CHAPTER 1

Taxation of Income, Wealth and Consumption

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§1.01 TYPES OF TAXES, TAX REVENUE AND TAX LAW

[A] Characteristics and Objectives of Taxes

Taxes are paid by almost everybody. Business executives are confronted with several different types of tax in the context with most, if not all of their business decisions. The profit is subject to income tax. For the employees, labour tax has to be withheld and paid to the authorities. Value added tax is payable on products or services sold. The real estate in the business is subject to property tax. These are just a few examples of taxes within businesses. In this book, we show the basic principles of tax systems relevant to businesses, we discuss common features of tax systems in Europe and selected other countries, and we give insights on how taxes can affect business decisions.

What is a tax? In Germany, for example, section 3 of the German Fiscal Code defines taxes as 'payments of money, other than payments made in consideration for the performance of a particular activity, which are collected by a public body for the purpose of raising revenue and imposed by that body on all persons to whom the characteristics on which the law bases liability for payment apply; the raising of revenue may be a secondary objective.'

The general characteristics of a tax thus are:

- **Compulsion**: A taxpayer cannot choose between paying and not paying a tax. This means that once the taxable event happens, the taxpayer is legally obliged to pay.
- **Revenue collection**: Taxes are levied to raise revenue to finance public expenditure. Thus, a tax can be seen as a transfer of wealth from private taxable persons to public institutions.

- **Absence of consideration**: The taxpayer does not directly receive anything in return. Other compulsory levies such as governmental fees charged for administrative activities or for the use of public services, are paid in consideration for the service recipient. Compulsory contributions to the social security systems are often not seen as a tax since there is an actual or potential service entitlement.

In addition to revenue-raising, taxes can further include **political or economic objectives**. Taxation has in many countries a **redistribution** function: wealth and taxable income is reallocated from the rich to the poor. A progressive income tax rate, for example, has a redistribution effect because higher income is subject to absolutely and relatively higher taxes than lower income.

> The poor taxpayer with an income of EUR 10,000 shall be subject to a 5% income tax, equivalent to EUR 500 tax payment. The rich taxpayer with an income of EUR 100,000 shall be subject to a 50% income tax, equivalent to EUR 50,000. The rich taxpayer pays absolutely and relatively (50% > 5%) higher taxes on his income to the state. The tax revenue can then be redistributed in the form of social transfer payments to the poor.

A wealth tax is also often justified with a desire to redistribute wealth from the rich to the poor. Some countries also allow deducting charity donations from the taxable base, thereby encouraging taxpayers to give for good causes.

> A taxpayer seeks to donate EUR 1,000 to the Catholic Church. He is subject to a 30% income tax.
> Scenario A: The donation is not deductible from the income tax. The taxpayer bears the entire donation.
> Scenario B: The donation is deductible from the income tax. The taxable income of the taxpayer thus is reduced by EUR 1,000. As a consequence the taxpayer pays EUR 300 less tax. Effectively, the taxpayer bears only 70% of the donation (EUR 700). The remaining 30% is borne by the state in the form of lower tax revenue.

There can be a great variety of economic objectives within a taxation system. Some of the most common are to promote business or private investments or to use ecology-friendly technical equipment. Tax incentives frequently take the form of tax-free reserves, accelerated depreciation or reduced tax rates.

Concluding: Taxes are payments regulated by law made to a public body without receiving goods or services in return. One objective of taxes is always raising revenue to finance public expenditures. There can be further objectives with a socio-economic or political background.

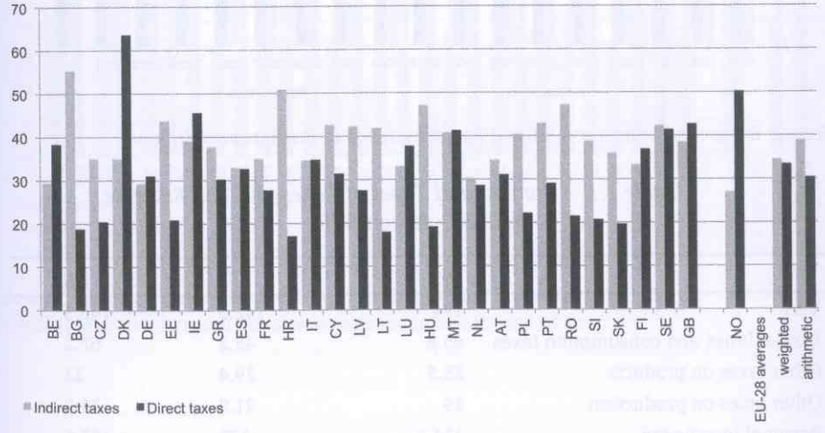
[B] Classification of Taxes

To provide a more fundamental understanding of taxation in an international context, taxes can be classified according to different criteria.

There are four criteria to classify taxes:
- Mode of imposition;
- Economic function;
- Legal criteria;
- Taxable base.

One possible way of differentiating among the different types of taxes is by the **mode of imposition**. This distinguishes between direct taxes which are intended to be borne by the legal or natural person on whom it is levied, and indirect taxes which are intended to be passed on by the payer to a consumer of goods and services. Direct taxes are typically imposed on personal or corporate income, or on capital or wealth, or on occasional benefits such as from a gift or inheritance. As opposed to this, indirect taxes like the value added tax (VAT) (including export levies and certain import tariffs) or the real estate transfer tax are generally levied upon consumption with the effect of making it more expensive.

Figure 1.1: Indirect and Direct Taxes as Percentage of Total Taxation EU-28



Source: European Commission (2014), Taxation trends in the European Union.

Among EU Member States, indirect and direct taxes each account for approximately 30%–40% of the average total taxation amount. In many countries such as France,

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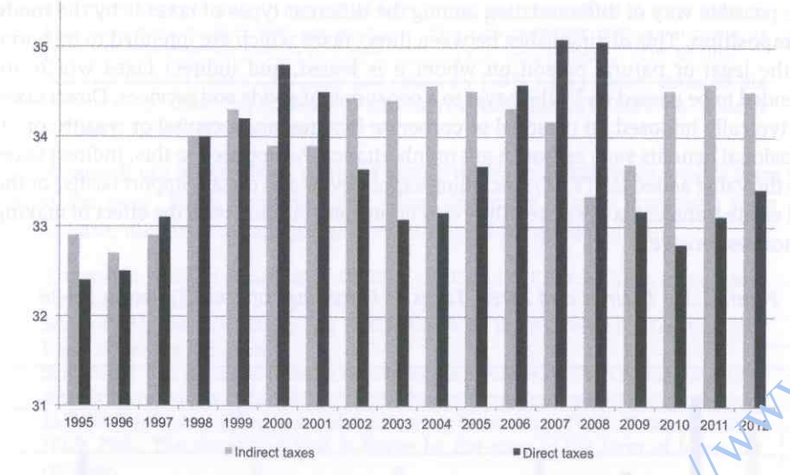
Slovakia, Hungary or Bulgaria, indirect taxes are the major source of tax revenue for the government (see Figure 1.1). This result is in line with the EU average tax revenue which shows a considerable decline of direct taxation since 2010, rising again until 2012, whereas indirect taxable revenue remained quite stable and above direct taxable revenue from 2010 to 2012 (see Figure 1.2). A country comparison between Germany, France and the United Kingdom (see Table 1.1) shows that the personal income tax and the VAT, generate the highest tax revenue in all three countries, and can thus be considered the single most important direct and indirect taxes with regard to revenue collection.

Figure 1.2: Indirect and Direct Taxes as Percentage of Total Taxation EU-28 Average



Source: European Commission (2014), Taxation trends in the European Union.

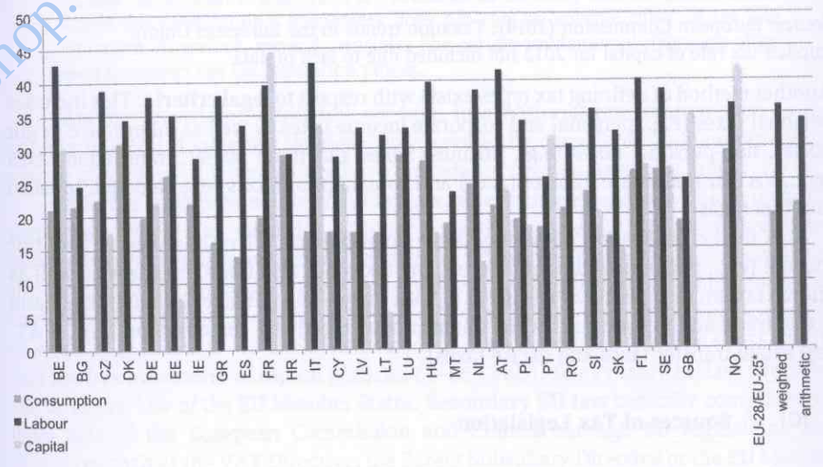
Table 1.1: Number and Types of Taxes and Tax Revenue (2012) – Billion EUR

	DE	*FR*	*GB*
VAT	194	142.5	140.5
Excise duties and consumption taxes	65.8	45.2	67.2
Other taxes on products	25.5	39.4	22
Other taxes on production	19	91.9	33.9
Personal income tax	234.6	172	185.6
Corporate income tax	72.1	46	55.2
Other direct taxes	17	34.9	51.1

Source: European Commission (2014), Taxation trends in the European Union.

Another possibility of classifying taxes is to arrange them according to their **economic function**. Taxes can thus be grouped by consumption, labour or capital. Consumption taxes are VAT and various excise duties such as taxes on alcohol, tobacco or fuel, while taxes on labour are mainly composed of personal income taxes on employment income such as wage withholding taxes and compulsory contributions such as social security contributions. Apart from the regular corporate income tax, taxes on capital include various taxes paid by companies and natural persons in connection with their investment and property owned. These taxes range from taxes on financial and capital transactions, on capital income, taxes on land and buildings, to capital transfer taxes such as inheritance tax. Regarding the EU average, labour taxes seem to be the most important with regard to the amount of the approximate tax base which remains constant over the years at an average ratio of slightly above 35% (see Figure 1.3 and Figure 1.4). Taxes on capital are about 30% of the average tax base while taxes on consumption are 19% of the total average tax base imposed in the EU.

Figure 1.3: Implicit Tax Rates in Percentage of Approximate Tax Base: Consumption, Labour and Capital



Source: European Commission (2014), Taxation trends in the European Union.
Implicit tax rate of capital not always calculated due to lack of data.

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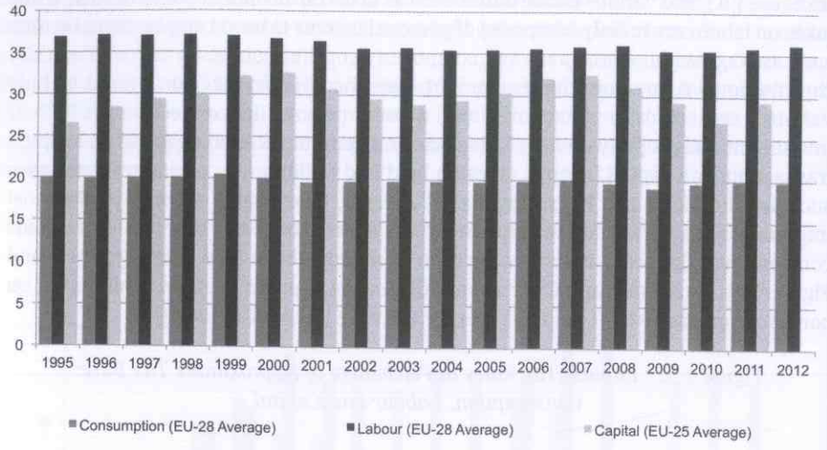
Figure 1.4: Implicit Tax Rates in Percentage: Consumption, Labour and Capital, EU-25/28 Average



Source: European Commission (2014), Taxation trends in the European Union.
Implicit tax rate of capital for 2012 not included due to lack of data.

Another method of defining tax types exists with respect to **legal criteria**. This includes personal taxes (e.g., personal and corporate income taxes as well as inheritance or gift taxes), non-personal taxes (e.g., business taxes and trade taxes), transaction taxes (e.g., VAT or real estate transfer taxes) and consumption taxes (e.g., alcohol, tobacco and fuel taxes).

A final classification possibility is the **taxable base.** . This base can be profit or income (e.g., personal and corporate income taxes but also trade, business as well as church taxes), the transfer of wealth (e.g., inheritance and gift taxes), capital (e.g., land taxes, trade and property taxes) or transaction respectively consumption (e.g., VAT, real estate transfer taxes and excise taxes).

[C] Sources of Tax Legislation

Apart from the classification of taxes, the different sources of tax legislation shall be considered in order to gain a comprehensive overview on the complexity of interrelations in international taxation.

> The **sources of tax legislation** are the supranational sources of bilateral tax treaties and EU law, the domestic constitutional framework and the tax acts themselves. The statute law is supplemented with case law and interpreted by administrative decrees.

One major feature of tax law is the **constitutional framework** of tax legislation in each country. The constitutional law should set clear rules of competency for domestic tax law and should build a framework for the application of formal and material aspects of differing tax legislation. Formal or legal aspects basically consist of the constitutional requirement that no tax can be levied without the statutory authority. This holds true in most countries. Yet, this legal provision does not guarantee justice of taxation. This only occurs if additional fair and justified criteria of distribution exist within the constitutional limits of tax law such as the ability-to-pay principle, progressive tax rules or the refusal of confiscation by taxation. In fact, a tax system which fulfils all formal legal requirements can still be considered unfair, if the ability-to-pay principle is violated or rate progression is arbitrary. However, the specific constitutional modality often differs between countries.

> There are some common law countries in which no constitutional framework for tax law exists. This is, for example, the case in the United Kingdom where there is no written constitution at all. In the United Kingdom, the sovereignty of Parliament is of paramount importance and shall not be limited by any constitutional principles. Yet, supranational law elements like the EU Treaty or the European Convention on Human Rights provide some quasi-constitutional limits to British tax law. In contrast to this, there are countries as Germany and the United States where the constitutional framework does not contain specific rules on tax law limitation. Therefore, general principles like certain fundamental rights are often used to restrict the tax legislation power.

Another overriding effect follows from **international tax treaties** such as the usually bilateral double tax treaties. They have to be considered as a supranational source of tax law which generally have precedence over domestic tax law.

Another supranational source of tax law, at least in the European Union, is the EU legislation which also overrides national tax law. In general, EU law differentiates between primary and secondary EU legislation. **Primary EU law** essentially consists of the fundamental freedoms of the EU Member States determined and implemented in the *Treaty on the Functioning of the European Union* (TFEU) such as the free movement of workers (Articles 45–48 TFEU), the freedom of establishment (Articles 49–55 TFEU) and the free movement of capital (Articles 63–66 TFEU). The Primary EU law overrules the domestic law of the EU Member States. **Secondary EU law** basically comprises the legal acts of the European Commission and Council through EU regulations and directives such as the VAT Directive, the Parent Subsidiary Directive or the EU Mergers Directive (see in detail Part II Chapter 7 §7.06[C]). Secondary EU law is implemented by transposition into the domestic law of EU Member States.

Domestic tax law includes formal and procedural elements such as administrative directives or court decisions as well as components of substance. Some countries set the rules in separate statutes for each tax, supplemented by overriding acts to deal with particular circumstances, such as a tax act for corporate reconstructions or foreign tax aspects, whilst others – such as France and the US – seek to regulate the entire field of taxation within a single code.

Tax jurisprudence (or tax case law) is handed down from courts at all levels and from all streams. This is especially relevant to countries where constitutional law is

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concepts of income taxation exist worldwide whereby the countries using them typically aim for a stronger level of competitiveness and a higher degree of neutrality in finance and investment decisions. Examples of such special concepts are the 'dual income tax' system applied in European Nordic countries, the 'box' system of the Netherlands and the 'notional interest deduction' in Belgium.

FURTHER READING

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CHAPTER 3

Taxation of Business Profits

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§3.01 CONCEPTS OF BUSINESS TAXATION: THE DUAL SYSTEM (PASS-THROUGH TAXATION VERSUS SEPARATE ENTITY APPROACH)

How to tax a business? In the preceding section we have already considered the taxation of businesses of self-employed persons. Depending on the country, the tax system distinguishes between sole proprietorships or sole traders, farmers, and freelancers of all kinds. Those businesses are not organized under any kind of legal form, but are done in the name and at risk of the owner. Further, we have only considered businesses of one single owner. What we did not yet consider was the taxation of businesses in the form of corporations or partnerships or any other organization.

With respect to those different organizational forms we find a great variety of taxation systems both within countries and around the world. All taxation systems have to deal with the question of how to tax the different forms of doing business. The problems here especially relate to:

- Organizational forms.
- Income shifting.
- Investment vs. earned income.
- Business income vs. employment income.
- Civil law.

Countries have to answer several basic questions such as:

- Can a multinational enterprise with shareholders all over the world be taxed in the same way as a small barber's shop with just one owner?

- Should the owner of the small barber's shop be taxed in the same way as an employed barber earning the same amount of income?
- Should businesses be taxed in the same way as investments on the capital market?

We have already learned that the self-employed are taxed in their own right. The business itself is not subject to tax, but the profit is passed-through to the owner where it is taxed according to the owner's personal characteristics (income level, family situation, personal expenses).

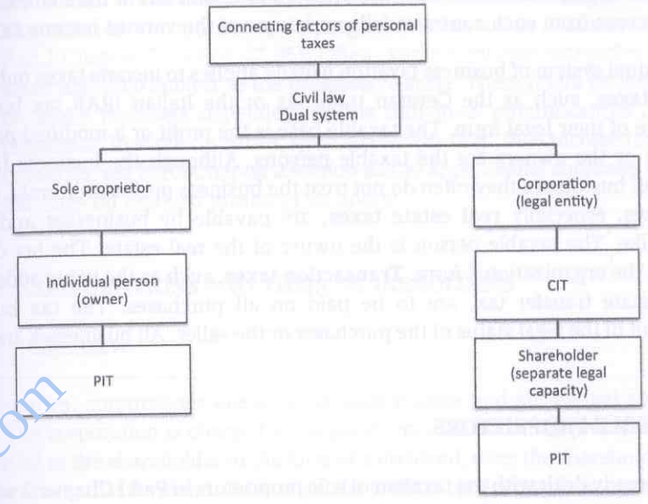
Pass-through taxation means that the income derived in the business is passed through to the owner and taxed by him. There is only one level of tax. This system is also called **transparent taxation**.

This concept cannot be transferred to the shareholder of large listed corporations. It is not practicable to allocate the corporation's profit to all shareholders and to tax it in their hands. It is easier to tax the corporation itself. In addition, one can tax the payments from the corporation to the owner. This is what is done under the separate entity approach.

The **separate entity approach** taxes each entity separately. A business organized under the legal form of a corporation is subject to the corporate income tax. The shareholder of the corporation is only subject to tax on income received. There are two levels of taxation. This system is also called the **corporate principle (deferral principle)**.

Corporations in all countries are subject to a corporate income tax, the corporate principle applies. Sole proprietors are usually taxed under the transparency principle (see Part I Chapter 2 section §2.03[C]). Partnerships are between both concepts as we shall see in Part I Chapter 3 section §3.04. This two-fold approach of taxing businesses is called the **dual system of business taxation**. Figure 3.1 visualizes the dual system.

Figure 3.1: The Dual System in Business Taxation



We shall now compare in an overview the differences of the two concepts:

- **Taxable entity**: Within pass-through taxation the owner is subject to tax on the business profits. Within the separate entity approach the corporation itself is subject to corporate income tax, the shareholder is taxed on the income he or she receives.
- **Qualification of income**: The profit derived by sole proprietorships is business income (or, depending on the kind of activity in some countries as income from farming or from freelancing). Corporations always derive business income. Payments to the individual shareholder qualify as income from any investment (dividends or interest on loans) or employment income (when the shareholder works for the corporation). When the shareholder is a corporation, the income received is business income since the corporate income tax typically only has one income category.
- **Qualification of assets and liabilities**: All assets used in sole proprietorships are business assets. All assets owned by a corporation are business assets, too. An individual shareholder, however, can have assets and liabilities as a shareholder in his private capacity.
- **Date of taxation**: The accrual principle is usually followed by sole proprietorships and corporations. An individual shareholder is taxed when the cash is received (cash method).

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- **Contractual relationships**: A sole proprietor cannot conclude a contract with his sole proprietorship, thus contractual relationships are impossible. However, a corporation can contract with its shareholders. For the shareholder, the income from such contracts falls under one of the various income categories.

The dual system of business taxation usually applies to income taxes only. **Other business taxes**, such as the German trade tax or the Italian IRAP tax businesses irrespective of their legal form. The taxable base is the profit or a modified profit, the businesses or the owners are the taxable persons. Although the business taxes are levied on all businesses they often do not treat the business profits uniformly. Further, capital taxes, especially **real estate taxes**, are payable by businesses and private persons alike. The taxable person is the owner of the real estate. The tax does not depend on the organizational form. **Transaction taxes,** such as the value added tax or the real estate transfer tax, are to be paid on all purchases. The tax burden is independent of the legal status of the purchaser or the seller. All businesses are treated uniformly.

§3.02 SOLE PROPRIETORS

We have already dealt with the taxation of sole proprietors in Part I Chapter 2 where we considered the taxation of business income as one income category of the personal income tax. Here, we only give a brief summary of the main characteristics of the taxation of sole proprietors:

- **Liability to tax**: a sole proprietor has an unlimited liability to personal income tax when he or she is resident or has a habitual place of abode in the country concerned. He or she is then subject to personal income tax on his or her worldwide income. If the residence or habitual place of abode is elsewhere the sole proprietor is liable to personal income tax only on income of domestic source (limited tax liability). This is the case when the business is located in the country but the sole proprietor lives abroad.
- **Type of income**: an individual earns business income from a sole proprietorship (or in some countries, depending on the activity, income from farming or freelancing). For the main characteristics of business income see Part I Chapter 2 section §2.03[C].
- **Determination of income**: (Part I Chapter 2 section §2.03[C]) the business profit is determined by accrual accounting with possible exceptions for small and medium sized enterprises. The tax base does not depend on whether profits are retained or withdrawn.
- **Date of taxation**: the accrual method determines the date of taxation. The personal income tax is an annual tax.
- **Treatment of losses** (see Part I Chapter 2 section §2.05): a loss offset against income from other sources is possible. Excess losses can be deducted from the total income of previous or subsequent years. A minimum tax exists in some countries.

- **Contractual relationships with the business**: are impossible as the business has no separate legal capacity. Thus all profits are business income and all assets used in the business are business assets and all belong to the owner.
- **Tax rates**: Most countries apply progressive tax rates to business income (see Part I Chapter 2 section §2.06). Often, various income categories are aggregated and then subject to the progressive scale. There might be joint taxation of family members depending on the individual circumstances of the sole proprietor. In some countries, special concepts (e.g., dual income tax in Nordic countries, see Part I Chapter 2 section §2.08) apply. Some countries offer lower flat rates on retained profits as an option.

§3.03 CORPORATIONS AND THEIR SHAREHOLDERS

[A] Overview

In all countries, corporations are separate legal entities and are treated so in the tax system: The corporation is charged to corporate income tax on its profits. Only when profit is paid to the shareholder in the form of a dividend, does the shareholder become subject to tax on that dividend. Otherwise, the profit is retained within the corporation; the shareholder receives no income and pays no tax.

> Under the **separate entity approach or corporate principle (deferral principle)** we find two levels of taxation. The profit is first taxed on the level of the **corporation**. Once the profit is distributed, the shareholder becomes taxable on distribution, i.e., on the corporation's profits for the second time. The dividend income is capital income of the individual **shareholder**.

The tax burden of a firm therefore crucially depends on the level under consideration. Does one have to account for the additional tax on the shareholder level or not? We deal with this question in Part I Chapter 3 section .§3.03 [C][4]. How the dividend is taxed on the shareholder level depends on how the corporate principle is implemented within a country:

(a) The dividend can be tax exempt with the justification that the profit has been already taxed on corporate level.
Or (b) The dividend can be taxed fully with the justification that these are two different persons, the corporation and the shareholder.
Or (c) There might be any tax model in between these extreme positions.

The taxation of the dividend further depends on whether the person of the shareholder is a corporation being itself subject to corporate income tax, or an individual subject to personal income tax. When the shareholder is an individual, the

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dividend income is, for him, capital income. However, if the shareholding is held within a business of this individual, the dividend may qualify as business income. Finally, taxation can depend on the participation level. A shareholder owning 100% of a corporation might be subject to different tax rules than one with only a 1% interest. Tax systems usually differentiate between substantial and non-substantial (minor or portfolio) shareholdings.

Further, a corporation and its shareholder can have mutual contractual relationships. These are accepted for tax purposes, too. Examples of contractual relationships are loans, management agreements or leasing contracts. The payments under contractual agreements are deductible by the payer and are taxable income of the recipient.

> A shareholder serves under a management contract. Her salary reduces the taxable income of the corporation and increases her total taxable income.

The taxation of payments received by shareholders again depends on the person of the shareholder. If the shareholder is an individual the payments are categorized by their nature. Income from an employment contract is employment income; income from a loan is interest income. Consequently, different tax rules regarding the tax base and the tax rate might apply.

Contractual agreements between the corporation and the shareholder are accepted in taxation. Payments to individual shareholders are classified by their nature.

Contractual agreements between the corporation and the shareholder imply only one level of tax. Depending on the relevant tax rates, taxpayers may have an incentive to conclude contractual agreements with their corporations rather than waiting for a dividend. In consequence, the authorities will only accept contractual agreements that would have been concluded between two unrelated parties in the same circumstances (arm's length principle, see Part I Chapter 3 section §3.03[E]).

The corporate principle with the taxation on two levels can be disadvantageous for groups of companies. This is often alleviated with privileges for dividends paid to other companies (see Part I Chapter 3 section §3.03[D][2]). Many countries allow group taxation where the corporate principle within the group is substituted by transparent taxation on the parent level (see Part I Chapter 3 section §3.03[F]).

[B] Corporate Level

[1] The Corporate Income Tax: Liability to Tax

What is a corporation? These are typically all private or public companies limited by shares or guarantee, such as the German *Aktiengesellschaft* (AG), the British *Limited Company* (Ltd.), the French *Société Anonyme* (SA) but also special forms like the US *Regulated Investment Company* (RIC) or the European *Societas Europaea* (SE).

As with the liability of individuals to personal income tax, a corporation can be subject to unlimited or limited corporate income tax liability. A corporation is subject to unlimited taxation if it has its legal seat and/or place of management in the respective country. The word 'and/or' is crucial in international tax planning. Most countries apply both conditions, in the sense that a corporation is subject to unlimited corporate income tax liability if either its place of management or its legal seat is in the given country or when both conditions are fulfilled. Few countries base the tax liability on only one of the two conditions.

> Suppose a corporation is established in Ireland under the Irish company law but managed from the United States. A corporation is subject to unlimited corporate income tax in Ireland if it has its (effective) place of management in Ireland. It is subject to unlimited corporate income tax in the United States if it has its legal seat in the United States. Where is this corporation subject to unlimited corporate income tax?

Unlimited tax liability means that the corporation is subject to tax on its worldwide income (**worldwide principle**). Otherwise a corporation is subject to limited corporate income tax on its local income only, i.e., on its income from the source country (**territorial principle**).

> A corporation has its legal seat and place of management in country A where it is subject to tax on its worldwide income. It receives dividends from a subsidiary in country B and rental payments for real estate located in country C. It is subject to limited tax liability on the dividend income in country B, and on the rental income in country C. (How potential double taxation of the income is avoided or mitigated in country A is explained in Part II).

A corporation is **subject to unlimited corporate income tax liability** on its worldwide income where it has its legal seat and/or place of management. A corporation is **subject to limited corporate income tax liability** on its income in a source country where it has no legal seat or place of management in case it derives local income.

[2] Determination of Taxable Income

By contrast to personal income tax, all income of a corporation is deemed to be **business income**. This is in line with company law which treats corporations as trades or businesses. As a consequence, there is no incentive to shift income by source within a corporation.

The **determination of the taxable income** (taxable profit) is usually similar to that of the business income under the personal income tax. Usually the profit is based on the accrual method. The corporate income tax is an **annual tax**.

The **profit** of the corporation in a tax year is taken either from the profit- and loss account or is calculated by taking the difference between the net assets at the end of the

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CHAPTER 6

Value-Added Tax

§6.01 HARMONIZED VAT IN THE EU

The value-added tax (VAT) is the only tax which is harmonized across all twenty-eight Member States of the EU (Article 113 TFEU). In 1977, the European Commission established in the 6th Council Directive 77/338/EEC of 17 May 1977 – the so-called 'Sixth Directive' – a common system of value-added taxes to represent a uniform basis for turnover taxes for all EU Member States. Since then, the basic directive has been frequently amended. In 2006, it was recast into the Council Directive 2006/112/EC of 26 November 2006 – the VAT Directive – which is the currently valid version of the original harmonization directive of 1977. It includes detailed instructions on taxable persons and transactions, the taxable amount and input tax regulations of the common VAT system in the EU. It also sets out those goods that may be taxed at reduced rates and rules on exempt and zero-rated supplies. The rules themselves are, however, not harmonized.

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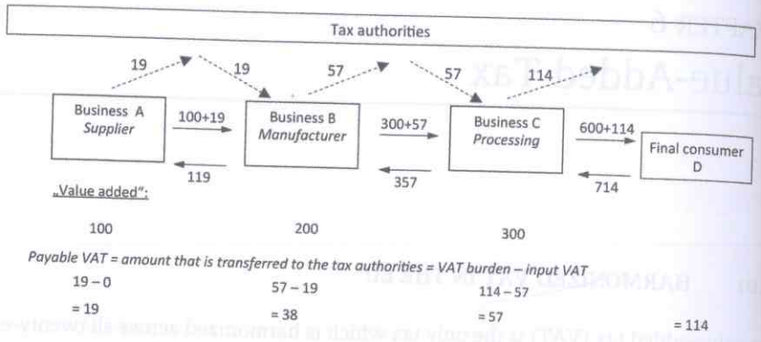
§6.02 THE VAT SYSTEM

Unlike all the other taxes discussed in the foregoing, personal income, corporate income, non-income and inheritance taxes which are linked to the economic success of the taxpayer, VAT is a consumption tax. It is independent of the economic success and status of the taxpayer and taxes the usage of income similar to a transaction tax. However, in contrast to most transaction taxes that burden the given transaction with a single charge, VAT is levied on the supplier but recovered by the business customer. This process is repeated until the supply reaches the final consumer, who has no right of recovery. VAT is therefore a multi-phase, single-burden transaction tax.

The VAT system determines that at every level of the supply chain, from raw material to manufacturing, from manufacturing to processing, and from processing to the final consumer, a common VAT is imposed by the tax authorities. However,

businesses are generally allowed to set off their input VAT against output VAT liability. This results in passing the net VAT payable to the next customer so that the final consumer at the end of the supply chain is the only one who effectively bears the VAT burden. Figure 6.1 clarifies the impact of the input VAT relief system.

Figure 6.1: The Input VAT Relief System



In Figure 6.1, each party involved in the economic process is liable to VAT on its own turnover. However, for businesses, the VAT is only a transitory item. Every business is allowed to reduce its VAT burden which it owes the tax authorities (the VAT effectively collected from other businesses) with the VAT paid to other businesses for the products acquired (inputs). This has the effect that the 'value added' generated in the production chain effectively remains untaxed within business circles.

> Business B in Figure 6.1, for instance, pays 119 for the product to the supplier and 57 as VAT burden to the tax authorities. Yet, it receives 357 for the product sold to the customer and 19 as input tax deduction for the VAT originally paid. That results in a 'value added' of 200 which is not burdened by VAT at the level of the Business B. (The value of 200 would still be subject to personal or corporate income taxation in this case.)

The VAT is not an expense for the business, since the VAT payable to the authorities is immediately refunded by a higher selling price to the customer.

> In fact, the final customer D is the only person in the value added chain who is ultimately burdened by VAT. He pays 114 VAT on the goods for which he cannot claim any input VAT deduction. This system of charging outputs and crediting inputs is designed to avoid cascade effects. If the VAT system did not allow businesses an input VAT deduction, the effective VAT burden would increase at every level of the value added chain (In the example the tax burden would increase to 190 instead of 114).

In a multi-phase business process this would mean a cumulative VAT burden whose exact amount would be impossible to identify. In a cross-border value chain, the determination of domestic and foreign VAT would be distorted by a system which taxes

the value added on a gross basis at every level without allowing an input VAT deduction. If – as is usual – it is intended to relieve exports of domestic taxation, the calculation of the 'drawback' (refund due from the authorities) is necessarily arbitrary as a business cannot know the tax burden inherent in its purchase prices. The VAT system therefore reflects the VAT status as an indirect consumption tax. Although all businesses are subject to VAT, the final consumer is the only person who bears the tax burden. The VAT is thus shifted to the ultimate consumer while the businesses function as 'tax collectors' for the authorities.

§6.03 TAXABLE PERSONS

In general, VAT can only be levied upon the turnover of a business and only a business can claim an input VAT deduction. Directive 2006/112/EC defines a taxable person for VAT tax purposes as any business person who carries on an economic activity within the European Union. The concrete purpose or result of the activity is irrelevant. That person should carry on its business independently on its own behalf. This basically excludes employees from VAT business circles. An economic activity is considered as an exploitation of any tangible or intangible asset for the purpose of earning income. This includes economic activities in manufacturing, the supply of services or in trade. Public bodies, such as state or local authorities are only considered to be taxable persons for VAT purposes insofar as they carry out business activities.

§6.04 TAXABLE TRANSACTIONS

Taxable transactions for VAT purposes include:

- the supply of goods;
- the supply of services;
- the import and export of goods into or out of the EU.

In general, the **supply of goods** is one of the most important taxable transactions in the VAT field. Directive 2006/112/EC defines it as a transfer of the right of the owner to dispose over a tangible asset. It is necessary that the beneficial ownership of the asset is transferred. The mere transfer of legal ownership rights is not enough.

The **supply of services** is defined as any transaction which does not constitute the supply of goods. This basically includes all business activities where consideration is paid for a service other than transfer or disposal of a tangible asset. A supply of services for VAT can also exist in the omission or sufferance of a certain activity or condition. Typical examples are the performance of independent services, letting immovable property, but also intermediary agency or transport services.

In addition, all supplies of business goods or services that are carried out by a business person for private purposes or for the staff are subject to VAT, if the VAT on those goods or services is deductible as input VAT for the business taxpayer. The transfer of business assets for purposes other than those of business, such as private use or free of charge use by the staff, is generally treated as a taxable transaction for

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VAT purposes. The same applies for the supply of services if business assets are used for private purposes or if services are provided to the staff completely free of charge. Exceptions only apply for small gifts to the staff.

The **import of goods** into the EU from a third country is also regarded as a typical taxable transaction. As a consumption tax, the VAT burden should be borne by the final consumer in his country of residence following the destination principle. However, a supplier cannot be assumed to know his customer's reason for making the purchase. Thus each step in the supply chain invoices and accounts for the VAT on its supply (output tax). Imports from third countries into the EU are brought into the chain with a charge to VAT (import VAT) levied by customs at the point of entry. Correspondingly, exports to third countries are exempt from VAT in the EU (zero rated) in order to relieve exports from domestic taxation.

Special rules apply for the **intra-community acquisition of goods**. Now that border and customs controls within the EU have been abolished, the VAT Directive establishes a special system for the cross-border transfer of tangible goods between EU countries. If the transfer is between businesses, the destination principle applies and the VAT basically fulfils its function as consumption tax. The buyer is charged to VAT on the imported goods in his own country (acquisition tax) while the foreign supplier zero-rates the sale. As part of the proof of the business context of the transaction (and in order to benefit from the deduction of input VAT in the destination country), both parties must record their VAT registration numbers which are held available to the respective tax authorities on request.

If the **buyer is a (private) consumer** rather than a business, the origin principle applies. The consumer is charged VAT in the state of supply under the rules of that country. In fact, the origin concept for VAT follows the European idea of a common market without border controls: Exports are taxed as domestic transactions while imports are generally exempt from domestic VAT taxation.

Special rules apply to mail order business and motor vehicles in order to reduce the market distortion from the different rates available to consumers. Mail orders are taxed in the country of destination – the amount is collected by the post office – once the supplier's mail order business has reached a certain level. New motor vehicles are also taxed in the country of the buyer, usually as part of the vehicle registration formalities.

§6.05 PLACE OF TAXABLE TRANSACTIONS

For the consistent allocation of taxing rights, it is necessary to establish the place of the taxable transaction for the supply of services in the EU under a common set of rules. Double taxation and unnecessarily high administration costs can thus be avoided in the case of cross-border transfers. For the **supply of goods**, it can generally be distinguished between a supply without transport and a supply including transport or dispatch:

- For goods which are not transported to the customer including for instance land and buildings but also the picking up of goods by the customer, the place

of taxable transaction is the place where the goods are located when the supply takes place or when the customer achieves the necessary right of disposal.
- If the goods are transported, the place of taxable transaction is determined by the location of the goods when the transport or dispatch begins. Special rules often apply for the supply of goods on board of ships, aircrafts or trains and for the supply of goods through distribution systems such as mail orders (see Part I Chapter 6 section §6.04 above).

There have been various changes to the rules on the place of **supply of services** over the years. The current version is laid down in the 'VAT package' of 12 February 2008:

- In general, if services are supplied by a business to a private person in another Member State, the place of the taxable transaction is deemed to be where the place of business of the supplier (or a fixed establishment from which the service is supplied).
- If services are supplied to another business, the place of the taxable transaction is the location of the recipient of services (following the destination principle).

These two general rules are superseded by a number of special rules. For example, services supplied in connection with immovable property, such as renting or construction work, are deemed to be rendered at the location of property. Services provided by an agent to a private person, are deemed to be rendered where the activities are physically carried out. Intra-community transport services to private persons, such as the transport of goods from one EU state to another, are generally supposed to take place at the place of departure. Transport services that are provided from the EU to a private person located in a third country are deemed to be taxed where the transport takes place. The taxable VAT amount is therefore split over the transport route with each state taxing its own portion. Special rules also exist for a range of miscellaneous services rendered to private persons in third countries. These include private consulting, engineering or legal services, telecommunication services or electronically supplied services. They are deemed to take place in the country of residence of the customer and are therefore invoiced free of VAT by an EU supplier.

The place of the taxable transaction with regard to the **private use** of goods and services or their free of charge supply to the staff, is generally deemed to be the main premises of the business.

§6.06 TAX EXEMPTIONS

Export and intra-community sales of goods are chargeable to VAT at a zero-rate (see Part I Chapter 6 section §6.04). This means that no VAT is charged to the customer whilst the supplier retains the right to a full deduction of the VAT paid on the inputs. Export and intra-community sales of goods are therefore fully relieved of the domestic

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VAT burden. Other sales are exempt from VAT, though this means that the supplier loses the right to deduct the relevant input tax.

One such exemption is that for sales which already have been subject to other transaction taxes, e.g., the transfer of immovable property subject to real estate transfer tax. Its VAT exemption avoids duplicating the burden. Other activities which are generally exempt from VAT due to specific transaction taxes are insurance and reinsurance premiums and turnover from betting and lottery activities. Other activities are generally exempt from VAT for social, cultural or economic reasons including banking, leasing or letting of immovable property, postal services, hospital and medical care, welfare and social security work, education as well as certain other cultural services. In the field of letting housing space and health care, the main reason for the exemption from VAT in national tax regulations is relieve private consumers. Banking transactions are exempt on the theory that one cannot 'add value' to money.

§6.07 TAXABLE AMOUNT

After having reviewed the taxable subject, the place of transaction and possible tax exemptions, the next step is to establish the taxable amount for VAT purposes. If the goods or services are supplied against payment, the taxable amount is everything that constitutes the consideration obtained by the supplier in return for the supply. Normally, VAT is levied on a gross basis including all subsidies directly linked to the price of the supply agreed upon by the supplier and the recipient. According to the VAT Directive, the open market value may also be used for the determination of the agreed price of the parties involved. Input VAT, however, should not be included in the determination of taxable amount. With respect to the import of goods from third countries, the taxable amount is the dutiable value assessed by customs. Establishing the taxable amount can be problematic in respect of private use, or the gratuitous transfer to staff of goods and services. These free-of-charge supplies are chargeable to VAT at cost or at the purchase price of comparable goods. If there is no purchase price, the cost to the business is taken. Free services are valued at the full cost of the provider.

§6.08 TAX RATES

According to the VAT Directive, each EU Member State applies its own standard VAT rate of not less than 15%. In practice, the VAT rates of the EU countries vary from 15% in Cyprus to 27% in Hungary with an overall average standard tax rate of 20.73% (see Table 6.1).

Each Member State may levy one or two reduced VAT rates of at least 5% on a specified range of goods or services. Examples are the supply of food (though not in restaurants), books and newspapers, theatres and concerts, the services of charities and local personal transport services by bus, tram or train. Among the EU Member States, reduced VAT rates vary from 5% on specified goods or services in Cyprus, Hungary, Lithuania, Poland or GB, 13% levied in Finland, Greece or Portugal and to the

18% imposed in Hungary. The average reduced VAT rate in the EU of 9.54% is about half of the average standard VAT rate.

Table 6.1: Overview VAT Rates (2014)

	Reduced Rate	*Standard Rate*
AT	10.0%/12.0%	20.0%
BE	6.0%/12.0%	21.0%
BG	9.0%	20.0%
CY	5.0%/9.0%	19.0%
CZ	15.0%	21.0%
DE	7.0%	19.0%
DK	-	25.0%
EE	9.0%	20.0%
ES	4.0%/10.0%	21.0%
FI	10.0%/14.0%	24.0%
FR	2.1%/5.5%/10.0%	20.0%
GB	5.0%	20.0%
GR	6.5%/13%	23.0%
HR	5.0%/13.0%	25.0%
HU	5.0%/18.0%	27.0%
IE	4.8%/5%/9.0%/13.5%	23.0%
IT	4.0%/10.0%	22.0%
LT	5.0%/9.0%	21.0%
LU	3.0%/6.0%	15.0%
LV	12.0%	21.0%
MT	5.0%/7.0%	18.0%
NL	6.0%	21.0%
PL	5.0%/8.0%	23.0%
PT	6.0%/13.0%	23.0%
RO	5.0%/9.0%	24.0%
SE	6.0%/12.0%	25.0%
SK	10.0%	20.0%
SI	9.5%	22.0%
EU average	*10.04%*	*21.43%*
AU	-	10.0% (goods & service tax)
CH (federal)	2.5%/3.8%	8.0%
JP	-	8.0%
NO	8%/ 15%	25%

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	Reduced Rate	*Standard Rate*
US		sales and use taxes (vary across US states & cities) 0% -7.5% state rate 0%-7.1% local rate

§6.09 CONCLUSION

In contrast to the direct personal and corporate taxation, the indirect **VAT** is the only tax so far to have been **harmonized** within the EU. Worldwide, there is no other similar harmonization system for VAT. The US does not levy a federal VAT at all, although many US states do levy local sales taxes of up to 7.5% of US state turnover. In fact, US state taxes show similarities to the European VAT, although they are far from being harmonized. Switzerland and Norway impose VAT and follow the VAT Directive of the EU even though they are not Member States.

The European VAT system itself is generally based on an **input VAT relief** for businesses and a charge on each output throughout the supply chain. Thus the final consumer effectively bears the VAT tax burden though only once. For the intra-community supply of goods between businesses and the import of goods into the EU, the **destination principle** is basically followed and the VAT can be considered as a consumption tax. Private recipients of goods or services bear the VAT of the country of the supplier (**origin principle**) though there are special rules to overcome the more serious distortions which that implies. The destination principle prevails for the supply of services between businesses while specific rules exist for certain services. Finally, social, cultural and economic goals are also reflected in the VAT system. They are realized with exemptions or reduced rates.

FURTHER READING

European Commission, 28 November 2006, 2006/112/EC, *on the common system of value added tax (The VAT Directive)*.

European Commission, 12 February 2008, 2008/8/EC, amending Directive 2006/112/EC, *as regards the place of supply of services (The VAT Package)*.

PART II International Business Taxation

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CHAPTER 7

Fundamentals of International Taxation

§7.01 LIABILITY TO TAX AND INTERNATIONAL DOUBLE TAXATION

[A] Personal and Corporate Income Tax

The most important personal taxes are the personal income tax, the corporate income tax, the property tax and the inheritance or gift tax. In international business relations, fiscal authorities levy those personal taxes only where there is a concrete link between the taxpayer or the taxable object and the country. This link can either be **personal** or **objective.**

In accordance with the residence principle, a **personal nexus** arises where there are personal relations to the territory of a country. For individual persons this connection is typically based on the residence or the habitual place of abode or domicile in the taxing country. Natural persons with their home in the given state, or who spend most of their time there, are generally taxed as residents of that state. Some countries, such as the United States consider citizenship as sufficient personal nexus regardless of the actual place of abode of the citizen. With respect to corporations, the legal seat or the effective place of management is typically considered as the personal connection to the country of residence. Individuals and corporations regarded as residents for tax purposes generally bear an unlimited tax liability. This means that under the **worldwide principle**, they are subject to tax in the country of residence on all income earned, from domestic and foreign sources. There are also variations on residency. Persons leaving a country are often deemed to maintain residency for a certain number of years in that country in order to avoid tax evasion and to curb the solely fiscally motivated movement of taxpayers between countries (**extended residency**). By contrast, foreign individuals earning a significant portion of their worldwide income in another country may sometimes opt for unlimited tax liability in that country (**optional residency**).

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If a personal nexus of this kind is not given and a person is not subject to unlimited tax liability, he may still bear limited tax liability on income earned within that country as long as an **objective nexus** is given. According to the **source principle**, individuals without a residence or habitual place of abode and non-resident corporations are subject to domestic taxation on their income derived from sources within a country other than the country of residency. Income effectively connected to the territory of this country, e.g., through the place of work or the location of property, is taxed by the domestic tax authorities under domestic tax rules. In accordance with the **territoriality principle**, only income that has its origin or source in the foreign country is considered for limited tax liability. No account is taken of income arising in other countries.

In practice, the co-existence of personal and objective connecting factors more than one country can lead to **double or non-taxation**. The simultaneous realization of objective and personal nexuses in two different countries is, in fact, the main cause of international double taxation. The following examples illustrate possible double taxation situations:

Example (1): **Co-existence of unlimited and limited tax liability**
R, a resident of country A, earns interest from country B. In this case, there is a classical co-existence of unlimited and limited tax liability. R is subject to unlimited tax liability on his worldwide income in his country of residence A, including the foreign interest income earned in B. At the same time, R is subject to limited tax liability in country B on that foreign source income. R is subject to double taxation since he has to pay taxes on the foreign interest income in country A as well as in country B.

Example (2): **Co-existence of limited tax liability**
C, a corporation resident in country X, has a permanent establishment in country Y which receives dividend income from a third country Z. Here, a co-existence of limited tax liability exists. Both states, Y and Z, levy taxes on the dividend income according to the source principle. C faces double taxation on the foreign dividend income (and even triple taxation with regard to its unlimited tax liability in country X).

Example (3): **Co-existence of unlimited tax liability**
B is resident in country X but has his habitual place of abode in country Y. Here, there is dual residence and therefore co-existence of unlimited tax liability. Both countries, X and Y, tax B on his worldwide income according to the residence principle. The same situation occurs if B is a US citizen living in another country. Since the United States applies the residence principle on all citizens independent of their actual place of living or physical presence in the United States, double taxation arises.

So far, the focus has been on **legal double taxation** arising from the taxation of the same tax subject (person), the same tax object (income), the identity of the tax assessment period and similarity of taxes. However, double taxation also arises if the tax subject is not identical, that is, if the same income is earned by two, for tax purposes, different persons. This results in **economic double taxation** which is regularly the case with dividend income received from foreign subsidiaries within a corporate tax system (see Part I Chapter 3 section §3.03[C]). A foreign subsidiary would typically be subject to unlimited tax liability on its total profit in its country of

residence. The shareholder is again subject to unlimited tax liability in its home country on its worldwide income including the received dividend income depending on the income tax system concerned (e.g., shareholder relief or classical taxation). In this case, economic double taxation is not limited to cross-border situations but can also occur in domestic situations, such as when a company distributes a dividend to its shareholder in the same country (see Part I Chapter 3 section §3.03[C]).

[B] Net Wealth Tax

With regard to net wealth taxes generally the same double taxation problem exists as with respect to personal or corporate income taxes. Unlimited and limited liability to tax also co-exists in the field of wealth taxation. This occurs when an individual or a corporation is resident in a country which levies taxes on the worldwide assets of the taxpayer (e.g., France, see Part I Chapter 4). If the taxpayer owns property such as a house or an office building in another country which imposes a net wealth tax on domestic assets (e.g., Luxembourg), he will be subject to unlimited liability to tax in France and to limited liability to tax in Luxembourg. Although the problem of international double taxation exists in theory, in practice, double taxation only occurs between countries which still levy a net wealth tax. The number of countries has decreased over the past few years, so that only a few are now left (see Part I Chapter 4).

[C] Inheritance/Gift Tax

International double taxation also exists in the field of inheritance or gift taxation. Unlimited tax liability is found in the country where the donor or beneficiary is resident. Depending on who is finally considered as being the taxpayer (estate or death duty, see Part I Chapter 5), either the donor or the beneficiary is subject to unlimited taxation on the worldwide inheritance or gift income in their country of residence. A limited tax liability only attaches to domestic assets transferred between donor and beneficiary, neither of whom is resident in the country where the assets are located. Co-existence of unlimited and limited liability to tax and therefore international double taxation also occurs if a donor resident in one country passes property to a beneficiary situated in another. Either the donor or the beneficiary or both would be taxed in the country of residence on the wealth transferred worldwide. One of them – depending on the estate or death duty – generally faces a tax burden from the limited tax liability of the country where the asset, e.g., immovable property such as a business building, is located. Limited tax liability is typically extended in case of a purely fiscally motivated transfer of residence of the donor or the beneficiary. Economic double taxation is also possible if domestic property is transferred from the donor to the beneficiary, and one country involved apply the estate, the other one the death duty (see Part I Chapter 5 section §5.03).

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[D] Local Profit and Non-income Business Taxes

Local profit taxes, such as the German trade tax, the Hungarian business tax or the Italian IRAP (see Part I Chapter 3 section §3.06) have an objective character; the so-called **benefit principle** justifies the levy of these taxes. Subject to tax are businesses with their legal seat (corporation) or permanent establishment (unincorporated business) within the jurisdiction of the country. Since profits from foreign activities would thus be included in the local profit tax base, double taxation arises if the foreign country also taxes those profits. International double taxation is avoided if local profit tax statutes take the domestic character of local profit taxes into account. In practice, profits from foreign direct investments, such as dividends from foreign subsidiaries or profits from foreign permanent establishments are usually excluded from the local profit tax base under local profit tax rules. Therefore, in practice, no serious problems of international double taxation arise in the field of local profit taxation from foreign direct investments. However, exports are influenced by local profit taxes since profits from sales to foreign customers are generally included in the local profit tax base. It is even not always the case that foreign profits taxed abroad are excluded. In Germany, for instance, dividends from (foreign) subsidiaries are included in the local profit tax base if they are paid on a shareholding of less than 15%.

All **local non-income taxes** like real estate, payroll or other special local taxes such as the French CFE, CVAE or the Spanish IAE (see Part I Chapter 4) generally follow the source principle. Thus, simultaneous taxation of real estate, payroll or other non-income activities like the added value is excluded. According to the territoriality principle, the sole taxation right of all these tax objects is clearly at source thus avoiding international double taxation.

[E] Transaction and Consumption Taxes

Taxation of cross-border transactions in the field of **value-added taxation (VAT)** is oriented towards either the destination or the origin principle (see Part I Chapter 6). The VAT depends on the factors in the consumer's place of residence if the importing country has the taxing right, and on those in the supplier's place of residence if the right to tax falls to the exporting country. Therefore, there is no problem of international double taxation if both countries apply the same set of rules. Within the EU, most problems of double VAT are avoided by the EU VAT harmonization.

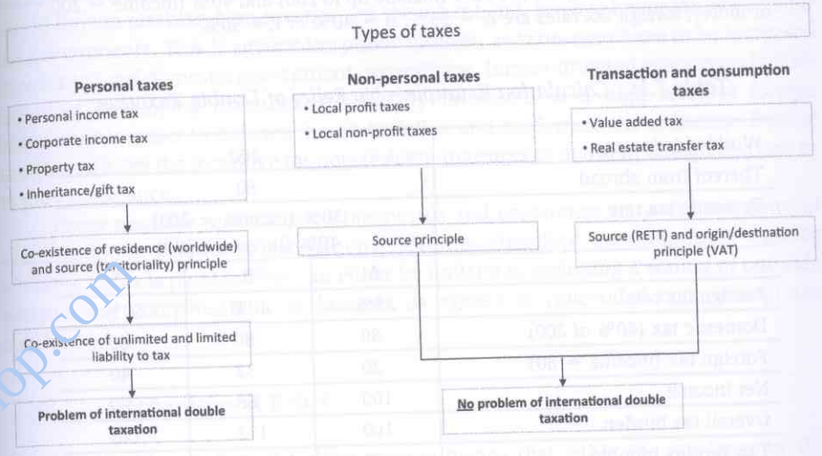
With regard to transaction taxes such as the **real estate transfer tax**, the problem of international double taxation is again non-existent. The sale or transfer of domestic land and buildings follows the territoriality principle and is generally taxed only where the property is situated.

[F] Conclusion

Taxation in both, the country of residence and the country of source, leads to **international double taxation** especially in the fields of personal and corporate

income taxes, property taxes and inheritance or gift taxes (see Figure 7.1). Since both wealth taxes and inheritance or gift taxes are of minor importance in an international setting, the following concentrates on personal and corporate income taxes.

Figure 7.1: Overview – Problem of International Double Taxation



The **simultaneous application** of **unlimited** and **limited liability** to tax often leads to taxation of the same taxable event in two countries at the same time. Double taxation can also arise in case of **co-existence** of **unlimited** or **limited tax liability**. The problem of international double taxation does not generally occur with respect to non-personal taxes such as local profit taxes, non-income taxes and with respect to transaction and consumption taxes. The source principle – respectively the origin or destination principle in the case of VAT – leads to a clear allocation of taxing rights so that double taxation cannot usually arise for these types of taxes.

§7.02 AVOIDANCE OF INTERNATIONAL DOUBLE TAXATION ON INCOME: DIFFERENT APPROACHES AND CONSEQUENCES

[A] Problem of International Double Taxation

The avoidance of international double taxation is in the interest of all parties concerned. This includes businesses and countries. International double taxation leads to

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an additional financial burden and a welfare loss for investors, countries and consumers alike. If a taxpayer carries out cross-border investments he might be taxed twice on his income. Table 7.1 illustrates the problem of international double taxation in this case:

> Resident taxpayer X earns a worldwide income of 200, 80 of which comes from abroad. Domestic tax rates are 30% (income up to 200) and 40% (income = 200 or more), foreign tax rates are A = 25%, B = 40% or C = 50%.

Table 7.1: Calculation Example – No Relief of Double Taxation

Worldwide income	200		
Thereof from abroad	80		
Domestic tax rate	30% (income < 200) 40% (income ≥ 200)		
	A	B	C
Foreign tax rate	25%	40%	50%
Domestic tax (40% of 200)	80	80	80
Foreign tax (income = 80)	20	32	40
Net income	100	88	80
Overall tax burden	100	112	120
Tax surplus (double taxation) = foreign tax	20	32	40

If taxpayer X only earns income in his country of residence and does not invest abroad, he faces a total domestic tax burden of 80. If he now invests in a foreign country, he still has to pay domestic taxes of 80 due to his unlimited liability to tax in his residence country. However, he is additionally subject to foreign taxes on the foreign income of 80. His total tax burden (domestic and foreign tax burden) thus varies from 100 (scenario A) through 112 (scenario B) to 120 (scenario C). X faces double taxation on a cross-border investment. The amount of double taxation is the tax in the source country on the foreign income, i.e., 20 (scenario A), 32 (scenario B) or 40 (scenario C). In each case, X has to bear a higher tax burden from investing in a foreign country.

From a **business-perspective**, net profits are reduced by double taxation. Cross-border activities are discriminated since a rational investor will not invest in other countries if purely domestic activities lead to a lower overall tax burden and thus – under otherwise the same conditions - to a higher net profit. Thus international investment decisions are distorted by international double taxation (and non-taxation). Competition and the free movement of capital and labour across borders are also hindered by double taxation.

From a **country perspective**, the public interest of state economies suffers from the overall efficiency loss caused by double taxation. Export-oriented states including developed countries like Germany and the United States usually like to see their companies and investors perform well in foreign markets in the interests of securing domestic labour markets and of utilizing domestic production capacities. Double taxation, however, disturbs this by distorting the competitiveness of domestic investors in foreign markets. Non-taxation, on the other hand, leads to lower tax revenue for the governments. This is against the public interest, as taxes then have to be increased in order to fund domestic government expenditure. Import-oriented economies including most developing countries are usually interested in a high level of foreign investment in order to balance the trade deficit and modernize the economy. Double taxation reduces the incentive for non-resident investors to invest in foreign markets or to provide finance.

These negative influences on businesses and economies show the necessity of avoiding double taxation in international relations. Therefore, the compulsory waiving of taxing rights is pivotal. This can either be unilateral, including a waiver of one side without any compensation, or bilateral as agreed in (two-sided compulsory) tax treaties.

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[B] Mechanisms of Relief

Avoiding double taxation of foreign income means that either the residence or the source country has to waive its taxing right. According to internationally accepted principles, the country of source is usually the state which retains its taxing right on specifically defined types of income while the country of residence waives its taxing right on income from cross-border investments by granting double taxation relief.

The **exemption method** and the **credit method** are the two basic relief mechanisms from international double taxation. There are other methods, too, such as the **deduction method**, the **lump-sum method** or the **remission mechanism**. All these methods avoid or reduce double taxation where unlimited and limited liability to tax co-exist and they can also be used to relieve simultaneous taxation in the country of residence or in the country of source (see examples in Part II Chapter 7 section §7.01[A]).

[1] Basic Methods

[a] Exemption Method

The two major mechanisms for relief of international double taxation in the residence country are the exemption method and the credit method. The **exemption method** is applied at the **tax base**. Foreign income is explicitly excluded from the worldwide income in the residence country and, consequently, is only taxed in the source country. The residence country basically deducts foreign income from the worldwide tax base leaving only domestic income to be taxed. The exemption method can be applied

including or excluding the effect of progression. If it excludes progression, it does not include the foreign income in the calculation of the progressive tax rate applied to domestic income. If it includes progression, it takes the progression effect into account. The tax rate for worldwide income, which would apply if no exemption existed, is used to calculate the domestic tax burden. However, progression has no effect on proportional (flat) tax rate structures (e.g., for the corporate income tax). For these taxes, the exemption method excluding and including progression leads to the same result. The calculation examples in Table 7.2 and Table 7.3 clarify the difference between the exemption method excluding progression and the exemption method including the progression effect (data from Table 7.1).

Table 7.2: Calculation Example – Exemption Method without Progression

Worldwide income	200		
Thereof from abroad	80		
Domestic tax rate	30% (income < 200) 40% (income ≥ 200)		
	A	B	C
Foreign tax rate	25%	40%	50%
Domestic tax on...			
Domestic income (30% of 120)	36	36	36
Foreign income (income = 80)	0	0	0
= Domestic tax due	36	36	36
+ Foreign tax (income = 80)	20	32	40
= Overall tax burden	56	68	76

X invests in the foreign country while his country of residence applies the exemption method without progression. Abroad, X is subject to the foreign tax of either 20 (scenario A), 32 (scenario B) or 40 (scenario C). At home, foreign income is exempt from domestic taxation. Since no progression effect is taken into account. X pays domestic taxes of 36 leading to an overall tax burden of either 56 (scenario A), 68 (scenario B) or 76 (scenario C).

Table 7.3: Calculation Example – Exemption Method with Progression

Worldwide income	200
Thereof from abroad	80
Domestic tax rate	30% (income < 200) 40% (income ≥ 200)

	A	B	C
Foreign tax rate	25%	40%	50%
Domestic tax on...			
Domestic income (40% of 120)	48	48	48
Foreign income (income = 80)	0	0	0
= Domestic tax due	48	48	48
+ Foreign tax (income = 80)	20	32	40
= Overall tax burden	68	80	88

The country of residence now applies the exemption method including the progression effect. The only aspect that changes in comparison to the exemption method without progression is the domestic tax rate applied to the domestic income. Since progression is now taken into account, the tax rate for the worldwide income (including foreign income) is used to calculate the domestic tax burden (40% instead of 30%). The domestic tax due is 48 (40% of 120) leading to an overall tax burden of 68 (scenario A), 80 (scenario B) or 88 (scenario C).

[b] Tax Credit Method

In contrast to the tax base as starting point for the exemption method, the **tax due on the worldwide income** marks the starting point for the **credit method**. The residence country calculates the domestic tax burden on the worldwide income of the taxpayer including the domestic and the foreign income. The foreign tax paid is then credited against the domestic tax due. The credit method is either **limited or unlimited**. If it is unlimited, the total foreign tax credit can be deducted from the domestic tax burden. If it is limited, the credit is limited to the domestic tax payable on the foreign income in relation to worldwide income.

The limited foreign tax credit thus generally amounts to the lower of the

$$\textit{foreign tax paid} \rightarrow \textit{or} \rightarrow \textit{domestic tax (worldwide income)} * \frac{\textit{foreign income}}{\textit{worldwide income}}$$

Domestic **personal allowances** have to be considered when determining the tax credit. Worldwide income typically amounts to taxable income before deducting personal allowances. The domestic tax calculated from the worldwide income is reduced by personal allowances thus reducing the limited foreign tax credit as well. The higher the domestic personal allowances of the taxpayer the lower is the foreign tax credit. Within the EU, this procedure violates the fundamental freedoms of the Treaty on the Functioning of the EU (TFEU). Therefore, in EU Member States, personal allowances are deducted from worldwide income.

Table 7.4 and Table 7.5 illustrate the difference between the unlimited and limited credit methods.

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CHAPTER 9
Allocation of Profits

Cross-border investments touch at least two jurisdictions: the residence country of the investor and the source country where the investment is carried out. The taxing right of each jurisdiction and the amount of foreign income ranking for relief from double taxation in the residence country, follow from the allocation of income between the two countries. The following deals with allocation of profits from direct business and direct investments via a PE or a subsidiary.

§9.01 ALLOCATION OF INCOME AND COSTS FROM DIRECT BUSINESS ACTIVITIES

The allocation of profits from direct business activities is necessary to determine the income of the investor subject to **limited liability to tax** in the source country. Taxation in the country of residence of the investor (**unlimited liability to tax**) is subject to double tax relief in respect of the foreign income:

For countries applying the **credit method** for the avoidance of double taxation the determination of the foreign source income is decisive for the determination of the available tax credits. In the United States, for example, the foreign tax credit is limited by the US tax liability on the worldwide income multiplied by the fraction of foreign source income over total worldwide income. US tax law has specific provisions defining which item of income qualifies as foreign source income or domestic income. Taxpayers with a higher proportion of foreign source income are entitled to a higher tax credit. Moreover, the foreign source income has to be determined under US tax provisions, which requires maintaining a 'shadow' US tax return for the foreign business activities qualifying as transparent under US tax rules.

If countries apply the **exemption method**, the amount of foreign income reduces the worldwide income and, thus, the tax liability in the residence country.

Income from direct business is allocated according to the origin of activities within the scope of the respective type of income as defined under statutory provisions.

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The **allocation of costs** related to foreign direct business activities follows from the allocation of direct business income. In principle, these costs are allocated to the respective income on the basis of their economic relationship to foreign direct business income (foreign source income). In general it is irrelevant whether costs accrue in the residence or in the source country, the **economic nexus** to the related income earned is sufficient and paramount. A legal nexus is not necessary. Refinancing costs incurred in the residence country of the investor can only be allocated to the income achieved (e.g., to interest income on a loan granted abroad or to foreign dividend received) if the loan was taken up to refinance the respective source of income. Costs connected to tax-exempt income from direct business are not usually tax deductible.

Profit allocations take **all direct and indirect costs** into account. If there is a direct connection between income and costs of direct business activities, the allocation of the net profits is usually unproblematic. **A direct connection** implies that costs and profits are identifiably interrelated by origin and purpose. For this reason, interest costs of a domestic loan raised to generate foreign income, are allocated exclusively to the foreign income. If **costs are only indirectly related** to domestic or foreign income (e.g., general research and development (R&D) costs where licenses are granted to domestic and foreign partners), the allocation is more problematic. In this context, indirect costs distinguish between variable and fixed costs. **Variable or performance-related costs** can usually be allocated to the respective domestic or foreign income in view of the actual connection to the domestic or foreign source on the basis of key variables, such as the sum of wages, the value of assets used or combinations of both. **Fixed or performance-independent costs** arise from the existence of the business itself and not by cross-border activities. For the determination of foreign profits from direct business activities (outbound activity), fixed costs are usually allocated to the domestic business in the residence country. For the determination of income in the source country (inbound activity), fixed costs should be allocated to the foreign business by the non-resident investor.

With outbound investments, **exchange rate fluctuations** can play an important role in the determination of income achieved from direct business activity. Inbound investments, on the other hand, are generally executed in domestic currency, so that foreign exchange rates can be ignored. The following example illustrates the process of the allocation of exchange rate profits and losses.

> German investor X holds a 5% share in a US company from which he is entitled to receive dividends of USD 200,000. The exchange rate is 1 USD/EUR at the moment of the dividend distribution resolution (say in April) and 0.75 USD/EUR when the dividends are paid (say in May).
> In this case, an exchange rate loss of EUR 50,000 occurs for X since the dividend's value in EUR at the moment of payment has fallen by one quarter to EUR 150,000 instead of the EUR 200,000 expected at the moment of the distribution resolution. The question of whether to allocate the exchange rate loss to domestic or foreign income depends on the method of accounting required by the statutory provisions of the residence country. If the German investor must follow the accrual principle (the shares are considered as business assets), profits accrue when the dividend is resolved. Thus, the foreign profit amounts to EUR 200,000 and the exchange rate loss is set against domestic profits. If the cash method is followed (as for privately held shares), income is generally recognized upon payment. Foreign income is thus EUR 150,000. Here, the exchange rate loss is allocated to the foreign income and not deducted from domestic profits.

With regard to the **payment of foreign taxes** similar exchange rate fluctuation effects can occur depending on the moment of income realization at the level of the domestic taxpayer.

§9.02 ALLOCATION OF BUSINESS PROFITS TO PERMANENT ESTABLISHMENTS

[A] Relevance of Profit Allocation

A **permanent establishment (PE)** is a **legally dependent** part of the business. Therefore, from a legal perspective, only one single profit exists for the whole business. This includes the foreign PE income. However, a PE is to a certain degree **economically independent** of other parts of the business. In any case, it is necessary to split the overall profit between the head office and the PE in order to determine the taxing rights on the profits between the resident country (head office) and the source country (PE). In the case of a domestic PE of a foreign head office (inbound case) business profits which can be allocated to the PE are generally subject to **limited taxation** in the hands of the head office. In case of a foreign PE established by a domestic head office (outbound case) the profits of the foreign PE are included in the worldwide income and subject to **unlimited taxation** in the residence country. As with income from direct business activities, the determination of foreign PE income is decisive for the **impact of the double taxation relief method** in the residence country. If the **tax credit method** is applied, the profits of a foreign PE determine the creditable foreign tax, whereas under the exemption method, foreign PE profits are generally deducted from the worldwide income in the residence country.

According to the **OECD MC**, the profit allocation between a PE and its head office should be based on the **direct method** following the principle of **actual economic connection** (Article 7(2) OECD MC) (see Part II Chapter 8 section §8.03[B][1]). In this context, the OECD follows the **functionally separate entity approach** and thus focuses on the **economic independence** of a PE.

Profits attributed to the PE are the profits that the PE would have earned at arm's length, in particular in its dealings with other parts of the enterprise, as if it had been a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions. Hence, for the allocation of profits between the head office and the PE, legal independence of a PE is assumed to a considerable degree. This so-called '**Authorized OECD Approach' (AOA)** is based on two steps. A **functional and factual analysis** identifies the functions performed, assets used, risks assumed and free capital owned by the PE so that the related income and costs can be allocated accordingly. This includes the consideration of the (external and internal) **dealings** between the enterprise and the PE including the transfer and use of assets and the provision of services. In a second step, these dealings have to be priced at arm's length

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using transfer pricing methods applicable to the valuation of transactions between associated enterprises (see Part II Chapter 9 section §9.03[B]).

[B] Allocation of Functions, Risks, Assets and Capital

In recent years, the AOA has been adopted by various countries in their **domestic tax law** (e.g., in Germany). The following, therefore, concentrates on the AOA and briefly comments on national provisions where necessary.

The AOA approach of the OECD demands that the head office and PE act as **separate and independent enterprises** with regard to the treatment of **internal dealings**. However, from a legal perspective, due to the lack of contractual arrangements, it is hard to tell which entity owns the assets, which bears the risk and how the resulting taxable income should be allocated. Therefore, the '**functionally separate entity**' approach is necessary. This approach is based on **four steps**: The allocation of significant people functions, risks, assets and capital to the PE and the other parts of the enterprise.

A first step is to determine '**significant people functions**' performed by the enterprise as a whole. In particular, those people functions have to be identified which are relevant for the acceptance and/or management of risks and for determining the economic ownership of assets required to perform the activities carried out by the PE. Therefore, the functional and factual analysis has to determine which activities and responsibilities are carried out by the personnel of the whole enterprise at the PE, which activities are conducted in the PE on behalf of the enterprise, and which activities are performed by personnel of other parts of the enterprise solely on behalf of the PE. The capacity of the people functions performed in the PE also has to be established in order to distinguish between original PE functions and services conducted by the PE for another part of the enterprise. Apart from significant people functions, the determination of other PE functions is necessary for the identification of all PE profits and losses, thereby taking into account activities related to third parties, to associated enterprises and to other parts of the enterprise.

The second step is to **allocate the risk** between the different parts of the enterprise. Business activities are never completely without risk. In contrast to subsidiaries that assume risk indicators under contractual arrangements, this is not possible for a PE as the whole enterprise bears the risk of the business. According to Article 7(2) OECD MC, the PE should be treated hypothetically as a separate legal entity capable of assuming risks. However, in the absence of contractual arrangements the allocation of risks between head office and PE can only be fact-specific. Following the arm's length principle, the attribution of risk depends on the behaviour of the related parties and on the economic circumstances decisive for business relations between independent parties. Thus, the risk is allocated to the PE based on the '**significant people functions**' determined in the first step. The risk is attributed to those functions performed by the PE personnel at source. The functional analysis might have revealed that the personnel of the PE periodically perform credit reviews of existing customers, assess the creditworthiness of new customers, investigate credit applications, manage

relations with collection agencies and authorize customer credits. These functions of credit management, which are relevant for the generation of PE income and are performed at the location of the PE, can be a basis for assigning the credit risk of the enterprise to the PE. All income, all provisions and also all financial consequences which are related to this credit risk should thus be attributed to the PE.

In a third step, the relevant **assets have to be allocated to the PE** in order to determine related income and losses. Here the concept of **economic ownership** comes into play. Generally it is necessary to distinguish between moveable tangible assets, immovable tangible assets (property) and intangible assets. **Moveable tangible assets** such as machinery, plant and equipment are generally allocated according to their place of use. This can be the place of production or the place of storage of the products. However, the allocation of those assets to the PE does not mean that all related income is attributed to the PE. This again depends on **people functions** which are performed by the significant employees of the PE. If tangible assets, bought by and used in the PE, are allocated to the PE, it does not automatically imply that gains from the sale of these assets are also allocated to and taxed at the level of the PE. This depends on the function that is carried out by the PE in the enterprise. Apart from the recommendation of the place of use as an indicator for the economic ownership, the place of performance of 'significant people functions' is decisive for tangible assets used or produced in different locations within the enterprise.

An exception to the economic ownership approach applies for **immovable tangible assets,** such as land or buildings. These assets usually follow the **situs-of-property principle** and are allocated according to the **place of location** where they lie. Real estate in a third country cannot be attributed to the PE (Article 21(2) OECD MC).

The allocation of **intangible assets** such as goodwill, patents, or brands is usually related to the place of the 'significant people functions'. Of particular importance is the question of who is responsible for taking business decisions and who bears the risk related to the intangible assets. If the intangible assets were developed by the enterprise, decisive features can be the determination of the development process, the examination and evaluation of test results or the formulation of goals. If the intangible assets were purchased, it is decisive which part of the enterprise (head office or PE) took the decision to buy, assessed any supplementary related development requirements and evaluated the business risks of the acquisition.

The fourth step is to **allocate capital** to the different parts of the enterprise. The hypothetical assumption of a separate legal entity requires the **classification of the funds** of the PE into components of **debt and equity**. Since contractual arrangements between head office and PE, legally there can be no separate funding of the PE. Rather the capital belongs to the whole enterprise. On the other hand, allocating equity capital to the PE is necessary in order to estimate its debt and thus its share of **deductible interest expenses**. From the perspective of the head office, an **increasing debt attributed to the PE** generally leads to an increase in its interest cost and thus to a reduction of PE profits in the country of source. At the same time, worldwide income subject to unlimited taxation in the residence country of the head office increases. Deductible interest expenses at PE level also have an influence on the double taxation relief in the residence country. Tax-exempt foreign income decreases (exemption

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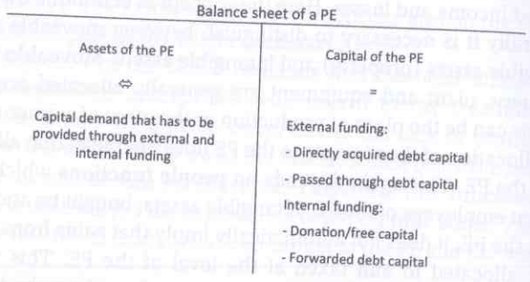
method) or the foreign tax credit is reduced (tax credit method) due to lower foreign PE income. In addition, tax planning issues can arise with regard to the allocation of functions and risks and with regard to the attribution and valuation of PE assets.

Figure 9.1: Allocation of Capital to a PE



The **necessary capital of the PE** is related to its assets allocated under the principle of **economic ownership** (see Figure 9.1). Assets of the PE can thus be funded either by debt or equity whereby one should distinguish between external and internal funding.

In most cases, the allocation of **external funding** is self-evident. It consists of **debt capital** directly acquired by the PE and debt capital acquired by the enterprise for purposes concerning the PE and passed through to the PE. The external debt capital is allocated as a liability to the PE. Interest payable to external capital providers typically reduce the profits of the PE.

The remaining capital need not covered by external sources is met from **internal funding.** This consists of forwarded debt capital and the donation or free capital. **Forwarded debt capital** is defined as the part of debt capital which is acquired by the whole enterprise for the purpose of generally financing the whole enterprise. A proportion can then be deemed as forwarded to the PE. As the deduction of such loans is not prohibited under the OECD, the interest payable by the enterprise can be allocated in proportion to the PE. The forwarded debt capital is calculated by subtracting the pre-determined donation capital from the total amount of internal funds.

The **donation or free capital** of the PE is the proportional equity capital of the whole enterprise which is attributed to the PE. As a component of equity capital, it cannot lead to a deduction for deemed interest. In general, the PE is required to have an arm's length amount of donation or free capital to support the functions undertaken, the risk allocated and the assets of the PE. The donation capital is generally determined in a two-step process. Firstly, the PE risks derived from the functions carried on by the PE are identified, quantified and economically owned assets are evaluated. In a next step, the donation capital is allocated to the PE in accordance with various authorized methods. For example, equity capital can be allocated in accordance with the proportion of the assets and risks attributed to the PE as determined by the functional and factual analysis (**capital allocation method**). Alternatively, the PE is required to have

the same amount of capital as an independent enterprise in the PE state performing the same or similar activities under the same or similar conditions (**thin capitalization approach**). A third way for financial institutions is to allocate the same amount of free capital required as an independent banking institution in the PE state would be required to show under bank regulations (**safe-harbour or 'quasi-thin-capitalization approach'**).

However, these methods have their weaknesses. Variations in market conditions can mean that they do not lead to arm's length results. Use of different methods in the PE country and the residence country of the head office may lead to differences in the allocation of profits, as the amount of donation or free capital affects the amount of interest expenses deductible from the profits of the PE. Article 7(3) of the current OECD MC resolves this problem, as the provision requires an adjustment in the residence country if the attributed PE profits have already been taxed in the source country.

Differences between the financing of a foreign subsidiary and the financing of a foreign PE still exist in practice. Since a PE remains legally a part of the enterprise, it cannot conclude a loan agreement in contrast to a foreign subsidiary. Debt and equity capital can only be allocated to the PE. Consequently, the total debt or equity capital allocated to all PE's can never exceed the total debt or equity capital of the whole enterprise. Interest allocated is not subject to withholding taxes at the level of the interest receiving head office. Therefore, tax planning issues can arise with regard to the allocation of functions and risks and with regard to attribution and valuation of PE assets.

[C] Allocation of Income and Costs

After the allocation of functions, risks, assets and capital between the PE and other parts of the enterprise, the next step under the 'functionally separate entity' approach is to identify **the dealings between the head office and the PE**. In accordance with Article 7(2) of the OECD MC, internal relations between the hypothetically separate legal PE and the head office should be treated similarly to transactions of the enterprise with third parties.

External transactions with third parties occur between at least two legal entities under a contractual arrangement. Income and costs (e.g., for the provision of services or the delivery of goods) are usually accounted for on the accrual principle so that profits are recognized on realization at the level of the enterprise. It is generally assumed that transactions with third parties are priced at external market prices. Dealings between the PE and the head office or between the PE and an external party are real and identifiable events of economic significance equivalent to transactions within a group of separate legal entities. Typical **internal transactions** are financing services and physical transfers of used fixed assets from the head office to the PE as necessary for its tasks. Other internal transactions are current assets and current liabilities assumed in the course of business operations.

The critical factor for the **evaluation of internal dealings** is the lack of contractual arrangements between the PE and the head office. Starting points for the

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evaluation of an internal dealing are the **accounting records** and **internal documentation** of the PE, as well as publicly available external documentation on similar transactions between third parties. The accounting records usually reflect the deemed 'contractual arrangements' between the PE and other parts of the enterprise on which the internal relations are based. From an outbound perspective, the head office is obliged to determine the total profits of the enterprise including the foreign PE under a worldwide set of financial statements according to the statutory provisions of the residence country. Profits of a foreign PE are usually computed from subgroup PE accounts. From the viewpoint of an inbound PE, the foreign head office will also have to determine the PE profits achieved in the source country from separate accounts drawn up according to the local statutory provisions. The recognition of dealings in the accounting records requires that the internal relations between the PE and the other parts of the enterprise are determinable and that they are actually provided by one of the related parties with respect to the arm's length principle. The OECD approach demands that the documented evidence of a dealing has to be based on a **functional and factual analysis** validating the dealing for the purpose of the income and cost allocation between the PE and the other parts of the enterprise.

If a dealing between the PE and another part of the enterprise is identified according to the functional and factual analysis (e.g., an internal service provided to the PE), this dealing must give rise to a **notional arm's length remuneration**, which, in turn, leads to a notional expense from the profits allocated to that PE. By contrast, if there are no identifiable dealings between the PE and the other parts of the enterprise, no costs can be allocated to the PE. However, the AOA has no influence on the law of the PE country and the decision on whether an expense should be considered as deductible for tax purposes, remains a matter for domestic law. In practice, though, deductible notional expenses affect the amount of taxable income in the PE country by reducing the ceiling imposed by the AOA. Typical deductible expenses at the level of the PE following the arm's length principle are arm's length rental payments (for the temporary hire of assets), costs including a mark-up (for the transfer of assets for resale, services or in case of forwarding of internal goods), deductible interest costs and royalty payments under the condition that sufficient free capital is allocated to the PE.

As a second step of the functionally separate entity approach, once the internal dealings between the PE and the enterprise have been identified, they should for treaty purposes be priced at arm's length. In order to do so, it is necessary to compare the dealings between the PE and other parts of the enterprise with transactions between independent enterprises. The arm's length remuneration of dealings should then be determined by applying the transfer pricing methods including traditional transaction methods such as the comparable uncontrolled price, the resale price and the cost plus method or profit based methods such as comparable profits/net margin and the profit split method (see Part II Chapter 9 section §9.03[B]).

[D] Transfer of Assets

If assets are transferred between the PE and other parts of the enterprise, the OECD's 'functionally separate entity' approach demands that the **transferred assets** should be **valued at market prices** according to the **arm's length principle**. In fact, especially for the country where assets were located prior to the transfer, a valuation at tax book values would otherwise result in a non-consideration of business profits irrespective of the double taxation relief method in the residence country. This is shown in the following example.

> The head office of the enterprise transfers shares to a foreign PE at the tax book value of 100; the market price is 120. The PE then sells the shares for 120. Profits are taxed at rates of 30% in both countries.
> In the example, the source country is entitled to tax the business profits earned by the PE (Article 7(1) OECD MC). The taxable profit is 20 resulting in a tax burden of 6 in the source country (30% of 20). The head office is generally subject to unlimited taxation in the residence country under the worldwide income principle. However, if the exemption method is applied, the foreign PE profit of 20 remains untaxed in the residence country. If foreign taxes are credited against domestic taxes, the resident tax due is again zero as the foreign tax of 6 can be completely credited against the domestic tax on the worldwide income of the head office (6). Thus, the residence country of the head office effectively would lose the taxing right on business profits earned through the PE asset if the transfer of assets to the PE took place at tax book value. Therefore, the **transferred assets should be valued at market prices** in order to meet the arm's length principle.

However, the valuation at market prices would result in an immediate taxation of the profits on the date of transfer for every transfer conducted between the legally dependent PE and other parts of the enterprise. In principle, an internal transfer taking place inside one separate legal entity should not be taxed until the profits are realized on sale to independent third parties. This timing conflict can be resolved with the balancing accounting method.

The **balancing accounting method** is a special accounting technique which neutralizes immediate profit recognition by setting up a **balancing item** in the accounts at the date of the asset transfer. In subsequent periods, the deferred item is released back to income in accordance with the realization of profits at the level of the buyer, either over the depreciation period of the asset or in full, if the asset is sold to a third party. The following example illustrates the balancing accounting method by considering the transfer of machines from the domestic head office to a foreign PE.

> A machine is booked as an asset with the tax book value of 100 in the accounts of domestic head office. It will be depreciated straight-line and the remaining useful life is two years. At the time of the transfer to the foreign PE, the market price was 120. At the level of the head office, the transaction profit will be neutralized with a passive balancing item of 20 (deferred income), which will be released back to profit over the next two years. This compensates the higher depreciation rate at PE level.
>
> (1) **Before transfer**, the head office capitalizes the machine at a tax book value of 100. The annual depreciation is 50. Nothing is transferred to the PE. Total annual costs are 50.

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(1)	Head office			PE
	Debit	Machine	Credit	-
		100		
(Tax book value)				
	Debit	Depreciation	Credit	-
		50		

(2) **On the date of transfer**, the machine is transferred to the PE at its market price of 120. The PE capitalizes the machine at the market price 'paid' of 120 and recognizes a liability to the head office in the same amount. The head office recognizes a receivable from the PE of 120. The machine is closed out at the tax book value of 100 so that a profit of 20 accrues at the level of the head office. This profit is immediately neutralized by a deferred income balancing item of 20 which is set off-balance so that it does not appear in the income statement. Thus, the transfer remains tax-free and has no impact on profits although the transferred assets are valued at market prices.

(2)	Head office				PE		
	Debit	Receivable	Credit		Debit	Machine	Credit
		120				120	
	Debit	Machine	Credit		Debit	Liabilities	Credit
		100				100	
	Debit	Deferred Income	Credit				
		20					

(3) **After the transfer**, the asset is depreciated straight-line over two years. The annual depreciation deducted from the PE profits is 60. Following the depreciation of the asset, the deferred profit item at the level of the head office is released in proportion to the depreciation rate (here 50%). Thus, the head office recognizes a profit of 10 (50% of the initial profit of 20) which effectively leads to a deferred taxation of the internal machine transfer depending on the depreciation rate. The total costs again amount to 50 (depreciation costs of 60 minus income of 10) which are similar to the transfer of the asset at the tax book value.

(3)	Head office			PE		
	Debit	Deferred income	Credit	Debit	Machine	Credit
		10	20		120	60
			(Opening balance)	(Opening balance)		
	Debit	Other income	Credit	Debit	Depreciation	Credit
		10			60	

The **balancing accounting method can be applied to all assets transferred** between the different parts of the enterprise irrespective of the direction of transfer (from PE to head office and vice versa), the location of the head office and PE (non-treaty or treaty country), and the method of avoiding double taxation in the residence country of the head office (exemption or tax credit method). In practice, however, most countries do not allow comprehensive use of the balancing accounting method because of their complexity if used on a wide scale. **Current assets** are usually **excluded** on the assumption that third party profit realization is reasonably assured within the short-term period for such highly circulating assets. The direction of transfer is typically limited to transfers from the head office to the PE as being the more usual. The reason is that, in practice, bookkeeping requirements at the level of the PE in case of transfers to the head office or to another PE belonging to the same enterprise can be limited to the head office or can even be non-existent. In addition, the scope of the balancing accounting method is usually limited to transfers within tax treaty countries where the allocation of taxing rights and the use of the double taxation relief method is determined.

Under **EU law**, the freedom of establishment (Articles 49–55 TFEU) demands non-discrimination of EU-wide cross-border transfers against tax-free domestic transfers (see de *Lasteyrie du Saillant*, Part II Chapter 7 section §7.06[D][2]). A tax-free asset transfer at book values between the head office and a PE in the same country does not limit the taxing right of the head office as the profits cannot escape from taxation. Rather, the profits are taxed on realization. Defining the income on a cross-border transfer of assets results in a comparable tax burden. Therefore, the balancing accounting method is consistent with the EU prohibition on immediate taxation of hidden reserves on cross-border asset transfers within the EU.

The **German balancing accounting method** is an example of EU conform taxation of cross-border asset transfers from a German head office to a foreign PE. Germany grants the option of deferring taxation by defining the gain on transfer of fixed assets from Germany to a foreign PE located in an EU Member State. For current assets as well as assets transferred to a PE situated in a third country, the deferral is not available. In these cases, the difference between the market value and the tax book value of the asset is realized and taxed immediately on the transfer. Fixed asset transfers within the EU are recognized at market prices; the taxation of unrealized profits is avoided by a deferred income item following the technique of the balancing accounting method. This deferred income item is released back to income straight-line in the year of the transfer and in the following four years, so that the taxation of the profit is effectively spread over five years. If the asset is withdrawn from the foreign PE, transferred to another non-EU country or sold to a third party, the remaining deferred income item is immediately released to income. The residual profit is taxable at the level of the head office as soon as the asset 'leaves' the privileged sphere of the PE.

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§9.03 SUBSIDIARY

[A] Relevance and Fundamental Approach

In a **multinational corporate group** consisting of a parent company and various affiliated domestic and foreign subsidiaries the attribution of company profits traditionally follows the **direct method**. According to the **separate legal entity approach**, each company, being a separate legally independent body, determines its profits under the statutory provisions of its residence country. In general, there is no application of the indirect method for the attribution of profits. However, the **indirect method** of applying a profit apportionment on a formula exists as a proposal for the EU-wide harmonization of corporate taxation (CCCTB, see Part II Chapter 10).

Under **contractual arrangements** between the members of an affiliated group of companies for services, delivery of goods and products, transfer of assets or intercompany financing, the **transfer prices** can increase or reduce the profits of the group members concerned as long as the contractual relations are accepted by civil law and tax law. It is obvious that transfer prices have an immediate impact on the taxable profits in the given jurisdiction. After all, the affiliated group is a body of **economically related members** with the overall goal of maximizing net group profits including minimizing the tax burden. The group tax position can be optimized by locating services and functions in favourable tax jurisdictions, so that transfer prices can help to shift profits to low-taxed entities (e.g., by extraordinary high transfer prices charged for services provided in high-taxed jurisdictions).

The **arm's length principle** is the internationally accepted standard to prevent arbitrary profit shifting between members of an affiliated group of companies. The arm's length principle requires that the **pricing between related companies has to be comparable to the pricing between unrelated companies conducting similar transactions**. The arm's length price should be the fair market value of a transaction which a prudent and conscientious business manager would charge for a transaction or service provided to an unrelated third party.

The verification of **arm's length prices** can be based on an **external comparison with transfer prices charged by independent parties for similar supplies** or on an **internal comparison with transfer prices charged to outside third parties.** In some cases, the arm's length price can be completely hypothetical such as when the product or service is not available in a similar form on the open market. If the price charged was not at arm's length, the taxable income will be adjusted accordingly, be it under domestic law, be it under the tax treaty (Article 9 OECD MC).

In some countries, **domestic law** treats under or overstatements of income from non-arm's length pricing as hidden profit distributions and hidden capital contributions (see Part II Chapter 9 section §9.03[C]). This can also apply to breaches of limitation to intercompany financing (see Part II Chapter 9 section §9.03[D]). The rules on hidden profit distributions and hidden capital contributions basically apply to the adjustment of inacceptable profit allocations between a controlling entity and its subsidiaries irrespective of the dividend distribution policy. A **hidden profit distribution** of the foreign subsidiary to its shareholder (parent company) occurs, for instance,

where the price for the purchase of assets or services by the foreign subsidiary from the domestic parent is inappropriately high. A **hidden capital contribution** of a parent company to its subsidiaries is the reverse case and occurs, for example, if the price charged for the delivery of assets to the foreign subsidiary is below the market price.

Tax treaties, too, call for the arm's length standard (Article 9 of the OECD MC). Affiliated companies must establish whether 'conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises' (Article 9(1) OECD MC). Article 9(2) of the OECD MC additionally determines the corresponding profit adjustment in the other state based on the arm's length price in case the transfer price has to be modified. This reduces the risk of double taxation from unilateral pricing adjustments which can occur if the market prices are not adjusted correspondingly in the residence and in the source country (However, the treaties do not refer to the concepts of hidden profit distribution or hidden capital contribution). The following example illustrates the risk of double taxation from varying profit adjustments in the two states.

> A machine is carried at the tax book value of 100 in the accounts of the parent company in country A. At the time of the transfer of the machine to the subsidiary in country B, the market price is 120 (transaction 1). Later, the machine is sold to a third party in country B (transaction 2). Under national law, country A follows the arm's length principle, country B does not.
>
> If there is no valid tax treaty between the two countries, country A realizes a taxable profit of 20 on the transfer to the subsidiary as the difference between the tax book value of 100 and the fair market value of 120 (transaction 1). However, country B does not follow the arm's length standard and thus considers the tax book value of 100 to be the purchase price. There is corresponding adjustment to the market price. The subsequent sale to a third party (transaction 2) leads to a profit of 20 being taxable in country B (sales price of 120 less adjusted purchase price of 100). Double taxation occurs for the affiliated company group as the transferred asset has to be taxed twice before leaving the group.
>
> A tax treaty between country A and B solves this problem, in principle, as both countries now follow the arm's length principle. According to Article 9(2) OECD MC, country B correspondingly follows the arm's length principle and recognizes a purchase price of 120. Thus, no profit is realized in country B from the third-party sale (sales price of 120 less purchase price of 120). In this case, the tax treaty avoids double taxation of the transferred asset inside the group. The overall profit is taxed only once – in this case in country A (transaction 1).

As tax treaty provisions only limit, but cannot create, taxing rights of the considered countries, Article 9 of the OECD MC is not a legal basis on its own. In principle, the adjustment of profits is only possible if it falls within the scope of a statutory adjustment provision of domestic law. However, the arm's length standard as determined in the tax treaty typically works as legal framework for the adjustment of transfer prices under domestic law, for example, in Germany in the Foreign Relations Tax Act.

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