The Taxation of Foreign Investments in Selected Countries

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ABSTRACT

Taxation of Foreign Investments in Selected Countries by Kersi B. Shroff, *coordinator*, examines the tax laws in France, Germany, Japan, South Korea, Singapore, Taiwan and the United Kingdom and related the means adopted for avoiding double taxation. (LL 91-5)

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THE TAXATION OF FOREIGN INVESTMENTS IN SELECTED COUNTRIES

Introduction

The international movement of capital is an important phenomenon in the contemporary world. Through direct and indirect investments across borders, the world economy is being reshaped. Governments seek to promote exports and encourage foreign investments; multinational corporations conduct operations in many different countries; domestic corporations in one country sell their products and services to other countries; and individuals from one country have earnings and investments in other countries.

Inherent in this international movement of capital is the question of its taxation. Most developed countries tax their residents or citizens, as in the United States, on their worldwide income. These countries also tax non-residents on income derived from sources within the country, creating a disincentive to international investment. A resident of one country will thus be subject to taxation twice on any foreign source income; in one country on the basis of his residence and in another country on the basis of the source of income.

Double taxation creates a conflict between the interests of capital exporting countries that emphasize the residence or nationality basis of taxation, and those countries that import capital and would prefer to tax the income derived by the capital on the source basis. When the tax rates

were low, this was not a serious problem, but most developed countries have a high rate of taxes, and "double taxation constitutes a major deterrent to international capital flows."[1]

The author of a study of double taxation thus observes that it "may be the most serious difficulty facing capital movements. At a high level of taxation, double taxation may in itself constitute an insurmountable obstacle to investment abroad."[2] The Organization for Economic Cooperation and Development (OECD) has stated that the harmful effects of double taxation on the movement of capital are so well known that it is superfluous to stress the importance of removing the obstacles that it presents.[3] The OECD has developed a model double taxation convention which is the basis for over two hundred treaties entered into by its members.

On the other hand, empirical evidence has shown that factors other than tax are more relevant to investment decisions, since the main concern in investing is to maintain security with a minimum risk to capital.[4] It is further stated:

> Under these circumstances, the tax factor does not generally appear to represent a significant barrier to foreign investment in developing countries. Furthermore, it may be noted that in the process of evaluating potential investment, much greater consideration is normally given, in the light of the substantial differences between developed countries and the relative scale of importance of

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[1] B. Arnold, *The Taxation of Controlled Foreign Corporations: An International Comparison* 3 (1986).

[2] M. Pires, *International Juridical Double Taxation of Income* 76 (1989).

[3] *Id*. at 76.

[4] A. Figueroa, *Tax Treaties and International Investment Flows in Taxation and International Capital Flows: A Symposium of OECD and Non-OECD Countries* 93 (1990).

foreign investment for developing economies, to the degree of effective impact of the local tax burden than to the nominal taxation level.[5]

Relief from Double Taxation

Most countries deal with the problem of double taxation in the following manner:

Foreign Tax Credit

Foreign taxes are allowed as a credit against the tax payable in the country of residence. The credit is granted either unilaterally or under bilateral conventions for the avoidance of double taxation. A tax credit is an advantageous form of avoiding double taxation in that for every dollar of foreign tax paid a dollar of domestic tax is saved. If the foreign tax is the same or higher than the domestic tax, the foreign tax credit will effectively exempt the foreign income from domestic taxation. However, if the domestic tax is higher, the tax credit method results in the payment of the higher of the two taxes. This would result in a disadvantage for a resident corporation against its foreign competition which may be paying a lower rate of tax.

A system of foreign tax credit also ensures fairness between taxpayers and can be said to be neutral as to the decision to export capital. Otherwise, as stated in the attached memorandum, "investors would prefer to invest domestically and foreign investment would be discouraged."

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[5] *Id*. Another paper was presented by C. Shepherd, on *Tax Obstacles and Incentives to Inward Investment in Non-Member Countries: The Experience of the United Kingdom*. A copy is appended.

Foreign Tax Exemption

Under this method, foreign source income is completely exempted from tax in the country of residence. The benefit of this system is that if the foreign tax is lower, the taxpayer only pays the foreign tax and remains on equal terms with his foreign competition. Apart from its administrative simplicity, the exemption method is also useful in cases where a foreign tax does not correspond to income or corporation tax in the residence jurisdiction, making a tax credit unavailable.

The double taxation treaties entered into with other countries by France and Germany use this method. A major argument against the exemption method is that it gives an advantage to enterprises which have foreign income in low tax jurisdictions, resulting in inequity between taxpayers. Nor is it fiscally neutral as between domestic and foreign investments-- "indeed the exemption method can be said to positively encourage overseas investment in low tax countries and the use of tax havens."[6]

Deduction of Foreign Taxes

Foreign taxes may also be deducted from the worldwide income taxed in the country of residence. This method treats a foreign tax as a deductible cost of doing business in a foreign country.[7]

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[6] D. Davies, *Principles of International Double Taxation Relief* 4 (1985).

[7] Arnold, *supra* note 1, at 3.

Country Reports

These methods of avoiding double taxation and the system of taxation of foreign income generally are examined in the attached reports. The analysis begins with a Congressional Research Service memorandum on the United States tax treatment of foreign direct investment. Reports prepared in the Law Library of Congress examine the parallel systems in three European countries, France, Germany and the United Kingdom, along with the tax regimes in the Pacific Rim countries of Japan, Korea, Singapore and Taiwan.

The United States taxes its citizens and domestic corporations on their worldwide income. The U.S. tax on the income of a foreign subsidiary corporation, or partially wholly owned by U.S. interests, is payable only when it is distributed in the U.S. The double taxation of foreign income is mitigated through the grant of foreign tax credits or allowing the foreign tax to be deducted from the income. The foreign tax credit may not exceed the U.S. tax payable on the foreign income. If the foreign tax paid is higher than the U.S. tax, the excess may be carried back for two years and forward for five years. Thus, double taxation is not entirely eliminated. The averaging of foreign income from high and low tax-rate countries is allowed, subject to restrictions tightened in 1986, thus increasing the amount of foreign tax credit that may be lost because it exceeds the U.S. rate of tax.

Japan, Germany, and the United Kingdom also tax resident individuals and corporations on their worldwide income and, like the United States, they also allow foreign tax credits. The exemption system in France is applied to foreign source business income, while investment income

is taxed on a worldwide basis.[8] The rates of taxation in these countries, however, are varied. Germany and Japan impose a much higher rate of tax than the United States. The United Kingdom's lowered corporation tax rate of thirty-five percent, is comparable to the thirty-four percent rate in the United States. Singapore taxes corporate income at thirty-two percent.

Japan's foreign tax credit is granted against Japanese corporation tax subject to limitations. The aggregation of all foreign taxes paid is allowed. Any excess credit may be credited against two other taxes, prefectural inhabitant and municipal inhabitant tax, but not against enterprise tax. Excess foreign credit may be carried forward or backward for five years. Since a foreign subsidiary of a Japanese corporation is taxed on earnings that are remitted to Japan, an indirect foreign credit is allowed. At the option of the corporation, instead of a credit, foreign taxes may be deducted from income.

Germany offers a unilateral tax credit to mitigate double taxation on the foreign income of individuals and corporations. The taxpayer may decline the credit and instead elect to deduct the foreign taxes. The option of a twenty-five percent flat rate of tax is also available. The deduction of foreign taxes is advantageous when due to losses incurred domestically a foreign tax credit would not be useful. When direct investment income is earned in the approximately fifty-five countries with which Germany has concluded a tax treaty, the foreign income is generally exempt from German taxation.

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[8] Arnold, *supra* note 1, at 5.

Foreign tax credit in the United Kingdom works the same way whether it is available under a tax treaty or unilaterally. The credit cannot exceed the United Kingdom tax payable on the income and any excess credit is lost. In common with Germany, a tax credit may be disclaimed and foreign tax deducted from income in cases in which there is no advantage in obtaining a credit.

France taxes domestic corporations only on profits realized from business conducted in France. Autonomous branches abroad of French corporations are also exempt from tax. French individuals, however, are taxed on a worldwide basis, with some exceptions. As stated, France avoids double taxation by giving an exemption on foreign source income rather than by way of tax credit.

Of the other Pacific Rim countries, Singapore has a territorial basis and taxes resident individuals and corporations on income arising domestically and foreign source income that is remitted to the country. Bilateral tax treaties entered into by Singapore allow a tax credit for foreign taxes paid. Any tax paid in a (British) Commonwealth country with which there is no treaty arrangement can be used as credit for up to one-half of the Singapore tax payable. The excess is not granted any further relief. South Korea taxes its residents and corporations on their worldwide income. An allowable foreign tax credit is limited to the amount of Korean taxes that are allocated under a formula to the foreign source income. The limit is based on foreign taxes overall, which reduces the availability of the credit.

Taiwan taxes the worldwide income of domestic corporations, but allows a credit for foreign taxes paid. As in the United States, the credit cannot exceed the amount of domestic tax applicable to the foreign income.

Tax Sparing

Except for the United States, most of the countries examined have special "tax sparing" provisions granting foreign tax relief in their treaties with developing countries. Tax sparing arises when a developing country wishing to attract investments offers tax concessions. Since foreign tax relief is available only if the tax has actually been paid, the investor derives no tax benefit in his country of residence. Tax sparing clauses are generally included in the tax treaties of these countries and deem the foreign tax spared as if it had been paid.

Controlled Foreign Corporations

Under the deferral principle, the taxation of foreign source income earned or received through a foreign corporation will be postponed until the controlling shareholders of that corporation receive dividends from it. This contrasts with the receipt of foreign income earned directly by a resident corporation, which will be subject to domestic tax with a credit allowed for any foreign taxes paid. For taxpayers in high-tax jurisdictions, the deferral principle allows an opportunity to use tax haven countries to postpone or avoid tax on foreign income.

The United States, along with Germany and the United Kingdom, limit the deferral principle for domestic corporations that have controlling interests in subsidiaries engaged in "tax

haven" activities. These measures generally tax the income of the subsidiaries as if it had been distributed to the controlling shareholders.

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FRANCE

France has entered into bilateral double taxation treaties with most of those countries with which it has economic relations.[1] Article 55 of the French Constitution states that "Treaties and agreements duly ratified or approved shall, upon their publication, have an authority superior to that of the laws subject to each agreement or treaty to its application by the other party."[2] These treaties generally contain provisions concerning mutual assistance in areas where taxation laws conflict and equal treatment of nationals is lacking. Although each treaty is different, the French system follows this general principle.

Taxation of Corporations

In contrast with many countries where a resident corporation is taxed on its worldwide income, French corporations are subject to corporate income taxes on profits realized from business conducted in France. Profits reserved to France by a double taxation treaty are not included in this rule.[3] Foreign branches of French corporations are exempt from corporate taxes if they have a permanent autonomous installation abroad, such as a branch, factory, or any other enterprise that generates profits. The same rule applies if the corporation has a representative

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[1] 2 *Lamy fiscal* 892 (Lamy, Paris, 1991) provides a list of 71 such countries.

[2] Art. 55, Constitution of the Fifth Republic, *in Code administratif* 11 (Dalloz, Paris, 1985).

[3] *Code général des impôts*, art. 209-1 (Paris, Dalloz, 1985), updated.

abroad who is directly employed by the corporation in a de facto subordinate position or the corporation maintains a complete cycle of commercial or industrial operations abroad. For example, the Conseil d'Etat held that a dealer who purchased goods in a foreign country and sold the same in yet another country could not benefit from the complete cycle rule because he did not maintain a warehouse or fixed place of business abroad. More importantly, in this case, all financial dealings and management decisions took place in France.[4] A second case involved the construction of a factory abroad. Here the same Court divided the operation in two parts. Those functions carried on in France were subject to French taxes, but those carried on abroad were not.[5]

In order to encourage investment abroad, the expenses of a French company that are connected with information, sales offices, or research facilities located in a foreign country may establish a reserve.[6]

French enterprises that invest, whether directly or through an intermediary, in the setup of sales establishments, research offices, or branch offices abroad, of which they hold at least 10% of the capital, may establish a reserve equal to the losses suffered during the first five years of

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[4] *Recueil de décisions du Conseil d'Etat*, March 14, 1979, p. 117. International conventions with French-speaking sub-Saharan countries allow for advantages that could be considered tax-sparing. Indeed, the definition of a permanent installation abroad is so wide that it allows those countries to tax a large number of activities that French laws and treaties do not generally permit. *See also* next paragraph below.

[5] *Id*. June 23, 1978, at 272.

[6] *Code général des impôts, supra* note 3, art. 39 *Octaies* A(1).

operation. The limit equals the sums invested in capital during the same years of operation. [7] The same article in the Code allows the tax-free reserve to equal the sum invested during the first five years for those countries listed for this purpose by the Ministry of the Economy and Finances.

Individuals

Individuals who are domiciled in France are treated differently. The Code states: "Persons who have their fiscal domicile in France are subject to income tax on their total income." [8] The term *domicile*[9] is defined for tax purposes to apply to those who:

-- have their home in France or those who maintain their principal headquarters there;

-- exercise an occupational activity in France, salaried or not, unless they can justify that the activity is not a major one; and

-- maintain France as the center of their economic activities.[10]

Income is determined by reducing expenses incurred to earn and maintain income from gross profits or receipts.[11]

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[7] *Id*. art. 29. The total income taxed includes dividends, interest, and royalties, except if there is a double taxation treaty to the contrary.

[8] *Id*. art. 4a.

[9] *Id*. art. 4b.

[10] *Id*.

[11] *Id*. at 7.

There are exceptions to this French rule of taxation. Shipping and air transportation conducted outside of France by French domiciliaries are exempt from French income taxes provided that reciprocity exists.[12] Income earned by French domiciliaries is also exempt from earned income taxes, if the person has already paid the equivalent of two-thirds of the taxes that he would have paid in France or if the employee has been working abroad for over 183 days for twelve consecutive months in specific fields such as prospecting, mining of natural resources, or the installation, operation, and development of industrial projects.[13]

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[12] *Id*. at 240.

[13] *Id*. art. 81 A, at 61.

GERMANY[1]

I. Overview

Germany taxes resident individuals and corporations on their worldwide income. The resulting international double taxation is eliminated or mitigated through treaties and unilateral measures.[2] Germany has concluded double taxation treaties for income taxes with approximately fifty-five countries,[3] and aside from a few exceptions these exempt the income from foreign direct investments from German taxation. The primary method of unilateral relief for income from non-treaty countries is the foreign tax credit. Yet, in evaluating the competitive effects of German tax law, the treaty practice is of much larger importance than the unilateral measures.

Germany has also enacted various anti-avoidance provisions to stem abuses that otherwise would be possible under the overall system of foreign income taxation, and these were strongly

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[1] This report discusses taxation as developed in the Federal Republic of Germany. With the German unification of October 3, 1990, these rules have also become the law of the formerly East German states, subject to various transition rules: Unification Treaty, signed August 31, 1990, II *Bundesgesetzblatt* (BGBl, official law gazette of the Federal Republic of Germany) 885.

[2] Unless otherwise indicated, the information provided in this contained in: H. Gumpel, Taxation in the Federal Republic of Germany (CCH) 11/2 (l987-); and B. Arnold, *The Taxation of Controlled Foreign Corporations: An International Comparison* 226 (Canadian Tax Foundation, 1986).

[3] C. Bellstedt, "Körperschaftssteuer-Tarifsenkung," 34 *Recht der Internationalen Wirtschaft* 285 (1988).

influenced by American law.[4] The most important of these are: limitations on the inclusion of certain foreign losses in the determination of worldwide income; the taxation of income earned by foreign controlled corporations as an exception to the otherwise prevailing rule that the income of a foreign subsidiary is taxed by Germany only upon distribution to the German parent; and transfer pricing rules. On the whole, German tax law is very complex and this report merely attempts to highlight the essential features of German taxation of foreign source income with some emphasis on direct investments.

II. Income from Treaty Countries

Since the early 1960s, German tax treaties have been adhering to the principles of the OECD Model Convention[5] by employing, among other concepts, that of the foreign permanent establishment and by using both the exemption and credit method to grant relief from double taxation. The German use of these principles, however, has preceded the OECD model. Moreover, recent revisions of German tax treaties have deviated so significantly from the model that it no longer can be considered as a relevant basis for comparison.

Under most German tax treaties, business income and losses of a foreign permanent establishment are exempt from German taxation; nevertheless, some losses were until recently

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[4] H. Becker, "Germany (Federal Republic): Treaty Shopping/Treaty Override," 28 *European Taxation* 383 (1988).

[5] OECD, *Draft Double Taxation Convention on Income and Capital* (Paris, 1963); OECD, *Model Double Taxation Convention on Income and Capital* (Paris, 1977).

deductible by the German taxpayer upon application. This deductibility was based on a law of 1972 that encouraged foreign direct investments[6] but was repealed in 1988.[7] Also exempt from German taxation under most treaties are dividends received by a German corporation holding at least 10% of the foreign company's share capital. The exemption method also applies to income from real property as well as to personal service income. The latter, however, is exempt only if a residence test in the foreign country is met. For other types of income (e.g., royalties, portfolio dividends), the foreign tax is credited against the German tax.

When foreign source income is exempted under a treaty, the German taxpayer generally is not subject to any German tax on the income, and this is an advantage to German taxpayers investing in low tax countries. In fact, the German reliance on the exemption method for direct investments in the German treaty practice can be viewed as a conscious policy decision of encouraging the competitiveness of German industry.[8] However, the exemption of foreign source income does not grant the individual German taxpayer as big a benefit as appears at first glance, because the exempted foreign income is nevertheless included in the computation of German taxable income for the purpose of determining the rate of taxation. Generally, this works to the disadvantage of individual taxpayers whose income tax progresses to 53%. Corporate taxpayers are not affected

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[6] Auslandsinvestitionsgesetz vom 18. August 1969, I BGBl, p. 1214, as amended.

[7] Art. 8, Steuerreformgesetz 1990 vom 25. Juli 1988, I BGBl, p. 1093.

[8] R. Preuninger, *Rechtsprobleme des Funktionswandesl deutscher Doopelbesteuerungsabkommen* 49 and 213 (Mannheim, 1980).

because corporate profits are taxed at flat rates (36% for distributed profits and 50% for retained profits).

When foreign income taxes are credited under a treaty, the German unilateral relief measures of a credit or deduction for the foreign taxes remain applicable to the extent that the treaty has not fully eliminated the double taxation on the income. In addition, German treaties with developing nations provide for a tax sparing credit against the German tax. The purpose of this credit is to reduce the German tax by the taxes that the developing country could have imposed but refrained from imposing so as to encourage investment.[9]

[9] *Id*. at 288.

III. Income from Non-treaty Countries

a. In General

The direct foreign tax credit is the primary method of unilateral relief. In addition, an indirect foreign tax credit for taxes paid by a foreign subsidiary is available to German corporate taxpayers. German law provides two alternatives to the foreign tax credit. Instead of accepting the credit, the taxpayer may elect to deduct the foreign taxes, or to apply for taxation at a flat-rate of 25% for certain business income and employment income. The deduction of foreign taxes in lieu of the credit is of interest to a German taxpayer with a domestic loss situation. In such a case, the credit, which cannot be carried forward or back to other tax years, would be of no use to the taxpayer. The deduction is also available for foreign income taxes that do not qualify for the credit.

The flat-rate taxation, on the other hand, is granted upon annual application in cases when the use of the foreign tax credit would be unusually difficult. The flat-rate is not available for income exempted under a treaty. Therefore, this method of taxation is primarily of advantage to large German companies that operate in many foreign countries.[10] The flat-rate is granted by administrative decree on the basis of a statutory authorization that allows the finance ministers to forgive or settle by a flat-rate the German taxes on foreign income when this is in the German economic or administrative interest. In addition to the flat-rate taxation, this authorization has also been used to exempt the employment income of German residents from taxation for work

[10] L. Schmidt, *Einkommensteuergesetz* 1837 (München) 1989.

performed abroad on German construction, installation, or assembly projects.[11] This exemption is particularly beneficial for German projects in countries that do not impose an income tax.

The German foreign tax credit essentially establishes the same tax liability for German taxpayers with foreign source income as is imposed on German taxpayers with only domestic income. On the other hand, the flat-rate tax and the exemption of an assembly worker's income are incentives for foreign investment, as is the tax sparing credit granted for income from subsidiaries in developing countries. Additional incentives for foreign direct investments in general and for investments in developing countries in particular were introduced in 1972. These allowed for tax deferrals through the creation of reserves, as well as for the deductibility of star-up losses (before a newly created company earned income). These incentives have been repealed in recent years for various reasons, among them, the complexity of the rules and their potential for abuse.[12] Some of these measures were abolished in 1988, in the course of a major tax reform that simplified tax law while slightly reducing tax rates.

B. The Direct Foreign Tax Credit

The direct foreign tax credit is available to resident individuals and corporations in essentially the same manner. In addition, the direct tax credit also applies to non-resident

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[11] Auslandstätigkeitserlass, I *Bundessteuerblatt* 470 (1983).

[12] Gumpel, *supra* note 1 at 11/2.8; *supra*, notes 7 and 8; J. Wagner, *Das Steuerreformgesetz 1990* 313 (Düsseldorf, 1989).

individuals or entities maintaining a business establishment in Germany, for third country taxes in connection with such an operation.

The direct foreign tax credit is granted only for foreign taxes that are comparable to the German income tax. It is also available for foreign income taxes paid to states and other political subdivisions. Only foreign taxes levied on foreign source income as determined in accordance with German source rules are creditable and the amount of the credit is limited by the German tax that would otherwise be imposed on the total qualifying income in the particular country (per country limitation).

The per country limitation restricts the averaging opportunities between high and low tax countries. On the other hand, this limitation is beneficial to a German taxpayer who sustained a loss in one country while having realized income from another. The German foreign tax credit does not limit the averaging opportunities between high and low taxes within a country. The averaging of income from different categories or "baskets" that is prohibited in the United States is allowed in Germany. However, a somewhat similar approach to section 9(4)(d) of the U.S. Internal Revenue Code is taken in the German rules limiting the deductibility of foreign losses in determining worldwide taxable income; losses from certain categories of foreign direct investments are deductible only against income from the same category in the same country.[13]

[13] § 2a, Einkommensteuergesetz vom 27. Februad 1987, I BGBl, p. 657, as amended.

The governance of the German taxation rules for determining the creditable foreign taxes has the effect that foreign capital gains taxes are creditable only to the extent that they would be taxed according to German law. In Germany, capital gains on non-business assets of individuals are taxed only in the case of short-term gains on securities (6-months', holding period) and real estate (2-year holding period). Gains from business assets of individuals and gains from corporate assets are taxed.

C. The Indirect Tax Credit

The indirect or "deemed paid" tax credit is available only to German corporations (not individual taxpayers). The credit applies to the income or profits of first tier affiliates of the German parent if he owns at least ten percent of the share capital of the affiliate. Moreover, it is required that the affiliate company is primarily engaged in active business or trade. The credit applies to profits or income from second tier affiliates only if the second tier affiliate has its seat or management in the same country as the first tier affiliate and the active business requirements are met.

For the income from subsidiaries in developing countries, the indirect tax credit takes the form of a tax sparing credit which, in effect, leads to the exemption of the foreign source income from German taxation.

IV. Evaluation

The German rules for taxing foreign source income have much similarity with American principles. Both Germany and the United States tax resident individuals and corporations on their worldwide income and limit the resulting international double taxation through a tax credit as the primary unilateral measure. Among the main differences between the two countries is the higher rate of taxation in Germany (at least for individual incomes and undistributed corporate profits), and the exemption of foreign source income from the German tax through the tax treaties.

The current German system of foreign income taxation is the product of a lengthy development in which various measures were enacted for different policy reasons. The treaty practice, which historically preceded the unilateral relief measures, adheres to a policy of capital import neutrality and it favors investments in low tax countries. The direct and indirect tax credit, on the other hand, embodies a policy of capital export neutrality by subjecting resident taxpayers to the same level of taxation, regardless of where they carry out their business activities. The German tax credit was developed in the 1960s and 70s, some forty years after its introduction in America.

Some of the German alternatives to the foreign tax credit (flat-rate taxation and non-taxation of income of assembly workers) are incentives to foreign direct investment. The 1970s led to further legislation that encouraged foreign investments, but most of these benefits have again been repealed. Since the 1970s, German attention has focused on creating anti-avoidance rules to forestall abuses of the international taxation rules. The tax policy with regard to developing

countries, particularly the treaty practice, has demonstrated a strong inclination to encourage such investments.

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JAPAN

Introductory Summary

A Japanese corporation operating through a foreign branch office is subject to Japanese taxation on its foreign branch profits. A Japanese corporation operating through a subsidiary abroad is not subject to Japanese taxation on the subsidiary's profits until earnings are repatriated to Japan as a dividend.

Direct and indirect foreign tax credits may be used in order to avoid double taxation between the U.S. and Japan, under the Corporation Tax Law and the U.S.-Japan Tax Convention. All foreign taxes paid directly by a Japanese corporation, through a branch or any other operation, can be credited against Japanese corporate taxes, with certain limitations. For a U.S. branch of a Japanese corporation, a direct foreign tax credit is allowed for U.S. taxes imposed on the branch operations; for a U.S. subsidiary of a Japanese corporation, a direct foreign tax credit is also allowed for withholding tax imposed on dividends. In both cases, the limit of the credit is computed on the basis of the corporation's overall foreign taxes, not per country. An indirect foreign tax credit is allowed a parent Japanese corporation when the earnings of a foreign first tier subsidiary (but not a holding company) are repatriated to Japan as dividends, subject to certain conditions. An indirect credit is allowed for underlying U.S. federal and state income taxes that the Japanese parent corporation is deemed to have paid on dividends received from the subsidiary.

Japan has anti-tax haven provisions, similar to the U.S. Subpart F rules, that require a Japanese parent corporation to report the income earned by a designated tax haven subsidiary.

The Japanese tax rate for corporations is high (a possible combined rate of 59.39%) compared with the U.S. rate (34-40%). This burdensome rate and the advantages for a subsidiary to reinvest rather than repatriate earnings are incentives for Japanese investment in the U.S.

Classification of Taxpayers

Under the Income Tax Law of Japan,[1] a resident is defined as an individual domiciled in Japan or having a residence in Japan for one year or more but who is not a non-permanent resident. A foreigner who does not intend to reside permanently in Japan, but who has had either a domicile or a residence in Japan continuously for five years or less is a non-permanent resident; after five years, he becomes a resident. A resident is subject to tax on his worldwide income.

A non-permanent resident is taxable on income earned in a foreign country only if it is remitted to and received by him in Japan. A person who is not a resident or non-permanent resident is classified as a non-resident and must pay Japanese tax only on income from sources in Japan, not on income from sources outside the country.

[1] Art. 2, ¶1, items 3-5, of the Income Tax Law, Law No. 33, Mar. 31, 1965, as last amended by Law No. 239, Aug. 1, 1989.

Under the Corporation Tax Law,[2] a domestic corporation is defined as a corporation with its head office or principal office in Japan. Its tax payment is based on its worldwide income. The head office or principal office of a corporation is usually designated in the corporate charter.

A Japanese corporation operating through a branch office in another country is subject to Japanese taxation on its foreign branch profits. A Japanese corporation operating through a subsidiary in another country is not subject to Japanese taxation on its subsidiary's profits until earnings are repatriated to Japan as a dividend.

Foreign Tax Credit

In order to avoid double taxation, Japan adopts three methods of providing foreign tax credit: (1) direct foreign tax credit, (2) indirect foreign tax credit, and (3) a tax-sparing credit system. The latter applies only to 12 developing countries by virtue of the respective tax conventions concluded between Japan and these countries; the Corporation Tax Law does not provide for this credit system. Between the United States and Japan, the direct and indirect credit systems apply, in addition to the provisions of the Convention Between the United States and Japan for the Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income of 1972.[3]

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[2] Art. 2, ¶1, items 3-4 of the Corporation Tax Law, Law No. 34, Mar. 31, 1965, as last amended by Law No. 40, Mar. 31, 1989.

[3] Hereinafter referred to as the U.S.-Japan Tax Convention, this convention was signed in Tokyo on Mar. 8, 1971 and entered into force on July 9, 1972; TIAS 7365.

1. Direct Foreign Tax Credit

All foreign taxes paid directly by a Japanese corporate taxpayer, through branch operations or any other operation, are creditable against the Japanese corporation tax on ordinary income and on undistributed profits, and inhabitant tax, subject to the allowable limitations.[4] The limit on foreign tax credit is the lesser of foreign tax actually paid or an amount computed as follows:

$$\text{Japanese corporation tax \& inhabitant tax} \times \frac{\text{total foreign source income}}{\text{total ordinary income}}$$

For a U.S. branch of a Japanese corporation, a direct foreign tax credit is allowed for U.S. taxes imposed on a branch operation. For a U.S. subsidiary of a Japanese corporation, a direct foreign tax credit is also allowed for withholding tax imposed on dividends.[5] The limit is computed not on a country-by-country basis, but on the corporation's overall foreign taxes. Therefore, foreign taxes paid to high-rate foreign countries may be averaged with those paid to low-rate foreign countries.[6] The total worldwide income is the amount of ordinary income from whatever country it might be derived, before the deduction of any losses carried over from previous taxable years. If the amount of foreign tax accrued in any taxable year exceeds the limit computed for that year, the excess may be credited against the prefectural inhabitant tax and the municipal inhabitant tax to the maximum limit of the respective taxes, but no credit is allowed against enterprise tax. Any

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[4] Art. 69, ¶1-3, of the Corporation Tax Law.

[5] Levey, *ed. Foreign Investment in the United States* 78 (1989).

[6] Arnold, *The Taxation of Controlled Foreign Corporations* 270 (Toronto, 1986).

excess foreign tax credits still remaining may be carried over for the next five succeeding years or carried back to the five preceding years.[7] The uncredited portion of any foreign tax not fully credited against the Japanese corporation tax for a given business year may be carried over for the next three years.[8]

2. Indirect Foreign Tax Credit

As was noted above, Japan does not tax the income of a Japanese corporation that conducts business through a subsidiary in another country. However, tax at the normal corporate rate (37.5%) is imposed on the parent corporation when earnings are repatriated to Japan as a dividend. In this instance, the parent corporation is entitled to an indirect foreign tax credit provided that the following two conditions are met: (1) 25% or more of the shares with voting rights or capital of the foreign subsidiary are owned by the Japanese parent corporation and have been owned by it for at least six months, and (2) the foreign subsidiary has been established only for the purpose of carrying on business in that foreign country and not for the purpose of avoiding Japanese tax.[9]

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[7] Yuji Gomi, *Guide to Japanese Taxes, 1990-91* 228 (Tokyo, 1990).

[8] *Id*. at 229.

[9] Art. 69, ¶4-5, of the Corporation Tax Law.

Under the provisions of the U.S.-Japan Tax Convention, indirect foreign tax credit is allowed for a Japanese parent corporation that owns more than 10% of the voting shares of a foreign subsidiary established in the United States from which it receives dividends.[10]

When both foreign tax and dividends are paid out by the subsidiary, the Japanese parent corporation is deemed to derive income for itself. Creditable foreign taxes include national or local foreign taxes that are similar to Japanese corporation tax. If the foreign tax rate is higher than 50%, the foreign tax allowed for foreign tax credits is limited to an amount equal to the 50% tax rate.[11] The indirect foreign tax credit is computed as follows:

Foreign tax paid by subsidiary

X dividends received by Japanese corporation

after tax income of subsidiary

Since the indirect foreign tax credit is applicable to first-tier subsidiaries, no tax credit is allowed for foreign income taxes paid by lower tier subsidiaries. Furthermore, no credit is allowed in Japan if the first tier subsidiary is merely a holding company.[12] For a U.S. subsidiary, an indirect credit is allowed for underlying U.S. federal and state income taxes that the Japanese parent corporation is deemed to have paid on the dividends received from the subsidiary.

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[10] Art. 5(1)(b) of the U.S.-Japan Tax Convention.

[11] Levey, *supra* note 4, at 78.

[12] Woodberry & Zimmerman, "Tax Planning for Japanese Investment in the United States," 11 *Hastings Int'l & Comp. Law Rev.* 414 (1988).

Accrued foreign taxes may, at the corporation's option, be deducted from taxable income as necessary expenses. If a domestic corporation elects to take foreign taxes as a credit, such foreign corporation taxes may not be deducted. The corporation must exercise its option on the total amount of foreign taxes accrued in each taxable year.

Tax Haven Legislation

The Special Taxation Measures Law contains anti-tax haven provisions. Under these provisions, a Japanese parent corporation is required to report the income earned by a designated tax haven subsidiary.[13] About 40 jurisdictions (countries, territories, international companies) are designated by the Ministry of Finance.[14] These jurisdictions are divided into three groups: (1) jurisdictions where there is no income tax or the tax is assessed at a significantly lower rate (less than 25%), such as the Bahamas and Hong Kong; (2) jurisdictions where foreign source income is tax-free, such as Panama and Uruguay; and (3) jurisdictions where certain lines of business are tax-exempt or taxed at a significantly lower rate (less than 25%), such as The Netherlands and Switzerland.

If a Japanese corporation owns 10% or more of the issued stocks of a foreign corporation in a tax haven, a proportional part of the undistributed profits of the tax haven company will be included in the gross income of that Japanese corporation because the profits are deemed

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[13] Art. 66-6, Law No. 26, Mar. 31, 1957, as last amended by Law No. 64, June 30, 1989.

[14] Gomi, *supra* note 7, at 187. *See also* Ministry of Finance Notification No. 38, 1978.

distributed to the Japanese shareholder. A designated tax haven subsidiary means a foreign corporation that has a head office or principal office located in a tax haven country or territory, and more than 50 % of the tax haven country's stocks or capital is owned directly or indirectly by residents or domestic corporations.

Comparison of Japanese Tax Rates With U.S. Rates

Japan imposes a national corporate tax at a standard rate of 37.5% (42% prior to April 1, 1988); it also imposes a local inhabitant tax (8.69%) and a local enterprise tax (13.2%). The U.S. standard corporate tax rate is 34-40% (*please see Attachment I*). Thus, it is possible for a Japanese corporation that does not distribute any income to pay a combined rate of 59.39% (63.89% prior to April 1, 1988).

From the above, it can be seen that Japanese tax rates are quite high as compared with U.S. tax rates. As a result, underlying U.S. income tax and withholding tax are usually insufficient to offset income received from a U.S. subsidiary (*please see Attachment II*). An example has been given[15] of a Tokyo-based Japanese parent corporation whose effective tax rate on dividend income is 56% (the 1988 rate), versus an effective combined U.S. federal and state income tax rate before withholding of about 40% in California. With the inclusion of the 10% U.S. withholding tax, the total effective U.S. tax rate mounts to about 46%. In this kind of situation, since the Japanese enterprise tax (13.2% rate, as above) cannot be offset by foreign tax credits, the Japanese parent

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[15] Woodberry & Zimmerman, *supra* note 12, at 419-420.

may prefer to have its U.S. subsidiary defer payment of dividends and reinvest earnings in the U.S., so as to avoid both the U.S. withholding tax and the additional Japanese tax.

Thus, Japanese taxes can be a heavy burden for Japanese corporations. This fact alone may provide an additional incentive for Japanese investors to invest in the United States. Furthermore, as the example illustrates, the high Japanese tax rates may discourage U.S. subsidiaries from repatriating their U.S. incomes to Japan and encourage them to reinvest in the United States to lessen the corporation's overall tax obligation.

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SOUTH KOREA

Classification of Taxpayers[1]

Korea's jurisdiction over taxpayers is based on their residence and the source of their income. It is clearly implied in the statutory provisions of Korean tax laws[2] that residents (individuals domiciled in Korea or who have had a residence there for at least one year) and domestic corporations are taxed on worldwide income, without regard to its source. Non-residents (individuals who are not residents as defined above) and foreign corporations (those with the head office or principal office abroad)[3] are taxed only on domestic source income.

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[1] The information in this report is summarized from a lengthy study, Chang-Rok Woo, "Tax Haven Opportunities for Korean Persons," *in Business Laws in Korea* 492-545 (2d ed., Seoul, 1989.).

[2] Corporation Tax Law, Law No. 1964, Nov. 29, 1967, as last amended by Law No. 3794, Dec. 23, 1985; Income Tax Law, Law No. 2705, Dec. 24, 1974, as last amended by Law No. 4019, Dec. 26, 1988.

[3] The term "principal office" is not defined in Korean tax law. It has been assumed that the principal office test is the same as other countries' "control or management test" as the test for determination of residence of a corporation. "Principal office" may mean the same as "head office" in the construction of Korean statutory terminology--the difference being that a (profit-oriented) juridical person's address under the Commercial Code is translated as "head office," whereas the address of a (non-profit oriented) juridical person under the Civil Code is translated as "principal office"--but it is unclear whether they are equivalent for tax purposes. As a result, "To date, the criteria for residence of a corporation that does not have a head office in Korea but is controlled and managed in Korea is an open question." Chang-Rok Woo, *supra* note 1, at 517.

Taxation of Foreign Source Income

Since Korean residents and domestic corporations are normally taxed on their worldwide income, a domestic corporation operating through a branch office in another country is subject to Korean corporation tax even though the income is not repatriated to Korea. However, the foreign subsidiary of a domestic corporation is recognized for tax purposes as a separate entity. Therefore, only income from it in the form of dividends repatriated to Korea is subject to Korean tax.

Foreign Tax Credit

In order to avoid double taxation, Korean tax laws allow a foreign tax credit for residents and domestic corporations. There are three categories of taxes levied by foreign governments that qualify for such credit: 1) taxes on excess profits and other taxes levied on the tax basis income, etc.; 2) surtaxes on corporate profit taxes; and 3) taxes on gross corporate revenues if such taxes are levied in lieu of a corporate profit tax.

Korean tax laws allow foreign tax credit only for residents and domestic corporations and only for taxes paid by the taxpayer. Korean tax laws, unlike those of the U.S., do not allow deduction of foreign taxes based on income or on their equivalent. Foreign tax credit is limited to the amount of Korean taxes that may be allocated to the taxpayer's foreign source income, based on the following formula for maximum credit allowed:

$$\text{Korean corporation tax/income tax} \times \frac{\text{foreign source income}}{\text{entire taxable income}}$$

The Korean corporation tax and income tax are calculated at a maximum rate of 33% and 55%, respectively.

Since the foreign source income of a resident taxpayer is computed not on a country-by-country basis, but on its foreign taxes overall, the profit or loss of a subsidiary in one country will affect the credit limit allowable on all the foreign taxes paid. In other words, loss operations will have a negative impact on the amount of foreign tax credit allowed and therefore threaten tax savings, whereas maximizing foreign source income on which no or low foreign tax is paid will have a positive effect on the amount of foreign taxes to be paid. Furthermore, as there is no provision in Korean tax law that allows excess foreign taxes to be carried forward or backward beyond the limitation, it is especially important to increase the foreign tax credit limit in order to secure tax savings.

Tax Haven Benefits

There are no specific provisions in Korean tax laws concerning tax havens, nor is the concept familiar to taxpayers or the government. Even material on the subject of tax haven operations in Korea is scarce.

Since there is no provision under Korean tax law on the taxation of Korean shareholders on income earned by Korean-controlled foreign corporations, taxholders may use holding companies in tax havens in order to minimize their overall tax burden and to gain the benefits of tax deferral. Indeed, it has been suggested that the use of subsidiaries in tax havens by such entities

as Korean export corporations or financial institutions might prove especially advantageous to Korean taxpayers.

Tax Incentives for Overseas Investment

Under the Tax Exemption and Reduction Control Law,[4] the dividend income that a domestic corporation receives from a foreign corporation in which it invests for the purpose of developing certain natural resources is exempt from Korean taxation insofar as that income is tax-exempt in the source country. In addition, income received from investments in certain overseas research development projects made with government approval is exempt from corporation tax and income tax, nor is this dividend income to be considered in the computation of presumptive dividends. The Law also has several provisions concerning deductible reserves for exports, foreign operations, overseas investment, and special accelerated depreciation. At the end of the third year from the year in which a reserve is established, the unused balance of the reserve reverts to taxable income distributed equally over the subsequent four years.

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[4] Law No. 3481, Dec. 31, 1981, as last amended by Law No. 4021, Dec. 26, 1988.

SINGAPORE

Overview

The highlights of the system under which residents of Singapore are taxed on their income from investments abroad can be summarized as follows:

--the income tax is based on the principle of territoriality, under which tax will as a rule be paid only on income derived from abroad and remitted into Singapore;

--a tax credit may be allowed for foreign income taxes paid on foreign source income by Singapore residents;

--income from portfolio investments abroad is taxable if the dividends are remitted to Singapore.

Specific Features

The taxation of investment income earned by residents of Singapore is governed by the Singapore Income Tax Act first passed in 1947, by regulations passed thereunder, and by the tax treaties into which Singapore has entered with other countries.[1]

The taxation of income in Singapore is based on the principle of territoriality, and basically the same rules are applicable in determining the income of both individuals and corporations. However, a distinction is drawn between residents and non-residents. Thus, a resident individual

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[1] Income Tax Act (hereafter: the Act), *in Tax Laws of the World: Singapore* (Ormond Beach, Fla., 1990).

will be taxed on income accruing in or derived from Singapore or received in Singapore from sources outside the country, while a non-resident individual will be taxed only on income generated in Singapore and not on remittances of income from sources outside Singapore. Resident companies are taxed on income arising in Singapore and on foreign income if remitted to Singapore. Non-resident companies with an establishment in Singapore are taxed on their Singapore-source income. The Singapore tax authorities have taken the view that such a non-resident company can also be liable for tax on its foreign source income remitted to Singapore, but it has not been conclusively held that such an interpretation is in accordance with the general principles of Singapore income tax law.[2]

Therefore, where foreign-source income is earned or received indirectly in Singapore through a non-resident company, the liability to pay Singapore tax on that income will depend upon whether or not that non-resident company has an establishment in Singapore. Non-resident companies without an establishment in Singapore will be taxed on Singapore-source income only and not on income from foreign sources, whether or not such foreign income is remitted into Singapore.

A resident is defined, in relation to an individual, as a person who, in the year preceding the year of assessment, resides in Singapore except for such temporary absences as may be reasonable and not inconsistent with the claim to be resident. The definition includes a person

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[2] "Singapore," *in* 4 *Taxes and Investments in Asia and the Pacific* (Int'l Bureau of Fiscal Documentation) 51 (Supp. No. 69, May 1990.)

who is physically present in Singapore for 183 days or more during that year. In relation to a company or body of persons, a resident is defined as meaning a company or body of persons the control and management of whose business is exercised in Singapore.[3]

Thus, an individual physically present in Singapore for a period of at least 183 days in any calendar year will be liable to income tax for the succeeding tax year. Such a resident will be taxed on income from investments abroad, but only if the income is either received in Singapore or remitted thereto.

In determining the place of residence of a company, it is assumed that the control and management of the company is exercised in the place where the persons appointed by the company's constitution to manage the company's affairs actually exercise their functions of ultimate control, which is to say, where the Board of Directors meets and conducts the company's business. Resident individuals are liable to income tax, levied at graduated rates, beginning at 3.5% and rising to a maximum of 33%. Companies are taxed on their chargeable income at the rate of 32%. However, there are many special provisions for particular types of business, which would lead to either a lower rate of taxation or complete exemption from income tax. Offshore income of an Asian Currency Unit of a financial institution, for example, is taxed at the concessionary rate of 10%.[4]

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[3] The Act § 2(1), *supra* note 1, at 10.

[4] Int'l Bur. Fisc. Doc., *supra* note 2, at 91.

Where a non-resident person or company carries on business with a resident person or company and the non-resident controls the resident, that non-resident may be liable to pay tax in Singapore if the course of business is arranged in such a manner that the resident receives less than the ordinary profit that would arise between unrelated parties. In such a case, the non-resident may, in the name of the resident, be assessed on a "fair percentage" of the profits derived from the trading, as if the resident is an agent of the non-resident.[5] Also, if the true amount of taxable income cannot be readily ascertained, it will be determined as a fair and reasonable percentage of the turnover of the business done by the non-resident with the resident.[6] Subsidiaries are generally taxed separately from their parent and sister companies, but the above provisions may be applied in determining the tax liability of branches and subsidiaries.

Under the Income Tax (Concessionary Rate of Tax for Asian Currency Unit Income) Regulations of 1988, a number of types of transactions have been made subject to the 10% concessionary rate of tax on the resulting income. Approved securities companies also pay the same reduced rate on income derived after September 16, 1988, from trading in non-Singapore dollar securities with non-residents, ACUs, and other approved securities companies.

For purposes of taxation, investment companies are classified into two categories: investment dealing companies and investment holding companies. While investment dealing

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[5] The Act, § 52(2), *supra* note 1, at 110-111.

[6] The Act, § 52(3), *supra* note 1, at 111.

companies are taxed the same as ordinary trading companies, investment holding companies are governed by some special rules. The investment income of such holding companies is deemed not to be trading income, with a consequent restriction on the deductions that may be taken.

Dividends received from abroad are taxable only if they are received in Singapore.

The Income Tax Act grants relief from double taxation with respect to tax paid in a Commonwealth country with which Singapore does not have a treaty arrangement. Residents of Singapore will be entitled to a credit against their Singapore tax if the Commonwealth tax rate does not exceed one half of the Singapore rate of tax. Otherwise, one half of the Singapore tax is granted as a relief.

Section 48(a) pertains to a resident of Singapore and specifies that if the rate of Commonwealth tax does not exceed half of the rate of tax appropriate to his case under the Singapore Income Tax Act, the rate at which relief is to be given is to be the rate of Commonwealth tax, and section 48(b) provides that in any other case the rate at which relief is to be given is to be half the rate of tax appropriate to his case. Therefore, if the Commonwealth tax rate is higher than half the Singapore tax rate, the Singapore resident still has to pay the other half of the Commonwealth or foreign tax.[7]

The question then is whether or not this foreign tax is deductible from the chargeable income of the Singapore resident? According to section 15 of the Income Tax Act, any foreign

[7] The Act, § 48, *supra* note 1, at 104-105.

income taxes paid are not deductible as a business expense which would then be used to set off income for the computation of profits. Any foreign taxes paid over and beyond any relief available, under either the provisions for Commonwealth countries or for countries with which Singapore has a double taxation treaty, will have to be paid by the taxpayer without any set-off.[8]

Section 50A provides for a unilateral tax credit, available with respect to countries with which double taxation agreements exist, to be extended to residents of Singapore for foreign tax paid in respect of income from professional, consultancy, and other services as may be so prescribed, and including income from employment, in territories with which no double taxation agreements have been concluded. Such territories are to be announced by ministerial regulation, according to the same section. It was not possible to determine what territories have been so named to date, but obviously any such countries would be outside the Commonwealth, since provision is made elsewhere in the Income Tax Act for Commonwealth countries.[9]

Singapore has signed treaties with a number of countries for the avoidance of double taxation, under which specified foreign taxes, generally income taxes, are allowed as a credit against the taxpayer's Singapore tax. Tax-sparing provisions are to be found in some of these agreements, generally relating to tax foregone under the Singapore Economic Expansion

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[8] *Id*. at 44.

[9] *Id*. at 108.

Incentives (Relief from Income Tax) Act of 1967. Examples are its treaties with Australia[10] (Art. 18), Denmark[11] (Art. 20), India[12] (Art. 24), and Japan (Art.).[13]

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[10] Art. 18, in P.O.G. Hong and L. Chan, *Handbook of Singapore Tax Statutes* 255-623 (Singapore, 1986).

[11] Art. 20, *id*.

[12] Art. 24, *id*.

[13] Art. 21 *id*. .

TAIWAN (REPUBLIC OF CHINA)

Under the Income Tax Law, individuals are taxed on income from sources in the Republic of China (ROC) only.[1] Profit-seeking enterprises, however, if they operate within the territory controlled by the Republic of China (Taiwan and several other islands), are taxed on income derived both inside and outside that territory. If outside income has already been taxed by the source country, that tax may be credited against the amount of tax owed in the Republic of China, provided that evidence of the tax payment is presented (art. 3). The amount of the deduction is not to exceed what the tax on that income would be under ROC law. The system for taxation of foreign investments, at least those by enterprises rather than individuals, is thus in general outline similar to that of the United States.

There have also been tax incentives for investments in certain fields under the Statute for the Encouragement of Investment.[2] The fields included manufacturing, handicrafts, mining, agriculture, forestry, fishery, animal husbandry, transportation, warehousing, public utilities, construction of public facilities, construction of public housing, technical services, hotels, and construction involving the use of heavy machinery. This Statute expired at the end of 1990[3]; new legislation was adopted December 26, 1990, by the Legislative Yüan, and went into effect January

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[1] Art. 2, Income Tax Law, promulgated Feb. 17, 1943, as amended, Dec. 30, 1987.

[2] Promulgated Sept. 10, 1960, as amended on Jan. 26, 1987.

[3] Art. 89, Statute for Encouragement of Investment (hereafter: the Statute), *id.*

1, 1991,[4] but the text is not yet available in the Library. Under the Statute as it was, when an enterprise made investments in particular areas, it was eligible for either a four or five-year period of tax exemption or accelerated depreciation of fixed assets.[5] Furthermore, if the enterprise elected the exemption, it could delay the start of the period for up to two years.[6] These investment incentives were applied to venture capital investments abroad when

1) investment is in the exploration, development, or processing of natural resources which would be shipped back to the ROC; or

2) investment is in the production or processing or agricultural and industrial raw materials specifically identified by the government, whether the products were to be sold domestically or overseas; or

3) investment is designed to transfer to the ROC technologies as specified by the government; or

4) investment is in enterprises specified by the government, with the product to be sold domestically or overseas.[7]

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[4] According to Mr. F. Huang of the Coordination Council for North American Affairs, in a phone conversation Feb. 7, 1991. The Council is the representative of Taiwan in the United States.

[5] Art. 6, the Statute, *supra* note 2.

[6] Art. 7, *id*.

[7] Art. 8, *id*.

UNITED KINGDOM

Scope of Taxation

The United Kingdom taxes all resident individuals on their worldwide income.[1] The income of non-residents is taxed only if it arose in the United Kingdom. Similarly, a company resident in the United Kingdom is subject to a corporation tax on all profits, including that from foreign sources.[2]

These rules are subject to two main qualifications. First, in some cases, tax is only payable if the foreign income is remitted to the United Kingdom. Secondly, since such income may be liable to taxation in the country in which it arises, a credit, exemption, or deduction may be available for the foreign tax paid.

Taxation of Individual Foreign Investment

The overseas investment income of United Kingdom residents is taxed in the full amount. The basic rate of income tax is, however, in the following two cases charged only if the income is remitted to the United Kingdom: first, income received by a resident who is not domiciled in any part of the United Kingdom, and second, income received by residents who are citizens of the

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[1] Income and Corporation Taxes Act (ICTA), 1988, ch. 1. Some differences apply if the individual though resident is not "ordinarily resident" or domiciled in the United Kingdom. Non-residents are taxed only on income derived from United Kingdom sources.

[2] ICTA, §§ 6(1) and 8(1). Until 1988, residence of a company was determined by whether central control and management was exercised in the United Kingdom. Now a United Kingdom incorporated company is treated as a resident regardless of where the management or control is exercised: Finance Act, 1988, ch. 39, § 66 and Sched. 7.

(British) Commonwealth or of the Republic of Ireland but are not "ordinarily resident"[3] in the United Kingdom.[4]

There are anti-avoidance provisions to prevent the exploitation of the liberal remittance basis. Thus, where foreign income is used to discharge a loan made in the United Kingdom, it is considered as having been remitted to the United Kingdom.[5] Similar, but more elaborate, schemes are also proscribed.

Taxation of Foreign Corporate Income

A resident company is subject to Corporation Tax (CT) on all its profits, wherever arising and regardless of whether it is remitted to the United Kingdom. The current rate of CT is thirty-five percent.

The profits of a foreign subsidiary owned by a United Kingdom company are taxed only when they are remitted to the country in the form of interest or dividend. Since 1984, however, United Kingdom companies are also taxed on the income of "controlled foreign companies," i.e. companies that are resident in a tax haven or low tax-rate country but are controlled by United Kingdom residents. The tax is imposed if ten percent or more of the income of a controlled foreign company is distributed to a United Kingdom resident company.[6] These provisions are "intended to prevent the avoidance of CT by resident companies through the accumulation of profits in tax

[3] No statutory definition of "ordinarily resident" is provided, but it is considered to connote residence which is habitual or coupled with a degree of certainty.

[4] ICTA, § 65(4).

[5] *Id.* § 65(6).

[6] *Id.*, §§ 747-756.

haven subsidiaries."[7] However, under a motive test, the tax is not applicable if it was not the main purpose of the transactions to achieve a reduction in the tax and the company was not set up with the main purpose of avoiding tax.

Additionally, interest earned on investments in certain "offshore funds" is also liable to CT. The tax arises if at the time of the acquisition it is reasonably expected that the interest earned in seven years would approximate the market value of a fund's underlying assets.[8]

Foreign Tax Relief

To ameliorate the situation in which the United Kingdom and another country together seek to tax particular income, the United Kingdom has entered nearly one hundred of bilateral conventions for the avoidance of double taxation. Where such treaties exist, the United Kingdom tax is reduced by a credit of the foreign tax paid.[9] Even in the absence of a convention with a country, the United Kingdom may grant a deduction against a domestic tax on income taxed abroad.[10] The income derived by United Kingdom residents from foreign investment is granted relief from double taxation under both these provisions.

The amount of double tax relief, however, cannot exceed the amount of United Kingdom tax that would have been paid or incurred on the foreign income.[11] Thus, where the rate of tax in

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[7] Darlington and Sandison, 68-8th T.M. *Business Operation in the United Kingdom -- Taxation*, A-90 (1988-).

[8] ICTA, §§ 757-764.

[9] *Id.*, § 793.

[10] *Id.*, § 790.

[11] *Id.*, §§ 796 & 797.

a foreign country exceeds the United Kingdom rate, the excess is not deductible, nor can it be carried forward for deduction against future foreign income.

A company may also obtain relief on dividends received from a foreign company if it controls not less than ten percent of the voting power of the foreign company. There is no "tiering" effect as provided in the United States law. The foreign tax credit is available in respect of the profits of a third or fourth foreign company paying a dividend to a foreign company paying a dividend to the United Kingdom company, provided the ten percent ownership rule is met.[12]

Another difference with the United States system is that the United Kingdom does not permit the aggregation of foreign income and foreign tax from different sources. Thus, averaging of all foreign tax rates is not allowed. The argument against aggregation is that it could produce an inequity of treatment between different taxpayers.

In common with other developed countries, the United Kingdom provides in its double taxation conventions, credit for tax sparing, e.g., a moratorium during which no tax is payable by a foreign investor in a developing country. The United Kingdom investor is deemed to have paid the tax exempted in the developing country and a tax credit is granted for the tax.

A United Kingdom taxpayer may disclaim a foreign tax credit and instead claim a deduction from income of the foreign tax paid.[13] This is advantageous in cases where because of an available loss, no United Kingdom tax is payable. In such cases a foreign tax credit is useless whereas a deduction gives a greater loss for carrying forward against future income.

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[12] *Id.*, § 801.

[13] *Id.*, §§ 805 and 811.

Inter-company Pricing

Transfer pricing is counteracted with the object of preventing the export of profits through artificial pricing arrangements between companies. An example of such an arrangement occurs when a United Kingdom corporation charges its foreign subsidiary an artificially low price for goods sold. Under the anti-avoidance provisions, an arm's length transaction price may be substituted for the low price and income computed accordingly.[14]

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[14] *Id.*, § 770.