Fundamentals of International Tax Planning

Chris Finnerty Paulus Merks Mario Petriccione Raffaele Russo

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Fundamentals of International Tax Planning

Why this book?

Economic activities have never been as global as they are today. This has contributed to the increase in the mobility of economic activities around the globe and has created opportunities – as well as problems – for the players in the world economy.

Looking at this setting from a tax perspective, Fundamentals of International Tax Planning provides readers with a basic knowledge of the tools currently used by multinational enterprises to benefit from the opportunities and overcome the problems created by the expansion of the market.

In other words, this book looks at techniques used to reduce an MNE's tax burden. Planning techniques are described in a neutral and concise manner, without taking into account a specific jurisdiction, but based on the principles that underlie them.

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Sample chapter

FINANCING ACTIVITIES

8.1. General

8.1.1. The choice between debt and equity

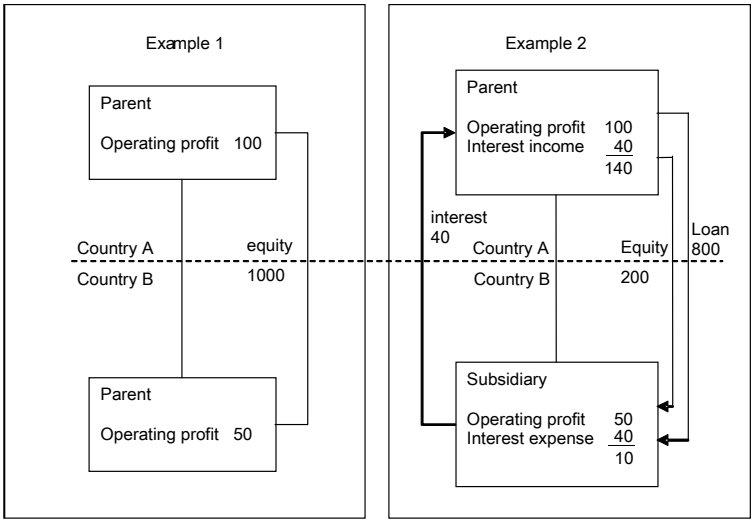
Most countries' tax systems make a fundamental distinction between the tax treatment of debt and that of equity. Debt is generally regarded as a resource that does not belong to the company; as a general rule, therefore, interest is treated as a tax-deductible expense (subject to restrictions and limitations). The underlying principle is that, if a company pays for the use of a resource that does not belong to it and that it uses for the purpose of its business, whether the resource be real property, equipment, intellectual property or loan capital, the remuneration paid for the use of that resource is a tax-deductible expense.

By contrast, as a general principle the remuneration that a company pays to its shareholders on its own capital is not tax deductible. The underlying concept here is that, by definition, a company's equity is part of the company's own resources and accordingly dividends paid to shareholders are not comparable to remuneration paid for other factors of production. This principle is not universally followed. For example, Brazil allows tax relief for dividends up to an amount equivalent to a notional amount of interest on the company's equity. Similarly, Belgium allows the deduction of a notional amount of interest, calculated on the equity of Belgian resident companies and permanent establishments.

Borrowings and equity are also often treated differently for the purpose of withholding tax. Several countries, for example Brazil, India, the United Kingdom and, in certain circumstances, China, do not apply a withholding tax on dividends paid to foreign companies but do so on interest. Instead of dividend withholding taxes, several countries (e.g. India and South Africa) levy an additional tax on a company when it pays a dividend; by contrast, distribution taxes normally do not apply to interest. Finally, raising debt and raising equity is often subject to different exchange control procedures, where an exchange control regime is in place.

As in the case of other resources, MNEs can generally choose how much equity to provide to their subsidiaries and therefore how much those subsidiaries need to borrow from the parent, from other group companies or from outside the group. Where the parent and the subsidiary are in different jurisdictions, the amount of equity that the parent provides to the subsidiary will affect the allocation of taxable profits between the two jurisdictions. This is illustrated in the two alternative examples in Table 10.

Table 10: Debt versus equity financing



The only difference between the two examples is that in Example 1 the parent finances the subsidiary entirely with equity, whereas in Example 2 it finances it with a mixture of debt and equity. In both examples, the overall profit of the group is the same, i.e. 150. However, in Example 1 country A taxes 100 and country B taxes 50, whereas in Example 2 the split of taxable profits is 140 for country A and only 10 for country B. In other words, the extent to which the subsidiary is leveraged has a major impact on the split of tax revenue between country A and country B. Because of the effect of leverage on the allocation of taxable profits between countries, many jurisdictions have introduced rules to limit the deductibility of interest expense in cases where leverage is regarded as excessive (so-called "thin capitalization" rules, discussed in Chapter 12).

There is also another way in which jurisdictions can mitigate the effect of leverage on their tax revenues, namely the application of a withholding tax. A withholding tax can in principle counteract the base-shifting effect of leverage. Let us return to Examples 1 and 2 in Table 10 above and suppose that the tax rate in both countries is the same (30%), that country B imposes a 30% withholding tax on interest and that country A gives full credit for such withholding tax. In this case, the tax collected by each country in each of the two examples will be the same, as shown in Table 11.

Table 11: Application of withholding tax

Example 1 (continued from Table 10)	
Country A	
Operating profit	100
Taxable income	100
Tax at 30%	30
Total tax revenue	30
Country B	
Operating profit	50
Tax at 30%	15
Total tax revenue	15

Example 2 (continued from Table 10)	
Country A	
Operating profit	100
Interest income	40
Taxable income	140
Tax at 30%	42
Less credit for withholding	12
Total tax revenue	30
Country B	
Operating profit	50
Interest expense	40
	10
Tax at 30%	3
Withholding tax	12
Total tax revenue	15

For reasons explained later in this chapter, imposing such a withholding tax will often render a jurisdiction very unattractive from the fiscal viewpoint. In particular, effective denial of tax relief in the country of the subsidiary (whether through thin capitalization rules, withholding taxes or otherwise) will often result in the MNE being unable to obtain tax relief for some of its external interest expense in *any* jurisdiction. To mitigate this effect, and to make themselves more attractive as investment destinations, many countries have entered into double tax conventions that very significantly reduce or eliminate the incidence of withholding taxes on interest. Moreover, withholding tax rates under domestic law are generally set at rates lower than the corporate income tax rate, and in many countries either no withholding tax is imposed or widely applicable exemptions are

available (e.g. in France, Germany, South Africa and the United Kingdom).

In jurisdictions that have an exchange control regime, the need for exchange control approval for borrowings can also be used as an effective mechanism to limit the extent of leverage in local subsidiaries of foreign MNEs. As an example, China and India have exchange control regimes that serve as an effective limitation on leverage and that in this respect, perform a similar function to withholding taxes and thin capitalization rules.

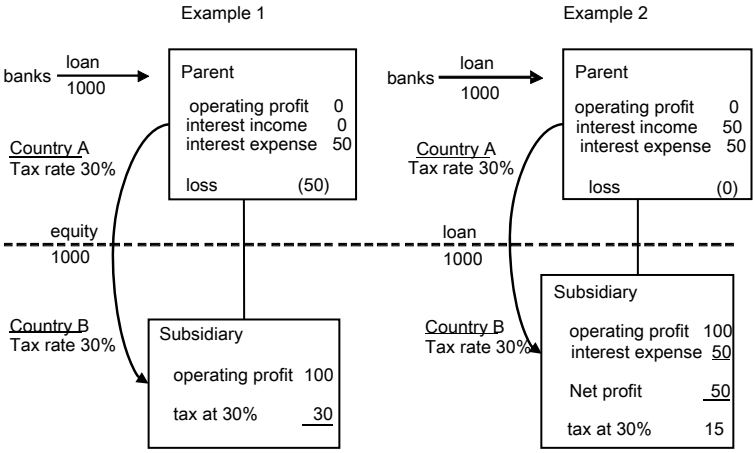
Looked at from the viewpoint of the group as a whole, the choice of the form of financing in the subsidiaries (equity or debt) is not *just* a question of *allocation* of taxable profit between different jurisdictions, but often affects the quantum of the taxable profits of the group as a whole, taking all jurisdictions together. This is due to several reasons. First, it is not automatically true that the parent is taxed on the interest received from the subsidiary. For example, for a parent based in Hong Kong such interest income would be exempt from Hong Kong tax as being foreign-source income. The same would be true, in general, for a parent based in Malaysia. Secondly, as discussed later in this chapter, there are many instances where a parent is able to ensure that there is no tax charge on the interest income. Thirdly, and most importantly, if the parent borrows to finance equity in the subsidiary, the question arises as to what deduction the parent is able to obtain for the corresponding interest expense. This is discussed in more detail below.

Several jurisdictions (e.g. China, Hong Kong, South Africa and Switzerland) do not allow the deduction of interest expenses on borrowings used to finance equity in subsidiaries. In such cases, leveraging the subsidiary may be the only way in which the MNE can deduct external interest expenses. A similar problem arises in the United States, where the interest expense is in principle deductible but, if the subsidiary is located abroad, reduces the amount of foreign-source income and therefore the maximum amount of double tax relief that can be claimed in the United States.

A similar issue is encountered by MNEs that are based in countries where they do not have substantial operations, their presence being limited to holding activities that generate no net taxable profits in the country where the holding company is located. For such an MNE, borrowing in the home country to finance equity in foreign subsidiaries will be very unattractive, pushing up the effective tax rate as illustrated in Table 12. This problem is frequently encountered by MNEs based in locations chosen because of

their well-developed capital markets, for example Hong Kong, Luxembourg, Switzerland and the United Kingdom.

Table 12: Impact of form of finance on ETR



The tax position for the MNE as a whole is:	
Group profit:	
Subsidiary	100
Parent	(50)
Group profit	50
Tax paid	30
i.e. tax rate	60%

The tax position for the MNE as a whole is:	
Group profit:	
Subsidiary	50
Parent	0
Group profit	50
Tax paid	15
i.e. tax rate	30%

8.1.2. Generation of cash in the leveraged subsidiary

A leveraged subsidiary may use the cash generated by its operations to pay down the debt due to the parent. However, it may also choose not to do so. For example, it may be more tax efficient for the subsidiary to instead use the cash to make an investment the return on which does not give rise to a tax charge (e.g. because it benefits from some kind of participation exemption). In some jurisdictions (e.g. France with its *acte anormal de gestion* test and the United Kingdom with its transfer pricing rules) it may be open to the tax authorities to question whether, in “an arm’s length world”, the

subsidiary would in fact have used the cash to pay off some of the debt, thus reducing the deductible interest expense.

One way for the subsidiary to resist such a challenge may be to structure the debt so that the borrower has at least an option to repay the loan by issuing shares in satisfaction of it, so that finding the cash to pay off the debt is not an issue. Another approach would be to justify using the cash to make the investment by reference to the high rate of return compared with the cost of borrowing.

Governments will of course have a range of choices in deciding how strongly to push MNEs to reduce the indebtedness in their local subsidiaries at the earliest opportunity. Some governments will take the view that at least a certain level of debt should be accepted so as to preserve the country's tax competitiveness, whilst others may take the view that revenue generation is their first priority and therefore impose stricter conditions for the deductibility of interest.

8.1.3. How an MNE can subsequently modify the mix of debt and equity

Suppose that, for whatever reason, a parent company has financed a subsidiary entirely with equity (or that the subsidiary has paid off the debt that it previously had). The question arises as to how the leverage in the subsidiary can subsequently be increased.

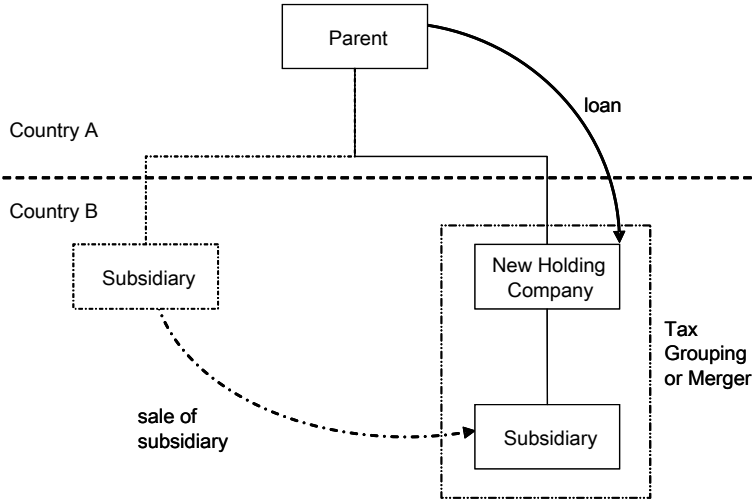
One way of introducing debt is for the subsidiary to borrow from the parent to pay a dividend or to repay, redeem or buy back share capital. This will not be effective in all countries. In particular, the following points need to be verified: (i) the deductibility of the interest expense on a borrowing taken out for these purposes; (ii) the feasibility under the company law of the subsidiary's jurisdiction; and (iii) the other tax consequences, such as any applicable dividend withholding or distribution tax, or any tax at the level of the parent on the corresponding receipt.

An interesting question arises here in countries where the test for the deductibility of interest expense is whether it is incurred to generate business profits. One approach is to look at the ongoing function of the borrowing. Following this approach, the interest is incurred to generate business profits because the borrowings are used as replacement finance for the working

capital of the company that was previously financed by equity. The other approach is to look at the immediate use of the funds borrowed (i.e. payment of the dividend/repayment of capital), leading usually to the conclusion that the interest is not incurred to generate business profits. There are court decisions on this question in several countries, including Canada, where the Supreme Court decided in *Bronfman Trust v. The Queen* ([1987] 1 SCR 32), that the immediate purpose was decisive, and Australia, where the Full Federal Court in Melbourne decided in *FC of T v. Roberts* (1992 ATC 4380) that the ongoing function should prevail, subject to certain conditions.

A second way of releveraging the subsidiary may be for the parent to sell the subsidiary to a leveraged new holding company in the country of the subsidiary, as shown in Table 13. Again, this will not be effective in all countries. For example, this technique presupposes that country B allows some form of tax consolidation or tax-free merger. Secondly, it presupposes that the interest expense in the new holding company in country B is deductible. Thirdly, it presupposes that the subsidiary can be transferred under the new holding company without a significant tax cost. In this regard, it should be noted that several jurisdictions have specific anti-avoidance rules designed to prevent this kind of debt pushdown; this is the case, for example, of the debt creation rules in France (Art. 223B, al. 7 CGI – so-called "*amendement Charasse*") and Germany (§ 8a, Abs. 6 KStG). There are also other countries where such a debt pushdown may be vulnerable to challenge on the basis of more general anti-avoidance rules.

Table 13: Sale of subsidiary to leveraged new holding company



It is not clear why, as a policy matter, a government should draw a distinction between one MNE whose subsidiary has a certain level of debt from inception and another, which has the same level of debt as a result of a debt pushdown. In the author's opinion, normal considerations of equity would imply that the two MNEs should be treated in the same way, and that the role of limiting the amount of taxable income reduced by interest expenses should belong to thin capitalization rules and withholding taxes.

8.1.4. Currency aspects

If the country of the parent and that of the subsidiary have different currencies, then the issue arises as to the currency in which the loan from the parent to the subsidiary should be denominated. In general, a loan denominated in any currency other than that of the subsidiary will give rise to an exposure to tax on any foreign exchange gains in the subsidiary. Such an exposure would be purely intragroup, i.e. the MNE as a whole would have no such gains. In practice, therefore, loans to subsidiaries are normally denominated in the currency of the subsidiaries involved.

It should be noted that the loan from the parent to the subsidiary can economically be denominated in the local currency of the subsidiary even if

such currency is not available internationally. In such cases, the loan will normally be advanced physically in, say, US dollars, but the amount of dollars that the subsidiary is liable to repay will depend on the exchange rate between the dollar and the local currency of the subsidiary at the time of repayment.

Exchange control considerations may also affect the currency in which the loan is denominated. Looking now at the position from the viewpoint of the parent, a loan denominated in the currency of the subsidiary will give rise to an exchange rate exposure in the country of the parent, unless the parent itself has borrowings in the same currency that match the loans to the subsidiary. The exchange gains in question will be purely intragroup and therefore again the MNE will face the prospect of paying tax on an exchange gain that does not exist from the viewpoint of the MNE as a whole.

There is a range of measures that the MNE can take to eliminate this exposure. One possibility is for the parent to cover the exposure with an appropriate derivative entered into with a third party, for example a forward sale of currency of the country of the subsidiary (see Chapter 9 on derivatives). A second is for the parent to capitalize an appropriate finance company that lends to the subsidiary involved and that is not taxable on any exchange gain, for example because its functional currency is the same as that of the borrowing subsidiary, or because it is located in a low-tax jurisdiction (this approach is discussed later in this chapter). A third approach is to structure the loan as a hybrid such that any exchange gains are not taxable in the country of the parent (see discussion later in this chapter).

Of course, if the parent *is* borrowing externally to obtain the finance to be provided to the subsidiary, then it will normally be commercially desirable for such borrowing to be denominated in the currency of the subsidiary. This will allow the MNE's borrowing to match the underlying assets from the commercial viewpoint. If the finance is provided to the subsidiary as debt, then usually this will also allow matching of the external borrowing with onward loans to the subsidiary at the parent company level. However, if the finance from the parent to the subsidiary is provided in the form of equity, then it will need to be confirmed whether the tax law of the parent company allows matching of the borrowing with the equity in the subsidiary.

8.1.5. The arm's length interest rate

The general principle applicable is that in order for interest expense to be deductible, the interest rate paid should be arm's length. The arm's length interest rate will to a large extent depend on the risk borne by the lender. An MNE can influence the applicable arm's length interest rate by varying the risk profile of the debt.

In many countries, for example, tax relief is available for interest on a mandatory convertible loan, i.e. a loan that is repayable through a share issue by the borrower. Due to the higher risk profile compared with a conventional loan, such a debt will normally carry an arm's length interest rate that is significantly higher than the arm's length interest rate on conventional debt (unless the terms of the conversion are exceptionally favourable).

It may be possible to increase the risk of the lender, and therefore the arm's length interest rate, even further by making the debt convertible only at the option of the borrower. In this case the lender only has the downside of convertibility if, say, the shares are worth less than expected. If they are worth more, then presumably the borrower will repay in cash. Based on normal arm's length principles, such additional risk will be remunerated through a correspondingly higher interest rate.

Another possibility would be to issue a dual currency loan, which gives the borrower the option to pay interest and the principal amount in any of the two currencies in which the loan is denominated. Such a type of loan would increase the risk for the lender and therefore increase the arm's length interest rate.

The foregoing are simply further illustrations of the principle that an MNE usually has a large scope for choosing the jurisdictions in which its profits arise through the allocation of functions, assets and risks among different group companies.

Notes

Notes

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