INTERNATIONAL TAXATION

This chapter examines the taxation of domestic source income earned by non-residents (inbound investment), the taxation of foreign source income earned by and distributed from resident entities (outbound investment), the role of double taxation agreements and the treatment of related party transactions.

In relation to dividend and interest income generated by inbound investment, most countries apply withholding taxes levied at lower rates where double taxation treaties apply. As a response to concerns about capital mobility and the cost of capital, withholding rates under many treaties have tended to fall still further, including in Australia where it has broadened somewhat its exemption from interest withholding tax recently. In numerous jurisdictions, rules operate to police the boundary line created by the differential tax treatment of debt and equity and have been subject to continual maintenance.

In relation to outbound investment, most Group 1 countries tax residents on worldwide income and allow foreign tax credits. Access to those credits is commonly restricted to a country-by-country basis; most countries allow carry-forward of credits; only some allow carry-back. Complex anti-deferral regimes apply in a smaller number of these countries.

Interaction of entity and personal taxation on foreign source income produces foreign and domestic layers of tax for individual taxpayers. One group of countries, including Australia, does not seek to relieve this double taxation. A second group partially taxes distributions of such income, while a third group ensures such distributions are exempt.

Introduction

Purpose

5.1 A key feature of tax systems concerns the taxation of income which has links to more than one jurisdiction through either the source of the income or the country of residence of the taxpayer. The purpose of this chapter is to examine:

- the taxation of domestic source income earned by non-residents;
- the taxation of foreign source income earned by resident entities, and its distribution to resident and non-resident shareholders (the conduit case);
- anti-deferral regimes relating to foreign source income;
- double taxation agreements; and
- the treatment of related party transactions.

Approach

5.2 The comparison of treatment in different countries is done under the above five headings. On some issues, information is presented for both Group 1 and Group 2 countries but most of the comparison is confined to Group 1.

5.3 The division between the taxation of inbound investment and outbound investment is somewhat artificial and is done mainly for the purpose of presentation. Clearly, the tax system has a primary goal of raising revenue but it must do so in a way which allows for the most economically efficient outcome and which is mindful of the impact of taxation on the cost of capital.

5.4 Most countries tend to adopt a system which is a mixture of source-based and residence-based taxation. In other words, they tend to tax the income of non-residents only when earned in that jurisdiction and the income of residents on a world-wide basis. Inevitably, this results in deviations from what would be regarded as global neutrality, whereby all income was taxed uniformly on a current basis with full credits at the level of the individual for foreign taxes. The taxation treatment in all countries must be seen in this light. It represents a series of tradeoffs between national objectives and global neutrality. Where a particular country arrives at in this tradeoff depends on its perceptions of the relative importance of international capital flows to national economic welfare.

Key comparisons

Taxation of domestic source income of non-residents

5.5 Australia, like all developed countries, both imports and exports substantial amounts of capital. It is, however, a significant net importer, including of know-how, so it is appropriate that the taxation of domestic source income of non-residents be carefully addressed. Inappropriate tax treatment of inbound investment could be expected to have more significant economic implications, simply because of the size of inbound investment.

5.6 Table 5.1 summarises the treatment of income of non-residents in Group 1 countries. It deals with three aspects of the treatment of inbound investment:

- taxation of dividends;
- taxation of interest; and
- limitations on the deductibility of interest by certain non-resident investors.

5.7 Table 5.2 summarises the taxation of dividend income of non-residents in Group 2 countries.

5.8 A brief discussion is also included on the taxation of non-residents without a permanent establishment. While this issue is a contentious one, its complexity prevents a more extensive discussion.

Taxation of dividend income

5.9 Most countries tax dividends paid to non-residents but this may be varied under treaty or by the operation of the imputation system. For example, Australia does not tax dividends paid to non-residents where those dividends are fully franked. The United Kingdom, Ireland and Singapore in particular do not apply withholding tax, while the Netherlands does not tax dividends to European Union residents who qualify as direct investors. Chile taxes dividends at a fairly high rate but its underlying corporate rate is rather low — the aim being to discourage repatriation of dividends and hence retain capital within Chile to promote development.

5.10 It is also common practice to tax portfolio investment more heavily than dividends from direct investment. Germany only taxes portfolio dividends while Sweden and Japan reduce the rate for direct investment.

5.11 New Zealand provides a reduction of company tax for dividends distributed to non-residents. This is done by switching an amount of tax from company tax to withholding tax at the time a dividend is distributed to a non-resident. This enables the dividends to be subject to withholding tax without any increase in the overall taxation of the income from which the dividend has been paid. Non-resident shareholders may be able to obtain a foreign tax credit in the country of residence that might not otherwise have been available, reducing the overall rate of tax on non-residents.

Taxation of interest income

5.12 Most countries tax interest payments to non-residents under their domestic provisions at a withholding tax rate between 10 per cent to 20 per cent. However, this rate is very frequently reduced under treaty and the circumstances would generally be rare where the higher rate applied. The difficulty with high withholding taxes on interest is that a very clear shift in the incidence of the tax tends to occur. The after-tax rate of return on international lending is set by international capital markets. Consequently lenders will not accept the burden of the tax if they are not able to utilise the credit in their home country; a common outcome because of the limitations that countries typically impose on the use of foreign tax credits. Thus, loan agreements often see the interest payable grossed-up to allow for interest withholding tax payable. In these cases, the tax tends to increase the cost of capital to the borrower rather than impose a burden on the lender.

5.13 The Netherlands does not levy tax on interest payments. Australia offers a broad range of exemptions for interest withholding tax but retains a rate of 10 per cent in those cases where an exemption is not available, typically where the loan is not in the form of widely held securities.

5.14 It has now become commonplace for countries to reduce the rate to zero under treaties. The UK-USA treaty in particular has a zero rate as do many of the treaties that the United Kingdom has with European countries.

Table 5.1: Income of non-resident taxpayers — Group 1 countries

Country	Treatment of withholding tax on dividends to non-residents	Treatment of withholding tax on interest to non-residents	Application of thin capitalisation rules
Australia	Withholding tax on unfranked dividends is 30%. This reduces generally to 15% in the case of double tax agreements. Franked dividends attract no withholding tax. Foreign Dividend Accounts allow foreign source dividend income to certain non-residents to pass through an Australian company tax free.	The rate of withholding tax on interest is 10% with a broad range of exemptions.	Limits are placed on the deductibility of interest paid by an Australian enterprise on debts it owes to a non-resident who owns at least 15% interest in the enterprise as well as debts owed to non-resident associates of the foreign controller. The rules also cover situations where the non-resident controller guarantees debt provided by a foreign third party such as a bank.
Canada	The basic rate is 25%, reduced to 15%/10%/5% under treaties (5-10% on US treaty).	The basic rate is 25% but is lower under tax treaties. Interest on government debt and arm's length debt with a maturity greater than five years is exempt.	Canadian rules disallow interest expense where debt owing to related non-residents exceeds three times the corporation's equity at any point during the year.
Chile	Dividends are essentially taxed at 35% less a credit for the 15% First Category Tax (FCT). The dividend is grossed-up for this 15%. If recipient is a resident of a non-treaty country, surplus foreign tax credits at company level (i.e. those in excess of limitation of 15% FCT) are lost. But if the person is a resident of a treaty country, surplus foreign tax credits unused at the company level can be used to offset tax on distribution (for residents and non-residents), provided that the total foreign tax credits claimed do not exceed 30%. Currently, Double Tax Agreement only with Argentina, although treaties with Canada and Mexico are before the Congress for ratification.	Interest is taxed at 35% unless being paid to registered foreign financial institutions and foreign banks, foreign suppliers, and foreign holders of bonds in foreign currencies authorised by the Central Bank, where the rate is 4%.	No new loans will be authorised if the debt/equity ratio of 50/50 is breached in DL 600 investments. Investments made through Chapter XIV of the Central Bank Rules are not subject to thin capitalisation rules.
France	Companies resident in treaty countries with interests of 10% or more in the French company making the distribution can generally obtain a refund of the equalisation ('top up') tax (less a 5% withholding tax on the gross dividend including the equalisation tax). See Table 3.4. Other shareholders are entitled to a refund of any 'avoir fiscal' (imputation) credits attached (such credits would arise typically in respect of income taxed in France), less a withholding tax on the gross dividend at the applicable withholding tax rates. These rates are 25%, reduced to 15%/10%/5% under treaties, with the withholding tax applied to dividends grossed-up by 'avoir fiscal' credits attached. Dividends payable to qualifying EU residents are tax free, provided certain conditions are met.	The base tax rate on interest paid to non-residents is 15%. This rate may be higher or lower depending on the particular type of interest involved. Interest payments which are exempt include those on loans contracted abroad, some state bonds, corporate bonds and negotiable debt instruments.	There is a limitation of the deductibility of interest paid to direct shareholders. There is no limitation for indirect shareholders.

Table 5.1: Income of non-resident taxpayers — Group 1 countries

Country	Treatment of withholding tax on dividends to non-residents	Treatment of withholding tax on interest to non-residents	Application of thin capitalisation rules
Germany	Dividends from direct investments are subject to 25% withholding tax. Portfolio dividends are subject to withholding tax at the rate of 15%. This rate reduces to between 5% and 15% under treaties. Dividends paid to qualifying EU residents are tax free.	The basic rate is 30% but may be lower under treaties.	Thin capitalisation rules apply where the debt-equity ratio exceeds certain limits depending on a variable or a fixed interest rate. Where interest paid to a related party (and non-related party under certain conditions) is deemed to be excessive, the interest is treated as a hidden profit distribution. Thus, the excess amount is not deductible for German corporate income tax purposes and is subject to withholding tax.
Ireland	Withholding tax is not collected on dividend payments to non-residents.	The basic rate is 24%, however usually no tax applies if a double tax treaty is in place.	Related party interest may be treated as a dividend. Overridden by Irish Financial Services Company provisions and by all but six treaties. Australian treaty is one of the six.
Japan	The basic rate is 20% but may be changed by tax treaty. Reduced rate generally 15% portfolio and 10% direct investment (usually more than 25% shareholding).	The basic rate is 15% but may be changed by tax treaty.	Japan's thin capitalisation rules only apply to related party debt. The interest is partly excluded from the corporation's deductible expenses when the amount borrowed is three times the amount of capital from lending shareholders.
Netherlands	Dividend payments to non-residents are taxed at 25%, exempted or reduced to 15%/5% under treaties. Dividends payable to qualifying EU residents are tax free.	Withholding tax is not collected on interest payments to non-residents.	Certain intra-group debts may be re-classed as equity.
New Zealand	15% for treaty countries, 30% for non-treaty countries to the extent not fully franked. The foreign investor tax credit regime effectively reduces company tax by an amount equal to the dividend non-resident withholding tax (NRWT) paid by the New Zealand company to the extent that the dividends paid to the non-resident are fully franked and the company has paid a supplementary dividend to the non-resident equal to the amount of the NRWT.	15% tax is applicable subject to treaty conditions. Interest payable to arm's length lenders eligible for approved issuer levy, under which interest is exempt from withholding tax but subject to 2% stamp duty.	Interest deductions are limited where the New Zealand's group debt/equity ratio is greater than 75% for the particular entity and greater than 110% for the entire group. This applies to all debt, not just related party debt.
Singapore	No withholding tax on dividends.	Interest payments to non-residents are taxed at 15% and may be reduced by treaty.	No thin capitalisation rules apply.
Sweden	15% on portfolio interests and 5% on direct investment (usually more than 10%).	No interest withholding tax is applied.	No thin capitalisation rules apply.

Table 5.1: Income of non-resident taxpayers — Group 1 countries

Country	Treatment of withholding tax on dividends to non-residents	Treatment of withholding tax on interest to non-residents	Application of thin capitalisation rules
Taiwan	Individual investors are charged 35%, corporates 25%. These may be reduced to 20% if the investments are approved under the Statute for Investment by Foreign Nationals. There is a 10% surtax on undistributed profits, creditable against the withholding tax.	Interest payments to non-residents are taxed at 20%.	No thin capitalisation rules apply.
United Kingdom	Withholding tax is not collected on dividend payments to non-residents. ACT system applies and some treaties allow for at least partial extension of the dividend credit to non-residents.	The withholding tax rate on interest payments to non-residents is 20% for non-treaty countries. The rate is 0% under most treaties, including with the US and most European countries.	Where interest paid to a related party is deemed to be excessive, the interest is reclassified as a distribution. The acceptable debt/equity ratios vary from industry to industry under application of an arm's length principle.
United States	The 30% rate may be reduced or eliminated by tax treaties.	The 30% rate may be reduced or eliminated by tax treaties.	US 'earnings stripping' rules exist to accomplish similar objectives. These rules apply only to corporations with a debt to equity ratio exceeding 1.5 to 1. Interest allocation rules exist for determining foreign tax credit allowances but not deductibility of interest for tax purposes.

Table 5.2: Income of non-resident taxpayers — Group 2 countries (dividends only)

Country	Treatment of withholding tax on dividends to non-residents
Argentina	Currently no withholding tax on dividends.
Belgium	Withholding tax at 25%, reduced to 15% for dividends from certain shares or under treaties. Payments to parent company in another EU country are tax-exempt if minimum 25% shareholding in distributor continuously for a year (EU Parent/ Subsidiary relief).
Brazil	No withholding tax on dividends.
China	Withholding tax at 20%, reduced to 10% in designated areas or under treaties. Tax-exempt for distribution from foreign investment enterprises.
Croatia	No withholding tax on dividends.
Denmark	Withholding tax at 25%, reduced to 15% under certain treaties. EU Parent/ Subsidiary relief applies.
Finland	Withholding tax at 28%, reduced to 15% or 10% under treaties. EU Parent/ Subsidiary relief applies.
Israel	Withholding tax at 25% (or 15% if paid by Approved Enterprise), reduced or exempted under treaties.
Italy	Withholding tax at 27%, reduced to 10% or 15% under treaties. 12% refund (for 27% tax paid) available under certain conditions.
Malaysia	No withholding tax on dividends.
Mexico	No withholding tax on dividends.
Norway	Withholding tax at 25%, reduced to 15% under certain treaties.
South Korea	Withholding tax at 27.5%, reduced to 10% or 15% under treaties. Imputation credit allowed under certain treaties.

Thin capitalisation and limitations on interest deductibility

5.15 The application of thin capitalisation rules is not universal, with four of the surveyed countries not applying such rules (Taiwan, Singapore, Sweden and Ireland). Most jurisdictions' thin capitalisation rules apply just to debt issued by parties related to the company's shareholders. However, two countries — the United States and New Zealand — take account of all debt issued by non-resident lenders, whether or not the lender is associated with the company's shareholders. In fact, the United States does not have thin capitalisation rules similar to other jurisdictions, but achieves similar results through its earnings stripping rules. These rules are rigidly enforced and are regarded as very effective in dealing with high levels of gearing.

5.16 Interest expense deductions are generally disallowed under thin capitalisation rules when the debt-equity ratio of a corporate group exceeds specified limits. The most stringent rule is applied in Chile where no new loans will be authorised if the debt/equity ratio of 50/50 is breached. In some countries, the thin capitalisation rules allow for reclassification of debt in cases where the debt is deemed to be excessive. For example, in the Netherlands, certain intra-group debts may be re-classed as equity, while in the United Kingdom interest on such debt may be reclassified as a distribution.

Non-residents without a permanent establishment

5.17 The taxation of income of non-residents without a permanent establishment tends to be a very vexed and complex issue. If a taxpayer can establish that the activity is in the nature of business activity but that there is not a permanent establishment in Australia, then it may be the case that Australian tax cannot apply. This will depend on whether there is a treaty in force and whether the treaty has a favourable definition of a permanent establishment. This has recently been the subject of considerable debate in Australia and the outcome depends on a range of complex issues.

5.18 Similar considerations apply in most other countries. The issue hinges on the definition of a 'permanent establishment' in each treaty and hence the treatment is unlikely to be uniform even within the one country.

Taxation of foreign source income

5.19 This part of the analysis deals with the treatment of foreign source income earned by resident entities (including the operation of the foreign tax credit system) and its distribution to resident shareholders. It also deals with so-called 'conduit' cases where foreign source dividends received by a domestic company are then paid to non-residents.

5.20 Table 5.3 shows in broad terms how the foreign income of residents is dealt with in Group 1 countries.

Table 5.3: Summary of tax treatment of foreign source income

Country	Description of tax treatment
Australia	Residents are taxed on worldwide income, unless a specific exemption applies. A direct credit is allowed for foreign tax paid on foreign income, up to the amount of Australian tax payable. Different classes of foreign income are quarantined. Tax credit is also available for taxes paid on foreign dividends. Income earned in a wide range of countries is exempt including when received as a dividend. In these cases the foreign tax credit system is not applied.
Canada	All income and capital gains earned by a Canadian resident must be included in its Canadian tax return. A foreign tax credit or deduction is allowed on its Canadian tax liability for foreign taxes already paid.
Chile	Chilean residents are taxed on their worldwide income. There is a foreign tax credit that can be used for taxes paid abroad.
France	Only profits from operations in France are subject to French income tax. Income resulting from business carried on abroad is exempt. Dividends are taxable with a credit provided by treaty.
Germany	A resident taxpayer is subject to taxation on its worldwide income. Foreign tax credits are generally allowed for foreign tax paid.
Ireland	Resident companies are subject to tax on worldwide profits. Credits are available under tax treaties, or where the resident company receives dividends from a non-treaty based company in which it has a 25% holding. The credit is for withholding taxes and underlying taxes.
Japan	A domestic corporation is subject to income tax on its worldwide income. Foreign tax paid on foreign source income may be credited against tax on ordinary income.
Netherlands	The taxable base is worldwide income less allowable deductions. Based on bilateral tax treaties or Unilateral Decree, relief is granted for foreign source income. The relief granted per country is generally a reduction of the tax amount by a percentage equal to the percentage of foreign source income to worldwide income. Excess credits can be taken into account in subsequent years.
New Zealand	Residents are taxed on their worldwide income on a current basis, even where the income is earned via a controlled foreign entity. Dividends are then exempt when paid out of previously attributed income.
Singapore	Foreign source income is only taxable in Singapore upon remittance. Tax credits may be claimable against Singapore tax payable under tax treaty relief or unilateral tax credit relief for certain income (e.g. dividends) under domestic tax laws. Credits claimable are limited to the lower of Singapore tax payable on the income or foreign taxes suffered. Excess credits are disregarded.
Sweden	Resident companies and individuals are taxed on their worldwide income.
Taiwan	Resident enterprises are taxed on their worldwide income. If foreign tax has been paid on foreign income, a credit may be allowed for the payment, up to the amount of Taiwanese tax payable on the income.
United Kingdom	Foreign source income is fully taxable for residents, with tax credits given for foreign taxes paid on foreign income. Each income source is calculated independently. The credit allowed is limited to the UK tax on the foreign income. If a credit is not claimed, the taxpayer may claim a tax deduction for the amount of foreign tax paid.
United States	US entities are subject to tax on worldwide income. A foreign tax credit is allowed to mitigate double taxation on foreign source income. Quarantining and limitation on credits are widespread and complex.

5.21 Most Group 1 countries tax residents on their worldwide income under the operation of a foreign tax credit system. Singapore is essentially a territorial system as the income is not taxed until remitted to Singapore. This applies even when the income is earned directly rather than through a foreign entity. France taxes only domestic income so that all foreign source income (other than dividends from foreign entities) are exempt. The Netherlands operates a system which relieves foreign income from tax in a way which depends on the ratio of foreign source income to worldwide income. This can lead to substantial relief from tax on foreign income.

Operation of foreign tax credit system

5.22 Foreign tax credit systems operate differently at the level of the individual compared with at the level of a separate entity. Thus, 'parent' companies typically receive credits for underlying tax paid by a foreign entity but individuals only receive credit for direct taxes paid, typically withholding tax on the dividend. The description provided here is of the treatment at the level of the entity but a later section deals with the interaction between the treatment of individuals and entities.

5.23 Table 5.4 provides a summary of the foreign tax credit systems in operation in the Group 1 countries. Most countries limit foreign tax credit systems to the lesser of the amount of foreign tax paid and the domestic tax that would have been paid. Some countries also allow exemption in certain circumstances (Australia and Germany) or effectively achieve the same outcome through the method of calculating the credit (the Netherlands).

5.24 Most countries vary their position under treaty but the variations are not generally dramatic so far as the provision of foreign tax credits is concerned. France is one exception as it does not generally provide credits where there is no treaty.

5.25 Most countries allow carry-forward of tax credits and some allow carry-back. However, this is not universal. In particular, Singapore does not allow the carry-forward of credits. It does have one other interesting feature in that dividends that have been subject to the foreign tax credit system can be credited to an account and are then exempt when distributed to shareholders. Thus, the Singapore system ensures that only a single layer of worldwide tax applies to income, at a rate not lower than the Singapore company tax rate.

5.26 It is common to limit access to foreign tax credit systems on a country-by-country basis or in some other way which limits the ability to mix heavily-taxed and lightly-taxed income. For example, this is the case in the United States, United Kingdom, Sweden, Ireland and Canada. In practice, taxpayers can frequently get around such limitations by mixing income from different countries in a special purpose company set up in a suitable jurisdiction. Thus, the quarantining is often more of an issue about the cost of compliance rather than about an inability to utilise maximum credits.

5.27 There are different views about the appropriate treatment of different sources of income. Some argue that mixing of income should be allowed as on average the income will have paid foreign tax equal to the domestic tax level. Others argue that this type of mixing provides an incentive to earn income in low tax jurisdictions and will bias investment results in this way. Clearly this represents an area where it is necessary to define the appropriate broad policy framework before settling on the detailed approach.

5.28 In countries which do not allow a carry-forward of credits, it is not unusual for a taxpayer to take a deduction for foreign taxes paid rather than a credit. For example, if a taxpayer is in a loss position, the foreign tax credits would not be useful and the more favourable outcome for the taxpayer would be to report income after deducting foreign taxes paid rather than lose the credits. This is particularly the case in Germany and the United Kingdom.

Table 5.4: Foreign tax credits

Country	Method of calculating foreign tax credits	Carrying forward foreign tax credits
Australia	A direct credit is allowed up to the amount of Australian tax payable. Income is quarantined into four classes for the purpose of determining net income and tax credits. The taxpayer's average rate of tax is applied to the adjusted net foreign income. Net foreign income equals gross foreign income minus allowable deductions and carried forward domestic losses. Much of the income of foreign branches and dividends from foreign entities is exempt as it is regarded as coming from comparable tax countries.	Tax credits can be carried forward five years but may not be carried back.
Canada	The credit allowed is equal to the lesser of the tax paid to the foreign jurisdiction and the Canadian tax applicable to the foreign business income. A test involving three possible tax calculations is performed to arrive at the maximum credit allowed. Credits limited on a per country basis.	Business income foreign tax credit can be carried forward seven years and back for three years. Non-business credits (essentially property income, including royalties, rent and interest) cannot be carried forward or back.
Chile	Withholding tax and corporate tax paid overseas may be credited against the First Category Tax. If a double tax treaty exists with the foreign country, the credits can also be used against the taxes levied on profit distributions to the owners (30% limit).	Excess credits may be carried forward.
France	If no treaty exists, income is reported net of foreign taxes, i.e. there is no credit. In treaty situations income is either exempt from company income tax or a tax credit is granted for withholding tax paid abroad.	Excess credits may not be carried forward.
Germany	In the case of a treaty, dividends will generally be exempt. In non-treaty cases, credits for direct taxes paid are available to individuals and companies up to the limit of German tax with a per country limitation. Underlying tax credit is allowed where there is an interest in the foreign entity of 10% or more.	No carry-forward or -back of excess credits. Deduction can be taken if the taxpayer in loss and hence would not be liable for German tax.

Table 5.4: Foreign tax credits

Country	Method of calculating foreign tax credits	Carrying forward foreign tax credits
Ireland	Tax credits are allowed if the company is resident in Ireland, the credit will be used to reduce corporate tax payable, and the credit is less than the Irish corporation tax applicable on the foreign income, with a per country limitation.	No carry-forward of excess credits.
Japan	A direct credit is allowed up to the amount of Japanese tax payable. Underlying tax credit allowed where there is 25% shareholding or more in the foreign entity. Foreign tax credit claimable is limited to the lower of the actual foreign tax paid and the Japanese tax otherwise payable on the income.	Excess credits may be carried forward for three years.
Netherlands	Tax relief for business income (e.g. of a branch) is granted per country in the form of a reduction of the tax amount by a percentage equal to the percentage that the foreign-source income bears to the worldwide income. Tax credits are also granted per country for dividends, interest and royalties, equal to the lower of tax paid or Dutch tax otherwise payable.	Tax relief and tax credits may be carried forward to subsequent years.
New Zealand	Foreign tax credits claimable are limited to the lower of the actual foreign tax paid and the New Zealand tax otherwise payable on the income.	Credits on attributed CFC income may be carried forward, except on income from 'grey list' countries. Same shareholder continuity of interest applies as with carry-forward of losses. Otherwise, excess credits are wasted.
Singapore	Foreign tax credit claimable is limited to the lower of the actual foreign tax paid and the Singapore tax otherwise payable on the income. The Singapore Revenue may apply the limitation on per country and/or per income stream basis. Where FTC has been allowed, an amount computed according to a prescribed formula can be credited to special account and used to pay tax exempt dividends to shareholders.	Excess credits cannot be carried forward or back.
Sweden	Foreign tax credit claimable is limited to the lower of the actual foreign tax paid and the Swedish tax otherwise payable on the income. Credits limited on a per country basis.	Excess credits may be carried forward for three years but no carry-back.
Taiwan	Foreign tax paid is creditable against the total Taiwan income tax liability to the extent of the Taiwan income tax attributable to the foreign income.	No carry-forward or -back of foreign tax credits is allowed.
United Kingdom	Foreign tax credits claimable are limited to the lower of the actual foreign tax paid and the UK tax otherwise payable on the income. Credit limitation on a source by source basis (i.e. look at each affiliate separately). Common to use non-resident entity to mix income from different sources to maximise use of credits. Government currently considering relaxing limitations. If the tax paid is not claimed as a credit, a deduction is allowed.	Excess credits cannot be carried forward but the taxpayer could claim a deduction. A taxpayer cannot offset some and deduct the remainder from the same income source.
United States	The amount of foreign tax paid may be claimed against US tax liability, but there is a complex set of limitations. The limitations essentially arise through a system which allocates foreign income to about 8 baskets based on type of income rather than on country. Interest allocation rules also apply to determine the amount of foreign income. Essentially, the foreign tax credit is limited to the US tax liability that would be due on the foreign source income. Only companies receive credit for underlying taxes paid by foreign affiliates.	Excess tax credits may be carried forward five years, and back two years. Proposed legislation would adjust this to seven years and one year, respectively.

Interaction of personal income tax and foreign source income

5.29 The interaction between the tax treatment of foreign source income and the personal income tax system in the local jurisdiction is of interest in three cases:

- where foreign source dividends are paid directly to resident individuals;
- where foreign source dividends are paid to resident companies which in turn pay dividends to resident individuals; and
- where foreign source dividends are paid to resident companies which in turn pay dividends to residents in a third country ('conduit' arrangements).

Tables 5.5 and 5.6 summarise the tax treatment of these three cases in the Group 1 and Group 2 countries respectively. In the first two of the three cases, reference should be made to the discussion of dividend imputation schemes which appears in Chapter 3 (see Table 3.3). In addition, the discussion of the tax treatment of foreign source income above is of direct relevance.

5.30 Of central importance here is the extent to which the interaction of the personal income tax system and the taxation of foreign source income of companies effectively results in two layers of taxation for individual taxpayers, one in the foreign country and one in the domestic country. This can distort investment decisions and international capital flows between jurisdictions. In particular, as noted below in the discussion of conduit cases, the sometimes high rates of tax payable at each point can act as a deterrent to such financial flows. This is addressed to varying degrees by the provision of foreign tax credits as well as by tax exemption of dividends.

5.31 On the basis of their tax treatment of the three cases listed above, the 27 countries in the sample may be broadly grouped as follows:

- Countries where a foreign tax credit is allowed on foreign source income, with distribution through dividends to resident taxpayers being taxable. A large number of countries fall into this category (including Australia, New Zealand, the United States, Taiwan, China).
- Countries where a foreign tax credit is allowed on foreign source income with distribution through dividends to resident taxpayers partially taxed (Canada, Japan, the United Kingdom).
- Countries where a foreign tax credit is allowed on foreign source income with distribution through dividends to resident taxpayers exempt from tax (including Singapore, Argentina, Brazil, Malaysia and Croatia).

5.32 Partial taxation of foreign source dividends is achieved in several ways. For example, in Canada and Japan, partial taxation occurs where tax is applied on the grossed-up amount and a credit (specified proportion of the grossed-up amount) is allowed. The allowed credit is determined only by the size of the grossed-up dividend and not by how much tax has been paid at the company level. In other countries, reduced tax rates are applied on foreign source dividend earnings.

5.33 The treatment in different countries indicates that there has been some effort to reduce or eliminate the burden of additional tax that can occur with foreign source income. However, the policy approach is not uniform between countries. Australia and New Zealand both take the position that a full layer of domestic tax should be payable on distributed dividends at the marginal tax rate of the individual shareholder. This means that two layers of tax will apply.

5.34 Other countries take the view that such treatment is to the disadvantage of their domestic multinationals and attempt to relieve some or all of this double layer of taxation. This is one of the key results that emerges from the United Kingdom changes which come into effect from April 1999. Under the changes, shareholders will receive a credit for tax paid at the company level but the credit will be independent of the amount of company tax paid. Thus dividends received from foreign sources will generally pay little United Kingdom tax because of foreign tax credits. Nevertheless, the dividend credit will be available to the shareholders.

5.35 Increased globalisation of world economies has elevated this point to a key policy issue. In some countries where the two layers of tax apply, there are increasing threats from multinationals that they will change residence in order to reduce their global taxation and to improve competitiveness.

Conduit cases

5.36 A conduit case in its simplest form involves a company which is resident in one country receiving a dividend from a second country and then paying a dividend to a resident of a third country. Depending on the treatment of such dividends, the overall tax impost can be so high as to discourage such arrangements.

5.37 Countries use a variety of methods to reduce the tax burden on such dividends. Australia uses a Foreign Dividend Account to allow dividends that are exempt (essentially dividends that have been comparably taxed in another country) to flow to non-residents with no tax liability. This does not apply where the dividend has arisen from a low tax country.

5.38 New Zealand's conduit regime also has the effect of sheltering from New Zealand company tax foreign source income attributable to non-resident shareholders. However, foreign source dividends paid to non-residents are still subject to withholding tax.

5.39 Singapore exempts the payment of dividends to non-residents out of income that has been subject to the foreign tax credit system. Thus, in the case of a conduit, Singapore tax will be paid only where the income from which the original dividend was paid was taxed at a rate lower than the Singapore rate.

Table 5.5: Summary of dividend taxation system — Group 1 countries

Country	Foreign source dividend distributed to resident shareholders	Treatment of dividends received from a second country and paid to resident of a third country
Australia	Dividends from comparable tax countries exempt to corporate shareholders. In other cases, included in taxable income, but foreign tax credit allowed (including underlying foreign corporate tax for companies) limited to comparable domestic tax payable on same underlying profits. Subsequent distributions to resident individual shareholders are taxable.	Foreign Dividend Account (FDA) allows dividends to flow through untaxed if received from 'comparable tax' country listed in regulations. Benefit reduced if also have domestic shareholders and domestic income as dividend must be paid equally to all shareholders.
Canada	Individual shareholder: Where the dividend is received from a corporation that is not a foreign affiliate, the dividend is included in taxable income, but foreign tax credit allowed limited to comparable domestic tax payable on same underlying profits. Subsequent distribution to resident individual shareholders subject to partial imputation – taxed on grossed-up amount (by ¼) and a credit at 13.33% of the grossed-up amount allowed. Corporate shareholder owning more than 10% (foreign affiliate): Where the dividend is received from the active business income of a foreign affiliate (exempt surplus), it is not included in the Canadian taxable income of the corporate recipient. Dividends from earnings other than active business income of the foreign affiliate are included in taxable income and a deduction is allowed with respect to the foreign taxes payable.	Withholding tax at 25%, reduced to 15%/10%/5% under treaties.
Chile	Dividends subject to FCT, but foreign tax credit allowed (for both withholding tax and underlying corporate tax) under treaties if certain conditions satisfied, subject to limits. Subsequent distribution to resident individual shareholders taxable.	Foreign source dividends received and subsequent distributions to non-resident are both subject to general taxation. However, if the foreign distributor is a resident of a treaty country, a foreign tax credit (up to a limit of 30%) is available against the withholding tax levied on the subsequent distribution to the non-resident.

Table 5.5: Summary of dividend taxation system — Group 1 countries

Country	Foreign source dividend distributed to resident shareholders	Treatment of dividends received from a second country and paid to resident of a third country
France	Dividends under affiliation privilege (broadly from companies in which the recipient has a 10% or greater interest) are exempt from corporate tax. Upon re-distribution, an equalisation tax (equivalent to a 'top up' tax to the extent the distributions have insufficient imputation credits or 'avoir fiscal') is imposed equal to half the distributed dividend. But if the dividend is sourced from a treaty country, the equalisation tax is reduced by avoir fiscal and foreign tax credits for withholding and underlying tax. Resident individual shareholders are taxed on dividends they receive (including credits attached) with a credit for the avoir fiscal (imputation credit).	Inbound withholding tax can, with certain limitations, be offset against outbound withholding tax and equalisation tax.
Germany	Dividends from comparable tax countries subject to direct imputation to corporate shareholders. Dividends under international affiliation privilege in treaties not taxable under certain conditions. In other cases, included in taxable income, but foreign tax credit allowed (including underlying foreign corporate tax under certain conditions) limited to comparable domestic tax payable on same underlying profits. Subsequent distribution of fully franked dividends to resident individual shareholders subject to full imputation. Distribution of non-fully franked dividends may be exempt from equalisation tax and no credit allowed for shareholder.	No special arrangements.
Ireland	Included in taxable income, but credit allowed for foreign withholding and underlying taxes under treaties or with minimum 25% shareholding in distributor, limited to comparable domestic tax payable on same underlying profits. Subsequent distribution to resident individual shareholders taxed on gross basis (including related tax credit) and then reduced by the same tax credit.	No special arrangements.
Japan	Included in taxable income, but foreign tax credit allowed (provided that the recipient company held at least 25% voting rights in distributing foreign company for 6 previous months) limited to comparable domestic tax payable on underlying profits. Subsequent distributions to resident individual shareholders are taxable (and are subject to 20% withholding tax, which is creditable to the recipient).	No special rules. Distribution of foreign source dividends to non-residents is subject to 20% withholding tax but may change by tax treaty.
Netherlands	Included in taxable income (unless the participation exemption is applicable). Foreign tax credit allowed on a per country basis limited to withholding tax levied. Subsequent distributions to resident individual shareholders fully taxable at progressive tax rates, but 25% tax applies if substantial shareholding in distributor.	Under certain conditions, upon redistribution of foreign source dividends, part of the foreign tax credit is applied against the withholding tax collected by the Dutch company.
New Zealand	Dividends exempt from income tax, but subject to foreign dividend withholding payment (FDWP) (except for dividends from grey list countries) at 33% of gross dividend. Credit allowed for foreign withholding tax and underlying tax (if minimum 10% shareholding and authorised to appoint directors in distributor) limited to lower of actual tax paid and comparable domestic tax payable on underlying profits. Subsequent distributions to resident individual shareholders are taxable and subject to full imputation.	Exempt from NZ company tax under conduit provisions. Withholding tax still applies.

Table 5.5: Summary of dividend taxation system — Group 1 countries

Country	Foreign source dividend distributed to resident shareholders	Treatment of dividends received from a second country and paid to resident of a third country
Singapore	Included in taxable income upon receipt in Singapore, but foreign tax credit allowed at lower of actual foreign tax or domestic tax payable on the income. To the extent foreign dividends are sheltered from Singapore tax by virtue of FTCs, distributions from this source are exempt, to both resident and non-resident shareholders (section 13E account dividends).	No special rules apply.
Sweden	Included in taxable income, but foreign tax credit allowed limited to comparable domestic tax payable on same underlying profits. Subsequent distributions to resident individual shareholders normally taxed at 30% with no tax credits.	No special rules apply.
Taiwan	Included in taxable income, but foreign tax credit allowed limited to comparable domestic tax payable on same underlying profits. Subsequent distributions to resident individual shareholders subject to full imputation.	No special rules. Distribution of foreign source dividends to non-residents is subject to 20% withholding tax but may change by tax treaty.
United Kingdom	Included in taxable income, but foreign tax credit (or tax deduction) allowed (including underlying credit when minimum 10% voting rights in distributor) per income source at lower of actual payment or comparable domestic tax payable on same profits. Subsequent distribution to resident individual shareholders subject to partial imputation — taxed on grossed up amount (by ACT rate of ¼) and then reduced by the same tax credit. See paragraph 5.34 for changes post April 1999.	No withholding tax on dividends. Under some treaties it is possible to obtain a refund of a small component of the ACT paid on the distribution of the dividend.
United States	Included in taxable income, but foreign tax credit allowed limited generally to comparable domestic tax payable on same underlying profits. Subsequent distribution to resident individual shareholders fully taxable.	No special rules apply.

Table 5.6: Summary of dividend taxation system — Group 2 countries (cont)

Country	Foreign source dividend distributed to resident shareholders	Treatment of dividends received from a second country and paid to resident of a third country
Argentina	Included in taxable income, but tax credit allowed to the limit of tax increase corresponding to the dividends. Subsequent distribution to resident individual shareholders not taxable.	Withholding tax is not applicable to dividends. However, amendments have been proposed to impose 35% withholding tax on distribution of untaxed foreign source dividends to non-residents.
Belgium	Dividend received deduction applies if distributor subject to comparable tax system, with exceptions. Subsequent distribution to resident individual shareholders taxed at 25% or 15% (for dividends from certain shares).	Where foreign source dividends qualify for the dividend received deduction (i.e. up to 95% of the dividends exempt from tax), their distribution to non-residents is subject to the normal 25% withholding tax which may change by tax treaty. Distribution to qualifying EU residents is tax free.
Brazil	Included in taxable income, but foreign tax credit allowed. Subsequent distribution to resident individual shareholders not taxable.	No withholding tax is imposed on dividends paid to non-residents.
China	Included in taxable income, but foreign tax credit allowed. Subsequent distribution to resident individual shareholders fully taxable.	Foreign source dividends distributed by foreign investment enterprises to non-residents are currently exempted from tax. Distributions by other companies are subject to 20% withholding tax, normally reduced to 10% by tax treaty.
Croatia	Dividends not taxable.	No withholding tax is imposed on dividends paid to non-residents.
Denmark	Dividends not taxable if minimum 25% shareholding satisfied and distributor subject to comparable tax system, otherwise fully taxable but foreign tax credit allowed. Subsequent distribution to resident individual shareholders tax-exempt if minimum 25% shareholding satisfied, otherwise taxable at 25%.	Distribution of untaxed foreign source dividends is normally subject to 25% withholding tax but may change by tax treaty. Distribution to qualifying EU residents is tax free.
Finland	Dividends taxable under controlled foreign company rules.	Distribution of foreign source dividends to non-residents is subject to 28% withholding tax but may change by tax treaty. Underlying imputation credit is available against corresponding withholding tax under certain tax treaties. Distribution to qualifying EU residents is tax free.
Israel	Dividends taxable at 25%, but foreign tax credit allowed where treaties exist. Subsequent distribution to resident individual shareholders subject to tax at 25% (or 15% if paid by Approved Enterprise) withheld by distributor.	Distribution of foreign source dividends to non-residents is subject to 25% withholding tax but may change by tax treaty. Distribution by a qualifying Approved Enterprise is subject to 15% tax. The Israel Finance Minister may provide refund to a non-resident where the latter's foreign tax credit in its country of residence is less than Israeli tax paid.
Italy	40% dividends taxable if minimum 20% shareholding in distributor (10% if distributor is listed). 95% dividends exempt from tax if distributor is in another EU country. Dividends fully taxable if distributor is resident in tax haven countries. Subsequent distribution to resident individual shareholders subject to full imputation.	Distribution of foreign source dividends to non-residents is subject to 27% or 21% withholding tax but may change by tax treaty. Up to 12% of the distribution taxed at 27% may be claimed by non-residents under certain conditions.

Table 5.6: Summary of dividend taxation system — Group 2 countries (cont)

Country	Foreign source dividend distributed to resident shareholders	Treatment of dividends received from a second country and paid to resident of a third country
Malaysia	Dividends not taxable (except from banking, insurance, air or sea transport). Subsequent distribution to resident individual shareholders not taxable.	No withholding tax is imposed on dividends paid to non-residents.
Mexico	Dividends taxable upon distribution.	No withholding tax is imposed on dividends paid to non-residents.
Norway	Full imputation applies to dividends, grossed-up by withholding tax and proportionate foreign underlying tax (if minimum 10% shareholding). Credit limited to Norwegian tax payable. Subsequent distribution to resident individual shareholders subject to full imputation.	Distribution of foreign source dividends to non-residents is subject to 25% withholding tax but may change by tax treaty. No imputation tax credit is available on distribution to non-residents.
South Korea	Full imputation applies to dividends, grossed-up by proportionate foreign underlying tax and credit allowed (in addition to that for foreign withholding tax). Subsequent distribution to resident individual shareholders subject to full imputation.	Distribution of foreign source dividends to non-residents is subject to 27.5% withholding tax but may change by tax treaty. Imputation tax credit may be available on distribution against the corresponding withholding tax under certain tax treaties.

Anti-deferral regimes for foreign source income

Controlled foreign companies

5.40 Some countries, including Australia, tax certain income of foreign affiliated entities of a resident taxpayer on an accrual basis. This means that, even though the income has not been remitted to the country of residence of the taxpayer, income of the foreign affiliate is attributed to the taxpayer and taxed on a current basis. This is most common where the resident taxpayers, together with associates, are capable of controlling the foreign entity. In general, only certain types of income are taxed in this way, typically passive income or tainted income (income which involves related party transactions). Tax systems of this type are generally referred to as controlled foreign company regimes.

5.41 Table 5.7 shows those countries which tax income in this way. Of the fourteen Group 1 countries, ten have a controlled foreign company system of some type. The most rigorous of these systems is in New Zealand, which does not exempt active business income — all income of controlled foreign companies is subject to attribution except where the controlled foreign company is resident in a specified country which itself has a controlled foreign company regime.

Table 5.7: Tax treatment of controlled foreign companies

Country	Description of tax treatment	Types of income taxable	Calculation of tax
Australia	A company is deemed to be a controlled foreign company if one of the 'control tests' is satisfied. The controlled foreign company rules cover companies resident in all countries other than Australia, but the type of income included depends on the category of country in which the controlled foreign company resides.	The types of income taxable include interest, dividends, royalties, and amounts arising from related party transactions.	The tax applies to the taxpayer's share of the controlled foreign company's attributable income, which is included in the resident taxpayer's income. This income is calculated on a notional basis, using a modified form of the rules that apply to the calculation of taxable income of a resident company. Credit relief is available to prevent double taxation.
Canada	If a Canadian taxpayer owns more than 10% of any class of shares of the corporation and they, or not more than four other Canadian residents, have control of the corporation, it is deemed a Controlled Foreign Affiliate (CFA). Foreign accrual property income (FAPI) earned by a CFA of a resident taxpayer is taxed in Canada as it is earned, rather than when distributed.	FAPI includes income from property and business other than active businesses, and taxable gains on disposal of certain property. FAPI also includes some income which is not traditionally considered passive income.	A resident taxpayer includes in its income for the year, its proportion of FAPI earned by a CFA. The taxpayer may be entitled to a deduction for part of the underlying foreign taxes paid on the foreign source income that it reports. Income earned by a CFA from active business is not included in the recipient's Canadian taxable income when repatriated by way of dividend to a corporate shareholder.
France	Any French company owning at least 10% of the shares in a foreign subsidiary, in a country where the effective tax rate is less than two thirds of the French rate, is subject to French income tax on the profits of the controlled foreign company in proportion to its shareholding.	The parent company may escape taxation by proving that the foreign subsidiary's principal purpose is not to benefit from the privileged tax system but to carry out a genuine industrial or commercial activity and to perform this activity on the local market.	Taxable income of the controlled foreign company company is computed according to French CIT rules and taxed separately in proportion to the French company's holdings. Any local CIT can be offset against corresponding French CIT.
Germany	If German-resident individuals or companies own — either directly or indirectly — more than half of the shares or voting rights in a foreign company which only generates 'passive' income, then that foreign entity is considered to be an 'intermediate company'.	Under controlled foreign company legislation, passive income is income other than from an active business operation.	If the income is taxed at a rate of less than 30% in its country of origin, it will be subject to the German controlled foreign company legislation which attributes the income to all resident shareholders owning in total more than 50% of the foreign entity. The general rules apply to the calculation of taxable income.
Japan	If a domestic corporation (including a family corporate group) owns 5% or more of the issued stocks of a foreign subsidiary in a tax haven, which includes a foreign corporation more than 50% of whose issued stocks or voting-right stocks is directly or indirectly owned by resident or domestic corporations.	Undistributed profits principally mean net income, excluding corporation tax imposed on the undistributed profits of a foreign subsidiary and the amount of dividends paid. Passive and active income are not distinguished.	Taxed on shareholder share of all the income of the entity.

Table 5.7: Tax treatment of controlled foreign companies

Country	Description of tax treatment	Types of income taxable	Calculation of tax
Netherlands	There is no controlled foreign company regulation as such. Indirect controlled foreign company legislation resides in the Corporate Income Tax Act. This applies for a participation in a non-resident company of at least 25%, if 90% or more of the assets of the non-resident company consist, directly or indirectly, of portfolio investments or of assets of passive group finance companies. This applies only for persons subject to corporate income tax.		The increase in the fair market value of a qualifying participation is included in the taxable income of a resident company, subject to corporate income tax.
New Zealand	A foreign company is a controlled foreign company if at any time during the year a group of five or fewer New Zealand residents hold over 50% (or a single New Zealand resident holds at least 40%) of the company, or have the power to control the company to ensure business is conducted in accordance with the wishes of that group. The rules apply to all foreign companies except if the company is resident in a 'grey list' country.	The tax is assessed on income or losses which the company would have derived or incurred had it been a resident of New Zealand. The income or loss is then attributed to the taxpayer in accordance with their interests in the controlled foreign company.	The income interest, direct or indirect, of a New Zealand resident (including that held by associated parties) in a foreign company determines the net income/loss attributable to the resident.
Sweden	An entity is a controlled foreign company if Swedish residents directly and indirectly hold at least 50% of the entity at the end of the year.	All income is attributed but the measures do not apply to a controlled foreign company resident in a treaty country or in a comparable tax country. That is, the measures are confined to tax haven countries.	Taxed on shareholder share of all the income of the entity where the shareholder has an interest greater than 10%.
United Kingdom	To be a controlled foreign company the company must be under the 'control' of persons resident in the UK. 'Control' means the ability to exercise control, whether direct or or indirect, over the company's affairs. The controlled foreign company laws only attribute income to UK corporations.	There is no specific distinction between 'passive' and 'active' income. However one of the exemptions to the controlled foreign company rules arises if the company has been engaged in 'exempt activities'.	The controlled foreign company's chargeable profits are calculated as the total profits of the company (excluding capital gains) which would be chargeable to UK corporation tax for the period. The assumptions referred to are numerous and include such things as assuming the company is not a close company, all claims and elections have been made, and certain assumptions concerning depreciation. The controlled foreign company's profits are attributed to its UK resident shareholders based on each shareholder's proportionate interest in the controlled foreign company. Only corporate shareholders with a controlled foreign company may have income attributed to them. The shareholder gets a credit for tax paid by the controlled foreign company.

Table 5.7: Tax treatment of controlled foreign companies

Country	Description of tax treatment	Types of income taxable	Calculation of tax
United States	A controlled foreign company is one in which more than 50% of the vote or value in the company is owned by US shareholders. A US shareholder is one who actively or constructively owns 10% or more of a foreign corporation's voting interest. There are no geographical barriers to the application of controlled foreign company rules.	Income deemed to arise from certain tax avoidance transactions is taxable to the US shareholders. These transactions include artificially shifting income away from the country of sale.	Only the US shareholders (as defined) are taxed on their pro-rata share of taxable controlled foreign company earnings. US persons who are not US resident shareholders are not subject to tax on these earnings.

5.42 Controlled foreign company systems are complex and those in operation in Australia, Canada, New Zealand and the United States in particular typify this. The complexity arises because of lack of clarity in the underlying policy and, particularly in the case of Australia, the subsequent difficulty in tracking income of different types to ensure that it is eventually taxed in a particular way. The underlying problems result from the difficulty in defining the type of income to be taxed and the features of foreign tax systems which can encourage 'tax avoidance'.

5.43 Of the remaining controlled foreign company systems, most are regarded as relatively narrow in their application. This particularly applies to the systems in Canada, France, Japan, the Netherlands and Sweden. The United Kingdom system in practice is also fairly narrow as the active business exemption is broad and can be established in a wide range of cases.

Foreign investment funds

5.44 A different system of taxation is required where non-residents derive income via a foreign entity which they do not control. Such entities are referred to in Australia as foreign investment funds (FIF).

5.45 Of the Group 1 countries, eight have some form of FIF system (see Table 5.8). This is essentially the same set of countries that have controlled foreign company systems, with the exception of Japan, Sweden and the United Kingdom. In most of these countries, the operation of the schemes is fairly narrowly based and designed to capture mainly property income, principally capital gains and rental income.

Table 5.8: Taxation of foreign investment funds — passive / portfolio

Country	Description of tax treatment	Types of income taxable	Calculation of tax
Australia	The FIF measures apply where Australian residents hold interests in foreign entities or investments which fall outside the scope of the foreign source income rules applicable to controlled foreign companies and transferor trusts. The FIF rules look more to the nature of the activities carried on, rather than the country of residence of the FIF.	FIF income which accrues to the taxpayer during a notional accounting period of the FIF is assessable, provided the taxpayer was a resident of Australia for any part of the period. Certain exemptions from FIF measures are available.	There are three methods available to the taxpayer in calculating FIF income: ▪ the market value method taxes the difference in the opening and closing market value of the FIF; ▪ the deemed rate of return method applies to the opening value of the FIF; and ▪ the calculation method uses a rough calculation of the FIF's profit.
Canada	Attribution occurs in non-controlled situations where a Canadian taxpayer has an interest in a foreign investment vehicle essentially earning passive income and providing the taxpayer with a tax deferral advantage.	Income derived from certain portfolio investments, including shares of the capital stock of one or more corporations, indebtedness or annuities, interest in one or more corporations, trusts, funds or entities, commodities, real estate, currency of a country other than Canada, and rights to the above.	Where a taxpayer invests in offshore investment funds that derive their value primarily from certain portfolio investments, and where one of the main reasons for the invesment fund is to reduce or defer the tax which would otherwise have applied in respect of the portfolio income had such income been earned directly by the taxpayer, the taxpayer is required to include in income for the year an amount equal to 'designated cost', as defined, of investment in offshore investment fund at the end of each month multiplied by a prescribed rate of interest.
France	An enterprise which transfers assets abroad to a third person or a trustee for the purpose of managing such assets or meeting existing or future obligations is taxable on the profits derived from the management or the sale of such assets or assets acquired in substitution of such assets.	While the terms of this provision are general the main objective is to define a tax treatment for complex financial operations, such as debt defeasance transactions.	The taxable profit is computed according to French Corporate Income Tax (CIT) rules separately from the French company's CIT taxable operations according to specific accounting provided by the transferee. A tax credit is granted for foreign CIT paid on corresponding profits.
Germany	Even in an uncontrolled situation the regular stock ownership rules apply under certain conditions. The non-distributed income is subject to income taxation to a resident taxpayer provided the investment fund generates certain types of income. In order to avoid harmful tax consequences, a tax representative has to be appointed and special periodic reporting and information rules have to be observed.	Taxable income in this context is income derived from capital sources and real property.	The taxable income has to be calculated according to German domestic tax law.

Table 5.8: Taxation of foreign investment funds — passive / portfolio

Country	Description of tax treatment	Types of income taxable	Calculation of tax
Ireland	The rules which apply are the Offshore Funds Legislation, and the rules concerning the transfer of assets abroad.	Taxable income derived from disposal of interest in offshore 'roll-up' funds, unless the fund is a distributing fund (i.e. distributable within 18 months of year-end).	Where taxpayers invest in offshore 'roll-up' funds they are liable to income tax rather than capital gains tax on disposal of their interest in the fund, unless the fund is a distributing fund. In addition, an individual is liable to income tax if, following a transfer of assets abroad, income generated by the assets becomes payable to a person resident and domiciled outside the State but the individual retains the power to enjoy the income or any capital sum connected with the transfer.
Netherlands	Dutch individuals, subject to individual income tax, holding shares of foreign qualifying investment companies must report deemed income. Qualifying investment companies are in general non-Dutch resident companies of which the capital is divided in shares and the assets consist, directly or indirectly, of at least 50% of portfolio investments.		A deemed amount equal to 4.8% or 6% (depending on the nature of assets of the foreign company) of the face value of the shares at the beginning of the calendar year must be reported as taxable income. This deemed income can, under conditions, be reduced.
New Zealand	An interest in a foreign entity may constitute an interest in a foreign investment fund. For this purpose a foreign entity is defined to be one of the following: a foreign company (as defined under controlled foreign companies rules); a natural person not resident in New Zealand who is the insurer under life insurance policies offered and entered into outside New Zealand; a foreign superannuation scheme, being a superannuation scheme constituted outside New Zealand.	All types of income, both active and passive. The definition of foreign investment fund is very broad. Essentially, it applies to any foreign entity and extends to interests in offshore superannuation and life insurance arrangements. The scope of the definition is reduced by a number of specific exclusions.	Foreign investment fund income forms an item of gross income. The income or loss from a foreign investment fund is to be calculated according to one of the following: the comparative value method; the deemed rate of return method; the accounting profits method; the branch equivalent method. Restrictions exist in relation to which methods may be used.
United States	With some exceptions, a Passive Foreign Investment Company (PFIC) is a foreign corporation that earns at least 75% of its income from passive income or uses at least 50% of its assets to generate passive income. Any U.S. person owning stock in a PFIC is subject to the PFIC rules.	Shareholders that receive actual dividends from a PFIC, or that dispose of their PFIC stock, are charged a deferral charge.	Taxable income is calculated either based upon the amount received in a distribution from a PFIC or if the PFIC is a qualified electing fund, based upon the shareholder's pro rata share of the PFIC's ordinary income and capital gains had that amount been distributed with respect to the shareholder's stock.

5.46 The most comprehensive rules are those in Australia, New Zealand and the United States. Both Australia and the United States restrict the operation of their rules to essentially investment income, principally interest, dividends and certain capital gains. The United States rules include a feature which means that instead of taxing income as it is earned by the foreign investment vehicle, tax can be deferred until a distribution is received but a deferral tax is then applied. The New Zealand rules cover all types of income and tax on a deemed rate of return basis if the taxpayer does not have sufficient information to apply other methods.

Double taxation agreements

5.47 There are many instances where the taxation treatment in a particular country varies depending on whether a tax treaty is in place dealing with the income. Such treaties deal not only with the source of the income but importantly with the rate of tax to be applied. The rate of withholding taxes is commonly reduced under treaties, frequently to zero by capital exporting countries (who gain reciprocity from their treaty partners). In addition, a number of countries exempt dividends received from treaty countries rather than apply the foreign tax credit system.

5.48 Because of the lower taxation provided for in treaties and the greater certainty of treatment, countries with substantial treaty networks represent attractive locations for investors. Such treaty networks can be particularly important in deciding where to locate holding companies so as to simplify the movement of capital between jurisdictions as investment needs dictate.

5.49 There are two notable features about the treaty networks of the countries examined. The first is that the European countries have extensive treaty networks in place, 90 countries in the case of France and more for the United Kingdom. Although in part also dependent on the geographic spread of the treaties, such networks can be a very attractive feature for an investor. An investor with considerable interests in Asia will be interested in the Asian treaty network of a country and not in the total number of treaties.

5.50 The second feature, not fully shown in Table 5.9, is the extent to which countries have been seeking to reduce withholding rates under treaties, to zero in many cases. This tends to assist the global movement of capital and can reduce the overall tax burden on taxpayers, depending on their ability to absorb credits for foreign taxes.

Table 5.9: Tax treaties

Country	Countries with Double Tax Agreements (DTAs)	Modification of domestic laws by DTAs
Australia	DTAs in force with 37 countries.	Australian source business profits of non-residents are not taxable in Australia if the non-resident does not have a permanent establishment in Australia.
Canada	DTAs in force with 67 countries.	Withholding tax rates are generally reduced and taxation is limited to businesses with permanent establishments within Canada.
Chile	Argentina	Income is taxed at the source only.
France	DTAs in force with 90 countries.	Provides for modification of territoriality principles, reduction or exemption from withholding taxes, foreign tax credit determination and the influence of non discrimination clauses.
Germany	DTAs in force in approximately 70 countries.	Provides for modification of territoriality principles and reduction or exemption from withholding taxes. Exemption method for certain types of income (branch, real estate, self-employed, employed).
Ireland	DTAs in force with 29 countries.	Withholding tax rates are generally reduced and taxation is limited to businesses with permanent establishments within Ireland, as well as affecting tax credits.
Japan	DTAs in force with 44 countries.	The treaties provide for reduction in withholding tax rates.
Netherlands	DTAs in force with 63 countries.	Tax treaties can diminish applicable tax rates such as withholding taxes.
New Zealand	DTAs in force with 25 countries.	Withholding tax rates are generally reduced and taxation is limited to businesses with permanent establishments within New Zealand.
Singapore	DTAs in force with 36 countries.	Withholding tax rates are reduced or the income is exempted from withholding tax. Tax sparing reliefs may be applicable. A foreign investor may be given credit against the home country tax on the exempt income as if foreign tax has already been paid on that income in the overseas state.
Sweden	DTAs in force with 74 countries.	Rates of withholding tax are reduced, and in some cases the credit for foreign tax is extended.
Taiwan	Australia, Indonesia, New Zealand, Singapore, South Africa, Vietnam	Wthholding tax rates are reduced from the normal rate of 20%. The rates vary across country and income type.
United Kingdom	DTAs in force with 105 countries.	Provides exemption or reduces withholding tax rates, provides credit for foreign tax paid, and imposes arm's length principle in some cases.
United States	DTAs in force with 46 countries.	Withholding tax rates are reduced and taxation is limited to businesses with permanent establishments within the US.

Related party transactions (transfer pricing)

5.51 All of the countries in Group 1 have some type of provisions for dealing with transfer pricing, although Ireland's transfer pricing rules apply only to companies eligible for the 10 per cent manufacturing tax rate. Some countries, including the Netherlands and Singapore, have very basic rules which do not specify the approach to be taken to transfer pricing. Other countries have rules in place but regard the rules as essentially anti-avoidance in nature to be used where serious cases of avoidance are identified.

5.52 Most countries claim to follow the OECD guidelines. This provides significant assistance to taxpayers but the guidelines can be difficult to apply in particular cases such as where a particular transaction is not very profitable for either party. The only real way to assess the transfer pricing rules in particular countries is by practical experience.

5.53 Of the 14 Group 1 countries, transfer pricing is most actively dealt with in Australia, US, Canada, Japan, Germany and to a lesser extent in the United Kingdom and France. In most Asia Pacific countries, rules relating to arm's length dealings exist but the extent of action by the tax authorities to ensure compliance is limited.

5.54 One of the difficulties with the transfer pricing rules in each country is the lack of clear requirements. This is largely reflective of the fact that the arm's length principle underlying the approach does not provide a closely defined outcome. However, more practical issues also arise. For example, countries generally require that transfer pricing practices be well documented but little practical guidance is available. Moreover, this tends to be an area where opinions differ a great deal on what is required under the law compared with what the revenue authority believes is necessary.

5.55 As more countries show a concern with transfer pricing, compliance becomes difficult and costly for taxpayers. Even where the two tax jurisdictions involved in a transaction claim to follow the OECD guidelines, the same practical problems can arise. This reflects the degree of flexibility inherent in the arm's length approach and the natural tendency for tax authorities to try to apply the principle in a way which gives a favourable tax revenue outcome for that country.

5.56 There is no simple solution to these problems. However, in most countries some improvement could result if there were a clearer alignment between the law as set out in legislation and the practice of the revenue authorities. Currently, taxpayers in many jurisdictions are unable to assess their legal position relative to the expectations of the revenue authority. Part of the solution to this problem will emerge gradually as the transfer pricing policies of multinational groups are challenged by revenue authorities in different countries. Given the global nature of the issue, it is not one on which much progress can be made on a unilateral basis.