Taxation of Passive Foreign Investments

Brazil • China • France • India • Japan • Mexico
South Africa • United Kingdom

September 2009

LL File No. 2009-003270
LRA-D-PUB-000257

The Law Library of Congress, Global Legal Research Directorate
(202) 707-5080 (phone) • (866) 550-0442 (fax) • law@loc.gov • http://www.law.gov

This report is provided for reference purposes only.
It does not constitute legal advice and does not represent the official opinion of the United States Government. The information provided reflects research undertaken as of the date of writing.
It has not been updated.

2009-003270

LAW LIBRARY OF CONGRESS

COMPARATIVE SUMMARY

TAXATION OF PASSIVE FOREIGN INVESTMENTS

I. Introduction

The country reports provided address the issue of the tax treatment given to passive individual investments made by individuals from the United State under the laws of Brazil, China, France, India, Japan, Mexico, South Africa, and the United Kingdom.

The reports (except for the report on Mexico) also discuss the avoidance of double taxation treaties existing between the United States and the above enumerated jurisdictions, if any, and their application to the issue at hand.

II. Taxation of Dividends, Interests and Real-Estate Investments

With the exception of India, all of the countries surveyed appear to impose taxation on returns realized from real estate related investments made by a non-resident. An investment in real-estate gives rise to taxable capital gains in the event of disposal of the property in France, Mexico, and South Africa. In South Africa, the non-resident investor is taxed only if he/she had at least a 20% interest in a company or entity at least 80% of whose equity was tied to real estate investment. In China and the United Kingdom, an interest of a non-resident in real estate is subject to income tax upon disposal of the property. China also imposes income taxes on returns from investments on rental property. In Brazil, matters of taxation of investments on real estate are under the jurisdiction of local governments.

Brazil, China, France, and Japan impose taxes on dividends earned by individual non-resident investors. In Brazil, such dividends are exempt from taxation if they are re-invested in the country. In France, the taxes imposed on dividends earned by United States investors are lower than those that other non-residents are required to pay due to the tax treaty that France has with the United States. India, Mexico, South Africa, and the United Kingdom do not impose taxes on dividends.

France and South Africa do not impose taxes on interest earned by non-resident investors. The United Kingdom imposes taxes on interests earned by non-residents, except for those investors from the United States who are exempted under the provisions of the double tax treaty that exists between the United Kingdom and the United States. China, Japan and Mexico impose taxes on interest earned by non-resident individuals, while India only levies such taxes from companies.

III. Avoidance of Double Taxation Treaties

All of the countries surveyed with the exception of Brazil have entered into an avoidance of double taxation treaty with the United States. While the reports do not provide an in-depth analysis of the various treaties, they do discuss the relevant provisions.

The Avoidance of Double Taxation Treaties that the United States has with China, France, South Africa, and the United Kingdom all provide that gains realized from investment on real estate by a United States investor may be taxed in the country where the property is situated.

Prepared by Hanibal Goitom
Foreign Law Specialist
September 2009

2009-003270

LAW LIBRARY OF CONGRESS

BRAZIL

TAXATION OF PASSIVE FOREIGN INVESTMENTS

Executive Summary

Foreign capital as well as the remittance of profits abroad are regulated by Law No. 4,131 of September 3, 1962, which determines that all foreign capital entering into the country, as well as remittance of funds abroad, must be registered with the Brazilian Central Bank. It also defines foreign capital for investment purposes, and lists the types of income subject to taxation and the respective rates.

Foreign investors may acquire real estate as long as some requirements are met. However, certain restrictions are imposed on properties located in rural or coastal areas. Taxation is carried out at the municipal level and the rates vary according to the value of the property.

Before investing in the Brazilian capital market, a foreign investor must meet a few requirements established by the national Monetary Council and register with the appropriate authorities. On December 21, 2004, Law No. 11,033 reduced from 20% to 15% the income tax rate of profits derived from transactions on the stock exchange market and other transactions, and adopted a progressive tax schedule according to the length of time of the investment.

I. Introduction

This report covers the Brazilian laws that may be applicable and relevant to the taxation of foreign investments. It provides the definition of foreign capital; identifies the types of income subject to income tax and the respective tax rates; and lists the requirements for acquiring real estate and the taxation involved, as well as the regulation and taxation of capital markets.

II. Foreign Capital

A. Constitutional Principle

Article 172 of the Brazilian Constitution determines that the law must regulate, on the basis of national interests, foreign capital investment, grant incentives for reinvestments, and remittance of profits.[1]

B. Law No. 4,131 of September 3, 1962 – Foreign Capital Investment Law

Foreign capital investments and the remittance of profits abroad are regulated by Law No. 4,131 of September 3, 1962,[2] and Law No. 4,390 of August 29, 1964.[3] Decree No. 55,762 of February 17, 1965,[4] regulates Law No. 4,131 as amended by Law No. 4,390.

C. Definition of Foreign Capital

Foreign capital is defined as goods, machinery, and equipment that enter in Brazil with no initial expenditure of foreign exchange, for the purpose of production of goods or services, as well as any financial or monetary resources brought into the country to be used in economic activities, provided that, in both cases, they belong to individuals (*pessoas físicas*) or companies (*pessoas jurídicas*) that have their residence, domicile or headquarters abroad.[5]

The same legal treatment applied to domestic investment capital is applied to foreign investment capital, and any discrimination in this regard is prohibited except the ones foreseen in Law No. 4, 131 of September 3, 1962.[6]

Article 3 of Law No. 4,131 created in the Superintendence of Currency and Credit (*Superintendência da Moeda e do Crédito*), now the Central Bank of Brazil (*Banco Central do Brasil*),[7] a special service to register the entrance of foreign capital, whatever

---

[1] CONSTITUIÇÃO DA REPÚBLICA FEDERATIVA DO BRASIL DE 1988 [C.F.] art. 172, *available at* the website of the Brazilian Presidency, http://www.planalto.gov.br/ccivil_03/Constituicao/Constituiçao.htm.

[2] Lei No. 4.131, de 3 de Setembro de 1962, *available at* http://www.planalto.gov.br/ccivil_03/Leis/L4131-Compilada.htm.

[3] Lei No. 4.390, de 29 de Agosto de 1964, *available at* http://www.planalto.gov.br/ccivil_03/LEIS/L4390.htm#art3.

[4] Decreto No. 55.762, de 17 de Fevereiro de 1965, *available at* http://www.planalto.gov.br/ccivil_03/decreto/Antigos/D55762.htm.

[5] Lei No. 4.131, de 3 de Setembro de 1962, art. 1.

[6] *Id.* art. 2.

[7] On December 31, 1964, article 8 of Law No. 4,595 transformed the Superintendence of Currency and Credit into the Central Bank of the Republic of Brazil. Law No. 4,595 of December 31, 1964, is *available at* http://www.planalto.gov.br/ccivil_03/Leis/L4595compilado.htm.

its form of entry in the country, as well as international financial transactions, which must register, inter alia:

- All foreign capital that enters into the country under the form of direct investment or a loan, in cash or goods;[8]

- Remittances sent abroad as a return of capital or as income of this capital, profits, dividends, interest, and depreciation, as well as royalties, payments for technical assistance, or any other evidence involving the transfer of income out of the country;[9] and,

- The reinvestments of profits of foreign investment capitals.[10]

D. Taxation

Article 41 of Law No. 4,131 lists the types of income subject to income tax, including, inter alia, dividends and any bonuses paid by shares (*ações ao portador*);[11] and profits, dividends and any other benefits derived from nominal shares, or other title, obtained from the capital of companies that are received by individuals or companies with residence, domicile, or headquarter abroad, or by subsidiaries of foreign companies.[12]

An additional income tax is imposed on the profits and dividends of foreign investments that are distributed to individuals or companies with residence or headquarters abroad every time the average of distributions in a three-year period exceeds 12% of the capital and reinvestments registered according to articles 3 and 4 of Law No. 4,131.[13]

The additional income tax is imposed according to the following schedule:[14]

- For profits between 12% and 15% over the capital and reinvestments →40%;

- Between 15% and 25% → 50%;

- Above 25% → 60%.

---

[8] Lei No. 4.131, art. 3(a).

[9] *Id.* art. 3(b).

[10] *Id.* art. 3(c).

[11] *Id.* art. 41(a).

[12] *Id.* art. 41(c).

[13] *Id.* art. 43.

[14] *Id.* art. 43(§1).

The dividends and profits reinvested in the country as established in article 7 of Law No. 4,131 are exempt from the additional taxation determined by article 43 of Law No. 4,131.[15]

Article 7 defines as reinvestments, for the purpose of Law No. 4,131, the income earned by companies established in the country and paid to individuals or entities resident and domiciled abroad that is reinvested in the same companies or in another sector of the national economy.[16]

Profits from the sale of real estate, including the assignment of rights (*cessão de direitos*), when the owner is an individual or legal entity resident or headquartered abroad, are subject to income tax at the rates provided by article 43 of Law No. 4,131.[17]

In case of breach of any of the provisions established by Law No. 4,131, the agent is subject to a penalty, without prejudice to the specific penalties provided in the law and those applied by the Central Bank of Brazil, according to the regulations established by the National Monetary Council (*Conselho Monetário Nacional*).[18]

III. Income Tax Law

Income tax is regulated by Decree No. 3,000 of March 26, 1999 (*Regulamento do Imposto de Renda - RIR*).[19] According to article 3, income of any nature received in the country by individuals (*pessoa física*) that are resident or domiciled abroad are subject to income tax,[20] depending on the income bracket, at rates of 15% to 25%,[21] and legal entities (*pessoa jurídica*), whether commercial or civil, at a rate of 15% on net profits.[22]

A. Withheld Income Tax

Withheld income tax (*Imposto de Renda Retido na Fonte - IRRF*) is due on income paid, credited, remitted, or delivered to nonresidents, at the rate of 15% or 25% depending upon the beneficiary's country of residence and the nature of the income.[23]

---

[15] *Id.* art. 43(§2).

[16] *Id.* art. 7.

[17] *Id.* art. 46.

[18] *Id.* art. 58.

[19] Decreto No. 3.000, de 26 de Março de 1999, *available at* http://www.planalto.gov.br/ccivil_03/decreto/D3000.htm.

[20] *Id.* art. 3.

[21] *Id.* arts. 86(II), 620(II), 685.

[22] *Id.* art. 541.

[23] *Id.* art. 685.

The capital gain realized by an individual or company resident or domiciled abroad is assessed and taxed in accordance with the rules applicable to residents in Brazil.[24] Article 691 of Decree No. 3,000 lists the situations where certain types of income received by residents or domiciled abroad are exempt from withheld income.[25]

Revenues generated by real estate in the country,[26] as well as royalties for any purpose,[27] that are paid, remitted, credited, used, or delivered to an individual or company that is resident or domiciled abroad are subject to withheld income tax at a rate of 15%.

IV. Real Estate

A. Registration

There are no restrictions for the acquisition of real estate made by foreign individuals or foreign companies. However, rural[28] and coastal[29] areas are subject to limitations. In addition, prior to purchasing real estate in Brazil, foreign individuals must first register with the National Register of Individual Taxpayers (*Cadastro Nacional de Pessoas Físicas – CPF*)[30] and foreign companies must register with the General Register of Legal Entities (*Cadastro Nacional da Pessoa Jurídica – CNPJ*).[31]

B. Taxation

Article 156 of the Brazilian Constitution determines that the municipalities (*municípios*) have the power to levy taxes on non-gratuitous *inter-vivos* transfers of real property, by whatever instrument, whether by natural or physical accession, and any *in rem* rights to real property, except for guarantees, as well as the assignment of rights for the property's acquisition.[32]

---

[24] *Id.* art. 685(§3).

[25] *Id.* art. 691.

[26] *Id.* art. 705.

[27] *Id.* art. 710.

[28] C.F., art. 190; Lei No. 5.709, de 7 de Outubro de 1971, *available at* http://www.planalto.gov.br/ccivil_03/Leis/L5709.htm and Decreto No. 74.965, de 26 de Novembro de 1974, *available at* http://www.planalto.gov.br/ccivil_03/decreto/1970-1979/D74965.htm.

[29] Decreto-Lei No. 9.760, de 5 de Setembro de 1946, art. 205, *available at* http://www.planalto.gov.br/ccivil_03/Decreto-Lei/Del9760.htm.

[30] Instrução Normativa SRF No. 461, de 18 de Outubro de 2004, art. 20(XI)(a), *available at* the website of the Secretaria da Receita Federal - SRF (the Brazilian equivalent of the U.S. Internal Revenue Service), http://www.receita.fazenda.gov.br/Legislacao/Ins/2004/in4612004.htm.

[31] Instrução Normativa SRF No. 200, de 13 de Setembro de 2002, art. 12(§4)(I), *available at* http://www.receita.fazenda.gov.br/legislacao/Ins/2002/in2002002.htm.

[32] C.F., art. 156(II).

The National Tax Code (*Código Tributário Nacional*)[33] further regulates the subject and its article 39 determines that the tax rates may not exceed the limits established by the Federal Senate.

The tax rate on real estate transactions (*Imposto sobre a Transmissão de Bens Imóveis - ITBI*) varies from municipality to municipality. In São Paulo, the rate ranges from 0.5% to 2%, depending on the value of the property.[34]

Revenues generated by real estate in the country that are paid, remitted, credited, used, or delivered to an individual or company that is resident or domiciled abroad are subject to withholding tax at a rate of 15%.[35]

V. Capital Market

Resolution No. 2,689 of January 26, 2000, issued by the National Monetary Council (*Conselho Monetário Nacional*), regulates the investments of foreign individuals or foreign companies in the Brazilian capital market.[36] It defines foreign investors[37] for the purpose of the regulation and sets forth the requirements a foreign investor must meet before investing in the capital market.[38]

In light of Resolution No. 2,689, on December 21, 2004, Provisional Measure No. 206 of August 6, 2004, was converted into Law No. 11,033.[39] According to Brazil's Securities and Exchange Commission (*Comissão de Valores Mibiliários - CVM*),[40] Law No. 11,033 promoted significant changes in the tax treatment applied to financial

[33] Código Tributário Nacional, Lei No. 5.172, de 25 de Outubro de 1966, *available at* http://www.planalto.gov.br/ccivil_03/Leis/L5172.htm.

[34] Decreto No. 46.228, de 23 de Agosto de 2005, art. 11, *available at* the website of the Municipal Goverment of São Paulo, http://ww2.prefeitura.sp.gov.br//arquivos/secretarias/financas/legislacao/Decreto-46228-2005.pdf.

[35] Decreto No. 3.000, de 26 de Março de 1999, art. 705, *available at* http://www.planalto.gov.br/ccivil_03/decreto/D3000.htm.

[36] Resolução CMN No. 2.689, de 26 de Janeiro de 2000, art. 1, *available at* the website of the Brazilian Central Bank, https://www3.bcb.gov.br/normativo/detalharNormativo.do?N=100014927&method=detalharNormativo.

[37] *Id.* art. 1(§1).

[38] *Id.* art. 3.

[39] Lei No. 11.033, de 21 de Dezembro de 2004, *available at* http://www.planalto.gov.br/ccivil_03/_Ato2004-2006/2004/Lei/L11033.htm.

[40] The Securities and Exchange Commission is a federal agency (*autarquia federal*) subordinated to the Ministry of Finance and responsible for, inter alia, the permanent control of the activities and services of the securities market, as provided for in article 1 of Law No. 6,385 of December 7, 1976, and the disclosure of information relating to the market, individuals participating in it, and the securities traded thereon. Law No. 6,385 of December 7, 1976, art. 8(III), *available at* http://www.planalto.gov.br/ccivil_03/Leis/L6385compilada.htm.

operations.[41]

The income tax rate for profits derived from transactions on the stock exchange market and other transactions was reduced from 20% to 15%; on other types of transactions, a progressive tax schedule was adopted according to the duration of the investment, with tax rates ranging from 15% to 22.5%. Depending on the origin of the investment, the applicability or non-applicability of the taxation, as well as the applicable tax rate, is different for those investments arising from countries or dependencies that do not tax income or that do tax income at a percentage below 20% (considered as low-tax jurisdictions).[42]

A tax table with the different types of investments and the respective tax rates is available at the website of Brazil's Securities and Exchange Commission.[43] In addition, Normative Instruction SRF No. 188 of August 6, 2002,[44] lists the countries with a more favorable taxation system.

VI. Double Taxation Treaty

Brazil does not have a bilateral treaty with the United States on the avoidance of double taxation.[45]

Prepared by Eduardo Soares
Foreign Law Specialist
September 2009

---

[41] Comissão de Valores Mobiliários, Portal do Investidor, *available at* http://www.portaldoinvestidor.gov.br/InvestidorEstrangeiro/Impostosetaxas/tabid/190/Default.aspx (last visited Sept. 22, 2009).

[42] *Id.*

[43] *Id.*

[44] Instrução Normativa SRF No. 188, de 6 de Agosto de 2002, *available at* http://www.receita.fazenda.gov.br/Legislacao/ins/2002/in1882002.htm.

[45] Secretaria da Receita Federal, *available at* http://www.receita.fazenda.gov.br/legislacao/AcordosInternacionais/AcordosDuplaTrib.htm.

2009-003270

LAW LIBRARY OF CONGRESS

CHINA

TAXATION OF PASSIVE FOREIGN INVESTMENTS

Executive Summary

China taxes non-resident individuals on their Chinese source income. A tax treaty has been signed between China and the United States to avoid double taxation on income. As a general rule and without consideration of the tax treaty, interest, dividends, royalties, rental income and gains from the sale of real property are subject to individual income tax at a flat rate of 20% under Chinese law. The tax treaty provides a 10% tax rate on interest, dividends and royalties that United States residents derived from China, where the recipient is the beneficial owner of such interest, dividends or royalties.

I. Legal Framework and Definitions

China has two separate and distinct income tax codes, with each one applicable to either individuals or to enterprises; the Individual Income Tax Law[1] and the Enterprise Income Tax Law.[2] The State Council, China's cabinet, has the authority to formulate administrative regulations, which include the Implementing Regulations of the Individual Income Tax Law (IITL Implementing Regulations).[3] Departments of the central government (in particular the Ministry of Finance (MOF) and the State Administration of Taxation (SAT)) also issue departmental rules and decrees concerning taxation, including those which concern deductions and exemptions. Local authorities may also grant tax deductions and exemptions within their share of the tax revenue, which will not be covered by this report.

China and the United States have signed a treaty to avoid double taxation on income. It was signed with a protocol on April 30, 1984, and a second protocol was signed on May 10, 1986 (Treaty).[4]

---

[1] Individual Income Tax Law (adopted by the National People's Congress (NPC) on Sept. 10, 1980, *last revised* on Dec. 29, 2007, effective Mar. 1, 2008) [IITL]. 2007 LAWS AND REGULATIONS OF THE PEOPLE'S REPUBLIC OF CHINA [ZHONGHUA RENMIN GONGHEGUO FAGUI HUIBIAN] (FAGUI HUIBIAN) 771-775.

[2] Enterprise Income Tax Law (adopted by the NPC on Mar. 16, 2007, effective Jan. 1, 2008) [EITL]. 2007 FAGUI HUIBIAN, 757-765.

[3] IITL Implementing Regulations (promulgated by the State Council on Jan. 28, 1994, *last revised* Feb. 18, 2008, effective Mar. 1, 2008) art. 5, *available at* the State Administration of Taxation (SAT) website, http://www.chinatax.gov.cn/n480462/n480513/n480902/7515970.html (last visited Aug. 27, 2009).

[4] United States-The People's Republic of China Income Tax Convention (entered into Force on January 1, 1987), http://www.irs.gov/pub/irs-trty/china.pdf. *See* specifically, art. 22, Elimination of Double Taxation.

The purpose of this report is to examine the tax treatment of individual foreign investors with regards to their "passive" investment in China. Therefore, the domestic enterprise income tax will not be covered. "Passive investment income" is not specifically defined under Chinese tax law. For the purpose of this report, taxation on the following investment income will be discussed:

- Interest;
- Dividends;
- Royalties;
- Rental income from real property; and,
- Gains from the sale of real property.

A. Foreign Individuals Under the Tax Law

The Individual Income Tax Law distinguishes treatment of the income tax of individuals based upon their domicile and length of stay in China. Individuals domiciled in China, or who are not domiciled, but have lived in China for one year or more (i.e., resident individuals) are taxed on their world-wide income. Individuals who have no domicile in China and have not lived in China, or who have lived in China for less than one year (i.e., non-resident individuals) are taxed on their Chinese source income.[5]

B. Chinese Source Income

Income obtained from sources inside of China, regardless of the place of payment, is deemed Chinese source income which (as defined by the IITL Implementing Regulations) includes the following:

(i) Income received for the lease of property to a lessee for use inside China;

(ii) Income from the assignment of property in China such as buildings, land use rights, etc., or for the assignment in China of any other property;

(iii) Income received for the licensing of various proprietary rights for use in China; and,

(iv) Income from interests, dividends and extra bonuses received from companies, enterprises and other economic organizations or individuals in China.[6]

---

[5] IITL art. 1; FAGUI HUIBIAN at 771.

[6] IITL Implementing Regulations, art. 5, http://www.chinatax.gov.cn/n480462/n480513/n480902/7515970.html (last visited Sept. 22, 2009).

II. Taxation on Passive Investment Income Earned by Foreign Individual Investors

As a general rule established up by the Individual Income Tax Law (and without consideration of the Treaty), interest, dividends, royalties, rental income of real property and gains realized from the sale of real property are subject to a flat 20% tax. The law provides in article 3 that, "[F]or income from royalties, interest, dividends, bonuses, lease of property and transfer of property, incidental income and income from other sources, a flat rate at 20% shall apply."[7]

A. Interest and Dividends

For income from interest and dividends, the taxable income is the amount of money received for each payment.

Although interest and dividends are generally subject to a 20% tax rate, taxation on the interest income received from savings deposits is regulated separately by the State Council, and is currently taxed on a 5% tax rate.[8] Also, the Individual Income Tax Law exempts interest received from government bonds and financial bonds issued by the State from individual income taxation.[9]

According to the Treaty, interest arising in one country and paid to a resident of the other country, and dividends paid by a company which is a resident of one country to a resident of the other country, may be taxed in the other country.[10] However, such interest and dividends may also be taxed in the country in which the company paying the dividends is a resident or the interest arises, but if the recipient is the beneficial owner of the interest or dividends, the tax so charged shall not exceed 10% of the gross amount of the interest or dividends.[11]

B. Royalties and Rental Income from Real Property

Income from royalties, including those obtained from provision of the right to use patent rights, trademark rights, copyrights, non-patented technology and other proprietary rights are subject to individual income tax.[12] Income from the rental of property is also subject to individual income tax, and includes income obtained by individuals from the lease of buildings and land use rights.[13] The taxable income on royalties and rental income on real property are calculated in the same way, as follows:

---

[7] IITL art. 3(5), FAGUI HUIBIAN at 772.

[8] IITL, art. 12, FAGUI HUIBIAN at 774.

[9] IITL, art. 4(2), FAGUI HUIBIAN at 772.

[10] The Treaty, arts. 9 (1) & 10 (1).

[11] The Treaty, arts. 9(2) & 10 (2).

[12] IITL Implementing Regulations, art. 8(6), http://www.chinatax.gov.cn/n480462/n480513/n480902/7515970.html (last visited Sept. 22, 2009).

[13] There is no private land ownership in China; instead, the owner is granted the land use right to use the land collectively owned or owned by the state.

(i) For income received in a single payment of less than RMB4, 000 (approximately $571), a deduction of RMB800 (approximately $114) is allowed for expenses.

(ii) For income received in a single payment of RMB4,000 (approximately $571) and above, a deduction of 20% is allowed for expenses.[14]

Similar to the treatment of interest and dividend income, where the royalties arising from one country and paid to a resident of the other country are taxed in the country where the royalties arise, the Treaty reduces the rate to 10% of the gross income of the royalties, if the recipient is the beneficial owner of the royalties.[15]

C. Gains from the Sale of Real Property

For gains realized from the sale of real property, the taxable income is the balance remaining after deducting the original value of the property and reasonable expenses from the income derived from such transfer, according to the Individual Income Tax Law.[16]

Although the Individual Income Tax Law imposes taxes on income realized from the sale of Chinese real property, regardless of the purpose for which the property is used, the government financial agency may decide to deduct or exempt the income from the tax applicable to the transfer of non-commercial real properties under prescribed circumstances.[17] For example, according to a 1999 Ministry of Finance document, the gain from transferring the family's sole residence is exempted from individual income taxes, as long as the residence has been used as such for more than five years.[18]

Under the Treaty, gains derived by a resident of one country from the alienation of real property situated in the other country may be taxed in the country where the real property is situated.[19] Gains realized from the alienation of shares of the capital stock of a company, the property of which consists directly or indirectly principally of real property situated in a country may also be taxed in that country.[20]

Prepared by Laney Zhang
Foreign Law Specialist
September 2009

---

[14] IITL art. 6(4); FAGUI HUIBIAN at 773.

[15] The Treaty, art 11 (2).

[16] IITL art. 6(5); FAGUI HUIBIAN at 773.

[17] IITL arts. 4(10) and 5(3); FAGUI HUIBIAN at 772.

[18] Guo Shui Fa [2006] No. 108 (issued by the State Administration of Taxation on July 18, 2006), *available at* the SAT official website (in Chinese), http://www.chinatax.gov.cn/n480462/n480513/n480979/n554064/1629002.html (last visited Sept. 22, 2009).

[19] The Treaty, art. 12(1).

[20] The Treaty, art. 12(4).

2009-003270

LAW LIBRARY OF CONGRESS

FRANCE

TAXATION OF PASSIVE FOREIGN INVESTMENTS

Executive Summary

Foreign individuals who do not have their tax domicile in France are taxed on their French source income, which includes income originating from real property, dividends distributed by French companies, and income from French securities and other capital invested in France.

Dividends, interest, and fixed income securities and capital gains on the sale of real property are subject to withholding taxes. Income originating from real property is subject to French income tax at progressive rates under the same principles applicable to French residents.

France and the United States have signed a tax treaty. In some instances it reduces the rates of withholding.

I. Background

Individuals who do not have their tax domicile in France[1] (whether they are French or foreign nationals) are only taxed on their French source income.[2] French source income is usually divided into two categories.[3] The first category includes income originating from property and real property rights located in France, income from French securities and other capital invested in France, income from business activities carried on in France, income from professional activities, and capital gains explicitly subject to taxation.[4] The second category covers income regarded as French source income because the payor of the income is located in France, for example, pensions and income from industrial and intellectual property rights.[5] As a

---

[1] CODE GENERAL DES IMPOTS (C.G.I.) art. 4 B (Dalloz 2009). An individual is considered to be a tax resident in France if he satisfies one of the following requirements: (1) he has a home in France (defined as the place where the taxpayer and his family normally live); (2) his principal place of residence is in France (a minimum of 183 days in France is required); (3) he has a business activity in France, unless he can prove that such activity is only ancillary; or (4) the center of his economic interests is in France. *Id*.

[2] *Id*. art. 4 A(2).

[3] *Id*. art. 164 B.

[4] *Id*.

[5] *Id*.

general rule, the tax base for these French source income items is determined under the same rules that would be applicable to individuals domiciled in France.[6]

France and the United States signed a tax treaty in 1994, which was amended in 2004 (the "1994 Treaty").[7] An additional protocol further amending the treaty was signed on January 13, 2009. The Protocol will enter into force upon ratification by both countries. It was referred to the United States Senate on September 11, 2009.[8]

II. Taxation of Investment Income Earned by Small Individual U.S. Investors

A. Dividends

As a general rule and in the absence of a tax treaty, all dividends or other distributions by French companies to individuals who do not have their tax domicile in France are subject to a final withholding tax of 25% except for residents of the European Union for whom the withholding tax is 18%.

The 1994 Treaty reduces the withholding rate for dividends to 15%.[9]

B. Interest and Fixed Income Securities

Interest paid on debts and fixed income securities are generally subject to a final withholding tax of 18%, although exemption and lower rates may apply to certain types of interest.[10] The 1994 Treaty provides that "Interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State."[11] The French tax administration has, however, decided to unilaterally reduce the withholding rate to 0%.[12]

---

[6] FRANCIS LEFEBVRE, MÉMENTO PRATIQUE FISCAL § 441 (Lefebvre, 2009).

[7] Convention Between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital (as amended through 2004), *available at* the website of the International Bureau of Fiscal Documentation (IBFD), http://ip-online.ibfd.org/data/treaty/docs/html/tt_fr-us_02_eng_1994_tt.html (last visited on Sept. 22, 2009).

[8] Protocol and Memorandum of Understanding to Treaty between the United States and France, *available at* the IBFD website, http://ip-online.ibfd.org/data/tns/docs/html/tns_2009-09-11_us_1.html (last visited Sept. 22, 2009).

[9] Convention Between the Government of the United States of America and the Government of the French Republic, *supra* note 6, art. 10.

[10] C.G.I. art. 125 A.

[11] Convention Between the Government of the United States of America and the Government of the French Republic, *supra* note 6. art. 11.

[12] FRANCIS LEFEBVRE, *supra* note 6, § 7531.

C. Real Property Income

Foreign individual investors earning income from real property situated in France in a private or a business capacity are subject to French income tax at progressive rates under the same principles applicable to French residents.[13] Their income tax is determined according to their family coefficient (the taxpayer's marital status and number of dependent children) and the tax rate schedule for the relevant year. However, according to a special rule, they may not be taxed at an effective rate below 20% (14.4% for income arising in France's overseas *départements*—France's main territorial units).[14] This rule will not apply and the taxpayer may be subject to a more favorable rate if he can show that his tax rate on his worldwide income would be below 20% if he were a French resident.[15]

The 1994 Treaty simply provides that "Income from real property situated in a contracting State may be taxed in that State."[16]

D. Real Property Capital Gains

Capital gains realized on the sale of French real estate on a habitual basis by foreign individual investors are subject to a 50% withholding tax due and payable at the time the deed is recorded.[17] The rate is 33.33% if it is an occasional sale. There is no definition of what constitutes the sale of real estate on an occasional or habitual basis. It is decided on a case-by-case basis by the tax authorities, who look at the number, importance, nature, and frequency of the sales.[18]

The taxable capital gain is calculated on the sale price minus the purchase price, increased by acquisitions expenses together with the costs of improvements made to the property, if any.[19] The capital gain is reduced by 10% for each year of ownership after the fifth year, resulting in a full capital gain tax exemption with respect to property held for more than fifteen years.[20] If the sale price of the property is equal to or less than €15,000 (about US$21,000) the seller is exempt from capital gains tax.[21]

---

[13] *Id*. § 444.

[14] C.G.I. art. 197 A(a).

[15] *Id*.

[16] Convention Between the Government of the United States of America and the Government of the French Republic, *supra* note 7, art. 6.

[17] C.G.I. arts. 244 *bis*, 35.

[18] FRANCIS LEFEBVRE, *supra* note 6, § 2611.

[19] C.G.I. art. 150 V.

[20] *Id*. art. 150 U(II)(1).

[21] *Id*. art. 150 U(II)(6).

The withholding tax represents a final taxation. No additional personal income tax is due on the capital gain. The 1994 Treaty confirms France's right to impose this withholding tax.[22]

Prepared by Nicole Atwill
Senior Foreign Law Specialist
September 2009

---

[22] Convention Between the Government of the United States of America and the Government of the French Republic, *supra* note 7, art. 13.

2009–003270

LAW LIBRARY OF CONGRESS

INDIA

TAXATION OF PASSIVE FOREIGN INVESTMENTS

Executive Summary

Passive investments are described as investments in which the investor has no management or control over the company. Income generated in such cases may be by way of dividends, interest, royalties, etc. Tax law in India treats such U.S. investors as non-residents entitled to a lenient tax burden. The tax liability of non-residents for profits on passive investments is 20%.

I. General Tax Structure

India has a well-developed tax structure with the authority to levy taxes divided between the Central Government and the state governments. The Central Government levies direct taxes, such as income tax and corporate tax, and indirect taxes, including customs duties, excise duties, and the central sales tax. The states are empowered to levy state sales taxes.

The liability to pay income tax varies depending on a person's non-resident or resident status. The expression "non-resident" also includes one who is "not ordinarily resident." A "person" includes an individual, a company, a firm, an association of persons, a local authority, and every artificial juridical person.[1] A "non-resident" or "not ordinarily resident" person means a person who has been non-resident in India in nine out the ten preceding years, or a person who has been in India for less than 730 days preceding the year in question.[2]

II. Taxes on the Passive Income of Foreign Entities

Categories of passive income, such as interest, royalties, technical services, etc., that are sourced from India by foreign companies are taxed on a gross income basis, which means that tax liability is determined on the basis of gross receipts without going into the question of expenses incurred in earning those receipts. The rate of tax, which is 20%, is determined at a figure lower than the general rate of tax applicable to total income, as the latter takes into account the possible expenses in earning income.[3]

[1] The Income-tax Act, No. 43 of 1961, § 2(31).

[2] *Id.* § 6(6).

[3] *Id.* § 115A.

There is no withholding tax on dividends in India and dividends earned by a shareholder are currently exempt from tax in India. However, the company paying the dividends is required to pay the dividend distribution tax (DDT).[4]

III. Double Taxation Avoidance Treaty

India entered into a Tax Convention with the United States in 1989 that has as its objective the avoidance of double taxation and the prevention of fiscal evasion with respect to income taxes.[5] One of the important terms used in the Convention is the term "Permanent Establishment" or PE.[6] The term, however, is not defined in the Indian Income-tax Act. Under the Convention, tax is computed by treating the PE as a distinct and independent enterprise. In order to avoid double taxation, the Convention provides that a resident of the U.S. is liable to pay tax either directly or by deduction in the foreign country in respect of income from any source, but he is allowed credit in the U.S. against such taxes.[7]

Thus, the tax treaty provides a favorable alternative mode for determining the tax liability of a businessman who is a U.S. resident. An annual tax is levied on income earned in a tax year as per the rates prescribed for that year.

Prepared by Krishan S. Nehra
Senior Foreign Law Specialist
September 2009

---

[4] *Id.*

[5] Convention Between the Government of the United States of America and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income Together with a Related Protocol, signed Sept. 12, 1989, entered into force Dec. 18, 1990, Treaty Doc. 101-5, *available at* http://www.unclefed.com/ForTaxProfs/Treaties/india.pdf.

[6] *Id*. art. 5.

[7] *Id*. art. 25.

2009-003270

LAW LIBRARY OF CONGRESS

JAPAN

TAXATION OF PASSIVE FOREIGN INVESTMENTS

Executive Summary

Passive foreign investment income is considered domestic income when it arises from a source located within Japan. Japan taxes the domestic income of non-residents, including interest, dividends, and distributions of profit. These are subject to separate taxation, withheld by the source, when the individual is a non-resident who does not have a business or a representative in Japan. The tax rate for dividends and distribution of profits is 20%. The tax rate for interests is 15%. Under the Double Taxation Avoidance Treaty, the United States taxes on interests and dividends received by U.S. individual residents, that are regarded as domestic source income in Japan, but Japan may still tax on them at the rate of 10%.

I. Japanese Income Tax Law

This report discusses Japan's tax treatment of individual investors from the United States as it relates to passive investments in Japan.

Japan taxes the domestic incomes of non-residents.[1] Interest, dividends, and distributions of profits are included among the types of domestic income.[2] These items are taxed separately from other aggregate income when the taxpayer is a non-resident individual who does not have business or a representative in Japan.[3] The tax rate for dividends and distributions of profits is a 20%.[4] The tax rate for interest is 15%.[5] These taxes are withheld at the source.[6]

Included in the taxable interest of non-residents are:

---

[1] Shotokuzei hō [Income Tax Law], Law No. 33 of 1965, *as amended*, art. 164.

[2] *Id*. art. 161.

[3] *Id*. art. 164, para. 2.

[4] *Id*. art. 170.

[5] *Id*.

[6] *Id*. art. 212, para. 1.

(a) A portion of the interests on credit issued by foreign corporations that is regarded as accrued by the business that was operated in Japan, and other interest specified in a Cabinet Order; and

(b) Distributions of the profits of joint trusts, bond investment trusts, or investment trusts on employment bonds and debentures, and others issued for public subscription that have been entrusted to business places in Japan.[7]

The taxable dividends of non residents include:

(a) Dividends of surplus, dividends of profits, distributions of surplus or fund interests from a domestic corporation; and,

(b) Distributions of profits of investment trusts (excluding bond investment trusts and investment trusts on employment of bonds and debentures and others issued for public subscription), or specified beneficiary certificate issuance trusts that have been entrusted to business places in Japan.[8]

With respect to investments made to those who operate businesses in Japan, distributions of profits received according to anonymous association contracts, including similar contracts as prescribed by a Cabinet Order are taxed.[9]

II. <u>United States - Japan Tax Treaty</u>

The United States and Japan entered into a treaty, the Convention between the Government of Japan and the Government of The United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income ("the Treaty").[10] When the Treaty has an inconsistent provision with the Income Tax Law, the treatment of domestic source income follows that of the Treaty.[11]

Under the Treaty, "[I]nterest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other Contracting State."[12] For a U.S. individual investor, the United States may tax the interest arising in Japan. However, Japan may still tax the interest at the rate of 10 % of the interest.[13]

---

[7] *Id*. art. 161, item 4.

[8] *Id*. art. 161, item 5.

[9] *Id*. art. 161, item 11.

[10] Convention Between The Government of Japan And The Government of The United States of America For The Avoidance of Double Taxation And The Prevention of Fiscal Evasion With Respect to Taxes on Income, Nov. 6, 2003, *available at* the United States Treasury website at http://www.ustreas.gov/press/releases /reports/conventionfinal.pdf.

[11] Income Tax Law, Law No. 33 of 1965, *as amended*, art. 162.

[12] Double Taxation Treaty, *supra* note 10, art. 11, para. 1.

[13] *Id*. art. 11, para. 2.

Also, under the Treaty, "[D]ividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other Contracting State."[14] For a U.S. individual investor, the United States may tax on the dividends that the U.S. resident receives from a company in Japan. However, Japan may still tax on dividends at the rate of 10% of the dividends.[15]

Prepared by Sayuri Umeda
Senior Foreign Law Specialist
September 2009

---

[14] *Id*. art. 10, para. 1.

[15] *Id*. art. 10, para. 2 (b).

2009-003270

LAW LIBRARY OF CONGRESS

MEXICO

TAXATION OF PASSIVE FOREIGN INVESTMENTS

Executive Summary

Mexico's Income Tax Law provides that nonresidents that receive income in cash from sources located in Mexico are obligated to pay income tax. Rental income and capital gains are subject to a 25% withholding tax. Interest derived from Mexican sources is subject to a final withholding tax at different rates.

I. Introduction

This report provides a brief summary of the most relevant provisions concerning the tax treatment of individual foreign investors by Mexico's domestic income tax law, as it relates to passive investments.

Mexico's Income Tax Law provides that nonresidents who receive income in cash from sources located in Mexico are obligated to pay income tax.[1] "Income tax on payments to non-residents…is generally paid through withholding."[2]

A list of tax rules applicable to specific types of passive investments follows.

II. Real Property

The following excerpt provides a brief summary of the rules applicable to the taxation of income from real property:

> "Rental income derived by non residents from the leasing of Mexican-situs immovable property…is subject to a 25% withholding tax on gross payments.
> …
> Capital gains realized by non-residents from the transfer of immovable property are subject to a 25% withholding tax on the gross amount."[3]

---

[1] Ley del Impuesto sobre la Renta [Income Tax Law], *as amended*, art. 179, Diario Oficial de la Federación [D.O.], Jan. 1, 2002, *available at* http://www.diputados.gob.mx/LeyesBiblio/pdf/82.pdf. This hyperlink connects to the official website of Mexico's House of Representatives.

[2] Mexican Tax Guide (CCH) § 3565, at 2559 (2007).

[3] INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION (IBFD), GLOBAL INDIVIDUAL TAX HANDBOOK 2009, "Mexico, Non-Residents," at 435 (IBFD, 2009). *See also* Ley del Impuesto sobre la Renta [Income Tax Law], *as amended*, arts. 141, 186, 189, 210(III-IV).

III. Interest

The following excerpt from an International Bureau of Fiscal Documentation (IBFD) handbook provides a brief summary of the rules applicable to the taxation of interest:

> Interest derived from Mexican sources is subject to a final withholding tax at different rates, as follows:
>
> 4.9%. –
>
> - Interest paid in respect of publicly traded securities in Mexico and securities publicly traded abroad through banks and stockbrokerage firms in a country with which Mexico has a tax treaty, provided that the securities are registered with the Special Section of the National Securities Register.
>
> 10%. –
>
> - Interest relating to securities publicly traded through banks and stock brokerage firms in a country with which Mexico does not have a tax treaty, provided that a notification regarding the transaction has been presented before the National Banking and Securities Commission (Comisión Nacional Bancaria y de Valores); …
>
> 21%. –
>
> - Interest which is not subject to the 4.9% or 10% rates mentioned above, paid by Mexican financial institutions; and…
>
> 28%. –
>
> - All other income.[4]

IV. Dividends

As noted in a leading guide on Mexico's tax system, "Dividends paid out from after-tax profits are subject to no further taxation. Dividends from profits that have not been previously taxed are taxed to the distributing entity, not to the shareholders."[5]

Prepared by Gustavo Guerra
Senior Foreign Law Specialist
September 2009

---

[4] IBFD, *supra* note 3, at 434-435. *See also* Ley del Impuesto sobre la Renta [Income Tax Law], *as amended*, arts. 177, 195.

[5] Mexican Tax Guide (CCH) § 3660, at 2611 (2007).

2009-003270

LAW LIBRARY OF CONGRESS

SOUTH AFRICA

TAXATION OF PASSIVE FOREIGN INVESTMENTS

Executive Summary

South Africa imposes taxes on non-residents for income derived from sources within South Africa. Non-residents are exempt from paying taxes on small passive investments in South Africa, except in limited circumstances with regard to real-estate investments.

South Africa has an avoidance of double taxation treaty with the United States which allows for taxation of United States investors in South Africa on certain passive real-estate related investments.

I. Taxation System

The South African taxation system is based on residence and source. The South African Income Tax Act requires residents to pay taxes on their income regardless of its source. Non-residents are taxed on income "from a source within or deemed to be within the Republic [of South Africa]."[1]

South Africa has what may be characterized as a unitary tax system. In this system, the gross income of an individual is identified and the relevant deductions are made from that income to determine the taxable income. The taxable income is then taxed in a single assessment.[2] The tax imposed on the taxable income under the Income Tax Act is called "normal tax." In determining the taxes owed by a person, the taxable capital gains are determined under the appropriate schedule and this amount, if any, is added to the taxable income.[3]

A non-resident individual appears to be exempt from the payment of income taxes on passive investments such as interests or dividends.[4] The exception to this appears to be where

---

[1] Income Tax Act No. 58 of 1962, §1, 15 STATUTES OF THE REPUBLIC OF SOUTH AFRICA (Butterworths, current through 2007).

[2] *Id. See also* Kevin W. Joselowitz and Michael M. Katz, Taxation and Foreign Exchange *in* A LAWYERS GUIDE TO DOING BUSINESS IN SOUTH AFRICA, 71 (ABA, 1996).

[3] Income Tax Act No. 58 of 1962, sched. 8.

[4] *See* Joubert, 22 THE LAW OF SOUTH AFRICA: REVENUE, 122, 123 (LexisNexis, 2nd ed. 2007).

they have acquired certain types of interests in real estate, which could under limited circumstances give rise to taxable capital gains.[5]

South Africa has acceded to the Avoidance of Double Taxation Treaty with the United States. The treaty was signed on February 17, 1997 and ratified December 28, 1997.[6]

II. Taxes on Real Property

An investment in real property in South Africa by a non-resident gives rise to taxable capital gains in certain limited circumstances.[7] A non-resident investor is said to have an interest in real property in South Africa when:

- such person holds at least 20% equity of a company or any other entity; and,
- at least 80 % of the value of the net assets of the company or entity is directly or otherwise attributable to immovable property (which is not trading stock) in South Africa.[8]

The investor's interest in the company or entity may be direct or indirect, i.e., through another company.[9] It may also be held alone or together with a "connected person."[10]

Non-residents who have an interest in real property as specified by the law are subject to a capital gains tax on monies realized from the "disposal" of the property, or on any interest or right in the property during the year of assessment.[11]

---

[5] Another exception of course is the tax levied on royalties. Taxes are due if an amount is deemed to have accrued to a person from a source in South Africa for:

1) "any patent, design, trademark, copyright, model, pattern, plan, formula or process of any other property of a similar nature; or
2) motion picture film, or any film or video tape or disk, any sound recordings or advertising matter." *See* Income Tax Act No. 58 of 1962, §35(1) (a), 15 STATUTES OF THE REPUBLIC OF SOUTH AFRICA (Butterworths, current through 2007).

[6] *See* SUMMARY OF ALL TREATIES FOR THE AVOIDANCE OF DOUBLE TAXATION, *available at* the South African Revenue Service portal, http://www.sars.gov.za/home.asp?pid=3906 (official source) (last visited Sept. 22, 2009).

[7] Income Tax Act No. 58 of 1962, para. 2(1), sched. 8, 15 STATUTES OF THE REPUBLIC OF SOUTH AFRICA (Butterworths, current through 2007).

[8] *Id.*

[9] DAVID CLEGG, LEXISNEXIS PRACTICAL GUIDE TO CAPITAL GAINS TAX, 11 (LexisNexis, 8th ed. 2008). This book examines the South African laws related to capital gains.

[10] The term "connected person" is a term of art and is defined under §1 of the Income Tax Act No. 58 of 1962. The term generally refers to:

> "individuals and their relatives and trusts of which they are named beneficiaries and companies held as to at least 20%; companies within a group of companies, companies held at least 20 % if no other person holds majority voting rights, and companies controlled by connected persons" *id.*

[11] *Id*. sched. 8 para. 2(1).

The term "disposal" is a legal term of art defined as "any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset."[12] The law provides scenarios that qualify as deposal of an asset. The Income Tax Act identifies the following as acts of disposal:

a) the sale, donation, expropriation, conversion, grant, cession, exchange or any other alienation or transfer of ownership of an asset;

b) the forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry or abandonment of an asset;

c) the scrapping, loss, or destruction of an asset;

d) the vesting of an interest in an asset of a trust in a beneficiary;

e) the distribution of an asset by a company to a shareholder;

f) the granting, renewal, extension or exercise of an option; or

g) the decrease in value of a person's interest in a company, trust or partnership as a result of a value shifting arrangement.[13]

In an attempt to limit the application of the above enumerated list, the Income Tax Act makes an exclusionary provision available, which states that there is no disposal of an asset:

a) by a person who transfers the asset as security for a debt or by a creditor who transfers that asset back to that person upon release of the security;

b) by a person in respect of the issue of any bond, debenture, note or other borrowing of money or obtaining of credit from another person;

c) by a person where a disposal is made to correct an error in the registration in the deeds registry of immovable property in that person's name;

d) by a lender to a borrower or by a borrower to a lender where any security has been lent by a lender to a borrower in terms of a securities lending arrangement;

e) by a person where that asset vests in the Master of the High Court or in a trustee, in consequence of the sequestration of the estate of the spouse of that person, as contemplated in the Insolvency Act of the Insolvency Act and where that asset is subsequently released by the Master or that trustee as contemplated in that section;

f) if it constitutes an equity instrument, which has not yet vested; or,

---

[12] *Id*. sched 8 para. 11.

[13] *Id*.

g) by a person on the cession or release of a right to acquire a marketable security in whole or in part for a consideration which consists of or includes another right to acquire a marketable security in certain circumstances.[14]

An individual's taxable capital gain for the year of assessment is 25% of that person's net capital gain.[15] The rate of taxation for an individual for the year of assessment ending February 2009 is listed in the table below.[16]

Taxable income		
Exceeds	But does not exceed	Rates
R	R	R
0	122,000	18%
122,001	195,000	21,960 + 25 % of amount over 122,000
195,001	270,000	40,210 + 30% of amount over 195,000
270,001	380,000	62,710 + 35% of amount over 270, 000
380,001	490,000	101,210 + 38% of amount over 380,000
490,001	and over	143,010 + 40% of amount over 490,000

III. The Avoidance of Double Taxation Treaty

The Avoidance of Double Taxation Treaty authorizes South Africa to impose taxes on capital gains of a United States resident "attributable to the alienation of real property" in South Africa.[17] The term "immovable property" or "real property" is to be defined in accordance to the law of the country where it is located.[18]

Prepared by Hanibal Goitom
Foreign Law Specialist
September 2009

---

[14] *Id*. Long lists of events that are treated as disposal of an asset have been omitted.

[15] *Id*. sched. 8 para. 10(a).

[16] Marius Botha, Corporate & Personal Financial Planning, A15 (LexisNexis, 2009). This book examines the South African laws relevant to financial planning. 1 USD is equivalent to 7.38 ZAR. XE, Universal Currency Converter, *available at* http://www.xe.com/ucc/ (unofficial source).

[17] Convention Between the Republic of South Africa and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, *art*. 6, 13, available *at* the South African Revenue Service portal, http://www.sars.gov.za/home.asp?pid=3919 (official source) (last visited Sep. 22, 2009).

[18] *Id.*

2009–003270

LAW LIBRARY OF CONGRESS

UNITED KINGDOM

TAXATION OF PASSIVE FOREIGN INVESTMENTS

Executive Summary

The taxation of assets of non-UK residents is quite complicated. There are varying rules and rates according to different types of income earned, with passive income being treated differently if it is a dividend or bank interest. Income generated through real estate investments are further treated differently and taxed at a higher rate.

"Parliament may legislate for the levying of taxes but there is a jurisdictional limitation to the persons who may be subjected to those taxes. That limitation is one of practical enforcement."
CCH British Tax Guide, ¶ 120-000.

I. Introduction

The general principle in the tax law of the United Kingdom is that non-UK residents are "liable to income tax on all UK-source income, subject to certain specific exemptions, and to reductions or exemptions given in a double tax treaty."[1] Income tax in the UK varies according to the amount an individual earns in each fiscal year. The basic rate of income tax is now 20% for income up to £37,400 (approximately US$60,000) and 40% for income over this amount.[2]

The rules of tax law regarding residence for individuals in the UK involve a number of factors. Individuals are considered to be resident in the UK if they are present there for 183 days or more during the tax year.[3] There is no exception to this rule. However, failing to meet this requirement does not automatically make a person nonresident. A number of other criteria are taken into account, such as visits that average more than ninety-one days a tax year over up to four consecutive years;[4] and the "location of [the persons] family, property and business or social connections[.]"[5]

---

[1] International Bureau of Fiscal Documentation, *Taxation of Individuals in Europe*, ¶ 7.3.1.1. The main piece of legislation regulating income tax in the UK is the Income and Corporation Taxes Act 1988, c. 1.

[2] HM Revenue and Customs, *Rates and Allowances: Income Tax*, http://www.hmrc.gov.uk/ rates/it.htm (last visited Sept. 22, 2009).

[3] HM Revenue and Customs, *Income Tax When Leaving the UK*, http://www.hmrc.gov.uk/ incometax/tax-leave-uk.htm (last visited Sept. 22, 2009).

[4] *Id*.

[5] HM REVENUE AND CUSTOMS, RESIDENCE, DOMICILE AND THE REMITTANCE BASIS 18, ¶ 2.2 (Apr. 2009), http://www.hmrc.gov.uk/cnr/hmrc6.pdf.

II. Nonresidents: Taxation on Passive Income from Investments, etc.

As noted above, non-UK residents are liable to income tax on all UK-source income. This includes passive income (commonly referred to in the UK as "investment income"), such as dividends, interest, income from annuities, royalties, etc.—income that is not earned by an individual as an employee, or through a business or trade.[6] If the country the non-UK resident is in has a double taxation agreement with the UK, it may be possible for the individual to obtain reliefs or exemptions.[7]

The rates of tax on income are quite complicated in the UK, and it has been noted that "no accurate description could be readily comprehensible; and no comprehensible description could be accurate. The complexity appals [sic] even tax practitioners enured [sic] to it."[8] Generally, non-UK residents are taxed at the source—i.e., the bank or building society will automatically withhold the basic rate of tax before paying any interest to the individual. In general terms, depending upon the type of interest earned, the tax rates vary according to the tax rate bracket the individual falls in, which ranges from 20 to 40%.[9] HMRC has stated that non-UK residents do not pay taxes on dividends from UK companies.[10] For US residents, the rate of tax levied by the UK on residents of the US is subject to the terms of its double taxation agreement.

III. Allowances

There is a system of tax credits in the UK known as allowances that may be used to offset individuals' income tax liability. Generally, nonresidents are exempt from using these allowances; however, there are certain categories of non-UK residents that may use them. These include:

> Commonwealth citizens (this includes British citizens); or nationals of any European Economic Area (EEA) state (Austria, Belgium, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Liechtenstein, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, and the United Kingdom); for tax years from 2004-05 onwards, this includes Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia and for tax years from 2006-07 onwards, Bulgaria and Romania are also included.[11]

---

[6] *Id*. at 6, ¶ 9.1.

[7] HM Revenue and Customs, *Income Tax When Leaving the UK*, *supra* note 3.

[8] JAMES KESSLER, TAXATION OF FOREIGN DOMICILIARIES ¶ 16.9 (3rd ed., 2004).

[9] HM Revenue and Customs, *Rates and Allowances: Income Tax*, *supra* note 2.

[10] HM REVENUE AND CUSTOMS, RESIDENCE, DOMICILE AND THE REMITTANCE BASIS, *supra* note 5, at 6, ¶ 9.1.

[11] HM Revenue and Customs, *UK Allowances for Non-Residents*, http://www.hmrc.gov.uk/CNR/allow_nonres.htm.

IV. Real Estate

Rental income on property[12] in the UK is subject to tax, regardless of whether the landlord is a UK resident or not. The UK operates a program known as the "Non-Resident Landlord Scheme" for non-UK residents, administered by Inland Revenue's Centre for Non-Residents (CNR).[13] This scheme applies to individuals, companies, and trusts.

Under the scheme an individual's residence is determined by the person's usual place of abode rather than by the traditional definition of nonresidence for tax purposes in the UK.[14] A person is considered a nonresident if he or she usually lives outside the UK. An absence from the UK for six months or less is considered temporary and not sufficient to qualify the individual for the scheme.[15] The scheme serves to tax the UK rental income of nonresident landlords at the basic rate of income tax, which is currently 20%.[16] This tax is typically obtained by letting agents,[17] who manage the property and collect the rent on the landlords' behalf, deducting the basic rate tax from any rent they collect. Letting agents that operate under the Non-Resident Landlord Scheme must register with Her Majesty's Revenue and Customs Residency "within 30 days of the date on which they are first required to operate the scheme."[18] The letting agent then receives a registration number and information on how to operate within the program, such as how to submit the tax deducted to the Inland Revenue's Accounts Office.[19] If the landlord does not use a letting agent, the tenant is responsible for withholding

[12] The definition of what rental income includes is broad, and extends to: "income from letting furnished, unfurnished, commercial and domestic premises, and from any land; where property is let furnished, any separate sums from the tenant for the use of the furniture; rent charges, ground rents and feu duties; premiums and other similar lump sums received on the grant of certain leases; income arising from the grant of sporting rights, such as fishing and shooting permits; income arising from allowing waste to be buried or stored on land; income from letting others use land; insurance recoveries under policies providing cover against non-payment of rent; and service charges received from tenants in respect of services ancillary to the occupation of property." HM Revenue and Customs, *The Non-resident Landlords Scheme Guidance notes for letting agents and tenants*, 2003, ¶ 9.7, *available at* http://www.hmrc.gov.uk/CNR/nrl_guide_notes.pdf.

[13] This program is regulated by Section 42A Income and Corporation Taxes Act 1988, c. 1, and the Taxation of Income from Land (Non-residents) Regulations 1995, SI 1995 No. 2902.

[14] HM Revenue and Customs, *The Non resident Landlords Scheme*, http://www.hmrc.gov.uk/CNR/nr_landlords.htm#11 (last visited Sept. 22, 2009).

[15] HM Revenue and Customs, *The Non-resident Landlords Scheme Guidance notes for letting agents and tenants*, *supra* note 12, ¶ 2.3.

[16] *Id.* (generally); HM Revenue and Customs, *Rates and Allowances: Income Tax*, *supra* note 2.

[17] HM Revenue and Customs considers a letting agent as a "person who: has a usual place of abode in the UK; acts for a Non resident landlord in the running of their UK rental business; has the power to receive income of the Non resident landlord's rental business, or has control over the direction of that income; and is not an 'excluded person.' An excluded person is someone whose activity on behalf of a Non resident landlord is confined to providing legal advice/services. However, solicitors who draw up a lease and collect the rent for the first period are not excluded persons." HM Revenue and Customs, *The Non resident Landlords Scheme*, *supra* note 14.

[18] *Id.*

[19] *Id.*; HM Revenue and Customs, *The Non-resident Landlords Scheme Guidance notes for letting agents and tenants*, *supra* note 12,¶ 1.2.

the tax on rent of over £100 per week (approximately US$160) and paying this to the Inland Revenue's Accounts Office on a quarterly basis.[20]

There are certain deductible expenses that can be taken off the amount of rent that serves to reduce the taxable amount. These deductible expenses are those that "are incurred wholly and exclusively for the purposes of the rental business [and that are] not of a 'capital' nature."[21]

In certain circumstances,[22] nonresident landlords can obtain approval from Her Majesty's Revenue and Customs to receive rents with no tax withheld from either the letting agent or tenant, who will receive a letter from Her Majesty's Revenue and Customs stating they do not need to deduct taxes. However, the rent is still liable to taxation and the nonresident landlord must include it in any tax return sent to them by Her Majesty's Revenue and Customs.[23]

A further provision that makes gains on the sale of property by nonresidents chargeable to tax in the UK is provided under section 756 of the Income Tax Act 2007.[24] This Act provides that gains arising from the disposal of land are to be treated as income if:

- the land is acquired with the sole or main object of realising a gain from disposing of all or part of the land,
- any property deriving its value from the land is acquired with the sole or main object of realising a gain from disposing of all or part of the land,
- the land is held as trading stock, and
- the land is developed with the sole or main object of realising a gain from disposing of all or part of the land when developed.[25]

If the sale of property by non-UK residents meet these criteria, gains made on the sale of the property are liable to UK income tax, subject to any double taxation treaty.[26]

---

[20] HM Revenue and Customs, *The Non-resident Landlords Scheme Guidance notes for letting agents and tenants*, *supra* note 12, ¶ 7.

[21] HM Revenue and Customs, *The Non resident Landlords Scheme*, *supra* note 14. For further information regarding what is considered to be a capital expense, *see* HM Revenue and Customs, *Property Income Manual*, http://www.hmrc.gov.uk/manuals/pimmanual/index.htm (last visited Sept. 22, 2009).

[22] These circumstances are where: the nonresident landlord's "UK tax affairs are up to date; or they have not had any UK tax obligations before they applied; or they do not expect to be liable to UK income tax for the year in which they apply; or they are not liable to pay UK tax because they are Sovereign Immunes (these are generally foreign Heads of State, governments or government departments)." HM Revenue and Customs, *The Non resident Landlords Scheme, supra* note 14.

[23] *Id*.

[24] *See also* Martin Palmer, *Sheltering the Profits of UK Land Development Deals Post-Finance Bill 2008*, June 2008, [2008] J.T.C.P. 130.

[25] Income Tax Act 2007, c. 3, § 756(3).

[26] The UK has concluded over 100 tax treaties relating to the avoidance of double taxation and claims to have the largest network of treaties on this subject. The UK currently uses the OECD Model Convention for its tax

V. Capital Gains Tax

Non-UK residents are generally exempt from Capital Gains Tax (CGT), which is currently a flat rate of 18%[27] levied on all the chargeable gains of individuals during the year in which they are resident, or ordinarily resident, in the UK.[28] Thus, with limited exceptions, a nonresident is generally exempt from UK CGT, regardless of the location of the asset disposed of.[29]

VI. Double Taxation Treaties

The UK has concluded over 100 tax treaties relating to the avoidance of double taxation and claims to have the largest network of treaties on this subject.[30] The UK currently uses the OECD Model Convention for its tax treaties.[31] The UK and the US have a tax treaty[32] that provides that income from real property shall be taxed in the country in which the property is located;[33] and interest and royalties be taxed only in the country in which the beneficial owner is resident.[34]

The situation with dividends is a little more complicated, although ultimately the tax rate will not exceed 15%. The explanatory notes to the legislation implementing the tax treaty in the UK state:

> [D]ividends shall not be taxed in the country of source where they are beneficially owned by a company that has owned shares representing 80 per cent. or more of the voting power of the company paying the dividends for a 12-month period ending on the date the dividend is declared, or where the dividend is beneficially owned by a pension scheme (Article 10). Otherwise, the rate of tax imposed in the country of source on dividends beneficially owned by a resident of the other country is not to exceed 5 per cent. of the

---

treaties. UK Trade and Investment, *Tax in the UK*, Dec. 2007, http://www.ukinvest.gov.uk/United-Kingdom/4016067/en-GB.html; II THE TAXATION OF COMPANIES IN EUROPE ¶ 8.6.1.

[27] For 2008-09 and later years, Capital Gains Tax is charged at a flat rate of 18 %. *See* http://www.hmrc.gov.uk/CGT/intro/basics.htm.

[28] Taxation of Chargeable Gains Act 1992, c. 12, § 2. This Act provides that "… a person shall be chargeable to capital gains tax in respect of chargeable gains accruing to him in a year of assessment [1] during any part of which he is resident in the United Kingdom, or [2] during which he is ordinarily resident in the United Kingdom."

[29] JAMES KESSLER, su*pra* note 8, ¶ 17.1.

[30] UK Trade and Investment, *Tax in the UK*, *supra* note 26.

[31] II THE TAXATION OF COMPANIES IN EUROPE, *supra* note 26, ¶ 8.6.1.

[32] Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains, signed July 24, 2001, entered into force Mar. 31, 2003, 2224 U.N.T.S. 247. Further information on the tax treaty is available at HMRC, *Tax Bulletin, Special Edition, UK/US Double Taxation Agreement*, April 2003, http://www.hmrc.gov.uk/bulletins/tbse6.pdf.

[33] Convention for the avoidance of double taxation, *supra* note 32, arts. 6, 13.

[34] *Id*. arts. 11, 12.

> gross amount of the dividends when the beneficial owner is a company owning, directly or indirectly, shares representing at least 10 per cent. of the voting power of the company paying the dividends. In all other cases the rate of tax shall not exceed 15 per cent of the gross amount of the dividends.[35]

Prepared by Clare Feikert-Ahalt
Senior Foreign Law Specialist
September 2009

[35] The Double Taxation Relief (Taxes on Income) (The United States of America) Order 2002, SI 2002/2848, Explanatory Note*, available at*: http://www.opsi.gov.uk/si/si2002/20022848.htm (last visited Sept. 22, 2009).