International Taxation

1st part: Introduction

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Basics of Tax System

Typical taxes are:

- Customs
- Indirect taxes
  - Consumption taxes

    Taxes on mineral oil, cigarettes, coffee, alcohol, beer, energy
  - Value Added Tax (VAT)/Sales Tax
- Direct taxes
  - Income Tax (for individuals)
  - Corporate Income Tax (CIT – for corporations)
  - Surcharges (in Germany: Solidarity surcharge)
  - Net value tax (not in Germany)
  - Municipal Taxes (in Germany – trade tax)
  - Other Taxes

Basics of Tax System

Basic distinction between

- Taxation of individuals
  - applicable taxes: income tax, trade tax, solidarity surcharge
- Taxation of partnerships
  - applicable taxes: trade tax, but not income tax (if treated as transparent)
  - In Russia: treated as corporations
- Taxation of corporations
  - Applicable taxes: corporate income tax, trade tax, solidarity surcharge

Basic of Tax System

Partnerships

- Partnerships treated as transparent
  - In Russia: intransparent
- Therefore not subject to income tax
- Income of partnerships is allocated to participants
- Participants are taxed with part of partnership income allocated to them
  - income stream: business profits
- Interests, rents, remuneration of services paid to participants are not deducted from income of partnership, but treated as part of partnership income (“Special remunerations”)

Basics of Tax System

Corporations

- Treated as intransparent
- Only one income stream (business income)
- Interests only partly deductible (30 % of EBIDTA), but carry forward
- No tax free zone
- Germany: Flat tax rate of 15 % (plus solidarity surcharge)
- Dividend taxed as income of shareholder; withholding tax 25 %
- Therefore double taxation of distributed profits, but normally relieved
- Different relief systems:
  - Germany: Dividends tax free if shareholder is a corporation (same in Russia); Dividends taxed with 60 % if shareholder is an individual
  - Reduced CIT rate for distributed profits
  - Tax credit systems

Basics of International Taxation

Scope of income tax/CIT:

- Most countries operate a system of “worldwide income” for their residents
- Some countries operate a “territorial regime”: Only income from sources of the own state are taxed
  - Some countries in Middle/South America
- Some countries do not impose direct taxes on income
  - Kuwait, Qatar, Saudi Arabia, United Arab Emirates, Tax havens
- Some countries operate a “remittance system”: Foreign-based income from individuals not having their domicile in the country is only taxed if remitted in the country
  - UK, Ireland, Singapore

Basics of International Taxation

Scope of income tax/CIT:

- Individuals are subject to unlimited taxation in state of residence/substantial presence (taxation of worldwide income) □ residence rule;
- Otherwise individuals and corporations are subject to limited taxation with source income only □ source rule
- Therefore basic distinction: State of residence – state of source
- Residence/physical presence of an individual means:
  - Living home in a country, or
  - physical presence during a certain period of time (Germany: more than 6 month; Russia: 183 days or more)
  - Citizenship (USA)
  - Domicile (UK)

Basics of International Taxation

Example: USA

Unlimited taxation rule is applied if taxpayer

- Has the nationality of the US (irrespective where he is resident)
- Holds a Green Card
- Meets the physical presence test

  Physical presence if tax payer on a weighted average of the last 3 years was more than 183 days present in the US

  weighted average:

  days present of the running year plus 1/3 of previous year plus 1/6 of year before previous year

Basics of International Taxation

Unlimited taxation of Corporations

- Place of central (effective) management
- Place of registered office
- Established in accordance with national law
- Place where general meeting of shareholders is held
- Place where books and records are maintained

Basics of International Taxation

Limited taxation:

- Genuine links: Country can tax income of non-residents if
  - from sites situated in that country
  - from permanent establishments located in that country
  - from employment carried out in that country
  - from capital, if debtor/payer is resident in that country
  - from sales of shares if the corporation whose shares are sold has its registered office or place on management in Germany (if shareholder is resident in that country: unlimited taxation)
- Benefits covering basic needs of individuals not granted
- System of withholding taxes largely used

Basics of International Taxation

Withholding tax system:

- Taxes in case of limited taxation in the source state is raised by withholding taxes normally for the following income streams:
  - Employment (PAYE)
  - Dividends (German withholding tax rate: 25 %)
  - Interests (Germany: not subject to limited taxation)
  - Royalties (German withholding tax rate: 15 %)
  - Payments to sportsmen, artists etc (German withholding tax rate: 15 %)
- No withholding tax on (depending on national tax laws):
  - Permanent establishments
  - Professional services
  - Agriculture
  - Rent from sites

Basics of International Taxation

Withholding tax system:

- Withholding tax is levied on gross income
  - Therefore no deduction of expenses, no refund
- Withholding tax covers full tax liability
  - No additional tax assessment

Example:	Dividend	Royalty
Gross amount	100	100
Tax of payer	15	0
Net amount	85	100
Withholding tax 20 %	17	20
Costs of payee	1	75
Net amount	67	5
Taxable (Div: 60 % of 84)	50,4	25
Tax of payee 40 %	20,2	10
Tax credit	17	20
Net amount after tax	63,8	5

Basics of International Taxation

Avoidance of double Taxation

- Unilateral method: tax credit
- Method in Double Taxation Agreements (DTA):
  - Exemption method
  - Tax credit method
  - Fictious tax credit/economic development zones
- Effects:
  - Tax credit method: Neutrality of capital export (Income of investments is taxed with the tax rate of state of residence of investor: no difference if he invests in his own or in a foreign state)
  - Exemption method: Neutrality of capital import (Income of investments is taxed with the tax rate of the state of investment: no difference if the invested funds come from the state of investment or from abroad)

Basics of International Taxation

Aim: Neutrality of tax systems

- Tax system is “neutral” if it has no effect on costs of investments/costs of financing
- Complete neutrality of tax systems cannot be achieved; politicians have to make a choice taking into account the political preferences
  - System of neutrality of capital exports (tax credit method) achieves tax neutrality in the state of residence, but not in the state of investment
  - System of neutrality of capital import (exemption method) achieves tax neutrality in the state of investment, but not in the state of residence
- Exemption method is therefore preferred by states where investment in foreign states has priority (eg Germany; West European States)
- Tax credit method is preferred by states who concentrate more on domestic markets (eg US, UK, Russia)

Basics of International Taxation

Exemption method

- Only in DTA, not unilaterally
- Advantages:
  - Tax benefits of source state remain effective
  - Administratively not complex
  - Does not involve two tax authorities
  - Eliminates actual and potential double taxation
- Disadvantages:
  - No tax revenue for state of residence
  - Losses may be disallowed by state of residence
  - Encourages use of tax havens
  - Calculation of effects on progression may be difficult

Basics of International Taxation

Tax Credit Method

- Direct tax credit: Taxes paid by the taxpayer in another country on foreign based income are credited
  - What is “foreign based income”? Conflict of Qualifications
- Advantages:
  - Deduction of foreign losses in country of residence
  - Discourages use of tax havens
- Disadvantages
  - Possibility of excess foreign tax credit, tax bill therefore higher
  - Eliminates tax relief given in source state
  - Eliminates only actual double taxation
  - Can be complicated

Basics of International Taxation

Tax Credit Method

Excess tax credit can result from

- Limitation of tax credit to domestic tax liability, if source tax is higher
- Tax credit system
  - Per country limitation
  - overall limitation
  - per-category-limitation
  - Germany: per country limitation
  - Russia: unclear
- Domestic losses
- Difference in calculation of tax base
- Timing differences
- Excess tax credit: carry-forward, carry-back or deduction as expense

Basics of International Taxation

Special forms of tax credit method:

- Indirect tax credit (credit of underlying taxes):
  - Credit of taxes not paid by the tax payer (but by the company he has invested in)
  - How deep can the company chain be?
  - Not granted in Russia (in Germany not applicable since dividend is tax-free)
- Fictitious tax credit (Tax sparing credit)
  - Credit of taxes which have not been paid
  - In case of less developed countries only
  - Has mostly the effect of an exemption

Basics of International Taxation

Tax Credit Method

- Effects of per country limitation

Income from state X: 10.000 €, withholding tax 25 %
Income from state Y: 10.000 €, withholding tax 15 %
Tax rate in state of residence: 20 %.

State	X	Y	Sum
Income	10.000	10.000	20.000
Tax	2.000	2.000	4.000
Tax credit	-2.500	-1.500	- 4.000
Remaining tax	0	500	

Germany and Russia: No carry-forward of unused tax credit; therefore problem of timing/tax base differences

Basics of International Taxation

The unrestricted taxation in the country of residence ("residence rule") of the taxpayer collides with the restricted taxation of the same income in the source country ("source rule") therefore causing double taxation.

International Tax Planning deals with 2 questions:

- How to make sure, that the profit of a transaction/an investment is only taxed once? "defensive" tax planning
- How to make sure that the profit is taxed at the lowest possible rate? "offensive" tax planning