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TAXATION OF INCOME REPATRIATED BY FOREIGN SUBSIDIARIES

Canada, France, Germany, Italy, Japan, Russia, and the United Kingdom

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CANADA

TAXATION OF INCOME REPATRIATED BY FOREIGN SUBSIDIARIES

The general rule in Canada is that corporations are taxable on their worldwide income. The earnings of a foreign subsidiary paid to a Canadian corporation as a dividend or similar type of transaction must be included in the Canadian corporation's income for that year.[1] However, Canada allows Canadian corporations to claim a foreign tax credit on dividends which have already been taxed in a foreign jurisdiction with which Canada has a tax treaty.[2] The purpose of this deduction is to prevent double taxation.

Canada does not tax the foreign earnings of a corporation both when they are earned and when they are repatriated. The Income Tax Act does not require foreign earnings upon which Canadian taxes have already been paid to be declared again upon repatriation.

The earnings of a corporation from a non-active business that are not repatriated may be taxable as "foreign accrual property income."[3] The purpose of this rule is to prevent taxpayers from using no-tax or low-tax jurisdictions to avoid Canadian income tax. Once taxed in Canada, "foreign accrual property income" is not taxed a second time if it is repatriated; however, active business income can in certain circumstances be sheltered in foreign jurisdictions if it is not repatriated.[4] Such income does become taxable in Canada when it is repatriated.[5]

The taxation of foreign earned income in Canada is a highly complex subject. Dependent variables include where the income is earned, whether the subsidiary is an affiliate or controlled, the type of income earned, the type of payment that is made, and applicable treaty provisions.[6]

Prepared by Stephen F. Clarke
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January 2009

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[1] Income Tax Act, R.S.C. ch. 1, § 3 (5th Supp. 1989), as amended, *available at* http://laws.justice.gc.ca/en/showdoc/cs/I-3.3/bo-ga:l_I-gb:l_A//en?noCookie (last visited Jan. 30, 2009).

[2] *Id*. § 113.

[3] *Id*. § 91(1).

[4] JOANNE E. MAGEE, UNDERSTANDING INCOME TAX 2004-2005 at 612-615 (2004).

[5] *Id*.

[6] *Id*.

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FRANCE

TAXATION OF INCOME REPATRIATED BY FOREIGN SUBSIDIARIES

The French income tax system for corporations is based on the territoriality principle. The General Tax Code provides that only profits derived from a business carried on in France and profits taxable by France under an international double taxation treaty are subject to corporate tax in France.[1] This principle applies to both French and foreign companies doing business in France. As a consequence, a French company that incurs losses in a foreign branch or subsidiary cannot deduct these losses, apart from exceptions.

Profits are usually repatriated in three ways: transfer or distribution of net profit from a branch or subsidiaries; interest on loans or advances granted by the foreign parent company; and royalties or management fees.[2]

Royalties and management fees will not be taxable if the transactions are conducted at "arm's length," otherwise they will be regarded as income. The French tax authorities are empowered to make the necessary inspections and rectifications. The actual application of this principle is interpreted in several administrative notes issued by the tax authorities.[3]

As far as dividends redistributed by a foreign subsidiary, the answer depends on whether the company that receives the dividends is deemed a parent company or not. A company which, for tax purposes, does not qualify as a parent company of another company is subject to normal corporate income tax on the dividends (25 percent). If the company is deemed to be a parent company, ninety five percent of the gross dividends it receives from its subsidiaries is tax exempt. The remaining five percent is presumed to be a "service charge" incurred by the parent company.[4]

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[1] CODE GENERAL DES IMPOTS art. 209I (Dalloz 2008).

[2] Ch. 4, *Business Taxes in France*, *in* INVEST IN FRANCE AGENCY, DOING BUSINESS IN FRANCE 54, 55 (2008 ed.), *available at* http://www.invest-in-france.org/corporate/en/ifa-useful-documents.html?id=34. The Invest in France Agency was created in 2001. It is supervised by the French Ministry of Economy. Its main mission is to promote international investment in France.

[3] Lovells, Paul, Hastings, Janofsky & Walker LLP, Doing Business in France 13-64, 13-65 (LexisNexis 2007) (looseleaf publication).

[4] CODE GENERAL DES IMPOTS arts. 220(1), 216 (i).

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GERMANY

TAXATION OF INCOME REPATRIATED BY FOREIGN SUBSIDIARIES

Executive Summary

In Germany, the repatriation of profits from a foreign subsidiary is favored by generally exempting from the corporate income tax a total of 95 percent of the income derived from corporate dividends and from capital gains from the sale of shares or participations.

I. World-wide Taxation

Germany taxes its resident corporations on their world-wide income.[1] This principle is also applied to individuals residing in Germany[2] and the taxation of world-wide income 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 burden of unlimited tax liability is mitigated through double taxation treaties, unilateral double taxation relief,[4] and, in the case of dividend and capital gains realized by a corporate shareholder, through low levels of taxation, as is explained below.

II. Taxation of Dividends

Germany exempts from taxation a total of 95 percent of the dividends distributed to a corporation that is subject to German taxation. This rule is provided in section 8b of the Corporation Tax Act [5] and it applies to dividends received from domestic corporations and foreign corporations alike,[6] and the thus favored recipient can either be a resident corporation or a foreign corporation that pays tax on its German source income. [7] This exemption of corporate dividend income has been developed since1999, and in its current form it is part of a reform of

[1] Körperschaftsteuergesetz [KStG], repromulgated Oct. 15, 2002, BUNDESGESETZBLATT [BGBl., official law gazette of the Federal Republic of Germany] I at 4210, as amended, § 1. A corporation resides in Germany if its head office or principal place of management is located there, irrespective of its place of incorporation. *Id.*

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

[3] KStG § 2; EStG § 49.

[4] W. BÄCHLE & T. RUPP, INTERNATIONALES STEUERRECHT 27 (Stuttgart, 2002).

[5] KStG § 8b, paras. 1 and 5.

[6] LOVELLS, BOESEBACK & DROSTE, GERMAN TAX AND BUSINESS LAW GUIDE paras. 133-20 through 133-60 (London, 2003).

[7] D. GOSCH, KÖRPERSCHAFTSTEUERGESETZ 802 (München, 2005).

the German corporation tax that aims at avoiding inter-corporate double taxation.[8] Under this system, the domestic dividend-distributing corporation is taxed at a 15.83 percent tax rate[9] on its earned income (whether distributed or not), and ultimately the domestic private shareholder is taxed on his dividend income.[10] 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.[11]

There are some exceptions from this principle that make dividends taxable if the shares are owned by banks, life insurers or pension funds. These exceptions, however, only affect corporate shareholders who reside in Germany, in the member states of the European Union (EU), or in Switzerland. [12]

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 deemed to be attributed to expenses related to this income that the corporation may be able to deduct in its general income computation. The result of this complex scheme is a definitive limitation of the tax exemption of dividends to 95 percent.[13]

III. Capital Gains

Capital gains derived by a corporation subject to German taxation from the sale of shares are taxed according to the same principles as dividends distributed by either a foreign or domestic corporation:[14] section 8b paragraphs 2 and 3 of the Corporation Tax Act exempt 95 percent of the capital gains derived by a corporate taxpayer from the sale of shares or of a participation in a German or foreign corporation. The remaining five percent of the gains are taxed at the actual corporate tax rate of 15.83 percent.[15]

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[8] B. ERLE & T. SAUTER, HEIDELBERGER KOMMENTAR ZUM KÖRPERSCHAFTSSTEUERGESETZ 518 (Heidelberg, 2006).

[9] 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.

[10] 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 percent surcharge, Solidaritätszuschlaggesetz, repromulgated Oct. 15, 2002, BGBl I at 4130, as amended, thus amounting to 21.1 percent.

[11] GOSCH, *supra* note7, at 791.

[12] KStG, § 8b, paras. 7 and 8.

[13] GOSCH, *supra* note 7, at 874.

[14] BÄCHLE, *supra* note 4, at 469; C. Bourseaux, *Germany*, in TAXATION OF COMPANIES IN EUROPE 8.4.2.3 (Amsterdam, 2004); LOVELLS, *supra* note 6.

[15] *See* explanations, *supra* note 9.

IV. Conclusion

Germany applies a very favorable tax regime to profits repatriated from a foreign subsidiary by exempting 95 percent of dividend and capital gains income from taxation. This mode of taxation, however, is part of the general German philosophy of avoiding corporate double taxation. It is not clear whether the result of facilitating the repatriation of profits was intended or whether it was an ancillary benefit of the German corporate tax reform that was enacted between the years 1999 and 2002.

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January 2009

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ITALY

TAXATION OF INCOME REPATRIATED BY FOREIGN SUBSIDIARIES

Executive Summary

Companies considered to be resident in Italy are taxed on their worldwide income. Special provisions apply to profits from subsidiaries in other European Community member states.[1]

Corporate taxes in Italy are governed by the Income Tax Code.[2] In general, corporate income taxes apply to resident and non-resident companies. Resident companies are subject to taxation on their income, regardless of where in the world that income was earned.[3] A resident company is defined as one where "its legal seat, place of effective management, or main business purpose is in Italy for the greater part of the financial year," regardless of the country in which the business was originally incorporated.[4]

Double taxation avoidance provisions in the Income Tax Code apply only to profits distributed by non-resident companies to their shareholders in Italy, not to income earned abroad by a resident company.[5]

Italy has implemented EC Directives on the subject of corporate taxation that apply specifically to the distribution of profits received by companies in member states that come from their subsidiaries in other member states.[6] These provisions thus do not apply to profits from subsidiaries that are located outside both Italy and the EC. The EC Directives state:

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[1] Please note that in the absence of an Italian foreign law specialist, this report was prepared based on available English-language materials.

[2] Testo unico delle imposte sui rediti (TUIR), Presidential Decree 917, Dec. 22, 1986, effective Jan. 1 1988, amended several times, notably by Legislative Decree 344, Dec. 12, 2003, which contained corporate tax reform, effective Jan. 1, 2004. Also *described in* Carlo Galli, *Italy*, 2 THE TAXATION OF COMPANIES IN EUROPE [TCE] 2.1.2 (International Bureau of Fiscal Documentation, June 2008).

[3] TUIR Art. 73; TCE, *supra* note 2.

[4] TUIR Art. 73(3); TCE, *supra* note 2, at 8.2.1.1.

[5] TUIR Art. 89(2)(3). Also *described in* Giuseppe Marino, *Italy*, 3 EC CORPORATE TAX LAW: COMMENTARY ON THE EC DIRECT TAX MEASURES AND MEMBER STATES IMPLEMENTATION [ECTL] para. 91 (International Bureau of Fiscal Documentation, Sept. 2008).

[6] EC Directive 435/90/EEC, on the common system of taxation applicable in the case of parent companies and subsidiaries of different member states, 1990 O.J. (L 225) 6, EURLEX, *available at* [http://eur-lex.europa.eu/LexUriServ/ LexUriServ.do?uri=CONSLEG:1990L0435:20040202:EN:PDF](http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1990L0435:20040202:EN:PDF) (last visited Jan. 29, 2009). The Directive was incorporated into Italian Law 142, Feb. 19, 1992, which authorized the government to issue appropriate legislation. This was done by Legislative Decree 136, Mar. 6, 1993. The Directive was placed into the 2003 revision of the TUIR as Article 89. The EC Directive itself was amended by Directive 2003/123/EC,

> Where a parent company or its permanent establishment, by virtue of the association of the parent company with its subsidiary, receives distributed profits, the State of the parent company and the State of its permanent establishment shall, except when the subsidiary is liquidated, either:
>
> ▪ refrain from taxing such profits, or
>
> • tax such profits while authorising the parent company and the permanent establishment to deduct from the amount of tax due that fraction of the corporation tax related to those profits and paid by the subsidiary and any lower-tier subsidiary, subject to the condition that at each tier a company and its lower-tier subsidiary meet the requirements provided for in Articles 2 and 3, up to the limit of the amount of the corresponding tax due.[7]

Although Italy's legislature at one time appeared to favor the second approach, that of a tax credit, rather an outright exemption, it eventually opted to have a ninety-five percent tax exemption apply to profits repatriated from a subsidiary located in another EC member state.[8]

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January 2009

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on the common system of taxation applicable in the case of parent companies and subsidiaries of different member states, Dec. 22, 2003, 2004 O.J. (L 007) 41 EURLEX, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX: 32003L0123:EN:HTML (last visited Jan. 29, 2009). Those revisions were implemented by Italy through Legislative Decree 49, Feb. 6, 2007, and concerned only taxation of outbound dividends paid to an EU parent company. *See* ECTL paras. 101-103.

[7] Council Directive 2003/123/EC of 22 December 2003, art. 4, § 1.

[8] ECTL, *supra* note 2, para. 118.

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JAPAN

TAXATION OF INCOME REPATRIATED BY FOREIGN SUBSIDIARIES

Similar to the United States, Japan taxes Japanese domestic corporations' worldwide income,[1] but the amount of foreign tax paid in the foreign country is deducted from the amount of tax that shall be paid to Japan.[2]

Recently, the government recognized that Japanese companies do not repatriate profits earned overseas under the current tax system.[3] The Ministry of Economy, Trade and Industry (METI) established the International Tax Sub-Committee in its Trade and Economy Cooperation Department and released a report in August 2008.[4] In the report, the Sub-Committee estimated that 17 trillion *yen* (US$ 189 billion, calculated by 1$ = 90 yen) was pooled in foreign subsidiaries.[5] The Tax Commission of the government recommended, in November 2008, that dividends of foreign subsidiaries not be included in the taxable income of Japanese parent companies.[6] The Cabinet recently submitted a bill to the Diet (Japan's parliament) that adopted the recommendation of the Commission.[7] The bill amends the Corporation Tax Law, as well as other tax law provisions.[8] The profits of the foreign subsidiaries are not subject to the

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[1] Hōjinzei hō [Corporation Tax Law], Law No. 34of 1965, as amended by Law No. 100 of 2007, arts. 5 and 21. While articles 5 and 21 do not impose limitations on the taxable income of domestic corporations, articles 9 and 138-140 of the Corporation Tax Law, which are applicable to foreign companies, in comparison, do impose limitations on the taxable income of foreign corporation that is domestic source income.

[2] *Id*. art. 69.

[3] Kokusai sozei shō iinkai [International Tax Sub-committee], the Ministry of Economy, Trade and Industry (METI), Waga kuni kigyō no kaigai rieki no shikin kanryū ni tsuite [Concerning Repatriation of Money Earned Overseas by Our Domestic Corporations], 1 Aug. 2008, *available at* http://www.meti.go.jp/press/20080822002/20080822002.pdf.

[4] *Id*.

[5] *Id*. attachment 1, citing METI, Kaigai jigyō katsudō kihon chōsa [Overseas Business Activities Report].

[6] Zeisei Chōsa kai [The Tax Commission], Heise 21 nendo no zeisei kaisei ni kansuru tōshin [Recommendations on 2009 tax reform], 7 Nov. 2008, *available at* http://www.cao.go.jp/zeicho/tosin/pdf/201128a.pdf.

[7] Heisei 21 nendo zeisei kaisei no yōkō [Summary of 2009 Tax Reform], Cabinet Decision, Jan. 23, 2009, *available at* the Ministry of Finance's website at http://www.mof.go.jp/seifuan21/zei001_a1.htm (click "tsuzuki ga arimasu [continued]" at the bottom).

[8] Shotokuzei hō tō no ichibu o kaisei suru hōritsu an [Bill to Amend Parts of the Income Tax Law and Other Laws], Kakuhō [Cabinet bill] No. 6 of the 171st Diet Session (2009), *available at* the House of Representative's website at http://www.shugiin.go.jp/index.nsf/html/index_gian.htm.

amendment, only the dividends.[9] Foreign subsidiaries in which Japanese companies invested more than 25 percent of capital are subject to the tax amendments.[10]

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January 2009

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[9] International Tax Sub-committee, *supra* note 3, at 2.

[10] Summary of 2009 Tax Reform, Cabinet Decision, Jan. 23, 2009, *available at* the Ministry of Finance's website at http://www.mof.go.jp/seifuan21/zei001_a2.htm. If a bilateral tax treaty specifies a different ratio of investment when it decides a company is a subsidiary, such ratio is applied, instead of 25 percent.

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RUSSIAN FEDERATION

TAXATION OF INCOME REPATRIATED FROM FOREIGN SUBSIDIARIES

Executive Summary

Russian legislation distinguishes between income repatriated by branches and subsidiaries of companies located in Russia. Income repatriated by branches is added to the gross company income and is subject to a flat nineteen percent income tax. Following the principles of territoriality and residency, the repatriated income of foreign subsidiaries is exempt from taxation, except for income received from participation in the subsidiary's capital (e.g., dividends, royalties, interest). The more that the subsidiary's capital is controlled by the parent company, the lower the tax rate is on repatriated income.

I. General Taxation of Subsidiaries

The Tax Code of the Russian Federation is the main legal act that defines the basic principles of taxation in Russia. The Tax Code treats foreign subsidiaries of Russian companies separately from main companies located in Russia according to principles of territoriality and residency. The Tax Code insists on separation of the assets and operations of the subsidiary from its parental company for the purposes of taxation.[1] All income of Russian legal entities is subject to a flat tax of 19 percent.[2]

A subsidiary company which is registered as a resident of a foreign state must pay all taxes under laws of the state in which it is located. Income of a subsidiary company is not recognized as part of the worldwide income of a Russian company and is not taxed in Russia as long as it is not repatriated home.[3] In this situation, the company avoids double taxation; however, this rule does not work with regard to the taxation of a foreign branch of a Russian company, which is considered to be a part of the Russian company and is taxed under Russian law entirely.

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[1] SOBRANIE ZAKONODATELSTVA ROSSIISKOI FEDERATSII (Collection of Russian Federation Laws, official gazette, SZ RF) 1998, No. 31, Item 3824, art. 288.

[2] Federal Law No. 65 of June 30, 2003, SZ RF, 2003, No. 22, Item 2066.

[3] *Supra* note 1, art. 246.

II. Taxation of Repatriated Income

Double taxation occurs when income in the form of dividends, interests, or royalties is transferred from the subsidiary to the parent company in Russia. The subsidiary company is taxed in the jurisdiction of its residency, and then all income received from participation in the capital of the subsidiary will be counted as part of general profit of the parent company and taxed at the place of its residency in Russia.

Some privileges are provided by Russian law to minimize double taxation within one business structure. The tax rate on repatriated income is proportionally lowered if the parent company controls more than 10 percent of the foreign subsidiary's capital. If more than half of the charter capital of a subsidiary company consists of the parent company's capital, the repatriated income is not taxable. There are no restrictions on the use of the repatriated capital.[4]

Non-monetary assets received by the Russian parent company are not considered income if they are not transferred to third persons during a one-year period.[5] Because the assets of a subsidiary are separated from those of the parent company, and the parent company is not liable for a subsidiary's obligations, the losses of a foreign subsidiary company cannot be deducted from the income of a Russian parent company. A foreign branch of a Russian company may share centralized management expenses with the main company located in Russia, and that will decrease the taxable income.

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[4] TAX CODE OF THE RUSSIAN FEDERATION, art. 251, Section 1.11.

[5] Guiding letter of the Russian Federation Ministry of Finance No. 03-11-04/2/63 of March 13, 2007, FINANSOVAIA GAZETA (official publication of the Ministry of Finance) March 26, 2007.

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UNITED KINGDOM

TAXATION OF INCOME REPATRIATED BY FOREIGN SUBSIDIARIES

A company resident in the United Kingdom "is chargeable corporation tax on all its income and capital profits wherever they arise and whether or not they are remitted to the UK."[1] Thus, companies must pay corporation tax on their worldwide profits, regardless of whether they are repatriated to the UK or not.

While there appears to be no additional tax on the repatriation of profits to the UK, the government has noted that "even though there is no additional tax to pay, the administrative costs for multinational business of complying with the … regime can be material."[2]

The following resources may be useful:

> Michael P. Devereux, *Taxing Foreign Profit: Economic Principles and Feasibility* (Centre for Business Taxation, Oxford Univ., Apr. 2008) (European Tax Policy Forum conference paper), *available at* http://users.ox.ac.uk/~mast1732/ETPF/Devereux.pdf. This paper considers the government's proposals to exempt foreign dividends from taxation and reviews the structure of taxes on international corporate profit;
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> Johannes Voget, *Headquarter Relocations and International Taxation* (Centre for Business Taxation, Oxford Univ./CentER, Tilburg Univ., Apr. 2008) (European Tax Policy Forum academic paper), *available at* http://users.ox.ac.uk/~mast1732/ETPF/Voget.pdf. This paper considers the role of taxes in the relocation of companies;
>
> HM Treasury, *Taxation of the foreign profits of companies* (June 2007), *available at* http://customs.hmrc.gov.uk/channelsPortalWebApp/downloadFile?contentID=HMCE_PROD1_027592. This is a consultation paper issued by Her Majesty's Treasury that provides proposals to change the way that foreign profits of companies are taxed and solicits opinions.

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[1] Rebecca Murry and John Furdson, British Tax Guide: Corporation Tax, 2008-9, ¶ 399-200, *citing* the Income and Corporation Taxes Act 1988, c. 1, § 8, *available at* http://www.opsi.gov.uk/ACTS/acts1988/ukpga_19880001_en_1 (unamended version).

[2] HM Treasury, *Taxation of the foreign profits of companies* (June 2007), ¶ 3.1, *available at* http://customs.hmrc.gov.uk/channelsPortalWebApp/downloadFile?contentID=HMCE_PROD1_027592.