# INTERNATIONAL TAX PLANNING — Companies

Para

Introduction ........ 1-010
Background to the Green and Sharp scenario ........ 1-020
Structuring the foreign business — branch or subsidiary? ........ 1-030
Financing the foreign business — loan capital or share capital? ........ 1-040
Debt/equity ratios — thin capitalisation ........ 1-050
Acquiring a foreign business ........ 1-060
Acquiring a foreign subsidiary ........ 1-070
Foreign holding company ........ 1-080
Groups of companies/consolidation ........ 1-090
Offshore holding company ........ 1-100
Offshore finance company ........ 1-110
Offshore licensing company ........ 1-120
Offshore trading company ........ 1-130
Special deductions, exemptions and incentives ........ 1-140
Profit reduction techniques ........ 1-150
Transferring foreign branch to foreign subsidiary ........ 1-160
Transferring other assets to foreign subsidiary ........ 1-170
Selling the foreign branch ........ 1-180
Selling the foreign subsidiary ........ 1-190
Return of capital ........ 1-200
Repatriation of profits ........ 1-210
Acquiring foreign business premises ........ 1-220
Exchange/currency fluctuations ........ 1-230
Foreign presence without foreign tax ........ 1-240
Tax treaty planning ........ 1-250
Foreign tax credits/double tax relief ........ 1-260
Exchange controls ........ 1-270
Remuneration of foreign executives ........ 1-280

http://www.pbookshop.com

| | Para |
|---|---|
| Specific industries | 1-290 |
| Some cautionary comments | 1-300 |

## ¶1-010 INTRODUCTION

As communications make the world smaller, business becomes increasingly international at all levels from the multinational to the proprietor-owned business. Whatever the size of the organisation, it is more likely than ever that it will need to plan its tax strategy on an international level.

This chapter is intended to assist companies planning to set up or acquire a foreign business. By identifying the key stages which occur during a business's international conception and growth, it is able to discuss and illustrate within a practical framework the international tax planning factors to be considered at each relevant stage.

Within its confines this chapter cannot aim to be exhaustive. But it will serve as a guide to international tax planning concepts and as a checklist to the international tax implications of each relevant stage of growth.

International tax planning is primarily concerned with the interaction of one country's tax system with another. Properly integrated and cohesive tax planning is essential when business spans international borders. Without proper co-ordination the plan may save taxes in the foreign country but be tax-expensive at home, or vice versa. Because of the pace of change in both domestic and international tax law and practice, regular review of the plan is also necessary in case a redesign is required to reflect these changes. There is a clear need for professional expertise.

http://www.pbookshop.com

The following example illustrates the areas requiring investigation. A company plans to set up a new business in, say, Canada, to manufacture a product already successfully produced and sold in its home country.

Should it operate in Canada as a branch or local subsidiary?

What permissions are required to export capital to Canada?

Are any home country permissions required?

If a subsidiary is formed, should its shares be owned in Canada, the home country or some third country?

Should the manufacturing patents to the product be sold or licensed to the Canadian entity?

Should the Canadian patent rights be owned in Canada, the home country or some third country?

These are just some of the questions that need to be answered before any transnational operation is undertaken. They underline the importance of international tax planning.

Needless to say, early and detailed discussion with professional advisers is essential before any foreign business acquisition or expansion is embarked upon. This chapter will serve as a useful aid to these discussions.

To put some of the principles that are discussed into a practical perspective, most topics are illustrated by the continuing story of the **Green and Sharp scenario**. The Green and Sharp families jointly own Enterprise Company, a manufacturer of printed circuit boards for computers, which is situated in the home country (HC) and is in the process of expanding its operations into a foreign country (FC).

(i) It is easier to justify overheads such as royalties and interest paid by a foreign subsidiary to its affiliates at home, as opposed to their payment by a branch to its head office.

(j) A foreign subsidiary affords much greater flexibility in the manner and timing of its profit repatriation to the home country. Its accumulated profits can be repatriated either as a dividend, or as a capital gain on sale or liquidation of the foreign subsidiary. The dividend or capital gain can be timed so as to be taxed in the home country at the best point in time, for example, when taxes are low or losses are being incurred. The choices are not available to a branch operation. In many countries its profits are automatically taxed at home as they arise. See ¶1-210 for a more detailed discussion on repatriation of profits.

(k) When a taxpayer sells the shares of a foreign subsidiary, the capital gain will usually be exempt from tax abroad. But when the taxpayer sells a foreign branch, the capital gain will usually be taxed abroad. See ¶1-180 and ¶1-190 for a more detailed discussion.

(l) Sometimes taxes arise when a foreign branch is transferred to a foreign subsidiary. Tax or exchange control consents may also be required for the transfer. These problems can be avoided by operating through a foreign subsidiary from the beginning.

(m) In contrast to the situation for branches, a number of countries reduce the tax charge on a subsidiary's profits by allowing dividends to be deducted, or by taxing distributed profits at a lower rate of tax.

(n) In some countries the rate of tax on a subsidiary's profits is lower than that applicable to a branch. Sometimes this disparity is alleviated by a double tax treaty.

A final thought concerns ownership. It will generally be assumed that the foreign operation will be a foreign branch or subsidiary of the home company. But in the case of a closely owned business, it may sometimes be more tax efficient if the foreign branch assets or the foreign subsidiary shares are instead owned by the individual shareholders of the home company.

http://www.pbookshop.com

### ▶ The Green and Sharp scenario

The Enterprise Group has now taken a policy decision to set up a selling operation of its own in FC in order to stimulate its sales there.

The group's product will be shipped to FC and held in its warehouse there. A small local sales force of its own will look for new customers and product lines, drawing the goods from stock held in the warehouse for shipment to local customers.

Financial forecasts prepared indicate that losses will be incurred in the first two years of operation, moving to break even in year three and profit in year four.

Because of its staff and warehouse premises Enterprise Group now has a taxable presence in FC and so will become liable to corporate tax there at the local rate of 40%.

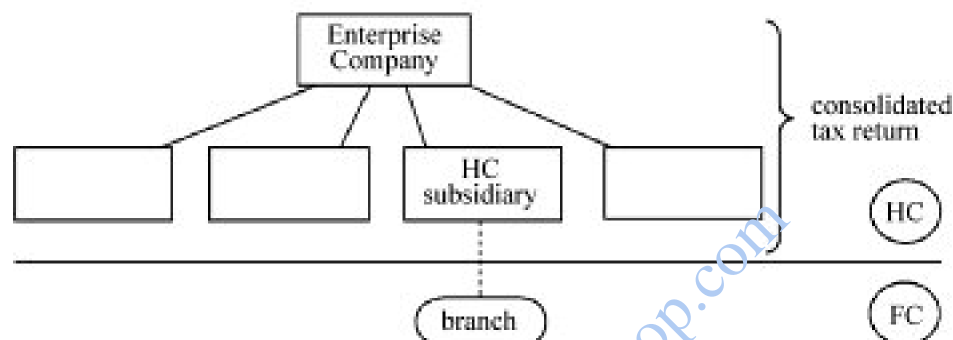
### ▶ The plan

A branch will be set up to commence operations in FC since it is expected that losses will be incurred initially.

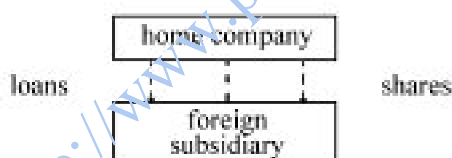
HC's tax legislation permits foreign branch losses to be offset against domestic profits. Additionally it provides for rapid depreciation of the warehouse purchased and provides for additional tax allowances for inflation in the inventory held by FC.

As a result significant foreign tax losses will be available to reduce the 50% corporate tax on HC's domestic profits.

In order to limit its financial exposure, Enterprise Company incorporates an HC subsidiary whose sole activity is the branch business in FC. Since HC allows tax consolidation of profits and losses — see ¶1-090 — the subsidiary's losses can be consolidated against the rest of the group's domestic profits.




## ¶1-040 FINANCING THE FOREIGN BUSINESS — LOAN CAPITAL OR SHARE CAPITAL?




http://www.pbookshop.com

There are basically two choices for investment into a foreign subsidiary — loan capital or share capital.

Interest is payable on loans, achieving a shift of profits homeward from abroad. This may or may not be advantageous depending on the respective tax rates at home and abroad. Dividends are payable on shares. Dividend payments are rarely tax deductible to the foreign subsidiary, but they are usually taxable to the recipient. For this reason they are usually less tax efficient than interest (but there are exceptions to this rule).

There is also the question of how repayment of the respective shares and loans is treated at home on receipt, and abroad on repayment. Normally loan repayment is preferable to share capital repayment because the latter usually attracts a capital gains tax (and sometimes an income tax) liability.

Once again commercial requirements may override tax planning. It may be necessary for the foreign subsidiary to have a significant equity base in order to project confidence and to help raise outside borrowings. If exchange controls exist in the foreign country they may require a certain level of equity in relation to debt borrowed. Very often the foreign country's tax laws will limit the ratio of debt to equity.

Debt/equity restrictions are discussed in greater detail at ¶1-050.

### Some advantages of loan capital

(a) The payment of loan interest is normally tax deductible and so is a tax efficient way to repatriate foreign profits effectively.

(b) When tax rates at home are lower than abroad, the payment of loan interest achieves a shift of profits out of a high tax area into a low tax one.

(c) The foreign subsidiary's after tax profits can be repatriated at no tax cost by repaying the loans it owes to the home company — see ¶1-200. But a check should be made that debt/equity restrictions do not result in loan repayments being classified as dividends — see ¶1-050.

(d) Subject to local exchange control considerations, the currency of the loan can be selected, ie a USA company could lend £ sterling or US$ to its United Kingdom subsidiary — see ¶1-230.

(e) Consequently, currency losses on repayment of loans may be tax deductible (but conversely, currency profits may be taxable).

(f) Often capital or stamp taxes are payable on the issue of share capital, but are not payable on the raising of loan capital.

(g) Loans are more flexible instruments. If necessary, they can be converted to shares. Shares cannot easily be converted to loans.

(h) As additional flexibility, loans may carry a low rate of interest compensated by premium on repayment or a discount on issue.

http://www.pbookshop.com

### Some advantages of share capital

(a) Share capital maximises the foreign subsidiary's retained profits and minimises the home company's income in the absence of a dividend.

(b) When tax rates abroad are lower than at home share capital thus achieves a shift of profits out of a high tax area into a low tax one.

(c) Certain tax incentives at home apply only to share capital, not loan capital, for example, tax deductions for capital invested into developing countries and inflation indexing of capital gains on profitable investments.

(d) Debt/equity restrictions at home and abroad will usually make it advantageous for share capital to be subscribed — see ¶1-050.

(e) Share capital naturally projects a better commercial image, and thus facilitates expansion.

#### ▶ The Green and Sharp scenario

Some three years on, financial projections have been exceeded and Enterprise Group's branch business in FC is now profitable. All tax losses incurred in earlier years have been overtaken by profits.

It is clear that the group is to have a permanent and expanding presence in FC and that incorporation of a local subsidiary — Enterprise (FC) — is a commercial necessity. The branch has now served its tax purpose since it is no longer incurring losses.

At the same time, Jack Green and Bernard Sharp have decided to increase the group's cash investment into FC. The group's bankers are willing to lend the necessary funds.

At home the group has gone from strength to strength and now has surplus cash resources.

HC's tax legislation imposes an accumulated earnings tax on the profits of closely held companies. Unless action is taken the group will be forced to pay dividends to its shareholders, resulting in additional tax liabilities.

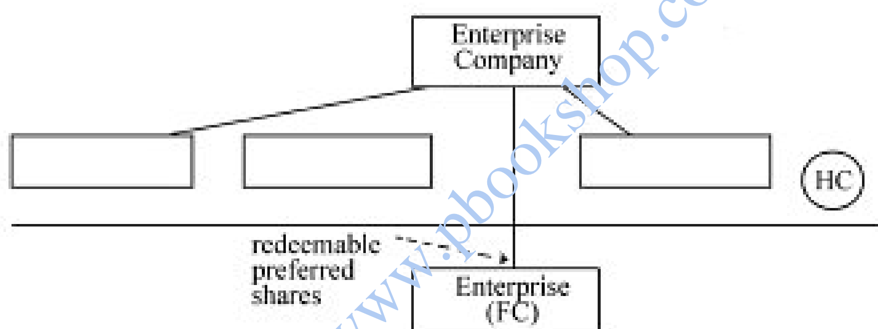
### ▶ The plan

Instead of taking up the bank facilities, Enterprise Company will utilise as much of its surplus cash resources as is prudent to finance the group's additional cash investment into its Enterprise (FC) subsidiary. This will prevent its having to pay dividends and avoid the accumulated earnings tax penalty.

Enterprise Company will invest the cash into Enterprise (FC) by way of share capital.

In this way the effective interest cost of the funds will be borne by the HC group whose tax rate of 50%, plus potential accumulated earnings tax, is higher than FC's 40% — until such time as Enterprise (FC) pays dividends to the HC group.

To facilitate tax free repatriation of Enterprise (FC)'s profits (see ¶1-040) the bulk of the share capital injection could be in the form of redeemable preferred shares payable as par value and thus attracting no tax liability on repayment.




http://www.pbookshop.com

## ¶1-050 DEBT/EQUITY RATIOS — THIN CAPITALISATION

Many foreign countries limit the amount of debt that a subsidiary (particularly one that is foreign owned) may borrow by reference to its equity base. They impose this debt limit through the mechanism of either their tax or exchange control legislation. In some cases company law specifies a minimum share capital or debt/equity ratio.

In some countries the relevant debt borrowings are limited to borrowings from affiliates. Third party debt is ignored. In other countries all borrowings are taken into account, but particularly borrowings guaranteed by the parent company.

As long as the specified debt/equity ratios are maintained, the interest paid on the debt will usually be tax deductible to the subsidiary. Similarly repayment of the debt will constitute a capital repayment.

If the ratio of debt to equity exceeds the specified limits the interest on the excess part of the debt (and in some countries, the USA for example, the entire interest) will not be tax deductible. And in some countries the debt repayment will constitute a dividend.

Generally speaking debt/equity limits are imposed by the foreign, investee country. However, it is sometimes the case that the home investor country imposes debt/equity restrictions on outward investment.

When its debt is high in relation to its equity base, the foreign subsidiary is said to be "thinly capitalised".

Obviously thin capitalisation in excess of the permitted ratios must be avoided. The investing company should therefore obtain professional advice on capitalisation of the foreign subsidiary before implementing its investment.

The following two examples are alternative debt/equity ratios:

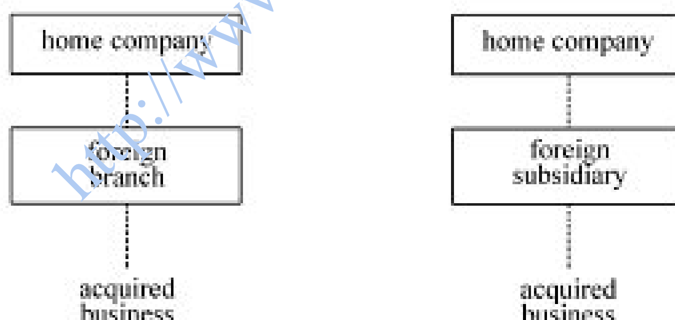
| | A | B |
|---|---|---|
| share capital | 100 | 500,000 |
| borrowings | 1,000,000 | 500,000 |

In example A the foreign subsidiary is clearly thinly capitalised. In example B it is reasonably safe to assume that any required debt/equity ratios have been adhered to.

In some countries it is possible to avoid thin capitalisation problems by means of back to back bank borrowings. Instead of the foreign subsidiary borrowing from affiliated companies, it borrows from a bank, secured by its affiliate's deposit with the same bank outside the foreign subsidiary's country. Alternatively, the foreign subsidiary's bank borrowing is simply guaranteed by its parent country. These manoeuvres are possible in some countries. In others, the parent's guarantee or security will be regarded effectively as a loan to its foreign subsidiary and so part of the debt subject to thin capitalisation restrictions.

http://www.pbookshop.com

## ¶1-060 ACQUIRING A FOREIGN BUSINESS




The following factors should be borne in mind when acquiring an existing foreign business.

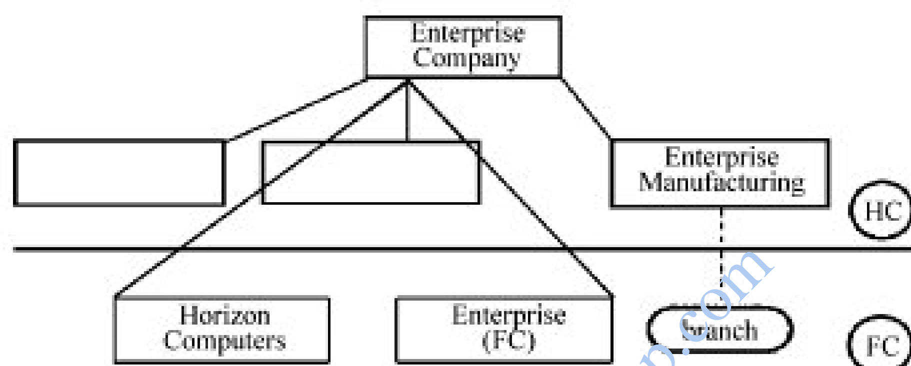
The price paid for the various assets of the business will invariably form the basis of tax deductions for them. For example, if a company purchases inventory it will obtain a tax deduction in the foreign country for the purchase price paid. Where capital assets are purchased, such as buildings or equipment, the price paid will form the basis of the depreciation deductions for tax purposes. This is in direct contrast to the position where shares of a foreign subsidiary are acquired — see ¶1-070.

If the foreign business purchased is to be a branch of the home company, the price paid will also form the basis of tax deductions in the home country (assuming foreign branch operations are taxed at home).

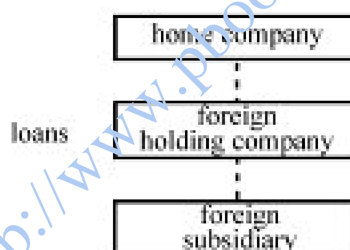
Enterprise Manufacturing (see ¶1-060) sells its manufactured product to Horizon, which sells it to the markets it has already established in FC.

FC's tax legislation restricts the use of accumulated tax losses where there has been a major change in ownership of its shares. However, these restrictions do not apply where the tax loss company continues to sell to the same markets as previously.

Thus Horizon's past tax losses can be offset by the profits it generates under Enterprise Company's ownership. Any element of the share price relating to tax losses will be paid for only as and when the tax loss offsets are agreed by the FC tax authorities.




## ¶1-080 FOREIGN HOLDING COMPANY




http://www.pbookshop.com

If investment is made into a country where groups of companies are recognised as a single entity for tax purposes (see ¶1-090) tax benefits can be gained by forming a foreign holding company which will incorporate or acquire the foreign subsidiary.

The principal benefit occurs where funds are borrowed to finance the foreign subsidiary's acquisition. The holding company can borrow the funds and utilise them to acquire the foreign subsidiary. Then the interest it pays on the borrowing can be offset against the taxable profits of the foreign subsidiary acquired, in a group or consolidated tax return.

Even if funds are not borrowed from third parties for the acquisition, it may be beneficial from a tax point of view for the holding company to borrow them from the home company. This will be advantageous where there are losses at home but profits abroad, or where tax rates at home are lower than abroad. The foreign holding company's payment of interest to the home company achieves a shift in profits to the lower tax area at home.

This emphasises a key choice. It must be decided whether the interest cost is best offset against profits at home or abroad. If an interest deduction is required in the home country, the funds should be borrowed at home and injected as share capital into

the foreign holding company or its subsidiary. If an interest deduction is required in the foreign subsidiary, the foreign holding company or subsidiary should borrow the funds.

In some circumstances it is possible for the interest paid by the foreign holding company to be deductible from the profits of the home company as well as those of the foreign subsidiary. This possibility arises where the foreign holding company is a "dual resident". However, most countries have now legislated to stop this manoeuvre.

It must be remembered that it will probably be necessary to ensure the foreign holding company is not thinly capitalised — see ¶1-050.

One disadvantage of a foreign holding company arises in the following situation. Suppose there is no capital gains tax in the home country when the foreign subsidiary is sold at a profit. This is the case, for example, in South Africa and usually in the Netherlands. On the other hand if a foreign holding company is formed to own the foreign subsidiary, and if it incurs foreign capital gains tax on its ultimate sale of the foreign subsidiary, the taxpayer will have unnecessarily incurred capital gains tax. In that situation a decision may have to be made between the immediate tax benefits of interest deductions, and the ultimate tax benefits of capital gains tax freedom.

A similar situation arises where the rate of capital gains tax in the home country is lower than in the foreign country.

### ▶ The Green and Sharp scenario

http://www.pbookshop.com

Because of further expansion and diversification at home, the group is not presently liable to tax in HC. However, it is now becoming very profitable in FC and paying tax there at the full 40% corporate rate.

A further substantial acquisition of a profitable wholly owned subsidiary, Target Computers, is currently being finalised to complement the manufacturing operations in FC. It is to be financed wholly by borrowings from the group's bankers.

### ▶ The plan

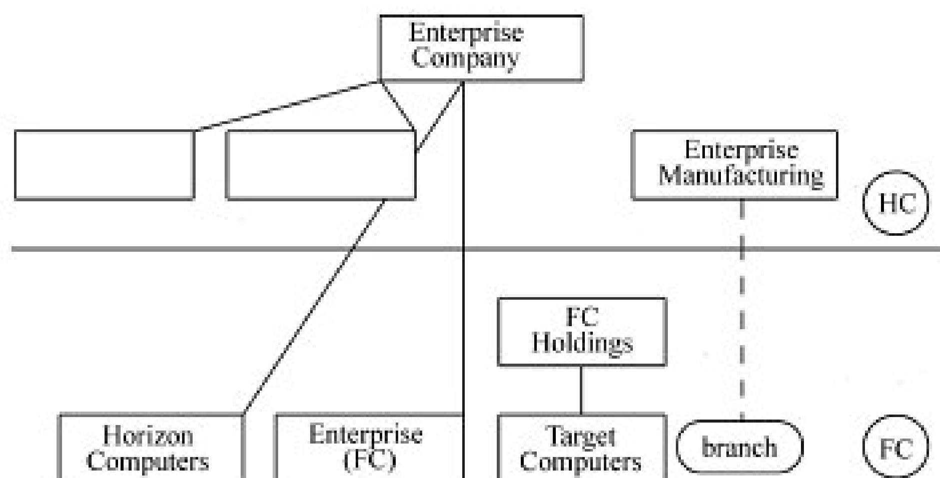
Enterprise Group incorporates in FC a newly owned subsidiary, FC Holdings, with a nominal share capital.

FC Holdings purchases the shares of Target Computers, borrowing funds direct from the group's bankers on the guarantee of the Enterprise Group in HC.

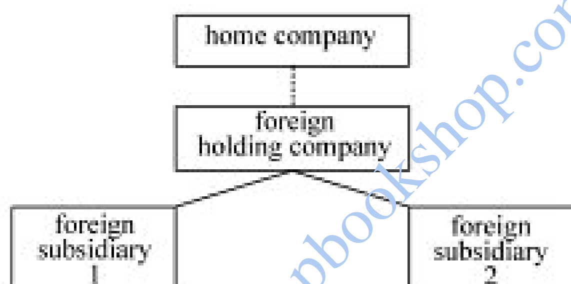
Initially FC Holdings has no dividend income from Target. It therefore incurs annual tax losses arising out of bank interest payments to the bank.

FC's tax legislation permits filing of consolidated tax returns — see ¶1-090. Accordingly the interest paid by FC Holdings can be offset against Target's profits.

Had the HC group borrowed the acquisition funds, the interest then paid would not have attracted immediate tax relief in HC because the group currently pays no tax there.




## ¶1-090 GROUPS OF COMPANIES/CONSOLIDATION




It will often be tax advantageous to form a group of companies in the foreign country in which business is done.

For example, a foreign group consisting of a holding company and its local trading subsidiary will facilitate tax deductibility of acquisition interest costs — see ¶1-080.

Where the taxpayer operates a number of different businesses in a foreign country a group of companies can be advantageous. As long as the foreign tax legislation recognises groups of companies the following will generally be possible.

Most importantly, profits and losses may be offset so that losses of one company can be offset against profits (and usually capital gains) of another in the same group.

Assets may be transferred between group companies free of taxes.

Dividends may be paid between group companies free of taxes.

The minimum degree of share ownership required in order to have a group of companies for tax purposes varies between 50.01% and 90%. Invariably, as illustrated above, the various local subsidiaries must be owned by a foreign holding company.

Sometimes the formation of a foreign group can be disadvantageous. This is particularly the case where there is no capital gains tax in the home country but there is capital gains tax in the foreign country. For example, a foreign group will attract foreign capital gains tax if the foreign holding company sells a subsidiary. Such a tax would have been avoided had the subsidiary been sold direct from the home country — see ¶1-080.

http://www.pbookshop.com

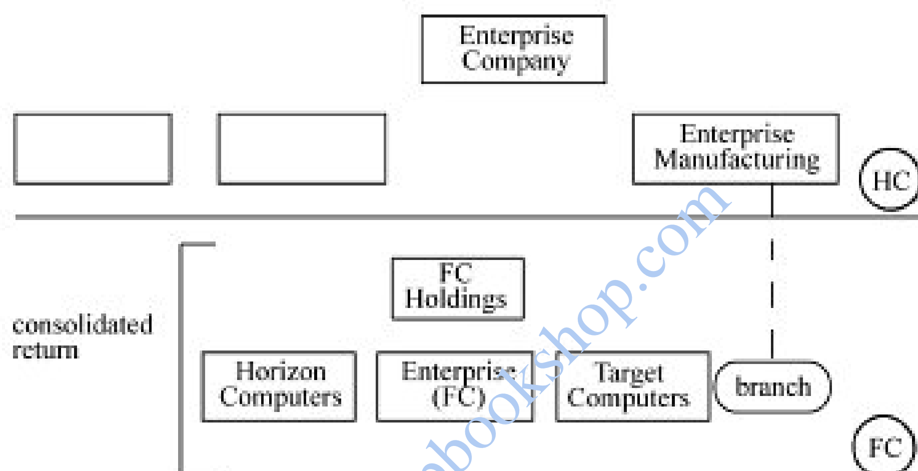
The ability to consolidate the results of a foreign subsidiary may be lost or limited when it joins or leaves a local group. This must be borne in mind when the group acquires or sells a subsidiary.

### ▶ The Green and Sharp scenario

For the reasons discussed above, it is now decided to form a group in FC.

Accordingly, Enterprise Company transfers its shares in Horizon Computers and Enterprise (FC) to FC Holdings.

See ¶1-170 for the tax ramifications of these share transfers.




http://www.pbookshop.com

## ¶1-100 OFFSHORE HOLDING COMPANY

It may be beneficial to incorporate an offshore holding company to own the foreign subsidiary. It might be located in one of a number of territories such as the Netherlands, Switzerland and Luxembourg which grant special tax privileges to holding companies. The offshore holding company may provide some or all of the following benefits.

### Advantages

*Reduced withholding taxes*

Withholding taxes on the foreign subsidiary's dividend payments can be reduced by having the foreign subsidiary owned by a holding company entitled to the benefit of a tax treaty.

### ▶ Example

Dividends paid by a USA subsidiary to its Hong Kong parent suffer a 30% USA withholding tax. If the Hong Kong company formed a Dutch company to own the USA subsidiary, USA withholding tax on payment of dividends to its Dutch parent might be reduced to 5%.

*Deferral of tax on dividends*

Depending on the tax laws of the home country, dividends received from the foreign subsidiary will be fully taxed at home. By interposing an offshore holding company, tax on such dividends can be deferred since they will be received by the offshore holding company rather than the home company. Due to tax privileges for holding

companies the offshore holding company will not be liable to pay tax on the dividend it receives.

*"Mix" of foreign taxes*

If the home country taxes dividends received from foreign subsidiaries, it will normally give foreign tax credits for the taxes paid by the foreign subsidiaries — see ¶1-260. Some countries do not permit foreign tax credits to be utilised on a worldwide basis. This means that excess foreign tax credits on income sourced in one country may not be capable of offset against domestic tax on income from another source. By placing all foreign subsidiaries under one offshore holding company, these foreign tax credits can be "mixed", so that high and low rates of taxes are brought together to provide a higher average rate.

*Deferral of tax on capital gains*

The taxpayer can defer home capital gains tax on selling a foreign subsidiary by having it owned by an offshore holding company. On selling the foreign subsidiary the offshore holding company will pay no capital gains tax.

*Exchange control freedom*

If the home country imposes exchange controls on foreign investments, the formation of an offshore holding company may allow profits to be repatriated from the foreign subsidiary but kept abroad, rather than brought home into the local exchange control system.

http://www.pbookshop.com

**Disadvantages**

These potential benefits may be counteracted by anti-avoidance rules in certain circumstances. The following are examples.

*Anti-treaty shopping*

The country in which the foreign subsidiary is located may have written into its tax treaties certain "anti-treaty shopping" provisions denying the reduced rate of withholding taxes on dividends and other items of income. The United States is currently writing such checks into new and renegotiated tax treaties into which it enters.

*Tax on offshore dividends*

The home country may impose anti-avoidance legislation which will have the effect of making the home country company automatically liable to tax on the dividends received by the offshore holding company. Home countries imposing such a method of taxation on "controlled foreign corporations" include the United States, Canada, Germany, Japan, France, Australia and the United Kingdom; however, see ¶1-130.

*Tax credits*

The home country may give foreign tax credits only in respect of first or second tier foreign subsidiaries. By interposing an extra tier in the form of the offshore holding company, foreign tax credits may thus be lost — ¶1-260.

*Capital gains*

Some countries apply the anti-avoidance rules mentioned at ¶1-100 to tax similarly capital gains realised by the offshore holding company.