World-Wide Taxation Versus Territoriality in Controlled Foreign Corporation Rules

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COMPARATIVE SUMMARY

WORLD-WIDE TAXATION VERSUS TERRITORIALITY IN CONTROLLED FOREIGN CORPORATION RULES

Executive Summary

In recent years, Germany, France, and Japan have increased their observance of the principle of territoriality in the taxation of foreign controlled corporations by exempting inter-corporate dividends either totally or to a large extent. The United Kingdom is in the process of enacting similar legislation.

I. Purpose of Comparison

This report focuses on the balance between world-wide income-based taxation and territorial taxation in the controlled foreign corporation rules of France, Germany, Japan, and the United Kingdom. These countries have anti-tax haven provisions that tax the domestic parent of a controlled foreign corporation (CFC) on income realized by the CFC but not distributed to the parent. This taxation of attributed income is in disregard of the otherwise prevailing principle of territoriality according to which the income of a corporation would only be taxed by the country of its headquarters. All the countries surveyed justify the overriding of the territorial principle with the need to counteract the apparent intent of the resident parent to evade domestic taxation by moving operations to a low tax country and by deferring the repatriation of the profits.

II. Scope of the Anti-Tax Avoidance Schemes

The criteria for applying CFC rules differ from country to country. These criteria include the definition of a tax haven, and the listing of the circumstances that make a foreign corporation a controlled one. Germany, in addition, distinguishes between passive and active income, and it applies the reach-through taxation of the anti-avoidance scheme only to income defined as passive. France, Japan, and the United Kingdom, on the other hand, tax all income of a controlled foreign corporation.

III. Definition of a Tax Haven

In France, a country with a tax-privileged regime is defined as one that has an effective tax rate of no more than half the French tax rate. In Germany and in Japan,[1] a country of low

[1] The information on Japan is in part based on the Act on Special Measures Concerning Taxation (Limited to the provisions related to nonresidents and foreign companies), Act No. 26 of March 31, 1957, as amended, chpt. II, *available at* http://www.japaneselawtranslation.go.jp/law/detail_list/?printID=&re=02&kn%5B%5D=%E3%81%9D&ky= financial&vm=02&id=41 (last visited June 9, 2009). An update of the attached country report on Japan will be provided in the near future.

taxation is one with a tax rate of less than 25 percent. In the United Kingdom, a country is a country of low taxation if its tax rate is less than 75 percent of the UK tax rate.

IV. Definition of a Controlled Foreign Corporation

Differences also exist in the definition of a controlled foreign corporation. In France and Japan, the general rule is that the domestic parent's ownership of 50 percent makes the foreign subsidiary a controlled corporation, yet under certain circumstances a corporation is controlled for a domestic parent with a 5 percent ownership share; in France this applies if the parent acts in concert with other domestic parents who also own parts of the controlled corporation. In Germany, 50 percent ownership is the general threshold for making a foreign corporation a controlled corporation, yet a threshold participation of 1 percent is sufficient for ownership in companies that specialize in certain passive income investment activities, and any investments in a real estate investment trust are subject to reach-through taxation.

V. Active and Passive Income

France, Japan, and the United Kingdom tax all income of a controlled foreign corporation. Germany, on the other hand, does not tax active income but merely treats passive income as earned. The German law lists all the active income and defines passive income as that not falling into a listed category. In practice, this amounts to treating interest and royalty income as passive. In 2001, Germany reclassified dividends as active income, and this reclassification makes the German system much more territorial, by leaving the subsidiary's income untaxed until repatriation.

VI. The Territoriality Principle and the Taxation of Inter-Corporate Dividends

Some eight or nine years ago, Germany and France began to exempt 95 percent of inter-corporate dividends from taxation. The German exemption applies to dividends from domestic and foreign sources alike. In France, the exemption is applied in a more differentiated manner to foreign dividends, because much income from foreign sources is already exempt from taxation, due to the prevailing principle of territoriality.[2] In April 2009, Japan enacted a 95 percent exemption of the dividend income from a foreign subsidiary, to encourage the repatriation of profits. The United Kingdom is contemplating a 95 percent tax exemption for inter-corporate dividend income from foreign and domestic sources, and this proposal is justified in terms of territoriality and a desire to adjust tax laws to the realities created by modern business practices.

Japan has adjusted its controlled foreign corporation rules to the new foreign dividend exemption[3] and the United Kingdom is also contemplating adjustments to its controlled foreign corporation rules, if and when the 95 percent tax exemption for inter-corporate dividends is enacted. Germany changed dividends to active income in its controlled foreign corporation scheme in 2001, thereby removing them from attribution to the parent, whereas France continues

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[2] 2 GUIDES TO EUROPEAN TAXATION, TAXATION OF COMPANIES IN EUROPE: FRANCE ¶ 2.3.1.2 (IBFD, Amsterdam, 2008).

[3] These changes will be described in an amendment to this report.

to tax the entire income of the controlled foreign corporation at the prevailing French rate of taxation, which for dividend income realized by the controlled corporation now has been reduced to 5 percent.

Exempting foreign dividends from taxation when they are earned or deemed to be earned strengthens the principle of territoriality in the taxation of income from foreign sources both for controlled foreign corporations and for other foreign subsidiaries. The anti-tax avoidance schemes of the surveyed countries were created in the last quarter of the 20th century in similarity to Subpart F of the U.S. Internal Revenue Code. All these schemes departed from the principle of territorial taxation that had formerly been adhered to more generally in the surveyed countries, particularly in France, where much business income from foreign operations is not taxable, even when repatriated.[4] The large-scale exemptions of inter-corporate dividends from taxation that have been available in France and Germany for some years, have just been enacted in Japan, and may soon be enacted in the United Kingdom, indicate a return to a stronger observance of the principle of territoriality in the taxation of foreign source income in general and also in the taxation of a foreign controlled corporation, because less of its income is now subject to the reach-through taxation of the resident parent.

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[4] 2 GUIDES TO EUROPEAN TAXATION, *supra* note 2.

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FRANCE

TAXATION OF CONTROLLED FOREIGN CORPORATIONS

Executive Summary

As an exception to the principle of territoriality and to defeat tax evasion, France attributes to French companies subject to French corporate tax the profits of certain foreign legal entities established in "tax privileged" jurisdictions and controlled by such French companies. Normal corporate tax rules apply. The profits of the foreign legal entities are deemed to be investment income taxable to the French company in proportion to the stocks, shares, or financial rights it holds directly or indirectly in such foreign legal entities. The parent-subsidiary tax exemption regime applicable to dividends will apply to dividends effectively distributed by the foreign legal entity to the French company if certain conditions are met. A safeguard clause excludes from this specific tax regime foreign legal entities established in the European Union unless they are purely artificial structures having as their sole purpose the avoidance of French tax, as well as legal entities principally engaged in commercial or industrial activities established outside the EU.

I. Introduction

As a general rule corporate income taxation is based on the principle of territoriality. As an exception to this principle, article 209B of the French General Tax Code aims at defeating tax evasion by taxing profits of certain foreign entities established in "tax privileged" jurisdictions and controlled by legal entities subject to French corporate tax. Article 209B was first introduced in 1980. It was substantially amended by the 2005 Finance Law, as the original version was likely contrary to EU law and the issue of whether a tax treaty would override its application was brought before the French administrative courts on several occasions.[1]

II. Scope of Article 209B

Article 209B provides that a legal entity subject to French corporate tax may be taxed in France on the profits of a foreign company established in a "tax privileged regime" country as defined by article 238A of the General Tax Code, where:[2]

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[1] I LAMY FISCAL: IMPOT SUR LES SOCIETES § 327 (Lamy 2009).

[2] CODE GENERAL DES IMPOTS (C.G.I.) art. 209B (Dalloz 2008).

- The legal entity exploits the foreign company (foreign permanent establishment); or

- The legal entity directly or indirectly owns more than 50 percent of the stocks, shares, financial rights, or voting rights in the foreign company. This percentage is reduced from 50 percent to 5 percent in situations where more than 50 percent of the stocks, shares, financial rights, or voting rights of the foreign legal entity are held by, (a) companies established in France that, if the foreign legal entity is listed on a regulated market, have acted in concert; or (b) foreign companies that are directly or indirectly placed under the control or dependency of a French company within the meaning of article 57 of the General Tax Code. Article 57 deals with transfer pricing.

A. Definition of 'Foreign Companies'

The Code defines "foreign companies" to include stock companies established outside of France, partnerships or similar entities, joint ventures, and trusts or similar entities.[3]

B. Determination of 'Tax Privileged Regime'

Since January 1, 2006, foreign companies have been deemed to be established or constituted in a country having a tax privileged regime if the effective taxation rate in the country is at least 50 percent lower than the tax rate in France.[4] The standard tax rate in France is 33.33 percent.[5] Prior to 2006, a country was considered to have a privileged tax regime where it imposed a tax burden on companies significantly lower than the tax rate imposed in France (generally, less than two-thirds of the French corporate tax).[6]

III. Tax Regime

As a general rule, normal French tax rules apply where income from a foreign permanent establishment or a foreign legal entity is attributed to a French company under article 209B. A brief overview of the main features of the applicable tax regime is provided below.

Article 209B provides that the profits or positive revenues of the foreign permanent establishment or of the foreign legal entities are subject to French corporate income tax. The profits of the foreign permanent establishment are taxed to the French company as ordinary income while the profits of the foreign legal entity are deemed to be investment income (*revenu de capitaux mobiliers*) taxable to the French company in proportion to the stocks, shares, or financial rights it holds directly or indirectly in such foreign legal entity.[7]

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[3] LAMY FISCAL, *supra* note 1, § 332.

[4] C.G.I. art. 238A.

[5] *Id*. art. 219(I).

[6] LAMY FISCAL, *supra* note 1, § 333.

[7] C.G.I. art. 209B.

The parent-subsidiary tax exemption regime applicable to dividends applies to dividends effectively distributed by the foreign legal entity to the French company if the conditions set forth by article 145 of the General Tax Code are met and as long as the French company has opted for this regime. This special regime is optional and parent corporations may choose to be subjected to the normal rules applicable to companies not deemed parent companies.[8]

Article 145 defines "parent company" as a company that owns at least 5 percent of the outstanding stock of the subsidiary as of the date of payment of the dividends and the shares of the subsidiary must have been held for at least two years.[9] If a company is deemed to be a parent company, 95 percent of the gross dividends it receives from its subsidiaries is tax exempt. The remaining 5 percent is presumed to be a "service charge" incurred by the parent company.[10]

The income attributed to the French company is not taxed separately but is included in the French company's taxable income, allowing the possibility to offset losses against these profits.[11] The foreign tax due on the profits attributed to the French companies is credited against the corresponding French tax, provided that the foreign tax is comparable to French corporate tax.[12]

IV. Safeguard Clause

The system of taxation imposed by article 209B is not applicable to the following cases:[13]

- The foreign permanent establishment or legal entity is established in the EU and is not a purely artificial structure having for its sole purpose the avoidance of French tax. The definition of "artificial structure" can be found in the *Cadbury Schweppes* case decided on September 12, 2006, by the European Court of Justice.[14] The French tax authorities must show that the legal entity's purpose was to avoid paying French tax.

- The foreign permanent establishment or legal entity is established outside the EU and is principally engaged in commercial or industrial activities. In this case, however, the French company must show that the following operations of the foreign entity are not motivated by tax reasons: (1) more than 20 percent of the company's income is derived from the management, preservation, or increase of shares, participations, or assets for its own account or for the account of a group of companies that are controlled by the company established in France, or from the sale or concession of

[8] LAMY FISCAL, *supra* note 1, § 337.

[9] C.G.I. art. 145.

[10] *Id*. art. 216.

[11] LAMY FISCAL, *supra* note 1, § 339.

[12] *Id*. § 341.

[13] *Id*. § 345.

[14] Cadbury Schweppes v. Commissioner of Inland Revenue, Sept. 12, 2006, ECJ, 2006 O.J. (C 281) 5.

intangible rights related to industrial, intellectual, or artistic property; or (2) more than 50 percent of the company's income is derived from the operations mentioned in (1) and from intra-group services, including financial services.

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GERMANY

TAXATION OF CONTROLLED FOREIGN CORPORATIONS

Executive Summary

Germany enacted controlled foreign corporation rules in 1972, following the model of Subpart F of the U.S. Internal Revenue Code. In 2001, however, the German taxation of foreign controlled corporations became more territorial than its U.S. counterpart. At that time, Germany classified dividends as active income in its controlled foreign corporation rules, thereby exempting them from the reach-through taxation that is imposed on the passive income of the resident parent. This change was preceded by a change in domestic tax legislation that generally reduced the tax rate on inter-corporate dividends, both foreign and domestic, to 5 percent.

I. Development of the Controlled Foreign Corporations Rules

Germany taxes its resident corporations[1] and individuals[2] on their worldwide income. This principle is described in German tax parlance as "unlimited tax liability," in contrast to the concept of "limited tax liability" on the basis of which corporate and individual residents of other countries are taxed on their German source income.[3] In practice, however, the German residents' unlimited tax liability is mitigated through double taxation treaties and unilateral double taxation relief. Until 1972, the exemption of foreign source income under many double taxation treaties may have been the only territorial factor in the otherwise world-based taxation of German residents.[4]

In 1972, Germany introduced another form of taxation on a worldwide basis, by enacting the International Transactions Tax Act of 1972[5] (hereafter, ITTA), which taxes Germans who relocate themselves and/or their income to tax haven countries as though their gainful activities and/or their assets had remained in Germany. One of the ITTA schemes to counteract tax avoidance is the tax regime for controlled foreign corporations (CFC).[6]

[1] Körperschaftsteuergesetz [KStG], repromulgated Oct. 15, 2002, BUNDESGESETZBLATT [BGBl. official law gazette of the Federal Republic of Germany] I at 4210, as amended, § 1.

[2] Einkommensteuergesetz [EStG], repromulgated Oct. 19, 2002, BGBl. I at 4210, § 1.

[3] KStG § 2; EStG § 49.

[4] EKKEHARD BÄCHLE & THOMAS RUPP, INTERNATIONALES STEUERRECHT 27 (Stuttgart, 2002).

[5] Aussensteuergesetz [AStG], Sept. 8, 1972, BGBl I at 1713, last amended by Gesetz, Dec. 19, 2008, BGBl I at 2794.

[6] AStG §§ 7 - 14.

Subpart F of the U.S. Internal Revenue Code[7] served as the model for these German rules.[8] Until the year 2000, the German CFC rules underwent little change, but since then several important changes have been made that affect the balance between the principles of worldwide taxation and territorial taxation.

- In 1972, the German CFC rules applied to a controlled corporation that generally was defined as owning 50 percent of its subsidiary, while a threshold participation of 10 percent was sufficient for ownership in certain companies that specialize in investment activities. In 2001, this latter threshold was lowered to an ownership of 1 percent,[9] and since 2007, there is no threshold at all for investments in a foreign real estate investment trust: any such investment leads to the reach-through taxation of the domestic investor.[10]
- In 1972, the level of taxation that made a foreign country a tax haven was 30 percent or less, yet with the enactment of a Tax Reduction Act in 2000, the threshold was lowered to 25 percent.[11]
- In 1972, passive income included interest, dividends, royalties and similar types of income. In 2001, however, dividends were declared to be active income, and therefore were no longer attributed to the resident parent.[12]
- Finally, in 2008, the law was reformed to make the CFC rules largely inapplicable to other European Union countries.[13] This latter change was required under European Union law.[14]

The elimination of dividends (and also capital gains) from the passive investment category in 2002 was occasioned by a reform of German corporation law that was enacted between 1999 and 2001 and that exempts from taxation 95 percent of the dividends distributed to a corporation that is subject to German taxation.[15] This rule is provided in section 8b of the Corporation Tax Act,[16] which exempts dividends received from domestic corporations and

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[7] 26 U.S.C. (I.R.C.) §§ 951-964 (1999), Subpart F – Controlled Foreign Corporations.

[8] L. REHFELD, DIE VEREINBARKEIT DES AUSSENSTEUERGESETZES MIT DEN GRUNDFREIHEITEN DES EG-VERTRAGES 237 (Frankfurt, 2008). For a comparison of the economic effects of Subpart F and the German scheme, *see* SANDRA GROSSE, SUBPART F ALS REFERENZ FÜR DIE DEUTSCHE HINZURECHNUNGSBESTEUERUNG (Frankfurt, 2003).

[9] THOMAS REITH, INTERNATIONALES STEUERRECHT 42 (2009).

[10] AStG § 21.

[11] *Id.*

[12] THOMAS REITH, *supra* note 8.

[13] AStG § 21.

[14] Case C-196/04, Cadbury Schweppes plc v. Comm'rs of Inland Revenue, 2006 E.C.R. I-7995.

[15] BERNARD ERLE & THOMAS SAUTER, HEIDELBERGER KOMMENTAR ZUM KÖRPERSCHAFTSSTEUERGESETZ 518 (Heidelberg, 2006).

[16] KStG § 8b, paras. 1 & 5.

foreign corporations alike.[17] Under this system, the domestic dividend-distributing corporation is taxed at a 15.83 percent tax rate[18] on its earned income (whether distributed or not), and ultimately the resident private shareholder is taxed on his dividend income.[19] In between these two stages, when a corporation receives dividends from its subsidiary or from portfolio investments, this income is generally not taxed. Foreign corporations are included in this exemption from taxation, in order to grant them equal treatment.[20]

The actual exemption of only 95 percent of dividend income results from section 8b, paragraph 5, which provides for the taxation of 5 percent of the dividend income on the grounds that this percentage is attributed to expenses that the corporation may be able to deduct in its general income computation and that may have been incurred in the generation of the exempted income.[21]

III. The Current Controlled Foreign Corporation Rules

A. Overview

This report is limited to describing the basic features of the foreign controlled corporation rules on the basis of which certain income realized by a foreign corporation is attributed to the parent even though the foreign corporate income was not distributed to the parent. These features are:

- The definition of a CFC;
- The definition of a low country of taxation (tax haven); and
- The definition of passive income.

The statutory provisions are very complex and include rules on how to reconcile the attribution of controlled foreign corporation income with double taxation treaties; how to calculate the income of third-tier subsidiaries; and how to tax repatriated profits after they have already been taxed by attribution of the income. These aspects of the German CFC scheme are not explained in this report.

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[17] DROSTE KILIUS DRIEBEL, GERMAN TAX AND BUSINESS LAW GUIDE paras. 133-20 through 133-60 (London, 2003); DIETMAR GOSCH, KÖRPERSCHAFTSTEUERGESETZ 802 (München, 2005).

[18] Added to the corporate tax rate of 15 percent, KStG § 23, is a surcharge of 5.5 percent of the tax rate, Solidaritätszuschlagsgesetz, repromulgated Oct. 15, 2002, BGBl. I at 4130, as amended, thus increasing the tax rate to 15.83 percent.

[19] Individual taxpayers, both foreign and domestic, who have portfolio holdings of shares in German companies are subject to a withholding tax of 20 percent, EStG § 20, para. 1, in conjunction with EStG § 49, para. 5(a), plus a 5.5 percent surcharge, Solidaritätszuschlaggesetz, repromulgated Oct. 15, 2002, BGBl I at 4130, as amended, thus amounting to 21.1 percent.

[20] DIETMAR GOSCH, *supra* note 17, at 791.

[21] *Id*. at 874.

B. Definition of a Controlled Foreign Corporation

In Germany, 50 percent ownership is the general threshold for making a foreign corporation a controlled corporation, yet a participation of 1 percent is sufficient for ownership in certain companies that specialize in certain passive income-generating investment activities, and no threshold at all applies to real estate investment trusts: any income realized from a foreign real estate investment trust is subject to the reach-through taxation. [22]

Since 2008, the controlled foreign corporation rules do not apply to income from corporations located in other member states of the European Union, if these corporations engage in any meaningful industrial or commercial activity.[23]

C. Definition of a Tax Haven

Germany applies the anti-tax avoidance scheme for controlled foreign corporations to countries with a low level of taxation, and these are currently defined as countries that impose a tax liability of less than 25 percent on the income of the controlled corporation.[24]

D. Active and Passive Income

The German law provides for the taxation of passive CFC income, while exempting active income from reach-through taxation. The law lists all the categories of active income to which the CFC regime is not applied and defines passive income as that not falling into a listed category. In practice, this amounts to treating interest and royalty income as passive.[25] In 2001, Germany reclassified dividends as active income (and also capital gains),[26] and this reclassification makes the German system much more territorial, by leaving the subsidiary's income untaxed until repatriation.

IV. Concluding Remarks

Germany has developed its controlled foreign corporation rules so as to reach foreign passive income that its private or corporate resident investors want to shield from domestic taxation. For this purpose, thresholds of ownership have been lowered or even removed, when assets are moved abroad for no apparent purpose other than to invest them. No reach-through taxation, however, is applied to dividends. These are treated like active business income that remains untaxed until repatriation. This favorable treatment of dividends appears to be in keeping with the general German philosophy of reducing corporate tax burdens, according to

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[22] AStG § 8, para. 1.

[23] Holger Häuselmann, *Steuerliche Änderungen durch das Jahressteuergesetz 2008 vom 8.11.2007*, BETRIEBS-BERATER 20 (2008).

[24] AStG § 8, para. 3

[25] *Id*. para. 1.

[26] *Id*. para. 1, nos. 8 & 9.

which all inter-corporate dividends, both foreign and domestic, are taxed when distributed at a rate of 5 percent.

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JAPAN

NEW DEVELOPMENTS IN THE TAXATION OF CONTROLLED FOREIGN CORPORATIONS

Executive Summary

The 2009 Corporation Tax amendment introduced a foreign dividend exemption. The Foreign Tax Credit system has also been amended to reflect this change.

I. Exemption of foreign dividends

Prior to the 2009 tax year, dividends received by an overseas subsidiary was included in corporate taxable income and subject to taxation at the normal rates for corporate taxes. This system discouraged Japanese parent corporations from transferring dividends from their foreign subsidiaries to themselves, because the tax rate for Japanese corporations are generally higher than that of other countries.[1] To encourage the repatriation of overseas earnings, the 2009 amendment to the tax laws[2] introduced the "foreign dividend exemption." Under the 2009 law, dividends received by domestic corporations from a foreign company in which the domestic corporation has held at least 25% of the outstanding shares for a continuous period of at least six months can be excluded from the company's taxable income.[3] 5 % of the dividends are deducted from the taxable income because this amount is regarded as costs.[4] Therefore, 95% of the dividends are excluded from the parent corporation's taxable income. Profits from the foreign branches of corporations are not included in the new system. Also, foreign investment

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[1] Kokusai sozei shō iinkai [International Tax Sub-Committee], Ministry of Economy, Trade and Industry, Wagakuni kigyō no kaigai rieki no shikin kanryū nit suite [Regarding Repatriation of Japanese Companies' Overseas Profits] (August 2008), *available at* http://www.meti.go.jp/press/20080822002/20080822002.pdf.

[2] Shotoku zei hō no ichibu o kaisei suru hōritsu [Law to Amend Parts of Income Tax Law and others], Law No. 13 of 2009.

[3] Hōjin zei hō [Corporation Tax Law], Law No. 34 of 1965, *last amended by* Law No. 13 of 2009, art. 23-2 and Hōjin zei hō sekō rei [Corporation Tax Law Enforcement Order], Order No. 97 of 1965, *last amended by* Order No. 105 of 2009, art. 22-3, para. 1.

[4] Corporation Tax Law, Law No. 34 of 1965, *last amended by* Law No. 13 of 2009, art. 23-2, and Corporation Tax Law Enforcement Order, Order No. 97 of 1965, *last amended by* Order No. 105 of 2009, art. 22-3, para. 2.

income, such as interest, royalties or capital gains from the transfer of shares in foreign subsidiaries, is not included in the new taxation system.[5]

II. Foreign Tax Credit System

Under Japan's old tax law, in order to eliminate double taxation, a foreign tax credit (FTC) was allowed when the corporation directly paid foreign taxes on the dividend,[6] or when the dividend paying subsidiary paid foreign taxes on the dividend.[7] To receive the foreign tax credits paid by the subsidiary, the corporation must have held 25% or more of the total number of shares,[8] amount of investment in capital or voting shares for at least six months prior to the dividend declaration date.[9] The introduction of the foreign dividend exemption under the new law eliminates the potential for double taxation on foreign dividends. Foreign withholding taxes paid directly on exempt dividends cannot be regarded as a loss to the domestic parent corporation.[10] When the foreign dividend exemption is not applied, the domestic parent company is eligible for a direct FTC claim.

III. Others

The tax rules regarding dividends received from a specified foreign subsidiary (SFS) have also been amended.[11] An SFS is a subsidiary that is located in tax haven countries.

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[5] Masaaki Suzuki, Kokugai shotoku menjo hōshiki o dou kangaeru ka [How To Think About Foreign Income Exemption System], MIZUHO REPORT, Apr. 23, 2009, 18.

[6] Corporation Tax Law, Law No. 34 of 1965, *last amended by* Law No. 23 of 2008, *before amended by* Law No. 13 of 2009, art. 69, para. 1.

[7] *Id*. art. 69, para. 8.

[8] *Id*.

[9] Corporation Tax Law Enforcement Order, Order No. 97 of 1965, *last amended by* Order No. 156 of 2008, *before amended by* Order No. 105 of 2009, art. 146.

[10] Corporation Tax Law, Law No. 34 of 1965, *last amended by* Law No. 13 of 2009, art. 39-2.

[11] Sozei tokubetsu sochi hō [Tax Special Measures Law], Law No. 29 of 1957, *last amended by* Law No. 13 of 2009, arts 66-6, 66-8, 66-9-2, 66-9-4, 68-90, 68-92, 68-93-2, and 68-93-4.

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UNITED KINGDOM

NEW DEVELOPMENTS IN THE TAXATION OF CONTROLLED FOREIGN CORPORATIONS

Executive Summary

The United Kingdom has not distinguished between passive and active income for foreign subsidiaries of UK resident companies. It determines the taxes payable by reference to the type of company, and then subsequently applies controlled foreign companies (CFC) rules to all the income of that company. It has recently announced measures that will largely exempt dividends of foreign companies from taxation.

I. Introduction

In the 2007 Budget, the United Kingdom's Chancellor of the Exchequer proposed to reform the taxation of the profits of foreign companies to meet the government's objective of maintaining "a competitive tax system for business ... [by] modernising and creating a more straightforward regime for taxing foreign profits."[1] A consultation paper was published in June 2007,[2] and the government has undertaken extensive discussions with the business world over the past few years.

II. Controlled Foreign Companies

The UK has had a tax system for controlled foreign companies (CFCs) in place since 1984. These rules were "originally designed to counter both tax deferral and the artificial diversion of profits from the UK."[3] The system of taxation of CFCs is highly complex; this report provides only a brief and very basic overview of it.

[1] HM TREASURY, TAXATION OF THE FOREIGN PROFITS OF COMPANIES: A DISCUSSION DOCUMENT (June 2007), *available at* http://customs.hmrc.gov.uk/channelsPortalWebApp/downloadFile?contentID=HMCE_PROD1_027592.

[2] *Id*.

[3] Letter from the Financial Secretary of the Treasury to the Hundred Group Fiscal Committee regarding Future Direction of Travel for Taxing Foreign Subsidiaries (Nov. 24, 2008), http://www.hm-treasury.gov.uk/d/pbr08_foreignprofits2_992.pdf.

III. Definition of a Controlled Foreign Company

Under the Income and Corporate Tax Act 1988, a CFC is considered to be controlled by a UK person if the UK resident has more than 50 percent of the share capital or voting power.[4] Additionally, if this threshold is not met, it is considered controlled if:

- There are two people who together control the company;
- One of those people resides in the UK and controls at least 40 percent[5] of the company; and
- The other person controls at least 40 percent[6] of the company, but not more than 55 percent.[7]

These companies are liable to taxation in the UK if they are subject to a lower level of taxation in their country of residence than if resident in the UK, unless one of five exemptions is met.[8]

The UK considers low tax countries to be those that subject the company to a level of taxation that is less than 75 percent of what the company would be liable to pay had they been resident in the UK, although certain countries that have "designer rates" are also considered to be low tax.[9]

IV. Taxable Income of Controlled Foreign Companies

The CFC rules focus on the type of company, which is determined by reference to the business that company conducts. If the company falls within a type that is taxed, the CFC rules apply to all the income of that company, rather than requiring a determination of passive versus active income.[10] This has been referred to as an "entity based 'all or nothing' regime."[11]

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[4] Income and Corporation Taxes Act 1988, c. 1, § 416.

[5] Ownership is determined according to the test in the Income and Corporation Taxes Act 1988, c. 1, § 755D(3).

[6] Ownership in this instance is determined according to the test in the Income and Corporation Taxes Act 1988, c. 1, § 755D(4).

[7] *Id.*, c. 1, § 747(1A).

[8] *Id.* § 747(1) & sch. 25. There are five exemption tests: the acceptable distribution test; the exempt activities test; the *de minimis* test; the public quotation test; and the motive test. *Id.*

[9] *Id.* § 750 & sch. 24. *See also* II THE TAXATION OF COMPANIES IN EUROPE: UNITED KINGDOM ¶ 10.4 (2008) The UK's current corporate tax rate is 28 percent.

[10] HM Revenue and Customs, Budget Note: Controlled Foreign Companies, http://www.hmrc.gov.uk/news/budget/cfc.pdf (last visited June 8, 2009).

[11] HM TREASURY, *supra* note 1, ¶ 1.16.

V. Proposed Changes

A package to reform the taxation of foreign profits received by UK companies, known as the "foreign profits package," has been introduced in the annual Finance Bill of 2009.[12] The annual Finance Bill serves to introduce measures that are proposed in the government's annual budget. The government has undertaken considerable consultation on these provisions, the most thorough dating from June 2007.[13] The government had initially consulted on a taxation regime that would distinguish between passive and active income; however, this was met with great opposition and was ultimately dropped from the Finance Bill.

The part of the foreign profits package that has attracted the most attention are new provisions in the Finance Bill 2009, which will provide a number of exemptions for the dividends of large and medium sized companies from corporate taxation in the UK, regardless of the source.[14] If these provisions are enacted, they will enter into force on July 1, 2009.

The new measures will treat foreign and UK dividends in the same manner, providing a number of exemptions from taxation.[15] Thus dividends will remain taxable; however, they will be subject to exemptions that will render them "largely exempt from corporation taxes."[16] The government has noted that introducing dividend exemptions:

> represents a move towards a more territorial system of taxing foreign subsidiaries so that a new CFC system should not tax profits that are genuinely earned in overseas subsidiaries. While we still want to counteract the artificial diversion of profits from the UK, the CFC rules should achieve this in a way that reflects modern business practice.[17]

These exemptions are not occurring in isolation and a number of other measures are being simultaneously introduced. The Treasury Office has announced that this reform will be accompanied by:

> a limited restriction to the interest deduction rules, which has been refined following discussions with business and will be introduced for accounting periods beginning on or after 1 January 2010. Furthermore, consequential changes to the controlled foreign companies (CFC) rules and replacement of the Treasury Consent rules with a post-transaction reporting requirement will be introduced from 1 July 2009.[18]

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[12] Finance Bill 2009, Bill 90, 2008-09, cls. 930D-930P.

[13] HM TREASURY, *supra* note 1.

[14] Finance Bill 2009, Bill 90, 2008-09.

[15] For a summary of the exemptions, *see* Gary Barnett, *Taxation of Foreign Dividends: Draft Legislation and Guidance*, LEXISNEXIS TAX DIRECTORS NEWS, http://www.lexisnexis.com/COMMUNITY/TAXDIRECTOR/blogs/tax_director_news/archive/2008/12/11/10224.aspx (last visited June 8, 2009).

[16] HM Revenue and Customs, Taxation of Foreign Profits, Apr. 2009, http://www.hmrc.gov.uk/budget2009/bn05.pdf.

[17] Letter from the Financial Secretary of the Treasury, Nov 24, 2008, *supra* note 3.

[18] HM TREASURY, *supra* note 1.

The government is currently continuing its consultations on how to reform the rules relating to CFCs to "enhance the UK's competitive position."[19]

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[19] Letter from the Financial Secretary of the Treasury, Nov 24, 2008, *supra* note 3.