Fundamentals of International Taxation

Income Tax Treaties

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Treaty Benefits

Purposes of Income Tax Treaties

- Reduction in withholding taxes
- Higher threshold for imposing tax on business profits
- Relief from double taxation
- Exchange of Information
- Resolution of double tax issues

Reduction of Taxes

- Reduction of withholding taxes on dividends
  - U.S. domestic law – 30% withholding tax
  - Treaties –
    - 5% & 15%
    - Higher rates in treaties with certain developing countries
    - 0% with certain major trading partners (England, Australia)
- Elimination of withholding taxes on interest and royalties
  - U.S. domestic law – 30% withholding tax
- Reduction of branch profits tax to dividend withholding rate

Business Profits

- Permanent establishment must exist before business profits can be taxed in source country
  - Compare U.S. domestic law – sole requirement is that foreign person is engaged in a U.S. trade or business during the year
  - Special rules for deferred compensation, deferred payment sale, recapture of depreciation

Business Profits

Permanent Establishment

P General Definition

- A fixed place of business through which the business of an enterprise is wholly or partly carried on

Specific inclusions--

- A place of management
- A branch
- An office
- A building site or construction or installation project
- A factory
- A workshop
- A mine, oil or gas well, quarry, and the like

Business Profits

Permanent Establishment

- Specific exclusions
  - The use of facilities solely for the purpose of storage, display or delivery of merchandise
  - The maintenance of merchandise solely for the purpose of storage, display or delivery
  - The maintenance of merchandise solely for the purpose of processing by another

Business Profits

Permanent Establishment

- Specific exclusions
  - The maintenance of a fixed place of business solely for the purpose of purchasing merchandise or collecting information
  - The maintenance of a fixed place of business solely for the purpose of carrying on any other activity of a preparatory or auxiliary character

Business Profits

Permanent Establishment

- Agency Rule
  - An agent, other than an independent agent acting in the ordinary course of his business, is a permanent establishment if it
    - Acts on behalf of an enterprise
    - Has an authority to conclude contracts that are binding on the enterprise and
    - Habitually exercises that authority in a Contracting State

Business Profits

Permanent Establishment

- Independent Agent Rule
  - A broker, general commission agent, or any other agent of an independent status is not a permanent establishment, provided that it is acting in the ordinary course of business
  - For this rule to apply, an agent must be both:
    - Legally independent – i.e., the agent is not a subsidiary
    - Economically independent – i.e., the agent would go out of business if contract were terminated

Relief From Double Taxation

- Two methods to eliminate double taxation
  - Credit method
    - Foreign taxes actually paid can be used to offset U.S. tax on that income
    - Indirect credit for taxes paid by 10% subsidiary
    - Exclusive method to eliminate double taxation for U.S. residents and corporations

Relief From Double Taxation

- Two methods to eliminate double taxation (Cont.)
  - Exemption method
    - Income attributable to a foreign permanent establishment and dividends from 10% subsidiary are exempt from home country tax if the permanent establishment or subsidiary is subject to tax in host country
    - U.S. persons are not entitled to rely on this method of double tax relief

Relief From Double Taxation

Foreign Tax Credit

- For U.S.-based taxpayers, the foreign tax credit is subject to the limitations of U.S. tax law as it may be amended from time to time
  - Examples of amendments
    - Basket rule
    - Alternative minimum tax cannot be totally offset

Relief From Double Taxation

Foreign Tax Credit

- Special source rule
  - If foreign country may impose tax, the income is deemed to arise in that country
    - Capital gains attributable to permanent establishment
    - Royalties paid by a local resident or permanent establishment
  - If the source of income is changed under this rule, a separate basket is used

Inherent Conflicts Between Code & Treaties

Item	Code	Treaty
Dividends	30%	5% & 10%/0%
Interest/Royalties	30%	0%
Branch Profits Tax	30%	5% & 10%
Foreign tax credit limitation	General source rules	Treaty source rules
Business Profits Tax Threshold	Engaged in Trade/ Bus.	Permanent establishment

Treaty Shopping

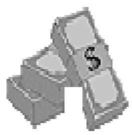
Treaty Shopping

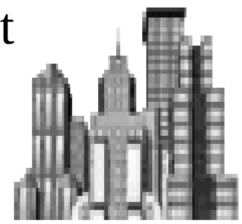
Economic Transaction in the Absence of a Treaty

Residence Country

U.S.

Economic Investment

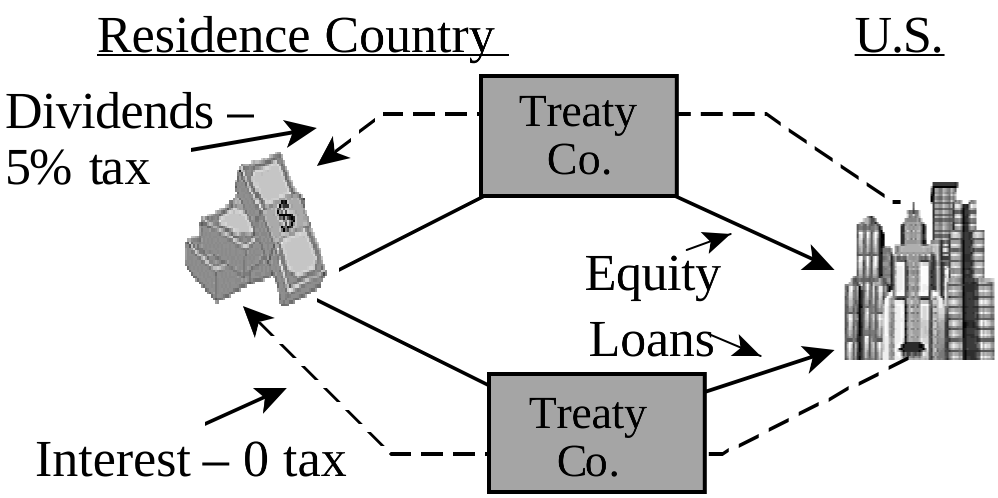




Dividends and Interest are Subject to 30% Withholding Tax

Treaty Shopping

Restructured Transaction to Benefit from Treaty



Treaty Shopping

Concepts of Plan

- Have Appropriate Form
- Have Appropriate “Minimum” Tax Ruling
- Structure Outside the U.S. Ignored
- Lenient Standards of Business Purpose

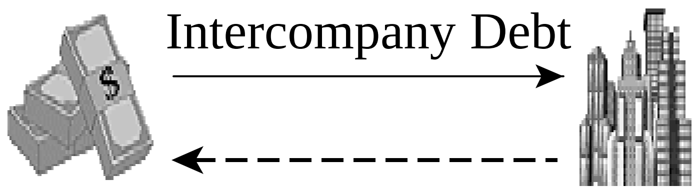
Treaty Shopping

Aiken Industries *Case*

Original Structure

Bahamas

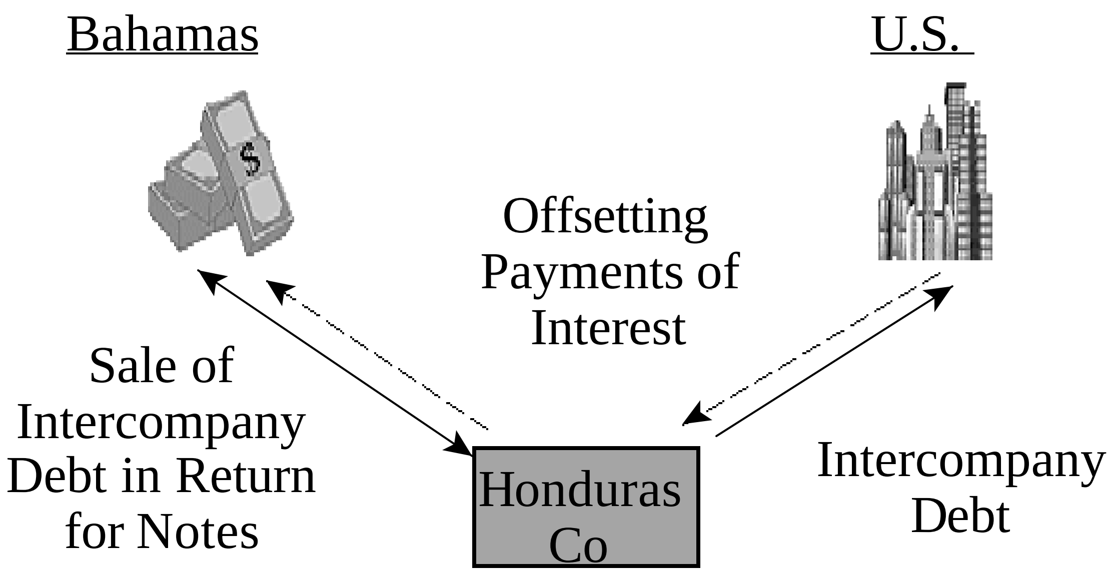
U.S.



Interest Payment Subject to 30%
Withholding Tax

Treaty Shopping

Aiken Industries Case



Treaty Shopping

Aiken Industries Case

- Tax Court Holding –
  - Treaty inapplicable
  - Treaty exempts interest "received by" corporation resident in Honduras
  - "Received by" means economic ownership not temporary possession pursuant to conduit arrangement

Treaty Shopping

- Rev. Rul 84-152 —
  - Facts are similar to Aiken, except that treaty resident is in place from the beginning and the treaty remains in effect at time of I.R.S. examination
    - Tax avoidance existed because the primary purpose for the finance subsidiary was to obtain tax treaty benefits
    - Other possible business reasons for the structure were not sufficient to overcome the conduit nature of the transaction

Treaty Shopping

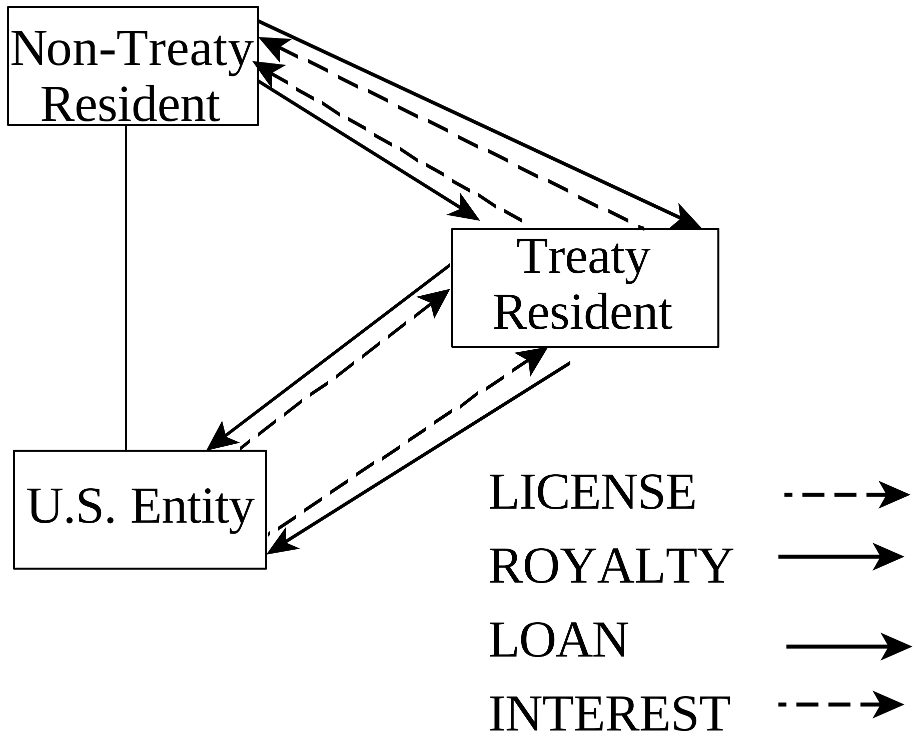
- Problems with conduit-based approach in litigation
  - Difficult to enforce if transaction involves unrelateds
  - I.R.S. does not always succeed
    - SDI Netherlands B.V. — Back-to-back Royalty Structure
    - Northern Indiana Public Service Company — Eurodollar Finance Subsidiary

Treaty Shopping

- New approaches adopted by Congress, Treasury, and the I.R.S. to stop treaty shopping –
  - Anti-conduit rules added to Code & Regulations
  - Earnings stripping provisions added to Code
  - Limitation on Benefits provision added to Treaties
  - Compliance initiative is added to Withholding Regulations
- Each hurdle must be overcome to obtain treaty benefits

Anti-Conduit Regulations

Typical Conduit Fact Pattern



Anti-Conduit Regulations

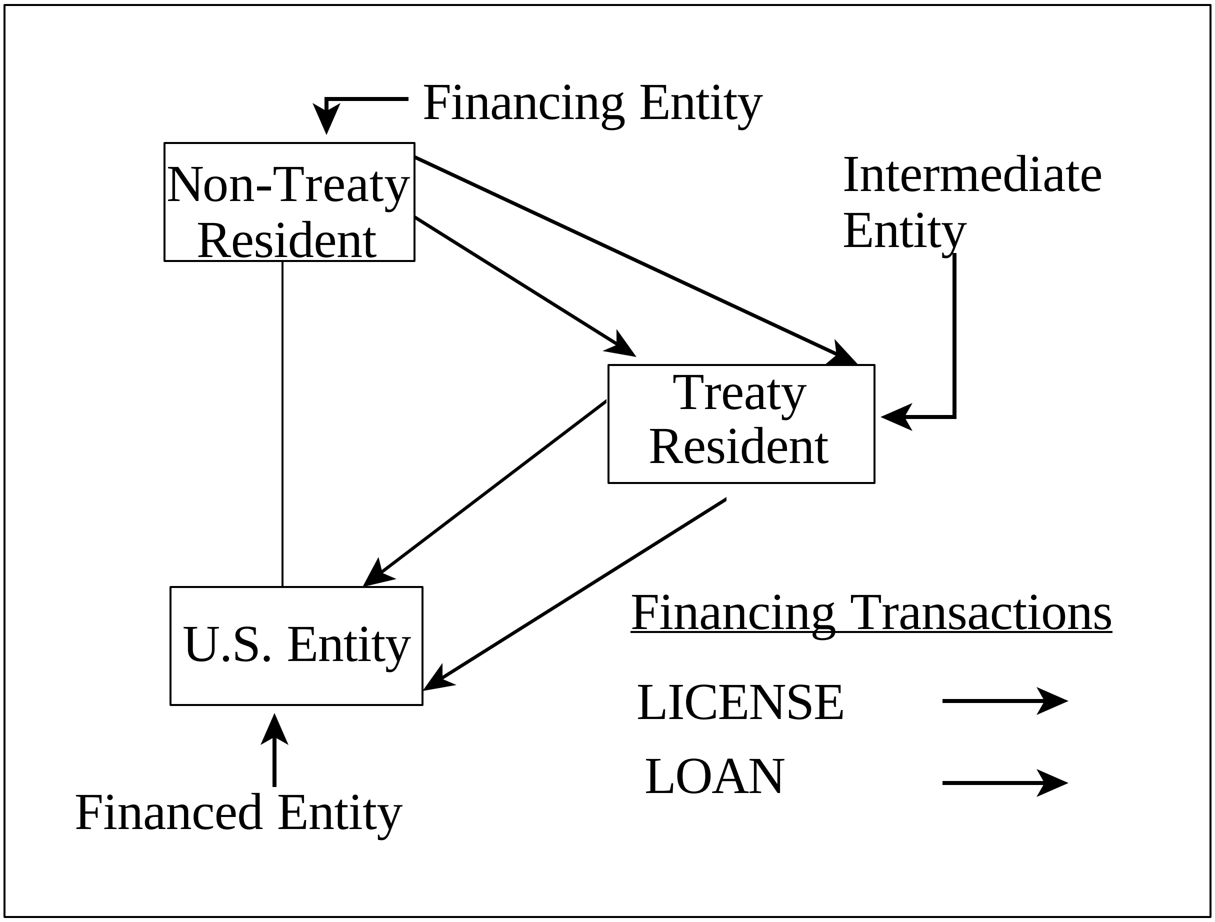
- Legislative regulations are authorized by Code §7701(l)
- Regs. §1.881-3 –
  - I.R.S. may disregard the participation of one or more “intermediate entities” in a “financing arrangement” that act as “conduit entities”
  - Applies to Code §881 substantive tax
  - Applies to Code §1441 withholding tax

Anti-Conduit Regulations

- Financing Arrangement
  - A series of transactions
  - The financing entity advances money or other property, or grants rights to use property
  - The financed entity receives money or other property, or rights to use property
  - The advance and receipt are effected through one or more intermediate entities
  - Financing transactions link the financing entity, each of the intermediate entities, and the financed entity

Anti-Conduit Regulations

- Financing Transaction
  - Debt
  - Redeemable stock where redemption is likely to occur or is contemplated
  - Leases or licenses
  - Any other transaction where –
    - A person makes an advance of money or other property or grants rights to use property to a transferee
    - The transferee is obligated to repay or return a substantial portion of the money or other property advanced, or the equivalent in value

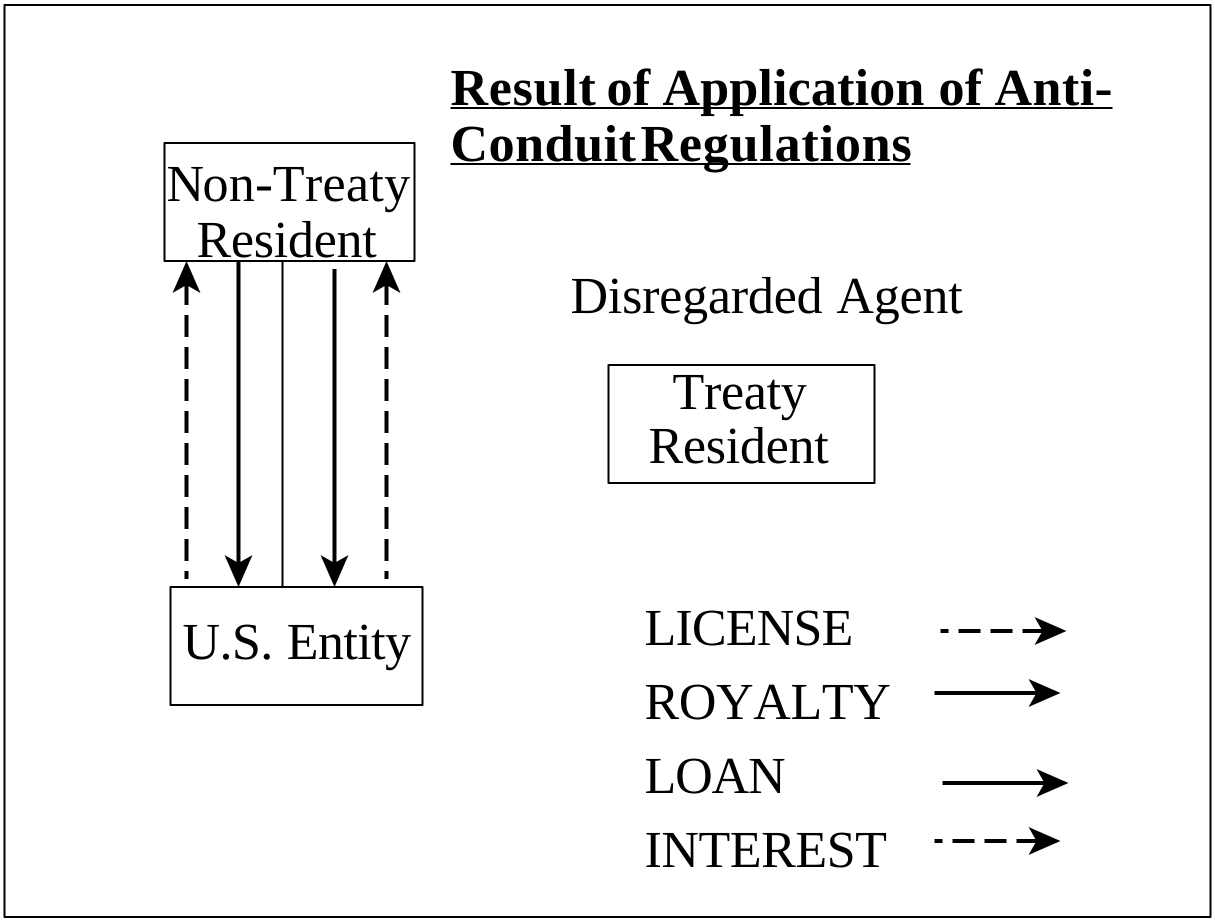

Financing Entity
Non-Treaty Resident
Intermediate Entity
Treaty Resident
U.S. Entity
Financing Transactions
LICENSE
LOAN
Financed Entity

Anti-Conduit Rules

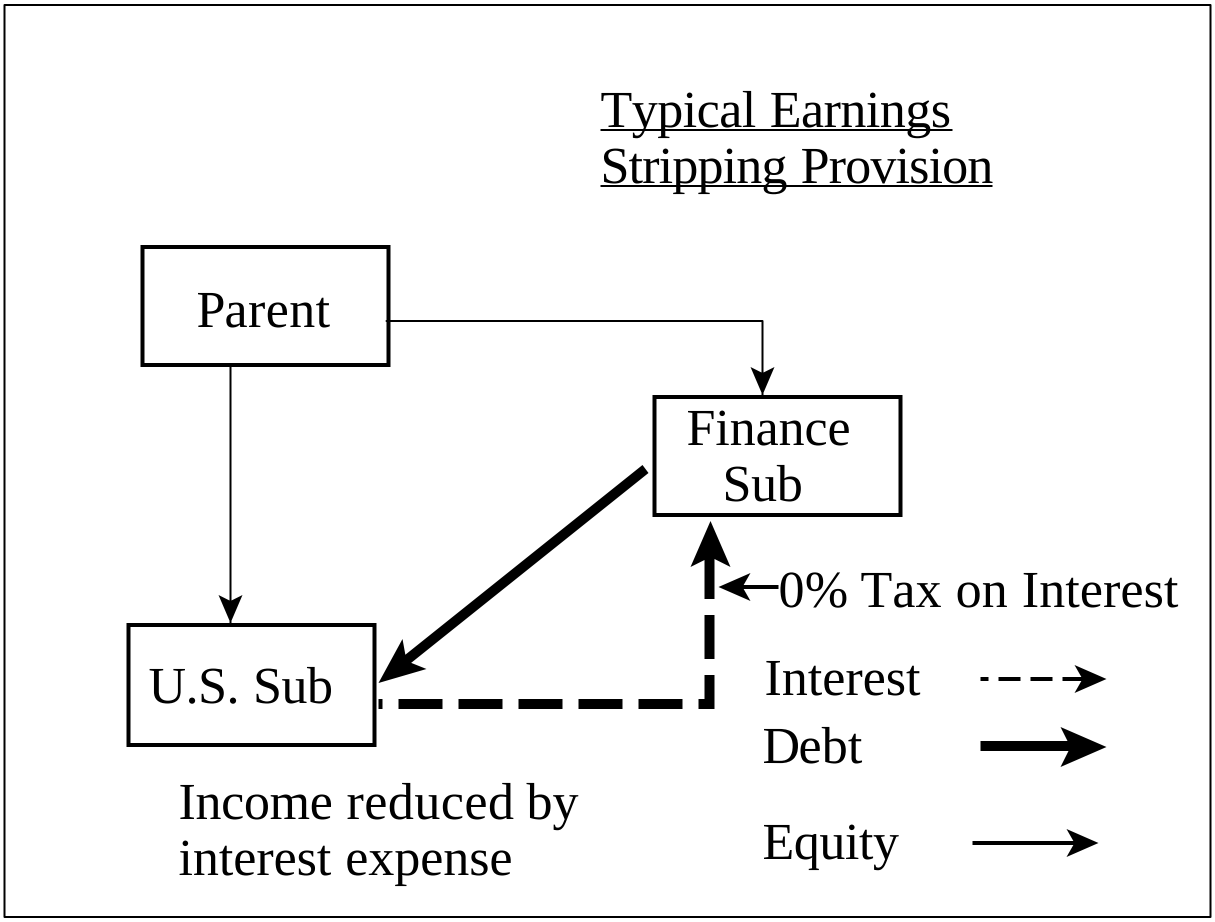
- An intermediate entity is a conduit entity if--
  - Its participation reduces the tax imposed by Code §881
  - Its participation is pursuant to a tax avoidance plan and
  - Either –
    - The intermediate entity is related to the financing entity or the financed entity or
    - The intermediate entity would not have participated in the financing arrangement but for participation of the financing entity in the financing transaction with the intermediate entity

Anti-Conduit Regulations

- If a financing arrangement involves use of a conduit transaction
  - The financing arrangement is characterized as a financing transaction directly between the financed entity and the financing entity
  - The disregarded conduit entity is treated as an agent of the financing entity
  - The conduit entity may not claim the benefits of a tax treaty
  - The financing entity may claim the benefits of an income tax treaty


Result of Application of Anti-Conduit Regulations
Non-Treaty Resident
U.S. Entity
Disregarded Agent
Treaty Resident
LICENSE
ROYALTY
LOAN
INTEREST

Earnings Stripping


Typical Earnings
Stripping Provision
Parent
Finance
Sub
U.S. Sub
0% Tax on Interest
Interest
Debt
Equity
Income reduced by
interest expense

Earnings Stripping Provisions

- Code §163(j) provides a limitation on the interest expense that may be deducted by a U.S. Corporation that
  - Has "excess interest expense" and
  - Is "overcapitalized" with debt, and
  - Has "disqualified interest"

Earnings Stripping Provisions

- A corporation is overcapitalized with debt if its debt-equity ratio exceeds 1.5-to-1
- If a treaty reduces withholding tax rate, but does not eliminate withholding tax, a pro-rata portion of the interest paid to the related person will be treated as if exempt from U.S. tax

Earnings Stripping Provisions

- Excess interest expense is the excess of "net interest expense" over the sum of:
  - 50% of "adjusted taxable income" plus
  - "Excess limitation" carryforward from the preceding three years.
- "Adjusted taxable income"
  - Taxable income adjusted by adding back:
    - Net interest expense,
    - NOL carryovers,
    - Depreciation, amortization, and depletion

Earnings Stripping Provisions

- Disqualified Interest –
  - Interest paid to a related person that is not subject to full U.S. withholding tax on receipt
  - Interest paid on a loan from an unrelated party if:
    - No U.S. withholding tax is imposed on the gross amount of the interest paid and
    - The loan from the unrelated party is "guaranteed" by a related foreign person.

Earnings Stripping Legislation

- Triggers may be revised under several legislative proposals under review by Congress
  - Definition of over-capitalization would be lowered to 1.35:1
  - If the debt-equity ratio of U.S. subsidiary exceeds worldwide group’s debt-equity ratio ratio:
    - The interest expense on the excess is disallowed
    - Disallowed interest expense cannot be recovered in future years
    - No offset for interest income

Limitation on Benefits Article

Limitation on Benefits

- Goals:
  - Prevents treaty shopping
  - Provides Incentives for Countries to Negotiate Treaties with the U.S. That Benefit U.S.-based Companies
  - Ensures That Treaty-Based Exceptions to U.S. Domestic Law Have Limited Application to “True” Residents of Treaty Jurisdiction
  - Distinguishes Between Prevention of Double Taxation and Complete Absence of Taxation

Limitation on Benefits Provisions

- Virtually all income tax treaties of the U.S. with major trading partners contain L.O.B. provisions
- Exceptions:
  - The existing U.K. Treaty, but not its replacement
  - Japan
  - Hungary

Limitation on Benefits Provisions

- L.O.B. provisions vary from treaty to treaty
- Underlying Philosophy –
  - To obtain treaty benefits, treaty resident must have substantial economic contacts with country of residence
  - Corporate resident may qualify as to all its income if certain tests are met
  - Corporate resident may qualify as to some of its income if other tests are met

Limitation on Benefits Provisions

- Broad themes for qualification —
  - Individual residents
  - Governmental entities
  - Publicly traded companies
  - Subsidiaries of publicly traded companies
  - Companies that are locally owned or owned by U.S. residents if base erosion is absent
  - A company owned by a defined class of third country persons (E.U. or N.A.F.T.A.)

Limitation on Benefits Provisions

- Companies that have active business expanded into U.S. may qualify for benefits with regard to a stream of income, if
  - The business in the residence country is substantial
  - The stream of income is connected with or incidental to that business

Limitation on Benefits Provisions

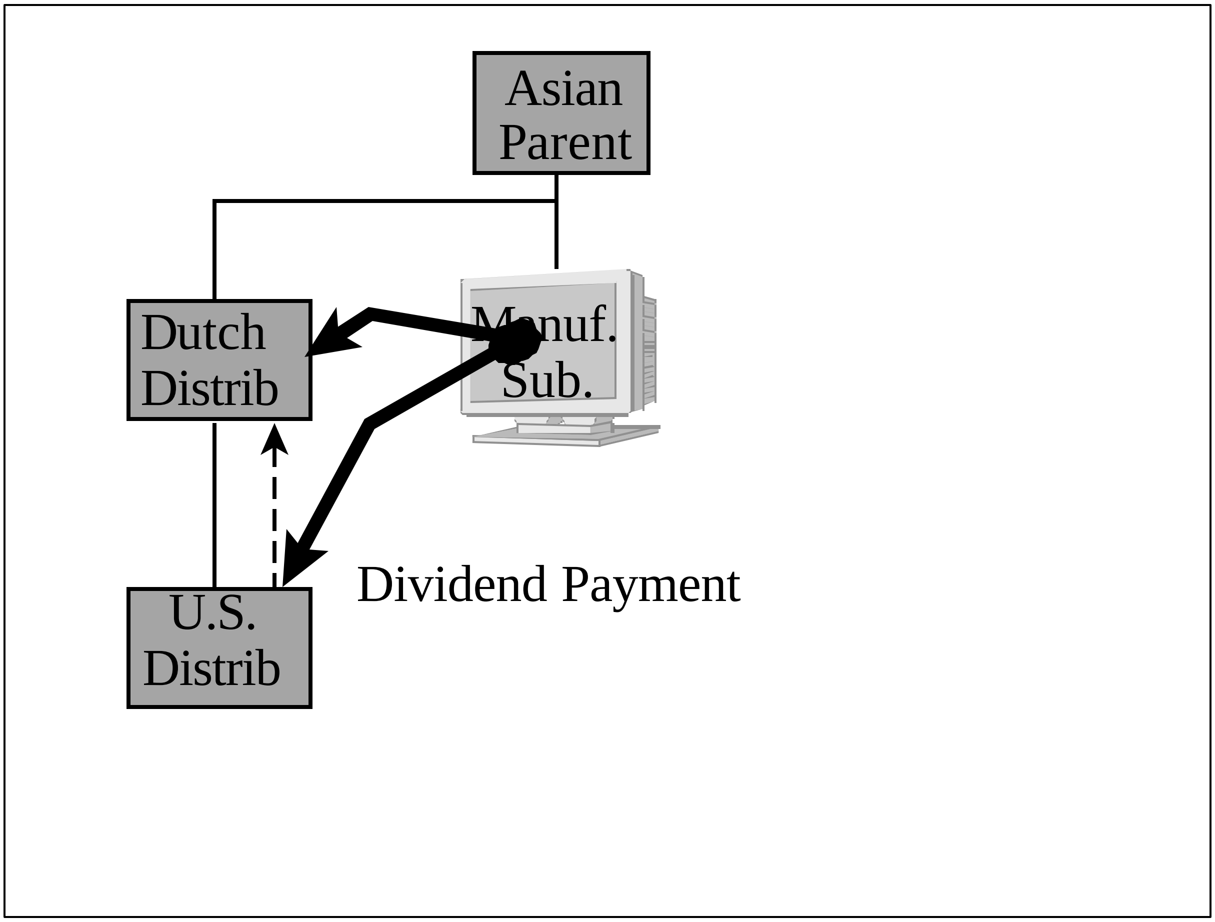
- Substantial Business Abroad
  - In the U.S. Model Treaty, two tests exist to measure substance:
    - Facts & circumstances test
    - Objective test based on factors:
      - Assets, gross income & payroll in home country compared with counterparts in host country
      - Home country activities must aggregate to 10%, no activity can be less than 7.5%

Limitation on Benefits Provisions

- Substantial Business Abroad
  - Some treaties look to company on a stand-alone basis; others apply test on a group-wide basis within country
  - Most treaties apply factors during the prior year;
  - Some treaties provide alternative measuring period of 3 prior years

Limitation on Benefits Provisions

- Substantial Business Abroad
  - Income-producing activity in the host State must be connected to the business carried on in the country of residence
    - Vertical or horizontal integration
    - The design, manufacture, or sale of the same types of products or similar services
  - Alternatively, income-producing activity in the host State must be complementary to the business
    - Part of same overall industry and profitability of each are related
    - Airline and airport hotels


Asian
Parent
Dutch
Distrib
Manuf.
Sub.
U.S.
Distrib
Dividend Payment

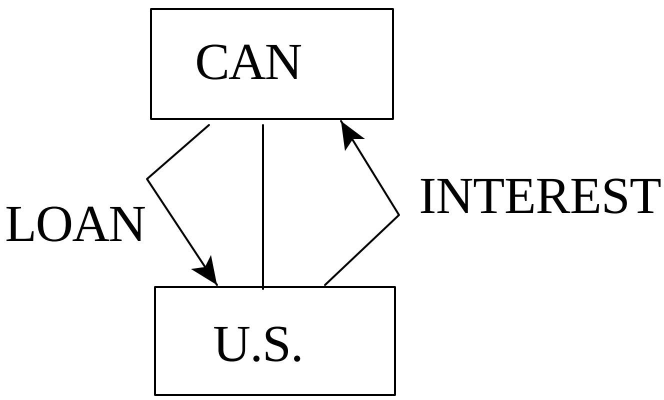
Hybrid Entities

- Hybrid entities have been used to avoid L.O.B. provisions
- Basic approach takes advantage of incongruences between U.S. and foreign law–
  - Under U.S. concepts, payment goes through hybrid entity to a qualified resident; therefor treaty applies
  - Under foreign law concepts, no taxable payment is ever received by resident; therefor no tax is imposed

Hybrid Entities

<u>Economic Transaction</u>

Canadian parent makes loan to U.S. subsidiary

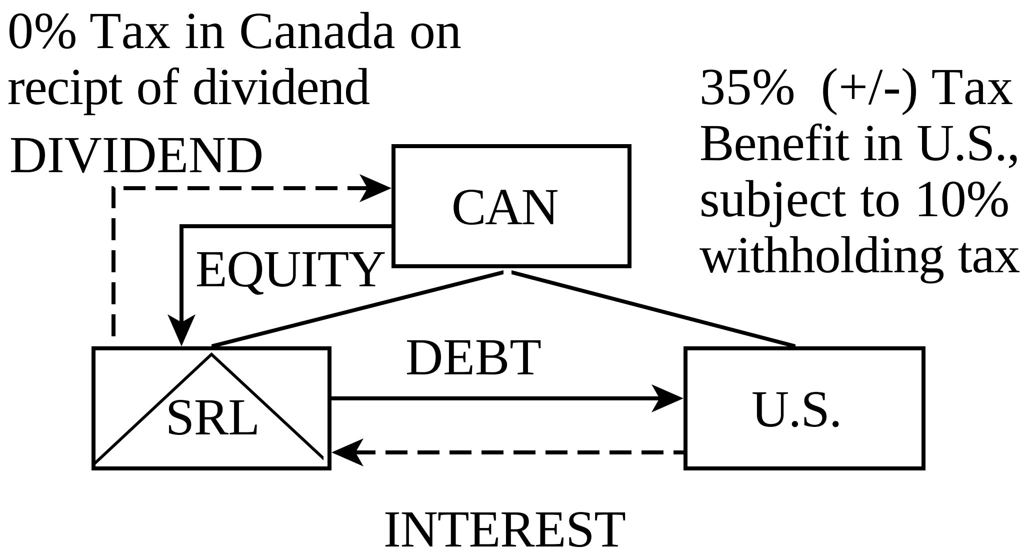


45% (+/-) Tax in Canada on receipt of interest

35% (+/-) Tax Benefit in U.S., subject to 10% withholding tax

Hybrid Entities

Benefit derived from use of hybrid entity

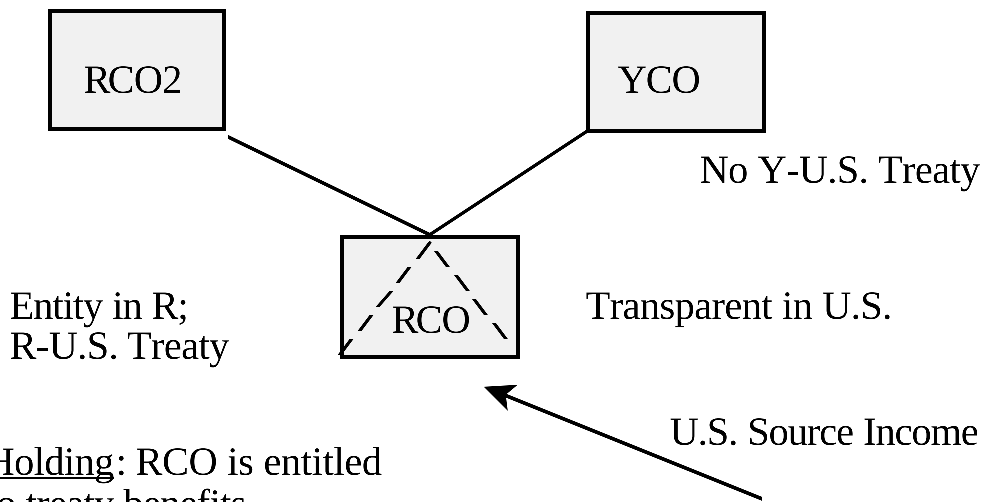


Payments to Hybrid Entities

- **Regs. §1.894-1**
  - Payments of U.S. source income to an entity that is treated as fiscally transparent for U.S. Federal income tax purposes but as a taxable entity under the tax laws of the treaty partner are not eligible for treaty relief
  - Fiscal transparency means –
    - Current income taxation for shareholders
    - As if they received income directly from source

Hybrid Entity Regulations

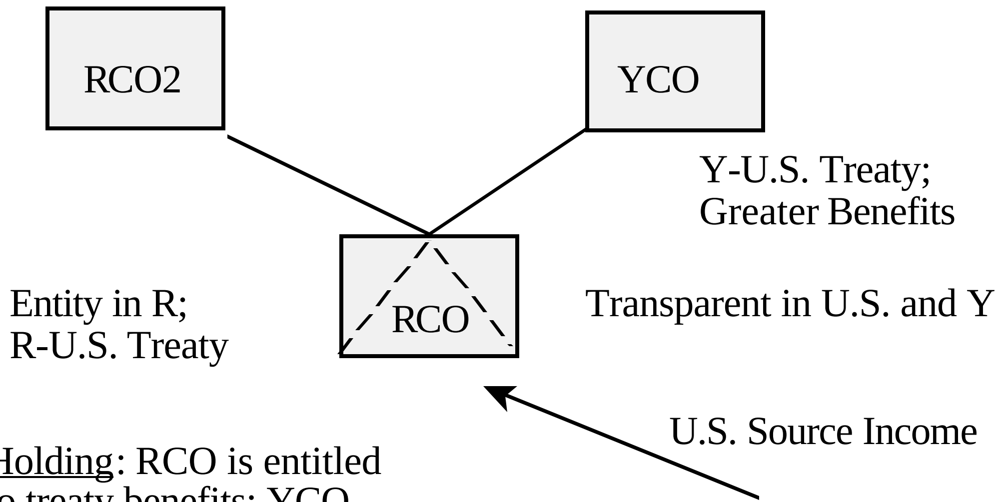
Example 1



<u>Holding</u>: RCO is entitled to treaty benefits

Hybrid Entity Regulations

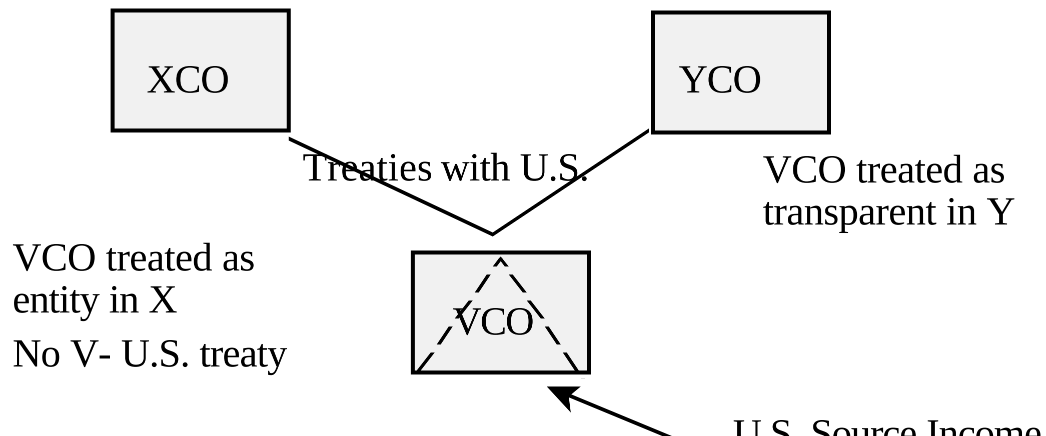
Example 3



Holding: RCO is entitled to treaty benefits; YCO is entitled to treaty benefits for its share of income

Hybrid Entity Regulations

Example 4



Holding: YCO is entitled to treaty benefits; XCO and VCO are not entitled to benefits

Withholding Tax – Compliance Initiaative

Compliance

- Absent actual knowledge or reason to know otherwise, a withholding agent may rely on a claim of tax treaty relief if —
  - Prior to the payment
  - The withholding agent can reliably associate the payment with documentation
  - The documentation shows that the payment is made to a foreign beneficial owner

Compliance

- W-8 BEN
- Advises the U.S. payer that the recipient is–
  - A foreign person
  - Not subject to backup withholding
  - The beneficial owner and not a conduit or agent
  - Entitled to treaty benefits after application of L.O.B.
  - The holder of a properly issued taxpayer identifying number in the U.S.

Compliance

- W-8IMY
- This document advises the payer that –
  - The recipient is not the beneficial owner of the income
  - The recipient of the income is an intermediary
- The intermediary has an obligation to obtain a Form W-8BEN or a Form W-9 from beneficial owners and to furnish information to payer and I.R.S.

Compliance

- Qualified intermediary exception to furnish FormsW-8BEN for foreign beneficial owners
  - Foreign financial institution may enter agreement with the I.R.S. to collect and retain information and to withhold U.S. tax at proper rate
  - Part of "Know Your Customer" obligations of financial institutions
  - Treaty qualification for customers is monitored by financial institution
  - Treaty withholding is applied on a group-wide basis with no individual identification
  - Only W-9 information for individual Americans is provided to I.R.S.

Compliance

- Foreign financial institutions who invest client funds take the reporting obligation seriously
- Backup withholding is imposed on total sales proceeds for securities transactions handled by foreign brokerage accounts
- Estate tax compliance is now being taken seriously by transfer agents

The End