Main Subject 2

Key Practical Issues

TO ELIMINATE DOUBLE TAXATION

Of Business Income

PANELISTS

Carolina del Campo, Spain

Peter van Dijk, Canada

Luciana Rosanova Galhardo, Brazil

Juergen Luedicke, Germany

Larry Magid, Australia

General Reporter

Gauthier Blanluet, France

Chair

Phil West, USA

Scope

Focus on **PRACTICAL ISSUES**

Setting the Scene

Seminar C: Credit vs. Exemption Policy Issues

Seminar D: Double Taxation and EU Law

- These are concurrent

Scope

Topics Excluded:

- Indirect Taxes
- Domestic Double Taxation
    - Classical vs. Integrated Systems

Scope

Topics Addressed Only Tangentially:

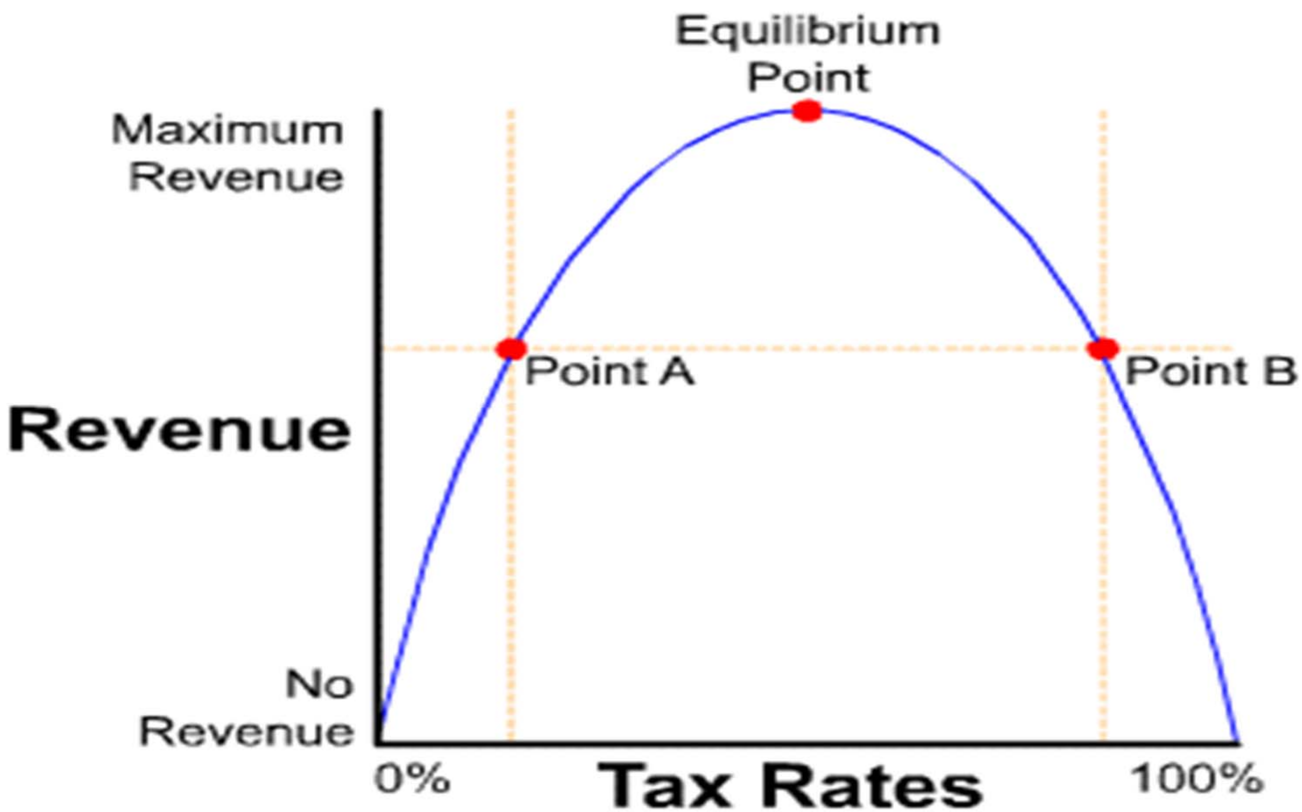
- Individual Taxes
- Double Non-Taxation
- Juridical vs. Economic Double Taxation
- Transfer Pricing

Key Messages

- Double Taxation – Why do we care?
  - Disincentive to invest and create jobs
  - Double non-taxation – level playing field issue
  - Not more government revenue – the Laffer Curve

Key Messages

The Laffer Curve:



Key Messages

- Corporations are not People

- Taxing Corporations – not a left-right issue
  - Spending revenue → politics
  - Raising revenue → efficiency

- Corporations – you get what you deserve!
  - Be transparent
  - Respect policy
  - Collaborate with policy and revenue authorities

Hypothesis #1

Relatively simple practical recommendations could, if implemented, effectively address deficiencies in current rules for eliminating double taxation of business income

Hypothesis #2

Despite conventional wisdom, **exemption systems are no better than credit systems** at eliminating double taxation

Hypothesis #3

In light of taxpayer calls for less inter-governmental coordination, **national governments already do enough** to eliminate double taxation

Taxpayer efforts: Oppose EU harmonization, OECD tax competition work, rules against tax arbitrage, etc.

Government Efforts: Domestic law relief, treaty relief, and competent authority proceedings

Summary of General Report

Conventional Wisdom

In principle, worldwide taxation systems generate double taxation, whereas territorial taxation systems do not

Worldwide taxation: residents are taxed on domestic and foreign income

Territorial taxation: residents are taxed on domestic source income only

Real World

Territorial taxation systems **do not** ignore juridical double taxation

Both systems are **equally exposed** to economic double taxation

Methods for Relief of Double Taxation

Exemption Method:

- Country of residence **excludes** foreign source income from domestic tax base of its residents
- Foreign source income may or may not be taken into account when determining rate of taxation applicable to other income

Credit Method:

- The country of residence **includes** the foreign source income in the domestic tax base of its residents, **and**
- A credit is allowed for the foreign tax due on such foreign income

Credit Methods

Full Inclusion Regime: foreign source income is taxed on a current basis

Deferral Regime: foreign source income is taxed when repatriated home

Credit Methods

Ordinary Credit Method : foreign tax reduces domestic income tax on foreign income only

Full Credit Method: foreign tax reduces domestic income tax on all income, whether foreign or domestic

Indirect Tax Credit Method: credit for underlying foreign taxes paid on foreign subsidiary profits out of which a dividend is received

Conventional Wisdom

Territorial tax systems eliminate double taxation by applying the **exemption method**

Worldwide taxation systems eliminate double taxation by applying the **credit method**

Real World

No Pure Exemption System

- Credit method applicable to passive income
- Impact of tax treaties

No Pure Credit System

- Impact of tax treaties
- Targeted exemptions, e.g. non-portfolio dividends
- Deferral rule

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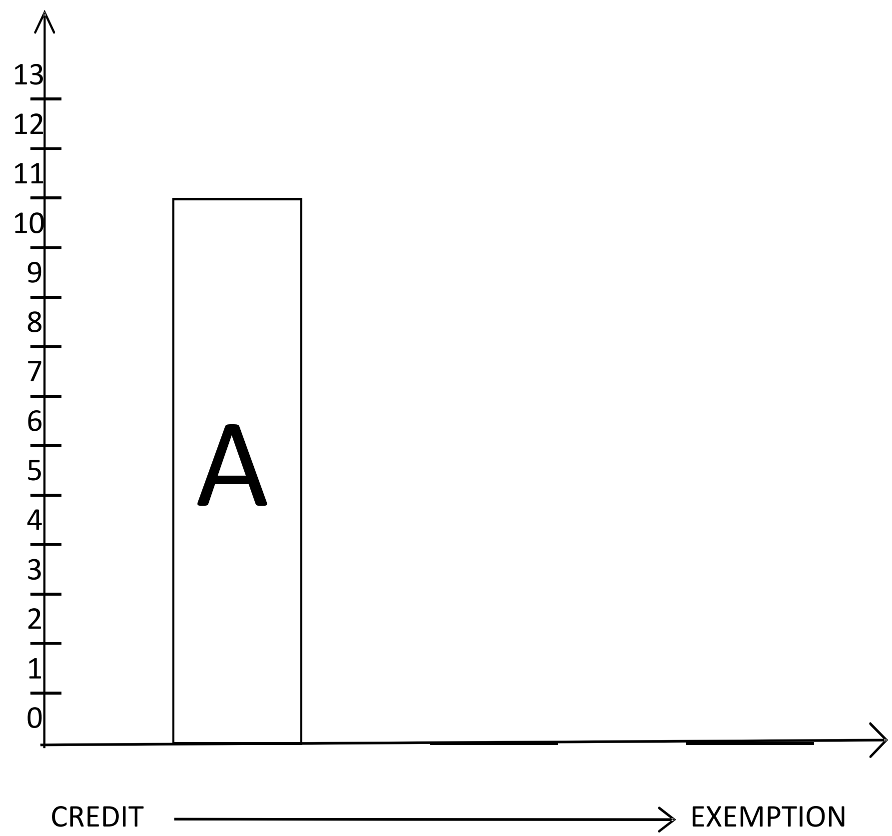
Country Classification (1)

Worldwide Taxation Group (A group)

- Credit method for active business income from foreign branches
- Credit method for foreign passive income, including non-portfolio dividends from foreign subsidiaries
- Targeted exemptions, only in a treaty context
- Norway, India, the major part of Latin America (including Brazil) and the U.S.



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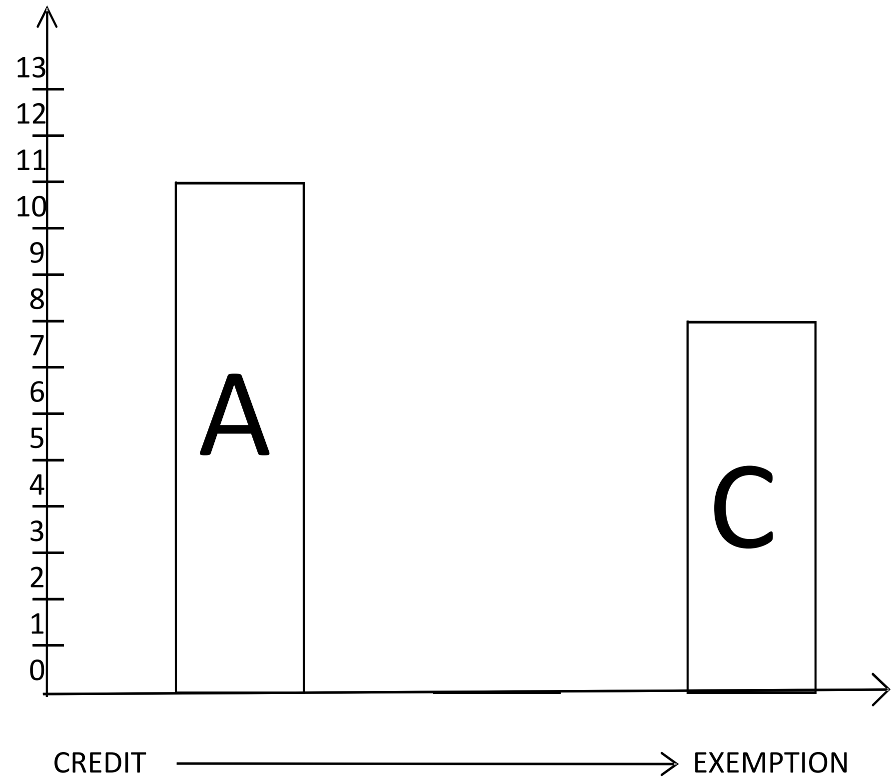
Country Classification (2)

Territorial Taxation Group (C group)

- Exemption of active business income from foreign branches
- Exemption of non-portfolio dividends from foreign subsidiaries
- Credit method for other foreign passive income
- Australia, Austria, Denmark, Estonia, France, the Netherlands, Spain and Switzerland



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Country Classification (3)

Hybrid Systems (B group)

- Credit method for active business income from foreign branches
- Credit method for foreign passive income

and

- Exemption of non-portfolio dividends from foreign subsidiaries
- Exemption of branch profits in a treaty context
- Belgium, Canada, Germany, Finland, Luxembourg, Malta, New Zealand, Poland, Portugal, Russia, South Africa, Sweden, The UK

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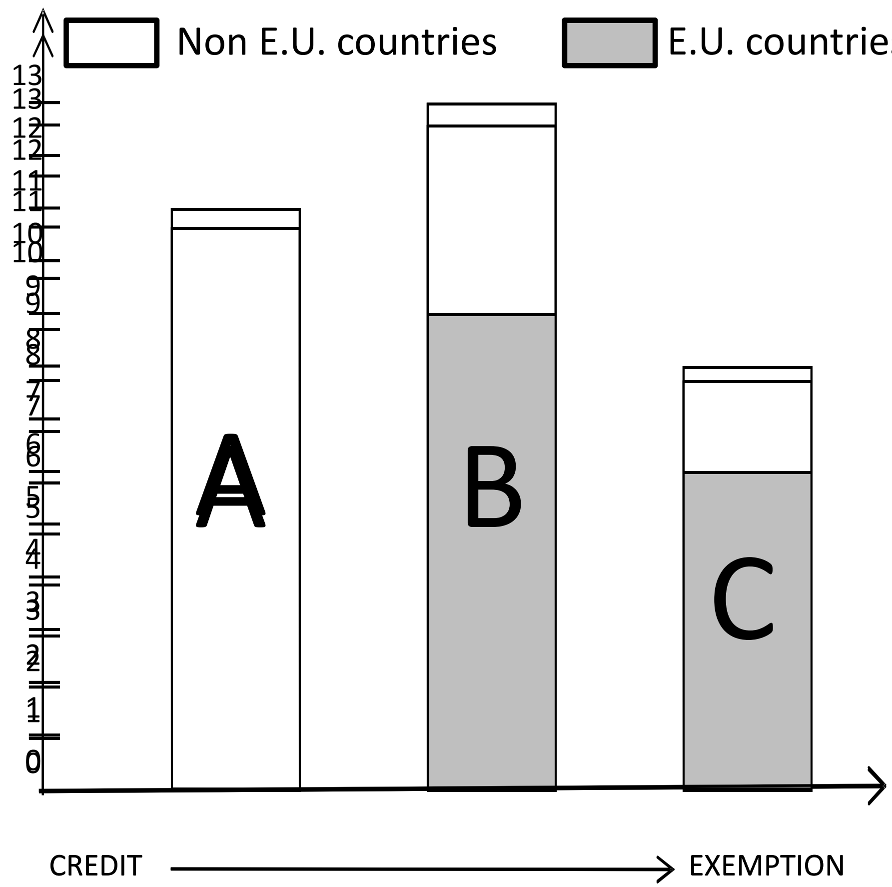

Exemption Method: Conventional Evaluation

Pros

- Simplicity
- Low administrative burden

Cons

- Need for expense allocation rules
- No deduction of foreign losses against domestic income
- High sensitivity to tax planning activity

Credit Method: Conventional Evaluation

Pros

- Low sensitivity to allocation of deduction
- Ability to deduct foreign losses against domestic income
- Low level of tax planning activity

Cons

- Complexity of rules on (i) foreign tax credit limitation and (ii) indirect tax credit
- High administrative burden

No Ideal World

Both systems generate similar risks of double taxation

Both systems are equally vulnerable to tax planning

Both systems can be complex to manage

Conventional Wisdom
vs.
Reality

Expense Allocation: Conventional Wisdom

- **Exemption system:** no deduction for expenses allocated to exempt income
- **Credit system:** deduction of expenses allocated to foreign income

→ Exemption system may lead to double taxation.

Expense Allocation: Reality

- **Credit system:**
  - – Expense allocation for calculating FTC
    - Over-allocation to foreign income
    - Inappropriately reduced FTC limitation

➔ Credit system can also lead to double taxation

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Expense Allocation: Exemption Country Example - PE

- **State of head office:** Allocation of (deductible) general overhead cost / general financing cost to head office and PEs according to ratios, e.g. assets, turnover, headcount etc.
- **State of PE:** deduction, but
  - only if directly connected to PE
  - allocation by different allocation keys

Expense Allocation: Exemption Country Example - Sub

- **State of parent:** expense allocated to participation in ForCo
  - Type (A) countries: not deductible
  - Type (B) countries: deductible (but e.g. 5% of dividends deemed non-deductible expense)
- **State of ForCo:** no deduction

➔ In case (A) economic double taxation, in case (B) partly.

Expense Allocation

Comments on U.S. System and Developments

- Rules currently apply to measure the "foreign tax credit limitation"
  - Can produce double tax, esp. interest allocation rules (introduced to address perceived abuse)
  - Rules are highly complex and often unclear

Expense Allocation

Comments on U.S. System and Developments

- The Obama Administration has proposed deferring a portion of expense deductions until related deferred income is repatriated

Deduction of Losses: Conventional Wisdom

- Two methods to eliminate double-taxation by resident state:
  - Exemption
  - Credit
- Conventional wisdom:
  - Exemption systems give rise to double taxation by denying deduction of foreign losses

Deduction of Losses: Reality

Credit systems can limit deduction of foreign losses in several ways

- Limits for deductions
- Inability to deduct foreign losses from domestic income
- Recovery of overall foreign losses and foreign branch losses

Deduction of Losses: Credit Country Example

- Brazil: Worldwide taxation since 1995
  - Foreign earnings and gains are included in income of Brazilian corporations
- But losses from foreign transactions can only be offset against foreign profits

Deduction of Losses: Exemption Country Example

France: Losses of foreign subsidiaries

- Worldwide consolidation subject to ruling
- Small and medium size businesses
- Debt waivers

Deduction of Losses: Exemption Country Example

France: Losses of foreign branches

Subsidies granted to branches may be deducted from French taxable income of the head office if:

- Commercial relationship between the branch and the head office
- Subsidy allows the company to develop or maintain its French business

Tax Planning Activity: Conventional Wisdom

- Exemption systems seem to offer a high reward for successful tax planning:
  - Outright exemption from tax in the country of residence
- They encourage tax planning (or tax avoidance) to a greater extent than tax credit systems would.

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Tax Planning Activity: Reality

- Taxpayers under exemption systems and taxpayers under tax credit systems are both rewarded for allocating (or shifting):
  - income to foreign sources, and
  - deductions to domestic income.

Tax Planning Activity: Reality

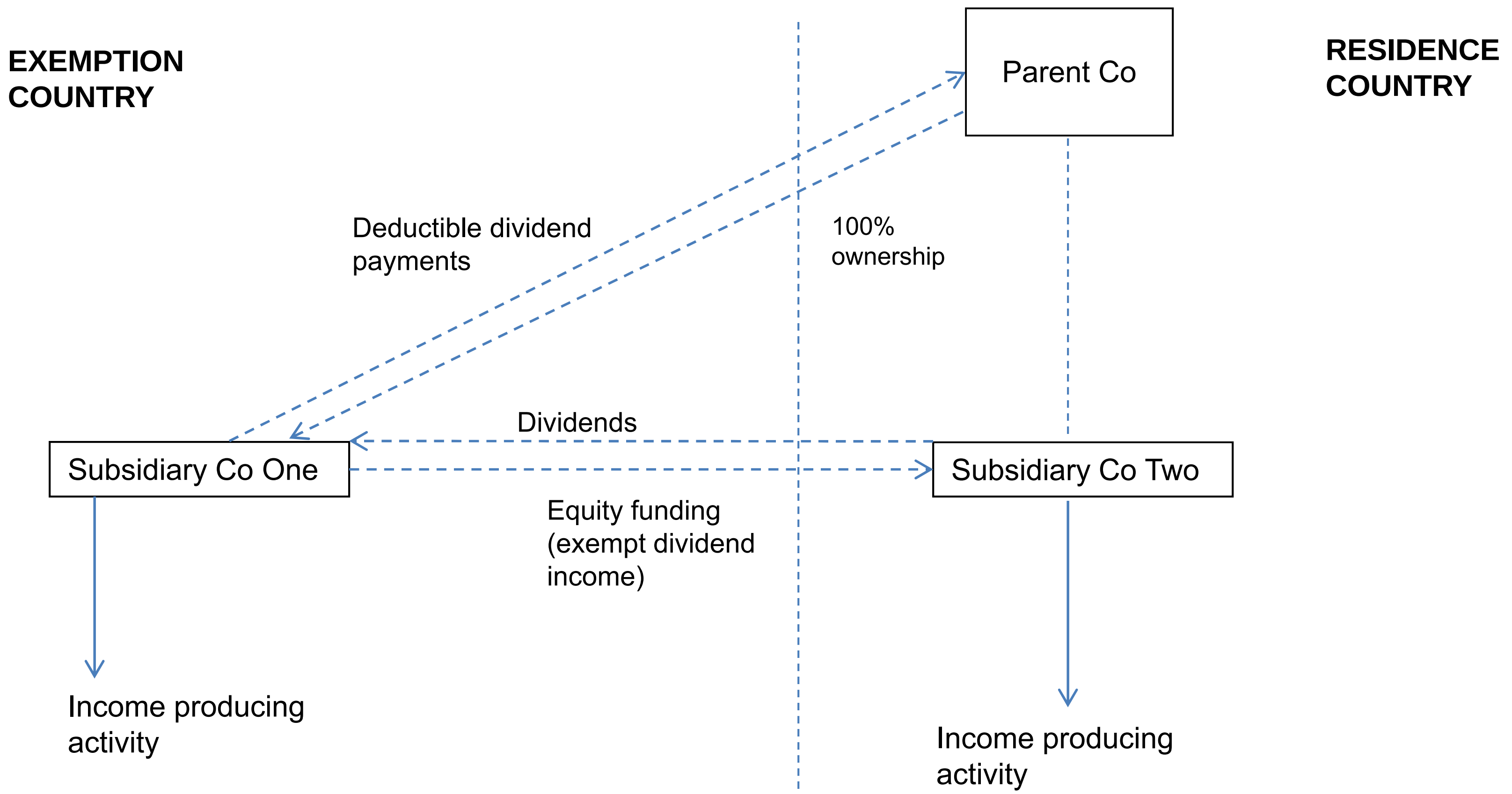
- Rewards may differ in degree, but not as much as it may seem:
  - Shifted net income is often subject to foreign tax for the exemption system taxpayer.
  - The tax credit system taxpayer may achieve lengthy deferral of residence country tax.
  - No absence of tax planning activity is detected in tax credit system countries.

Tax Planning Activity: Exemption Country Example

Exemption countries often:

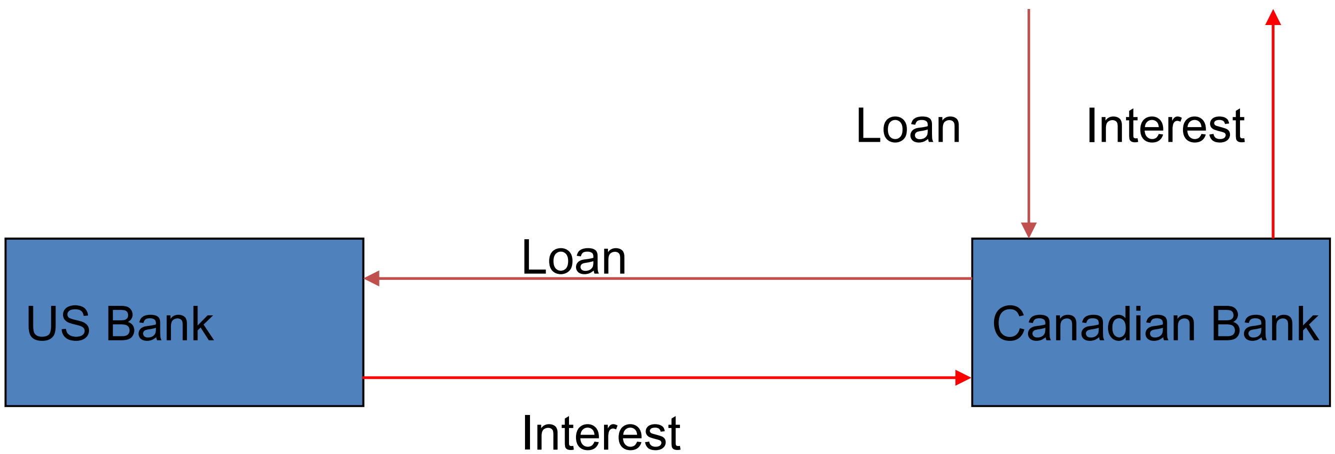
- Limit the exemption to active income (rather than passive income, which is more easily shifted);
- Impose tax by attribution on the passive income of controlled foreign companies;
- Apply anti-avoidance rules to counter artificial means of shifting income and deductions.

Tax Planning Activity: Exemption Country Example



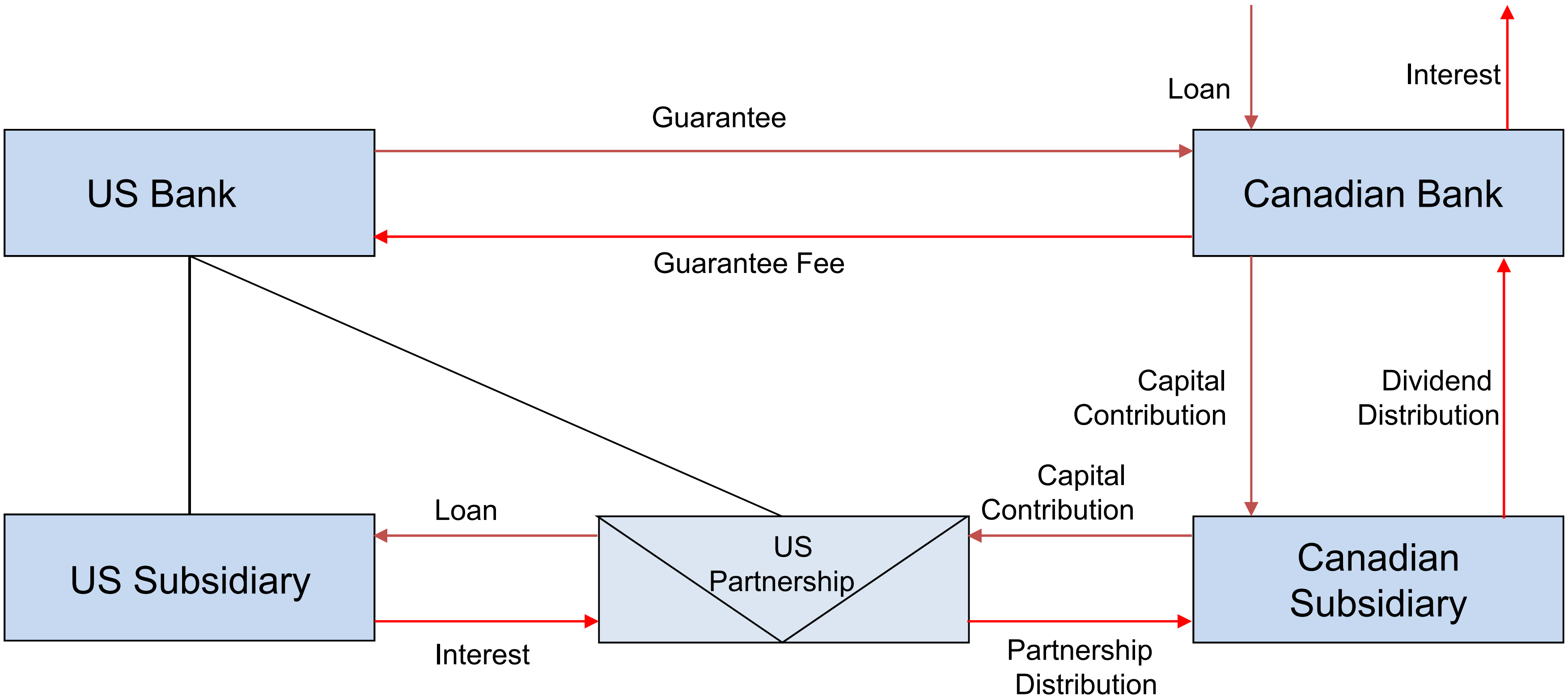
Tax Planning Activity: Credit Country Example

FTC Generator 1



- Alternative transaction: Canadian Bank lends directly to US Bank – interest on loan is fully taxable in Canada

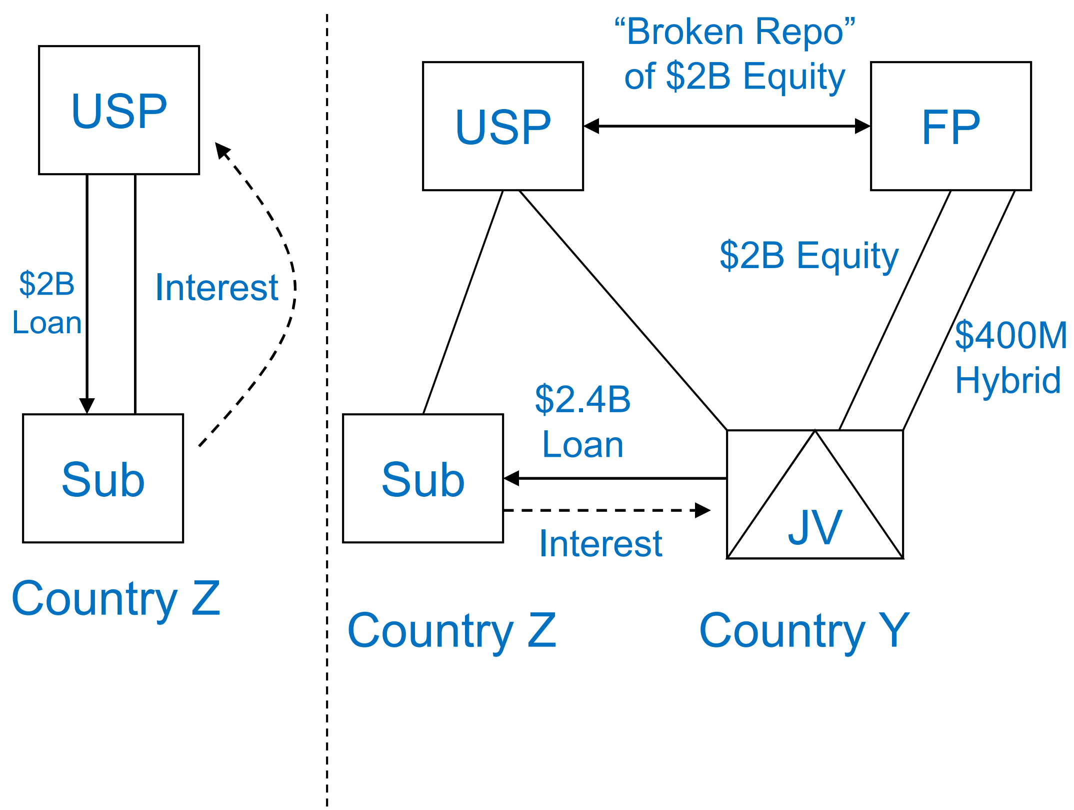
FTC Generator 1



- Partnership distribution to Canadian Bank carries foreign tax credit – Partnership distribution effectively tax exempt in Canada
- New legislation denies the foreign tax credit

Tax Planning Activity: Credit Country Example

FTC Generator 2 – Active Foreign Sub



Facts: USP finances formation of its Country Z sub with significant debt.

Country Z is about to tighten its earnings stripping rules in a manner that would deny Country Z a deduction for interest on its intercompany debt.

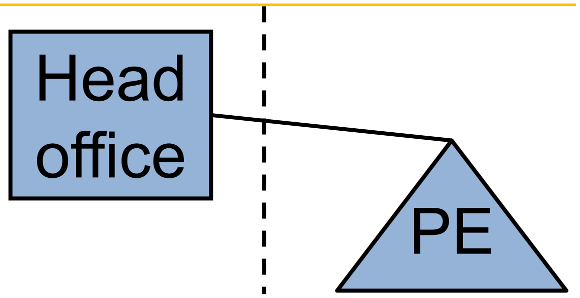
USP presented with opportunity to refinance debt (a) through structure avoiding Country Z's new earnings stripping rules & (b) at rate marginally but materially better than market rate it is currently using. The structure requires USP to invest through a JV that is subject to tax in Country Y.

Tax Planning Activity: Credit Country Example

FTC Generator 2 – Active Foreign Sub: Results

- Under Old Country Z law, the subsidiary is financed with a loan on which the interest is deductible in Country Z and taxable in the United States.
- Under new Country Z law, the interest would not be deductible in Country Z, generating taxable income in Country Z that would generate FTCs for USP.
- Under the proposed structure, the interest would continue to be deductible in Country Z, but would be taxable in Country Y.
- Are the FTCs denied in the U.S.?

Tax Planning Activity: Comment on Progressive Rates



	Alternative 1		Alternative 2	
	Year 1	Year 2	Year 1	Year 2
Head office	+100	+100	+100	+100
PE	0	0	**–100**	**+100**
CREDIT **Tax** (say)	30	30	0	**70**
EXEMPTION **Tax** (say)	30	30	0	**35**

- Progressive tax rate
- Progression clause for exempt income

➔ Different effects of PE profit and loss (Alternative 2) under CREDIT vs. EXEMPTION system

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Complexity: Conventional Wisdom

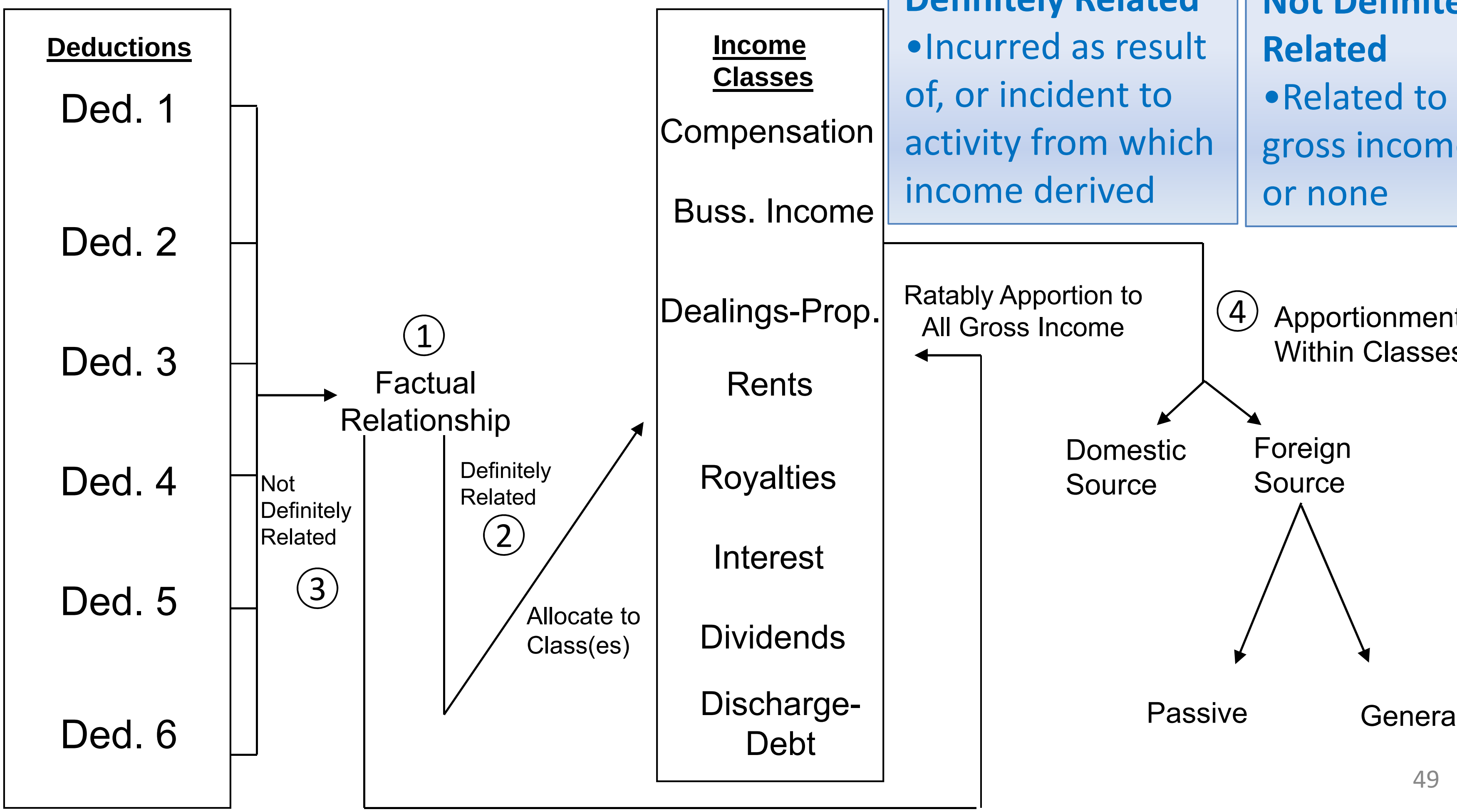
- There is a high degree of complexity in credit systems
  - Income must be defined and characterized for proper "basketing"
  - Expense Allocation
  - Very difficult indirect credit factual determinations

- How does a taxpayer obtain necessary information from lower tier entity:
  - When lack majority ownership?
  - When a dividend is paid many years after it is earned?

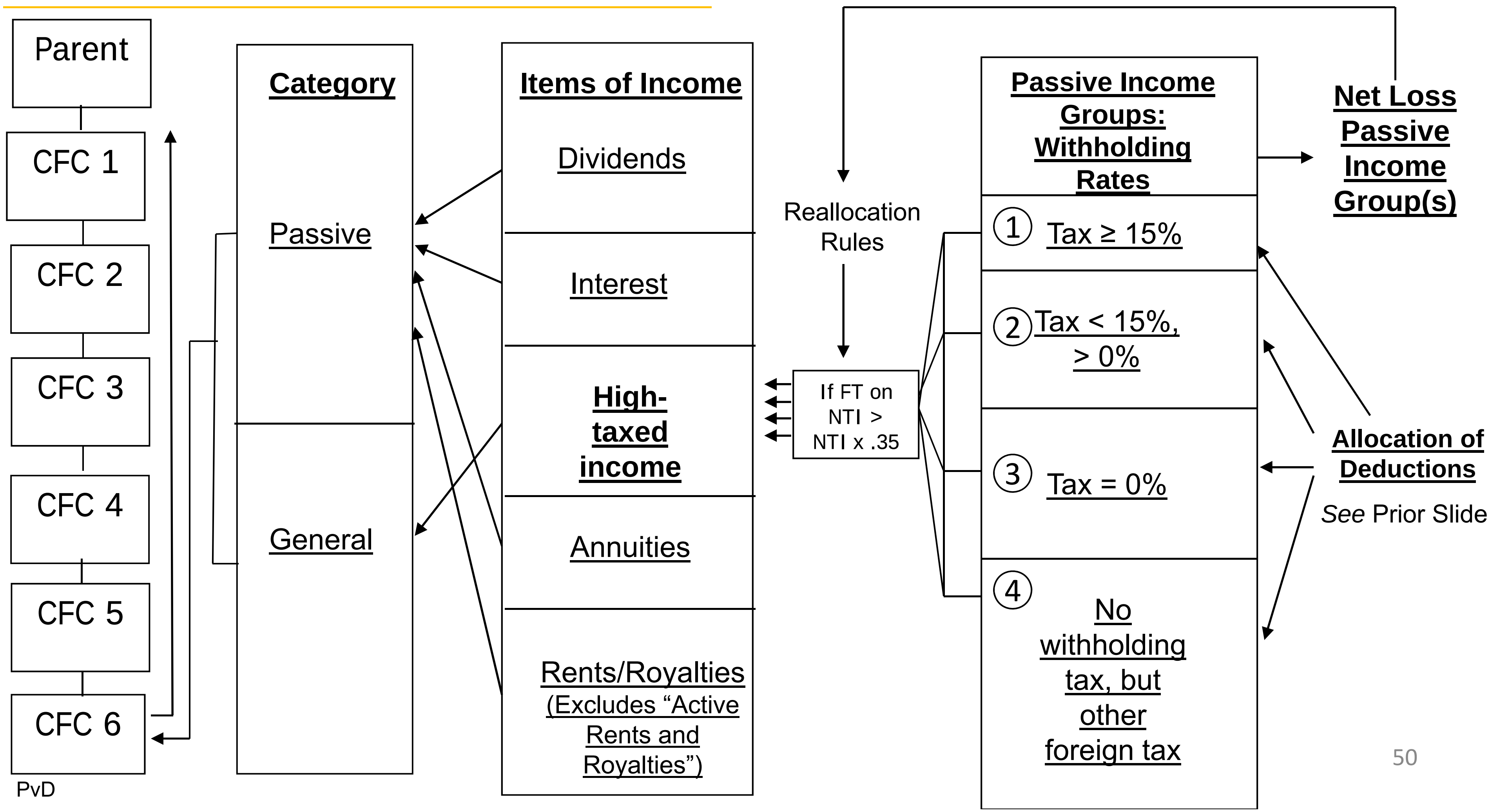
Complexity: Credit Country Example

Definitely Related
- Incurred as result of, or incident to activity from which income derived

Not Definitely Related
- Related to all gross income or none



Complexity: Credit Country Example



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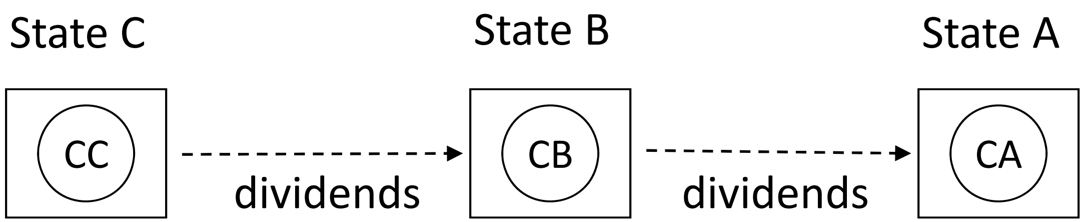
Complexity: Reality

- Exemption Systems have detailed rules for sourcing income and related expenses
  - Limited to active income
    - What is passive income?
  - Detailed anti-avoidance provisions
  - Strong transfer pricing enforcement required

Complexity: Reality

- Exemption System Complexity
  - Canadian Foreign Affiliate System
    - 3 Surplus Pools to be tracked
      - Exempt Surplus
      - Taxable Surplus
      - Mixed Surplus

Complexity: Exemption Country Example



Two requirements:

1. **Taxation**
2. **Active Income**

CdC

Complexity: Exemption Country Example

1) Taxation: CB has to be taxed

- When is it considered to be taxed?
  - ✓Similar nature
  - ✓Tax rate
- If CB is not taxed but CA is taxed, is it enough?
- Existence of DTA may eliminate requirement for non-domestic taxation

Complexity: Exemption Country Example

2) Foreign "active income"

- %
- Definition of active income
  - o Services, certain business activities,
  - o Dividends from other companies (same requirements)

Complexity: Exemption Country Example

Limitations and anti-abuse:

- Certain jurisdictions (lack of taxation or information)
- Dividends related to income that was previously deductible or not included in tax base

Examples of Other Significant Issues Creating Double Taxation

Examples of Significant Issues:

Source of Income: Listing of Potential Source Conflicts

- Existence of a PE and Attribution of profits to PE
- Allocation of expenses
- Adjustments made to PE
- Conflict of residence
- Person subject to tax

Examples of Significant Issues:

Source of Income: Example of Source Conflicts

Existence and attribution of profits to PE

- Article 5:
  - There has to be the same interpretation
  - MAP: are Competent Authorities obliged to reach an agreement?

- Article 7
  - Tax base should be calculated according to each legislation (new and old Art 7)
  - Example: different rules for depreciation: timing issues
  - In most of the cases (credit method) double taxation will not be completely eliminated

Expense Allocation

- Denial of deduction for foreign expenses and costs may lead to double taxation
  - Cost sharing

Expense Allocation

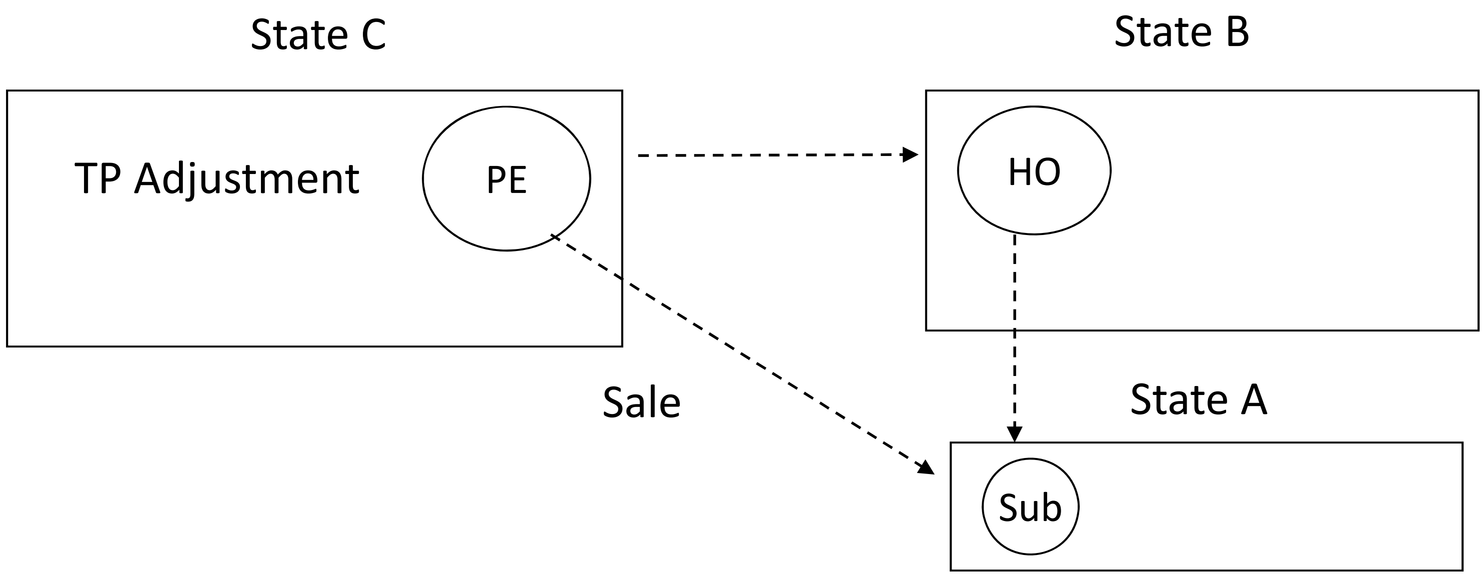
Brazil: Technological Innovation

- To incentivize domestic technological innovation, Brazil restricted deductions for technological innovation
  - Expenses may only be deducted if paid to individuals or legal entities resident and domiciled in Brazil
  - Exception for payments to obtain and maintain patents and trademarks abroad

Examples of Significant Issues:

Source of Income: Example of Source Conflicts

Adjustments made to PE



- Is C-A DTA applicable? 7, 9
- Possible solution

CdC

Examples of Significant Issues:

Source of Income: Example of Source Conflicts

Conflict of residence

Which treaty should apply?

State B

Residence Established Through MAP

State C

Payor

Income

Person X

State A

MAP A-B

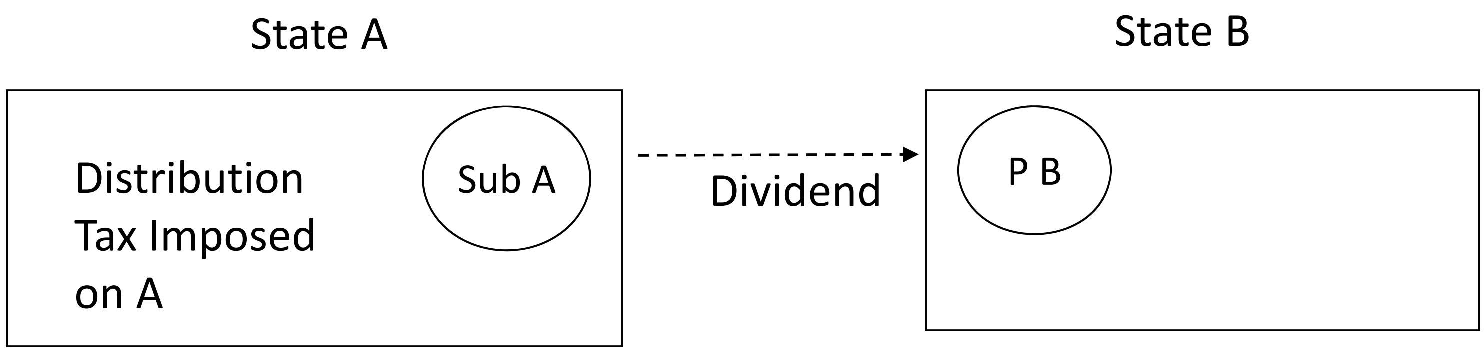
Claims Residence

- Should B eliminate double taxation in any case?

Examples of Significant Issues:

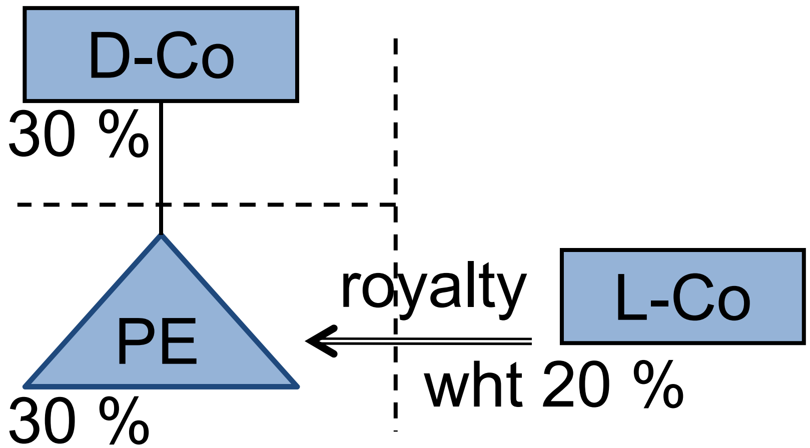
Source of Income: Example of Source Conflicts

Person subject to tax



- If withholding tax is imposed on Sub A, is PB going to be able to credit it?
- Should the Treaty address this?

Comment Regarding Triangular Case



- Tax credit in state D
  - only for PE tax?
  - also for ***L tax***?

	L	PE	D	Total
A1	**20**	**30**	30-30 = **0** ✓	**50**
A2	**20**	**30**	30-***20***-30 = -**20** **?**	**30**
B1	**20**	30-20 = **10**	30-10 = **20** **?**	**50**
B2	**20**	30-20 = **10**	30-***20***-10 = **0** ✓	**30**

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Examples of Significant Issues:

Character of Income

Listing of Potential Character Conflicts

- Technical Services vs. Business Profits
- Dividends/Business Profits vs. Interest

Examples of Significant Issues:

Character of Income: Example of Character Conflict

Services vs. **Business Profits**

- Controversy over application of tax treaties
  - Renault Case: Brazil vs. France
    - Services performed outside Brazil to help establish Brazilian plant
    - Article 7 (Business Profits) should apply to avoid withholding tax: Taxpayer had no PE
    - Tax authority position: service payments not within Article 7, but within Article 21 (other income) → WHT

Examples of Significant Issues:

Character Conflicts: National Responses

- Some treaties avoid double taxation by providing explicitly that payments for technical services are treated as royalties
  - E.g. Norway-Brazil, Hungary-Brazil, Spain-Brazil and Portugal-Brazil treaties

- Other treaties expressly authorize the assessment of WHT on technical services, provided that the residence state credits
  - E.g. Brazil-Belgium and Brazil-Argentina treaties

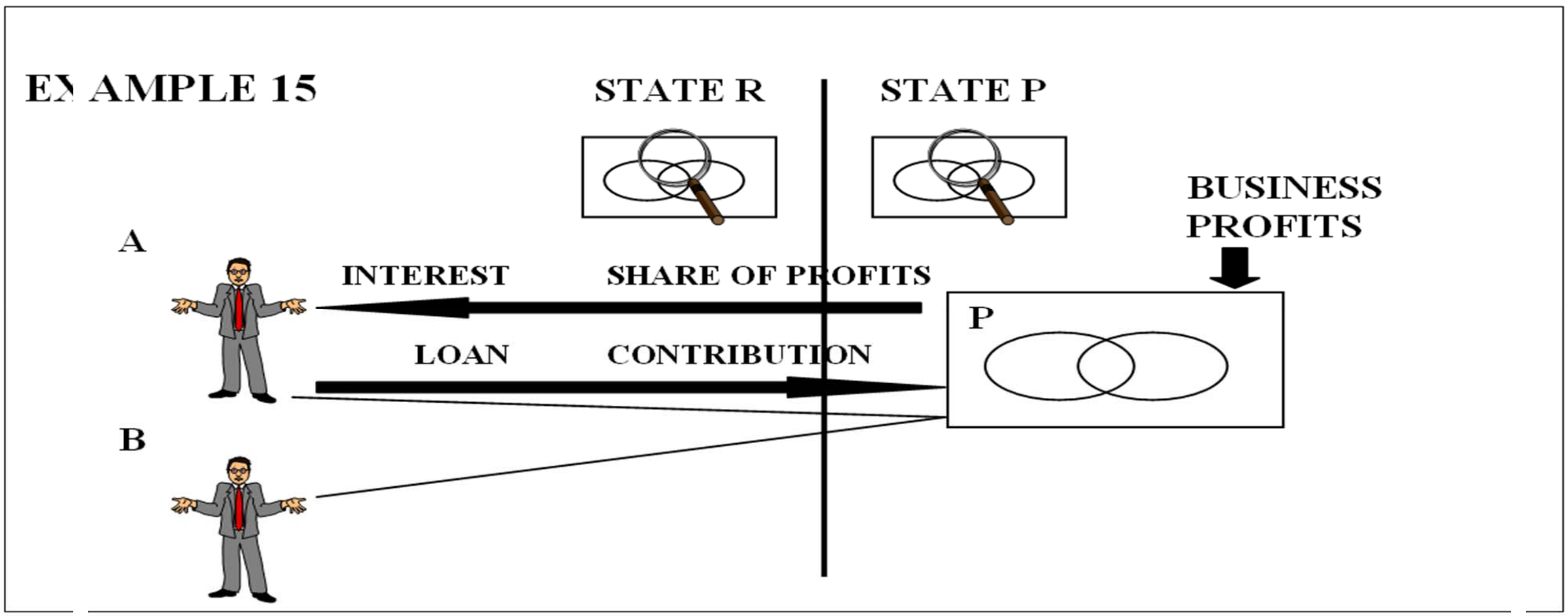
Examples of Significant Issues:

Character of Income: Example of Character Conflict

Interest vs. **Business Profits/Dividends**

- Controversy over application of Tax Treaties
  - Can interest on loans between related parties be deemed business profits or dividends?
  - Depends on domestic tax law and the relevant tax treaties
  - Both domestic law and treaties may lead to double taxation

A makes a loan to partnership P; P pays interest to A; State R recognizes loans between partners and partnerships but State P does not; both States apply Art. 7 to the income of P, but State R considers that Art. 11 should apply to the payment made to partner A.



Examples of Significant Issues:

Entity Classification: Listing of Potential Classification Conflicts

- Inconsistent classification of entities can prevent double tax relief
- Companies or partnerships may be transparent in one country, opaque in another
- Group status in one country may not be recognized in another

Examples of Significant Issues:

Entity Classification: Conflict Example

- Source country taxes owner of transparent entity
- Residence country treats entity opaque:
- Denies FTC: owner did not derive income subject to tax
- Delays FTC: owner did not derive income until later distributed

Examples of Significant Issues:

Entity Classification: Conflict Example

- Treaty resident owners of transparent investment vehicle denied treaty relief:
- Source country treats vehicle as opaque
- OECD: source country should apply residence country classification to allow relief

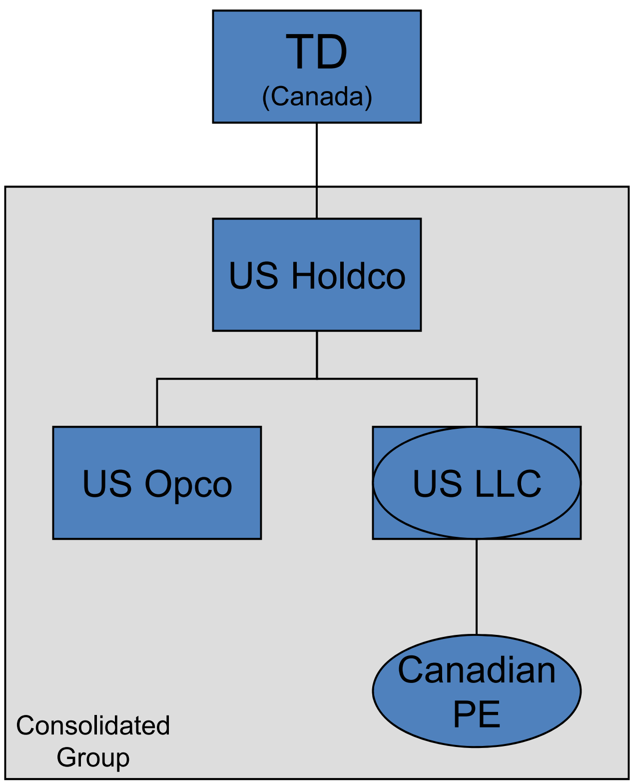
Examples of Significant Issues:

Entity Classification: National Response

- Flexible treatment of hybrids to allow FTC more common (example: Australia)
- Increased adoption of Treaty provisions to look through entities disregarded by residence country (examples: Australia-NZ, Australia-Japan, Germany-UK, many US treaties)

Examples of Significant Issues:

Entity Classification: Classification Conflict Example

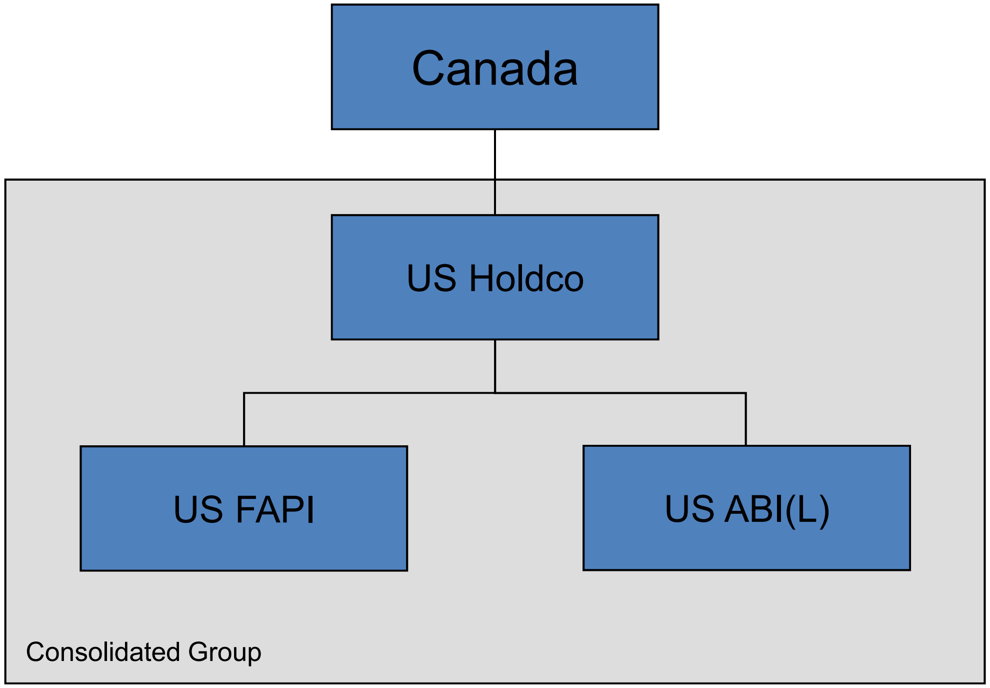


- US LLC is disregarded for US tax purposes and corporation for Canadian tax purposes
- Canadian PE remittances subject to 25% branch tax – reduced to 5% under US-Canada Tax Treaty
- **Question:** Is US LLC resident under US-Canada Tax Treaty – Is US LLC "liable to tax"?
  - CRA says No – Tax Court of Canada says Yes
- Issue addressed in new US-Canada Treaty, effective 12.15.2008 (see Art. IV)

Examples of Significant Issues:

Example of Credits Realized in Loss Years

Canadian CFC rules – Canadian parent with US subs



Practical Implications

Recommendations

- Treaties
  - Follow the treaty!
  - Treaty relief for double taxation of dividends
  - Expanded MAP arbitration
  - Allow the application of MAP to PE
  - Broader inclusion of provisions for fiscally transparent entities
    - Or include a clause to resolve discrepancies (e.g., follow a residence definition)
  - Allow credit by payee even where payor is liable, e.g., for dividend distribution tax

Practical Implications

Recommendations

- Reconsider inability to deduct foreign losses (with recapture?)
- For Credit Countries
  - Move to exemption system???
  - Adopt source countries' treatment of source, character, identity of taxpayer
  - Extend FTC carryforward period
  - Accept that:
    - Income may originate in more than one country
    - All taxes (at least income taxes) are eligible for credit
    - All taxes (at least income taxes) are eligible to be reduced by FTC

Testing the Hypotheses

True or False?

Relatively simple practical recommendations could, if implemented, effectively address deficiencies in current rules for eliminating double taxation of business income

Testing the Hypotheses

True or False?

Despite conventional wisdom, **exemption systems are no better than credit systems** at eliminating double taxation

Testing the Hypotheses

True or False?

In light of taxpayer calls for less inter-governmental coordination, **national governments already do enough** to eliminate double taxation

Thank You