BACKGROUND AND SELECTED ISSUES RELATED TO THE U.S. INTERNATIONAL TAX SYSTEM AND SYSTEMS THAT EXEMPT FOREIGN BUSINESS INCOME

Scheduled for a Public Hearing
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INTRODUCTION

The House Ways and Means Committee has scheduled a public hearing for May 24, 2011 on the rules in certain foreign jurisdictions for taxing foreign income. This document,[1] prepared by the staff of the Joint Committee on Taxation, describes the U.S. international tax rules applicable to foreign income of resident taxpayers, provides a general overview of a territorial system of taxation, including a brief discussion of basic design considerations, and summarizes the rules of nine selected countries for the taxation of foreign income.

[1] This document may be cited as follows: Joint Committee on Taxation, *Background and Selected Issues Related to the U.S. International Tax System and Systems that Exempt Foreign Business Income,* (JCX-33-11), May 20, 2011. This document can also be found on our website at www.jct.gov.

I. PRESENT LAW: WORLDWIDE TAXATION AND DEFERRAL OF ACTIVE BUSINESS INCOME

A. In General

The United States has a worldwide tax system under which U.S. resident individuals and domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned directly, including as a result of a domestic corporation's conduct of a foreign business itself (by means of branch operations in the foreign jurisdiction) rather than through a separate foreign legal entity, or through a pass-through entity such as a partnership, is taxed on a current basis. Foreign business income earned by a domestic parent corporation indirectly through a foreign corporate subsidiary generally is not subject to U.S. tax until the income is distributed as a dividend to the domestic corporation. This rule is circumscribed by the anti-deferral rules of subpart F of the Internal Revenue Code, which provide that a domestic parent corporation is subject to U.S. tax on a current basis with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries. To mitigate double taxation of foreign-source income, the United States allows a domestic corporation to claim a credit for foreign income taxes paid by it and its foreign subsidiaries.

Present law provides detailed rules for the allocation of deductible expenses between U.S.-source income and foreign-source income. These rules do not affect the timing of the expense deduction. A domestic corporation generally is allowed a current deduction for its expenses (such as interest and administrative expenses) that support income that is derived through foreign subsidiaries and on which U.S. tax is deferred. Instead, as is described in more detail in section I.B.2 below, the expense allocation rules apply to a domestic corporation principally for determining the corporation's foreign tax credit limitation. This limitation is computed by reference to the corporation's U.S. tax liability on its taxable foreign-source income in each of two principal limitation categories.

B. Principal Features

1. Anti-deferral regimes

Subpart F

Under the subpart F rules,[2] 10-percent or greater U.S. shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on their pro rata shares of certain income earned by the CFC, whether or not the income is distributed to the shareholders. A CFC is defined generally as a foreign corporation with respect to which U.S.10-percent shareholders own more than 50 percent of the combined voting power or total value of the stock of the corporation.

Income subject to current inclusion under subpart F (before consideration of the temporary rules described below) includes, among other categories, insurance income and foreign base company income. Foreign base company income consists of foreign personal holding company income, income from certain transactions involving a related person (for example, income derived from services performed for or on behalf of a related person outside the country in which the CFC is organized), and income attributable to certain oil and gas activities.[3]

Foreign personal holding company income generally comprises the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and real estate mortgage investment conduits ("REMICs"); (3) net gains from commodities transactions; (4) net gains from certain foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; (7) payments in lieu of dividends; and (8) amounts received under personal service contracts.

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, as a securities dealer, or in the conduct of an insurance business (so-called "active financing income").[4] So-

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[2] Secs. 951-964. Unless otherwise specified, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

[3] Sec. 954.

[4] Secs. 953(e) and 954(h), (i). The temporary exceptions from the subpart F provisions for active financing income applied only for taxable years beginning in 1998 (Taxpayer Relief Act of 1997, Pub. L. No. 105-34). Those exceptions were modified and extended for one year, applicable only for taxable years beginning in 1999 (Tax and Trade Relief Extension Act of 1998, Pub. L. No. 105-277). The Tax Relief Extension Act of 1999 (Pub. L. No. 106-170) clarified and extended the temporary exceptions for two years, applicable only for taxable years beginning after 1999 and before 2002. The Job Creation and Worker Assistance Act of 2002 (Pub. L. No. 107-147) modified and extended the temporary exceptions for five years, for taxable years beginning after 2001 and before 2007. The Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. No. 109-222) extended the temporary provisions for two years, for taxable years beginning after 2006 and before 2009. The Energy Improvement and Extension Act of 2008 (Pub. L. No. 110-343) extended the temporary provisions for one year, for taxable years beginning after 2008

called "look-through rules" temporarily provide that dividends, interest, rents, and royalties received by one CFC from a related CFC are not treated as foreign personal holding company income to the extent attributable or properly allocable to non-subpart F income of the payor. For these purposes, a related CFC is a CFC that controls or is controlled by the other CFC, or a CFC that is controlled by the same person or persons that control the other CFC. Ownership of more than 50 percent of the CFC's stock (by vote or value) constitutes control for these purposes.[5]

In addition to current U.S. taxation of insurance income and foreign base company income, U.S. 10-percent shareholders are subject to taxation currently on income that is deemed to be distributed when a CFC increases its investment in U.S. property. For this purpose and subject to certain exceptions, U.S. property includes tangible property located in the United States, stock or debt of a related U.S. person, and rights to use certain intangible property in the United States.

Passive foreign investment companies

U.S. shareholders (both individuals and corporations) are effectively taxed currently on earnings of a passive foreign investment company ("PFIC"), regardless of the amount of the PFIC's stock that they own. A PFIC is any foreign corporation: (1) 75 percent or more of the gross income of which is passive, and (2) at least 50 percent of the assets of which produce passive income or are held for the production of passive income.[6] Passive income generally is the same as foreign personal holding company income, as defined for subpart F purposes.[7]

The PFIC rules provide three different methods of taxation. The first is the "excess distribution" regime under which gains from the disposition of PFIC stock and distributions that exceed prior year averages are deemed to have been earned ratably over the U.S. taxpayer's holding period and are subject to an interest charge to reflect the time value of the deferred tax payment. The excess distribution regime can be avoided if a U.S. shareholder elects to treat the PFIC as a qualified electing fund (a "QEF"). If a QEF election is made, the U.S. shareholder is taxed currently on its share of the QEF's earnings. QEF elections may be made only if the PFIC provides sufficient data to its shareholders that the PFIC's ordinary earnings and net capital gain can be determined each year. For investors in publicly traded PFICs (such as foreign mutual

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and before 2010. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Pub. L. No. 111-312) extended the temporary provisions for two years, for taxable years beginning after 2009 and before 2012.

[5] Sec. 954(c)(6). The temporary look-through rules applied only for taxable years of foreign corporations beginning after December 31, 2005 and before January 1, 2009, and to the taxable years of U.S.10-percent shareholders with or within which the specified tax years of such foreign corporations end. Sec. 954(c)(6)(B). The Energy Improvement and Extension Act of 2008 (Pub. L. No. 110-343) extended these temporary rules for one year, for taxable years beginning after 2008 and before 2010. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Pub. L. No. 111-312) extended the temporary provisions for two years, for taxable years beginning after 2009 and before 2012.

[6] Sec. 1297(a).

[7] Sec. 1297(b).

funds), who may not be able to make QEF elections, there is also a mark-to-market election. In that case, the U.S. shareholder includes the annual unrealized gain or loss in its PFIC stock for the year in its taxable income.

2. Foreign tax credit

Subject to certain limitations, a domestic corporation is allowed to claim a credit for foreign income taxes it pays. A domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation is allowed a "deemed-paid" credit for foreign income taxes paid by the foreign corporation that the domestic corporation is deemed to have paid when the related income is distributed or included in the domestic corporation's income under the anti-deferral rules.[8]

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income (as determined under U.S. tax accounting principles).[9] The limit is computed by multiplying a taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may carry back the excess foreign taxes to the previous year or carry forward the excess taxes to one of the succeeding 10 years.[10]

The computation of the foreign tax credit limitation requires a taxpayer to determine the amount of its taxable income from foreign sources in each category by allocating and apportioning deductions between U.S.-source gross income, on the one hand, and foreign-source gross income in each limitation category (described below), on the other. In general, deductions are allocated and apportioned to the gross income to which the deductions factually relate.[11] However, subject to certain exceptions, deductions for interest expense and research and experimental expenses are apportioned based on taxpayer ratios.[12] In the case of interest expense, this ratio is the ratio of the corporation's foreign or domestic (as applicable) assets to its worldwide assets. In the case of research and experimental expenses, the apportionment ratio is based on either sales or gross income. All members of an affiliated group of corporations generally are treated as a single corporation for purposes of determining the apportionment ratios.[13]

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[8] Secs. 901, 902, 960, 1295(f).

[9] Secs. 901, 904.

[10] Sec. 904(c).

[11] Treas. Reg. sec. 1.861-8(b) and Temp. Treas. Reg. sec. 1.861-8T(c).

[12] Temp. Treas. Reg. sec. 1.861-9T and Treas. Reg. sec. 1.861-17.

[13] Sec. 864(e)(1), (6); Temp. Treas. Reg. sec. 1.861-14T(e)(2).

The term "affiliated group" is determined generally by reference to the rules for determining whether corporations are eligible to file consolidated returns.[14] These rules exclude foreign corporations from an affiliated group.[15] The American Jobs Creation Act of 2004 ("AJCA") modified the interest expense allocation rules for taxable years beginning after December 31, 2008.[16] The effective date of the modified rules has been delayed to January 1, 2021.[17] The new rules permit a U.S. affiliated group to apportion the interest expense of the members of the U.S. affiliated group on a worldwide-group basis (i.e., as if all domestic and foreign affiliates are a single corporation). A result of this rule is that interest expense of foreign members of a U.S. affiliated group is taken into account in determining whether a portion of the interest expense of the domestic members of the group must be allocated to foreign-source income. An allocation to foreign-source income generally is required only if, in broad terms, the domestic members of the group are more highly leveraged than is the entire worldwide group.

The foreign tax credit limitation is applied separately to "passive category income" and to "general category income."[18] Passive category income includes passive income, such as portfolio interest and dividend income, and certain specified types of income. General category income includes all other income. Passive income is treated as general category income if it is earned by a qualifying financial services entity. Passive income is also treated as general category income if it is highly taxed (that is, if the foreign tax rate is determined to exceed the highest rate of tax specified in section 1 or 11, as applicable). Dividends (and subpart F inclusions), interest, rents, and royalties received by a U.S.10-percent shareholder from a CFC are assigned to a separate limitation category by reference to the category of income out of which the dividends or other payments were made.[19] Dividends received by a 10-percent corporate

[14] Secs. 864(e)(5), 1504.

[15] Sec. 1504(b)(3).

[16] Pub. L. No. 108-357, sec. 401.

[17] Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, sec. 551(a) (2010).

[18] Sec. 904(d). AJCA generally reduced the number of income categories from nine to two, effective for tax years beginning in 2006. Before AJCA, the foreign tax credit limitation was applied separately to the following categories of income: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) certain dividends received from noncontrolled section 902 foreign corporations (also known as "10/50 companies"), (6) certain dividends from a domestic international sales corporation or former domestic international sales corporation, (7) taxable income attributable to certain foreign trade income, (8) certain distributions from a foreign sales corporation or former foreign sales corporation, and (9) any other income not described in items (1) through (8) (so-called "general basket" income). A number of other provisions of the Code, including several enacted in 2010 as part of Pub. L. No. 111-226, create additional separate categories in specific circumstances or limit the availability of the foreign tax credit in other ways. See, e.g., secs. 865(h), 901(j), 904(d)(6), 904(h)(10).

[19] Sec. 904(d)(3).

shareholder of a foreign corporation that is not a CFC are also categorized on a look-through basis.[20]

3. Transfer pricing

A basic U.S. tax principle applicable in dividing profits from transactions between related taxpayers is that the amount of profit allocated to each related taxpayer must be measured by reference to the amount of profit that a similarly situated taxpayer would realize in similar transactions with unrelated parties. The transfer pricing rules of section 482 and the accompanying Treasury regulations are intended to preserve the U.S. tax base by ensuring that taxpayers do not shift income properly attributable to the United States to a related foreign company through pricing that does not reflect an arm's-length result.[21] Similarly, the domestic laws of most U.S. trading partners include rules to limit income shifting through non-arm's-length pricing.

Section 482 authorizes the Secretary of the Treasury to allocate income, deductions, credits, or allowances among related business entities when necessary to clearly reflect income or otherwise prevent tax avoidance,[22] and comprehensive Treasury regulations under that section adopt the arm's-length standard as the method for determining whether allocations are appropriate. The regulations generally attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been unrelated parties dealing at arm's length. For income from intangible property, section 482 provides, "In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."

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[20] Sec. 904(d)(4).

[21] For a detailed description of the U.S. transfer pricing rules, see Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010, pp. 18-50.

[22] The term "related" as used herein refers to relationships described in section 482, which applies to "two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests."

II. TERRITORIAL SYSTEM

The remainder of this pamphlet addresses territorial systems of taxation. This section provides an overview of principal features of a territorial taxing system and includes a brief discussion of basic design considerations.[23]

A. Principal Features

1. In general

A strict territorial system, one that bases taxation entirely on whether income is foreign or domestic, would exempt all foreign income. The territorial systems of major U.S. trading partners do not provide this complete exemption. Instead, existing territorial systems exempt foreign income only if the income satisfies certain requirements. For example, exemption may be available only for income attributable to the conduct of a foreign business. Foreign business income may be eligible for exemption only if it is subject to meaningful tax in the foreign jurisdiction or is derived in a jurisdiction that has in force an income tax treaty with the taxpayer's country of residence. Income that does not satisfy the requirements for exemption under existing territorial systems generally is taxed as it is earned or when it is repatriated, and a deduction or credit for foreign income tax imposed on the income may be allowed. The descriptions in section III of the territorial regimes of selected countries provide examples of rules that distinguish between exempt and non-exempt income.

A related question is the mechanism by which exemption of foreign business income is provided under a territorial system. In theory, exemption could be allowed as income is earned, whether directly or through foreign companies. By contrast, territorial systems of the major U.S. trading partners generally provide exemptions for dividends received by resident companies from foreign companies. Dividend exemption may be available only if certain requirements are satisfied, including that the resident company receiving the dividend owns a certain percentage (10 percent, for example) of the stock of the foreign company paying the dividend. Territorial systems that operate by means of a dividend exemption typically tax non-dividend foreign income such as royalties or interest derived directly by resident taxpayers.

The following sections describe additional issues related to the scope of the tax exemption provided under territorial systems of taxation.

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[23] Proposals have been made for the adoption of a territorial system in the United States, including National Commission on Fiscal Responsibility and Reform, The Moment of Truth (December 2010), pp. 28-35; The President's Economic Advisory Board, *The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation*, August 2010, pp. 89-91; U.S. Department of the Treasury, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century,* December 20, 2007; President's Advisory Panel on Federal Tax Reform, *Simple, Fair and Pro-Growth: Proposals to Fix America's Tax System* (November 2005); Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), January 27, 2005, pp. 186-97.

2. Expenses

A corporation with foreign operations may incur expenses in generating foreign income that is exempt under a territorial system. A question is whether a territorial system should allow a deduction for these expenses.

Most jurisdictions with territorial systems permit deductions for resident companies' expenses for generating exempt foreign income. Some countries allow these deductions but impose tax on a small percentage of foreign dividends (five percent, for example). A question in designing a territorial system might be whether this tax should be imposed when dividends are paid or when income out of which dividends are paid is earned.

A territorial system that permits a deduction for an expense incurred to produce exempt foreign income may not achieve a matching of taxable income items with deductible expense items. Disallowing a deduction for the expense may, however, cause the expense not to be deductible in any country (because the country in which the income is derived also may not permit a deduction).

A number of countries with territorial systems of taxation deny deductions for a portion of a resident company's interest expense if the resident company, or a multinational group that includes a resident company, has indebtedness (in some cases related-party indebtedness and in other cases related- and unrelated-party indebtedness) that exceeds a threshold level. Countries have different measures of permitted levels of indebtedness. Measures include debt-to-equity ratios and comparisons of domestic and foreign leverage within a group.

A question in this context is whether, if the United States adopted a territorial system, the U.S. present law earnings stripping rules, which deny a deduction for a portion of interest expense on related-party indebtedness when a corporation's debt-to-equity ratio and interest expense in relation to income exceed certain levels,[24] should be retained, modified, repealed, or replaced with other interest limitation rules. Although the earnings stripping rules apply to both foreign-controlled and U.S.-controlled groups, they are important in practice mostly for foreign-controlled groups, in part because income under subpart F generally would result from loans to a U.S. parent corporation from its foreign subsidiary. If a concern in a territorial system is that resident corporations will reduce their U.S. tax liabilities by borrowing (from unrelated or related parties) to produce exempt income, consideration might be given to interest limitation rules that would have more uniformity of application to domestically-controlled and foreign-controlled groups and to unrelated and related party borrowing.

3. Controlled foreign company rules

Many territorial systems impose current taxation on certain items of foreign income derived not only by resident companies directly, but also by foreign companies owned in whole or part by resident companies. As described previously in section II.A.1, these controlled foreign company rules may, among other possibilities, tax foreign income that has been subject to tax in

[24] Sec. 163(j).

the foreign jurisdiction at less than a threshold rate or that has been derived in a jurisdiction that does not have an income tax treaty with the jurisdiction in which the parent company is organized.

As described above in section I.B.1, the subpart F rules of U.S. law impose current U.S. taxation on U.S. 10-percent shareholders of a CFC for their shares of certain items of investment income or highly mobile income derived by the CFC. If U.S. policymakers were to consider a territorial system of taxation, a question would be whether the subpart F rules should be maintained, modified, repealed, or replaced with other rules that impose tax on certain foreign income.

4. Gain or loss on the sale of foreign subsidiary stock

Territorial taxing systems that operate by means of a dividend exemption have different rules for the taxation of a resident company's gain or loss from the sale of stock of a foreign subsidiary. One possible rule is that gain from the sale of this stock is exempt to the extent the gain represents earnings of the foreign subsidiary that would be exempt if distributed to the parent company as a dividend. Gain from the sale of foreign subsidiary stock may, however, also be attributable to unrealized appreciation in assets of the foreign subsidiary that produce income that is either exempt or currently taxable (or in part exempt and in part currently taxable) under the territorial rules. In theory, gain might be exempt to the extent it represents unrealized appreciation in exempt-income-producing property. Other possible rules include a complete tax exemption for gain from the sale of foreign subsidiary stock or taxation of the entire amount of the gain. Rules for losses from the sale of foreign subsidiary stock would also be necessary.

5. Foreign branches

There are two broad alternatives for the taxation of foreign branches of resident companies under a territorial taxing system. Under one alternative, a foreign branch might be taxed in the same manner as a foreign subsidiary. Transactions between the foreign branch and the domestic headquarters would be treated as if they were transactions between a foreign subsidiary and a resident company. In a dividend exemption system, certain payments made by the foreign branch would be treated as dividends and would be exempt under rules equivalent to those applicable to actual dividend payments made by foreign subsidiaries. More broadly, taxpayers and the Internal Revenue Service would be required to account separately for transactions that under present law are intra-company activities and for earnings and profits and other items of foreign branches.

Alternatively, a foreign branch's foreign income might be wholly exempt, wholly taxable, or partly exempt and partly taxable as it is earned. This treatment of foreign branch income might avoid possible administrative complications of accounting for intra-company transactions and branch items, but by providing differing tax rules for branch and subsidiary income, it might treat similarly situated taxpayers differently and could introduce new tax considerations into the decision whether to operate abroad through branches or subsidiaries.

The treatment of foreign branch losses in a territorial system might warrant particular consideration. A basic question is whether the treatment of foreign branch losses should follow

the treatment of foreign branch income, or whether the rules for losses and income might vary from one another.

Foreign partnerships present issues similar to (but in some situations more complicated than) those raised by foreign branches.

6. Intangible property income

As described previously, in dividend exemption systems non-dividend payments from foreign subsidiaries to resident companies typically are fully taxable. These non-dividend payments may include, among other items, royalties for the use of intangible property such as patents or other know-how.

Over time, full taxation of foreign royalties could affect taxpayer decisions about where to develop and own intellectual property, although many non-tax factors also affect these decisions, and the development and ownership decisions are separable from one another. In the short run, however, in the absence of perfect administration of arm's-length-based transfer pricing rules, a resident company could reduce the amount of its taxable royalties in respect of existing intangible property by interacting with foreign related parties at non-arm's-length terms (by, for instance, characterizing as exempt dividends all or a portion of payments that as an economic matter are royalties because they are for the use of the intangible property). As described in section I.B.3, transfer pricing rules generally are intended to ensure an arm's-length division of income when related parties transact with one another. Transfer pricing is important under U.S. present law because it determines how much income is subject to current U.S. taxation. Transfer pricing rules could be expected to remain significant under a territorial system because those rules would determine, in part, how much income could be repatriated in the form of exempt dividends. Transfer pricing disputes between the government and taxpayers under present law often involve pricing of related party transactions in intangible property.

To address concerns about the effects of a territorial system on where intellectual property is developed and owned, consideration might be given to rules providing favorable tax treatment of income related to intangible property. Some countries with territorial systems provide reduced tax rates on income attributable to taxpayer-developed patents or other intellectual property (sometimes referred to colloquially as "patent box" regimes). As one alternative, a limited exemption could be provided for a resident company's royalty income received from a foreign subsidiary for the subsidiary's use of intangible property in the conduct of a foreign business.

Alternatively, or in conjunction with rules providing favorable treatment of intangible property income, concerns about the effects of a territorial system on the location of development and ownership of intellectual property could be addressed by making U.S. present law transfer pricing or subpart F rules more stringent. Recent proposals to provide more

stringent rules have prompted debate that might be relevant to discussions about adoption of a territorial system.[25]

[25] For analysis of two recent proposals, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2011 Budget Proposal* (JCS-2-10), August 16, 2010, pp. 241-85.

B. Transition

If the United States adopted a territorial system of taxation, various transition issues would need to be considered. One issue is the treatment of earnings attributable to periods before the enactment of the territorial legislation. One approach is to have the exemption system apply only in respect of CFC earnings generated after the effective date. Under this approach, the pre-enactment rules would apply to previously untaxed earnings.

A variation of this transition rule is to provide a limited period in which taxpayers may make an election to repatriate some or all of their pre-effective date earnings at a reduced tax rate (perhaps under rules similar to the temporary, elective dividends received deduction enacted in 2004 for repatriated earnings[26]).

An alternative approach would exempt from tax all CFC earnings and profits paid as dividends after the effective date of the new system. A variation of this approach would deem all pre-effective date earnings repatriated under present law rules (at the regular tax rate or at a reduced rate), perhaps over a multi-year period.

[26] Sec. 965.

III. TERRITORIAL SYSTEMS OF SELECTED COUNTRIES

A. Australia[27]

1. In general

Australian resident corporations are subject to income tax on a worldwide basis, at a marginal rate reaching 30 percent. Various exclusions, credits, and other special rules operate to provide a participation exemption for certain categories of foreign-source income. Income that may be entirely or partially exempt include dividends paid out of active earnings of a foreign affiliate, capital gains from a foreign permanent establishment, and foreign branch profits.

The scope of the exemption for foreign-source dividends encompasses dividends from non-portfolio investments in which the Australian company owns at least a 10-percent voting interest, without any required holding period, as well as dividends paid by controlled foreign companies out of income that was previously taxed. These exemptions parallel the result applicable to most dividends under the imputation system since 1987, which is intended to avoid the imposition of tax on corporate earnings both at the corporate level when earned and at the shareholder level when distributed. Under the imputation system, an Australian resident receives credit for the tax previously paid on the income underlying the dividend from an Australian corporation. Dividends are "franked" to identify the amount of tax paid with respect to the underlying income funding the dividend. The recipient reports the dividend, grossed-up by the amount of the tax paid, and claims a credit in the "franked" amount.

2. Expenses

Deductions for expenses incurred in generating the profits that result in exempt non-portfolio foreign dividends and foreign branch profits are not generally allowed, nor are credits permitted for foreign income tax paid with respect to the foreign exempt income. Expenses incurred in financing debt are excepted from the general rule of disallowance, provided that the expenses satisfy the thin capitalization rules. Those rules limit the portion of debt expenses that may be deducted when the entity's debt-to-equity ratio exceeds certain limits. The limits vary depending on whether the investing entity is inbound, outbound, or both, and whether the investing entity is an approved deposit-taking institution, with a safe harbor debt-to-equity ratio of three-to-one available in most cases. The rules apply economic substance principles to determine whether instruments are to be treated as debt or equity. The expenses that may be limited under these rules include interest payments or loan fees that an entity would otherwise be entitled to deduct, but not rental expenses on certain leases and some foreign currency losses.

[27] This description of Australian law relies largely on information found on the Australian Tax Office website, www.ATO.gov.au, and Law Library of Congress, *Taxation of Foreign Source Income of Resident Corporations, Report for Congress* (April 2011). This description and the descriptions of the tax rules of the eight other countries that follow are intended to serve as general overviews. Many details have been omitted and simplifying generalizations have been made for ease of exposition.

The thin capitalization rules affect both Australian and foreign entities that have multinational investments, regardless of whether they hold the investments directly or through Australian entities. Under the thin capitalization rules, the amount of debt used to fund the Australian operations of both foreign entities investing into Australia (inbound) and Australian entities investing overseas (outbound) is limited. The thin capitalization rules for any given income year do not apply to Australian resident entities that have no cross-border investments, to foreign entities that have no investments (such as assets) or permanent establishments in Australia, or to entities that meet any of the threshold tests described below.

There are three threshold tests. The first two ensure entities with relatively small debt deductions (less than AUD$250,000 (US$254,588) in the tax year) or small overseas investments (an outbound investor that is not foreign controlled and whose Australian assets are at least 90 percent of worldwide assets) are not subject to the thin capitalization rules.[28] A third threshold test provides that debt deductions incurred by special purpose entities, established to manage certain risks, are not limited by these thin capitalization rules.

3. Controlled foreign company rules

Australia currently has an accruals taxation system, similar to the antideferral regime under the subpart F rules in the United States.[29] Under the accruals taxation system, most foreign-source income of a controlled foreign company is taxed, if at all, on the basis of a notional dividend to an Australian owner or shareholder. The portion taxable to the owner or shareholder is determined by reference to the ownership share attributed to the shareholder, known as an attributable taxpayer. An attributable taxpayer is an Australian entity that has a controlling interest, inclusive of interests held by associates, of a specified level.

Controlled foreign company status is determined by one of three control tests: strict control, assumed controller test or the de facto control test. Strict control exists if at least 50 percent of the company is owned or may be acquired by a group of five or fewer Australian one-percent entities (resident Australian entities that own at least one-percent of the foreign company), including their associates or members. The assumed controller test is met if an Australian entity and its members or associates own or are entitled to acquire at least a 40 percent interest in the company, and the remaining interest is not controlled by an unrelated party or parties. The de facto control test is met if a group of five or fewer Australian entities effectively controls the company.

The holder of a 10-percent interest is an attributable taxpayer, regardless of which of the three control tests is met for controlled foreign company status. In addition, an Australian one-percent entity may be an attributable taxpayer if it is one of a group of five or fewer owners

[28] U.S. dollar equivalents were calculated using the currency rate for January 1, 2011, according to OANDA's FX Converter, available at http://www.oanda.com.

[29] The Australian government recently proposed draft legislation that would reform the foreign source attribution rules. To review the draft and explanatory materials, see The Treasury, "Exposure Draft--Reform of the Foreign Source Income Deferral Rules," www.treasury.gov.au/contentitem.asp?NavId=37&contentID=1930 (as of May 17, 2011).

holding de facto control of the foreign company. The attributable taxpayer is deemed to have received a dividend equal to its pro rata share of assessable earnings in the tax year accrued. When those earnings are actually distributed, the dividend is exempt from taxation as previously taxed income.

The amount of assessable income of a controlled foreign company under the accruals taxation system depends upon the conduct of an active business, the character of the income as "adjusted tainted income," and whether the company is resident in a listed country. Adjusted tainted income includes all passive income as well as income from sales or services transactions with related parties. Listed countries are defined by statute as foreign jurisdictions that impose income tax on a basis comparable to that of Australia. The listed countries are Canada, France, Germany, Japan, New Zealand, the United Kingdom, and the United States.

Income derived from a company in a listed country that operates an active business in that country is eligible for exemption from Australian tax unless the income was both tainted and eligible for a tax concession in the listed country. Income derived by a company resident in an unlisted country qualifies for exemption from accruals taxation only if the company conducts an active business in that jurisdiction and the income is not "adjusted tainted income."

4. Gain or loss on the sale of foreign subsidiary stock

Gain from the disposition of stock in certain foreign companies is subject to exemption if the following conditions are met. The company whose stock is being sold must have operated an active business abroad. The taxpayer must hold at least a 10-percent voting interest in the company. Finally, the taxpayer must meet a holding period of 12 months within the two-year period preceding the sale of stock.

In addition, a capital loss with respect to the disposal of a branch asset may be nondeductible if the gain from disposal of such an asset would have been exempt.

5. Foreign branches

Active business income earned by a foreign branch or permanent establishment of an Australian resident company is generally exempt from accruals taxation, depending upon the character of the income as "adjusted tainted income" and whether the company's residence is in a listed country. Adjusted tainted income includes all passive income as well as income from sales or services transactions with related parties. Income of branches in a listed country that operate an active business in the listed country is exempt from Australian tax unless the income was both tainted and eligible for a tax concession in the listed country. Branches that reside in unlisted countries qualify for exemption of income from accruals taxation only if they conduct an active business in that jurisdiction and the income is not "adjusted tainted income."

6. Intangible property income

Australia does not have a special regime governing the taxation of foreign-source income from intangible property. Resident companies are taxable on royalties from all sources. Both the controlled foreign company rules and the exemption for foreign branch profits provide that tainted royalty income is treated as passive income, and is thus currently taxable. Tainted

royalty income is royalty income derived from assigning any intangible property or right to such property other than an assignment by a foreign branch or subsidiary of property it substantially developed to an unrelated party in the course of carrying on the business of the branch or subsidiary.

B. Canada[30]

1. In general

Like the United States, Canada generally subjects Canadian resident corporations to current taxation on worldwide income while providing deferral for income earned by a foreign corporation in which the Canadian resident corporation is a shareholder and relief from double taxation by way of a foreign tax credit mechanism. Nonetheless, Canadian law applies the principles of territorial taxation by exempting certain qualifying distributions out of active earnings of certain foreign subsidiaries located in treaty jurisdictions. For 2011, the combined federal and provincial corporate income tax rate generally ranges from 26.5 percent to 32.5 percent (25 percent to 31 percent for 2012) depending on the province in which the Canadian resident corporation is located.[31]

Dividends received by a Canadian resident corporation out of certain active earnings of a foreign affiliate may be wholly or partially exempt from Canadian taxation. This exemption is accomplished by providing the Canadian resident corporation with a deduction equal to all or a portion of the eligible dividend received from the foreign affiliate. For this purpose, a foreign affiliate is defined as a nonresident corporation in which the Canadian taxpayer's equity percentage is at least one percent, and the equity percentage of the taxpayer and related persons is collectively at least 10 percent.

The amount of the deduction is determined based on whether the dividend is paid out of exempt surplus, taxable surplus, or preacquisition surplus. A 100-percent dividends received deduction is allowed to the extent the dividend is paid out of exempt surplus. Exempt surplus includes income of a foreign affiliate attributable to an active business carried on in a designated treaty country. A designated treaty country is one with which Canada has a treaty that is in force for the year in question. Additionally, exempt surplus treatment has also been extended to countries with which Canada does not have a tax treaty in force but with which Canada has entered into a comprehensive tax information exchange agreement ("TIEA").

Taxable surplus includes income from an active business carried on in a country that is not a designated treaty country on which foreign income and withholding taxes have been paid. While not exempt from Canadian taxation, dividends out of taxable surplus may carry with them a deduction attributable to the underlying foreign taxes imposed on the foreign affiliate. The deduction is computed by multiplying the relevant tax of the foreign affiliate by a fraction equal to one over the Canadian corporate tax rate and is intended to have an economic effect similar to that of a foreign tax credit.

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[30] This description of Canadian law relies largely on Patrick Marley & Richard Tremblay, *Business Operations in Canada*, BNA Tax Management Portfolio No. 955-4th; International Bureau of Fiscal Documentation ("IBFD") Canada Taxation and Investment; and Law Library of Congress, *Taxation of Foreign Source Income of Resident Corporations, Report for Congress* (April 2011).

[31] This includes a reduction to the Canadian federal rate that relates to a 10-percent rebate that applies to income that has been earned in a Canadian province or territory and an additional 10-percent rate reduction to the extent the income does not currently benefit from other preferential tax treatment.

Payments made by foreign affiliates that are not out of exempt surplus or taxable surplus are generally treated as distributed out of preacquisition surplus. Payments out of preacquisition surplus are treated as a return of capital and deductible in computing taxable income. However, such amounts reduce the adjusted cost base of the shares and may trigger gain to the extent in excess of the adjusted cost base.

A December 2008 report issued by the Canadian Ministry of Finance appointed Advisory Panel on Canada's System of International Taxation had, as one of its recommendations, that the existing exemption system be expanded to cover all foreign active business income earned by foreign affiliates.[32]

2. Expenses

Canada does not have rules that disallow a deduction for expenses of a Canadian resident corporation to the extent those expenses are attributable to exempt foreign dividends.[33] However, Canada does have thin capitalization rules designed to limit the ability of nonresidents of Canada to withdraw profits through deductible interest payments.

In general, the thin capitalization rules limit the deductibility of interest paid or payable by a Canadian corporation to specified nonresidents if the debt of the Canadian corporation exceeds two times the equity of the Canadian corporation. When this occurs, a prorated portion of any interest paid is not allowed in computing income of the Canadian corporation. The disallowed amount is treated as a dividend that must be paid out of earnings accumulated after Canadian tax.

For purposes of applying these rules, a specified nonresident is a nonresident shareholder who, either alone or together with persons with whom the shareholder does not deal at arm's-length, owns shares that meet a 25-percent vote or value test.

3. Controlled foreign company rules

Canada's foreign accrual property income ("FAPI") rules, which were originally modeled after the U.S. subpart F rules, are designed to prevent Canadian resident shareholders from being able to avoid or defer Canadian taxation by earning certain types of passive or mobile income through a controlled foreign affiliate. The FAPI of a controlled foreign affiliate is imputed to a Canadian resident in proportion to the Canadian resident's participating percentage (i.e., the percentage of shares held directly or indirectly) in the controlled foreign affiliate at the end of the tax year. For this purpose, a foreign corporation is treated as a controlled foreign affiliate in cases in which the Canadian corporation has *de jure* control giving it the ability to elect a majority of the board of directors of the foreign corporation. This control generally occurs if the

[32] Advisory Panel on Canada's System of International Taxation, *Final Report*: *Enhancing Canada's International Tax Advantage* (December 2008), available at http://www.apcsit-gcrcfi.ca/index-eng.html (hereinafter December 2008 Advisory Panel Report).

[33] Although the 2007 Budget proposed restricting interest deductibility on debt used to acquire foreign corporation shares paying exempt dividends, this rule was withdrawn as part of the 2009 Budget.

Canadian corporation has more than 50 percent of the voting power of all outstanding shares of stock. A foreign corporation may also be treated as a controlled foreign affiliate under an alternative test that looks to whether there is a collection of persons that control the corporation consisting of the taxpayer, persons that do not deal at arm's-length with the taxpayer, up to four other Canadian residents, and all persons who do not deal at arm's-length with Canadian residents.

In general, FAPI consists of foreign direct investment income of a passive nature (such as dividends, interest, rent and royalties) and certain capital gains. Additionally, FAPI also includes the following:

1. income from the rendering of services if the cost of those services is deductible in calculating the income of the controlling shareholders or of a related person from a business carried on in Canada;

2. income from the sale of property if either:
   - the cost of the property will be included in the income of the taxpayer or a non-arm's-length person in calculating income from a business carried on in Canada; or
   - the property sold by the foreign affiliate was not produced or processed in the country in which the foreign affiliate was established;

3. income from the insurance of persons resident in Canada or of property situated in Canada;

4. interest and rental income on debt and lease obligations of persons resident in Canada; and

5. income from an investment business, defined as a business that has as its principal purpose the earning of income from property (unless such activities constitute the principal business of the foreign affiliate and the foreign affiliate has more than five full-time employees in the business).

However, items (2), (3), and (4) do not apply in cases in which more than 90 percent of the foreign affiliate's income of that type is derived from transactions with arm's-length entities.

In the 2007 Budget, the Ministry of Finance announced that FAPI will be extended to include business income earned in a country with which Canada has neither a tax treaty nor a TIEA. The extension of the FAPI concept is scheduled to occur on a country-by-country basis, subject to negotiations with that country. In the case of a non-treaty, non-TIEA country that was in the process of negotiating a TIEA with Canada on March 19, 2007, FAPI treatment will apply if the negotiations are not successfully completed before 2014. In the case of other non-treaty, non-TIEA countries (i.e., Canada proposes TIEA negotiations, or negotiations start without a Canadian proposal, after March 19, 2007), FAPI treatment will apply only if those negotiations are not successfully completed by the fifth anniversary of the earlier of the start of TIEA negotiations and the date on which Canada proposed the TIEA negotiations.

4. Gain or loss on the sale of foreign subsidiary stock

The sale of stock of a foreign subsidiary generally is subject to Canadian taxation under the general rules applicable to capital gains and losses of Canadian resident corporations. As a result, 50 percent of capital gains are taxable and included in the corporation's taxable income at ordinary rates. Likewise, 50 percent of capital losses are deductible, but generally only against capital gains. Any excess of allowable capital losses over taxable capital gains in the current year can be carried back three years and forward indefinitely, to be applied against net taxable capital gains from those years, except in the case of an acquisition of control. For purposes of applying these rules, there is no particular holding period requirement.

The December 2008 Advisory Panel Report included in its recommendations that the exemption system be extended to capital gains and losses realized on the disposition of shares of a foreign affiliate in cases in which the shares derive all or substantially all of their value from active business assets.

5. Foreign branches

Income of a foreign branch of a Canadian resident corporation is taxable in Canada when earned. In computing the taxable profit or loss of the foreign branch, a Canadian taxpayer can usually take a deduction for the same types of expenses that would have been available for such expenses had they been incurred in Canada. The Canadian resident corporation is allowed a foreign tax credit with respect to any foreign income or profits tax imposed on the foreign branch.

6. Intangible property income

Canada does not have a special tax regime or tax rate that applies to intellectual property income. Therefore, royalty income received by a Canadian corporation is currently taxable at the applicable corporate income tax rate discussed above.

C. France[34]

1. In general

French resident companies, defined as those that have their legal seat in France or are effectively managed and controlled from France, generally are taxed on a territorial basis. Accordingly, business income and losses realized through enterprises operating outside France generally are not taken into account for French tax purposes. Nevertheless, tax is imposed on worldwide income from passive foreign sources (for example, royalties, interest, and dividends that do not qualify for the participation exemption), unless it can be shown that such income is connected to foreign business operations. French tax law generally does not provide for foreign tax credits, so income subject to foreign tax that is not exempt from tax in France is taxable in France net of any foreign tax paid.[35]

French resident parent companies may elect a participation exemption in respect of certain dividends received from their resident and nonresident subsidiaries. To qualify for the regime, the parent must have a participation in the subsidiary that represents at least five percent of the voting rights and financial rights in the subsidiary and must have held the participation for at least two years (or commit to hold the shares for at least two years). The participation exemption is not complete, however, and an amount equal to five percent of the dividend must be added to the parent company's income (effectively, there is a 95-percent participation exemption). This amount is deemed to correspond to nondeductible expenses incurred in connection with earning the dividends, although if the company demonstrates that the actual expenses are less, it need include in income only an amount equal to the actual expenses.

If a subsidiary is located in a country identified as a noncooperative state or territory, the participation exemption is not available with respect to dividends paid by that subsidiary. A noncooperative state or territory is defined as a state or territory that (1) is not a member of the European Union, (2) is reviewed and monitored by the Organisation for Economic Cooperation and Development Global Forum on Transparency and Exchange of Information, (3) has concluded 12 or fewer tax information exchange agreements, and (4) has not signed a tax information exchange agreement with France.

The standard corporate tax rate is 33⅓ percent.[36] In addition, companies whose turnover exceeds €7,630,000 ($10,177,886) are subject to an additional social security surtax of 3.3

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[34] The information in this section is based in large part on Edouard Milhac & Annabelle Bailleul-Mirabaud, *Business Operations in France*, Tax Management Portfolio No. 961-4th; Eric Robert, International Bureau of Fiscal Documentation, IBFD European Taxation Database, France, available at http://checkpoint.riag.com (last accessed May 16, 2011); and Law Library of Congress, *Taxation of Foreign Source Income of Resident Corporations, Report for Congress* (2011).

[35] Most tax treaties, however, provide a tax credit for withholding taxes paid on passive income.

[36] Small and medium-sized enterprises are taxed at a reduced rate of 15 percent on the first €38,120 ($50,849) of profits. Except where otherwise indicated, the quoted tax rates and threshold amounts apply in 2011. U.S. dollar equivalents were calculated using the currency rate for January 1, 2011, according to OANDA's FX Converter, available at http://www.oanda.com.

percent levied on the portion of their aggregate corporate tax that exceeds €763,000 ($1,017,789). The result is a combined tax rate of 34.43 percent.

2. Expenses

In general, a French resident company may fully deduct expenses that support exempt dividends. However, the five-percent portion of a dividend that is subject to tax under the participation exemption is deemed to correspond to a management charge related to earning the exempt dividend. If a company demonstrates that the actual charges are less than that five percent, the company is taxed only on the actual charges.

Despite the broad allowance of deductions for expenses related to exempt dividends, deductions for interest paid to related parties (and to third parties on loans that are secured by related parties) may be limited. In general, related-party interest deductions are limited if the interest paid exceeds three thresholds: (1) an amount determined using a formula incorporating a related-party debt-to-equity ratio of 1.5-to-1; (2) 25 percent of adjusted current profits (i.e., operating profits before the deduction of taxes, related-party interest, depreciation and amortization, and certain lease payments) for the year; and (3) interest income received from related parties. If interest exceeds all three thresholds, the interest deduction is limited to an amount equal to the highest of the three thresholds plus €150,000 ($200,090). The excess interest deductions may be carried forward, although they are reduced by five percent annually starting with the second carry-forward year. A safe harbor is available that nevertheless allows a company to fully deduct interest that does not satisfy the three thresholds if the company can demonstrate that its debt-to-equity ratio does not exceed the debt-to-equity ratio of the worldwide group to which it belongs.

In addition, a French resident company is not allowed to deduct direct expenses of, and certain head office expenses attributed to, foreign branch operations, which generate income exempt from French taxation.

3. Controlled foreign company rules

France has controlled foreign company rules that apply to provide for taxation of the profits of certain foreign entities or permanent establishments. A pro rata portion (which is 100 percent in the case of a wholly owned subsidiary or branch) of the profits are taxable to a French resident company if (1) the French resident company directly or indirectly holds a participation of more than 50 percent (whether voting rights or financial rights, or both) in the foreign entity (or permanent establishment), and (2) the foreign entity (or permanent establishment) is subject to an effective rate of tax in its country of residence that is at least 50 percent lower than the rate of tax that would apply in France. An anti-abuse rule reduces the participation threshold to five percent if more than 50 percent of the interests in the foreign entity (or permanent establishment) are controlled by French resident companies or by foreign entities directly or indirectly controlled by French resident companies.

The controlled foreign company rules generally do not apply to an entity (or permanent establishment) resident in another member of the European Union, unless the French tax authorities can demonstrate that the entity (or permanent establishment) is part of an artificial

arrangement intended solely to avoid French tax. In addition, the controlled foreign company rules do not apply to an entity (or permanent establishment) resident outside the European Union if the entity (or permanent establishment) is principally engaged in commercial or industrial economic activities in its country of residence. However, if more than 20 percent of the entity's (or permanent establishment's) income is passive or more than 50 percent of the entity's (or permanent establishment's) income is passive or from services provided to related parties, the controlled foreign company rules will apply unless the taxpayer demonstrates that the location of the foreign entity (or permanent establishment) is not based solely on tax considerations. If the foreign entity (or permanent establishment) is located in a country identified as a noncooperative state or territory, the burden to prove that the entity (or permanent establishment) is principally engaged in commercial or industrial economic activities in its country of residence shifts from the tax authorities to the taxpayer.

4. Gain or loss on the sale of foreign subsidiary stock

A 95-percent participation exemption applies to capital gains on dispositions of certain shareholdings by a French resident company. To qualify for the exemption, (1) the shareholding disposed of must be eligible for the dividend participation exemption regime described above, and (2) the seller generally must have held the shareholding for at least two years prior to disposal. Sellers may not utilize capital losses realized with respect to shareholdings eligible for this participation exemption.

A French resident company that realizes a capital gain on any other sale of a foreign subsidiary's stock generally must include the gain in its French taxable income. If a capital loss is realized, the loss is deductible.

5. Foreign branches

Subject to the controlled foreign company rules described above, income a French resident company earns from foreign business operations, including from a branch, generally is exempt from French tax. Importantly, this exemption does not extend to income from passive foreign sources (for example, royalties, interest, and dividends that do not qualify for the participation exemption) that is not connected to the foreign business operations.

A French resident company generally cannot utilize losses from its foreign business operations for French tax purposes.

6. Intangible property income

No special tax treatment applies to royalties. When received by French resident companies, they are included in income and taxed in the same manner as other income, although the long-term capital gain rate of 15 percent applies to certain proceeds derived from intellectual property.

D. Germany[37]

1. In general

Dividends received by a German resident corporation from a foreign corporation are 95 percent exempt from German income taxation. This 95-percent exemption is generally the same as the exemption that applies to dividends received from German corporations.

The 95-percent exemption is available for dividends received in respect of both portfolio (less than 10 percent) holdings and substantial shareholdings. There is also no requirement that stock in respect of which exempt dividends are received be held for a certain minimum period.

If a German corporation directly receives foreign-source non-dividend income such as interest or royalties, that income is taxable in Germany under the generally applicable corporate tax rules.

2. Expenses

Deductions for expenses that support exempt foreign dividends generally are allowed. The five-percent portion of a dividend that is taxable is intended to be a proxy for rules that would disallow a deduction for expenses related to exempt foreign income.

Although deductions for expenses related to exempt dividends are generally allowed, deductions for interest expense are limited under rules that took effect in 2008. Broadly, unless one of three possible exceptions applies, a company's excess of interest expense over interest income ("interest surplus") is deductible only up to 30 percent of the company's taxable income before interest, taxes, and depreciation and amortization. The rules apply irrespective of where the ultimate shareholders of the company are residents of Germany.

The restriction on the deductibility of interest surplus generally does not apply if a company's interest surplus is less than €3 million. A company also is not generally subject to the limitation if it is not part of a group of companies. A company is considered part of a group of companies if it is or could be part of a consolidated group for German accounting purposes. This exception is not available if interest on loans from 25-percent-or-greater shareholders or certain related parties exceeds 10 percent of the interest surplus. If the company is part of a group of companies, the interest limitation rules nonetheless generally do not apply if the German resident company that is part of the group is not more thinly capitalized than the overall group under a measure of equity in relation to total balance sheet assets.

[37] This description of German law relies largely on Dirk Pohl, *Business Operations in Germany*, BNA Tax Management Portfolio, 962-3rd; International Bureau of Fiscal Documentation ("IBFD") European Tax Surveys, Germany – Corporate Taxation; and Law Library of Congress, *Taxation of Foreign Source Income of Resident Corporations, Report for Congress* (April 2011).

3. Controlled foreign company rules

A German resident corporation or individual is subject to annual German income tax on the resident's share of certain items of passive income derived by a controlled foreign corporation in which the resident owns stock.

A controlled foreign corporation under German law is a nonresident corporation more than 50 percent of the stock (by vote) of which is owned directly or indirectly, and actually or constructively, by German resident taxpayers. Any German domestic corporation or resident individual that owns stock in a controlled foreign corporation is subject to the controlled foreign corporation rules regardless of the size of the stock ownership.

German law provides a list of items of income that are considered active and are therefore not subject to the controlled foreign corporation rules. Items of income of a controlled foreign corporation that are not on the active list are considered passive and are taxed on a current basis to the controlled foreign corporation's German shareholders unless either the tax rate test or European Union requirements described below are satisfied. Active income includes, with various exceptions, manufacturing, sales, and services income; certain banking, insurance, and financing income; limited categories of rental and royalty income; and most dividend income. Principal categories of passive income are interest and many royalties.

Passive income is not attributed to a controlled foreign corporation's German shareholders if the income is subject to income tax at a rate of at least 25 percent. The 25 percent rate threshold is an effective tax rate calculated under German tax law principles.

The controlled foreign corporation rules do not apply to a corporation organized in another European Union or European Free Trade Association member state if the corporation engages in meaningful industrial or commercial activity in its country of residence.

Under special rules, a German resident who owns at least one percent of a foreign company that mostly derives income of a passive investment character is subject to annual German income tax on the resident's attributable share of the foreign company's income. For these passive investment companies, the attribution rules apply even if German residents in the aggregate own 50 percent or less of the companies.

4. Gain or loss on the sale of foreign subsidiary stock

With limited exceptions, a German corporation's gain from the sale of stock of another corporation, whether domestic or foreign, is generally 95-percent exempt from German income taxation. The five-percent taxable portion of gain is intended to represent financing costs associated with owning the stock of the other corporation.

A German corporate shareholder's loss from the sale of stock of another corporation generally is not allowed as a deduction.

5. Foreign branches

German resident companies are taxable in Germany on income derived through foreign branch operations unless the terms of an income tax treaty exempt from German tax the income attributable to a permanent establishment that the German resident company maintains outside Germany. If a German company transfers property to a foreign branch the income of which is not exempt from German tax under a treaty, no taxable gain generally results from the transfer because income from the property will remain subject to German tax.

Subject to a number of limitations, foreign tax income tax paid in respect of income from foreign branch operations is allowed as a credit against German income tax.

6. Intangible property income

Germany has no special rules for the taxation of foreign-source royalty income. As described previously, German resident companies are subject to German corporate tax on royalties received from related and unrelated nonresident companies.

E. Japan[38]

1. In general

Until recently, Japan generally imposed corporate tax on worldwide income in a tax system generally similar to that of the United States. The corporate tax comprises three levies: an income tax imposed at the national level, an enterprise tax imposed by prefect authorities and an inhabitants tax imposed by prefect or municipal authorities. The national corporate income tax rates are graduated, with the highest marginal rate of 30 percent for years 1999 to 2010 for large companies, and lower rates for small and mid-sized companies (companies that have capital not in excess of ¥ 100 million ($1,228,780),[39] and that are not a subsidiary of a company with capital in excess of ¥ 500 million ($6,143,920). To the extent that income was subject to tax in both Japan and another jurisdiction, double taxation was relieved by operation of foreign tax credits or by operation of its various tax treaties. Earlier this year, it was announced that the national corporate income tax rates would be reduced by five percentage points, setting the new maximum rate at 25 percent.

In 2009, tax reforms moved the system towards a territorial regime. Introduced in an effort to encourage the repatriation of overseas earnings, the 2009 amendment to the tax laws introduced the foreign dividend exemption system. Under the foreign dividend exemption system, a company may omit 95 percent of qualifying distributions. To qualify, the dividends must be received from a foreign company in which the domestic corporation claiming the exemption has held at least 25 percent of the outstanding shares for a continuous period of at least six months. Foreign investment income, such as interest or royalties, is not exempted. In addition, gain from the transfer of shares in foreign subsidiaries does not qualify for the exemption.

2. Expenses

In general, all necessary and reasonable expenses, costs, and losses may be deducted from gross income in order to arrive at net income except where otherwise provided under the relevant laws. Japan does not have any rules that disallow a deduction for expenses of a Japanese resident corporation to the extent those expenses are attributable to exempt foreign dividends. However, Japan has thin capitalization rules designed to limit the ability of nonresidents of Japan to withdraw profits through deductible interest payments. No deduction is permitted for interest paid to a foreign controlling shareholder on indebtedness to the extent that the indebtedness causes the average balance of liabilities due (to either a foreign controlling shareholder or capital supplier) to the capital held by the foreign controlling shareholder to exceed a three-to-one ratio. Where a company maintains a less than three-to-one debt-to-equity

[38] This description of Japanese law relies largely on IBFD Asia-Pacific Taxation, Japan Country Analysis: Corporate Taxation and Law Library of Congress, "Taxation of Foreign Source Income of Resident Corporations, Report for Congress" (April 2011).

[39] U.S. dollar equivalents were calculated using the currency rate for January 1, 2011, according to OANDA's FX Converter, available at http://www.oanda.com.

ratio, it is not treated as thinly capitalized even if lending from a foreign controlling shareholder or capital supplier exceeds three times the foreign controlling shareholder or capital supplier's equity interest. In cases where the total average liabilities for a year of a company that may be subject to this rule do not exceed three times its own capital, the disallowance of the interest deduction does not apply.

A foreign controlling shareholder is a nonresident or foreign company that controls the domestic company by reason of majority capital ownership, whether directly or indirectly, or owns more than 50 percent of the domestic and foreign company's capital directly or indirectly, or has a special relationship with the company, such as one in which the domestic company's business is dependent on transactions with the foreign shareholder.

3. Controlled foreign company rules

Japan has a set of rules under which the parent companies of specified foreign companies are considered to have received deemed dividends from the subsidiaries, in a manner similar to that of the CFC regime in the United States. The Japanese controlled foreign company regime is part of a set of anti-avoidance rules, including a general anti-avoidance rule for related corporations, to deter overly aggressive tax planning.

A controlled foreign company is a foreign corporation that is located in a low-tax country, is subject to an effective tax rate of less than 20 percent and is owned directly or indirectly by Japanese companies, resident individuals, or nonresidents who have a special relationship with residents, such as a family relationship, or are financially dependent on residents.

A portion of the income of a controlled foreign company is deemed to be income of the Japanese resident shareholder and is included in calculating the shareholder's gross income if a Japanese resident or corporation directly or indirectly holds 10 percent or more of the outstanding shares of the controlled foreign company; or a Japanese corporation belongs to a family shareholder group that directly or indirectly holds 10 percent or more of the outstanding shares of the controlled foreign company. Dividends paid by a controlled foreign company to a domestic corporation that are subject to the foreign dividends exemption rule are excluded from the taxable income of the domestic corporation.

Japanese shareholders who directly or indirectly own 10 percent or more of the shares of a controlled foreign company are subject to taxation on their share of taxable undistributed profits of the subsidiary.

A controlled foreign company's income is not deemed to be the income of the domestic corporation if the controlled foreign company is actually doing business in a low-tax country and satisfies the following requirements:

- The controlled foreign company maintains an office, store, factory or other fixed place of business necessary to conduct its business in the country where the head office of the controlled foreign company is located;
- The controlled foreign company actually controls and administers its business; and

- If the business of the controlled foreign company is a wholesale, banking, trust, securities, insurance, or ocean or air transport business, the controlled foreign company does business with parties that are regarded as unrelated for the purpose of the controlled foreign company regime; or
- If the business of the controlled foreign company is none of the above, the controlled foreign company does business mainly within the country where its head office is located.

A 2010 amendment to the Tax Special Measures Law created exceptions to the above exceptions. A proportionate share of certain passive income of a controlled foreign company may be included in the domestic company's taxable income even in the above exceptions. However, if the passive income of a controlled foreign company is less than ¥ 10 million (approximately $123,000) or less than five percent of a controlled foreign company's income, it is excluded. Passive income taxable under the Special Measures Law includes the dividends received by a controlled foreign company from another company in which the controlled foreign company holds less than 10 percent of its shares; interest on bonds, gain from redemption or sale of bonds, capital gains from the sale of shares through financial instrument exchanges where the controlled foreign company holds less than 10 percent of the shares, royalties (unless the intellectual property was developed by the controlled foreign company) and income from the leasing of vessels or aircrafts.

4. Gain or loss on the sale of foreign subsidiary stock

Capital gains from the sale or transfer of shares in foreign subsidiaries is not eligible for the foreign dividend exemption.

5. Foreign branches

The tax treatment of income received by a Japanese corporation from a member organization in a foreign country depends upon how that member organization is regarded under Japanese tax law. The juridical entities are entities that are themselves taxpayers under Japanese law include the kabushiki kaisi (the closest equivalent to a corporate entity) and yugen kaisha ("YK", a close counterpart to a limited liability partnership, authority for which was abolished in 2006, but existing YKs may continue to operate as tokurei yugen kaisha ("TYK")). For such entities, the profit allocated from the partnership is regarded as a dividend when it is actually sent to the domestic corporation and is eligible for the foreign dividend exemption. If the partnership is regarded as a kumiai (association) that is a flow-through, then each individual member is subject to tax for the share of profit under Japanese law. The profit so distributed is not eligible for the foreign dividend exemption. Branches are in the nature of unincorporated associations, and profits from the foreign branches of corporations are not eligible for the exemption.

6. Intangible property income

Income from intellectual property owned by a domestic company or a controlled foreign company is generally treated as passive income and is not eligible for the foreign exemption. There is no special set of rules applicable to income from intellectual property.

F. Netherlands[40]

1. In general

The Netherlands generally taxes resident companies on their worldwide profits, including foreign-source dividends, interest, and royalties, at a 25-percent rate, with relief from double taxation provided by way of a foreign tax credit. However, Dutch law applies the principles of territorial taxation by exempting certain qualifying distributions from corporate taxation under a participation exemption regime.

The participation exemption applies to both domestic and foreign shareholdings. In general, a shareholding is treated as an eligible participation under the participation exemption regime if the taxpayer (other than a Dutch qualified investment company that is subject to a corporate income tax rate of zero percent) holds at least five percent of the nominal paid-up capital of a company of which the capital is partially or wholly divided into shares.[41] A less than five percent direct shareholding may also be a qualifying participation if another company in the group owns a stake of at least five percent in the same subsidiary. However, an interest of five percent or more in a passive subsidiary (i.e., one that is largely investing or passively financing) is only considered a participation if the subsidiary complies with the subordination requirement (i.e., an effective tax burden of at least 10 percent). Additionally, the participation exemption does not apply if the Dutch taxpayer or the subsidiary is considered to be an investment institution. Notwithstanding the five-percent ownership requirement, if a participation is maintained for more than one year, the participation exemption will continue to apply for an additional three years even if the interest held by the Dutch resident falls below five percent.

2. Expenses

The Netherlands does not have rules that disallow a deduction for expenses of a Dutch resident company to the extent those expenses are attributable to income that is exempt under the participation exemption regime.[42] Nonetheless, costs and expenses incurred on the disposal of a

[40] This description of Dutch law relies largely on Kees van Raad (as updated by Maarten van der Weijden), *Business Operations in The Netherlands*, BNA Tax Management Portfolio, 973-2nd; International Bureau of Fiscal Documentation ("IBFD") European Tax Surveys, Netherlands – Corporate Taxation; Law Library of Congress, *Taxation of Controlled Foreign Corporations in Selected OECD Countries, Report for Congress* (October 2009); and Ernst & Young, *The 2010 Worldwide Corporate Tax Guide - Netherlands* (April 2010).

[41] Where under the terms of a tax treaty with another European Union member state the dividend tax is reduced according to a voting rights criterion (as, for example, under the treaties with Germany, Ireland, and the United Kingdom), a participating interest also qualifies if the Dutch taxpayer controls at least five percent of the voting rights of the company located in the other member state.

[42] Prior to 2004, expenses incurred with respect to qualifying foreign participations, such as interest expenses, were not deductible for Dutch corporate income tax purposes, unless the expenses were instrumental in generating Dutch taxable income. In the *Bosal* case, the European Court of Justice ruled that this measure was incompatible with European Union law and, consequently, was not applicable to expenses related to qualifying European Union participations. Case C-168/01, *Bosal Holding BV v. Staatssecretaris van Financien*, 2003 E.C.R. I-9409. As a result, the Netherlands changed this rule with respect to both qualifying European Union and non-European Union participations.

participation (for example, lawyers' fees, stock-exchange duties, and notary fees) are not deductible.

In general, interest payments on loans, bonds, debentures, and other debts of the company are fully deductible as normal business expenses for Dutch corporate income tax purposes. However, the Netherlands has thin-capitalization rules designed to avoid the erosion of the Dutch tax base within corporate groups by providing that interest paid in respect of excessive debt is generally not deductible. Under these rules, interest expenses (and other costs) with respect to related-party loans (or deemed related-party loans[43]) may be partly or completely disallowed if the taxpayer is part of a group, as defined in the Dutch Civil Code. The maximum amount of interest disallowed under these rules is limited to the net related-party interest.

The rules provide two ratios to determine the amount of excess debt. Under the first ratio, which is a fixed ratio, the average fiscal debt may not exceed more than three times the company's average fiscal equity plus €500,000 ($666,965).[44] For purposes of determining this ratio, debt is defined as the balance of the company's loan receivables and loan payables. The balance sheet for tax purposes is used to determine the average debt and equity.

Alternatively, when the company files its corporate tax return, it may elect to apply for the group ratio. Under this alternative, the company may look at the commercial consolidated debt-to-equity ratio of the (international) group of which it is a member. If the company's commercial debt-to-equity ratio does not exceed the debt-to-equity ratio of the group, the entire tax deduction for interest on related-party loans is allowed.

If there is no excessive debt, then the thin capitalization provisions do not apply.

3. Controlled foreign company rules

The Netherlands does not have a formal controlled foreign company regime but does have a regime that is intended to discourage tax deferral through the creation of low-taxed passive subsidiaries referred to as "low-taxed portfolio participations." While there is no strict definition of a "country of low taxation," a company's activities are assumed to be passive when the country does not levy an effective tax rate of at least 10 percent on the income of the company. In this situation, in cases in which the parent holds at least a 25-percent participation and at least 90 percent of the subsidiary's assets are passive (defined as "free portfolio investments" under Dutch tax law), the shares of the participation must be marked-to-market annually with any increase in value being included in the taxable profits of the Dutch parent. This annual revaluation is required instead of the approach often used by other jurisdictions of

[43] Deductions for interest on third-party debt is generally allowed; however, in cases in which such debt is formally granted by a third party but is, in substance, actually owed to a related party, the thin-capitalization rules apply.

[44] U.S. dollar equivalents were calculated using the currency rate for January 1, 2011, according to OANDA's FX Converter available at http://www.oanda.com.

requiring an attribution of the underlying profits of the shareholding to the Dutch parent. Furthermore, it occurs regardless of whether any of the underlying profits are distributed.

In cases in which a subsidiary qualifies as a low-taxed portfolio investment, it is excluded from the participation exemption regime. Instead, a foreign tax credit system applies to provide relief from double taxation at the Dutch parent. Under this system, income derived from a low-taxed portfolio participation is generally grossed up and taxed at the standard Dutch corporate income tax rate, while allowing a credit for the underlying taxes.

4. Gain or loss on the sale of foreign subsidiary stock

In cases in which a domestic or foreign shareholding meets the above requirements to be treated as an eligible participation, any gain on the disposition of such shares is exempt from Dutch corporate taxation. Likewise, any loss on the disposition of such shares is nondeductible.

5. Foreign branches

The profits of a foreign branch of a Dutch resident company that meets the definition of a foreign permanent establishment[45] generally qualify for an exemption through a proportional tax reduction (also commonly referred to as "exemption with progression").[46] Under this exemption with progression approach (which also applies to certain employment income and foreign immovable property income), the Dutch resident company must first compute Dutch tax based on its worldwide income, including the income of the foreign permanent establishment. The amount of tax due is then reduced by the Dutch resident company's ratio of foreign income to worldwide income.

Foreign losses of a permanent establishment are deductible against worldwide income in computing taxable income of the Dutch resident company. However, foreign losses incurred in a preceding year will reduce the foreign profits otherwise eligible for relief in subsequent years so as to reduce the relief and prevent the double counting of losses. Furthermore, as profits and losses of foreign permanent establishments are taken into account on a per-country basis, foreign profits derived from one country are not offset by losses incurred in another country.

To the extent a foreign permanent establishment is converted into a subsidiary, the participation exemption does not apply until the losses sustained through the former permanent establishment in the years prior to the conversion are fully recaptured. In such a situation, dividends distributed by the subsidiary and capital gains on the disposal of shares in the subsidiary are generally taxed until such losses are fully recaptured, after which the participation

[45] The Dutch definition of permanent establishment is similar to that which is found in the OECD Model Convention. The OECD Model Convention defines a permanent establishment as a fixed place of business through which the business of an enterprise is wholly or partially carried on. Organisation for Economic Cooperation and Development, Model Tax Convention on Income and on Capital, article 5(1) (2010).

[46] Income from certain foreign finance activities carried on through a foreign permanent establishment does not qualify for this exemption. Instead, relief from double taxation is accomplished by way of a foreign tax credit.

exemption is applicable. In some circumstances, however (e.g., the shares in the company in which the participation is held are transferred to a non-resident related entity), losses incurred through a foreign permanent establishment converted into a foreign subsidiary must be recaptured immediately.

6. Intangible property income

When certain requirements are met, a taxpayer may elect to apply the Dutch Innovation Box regime. The purpose of this regime is to encourage innovation and investment in research and development.[47] Net income from qualifying property within the Innovation Box is effectively taxed at a rate of five percent. This is accomplished by only taking into account 5/25ths of the qualifying profits. The special five-percent rate applies only to the extent that the net earnings derived from the qualifying property exceed a threshold. This threshold is the total intangible development costs attributable to the qualifying property. Such intangible development costs are deductible when incurred at the regular corporate income tax rate (i.e., currently 25 percent). Although losses on the exploitation of the qualifying property are also still deductible at the 25-percent rate, these losses are subject to recapture through an increase in the threshold.

Intangible assets qualify for Innovation Box treatment only to the extent the assets were developed by the taxpayer itself or on account of the taxpayer. For the Innovation Box regime to apply with respect to a given intangible asset, the taxpayer must have been granted a patent, a plant breeder's right (this right is granted for newly invented seeds), or a research and development declaration from the Ministry of Economic Affairs with respect to that intangible asset. Trademarks, logos, and similar assets do not qualify. For the income to qualify for the special five-percent rate, more than 30 percent of the income must be allocable to the patent, breeder's right, or research and development declaration.

A Dutch taxpayer may selectively elect the Innovation Box regime (e.g., elect with respect to some intangible assets and not others). Furthermore, there is no limit on the amount of income from intangible assets that can be taxed at the reduced rate.

[47] The Innovation Box succeeded the Patent Box regime, which was effective from January 1, 2007, until it was replaced by the Innovation Box as of January 1, 2010.

G. Spain[48]

1. In general

Resident corporations[49] are subject to tax in Spain on their worldwide income. To prevent double taxation, there are exemptions, deductions, and tax credits applicable to income derived from foreign sources. Spain has two methods for granting double tax relief, 1) a tax credit or deduction against Spanish tax for the actual corporate income tax paid abroad, and 2) an exemption from income for qualifying participations. Spain generally does not tax the income of foreign subsidiaries until it is distributed. Any available exemption, deduction, or credit is applicable when income is distributed.

Dividends and capital gains from foreign subsidiaries qualify for an exemption from the Spanish corporate tax if the resident corporation owns a participation of at least five percent of the foreign company and has held the participation for at least one year prior to the date on which the dividend is payable. In addition, certain anti-avoidance criteria must be met for the exemption to apply.

In order to qualify for the exemption, the income from the foreign subsidiary must have been subject to tax in the foreign country that is deemed equivalent to the Spanish corporate tax. The subsidiary must have been subject to and not exempt from such tax for the entire year in which the dividend is received. The tax in the foreign country is deemed to be equivalent to the Spanish corporate tax if the foreign subsidiary has a permanent establishment located in a country with which Spain has a tax treaty with an exchange of information clause. At least 85 percent of the foreign subsidiary's income out of which the dividend was paid must be derived from business activities carried on outside Spain. The exemption does not apply if the foreign subsidiary is located in a country that is considered a tax haven under Spanish regulations.[50]

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[48] This description of Spanish law relies largely on Baker & McKenzie Madrid S.L., "Business Operations in Spain," *BNA Tax Management Portfolio*, 989-5th; Law Library of Congress, *Taxation of Foreign Source Income of Resident Corporations, Report for Congress* (April 2011); and IBFD European Tax Surveys, "Spain – Corporate Taxation."

[49] A company is resident in Spain if it has its statutory seat or place of effective management in Spain. Spanish residence can be presumed by the tax administration when a corporation is located in a tax haven or a no-tax jurisdiction and its principal assets are in Spain or its main business is located in Spain, unless the taxpayer can prove that the corporation is managed in the tax haven jurisdiction and that there are valid economic reasons for it to be established there.

[50] Spanish regulations list 48 countries as tax havens, including Hong Kong, Cayman Islands, Bermuda, Malta, the Isle of Man, Lichtenstein, Macao, Luxembourg (with respect to income from certain entities), and Singapore. For the complete list of countries deemed to be tax havens under Spanish law, see, Real Decreto 1080/1991 of July 5, 1991, as amended by Real Decreto 116/2003, available at http://www.boe.es/boe/dias/1991/07/13/pdfs/A23371-23371.pdf.

The exemption is not available if the main purpose of the subsidiary is to benefit from the tax exemption,[51] or if losses of the subsidiary are deductible by way of depreciation of the relevant participation.[52]

2. Expenses

Spain does not have expense disallowance rules for expenses attributable to exempt dividends and capital gains.

Spain has thin capitalization rules that apply to related party debt unless the related party is a resident of another European Union country that is not considered a tax haven under Spanish law. If the net interest-bearing debt of an entity that is not a financial institution, made directly or indirectly, to one or more related individuals or entities that are not resident in Spain exceeds three times its capital, the interest attributable to the excess is considered a dividend and not as a deductible expense. The deemed dividend is subject to any applicable dividend withholding tax. With the permission of the Spanish tax administration, the taxpayer may be able to apply a different ratio, based on the financing that the entity would have been able to obtain under normal market conditions from unrelated parties, if the lender is not located in a listed tax haven.

3. Controlled foreign company rules

Spain has controlled foreign company rules referred to as the "international tax transparency regime." Under this regime, a Spanish resident company is liable for corporate income tax on some passive income, such as interest, dividends, capital gains, and real estate losses, of non-European Union resident companies or of companies based in tax haven countries.[53]

These rules apply where the Spanish resident company owns at least 50 percent of the capital, equity, or voting rights, and where the controlled foreign company has "tainted income." Tainted income includes: (1) income from real estate or related rights, unless the real property is effectively connected to a business activity; (2) income derived from participating in the equity of any kind of entity or as a consequence of granting third parties the right to use the company's financial resources;[54] (3) income from banking, financial, insurance and service activities

[51] This is deemed to be the main purposes of a subsidiary when the subsidiary carries on the same activities in the same market that were previously carried out by a Spanish entity within the same group.

[52] Spanish law generally allows for depreciation of the shares of the subsidiary when a dividend is paid. However, the Spanish resident corporation cannot both exempt the income and take a deduction for the depreciation in shares.

[53] A controlled foreign company that is resident in a tax haven jurisdiction is deemed to have tainted income of 15 percent of the Spanish shareholder's cost of acquiring the tax haven company, unless the Spanish shareholder provides evidence of contrary income amounts, or includes the tax haven company in its consolidated balance sheet.

[54] This category includes all kinds of financial income derived from equity or debt instruments and includes many exemptions including an exemption for income from credit activities that can be characterized as business activities.

supplied directly or indirectly to resident individual or corporate related parties, if the related party is entitled to deduct the amount paid for Spanish income tax purposes;[55] and (4) capital gains from the transfer of these types of assets accrued by the controlled foreign company. If the controlled foreign company pays local corporate tax on the tainted income that is at least 75 percent of the tax the company would have paid under the Spanish tax regime, it is not subject to these rules.

Income derived from business activities, capital gains, and the transfer of rights of business assets is excluded from taxable income if it is derived from entities in which the resident taxpayer has a direct or indirect interest of more than five percent and the following prerequisites are met: (1) the nonresident company has the supervision and management of the participation through the appropriate organization of means and personnel; and (2) at least 85 percent of the income of the entities from which the income is obtained is created by carrying out business activities.

If the amount of passive income derived from the Spanish resident parent company is 15 percent or more of the net profits or four percent of the total turnover of the controlled foreign company, the Spanish resident company includes the proportionate share of income in its tax base.

4. Gain or loss on the sale of foreign subsidiary stock

Capital gains from the sale of foreign subsidiary stock also qualify for an exemption from the Spanish corporate tax if the participation requirements, one-year holding period, and anti-avoidance criteria discussed above are met. The subsidiary must have been subject to an equivalent tax throughout the entire holding period for capital gains to be excluded.

5. Foreign branches

Income derived from a foreign branch is exempt from Spanish corporate income tax if the foreign branch is considered a permanent establishment.[56] To be exempt, the income of the foreign permanent establishment must be derived from the carrying out of business activities. This condition is met if at least 85 percent of the income corresponds to income obtained abroad, and is not subject to the deduction under the Spanish income tax regime. Wholesale commerce, services, credit and financing, and insurance and reinsurance are activities which could be considered as deriving foreign income. Additionally, the income derived by the permanent establishment must be subject to tax with an equivalent tax to the Spanish income tax, and must not be located in a tax haven country.

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[55] This type of income will not be tainted income if more than 50 percent of the controlled foreign company's income from such activities arises from transactions with unrelated parties.

[56] An entity is considered to be doing business through a permanent establishment if it has any permanent facilities or workplaces abroad where it carries out its business activities in whole or in part. If the activities are located in a country with which Spain has a tax treaty, the provisions of the treaty apply to determine if there is a permanent establishment.

The exemption for foreign branch income does not apply where losses from the branch were allowed in prior tax periods. The exemption applies to the income from the branch only after the losses are fully recaptured. Additionally, the exemption for foreign branch income does not apply where the permanent establishment was established abroad for the sole purpose of benefiting from this preferred tax treatment.

6. Intangible property income

Spain adopted a patent box regime in 2007 that reduces the rate of corporate income tax on income derived from intellectual property. Fifty percent of the income derived from the transfer of the right to use qualifying intellectual property is exempt from corporate tax in Spain. Intellectual property rights included in the incentive regime include patents, drawings or models, plans, secret formulas or procedures, and rights on information related to industrial, commercial, or scientific experiments. The patent box regime does not distinguish between intellectual property income from foreign and domestic sources.

In order to qualify for the reduced tax: (1) the intellectual property must have been created by the company transferring the right; (2) the recipient of the right must actually use the intellectual property for business activities; (3) if the recipient is a related company, the intellectual property cannot be used to generate a deductible expense for the transferring company; (4) the recipient company must not be located in a listed tax haven jurisdiction; (5) in the case where one intellectual property contract includes other services, the consideration related to the intellectual property must be clearly differentiated within the contract; and (6) the transferring taxpaying company must keep records of income and expenses pertinent to the intellectual property rights subject to the transfer.

H. Switzerland[57]

1. In general

Switzerland is a federation of 26 sovereign cantons (states). Corporate income taxes are levied at both the federal (at a flat 8.5-percent rate) and cantonal (at varied rates) levels, with cantonal taxes exceeding federal taxes in several cantons.[58] In addition, Switzerland's 2,600 municipalities are generally empowered to levy their own taxes.

Swiss resident companies, defined as those that are incorporated in Switzerland or are effectively managed or controlled from Switzerland, generally are taxed on a territorial basis. Income from foreign permanent establishments and foreign real property is exempt from Swiss taxation, but considered when determining tax rates.[59] In addition, tax relief is granted for dividends received from foreign and domestic participations at both the federal and cantonal level, and the cantons and municipalities generally exempt holding companies from cantonal and municipal income taxes.[60]

The tax relief granted for certain qualified dividends takes the form of a "participation deduction." Dividends qualify for a participation deduction if the parent company owns (i.e., "participates in") at least 10 percent of the total share capital of the subsidiary, or holds shares worth at least one million Swiss Francs (CHF) ($1.069 million).[61] Additionally, a parent company can receive the participation deduction if it is entitled to 10 percent of the profits of the subsidiary. A company does not need to have held its shares for any minimum period to qualify for the participation deduction. As described more fully below, a company also receives a deduction for capital gains from the sale of qualifying participations.

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[57] The information in this section is based in large part on Peter R. Altenburger et al., *Business Operations in Switzerland*, Tax Management Portfolio No. 986-3rd, Roger M. Cadosch, International Bureau of Fiscal Documentation, IBFD European Taxation Database, Switzerland, available at http://checkpoint.riag.com (last accessed May 2, 2011), and Law Library of Congress, *Taxation of Foreign Source Income of Resident Corporations, Report for Congress* (2011).

[58] The discussion that follows describes the tax treatment at the federal level. Cantonal tax treatment generally is similar to federal tax treatment, except as otherwise noted.

[59] This feature of the Swiss tax system has no effect on a company's federal taxes, but is often significant in determining cantonal taxes as many cantons have progressive corporate tax rates.

[60] The exemption from cantonal and municipal income taxes is available to a holding company if (1) the main purpose of the company is to hold and manage long-term investments in affiliated companies, (2) the company does not carry on an active trade or business in Switzerland, and (3) at least two-thirds of the company's total assets consist of qualifying investments or two-thirds of the company's total income is derived from qualifying investments.

[61] Except where otherwise indicated, the quoted tax rates and threshold amounts apply in 2011. U.S. dollar equivalents were calculated using the currency rate for January 1, 2011, according to OANDA's FX Converter, available at http://www.oanda.com. Prior to 2011, the required participation levels were 20 percent of the total share capital or CHF two million ($2.137 million).

The tax relief equals a company's net income from qualifying participations over the company's worldwide taxable net income. The company's total corporate income tax is reduced by an amount equal to this percentage. The net income from qualifying participations equals gross dividends received from the participation less financing costs and administrative costs (which are presumed to equal five percent of the gross dividend received, as discussed further below).

2. Expenses

In general, a Swiss resident company may fully deduct expenses other than interest that are related to earning income that is exempt from tax (income from foreign permanent establishments and foreign real property) or the tax on which may be offset by the participation deduction. Switzerland requires a formulary allocation of interest expense to such income (using an asset ratio method that compares the tax book value of the investment that generated the income to total assets). The application of these rules has an effect similar to a disallowance of some interest expense deductions; however, these rules generally apply only to the extent that such interest is attributable to a foreign participation in a year in which the foreign participation distributes an exempt dividend to Switzerland. The amount of the participation deduction equals the gross dividend received from the participation less attributable financing costs and administrative costs. The administrative costs are presumed to equal five percent of the gross dividend received from the participation, although this presumption is rebuttable.

In general, there are no limitations on the deduction of interest expense to the extent the debt is owed to independent third parties (which are not collateralized by the debtor company's shareholders or parties related to the shareholders), other than the indirect disallowance discussed above. If debt is owed to related parties, financial companies may have a maximum debt-to-equity ratio of six-to-one. For other companies, a company may have debt equal to a percentage of its assets (the percentages vary from 50 percent of fixed assets to 100 percent of cash). A company may attempt to establish that debt exceeding these safe harbors is nevertheless arm's-length; if the company is successful, any interest paid with respect to that debt is fully deductible.

3. Controlled foreign company rules

Switzerland does not have controlled foreign company rules.

4. Gain or loss on the sale of foreign subsidiary stock

The participation deduction applies to capital gains on substantial participations sold by a Swiss resident company. To qualify for the deduction, (1) the participation sold must represent at least 10 percent of the total capital of the subsidiary or entitle the seller to at least 10 percent of the profits of the subsidiary, and (2) the seller must have held the participation for at least one year prior to the sale.

A Swiss resident company that realizes a capital gain on any other sale of a foreign subsidiary's stock generally must include the gain in its Swiss taxable income. If a capital loss is realized, the loss is deductible.

5. Foreign branches

Income a Swiss resident company earns from a foreign permanent establishment, including a branch, is exempt from Swiss tax at the federal level.

A Swiss resident company may use losses of a foreign permanent establishment to offset profits realized in Switzerland to the extent those losses cannot be utilized at that time in the country in which the permanent establishment is located. If the losses are set off against profits of the permanent establishment in the country in which it is located within the next seven years, however, then an amount of income equal to the loss utilized in the permanent establishment's country of residence becomes taxable in Switzerland.

6. Intangible property income

No special tax treatment applies to royalties at the federal level. When received by Swiss resident companies, they are included in income and taxed in the same manner as other income.

Royalties may be exempt from cantonal income tax if received by a cantonal holding company. In addition, the canton of Nidwalden introduced the first license box system in Switzerland on January 1, 2011. Under this system, companies (or branches) in Nidwalden pay a flat tax of 1.2 percent on their net licensing income in lieu of any other cantonal or municipal income taxes that would otherwise apply to that income. Licensing income includes payments received for the use (or right to use) certain intellectual property, including copyrights, patents, trademarks, designs or models, plans, and secret formulas or processes. The license box system is available with respect to income from both existing and new intellectual property, as well as income from both self-developed intellectual property and intellectual property acquired from third parties. A company (branch) that desires to utilize the license box system must apply and get tax authority approval. In addition, the company (branch) must have substance in Nidwalden, such as owning office space, employing qualifying personnel, or exercising management functions in the canton.

I. United Kingdom[62]

1. In general

The United Kingdom generally taxes resident companies on all income and capital profits regardless of where they arise. Corporations pay tax at a rate of 27 percent on profits equal or exceeding £1.5 million ($2.3 million).[63] A small profits rate applies to small corporations with a graduated rate and phase-out structure in place. The United Kingdom is currently in the process of lowering its corporate rate, with the aim of reaching a flat rate, applicable to large corporations, of 24 percent.

The United Kingdom is also in the process of making significant changes in its tax system to move towards a more territorial tax system. In 2009, legislation was introduced that exempts 100 percent of dividends received by large- and medium-sized companies from United Kingdom taxation. Small companies (those employing less than 50 people and with annual turnover or balance of £10 million ($15.5 million) or less) are not eligible for the exemption unless the dividend paying company is located in a territory that has a double tax treaty with the United Kingdom containing a standard OECD nondiscrimination clause.

The exemption of foreign dividends was partly intended to remove the distinction between United Kingdom-source dividends and European Union-source dividends in order to comply with the principles of freedom of establishment and the free movement of capital provided for in the European Community Treaty. The exemption is broader than it would have to be under the treaty, as it does not distinguish between European Union and non-European Union member states, but applies to dividends from all countries outside the United Kingdom.

Dividends from the following categories are exempt: (1) the dividend is paid from a company controlled by the United Kingdom company;[64] (2) the dividend is paid in respect of non-redeemable ordinary shares; (3) the United Kingdom company is a portfolio shareholder;[65] (4) dividends are paid in respect of profits that do not reflect the results of a transaction or series of transactions which achieve a (non-negligible) reduction in United Kingdom taxation; or (5) if dividends are similar to interest, and the receiving company is not connected, the paying company is not an open-ended investment company, unit trust or offshore fund, and the shares

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[62] This description of United Kingdom law relies largely on Peter Nias, James Ross, Lee Khvat, and Clare Morison, "Business Operations in the United Kingdom," *BNA Tax Management Portfolio*, 989-5th; Law Library of Congress, *Taxation of Foreign Source Income of Resident Corporations, Report for Congress* (April 2011); IBFD European Tax Surveys, "United Kingdom – Corporate Taxation;" and information found on the HM Treasury website at http://www.hm-treasury.gov.uk/.

[63] U.S. dollar equivalents were calculated using the currency rate for January 1, 2011, according to OANDA's FX Converter, available at http://www.oanda.com.

[64] Dividends could also qualify under this class, subject to certain conditions, if the United Kingdom company is one of two persons who, taken together, control the dividend paying company.

[65] A portfolio shareholder holds less than 10 percent of the issue share capital and is entitled to less than 10 percent of the profits of the paying company.

are not held for an unallowed purpose (i.e., to obtain a tax advantage). The exemption from tax is broad, but companies may elect out.

Distributions from the following categories are not eligible for the exemption: (1) non-redeemable shares if there is a scheme to avoid taxation and rights are obtained equivalent to the rights of either a preferential shareholder or a shareholder of a redeemable share; (2) a portfolio shareholding where a larger shareholding is split between connected companies in order to meet the portfolio shareholding limitations; (3) part of an arrangement to yield a return that is economically equivalent to interest and part of a tax advantage scheme; (4) tax advantage schemes that include any deduction given under foreign tax law in respect of an amount calculated by reference to the distribution; (5) tax advantage schemes that involve recipients that make payments or give up income in order to receive a distribution; (6) tax advantage schemes that involve payments not at arm's length; and (7) distributions that have been artificially diverted from a company for which the distribution would have been a trade receipt.

2. Expenses

In general, the United Kingdom allows domestic tax deductions for expenses that are associated with foreign-source dividend income. The United Kingdom has had thin capitalization rules since April 1, 2004. These rules apply to both domestic and cross-border loan transactions. The thin capitalization test relies heavily on the arm's-length standard to regulate excessively leveraged financing structures. A United Kingdom company is thinly capitalized for tax purposes when it has more debt than it could and would have borrowed on its own resources, because it is borrowing either from or with the support of related parties. In this case, the transfer pricing rules generally disallow the deduction for interest expense that exceeds what it would have been in the absence of the special relationship between the borrower and the lender. Other anti-avoidance rules apply to limit interest in certain situations including where one of the main purposes for the loan arrangement is to secure a tax advantage.

The United Kingdom also introduced a limited interest restriction measure (the "worldwide debt cap"). The worldwide debt cap applies to medium- and large-sized companies and limits the deductibility of interest payments in certain instances. The limit is based on a formula derived from a comparison of the enterprise's internal debt with its external debt. This worldwide debt cap limitation restricts the deductibility of interest and other finance expense on intra-group debt of United Kingdom companies in cases in which the United Kingdom interest expense is excessive by reference to such expense in the worldwide group.[66]

[66] Under these rules, a Gateway Test is applied to determine if net debt of the United Kingdom taxpayer is greater than three quarters of the gross debt of the worldwide group. If the net debt exceeds this threshold, the United Kingdom company must apply more detailed rules to determine the portion of related party interest expense that is disallowed. These rules, however, do not apply to certain qualifying financial services groups. Susan Bell, "Section 11 and Schedule 5 Worldwide Debt Cap," *British Tax Review*, Issue 1 (2011).

3. Controlled foreign company rules

The United Kingdom has controlled foreign company rules that provide for taxation of the controlled foreign company profits under certain conditions. The profits are taxable if (1) the company is resident outside the United Kingdom; (2) the company is controlled by persons resident in the United Kingdom;[67] and (3) the company is subject to a lower level of taxation in the territory in which it is resident. A lower level of taxation means, with respect to any accounting period, the taxation paid on the company's profits is less than three quarters of the corresponding United Kingdom taxation that would be chargeable on such profits if the company were resident in the United Kingdom.[68] If the controlled foreign company rules apply, then all of the company's income apportionable to the United Kingdom resident is subject to tax; no distinction is made between passive and active income.[69] There are certain exceptions to the controlled foreign company rules, including a de minimis exception if the chargeable profits for the relevant account period do not exceed £50,000 ($77,499), an exception for income sourced in certain excluded countries (including countries in the European Economic Area), and a motive test where the transaction giving rise to the controlled foreign company did not have as a purpose a reduction in United Kingdom tax by diverting profits from the United Kingdom.

The United Kingdom has proposed reforming the controlled foreign company rules. The 2011 budget proposal includes narrowing the controlled foreign company rules to target profits that are artificially diverted from the United Kingdom. The new rules include an exemption for intra-group activities where the activities have minimal connection to the United Kingdom, and for controlled foreign companies whose main business is the exploitation of intellectual property where the controlled foreign company and the intellectual property have minimal connection to the United Kingdom. Additionally, the de minimis exception is £200,000 ($309,996) under the 2011 proposed budget.

4. Gain or loss on the sale of foreign subsidiary stock

The United Kingdom tax system provides for a participation exemption from capital gains tax for United Kingdom resident companies derived from a substantial shareholding. A substantial shareholding arises when a company holds no less than 10 percent of the company's

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[67] Control for these purposes means the power of a person to secure either by holding shares or voting power or by powers conferred by the articles of association or other document that the affairs of the company are conducted in accordance with his wishes. A company may also meet the control test if two persons together control it and, broadly, a United Kingdom resident person has at least a 40 percent interest and another person has at least a 40 percent interest an no greater than a 55-percent interest.

[68] There are anti-avoidance provisions targeted at "designer rate" tax regimes which set aside the lower level of taxation condition where the tax payable is determined under provisions the HMRC has determined to be designed to enable companies to exercise significant control over the amount of tax that they pay. The regulations identify specific provisions in specific locations as designer-rate tax regimes.

[69] In response to the 2006 European Court of Justice ruling in *Cadbury Schweppes* (Case C-196/04), a reduction is allowed for profits that are not wholly artificial arrangements where the subsidiary is engaged in genuine economic activity in another member state.

share capital, is beneficially entitled to no less than 10 percent of the company's profits, or would be beneficially entitled to no less than 10 percent of the assets upon the winding-up of the company. Additionally, the company that is disposing of the assets must have owned the shares for a minimum of twelve consecutive months within a two-year period prior to disposal. There is also a requirement that the investing company and the company invested in must be a trading company or a member of a trading group. For these purposes, a "trading company" is a "company carrying on trading activities whose activities do not include to a substantial extent activities other than trading activities." In this context, the term "substantial" is interpreted to mean where non-trading income, activities, or expenses are more than 20 percent of the activities of the company.

5. Foreign branches

The United Kingdom is considering an exemption for profits from foreign branches of United Kingdom companies. Currently, foreign branch income is taxable. The large majority of businesses in the United Kingdom do not utilize foreign branches. Branches tend to be used by larger companies in the oil and gas, banking, and insurance sectors.

Under the proposed exemption for foreign branches, companies may elect to exempt the profits from foreign branches if they are attributed to a permanent establishment in accordance with either a treaty or, where no such treaty exists, in accordance with the OECD model convention. If profits are exempt from corporate tax, then losses would also be excluded to the extent they arise from foreign permanent establishments. The election once made would be irrevocable. The exemption would exclude capital gains as well as investment income that is effectively connected to the branch.

Anti-avoidance rules similar to the controlled foreign company rules would apply to prevent abuse. Where the foreign tax liability of the foreign branch is less than three quarters of the corporate tax that would be payable on the same profits if they were taxable in the United Kingdom, then the branch must meet certain conditions (including the motive test) in order for the exemption to apply.

6. Intangible property income

The United Kingdom does not currently have special rules for treating foreign source intellectual property income differently from other categories of foreign-source income. The government plans to introduce a preferential tax regime for profits arising from patents.[70] The "patent box" rules would apply a 10 percent corporate tax on income from patents, including patent royalties and imbedded royalty income from the sales of patented products booked in the United Kingdom. The patent box regime will be elective beginning in April 2013, and will apply to patents for which the technology was first commercialized after November 29, 2010.

[70] The government will issue a consultation document on the patent box measure in May 2011, with legislation proposed for the Finance Bill 2012. See HM Treasury, Overview *of Tax Legislation and Rates*, (March 23, 2011) p. 22, available at http://cdn.hm-treasury.gov.uk/2011budget_taxation_overview.pdf.

In late November 2010, the United Kingdom government published details of its corporate tax reform program proposal containing details of proposed changes to the United Kingdom's controlled foreign company regime with important implication for the taxation of foreign intellectual property profits. While the reforms are generally considered to be more favorable to taxpayer, the new rules are, nonetheless, intended to ensure that intellectual property profits artificially diverted to low tax jurisdictions remain taxable in the United Kingdom, but that the ways in which groups manage their commercial operations overseas are not distorted or inhibited. One of the reforms is a tax exemption for controlled foreign companies that have a main business of exploiting intellectual property where the intellectual property and the controlled foreign company have minimal connection with the United Kingdom.[71]

[71] HM Treasury's 2010 report explained that the rules would be designed to target high-risk areas including: (1) circumstances where intellectual property has been developed in the United Kingdom and transferred to a low-tax jurisdiction; (2) where intellectual property is held offshore and effectively managed in the United Kingdom (an example would be where 90 percent of the activity takes place in the United Kingdom but most of the profits arise in a low-tax jurisdiction); and (3) United Kingdom funds are used to invest in intellectual property that is held offshore, but the United Kingdome does not receive a return on that investment.