qualify for the credit in respect of first-tier subsidiaries, the parent corporation must own directly 25 percent or more of the outstanding shares (or shares with voting rights if the corporation has issued non-voting shares) in the subsidiary for a continuous period of at least six months immediately before the date on which the decision to distribute the dividend is made (the "ownership requirement"). In order to qualify for the credit in respect of second-tier subsidiaries, the first-tier subsidiary must meet the ownership requirement with respect to the second-tier subsidiary, and the Japanese parent also must meet the ownership requirement indirectly with respect to the second-tier subsidiary.

Controlled foreign corporation (CFC) tax rules

In principle, under Japanese anti-tax haven rules, a resident company which owns directly or indirectly five percent or more of the total shares issued by a CFC company in a tax haven country is subject to Japanese taxation on a current basis on the pro-rata share of the undistributed taxable profits of the CFC company.

A CFC company is a foreign company whose head office or main office is located in a country which does not impose an income tax, or a foreign company with an effective tax rate for the year of 25 percent or less, and more than 50 percent of whose voting shares or total shares are directly or indirectly owned by Japanese companies and Japanese residents.

The CFC rules do not apply if the tax haven subsidiary meets all of the following requirements:

1) Business activity criterion: The main business activity of the specified foreign subsidiary is not merely holding shares or intangible assets, or leasing ships or aircrafts. Various factors (e.g., gross sales amount or net income, number of employees, the volume of assets, etc.) must be taken into consideration to determine its main business.
2) Substance criterion: The specified foreign subsidiary must have an office, shop, factory or any other fixed place in the country where its head or main office is located.
3) Management and control criterion: The specified foreign subsidiary administrates and manages its business by itself in the country where its head or main office is located. Whether the administration and management are conducted by itself is determined based on all facts (e.g., the place of its shareholders meeting and board member meeting, the place of management activity, the place of bookkeeping and where it is maintained and any other relevant circumstances).

4) Non-related party transaction criterion or location criterion: These criteria apply based on the main business activity of the specified foreign subsidiary.

   - Non-related party transaction criterion: If the main business activity of the specified foreign subsidiary is the wholesale sale of goods, banking, trust, securities, insurance, shipping or air transport, more than 50 percent of its main business should be transacted with third parties. In the case of wholesales business, either the purchase or sales amount is used for the 50 percent test.
   - Location criterion: If the main business activity of the specified foreign subsidiary is other than those mentioned above, the main business activity has to be conducted in the same country where its head or main office is located in order to meet the location criterion.

Rates

The effective tax rate is generally approximately 42 percent for companies with paid-in capital up to ¥100 million, and approximately 41 percent for companies with paid-in capital of more than ¥100 million. These rates are an aggregate of national corporation tax, inhabitants tax and enterprise tax.

Tax treatment of expenses attributable to earning foreign income

Expenses relating to the earning of foreign source income reduce foreign source income for the purpose of calculating the foreign tax credit, described above. There is no other restriction on the deductibility of expenses, other than the general restrictions described below.

Allocation and apportionment of expenses to foreign source income

For Japanese tax purposes, in order to calculate foreign source income, firstly, the directly allocable expenses should be allocated to the corresponding category of income. Secondly, certain expenses should be apportioned to foreign source income.

Interest expense allocation

After allocating the interest expenses directly allocable to foreign source income (e.g., interest expense arising from the loans taken specifically for business in foreign countries), the remaining interest expenses should be apportioned between domestic and foreign source income. Generally speaking, the interest expenses are allocated based on the ratio of the corporation's foreign assets to worldwide assets.

Overhead expenses

Overhead expenses are also allocated first directly to corresponding foreign source income (if any) and then apportioned between domestic and foreign source income. As a general rule, the overhead expenses apportioned to foreign source income are calculated based on a reasonable basis such as revenue, the value of assets, and the number of employees.

Other expenses

Other expenses such as reserves, appraisal loss, donations to related parties, and entertainment expenses are also apportioned to foreign source income based on the applicable methods.

General limitations on the deductibility of expenses

Thin capitalization

The Japanese thin capitalization rules are designed to prevent excessive tax deductions on interest payments made to foreign related companies where the borrower has excessive related party debt in relation to its normal borrowing capacity with an independent lender. As a general rule, the debt-to-equity ratio to which the thin capitalization rules should be applied is 3:1. Notwithstanding, the debt-to-equity ratio of a Japanese company with comparable business, scale and other conditions may be taken into consideration to determine whether a ratio other than the 3:1 ratio may be applied, subject to approval by the Japanese tax authorities.

Transfer pricing with respect to interest expense

Transfer pricing legislation is designed for the purpose of preventing tax avoidance by corporations through cross-border transactions between a Japanese taxpayer corporation and a foreign affiliated company ("foreign affiliated transaction"). The rules may also apply to cross-border transactions carried out through an individual or an unaffiliated corporation where such transactions are recognized as foreign affiliated transactions in substance.

The consideration for a foreign affiliated transaction must be on an arm's-length basis and the arm's-length price may be substituted in determining the taxable income of the taxpayer corporation. Differences, if any, between the arm's-length price and the amount declared by the taxpayer corporation are not allowed as a tax deduction.

Anti-avoidance rules

Japanese tax law permits the application of a substance over form approach in respect of specified transactions. Transactions (not only cross-border transactions but also domestic transactions) of a family corporation may be disregarded or reconstructed for tax purposes in such form and upon such conditions as the National Tax Authority regards as usual and reasonable if such transactions have the result of "unreasonably reducing the family corporation's tax liability". A "family corporation" is defined as a Japanese corporation of which 50 percent or more of its shares are held, directly or indirectly, by three or fewer independent shareholders.

Netherlands

System for taxing foreign income

Dutch corporate income tax is levied on all companies established and/or resident in the Netherlands and on certain non-resident companies that derive income from the Netherlands. Resident companies are subject to taxation on their worldwide income, including trading income, foreign source income, passive income and capital gains.

Participation exemption

Under the Dutch participation exemption, qualifying dividends and capital gains from the sale of shares in subsidiaries are fully tax-exempt.

As a general rule, capital losses and a decline in value of the shares in a qualifying participating interest are not deductible. However, subject to complex anti-abuse rules, certain exceptions may apply. For example, losses incurred on a completed liquidation of the subsidiary are tax-deductible. Generally, the deductible amount is equal to the difference between the funds invested and the liquidation proceeds. This amount will be reduced by dividend payments made in the past five (or sometimes 10) years. Liquidation losses may not be deducted if the activities of the liquidated subsidiary are continued elsewhere within the same group. The deduction of losses incurred in the liquidation of an intermediate holding company may be denied in certain situations.

The participation exemption generally applies if the parent company holds five percent or more of the nominal paid-up capital in a domestic or foreign company. However, if a company holds less than five percent in a subsidiary, but a related company has a qualifying participation, the company holding less than five percent may tag along and enjoy the participation exemption.

There are many detailed rules with regard to the participation exemption, most of which pertain to potential abuse. The main exception concerns shares in a low-taxed portfolio investment company: the participation exemption does not apply if the subsidiary is a (passive) portfolio investment company which is subject to a profit tax resulting in an effective corporate income tax rate of less than 10 percent (calculated according to Dutch principles). Low-taxed companies with active operations will therefore be able to qualify for the participation exemption.

Whether or not a company is considered to be a portfolio investment company is determined by an asset test. If the assets of the participation consist, directly or indirectly, of more than 50 percent of portfolio investments, it is considered to be a portfolio investment company. This is a continuous test based on the fair market value of the assets. Portfolio investments are assets which are not reasonably required for the business activities of the company. Detailed rules apply to the qualification of the assets of a subsidiary. An exception applies to qualifying real estate investment subsidiaries.

A credit system for underlying tax on income and gains derived from shares applies to low-taxed portfolio investment companies. The credit system provides for a deemed credit of five percent. However, if the subsidiary is effectively not subject to tax at all, the deemed tax credit will not apply.

The participation exemption also applies to currency gains and losses arising from instruments used to hedge conversion risks on investments in foreign subsidiaries, to options, and to profits derived from converting convertible bonds. Income from a hybrid loan that is granted by the taxpayer to a qualifying debtor also falls under the participation exemption.

For decades, profits generated by (qualifying) participations in companies have been tax-exempt for entities based in the Netherlands. This participation exemption sets an international standard. The use of the exemption method to avoid international double taxation allows Dutch companies to operate in foreign countries under the same tax conditions as other companies operating in that country (capital import neutrality).

Foreign branch profits

Profits earned by a foreign branch of a company that is a resident of the Netherlands are exempt from corporate income tax if the branch is subject to foreign tax, regardless of the applicable foreign tax rate. Foreign losses are deductible from domestic taxable profits. However, future profits are, in principle, set off by such losses for the purpose of applying the foreign corporate income tax exemption.

Controlled foreign corporation (CFC) rules

The Netherlands does not have general CFC rules. However, low-taxed subsidiaries with assets of more than 90 percent portfolio investments and in which the Dutch taxpayer holds at least 25 percent have to be valued at fair market value. As a result, any increase in value in the low-taxed subsidiary each year is included in income.

Double taxation relief

Relief from double taxation for resident taxpayers may be provided by way of a tax treaty or under domestic rules. Relief generally takes the form of an exemption for real estate income or gains and a credit for foreign withholding taxes on foreign passive income such as dividends (unless covered by the participation exemption), interest and royalties. The credit is generally limited to the lower of the actual foreign tax and the Dutch tax attributable to the income.

Where neither a tax treaty nor the unilateral decree is applicable and the income is not exempt from Dutch taxation, relief for foreign taxes may be available under domestic law by way of a deduction in computing taxable profits.

Rates

The Netherlands has a three-tier system with progressive tax rates. From January 1, 2008, the applicable corporate tax rates and brackets are: €0 to €40,000 — 20 percent; €40,000 to €200,000 — 23.5 percent; and income exceeding €200,000 — 25.5 percent.

In order to compete with other countries (in particular other EU countries), the Netherlands has lowered its corporate income tax rates from 34.5 percent in 2004 to 31.5 percent in 2005, 29.6 percent in 2006, and 25.5 percent in 2007. No future rate changes have been announced.

This graduated corporate income tax rate reduction to 25.5 percent, together with the participation regime, reflects the Netherlands' commitment to being an attractive country for corporate investment. Other incentives for foreign investment include the broad availability of tax rulings, the lack of capital duty, an extensive treaty network and no withholding tax on interest and royalties.

General limitations on the deductibility of expenses

In order to determine whether costs can be deducted for Dutch tax purposes, the costs must actually be incurred for the risk and account of the relevant Dutch company.

The costs must also meet the arm's length principle (in line with the transfer pricing guidelines of the OECD). The arm's length principle is codified in the Corporate Income Tax (CIT) Act. The arm's length requirement will be deemed not to have been met if the terms and conditions of transactions between associated entities are such that unrelated parties would not have agreed to them.

Finally, expenses of a corporation are deductible if they are based on "sound business motives". This is a Dutch principle which, while not defined in the legislation, could be compared with international accounting principles, with certain differences.

Certain expenses are specifically non-deductible, including the following:

- Dutch corporate income tax and foreign taxes (if double taxation relief applies);
- boats used for business entertainment; and
- fines and penalties.

Interest expense will not be deductible if the instrument in respect of which it is payable is not characterized as debt for tax purposes. According to the Dutch Supreme Court, the qualification of a debt instrument for Dutch tax purposes will, in principle, be based on the civil law rules. The Supreme Court has summarized the conditions under which a civil law debt will be reclassified as capital for Dutch tax purposes:

- the remuneration on the loan depends (almost) entirely on the profit of the borrower;
- the loan is subordinated to all creditors; and
- the loan has no term, or has a term of more than 50 years.

Tax treatment of expenses attributable to earning foreign income

Foreign branches

The Dutch corporate income tax computation is based on the worldwide income of a resident company. Accordingly, the results of a foreign branch are immediately included in the annual Dutch income with an exemption for the foreign branch income. The OECD Transfer Pricing Guidelines provide rules for the allocation of expenses relating to the foreign branch income.

Shareholder costs

As of January 1, 2004, all costs relating to the holding of a participation qualifying for the Dutch participation exemption are deductible. However, there is an exception for costs relating to the acquisition or disposal of a participation qualifying for the Dutch participation exemption regime. These costs are not deductible and must be included in the cost base of the participation. An example of such costs would include banking and professional fees. Interest expense relating to the acquisition of a participation is deductible subject to the comments below under "Limitations on deductibility of interest".

In addition to the OECD Guidelines on inter-company dealings, the Dutch State Secretary has published its policy with respect to inter-company pricing and costs. In short, costs relating to qualifying shareholder's activities can be deducted at the level of the holding company without any recharge. However, costs relating to services provided to group companies resulting in a commercial or economical value for which a third party would have charged a fee, should in principle be recharged.

Limitations on the deductibility of interest

Interest paid on a loan owing to either a third party or a related party is in principle deductible for Dutch tax purposes. However, Dutch tax law provides for three important limitations with respect to interest paid to related parties.

1. Dutch anti-base erosion rules

The Dutch CIT Act contains an anti-avoidance rule intended to prevent an interest deduction in circumstances, generally, that relate to the transformation of equity into debt. For transactions whereby an interest expense is created at the level of a Dutch company, anti-abuse legislation may apply if the underlying purpose of the transactions is to create the interest deduction.

If a loan is received from an unrelated third party, it does not fall within the scope of Dutch anti-abuse legislation, and the interest on the loan is therefore deductible regardless of the use of the loan proceeds.

Interest due on loans that is legally or in fact, directly or indirectly, payable to an affiliated company is not deductible for Dutch CIT purposes if, among other things, the loan payable relates to a tainted transaction such as a dividend distribution, a capital contribution and/or an acquisition or expansion of an interest in a company. This provision applies equally to the purchase of foreign and Dutch companies.

However, inter-company interest may be deductible based on the following two exemptions from the anti-abuse legislation:

a. Sound business reasons requirement

The anti-base erosion rules will not apply if the taxpayer can provide evidence that the loan itself and the tainted transaction were mainly entered into for sound business reasons.

A third party acquisition is, in general, considered to be motivated by sufficient business reasons to meet this exception. With respect to the financing of a transaction, a safe-harbour rule may apply if the group company providing the loan obtains the necessary funds through a bank. As stated in the legislative history, business reasons are deemed to be present provided that the loan is on arm's-length terms and the bank loan can be "linked" to the inter-company loan.

In all other cases, it will need to be substantiated that the loan is granted for sound business reasons and not merely for the creation of the interest deduction. This is a very factual test and neither the law nor parliamentary history explains in detail what conditions are necessary to meet this test. A review of the facts and circumstances at the time the loan is granted is necessary to determine whether sufficient business reasons are present.

b. Compensating levy requirement

If the company cannot prove that the granting of the loan and the tainted transaction are based on sound business reasons, another exemption is available if the interest received (or accrued) by the creditor is subject to actual taxation of at least 10 percent (calculated under Dutch rules) provided that the actual taxation is not obstructed by a carryforward of losses, or other claims that originated in the past. However, if the payments will not be effectively taxed due to losses or claims arising in a current year, or in the near future, the deduction will still be denied.

As of 2008, another condition has been added to this requirement: both the transaction and the loan must be predominantly supported by business reasons, even if the income is taxed at a 10-percent rate. As an example of a transaction which concerned the government, the official explanation uses a Dutch entity making a capital contribution to an Irish or Cyprus subsidiary, which immediately lends the cash back to the Dutch entity in a circular flow of funds. Although the interest may be taxed to the Irish or Cyprus entity at 10 percent, the interest deduction could be denied if the tax inspector could show that the loan and/or the transaction was not entered into predominantly for business reasons.

As a formal matter, the burden of making the determination of insufficient business reasons is on the tax inspector if the interest is taxed at a rate of at least 10 percent. If the interest is taxed at a rate lower than 10 percent, the burden will be on the taxpayer.

2. At arm's length conditions (article 10b Dutch CIT Act)

The interest paid and capital losses realized on a loan are also not deductible if the following characteristics are present:

- the debtor and creditor are related companies;
- the loan has no term or a term of more than 10 years; and
- the remuneration on the loan deviates considerately (i.e., by 30 percent or more) from an arm's-length interest rate.

3. Thin Capitalization Rules

The Dutch CIT Act also provides thin capitalization rules. If a Dutch corporate taxpayer is part of a group and has an "excess debt" position, interest due on intra-group debt may not be fully tax deductible for Dutch tax purposes. In order to determine whether the taxpayer has an excess debt position, two tests are applicable:

a. The fixed ratio test (3:1)

Under this fixed ratio test, excess debt is the average amount of borrowed capital that exceeds three times the average fiscal equity plus a threshold of €500,000. The average amount of borrowed capital and the average amount of fiscal equity are computed based on the respective amounts at the beginning and end of a fiscal year. The amount of debt which has to be taken into account for this fixed ratio test is the net loan amount (loans payable less loans receivable).

b. The group ratio test

As an alternative to applying the fixed ratio test, a company may from year to year decide to apply the average debt-to-equity ratio of the (international) group to which it belongs as its maximum ratio. Unlike the fixed ratio test, the respective ratios will be established on the basis of the respective statutory (consolidated) accounts.

Although the thin capitalization rules take third-party debt into consideration when calculating ratios, only interest due on debt between related parties can be disallowed. In certain circumstances third-party debt may be considered related-party debt if guaranteed by a related company.

The above-listed extensive rules applicable to interest deductions are designed to prevent the erosion of the Dutch tax base. These rules are very strict and offer little opportunity for tax planning. However, planning is available if interest is non-deductible due to the thin capitalization rules. For example, the equity of the company can be improved through the contribution of group companies (no capital duty and participation exemption applicable on subsidiaries).

General anti-avoidance rule

The principle of fraus legis (abuse of law) developed under case law is not included in Dutch tax law, but is accepted as an anti-avoidance rule in the Netherlands. Under this principle, the spirit of the law is decisive, rather than the exact wording. It is used as a last resort by the tax authorities.

Sweden

System for taxing foreign income

Swedish domestic legislation generally provides that all income that arises in Sweden, as well as income derived from abroad by a Swedish resident company (e.g., foreign branch income), is subject to Swedish taxation. There is no general exemption for foreign branch income under domestic rules.

For Swedish resident companies, relief from double taxation in respect of branch income is usually achieved by the credit method. Where relief is not given under a double tax treaty, Sweden gives credit unilaterally to Swedish residents; however, the credit is limited to the amount of Swedish tax payable on the foreign source income.

Where not attributable to a permanent establishment in the source state, interest, dividends and royalties received from a foreign source are generally taxed on a gross basis with a foreign tax credit provided for the withholding tax. The tax credit available is limited to the amount of Swedish tax payable on the foreign source income.

Dividends received from foreign subsidiaries are generally exempt from tax under the Swedish participation exemption regime.[50]

Sweden has adopted controlled foreign corporation legislation according to which a Swedish company will be regarded as a tax liable shareholder of a foreign legal entity if shares representing at least 25 percent of the foreign legal entity's capital or votes are held or controlled by the shareholder, and the foreign legal entity is subject to low taxation (for Sweden, a tax rate of approximately 15.4 percent is regarded as sufficiently low to trigger the application of these rules). If these requirements are met, a Swedish shareholder will be taxed on its part of the taxable income.

Recently, legislation was passed that exempts a company from the CFC rules if the company can show that the foreign subsidiary was actually established in the foreign state for genuine business reasons. Under the new rule, certain conditions have to be fulfilled to demonstrate that "genuine business reasons" exist. For example, the CFC must have its own premises (to distinguish it from letterbox companies) and must have the required equipment for carrying out its responsibilities. These new rules became effective as of January 1, 2008.[51]

The corporate tax rate is 28 percent. There is no expected change to this rate.

50 Dividends derived by a Swedish resident company from a non-resident company are exempt under the Swedish participation exemption rules provided the non-resident company is regarded as comparable to a Swedish limited liability company (i.e., holdings in partnerships are not covered) and the shares are considered as "business-related". Unquoted shares are always regarded as business-related. Quoted shares are regarded as business-related if the holding represents at least 10 percent of the company's voting rights or where the shareholding is considered held for "business reasons". In addition, quoted shares must be held for at least one year. Dividends may also be exempt under the EU Parent Subsidiary Directive 90/435/EEC (10 percent capital holding requirement).

51 Prop. 2007/08:16.

Tax treatment of expenses attributable to earning foreign income

All business expenses incurred in obtaining or safeguarding income subject to taxation are deductible. Interest payments and other expenses relating to domestic or foreign investments, are fully deductible for Swedish tax purposes provided the terms are determined on an arm's-length basis.

For purposes of computing a foreign tax credit, all foreign branch income shall be included. For computation purposes, foreign branch income shall be reduced by business expenses attributable to the foreign branch, i.e., expenses that are deductible under Swedish tax rules. In addition, case law exists with respect to which expenses that shall reduce the income of the foreign branch and accordingly reduce the amount of tax credit available.

When attributing income to Sweden and the source state for tax credit purposes, principles contained in the Commentary to the OECD Model Tax Convention would apply. In addition, accepted accounting standards and legal rules would be considered.

General limitations on the deductibility of expenses

Sweden does not have any thin capitalization, fat capitalization or ratio-based rules to limit the deductibility of expenses. However, all transactions must be at arm's length. There are currently no changes expected, but future changes are possible.

As a general rule under Swedish tax law, business expenses are deductible only insofar as they are incurred in obtaining or safeguarding income subject to Swedish taxation. An exception applies for interest expense, which is deductible regardless. Thus interest expense relating to the acquisition of shares is deductible even if dividends on the shares are not subject to tax under the participation regime.

Further, there is a general anti-avoidance rule under the Tax Avoidance Act according to which a transaction may be disregarded for tax purposes if it is designed to provide the taxpayer with an improper tax benefit. The Tax Avoidance Act can be applied to transactions provided the following cumulative prerequisites are met: the transaction, alone or together with another transaction, constitutes part of a procedure that results in a significant tax benefit for the taxpayer; the taxpayer, directly or indirectly, takes part in the carrying out of the transaction or transactions; such a tax benefit is assumed to have been the predominant reason for the transaction; and taxation on the basis of the transaction would be in violation of the purpose of law.

The Swedish Tax Agency has previously attempted to apply the Tax Avoidance Act to challenge structures in which a Swedish subsidiary of a foreign company finances the acquisition of a subsidiary within the group with an interest bearing loan from the foreign parent. However, in a recent court case[52] the Swedish Supreme Administrative Court ruled that the Act could not be applied to a similar transaction in which a Swedish subsidiary acquired Swedish subsidiaries from its Swedish parent company in exchange for debt. It is the view of the Swedish Tax Agency

52 RR case no. 6699-04, 6701-04 and 6703-04.

that the outcome in the case would not have been different if the ultimate parent company had been a non-resident entity and interest payments on the loan had been paid to that company, thus lowering the taxable business income in Sweden.

Hence, as a result of the outcome in the case, the Swedish Tax Agency has altered its position and will not challenge such transactions using the Tax Avoidance Act. The Swedish Tax Agency has announced that it will investigate whether the Tax Avoidance Act is too inefficient and should be changed.

United Kingdom[53]

System for taxing foreign Income

Currently, UK resident companies are taxed on their worldwide profits (income and capital gains), including dividends received from non-resident companies.

In general, relief from double taxation is given by the ordinary credit method, either unilaterally or through the provisions of a double tax treaty. Credit relief is given for those foreign taxes, including national, provincial and municipal taxes, that correspond to UK corporation tax or that are covered by a tax treaty. Credit is restricted to the foreign tax that would have been payable if all reasonable steps had been taken to minimize the amount of such tax. Credit is also limited to the UK corporation tax attributable to the foreign income or gains, generally calculated on a source-by-source and item-by-item basis. There are also specific anti-avoidance rules to counter certain arrangements designed to artificially increase the available double tax credits.

An election may be made to deduct the foreign tax as an expense instead of claiming credit relief.

Generally, relief is available for underlying taxes paid on the profits distributed to the United Kingdom, where the UK company owns, directly or indirectly, at least 10 percent of the voting power in the foreign company paying the dividend. The application of the double tax relief rules for dividends can be extremely complicated, especially for dividends paid between a chain of companies where at each level a cap could be applied to prevent so called offshore mixing of high and low tax credits.

Broadly, excess foreign tax credits in respect of dividends can be:

- offset against other overseas dividends received by the same UK company in the same period, subject to certain restrictions;
- carried back three years;
- carried forward indefinitely; or
- group relieved to other UK group companies.

Excess foreign tax credits in respect of an overseas branch can generally be:

- carried back three years against profits of the same branch; or
- carried forward indefinitely against profits of the same branch.

53 Some of the material in this summary has been taken from Sandra Slaats (2007), "Financing Foreign Affiliates: An Overview of the Canadian Proposals and the Rules in Selected Countries", *Canadian Tax Journal*, vol. 55, no. 3, pp. 676–712. Please refer to that article for more detail.

Controlled foreign company legislation

The UK also has controlled foreign company legislation that may require an inclusion in taxable income for UK resident shareholders of companies resident in low-tax jurisdictions. The inclusion is based on a proportion of that company's chargeable profits calculated under UK tax principles, but not its capital gains.

Broadly, a foreign company is "controlled" if UK shareholders are able to secure that the company's affairs are conducted in accordance with their wishes. However, there are special joint venture with non-resident provisions and anti-avoidance legislation designed to prevent the circumvention of the control rules.

The foreign company must be resident in a low-tax jurisdiction in order for the CFC rules to apply. A low-tax jurisdiction is one where the tax paid is less than three-quarters of the UK tax which would be payable applying UK tax principles.

There a number of exclusions from the application of the CFC rules. These include exceptions for:

- de minimis profits;
- exempt activity companies;
- non-UK tax motivated transactions;
- companies that pay at least 90 percent of their chargeable profits to the United Kingdom; and
- companies on an "excluded countries list" which meet certain conditions.

Under current legislation, the focus of the UK CFC rules is the character of the overseas entity as a whole rather than the character of particular sources of income.

The United Kingdom is in the middle of a consultative process on the taxation of a company's foreign income. The process has included informal discussions with business during 2006 and the release of a discussion paper on June 21, 2007.[54] Consultations are continuing, with the new system potentially effective in 2009.

The 2007 discussion document proposes to replace the foreign tax credit system with an exemption system for most foreign dividends received by large and medium sized UK companies in respect of holdings of 10 percent or more, and to replace the CFC rules with a modernized controlled companies regime.

54 HMRC/HMT, *Taxation of the Foreign Profits of Companies: A Discussion Document*, June 21, 2007.

Some of the drivers of the proposals included:

- globalization, particularly the increase in foreign ownership of UK companies;[55]
- the increased use of exemption systems by other countries;[56]
- a desire to improve the competitiveness and attractiveness of the United Kingdom as a location for multinational business;[57]
- a concern about the current system's complexity and compliance costs;[58] and
- a concern about the current system's bias against the repatriation of profits, which distorts commercial decision making.[59]

However, the paper notes that a credit system affords a degree of protection to the tax base since profits must ultimately be repatriated. The paper suggests that the tax base can be protected under an exemption system by a modern income-based controlled companies (CC) regime, which would replace the existing CFC rules, and targeted interest deductibility changes (discussed below).[60]

Whilst a detailed discussion of the proposed CC rules is not possible as the consultation document will not be published until summer 2008, it is clear that any proposals would be designed to "refocus the regime from an entity based 'all-or-nothing' regime to a targeted, income-based regime which will tax the UK parent on specifically defined mobile/passive income that is within (its) control…"[61] The new regime outlined in the 2007 discussion document would appear to be quite similar to the Canadian FAPI rules, applying to passive income and to certain mobile types of active business income. Exemptions would be provided for, amongst other things, certain intra-group payments, similar to the Canadian deeming rule, although the scope of these exemptions is not entirely clear.[62]

Rates

The tax rate for large companies is 28 percent from April 2008 (a reduction from 30 percent) and 21 percent for small companies. Small companies are defined as companies with taxable profits of less than £300,000 per annum, proportionately reduced for the number of associated, worldwide companies.

55 Supra note 54, paragraphs 2.7 and 2.8.

56 Supra note 54, paragraphs 2.16, 3.2, and 3.7.

57 Supra note 54, paragraph 2.19.

58 Supra note 54, paragraphs 2.20 and 3.1.

59 Supra note 54, paragraph 3.5.

60 Supra note 54, paragraph 3.8.

61 Supra note 54, paragraph 4.8. The CC rules will also be extended to investments in UK companies, thus the name change from "CFC". This change relates to EU law considerations (see the discussion in Joann M. Weiner (2007), "Exempting Foreign Profits from Taxation in the U.K.", *Tax Notes International*, vol. 47, no. 3, pp. 214-20 at 220).

62 Supra note 54, paragraphs 4.25 and 4.26.

Tax treatment of expenses attributable to earning foreign income

There are no additional restrictions on the deductibility of expenses which relate to the earning of foreign, rather than UK, source income.

However, expenses may need to be allocated to foreign income in order to compute the foreign tax credit available in the United Kingdom. There are no detailed provisions for determining the allocation of such expenses. For example, in respect of trading income account needs to be taken of:

- deductions or expenses which would be allowable in the computation of the taxpayer's liability;
- a reasonable apportionment of allowable deductions or expenses which relate partly to the transaction, arrangement or asset from which the income or gain arises and partly to other matters; and
- expenses of a company connected with the taxpayer, insofar as reasonably attributable to the income or gain.

General limitations on the deductibility of expenses

Transfer pricing/thin capitalization

The primary purpose of UK transfer pricing legislation is to prevent the diversion of UK-taxable business profits from a UK resident to a related non-resident person by transactions between them that are on other than arm's length terms. However, the legislation does apply to transactions between related UK parties. If a UK resident undercharges, or is overcharged by, an associate, it is obliged to adjust its taxable profits/losses to reflect the price which would have been charged between independent persons dealing at arm's length. A compensating adjustment may be available if the counterparty is also UK tax resident.

Thin capitalization is within the scope of the transfer pricing legislation. Permissible debt/equity ratios and levels of interest cover are governed by the arm's length principle and are subject to negotiation with the UK tax authorities taking into account the specific circumstances of the company and the industry in which is operates. There are no "safe harbour" rules in the United Kingdom for thin capitalization purposes. Excessive interest is disallowed for the borrower (but not recharacterized as a distribution). Again, a compensating adjustment may be available if the counterparty is a related party UK lender.

Anti-arbitrage rules

Specific anti-avoidance rules were introduced in 2005 to counter certain arrangements, which can be broadly split as follows:

- restriction of a deduction where a scheme involving a hybrid entity or instrument increases the UK tax deduction; and
- taxation of certain receipts representing a contribution of capital to a UK company in a non-taxable form while it creates a tax deduction for the payer.

Per the UK tax authorities guidance, these rules "… are targeted against contrived arrangements … they will not apply to most companies nor to the majority of transactions undertaken by companies".

Deduction of interest

A comprehensive code dealing with the taxation of loan relationships was introduced in 2006 and interest expense may be restricted by the "unallowable purpose" rule contained within that code. The rule may apply to limit the deduction of interest expense where the main purpose, or a main purpose, of a borrowing is to generate a UK tax advantage. To date the application of this anti-avoidance legislation has been relatively narrow.

The deductibility of interest was one of the topics covered in the 2007 discussion document.

While acknowledging that there may be a need to tighten the rules on interest deductibility if the UK introduces an exemption system, the discussion paper states that there is no need for "complex interest restriction rules, such as those based on apportionment".[63] The paper lists a number of options, such as:

- the disallowance of interest allocated to foreign profits (either by tracing presumably, like the original Canadian budget proposals, or by formula);
- "thinner capitalization" rules which would disregard the value of subsidiaries when determining allowable interest deductions; and
- "fat capitalization" rules which would deem a parent to have received interest from a subsidiary if it is funded with little or no debt.[64]

However, given the complexity and compliance difficulties inherent in all these options, and the fact that the Exchequer receives little tax in respect of foreign profits in any event, all of these options were rejected.[65]

63 Supra note 54, paragraph 5.2.

64 Supra note 54, paragraph 5.4.

65 Supra note 54, paragraph 5.5.

However, the discussion paper considers two targeted anti-avoidance measures:

- the existing "unallowable purpose" rules would be strengthened;[66] and
- interest claimed by UK members of a multinational group would be restricted by reference to the group's total consolidated external finance costs.

The discussion document contained little or no detail regarding the application of the second measure, and more detail is expected in the consultation document which is due to be published in summer 2008. It has been suggested that the limitation would only be applicable if the actual amount of debt of the UK group exceeds the entire arm's-length debt of the world-wide group. If this is what is intended, rather than a proportionate limitation based on relative assets values or a similar test, the provision would not be expected to be very restrictive.

Connected party interest

Generally, interest is tax deductible on an accruals basis. However, interest payable to a connected party which is not subject to UK corporation tax that is not paid within 12 months of the end of the accounting period in which it is accrued, becomes tax deductible on a paid basis.

66 Supra note 54, paragraph 5.8. The discussion paper would seek to bolster the effectiveness of the rules by broadening the focus on the purpose of the borrowing to encompass the purpose of related schemes or arrangements and the purpose(s) of other group companies.

United States[67]

System for taxing foreign income

Credit System

The United States taxes all income of domestic corporations without regard to the source of the income. As in Canada, the U.S. taxation of active foreign business income earned by foreign corporate subsidiaries of domestic corporations generally is deferred until the income is repatriated to the U.S. parent company in the form of dividends, or realized on the disposition of the shares of the foreign corporation. The exception to this general "deferral" principle is set forth in a part of the Internal Revenue Code (IRC) known as "subpart F," which requires the U.S. parent company to include in its income all or a portion of the unrepatriated earnings of a controlled foreign corporation in certain circumstances (e.g., passive income, investments in U.S. property). Even in situations not involving "controlled" foreign subsidiaries, a U.S. corporation may owe current U.S. tax on unrepatriated earnings of a foreign corporation in which it owns stock, or otherwise face adverse U.S. tax consequences, if a predominant portion of the foreign corporation's income or assets is passive.

The United States seeks to prevent the double taxation of foreign source income by allowing a foreign tax credit. Under U.S. law, a U.S. corporation may claim a credit against its pre-credit U.S. tax liability for foreign income taxes that the U.S. corporation itself pays or accrues (the "direct credit") and, if the U.S. corporation receives a dividend or a "subpart F" inclusion from a foreign corporation, for a portion of the foreign income taxes paid by the foreign corporation, associated with its earnings included in the U.S. corporation's income, and thus "deemed" paid by the U.S. corporation (the "indirect credit" or "deemed-paid credit"). Since 1986, the amount of taxes deemed paid by the U.S. corporation with respect to an income inclusion have generally been determined by pooling the foreign corporation's post-1986 taxes and earnings.[68] Pooling was introduced at that time to address perceived defects in the prior-law indirect credit rules, which more closely tied taxes deemed to be paid with the particular taxes actually imposed on the earnings deemed to be repatriated. Twenty years of experience with pooling, in turn, has led to a perception of defects in the pooling regime, and to proposed cures for these defects.

On the theory that the credit should not shelter U.S. source income from U.S. tax, the amount of foreign tax credit that can be claimed in any one year is limited to the U.S. tax otherwise payable on the U.S. corporation's foreign source taxable income (mathematically, pre-credit U.S. tax times the ratio of the taxpayer's foreign source taxable income to the taxpayer's entire taxable income). This so-called "foreign tax credit limitation" is computed separately

67 Some of the material in this summary has been taken from Sandra Slaats (2007), "Financing Foreign Affiliates: An Overview of the Canadian Proposals and the Rules in Selected Countries", *Canadian Tax Journal,* vol. 55, no. 3, pp. 676-712. Please refer to that article for more detail.

68 Exceptions to the general rule include the ability of a taxpayer to deduct (instead of credit) foreign taxes and the inability to credit foreign taxes associated with certain foreign countries.

for different types (or "baskets") of income (currently, general category income and low-taxed passive category income), and not on a per-country basis. Foreign taxes that exceed the limitation may generally be carried back one and forward 10 years.

Internal U.S. law, rather than tax treaties, provides the bulk of the United States double tax relief. Tax treaties can affect foreign tax credits, however, by reducing or eliminating the amount of certain foreign income taxes incurred, affecting the source of income (and thus increasing the foreign tax credit limitation), and in rare cases affecting whether certain taxes are considered creditable income taxes. It should be noted that, in cases where foreign taxes can be reduced by a treaty, but the taxpayer fails to take advantage of the reduction, the foreign tax that could have been reduced is generally not creditable.

While the U.S. tax rules are very complex, particularly as they relate to the foreign tax credit calculation, the tax planning opportunities available to U.S. multinationals are also extensive. This reflects the mechanical rules that govern the computation of the foreign tax credit limitation and of "deemed-paid" taxes. Planning therefore focuses on the timing of when foreign taxes are deemed paid and the amount of foreign source taxable income generated (e.g., changing the source of gross income from domestic to foreign, decreasing the portion of deductions allocated and apportioned to foreign source gross income, and "hyping" the amount of foreign taxes associated with a multi-year pool of foreign subsidiary earnings). The "check-the-box" rules allow U.S. multinationals significant latitude in this respect. One example of this involves a popular structure, an "E&P splitter", which uses hybrid entities to direct foreign subsidiary earnings on the one hand, and the associated foreign taxes on the other, to separate entities treated as corporations for U.S. tax purposes. Because a U.S. taxpayer has flexibility in the timing of repatriations from each entity, the structure allows the U.S. taxpayer to better control its foreign tax credit claims. (It should be noted that the U.S. Treasury Department has plans to change its regulations in a way that will impact the effectiveness of this planning.)

Foreign tax credit planning has also become easier with a recent relaxation of the subpart F rules. As described earlier, the subpart F rules represent an exception to the deferral system that generally applies to the unrepatriated earnings of a CFC. For example, a current, subpart F, income inclusion is generally triggered for a U.S. corporation if that corporation owns a CFC that earns certain passive income (e.g., certain interest) and has unrepatriated earnings. A relaxation of the subpart F rules potentially provides taxpayers with increased abilities to control the timing of when foreign earnings are taxed in the United States, thereby improving their capacity to manage their foreign tax credit positions. The recent relaxation in the subpart F rules generally exclude inter-affiliate payments from triggering subpart F income.[69] In this respect, the U.S. rules have been brought closer to Canada's own deeming rule, which does not restrict inter-affiliate payments to affiliates resident in the same country.

69 This exclusion rule applies with respect to taxable years of foreign corporations that begin after 2005 and before 2009. The Administration's Fiscal Year 2009 Revenue Proposals (2008 Blue Book) include a plan to extend this period by one year.

Other planning opportunities allow U.S. companies to create low-taxed foreign source income that can facilitate the repatriation of high-taxed foreign source income, and to accelerate or manage their foreign tax credits. In general, planning aims to allow U.S. companies to use the foreign income tax liabilities triggered by their business operations so as to reduce U.S. taxes in the most efficient manner possible.

A number of avenues have been pursued by the U.S. government to attack instances when there is a perceived abuse of the U.S. foreign tax credit. In the courts, various structures and planning have been challenged on the basis they were shams, that they did not reflect the economic substance of the underlying arrangements, or that they should be recharacterized to produce a different, and more appropriate, result. There is also a statute providing that, if certain acquisitions are made with the principal purpose of avoiding U.S. federal tax by securing a tax benefit, then government authorities may disallow the benefit. More recently, minimum holding period rules were enacted that target cases where certain assets are acquired to facilitate the transfer of foreign tax credits from those who could not benefit from them to those who could.

There are also U.S. tax rules that seek to discourage overly aggressive tax planning by requiring the reporting of certain transactions to the Internal Revenue Service (and in some cases where penalties are imposed, to report them to shareholders). Amongst the transactions covered by these rules are certain transactions that may be undertaken to obtain favourable foreign tax credit results.

Nevertheless, in practice, there remain many opportunities for a U.S. corporation to manage its utilization of foreign tax credits, depending on the corporation's facts and circumstances and the level of planning undertaken. The November 2005 report of the President's Advisory Panel on Federal Tax Reform noted the importance of the circumstances of each taxpayer to the tax results that can be achieved under the current system, and concluded that tax planning "may effectively allow corporations to obtain territorial tax treatment for active business income through 'self-help,' and some corporations may be able to receive tax treatment that is even more favourable."[70] In 2006 a task force of the American Bar Association similarly concluded "for U.S. multinational taxpayers, the U.S. rules, despite their complexity, can be the best of all worlds."[71]

The President's Advisory Panel recommended that the United States adopt a territorial (exemption) system of taxation for foreign earnings in order to eliminate certain distortions caused by the current deferral and credit system, particularly the disincentive to repatriate funds to the United States.

70 President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* (Washington, D.C.: President's Advisory Panel on Federal Tax Reform, November 2005), available at www.taxreformpanel.gov/final-report.

71 American Bar Association Section of Taxation Task Force on International Tax Reform, "Report of the Task Force on International Tax Reform", *The Tax Lawyer*, vol. 59, pp. 649-76 (Spring 2006). The Task Force report contains a detailed analysis of the President's Advisory Panel proposals and other U.S. proposals to introduce a territorial system.

Other proposals for changes to the current deferral and credit system have been put forward. Some of the other possibilities being discussed include the following:

- A bill was introduced by Ways and Means Committee Chairman Rangel in October 2007 that would significantly modify the timing of when foreign taxes paid by a U.S. corporation or its CFCs are deemed paid by the U.S. corporation or are otherwise taken into account for credit purposes. The change would cause a U.S. corporation's deemed-paid taxes upon a repatriation from any CFC to be determined by a single, uniform, group-wide fixed ratio as applied to the amount of the repatriation, where the uniform fixed ratio is based on the ratio of foreign income taxes paid by the corporation and all of its CFCs to their combined foreign source income.[72] The foreign taxes of the combined group of U.S. and foreign companies that are not taken into account for U.S. credit purposes when first paid would become available for credit by the U.S. corporation as the associated pool of deferred foreign income is subject to U.S. tax (generally, in the case of foreign taxes imposed on CFCs, only after subsequently earned CFC income has been included in the income of the U.S. corporation).

- Repeal of some or all of the deferral opportunities available under the current system has been proposed on occasion. A sweeping proposal to repeal deferral was proposed, for example, by the Kennedy Administration in 1961.[73]

Tax rate

U.S. corporations are generally subject to graduated income tax rates for regular tax purposes, with the maximum U.S. federal tax rate being 35 percent. There are on-going discussions of tax reform that could impact the tax rates in the future.

For example, the Rangel bill that is mentioned above proposes a reduction in the top corporate tax rate to 30.5 percent. Also, in a background paper, which was released at the U.S. Department of Treasury's July 23, 2007 "Business Taxation and Global Competitiveness" conference, the United States is identified as having the second highest statutory corporate tax rate amongst the OECD countries. The report advocates that a broadening of the tax base and decrease in the statutory corporate tax rate would improve the United States' global competitive position. In a related report, issued by the U.S. Department of Treasury on December 20, 2007, entitled *Approaches to Improve the Competitiveness of the U.S. Business*

72 To illustrate the impact of this proposed change, assume a U.S. C corporation, USP, wholly-owns two foreign corporations, FC1 and FC2, with the following facts:
- FC1 only generates subpart F income;
- in Year 1, FC1 has E&P of $900 and foreign income taxes of $100 (i.e., a 10 percent foreign effective tax rate);
- FC2 generates active business income and does not have any investments in U.S. property;
- in Year 1, FC2 has E&P of $700 and foreign income taxes of $300 (i.e., a 30 percent foreign effective tax rate).

Under current rules, USP would have foreign taxes available for credit in Year 1 of $100. The proposed changes would, instead, provide that USP has foreign taxes available for credit in Year 1 of $225. This is calculated as the total foreign income taxes of $400 multiplied by the ratio of currently-taxed foreign income (i.e., $900) to the total of currently-taxed foreign income and deferred foreign income (i.e., $900 plus $700). In effect, the proposed changes result in an averaging of the USP worldwide group's foreign effective tax rates.

73 For example, the July 31, 2007 CRS Report for Congress, entitled *Reform of U.S. International Taxation: Alternatives*, discusses the territorial-based system and the repeal of deferral.

Tax System for the 21st Century, three broad reform alternatives are discussed, including one that involves a business tax rate reduction. At present, no single reform alternative is considered imminent.

Most states also impose an income tax. State income tax rates vary significantly, but a five percent rate is widely used as a proxy for an average (even though there are many instances when this is inappropriate).

Tax treatment of expenses attributable to earning foreign income

Tangible assets that are used predominantly outside of the United States are depreciated at a slower rate for U.S. tax purposes than they otherwise would be if they were used predominantly in the United States. All other things being equal, over the life of a U.S. corporation's foreign operations, this has the effect of accelerating the recognition of taxable income to the earlier years.

Expenses associated with income that is exempt from U.S. taxation are generally not deductible. However, this provision does not impact on those situations where the taxation of the associated income is merely deferred.

For example, interest expense of a U.S. corporation is generally deductible on a current basis in determining the corporation's taxable income even though the interest may have been incurred to purchase or carry stock in CFCs, and the active business income earned by the CFCs will not be included in the U.S. corporation's income until repatriated. The United States has no rules similar to the 2007 Canadian budget proposals. However, a portion of the parent's interest expense must be allocated to foreign income for purposes of the foreign tax credit calculation. As described below, this allocation is generally calculated on the basis of the relative tax values of foreign and domestic assets. The allocation of interest expense of the U.S. parent company against foreign source income can make it difficult to repatriate earnings to the United States without incurring an additional U.S. tax cost. This should become easier in many cases if a one-time election, introduced by the American Jobs Creation Act of 2004, comes into effect as scheduled in taxable years beginning after 2008. An electing U.S. corporation will be permitted to avoid allocating and apportioning its interest expense to foreign source income if it is not over-leveraged relative to the combined group consisting of the U.S. corporation and its CFCs.

In general, deductions are first directly allocated to the income to which they are "definitely related". Whether an expense is "definitely related" is based on whether there is a causal relationship with the income (i.e., whether the expense was incurred as a result of, or incident to, an activity or property that generated the income). Once this "class of gross income" to which the deductions are to be allocated is determined, if the class consists only of income of one source, the deductions reduce only income of that source. If the class consists of both U.S. and foreign source income, further apportionment between these groupings within the class of gross income must be made based on formulae that should reflect, to a reasonably close extent, the relationship between the deductions and the groupings of income.

There are special rules that apply in the case of certain deductions. Two, in particular, are as follows:

- Interest is generally allocable to all income and apportioned on the basis of the relative values of the U.S. corporation's gross assets that generate U.S. source and foreign source income,[74] using the same apportionment ratio for every member of a U.S. affiliated group of companies. Exceptions to these principles apply only in limited circumstances (e.g., interest associated with integrated financing transactions, third party debt of U.S. corporations holding the debt of CFCs, etc.). Because this method treats the stock of a foreign subsidiary (rather than the gross assets of the foreign subsidiary) as gross assets of the U.S. corporation, it can result in the allocation of the U.S. corporation's interest expense to stock of a foreign subsidiary, and thus to foreign source income (thereby reducing the foreign tax credit limitation) even in cases where the foreign subsidiary is at least as leveraged as the U.S. corporation, and arguably only the debt of the foreign subsidiary is properly allocable to foreign source income. To address complaints about the bias under the existing interest allocation and apportionment rules to potentially over-allocate interest to foreign source income, for tax years beginning after 2008 an election may be made to apportion interest on a worldwide affiliated group basis.[75] Bills have been introduced to either delay, modify, or eliminate, the ability to make this election in order to pay for other tax provisions (e.g., housing assistance).

- Research and development deductions are allocated and apportioned first to product categories. Then, there are two options available. The first, a sales method, apportions 50 percent of the deductions to the location, if any, where more than 50 percent of the deductions were incurred, and apportions the remaining deductions in proportion to sales. The second, a gross income method, apportions 25 percent of the deductions to the location, if any, where more than 50 percent of the deductions were incurred, and generally apportions the remaining deductions in proportion to gross income.

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74 If value for this purpose is based on adjusted tax basis, then the value of stock in a corporation (e.g., a CFC) that is 10 percent or more owned by the U.S. affiliated group, but not part of the U.S. affiliated group, also includes the share of earnings and profits history of the corporation during the period the stock has been held.

75 To illustrate the bias under the existing interest apportionment rules, and the difference between the impact of making, versus not making, the election to apportion interest on a worldwide affiliated group basis, consider a simplified example involving a U.S. corporation with a wholly-owned foreign operating subsidiary and the following facts:

- U.S. corporation owns operating assets valued at $100 and stock of the foreign corporation valued at $100;
- U.S. corporation incurs $10 of third-party interest expense;
- Foreign corporation has assets valued at $500 and liabilities of $400; and
- Foreign corporation incurs $40 of third-party interest expense.

"Value" can be determined in a number of ways but is not specified here to simplify the example. Assume also that there is no difference between interest expense and the amount deductible for U.S. tax purposes. Under the existing interest apportionment rules, $5 of the interest incurred by U.S. corporation would be apportioned to foreign source income (i.e., $10 of interest multiplied by the ratio of $100 in value of foreign corporation shares to total value of $200). In contrast, if the election is made to apportion interest expense on a worldwide affiliated group basis, no interest would be apportioned to foreign source income (i.e., $50 of combined interest multiplied by the ratio of $400 in value of foreign assets to total value of $500, less $40 of interest incurred by the foreign corporation).

The Rangel bill that would affect the timing of when foreign taxes are considered incurred, as described above, would also require that taxpayers defer deductions for expenses that would have been allocated to deferred income of a CFC had that income been subject to current taxation.

As noted above, the President's Advisory Panel recommended adoption of a territorial system of taxation. However, the territorial system would include restrictions on the deductibility of interest expense. Interest expense would only be disallowed however to the extent that the U.S. operations of a U.S. multinational were more heavily leveraged than the multinational's foreign operations. Interest expense would be disallowed to the extent that the ratio of foreign debt to foreign assets was lower than the worldwide ratio of debts to assets. Some portion of general and administrative expenses would also be allocated to foreign income and disallowed.

Depending on the details of implementation and on other changes that may accompany possible redesigns of the U.S. international tax rules, it is generally believed that some U.S. multinationals would benefit from a territorial system, or even from a repeal of deferral, while some would be hurt by a change to either of these systems.[76] Perhaps because of this disparity of interests, no changes are expected in the near term.

Dual consolidated loss rules

The U.S. system contains dual consolidated loss (DCL) rules, which, broadly speaking, were enacted to prevent a single economic loss from being used to reduce tax on two separate items of income — one of which is subject to current tax in a foreign country but not in the United States and the other of which is taxed in the United States but not in the foreign jurisdiction. The drafters believed that, through such "double dipping," worldwide economic income could be rendered partially or fully exempt from current taxation. The DCL rules deny U.S. corporations the benefit of consolidating their income for tax purposes with the net operating losses of "dual resident companies" (DRCs) — affiliated U.S. corporations that are also taxed by a foreign country on a residence basis. The rules also deny U.S. corporations deductions for net operating losses of their own "separate units" (e.g., their own foreign branches or hybrid foreign-resident entities).[77]

The DCL rules impact a number of, but not all, inter-group financing transactions. For example, the Tower structure commonly used for inbound investment into the United States, well known to the U.S. Treasury and a target of new Canadian section 18.2 is not caught by the U.S. DCL rules. This is because the partnership in the Tower structure, while it is treated as a U.S. corporation under the check-the-box rules, is neither a DRC nor a "separate unit" of a domestic corporation. More relevant from the perspective of outbound taxation, there are numerous examples of hybrid entity and hybrid instrument structures which are used for financing Canadian subsidiaries of U.S. companies that also remain viable despite the final regulations.[78]

76 See Edward D. Kleinbard, "Throw Territorial Taxation From the Train", *Tax Notes,* vol. 114 (February 5, 2007), at p. 547 [2007 TNT 25-65] for a criticism of territorial taxation and the advocacy of a full accrual system for all foreign income.

77 IRC Section 1503(d), first introduced in 1986.

78 A number of these structures will also survive the September 2007 protocol to the Canada-U.S. tax treaty.

The viability of many structures even after the enactment of the DCL rules in 1986 is the result of a choice (possibly unintentional) that was made when drafting the DCL rules — that is, they were written to affect *entities* taxed as residents of foreign countries, but not *income* taxed in the hands of such entities, if the income was not also earned by an entity that is taxed as a resident of a foreign country (but instead was earned, for example, by an entity treated as fiscally transparent in the foreign country). However, the United States has not seen fit to expand the DCL rules to eliminate this disparity in the 22 years following their original enactment. The reason may be a certain U.S. ambivalence about denying taxpayers the benefits of international tax arbitrage.

For example, Kevin Dolan, Senior Vice President of Merrill Lynch, has recently argued that the United States has a longstanding laissez-faire attitude to international tax arbitrage, and the DCL rules are an anomaly. In a May 31, 2007 letter to Treasury and IRS officials concerning proposed regulations to be issued under IRC section 901[79] he wrote:

> International tax arbitrage is both pervasive in the U.S. tax system and well accepted. International arbitrage in leasing has existed for decades and is explicitly sanctioned.[[80]] It is perfectly acceptable for a lessor to be treated as the tax owner of leased equipment for U.S. tax purposes even though the lessee is treated as the owner for foreign tax purposes, thereby entitling both parties to claim depreciation and/or investment tax credits in their home countries. It is also pervasive in the subchapter C area[[81]] and in the financial products area.[[82]] International tax arbitrage was even sanctioned in the foreign tax credit area as recently as 1998 in Notice 98-5, which clearly accepted arbitrage in foreign tax credit transactions provided that they satisfied economic substance principles. Former International Tax Counsel Hal Hicks was quoted as saying that, from a tax policy perspective, Treasury does not believe that international tax arbitrage is an "inherent tax evil":
>
>> There's nothing inherently wrong with cross-border tax arbitrage. It is a natural byproduct of the global economy interacting with disparate tax systems. The question is not whether there is a foreign tax benefit, but how the U.S. rules apply.[[83]]
>
> Similarly, Former Chief Counsel B. John Williams stated:
>
>> We all know that cross-border activities are vital to our economy. They necessarily involved two tax authorities and we can expect from time to time inconsistent treatment of tax items or structures by the Internal Revenue Code as compared to the tax law of a foreign country. We are confident in the principles and integrity of our tax law and, unless the law requires otherwise, we will determine the appropriate tax treatment of an item based solely on the application of U.S law. In certain cases, Congress has provided that the U.S. tax treatment of a transaction be determined through an analysis that, to some degree, takes

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79 D. Kevin Dolan, "Tax Professional Seeks Withdrawal of Proposed Foreign Tax Credit Regs (Public Comments on Regulations)", Tax Analysts Document Number 2007-13277, May 31, 2007 [2007 TNT 107-52]. Mr. Dolan was writing in his individual professional capacity and not on behalf of Merrill Lynch.

80 Technical Advice Memorandum 9748005 (August 19, 1997).

81 See, for example, Rev. Rul. 80-154, 1980-1 C.B. 68, Rev. Rul. 83-142, 1983-2 C.B. 68, and PLR 9835011 (May 26, 1998) as to cash distributions that were disregarded for U.S. tax purposes but not for foreign tax purposes, and private letter rulings (PLRs) 9111033 (Dec. 17, 1990) and 9344009 (Aug. 4, 1993) as to reorganization transactions that were treated as taxable sales for foreign purposes but as tax-free reorganizations for U.S. purposes.

82 See, for example, Rev. Rul. 74-27, 1974-1 C.B. 24, PLR 9322039 (Mar. 11, 1993), and PLR 9125038 (Mar. 27, 1991) as to repos, and Rev. Rul. 81-251, 1981-2 C.B. 156, Rev. Rul. 78-118, 1978-1 C.B. 219, and general counsel memorandum (GCM) 35405 (July 19, 1973) as to loan participations.

83 Sheryl Stratton, "Tax Arbitrage Not Inherently 'Evil,' Treasury Official Says," Tax Analysts Document Number 2006-787, Jan. 13, 2006 [2006 TNT 9-3].

> into account the foreign tax treatment of the transaction. Examples include Section 894(c), which addresses certain treaty abuses, and Section 1503(d) [the DCL rules], which limits the availability of a double deduction in the U.S. and a host country for the same item of tax accounting loss. Where there is no statutory mandate, however, we will determine the U.S. treatment of the transaction by applying the appropriate U.S. tax principles.[[84]]

> As stated more eloquently above, there is no principle in the foreign tax credit rules or elsewhere that suggests that U.S. tax consequences should turn on foreign tax treatment. Even the exceptions cited by Mr. Williams are anomalies. Section 894(c) relates to bi-lateral income tax treaties, which are a negotiated bargain between two countries whereby one gives up the right to tax in order to cede that right to the other country in order to mitigate double taxation. Quite naturally, the U.S. government did not want to cede the right to tax if in fact the treaty partner is not imposing tax, and it made sense in that context to give up U.S. tax only if the foreign treaty partner is in fact imposing tax. *Section 1503(d) precludes "double dipping" of interest deductions, which generally involves some form of arbitrage. But most of us are still trying to figure out what U.S. tax policy exists for denying a U.S. multinational an interest deduction that also reduces foreign tax. That provision was more of a protectionist trade measure aimed at foreign multinationals that were buying U.S. companies, and U.S. multinationals got caught in the middle because it would have been difficult to defend a non-reciprocal provision aimed only at foreign buyers.* [emphasis added][85]

Mike Danilack and Irwin Halpern, in a 2002 article which discusses the history and policy surrounding the DCL rules, agree that the rules were designed originally to address double dips into the United States in order to prevent foreign buyers of U.S. companies from having an advantage over U.S. buyers but were extended before enactment to outbound transactions primarily in what they argue was a misguided attempt to mitigate the potential for a successful discrimination challenge.[86] Their view is that the regulatory drafters subsequently extended the application of the rules in the outbound context beyond the original goals of Congress, resulting in unduly burdensome and discriminatory rules applicable to U.S. multinationals. They state that the DCL rules, in 2001 at least, were out of line with the current U.S. thinking on international tax arbitrage:

> …it is clear that unilateral harmonization or anti-arbitrage efforts [like the DCL rules] are out of synch with current thinking. Over the past several years, such efforts have been viewed uniformly as weighing heavily on the export neutrality side of the balance, to the detriment of the global competitiveness of U.S. enterprises. To wit, the U.S. government has pruned away a number of recent anti-arbitrage undertakings before they could come to fruition. The Notice 98-11 saga is well known and will not be retold here. It must be noted, however, that underlying that proposal was the basic hypothesis that a reduction of foreign taxes should lead to a subpart F inclusion. Thus, the drafters of Notice 98-11 viewed achieving both foreign tax reduction and deferral of U.S. tax as counter to sound U.S. tax policy. This hypothesis has been criticized strongly by both taxpayers and Congress[[87]] and, at least for the time being, has been effectively quashed.[88]

84 B. John Williams, Jr., "Chief Counsel Statement on Transfer Pricing, International Tax Issues", Tax Analysts Document Number 2003-7169, Mar. 18, 2003 [2003 TNT 54-47].

85 Mr. Dolan's letter became the basis of an article which raises similar points: Kevin Dolan, "Foreign Tax Credit Generator Regs: The Purple People Eater Returns," *Tax Notes,* vol. 115 (June 18, 2007), at p. 155 [Tax Analysts Document Number 2007-14380].

86 See Michael Danilack and Irwin Halpern, "It's Time to Rethink the Dual Consolidated Loss Rules", *Journal of Taxation of Global Transactions*, Spring 2002, at p. 53. In their view, the extension was misguided because a discrimination challenge would not have been successful.

87 See, for example, H.R. 672, 106th Cong., 1st Sess. (1999); S. 572, 106th Cong., 1st Sess. (1999).

88 The article provides several other examples. The authors make the case that tax treaties or multilateral consultations present the only effective means to address "double non-taxation" and similar issues.

So, while the effectiveness of the DCL rules is open to debate (certainly they do not restrict many double dips both into and out of the United States), there is a view that they are burdensome to U.S. taxpayers and out of step with the general U.S. approach to international tax arbitrage.

General limitations on the deductibility of expenses

Apart from the rules mentioned above with regard to expenses incurred to earn foreign income, there are various restrictions on the deductibility of expenses that generally apply. Some of the major ones include, but are not limited to, the following:

- The United States has no generally-applicable, bright-line thin capitalization rules (based on a specific debt-to-equity ratio), but debt may be recharacterized as equity in certain circumstances, such as where the entity is too thinly capitalized. If debt is recharacterized as equity, the interest on such debt would not be deductible. Characterization is based on the substance of the instrument and borrowing circumstances, with no single factor controlling in this determination. However, for instruments issued after October 24, 1992, there is an added condition that the characterization adopted by the issuer (unless there is disclosure of inconsistent treatment) is binding on the issuer and holders of the instrument; the IRS is not so bound.

- One bright-line thin capitalization rule (the so-called "earnings stripping" rules) applies perhaps most often to foreign-owned U.S. corporations. This rule denies interest deductions where the U.S. corporation's debt-to-equity ratio exceeds 1.5:1, "excessive" interest deductions would otherwise be claimed by the U.S. corporation, and the interest paid by the corporation to a related person does not correspondingly generate U.S. tax. Third party financing arrangements that involve foreign related party guarantees may also trigger the application of these rules. Because these rules generally focus on situations involving inbound investments into the United States they do not generally affect U.S. multinational corporations with outbound activities. When the rules do apply, they defer the amount of "excessive" interest deducted based on the level of "adjusted taxable income" generated by the taxpayer.[89] The disallowed interest deductions under this provision can be carried forward indefinitely. There have been proposals to tighten these rules, most recently by eliminating the 1.5:1 debt-to-equity safe harbour, limiting the carry forward period for disallowed interest deductions to 10 years, and modifying the definition of "excessive" deductions in some cases.

- There are various capitalization provisions that can apply to require the capitalization of costs that are expensed for book purposes. The UNICAP rules, for example, require capitalization of expenses, including interest in certain cases, to property.

- Expenses charged by related parties must be determined on arm's-length terms.

89 "Adjusted taxable income" is the corporation's taxable income, computed without regard to items such as the net interest expense, net operating losses, tax depreciation, and tax amortization. Under the current rules, interest is considered "excessive" to the extent the net interest expense exceeds 50 percent of the adjusted taxable income.

- Certain amounts, including interest, owing to foreign related persons can only be deducted on a cash basis of accounting.
- The U.S. Treasury Department has, and has exercised, the authority to prescribe regulations that would prevent the avoidance of U.S. tax through certain uses of related persons, pass-through entities, or other intermediaries, and recharacterize multi-party financing transactions as transactions directly between two or more such parties (e.g., the "conduit financing regulations").
- A portion of the original issue discount[90] incurred on certain long-term, high-yield debt instruments may be disallowed if there are significant amounts of interest payments that can be delayed under the terms of the instrument. Deduction of the original issue discount that is not disallowed in these circumstances is deferred until payments are made.
- Deductions are not allowed for interest on corporate debt instruments that call for substantial payments of principal or interest using equity of the issuer or a related party.
- If a corporation incurs a net operating loss and claimed interest deductions that arose in connection with certain acquisitions or distributions, the portion of the net operating loss attributable to the interest may not be carried back.
- In certain cases, debt may be issued by a corporation to acquire stock or substantial assets of another corporation. If the debt is convertible, directly or indirectly, to stock of the issuer and other conditions apply, there is a threshold amount beyond which interest on the debt instrument may not be deducted.
- Finally, the United States also has rules that can deny a deduction in certain circumstances in respect of interest paid by a domestic reverse hybrid entity[91] to a related foreign interest holder. The rules may apply if the interest does not exceed payments from a domestic U.S. entity that are characterized as dividends under the laws of the foreign interest holder. If the rules apply, the interest is recharacterized as a dividend for U.S. tax purposes.

90 The original issue discount can loosely be thought of as the "true" interest (versus the nominal interest) on a debt instrument. The concept recognizes that the time value of money.

91 A domestic reverse hybrid entity is treated as a U.S. corporation for U.S. federal income tax purposes and as a flow-through entity for tax purposes in the foreign jurisdiction.