THE COMPETITIVE BURDEN:

TAX TREATMENT OF U.S. MULTINATIONALS

By Ernst & Young

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A Tax Foundation Special Report

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Price: $10.00
$5.00 for members
Add $2.00 postage and handling

Acknowledgements

Ray Haas, an international tax partner, Ernst & Young, located in New York, is the author of this study.

The following people assisted in its preparation, review and updating:

Masatami Otsuka, Of Counsel, Jones, Day, Reavis & Pogue, New York

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Table of Contents

THE COMPETITIVE BURDEN: TAXATION OF U.S. MULTINATIONALS

Introduction

On September 12, 1991, the Ways and Means Committee of the U.S. House of Representatives concluded ten days of hearings on factors affecting U.S. international competitiveness. Hopefully, these hearings will act as a catalyst to spark more interest in the issue of how U.S. tax policy affects the ability of U.S. multinationals to compete in a global market place.

This paper has a slightly more narrow focus than the Ways and Means Committee hearings, but also addresses the ability of the U.S. multinationals to compete abroad. The purpose of the paper is to compare the United States' treatment of its multinationals to the way multinational corporations are treated under the tax policies of three of our international competitors: The Netherlands, Japan, and Germany.

The Research and Policy Committee of the Committee For Economic Development in a Report released in July 1987, titled "Toll of the Twin Deficits" (Budget and Trade), p. 58, states:

> "U.S. tax policy as applied to the taxation of foreign income should be sensitive to avoiding unreasonable and detrimental burdens on international trade. This is particularly so when our major trading partners do not impose similar burdens on their own multinational firms.
>
> "The tax legislation of 1986 contains a series of provisions relating explicitly to the international operations of U.S. firms. It is widely acknowledged that these provisions were developed with little attention to their likely effects on international competitiveness. We are concerned that these provisions could have serious adverse effects on the competitive position of U.S. firms ..."

This study has, therefore, selected for detailed analysis four major international trading countries, each illustrating a somewhat different tax policy toward its own multinational companies: the United States, The Netherlands, Japan and Germany. (See the detailed analysis of the system used by each in the taxation of its multinationals in Appendices Nos. 1, 2, 3 and 4, respectively and a summary comparison of the four countries highlighting the results of the study in Appendix No. 5.)

The overall systems of these countries, while similar in many respects, differ significantly in certain key aspects that affect the relative competitiveness of their multinationals. These differences provide valuable insights into the type of tax policies that will promote United States multinational competitiveness.

No attempt has been made to analyze the tax systems of all the international trading countries, since the tax systems of the countries chosen illustrate most of the tax policy questions involved and a wide range of solutions.

In making this study of the four tax systems, the key elements of each of the systems have been analyzed and compared in order to assess the relative competitive tax positions of the multinationals of each nation. The clear conclusion of this analysis is that The Netherlands' multinationals have a strong competitive tax advantage over the multinationals of the other countries studied, since The Netherlands has long followed the policy that is referred to as the "territorial" tax system. Briefly stated, that system looks generally on all income earned by its multinationals outside its own territory, through a foreign business presence, as exempt from tax if that income is actually (or in theory) subject to any foreign income tax.

This recognition by The Netherlands of the right of foreign jurisdictions to tax operations within those jurisdictions allows Netherlands multinationals to conduct their foreign operations according to normal economic and business principles undistorted by economic and fiscal pressures in the home country. The Netherlands' policy considers that the parent company residence or nationality of a multinational, or its stock ownership in a foreign subsidiary, does not earn for it the right to reach beyond its territorial limits in its search for revenues. The result is that from a tax perspective, The Netherlands' multinationals are able to compete more effectively than those of the other three countries studied.

By way of contrast, the United States has *de facto* adopted exactly the opposite policy. Over the last 15 years, while expressing support for the principle of avoidance of double taxation and the integrity of legal foreign corporate entities, the United States has reached farther and farther into the foreign operations of its multinationals, imposing increasing tax burdens and administrative complexities. This continuing effort to bring more foreign revenues into the net of current taxation, and to restrict the usefulness of the foreign tax credit, represents an overreaching policy and implementation of global tax jurisdiction.

As a result, the United States subjects the foreign operations of its multinationals to the severest tax constraints and the heaviest tax burden of any of the four countries studied. For example, for the taxable year 1984, the latest year for which statistics are available, and well before the numerous and severe changes in the taxation of foreign source income by the Tax Reform Act of 1986, the IRS Statistics of Income (Fall of 1989, IRS Bull., Vol. 9, No. 2, pg. 31 et seq.) reports that Subpart F income subject to United States tax amounted to $4.4 billion for the year. This means that $4.4 billion of foreign subsidiary earnings of United States controlled foreign corporations were subject to current United States tax whether or not remitted to the U.S. parent corporation. In contrast, were these operations controlled by their Netherlands competitors, earnings retained abroad would in no circumstances have been subject to home country tax, and, in most cases, the same result would apply even if the earnings were remitted back to The Netherlands.

While Japan and Germany have systems for taxing their own multinationals, which are somewhat similar in form to that of the United States, neither applies them as broadly. For example, with respect to income from operations of its multinationals in foreign countries with which Germany has an income tax treaty, the territorial principle, similar to that of The Netherlands, applies. Likewise, the German and Japanese rules preventing deferral of home country taxation are much narrower in application than the United States rules. Furthermore, they give a credit against home country tax for foreign taxes paid, with a minimum of restrictions, and have rules governing the foreign tax credit that are not nearly as onerous as are those of the United States. Thus, the multinationals of Japan and Germany are somewhat disadvantaged in their tax burdens vis-a-vis The Netherlands, but are far less burdened than their United States competitors.

Of the nations studied, only the United States has not adopted a policy of "tax sparing." Under that policy, The Netherlands, Japan and Germany have entered into tax treaties with developing countries, which provide that if the host country exempts income from local taxes as a local incentive, the home country of the multinational will not impose its tax fully on that income. In other words, it will "spare" the income from tax by giving a credit against its tax equal to an amount based on the tax "deemed" paid to the host country. These treaties and/or a home country policy that provides an outright exemption for foreign earnings from home country tax, allow the multinationals of the other three countries to tap the low cost labor and raw material markets in developing countries at a much lower after-tax cost than is possible for their United States competitors. Thus, United States multinationals are at a competitive disadvantage.

Technical Considerations in Making the Comparisons

This analysis compares the impact of the tax systems of each of the four countries studied on the international operations of their multinationals. This, in turn, allows a determination of whether, and to what extent, United States multinationals' operations are helped or impaired by the United States tax system, as compared to multinationals based in, and subject to the tax systems of, the other three countries studied. The tax systems of all four countries are different, and a more technical and detailed analysis of their treatment of international operations is contained in the various appendices attached. Also included in these appendices are any announced tax reform proposals *known at this time*.

There are three primary attributes that establish the basic framework for the taxation of the international operations of multinational companies:

[1] Rules relating to the exemption or deferral of home country tax on foreign operations and income;
[2] Foreign tax credit utilization rules that determine the ability of a company to offset home country tax on foreign operations by taxes paid to foreign countries; and
[3] The extent to which tax treaties are used to modify the above rules.

Exemption or deferral is the ability of a company to eliminate permanently, or postpone, home country taxation on income from foreign operations.

With respect to the foreign tax credit system, which is a common feature of the tax systems of all four countries, two basic principles apply:

First, the foreign taxes that may be credited against home country tax must have been levied on foreign source income. That is, the credit can never reduce the home country tax on home country source income.

Second, the amount of the foreign taxes that may be credited may not exceed the amount of home country taxes that would otherwise be payable in respect of such foreign source income.

Most multinationals do not operate in a single country and they normally view their tax liability as an average effective rate for all their operations. Thus, the issue that concerns them is the ability to conduct foreign operations in high tax countries and to offset excess taxes paid in such countries against low taxed foreign source income from some other country. If the total of foreign taxes paid on foreign source income equals or exceeds the home country tax, no additional tax should be due. To the extent such an offset is not available, the multinational company's worldwide tax liability increases and its competitiveness decreases.

Some of the other relevant areas of comparison, which are handled approximately in the same fashion in each country studied or the enforcement of which is too subjective to allow a comparative assessment, have been omitted from this analysis. Among them are the following:

[1] Intercompany pricing on inventory sales.
[2] Outbound transfers of assets to foreign operations.
[3] Final home country taxation on the disposition of foreign operations.
[4] Foreign currency issues.

§1.01 Exemption or Deferral of Home Country Tax

Each of the countries studied has a significant, fairly high national corporate income tax rate. Depending on the degree to which a domestic corporation distributes its profits to its shareholders (and disregarding, for purposes of this analysis, the second level shareholder tax), the nominal corporate tax rate is in the 34% to 50% range. This rate is not at all atypical for developed, industrialized nations, but is, as one would expect, far higher than the effective tax rates prevailing in developing countries, which wish to provide incentives for locating operations there (*e.g.*, Ireland and Singapore).

The nominal national tax rates on undistributed income of the four countries analyzed put both Japan (45% including inhabitant's tax) and Germany (50%) at the high end of the range, and the United States (34%) and The Netherlands (35%) at the low end. In addition, multinationals in the United States, Japan and Germany are also subject to significant local taxes.

It would be a mistake, of course, to consider only the nominal tax rates in comparing these four countries. Instead, the issue addressed in this analysis is whether these higher nominal tax rates translate into high effective tax rates on the international operations of multinational corporations, when those nominal rates are combined with exemption or deferral, foreign tax credit and tax treaty provisions.

When the operation of all these provisions is considered, as hereinafter described, the United States is at the highest end of the effective tax rate scale on foreign operations of its multinationals. Paradoxically, it is clear that under the Tax Reform Act of 1986, United States multinationals, while receiving a reduction in the nominal tax rate, have in many cases found their tax liability on foreign source income actually increased due to other changes made by that Act.

[1] Inclusion of Foreign Operating Income and Dividends from Foreign Subsidiaries in Home Country Tax Base

The United States requires full inclusion of all income earned abroad, regardless of the form in which it is eventually realized by the United States company, with the exception of part of the profit earned on export profits by a Foreign Sales Corporation (FSC) and on the qualifying income of an operation in Puerto Rico or the United States Virgin Islands. Thus, when dividends are paid from foreign subsidiaries, the underlying earnings are included in the taxable income of the United States parent company (and a foreign tax credit is available for the subsidiary's tax incurred, subject to limitations discussed below). The income of a foreign branch is included as earned.

In contrast, The Netherlands provides an exemption from Netherlands tax (technically a deduction from the tax payable equal to Netherlands tax) for the earnings realized by a foreign branch of a Netherlands company subject to tax in the foreign country. This is typically true even if a foreign country that does not have a tax treaty with the Netherlands offers tax incentives to the Netherlands company, the effect of which is to waive any foreign tax. If a treaty exists between the Netherlands and the foreign country (*e.g.*, Singapore), there is no Netherlands tax even if the foreign branch is not subject to local tax. Thus, low taxed foreign operations of a Netherlands company are permanently exempt from Netherlands corporate tax.

The same thing is true if the Netherlands company chooses to operate in a foreign country through a foreign subsidiary. The technical mechanism for this result is the participation exemption, which is, in effect, an exemption attributable to the ownership interest of the Netherlands parent. It allows the dividends and the gains on disposition of the shares of the foreign subsidiary that are subject to foreign tax to be realized free of any Netherlands taxation.

In the case of Germany, under its newer tax treaties with most developed and many developing countries, the same basic rule applies, as discussed above for the Netherlands. Namely, the foreign branch income and dividends from 10% or more controlled subsidiaries are realized by the German company without any further German corporate taxation. Technically, if German companies were to distribute these earnings to their shareholders, the German corporation would be subject to a supplementary 36% German corporate tax. Many German companies typically do not distribute to their shareholders an amount in excess of domestic earnings, and by virtue of German technical rules, domestic earnings are considered distributed before foreign earnings.

The resulting Netherlands and German exemption from home country tax of foreign subsidiary dividends from nominally high taxed jurisdictions may at first glance appear not to be a great benefit. For example, one might question whether there is any competitive advantage in having a dividend from a Canadian subsidiary to a Netherlands or German parent company exempted from the parent's home country tax because the nominal Canadian rate is quite high. However, the effective rate of Canadian taxes of many manufacturing and processing operations is significantly less than the nominal rate. Therefore, even though the effective Canadian tax rate is very low, the home country exemption system allows the parent company to avoid tax on the dividend because the tax law effectively treats the Canadian operation the same as it would a foreign operation that is subjected by foreign law to a nominally high rate. Furthermore, such home country tax systems provide an incentive to reduce foreign (*e.g.*, Canadian) tax by any available tax planning techniques.

Japan, at first glance, has a system that appears to be comparable to the United States in that all the income for Japan-based multinational corporations will currently, or at sometime in the future, be included in the Japanese corporation's taxable income. However, there are several aspects of the system not present in the United States tax system that will significantly reduce the Japanese home country tax on that included income.

First of all, a Japanese corporation is allowed a deduction in an amount equal to 12% and 16%, respectively, of the gross proceeds (up to 40% of taxable income) received from the foreign sale or license of certain technology, and from the provision of foreign technical services, even if those proceeds are from related parties. This reduces the Japanese tax on this gross income down to a range that is much more in line with the nominal United States range.

In addition, Japan also has a system of tax treaties allowing tax sparing with many developing countries, such as Indonesia, Ireland, Singapore, Malaysia and Brazil. These treaties have the effect of causing that income, when it is remitted back to Japan, to be subject to a significantly lower effective tax rate. This reflects Japan's willingness to spare the company the Japanese tax on the amount of taxes waived by the foreign country. See more detailed discussion in the section below on foreign tax credits.

[2] Loans by Foreign Subsidiaries of Earnings to Home Country Parent Corporation

Under the United States rules, if a foreign subsidiary accumulates earnings from operations at a low effective tax rate, and then loans those earnings to its United States parent corporation or any other related United States corporation, the United States tax rules will consider that loan to be the equivalent of a dividend. A residual United States tax would, therefore, be due on the difference between the United States tax on the dividend equivalent amount, and the effective foreign tax available as a foreign tax credit.

None of the other countries studied have such a provision in their law. Therefore, when examining their relative fiscal and financial strengths, the multinational companies based abroad can call upon this resource without adverse tax consequences, which a United States company cannot: the use of foreign earnings to obtain parent company financing without also incurring a significant home country tax. This tax policy obviously discourages United States multinationals from using otherwise available low cost capital to develop facilities at home.

[3] Current Home Country Taxation of Non-Repatriated Foreign Subsidiary Earnings

Tax rules that require the home country of the parent to tax currently income of foreign affiliates, whether or not actually distributed to the parent, because under home country rules it is deemed to be "tainted" for some tax policy reason, are referred to as Subpart F type rules. The reference derives from the U.S. Internal Revenue Code. Japan and Germany have such rules but they are quite narrow in scope, which mitigates their impact substantially. The Netherlands has no Subpart F rules but has recently enacted rules that could cause current taxation of investments in passive foreign investment companies, in which virtually all assets are non-business assets.

The United States has both Subpart F rules and recently enacted Passive Foreign Investment Company rules that require current taxation of various defined types of income, even though earned but not distributed by a controlled foreign corporation. These rules are very extensive, are wide in scope, very complex and include active commercial activities in addition to foreign passive income. They seek to eliminate deferral of United States tax on foreign subsidiary earnings on virtually all passive income. This includes such items as interest, rents, royalties, etc., and income of certain active business activities, such as banking, shipping, related party insurance activities and sale and service operations taking place outside of the country of incorporation. Each of these types of activities has been added or expanded in legislation starting in 1962.

In Japan, the narrow scope of the anti-deferral rules mitigates very substantially the impact of current taxation on so-called tainted income. The basic approach in Japan is to begin with a list of countries that are designated as tax havens. The list of these countries is attached to Appendix No. 3. Thus, subsidiaries operating outside of these countries are not subject to the anti-tax haven legislation, even if they are subject to no, or low, foreign tax, regardless of the nature of their activities. Even if a foreign subsidiary operates in a designated tax haven, its income will not be subject to current Japanese taxation if it engages in a "legitimate business activity" as defined by statute. The statutory test requires the foreign subsidiary only to demonstrate that it is carrying on an active business in a foreign country. Finally, the Japanese anti-deferral rules do not apply to a foreign base sales company that does not transact both sides of the transaction (purchase and sale) with a related party. Therefore, some sales activity involving inter-company transactions can be located in the low tax jurisdiction, even if it is a designated tax haven, without causing current Japanese taxation of the foreign subsidiary's earnings.

In Germany, the basic approach, exemptions from, and narrow scope of, the anti-deferral rules mitigate very substantially the impact of current taxation on so-called tainted income.

Germany has Subpart F equivalent rules providing for loss of deferral and the current taxation of certain defined tainted income. For example, with respect to German foreign base sales companies, sales income is tainted only when the company is acting with respect to a product that is exported from Germany or imported into Germany by a related party. Therefore, if the product flow is completely outside of Germany, no German anti-deferral rules apply.

Even if the goods are exported from Germany to a related foreign company, the related company's income is not deemed taxable to the German parent company if the related company transacts the sales activity and the various auxiliary features of the sales activity, without the assistance of the German parent company or another related person, and it engages in these types of trading activities with the public at large.

The German anti-deferral rules do not operate in any event unless a foreign country's effective foreign tax rate is less than 30%. The official German list designating such countries is contained in Attachment A to Appendix No. 4.

Finally, in those countries in which German Subpart F type income is subjected to less than 30% local tax, but with which Germany has a tax treaty, even though the German Subpart F equivalent rules could treat a foreign subsidiary's income as includible in the German parent's taxable income, tax treaty provisions may nevertheless override Subpart F type treatment. With respect to countries that have tax treaties with Germany, which exempt from German tax dividends to qualified German parent companies, the foreign corporation's tainted income is exempt from the Subpart F equivalent rules whether or not it is distributed to the German parent corporation. This is true even in Switzerland, which is on the tax haven list, as long as the income of the Swiss subsidiary is active in nature. Germany regards these treaty provisions as controlling and, therefore, any dividends actually paid out of the earnings or any undistributed profits will not be included in German taxable income.

In summary, in this major area, United States multinationals are disadvantaged by home country tax costs to a far greater degree than are any of their competitors in the other three countries. The Netherlands has no Subpart F type taxation. In Germany and Japan, the rules are far less broad in scope and complexity than the United States provisions and contain many exceptions. Overall, the application is far less onerous than in the United States.

[4] Home Country Tax Recognition of Foreign Losses

A United States corporation can currently deduct losses in its foreign branches subject to the various rules regarding foreign tax credits. A United States parent of a foreign subsidiary cannot currently deduct losses incurred by the subsidiary; however, the parent can write off its investment if it becomes completely worthless. Additionally, while the tainted income of a foreign subsidiary can be deemed distributed to the United States parent, there is not a symmetrical rule as to losses from tainted activity; these losses would not be currently recognized in the United States parent's income and losses.

In The Netherlands, even though foreign source income is effectively exempt from Netherlands tax, a net foreign branch loss may be deducted when incurred against domestic source income. This deduction will, however, reduce foreign source income otherwise exempt from Netherland taxation in the following years. Losses on the investment of the Netherlands corporation in the foreign subsidiaries are generally deductible when the foreign subsidiary is liquidated.

In Japan, while a foreign subsidiary's losses do not offset a corporate parent's domestic income, the Japanese tax law allows a Japanese taxpayer to take a current deduction (called an "overseas investment loss reserve") for 15% or more of its investment in corporations headquartered in developing countries. The reserve must be restored to taxable income beginning in the fifth year after it is established. Furthermore, a Japanese corporation can deduct the decrease in value of a foreign subsidiary's shares if the value of the underlying net assets decreases by 50% and it is expected that the decrease in value of the shares will not be recovered in the near future.

In this area, United States multinationals are again disadvantaged as compared to their competitors in The Netherlands, Japan and Germany because they can only obtain ordinary tax benefits from foreign losses in very restricted cases.

§1.02 Foreign Tax Credit Utilization and Tax Sparing Credit

The purpose of the second part of this analysis is to determine how flexible or inflexible the subject country systems are in allowing multinational companies to utilize foreign taxes as credits against their home country tax on foreign source income. All countries that have the foreign tax credit system think of it as the mechanism by which double taxation is avoided with respect to foreign source income. The rules of each country are quite different and, therefore, the ability of a multinational group to limit home country taxation on foreign source income to the higher of the foreign or home country rate may be jeopardized under some systems to a greater extent than under others.

Furthermore, contrary to the United States system, the tax systems of The Netherlands, Japan and Germany deliberately assist multinationals in investing in less developed countries by providing a tax sparing credit. This credit assures the multinational that it will receive the benefit of local tax incentives, by having it receive a home country tax credit on taxes assumed to be, but in fact not, paid to the host country.

[1] Overall or Per Country Foreign Tax Credit Limitation

The basic approach in the United States is to use the overall or worldwide foreign tax credit limitation method. However, extreme limitations are imposed on that method by the United States in its requirements of separate "baskets" of income. Japan has a partial worldwide limitation that is only applicable to taxes on income imposed at a rate of 50% or less. In contrast, Germany uses the per country limitation method. The Netherlands uses both a per country and an overall method, depending upon whether or not a treaty applies, but the income included in the tax base is really only a limited category of foreign income.

[2] Availability of Deemed Paid Foreign Tax Credits

The United States, Japan, and Germany all allow the home country parent corporations a foreign tax credit for corporate taxes incurred by foreign subsidiaries on earnings being distributed to a parent corporation. The specific detailed rules differ: The United States provides the greatest number of tiers down to which the deemed paid credit will be allowed, but as a practical matter this is not much of a competitive advantage. Multinational groups in the other countries can simply structure their own organizations in such a way so as not to include excessive layers of companies, and, thus, assure getting the benefit of the foreign tax credit.

[3] Blending of Foreign Taxes - Existence of Baskets of Income

The establishment in the 1986 Tax Act of separate baskets for foreign tax credit purposes will cause U.S. multinational companies to pay U.S. tax on foreign income that previously was covered by a foreign tax credit.

Pursuant to the 1986 Tax Reform Act (and to a lesser extent under prior law), the United States foreign tax credit limitation continues to be based upon the overall limitation. However, in implementation, it is a very different system because it is computed by segregating various types of income into separate baskets worldwide and computing a separate foreign tax credit limitation on each basket. For example, the United States now distinguishes between dividends from United States controlled and non-United States controlled foreign corporations even though the underlying type of income from these two sources is from exactly the same type of commercial undertaking.

Furthermore, the new United States rules place in separate baskets different types of income, which clearly arise in an active as opposed to a passive business. Shipping income, certain insurance income, financial services income, oil related income, and income from other general commercial activities are all subject to separate foreign tax credit limitations on a worldwide basis. As in the case with non-United States controlled ventures, there is no hint that these rules are intended to separate active from passive income; instead, it appears to be merely a matter of segregating both high taxed income and low taxed income for revenue raising reasons.

Passive income is separated from all the above types of income and is, itself, separated under the 1986 Act into three different categories worldwide: high withholding tax interest, high taxed passive income (which is put back into the overall business basket) and other passive income. Furthermore, the distinction between passive income and active income is in practice not a clear one.

Even though the United States claims it uses the overall limitation method to establish its foreign tax credit limitation, its method of implementation does not support this claim. This is because deliberately chosen types of foreign business and passive income, which are a normal part of a multinational's financial profile, cannot be combined in computing the overall limitation. The total impact of these provisions on United States multinationals is far more adverse than a simple per country limitation.

The Netherlands, with its broad exemptions from tax for foreign source income, can completely ignore the matters of blending foreign tax rates and of separate categories of income.

Germany does not make any distinctions in this regard among these various types of income. Japan has an overall foreign tax credit limitation with exceptions for certain withholding taxes on interest income and foreign taxes levied at a rate in excess of 50%. Germany has a straightforward per country foreign tax credit limitation; neither country sees fit to limit the use of foreign taxes as credits by a wide variety of types of income, as was done by the United States in the 1986 Tax Reform Act. Therefore, multinationals in these countries can generally arrange their affairs in such a way that they can blend high taxed income with low taxed income without regard to types of income. Obviously in Germany, since it uses the per country limitation, this blending can only be done within a particular country, but with respect to Japan it can be accomplished worldwide.

[4] Carryforward and Carryback of Foreign Tax Credit

The United States allows excess foreign tax credits to be carried back two years and forward five years, subject to the separate basket limitations.

To the extent that limited foreign tax credit situations exist in The Netherlands, excess credits may be carried forward eight years and, if the taxpayer elects, may be deducted instead of credited so that taxes are only imposed on the net amount of income after withholding taxes.

Japan allows excess foreign tax credits to be carried forward three years and, while it technically does not allow carrybacks of excess credits, it allows a three year carryforward of any excess of limitations over foreign tax credits actually used, which effectively yields the same result.

Germany allows no carryback or carryover of excess tax credits. Thus, its multinationals may be slightly disadvantaged as to those of the other three countries. However, by virtue of the use of the per country limitation and the numerous countries in which the exemption system applies by treaties, this situation is typically of no major significance.

[5] Foreign Losses and Their Impact on Foreign Tax Credit Limitation Calculation

If the home country recognizes a foreign source loss for foreign tax credit purposes, the effect will be to reduce the amount of foreign source income. Since the foreign tax claimed as a credit can never exceed the home country tax on the foreign source income, reducing that income likewise reduces the amount of useable foreign tax credits.

Under the United States tax system, foreign losses in the same basket as foreign income will offset that foreign income for purposes of the foreign tax credit limitation computation. To the extent there is a loss for an entire basket under the 1986 Tax Reform Act, that loss will then be applied on a pro rata basis to all other foreign source income baskets and will correspondingly reduce the foreign tax credit limitation in those other baskets of income. To the extent the foreign loss exceeds all other foreign baskets of income, it will offset domestic source income and create an overall foreign source loss. If, in a later year, foreign source income is realized in the basket that generated the loss, that income will be reclassified first as other foreign source income to the extent the loss reduced other foreign source income in prior years, and thereafter as United States source income to the extent the loss offset United States source income.

Unfortunately, in these subsequent years, the foreign taxes on the later year foreign source income are not also reclassified into the new baskets. The system, therefore, creates a mismatching of net foreign source income and available foreign tax credits. Furthermore, under the system, there is no symmetry when there is a United States source loss that offsets foreign source income. That is, there is no recharacterization of future United States source income to increase the income limitation in the foreign source basket to which the earlier loss was allocated.

Such losses are not a problem in The Netherlands, since most of the foreign source income is exempt from domestic tax in the first place.

Japan and Germany have no rules similar to those adopted by the United States. Japan, under the general overall limitation, will offset the foreign source loss against other foreign source income. To the extent the loss reduces foreign source income and, therefore, the foreign tax credit limitation, a Japanese multinational company may be adversely affected. However, there is no reshuffling of the loss, income, and taxes in subsequent years as a result of a loss in an earlier year. Germany merely will apply the net operating loss from a foreign source within its per country rules. It will not reallocate the loss to a different country if the loss exceeds the net income in the loss country.

The United States' multinationals are at a competitive disadvantage as compared to the multinationals in the other three countries, because their losses in a current year reduce not only the foreign tax credit for that year, but possibly also for subsequent years as well.

[6] Source of Income and Deductions

All four countries use the foreign tax credit system to reduce or avoid double taxes on taxable net foreign source income. Therefore, the rules of each, with respect to determining the source of income and expenses (*i.e.*, domestic source or foreign source), play a vital role in determining the impact of the home country tax. For example, the foreign tax credit may eliminate the United States tax on net foreign source income, but cannot reduce United States tax on net United States source income. Thus, to calculate the foreign tax credit, every item of income and expense must have a source.

Any item of income, which is subject to foreign tax but under home country rules is required to be sourced domestic, will incur added tax in the home country. Likewise, any item of expense, which is incurred in the home country but which under its rules must be sourced foreign, will increase domestic source income while reducing foreign source income and the foreign tax credit limitation.

Each of the four countries have different rules pertaining to source of income and the methodology of allocating and apportioning deductions against foreign source income. For instance, the United States has a large array of very specific rules for determining the source of items of income and expense. The Netherlands uses a tracing method to determine source of expenses. Japan has a set of relatively simple rules on sourcing, but also has some arbitrary rules limiting foreign source income. The Appendix for each country sets forth the specific applicable rules.

From the perspective of United States multinational companies, the 1986 Tax Reform Act interest expense allocation method, for example, is very detrimental. This method requires allocating the interest expense of all members of the United States consolidated tax return group over the combined assets of all the members of that group, rather than over the assets of the borrowing member of the group. Since the shares of foreign subsidiaries (measured to include the undistributed retained earnings) held by the U.S. group are included in determining the combined assets of the group, and borrowings of foreign subsidiaries are not, this will tend to allocate purely domestic interest expense against foreign source income. There are also somewhat adverse new source rules for allocating R&D and other expenses. This can cause limits on the use of the foreign tax credit, which can result in double taxation of foreign income. This problem is exacerbated in the United States by the 1986 Act and increases the competitive disadvantage for United States multinational companies.

[7] Tax Sparing Credit

The United States has no treaty in which it agrees to spare United States tax on income that could have been, but was not, taxed by the host developing country.

In contrast, all the other countries involved in the study have many treaties with commercially significant developing countries that allow tax sparing. The most dramatic example of this system is Japan, which with respect to a subsidiary operation in Singapore will wind up taxing Singapore income at 14%, rather than at the 45% nominal Japanese national and Inhabitants rate, even though Singapore waives the imposition of its normal 31% corporate tax rate. Thus, by virtue of a 31% tax sparing credit the worldwide effective rate of tax on the Singapore operations of a Japanese company is only 14% (plus any Japanese local tax thereon). A United States multinational, however, would be subject to a full United States tax.

The tax sparing credit also allows the withholding taxes, which can be but are in fact not levied on interest and royalty payments back to the home country, to be treated as if actually paid. The appendices contain a list of countries with which each of the countries studied has a tax sparing treaty.

This incentive to assist in the development of third world countries, not permitted by the U.S., hinders U.S. companies from getting low cost labor and raw materials.

Conclusion

This analysis of the systems of the United States, The Netherlands, Japan, and Germany for taxing multinational corporations compares the major variants involved in each system. A summary of the analysis is presented in chart form as Appendix 5.

The Netherlands' system of exempting from home country tax, as a practical matter, most foreign source income, based upon its policy of territoriality, sets it apart for purposes of this analysis. Its multinationals have a clear competitive advantage over those of the other three countries in that with a minimum of tax planning they are assured of almost no home country tax burden on foreign source income.

On the critical issues of loans by foreign affiliates to parent multinationals, Subpart F type legislation, recognition of foreign losses, limitations on the foreign tax credit, sourcing rules for expenses, blending of foreign tax rates on different types of income and tax sparing, Japan and Germany follow closely behind the Netherlands. The United States, however, on each of these critical issues, handicaps its own multinationals by imposing severe constraints and heavier tax burdens on foreign source income than do the other countries studied, due to its sweeping policy of global tax jurisdiction.

One particular example is the policy of the United States of refusing to enter into tax sparing treaties. All three of the other nations studied have the opposite policy. As a result, their multinationals are able to take advantage of local tax exemption incentives because their home countries either "spare" the exempted income from tax in order to preserve the inventive, or completely exempt the foreign earnings from home country tax in the first place. United States multinationals are prevented by United States tax policy from similarly receiving the benefit of such local incentives. This represents a serious competitive handicap for United States multinationals.

Finally, a major, although intangible, competitive disadvantage for United States multinational companies is the instability of the United States tax system in this area. Every year or two over the past twenty years, the system has been changed or changes have been threatened. The 1986 Reform Act made an even greater number of changes than usual, departing dramatically from the basic patterns followed by the other trading partners. Nevertheless, Congress enacted additional legislation in 1987, 1988, 1989 and 1990 which imposed numerous technical and a few high impact changes on U.S. businesses operating abroad.

These developments only serve to underscore the continuing problems posed to U.S. businesses because of constant changes to the United States tax system. Thus, not only are United States multinationals effectively subjected to heavier tax burdens on foreign income than their competitors, but their ability to do long term business planning has for many years been hampered so severely that their competitive posture is compromised.

If present trends continue, this competitive handicap of United States multinationals will continue into the future, absent a substantial change in legislative tax policy. In this regard, the Committee For Economic Development Report titled, "Toll of the Twin Deficits" (Budget and Trade) recommends (p.59):

"To avoid potential damage to the U. S. competitive position in world markets, we recommend an early review of the recent revisions in the tax treatment of foreign operations of U.S. firms that takes the U.S. competitive position into careful account and such modifications in the new provisions as may be appropriate in the light of this review."

The House Ways and Means Committee has concluded its hearings on the impact of U.S. tax policy on the international competitiveness of U.S. business. Hopefully, as a result of these hearings, the Congress will recognize that the United States is placing its multinationals at a serious disadvantage compared to the multinationals of the other countries studied. If they are to be competitive, the tax policies of avoiding double taxation of foreign source income and of recognizing the integrity of controlled foreign corporations and their earnings should be revisited from a perspective of sharpening the competitive position of United States multinationals, rather than continuing to mete out ever increasingly harsh tax treatment of their foreign operations.

Ernst & Young

Appendix No. 1

TAXATION BY THE UNITED STATES OF ITS MULTINATIONAL CORPORATIONS

Overview of United States Tax System

The United States taxes U.S. corporations based on their worldwide income. The earnings are again taxed to the domestic corporation's shareholders when they are distributed from the U.S. parent corporation to its shareholders. No relief is given at this second level of U.S. taxation for U.S. or foreign tax paid at the corporate level.

The current Federal tax rate is 34%. U.S. parent corporations and their 80 per cent owned domestic subsidiaries may file consolidated returns. In many cases, significant state and local taxes are levied in addition to the U.S. Federal Tax.

Under the general U.S. tax system, income that is earned in and taxed by a foreign country is also subject to tax by the U.S. In the case of foreign subsidiaries, this tax is generally imposed when the earnings are repatriated to the U.S., but in some instances the income is taxed currently even if it is not actually repatriated to the U.S.

The U.S. tax system attempts to avoid double taxation at the corporate level through a system of foreign tax credits.

§1.01 Exemption or Deferral of U.S. Income Tax

[1] Inclusion of Foreign Operating Income and Dividends in U.S.Tax Base

From the standpoint of U.S. based multinational corporations, the only types of international operations that are effectively exempt from U.S. tax are part of the export profit realized by a Foreign Sales Corporation[1] and the qualified income of a U.S. company operating in Puerto Rico or the U.S. Virgin Islands.[2]

While a U.S. corporation is currently taxed on its worldwide income,[3] earnings of a foreign subsidiary generally are not taxed until they are distributed to the U.S. corporate parent. Where the foreign rate is lower than the U.S. corporate rate, a lower current tax burden may be achieved by use of a foreign subsidiary of a U.S. corporation. When the foreign subsidiary pays a dividend to the U.S. parent, the dividend is taxed as income of the parent.[4] The foreign tax credit is designed to relieve the corporate double tax burden (one tax in the foreign country and a second in the U.S.) imposed on those earnings.

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1 U.S. Tax Code, §921.
2 U.S. Tax Code, §936, §27(b).
3 U.S. Tax Code, §11, §61.
4 U.S. Tax Code, §61(a)(7).

In addition to taxation of a foreign subsidiary's dividend payments to a U.S. parent, the amount of a foreign subsidiary's tainted income, as well as its increase in earnings invested either directly or indirectly in U.S. property at the close of any taxable year, is taxed currently by the U.S. to the extent that it would have been a dividend if distributed.[5] Included in the definition of U.S. property is tangible property located in the U.S., stock of a related domestic corporation, an obligation of a related U.S. person, and any right to use in the U.S. a patent, copyright, invention, model, design, secret formula or process, or similar property right acquired or developed by the controlled foreign corporation for U.S. use.[6]

[2] Loans by Foreign Subsidiaries of Earnings to U.S. Parent Company

A loan by a foreign subsidiary to a related U.S. corporation will be considered an investment in U.S. property as outlined above, and will result in the amount of the loan being taxed currently by the U.S. as a deemed dividend.[7] Thus, related U.S. corporations cannot use the funds domestically while at the same time continuing to defer U.S. tax on the loan amount.

[3] Current U.S. Taxation of Non-Repatriated Foreign Subsidiary Earnings Deemed to Have Some Type of Taint

Under the Subpart F provisions[8] of the Internal Revenue Code, the U.S. currently taxes certain income earned by a foreign subsidiary even though it is not repatriated to the United States. The Subpart F provisions were originally enacted in order to tax currently passive income earned abroad and to avoid long term deferral of U.S. taxation through the accumulation of foreign earnings abroad. However, the provisions have been amended frequently over the last several years and their scope has been consistently enlarged so that they now currently tax certain active business income earned by a foreign subsidiary.

Subpart F requires a U.S. corporation, which owns at least 10% of the voting power of a controlled foreign corporation (where U.S. shareholders own more than 50% of the voting power or value of the foreign corporation),[9] to include as a deemed dividend in its currently taxed income its pro-rata share of the controlled foreign corporation's undistributed earnings that are of a tainted nature.[10] Subpart F current income taxation will not be incurred if (1) the Subpart F income is a de minimus amount,[11] or (2) the foreign income tax imposed on the income is greater than 90% of the maximum U.S. rate.[12]

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[5] U.S. Tax Code, §956.
[6] U.S. Tax Code, §956(b).
[7] Id.
[8] U.S. Tax Code, §§951-964.
[9] U.S. Tax Code, §957.
[10] U.S. Tax Code, §951(a), §951(b), §957(c).
[11] U.S. Tax Code, §954(b)(3).
[12] U.S. Tax Code, §954(b)(4).

Under Subpart F, the U.S. parent's pro-rata share of each of the following categories of income is currently taxed as a deemed dividend to the parent:

a. Income from the insurance of U.S. risk;[13]

b. Foreign Base Company Income,[14] which is of four types:

   1. Sales income;[15]
   2. Services income;[16]
   3. Shipping income;[17]
   4. Oil related income.[18]

c. Foreign personal holding company income.[19]

The category likely to be most significant for the U.S. based multinational corporation with a manufacturing and sales foreign subsidiary is foreign base company sales income (FBCSI). FBCSI generally is income derived from the sale or purchase of personal property to or from a related person, or on behalf of a related person, where the property is manufactured and sold outside the country of incorporation of the controlled foreign corporation.[20] The significance of the FBCSI rules is that a U.S. based multinational corporation that manufactures products in the U.S. or elsewhere and sells them to a foreign subsidiary for sale anywhere except in the Controlled Foreign Corporation's country of incorporation will be currently taxed on the income earned in the foreign subsidiary. This result will occur regardless of the identity of the purchaser. The U.S. tax is imposed even though the earned funds remain in the foreign subsidiary and are used for active business operations there.

Obviously, to avoid double taxation of the same items of income, amounts taxed as a deemed dividend under Subpart F are not taxed again when they are later actually paid to the U.S. parent.[21] Also, the deemed dividend carries with it a deemed paid foreign tax credit[22] (discussed in Section 1.02, below).

The 1986 Tax Act introduced the concept of a Passive Foreign Investment Company (PFIC) to the U.S. tax law.[23] A PFIC is a foreign corporation where either 75% or more of its gross income is passive, or 50% or more of the average fair market value of its assets are held for the production of passive income. Under the PFIC rules, the U.S. will either currently tax U.S. shareholders on the

[13] U.S. Tax Code, §952(a)(1).
[14] U.S. Tax Code, §952(a)(2).
[15] U.S. Tax Code, §954(a)(2).
[16] U.S. Tax Code, §954(a)(3).
[17] U.S. Tax Code, §954(a)(4).
[18] U.S. Tax Code, §954(a)(5).
[19] U.S. Tax Code, §954(a)(1).
[20] U.S. Tax Code, §954(d)(1).
[21] U.S. Tax Code, §959.
[22] U.S. Tax Code, §960.
[23] U.S. Tax Code, §§1291-1297.

U.S. rate with excess credits on income in a different basket subject to an effective foreign tax in excess of the U.S. tax rate. Put differently, the worldwide tax liability can exceed the tax at the U.S. rate even though the foreign rate on all foreign source income is equal to or less than the U.S. tax rate.

These baskets require different foreign tax credit limitation computations for:

1) Different types of businesses: oil, shipping, financial services and other.

2) Different types of passive income: high withholding tax interest and low taxed passive income.

3) Dividends from U.S.-controlled v. non-U.S. controlled foreign corporations.

The separate limitation baskets will apply to payments received from controlled foreign corporations on a "look-through" basis. That is, payments received from them will be characterized based on the extent to which the income of these corporations is attributable to each of the separate baskets.

The "look-through" rule will not, however, apply for dividends received from non-controlled foreign corporations eligible for the Section 902 deemed paid foreign tax credit.[35] Dividends received from these corporations are automatically classified into a separate basket, regardless of the nature of the subsidiary's income out of which the dividends were paid. Since foreign countries often require at least 50% corporate ownership to be held by foreign nationals in order to do business in that country, it is likely that most U.S. multinational corporations will have some noncontrolled foreign subsidiaries. Because of the separate basket limitation, a U.S. multinational cannot blend foreign tax credits on identical types of income earned through controlled foreign corporations with similarly situated income earned through other foreign companies.

[4] Carryforward and Carryback of Foreign Tax Credit

Carrybacks and carryforwards of unused foreign tax credits are permitted under U.S. law. Credits can be carried back two years and forward five, subject to the separate basket limitations discussed above.[36]

[5] Foreign Losses and Their Impact on Foreign Tax Credit Limitation Calculation

To the extent that a separate basket of foreign source income actually has a foreign source loss, that loss is to be allocated pro-rata among the other separate foreign source basket categories first, with the excess after such pro-rata allocation to be allocated to U.S. source income.[37] This rule was introduced by the 1986 Tax Act. The effect of this change is to reduce the foreign tax credit limitation of other separate baskets, and, therefore, reduce the total credit.

[35] U.S. Tax Code, §904(d)(1), §904(d)(2)(E).
[36] U.S. Tax Code, §904(c).
[37] U.S. Tax Code, §904(f)(5), §904(f)(1).

Subsequent income in the separate basket having a prior loss must be recharacterized as income of the same character as the income previously offset by the loss, but the applicable foreign taxes are not recharacterized possibly resulting in a serious mismatching of income and tax.[38] In contrast, there is no subsequent resourcing of U.S. source income in situations where U.S. losses previously offset foreign source income.

[6] Source of Income and Deductions

The foreign tax credit may eliminate the U.S. tax on foreign source income, but cannot reduce U.S. tax on U.S. source income. Thus, to calculate the foreign tax credit, every item of income and expense must have a source. Any item of income which must be sourced domestic and any item of expense which must be sourced foreign will reduce the amount of otherwise useable foreign tax credits.

The U.S. establishes specific and detailed rules regarding the source of income and deductions.[39] For example, income from inventory sales is generally sourced by reference to where title passes.[40] However, when the inventory is manufactured by the seller, the income is generally sourced one-half at the location of manufacture, and one-half at the location where title passes.

In addition, specific rules apply to the allocation and apportionment of expense to calculate net foreign source income of each basket for foreign tax credit purposes. The U.S. Income Tax Regulations, Section 1.861-8, contain detailed rules for allocation of expenses to foreign source income. The 1986 Tax Act, however, contains new and more restrictive rules concerning the allocation and apportionment of all expenses.

For example, the Act broadens the apportionment rules for interest to require apportionment over all income producing assets on a consolidated basis approach, rather than the separate company approach of prior law.[41] Therefore, for purposes of the foreign tax credit limitation calculation, the net foreign source income of each member of an affiliated group is to be determined by apportioning all interest expense as if all members were a single corporation. For this purpose, foreign subsidiary borrowings are not taken into account. The net effect of this rule usually is to treat a substantial portion of purely domestic interest expense as foreign source. In addition, and contrary to the general fungibility theory, the interest expense allocation rules require that certain interest expense of the U.S. shareholders group be netted (the CFC interest netting rule) against interest income received from related CFCs. This rule is an attempt to prevent taxpayers from increasing the foreign tax credit limitation by borrowings and on-lending to the CFCs.[42]

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[38] U.S. Tax Code, §904(f)(5)(c).
[39] U.S. Tax Code, §§861-865, §§871-877.
[40] U.S. Tax Code, §861(a)(6), §862(a)(6).
[41] U.S. Tax Code, §864(e).
[42] Temporary Regulation §1.861-10T(e) and Proposed Regulation §1.861-10(e).

With respect to a foreign subsidiary of a Netherlands corporation, dividends received from it, and capital gains realized on the disposal of its shares owned by the Netherlands parent, are not includable in the corporation's profits for tax purposes. In order for this provision, however, to apply, the subsidiary must qualify for the so-called "participation exemption", (also known as an "affiliation privilege").[5] Conversely, capital losses on such subsidiaries are not deductible. An exception applies to certain capital losses incurred upon liquidation of the subsidiary. The possibility of offsetting taxable income with those liquidation losses has been limited.[6]

In order for this participation exemption to apply, the following conditions must be satisfied:

[a] The Netherlands parent must own at least 5% of the shares of the foreign subsidiary paying the dividend;
[b] The shareholding in the foreign subsidiary cannot be regarded as a current asset (stock), indicating that the shareholder has no intention to participate in the company, but rather acquires and sells the shares in the conduct of its ordinary trade or business;
[c] The foreign subsidiary must be subject to a foreign national profits tax (the rate or the temporary waiver of which is not material);[7] and
[d] The shares in the foreign subsidiary must not constitute a portfolio investment in the hands of the Netherlands parent.

Expenses attributable to foreign income covered by this ownership interest are generally not deductible.[8] Thus, interest paid on debt incurred to acquire stock in a foreign subsidiary is not deductible. Because of the Netherlands specific tracing rules, and provided sufficient equity is available, it should be possible to effectively finance the acquisition of a foreign subsidiary without having a disallowance of interest. However, interest paid on a loan, taken out in the last 6 months prior to an equity investment in a foreign subsidiary is not deductible unless it can be demonstrated that the loans were taken out for a different purpose than for investment in this foreign subsidiary.

The net effect of these rules is that, for all practical purposes, income received from a foreign permanent establishment and dividends from a wholly-owned operating foreign subsidiary are effectively exempt from Netherlands income taxation when received by the Netherlands parent corporation. This result will be achieved even if the foreign country either imposes a low rate of taxation or temporarily waives taxation as an incentive for investment.

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5 CITA, Art. 13.
6 CITA, Arts. 13d, 13e and 13f.
7 Ministry of Finance Instructions of February 20, 1985, No. 085-94.
8 CITA, Art. 13(1).

[2] Loans by Foreign Subsidiaries of Earnings to Netherlands Parent Corporation

Loans from foreign subsidiaries can be made to a Netherlands parent company without being deemed a dividend. Therefore, Netherlands corporations can use such loans as a mechanism to permanently defer Netherlands tax on income earned in a foreign country, while at the same time using the foreign funds domestically.

[3] Current Netherlands Taxation of Non-Repatriated Foreign Subsidiary Earnings Deemed to Have Some Type of Taint

There are no general Subpart F type rules relating to foreign operating subsidiaries of Netherlands corporations. However, a recent change of law requires a Dutch corporation owning an interest of 25% or more in a "passive foreign investment company" to revalue annually its interest in the foreign company to fair market value.[9] An increase in value of the foreign company would lead to current Dutch taxation as the participation exemption would not apply to interests in these types of foreign companies. A passive foreign investment company is defined as a foreign corporation the assets of which consist entirely or almost entirely (90%) of passive investments. Considering this definition the rule can be easily circumvented. The rule would also not be applicable if five unrelated Dutch companies each owned 20% of the passive foreign corporation. Therefore, the impact of this new rule should not be significant. Netherlands multinational companies can generally organize their international business operations to optimize foreign tax reduction planning without the concern that the actions will cause current imposition of the Netherlands tax on the undistributed income of the foreign subsidiaries, unless the foreign subsidiaries are passive investment companies.

[4] Netherlands Tax Recognition of Foreign Losses

Even though foreign source income is effectively exempt from Netherlands tax, foreign losses from a foreign permanent establishment may be deducted when incurred. For purposes of computing the foreign source income exemption, however, losses deducted in the prior eight years must be recaptured and taxed as foreign source income in one or more of the eight years following the year in which the loss was incurred.[10]

Losses on investments by the Netherlands corporate shareholder in foreign subsidiaries are recognized for Netherlands tax purposes when a foreign subsidiary is liquidated, but recently this allowance has been restricted.

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9 CITA, Art. 28(b).

10 Unilateral Decree, Art. 3(4). Most Dutch tax treaties incorporate this provision by reference to Art. 3(4), Unilateral Decree. Under a significant number of treaties only foreign losses from the particular treaty country involved have to be recaptured.

§1.02 Foreign Tax Credit Utilization and Tax Sparing Credit

Since the Netherlands has a system that for all practical purposes exempts foreign permanent establishment and foreign subsidiary dividend income from tax, the importance of its foreign tax credit system is relatively limited. It is further limited because the Netherlands has an extensive treaty network with both developing and developed countries. The foreign tax credit primarily applies to foreign withholding taxes levied on interest, royalties and taxable dividends received from foreign subsidiaries in treaty countries,[11] and in non-treaty developing countries.[12] The credit is typically the lower of the foreign tax paid or the portion of the total Netherlands tax effectively payable on the taxable royalty, interest or dividend. On dividends, the credit cannot exceed 25% of the dividend from developing countries.[13]

Netherlands taxpayers can deduct the foreign withholding tax rather than seek a credit when it is to their advantage to do so (as in the case of a worldwide loss).[14]

The primary purpose of the treaty network, from the perspective of Netherlands multinational companies, is to reduce or eliminate withholding taxes on royalties, interest and dividends flowing back to the Netherlands parent corporation.

[1] Overall or Per Country Foreign Tax Credit Limitation

The Netherlands has an overall limitation system,[15] which is modified to a per country method under some treaties on the limited types of income to which the foreign tax credit is applicable.[16]

[2] Availability of Deemed Paid Foreign Tax Credits

Dividends actually received by a Netherlands parent company from a controlled foreign subsidiary are generally exempt foreign source income under the participation exemption. If the dividends do not qualify for such treatment, they do not bring with them any indirect foreign tax credit.

[3] Blending of Foreign Taxes - Existence of Baskets of Income

Since, for all practical purposes, only foreign source royalties and interest are subject to Netherlands taxation, the question of blending of foreign taxes is so limited it has not received the attention of tax draftsmen. Similarly, there are no provisions for limiting the foreign tax credit based on separate baskets of income.

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[11] E.g., Netherlands/Belgium tax treaty of 1970, Arts. 10, 11, 12 and 24.

[12] Unilateral Decree, Arts 4 and 5.

[13] Unilateral Decree, Art. 5 (2).

[14] Unilateral Decree, Art. 6, and Ministry of Finance Instructions of August 13, 1981, No. 081-1454, BNB 1981/275, in conjunction with CITA, Art. 10.

[15] Unilateral Decree, Art. 5.

[16] E.g., Netherlands/Belgium tax treaty of 1970, Art 24(1)(3).

[4] Carryforward and Carryback of Foreign Tax Credit

Excess foreign tax credits can be carried forward for eight years. No carryback is available.[17]

[5] Foreign Losses and Their Impact on Foreign Tax Credit Limitation Calculation

Since the foreign tax credit has such limited application (generally, as discussed above, for interest and royalties received from foreign subsidiaries in any treaty country, or in non-treaty developing countries), foreign losses are relevant only to the extent they are incurred from foreign permanent establishments and, thereby, reduce worldwide foreign source income in the foreign tax credit limitation calculation.

[6] Source of Income and Deductions

The question of sourcing income and deductions for a Netherlands corporation arises in the context of income from a foreign permanent establishment, whose income is exempt from Netherlands tax. For purposes of allocating expenses to foreign source income, Netherlands uses the "tracing" method, in which expenses are allocated as domestic or foreign source depending on the purpose for which the expense was incurred.

[7] Tax Sparing Credit

An important aspect of tax treaties between the Netherlands and some of the developing nations is the allowance of a Netherlands tax sparing credit. For example, Singapore generally imposes a withholding tax of 31% on interest paid to nonresidents. However, under the Netherlands/Singapore Tax Treaty,[18] this rate is reduced to 10%. Also, some taxpayers may receive a further reduction pursuant to incentive programs in Singapore. If a Netherlands corporation obtains a reduced Singapore rate (assume 4%), the Netherlands allows it a tax sparing credit in addition to the actual foreign tax incurred. The credit is equal to twice the difference between the normal treaty tax rate of 10% and the actual reduced rate. In this example, the Netherlands would allow a foreign tax credit of 16%.

Reduced tax actually paid		4%
Tax Sparing Credit		
Normal Treaty Tax Rate	10%	
Less reduced tax actually paid	<u>4%</u>	
	6% x 2 =	<u>12%</u>
Total Foreign Tax Credit		16%

With respect to royalties, Singapore would generally impose a zero rate in connection with incentive operations and the Netherlands treaty would preclude

[17] Unilateral Decree, Art. 5 and Ministry of Finance Instructions of August 13, 1981, No. 081-1454, BNB 1981/275.
[18] Netherlands/Singapore tax treaty of 1971, Art. 24.

Singapore from taxing the royalty paid to a Netherlands company. Pursuant to the treaty, however, the Netherlands will nevertheless allow a foreign tax credit of 15.5% (50% of the nominal Singapore tax rate).

§1.03 Recently Introduced Tax Reforms and New Proposals

The participation exemption has been recently modified so as to curtail perceived abuses. Among other things, the deduction for capital losses incurred upon the liquidation of a foreign subsidiary has been limited. In general, however, the basic effect of the exemption system remains, and, therefore, the tax position of Netherlands multinational companies has not significantly changed.

There are, at present, no new proposals that would seriously alter the tax position of Netherlands multinationals.

Attachment A
To Appendix No. 2

DESIGNATED TAX HAVEN COUNTRIES

The Netherlands does not have a tax provision specifically dealing with tax havens. Therefore, there is no official list of tax haven countries.

Attachment B
To Appendix No. 2

COUNTRIES HAVING TAX TREATIES WITH THE NETHERLANDS PROVIDING FOR TAX SPARING CREDITS

1. China
2. Greece
3. India
4. Indonesia
5. Israel
6. Korea (Republic of)
7. Malaysia
8. Malta
9. Pakistan
10. Philippines
11. Singapore
12. Sri Lanka
13. Surinam
14. Turkey
15. Zambia

Appendix No. 3

TAXATION BY JAPAN OF ITS MULTINATIONAL CORPORATIONS

Overview of Japanese Tax System

Japan's National Corporate Income Tax is imposed on large corporations at a rate of 37.5%.[1] A local Inhabitants Tax is imposed by the prefectural and municipal governments, at a maximum combined rate of 20.7% of the National Corporate Income Tax.[2] The Inhabitants Tax is not deductible from the National Corporate Income Tax.

The result of these tax rates is that the aggregate effective National and local Inhabitants combined tax rate is approximately 45.26%. In addition, there is a Local Enterprise Tax (maximum of 13.2%), which is deductible in computing the National Corporate Income Tax and the local Enterprise tax itself. The resulting effective tax rate for all three taxes is 51.65%.

A Japanese corporation is subject to corporate income tax on its worldwide profits, subject to the rules and exceptions discussed below with respect to foreign source income.

Japanese corporations and their wholly owned Japanese subsidiaries may not file consolidated returns.

In addition to the normal tax structure applicable to its multinational companies, Japan has established a large network of treaties with industrialized countries, as well as with certain key developing countries such as Ireland and Singapore. A significant aspect of this treaty network is the tax sparing credit, which exists by treaty with some developing countries.[3] This reduces the Japanese tax rate (and the worldwide effective tax rate) on income earned in those countries.

§1.01 Exemption or Deferral of Japanese Income Tax

[1] Inclusion of Foreign Operating Income and Dividends in Japanese Tax Base

Earnings of a foreign branch of a Japanese corporation are included in the Japanese corporation's current taxable income.

A Japanese corporation is allowed a deduction, however, of an amount equal to 12% of the gross proceeds received from the foreign sale or license of patents and know how, even if those proceeds are from related parties.[4]

Japanese corporations providing technical services to foreign parties in the form of research, or certain kinds of technical supervision and inspection conducted by the Japanese corporate taxpayer itself, may deduct 16% of the gross proceeds

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1 Corporate Tax Law (Hojinzeiho) (hereafter: "CTL"), Art.66(1).
2 Local Tax Law (Chihozeiho) (hereafter: "LTL"), Arts. 51, 314-6.
3 See, *e.g.*, Japan/Ireland tax treaty, Art. 24; Japan/Singapore tax treaty, Art. 21.
4 Special Tax Measures Law (Sozei Tokubetsu Sochiho) (hereafter: "STML"), Art. 58.

from such services. The aggregate deduction for both of the above two transactions, *i.e.*, (1) sale or license of intangibles; and (2) provision of services, in any one taxable year is subject to the overall limitation of 40% of taxable income.

In contrast, except as noted under the "tainted" income discussion below, earnings retained in a foreign subsidiary are typically not taxed to the Japanese parent corporation until those earnings are distributed as dividend income to the Japanese corporation.

[2] Loans by Foreign Subsidiaries of Earnings to Japanese Parent Corporation

Loans from foreign subsidiaries can be made to a Japanese parent company without them being deemed a dividend. Therefore, Japanese corporations can use such funds as a mechanism to defer permanently Japanese tax on income earned in a foreign country, while at the same time using the funds domestically.

[3] Current Japanese Taxation of Non-Repatriated Foreign Subsidiary Earnings Deemed to Have Some Type of Taint

In certain circumstances, Japan imposes current taxation on a domestic corporation's pro-rata share of a foreign subsidiary's undistributed earnings. However, this taxation will only be imposed on certain shareholders of a foreign company if the company is located in a designated tax haven and does not engage in a "legitimate business activity."[5] More specifically, the following criteria must be met in order for a Japanese based multinational to be subject to current income taxation on a foreign subsidiary's undistributed earnings:

[a] The foreign subsidiary must be located in a country designated as a tax haven (See Attachment A);
[b] The Japanese parent corporation must directly or indirectly own at least 10% of the foreign subsidiary;
[c] More than 50% of the foreign subsidiary must be owned directly or indirectly by Japanese shareholders;
[d] The business activities of the foreign subsidiary must not meet the definition of legitimate business activities, as discussed below.

Therefore, subsidiaries that are located in designated tax havens will be subject to the risk of having their income currently taxed in Japan. Even if a subsidiary is organized under the laws of, or has its head office in a country, other than a tax haven country, it is deemed to be a tax haven subsidiary if it is: (1) controlled and managed in a designated tax haven country, and (2) is either organized under the laws of, or has its head office in, a country that does not tax foreign source income of a corporation controlled and managed outside of that country. Thus, if a subsidiary is not organized, headquartered, controlled, or managed in a tax haven country, then it would not be subject to the anti-tax haven legislation, even

[5] STML, Art. 66-6.

if it is subject to no, or a low rate of, foreign tax, and regardless of the nature of its activities.[6]

Even if a foreign subsidiary operates in a designated tax haven, its income will not be currently taxed if it engages in "legitimate business activity" as defined by statute. A subsidiary will be engaged in "legitimate business activity" if:

(1) There is a fixed place of business in the tax haven;[7]
(2) Local staff administers and controls the tax haven business activities;[8]
(3) The subsidiary's main line of business in the tax haven is other than holding securities, licensing activities, or leasing vessels or aircraft; and
(4) The majority of the subsidiary's business activities are either conducted in the haven or, if the subsidiary is a sales company, bank, securities company, trust company, insurance company, shipping company, or air freight company, more than 50% of its main line of business is from unrelated parties.[9]

Due to this "legitimate business activity" exception, most Japanese multinationals carrying on an active business in a foreign subsidiary will not be currently taxed on the subsidiary's income regardless of where the subsidiary is located.

Furthermore, the anti-tax haven rules would not apply to a foreign base sales company that has substance, if one side of the transaction (*i.e.*, either the purchase or the sale), is with an unrelated party. Therefore, some sales activities involving intercompany transactions can be located in a low tax jurisdiction, even if it is a designated tax haven, without incurring current Japanese tax on the foreign company's earnings. If a foreign operation is subject to the tax haven rules and it does not meet the legitimate business activity exception, then the earnings of the subsidiary are currently taxed as a deemed dividend to the Japanese parent.[10] The tax haven subsidiary may reduce the currently taxable income base by losses incurred by it during the preceding five years.[11]

If there is a deemed dividend to the Japanese parent under the tax haven rules, then subsequently declared dividends from the tax haven subsidiary are adjusted to avoid double taxation.[12] Also, the deemed dividend income from a tax haven subsidiary carries with it a deemed paid foreign tax credit, which is discussed more fully in Section 1.02, below.[13]

[4] Japanese Tax Recognition of Foreign Losses

A Japanese company's foreign source losses may be deducted when incurred.

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6 STML, Art. 66-6(4). See Part III for a discussion of proposed changes to the tax haven subsidiary rules.
7 STML, Art. 66-6(3).
8 Special Tax Measures Law Circular (Sozei Tokubetsu Sochiho Kankei Tsutatsu) (hereafter: "STML Circular"), Sec. 66-6-10.
9 STML Enforcement Order (Shikorei) (hereafter: "STML Enf. Ord."), Art. 39-16.
10 STML, Art. 66-6(1).
11 STML Enf. Ord. 39-14 (5)
12 STML, Art. 66-8
13 STML, Art. 66-7(1).

While foreign subsidiary losses do not offset a Japanese corporate parent's domestic income, the Japanese tax law has incentives to help stimulate investment in foreign countries. A Japanese taxpayer may take a current deduction (called an overseas investment loss reserve) for 15% or more of its investment in corporations headquartered in developing countries.[14] The reserve must be restored to income beginning in the fifth year after it is established, at a rate of 1/5 a year for five years.[15] Furthermore, there is a generally applicable provision which allows a Japanese parent corporation to deduct the decrease in value of a foreign subsidiary's shares if the value of the underlying net assets decreases by 50%.[16]

§1.02 Foreign Tax Credit Utilization

Since Japan has an inclusion system for foreign income, it uses the foreign tax credit to avoid double taxation at the corporate level for income that is earned abroad. Generally, the credit is allowed against the National Corporate Income Tax for the same proportion of the Japanese tax payable as the proportion of foreign source income to total worldwide income subject to the National Corporate Income Tax.[17] Any excess can be used to offset the Inhabitant's tax to the extent of (maximum) 20.7% of the credit allowable against the National Corporate Income Tax.[18]

A Japanese corporation can elect to deduct foreign taxes paid in lieu of a foreign tax credit.

[1] Overall or Per Country Foreign Tax Credit Limitation

Until recently, Japan used an overall foreign tax credit limitation system, without separate limits based either on type of income or a per country calculation.[19] For taxable years beginning on or after April 1, 1989, however, a foreign country's taxes in excess of 50% of taxable income, computed under the laws of the foreign country, are not creditable.[20] The excess portion is deductible. Thus, a modified form of per country limitation has been established. Foreign taxes in excess of 50% are deductible not creditable. However, a Japanese-based multinational can combine all foreign source income, and all remaining foreign taxes, thus, resulting in an averaging of effective foreign tax rates of 50% or less.

[2] Availability of Deemed Paid Foreign Tax Credits

Japan allows a deemed paid foreign tax credit on dividends received from both tax haven subsidiaries, and other subsidiaries owned 25% or more by the Japanese

[14] STML, Art. 55(1).

[15] STML, Art. 55(3).

[16] CTL Enforcement Order (Hojinzeiho Shikorei) (hereafter: "CTL Enf. Ord."), Art. 68(2); Corporate Tax Basic Circular (Hojinzei Kihon Tsutatsu) (Hereafter: "CTL Basic Circular") Secs. 9-1-9 and 9-1-9-2.

[17] CTL, Art. 69.

[18] LTL, Art. 53(9), 314-7 and 321-8(9)

[19] CTL, Art. 69(1).

[20] CTL, Enf. Ord. 142-3.

parent (this is reduced to 10% in some treaties).[21] This deemed paid credit is allowed only for first tier subsidiaries. If there is a deemed paid credit, the Japanese parent is treated as having paid its pro-rata share of the foreign taxes paid by the subsidiary, based on its share of distributed profits. Foreign source income and foreign tax credits are calculated on a LIFO basis when dividends are paid.[22]

[3] Blending of Foreign Taxes - Existence of Baskets of Income

With the exception of the limitation on the creditability of taxes imposed by high tax countries discussed above and on interest withholding taxes discussed below, both high tax and low tax (or zero tax) income of Japanese corporations can be combined,[23] thereby, blending the effective foreign tax rate for foreign tax credit limitation purposes. Joint venture, passive (other than certain interest), shipping, financial services, and other types of business income may, thus, be combined to realize an average foreign tax rate.

A portion of withholding taxes imposed upon interest income may not be creditable.[24] For taxpayers other than financial institutions, this special limitation applies if the company's interest income over a three year period ending with the current tax year exceeds 20% of the three year total of (1) gross profit on operating income plus (2) interest income. A variation of this rule is applicable to financial institutions.

If the limitation applies, only withholding taxes up to 10% of the interest income are creditable if the ratio of net taxable income to the sum of (1) gross profits on operating income plus (2) non-operating gross income is 10% or less, and only withholding taxes up to 15% of the interest income are creditable if the ratio is greater than 10%, but not more than 20%.

This special limitation applies only to withholding taxes on interest income realized directly by the taxpayer. It does not limit the creditability of foreign taxes imposed on net interest income or on withholding taxes imposed on interest income of a foreign subsidiary that may be claimed as a deemed paid credit.

[4] Carryforward and Carryback of Foreign Tax Credit

While technically there is no carryback allowed for Japanese foreign tax credits in excess of the prescribed limitations, the excess of limitations over credits for each of the preceding three years is allowed to be carried forward to absorb excess credits in the current year.[25] In effect, this has the same result as the allowance of a carryback.

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21 CTL, Art. 69(4).
22 CTL Enf. Ord., Art. 147(2)(i).
23 CTL, Art. 69(1).
24 CTL Enf. Order 142-3.
25 CTL, Art. 69(3).

Any tax credits unused after the utilization of prior year excess limitations may be carried forward three years.[26]

[5] Foreign Losses and Their Impact on Foreign Tax Credit Limitation Calculation

Foreign source income and losses offset one another in calculating the total net foreign source income for foreign tax credit limitation purposes. If there is an overall foreign source loss (that is, total foreign losses exceed total foreign income), then there is no foreign source income and no Japanese tax. However, the net foreign loss cannot be carried forward to reduce the foreign source income in future years.

[6] Source of Income and Deductions

Japan has a specific set of sourcing rules for both income and expense allocation and apportionment. Foreign source income includes deemed dividend income from designated tax haven subsidiaries, which is currently taxable to the Japanese parent.[27] The domestic sourcing rules are superseded by sourcing rules contained in specific income tax treaties.[28]

50% of otherwise foreign source income that is not subject to foreign taxation is deemed to be Japanese source income.[29]

A sale of inventory to a foreign buyer is foreign source if the sale is established through a foreign branch, or the foreign country imposes a foreign corporate income tax thereon.[30]

Common expenses (*i.e.*, those that are not specifically attributable to either domestic or foreign activities) are allocated between domestic and foreign sources based on a ratio of sales profit from foreign activities to total sales profit of the corporation or another reasonable method.[31] Interest expense for wholesale or manufacturing operations (other than interest on indebtedness incurred by a foreign permanent establishment) is allocated as domestic or foreign source based on the book values of the corporation's assets or other reasonable methods.[32]

For taxable years beginning on or after April 1, 1989, foreign source taxable income is limited to the greatest of: (1) 90% of total taxable income; (2) total taxable income multiplied by the ratio of foreign-based employees to total employees; and (3) total taxable income less the product of (a) total taxable income less foreign taxes multiplied by (b) one-tenth of the ratio of total taxable income to foreign taxes.[33]

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[26] CTL, Art. 69(2).
[27] STML, Art. 66-7(1).
[28] CTL, Art. 139
[29] CTL Enf. Order 142 (3)
[30] CTL Enf. Ord., Art. 142(4)(i).
[31] CTL Enf. Ord., Art. 142(6).
[32] CTL Basic Circular, Sec. 16-3-13.
[33] CTL Enf. Ord., 142.

[7] Tax Sparing Credit

An important aspect of tax treaties between Japan and fourteen other countries (See Attachment B) is the allowance of a Japanese tax sparing credit. This is accomplished by allowing a foreign tax credit based on the full statutory rate of the country where the income was earned, regardless of whether the local tax is reduced or eliminated.

For example, assume that in Singapore the normal corporate tax rate of 31% is forgiven under its pioneer incentive program to stimulate foreign investment. If a Japanese corporation has a subsidiary in Singapore, and Singapore grants full tax relief to that subsidiary under its pioneer incentive program, then the subsidiary would pay no tax to Singapore on its earnings. However, when the subsidiary pays a dividend to its Japanese parent, the parent would report dividend income and would treat the 31% forgiven Singapore tax as though it has been paid. This would effectively reduce the total Japanese tax on that dividend income from the normal effective rate of approximately 52% to 21%.

§1.03 Tax Reform

Legislation has been introduced to extend application of the specified tax haven subsidiary rules to certain income earned by a non-tax haven subsidiary through a branch in a listed tax haven. For example, if a Dutch financing subsidiary earns interest income through a Netherlands Antilles branch and, thus, avoids Dutch taxation, under the proposed legislation such income would most likely be currently taxable to the Japanese parent company.[34]

[34] Proposed STML Art. 40-4(5)

Attachment A
To Appendix No. 3

JAPANESE MINISTRY OF FINANCE DESIGNATED TAX HAVEN COUNTRIES

A. Countries which have low rates of taxation or no tax on all income:

1. Andorra
2. Anquilla
3. Bahamas
4. Bahrain
5. Bermuda
6. British Virgin Islands
7. Cayman Islands
8. Channel Islands (U.K.)
9. Djibouti
10. Hong Kong
11. The Isle of Man
12. Leichtenstein
13. Macao
14. Maldives
15. Monaco
16. Nauru
17. New Caledonia
18. The Republic of Vanuatu
19. Turks and Caicos Islands

B. Countries which have low rates of taxation or no tax on foreign source income:

1. Costa Rica
2. Panama
3. St. Helena
4. Solomon Islands
5. Uruguay

C. Countries which have low rates of taxation on specified types of business:

1. Antigua
2. Aruba
3. Barbados
4. Cook Islands
5. Cyprus
6. Elba
7. Gibraltar
8. Granada
9. Jamaica
10. Liberia
11. Luxembourg
12. Malta
13. Montserrat
14. Netherlands Antilles
15. Nevis
16. St. Vincent
17. Seychelles
18. Switzerland

Attachment B
To Appendix No. 3

COUNTRIES HAVING TAX TREATIES WITH JAPAN PROVIDING FOR TAX SPARING CREDITS

1. Brazil
2. India
3. Indonesia
4. Ireland
5. Korea
6. Malaysia
7. Pakistan
8. Peoples Republic of China
9. Philippines
10. Singapore
11. Spain
12. Sri Lanka
13. Thailand
14. Zambia

Appendix No. 4

TAXATION BY GERMANY OF ITS MULTINATIONAL CORPORATIONS

Overview of German Tax System

German National corporate taxation has a split-rate structure, under which profits retained within a German corporation are generally taxed at a rate of 50% and profits which are distributed out of the corporation are taxed at a 36% rate.[1] If distributed income is not taxed prior to the dividend distribution (as would be the case, for example, for dividends received from foreign subsidiaries operating in a country that has a tax treaty with Germany which so provides, as discussed below) then the full 36% tax is imposed upon the dividend by the German corporate parent. In addition, local trade taxes of approximately 13-20% are levied. These taxes are deductible in computing German national corporate taxable income.

Germany also has an "imputation" system, which subjects corporate dividends to most resident German shareholders to a single, rather than a double level of taxation. Under this imputation system, the shareholder is granted a credit against his income taxes for the corporate tax (generally 36%), which has been imposed on the distributed earnings. This is accomplished by "grossing up" the shareholder's income to include the amount of corporate tax imposed on the dividend and then allowing the shareholder a credit for the amount of tax so included in his income.[2]

German corporations and their German subsidiaries may file consolidated corporate income tax returns, if their businesses are integrated with that of the parent and the parent agrees to absorb all profits and losses for a five year period.[3]

In addition to the normal tax structure applicable to its multinational companies, Germany has established a large network of tax treaties with most of the industrialized nations of the world, as well as with certain key developing countries such as Ireland and Singapore. These treaties either supplement or override the normal German tax structure.

§1.01 Exemption or Deferral of German Income Tax

[1] Inclusions of Foreign Operating Income and Dividends in German Tax Base

A German corporation is, in principle, taxed on its worldwide income,[4] subject to the rules and exceptions discussed below.

Under its tax treaties, foreign permanent establishment income is exempt from German taxation. The same is true also under many treaties for dividends

1 Koerperschaftsteuergesetz, Corporation Income Tax Code (hereafter: "KStG"), §23(1), §23(5), and §27(1).

2 Einkommensteuergesetz, Individual Income Tax Code (hereafter: "EStG"), §20(1), Nos. 1 and 3 and §36(2), No. 3. KStG, §8(1).

3 KStG, §14 and §17.

4 KStG, §1(2).

received from foreign subsidiaries. This treaty exemption applies for dividends received from corporations that are owned at least 25% by the German corporate parent. Domestic law, however, reduces this percentage requirement from 25% to 10%.[5]

When these treaty provisions are applied in the context of the German imputation system, the typical result, for all practical purposes, is that earnings repatriated from a foreign subsidiary to a German parent through a dividend distribution are subject to no German taxation at the corporate level. This is due to the interaction of the German treaty exemption of dividend income with the ordering rules imposed by German domestic law controlling the distribution of the retained earnings of the German parent to its shareholders.

This system focuses on the "net available equity capital" of the German parent, which is categorized into three capital accounts, as follows:[6]

[a] A capital account that represents equity which has been taxed at a 50% rate.
[b] A capital account that represents equity which has been taxed at a 36% rate.
[c] A capital account that represents equity which has been taxed at a 0% rate (or has borne no taxation either through the German treaty exemption system for dividends received or through the foreign tax credit system).[7]

German tax law contains a set of ordering rules (the "HIFO" rules) for determining the order in which the available net equity capital will be deemed to have been distributed. Under these rules, income subject to the highest rate of taxation (*i.e.*, the 50% category) is deemed to be distributed first. Then the 36% category is deemed to be distributed, followed by the 0% category.[8] Therefore, the 36% taxation for distributed earnings received from a foreign subsidiary will essentially never be imposed on the German parent unless the corporation distributes more than the earnings generated by its German operations, which are contained in its capital accounts reflecting either the 50% or the 36% tax rate.

Normally, the German parent is careful not to distribute any amount deemed to be 0% tax rate equity. As a result, most German corporations experience no taxation on their foreign source income from a treaty country. This result was noted by Hugh J. Ault and Albert J. Radler, as follows:

> *"From this rule, it follows that exempt foreign source income which is not used for distribution can be retained tax-free within the company for an indefinite period of time. This allocation rules has led major German companies to follow a policy of proper "income mix". The profit needed for distribution should be*

[5] KStG, §26(7)

[6] KStG, §30(1), Nos. 1-3.

[7] Felix/Streck Commentary on KStG, Annotation No. 14 to §30.

[8] KStG, §28(3).

> *covered by fully taxed income from German sources so that exempt foreign source income can be held in the retained earnings account. So far it appears that only one major listed German company has been forced to use exempt foreign source income for distributions."*[9]

It should be noted that not only income which is exempt by treaty from the German corporation tax base falls into the zero taxed income category, but the category may also include income which has borne no German tax due to the operation of the foreign tax credit.[10]

[2] Loans by Foreign Subsidiaries of Earnings to German Parent Corporation

Loans from foreign subsidiaries can be made to a German parent company without the funds being deemed a dividend. Therefore, German corporations can use such funds as a mechanism to defer permanently German tax on income earned in a foreign country, while at the same time using the funds domestically.

[3] Current German Taxation of Non-Repatriated Foreign Subsidiary Earnings Deemed to Have Some Type of Taint

Current taxation is sometimes imposed upon the German parent for operations of a foreign subsidiary, even though the earnings are not repatriated back to Germany. This occurs through a system enacted by Germany that is similar in some respects to the United States Subpart F system.[11] Germany currently taxes the German parent on low taxed "base company income" of a "controlled foreign corporation." A controlled foreign corporation exists if a foreign corporation is considered owned more than 50% (by vote or value) by German residents.[12]

Furthermore, current income attribution to the German corporate parent (and, therefore, current taxation) will only be imposed if the foreign subsidiary has low taxed "base company income." Income is considered to be low taxed if it is realized by a subsidiary resident in a country officially considered to be a tax haven (See Attachment A) and possibly in other countries as well, if the effective rate is less than 30%. In determining whether the income is taxed at less than 30%, basically the statutory rate of taxation (considering special tax and treaty incentives, but not net operating losses) is applied.[13] "Base company income" is generally defined as passive income of the controlled foreign corporation.[14] Generally, active business income in the foreign subsidiary would not be base company income, with certain exceptions, the major exception being certain trading profits.

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9 The German Corporate Tax Law with 1980 Amendments, Ault and Radler, Kluwer, 1980, p. 37.
10 See Endnote No. 7, above.
11 Aussensteuergesetz, The International Transactions Act (hereafter: "AStG").
12 AStG, §7(2).
13 AStG, §8(3).
14 AStG, §8(1).

Trading profits will be considered base company income only if the goods being traded are exported from Germany or imported into Germany. Thus, income from typical foreign based company operations having nothing to do with physical flows of goods into or out of Germany are excluded from the definition of foreign base company income. Even if goods are exported from Germany to a related controlled foreign corporation or imported into Germany through such a corporation, the related corporation's income is not attributable to the German parent if the related company transacts the sales activity and the various auxiliary features of the sales activity without the assistance of the parent company or another related person, and if it engages in these types of trading activities with the public at large.[15]

Finally, even though the German Subpart F equivalent rules would treat a foreign subsidiary's income as includible in the German parent's taxable income, tax treaty provisions may nevertheless override this result. With respect to countries that have a tax treaty with Germany that exempts dividends to qualified German parent companies from German tax, the foreign corporation's tainted income is exempt from the Subpart F equivalent rules whether or not it is distributed to the German parent corporation. This is true even in Switzerland, which is on the tax haven list, as long as the income of the Swiss subsidiary is active in nature. Germany regards these treaty provisions as controlling and, therefore, any dividends actually paid out of the earnings or any undistributed profits will not be included in German taxable income.[16]

[4] German Tax Recognition of Foreign Losses

In Germany, if a type of foreign source business income is subject to German tax, foreign losses of that same type may be deducted when incurred, without recapture. Germany also allows a deduction of foreign permanent establishment losses even if its income would be exempt under a relevant treaty.[17] In such cases, profits generated by the permanent establishment in later years must be subjected to German taxation up to the total amount of the deducted losses. There is no time limit for such recapture. Germany no longer, however, allows the creation of a loss reserve for foreign subsidiaries generating losses.

§1.02 Foreign Tax Credit Utilization

Germany allows a foreign tax credit for foreign taxes paid. The credit is allowed for the same proportion of the German tax payable as the proportion of foreign source income to total worldwide income. The credit is available under German domestic tax law,[18] and is also provided for in certain German tax treaties.

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[15] AStG, §8(1), No. 4, a and b

[16] AStG, §10(5).

[17] Up to 1989: Auslandsinvestitionsgesetz, Foreign Investment Code (hereafter: "AIG"), §2; 1990 and Following years: EStG, §2a(3) & (4).

[18] KStG, §26 and EStG, §34c.

If income is exempt from German taxation (as, for example, the permanent establishment and the dividend income exemption found in most industrialized country treaties), then taxation imposed by a foreign country on that income is not eligible for the foreign tax credit.

A German corporation may elect, alternatively, to deduct foreign taxes paid, instead of using them as a credit.

[1] Overall or Per Country Foreign Tax Credit Limitation

Germany uses a per country foreign tax credit limitation system. Therefore, income and losses from more than one country cannot be offset to achieve a blended foreign tax rate for operations in several countries.[19] Neither can this result be achieved indirectly by establishing a single foreign holding company with operating subsidiaries in a number of other countries.

[2] Availability of Deemed Paid Foreign Tax Credits

Germany allows a deemed paid foreign tax credit for first and second tier affiliates owned at least 10% by the German parent.[20] In order to qualify for the deemed paid credit, the subsidiary must be involved in one of seven active business activities. Export sales activities, for example, would qualify as an active business, which would then, in turn, qualify for the deemed paid credit.

[3] Blending of Foreign Taxes - Existence of Baskets of Income

Except within a particular country, there is no blending of foreign tax rates and there is no provision for separate baskets of income.

[4] Carryforward and Carryback of Foreign Tax Credit

Germany allows no carryforward or carryback of foreign taxes for foreign tax credit purposes.

[5] Foreign Losses and Their Impact on Foreign Tax Credit Limitation Calculation

Foreign Losses offset foreign source income generated only in the same country and reduce worldwide taxable income for purposes of the foreign tax credit limitation calculation. However, Germany will not reallocate a net operating loss from one country to offset income generated in another country.

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19 Einkommensteuerdurchfuehrungsverordnung, Implementing Ordinance for the Individual Income Tax Law (hereafter: "EStDV"), §68(a) and Felix/Streck Commentary on KStG, Annotation No. 10 to §26.

20 KStG, §26(2) and (5).

[6] Source of Income and Deductions

Germany has a specific set of sourcing rules for determining "profits". It does not have special rules for allocating general expense as foreign or domestic source, but expenses may be allocated on a "tracing basis" if directly related to specific income. It is possible to plan around any adverse impact of the tracing system.

[7] Tax Sparing Credit

Another important aspect of tax treaties between Germany and thirty-three other countries (See Attachment B) is the allowance of a German tax sparing credit. This is accomplished by allowing a foreign tax credit based on a stated assumption that foreign taxes have been paid, even though they are forgiven by the foreign country.[21] Usually, the fictitious tax credit is available for all or some of the following items: dividends, royalties and interest. Depending on the treaty, the rate of tax credit is between 10% and 25%.

For example, in the Germany-Singapore tax treaty,[22] dividend income from a controlled Singapore subsidiary is exempt from German taxation. However, interest and royalty income paid to the German parent are not. Even if Singapore does not tax such income payments, Germany will nevertheless allow a foreign tax credit to the German parent, computed as though a 10% tax had been paid to Singapore on the interest and royalties.

§1.03 Announced Tax Reform Proposals

As of this date, no tax reform proposal relating to the multinational tax provisions have been officially put forward by the German Government.

21 Otto H. Jacobs, Internationale Unternehmensbesteuerung, International Taxation of Enterprises, pages 115 and following.
22 Germany/Singapore Tax Treaty, Art. 23(1), c and d.

Attachment A
To Appendix No. 4

GERMAN OFFICIAL LIST OF IMPORTANT COUNTRIES WITH LOW TAX RATES, PREFERENTIAL RATES OR TAX EXEMPTION FOR CORPORATIONS

1. Andorra
2. Angola
3. Antigua
4. Bahamas
5. Bahrain
6. Barbados
7. Bermuda
8. Campione
9. Cayman Islands
10. Channel Islands (Alderney, Guernsey, Jersey, Sark)
11. Gibraltar
12. Gilbert and Ellice Islands
13. Hong Kong
14. Isle of Man
15. Jamaica
16. Leeward Isles
17. Liberia
18. Liechtenstein
19. Luxembourg
20. Monaco
21. Netherlands Antilles
22. New Guinea
23. New Hebrides
24. Norfolk
25. Panama
26. Papuan
27. Republic of Vanuatu
28. Solomon Islands
29. St. Helena
30. Switzerland
31. Tonga
32. Turks and Caicos Isles
33. Virgin Islands

Attachment B
To Appendix No. 4

COUNTRIES HAVING TAX TREATIES WITH GERMANY PROVIDING FOR TAX SPARING CREDITS

1. Argentina
2. Brazil
3. China
4. Cyprus
5. Ecuador
6. Egypt
7. Greece
8. India
9. Indonesia
10. Ireland
11. Israel
12. Ivory Coast
13. Jamaica
14. Kenya
15. Korea
16. Liberia
17. Malaysia
18. Malta
19. Mauritius
20. Morocco
21. Norway
22. Pakistan
23. Philippines
24. Portugal
25. Singapore
26. Spain
27. Sri Lanka
28. Switzerland
29. Trinidad and Tobago
30. Tunisia
31. Turkey
32. Uruguay
33. Zimbabwe

Appendix No. 5

TAX TREATMENT OF MULTINATIONALS BY HOME COUNTRIES

ITEM	UNITED STATES	THE NETHERLANDS	JAPAN	GERMANY
EXEMPTION OR DEFERRAL OF HOME COUNTRY TAX				
Exemption of Foreign Branch Income from Home Country Tax	No (with exceptions for Foreign Sales Corporations and possessions operations)	Yes	Generally no (with exception for effective exemption under tax sparing treaties)	Yes, by treaty for developed and many developing countries
Exemption of Dividends from Controlled Foreign Subsidiaries, in Home Country Tax Base	No	Yes	No (with exception noted above)	Yes, by treaty for most developed and many developing countries
Loan by Foreign Subsidiary to Parent Without Home Country Tax	No	Yes	Yes	Yes
Current Home Country Taxation of "Tainted" Non-Repatriated Foreign Subsidiary Earnings	Yes	No	Yes (but less encompassing rules than U.S.)	Yes (but less encompassing rules than U.S.)
Home Country Recognition of Foreign Losses	Yes, for branches; no, for subsidiaries	Yes, for branches; no, for subsidiaries	Yes, for branches and with limits for subsidiaries	Yes, for branches; no, for subsidiaries
FOREIGN TAX CREDIT UTILIZATION				
Overall v. per Country Limitation	Overall, but with 10 separate categories of limitations	Overall (except for per country provided by some treaties)	Overall	Per country
Availability of Deemed Paid Foreign Tax Credit on Dividends	Yes	No (but not generally necessary)	Yes (but only from first tier companies)	Yes
Blending of Foreign Tax Rates on Different Types of Income	No	Yes	Yes (except for certain withholding tax on interest and taxes of high tax countries)	Yes
TAX SPARING CREDIT				
Tax Sparing Treaties	No	Yes	Yes	Yes

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