Advisory Panel on
Canada's System of
International Taxation

Taxation of Foreign Source Income in Selected Countries

Canadian Member Firm of PricewaterhouseCoopers

Report Prepared for the Advisory Panel on Canada's System of International Taxation

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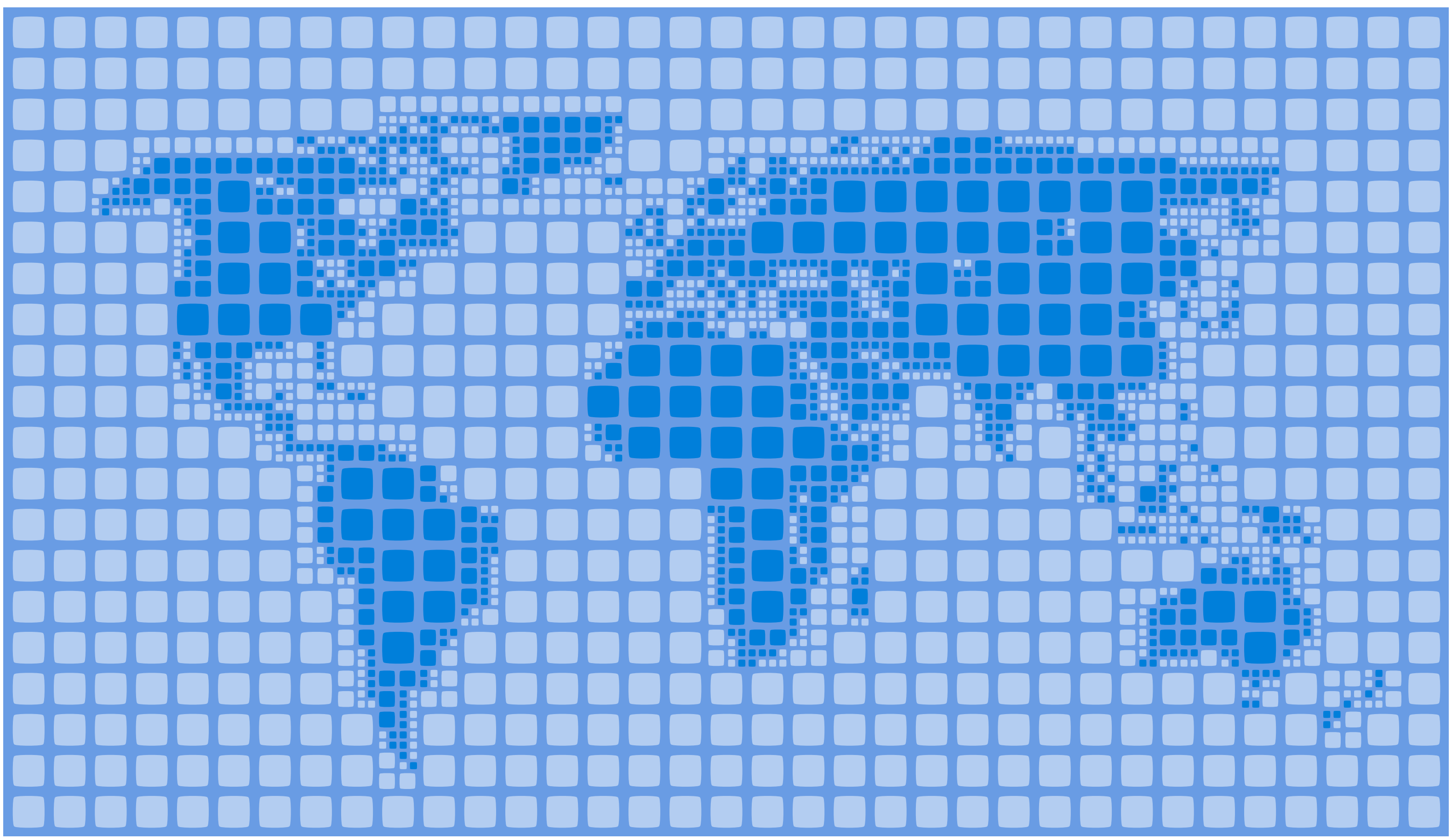

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Australia

This chapter provides an overview of the manner in which Australia taxes the foreign source income of Australian resident corporations under current and proposed legislation. As a general matter, Australian resident corporations have access to exemptions on the receipt of dividends from foreign corporations and on the realization of capital gains on the disposition of shares in foreign corporations. Australian resident corporations may also benefit from an exemption on active business income earned through foreign branches. Australian resident corporations further have access to foreign income tax offsets in mitigating the incidence of double taxation.

Basis for taxation

A corporation incorporated in Australia is considered an Australian resident corporation ("AUSCO"). A foreign corporation carrying on business in Australia will also be considered resident in Australia where its central management and control is situated in Australia or where its voting shares are controlled by Australian residents. A corporation resident in Australia is subject to corporate income tax in Australia on its worldwide income.

The standard corporate income tax rate is 30 percent.

Foreign income tax offset rules

Prior to July 1, 2008, the legislation requires foreign source income to be segregated into four classes: passive income, offshore banking income, other income, and certain amounts from non-resident non-complying superannuation (pension) funds. For this period, AUSCO may claim a direct foreign tax credit in respect of foreign national, provincial or local income taxes paid on foreign source income. The credit amount is computed on a class by class basis and is limited to the lesser of foreign income taxes paid and Australian corporate income tax that would be payable on the foreign source income of the relevant class. Excess foreign tax credits earned prior to July 1, 2008 by AUSCO may be carried forward for five years.

These foreign tax credit quarantining rules have been repealed and replaced with new foreign income tax offset rules. As of July 1, 2008, AUSCO is entitled to a non-refundable tax offset for an amount included in assessable income on which foreign income tax has been paid (in the case of a non-resident, the foreign income tax offset is in respect of third country foreign income tax paid). Where the amounts are only partly included in AUSCO's taxable income, the entitlement to the tax offset is prorated accordingly. AUSCO may only claim the offset in the year in which the relevant double-taxed amount is wholly or partly included in its taxable income for Australian tax purposes.

The tax offset is computed on a whole-of-income basis, not on a class by class basis. More specifically, the tax offset is limited to the potential amount of Australian tax payable on the double-taxed amounts and other non-Australian source income (referred to as the foreign tax offset cap) or AUD1,000, whichever is the greater. Where foreign income, profits or gains taxes paid exceed the foreign tax offset cap, AUSCO is not entitled to deduct or carry-forward the excess. AUSCO may refrain from calculating the foreign tax offset cap and use instead a AUD1,000 de minimis cap.

AUSCO may not claim a tax offset for foreign income, profits or gains taxes paid which are ultimately refunded to AUSCO or another entity, or where AUSCO or another entity receives a tax benefit as a result of the payment of such taxes.

Certain tax treaties concluded by Australia override Australia's domestic foreign tax credit rules and foreign income tax offset rules and provide, in lieu thereof, an exemption from Australian taxation on foreign source income.

Tax treaties

Foreign income taxes that are either exempt or reduced by a foreign government may be deemed to have been paid and are therefore included as part of foreign income taxes for double tax relief purposes. This is possible only where a tax treaty with the relevant foreign jurisdiction provides specifically for such a "deemed" (tax sparing) arrangement. Tax sparing is made available to Australian resident corporations under Australia's tax treaties with certain developing countries, so that Australian resident corporations may benefit from investment incentives otherwise granted by such jurisdictions.[1] Tax sparing is generally being terminated under Australia's recent tax treaty policy.

Foreign branches

As of July 1, 2004, active business income earned by AUSCO through a foreign branch is fully exempt from corporate income tax in Australia unless:

- the foreign branch is situated in a listed country (United States, United Kingdom, New Zealand, Canada, Germany, Japan, and France) and earns adjusted tainted income (e.g., passive income, tainted sales, tainted services income) which accounts for more than five percent of the foreign branch's gross income and the income is listed in Australian regulations as being "concessionally taxed" local income (income generally subject to tax exemptions or preferential tax treatment in the foreign jurisdiction); or

1 See, for example, the Australian tax treaties with Singapore, Malaysia, Sri Lanka, China, Kiribati, Korea, and Vietnam.

- the foreign branch is situated in another country (other than a listed country, as defined above) and earns adjusted tainted income (e.g., passive income, tainted sales, tainted services income) which accounts for more than five percent of the foreign branch's gross income.

Similarly, capital gains and capital losses realized by AUSCO on the disposition of assets used as part of the active business operations of a foreign branch are disregarded for corporate income tax purposes[2] unless:

- the foreign branch is situated in a listed country, as previously defined, and the capital gains or losses are specifically listed in Australian regulations as being "concessionally taxed" capital gains or losses having arisen on the disposition of passive-type assets; or

- the foreign branch is situated in another country (other than a listed country, as defined above) and the capital gains or losses arise from the disposition of certain passive-type assets.

The active business income or capital gains thus realized through a foreign branch need not actually be subject to tax in the relevant foreign jurisdiction for AUSCO to qualify for the participation exemption.

Where income earned or capital gains realized through a foreign branch are subject to corporate income tax in Australia, AUSCO may claim a direct foreign tax credit (prior to July 1, 2008) or a foreign income tax offset (as of July 1, 2008) for foreign taxes paid in respect thereof.

Foreign losses

Foreign losses incurred by AUSCO prior to July 1, 2008 are segregated into four classes: modified passive income, interest, offshore banking income and other income. Foreign losses falling within a specific class may only be used to offset foreign source income or profits earned and falling within the same class.

Foreign losses incurred by AUSCO subsequent to July 1, 2008 may be used to offset all domestic and foreign income. Foreign losses may be carried forward indefinitely. However, overall foreign losses carried forward from the most recent 10 years prior to July 1, 2008 will become a single pool of tax losses from July 1, 2008 and allowed as a deduction against domestic and foreign income over a period of at least five years from July 1, 2008 (subject to certain rules and restrictions).

Foreign capital losses realized by AUSCO may be used to offset domestic and foreign capital gains.

2 An exception applies in regards to income and capital gains from the operation of ships or aircraft in international traffic.

Dividends from foreign corporations

Dividends received by AUSCO from a foreign corporation after June 30, 2004 are fully exempt from corporate income tax irrespective of the country of residence of the paying foreign corporation where:

- AUSCO has a direct voting interest in the relevant foreign corporation of at least 10 percent (non portfolio investment);[3] and

- AUSCO does not receive the dividends in its capacity as trustee.

As such, the profits of a foreign corporation may effectively be repatriated to Australia tax free, provided the minimum ownership threshold is met.

The underlying profits (distributed as dividends to AUSCO) need not actually be subject to tax in the relevant foreign jurisdiction for AUSCO to qualify for the participation exemption.

AUSCO should not be able to claim a foreign tax offset in respect of withholding taxes levied by foreign jurisdictions on the payment of dividends qualifying for the participation exemption.

Where the above conditions are not satisfied, dividends received by AUSCO from a foreign corporation are fully subject to corporate income tax at the rate of 30 percent. AUSCO should be able to claim a direct foreign tax credit (prior to July 1, 2008) or a foreign income tax offset (as of July 1, 2008) in respect of withholding taxes paid to a foreign jurisdiction on the receipt of such dividends, but not for underlying taxes suffered.

Interest and royalty income

Interest and royalty income earned by AUSCO from foreign corporations is fully subject to corporate income tax at the rate of 30 percent. AUSCO, however, should be able to claim a direct foreign tax credit (prior to July 1, 2008) or a foreign income tax offset (as of July 1, 2008) in respect of withholding taxes paid to a foreign jurisdiction on the receipt of such amounts.

Capital gains and capital losses

As of April 1, 2004, a capital gain realized by AUSCO on the disposition of shares in a foreign corporation may be exempt from corporate income tax where all of the following conditions are met:[4]

- AUSCO has a direct voting interest in the relevant foreign corporation of at least 10 percent. Under applicable tracing rules, AUSCO will not be considered to hold a "direct voting interest" in a particular foreign corporation where such interest is held through an Australian trust or partnership.

3 The Australian Taxation Office (ATO) has issued two draft Taxation Determinations that provide that a dividend received from a foreign corporation will not be exempt where AUSCO receives the dividend through an Australian trust or partnership.

4 AUSCO is ordinarily subject to corporate income tax in Australia on capital gains realized on the disposition of shares in Australian resident corporations.

- The direct voting interest was held by AUSCO for a continuous period of at least 12 months in the two-year period preceding the said disposition. Short-term holdings do not qualify for the exemption.

- The shares in the relevant foreign corporation are not eligible finance shares[5] or widely distributed finance shares.[6] Following this condition, only shares giving AUSCO the right to participate in the operations of the foreign corporation qualify for the exemption.

The exemption is available, however, only to the extent the relevant foreign corporation carries on an underlying active business. In effect, a capital gain thus realized by AUSCO is reduced by a percentage (the "active foreign business asset percentage" or AFBAP) reflecting the degree to which the assets of the relevant foreign corporation are used in an active business. The AFBAP is broadly calculated as a percentage obtained when dividing the foreign corporation's active foreign business assets by its total assets. Where the AFBAP is 90 percent or more, the capital gain should be exempt from corporate income tax in Australia. Where the AFBAP is 10 percent or more, but less than 90 percent, the capital gain will be reduced by the percentage and the remainder of the gain should be subject to corporate income tax at the rate of 30 percent. Where the AFBAP is less than 10 percent, the whole capital gain should be subject to corporate income tax in Australia at the rate of 30 percent.

Capital losses realized by AUSCO on the disposition of shares qualifying for the exemption are not deductible.

The exemption is also available to reduce the income attributed to AUSCO under the Australian controlled foreign corporation regime (discussed below) and arising from the disposition by a controlled foreign corporation of shares in another foreign corporation.

Where the other criteria for the participation exemption are not satisfied (e.g., the holding period requirement), capital gains realized by AUSCO on the disposition of shares in a foreign corporation are fully subject to corporate income tax at the rate of 30 percent. AUSCO may, however, claim a direct foreign tax credit (prior to July 1, 2008) or a foreign income tax offset (as of July 1, 2008) in respect of income or gains taxes paid to a foreign jurisdiction on the disposition of such shares. Capital losses realized on the disposition of shares in a foreign corporation not qualifying for the participation exemption are deductible but only against capital gains.

5 Generally, eligible finance shares are shares issued by a corporation to an unrelated Australian financial institution and the payment of dividends on such shares can reasonably be regarded as an equivalent to the payment of interest on a loan.

6 Generally, widely distributed finance shares are shares issued to the public where the shareholders do not have an interest in the issuing corporation other than the right to obtain the repayment of the funds invested through regular dividend payments (considered a substitution for the payment of interest on a loan).

Controlled foreign corporation (CFC) regime

The Australian CFC regime may include an amount in the assessable income of AUSCO where the following three conditions are satisfied:

- The relevant foreign corporation is a CFC. A foreign corporation will be considered a CFC where:
  - at least 50 percent of the voting shares, paid-up share capital or rights to distributions of capital or profits are owned, directly or indirectly, by five or fewer Australian resident persons (including AUSCO), alone or together with associated persons;
  - at least 40 percent of the voting shares, paid-up share capital or rights to distributions of capital or profits are owned, directly or indirectly, by an Australian resident person (e.g., AUSCO), alone or together with associated persons and the foreign corporation is not controlled by a group of entities (not including the Australian resident and its associates); or
  - a group of five or fewer Australian resident persons (including AUSCO), alone or together with associated persons, have de facto (i.e., actual) control of the foreign corporation.
- AUSCO is an attributable taxpayer of the CFC. AUSCO will be considered an attributable taxpayer of the CFC where it owns, directly or indirectly:
  - at least 10 percent of the voting rights, paid-up share capital or rights to distributions of capital or profits in the CFC, alone or together with associated persons; or
  - at least one percent of the voting rights, paid-up share capital or rights to distributions of capital or profits in the CFC where AUSCO is part of a group of five or fewer Australian resident persons controlling the CFC (i.e., under the third test outlined for the first condition).
- The CFC has attributable income. Generally speaking, where the CFC passes an active income test, its income will not be attributed to AUSCO.[7] The CFC will pass the active income test where its "tainted income" does not exceed five percent of its gross turnover. "Tainted income" generally refers to the passive income of the CFC (e.g., dividends and interest) and certain sales and services income.

Where the CFC fails the active income test and the CFC is resident in a listed jurisdiction,[8] only its tainted income that is specifically designated in the Australian regulations as "concessionally taxed" income will be attributed to AUSCO. Tainted income that is "concessionally taxed" generally refers to the tainted income of the CFC that is not subject to tax or benefits from a tax reduction under the tax laws of the relevant listed jurisdiction.

7 An exception applies for specified income of the CFC (e.g., certain income from partnerships and trusts and notional foreign investment fund income of the CFC), which is attributed to AUSCO unconditionally.

8 Listed jurisdictions are Canada, France, Germany, Japan, New Zealand, the United Kingdom, and the United States. These jurisdictions are considered to have taxation systems closely comparable to the Australian tax system.

Where the CFC fails the active income test and the CFC is resident in an unlisted jurisdiction (i.e., all other countries), all tainted income of the CFC will be attributed to AUSCO.

The attributable income of a CFC is computed in accordance with Australian tax rules. As an example, dividends received by a CFC and qualifying for the participation exemption on dividends from foreign corporations, as discussed previously, are disregarded in computing the attributable income of the CFC.

Where the above conditions are satisfied, AUSCO will be taxed on the attributable income, as determined above, at the standard corporate income tax rate of 30 percent for the relevant fiscal year. Prior to July 1, 2008, AUSCO may claim an indirect foreign tax credit in respect of foreign income taxes paid by a CFC on profits attributed to AUSCO under the Australian CFC regime. As of July 1, 2008, AUSCO may claim a foreign income tax offset for foreign income taxes paid by the CFC on income or profits otherwise attributed to AUSCO under the CFC regime.

Dividends subsequently paid by a CFC to AUSCO (i.e., from income previously attributed to AUSCO) should be exempt from corporate income tax in Australia regardless of the jurisdiction of residence of the paying CFC (whether a listed or unlisted jurisdiction). AUSCO may claim a direct foreign tax credit (prior to July 1, 2008) or a foreign income tax offset (as of July 1, 2008) in respect of withholding taxes paid to a foreign jurisdiction on the receipt of dividends from previously attributed income of a CFC.

Foreign losses incurred by the CFC may be carried forward (subject to the CFC satisfying certain tests) and applied to reduce the attributable income of the CFC in a later year. As of July 1, 2008, foreign losses of a CFC are no longer segregated into classes.

Foreign investment fund (FIF) regime

Australian tax laws also contain measures dealing with passive foreign investment funds. These measures extend, inter alia, to shares and entitlements to acquire shares held by AUSCO in foreign corporations that do not qualify as CFCs and thus do not trigger the application of the Australian CFC regime. Generally speaking, and subject to important qualifications, the Australian FIF regime attributes to AUSCO increases or decreases in the value of shares or other interests held in foreign entities (including corporations) engaged in passive activities, regardless of where such entities are resident or located.

AUSCO is not generally subject to the Australian FIF regime in respect of shares held by it in foreign corporations (not qualifying as CFCs) where such shares are listed on an approved stock exchange and the foreign corporation is principally engaged in active business operations.

In addition, AUSCO is not generally subject to the Australian FIF regime in respect of investments in certain U.S. resident entities.

International tax planning

Australian resident corporations may pursue offshore investments with significant flexibility given the benefits associated with the various exemptions discussed in this paper:

- Participation exemption on capital gains realized on the disposition of shares in a foreign corporation to the extent the relevant foreign corporation carries on an underlying active business: Australian resident corporations may generally deduct financing costs incurred in acquiring shares in a foreign corporation (subject to Australian thin capitalization limits), even where an eventual disposition of such shares does not given rise to Australian taxation pursuant to the participation exemption. It is noted that the thin capitalization limits are broadly 75 percent x (Australian assets less certain liabilities). Therefore, the shares in a CFC will be excluded from the calculation of the maximum allowable debt for an entity.

- Participation exemption on dividends from foreign corporations: The participation exemption facilitates the repatriation of funds from jurisdictions that do not operate tax systems comparable to the Australian tax system (low-tax jurisdictions). Stated differently, Australian resident corporations are not faced with the problem of having profits trapped in low-tax jurisdictions: the participation exemption renders investments in low-tax jurisdictions attractive; also, the Australian CFC regime does not ordinarily apply to active business profits, even where earned in low-tax jurisdictions.

- Participation exemption on active business income earned through a foreign branch and on capital gains arising on the disposition of active business assets used in a foreign branch: The participation exemption offers Australian resident corporations greater flexibility in deciding whether they should pursue foreign investments by means of a foreign branch or foreign subsidiary. Australian resident corporations may not, however, deduct financing costs incurred in establishing foreign branches, where they may generally deduct financing costs incurred when incorporating or acquiring foreign subsidiaries (subject to Australian thin capitalization limits which are based on Australian assets as outlined above).

General anti-avoidance

Australian tax laws contain a general anti-avoidance rule pursuant to which the Australian tax authorities may deny a taxpayer a tax benefit where the scheme was entered into by a taxpayer with the dominant purpose of obtaining a tax benefit. The courts consider all relevant circumstances in arriving at a decision.

Australian tax laws do not contain specific provisions aimed at countering transactions executed in tax haven jurisdictions or entered into with persons resident in tax haven jurisdictions, although the CFC regime or the FIF regime may apply in these circumstances. The taxpayer must disclose on its Australian tax return all transactions executed in specified tax haven jurisdictions or entered into with persons resident in specified tax haven jurisdictions.

Enforcement and administration

The Australian tax authorities are active in enforcing compliance with Australian tax laws as they pertain to foreign source income of Australian resident corporations:

- The Australian tax authorities have a division focussed on countering aggressive tax planning. This division oversees the delivery of strategies for the identification, assessment, treatment and review of aggressive tax plans.
- The Australian tax authorities cooperate with other jurisdictions in prosecuting abusive transactions. For instance, Australia is part of the Seven Country Tax Haven Forum. The members of the Forum meet regularly to discuss and share strategies and techniques in addressing abusive international tax planning.
- The Australian tax authorities analyze intelligence on tax haven jurisdictions and major corporations operating in such jurisdictions. They develop such intelligence, in part, by cooperating with foreign tax authorities.
- The Australian tax authorities place focus in analyzing the flow of funds between Australian resident corporations and foreign corporations. This analysis permits the identification of issues pertaining to the enforcement of international tax legislation.

France

This chapter provides an overview of the manner in which France approaches the taxation of foreign source income. As a general matter, French resident corporations are not subject to tax in France on foreign source business income, even when such income is repatriated or remitted to France. French resident corporations are, however, subject to tax in France on foreign source passive investment income, such as interest, royalties and dividends not qualifying for an exemption. French resident corporations may benefit from exemptions on the receipt of dividends from foreign corporations and on the realization of capital gains on the disposition of shares in foreign corporations. French resident corporations further have access to direct foreign tax credits and, in certain instances, tax sparing credits under French tax treaties in mitigating the incidence of double taxation.

Basis for taxation

A corporation incorporated in France or having its effective place of management in France is considered a French resident corporation ("FRENCHCO"). A French resident corporation is not, however, subject to corporate income tax in France on all sources of income earned worldwide.

France operates, in part, a territorial system of taxation. More precisely, residents and non-residents of France alike are liable to pay French corporate income tax on business income arising in or derived from (i.e., "sourced" in) France through an enterprise operating in France pursuant to Article 209 of the French General Tax Code. The term "enterprise" includes permanent establishments, dependent representatives having authority to conclude contracts in France in the name of the relevant taxpayer, and business operations with full commercial cycles occurring in France. As such, FRENCHCO is not liable to pay corporate income tax in France on business income earned through an enterprise operating abroad, even when such business income is repatriated or remitted to France. Capital gains realized by FRENCHCO on the disposition of business assets pertaining to a permanent establishment abroad are also not subject to corporate income tax in France.

FRENCHCO is, however, subject to corporate income tax in France on passive investment income earned from all sources worldwide, except where the passive income is clearly attributable to a foreign permanent establishment. Generally speaking, passive investment income includes interest, royalties, and dividends not qualifying for the participation exemption (discussed below).

The standard corporate income tax rate is 33⅓ percent. Enterprises with a turnover exceeding €7,630,000 are subject to an additional social surcharge of 3.3 percent levied on that part of taxable income which exceeds €763,000 and calculated at the standard tax rate. The effective tax rate on the portion of taxable income exceeding €763,000 is thus 34.43 percent.

Where at least 75 percent of an enterprise is owned by individuals and the enterprise has a turnover of €7,630,000 or less, the enterprise will be taxed at a reduced rate of 15 percent on taxable income up to €38,120 and at the standard corporate tax rate on taxable income exceeding such amount.

Business income earned through an enterprise operating in France is further subject to a local business tax at rates varying from municipality to municipality. The taxable base is the annual rental value of commercial and industrial buildings and equipment used by the enterprise and reduced by 16 percent. The rate cannot exceed 3.5 percent of the enterprise's "value-added", defined as sales minus purchases and the value of inventory at the beginning of the fiscal year. The local business tax qualifies as a deductible expense for corporate income tax purposes.

A minimum tax applies for both corporate income tax and local business tax purposes.

Relief for double taxation

French tax laws do not offer any relief in respect of income taxes paid abroad on foreign source business income, as such income is not generally taxed in France. French tax laws also do not offer relief in respect of income taxes paid abroad on foreign source passive investment income, such as interest, royalties and dividends not qualifying for the participation exemption.

Tax treaties

Under French tax treaties, direct foreign tax credits are generally made available to FRENCHCO in respect of withholding taxes levied on dividends, interest, and royalties arising in treaty jurisdictions. Such credits are computed on a per country basis and excess credits may not be carried forward. An exemption from French corporate income tax is generally granted under French tax treaties in respect of active sources of income earned in treaty jurisdictions.

Foreign income taxes that are either exempt or reduced by a foreign government may be deemed to have been paid and are therefore included as part of foreign income taxes for purposes of obtaining a tax credit. This is possible only where a tax treaty with the relevant foreign jurisdiction provides specifically for such a "deemed" (tax sparing) credit. Tax sparing credits are made available to French resident corporations in French tax treaties with certain jurisdictions.

Deduction of foreign taxes

FRENCHCO may claim a deduction for withholding taxes levied by non-treaty jurisdictions on the payment of foreign source passive investment income.

Foreign losses

As France does not tax foreign source business income, FRENCHCO may not, in turn, deduct foreign losses incurred abroad through foreign permanent establishments or dependent representatives having authority to conclude contracts abroad in the name of FRENCHCO.

Dividend income

FRENCHCO may benefit from a 95 percent exemption on the receipt of dividends from French resident corporations and foreign corporations. The participation exemption is made available where FRENCHCO owns at least five percent of the capital (including both voting and financial rights) of the relevant subsidiary and has held the shares in the relevant subsidiary for at least two years. Dividends received on non-voting shares in a domestic or foreign corporation also qualify for the participation exemption where FRENCHCO otherwise meets the five percent threshold (e.g., where FRENCHCO owns five percent of the voting rights in a corporation and also owns non-voting preferred shares in the same corporation).

FRENCHCO is deemed to have non-deductible expenses equal to five percent of the dividends received, such that the exemption is equal to 95 percent of the full dividend amount. Where actual expenses incurred by FRENCHCO in relation to the receipt of dividends from French resident corporations are less than five percent of the dividend amount, FRENCHCO may claim the participation exemption in respect of the portion of the dividends received which exceeds actual expenses. FRENCHCO may thus benefit from an exemption exceeding 95 percent of dividends received but only on dividends from French resident corporations.

The dividend portion deemed to represent non-deductible expenses is added to the taxable income of FRENCHCO. FRENCHCO may benefit from a direct foreign tax credit under most French tax treaties with respect to withholding taxes levied by a foreign jurisdiction on the payment of dividends.

Expenses incurred by FRENCHCO in respect of dividends qualifying for the participation exemption are not deductible.

Where the applicable conditions are satisfied, the participation exemption is made available to FRENCHCO regardless of the tax situation of the relevant subsidiary. As such, FRENCHCO may benefit from the participation exemption on the receipt of dividends from foreign corporations resident in tax haven jurisdictions. This is one of the reasons for which the French controlled foreign corporation regime discussed below is required.

Where the participation exemption is not available, dividends received by FRENCHCO are taxed at the standard corporate tax rate of 33⅓ percent (the social surcharge also applies). In this case, FRENCHCO may also benefit from a direct foreign tax credit under most French tax treaties with respect to withholding taxes levied by a foreign jurisdiction on the payment of dividends.

Interest and royalty income

Foreign source interest and royalty income is generally taxed at the standard corporate tax rate of 33⅓ percent. Royalties received by FRENCHCO from domestic or foreign corporations and derived from the licensing of patents and patentable know-how are taxed at a reduced rate of 15 percent. The social surcharge further applies.

FRENCHCO may benefit from a direct foreign tax credit under most French tax treaties with respect to withholding taxes levied by a foreign jurisdiction on the payment of interest and royalty income. Alternately, FRENCHCO may deduct withholding taxes levied by non-treaty jurisdictions on interest and royalty payments.

Deduction of expenses

Under Article 238A of the French General Tax Code, interest, royalties and other payments made by FRENCHCO to a person established in a tax haven jurisdiction are deemed to be fictitious and not at arm's length. Such expenses are not deductible in France unless FRENCHCO can demonstrate that the payments made compensate services effectively rendered and constitute arm's-length payments.

Capital gains

FRENCHCO may benefit from a 95 percent exemption in respect of capital gains realized on the disposition of shares in French resident corporations and foreign corporations. The participation exemption is made available where at least one of the following conditions is satisfied:

- Dividends ordinarily received on the disposed shares qualify for the 95 percent participation exemption, as mentioned above.
- Dividends ordinarily received on the disposed shares do not qualify for the 95 percent participation exemption but the following conditions are met:
    - the disposed shares have a cost price of at least €22.8 million;
    - the disposed shares were held "durably" by FRENCHCO as a strategic participation (the term "durably" is defined by the French tax authorities); and
    - the disposed shares allowed FRENCHCO to influence or control the relevant subsidiary (e.g., by means of a shareholders' agreement).
- The disposed shares were previously acquired by FRENCHCO in the context of a public takeover bid and qualified as "participation shares" for accounting purposes.

FRENCHCO is deemed to have non-deductible expenses equal to five percent of the capital gains realized, such that the exemption is equal to 95 percent of the capital gain amount.

Expenses incurred by FRENCHCO in respect of capital gains qualifying for the participation exemption are not deductible. Capital losses realized by FRENCHCO on the disposition of shares qualifying for the participation exemption are also not deductible.[9]

Where the participation exemption is not available, capital gains realized by FRENCHCO are taxed as ordinary income at the standard corporate tax rate of 33⅓ percent (the social surcharge also applies). Capital losses realized by FRENCHCO on the disposition of shares not qualifying for the participation exemption can usually be offset against taxable profits or are eligible to be carried forward to be offset against future taxable profits.

9 This extends to capital losses realized on the liquidation of a foreign subsidiary.

International tax consolidation

FRENCHCO may request authorization from the Ministry of Finance to adopt one of the following tax consolidation methods:

Bénéfice consolidé

FRENCHCO may opt for group taxation generally for all of its direct establishments and its 50 percent subsidiaries (French or foreign) owned directly or indirectly by it. In these circumstances, FRENCHCO may combine its profits and losses with the profits and losses of such entities in determining its liability for tax in France.

Bénéfice mondial

FRENCHCO may opt for group taxation where it carries on operations abroad through foreign branches. In these circumstances, FRENCHCO may combine its profits and losses with the profits and losses of its foreign branches in determining its liability for tax in France.

In practice, approval of the above tax consolidation regimes is granted by the Ministry of Finance only for a few major corporations. Where consolidation is permitted, taxes on foreign source income and withholding taxes levied by foreign jurisdictions are credited against French corporate income tax. Foreign losses may also be deducted.

Controlled foreign corporation regime

Article 209B of the French General Tax Code embodies the French CFC regime.

Generally speaking, the French CFC regime applies where:[10]

- FRENCHCO carries on an enterprise abroad, as previously defined; or
- FRENCHCO controls, directly or indirectly, at least 50 percent of the shares, interest shares, financial rights or voting rights in a foreign corporation or foreign entity,[11]

and the foreign enterprise, corporation or entity is established or resident in a privileged tax jurisdiction.

Where the CFC regime applies, FRENCHCO is required to include in income the profits of the foreign enterprise or its proportion of the profits of the foreign corporation or entity taking into consideration both direct and indirect shareholdings or interests. The profits of the relevant foreign corporation or entity are deemed to have been distributed to FRENCHCO.

10 French permanent establishments of foreign corporations are also subject to the French CFC regime.

11 The foreign entity may be a corporation, a partnership, a civil company, an *Anstalt*, a grouping or an entity of any nature.

Where the profits of the relevant foreign enterprise, corporation or entity would have been partially exempt from French corporate income tax had they been sourced in France, FRENCHCO will be subject to tax in France under the CFC regime only on the non-exempt portion of the profits of the relevant foreign enterprise, corporation or entity.

The purpose of the CFC regime is to recapture profits transferred by FRENCHCO to foreign enterprises, corporations or entities established or resident in countries in which they enjoy a favourable tax regime, where such profits are not otherwise taxable in France by reason of the territoriality principle or the participation exemption on dividends.

The French CFC regime contains a specific anti-avoidance provision pursuant to which the requisite 50 percent threshold is reduced to five percent where:

- more than 50 percent of the shares, interest shares, financial rights, or voting rights in a foreign corporation or entity is held by FRENCHCO and other French resident corporations, whether related or unrelated to FRENCHCO;[12] or
- more than 50 percent of the shares, interest shares, financial rights, or voting rights in a foreign corporation or entity is held indirectly by FRENCHCO through French resident corporations and/or foreign corporations controlled by FRENCHCO or dependent on FRENCHCO.

A jurisdiction will be considered a privileged tax jurisdiction where the income tax liability of the foreign enterprise, corporation, or entity in such jurisdiction is less than 50 percent of the income tax liability that the foreign enterprise, corporation, or entity would have in France had it been carrying on the same operations or activities in France.

Where the profits are earned through a foreign enterprise established in a treaty jurisdiction, the French CFC regime will generally only apply where the French treaty contains an express clause permitting the application of the French CFC regime or where the French treaty provides for relief from double taxation on business income through the credit method (as opposed to the exemption method).

The profits earned by a foreign corporation or entity will be deemed to have been distributed to FRENCHCO, as stated above. Such income deemed distributed generally falls under the "other income" article of French tax treaties and is generally only taxable in the state of residence of the recipient, France in this case.

An income inclusion resulting from the application of the CFC regime may be offset by losses incurred by FRENCHCO from other sources. Losses incurred by the foreign enterprise, corporation or entity may not, however, reduce the French tax liability of FRENCHCO; these may be carried forward in certain situations.

12 Where the foreign corporation or entity is listed on a stock exchange, the reduction of the threshold to five percent will only occur where the French tax authorities can demonstrate that FRENCHCO together with other French resident corporations own more than 50 percent of the shares, interest shares, financial rights or voting rights in the relevant foreign corporation or entity and are acting in concert.

FRENCHCO may benefit from a foreign tax credit in respect of income taxes paid abroad by the foreign enterprise, corporation or entity on profits subject to tax in France under the French CFC regime provided the foreign taxes are comparable in nature to the French corporate income tax.

FRENCHCO may further obtain a foreign tax credit in respect of withholding taxes paid by the foreign enterprise, corporation, or entity to a third jurisdiction on the receipt of interest, royalties and dividends, where the third jurisdiction has concluded a tax treaty with France which contains an administrative assistance clause.

Dividends or distributions received by FRENCHCO from the relevant foreign enterprise, corporation, or entity from profits previously taxed in France under the French CFC regime are exempt from French corporate income tax.

The French CFC regime will not apply where FRENCHCO can demonstrate that the foreign enterprise, corporation or entity carries on an effective trading or manufacturing activity in its country of establishment or residence unless:

- more than 20 percent of the profits of the foreign enterprise, corporation, or entity are derived from portfolio management activities (securities, shares, and claims) and intangible rights management; or
- the profits derived from the above items and from inter-company services represent more than 50 percent of the profits of the foreign enterprise, corporation, or entity.

Even in these circumstances, the French CFC regime will not apply if FRENCHCO can demonstrate that the principal effect of using the relevant foreign enterprise, corporation, or entity is not to obtain an advantage from a privileged tax regime.

Moreover, the French CFC regime will not apply where the relevant foreign enterprise, corporation, or entity is established or resident in a European Union (EU) Member State unless the French tax authorities can demonstrate that the relevant foreign enterprise, corporation, or entity constitutes an artificial arrangement established to circumvent French tax legislation (the test applied is slightly different to the test applied under the abuse of law doctrine discussed below).

FRENCHCO must report to the French tax authorities the existence of foreign enterprises, corporations, or entities that potentially fall within the scope of the French CFC regime and file specific tax returns in regards to foreign enterprises, corporations, or entities that fall within the scope of the French CFC regime.

International tax planning

Planning strategies pursued generally involve the incorporation of subsidiaries in EU Member States or the European Economic Area (EEA) (EU Member States, Iceland, Liechtenstein and Norway). Such structures enable French resident corporations and their subsidiaries to benefit from the EU/EEA Directives and take advantage of the non-application of the French CFC regime to corporations resident within the EU (unless the French tax authorities can prove an artificial scheme). Several of the EEA or EU jurisdictions are extensively used in international tax structuring and offer significant tax benefits.

General anti-avoidance

The French tax authorities may counter transactions undertaken by taxpayers pursuant to the following general anti-avoidance doctrines:

- Abnormal acts of management: The French tax authorities may challenge management decisions which are contrary to the taxpayer's interests.
- Abuse of law: Under Article L64 of the French Tax Procedure Code, the French tax authorities may challenge legal arrangements which conceal the realization or transfer of profits (the "abuse of law" doctrine). An abuse of law will be found to exist where the relevant transaction is fictitious or was implemented solely for tax reasons.

Enforcement and administration

The French tax authorities generally rely on the Exchange of Information and Administrative Assistance clauses contained in French tax treaties to access foreign information concerning French resident corporations operating in treaty jurisdictions. The French tax authorities may gather additional information on foreign operations and activities of French resident corporations through non-tax information otherwise released and made public (e.g., compulsory bank and financial institutions filings, anti-money laundering international and domestic rules and processes).

Germany

This chapter provides an overview of the manner in which Germany taxes the foreign source income of German resident corporations under current and proposed legislation. As a general matter, German resident corporations have access to exemptions on the receipt of dividends from foreign corporations and on the realization of capital gains on the disposition of shares in foreign corporations. German resident corporations further have access to direct foreign tax credits and, in certain instances, tax sparing credits under Germany's tax treaties in mitigating the incidence of double taxation.

German tax reform

In 2007, the German government approved a major reform of German tax laws. The primary purpose of the reform is to render Germany a more attractive jurisdiction for domestic and foreign investors. Salient features of the reform include a reduction of the corporate income tax rate from 25 percent to 15 percent and a redrafting of the German general anti-avoidance rule.

The proposed changes became effective for taxation years beginning after May 25, 2007 and ending after January 1, 2008.

Foreign tax credits

A corporation incorporated under German law, having its head office in Germany or having its place of management in Germany is considered resident in Germany ("GERMANCO"). A corporation's place of management is situated where the day-to-day decisions concerning the corporation's business affairs are made. A corporation resident in Germany is subject to tax in Germany on its worldwide income.

More specifically, GERMANCO is liable to pay corporate income tax (*Körperschaftsteuer*) on its worldwide income at a rate of 15 percent (previously 25 percent). A 5.5 percent surcharge (the "solidarity levy") is imposed on corporate income tax, resulting in an effective tax rate of 15.825 percent (previously 26.375 percent) for GERMANCO.[13] Moreover, GERMANCO is liable to pay municipal trade tax (*Gewerbesteuer*) on its worldwide income (subject to certain adjustments including when income is earned through a foreign permanent establishment) at rates varying in most cases from 12 percent to 17.5 percent (previously 13 percent to 20.5 percent) depending on the municipality.[14] For fiscal years ending after 2008, the combined average effective tax rate will range from 27.825 percent to 33.325 percent (previously 39.375 percent to 46.875 percent).

13 The 5.5-percent surcharge is levied on corporate income tax after deducting tax credits (e.g., foreign tax credits).

14 Under the German reform, municipal trade tax is no longer a deductible business expenditure for corporate income tax and municipal trade tax purposes.

Direct tax credits

GERMANCO may benefit from a direct foreign tax credit in respect of foreign national, provincial or local income taxes paid on its foreign source income. The direct tax credit extends to foreign taxes paid by GERMANCO on income from operations carried on through a foreign branch and to withholding taxes levied on amounts received from foreign corporations.

The foreign tax credit may not exceed the German (net) income tax attributable to the foreign source income, subject to per country and per item limitations. Excess foreign tax credits may not be carried back or forward.

Certain tax treaties concluded by Germany override Germany's domestic foreign tax credit rules and provide, in lieu thereof, an exemption from German taxation on foreign source income.

Tax sparing credits

Foreign income taxes that are either exempt or reduced by a foreign government may be deemed to have been paid and are therefore included as part of foreign income taxes for purposes of obtaining a tax credit. This is possible only where a tax treaty with the relevant foreign jurisdiction provides specifically for such a "deemed" (tax sparing) credit. Tax sparing credits are made available to German resident corporations under Germany's tax treaties with certain developing countries, so that German resident corporations may benefit from investment incentives otherwise granted by such jurisdictions.

Deduction of foreign taxes

GERMANCO may elect to deduct the foreign income taxes paid on its foreign source income in lieu of claiming a direct foreign tax credit, as discussed above. The deduction is applied on a per country basis. A deduction may be beneficial, for instance, in years where GERMANCO is in a loss position.

Foreign losses

As a general matter, GERMANCO may not deduct foreign losses incurred abroad through a permanent establishment situated in a treaty jurisdiction, where the relevant tax treaty provides that income earned through a permanent establishment may only be taxed by the jurisdiction within which the permanent establishment is situated.

GERMANCO may, however, deduct foreign losses incurred through foreign branches in non-treaty jurisdictions or in jurisdictions having concluded a tax treaty with Germany whereby the tax treaty adopts the credit method in mitigating the incidence of double taxation and the foreign branch is engaged in a specified active trade.

Foreign losses realized by GERMANCO through a foreign permanent establishment engaged in non-trading activities in a particular jurisdiction may only be applied to reduce income arising from a similar activity carried on in the same jurisdiction in the current year or in following years.

GERMANCO may not generally deduct losses incurred in respect of investments made in foreign jurisdictions.

Dividends from domestic and foreign corporations

Dividends received by GERMANCO from German resident corporations and foreign corporations, including foreign corporations resident in EU Member States, in fiscal years ending after December 31, 2003 benefit from a 95-percent exemption from both corporate income tax and municipal trade tax. More specifically, five percent of the dividend amount is deemed to be a non-deductible expense and as such, the exemption is equivalent to 95 percent of the full dividend amount. GERMANCO need not comply with a minimum shareholding requirement or a minimum holding period requirement to benefit from the exemption.

Dividends received by GERMANCO are, however, subject to municipal trade tax where:

- GERMANCO holds less than 15 percent (previously 10 percent) of the share capital in the paying German resident corporation or foreign corporation at the beginning of its fiscal year; or
- GERMANCO receives the dividend from a foreign corporation resident outside of the EU where more than 15 percent (previously 10 percent) of the foreign corporation's gross income is constituted of passive income. GERMANCO's ownership percentage in the foreign corporation is irrelevant in this context.

Expenses incurred by GERMANCO in regards to dividends received from German resident corporations and foreign corporations are deductible for corporate income tax purposes. Such expenses are not deductible, however, for municipal trade tax purposes. Interest may only be deducted for corporate income tax and municipal trade tax purposes where the limitation of the new interest capping rules are not exceeded.

As GERMANCO benefits from a 95-percent exemption on the receipt of dividends from foreign corporations, GERMANCO may not claim a direct foreign tax credit in regards to withholding taxes levied on such dividends by foreign jurisdictions.

Banks, financial services institutions, and finance enterprises do not qualify for the participation exemption on dividends from German resident corporations and foreign corporations where the relevant shares are held for trading purposes.

Interest and royalty income

Interest and royalties earned by GERMANCO from foreign corporations are fully subject to corporate income tax and municipal trade tax in Germany. GERMANCO may benefit from a direct foreign tax credit or a deduction for foreign income taxes, as discussed above, in respect of withholding taxes paid to a foreign jurisdiction on the receipt of interest and royalties from foreign corporations.

Capital gains and capital losses

All capital gains realized by GERMANCO on the disposition of shares in German resident corporations and foreign corporations in fiscal years ending after December 31, 2003 benefit from a 95-percent exemption from both corporate income tax and municipal trade tax. More specifically, five percent of the capital gain thus realized by GERMANCO is deemed to be a non-deductible expense and as such, the exemption amount is equivalent to 95 percent of the full capital gain.

The 95-percent exemption is available to GERMANCO for both direct shareholdings and indirect shareholdings through a partnership provided the capital gains realized through the partnership pertain to the disposition of shares held in German resident subsidiaries or foreign subsidiaries. The exemption is not available where the shareholdings have been written down for tax purposes to their lower going concern value and have not since been revalued to a greater value. Moreover, capital gains realized by banks, financial services institutions and finance enterprises for trading purposes do not qualify for the exemption.

Where the disposed shares were originally acquired by GERMANCO in the context of a tax-free transaction (e.g., contribution or division of a business in exchange for shares or a share-for-share exchange), GERMANCO will need to have held the disposed shares for seven years subsequent to the transaction to qualify for the 95 percent exemption.

Moreover, where the disposed shares were originally acquired by GERMANCO at a value below fair market value as a result of an individual's contribution to capital, GERMANCO will need to have held the disposed shares for seven years subsequent to the contribution to qualify for the 95-percent exemption.

Capital losses realized on the disposition of shares in German resident corporations and foreign corporations are not deductible and cannot be applied to reduce taxable income where a capital gain realized on the disposition of the same shares would have ordinarily benefited from the 95-percent exemption. Otherwise, capital losses realized on the disposition of shares are deductible.

Controlled foreign corporation regime

GERMANCO will be deemed to have earned income from a foreign corporation where all of the following conditions are met:

- more than 50 percent of the share capital or voting rights in the relevant foreign corporation are held, directly or indirectly, by German resident corporations (including GERMANCO) and/or German resident individuals, alone or together with related persons;
- the foreign corporation is subject to tax in its country of residence at a rate of 25 percent or less;

- the foreign corporation earns passive income;[15] and
- the foreign corporation's passive gross income exceeds 10 percent of its total gross income or the foreign corporation's income exceeds €80,000.

GERMANCO will also be deemed to have earned income from a foreign corporation where it holds, directly or indirectly, more than one percent of the share capital or voting rights in the relevant foreign corporation if:

- the foreign corporation earns passive income of an investment nature;[16] and
- the foreign corporation's passive gross income of an investment nature exceeds 10 percent of its total gross income or the foreign corporation's income exceeds €80,000.

GERMANCO will further be deemed to have earned income from a foreign corporation where it holds, directly or indirectly, less than one percent of the share capital or voting rights in the relevant foreign corporation if:

- the foreign corporation earns exclusively or almost exclusively passive income of an investment nature;
- the foreign corporation's passive gross income of an investment nature exceeds 10 percent of its total gross income or the foreign corporation's income exceeds €80,000; and
- the shares of the relevant foreign corporation are not regularly traded on a stock exchange.

The German CFC regime will also be found to apply where the income attributable to GERMANCO from various controlled foreign affiliates exceeds €80,000. The deemed allocation of income will be in an amount equal to GERMANCO's proportionate share of the foreign corporation's retained earnings considering both direct and indirect shareholdings. Such income will be subject to corporate income tax and municipal trade tax in Germany at the regular rates. In essence, GERMANCO is treated as if it had itself earned the income of the relevant foreign corporation.

15 Passive income is defined as income not derived from active operations. Active operations include income derived from:

- farming and forestry;
- manufacturing;
- the activity of banks and insurance companies under certain conditions;
- trade activities and services under certain conditions;
- renting and licensing (in exceptional cases, e.g., self developed intellectual property);
- financing activities under very strict conditions (e.g., use of external capital market);
- dividends distributed by corporations; and
- the disposal of shares in another corporation as well as a capital reduction by or the liquidation of the said corporation under certain conditions (e.g., the underlying assets were used in active operations).

All activities not listed above are considered to give rise to passive income for the purposes of the German CFC regime.

16 Passive income of an investment nature is generally defined as income derived from holding, administrating and conserving or increasing the value of cash, receivables, securities, participations, or other similar assets, where such activities do not otherwise qualify as active operations for purposes of the German CFC regime.

Dividends actually received by GERMANCO from the relevant foreign corporation in the future are exempt from corporate income tax and municipal trade tax. Also, capital gains realized by GERMANCO in the future on the disposition of shares in the relevant foreign corporation are exempt from corporate income tax and municipal trade tax.

The German CFC regime will not apply where:

- the foreign corporation is resident in a EEA country and carries out a genuine economic activity;
- the passive income earned by the foreign corporation and otherwise subject to tax under the German CFC regime is derived in connection with such activities; and
- the EC Mutual Assistance Directive or a similar agreement is in force between Germany and the relevant jurisdiction.

In January 2007, the German Ministry of Finance issued a guidance notice pursuant to which it expressed its view that the German CFC rules are not to be applied where it can be demonstrated that the relevant foreign corporation, resident within the EU or the EEA, is engaged in active business operations and is not therefore an artificial construct. This view has been included in the revisions made to German tax laws as part of the 2007 tax reform.[17]

International tax planning

As discussed above, the German CFC regime does not apply where the relevant foreign corporation is resident within the EEA or EU provided adequate substance is found in the country of residence from an operations standpoint. This will be the case irrespective of the rate of tax actually paid by the relevant foreign corporation. Several of the EEA or EU jurisdictions are extensively used in international tax structuring and offer significant tax benefits.

Other planning ideas are based on the ability of German resident corporations to receive dividends from foreign corporations and to dispose of shares in foreign corporations without attracting German taxation.

Anti-avoidance legislation

The German legislature has incorporated anti-avoidance rules in various pieces of legislation.

- The Foreign Tax Affairs Law addresses cross-border transactions between related and affiliated persons. Specifically, the Foreign Tax Affairs Law encompasses extensive provisions on controlled foreign corporations (as discussed above) and passive foreign investment income.

17 This guidance notice was issued by the Ministry of Finance in light of the decision rendered by the European Court of Justice (ECJ) in the *Cadbury Schweppes* case (2006). More specifically, the ECJ concluded that the UK CFC regime violated taxpayers' freedom of establishment. The guidance notice and corresponding legislative amendments were required as the German CFC regime is not dissimilar to the UK CFC regime.

- The General Tax Code contains a general anti-avoidance rule which was completely rewritten as part of the 2007 tax reform. Under the revised version of the rule, a taxpayer cannot avoid a tax liability through an abuse of legal form or legal methods, where obtaining a tax advantage was the only reason for the underlying arrangement. An "abuse" is defined to occur where the chosen legal structure is inappropriate in comparison with other legal structures, as it produces a tax benefit that was not intended by the legislation. The taxpayer may counter accusations of abuse by demonstrating convincing non-tax motives justifying the underlying arrangement.

  Where an abuse of law is found to exist, the structure is disregarded for tax purposes. The taxpayer is reassessed on the assumption that an appropriate legal path was chosen.

  In conjunction with the revision of the general anti-avoidance rule, notaries are now required to send to local tax offices copies of legal documents executed in incorporating corporations and registering branches of foreign corporations.

- German tax laws further encompass special anti-avoidance rules aimed at countering treaty shopping and the misuse of EU Directives, as incorporated into German legislation. Specifically, these new provisions address structures designed to reduce or eliminate German withholding taxes on payments made by a German resident corporation to non-resident corporations.

Enforcement and access to information

GERMANCO has an obligation to cooperate with the German tax authorities. It must disclose all facts relevant to the calculation of its German tax liability and produce all documents pertaining to cross-border transactions or events executed with related parties (transfer pricing documentation) in foreign jurisdictions. GERMANCO must provide specific information pertaining to foreign operations upon request by the German tax authorities.

Hong Kong

This chapter provides an overview of the manner in which Hong Kong approaches the taxation of foreign source income. As a general matter, Hong Kong does not tax foreign source income, even when such income is repatriated or remitted to Hong Kong. Only income that arises in or derives from Hong Kong or income that is deemed to have arisen in or derive from Hong Kong is subject to profits tax in Hong Kong. Direct foreign tax credits are available only in regards to foreign income taxes paid to a jurisdiction having concluded a full scope tax treaty with Hong Kong, where the income is also subject to profits tax in Hong Kong.

Basis for taxation

A corporation having its central management and control in Hong Kong is considered resident in Hong Kong ("HKCO"). A corporation resident in Hong Kong, however, is not subject to tax in Hong Kong on its worldwide income. The residency status of HKCO is not the decisive factor in determining how HKCO will be taxed. As Hong Kong operates a territorial system of taxation, residents and non-residents of Hong Kong alike are liable to pay profits tax only on income arising in or derived from (i.e., "sourced" in) Hong Kong from a trade, business or profession carried on in Hong Kong. Accordingly, HKCO will not be liable to pay profits tax in Hong Kong on its foreign source income, even when such income is repatriated or remitted to Hong Kong.

Generally speaking, profits tax is levied at the rate of 17.5 percent.[18] Since only income arising in or derived from Hong Kong from a trade, business, or profession carried on in Hong Kong is subject to profits tax, the concept of "source" is the guiding principle in all instances. The issue of whether income is sourced in Hong Kong is largely a question of fact to be determined in light of all relevant facts and circumstances, and has been considered on several occasions by the courts.

In determining whether the source of income arises in or derives from Hong Kong, the courts generally consider what the taxpayer has done to earn the income and where such actions took place. If the key operations took place in Hong Kong or the principal income producing assets are situated in Hong Kong, the income will likely be considered sourced in Hong Kong. All relevant facts and circumstances are taken into consideration, but certain factors will usually be identifiable as having caused the income to arise in or derive from one jurisdiction over another:

- Trading income is usually sourced in the jurisdiction where the purchase and sales contracts were executed. The Hong Kong tax authorities are of the view that both contracts have to be executed outside of Hong Kong for the trading income to be considered sourced abroad and not be subject to Hong Kong profits tax.

18 A reduction of the profits tax rate from 17.5 percent to 16.5 percent is expected for the financial year 2008/2009.

- Manufacturing income is usually sourced in the jurisdiction where the goods are manufactured.
- Service income is usually sourced in the jurisdiction where the services giving rise to the income are rendered.
- Interest income is usually sourced based on the "provision of credit" test although in some cases, an "operations test" may be used, as discussed below. Different rules are applied for financial institutions.

An apportionment of income between Hong Kong and another jurisdiction may be possible for service income where the services are performed both in Hong Kong and the other jurisdiction. In general, the Hong Kong tax authorities will adopt a 50:50 apportionment between the two jurisdictions.

Hong Kong tax laws do not offer general guidance on the sourcing of income but do encompass specific rules that deem certain items of income to have been sourced in Hong Kong, as discussed below. The Hong Kong tax authorities have issued a Departmental Interpretation and Practice Note Number 21 (DIPN 21) offering taxpayers some guidelines on how the source of income is to be determined, specifically in light of certain key decisions rendered by the courts. Taxpayers may further request rulings from the Hong Kong tax authorities on the sourcing of income in the context of proposed transactions.

Where HKCO performs business operations substantially outside of Hong Kong, it must maintain sufficient and adequate documentation in regards to such operations, as the burden of proof is on the taxpayer to demonstrate that an item of income arose in or is derived from another jurisdiction in any dispute with the Hong Kong tax authorities.

Foreign tax credits

HKCO may claim a direct foreign tax credit only in regards to foreign income taxes paid to a jurisdiction having concluded a full scope tax treaty with Hong Kong for the relief of double taxation, where the income is also subject to Hong Kong profits tax. As Hong Kong operates a territorial system of taxation, it has entered into few tax treaties with other jurisdictions. In effect, there is little need to mitigate the incidence of double taxation, as Hong Kong does not generally tax foreign source income. At present, Hong Kong has entered into full scope tax treaties with Belgium, the People's Republic of China, Thailand and Luxembourg. Hong Kong has further entered into shipping agreements and airline agreements with various other jurisdictions.

Where a direct foreign tax credit is made available to HKCO, the credit shall not exceed the amount of Hong Kong profits tax computed in relation to the income. The direct tax credit extends to foreign income taxes paid by HKCO on income from foreign operations carried on through a foreign branch and to withholding taxes paid on amounts received from foreign corporations.

Deduction for foreign taxes

Foreign taxes paid by HKCO and imposed by a non-treaty jurisdiction regardless of whether or not HKCO realizes a profit, as opposed to foreign taxes imposed as a charge on income, may be deducted by HKCO in computing its taxable income in Hong Kong.

Where HKCO is deemed to have earned income sourced in Hong Kong pursuant to Hong Kong tax laws, it will be entitled to a deduction for corresponding foreign income taxes paid to the relevant non-treaty jurisdiction.

Dividend income

Dividends received by HKCO from Hong Kong resident corporations that are subject to Hong Kong profits tax and from foreign corporations are fully exempt from Hong Kong profits tax. Dividends include intercompany dividends, stock dividends or dividends-in-kind.

Interest income

Foreign source interest income is not generally taxable. As previously mentioned, for entities other than financial institutions, the jurisdiction of source of interest income is normally the jurisdiction where the credit was provided to the borrower, that is the place where the funds from which the interest income is derived were made available to the borrower. This provision of credit test does not apply where the loans are other than simple loans of money. In certain “finance company” type situations, an “operations test” may be applied to determine the source of the interest income. Further guidance in this area can be found in DIPN 13 *Profits Tax — Taxation of Interest Received*.

Interest earned after June 22, 1998 by a corporation carrying on a business in Hong Kong and derived from any deposit placed in Hong Kong with a financial institution is exempt from profits tax, unless the deposit secures a borrowing the interest expense on which is deductible for profits tax purposes. Financial institutions may not claim this exemption.

Interest earned by a bank or financial institution is deemed sourced in Hong Kong where the interest income arises through or from the carrying on of a business in Hong Kong by the relevant bank or financial institution, notwithstanding that the relevant funds are made available to the borrower outside of Hong Kong.

Royalty income

Royalties are deemed to have been sourced in Hong Kong where, inter alia, they are earned by a non-resident of Hong Kong:

- for the use of or the right to use in Hong Kong a trademark, patent, design, copyright material, secret process, or other property of a similar nature;
- for the use of or the right to use outside of Hong Kong a trademark, patent, design, copyright material, secret process, or other property of a similar nature, provided the royalties are deductible in computing the income of a person for Hong Kong profits tax purposes; and
- for the use in Hong Kong of cinema or television tape or any sound recording.

In the above circumstances, 30 percent of the royalty amount is deemed to constitute income subject to profits tax at the rate of 17.5 percent. The effective tax rate applied to royalties thus earned by non-residents is 5.25 percent. However, where the royalties are received by the non-resident from an associated corporation, 100 percent of the royalty amount is deemed to constitute income sourced in Hong Kong and is subject to profits tax at the rate of 17.5 percent, unless the Hong Kong tax authorities are satisfied that no person carrying on a business in Hong Kong has, at any time, owned the property in respect of which the royalties were paid.

Service income and commission fees

Where services are to be rendered by HKCO to a foreign corporation both inside and outside of Hong Kong, HKCO should consider entering into two separate services agreements with the foreign corporation to avoid disputes with the Hong Kong tax authorities with regards to the sourcing of income. An apportionment of income between Hong Kong and the relevant jurisdiction may also be possible, as previously discussed.

Service fees paid by HKCO to a foreign corporation for services rendered by the foreign corporation outside of Hong Kong on behalf of HKCO are not ordinarily subject to profits tax in Hong Kong.

Commission income earned by HKCO is generally not subject to profits tax where the activities giving rise to the commission income took place outside of Hong Kong.

Deduction of expenses

As a general matter, expenses incurred by HKCO in earning or producing income subject to profits tax are fully deductible. There are no territorial restrictions applied in determining the deductibility of an expense item. As such, a reasonable portion of overseas head-office expenses may be deducted in computing a Hong Kong branch's taxable income for profits tax purposes. Similarly, payments made by HKCO to related foreign corporations (e.g., management fees, royalties, and service fees) are fully deductible provided they represent arm's-length amounts and were incurred by HKCO in earning or producing income subject to profits tax.

Interest payable by HKCO to a foreign corporation other than an overseas financial institution is generally not deductible if the recipient foreign corporation is not subject to Hong Kong profits tax. Therefore, no deduction is usually allowed for interest paid by HKCO on borrowings from non-resident corporations which are not overseas financial institutions. In general, interest is only deductible where the recipient is taxable in Hong Kong or is a bona fide financial institution in Hong Kong or abroad.

Foreign losses

An income loss incurred by a foreign branch of HKCO is sourced outside of Hong Kong and is therefore not deductible for profits tax purposes. Similarly, income earned by a foreign branch of HKCO is sourced outside of Hong Kong and is therefore not taxable in Hong Kong.

Capital gains and losses

Hong Kong does not tax gains realized on the disposition of capital assets and does not permit the deduction of capital losses.

A gain realized by HKCO may, however, be subject to profits tax if it is of an income nature and is sourced in Hong Kong. A gain is of an income nature where, for example, it is realized in the course of an adventure or concern in the nature of trade or in the course of a profit-making scheme. This question is one of the most litigated issues in Hong Kong. The criteria that will be considered by the courts in determining whether a relevant asset was held by HKCO on income or capital account include:

- the declared intention of HKCO in holding the relevant asset;
- HKCO's financial ability to hold the asset long-term;
- the length of ownership;
- the work, if any, carried out in respect of the asset to improve its value;
- the rate of return obtained by HKCO in leasing out the asset in comparison with the rate of return obtained by HKCO in disposing of the asset;
- whether the transaction was isolated or carried out as part of a series of transactions (although an isolated transaction may constitute an adventure or concern in the nature of trade); and
- whether the disposition took place as a result of an unforeseen event.

In light of the above, gains realized by HKCO, for example, on the disposition of shares in corporations which were held on capital account are not subject to profits tax, while gains realized by HKCO on the disposition of shares in corporations which were held on income account are subject to profits tax unless the trading gains are considered to be foreign sourced. The source of profits from trading in listed shares is generally the location of the stock exchange of where the shares in question are traded, while the source of profits from trading in non-listed shares in foreign corporations is generally the jurisdiction where the purchase and sales contracts were executed (as previously discussed).

Moreover, where a person transfers a right to receive income from property and receives consideration in respect of the transfer, the consideration thus received is deemed to be a trading receipt arising in or derived from Hong Kong and is subject to profits tax. The above will not apply if the property is sold at the same time and to the same person to whom the right to receive the income is transferred.

Foreign exchange gains and losses

Hong Kong does not tax foreign exchange gains of a capital nature and does not permit the deduction of foreign exchange losses of a capital nature.

Foreign exchange gains that are a regular and normal incident to business operations carried on by a corporation are of an income nature and are subject to profits tax at the rate of 17.5 percent. Foreign exchange losses of an income nature are deductible for profits tax purposes.

Controlled foreign corporation regime

Hong Kong does not have rules applicable to foreign corporations generally referred to as "controlled foreign corporations" or "tax haven corporations" by other jurisdictions.

However, the general anti-avoidance rules contained in Hong Kong tax laws and referred to below may be applied by the Hong Kong tax authorities in circumstances where taxpayers direct profits offshore to avoid paying profits tax in Hong Kong. Specifically, the Hong Kong tax authorities pay special attention to attempts by taxpayers to create artificial offshore sources of income. Planning strategies pursued by taxpayers often involve fragmenting business operations to segregate in tax haven jurisdictions all foreign aspects of the relevant business operations.

Upon the request of the Hong Kong tax authorities, taxpayers are obliged to provide information required to verify claims that income is not sourced in Hong Kong.

Transactions with foreign corporations

Hong Kong tax laws do not contain provisions addressing the price set between HKCO and foreign related corporations for goods or services. However, there is a statutory requirement pursuant to which HKCO must receive from the foreign related corporation the ordinary profits that might be expected to arise in or derive from Hong Kong having regard to the circumstances of the transaction. Otherwise, the foreign related corporation will be deemed to be carrying on a business in Hong Kong and will be subject to profits tax on the underlying profits in the name of HKCO as if it were the agent of HKCO.

General anti-avoidance

Hong Kong tax laws contain a number of general anti-avoidance provisions pursuant to which artificial or fictitious transactions or transactions undertaken by a taxpayer for the sole or dominant purpose of obtaining a tax benefit may be disregarded in determining the taxpayer's liability for tax. The form and substance of the relevant transactions are both considered in determining whether the taxpayer falls within the scope of application of the general anti-avoidance rules. Taxpayers are generally permitted to pursue tax benefits available under the framework of Hong Kong tax laws. The general anti-avoidance rules are aimed at deliberately contrived tax avoidance schemes.

Other specific anti-avoidance measures deny the carryforward of tax losses where the dominant reason for a change in ownership was to access the tax losses, and counter non-arm's-length transactions between Hong Kong resident corporations and related foreign corporations.

Italy

This chapter provides an overview of the manner in which Italy taxes, under current and proposed legislation, the foreign source income of Italian resident corporations. As a general matter, Italian resident corporations have access to exemptions on the receipt of dividends from foreign corporations and on the realization of capital gains on the disposition of shares in foreign corporations. Italian resident corporations further have access to direct foreign tax credits and, in certain instances, tax sparing credits under Italy's tax treaties in mitigating the incidence of double taxation.

Foreign tax credits

A corporation having its place of management or principal business purpose in Italy is considered an Italian resident corporation ("ITALCO"). A corporation resident in Italy is subject to tax in Italy on its worldwide income pursuant to Article 81 of the Italian Tax Code (Presidential Decree 917 of December 22, 1986). All income earned by ITALCO, including foreign source income, is subject to corporate income tax (IRES — *Imposta sul Reddito delle Società*) levied at the rate of 27.5 percent.[19] Most foreign source income (e.g., income earned through a foreign branch) should not, in principle, be subject to the regional tax on productive activities (IRAP — *Imposta sul Reddito delle Attività Produttive*).[20]

Direct tax credits

ITALCO may benefit from a direct foreign tax credit in respect of taxes paid abroad on foreign source income. The direct tax credit extends to foreign taxes paid by ITALCO on income from foreign operations carried on through a foreign branch and to withholding taxes paid on amounts received from foreign corporations. Such foreign taxes may be credited against ITALCO's net tax in Italy in an amount equal to that part of the Italian tax which is proportional to the ratio of foreign source income to worldwide income, net of any losses of prior tax periods carried forward. Income earned abroad must be computed in accordance with Italian tax rules.

The direct tax credit is calculated on a per country basis. An excess credit computed in regards to one foreign jurisdiction may not be used against the Italian tax attributable to income derived from another foreign jurisdiction. Also, foreign losses incurred in one jurisdiction cannot reduce income derived from another jurisdiction; ITALCO may therefore claim a foreign tax credit in respect of the latter jurisdiction in these circumstances.

Under certain circumstances or in the case of a CFC participating in an international tax consolidation (see below), the credit computed in respect of the taxes paid abroad and exceeding the relevant portion of Italian taxes owing may be carried back or forward over an eight-year period.

19 Effective for tax periods commencing after December 31, 2007, the corporate income tax rate was reduced from 33 percent to 27.5 percent.

20 Specific rules apply to banks and other financial institutions.

When only a portion of the income earned abroad is included in ITALCO's worldwide income (by reason, for example, of an exemption under the Italian Tax Code), the foreign tax amount used in determining the available credit must be reduced accordingly.

Generally, the tax credit must be claimed on ITALCO's tax return for the year in which the foreign source income is included in the overall taxable base.

Certain tax treaties concluded by Italy override Italy's domestic foreign tax credit rules and offer, in lieu thereof, an exemption from Italian taxation on foreign source income.

Tax sparing credits

Foreign income taxes that are either exempt or reduced by a foreign government may be deemed to have been paid and are therefore included as part of foreign income taxes for purposes of obtaining a tax credit. This is possible only where a tax treaty with the relevant foreign jurisdiction provides specifically for such a "deemed" (tax sparing) credit. Tax sparing credits are made available to Italian resident corporations in Italy's tax treaties with certain jurisdictions (e.g., tax treaty with Sweden). These tax sparing clauses are generally limited to certain types of income, although some tax sparing clauses are general and extend to all sources of income.

Deemed residence rule

A foreign corporation is deemed resident in Italy where it holds a controlling participation in an Italian resident corporation and it is either (i) controlled, directly or indirectly, by Italian resident persons or (ii) managed by a board of directors (or other equivalent body) composed mostly of members resident in Italy. Where these conditions are satisfied, a reversal of the burden of proof arises and the foreign corporation bears the burden of demonstrating that its place of management is not situated in Italy. The deemed residence rule is procedural in nature and does not modify the criteria for residency under Italian tax law.

The deemed residence rule targets foreign holding corporations established by Italian resident corporations to achieve tax avoidance purposes.

Foreign losses

Foreign losses incurred by ITALCO through a foreign branch may be offset against current year earnings for corporate income tax purposes. Any excess may be carried forward for five years.

Dividends from foreign corporations

Dividends received by ITALCO from a foreign corporation benefit from a 95-percent exemption[21] from corporate income tax provided the foreign corporation is not resident in a tax haven or blacklist jurisdiction (see below). This exemption is not subject to a minimum holding period or a minimum holding percentage. Accordingly, ITALCO may benefit from the 95-percent exemption in respect of a dividend paid on a single share of a foreign corporation, held for a single day. The 95-percent exemption is, however, subject to the condition that the dividends were not fully or partially deducted in the state of source.

The five percent portion of the dividend represents ITALCO's ordinary income and is subject to corporate income tax at the rate of 27.5 percent. It may be offset by either current losses and/or available net operating losses.

Any foreign income taxes paid by the foreign corporation on the underlying profits are irrelevant for Italian tax purposes, as Italy does not provide for an indirect tax credit. However, ITALCO may benefit from a direct foreign tax credit in respect of withholding taxes imposed on the dividend by the foreign jurisdiction, but only proportionally to the taxable amount (i.e., five percent) of the dividend, pursuant to Article 165 of the Italian Tax Code.

Dividends are, in addition, fully exempt from the regional tax on productive activities (IRAP), previously mentioned. Accordingly, the effective overall tax rate will be 1.375 percent (or 27.5 percent of five percent).[22]

Dividends from tax haven corporations

Dividends received by ITALCO from a tax haven or blacklist corporation[23] are fully subject to corporate income tax at the rate of 27.5 percent. This is the case where the dividends are received by ITALCO directly from the tax haven corporation or indirectly from a tax haven corporation through another foreign corporation.

ITALCO may, however, apply for an ad hoc ruling to benefit from the 95-percent exemption, discussed above. To obtain such ruling, ITALCO must demonstrate that the holding of shares in the relevant tax haven corporation does not result in the sheltering of profits in the low tax jurisdiction. To this end, at least 75 percent of the profits realized by the tax haven corporation should be produced in jurisdictions that are not low taxing and should be ordinarily taxed by such jurisdictions. This must be demonstrated by ITALCO from the commencement of and throughout the period of ownership. Moreover, the dividends must not be deductible for income tax purposes in the country of residence of the paying corporation.

In July 2007, the Italian tax authorities issued a ruling concluding that, absent an ad hoc ruling, the 95-percent exemption was not available in circumstances where the Italian shareholder received dividends from a first-tier subsidiary resident in a tax haven or blacklist jurisdiction,

21 Specific rules apply to taxpayers adopting the IAS/IFRS accounting framework.

22 Specific rules apply to banks and other financial institutions.

23 The blacklist of jurisdictions offering privileged tax regimes was released by the Italian tax authorities in 2001.

even though the only source of income of the first-tier foreign subsidiary was a dividend received from a second-tier foreign subsidiary resident in a jurisdiction that was not a tax haven or blacklist jurisdiction.[24]

Finance Bill 2008 provides for the replacement of the existing blacklist with a white list identifying (i) jurisdictions which allow an adequate exchange of information with Italy for income tax purposes and (ii) jurisdictions which allow an adequate exchange of information with Italy and enforce a level of taxation similar to that of Italy. This new white list is expected to come into force through a decree to be issued by the Ministry of Finance. Existing tax rules directed at tax haven or blacklist corporations, as discussed in this paper, will extend to all foreign corporations resident in jurisdictions not mentioned in the forthcoming white list.

ITALCO may benefit from a direct foreign tax credit in respect of withholding taxes imposed by a foreign jurisdiction on a dividend from a tax haven corporation, proportionally to the full amount of the dividend where the dividend is fully taxable in Italy, pursuant to Article 165 of the Italian Tax Code.

Interest and royalty income

Interest and royalty payments received by ITALCO from foreign corporations are included in ITALCO's income and are taxed as ordinary income at the rate of 27.5 percent. ITALCO may, however, benefit from a direct foreign tax credit in respect of withholding taxes imposed by a foreign jurisdiction on the payment of such amounts.

Deduction of costs

Costs accrued by ITALCO in the context of business transactions carried out with foreign enterprises domiciled in tax haven or blacklist jurisdictions are non-deductible for Italian tax purposes. This is the case even where the foreign enterprise is an unrelated and independent third-party enterprise and without regard to the nature and purpose of the transaction.

The term "foreign enterprise" includes permanent establishments and the term "costs" includes any expenses, losses, or deductions that may reduce ITALCO's taxable income.

There are two exceptions to the above rule. ITALCO may deduct its costs if it demonstrates that (i) the foreign enterprise mainly carries on a commercial activity, or (ii) the transaction from which the costs accrued corresponds to an actual economic interest of ITALCO and the transaction was executed.

This limitation on the deductibility of costs extends to costs accrued by Italian resident corporations in connection with services rendered by professionals located in tax haven or blacklist jurisdictions.

24 Ruling 191/E (July 27, 2007).

Capital gains

ITALCO may benefit from a capital gains participation exemption under Article 87 of the Italian Tax Code on the disposition of shares in a foreign corporation where certain conditions are satisfied.[25]

Where these conditions are met, ITALCO will benefit from a 95-percent exemption[26] from corporate income tax. As such, only five percent of the capital gain realized by ITALCO on the disposition of shares in the foreign corporation will be subject to corporate income tax at the rate of 27.5 percent. The five-percent portion of the capital gain will be taxed as ordinary income and can ultimately be offset by either current losses and/or available net operating losses.

The capital gain is, in addition, fully exempt from the regional tax on productive activities (IRAP), previously mentioned. Accordingly, the effective overall tax rate will be 1.375 percent (or 27.5 percent of five percent).[27]

ITALCO need not demonstrate a minimum holding percentage to benefit from the participation exemption. However, the following four conditions will need to be met:

- ITALCO must have continuously held the relevant shares from at least the first day of the 12th month before the month in which the disposal occurred (the "Holding Period"). If ITALCO acquired shares in the foreign corporation at different times, the LIFO (last in, first out) method will apply. ITALCO will thus be considered to have first sold the shares last acquired. The Holding Period may be inherited as part of certain reorganizations.
- The relevant shares must have been registered by ITALCO as fixed financial assets (not as inventory) in the first financial statements closed during the Holding Period (the "Registration Requirement").[28] The manner in which the relevant shares are registered is only relevant in respect of the first set of financial statements closed after the acquisition of such shares. A change may be subsequently brought to the financial statements by ITALCO's directors. However, the decision on the manner in which the shares are registered may be challenged by the Italian tax authorities pursuant to the anti-abuse provision of Article 37-bis of Decree 600.
- The foreign corporation must not be a tax haven or blacklist subsidiary or, if it is a tax haven subsidiary, ITALCO must have obtained an ad hoc ruling confirming that the holding of shares in the foreign corporation does not result in the sheltering of profits in the low tax jurisdiction at any point in time during the period of ownership (the

25 ITALCO may benefit from the participation exemption also in respect of capital gains realized on the disposition of shares in Italian resident corporations. In these circumstances, ITALCO will need to comply with the first, second and fourth conditions, as discussed herein.

26 An 84-percent exemption was available for capital gains realized up to December 31, 2007.

27 Specific rules apply to banks and other financial institutions.

28 Specific rules apply to taxpayers adopting the IAS/IFRS accounting framework.

"Residence Requirement"). To this end, at least 75 percent of the profits realized by the tax haven corporation should be produced in jurisdictions that are not low taxing and should be ordinarily taxed by such jurisdictions. The Residence Requirement must be met from the beginning of the third fiscal year before the one in which the disposal occurred or, if a lesser period, from the time of incorporation of the foreign corporation. If the foreign corporation is a holding corporation, the Residence Requirement will need to be met by those subsidiaries which represent the greatest value when considering the foreign corporation's pool of assets.

- The foreign corporation must carry on a business activity, as defined in Article 55 of the Italian Tax Code (the "Activity Requirement"). The Activity Requirement must be met from the beginning of the third fiscal year before the one in which the disposal occurred or, if a lesser period, from the time of incorporation of the foreign corporation. The Activity Requirement cannot be met if the majority of a subsidiary's assets are real estate not effectively and directly used in its business activities. Generally speaking, the Activity Requirement will be deemed met in regards to the disposal of shares of corporations whose shares are listed in a regulated stock exchange market or the disposal of shares made in the context of a public tender offer. If the foreign corporation is a holding corporation, the Activity Requirement will need to be met by those subsidiaries which represent the greatest value when considering the foreign corporation's pool of assets.

Capital gains realized on dispositions that do not qualify for the participation exemption are fully subject to corporate income tax at the rate of 27.5 percent.

Capital losses

ITALCO may not deduct capital losses realized on the disposal of shares benefiting from the 95-percent capital gains participation exemption.[29] ITALCO may also not deduct expenses arising on the sale of the shares or write-downs.

Capital losses realized on the disposition of shares that do not qualify for the capital gains participation exemption are not deductible up to the amount of dividends received on the relevant shares not subject to taxation in Italy and distributed in the 36-month period preceding the disposition.

Controlled foreign corporation regime

Where ITALCO controls, directly or indirectly, a foreign corporation resident in a tax haven or blacklist jurisdiction, ITALCO must include in its taxable income that portion of the income of the CFC that is attributed to it in proportion to its shareholdings therein.

29 This includes capital losses realized on the dissolution of a foreign corporation held directly by ITALCO.

ITALCO must have control of the foreign corporation at the end of the accounting period of the foreign corporation for the CFC regime to apply. A foreign corporation will be deemed controlled where:

- ITALCO holds, directly or indirectly, the majority of the votes at the ordinary shareholders' meetings;
- ITALCO holds, directly or indirectly, sufficient votes to exert a decisive influence in the ordinary shareholders' meetings; or
- the foreign corporation is under the dominant influence of ITALCO due to a special contractual relationship.

Where the CFC regime applies, the income attributed to ITALCO is subject to separate taxation in the hands of ITALCO at the average tax rate otherwise applicable to its taxable income. In any case, the applicable tax rate cannot be lower than 27 percent. Such attribution occurs on the last day of the financial year of the foreign corporation and the income attributed cannot be offset by ITALCO's losses. ITALCO may claim a credit for foreign taxes paid abroad in regards to the attributed income pursuant to Article 165 of the Italian Tax Code.

Profits subsequently distributed by the CFC to ITALCO, whether by way of dividends or other forms of distribution, are excluded from ITALCO's taxable income up to the amount of income attributed and subject to tax pursuant to the CFC regime in the current year or in previous years. Foreign withholding taxes paid abroad on distributions thus excluded from ITALCO's taxable income are creditable in Italy up to the amount of Italian taxes previously paid under the CFC regime reduced by any corresponding tax credit for foreign taxes.

ITALCO's taxable base in the shares of the controlled foreign corporation is increased by the amount of income of the foreign corporation subject to tax in Italy annually under the CFC regime. Similarly, ITALCO's taxable base in the shares of the CFC is reduced upon the subsequent receipt of distributions from the foreign corporation.

The CFC regime does not apply in the following instances:

- ITALCO demonstrates that the controlled foreign corporation, which is resident in a jurisdiction with a privileged tax system, carries out principally an industrial or commercial activity in the country where it has its registered office. As a general matter, this condition is satisfied if the foreign corporation has an organized structure (e.g., offices and staff to carry out the relevant activities) in the foreign jurisdiction.
- The majority (i.e., at least 75 percent) of the income earned by the CFC arises in jurisdictions that are not low taxing and should be ordinarily taxed by such jurisdictions.

In the above instances, ITALCO must apply for a ruling issued by the Italian tax authorities confirming the non-application of the CFC regime.

CFC rules for foreign affiliated entities

The CFC regime also applies, with different attribution rules and procedures, to "affiliated entities" resident in tax haven or blacklist jurisdictions. An "affiliated entity" is a foreign entity in respect of which ITALCO holds, directly or indirectly, a profit entitlement exceeding 20 percent (or 10 percent in the case of listed corporations).

International tax consolidation

Italian resident joint-stock corporations and commercial entities subject to corporate income tax may opt for international tax consolidation where they are the ultimate controlling corporations of the relevant corporate group. In this case, all of the income and losses of the non-resident controlled corporations may be allocated to the Italian controlling corporation in proportion to its profit sharing percentage in the relevant non-resident corporations, regardless of actual distributions made and received during the year. Where the option is made for international tax consolidation, all non-resident corporations ultimately controlled by the Italian corporation must be included in the consolidation ("all in, all out" principle). The option cannot be revoked until the end of the Italian controlling corporation's fifth fiscal year and any renewals apply for at least three fiscal years. Various conditions apply before an Italian controlling corporation may access this regime.

International tax planning

Italian resident corporations may implement foreign structures to invest abroad while minimizing the overall effective tax rate on the investment income. These structures generally involve the incorporation of investment subsidiaries resident within the EU having branches also situated within the EU and entitled to a notional interest deduction for tax purposes. These structures also achieve a deferral of tax on profits earned abroad, as these may be reinvested abroad to achieve various business and investment goals without attracting immediate taxation in Italy.

Italian resident corporations may further implement foreign structures to mitigate the effects of the CFC regime in circumstances where certain activities are expected to be held in tax haven or blacklist jurisdictions. These structures generally involve the incorporation of a subsidiary resident within the EU having a branch situated in the relevant tax haven jurisdiction. The CFC regime will generally not apply where adequate substance and sufficient economic activity can be demonstrated at the level of the branch.

General anti-avoidance

Italian tax laws do not include a general anti-avoidance provision. A general anti-avoidance doctrine or principle also does not exist under Italian civil law. Tax avoidance is ordinarily dealt through specific anti-avoidance provisions.

Pursuant to the anti-abuse provision of Article 37-bis of Decree 600, the Italian tax authorities may disallow tax benefits resulting from any act or transaction carried out without valid economic reasons and to circumvent obligations or prohibitions under Italian tax law. However, the tax authorities may do so only where the said tax benefits result from one or more of the following acts or transactions:

- mergers, divisions, transformations, liquidations, and distributions to shareholders of reserves not consisting of profits;
- contributions to corporations and transactions for the transfer or utilization of business assets;
- transfers of debt claims and tax credits;
- EU mergers, divisions, transfers of assets, and exchanges of shares as well as the transfer of the relevant corporation's tax residency to a foreign jurisdiction;
- transactions concerning securities and financial instruments, including the manner in which they are registered in respect of the financial statements;
- transfers of assets and provision of services between corporations within the same consolidated tax group;
- payments of interest and royalties eligible for the withholding tax exemption under the EC Interest and Royalties Directive if made to a person directly or indirectly controlled by one or more persons established outside of the EU; or
- transactions between resident entities and affiliates resident in tax haven jurisdictions and regarding the payment of an amount under a penalty clause.

A tendency has emerged in Italian jurisprudence whereby Italian courts adopt a "substance over form" approach when counteracting abusive transactions, despite the fact that Italy is a civil law jurisdiction ordinarily driven by legal form.

Enforcement and administration

The Italian tax authorities are increasing their efforts in identifying and pursuing foreign structures with little or no commercial substance put in place by Italian resident corporations mainly to differ or reduce Italian taxation of Italian and/or foreign source income. The Italian tax authorities generally rely on the Exchange of Information clauses contained in Italian tax treaties to access foreign information concerning Italian resident corporations operating in treaty jurisdictions.

Japan

This chapter provides an overview of the manner in which Japan taxes the foreign source income of Japanese resident corporations. Generally speaking, Japanese resident corporations have access to direct and indirect foreign tax credits in mitigating the incidence of double taxation. Tax sparing credits may also be available under Japan's tax treaty network. Japanese resident corporations do not, however, have access to exemptions on the receipt of distributions or other income from foreign corporations or on the realization of capital gains on the disposition of shares in foreign corporations.

Foreign tax credits

A corporation having its head office or main office in Japan is considered a corporation resident in Japan ("JAPANCO"). The effective place of management of the corporation is not a relevant factor in determining residency. A Japanese resident corporation is generally referred to as a "domestic" corporation.

JAPANCO is subject to corporation tax (national income tax) on its worldwide income pursuant to the Corporation Tax Act (*Houjinzei Ho*, Law 34 of 1965). As such, JAPANCO's foreign source income is subject to corporation tax. Foreign source income will further be subject to enterprise tax and inhabitants tax, both of which are local taxes. As a general matter, the effective corporate tax rate of a Japanese resident corporation is around 41 percent (a reduced rate is applicable to income of no more than ¥8,000,000 for small corporations whose amount of capital is ¥100,000,000 or less).

Direct tax credits

JAPANCO may benefit from a direct tax credit in respect of all foreign taxes on income, such as foreign corporate income taxes (national or local), foreign withholding taxes, surtaxes, taxes on a part of income, taxes levied on specified gross receipts instead of tax on net income, whether levied by national governments, political subdivisions, or local authorities. The credit is not available in regards to penalties or delinquent taxes.

The foreign tax credit is available to JAPANCO for application against both corporation tax and inhabitants tax. The credit amount is limited to that part of the Japanese tax which is proportional to the ratio of foreign income to worldwide income. The maximum foreign tax credit available is determined on a worldwide basis ("overall limitation"), not on a country-by-country or source-by-source basis.

Foreign income is determined under Japanese taxation rules and regulations, which provide income sourcing rules and methods of determining foreign source income. Foreign source expenses, which should be deducted after the determination of foreign source income, must include overhead costs and other expenses (interest, bad debt reserves, revaluation losses, etc.) reasonably allocable to the foreign operations. The overhead costs may be allocated based on the ratio of the foreign gross sales to the worldwide gross sales or other methods agreed upon between JAPANCO and the Japanese tax authorities. In determining the foreign source income amount relevant for computing the available tax credit, losses incurred in a jurisdiction must be offset against income earned in other jurisdictions.

In addition, two-thirds of foreign source income not subject to foreign corporate income tax must be excluded from the computation, and also the amount of foreign source income is limited to the amount of JAPANCO's total income multiplied by (i) 90 percent, or (ii) the ratio of the number of foreign personnel against that of total personnel, whichever is larger.

Some tax treaties (e.g., the Japanese tax treaties with the United States and the United Kingdom) include a deemed sourcing rule pursuant to which income earned by a Japanese resident and taxed in the other contracting state under the relevant tax treaty will be deemed to have arisen from sources in that other contracting state for foreign tax credit purposes.

Where the amount of foreign tax imposed by a particular jurisdiction exceeds 50 percent of the tax base in such jurisdiction, the excess will not be creditable against Japanese tax. Such excess may, however, be deducted in computing taxable income (see below).

Where the amount of foreign tax creditable exceeds the amount of Japanese tax against which it is credited or where the maximum amount of the credit exceeds the actual amount of creditable foreign tax, the excess may be carried forward for three years.

A foreign tax credit is not available for application against enterprise tax. However, foreign branch income attributable to a business carried on abroad is exempt from enterprise tax.

Foreign income taxes claimed as part of a foreign tax credit cannot be deducted for corporation tax and inhabitants tax purposes.

The overall limitation system provides JAPANCO with tax planning opportunities in its international investment/business activities. Under an overall limitation, foreign taxes paid to jurisdictions with higher tax rates can be averaged with those paid to lower tax jurisdictions. This "cross crediting" opportunity is partly eliminated by the 50-percent tax base limitation and the exclusion of two-thirds of foreign exempt income, as stated above.

Indirect tax credits

JAPANCO may benefit from an indirect tax credit on the receipt of dividends from a first-tier foreign corporation — a credit for foreign taxes paid by the foreign-paying corporation on the underlying profits — provided JAPANCO has held at least 25 percent of the voting shares, outstanding shares or paid-in capital of the foreign corporation for no less than six months at the time of the distribution.

JAPANCO may further benefit from an indirect tax credit in respect of foreign taxes paid on underlying profits distributed by second-tier foreign corporations. Under this scenario, the second-tier foreign corporation pays a dividend to a first-tier foreign corporation, and the first-tier foreign corporation pays a dividend to JAPANCO. To qualify for this credit, the 25 percent indirect ownership interest in a second-tier foreign corporation must be held by JAPANCO through a single first-tier foreign corporation that itself directly holds a 25-percent ownership or more interest in the second-tier foreign corporation and has done so for a period of at least six months prior to the date on which the obligation to pay the relevant dividend amount was fixed.

Some tax treaties provide for a requisite percentage control lower than the 25-percent threshold in regards to distributions from first-tier foreign corporations. For example, the Japan-United States tax treaty provides that the requisite control is lowered to 10 percent of the total issued voting shares in the relevant subsidiary. This reduced ownership requirement does not extend to distributions from second-tier foreign corporations.

Since JAPANCO is eligible for an indirect foreign tax credit only for its first and second-tier foreign subsidiaries, there is a tax incentive for JAPANCO to engage in its international operations with a relatively “flat” corporate structure. For example, JAPANCO may establish a holding company in the Netherland as a “gateway” and incorporate its second-tier subsidiaries in other EU countries so that JAPANCO may benefit from lower withholding tax rates on dividends and also indirect foreign tax credits allowed for the second-tier subsidiaries.

Tax sparing credits

In addition to the above, foreign income taxes that are either exempt or reduced by a foreign government following incentives granted to achieve economic goals may be deemed to have been paid and are therefore included as part of foreign income taxes for purposes of obtaining a tax credit. This is only possible where a tax treaty with the relevant foreign jurisdiction provides specifically for such a “deemed” (tax sparing) credit (such as the Japanese tax treaties with Brazil, Thailand, and China). The tax sparing credit is available both in regards to foreign corporate income taxes (national or local) and foreign withholding taxes deemed paid, as well as foreign income taxes deemed paid by first-tier foreign corporations on underlying profits distributed. Tax sparing credits are generally being terminated under Japan’s recent tax treaty policy. For example, tax sparing credits for Malaysia, India, and Korea have already been abolished or have expired.

Deduction of foreign taxes

In each accounting period, JAPANCO has the option of applying foreign taxes to obtain either a tax credit (as described above) or a tax deduction for corporation tax and inhabitants tax purposes. This option must cover all foreign taxes imposed during the relevant accounting period. Once the option is made by JAPANCO to deduct foreign income taxes, any balance of excess foreign tax credits is lost.

For enterprise tax purposes, although JAPANCO cannot claim a foreign tax credit, it may deduct foreign income taxes in determining its taxable base.

Dividends from foreign corporations

Dividends received by JAPANCO from foreign corporations are fully subject to tax in Japan. Dividends include both actual dividends (cash or other property) and constructive dividends (e.g., transfers of retained earnings into capital). When dividends cannot be remitted due to restrictions in the relevant foreign jurisdiction, dividend income need not be recognized by JAPANCO until it becomes remittable.

Where a foreign corporation is liquidated and the amount of cash and/or assets distributed exceeds JAPANCO's investment in the foreign subsidiary, the excess will be treated as a dividend from the foreign corporation to the extent of JAPANCO's proportionate share of the undistributed income of the foreign corporation. The balance of the distribution which exceeds JAPANCO's basis in the foreign corporation and the dividend income, if any, will be treated as a capital gain, which will be fully taxed at the ordinary tax rates. If the balance of the distribution does not exceed JAPANCO's basis in the foreign corporation, a capital loss will be incurred and treated as an ordinary loss (see below).

A foreign tax credit may be available to JAPANCO, as discussed above.

Dividends between foreign corporations

Dividends paid between foreign corporations are not subject to taxation in Japan, unless:

- the recipient non-resident corporation has a branch office or other physical facility in Japan constituting a permanent establishment in Japan;
- the dividend is attributable to a business carried on through such permanent establishment by the recipient non-resident corporation; and
- the underlying profits are not subject to any foreign income tax in the country of residence of the paying non-resident corporation.

In these circumstances, the dividend is treated as business income attributable to a domestic business in Japan and is therefore subject to corporation tax in Japan.

Interest and royalty income

Interest and royalties received by JAPANCO from foreign corporations are fully taxable at the regular tax rates. A foreign tax credit may be available to JAPANCO, as described above.

Foreign losses

Domestic and foreign losses are treated in the same manner:

- there is no distinction between ordinary losses and capital losses;
- tax losses may be carried forward up to seven years provided the domestic corporation has a so-called blue form tax return filing status;[30] and
- restrictions apply on the carry-forward of losses where there has been a change in ownership.

Tax losses may only be carried back one year in strictly limited circumstances (e.g., the dissolution of a domestic corporation).

Anti tax haven regime

Where JAPANCO is a "major Japanese shareholder" of a tax haven corporation, JAPANCO may be subject to current Japanese taxation on its portion of the undistributed profits of the tax haven corporation. The undistributed profits of the tax haven corporation are treated as if they had been distributed concurrently to its shareholders, including JAPANCO, on a pro rata basis.

JAPANCO will be considered a "major Japanese shareholder" if it owns, directly or indirectly, at least five percent of the outstanding shares, voting rights, or distributive rights, whichever is greater (if the corporation issues different classes of shares in terms of voting rights or distribution rights), in the tax haven corporation. For the regime to apply, more than 50 percent of the outstanding shares, voting rights, or distributive rights in the tax haven corporation must be owned, directly or indirectly, by any combination of Japanese resident corporations and Japanese resident individuals. The five percent test and 50 percent test are measured at the end of the tax haven corporation's business year.

A tax haven corporation is a corporation having its head office or main office in a country which does not impose a corporate income tax or for which the effective rate of tax on income in the foreign jurisdiction is 25 percent or less pursuant to Article 39-14(1) of the Special Tax Measures Act Enforcement Order (STMA-EO). Detailed rules are provided for the computation of the effective rate of tax to be determined for each foreign subsidiary annually.

As a general matter, the income retained by the tax haven corporation is computed in accordance with Japanese tax rules and is limited to that portion of the tax haven corporation's retained income that is attributable to shares owned directly or indirectly in it by JAPANCO. Practically, the Japanese tax legislation does allow JAPANCO to compute the retained income of the tax haven corporation in accordance with the tax laws of the country of residence of the tax haven corporation, and adjust such amount pursuant to the provisions of Article 39-14 of the STMA-EO.

30 The blue form tax return system was established to encourage taxpayers to file tax returns based on proper accounting records. Any corporation may apply for permission to use a blue form tax return. Various tax privileges are specifically made available to corporations permitted to use this system.

JAPANCO is eligible for foreign tax credits with respect to the foreign tax imposed on the tax haven corporation's underlying profits. Since the Japanese foreign tax credit system does not adopt a "basket system" like that of the U.S., where the amount of the foreign tax paid is categorized by sources of income, no "look-through" type rules are provided in computing the tax haven corporation's income for Japanese tax purposes.

Where the tax haven corporation pays a dividend to another tax haven corporation or to another foreign corporation under the control of "major Japanese shareholders" in a jurisdiction that imposes little (i.e., tax rate of 25 percent or less) or no tax on dividends, such dividend amount will not be deductible from the tax haven corporation's retained income and will be included in JAPANCO's taxable income under the anti tax haven regime.

Losses of the tax haven corporation may not be offset against the taxable income of JAPANCO, although these losses may be carried forward and applied against the income retained by the tax haven corporation in the subsequent seven years.

Upon the subsequent payment of dividends by the tax haven corporation, JAPANCO may apply for a tax deduction for that portion of the dividend attributable to the shares owned by it directly or indirectly in the tax haven corporation. This tax deduction is limited to the amount included in taxable income by JAPANCO under the anti tax haven regime during the previous 10-year period. JAPANCO will further be entitled to claim the normal direct tax credit in regards to foreign withholding taxes paid on the dividend amount and the normal indirect foreign tax credit for foreign taxes paid by the tax haven corporation on the underlying profits distributed. In this case, an adjustment will be made to reverse the prior foreign tax credits taken with respect to the profits actually distributed, which were once deemed to be distributed under the anti tax haven regime.

The anti tax haven regime will not apply where all of the following conditions are satisfied:

- *The Business Test:* The principal business of the foreign corporation is other than to hold shares or securities, provide intangible properties, know how (including the right to use the same) and/or a copyright (including any rights similar thereto), or bareboat charters of vessels or aircraft.
- *The Substance Test:* The foreign corporation has a physical place of business (office, shop or factory) in the jurisdiction where its head office is located and carries on its business through such place of business.
- *Management, Control and Operations Test:* The foreign corporation is locally managed, directed, and controlled from the jurisdiction where its head office is located.

- *Non-Related Persons Test or Local Business Test:* The principal business of the foreign corporation is:
    - wholesale, banking, trust, securities, insurance, and ship or aircraft operations, of which more than 50 percent of the principal operating revenue (or purchases in the case of wholesale, or interest cost in the case of banking) is derived from transactions directly with persons other than "affiliated persons";[31] or
    - other business that is carried out primarily within the country where its head office is located.

Where the foreign corporation meets the first three conditions but fails to meet the fourth condition, JAPANCO is entitled to deduct 10 percent of the foreign corporation's staffing costs from the undistributed profits of the foreign corporation which are subject to current Japanese taxation under the anti tax haven regime.

Capital gains and losses

Capital gains realized by JAPANCO on the sale of shares in a foreign corporation are fully taxable in Japan at the ordinary tax rates. In effect, capital gains are treated as ordinary income. There is no special capital gains tax in Japan for corporate income tax purposes. Capital losses are also included in JAPANCO's other losses and can be offset against ordinary income.

Foreign exchange gains and losses

Receivables and payables held in foreign currencies must be translated into yen at the end of every fiscal year following stipulated translation methods. Translation gains and losses are treated as taxable income and losses. A corporation may elect the translation rate of either the historical rate or year end rate for each foreign currency for both short-term and long-term foreign currency receivables and payables.

Revenue, costs and expenses resulting from foreign currency transactions should, as a general matter, be recorded using the exchange rate prevailing on the date of recording. However, the average exchange rate for the preceding week or month or the rate at the preceding week or month end or at the beginning of the current week or month may be used if applied consistently.

With regards specifically to foreign branches of Japanese resident corporations, foreign currency denominated transactions may be translated into yen using the exchange rate prevailing at the year end.

Earnings of a foreign corporation are booked when paid as dividends, unless the anti tax haven regime is applicable. Practically, the amount of the dividend is converted into yen when received and is taxed accordingly.

31 "Affiliated persons" are defined to include Japanese resident corporations subject to the anti tax haven regime, Japanese resident corporations that own 50 percent or more of the issued shares of Japanese resident corporations subject to the anti tax haven regime, and other foreign corporations through which Japanese resident corporations hold an interest in the foreign corporation resident in the tax haven jurisdiction.

General anti-avoidance

The Japanese tax authorities may apply a substance over form approach in considering transactions from a fact-finding standpoint (e.g., recharacterization of a transaction), although such approach is sometimes reversed by the Japanese courts.

The tax authorities' attitude is stricter in regards to closely held corporations because the anti-avoidance rule explicitly set forth in the Corporation Tax Act is applicable to closely held corporations. This entitles the tax authorities to disregard transactions the result of which is to unreasonably reduce the taxpayer's tax liability. Under Japanese case law, an unreasonable reduction of a taxpayer's tax liability generally means a reduction resulting from a conduct or calculation which is otherwise unreasonable from an overall business standpoint.

International tax administration

The Japanese tax authorities have various means of fostering compliance with Japan's international tax laws:

- The International Operations Division facilitates exchanges of information with treaty partners and international meetings and cooperation.
- The Director of International Examination focuses on examining the manner in which large-scale enterprises engage in international trade.
- Specialized divisions have, as their focus, the examination of international tax avoidance schemes and the collection of information on overseas assets.
- Japan is a member of the Joint International Tax Shelter Information Centre (JITSIC). JITSIC is an international initiative to identify and curb tax avoidance and shelters and those who promote and invest in them. The members, who include the United Kingdom, the United States, Australia, Canada and Japan, exchange information about abusive tax schemes, their promoters and investors.

Netherlands

This chapter provides an overview of the manner in which the Netherlands taxes the foreign source income of Dutch resident corporations under current and proposed legislation. As a general matter, Dutch resident corporations may benefit from a full exemption from Dutch corporate income tax on dividends received from foreign corporations and on capital gains realized on the disposition of shares in foreign corporations provided certain conditions are satisfied. Moreover, Dutch resident corporations may obtain relief from double taxation through various exemptions and direct foreign tax credits made available under Dutch tax laws and Dutch tax treaties.

Double taxation relief

Corporations incorporated under Dutch civil law are deemed to be Dutch resident corporations regardless of the location of their place of effective management ("DUTCHCO").[32] Corporations incorporated abroad may also be considered resident in the Netherlands if they are managed and controlled in the Netherlands. A corporation resident in the Netherlands is subject to corporate income tax in the Netherlands on its worldwide income.

The Dutch corporate income tax rate is determined based on taxable income brackets. As from January 1, 2008, taxable income up to €40,000 is taxed at 20 percent, while taxable income between €40,000 and €200,000 is taxed at 23 percent. Taxable income in excess of €200,000 is taxed at the standard corporate income tax rate of 25.5 percent.

General exemption

Based on Dutch unilateral rules for the avoidance of double taxation, relief is granted in respect of the following sources of income earned abroad:

- income derived by DUTCHCO through a foreign permanent establishment[33] or from the activities of a foreign permanent representative;
- income earned by DUTCHCO from immovable property situated abroad;
- income earned by DUTCHCO from rights to the profits of an enterprise (excluding bonds and shares in the relevant enterprise) that is managed abroad; and
- income earned by DUTCHCO from activities during a non-interrupted period of 30 days in, on or above the exploration sea of another jurisdiction.

The above applies provided the income is subject to national income tax in the relevant foreign jurisdiction.

32 This deeming rule does not apply in respect of certain provisions of Dutch tax laws including those pertaining to the Dutch fiscal unity regime.

33 Income related to foreign passive finance branches is regarded as being derived from a foreign permanent establishment.

In these instances, DUTCHCO may claim a reduction of its tax liability in the Netherlands by a percentage equal to the percentage that the foreign source income bears to its worldwide income. This relief corresponds to a full exemption from Dutch corporate income tax on the foreign source income. Where the amount of worldwide income is insufficient to fully exempt the foreign source income, the unutilized portion of foreign source income may be carried forward indefinitely to reduce future profits.

The exemption is in general computed on a country-by-country basis and is reduced by foreign losses previously deducted by DUTCHCO. This claw-back of foreign losses is also applied on a country-by-country basis.

Foreign exchange gains and losses realized by DUTCHCO in respect of the difference between the functional currency of the Dutch head office and a foreign branch are not considered foreign source income or losses for purposes of the exemption (i.e., the amount for which an exemption is available is not necessarily the same as the amount of foreign source income that is included in worldwide profits, if translation results occur).

Foreign tax credits

Dutch tax laws do not offer general relief from double taxation in regards to withholding taxes levied by foreign jurisdictions on foreign source dividends, interest and royalties earned by DUTCHCO, unless these are earned through a foreign permanent establishment, as mentioned above.

DUTCHCO may claim a direct foreign tax credit specifically in respect of dividends, other than those qualifying for the participation exemption described below, interest and royalties arising in certain developing countries, provided the item of income is subject to income tax in the relevant jurisdiction. DUTCHCO is entitled to claim the credit in respect of withholding taxes levied on dividends, interest, and royalties arising in developing countries only where it is the beneficial owner of such income items. The foreign tax credit is limited to the lower of two amounts. The first limitation is the amount of foreign withholding tax. The second limitation is the Dutch corporate income tax which is levied on the income multiplied by the net foreign source income divided by worldwide income.

DUTCHCO may further claim a direct foreign tax credit equal to one-half of the Dutch corporate income tax rate in respect of foreign taxes levied on income earned mainly (i.e., more than 50 percent) through passive group finance/investment branches. Group finance activities of a foreign branch are not considered passive where they meet certain conditions set forth in regulations issued by the Ministry of Finance. The general exemption mentioned above extends to income earned through foreign branches actively engaged in intra-group financing activities.

Where DUTCHCO receives and pays interest and/or royalties onwards, within the group it belongs to, on contracts which are connected (conduit type transactions), these interest and royalty payments are not included in its taxable base, unless DUTCHCO runs "real risks" in connection with the transaction. In this case, no relief from double taxation is available to

DUTCHCO and the Netherlands provides a notification to the payor. DUTCHCO will be assumed to bear sufficient risk in relation to interest and royalty payments received where its equity is sufficient for the absorbed risk and is at least equal to the lower of one percent of its outstanding loans and €2 million.

Tax treaties

Under Dutch tax treaties, direct foreign tax credits are generally made available to DUTCHCO in respect of withholding taxes levied on dividends, interest and royalties arising in treaty jurisdictions provided such items of income are taxable in the Netherlands. An exemption from Dutch corporate income tax is generally granted under Dutch tax treaties in respect of other sources of income earned in treaty jurisdictions (e.g., income derived through foreign permanent establishments, foreign permanent representatives, immovable property and others).

Foreign income taxes that are either exempt or reduced by a foreign government may be deemed to have been paid and are therefore included as part of foreign income taxes for purposes of obtaining a tax credit. This is possible only where a tax treaty with the relevant foreign jurisdiction provides specifically for such a "deemed" (tax sparing) credit. Where a tax sparing credit is made available, DUTCHCO may claim such credit even if the foreign withholding tax levied is lesser. Tax sparing credits are made available to Dutch resident corporations in Dutch tax treaties with certain jurisdictions such as Brazil, Mexico and China.

Deduction of foreign taxes

Where none of the above methods for double taxation relief is available, DUTCHCO may deduct income taxes and withholding taxes paid to a foreign jurisdiction in respect of foreign source income otherwise taxable in the Netherlands.

Participation exemption

Dividends (including cash dividends and dividends in kind) and other distributions (including bonus shares and "hidden" profit distributions) received by DUTCHCO on qualifying shareholdings and capital gains realized by DUTCHCO on the disposition of qualifying shareholdings are fully exempt from Dutch corporate income tax. In the event the shares of a qualifying participation are denominated in another currency other than the functional currency of the Dutch corporation, any foreign exchange gain/loss is also not taken into account for Dutch corporate income tax purposes.

Capital losses realized on the disposition of qualifying shareholdings are not deductible. However, where DUTCHCO holds a qualifying shareholding in a foreign subsidiary and the subsidiary is liquidated, DUTCHCO is permitted to deduct a loss sustained on the liquidation of the foreign subsidiary where certain conditions are satisfied.

To qualify for the participation exemption, DUTCHCO must comply with the following requirements:[34]

- DUTCHCO owns at least five percent of the nominal paid-up share capital of the relevant corporation (whether resident in or outside of the Netherlands).
    - Where the Netherlands has entered into a tax treaty with another European Union Member State pursuant to which dividend taxation is reduced according to a voting rights criterion, shares held by DUTCHCO in a corporation resident in the relevant treaty jurisdiction will constitute a qualifying shareholding for purposes of the participation exemption provided DUTCHCO controls at least five percent of the voting rights therein.[35]
    - Where DUTCHCO does not meet the requisite five percent threshold, the shareholding may still qualify for the participation exemption if another corporation related to DUTCHCO[36] owns at least five percent of the nominal paid-up share capital or of the voting rights in the relevant corporation, as determined by the circumstances.
    - Where the requisite shareholding drops below the five percent threshold, the participation exemption may still apply for a period of three years from the date the threshold ceased to be met. This is only possible, however, where the shareholding had been previously owned by DUTCHCO or a related person for more than one year during which DUTCHCO fully enjoyed the benefits of the participation exemption.
- Not more than 50 percent of the assets of the relevant corporation consist of portfolio investments which are not necessary to the underlying business operations (otherwise referred to as "free" portfolio investments). Portfolio investments held by a corporation in its line of business are considered "good" assets.
    - In applying the asset test, the assets of the relevant corporation along with the assets of its direct and indirect subsidiaries are taken into consideration. The assets held by the direct and indirect subsidiaries of the relevant corporation are taken into account on a pro rata basis (depending on the shareholding percentage held by the relevant corporation). The asset test is thus applied on an aggregated asset basis.
    - Assets that are leased or put at the disposal of group companies and assets that are used for group licensing/financing activities are generally deemed to be portfolio investments. However, exceptions to this rule apply, if for instance, the group loans are regular short-term trade receivables.

34 The participation exemption is not available to qualified investment companies resident in the Netherlands, as these are subject to a corporate income tax rate of zero percent.

35 See, for example, the Dutch tax treaties entered into with Germany and the United Kingdom.

36 Generally speaking, two corporations will be considered related where one holds a direct or indirect interest of more than 33.3 percent in the other corporation.

- Participations of less than five percent in the nominal paid-up share capital or voting rights of a particular corporation are considered portfolio investments. The following are some other examples of portfolio investments: interest-bearing bank deposits, bonds, immovable property, securities.

- All relevant assets need to be taken into account at fair market value, including goodwill and other intangible assets (this is irrespective of how the assets are recorded on the balance sheet). Moreover, the asset test is a continuous test. Changes in the composition of the aggregated assets of the relevant corporation may, therefore, affect the applicability of the participation exemption.

- Where the relevant corporation has more than 50 percent of its assets consisting of free portfolio investments, the shareholding may still qualify for the participation exemption provided the relevant corporation is subject to tax in its country of residence at a minimum tax rate of 10 percent, as determined in accordance with Dutch tax standards.

The participation exemption extends to all participations constituting equity for Dutch tax purposes, including those that may be classified as debt by other jurisdictions (i.e., hybrid instruments).

Where DUTCHCO obtains the prior approval of the Dutch tax authorities, it may apply the participation exemption to foreign exchange gains realized in respect of debts entered into to finance the acquisition of a qualifying shareholding or financial instruments hedging such foreign exchange exposure.

The deduction of expenses incurred by DUTCHCO in relation to qualifying shareholdings (e.g., interest expense) is not restricted by the participation exemption rules, but might be restricted on the basis of other provisions. Expenses incurred by DUTCHCO in acquiring or disposing of a qualifying shareholding (e.g., lawyers' fees, stock-exchange duties, and notary fees) are not deductible.

A direct foreign tax credit is not available to DUTCHCO under Dutch tax laws or Dutch tax treaties in respect of withholding taxes levied by a foreign jurisdiction on dividends received on qualifying shareholdings. In effect, as the dividends are exempt from Dutch corporate income tax, there is no Dutch tax against which to credit the foreign withholding taxes.

Specific anti-avoidance measures pertain to the application of the participation exemption:

- Where a loan made by DUTCHCO to a related corporation was written off and was then sold to a related foreign corporation, the written off amount is directly treated as DUTCHCO's taxable income for tax purposes.

- Where a loan made by DUTCHCO to a related corporation was written off and was then converted into an investment in shares, informal capital or profit participation rights, the written off amount is treated as DUTCHCO's taxable income for tax purposes in pro rata of the participation's increase in fair market value. If the participation is disposed of to a third party, no taxable income would be recognized.

- Other anti-avoidance measures pertain to the conversion of a foreign permanent establishment with accumulated losses.

Dividends received by DUTCHCO on non-qualifying shareholdings and capital gains realized by DUTCHCO on the disposition of non-qualifying shareholdings are fully subject to corporate income tax at the usual rates. DUTCHCO may generally claim under Dutch tax treaties a direct foreign tax credit in respect of withholding taxes levied by a treaty jurisdiction on dividends from non-qualifying shareholdings. Capital losses realized on the disposition of shares that do not qualify for the participation exemption are deductible.

Low-taxed investment corporations

Where DUTCHCO does not qualify for the participation exemption because it does not satisfy the second and third conditions stated above, the relevant corporation in which DUTCHCO holds the tested shareholding will be classified as a "low-taxed investment corporation".[37]

In these circumstances, the income earned by DUTCHCO from the low-taxed investment corporation is grossed up and taxed at the usual tax rates, and DUTCHCO is entitled to claim a five percent credit for the underlying corporate income taxes paid by the low-taxed investment corporation or a full credit for the underlying corporate income taxes paid by the low-taxed investment corporation if this corporation is resident in a EU Member State. The credit is only available to DUTCHCO where the low-taxed investment corporation actually owes income tax in the relevant jurisdiction. The rules which determine the mechanics of the credit for low-taxed investment corporations are complex.

The five percent credit is also allowed for capital gains realized by DUTCHCO on the disposition of shares in low-taxed investment corporations.

Valuation of foreign shareholdings

Dutch tax laws do not contain a body of rules applicable to foreign corporations otherwise referred to as "controlled foreign corporations" or "tax haven corporations" by other jurisdictions.

However, the annual increase (or decrease) in the fair market value of certain shareholdings in foreign corporations is to be included (or deducted) in computing DUTCHCO's taxable income for the relevant year pursuant to a statutory valuation rule. This will be required where:

- the shareholding is not a qualifying shareholding for purposes of the participation exemption;
- DUTCHCO owns, alone or together with related persons, at least 25 percent of the capital or of the votes in the relevant foreign corporation; and
- 90 percent or more of the assets of the foreign corporation consist, directly or indirectly, of free portfolio investments or of finance assets of passive group finance corporations, as previously defined.

37 Specific rules apply where the tested shareholding is held by DUTCHCO in a corporation that owns immovable property and such property represents more than 90 percent of the corporation's assets on a consolidated basis to allow for a full exemption.

Foreign losses

DUTCHCO may deduct foreign losses incurred by it through a foreign branch. DUTCHCO may also deduct foreign losses incurred by a foreign subsidiary, where the shares held by DUTCHCO in the foreign subsidiary do not qualify for the participation exemption. Foreign losses may be carried back one year and may be carried forward for nine years.

Inter-company interest

The “group interest box” is an election made available to strengthen the investment climate in the Netherlands and foster the establishment of financing centres. The group interest box will become legally effective and available to taxpayers when the European Commission makes its determination as to whether or not this proposed regime constitutes state aid. It is not known when this determination will be made.

The election is optional. As such, corporate groups that have interest expenses exceeding interest income may continue to deduct their interest expenses at the standard corporate income tax rate of 25.5 percent.

Where the election is made, inter-company interest income up to a maximum amount equal to the statutory legal interest on the average fiscal equity of DUTCHCO for the relevant fiscal year is effectively taxed at the rate of five percent. The regime is thus limited to financing activities funded through equity contributions. Inter-company interest income includes interest earned on short-term investments intended for the acquisition of shares, units, or other interests.

The regime is available only where all members of a group that are subject to tax in the Netherlands join the election for a period of at least three years. A corporation will form part of a group if 50 percent or more of its shares are held by another corporation or if it holds 50 percent or more of the shares in another corporation. Where the corporation holds 50 percent or more of the shares in one or more corporations, these subsidiaries also form part of the group. It is possible for unrelated parties that work together to be considered a group (“opting in” option) and for an independent member of a group to be considered unrelated to the rest of the group (“opting out” option).

The group interest box is beneficial for Dutch resident corporations that earn interest from related corporations resident in other jurisdictions. In effect, the inter-company interest is taxed at the rate of five percent in the Netherlands, while the paying foreign corporation obtains a deduction in respect of the interest payment made in computing its foreign tax liability.

Foreign exchange gains and losses computed on the valuation of loans receivable or payable are not covered by the group interest box.

Royalties from patented intellectual property

As of January 1, 2007, DUTCHCO may deduct all costs incurred in developing intangible assets.

DUTCHCO may further elect to apply the "patent box" where certain conditions are satisfied. This election is made available to encourage innovation and investment in research and development.

The election is available only where DUTCHCO has been granted a patent or breeder's right for an intangible asset developed by DUTCHCO after December 31, 2006. As such, trademarks, logos, and similar assets do not qualify. Moreover, the election is available only in respect of an intangible asset for which 30 percent or more of the expected future profits are derived from patents granted to DUTCHCO.

DUTCHCO may make the election in respect of a specific intangible asset. DUTCHCO need not make the election in respect of all other self-developed intangibles.

Where the election is made, DUTCHCO's net income from patented intellectual property, including royalty income received foreign corporations, is effectively taxed in the Netherlands at the rate of 10 percent. The 10-percent rate applies only where the net earnings derived by DUTCHCO from self-developed intangibles exceed the associated development costs incurred by DUTCHCO. Moreover, the total net earnings from intangible assets that can be taxed at the rate of 10 percent is limited to four times the total amount of development costs incurred in respect of all intangible assets covered by the election.

DUTCHCO may ordinarily claim a direct foreign tax credit under Dutch tax treaties in respect of withholding taxes levied on royalties paid by foreign corporations resident in treaty jurisdictions. The amount of such credit is generally limited to the amount of Dutch income tax attributable to the royalty income.

As of January 1, 2008, Dutch corporations may also qualify for the patent box regime where they have incurred qualified research and development costs without having been granted a patent. The patent box regime will apply only where the qualified research and development costs are expected to become part of the relevant corporation's assets after December 31, 2007.

Interest and royalty income — other

Interest and royalties earned by DUTCHCO from foreign corporations and not qualifying for the group interest box or the patent box regimes respectively are subject to Dutch corporate income tax at the regular rates. DUTCHCO may generally claim a direct foreign tax credit under Dutch tax treaties in respect of withholding taxes levied on such interest and royalty income by treaty jurisdictions.

International tax planning

As a general matter, a multinational corporation may incorporate one or more subsidiaries in the Netherlands to function as holding companies, finance companies, and licence companies within the wider corporate group. Setting up Dutch intermediate subsidiaries is advantageous, as the corporate group may then benefit from reduced withholding tax rates on passive income flowing through the Netherlands. This is generally possible by reason of the extensive treaty network of the Netherlands and corresponding reduced withholding tax rates.

Moreover, Dutch intermediate subsidiaries will often benefit from the Dutch participation exemption, such that dividends received by Dutch intermediate subsidiaries on qualifying shareholdings and capital gains realized by Dutch intermediate subsidiaries on the disposition of qualifying shareholdings are generally exempt from corporate income tax in the Netherlands.

Specific anti-avoidance measures are in place, however, to counter the incorporation of Dutch subsidiaries performing financing or licensing activities within a corporate group where such activities involve little or no risk. In these circumstances, the Dutch subsidiaries may not claim a direct foreign tax credit in respect of withholding taxes levied by foreign jurisdictions on interest or royalty payments.

General anti-avoidance

Dutch tax laws incorporate the fraus legis doctrine pursuant to which a transaction that evades the intention of the law may be disregarded. The Dutch tax authorities may apply the fraus legis doctrine where:

- the primary purpose of the relevant transaction is the avoidance of tax; and
- the acts of the taxpayer frustrate the sprit and purpose of the legislation.

Enforcement and administration

The Dutch tax authorities generally rely on the Exchange of Information clauses contained in Dutch tax treaties to access foreign information concerning Dutch resident corporations operating in treaty jurisdictions. Dutch tax laws also contain similar provisions enabling the exchange of information between jurisdictions in certain instances. The Dutch tax authorities actively pursue the exchange of information with other jurisdictions where doing so is necessary to enforce Dutch tax laws and Dutch tax treaties and is not contrary to public policy.

Sweden

This chapter provides an overview of the manner in which Sweden taxes the foreign source income of Swedish resident corporations. As a general matter, Swedish resident corporations have access to exemptions on the receipt of dividends from foreign corporations and on the realization of capital gains on the disposition of shares in foreign corporations. Swedish resident corporations further have access to direct and indirect foreign tax credits, as well as tax sparing credits under certain Swedish tax treaties, in mitigating the incidence of double taxation.

Foreign tax credits

A corporation is resident in Sweden if it is incorporated under Swedish laws and is thus registered with the Swedish Companies Registration Office ("SWEDCO"). A corporation resident in Sweden is subject to tax in Sweden on its worldwide income. Income from all business activities is aggregated as one source of income — business income — and is taxed at the standard corporate income tax rate of 28 percent.

Direct and indirect tax credits

SWEDCO may benefit from a direct foreign tax credit in respect of foreign national, provincial, and local income taxes paid on its foreign source income, provided such foreign taxes are finally assessed or withheld. The direct foreign tax credit extends to foreign taxes paid by SWEDCO on income from foreign operations carried on through a foreign branch and to withholding taxes paid on amounts received from foreign corporations.

As of January 1, 2006, SWEDCO may further benefit from an indirect foreign tax credit where it owns an interest in a Swedish partnership, a European Economic Interest Grouping or a foreign fiscally transparent legal person that earns foreign source income, provided the foreign source income is subject to tax both in the relevant foreign jurisdiction and in Sweden.

The foreign tax credit may not exceed the Swedish income tax attributable to the foreign source income (overall limitation). This maximum foreign tax credit amount is calculated by multiplying the income tax on total foreign and Swedish net income by the ratio of foreign net income over total net income. Any excess credit may be carried forward for three years.

Certain tax treaties concluded by Sweden override Sweden's domestic foreign tax credit rules and offer, in lieu thereof, an exemption from Swedish taxation on foreign source income.

Tax sparing credits

Foreign income taxes that are either exempt or reduced by a foreign government may be deemed to have been paid and are therefore included as part of foreign income taxes for purposes of obtaining a foreign tax credit. This is possible only where a tax treaty with the relevant foreign jurisdiction provides specifically for such a "deemed" (tax sparing) credit. Tax sparing credits are made available to Swedish resident corporations in Sweden's tax treaties with certain jurisdictions (e.g., tax treaty with Italy).

Deduction of foreign taxes

Foreign preliminary or final foreign income taxes paid by SWEDCO on its foreign source income and which are deemed to be expenses pertaining to its taxable income in Sweden may be deducted by SWEDCO in computing its taxable income. As discussed above, SWEDCO may also claim a direct foreign tax credit in regards to such foreign taxes. Where a credit is also claimed by SWEDCO, the amount of the available credit will need to be reduced by the amount of Swedish tax saved as a result of the deduction of the same foreign taxes.

A deduction for foreign taxes is not available to SWEDCO in regards to foreign income taxes paid on income subject to the Swedish CFC regime (see below).

Dividends from domestic and foreign corporations

SWEDCO may benefit from a participation exemption on the receipt of dividends from Swedish resident corporations and foreign corporations where certain conditions are satisfied. With regards to dividends received from foreign corporations, the participation exemption will only be available to SWEDCO where, as an initial requirement, the foreign paying corporation is deemed to be "similar" to a Swedish corporation. Although Swedish law is silent on the matter, it is widely assumed that the foreign paying corporation must, as an entity, have characteristics similar in nature to those of a Swedish corporation from a corporate law standpoint (e.g., shareholders, share capital, etc.) and be subject to corporate income tax in the relevant foreign jurisdiction.

Dividends received by SWEDCO from Swedish resident corporations and foreign corporations satisfying the above requirement may be fully exempt from tax in Sweden where the underlying shares held by SWEDCO in the paying corporation qualify as "business related holdings".

Unlisted shares will generally qualify as business related holdings where they constitute fixed business assets.

Listed shares will generally qualify as business related holdings where:

- they constitute fixed business assets;
- they have been held for at least one year by SWEDCO at the relevant time; and
- they represent at least 10 percent of the voting rights in the domestic or foreign subsidiary, or they are otherwise considered necessary for the business operations of SWEDCO or of any of its affiliates.

A dividend on listed shares received by SWEDCO before the one year period has elapsed is still treated as being exempt. Should, however, the listed shares held by SWEDCO in the paying corporation be alienated or cease to be business related within one year from the date on which they qualified as business related holdings, the dividend will be taxable to SWEDCO.

Dividends received from domestic and foreign corporations on shares that do not qualify as business related holdings are fully taxable in Sweden as business income at the rate of 28 percent.

Where the dividends received are taxable, SWEDCO may benefit from a direct foreign tax credit in regards to foreign withholding taxes levied on dividends from foreign corporations.

Dividends from EU corporations

As discussed above, dividends received by SWEDCO from a foreign corporation (including a corporation resident within the EU) may be exempt from tax in Sweden where the foreign paying corporation is deemed to be similar to a Swedish corporation and the shares in the foreign-paying corporation qualify as business related holdings (previously defined).

Where the foreign-paying corporation is resident within the European Union and is found not to be similar to a Swedish corporation, dividends received by SWEDCO from such corporation may still be exempt from tax in Sweden. This is possible where the shares in the EU resident corporation qualify as "business related holdings" following a different set of criteria. More specifically, shares in a EU resident corporation will generally qualify as business related holdings where:

- SWEDCO owns at least 10 percent of the EU resident corporation's capital;
- the EU resident corporation is listed in the EC Directive 90/435/EEC (the "Directive");
- the EU resident corporation is tax resident in the relevant EU jurisdiction under the domestic tax legislation of the said EU jurisdiction and is not tax resident in a jurisdiction outside of the EU pursuant to a tax treaty signed by the relevant EU jurisdiction; and
- the EU resident corporation is required to pay one of the taxes listed in the Directive.

Where these criteria are met, the shares held by SWEDCO in the EU resident corporation will qualify as business related holdings, regardless of whether such shares are held by SWEDCO as capital assets or as inventory. Dividends received on such shares will, in turn, be exempt from tax in Sweden.

Dividends received by SWEDCO from EU resident corporations that are not similar to Swedish corporations and on shares that do not qualify as business related holdings, as defined in this section, are fully taxable in Sweden as business income at the rate of 28 percent.

Where the dividends received are taxable, SWEDCO may benefit from a direct foreign tax credit in regards to foreign withholding taxes levied on dividends from EU resident corporations, if any.

Interest and royalty income

Interest and royalty payments received from foreign corporations are included in the taxable income of SWEDCO and taxed as business income at the rate of 28 percent. SWEDCO may, however, benefit from a direct foreign tax credit in respect of withholding taxes imposed by a foreign jurisdiction on the payment of such amounts.

Foreign losses

SWEDCO may ordinarily deduct operating losses incurred by it through a foreign branch in determining its liability for tax in Sweden. Losses may be carried forward indefinitely but may not be carried back.

Capital gains

SWEDCO may benefit from a capital gains participation exemption on the disposition of shares and other securities in Swedish resident corporations and in foreign corporations that are deemed to be "similar" to Swedish corporations, as previously discussed. More specifically, capital gains realized by SWEDCO on the disposition of shares and other securities in resident and non-resident corporations meeting the above requirement are fully exempt from tax in Sweden provided the underlying shares or securities constitute business related holdings, as previously defined, and were held by SWEDCO as capital assets (not as inventory).

Capital losses realized by SWEDCO on the disposition of shares or securities in Swedish resident corporations and in foreign corporations that qualify as business related holdings are not deductible and cannot be applied to reduce the taxable income of SWEDCO.

Capital gains realized by SWEDCO on the disposition of shares or securities in Swedish resident corporations and in foreign corporations that do not qualify as business related holdings are taxable as ordinary business income at the rate of 28 percent.

Where SWEDCO exchanges shares in a Swedish resident corporation or in a foreign corporation, no tax will generally be recognized in Sweden until the shares received by SWEDCO on the exchange are ultimately disposed of or cease to exist. This is the case regardless of whether the exchanged shares were held on capital or income account. A cash compensation of not more than 10 percent of the par value of the shares received on the exchange is allowed and is fully taxable to SWEDCO at the rate of 28 percent. A capital gain, if any, realized by SWEDCO when the shares received on the exchange are ultimately disposed of or cease to exist is fully exempt from tax where the exchanged shares qualified as business related holdings.

Shell corporations

The capital gains participation exemption is not available where SWEDCO disposes of shares in a "shell" corporation. A foreign corporation will generally only be considered a shell corporation where it is taxable in Sweden at the time of the disposition or where it, directly or indirectly, owns (or owned at some point during the three years preceding the disposition) shares in a Swedish unquoted corporation. The rules will apply where the fair market value of the cash, shares and other marketable instruments (other than shares qualifying as business related holdings) and similar assets held by the disposed corporation exceeds 50 percent of the consideration received by SWEDCO on the disposition of the shares.

The full amount of the consideration received (not only the capital gain amount) will, in these circumstances, be fully taxable in Sweden at the rate of 28 percent. A full exemption may, however, still be available where certain formalities are satisfied such as the filing of a special shell company tax return.

Controlled foreign corporation regime

Where SWEDCO owns, directly or indirectly, shares in a foreign corporation, it is subject to tax in Sweden on its share of the foreign corporation's worldwide net profit where the following conditions are met:

- the income of the foreign corporation is deemed to be subject to low taxation in the relevant foreign jurisdiction; and
- at the end of the year, SWEDCO, alone or together with persons with whom it has a community of interests, controls, directly or indirectly, at least 25 percent of the capital or voting rights in the foreign corporation.

Two corporations are considered to have a community of interests where they are part of the same consolidated group or have equity interests in each other.

As a general matter, the income of a foreign corporation is deemed to be subject to low taxation if it is not taxed at all or is subject to tax at a rate that is lower than 15.4 percent (55 percent of the Swedish corporate tax rate of 28 percent) in the relevant foreign jurisdiction. The rate of tax applicable is determined on the basis of the foreign corporation's net income computed using Swedish tax rules. As such, the nominal tax rate in the foreign jurisdiction need not necessarily be below 15.4 percent.

However, income will not be considered to be subject to low taxation where the foreign corporation is resident in and subject to tax in one of the foreign jurisdictions listed in a "white list" appended to the Swedish CFC legislation, provided the income has not been expressly excluded from such list. Within the EEA, certain income arising in Belgium, Estonia, Ireland, Luxembourg and the Netherlands has been expressly excluded from the white list. To be covered by the white list, the foreign corporation must further be eligible for treaty benefits where it is resident in a foreign jurisdiction that has concluded a tax treaty with Sweden.

Where a foreign corporation is subject to tax in a foreign jurisdiction that is not mentioned on the white list, or earns income which has been expressly excluded from the white list, or is not entitled to treaty benefits under the Swedish tax treaty with the relevant foreign jurisdiction, SWEDCO will need to demonstrate that the foreign corporation is taxed abroad at a rate of more than 15.4 percent for the CFC regime not to apply.

SWEDCO may offset losses realized by a CFC against future taxable income arising in regards to such foreign corporation under the CFC regime and may do so within three years of the realization of the losses provided it is a shareholder (direct or indirect) in the foreign corporation in the year of realization of the losses and in the year that the losses are offset. SWEDCO may also set off its own business losses against the CFC's net profits.

A foreign tax credit is further available to SWEDCO in regards to the foreign income taxes paid by the CFC on its income in the relevant jurisdiction. Withholding taxes or income taxes paid by the CFC in a third jurisdiction may also be credited against SWEDCO's tax liability in Sweden. In all instances, the credit is limited to the Swedish income tax computed on SWEDCO's portion of the CFC's income. Any surplus credit over this limit may be carried forward for three years and applied against future Swedish taxes payable on the income of the CFC under the CFC regime.

Distributions from a CFC from profits that have already been subject to tax in Sweden under the CFC regime are received by SWEDCO tax free.

SWEDCO may benefit from the capital gains participation exemption, previously discussed, on the disposition of shares in a CFC.

As of January 1, 2008, SWEDCO may obtain an exemption from the application of the Swedish CFC regime where it can prove that the relevant CFC is resident within the EEA, was established in a foreign jurisdiction for business reasons and carries on real economical activities.

International tax planning

As discussed above, the Swedish CFC regime does not apply where the relevant foreign corporation is resident in a jurisdiction listed in the white list, irrespective of the rate of tax actually paid by the foreign corporation in its country of residence, provided the income has not been specifically excluded from the white list. The white list was introduced at a very late stage in the legislative process and it is not known the extent to which the legislature investigated the underlying tax systems of the jurisdictions mentioned on the white list. Several of the jurisdictions included on the white list are extensively used in international tax structuring and offer significant tax benefits to resident corporations. As the white list is an integral part of the Swedish CFC legislation, it can only be modified through legislative process. It may thus be difficult for the legislature to stay abreast of foreign tax incentives.

Moreover, foreign investors often use a Swedish holding company as a stepping stone to foreign investments, mainly because any income imputed to the Swedish holding company in regards to such foreign investments under the Swedish CFC regime can be largely offset through an interest expense. In effect, Swedish domestic tax legislation does not include thin capitalization rules, permits an unlimited deduction for arm's-length interest expenses and does not impose withholding taxes on interest payments to foreign corporations. The foreign investors may also benefit from the capital gains participation exemption on a future disposition of the shares in the Swedish holding company.

General anti-avoidance

Under Sweden's general anti-avoidance rule, a transaction may be deemed an act of tax avoidance and may be disregarded for Swedish tax purposes where all of the following conditions are satisfied:

- the transaction, alone or in conjunction with another transaction, results in a significant tax benefit for the taxpayer;
- the taxpayer is, directly or indirectly, a party to the transaction;

- the tax benefit enjoyed by the taxpayer is assumed to have been the predominant reason for the transaction; and
- taxation on the basis of the transaction, as organized by the taxpayer, would be in violation of the purpose of the law.

Taxpayers may request a ruling from the Swedish Advance Tax Ruling Board to ascertain whether the general anti-avoidance rule would be applied in regards to a proposed transaction.

Enforcement and administration

The Swedish tax authorities are proactive in countering structures that appear to be purely tax driven. In recent years, the Supreme Administrative Court has found in favour of taxpayers and has allowed certain of the structures considered inappropriate by the Swedish tax authorities.

The Swedish tax authorities generally rely on the Exchange of Information clauses contained in Swedish tax treaties to access foreign information concerning Swedish resident corporations operating in treaty jurisdictions. Also, the Swedish tax authorities may gather additional information as a result of the requirement under Swedish banking laws that banks report all payments exceeding USD 25,000 going in and coming out of Sweden.

United Kingdom

This chapter provides an overview of the manner in which the United Kingdom taxes the foreign source income of UK resident corporations under current and proposed legislation. As a general matter, UK resident corporations have access to an exemption, subject to certain conditions, on the realization of capital gains on the disposition of shares in foreign corporations. UK resident corporations also have access, in certain cases, to foreign tax credits and tax sparing credits under UK domestic law and tax treaties in mitigating the incidence of double taxation.

Foreign tax credits

A corporation incorporated in the United Kingdom or having its place of central management and control in the United Kingdom is considered UK resident ("UKCO"). A corporation's place of management is situated where the high level strategic decisions concerning the corporation's business affairs are made. A UK resident corporation is subject to tax in the UK on its worldwide income.

UKCO may benefit from a direct foreign tax credit in respect of foreign income taxes paid on its foreign source income (provided the tax is similar to UK income tax). This includes foreign taxes paid by UKCO on income from foreign operations carried on through a foreign branch. The foreign tax credit may not exceed the UK tax attributable to the foreign source income, although any excess foreign tax credits may be carried back three years or carried forward indefinitely and set off against income from the same foreign branch.

Foreign tax credits are also available in respect of withholding taxes paid on amounts received from foreign corporations, such as interest and royalties. Again, the foreign tax credit may not exceed the UK tax attributable to the foreign source income. See below for further information regarding foreign tax credits on dividends from foreign corporations.

Foreign income taxes that are either exempt or reduced by a foreign government may be deemed to have been paid and are therefore included as part of foreign income taxes for purposes of obtaining a tax credit. This is possible only where a tax treaty with the relevant foreign jurisdiction provides specifically for such a "deemed" (tax sparing) credit.

Deduction of foreign taxes

UKCO may elect to deduct the foreign income taxes paid on its foreign source income in lieu of claiming a direct foreign tax credit. A deduction may be beneficial, for instance, in years where UKCO is in a loss position.

Foreign losses

UKCO may deduct foreign losses incurred through foreign branches in non-treaty jurisdictions or in jurisdictions having concluded a tax treaty with the UK whereby the tax treaty adopts the credit method in mitigating double taxation and the foreign branch is engaged in an active trade.

Dividends from domestic and foreign corporations

Generally, dividends received by UKCO from other UK resident corporations are not taxable (except where received by a “dealer” in the context of a trade).

Dividends from foreign corporations, including foreign corporations resident in EU Member States, are taxable upon receipt. The dividend is grossed up for underlying taxes and taxed at the normal rates of corporation tax (28 percent for large corporations), although a tax credit is available on non portfolio dividends for the foreign tax paid on the profits which have sourced the dividend.

Non portfolio dividends are those from foreign corporations in which UKCO has at least a 10-percent interest. Similarly, for UKCO to obtain relief for underlying tax in relation to any dividend paid between two lower-tier foreign subsidiaries, it is necessary for those foreign subsidiaries to be related (i.e., a minimum 10-percent relationship between the two of them).

Dividends from foreign shareholdings in which UKCO has less than a 10-percent interest do not qualify for full credit relief. Instead, only withholding taxes paid on those dividends are potentially creditable.

The maximum cap on foreign tax credits is 45 percent of admissible underlying and withholding taxes (broadly income related taxes, but not capital taxes). Any overseas tax in excess of this threshold is lost. However, only a credit up to the UK liability (i.e., 28 percent) is available against each dividend. The 28-percent cap applies at each level of the corporate structure as the dividend is paid up to UKCO.

Excess credits therefore arise on overseas tax between 28 percent and 45 percent of the dividend. “Excess” current year credits can be carried back three years, surrendered to other UK group companies or carried forward to be used against certain qualifying dividends on which a UK tax liability arises.

The “pooling” of dividends and tax credits therefore takes place in the United Kingdom and it is not possible to mix high and low rate dividends from overseas.

It is not possible to specify the profits out of which dividends are paid. Instead, only the period in respect of which the dividend was paid may be specified.

Where relief for an amount of foreign tax is available abroad (either under a tax treaty or domestic law), credit for that tax will not be allowed in the United Kingdom whether or not the overseas relief is actually claimed. In other words, underlying credits will be limited to the minimum foreign tax payable.

For the purposes of calculating credit relief, dividends which are paid up through a chain of companies in order to satisfy an acceptable distribution policy (see below) for CFC purposes are treated as ring fenced. As a result, excess credits cannot be used to reduce the tax liability on these dividends.

Foreign tax credits are not available on dividends which are tax deductible by the paying foreign corporation.

The foreign tax credit legislation has an anti-avoidance rule which applies where, generally speaking, a scheme or arrangement (with certain defined characteristics) has as its main purpose, or one of its main purposes, the objective of causing an amount of underlying tax allowable in respect of a dividend paid by a foreign corporation to be taken into account. Where such a scheme or arrangement exists, the underlying credit will be denied.

Controlled foreign corporation regime

Where UKCO controls (by virtue of having more than 51 percent voting or economic rights) an overseas resident corporation, that foreign corporation will be a CFC if it is subject to a "lower level of tax". A foreign corporation is subject to a lower level of tax if the amount of tax which is paid under the law of the overseas territory in respect of the profits of the company which arise in any accounting period is less than 75 percent of the "corresponding UK tax" on those profits.

Subject to certain defences, when the CFC rules apply, the "chargeable profits" (broadly, the profits of the company as computed under UK corporation tax principles, except for capital gains) of the CFC are apportioned to the UK resident corporate shareholders, on the basis of their respective interests in the CFC, and are taxed at the level of those shareholders. The amount of the tax liability in respect of such chargeable profits is reduced by the CFC's "creditable tax" (i.e., foreign tax on the apportioned profits which would have qualified for double tax relief had the CFC itself been chargeable to UK corporation tax).

Following the *Cadbury Schweppes* case, where a CFC has a business establishment in a country within the EEA, an election can be made to reduce any apportionment by the amount attributable to work carried out by its employees in that territory. However, whilst changes have been introduced to the CFC rules to address issues raised in the *Cadbury Schweppes* and other cases, many still believe that the UK's CFC rules are still in breach of the EC Treaty.

No CFC apportionment is required in respect of an accounting period where the CFC meets one of the following five exemptions:

- *The CFC pursues an "acceptable distribution policy":* The CFC must pay 90 percent of its net chargeable profits as a dividend to persons resident in the United Kingdom where it is taken into account in computing the UK person's UK tax charge within 18 months of the end of the accounting period.

- *The CFC is engaged in "exempt activities":* The CFC must comply with several conditions throughout the period:

    - there must be a "business establishment" in its territory of residence;

    - what it does is "effectively managed" in its territory of residence; and

    - at no time during the period does the main business of the CFC consist of either i) an investment business or ii) the dealing in goods for delivery to or from the United Kingdom or to or from connected or associated persons, unless the goods are actually delivered into the territory in which the CFC is resident; and where the CFC is engaged in a wholesale, distributive, financial or service business, the CFC must meet certain conditions in relation to the gross trading receipts from that business.

There are special conditions under which a holding company can be regarded as carrying on exempt activities. In each case, the company must satisfy two further conditions (in addition to the establishment and effective management conditions noted above):

- a business test — the business must consist wholly or mainly of holding shares or securities of companies meeting certain criteria; and
- an income test — at least 90 percent of its gross income must meet certain criteria.

- *The CFC meets the "de minimis" exemption:* This applies if the CFC's chargeable profits are less than £50,000 per annum.
- *The CFC is located in an "excluded country":* Her Majesty's Revenue and Customs (HMRC) have published a list of excluded countries. Where a company is resident in a listed country, it does not benefit from any listed tax break, and where it meets certain income and gains requirements, no apportionment falls to be made.

  The income and gains requirement is met if the CFC's "non-local source" income (broadly, income from outside the CFC's territory of residence) does not exceed the greater of £50,000 or 10 percent of its commercially quantified income.

  There is a general anti-avoidance rule which denies the excluded country exemption if the CFC has been involved in a scheme or arrangement one of the main purposes of which is to reduce UK tax.
- *The CFC meets the "motive test"*: The company must meet both of the following conditions:
  - where a transaction reflected in the profits for the accounting period reduces UK tax, then either the reduction in tax is small, or the reduction in tax is not one of the main purposes of the transaction; and
  - diverting profits from the United Kingdom is not the main, or one of the main reasons for the existence of the company in the accounting period.

Capital gains and losses

Capital gains and losses arising on the disposal of certain UK and foreign shareholdings may be exempt under the United Kingdom's Substantial Shareholding Exemption ("SSE").

The exemption will apply where the following five conditions are satisfied:

- The disposal must be by a company.
- The disposal must be of shares or an interest in shares.
- There must be a "substantial shareholding" held in the company for at least 12 months at the time of disposal. A substantial shareholding means a holding of at least 10 percent of the ordinary share capital of a company, provided that this shareholding also gives an

entitlement to 10 percent of the income of the company, and 10 percent of the assets of the company on a notional winding up. Shares held by different companies within a 51-percent group can be aggregated in determining whether the 10-percent thresholds have been met.

- The vendor/investing company must have been a trading company or holding company of a trading group for at least 12 months prior to the disposal and immediately after the disposal.

  A sole trading company is defined as "a company carrying on trading activities whose activities do not include to any substantial extent activities other than trading activities". The definition is extended to include activities carried on for the purposes of a trade that any group member is carrying on or preparing to carry on, which should allow activities that would in themselves be non-trading to be counted as trading where undertaken for the trading purposes of the group. This should include, for example, group R&D companies or group property companies, but would not include a group property company leasing property outside the group.

  A group is defined as a company and all its 51-percent subsidiaries. Non-trading activities which are wholly carried on within the group (including the holding of shares in trading companies) are ignored in evaluating whether a group is a trading group or not.

  HMRC state that they consider that substantial in this context means more than 20 percent. Consequently, a company is only regarded as trading where less than 20 percent of the results are derived from non-trading activities. HMRC suggest that some or all of the following may be taken into account as potential measurements to determine a company's status:

  - gross income of the company;
  - the gross asset base of the company; and
  - expenses incurred, or time spent, by officers and employees of the company in undertaking its activities.

  Where (as often happens) these factors point in different directions, a view must be taken in the round on the overall status of the company/group. An advance clearance procedure is available.

- The company being disposed of must have been a trading company or holding company of a trading group for at least 12 months prior to the disposal and immediately after the disposal.

  There is an extension to cover the case where the company invested in is not a qualifying company at the date of disposal, provided that a hypothetical disposal at some point in the previous two years would have been exempt. This rule is intended to apply if, for example, a company ceases to trade and is then placed into liquidation.

The SSE legislation has an anti-avoidance rule which applies where, generally, "arrangements" are made, from which the "sole or main benefit" is expected to be that a gain on a disposal will be exempt under the SSE legislation. The anti-avoidance legislation simply denies exemption on that gain.

The SSE does not apply to intra UK group transfers of shareholdings and these are on a no-gain/no-loss basis.

Proposed tax reform

In July 2007, HMRC published a discussion document entitled the *Taxation of Foreign Profits*. HMRC's stated objective of the proposals is to render the United Kingdom a more competitive jurisdiction for domestic and foreign investors and simplify the UK tax code.

The document addresses, inter alia, the potential reform of the UK CFC rules and the taxation of foreign dividends. Representations from industry and practice have been made in response to the document and it is expected that the UK government's next step will be to issue draft regulations around the Summer of 2008, with legislation possibly enacted in the Spring/Summer of 2009. The broad form in which HMRC have indicated they would like the proposals to ultimately take effect is summarized below.

CFC proposals

- The current CFC rules are to be repealed and replaced with rules relating to "controlled companies". The rules will apply to both UK and foreign-controlled corporations.
- In contrast to the existing CFC rules, the new rules will not operate in an entity-based way, but will specifically target defined mobile income.
- Most of the income covered by the new rules will be "passive income" (e.g., dividends, interest, annuities and other purchased income streams, royalties and rents).
- Income from ownership of, or rights over, intangible assets will also be regarded as passive income.
- Gains will also be included within the new regime to a limited extent. These are the gains which arise from the disposal of assets which give rise to passive income, or the disposal of assets which arise from the conversion of passive income into capital assets.
- Generally, active income will not be included in the new rules. However, income arising from dealing in goods for delivery to or from the UK, or to or from affiliates where the goods are not delivered to the territory of residence of the controlled company, will not be regarded as active income. Similarly, intra-group or UK-derived sales or service income from a "wholesale, distributive, financial or service" business will not be regarded as active income. This proposal mirrors the existing CFC provisions (see above).

Taxation of foreign dividends proposals

- There will be a full participation exemption for non portfolio (i.e., greater than 10 percent shareholding) dividends received from foreign corporations to which the proposed controlled company rules apply or where dividends are paid out of profits that would have been exempt under the new controlled company rules.

- Where non portfolio dividends are received from foreign corporations to which the proposed controlled company rules do not apply, a system of credit-based relief (similar to the current credit regime) is proposed, unless the dividends are paid out of non passive income.

- HMRC have stated that they will also look at the current inequality that exists between portfolio dividends received from UK corporations (currently exempt) and foreign corporations (where only withholding tax suffered is creditable). The options include making both i) exempt, ii) fully creditable, or iii) fully taxable.

International tax planning

Despite a raft of anti-avoidance measures introduced by HMRC over recent years, international tax planning opportunities are still available. The planning is often complex, although in broad terms, opportunities are available to:

- increase the amount of foreign tax credits on dividends paid by foreign corporations to the United Kingdom;

- debt fund the United Kingdom in order to acquire foreign assets;

- debt finance foreign corporations in a tax efficient manner; and

- ensure that foreign corporations are not regarded as CFCs, or if they are so regarded, to ensure that any CFC apportionment is diluted.

Enforcement and access to information

UKCO has an obligation to cooperate with HMRC. It must self-assess the calculation of its UK tax liability, including the liability arising from its foreign source income.

The UK tax code also requires advance clearance from HM Treasury before certain transactions can be carried out by foreign corporations which are controlled by UKCO. Such transactions include the creation or issue of shares and the creation or issue of debentures by foreign corporations controlled by UKCO.

HMRC also have other means of fostering compliance with the UK's international tax laws, including exchanges of information with treaty partners. HMRC is also a member of the Joint International Tax Shelter Information Centre (JITSIC). JITSIC is an international initiative to identify and curb tax avoidance and shelters and those who promote and invest in them. The members, who include the United Kingdom, the United States, Australia, Canada and Japan, exchange information about abusive tax schemes, their promoters and investors.

United States

This chapter provides an overview of the manner in which the United States approaches the taxation of foreign source income. The United States generally operates a worldwide tax system with respect to the income of its residents. The United States imposes worldwide taxation on U.S. persons — citizens, residents, and domestic entities (including U.S. corporations) — and source-based taxation on foreign persons.

The earnings of foreign subsidiaries of a U.S. corporation are generally not taxed until they are actually repatriated as dividends to their U.S. parent, deemed repatriated on the sale of the foreign subsidiary or deemed distributed under the U.S. anti-deferral rules under Subpart F of the Internal Revenue Code (the "Code"). Until that time, the U.S. tax on foreign source income of foreign subsidiaries is generally deferred.

To reduce double taxation on income earned in another tax jurisdiction, U.S. resident corporations may obtain relief from double taxation through both direct and indirect foreign tax credits made available under U.S. domestic tax law and through various sourcing rules available under U.S. tax law and various U.S. tax treaties.

Basis for taxation

A corporation incorporated in the United States is considered a U.S. resident or "domestic corporation" ("USCO") regardless of the location of its management. A domestic corporation is subject to U.S. corporate income tax on its worldwide income. A corporation not incorporated in the United States is considered a non-U.S. resident corporation or a "foreign corporation". A foreign corporation is subject to U.S. corporate income tax only on income that is effectively connected ("effectively connected income") with a U.S. office or fixed place of business. Effectively connected income is usually limited to income from U.S. sources but may include income from foreign sources if the U.S. office of the foreign corporation "materially" participates in the realization of such income.

Both domestic and foreign corporations are subject to federal tax on taxable income at graduated tax rates as follows:[38]

Less than $50,001	15%
$50,001 to $75,000	25%
$75,001 to $10,000,000	34%
Over $10,000,000	35%

38 All amounts in this chapter are expressed in U.S. dollars.

For increments of income between $100,001 and $335,000, a five percent surcharge applies to reduce the benefit of the lower-tier tax rates. A surtax, the lesser of three percent or $100,000, applies to taxable income over $15 million to reduce the benefit of the 34 percent tax rate. Above $18,333,333, the tax rate becomes a flat 35 percent.

Personal service corporations are taxed at a flat rate of 35 percent regardless of the amount of their taxable income. Personal holding company income of certain personal holding companies is subject to an additional 15 percent surtax.

In addition to federal tax, most U.S. states levy a state corporate income tax at corporate tax rates ranging from zero to 12 percent.

Alternative Minimum Tax

The purpose of the Alternative Minimum Tax (AMT), applied since 1969, is to prevent what is considered an overuse of tax deductions. AMT is paid to the extent it exceeds a corporation's regular U.S. corporate income tax liability. AMT is imposed at a flat rate of 20 percent on alternative minimum taxable income (AMTI) in excess of an exemption amount. AMTI is a corporation's regular taxable income adjusted to limit the tax benefits of certain deductions for depreciation and other "tax preference" items.

S corporations and other pass-throughs

Certain U.S. corporations that are held by U.S. residents that make an "S" election are not taxed as corporations. Instead, their net income passes through and is taxed directly to the shareholders.

In addition, certain other types of U.S. corporations including real estate mortgage investment conduits, real estate investment trusts, and regulated investment companies are generally treated as pass-through entities for U.S. federal tax purposes.

U.S. entity classification rules

The United States has enacted regulations that allow certain taxpayers to "elect" their entity classification status for U.S. federal tax purposes. The rules generally allow non-incorporated entities, including Limited Liability Companies (LLCs) and partnerships to "elect" corporate tax status for U.S. federal tax purposes. U.S.-incorporated corporations are considered "per se" entities and cannot elect an entity classification status other than a corporate tax status. Foreign "eligible entities" (i.e., foreign entities that are not "per se" foreign corporations), however, can elect to be taxed either as foreign corporations or foreign partnerships or foreign fiscally transparent entities. As a result of these elections, "hybrid" entities can be created (i.e., entities that are taxed in the United States differently from either their legal or foreign tax status).

Relief for double taxation

The U.S. foreign tax credit (FTC) system is detailed and complex. Foreign tax credits may generally be claimed either on a paid or accrued basis. A credit for foreign taxes paid to a foreign government cannot exceed the U.S. tax on the foreign source income, i.e., the United States will not allow foreign taxes to offset U.S. taxes on U.S. income, nor will it refund foreign taxes imposed at a higher rate than that imposed by the United States. Not all taxes paid to a foreign government are creditable. A foreign levy must be a tax, as distinguished from a fee, a fine, or other payment to a foreign governmental agency and its "predominant character" must be that of an income tax in the U.S. sense (i.e., a tax on income).

The FTC rules are generally elective. In any year, a taxpayer can elect to claim a deduction for foreign taxes paid in lieu of a foreign tax credit. The deduction for a foreign tax that is creditable and foreign tax credit for such a tax are mutually exclusive but both allowed under the U.S. tax system. The election can be made independently for each separate taxable year and can be changed any time before the expiration of the period for claiming a refund of tax. For non-creditable tax, only a deduction is allowed.

The FTC rules provide both a "direct" and "indirect" foreign tax credit mechanism. A "direct" foreign tax credit may be claimed by all taxpayers on foreign taxes paid on foreign source income earned by the taxpayer. The "indirect" foreign tax credit, however, may only be claimed by a U.S. domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation. The indirect credit is a "deemed paid" foreign tax credit that is available when a corporation receives an actual or deemed distribution from a foreign subsidiary. The amount of the deemed credit is based on the amount of foreign earnings distributed or deemed distributed by the foreign subsidiary and the underlying foreign taxes paid by the foreign subsidiary on these earnings.

Creditable foreign taxes in excess of a foreign tax credit limitation can be carried forward 10 years or carried back one year to the extent there is excess credit limitation room for a particular basket of income.

FTC basket limitation

A foreign tax credit limitation is applied on a "basket-by-basket" basis to avoid cross-crediting of taxes paid on business and investment income. The two current baskets[39] of income used are the "general limitation" basket into which most active business income is placed and the "passive income" basket (e.g., dividends, interest, royalties, and capital gains). This system permits a U.S. taxpayer to place all worldwide business foreign source income in one basket and allows the taxpayer to claim foreign tax credits on all income taxes paid on that income in that basket. The operation of the limitation produces an incentive for taxpayers to arrange the sources of their foreign income in such a way that the blended rate of foreign tax on that income is equal to or less than the effective U.S. tax rate on that income.

39 Prior to 2006, there were nine separate categories of income baskets, but for tax years after 2005, the number of foreign tax credit limitation categories is reduced to the passive and general limitation baskets.

U.S. tax treaties

In addition to the U.S. domestic tax rules, treaties entered into by the United States may affect the taxation of international income. The United States has entered into over 50 bilateral income tax treaties with foreign jurisdictions. Tax treaties have the force and effect of law. If there is a direct conflict between a treaty and the Code, the last enacted statute or treaty (i.e., last-in-time) generally controls.

Recent U.S. tax treaties typically have sourcing of income rules that are generally consistent with the U.S. domestic sourcing rules. Many U.S. tax treaties include a resourcing provision in the Articles dealing with the Elimination of Double Taxation. Article XXIV(3) of the U.S.-Canada Income Tax Treaty provides that profits, income, or gains (other than certain gains derived for the alienation of property by former residents of a contracting state) that can be taxed in the other contracting state in accordance with the convention, are sourced to the other contracting state.

Several U.S. treaties specifically limit the resourcing provisions of the treaty "elimination of double tax" article for purposes only of determining a credit for foreign taxes paid to the treaty partner, not for foreign taxes paid to a third country. Other treaties do not contain an explicit, separately-stated, treaty resourced separate basket.

In those few areas where the treaty sourcing rules produce a different result than the U.S. domestic source rules, the source rule given priority is determined under the last-in-time principle.

Treatment of foreign losses

Foreign losses are generally deductible in computing taxable income by USCO but certain FTC implications may result. A foreign loss within a separate basket must offset foreign source income in other baskets before reducing U.S. source income. If the foreign loss basket has a foreign gain in subsequent years, the loss that was allocated to income from another basket in an earlier year is characterized as income from another basket.

If USCO generates an overall loss from foreign sources in a year, whether the loss is related to business operations or an allocation of expenses to foreign sources, an "overall foreign loss" is generated. Foreign source income earned in subsequent years is resourced as domestic income to the extent of the lesser of the balance of the overall foreign loss or half of the taxpayer's foreign source income until the overall foreign loss is eventually recaptured.

"Overall domestic loss" rules also resource domestic income as foreign source income. An overall domestic loss is a domestic loss which offsets foreign source income in a year. If a taxpayer sustains an overall domestic loss in a year, domestic source net income earned in subsequent years is sourced as foreign source income to the extent of the lesser of the balance of the overall domestic loss or of the taxpayer's domestic source income until the overall domestic loss is recaptured.

Foreign losses, as is the case with domestic losses, may generally be carried back two years and forward 20 years. Specified liability losses, i.e., losses resulting from a product liability or expenses incurred in the investigation or settlement of, or opposition to, claims against a U.S. corporation on account of product liability may be carried back 10 years.

Denial of deductions

U.S. tax rules limit the deduction of any loss from the sale or exchange of property, directly or indirectly, between related persons. In addition, the deduction for the payment of interest to related foreign parties is denied until the interest is actually paid.

In addition to the deemed-paid interest limitation, the U.S. "earnings-stripping" rules limit the ability of a U.S. corporation to claim tax deductions for interest on debt owed to, or guaranteed by, certain non-U.S. affiliates (and other tax-exempt persons), i.e., limiting the ability to "strip" income from the United States.

In general, under current law, the earnings-stripping rules limit interest deductions if (i) USCO's debt-to-equity ratio for the taxable year exceeds 1.5:1 and (ii) its "net interest expense" (the excess of interest paid or accrued over interest includible in gross income) exceeds the sum of 50 percent of "adjusted taxable income" (generally, taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization and depletion) plus a prescribed "excess limitation" carry-forward. If these two conditions are met in a given year, then the lesser of excess net interest or "disqualified interest" is disallowed as a deduction for such year.

Tax consolidation

An affiliated group of U.S. corporations may elect to have their common parent file one consolidated income tax return in lieu of the filing of separate returns by each U.S. corporation. In order to consolidate, a U.S. common parent corporation of the U.S. affiliated group must own at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of at least one member of the U.S. affiliated group and the affiliated group must be connected through stock ownership with a common parent corporation through one or more chains of eligible corporations.

Generally, a foreign corporation may not be included in an affiliated group of corporations for the purposes of filing a U.S. consolidated return. In certain cases, however, the U.S. parent may elect to include a wholly-owned subsidiary incorporated in a contiguous country (Mexico or Canada) in a U.S. consolidated return group if that subsidiary is maintained solely for the purpose of complying with the laws of the contiguous country as to title or the operation of property.

Where a U.S. corporation is included in the consolidated filings of an affiliated group in a foreign tax jurisdiction, "dual consolidated loss" limitations may apply. Under these rules, the corporation's loss, referred to as the dual consolidated loss, cannot reduce the taxable income of any other member of the U.S. affiliated group.

Dividends from foreign corporations

U.S. tax is generally deferred until foreign subsidiaries' active business income is returned to the U.S., typically through a dividend to the parent corporation. Dividends received from foreign subsidiaries and affiliates are taxed upon remittance. Dividend income generally takes its source from the place of incorporation of the corporation that pays it.

An important exception to the rule of residence is the so-called 80-20 rules. Interest and dividends received from a domestic corporation is treated as foreign source income if 80 percent or more of the gross income of the payor calculated over a three-year look-back period is "active foreign business income".

Interest and royalty income

Interest, royalties and rents, and other payments received from foreign subsidiaries and affiliates are not deferred and are generally taxed on an accrual basis. Foreign source interest and royalty income is generally taxed at the standard corporate tax rates.

USCO may benefit from a direct foreign tax credit under most U.S. tax treaties with respect to withholding taxes levied by a foreign jurisdiction on the payment of interest and royalty income. Alternatively, USCO may deduct withholding taxes levied by non-treaty jurisdictions on interest and royalty payments. To the extent royalties are foreign sourced and classified as passive, they are ordinarily subject to full U.S. taxation less any foreign taxes actually paid on the royalties. On the other hand, if foreign source royalty income is active and falls within the general limitation category, U.S. tax on such income may be offset with excess foreign taxes associated with other high-taxed general limitation category income. Active characterization, and the resulting ability to cross-credit, is particularly significant for royalties because they are often subject to low or no foreign tax.

Capital gains

Capital gains of USCO are generally taxed at the standard corporate rates. A gain resulting from the sale of personal property (including shares of a corporation) is generally sourced based on the residence of the seller. Capital gains may be offset against capital losses. Corporate capital losses may be carried back two years and carried forward five years.

Gains from the sale of shares are generally taxed as capital gains unless the shares are shares of a CFC. The gain recognized on a sale or exchange or redemption of stock of a CFC is treated as a dividend to the extent of the earnings and profits that has not previously been distributed to its U.S. parent as dividends or included in income of the U.S. parent under Subpart F (see discussion below). The amount by which the gain is recharacterized as a dividend reduces the capital gain on the transaction by a like amount.

Controlled foreign corporation regime

A CFC of a U.S. domestic corporation is subject to certain anti-deferral rules generally referred to as the "Subpart F rules". Generally, a foreign corporation is a CFC if more than 50 percent of the votes or value of the corporation's stock is owned directly, indirectly, or constructively by U.S. persons that own at least 10 percent of the voting stock of the corporation.

The Subpart F rules apply only if the U.S. persons control the foreign corporation for an uninterrupted period of at least 30 days. Each U.S. shareholder must currently include in income its pro rata share of the CFC's Subpart F income, regardless of whether the income is distributed by the CFC. Subpart F income generally includes passive and other types of highly mobile income, such as dividends, interest, rents, and royalties, as well as income from certain sales and service transactions with related parties.

If a U.S. shareholder included in income actual dividends, interest, rents, or royalties from a CFC, the appropriate limitation basket for the income is determined not with reference to the character of the item of income itself but with reference to the underlying income of the CFC. To this extent, the CFC is treated as a pass-through entity or a conduit. If all of the underlying income of the CFC is active business income, all will fall into the general limitation basket.

A relief provision is available under Subpart F rules to ensure that subsequent dividends received by U.S. shareholders out of previously-taxed CFC income are not taxed again upon distribution.

Passive foreign investment company rules

To supplement the CFC rules, the U.S. adopted passive foreign investment company (PFIC) rules that apply to U.S. taxpayers who own shares in foreign corporations in which the income earned and assets held are primarily passive in nature. The taxation of PFICs does not depend on any threshold or control by U.S. persons. A U.S. shareholder of a PFIC pays tax and an interest charge on the receipt of certain distributions and upon the disposition of stock in the PFIC. A gain from a disposition is treated as ordinary income earned rateably over the shareholder's holding period of the stock in the PFIC. The shareholders must pay an interest charge (equivalent to the value of the deferred U.S. taxes) imposed on the realized gains unless they make the Qualified Electing Fund election. Shareholders of an electing fund are instead taxed currently on their share of the earnings of the electing fund.

A foreign corporation owning 25 percent or more of the stock of another corporation is treated, for the purpose of determining its status as a PFIC, as if it held directly its proportionate share of the assets of the other corporation and received its proportionate share of the other corporation's income.

International outbound tax planning

U.S. outbound tax planning strategies focus on relevant business and tax issues to defer foreign source income and to maximize the use of foreign tax credits to offset the U.S. tax on foreign source income that is repatriated. To the extent that U.S. tax rates fall relative to foreign tax rates, the importance of the minimization of foreign tax on repatriated income increases in tax planning.

Anti-inversion rules

Tax planning for U.S. based-multinational corporations often includes inversion planning. Recently enacted anti-inversion legislation, however, now eliminates the benefits traditionally available to a U.S. corporation that chooses to "reincorporate" in a jurisdiction where it and its affiliated group do not conduct meaningful and substantial business activities. The inversions targeted by the new legislation involve transactions where USCO is acquired (or substantially all of its properties are acquired) by a foreign corporation, if there is a sufficient degree of continued ownership by the former shareholders of USCO in the foreign corporation after the inversion transaction. The rules look to ownership by all shareholders, not just shareholders who are U.S. persons.

In cases where the "ownership continuity" by former shareholders of USCO is between 60 percent and 80 percent, the anti-inversion rules operate to increase the tax cost of the inversion by denying USCO the use of its tax attributes (such as net operating losses), and by imposing a tax on certain income received from related entities during the 10 year period following the inversion. In cases where the ownership continuity by former shareholders of USCO in the foreign corporation is 80 percent or more, the rules deny the traditional benefits of an inversion because they provide that the foreign corporation will, for all U.S. tax purposes, be treated as a U.S. corporation. Importantly, the statutory provision specifies that it is to override any treaty provision.

General anti-avoidance

The United States does not have one statutory overall or general anti-abuse rule. The United States, however, does have a number of judicial doctrines that have been applied in the courts to counter aggressive tax planning. The doctrine of substance over form is distinct from other doctrines. Courts are not bound by the form of a transaction chosen by the taxpayer (or by tax benefits claimed to follow from that form) where the form does not match the objective economic reality, i.e., the true nature of the transaction. The doctrines of business purpose and economic substance are related doctrines applied by courts as "tools" in certain cases to test whether tax benefits literally available under a statute or regulation should be denied because of insufficient non-tax reasons for the transaction. The theory behind the application of these doctrines is that taxpayers are not entitled to tax benefits where a transaction is not entered into with a business purpose (subjective test) or with a reasonable possibility of pre-tax profit (objective test), but instead is concocted or engineered to take advantage of a complicated tax code to claim tax benefits not contemplated by a reasonable application of the language and purpose of a statute or regulation. It is not entirely clear from case law whether the business purpose and "profit" tests are separate tests or the same test, or, if they are separate tests, whether just one of the two tests or both need to be satisfied.

Enforcement by tax authorities

The Code has stringent reporting requirements for U.S. taxpayers owning foreign property, owning interests in CFCs and PFICs, and engaging in transactions with related foreign corporations. Serious penalties may be imposed for failure to comply. In addition, the Internal Revenue Service devotes considerable resources to auditing U.S. taxpayers with respect to foreign transactions.

Prospect of tax reform

The Joint Committee on Taxation has issued several reports to the Senate Committee on Finance and House Ways and Means Committee on the effectiveness of the current U.S. international tax system and the impact of the system on the competitiveness of U.S. corporations doing business abroad. The reports to the House compared the U.S. worldwide system of taxation with selected territorial and non-territorial systems of taxation in other jurisdictions. The reports generally found no empirical evidence that the current U.S. tax system hinders the competitiveness of U.S. corporations doing business abroad.

Critics of the U.S. system of worldwide taxation have argued that a territorial tax system would increase tax competiveness. The Senate Report found no definitive evidence of this and notes that a switch by the United States to a territorial system would require a renegotiation of all existing treaties at a considerable cost because of the extensive U.S. network of bilateral U.S. tax treaties.

The reports found that the deferral of tax on income earned abroad by foreign subsidiaries of U.S corporations is an important incentive for outbound investment but that the cost of this deferral is the added complexity of the system and that the U.S. foreign tax credit limitation system is among the most important revenue features of the U.S. system of international taxation.