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THE RULES OF GERMANY, JAPAN AND THE UNITED STATES FOR THE TAXATION OF TRANSNATIONAL CORP0RATE INCOME

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ABSTRACT

This paper juxtaposes the German, Japanese and United States rules for the taxation of transnational income. It emphasizes the rules for direct taxation that have been (or will be) applied to multinational corporations from 1985 to 1992.

This working paper is taken from an appendix to "Linkages Between Tax Systems: An Analysis of the Corporate Tax Consequences of Transferring Royalties, Interest and Dividends Between Germany, Japan and the United States," a dissertation that was defended at The University of Michigan in January, 1991.

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THE TAXATION OF TRANSNATIONAL INCOME

This paper juxtaposes the German, Japanese and United States rules for the taxation of transnational income.[1] These tax rules apply both to the income earned overseas by residents and to the income earned at home by the resident of another country. Transnational income includes payments remitted within a firm from one tax jurisdiction to another as well as receipts from unrelated foreign licensors and portfolio investments.

The emphasis is upon the rules for direct taxation[2] that have been (or will be) applied to multinational corporations from 1985 to 1992.[3] During much of this time, the tax environment of international business has been unstable. The 1986 Tax Reform Act changed many of the important tax rules for the domestic and international business transactions of American taxpayers. By 1992, tax reform will make the statutory tax rates lower in Germany and Japan, and the split-rate tax system of Japan[4] will end. A new tax treaty between the United States and Germany will be in force.[5]

At the core of tax policy toward transnational income is the approach used by a country's tax authority to justify its jurisdictional claim. The nexus (or relationship that justifies the taxation) can be based upon the citizenship of the taxpayer, the location of the economic activity, or both.

Under the residential approach, the jurisdictional claim is based upon the relationship between the tax authority and the citizenship of the "person"[6] earning the income. A country with this philosophical approach will tax all income of residents, regardless of where it was earned, and will provide a tax credit for foreign taxes paid on the same income. The credit is limited to the home country tax owed on the foreign income.

Under the territorial (or source) approach, the jurisdictional claim is based upon the relationship between the tax jurisdiction and the activity that generated the income. A country with this philosophical approach will exempt income earned abroad from further

taxation in the home country and will deny tax relief at home for taxes paid abroad on the exempt income.

None of the countries compared in this paper bases is claim exclusively on one of these approaches. By treaty, Germany uses the territorial approach when dividends from foreign subsidiaries are paid to its citizens; it exempts this transnational dividend income from further tax in the home country. However, Germany applies the residential approach when transnational income is earned from portfolio investments, from licensing agreements or from interest payments and when no tax treaty has been signed with the country where the income was generated. Few tax havens have signed tax treaties with Germany.

Japan and the United States apply the residential approach and tax the transnational income earned by its residents without regard to where it was generated. However, each applies the territorial approach to reach the income earned within the jurisdiction by nonresidents.

TAX TREATIES

The countries whose tax systems are described below have a complete set of tax treaties, one with the other. This is not universally true.

Tax treaties[7] are important in international business because they provide the rules to harmonize two potentially conflicting tax systems, and they override the domestic statutory law of the signatories.[8] These bilateral agreements rest on two fundamental principles. The first is that a government which takes a residential approach to taxation can exercise this tax jurisdiction over its own residents only. The second is that the country of residence must yield the primary tax jurisdiction to the country where the income is generated. In other words, the country of source has the right to tax first the income that is earned within its territory.[9]

Avoidance of Double Taxation

The jurisdictional approach of the home country is stated formally in the tax treaties that it ratifies. An important function of tax treaties is to establish the limits of each party's jurisdictional claim, so transnational income is not subject to double taxation. The additional taxation would deter international commercial activity if tax relief were not available.

The tax treaties of the United States are now based on the Treasury Department's Model Income Tax Treaty.[10] Most other recent treaties (such as that between Germany and Japan) follow the Organization of Economic Co-operation and Development (OECD) Draft Convention of 1963, as amended in 1977.[10] [11] An important difference in the two model treaties is the approach taken to the tax jurisdiction of the home country. The United States Model endorses the residential approach; the OECD Model endorses both the residential and the territorial approaches, and allows either the exemption method or the credit method to be used to avoid double taxation.[12]

The Right to Tax

The right to tax income depends upon a nexus between the tax jurisdiction and the person earning the income (residential approach) or the activities generating the income (territorial approach). Because a country can apply the residential approach only to its citizens and residents, it must apply the territorial approach to reach to the income of non-residents who are in contact with its economy.

Source rules are the core of the territorial approach. They define the activities which create the nexus between the taxing country and the income (and deductions) generated by economic activity. For this reason, they are an important part of a tax treaty. They will be presented in greater detail later.

In a host country, a "foreign corporation" is a business that earns income within the host's borders but is organized under the laws of another country. The degree of contact

between the foreign corporation and the economy of the host country determines which country has primary jurisdiction over the income of the business. The host country has no tax jurisdiction over the foreign corporation until it surpasses a minimum threshold of activity. When the foreign corporation owns either a "permanent establishment" or an income-producing asset in the host country, the minimum threshold is surpassed.

For permanent establishments, source rules determine what income is "attributable" to its business. For capital investments, source rules state the jurisdiction where specific categories of income are generated for tax purposes; this jurisdiction has the right to tax the income first.

Permanent Establishment in the Host Country

A clear definition of what constitutes a permanent establishment is an important part of a tax treaty. When no tax treaty exists, the statutory law of the host country determines the threshold of "being engaged in a trade or business." A branch, office, or factory (that is, a "fixed place of business") located in the host country are business structures that come under the definition of a permanent establishment in both model tax treaties. However, an affiliate owned by the foreign corporation but incorporated in the host country is not a permanent establishment but rather a domestic taxpayer in the host country.

Thus, almost any business activity of a foreign person in the host country leads to the creation of a permanent establishment. The existence of a permanent establishment is the nexus between the host country tax authority and the business activity of a foreign corporation in the host country. The host country has primary tax jurisdiction over the net income of a permanent establishment within its borders.

In Germany, business profits are attributable to a permanent establishment when they are the result of its economic activity in Germany (or in a third country). Most expenses related to this income can be deducted, even when they originate outside

Germany. The exception is head-office charges for interest; the taxpayer must show that the funds were borrowed for use in the permanent establishment and that the interest was paid.[13]

The net income of a permanent establishment in Germany is taxed at a flat rate of 50% whether repatriated or not. It is not subject to a withholding tax when remitted.[15]

The tax treaty between the United States and Japan incorporates the concept of "effectively connected" income as used in the United States. Income derived from property or rights is effectively connected when it has been used (or held for use) in the industrial and commercial activity of the permanent establishment and when this activity was a material factor in realizing the income from the assets.[16] A portion of head office expenses can be charged to the permanent establishment, but royalties and interest payments (except for interest paid by bank branches) to the head office are not allowable tax deductions.[17]

The net income of a permanent establishment is taxed in Japan at the corporate rate for undistributed earnings, but earnings remitted to the home country are not subject to any withholding tax.[18]

Under the statutory law of the United States, a foreign corporation that is "engaged in a trade or business" is subject to tax on its effectively connected income.[19] When a tax treaty is in force, the concept of a permanent establishment serves the same function as this "engaged-in-business requirement."[20] The industrial and commercial profits attributable to a permanent establishment in the United States are taxable in the United States, after deduction of expenses which are "reasonably connected" with the income.[21]

The effectively connected income of a permanent establishment is taxed at the rates applicable to a domestic corporation in the United States.[22] There is no withholding tax when profits are remitted to the home country,[23] but since the passage of the 1986 Tax Reform Act, a branch level tax on profits not retained in the business may be taxed at a 30% rate, unless the rate is reduced by a tax treaty.[24]

Capital Investment in the Source Country

The ownership of assets is the second way that a nexus can be created between the foreign corporation and the tax authorities of the country where the assets are located. The taxation of royalty payments, interest income and dividends from both portfolio and direct investments comes under this provision.

Income from Financial Assets and Licensing Contracts. A foreign corporation can lease its technology, loan out its funds and acquire the stock of other corporations without creating a permanent establishment. Normally, the gross amount of this investment income is sourced to the host country and taxed through withholding.

In Germany, a foreign corporation is considered a "limited" taxpayer[25] who is taxable by reference to German source income only. When this income is passive (royalties, interest and dividends) the tax liability is settled in full when withholding taxes have been deducted from the remittance.[26]

In Japan the "separate tax"[27] on royalty income and dividends[28] paid to nonresidents who have no permanent establishment corresponds to the German concept of "limited" taxpayers. The tax withheld satisfies the nonresident taxpayer's liability.

In the absence of a permanent establishment, the United States taxes foreigners on the income that is generated by assets located in the United States.[29] This income from royalties, interest and dividends is called "periodic income," because it is generated at regular intervals. It is also predictable in the sense that it is a known percentage or amount.

When a foreign corporation has both investments and a permanent establishment in the host country, there can be a problem in determining whether the investment income is effectively connected to the trade or business. When the United States is the host country, (1) the acquisition of investment assets with funds generated by the trade or business, (2) the retention in the trade or business of income from the investment, or (3) the materiality

(in earning the income) of the activities of the trade or business, is sufficient to attribute the income to the permanent establishment.[30] [31]

Income from Direct Investments. In addition to the passive investments described above, foreign corporations can invest in affiliates in the host country. From the host country's perspective, the local business activity is carried on by a domestic resident; the foreign ownership has no effect on the nexus between the host country tax authorities and the affiliate. The country where the foreign owners reside must defer taxation until funds are remitted from the affiliate to its owners, unless the income can be characterized as tainted and taxed immediately for that reason. In theory at least, the foreign owners could avoid taxes of the home country altogether by continually reinvesting the affiliate's income in real assets overseas.

When the affiliate remits dividends to foreign owners, the payment is taxed by withholding at the source in the same manner as other investment income. It then becomes subject to the tax jurisdiction of the home country.

Categories of Transnational Income

The focus of this paper is the transnational income generated by three commonly used methods of transferring funds across tax jurisdictions: royalties, interest, and dividends. Dividends include those actually paid (or declared) by portfolio and direct foreign investments and those deemed to have been made by controlled foreign corporations.

Management or service fees are another mode of transferring funds between affiliated businesses.[32] They are reimbursements from the affiliate to the parent for expenditures made on the affiliate's behalf. If inflated, such payments are a potential conduit of profits without withholding taxes. For this reason Germany and Japan tend to scrutinize these deductions carefully and to require documentation with written agreements[33] in order to show that the fees are offset by the actual expenses attributable to

them and do not consist of profit transfers. Because of this scrutiny, the net effect of management fees upon taxable income is usually negligible, and they are omitted from further discussion.

Royalties

Royalty income is the consideration derived from the transfer to a licensee for the use of intangible assets such as patents, trademarks, designs, know-how and copyrights. Multinational enterprises use licensing agreements to achieve production of their product(s) by firms situated in other countries. The foreign manufacturer can be an unrelated business or an affiliate owned by the licensor. Royalty payments are normally based upon observable criteria such as sales or units of production.[34]

Interest

This paper considers only the interest earned on loans that are incidental to the normal activity of a multinational firm whose primary business is manufacturing and sales. Interest payments are the consideration for loans that can be made internally from the investor,[35] or externally by unrelated lenders from either the host country or another country.

Dividends

Dividends are distributions of a portion of the residual earnings to the holders of equity. The tax treatment of dividends depends upon the percentage of stock in the distributing corporation owned by the recipient. When the percentage is small, the investor is presumed to have little, if any, control over the dividend remittance policies of the investee. The percentage of ownership determines the withholding tax rate on the dividends paid out to the owner of foreign portfolio or direct investments. These different rates will be discussed under tax treaties.

As the degree of ownership increases, the investor and the investee begin to function as a single economic entity. At the 50% level of ownership, the investor controls the affiliate and the two are considered related parties.

Under the tax law of the United States, when ownership is greater than 50%, the investment meets the definition of a controlled foreign corporation.[36] When a controlled foreign corporation earns certain kinds of income, a dividend to the parent is deemed to have been made.[37] Since no transfer of cash has taken place, there is no withholding tax, but a tax liability is created in the United States. Later when actual dividends are repatriated, they are free of American tax to the extent they were previously taxed as deemed dividends.[38] Deemed dividends will be discussed again in the context of both tainted income and the foreign tax credit.

Rules for Determining the Source of Income

Because the three bilateral tax treaties between Germany, Japan and the United States often take precedence over the domestic statutory law of all three countries,[39] the source of income remitted between any two of these countries can be determined from the tax treaty provisions.

Royalties and Interest

In transactions between Japanese and German residents, the treaty overrides Japanese law on the source of royalty income.[40] The residence of the payer of the royalty (rather than that of the user of the technology) determines the source of the income.[41]

In transactions between residents of Germany and the United States, the source of royalty payments and interest income is not an issue because the treaty exempts both from withholding tax in the host country and subjects both to tax in the home country, unless they are attributable to the business of a permanent establishment.[42]

This contrasts with the tax treatment of transactions between residents of Japan and the United States in which the location of the user determines the source of the income;

royalties paid for the use of (or the right to use) the property within the host country sources the income to the host country.[43]

The Japanese tax treaties with Germany and the United States and domestic Japanese statutory law[44] all determine the source of interest income in the same way: to the country where the payor of the interest is located. However, should the interest be incurred in connection with the indebtedness of a permanent establishment, it would be deemed to arise in the country where the permanent establishment is located.[45]

Dividends

The tax treaties between Germany, Japan and the United States all subject dividend income that is remitted between any two of the countries to a withholding tax in the country where the distributing corporation is located. All dividend remittances to residents of Japan or the United States are taxed in the home country as well. Portfolio dividends remitted to German residents are also taxed in Germany.[46] [47]

Withholding Rates

In the source country, taxes on transnational remittances can be collected most efficiently at the time of payment. The withholding means that the investor receives royalty payments, interest income and dividends net of the tax.

Most countries have statutory withholding tax rates[48] that are modified through tax treaty provisions. For example, were there not a tax treaty between the United States and Germany or Japan, the royalty payments and interest income of foreign corporations, which were sourced in the United States but not effectively connected with a business in the United States, would have been taxed at a flat rate of 30%.[49] The tax treaties cut the rate to 15% or less.[50] A country can enact a high statutory withholding tax rate to induce other countries to sign tax treaties with it.[51]

The tax treaty can stipulate a withholding tax rate of zero. The United States has historically been willing to forego a high withholding tax rate on payments made to foreign

persons in exchange for a strong claim on income of the same character earned by its own citizens overseas.[52] This extension of the residence approach to tax jurisdiction is combined with a modification of the principle that the territorial approach should be applied to foreign persons. The tax treaty between the United States and Germany is a good illustration of this tradeoff.[53]

Royalties and Interest

Royalty and interest and payments between Germany and the United States are free of withholding tax. Royalty and interest payments between Japan and either Germany or the United States face a 10% withholding tax.[54] [55]

Dividends

Because tax treaties call for different withholding rates on dividends from affiliates and dividends from portfolio investments, they define the cutoff between the two for withholding purposes. On payments between Germany and Japan, ownership of less than 25% of the shares of voting stock of the distributing company will classify the recipient as a minority (or portfolio) shareholder.[56] The distinction between portfolio and direct investment is not made for dividend payments between Germany and the United States.[57] Between Japan and the United States, a holding of under 10% will classify the recipient as a minority shareholder.[58]

Portfolio dividends encounter a 15% withholding tax on payments between any of the three countries of this study.[59]

Dividends from an affiliate in Germany face a 15% withholding tax. The withholding rate from the United States to Germany is also 15%; from the United States to Japan it is 10%. The withholding tax rate from Japan to either Germany or the United States is 10%.[60]

It has been intended that the withholding tax rate on affiliate dividends between Germany and the United States should drop to 10% in 1990 and 1991 and to 5% in 1992 as

a consequence of the recently signed tax treaty.[61] The withholding tax levied on distributions from German affiliates to an investor in the United States has been a longstanding issue of contention between the two countries.[62]

TAXATION OF INCOME EARNED IN THE HOST COUNTRY

Domestic statutory law, domestic regulations and the domestic interpretation of both define the tax rates and bases for economic activity within a tax jurisdiction. The mix of taxes (individual versus corporate, direct versus indirect) is different in each national jurisdiction.

Legislative Framework

The legislative framework for German taxes is laid down by Acts of the Federal Parliament.[63] Major changes are infrequent. The last occurred in 1978, when Germany ended its split-rate system of tax and replaced it with an imputation system[64] with split rates.[65]

Tax legislation is a major tool of Japanese industrial policy.[66] Statutory tax laws[67] are backed up by circulars and enforcement orders to detail how the laws are to be implemented. The recent trend has been to cut back on the tax incentives for the exemption of income, tax credits and tax deferrals, but other tax incentives remain. Formal transfer price legislation for cross-border transactions was introduced in 1986 as an amendment to the Special Measures Tax Law.[68] The Corporation Tax Law appears to have remained unchanged in important aspects since its enactment.

Current tax law of the United States is based on the Internal Revenue Code of 1986. The Tax Code is interpreted with the guidance of Regulations issued by the United States Treasury Department. Revenue Rulings issued by the National Office of the Internal Revenue Service are another source of clarification.[69]

Until the early 1960's the tax system of the United States was stable with respect to international transactions, but from the mid-1960's legislation in this area has been abundant.[70] These changes have brought the passive income of foreign affiliates owned by the residents of the United States into the ambit of current taxation.[71] They have also reduced the opportunities for transfer price manipulation.[72] Significant recent changes[73] took place with enactment of the 1986 Tax Reform Act which lowered the federal tax rate, broadened the tax base and made record keeping for international transactions more complicated for investors based in the United States.[74]

Legal Form of Affiliate Organization

Foreign investors tend to organize as an affiliate or subsidiary rather than as a branch, especially within the United States, because the corporate form insulates the foreign parent from the potential effects of antitrust, securities regulation or product liability.[75]

The typical form of foreign participation in Germany is a wholly, or substantially majority-owned affiliate. Most affiliates are structured as private companies (GmbH), a legal form which is less formal than a corporation (AG) but still carries most of the benefits of corporate organization.[76] Foreign affiliates in Japan are organized as corporations (KKs), a form that corresponds in many ways to corporate organization in the United States.[77]

Important Direct Taxes

The direct taxes considered here are those levied on corporate income. In Germany they include the corporation tax (*Körperschaftsteuer*) and the municipal trade tax (*Gewerbesteuer*) on income.[78] In Japan they include the corporation tax (*hojin zei*), the local inhabitants tax (*jumin zei*) and the enterprise tax (*jigyo zei*). In the United States, they include the federal corporate income tax and the state and local income taxes.

The three countries all impose a national corporate income tax on industrial and commercial activity within their tax jurisdiction. The relative importance of this tax differs across countries, as shown in Table 1. Germany relies on indirect taxes (VAT) for almost 25% of its national revenue. Japan relies more on corporate income taxes than on individual income taxes. In contrast, United States relies more upon individual income taxes; however, the corporate proportion of revenue should have increased after the 1986 Tax Reform Act went into effect.[79]

National Corporate Taxes

Statutory tax rates differ across countries. Japan and Germany employ the split-rate method which means that they tax distributed earnings at a lower rate. For 1988, if income could be fully distributed, the nominal rates for national taxes in the three countries would similar: Germany at 36%, Japan at 32% and the United States at 34%.[80]

In a split-rate system, the lower tax rate on distributions should favor a high dividend payout ratio, because it creates a tax cost for earnings retained for internal investment.[81] However, this does not appear to be the case. From 1984 to 1988 (the last year for which data is available), the ratio of dividends paid to net income has ranged from 36% to 40% in Germany and from 26% to 31% in Japan. By contrast, corporations based in the United States distributed from 45% to 64% of their net income during this period.[82]

In addition to a dual tax rate, Germany has an imputation procedure. In 1988, the dual tax system brought the rate of corporation tax from 56% to 36% of its base. The imputation system ensures that the 36% is paid on corporate income only once.

The imputation works like a domestic "foreign tax credit" wherein the shareholder's dividend income is grossed up to his share of the pretax corporate income supporting the dividend and a credit is given to the shareholder for the taxes the corporation is imputed to have paid on the income. The result is that dividends received are treated as net of tax which was paid by the corporation but is attributed to the recipient.

Table 1

Details of Sources of Tax Revenues in 1988

(Percentages)

	Germany	Japan	United States
Direct Taxes:			
Individual Income	29.0	23.8	36.2
Corporate	3.6		
Municipal Trade	1.4		
Corporation		15.0	
Inhabitants		3.4	
Enterprise		4.5	
Federal			5.5
State and Local			1.5
Corporate Income	5.0	22.9	7.0
Other Taxes:			
Social Security	37.3	28.6	38.8
Taxes on Property	3.2	11.4	10.2
Taxes on Goods and Services	24.3	13.3	16.7
Other	1.2	--	1.1
Total	100.0	100.0	100.0

Source: Revenue Statistics of OECD Member Countries, 1965-1988. Tables 45, 49 and 60. Paris: Organisation for Economic Co-operation and Development, 1989.

This process requires that the earnings of the distributor be classified according to the rate of corporation tax levied on them. The categories are EK 56 (fully taxed income), EK 36 (partially taxed income), and EK 01 (tax-exempt income).[83] Distributions from EK 56 benefit from a tax reduction that brings the effective rate to 36%. Distributions from EK 36 are neutral; they lead to neither a reduction nor a penalty. Distributions from EK 01 trigger a surcharge (*Erhöhungsbetrag*) in order to bring the tax rate up to 36%, presumably so the recipient can claim the imputation credit for taxes the distributor has paid.

Dividends are presumed to have been distributed first from EK 56, then from EK 36 and last from EK 01 when the other categories are exhausted.

Local Taxes

National taxes account for only a part of the direct tax burden. Taxes on corporate income levied by states, municipalities and local governments augment the national tax rate by differing amounts. Most, but not all, of the subfederal taxes are deductible for the calculation of the base for the national tax. For some of the subfederal taxes, adjustments are made to income, so the tax base may also differ from that of the national tax.

In Germany, the municipal trade tax on income[84] creates large obligations. The rate of the municipal trade tax on income varies between 10% and 25%; and a nominal rate of 20% is common. This tax is itself deductible towards the corporate income tax, so when the nominal rate is 20%, the effective rate is 16.7%.[85] The base is income before tax to which half of the interest expense has been added back.[86]

In Japan, the inhabitants tax and the enterprise tax are levied at relatively high nominal rates. The enterprise tax is imposed by prefectures only. The nominal rate is 13.2%, and the base is taxable income, as calculated for the national corporate income tax. The tax paid is deductible from the corporate tax and from the enterprise tax itself.[87]

The inhabitants tax is imposed by the prefectures and municipalities where the corporation has located its business offices or factories. It is a percentage of the

corporation tax (before tax credits except for the investment tax credit). The maximum percentage of 20.7%, which applies to the Tokyo metropolitan area, gives an effective rate of 6.62% on distributed profits and 8.69% on undistributed profits for 1988.[88] This tax is not deductible from the national corporate income tax.[89]

In the United States, states and municipalities can impose income taxes upon business entities operating within their jurisdictions. The rates and bases vary across locations, but a combined state and local nominal rate as high as 12% can be imposed, and a combined state and local nominal rate of 10% is not unusual.[90] State and local income taxes are deductible in the determination of the federal income tax.[91]

Allowable Deductions for Ordinary Business Expenses, Royalties and Interest Payments

In Germany, Japan and the United States, expenses, which are "reasonably connected" with industrial or commercial profits, are deductible.[92]

Licensing agreements are used widely by foreign businesses to have their product manufactured in Germany, and the royalty payments are normally deductible.[93] The interest paid on loans and debts incurred for business purposes is also normally deductible in Germany, unless economically connected with tax exempt income.[94]

As the obligation to pay them accrues, Japanese taxpayers normally may deduct royalties and interest (unless it is attributable to the holding of shares).[95]

Royalty payments are deductible in the United States, and under most circumstances a business incorporated in the United States can deduct all interest paid or accrued during the year.[96]

SPECIAL INTERNATIONAL TAX PROBLEMS

From the tax authority's perspective, income escapes taxation through the improper use of transfer prices and tax havens. Statutory law specifically addresses these two concerns: transfer prices and tax havens. Transactions with related firms located in tax

havens can lead to careful scrutiny of the transfer price on the presumption that they are driven by tax avoidance.[97]

Transfer Prices

Notional or transfer prices are attached to intrafirm transfers of royalties and interest.[98] In theory, they should be arm's length, the price that would be set between independent contracting parties. In actuality, they can be a tax planning tool to shift profits. The rates for intracorporate royalty and interest payments are transfer price decisions.

Perhaps because of its territorial approach, the thrust of the German transfer price legislation is directed to the German affiliates owned by a foreign investor. The benchmark is that the business in Germany should not be burdened with charges which an independent distributor would have found unacceptable.

In Japan, transfer pricing has been a domestic issue because consolidated tax returns are not permitted.[99] In 1986, the Japanese amended their transfer pricing legislation[100] to cover cross-border transactions of inventory, loans, consultations and technical assistance between closely related parties.[101]

Transfer pricing provisions apply to taxpayers of the United States when two or more organizations, trades, or businesses are owned (or controlled) directly (or indirectly) by the same interest. The purpose of these rules is "to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer."[102] When funds are advanced within the corporate group from one member to another, interest must be charged; a rate of between 11% and 13% has been regarded as a "safe haven," a rate that is normally acceptable.[103] When royalties are based upon the licensee's output or sales or upon reciprocal licensing rights, the form of consideration is usually considered to be arm's length.[104]

Transfer pricing abuse is a central concern of national tax authorities, and most tax codes or regulations incorporate guidelines for a fair price. In this discussion, the presumption is that transfer prices are within the letter and intent of the law.

Tax Havens

Germany,[105] Japan[106] and the United States[107] all have tax rules which can subject income earned in low-tax areas to current taxation in the home country, whether repatriated or not. The rules for determining which low-taxed earnings are tainted income and for imposing current taxation on this income vary from one tax jurisdiction to another.

Resident shareholders in Germany must include "attributable tainted income"[108] in their current taxable income[109] when the tax rate in the foreign tax jurisdiction where the affiliate is organized[110] is less than 30%,[111] and when the foreign affiliate meets the definition of a foreign controlled corporation.[112] The income is included as a deemed dividend.

Deemed distributions are treated in tax treaties as if they were actual dividend distributions; this means that should treaty exemptions apply, the German investor would not need to make an "attribution" of the tainted income.[113] However, tax havens normally have no tax treaties with Germany, so in practice the deemed dividend tends to be included in the taxable income of the taxpayer.

"Attributable tainted income" is the tax haven income computed according to the provisions of German tax law. It is net of the expenditures which are economically connected to it, including any income taxes or net worth taxes which may have been levied upon it. It is also reduced by any actual dividend distributions.[114]

Japanese shareholders must pay current tax on the "taxable undistributed profits" of "designated tax haven affiliates." The thrust of Japanese tax haven legislation is directed toward identification of these "designated tax haven affiliates." It is an "all-or-nothing" situation. Should an affiliate meet the definition, then all of its undistributed profits,

however earned, would be reported currently by its Japanese shareholders.[115] Should the affiliate fail to meet the definition, it could earn passive income and defer payment of Japanese tax until its repatriation.

To be defined as a "designated tax haven affiliate" the foreign corporation must meet several criteria. First, the affiliate must be organized or have its seat of management in a country designated as a tax haven.[116] Second, directly or indirectly, more than 50% of the affiliate must be controlled by Japanese shareholders.[117] Last, the affiliate must have been organized with the intent of shielding profits from higher income tax rates through the artificial diversion of income to a low tax country. An affiliate engaged in legitimate business activity in the tax haven or doing business with unrelated parties is outside the definition, as long as it is not also acting as a holding company for the receipt of dividends, royalties or other revenues generated outside the tax haven.[118] In summary, the rules for tainted income are imposed only when a controlled affiliate is both (a) located in a designated tax haven and (b) not engaged in legitimate local business activity.

To avoid double taxation, when the undistributed past profits of these "designated tax haven affiliates" are later distributed as dividends, they reduce the amount of the current undistributed taxable profits on a pro rata basis.[119]

Rather than list tax haven countries, the approach of the United States has been to define categories of income which are tainted and to bring them into current income regardless of where the income was earned or whether it is repatriated. This approach has led to the complex provisions found in subpart F of the United States Tax Code. What follows is a simplified presentation of some of its important provisions. These subpart F rules will tie in with the separate limitation categories to be discussed later under the foreign tax credit.

The provisions of subpart F apply only to controlled foreign corporations.[120] Further, unless over $1,000,000 (or 5% of the gross income of the controlled foreign corporation) is foreign base company income,[121] subpart F provisions do not apply.[122] If

over 70% of the gross income is foreign base company income, all income will be treated as foreign base company income.[123] Within the 5% and 70% range, the earnings of the controlled foreign corporation are split into streams where subpart F applies and where it does not apply. The provisions of subpart F affect only United States shareholders who control 10% or more of the voting power of its stock.[124]

Foreign base company income is the sum of five categories of income. In the context of this discussion, the two important categories are (1) foreign personal holding company (FPHC) income and (2) foreign base company sales income.[125] The American taxpayer can exclude income which would otherwise fall into the foreign base company income categories,[126] when he can show that it was subjected to a high rate of foreign tax (over 90% of the maximum federal tax rate).[127]

Foreign personal holding company (FPHC) income includes dividends, interest and royalties.[128] However, royalties received from unrelated persons[129] and derived in the active conduct of a trade or business are excluded from FPHC income.[130]

Foreign base company sales income is the income of controlled affiliates that purchase or sell personal property. It is derived when the controlled foreign corporation is interposed in a transaction in which one of the parties is related to it. (The other party may be unrelated.) Further, one party to the transaction must be outside the country where the controlled foreign corporation is organized, and the personal property must be sold without significant value having been added by the seller (the controlled foreign corporation).[131]

To summarize, income which is tainted for tax policy reasons looses the privilege of tax deferral and is taxed currently to the shareholder as a deemed dividend (or a "subpart F inclusion"). The principles of computing the deemed-paid foreign tax credit (to be discussed below) apply as if the deemed dividend had been an actual remittance.[132] When dividends are later distributed out of tax haven earnings and profits, they are free of tax, to the extent that the income had been previously taxed under the rules of subpart F.[133]

HOME COUNTRY TAXATION OF TRANSNATIONAL INCOME

Income earned overseas becomes subject to taxation in the home country when it is repatriated as royalties, interest or dividends and when it is earned in tax havens and/or deemed to be tainted.

Royalties and interest received in Germany from foreign sources are normal business income, subject to both the trade tax and the corporate income tax. A credit (or a deduction) against the corporate tax due is given for foreign (withholding) taxes paid.[134]

In Germany, dividends received from foreign corporations are taxable income unless exempted from the corporation tax by a tax treaty. When not exempt, the foreign dividend can be included either at the gross amount (with a credit for the withholding tax) or for the amount actually received net of the withholding tax. Dividend income from holdings of 10% or more are free of the municipal trade tax.[135]

The 10% threshold means that dividends from portfolio investments face the corporate income tax and the municipal trade income tax in Germany, however, the foreign tax credit for taxes imposed earlier is available.

Unless attributable to the overseas branches of a Japanese corporation, royalty payments and interest income received in Japan from foreign investments face the same tax treatment as domestic income. They are included in the base for all income taxes, including the enterprise tax.[136]

Royalties received from foreign sources are entitled to a special tax deduction in Japan. When paid in foreign currencies, 25% of royalties and 16% of technical assistance fees are excluded from taxable income (to a ceiling of 40% of taxable income for one year).[137] The remainder is subject to all Japanese taxes, including the local enterprise tax (to which the special allowance does not apply).[138]

The United States treatment of royalty payments and interest income from foreign investments is similar to that of Japan; both are included in the gross income of the investor.[139]

In Japan and the United States, dividends from foreign sources are includable in the gross income of the investor, and a foreign tax credit can offset at least part of the foreign taxes paid.[140]

AVOIDANCE OF DOUBLE TAXATION

Dividends are distributed out of after-tax earnings. The underlying income has already been taxed in the host country because the distributing corporation is a tax resident there. The taxation of dividends in the home country creates a potential double taxation problem which is resolved by either exempting the dividend income or by allowing a credit for the host country taxes paid.

Exemption Method

In Germany, a 10% holding triggers the applicability of tax treaty provisions for exemption of foreign source dividend income from German tax.[141] The exemption concept applies to dividends from foreign operations received by German corporate investors as long as the following conditions hold: (1) the recipient must be a German company limited by shares (*Kapitalgesellschaft*), (2) the company distributing the dividend must be located where a tax treaty applies (as in Japan and the United States),[142] (3) the recipient company must own at least 10% of the voting shares of the distributing company,[143] and (4) the dividends cannot be exempt from tax in the payor's country.

Under the exemption method of Germany, foreign source income is excluded from the base for the income and municipal trade taxes, but taxes paid in the host country on this income are not eligible for a foreign tax credit in Germany.[144]

Foreign Tax Credit Method

In the other approach for the avoidance of double taxation, the recipient of dividends from foreign investments can claim a foreign tax credit (or a deduction)[145] on (1) direct taxes imposed on net income and (2) gross revenue in lieu of net income

(withholding taxes) paid to foreign governments. Normally a credit is of greater benefit to the taxpayer than a deduction.

The allowable foreign tax credit is the lesser of the actual foreign taxes paid on the foreign source income and a limitation or ceiling. The general approach to calculating a foreign tax credit ceiling is (1) to find the ratio of foreign source taxable income to total taxable income and (2) to multiply it by the home country income taxes on the total taxable income.[146] This gives the maximum credit allowable for the foreign taxes. The rationale for the limitation is that the foreign tax credit should offset the home country burden for taxes paid on foreign income but that it should not erode the home country tax on domestic income.

As noted earlier, tax treaties determine the source of transnational royalty, interest, and dividend income. The numerator of the limitation fraction (taxable income) includes foreign-source dividends (grossed up for both deemed-paid and withholding taxes) and foreign-source royalties, interest, and portfolio dividends (grossed up for withholding taxes). Any expenses or indirect costs of the Japanese or American investor that relate directly to earning the income (or are to be allocated against it) would be deducted at this step of the calculation.[147]

Credit for Direct Taxes

Direct taxes are the withholding taxes deducted at the source from the remittance. For purposes of the foreign tax credit, they are considered to have been paid by the recipient of the transfer.[148]

Deemed-Paid Credit

Taxes paid by the affiliate, on the income generating a dividend payment, can be included in the foreign tax credit calculation of the investor.[149] The rationale is that the investor is deemed to have paid a pro rata share of the foreign affiliate's taxes when its pre-tax income is included in the investor's tax base.

Because the income taxes of the host country are based on taxable income for the period, which normally is greater than the affiliate's dividend, only a portion of the affiliate income taxes can be included in the foreign tax credit calculation of the investor. To calculate the investor's pro rata share, (1) the ratio of gross dividends[150] to affiliate earnings[151] is (2) multiplied by the foreign income taxes paid.[152] This formula is sensitive to changes in both the foreign affiliate earnings, which must be determined by United States tax accounting rules for affiliates owned by American investors.[153]

These deemed-paid taxes are used in two places. They enter into the amount of creditable foreign taxes, which is the foreign tax credit when it is smaller than the ceiling. They also enter into the determination of foreign source income for the limitation calculation, because the dividend received must be "grossed-up" to its equivalent of taxable income.[154]

Eligibility. To use the formula, the taxpayer must meet conditions of eligibility. The taxpayer must be a "parent" in the sense that it owns a substantial percentage of the affiliate's voting equity. The percentage is 10% for German and American investors[155] and 25% for Japanese investors, except for Japanese investments in the United States where it becomes 10%.[156]

Thus, the indirect tax credit applies to the owners of foreign direct investment abroad but not to the owners of portfolio investments. Furthermore, the foreign tax credit can be taken for taxes paid by the second-tier affiliates of German investors and by the third-tier affiliates of American investors, as long as the ownership requirements are met.[157] Tiers of investments are structured to ensure that availability of the indirect tax credit will not be a potential problem.[158]

Foreign Earnings and Foreign Taxes. When the foreign affiliate has been in existence for several years, there can be a problem in determining (1) which year's earnings are being distributed and (2) which year's taxes are to be brought into the calculation.

The German approach is the most direct. There is no carryover of unused credits to another year, so the earnings and the taxes must be those of the current year.[159]

Japan uses a last-in first-out flow (LIFO) assumption for both foreign earnings and foreign taxes.[160] Should the dividend remitted be greater than current earnings, the current accounts would be used up first and then some of the earnings and associated taxes would be attributed to the immediately preceding year.

The approach of the United States is the most complicated. Before the 1986 Tax Reform Act, the United States used the same LIFO method that the Japanese apply.[161] However, beginning in January 1987, a pooling of foreign earnings and profits and of foreign income taxes has been required. The intent of the change was to close a potential source of manipulation of the deemed-paid foreign tax credit through the timing of dividend payments.[162] The effect is that separate pools of undistributed foreign earnings and profits and foreign taxes must be maintained both by year and by "basket" (or "separate limitation category" of income, to be discussed below).[163] As a corollary, expenses and taxes must be allocated to the different categories of income earned by the foreign affiliate.

Allocation of Expenses

Particularly for corporations based in the United States, foreign-source income (the numerator in the foreign tax credit limitation calculation) and foreign after-tax earnings (the denominator in the deemed-paid credit calculation) are both sensitive to the rules for sourcing income and allocating expenses among affiliated corporations.

When the home country tax rate is lower than the foreign rate, the ceiling tends to be lower than the creditable taxes. This is an excess foreign tax credit position. It means that the home country taxpayer is being taxed at the higher host country rate and owes no additional taxes in the home country on the dividend or the income supporting it. In contrast, when the home country tax rate is higher than the foreign rate, the ceiling tends to

be higher than the creditable taxes, and the taxpayer is in a deficit foreign tax credit position. The tax offset is limited to foreign creditable taxes, and the taxpayer owes additional tax to the home country tax authority. A tax position with few, if any, excesses or deficits is most desirable; a position with excesses for one kind of income and deficits for another kind of income is least desirable. The latter occurs when higher foreign taxes can not be used to offset the home country tax liability.

Both (1) foreign revenues that are sourced to domestic income and (2) domestic expenses that are allocated against foreign-source income decrease the limitation through their effect on the formula. Once an American taxpayer is in an excess tax credit position, each additional dollar of the investor's expense allocated against the foreign-source income can reduce taxes by only 34 cents, the amount shielded by a deduction.

Because many foreign tax rates are higher than the home country tax rate (especially for investors headquartered in the United States), one objective of tax planning has been to maximize the foreign source income earned at low rates of foreign tax in order to offset other income which was earned at higher rates of tax. Another objective has been to allocate expenses against highly taxed foreign income in order to bring down the effective foreign tax rate.

The category of expense that is most relevant for this paper is interest.[164] Interest is controversial because cash is a fungible commodity. The choice of who should borrow and where to borrow can be tax motivated in whole or in part. Since the 1986 Tax Reform Act, the interest expense of American taxpayers must be apportioned over all income-producing assets on a consolidated basis, and foreign borrowing is not considered in the calculation.[165]

Separate Limitation Categories

Separate limitation categories constrain the taxpayer's ability to obtain an average effective foreign tax rate by offsetting income against losses and by blending income which has been taxed at different rates.

Germany

For the foreign tax credit, Germany has a per-country limitation system that allows for the offsetting of income against losses within each country but not between countries. Income and taxes from different countries cannot be aggregated to achieve a blended foreign tax rate nor can the effect of aggregation be achieved indirectly through the establishment of a single foreign holding company with operating affiliates in a number of countries.[166]

When foreign source income is by treaty exempted from German tax, foreign losses can still be deducted from German tax with the proviso that subsequent profits be subject to German tax up to the amount of the loss deduction (that is, recaptured). Further, the losses of a 50% owned foreign affiliate (in a developed country) can be deducted through a loss reserve for five years after the investment was acquired. Later, the loss reserve must be restored to income, even if the investment has been written off.[167]

Japan

The Japanese allow for the blending of all foreign source income and losses in the determination of net foreign source income.[168] Due to the overall limitation, the Japanese corporation can combine all foreign source income and all foreign taxes to obtain an averaging of the foreign effective tax rates. There are no separate limits by country or by type of income.

Japanese foreign tax credits are applied first to the national corporate income tax liability.[169] Any excess can then be applied to the inhabitants tax.[170] Both excess foreign

tax credits and deficiencies in foreign taxes (which lead to a deficit foreign tax credit position) can be carried forward.[171]

United States

When foreign royalties, interest, and dividends are received by an American investor, they undergo a series of tests to place them in the appropriate basket. Within each basket, the ceiling for the foreign tax credit is calculated separately on an overall (or worldwide basis).

Before 1987 there were only two baskets, one for interest and one for everything else. Use of the interest basket was restricted. It excluded all interest income from (1) the active conduct of the taxpayer's business abroad (such as on accounts receivable), (2) banking or financing business activity, and (3) corporations in which the taxpayer owned 10% or more of the voting stock.[172]

Since enactment of the 1986 Tax Reform Act, these tests have become a complex web of rules. The motivation for the rules was the perception that the taxpayer manipulated passive income that had been taxed at low rates in order to absorb the tax credits attributable to income that had been taxed at high rates and the belief that the reduction of the federal tax rate would increase the temptation to engage in this "abusive" behavior.[173] The express purpose of the new rules was to preclude cross-crediting, the use of income subjected to low taxes to offset income subjected to high taxes in order to achieve an average effective foreign tax rate that was close to the federal tax rate.

One tax analyst has called the outcome of these reforms "the ultimate mousetrap."[174] For simplification, this paper omits discussion of intertemporal adjustments[175] and baskets that are appropriate only for specialized income flows.[176] The baskets to be included are (1) passive income,[177] (2) high withholding tax interest,[178] (3) financial services income,[179] (4) dividends from noncontrolled section 902 corporations,[180] and (5) general (or overall) separate limitation income.[181]

The transnational income of concern is royalties, interest, and dividends received from foreign investments and subpart F inclusions (the foreign personal holding company income described earlier). Each component of this foreign source income goes initially into the general basket and remains there unless diverted by a test to another basket.

The first test diverts dividend income earned from section 902 uncontrolled foreign corporations (called "10-50's" from the ownership percentage range of the American investor). Dividends from each 10-50 are routed to a individual separate limitation basket, i.e., one basket per affiliate.[182] Royalties and interest from 10-50's and transnational income from other investments remain in the general basket for further testing.[183]

The second test examines the American taxpayer's interest receipts to determine whether any have been subject to high withholding tax rates. When the withholding tax on the remittance has been greater than 5%, the interest income is diverted to the high withholding tax interest basket.[184]

In the third test, any interest expense which has been paid or accrued by a controlled foreign corporation to the American shareholder is allocated against any foreign personal holding company income earned by the controlled foreign corporation. The effect of the allocation is to remove passive income and the related expense at the level of the foreign affiliate; at the level of the American taxpayer, the interest income remains in the general basket.[185]

The purpose of this "anti-abuse rule"[186] is to prevent taxpayers from manipulating loans and debts so some interest expense could be allocated against highly-taxed manufacturing income and some highly-taxed interest income could remain to be blended with interest income generated in countries with low tax rates; this blending of interest income would decrease the United States tax liability, because the average effective foreign tax rate would become closer to 34%.[187] Instead, this netting procedure neutralizes highly-taxed interest income that could otherwise be aggregated with interest income taxed at low rates.

The fourth test applies look-through rules when appropriate. Should less than $1,000,000 (or 5% of the controlled foreign corporation's gross income) be foreign base company income, the look-through rules can be ignored.[188]

The intent of look-through rules is to classify income according to the way in which it was earned by the foreign affiliate rather than the form in which it was received by the American taxpayer. The rules apply to royalty, interest and dividend payments from controlled foreign corporations[189] and to subpart F inclusions[190] (which are also from controlled foreign corporations). Look-through rules are the part of the United States Tax Code that ties together the base company income provisions of subpart F and the separate limitation categories of section 904.[191]

In a fifth test, when the look-through rules are applied to dividends, the taxpayer can use the 90%-rule to prevent income earned in a country with high taxes from inclusion with foreign base company income.[192] The highly taxed dividend income would remain in the general basket.

The sixth test applies look-through rules[193] to royalty and interest income from controlled foreign corporations. These transfers are income to the American investor and expenses to the affiliate. Should the American investor license property rights to the subsidiary in exchange for a royalty based upon the affiliate's gross receipts, the affiliate's revenue would normally be active,[194] and the investor's income would be active as well. It would remain in the general basket.[195] Should the subsidiary earn passive (foreign personal holding company) revenue, the interest or royalty expenses of the affiliate would be allocated against it. These payments would be diverted to the American taxpayer's passive basket.

To the extent that the controlled foreign corporation's revenue was dividends, the look-through rules would be applied again to the next tier of investments. At the end of the tests, any portion of the dividend remittance that had not been diverted would remain in the general basket.

For subpart F inclusions, the look-through rules ensure that the income is identified with the foreign base company income category that made it part of the deemed dividend.[196] However, the high tax rates of Germany and Japan preclude the American investor from having deemed dividends from affiliates located there.

In contrast to subpart F inclusions, the dividends received from controlled foreign corporations represent the aggregation of its earnings and profits from different activities. In order to classify dividend income in the way that was earned by the subsidiary, the ratio of the earnings and profits attributable to an income category to the total earnings and profits of the affiliate must be calculated.[197] This is accomplished by splitting the gross income of the affiliate into separate limitation categories and by allocating expenses and foreign taxes to each category. To complicate matters further, foreign subsidiary's earnings and profits must be determined by the tax accounting rules of the United States.[198]

Had the allocation of expenses created a loss situation in a basket, the loss would have been allocated among the other baskets on a proportionate basis.[199] Then in subsequent years, income equal to the prior year's losses would be added to baskets which had previously benefited from the loss deduction.[200]

In the seventh test, any royalty and interest income that might be remaining in the general basket is subjected to the high-tax kick-out rule.[201] Should the effective foreign tax rate exceed the maximum federal rate, the income would remain in the general basket. The procedure requires that expenses be allocated against the income (as they were in look-through rules) before the effective foreign tax rate can be determined.

The 90%-rule differs from the high-tax kick-out rule. The former applies to dividends; the latter applies to royalty, rental and interest income. Further, the 90%-rule is based on statutory tax rates while the high-tax kick-out is based on an effective tax rate, that takes into consideration both the taxes withheld and the allocation of expenses against the income.[202]

At the conclusion of this series of tests, all the transnational income of the American investor will have found a place in the overall basket or in one of the separate limitation baskets. The formula for the foreign tax credit limitation is applied once to each basket which contains income. Because the procedure precludes cross-crediting, it is likely that the American taxpayer will have (1) excess foreign tax credits in the high-tax baskets and (2) a tax liability for foreign source income in the low-tax baskets. The unused foreign tax credits can be carried over within the separate limitation categories.[203]

Footnotes

[1]Language precluded the use of primary sources for tax legislation for Germany and Japan. Guides for all the tax systems were found in (1) Arthur Young & Company, The Competitive Burden: Tax Treatment of U.S. Multinationals (Washington, D.C.: The Tax Foundation, 1988), (2) Coopers & Lybrand International Tax Network, International Tax Summaries: A Guide for Planning and Decisions (New York: John Wiley & Sons, 1989), and (3) Price Waterhouse, Corporate Taxes: A Worldwide Summary (n.p.: Price Waterhouse Center for Transnational Taxation, 1987).

The sources of information about German tax are (1) Juergen Killius, Foreign Income: Business Operations in West Germany, Tax Management Portfolio No. 174-4th, ed. Leonard L. Silverstein (Washington, D.C.: The Bureau of National Affairs, Inc., 1985), (2) Price Waterhouse, Doing Business in Germany, Information Guide (n.p.: Price Waterhouse World Firm Limited, 1988), (3) Touche Ross (Treuverkehr AG), Germany: Tax and Investment Profile (Frankfurt/Main: Touche Ross International, 1988).

The sources of information about Japanese tax are (1) Griffith Way, Rosser H. Brockman, and Masatami Otsuka, Foreign Income: Business Operations in Japan, Tax Management Portfolio No. 51-7th, ed. Leonard Silverstein (Washington, D.C.: Tax Management Inc., The Bureau of National Affairs, Inc., 1984), (2) Price Waterhouse, Doing Business in Japan and September 30, 1986 Supplement, Information Guide, (n.p.: Price Waterhouse Center for Transnational Taxation, 1983), and (3) Touche Ross (Tohmatsu Awoki & Co), Japan: Tax and Investment Profile (Tokyo: Touche Ross International, 1985).

The sources information about American tax are (1) the U.S. Tax Code, in particular sections 904 and 954, (2) Price Waterhouse, Doing Business in the United States, Information Guide (n.p.: Price Waterhouse Center for Transnational Taxation, 1988), (3) Price Waterhouse, U.S. Corporations Doing Business Abroad (n.p.: Price Waterhouse Center for Transnational Taxation, 1985), (4) Fuller (1986), (5) Lindsay (1987), and (6) McCawley (1987).

[2]Value added taxes (VAT), sales taxes, taxes based on property or capital, and other indirect taxes are outside the scope of this analysis. Their exclusion is justified because they are unavoidable taxes, a cost of doing business in the host country. Because they are not based on income, they have no impact upon the foreign tax credit calculation,

and they play no role in determining the home country tax cost of transfers across the borders of the host country.

[3]Recently, a Solidarity Surcharge (*Solidaritätszuschlag*) of 7.5% has been imposed on the German corporation tax for income earned from 1 July 1991 until 30 June 1992. See Tax Notes International, April 1991, 413.

See John Turro, "Tax Treaties: German Parliament Approves U.S.-F.R.G. Tax Treaty: But Will It Apply to the East?" Tax Notes International, November 1990, 1121-1124 and MaryGael Timberlake, "Tax Treaties: U.S. Treasury Department Says Germany Is Delaying Income Tax Treaty for Estate Tax Deal, Germany Blames U.S." Tax Notes International, April 1991, 375-376.

[4]The other important tax law change since 1985 is the introduction of a 3% sales tax in Japan on 1 April 1989 and the concomitant repeal of the Commodity Tax. For a discussion of the reform, see "Confusion Over New Japanese Sales Tax Gives Fresh Meaning to April Fools Day," Wall Street Journal, 14 May 1989.

[5]A recently signed tax treaty between Germany and the United States was ratified in August 1991. It will apply retroactively to 1 January 1990 (for states in the former West Germany) and to 1 January 1991 (for states in the former East Germany). Obstacles centered on extension of the treaty to the five new states created when Germany unified and on the European Community's response to anti-treaty shopping clauses in the document.

John Turrow, "European Community: Treaty of Rome Controversy May Further Delay U.S.-Germany Treaty's Entry into Force," Tax Notes International, May 1991, 477-478, and "Tax Report," The Wall Street Journal, 28 August 1991, 1.

[6]A corporation is a juridical person.

[7]The important treaties for this paper are

1. Protocol modifying the Convention of July 22, 1954 between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation with respect to Taxes on Income, Sept. 17, 1965 (Oct. 19, 1965), U.S.T. 1876, T.I.A.S. No. 5920 (hereafter cited as US-Germany).

This treaty has been under renegotiation since Germany changed the corporate tax system in 1977. The stumbling block has been the rate of tax withheld on dividend distributions from German affiliates to the American corporate investor. The rate is 25% less a refund of 10%, making the ultimate tax burden 45.6% (36% plus 15% of 64, or 9.6) when the trade tax is disregarded. Killius, Germany, A-71.

A new tax treaty between Germany and the United States was initialled on 16 December 1988. Killius, Germany, C&A 51]. See footnote number 5.

2. Convention between the United States of America and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, Mar. 8, 1971 (1972) U.S.T. 967, T.I.A.S. No. 7365 (hereinafter cited as US-Japan).

3. Agreement between Japan and the Federal Republic of Germany for the Avoidance of Double Taxation with respect to Taxes on Income and to Certain other

Taxes, May 10, 1967 (June 9, 1967), U.N.T.S. 134, No. 9715 (hereinafter cited as Japan-Germany).

[8]Some provisions of the Technical Corrections Bill of 1988 enable statutory tax law of the United States to take priority over tax treaties. See McIntyre (1989, 2-63 through 2-66) and U.S. Tax Code section 894(a).

[9]For a discussion of this issue, see McIntyre (1989, 1-11).

[10]Treasury Department's Model Income Tax Treaty, June 16, 1981, Commerce Clearing House, Inc., Tax Treaties 1981, 254 (hereinafter cited as US Model).

[10]Organization for Economic Co-operation and Development Model Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital, Commerce Clearing House, Inc., Tax Treaties 1980, 207 (hereinafter cited as OECD Model).

[11]Killius, Germany, A-69.

[12]OECD Model, Art. 23A.

[13]Killius, Germany, A-39.

[15]Killius, Germany, A-40; Price Waterhouse, Germany, 137.

[16]US-Japan Art. 6(8) in Way et al., Japan, A-64.

[17]Price Waterhouse, Japan, 105.

[18]Price Waterhouse, Japan, 105.

[19]U.S. Tax Code section 864(c)(1).

[20]McIntyre (1989, 2-11).

[21]US-Germany Art. III(1), (2), and (3), US-Japan Art. 8(1), (2), (3), and (5), and Japan-Germany Art. 7(1), (2), (3) and (4).

[22]Price Waterhouse, United States, 177.

[23]For tax rules before the 1986 Tax Reform Act, see Peat Marwick, Investment in the United States (1983, 34).

[24]Price Waterhouse, United States, 178.

[25]The branch of a foreign corporation would be a "limited" taxpayer.

An "unlimited" taxpayer is a corporation whose seat and/or place of management is in Germany. The entire worldwide income of an unlimited taxpayer is potentially subject to German tax, except as excluded under tax treaties or under domestic law. Price Waterhouse, Germany, 106.

[26]Price Waterhouse, Germany, 135.

[27]ITL Art. 164(2)(2) in Way et al., Japan, A-79.

[28]ITL Art. 161(5) in Way et al., Japan, A-79.

[29]For the rules of the United States, see U.S. Tax Code sections 871(a)(1)(A) and 881(1)(a).

[30]McIntyre (1989, 2-19 to 2-20), U.S. Tax Code section 864(c)(2) and U.S. Treasury Regs. section 1.864-4(c)(2)(iii)(b).

[31]Before 1966, investment income that was unrelated to a trade or business in the source country could have been attracted to its income and taxed with it under the "force-of-attraction-rule." In that year the concept of effectively connected income was enacted in the United States Tax Code to encourage foreign investment in portfolio assets located in the United States. Tax treaties tend to override the force-of-attraction principle by stating explicitly that only income attributable to a permanent establishment can be subject to its tax. McIntyre (1989, 2-17 to 2-18).

[32]Rentals for leased assets are not considered here, because in the host country, the leased asset is considered a business separate from the affiliate.

[33]Killius, Germany, A-35 and Price Waterhouse, Japan, 79-80.

[34]In cross-licensing agreements, the consideration is the right to use the intangible property of the other party; this is difficult to measure and thus to tax.

For instance, there is no Japanese withholding on the transfer of know-how when the know-how itself is the only consideration in a cross-licensing agreement. TM Japan A-85.

[35]The affiliates of both Japanese and German corporate investors can make loans upstream to their investor, a strategy which can permanently defer home country taxes on income earned abroad. By contrast, a loan made by a foreign affiliate to its American investor is considered an investment in United States property and taxed currently as a deemed dividend to the investor. This income is taxed on the basis of the increase in the loan amount from year to year.

In the past investors in the United States have dodged this requirement by paying back loans from foreign affiliates before the end of the foreign unit's accounting year ended and then by borrowing again early in the next year. Rev. Ruling 89-73 of the Internal Revenue Service has put an end to this practice. The Wall Street Journal, 24 May 1989.

U.S. Tax Code section 956(b). This is different from subpart F income which is currently taxed as a deemed dividend under U.S. Tax Code section 951(a)(1)(A) and (B). Arthur Young, 8, 22, 41, and 53.

[36]U.S. Tax Code section 957.

[37]U.S. Tax Code section 960.

[38]U.S. Tax Code section 959.

[39]The Technical Corrections Bill of 1987 overrides tax treaties in several places, such as the branch tax and the foreign tax credit limitation provisions. For a technical discussion, see the Committee of U.S. Activities of Foreign Taxpayers and Foreign Activities of U.S. Taxpayers of the New York State Bar Association Section of Taxation, "Legislative Overrides of Tax Treaties," Tax Notes, November 30, 1987, 931-937.

[40]Under Japanese statutory law, royalties are domestic source income in Japan when the licensee is engaged in business in Japan (ITL Art. 161(7) in Way et al., Japan, A-74 and A-75) and the royalties are related to this business (CTL Art. 138(7); ITL Art 161(8) in Way et al., Japan, A-67). Thus, location of the user of the technology normally determines the source of income. A payment made by a licensee to a Japanese firm for the use of industrial property rights outside Japan would not be Japanese source income. It would not be subject to withholding tax for that reason.

[41]If payer and user are different business units, this rule can shift the source of income. If a Japanese taxpayer acquires technology from a German licensor to use in its affiliate in Germany, and if it pays for the license from its headquarters in Japan, it must withhold tax on the payment. Japan-Germany Art. 12(5). See also Way et al., Japan, A-83 and A-84.

[42]US-Germany Art. VIII(1), (2) and (4) (royalties) and Art. VII (1), (2) and (3) (interest).

[43]US-Japan Art. 6(3).

[44]Under Japanese domestic law, income from the holding of debt securities issued by Japanese corporations is Japanese source income regardless of where the securities are held or used (CTL Enf. Order Art. 177(1)(i); ITL Enf. Order Art. 280(1)(i) in Way et al., Japan, A-65). The same holds for interest on bank deposits in Japan (CTL Art. 138(4); ITL Art. 161(4) in Way et al., Japan, A-67). Interest income on a business loan to a borrower in Japan is also Japanese domestic source income (CTL Art. 138(6); ITL Art. 161(6) in Way et al., Japan, A-67).

[45]Japan-Germany Art. 11(7); US-Japan Art. 6(2).

[46]CTL Art. 130(5); ITL Art. 161(5) in Way et al., Japan, A-67.

[47]US-Germany Art. IV, Art. VI(1) and (2), and Art. XV(1); US-Japan Art. 6(1) and Art. 12; Japan-Germany Art. 10 and Art. 23.

[48]In Germany and Japan, tax is withheld on payments of dividends and interest (Japan only) to domestic as well as to foreign recipients. Price Waterhouse, Germany, 185-188 and Price Waterhouse, Japan, 22-23.

A measure to levy a 10% withholding tax on interest income, with refunds to nonresidents, came into effect in 1989 but was rescinded in a few months. The tax led to record capital flight from Germany. See "Bonn Appears Likely to Suspend Tax on Interest Income Before Kohl Speech," The Wall Street Journal, 24 April 1989.

[49]Price Waterhouse, United States, 174.

[50]One summary of United States tax treaty modifications to the statutory withholding tax rates can be found in McIntyre (1989, B-4 to B-7).

[51]See McIntyre (1989, 2-40].

[52]McIntyre (1989, 2-69 to 2-71) has made this observation. He noted that the policy of claiming exclusive jurisdiction over investment income to the country of residence enhanced United States revenues from the time of World War II to the early 1980's. It would benefit the revenues of the United States less today because the level of foreign investment in American financial assets has increased relative to the investment of American citizens in foreign assets.

[53]Royalties. Japan-Germany Art. 12(1); US-Japan Art. 14(1).

Interest. Japan-Germany Art. 11(2); US-Japan Art 13(1).

Dividends. US-Germany Art. VI(1) and (2); Japan-Germany Art. 10(1); US-Japan Art. 12(1).

The tax treaty between the United States and Germany exempts royalty income from tax in the host country when there is no permanent establishment there. US-Germany Art. VIII(1) and (2).

The tax treaty between the United States and Germany exempts interest income from tax in the host country when there is no permanent establishment there. US-Germany Art. VII(1) and (2).

[54]Japan-Germany Art. 11(2) and Art. 12(2); US-Germany Art. VII(1) and (2) and Art. VIII(1) and (2); US-Japan Art. 13(4) and Art. 14(2).

[55]The United States exempts from withholding taxes two categories of interest income earned by foreign persons. The first is interest on deposits, an exemption which encourages foreigners to lend money to banks in the United States. Before the 1986 Tax Reform Act, the interest on these loans was classified as foreign source income. Today, the interest is American-source income that has an explicit exemption from withholding tax. The change emphasizes the intent that this income be subject to tax of the United States when earned by residents of the United States and should it not be exempt for tax policy reasons. See McIntyre (1989, 2-46 and 2-50 to 2-51), prior U.S. Tax Code section 861(a)(1)(A) and (c) (repealed) and U.S. Tax Code sections 871(i) and 881(d).

The second exemption applies to the portfolio interest income earned by qualifying nonresident alien individuals and foreign corporations. The policy goal of this exemption has been to enable borrowers of the United States to access the Eurobond market directly rather than relying upon indirect access through finance subsidiaries located in the Netherlands Antilles. This exception was enacted in 1984 to enable the U.S. Treasury Department to finance large deficits incurred in the 1980's through the Euromarket for bonds. However, the lower Euromarket interest rates were offset in part by the reduction in revenues which the 30% withholding tax would have generated. See McIntyre (1989, 2-47 to 2-49) and U.S. Tax Code sections 163(f) and 871(a).

In an ideal world, the investor would finance the foreign affiliate from loans in the host country to minimize his exposure to economic risk. This discussion ignores any loans obtained from third parties. Next, managements fees would be justified to the largest extent possible, because they are not subject to withholding taxes. Royalties would also be maximized to the extent justified from the technology transferred and the level of sales.

Last, there must be some dividends remitted, because without foreign profits there is no reason to transact business overseas.

[56]Japan-Germany Art. 12(2) and (3).

[57]Coopers & Lybrand (1989, G-7 and U-35).

[58]US-Japan Art. 12(b)(1).

[59]Japan-Germany Art. 10(2); US-Germany Art. VI(1) and (2); and US-Japan Art. 12(2)(a). On remittances from Germany to Japan the withholding rate is 25% on dividends from participating bonds and/or silent partnerships.

[60]Japan-Germany Art. 10(3)(a) and (b); US-Germany Art. VI(1) and (2); and US-Japan Art. 12(2)(b).

[61]Tax Treaties. New Developments. 27 December 1988, 9775.

According to The Wall Street Journal, the new tax treaty between Germany and the United States should have been ratified in early 1991. See "Tax Report," The Wall Street Journal, 23 January 1991, 1.

In footnote 5 the reasons for the delay are discussed in more detail.

[62]Killius, Germany, A-71.

[63]In Germany, the Corporate Income Tax Law of 1976 (*Körpersschaftsteuergesetz* or KStG) determines the taxation of domestic corporations. The taxation of tax haven operations is laid out in the Foreign Tax Act (*Aussensteuergesetz* or AStG). The Individual Income Tax Code (*Einkommensteuergesetz* or EStG) is the source of rules for the imputation credit for dividends.

The basic statute in Germany governing foreign trade and foreign exchange contracts is the Foreign Trade Act of 1961 (*Aussenwirtschaftgesetz* or AWG). Outward foreign direct investment is regulated by the Foreign Investment Code (*Auslandsinvestionsgesetz* or AIG).

[64]In the German imputation system, an imputed tax credit reduces the domestic shareholder's tax by the tax paid by the corporation on the same income. The foreign investor cannot claim the imputation credit because it is not recognized by tax authorities outside Germany. Price Waterhouse, Germany, 116.

The current system of tax in Japan was also designed as an imputation system, and, although modified, the basic concept continues; dividends received from a domestic corporation are excluded from taxable income. Price Waterhouse, Japan, 71.

[65]The change was made because the rate of withholding on dividends paid abroad (determined by tax treaty) was usually less than the difference in the retention and distribution rates; the system was not neutral. This has been called the "foreigner effect." Eckford and Lawson (1984, 151-154).

Tax reform with a lowering of tax rates has been discussed for the 1990. An increase in the VAT has been proposed to compensate for the revenue foregone with the lower rates. Price Waterhouse, Germany, 103-104.

For recent developments in Germany, see footnote 4.

[66]For a detailed discussion of the tools of Japanese industrial policy, see Wakiyama (1986, 478-483).

[67]The Japanese rules for corporate taxation are set out in three laws. The Income Tax Law (ITL or *shotokuzeiho*) sets out rules applicable to both corporations and individuals. The Corporation Tax Law (CTL or *hojinzeiho*) has established the rules for the corporate tax such as the foreign tax credit. The Special Measures Tax Law (SMTL or *sozei tokubetsu sochiho*) contains provisions for incentives to certain activities and tax haven legislation. These laws are supplemented by circulars, cabinet enforcement ordinances and ministerial regulations.

Foreign investment in Japan is regulated through the Foreign Exchange Control Law (FECL, known informally as *gaitameho*). This law governs equity investment in Japanese companies for foreign investors, technological assistance agreements, loans from foreign investors, and certain remittances of funds outside Japan. Way et al., Japan, A-1.

[68]Price Waterhouse, Japan, 3-4.

[69]Income taxation in the United States has its roots in the Sixteenth Amendment to the Constitution which was immediately followed by the enactment of the Revenue Act of 1913. This allowed for the levy of a flat 1% tax on corporate income. From 1913 to 1939 various revenue acts were passed; these were codified into the Internal Revenue Code of 1939. In 1954 tax law was codified again. The Internal Revenue Code of 1986 carries over most of the provisions of the 1954 Code. West's Federal Taxation: Comprehensive Volume, 1989 Annual Edition, ed. William H. Hoffman, Jr. and Eugene Willis (St. Paul: West Publishing Company, 1989), 1-3, 23-2 to 23-7.

The United States has no formal registration or approval procedures at the federal level for inward foreign direct investment. The Committee of Foreign Investment in the United States (CFIUS) was created in 1975 (under the Treasury Department) to monitor acquisitions by foreign interests. To date, it has investigated only acquisitions by foreign government interests. Price Waterhouse, United States, 36.

[70]The Revenue Act of 1962 defined the controlled foreign corporation, introduced the provisions of subpart F, and created a separate foreign tax credit limitation for passive interest income.

In 1977 new guidelines were issued for the allocation of research and development and stewardship expenses.

The Economic Recovery Tax Act of 1981 (ERTA) suspended the allocation and apportionment rules for research and development and allowed it to be allocated in full against United States income. It also provided for accelerated (ACRS) depreciation and for investment tax credits which applied only to investments in the United States.

Payments on portfolio interest on registered or qualified bearer debt obligations became exempt from withholding tax in the United States as part of the Tax Reform Act of 1984.

The Technical Corrections Bill of 1987 introduced provisions to impose higher taxes when foreign corporations that do business in the United States (as branches) pay

interest and dividends than that on similar payments made by American corporations. Its provisions are intended to override prior tax treaties made by the United States.

For a technical discussion of the history of tax legislation in the United States as it relates to provisions of the foreign tax credit and the deferral of tax on the unrepatriated income of foreign subsidiaries, see William P. McClure and Herman B. Bouma, "The Taxation of Foreign Income from 1909 to 1989: How a Tilted Playing Field Developed," Tax Notes, June 12, 1989, 1379-1410.

[71]U.S. Tax Code sections 951-964, known as subpart F.

[72]U.S. Tax Code section 482.

[73]These included changes in the rules for (1) the foreign tax credit, (2) the sourcing of income, (3) income subject to current inclusion under Subpart F provisions, (4) the taxation of foreign branches in the United States, and (5) foreign exchange transactions.

[74]The introduction of an elaborate system of separate limitation categories to segregate income streams subject to differing rates of foreign tax is responsible for much of the added international complexity. U.S. Tax Code section 904.

[75]Price Waterhouse, United States, 79.

[76]Price Waterhouse, Germany, 117.

[77]Price Waterhouse, Japan, 38

[78]An important German tax is omitted because its base is capital rather than income. This is the net worth tax (*Vermögensteuer*). It is not deductible for either the corporate income tax nor the municipal trade tax on income. Price Waterhouse, Germany, 169-170.

[79]Gillian M. Spooner and Emil M. Sunley. The Corporate Tax Burden in the United States (Morristown, NJ: Financial Executives Research Foundation, 1988).

[80]A taxpayer cannot distribute all pre-tax earnings, because some income has to be retained to pay taxes.

As a special measure, the national corporate tax rate in Japan was increased by 1.3 percentage points on income earned before 31 March 1987. The regular corporate income tax rates were in effect for the year ending 31 March 1989. Price Waterhouse, Japan, 7-8.

Since April 1989, Japan has been phasing in new tax rates. After April 1990 there is one rate of tax on both retained and distributed earnings. For large corporations this rate is 37.5% for the national corporate tax, 7.76% (20.7% of the corporate tax) for the local inhabitants tax at the maximum rate, and 12.6% for the local enterprise tax (Tokyo rate). This leads to an aggregate nominal rate of about 60.88% and an aggregate effective rate of about 54.07% (after adjustment for the deductibility of the local enterprise tax). Way et al., Japan, 13.

The statutory rate for the federal tax of the United States was 46% in 1985.

[81]In both Germany and Japan, debt-to-equity ratios are high and banks play an important role in the financing of corporate investment. Nonetheless, Japanese

corporations tend to pay modest dividends and use earnings to expand or to help associated companies raise money. See "Attitudes Change on Japanese Shareholders," Wall Street Journal, 27 June 1989. Koito Manufacturing Co. has tended to pay out 0.2% of its share price which is about 40% of earnings, a relatively generous amount.

In Germany the debt/equity ratio is generally 9:1. See Price Waterhouse, Germany, 116.

In Japan the debt/equity ratio has been 4:1. See Price Waterhouse, Japan, 33.

The debt/equity ratio of businesses incorporated in the United States tends to reflect a larger proportion of equity relative to debt, an observation which is consistent with the depth of the market for equity.

[82]The source of the ratios presented here is Worldscope™, a data base produced from the financial statements of multinational firms headquartered throughout the world. The primary source of Worldscope™'s information is company annual reports.

The profiles are designed to make it possible to compare financial statements across the world. They are presented with documentation of the procedures used in order to make them comparable across nations. The accounting conventions used in West Germany and Japan are given on pages 35-38. A detailed presentation of the research design used to compile the financial profiles is given on pages 11-16 of the Worldscope™ Industrial Company Profiles (1989). The country averages are taken across many manufacturing industries.

[83]"EK" stands for *verwendbares Eigenkapital*, the categories of "net-available capital" that a German corporation is required to use. Any excess of assets over nominal equity capital is assigned (according to tax paid on it) to one of these categories. There are infrequently used categories besides those discussed above. Killius, Germany, A-24 to A-25, and Price Waterhouse, Germany, 126-129.

[84]Germany also levies a municipal trade tax on capital. It is outside the scope of the proposed research because it has no effect on the home country tax of affiliates owned by foreign investors in Germany.

[85]This rate assumes a provisional federal rate of 5% on income and a multiple of 400% to obtain a 20% nominal rate. The deductibility of the tax makes the effective rate 16.7%. This calculation is: (100 x 20)/20. See Touche Ross, Germany, 50-51.

[86]The net worth tax is also added back since it is not deductible.

[87]Income related to overseas branches is excluded from the base of the enterprise tax.

To allow for the deductibility of the enterprise tax, the nominal rate should be decreased by 7.45%. Price Waterhouse, Japan, 87; Price Waterhouse, Corporate Tax: A Worldwide Summary (n.p.: Price Waterhouse Center for Transnational Taxation, 1987), 190.

[88]Local governments also impose a small per capita (or equalization) tax based on paid-in capital and number of employees. This tax is outside the scope of the proposed research because it has no effect on the home country tax of affiliates owned by foreign investors in Japan.

[89]Way et al., Japan, A-33.

[90]The nominal rates of state and local taxes vary from 3% to 12% in the United States. See Price Waterhouse 1988 US, Appendix 1-B.

[91]Price Waterhouse, United States, 166.

[92]Killius, Germany, A-32; Price Waterhouse, United States, 151.

[93]Price Waterhouse, Germany, 122. Patent royalties are also subject to a value-added tax when paid to a non-resident, but this indirect tax is not included in the model. Price Waterhouse, Germany, 165; Touche Ross, Germany, 37.

[94]Section 3(c) EStG; 26(1)(1) KStG in Killius, Germany, A-33.

[95]Way et al., Japan, A-33.

[96]Price Waterhouse, United States, 153-154.

[97]Glautier and Bassinger (1987, 323-325).

[98]Transfer prices are also attached to products transferred within the corporate group. They affect import duties and value-added taxes as well as direct taxes.

[99]Way et al., Japan, A-27.

[100]The legislation took effect on 1 April 1986. STML 66(5).

[101]Closely related parties are defined to occur when 50% or more of the stock is owned by three (or less) shareholders. Way et al., Japan, C&A 2-3; Touche Ross, Japan, 34-35.

[102]U.S. Tax Code section 482 and U.S. Treas. Reg. sections 1.482-1 and 1.482-2.

[103]This does not apply when the American taxpayer borrows funds at the location of an affiliate and then lends the funds to the affiliate. This also does not apply when the loan is denominated in a foreign currency. Price Waterhouse, U.S. Corporations Abroad, 33-34.

[104]Price Waterhouse, U.S. Corporations Abroad, 35.

[105]Specific legislation to combat the abuse of tax havens comes out of the Foreign Tax Act (AStG). Sections 7-14 define controlled foreign corporations and base company income. Killius, Germany, A-63 to A-67.

[106]Articles 66(6) through 66(9) of the SMTL define tax haven affiliates and the current taxation of their income. Way et al., Japan, A-50.

[107]In subpart F (U.S. Tax Code, sections 951-964), tainted income is defined and the rules for its taxation are given.

[108]Good income (as opposed to tainted income) includes that from (1) manufacturing activities, rents and royalties (under stringent limitations listed in Section

8(1)(6) AStG), (2) borrowing and lending of money (when funds are borrowed exclusively on foreign capital markets and contributed to businesses located outside of Germany which generate untainted income, and (3) dividends if the foreign controlled corporation holds at least 25% of the distributing corporation which generate good income in the same state as the investor. Income which is not in the catalogue of good items is tainted or base. Section 8 AStG in Killius, Germany, A-64 to A-65.

The second category puts restrictions on the use of financing affiliates in tax havens such as the Netherlands. Before the enactment of the AStG, German corporations had finance affiliates issue bonds with the guarantee of the investor corporation to avoid the withholding tax on interest payments to nonresident investors. Under Section 8(1)(7) AStG, this activity leads to an attribution of the spread retained by the finance affiliate unless the funds are loaned to foreign affiliates which generate good income. Killius, Germany, A-65.

[109]Attributable tainted income is included in the taxable income of resident shareholders in the financial year which closes after the financial year of the foreign controlled corporation. However, losses are disregarded.

[110]This is the location of the principal place of management or the statutory seat of the affiliate.

[111]Section 8(3) AStG. These low-tax countries are listed by the Ministry of Finance, Killius, Germany, A-66.

[112]A controlled foreign corporation is essentially a foreign corporation in which more than 50% of the shares (or total voting power of all the shares) is owned by resident taxpayers. There is no minimum shareholding requirement; the attribution provisions of the AStG apply to all shareholders. Section 7(1) AStG in Killius, Germany, A-64.

[113]Decree of July 11, 1974, No. 10.5.2. in Killius, Germany, A-66.

If two affiliates in a chain of ownership generate tainted income, the income of one can offset the losses of the other. Tax Court of Hamburg of November 11, 1982, RIW 1983, 540 in Killius, Germany, A-66.

[114]Killius, Germany, A-66.

Note that because there is no tax treaty, there is no tax credit.

[115]Shareholders who own 10% or more (or who are part of a group which collectively earns 10% or more) are required to currently report their income from "designated tax haven affiliates." SMTL Arts. 66-6(i) and (ii) in Way et al., Japan, A-51.

[116]The Ministry of Finance has listed these countries in Notification No. 38 of 1978, which has been subject to amendment since then. These are countries where corporate income (or the foreign source income of domestic corporations) is tax exempt or taxed at low rates. Way et al., Japan, A-51.

[117]The shareholdings of affiliated nonresidents are considered in the calculation. Lower-tier affiliates (to any level) are taken into account. SMTL Art. 66-6(2)(i) in Way et al., Japan, A-51.

[118]To avoid being a "designated tax haven subsidiary" the affiliate which meets the following five requirements: (1) It must have a fixed place of business in the tax haven. (2) It must have local staff. (3) Its main line of business must not be the holding of financial assets, licensing or leasing. (4) Dividend income must be less than 5% of total revenues. (5) The majority of its transactions must be in the tax haven or with unrelated parties. Related parties include Japanese shareholders, affiliated companies, and intervening foreign corporations through which Japanese shareholders have an interest in the corporation. SMTL Art. 66(2) in Way et al., Japan, A-52.

[119]Way et al., Japan, A-53.

[120]A controlled foreign corporation is a foreign subsidiary in which over 50% of the voting stock is owned by United States shareholders. U.S. Tax Code section 957.

[121]Gross insurance income is added to foreign base company income for the tests below. It is not discussed in the text because it is outside the scope of the model.

[122]This is the *de minimus* rule. U.S. Tax Code section 954(b)(3)(A).

[123]This is the full inclusion rule. U.S. Tax Code section 954(b)(3)(B).

[124]U.S. Tax Code section 951(b).

[125]U.S. Tax Code sections 954(c) and (d).

The other categories are foreign base company service income (U.S. Tax Code section 954(e)), foreign base company shipping income (U.S. Tax Code section 954(f)), and foreign base oil related income (U.S. Tax Code section 954(g)).

[126]An exception is oil-related income.

[127]The exception is for income subject to high foreign taxes. This objective rule replaced the subjective "not-formed-or-availed-of-rule" previously located in the same U.S. Tax Code section 954(b)(4).

[128]U.S. Tax Code section 954(c)(1)(A).

[129]The threshold for being a "related person" is ownership of "50% or more" in 1988, a change from "more than 50%" in 1985. U.S. Tax Code section 954(d)(3)(A) and (B) In contrast, the threshold for "control" is "more than 50%" by vote or value. U.S. Tax Code section 957(a). This could lead to problems in a joint venture context; a 50-50 joint venture could be "related" but "not controlled" at the same time. Fuller (1986, 23).

[130]These are active, as contrasted to passive, royalties. U.S. Tax Code section 954(c)(2)(A).

Also excluded are dividends and interest received from a related person which is (1) organized within the same country as the controlled foreign corporation and (2) uses most of its assets in a trade or business within that country. Royalties from related persons for the use of property within the same country as the controlled foreign corporation is organized are also excluded.

Interest, rents and royalties are not excluded if they create or increase a deficit that can be used to reduce the subpart F income of the payor or of another controlled foreign corporation. This is a new restriction from the 1988 TMRA (Technical Miscellaneous Revenue Act of 1988) and thus a change from 1985. U.S. Tax Code section 954(c)(3)(B).

[131]U.S. Tax Code section 954(d)(1).

[132]Killius, Germany, A-66; SMTL Art. 66-7 in Way et al., Japan, A-47; and U.S. Tax Code section 960.

[133]U.S. Tax Code section 959.

The Japanese shareholder can reduce current undistributed profits of "designated tax haven subsidiaries" by the amount of dividends distributed. SMTL, Art. 67 in Way et al., Japan, A-48. The same kinds of rules apply to German shareholders. Killius, Germany, A-66.

[134]Price Waterhouse, Germany, 147-148.

[135]Price Waterhouse, Germany, 119 and 147.

[136]CTS Arts. 4(1), 5; LTL Arts. 23(1)(3) and (4), 292(1)(3) and (4), 72-15 in Way et al., Japan, A-24.

[137]SMTL Art. 58 in Way et al., Japan, A-40 to A-41 and C&A 3.

In 1985 the deduction for supplying technical information and industrial property rights was 28% rather than 25%. Way et al., Japan, A-40.

[138]Price Waterhouse, Japan, 86.

[139]Price Waterhouse, United States, 197.

[140]CTL Art. 23 in Way et al., Japan, A-30 to A-31; Price Waterhouse, United States, 197; and U.S. Tax Code sections 901 and 902.

[141]Price Waterhouse, Germany, 94, 131, and 147.

[142]According to German tax treaties currently in force, both Japanese- and United States-source income are exempt from the German tax base. US-Germany Art. 12(1); Japan-Germany Art. 23.

[143]The stated percentage in tax treaties is 25%, but domestic law reduces this to 10%. Japan-Germany Art. 10(3)(b); US-Germany Art. XV(1)(b)(aa); and KStG Section 26(7) in Arthur Young (1988, 52).

[144]Killius, Germany, A-31; Arthur Young (1988, 55).

Presumably this provision pertains to withholding taxes on the remittance as well as to income taxes.

[145]CTL Art. 41 in Way et al., Japan, A-48; U.S. Tax Code section 164 in Arthur Young (1988, 55).

When a deduction is taken in lieu of a foreign tax credit, it is claimed by including foreign source income at the net amount received, that is, without the gross-up for foreign taxes paid.

Foreign taxes which do not qualify for the German tax credit can be deducted as business expenses. Section 34(c)(3) EStG. Killius, Germany, A-67 and A-68.

[146]Section 26(1) KStG and section 34(c) EStG in Killius, Germany, A-67; CTL Art. 69 and CTL Enf. Order Art. 142 in Way et al., Japan, A-46; and U.S. Tax Code section 904(a); Price Waterhouse, United States, 203.

In the denominator of the Japanese limitation fraction, both domestic- and foreign-source losses are deducted; in the numerator only foreign-source losses are deducted. Carryovers of losses may be deducted from current income in the calculation of the denominator. The numerator cannot be more than 90% of the denominator. CTL Enf. Order 142 in Way et al., Japan, A-46, C&A 3-4.

After 31 March 1991, only 50% of foreign-source income which is untaxed can be included in the numerator. This is a decrease from 66 2/3% in 1989. Way et al., Japan, C&A 4 (7/3/89).

[147]Way et al., Japan, A-46; Price Waterhouse, U.S. Corporations Abroad, 44-47.

[148]Price Waterhouse, Germany, 148; CTL Art. 69 in Way et al., Japan, A-46; and U.S. Tax Code section 903.

In Germany, credit is given for foreign income taxes which correspond to the German income tax under Section 4(d) EStG. Killius, Germany, A-67.

Withholding taxes on dividend remittances (for any percentage of ownership) are includable in the credit calculation. Touche Ross, Germany, 41.

[149]Section 26(2) to (5) KStG in Killius, Germany, A-67; CTL Art. 69(4) in Way et. al, Japan, A-47; and U.S. Tax Code section 902.

[150]Dividends received plus withholding tax deducted at the source.

[151]This is an after-tax amount.

[152]Killius, Germany, A-68; CTL Enf. Art. 147 in Way et. al, Japan, A-47; Price Waterhouse, Japan, 96; and Price Waterhouse, United States, 201.

[153]Price Waterhouse, U.S. Corporations Abroad, 43.

[154]CTL Enf. Art. 147 in Way et. al, Japan, A-46; U.S. Tax Code section 78.

Presumably, the taxable dividend income in Germany is grossed up as well.

[155]Section 26(2) KStG in Killius, Germany, A-68; Price Waterhouse, United States, 201; and U.S. Tax Code section 902.

[156]CTL Art. 69(4) in Way et. al, Japan, A-47; US-Japan Art. 5(1)(b). The 10% also applies to remittances from affiliates in Australia.

[157]Section 26(5) KStG in Killius, Germany, A-68; Arthur Young (1988, 13 and 44); and Price Waterhouse, United States, 201.

[158]Arthur Young (1988, 13 and 44).

[159]Price Waterhouse, Germany, 148.

The lack of carryovers means that foreign tax credits would be worthless should the investor have an overall loss for the year. This is one time when a deduction would be more advantageous for the taxpayer. The deduction can be used individually by country, source of income and year. Price Waterhouse, Germany, 148.

[160]CTL Enf. Order Art. 147(2)(ii) in Way et. al, Japan, A-47.

[161]Price Waterhouse, U.S. Corporations Abroad, 42.

[162]Fuller (1986, 13).

[163]Price Waterhouse, United States, 201.

[164]Export sales income and research and development expense are two important categories which are outside the scope of this paper.

[165]The effect is to allocate domestic interest expense to foreign sources; this reduces the foreign tax credit without affecting the taxes in the foreign location (which does not recognize the deduction). Arthur Young (1988, 27).

Before this tax legislation, interest could be apportioned on a company-by-company basis. U.S. Tax Code section 864(e). In another change, interest paid by a controlled foreign corporation to its American investor (or to another related business unit) must now be allocated first to passive (subpart F) income. U.S. Tax Code section 954(b)(5).

[166]Arthur Young (1988, 56).

[167]AIG section 3 in Arthur Young (1988, 54-55).

[168]CTL Art. 69(1) in Arthur Young (1988, 43-44).

[169]CTL Enf. Order Art. 144 in Way et. al, Japan, A-48.

[170]CTL Enf. Order Art. 143 in Way et. al, Japan, A-48.

[171]The carryforward of the foreign tax deficiency allows for the same effect of averaging over time that a carryback provides. The Japanese system does not allow for carrybacks. CTL Art. 69(2) and 69(3) in Way et. al, Japan, A-48.

[172]Prior U.S. Tax Code section 904(d)(2) (repealed).

[173]Lindsay (1987, 102).

[174]Lindsay (1987, 102).

[175]U.S. Tax Code sections 902 (multi-year pools), 904(e)(4)(B) (carryovers), and 904(f)(5)(C) (recharacterization).

[176]The omitted separate limitation categories are (1) shipping income, (2) DISC dividends, and (3) income and distributions from foreign sales companies. U.S. Tax Code section 904(d)(1).

[177]U.S. Tax Code section 904(d)(1)(A).

[178]U.S. Tax Code section 904(d)(1)(B).

[179]U.S. Tax Code section 904(d)(1)(C).

[180]U.S. Tax Code section 904(d)(1)(E).

[181]U.S. Tax Code section 904(d)(1)(I).

[182]U.S. Tax Code section 904(d)(1)(E).

[183]Royalties from a 10-50 will remain in the passive basket because a shareholding greater than 50% is required to make them active income.

[184]U.S. Tax Code section 904(d)(2)(B)(i).

When dividends are received from a 10-50, the rule applies in another way. When the interest income of a 10-50's has been subjected to a high rate of withholding tax, the excess over the 5% benchmark is not considered a tax payment for foreign tax credit purposes. U.S. Tax Code section 904(d)(2)(E)(ii).

[185]See McCawley (1987, 59:15).

[186]U.S. Tax Code section 954(b)(5).

[187]For an illustration, see in Fuller (1986, 7).

[188]This is the same *de minimus* rule of U.S. Tax Code section 954(b)(3)(A) that was discussed earlier.

[189]U.S. Tax Code section 904(d)(3)(A)

[190]U.S. Tax Code section 904(d)(3)(B)

[191]Beginning in 1962, certain types of interest income have been diverted to a separate limitation category of U.S. Tax Code section 904(d). Look-through rules came in with reforms of 1984 to supplement these rules and the resourcing rules of U.S. Tax Code section 904(g). Lindsay (1987, 102).

[192]This is the high tax exclusion rule of U.S. Tax Code section 954(b)(4) that was discussed earlier.

[193]U.S. Tax Code section 904(d)(3).

[194]Royalty income can be characterized as active or passive. For the royalty revenue to qualify as "active," the taxpayer must be regularly engaged in the development and/or production of property of "such kind" when the income is received from foreign sources (U.S. Treas. Reg. section 1.954-2(d)(1)(iii)(a) cited in Lindsay (1987, 106)). Royalties derived from the active conduct of trade or business with unrelated parties are not passive (Lindsay 1987, 106) Royalties are passive income when received from a noncontrolled foreign affiliate (Fuller 1986, 5).

[195]Lindsay (1987, 118-119).

[196]U.S. Tax Code section 904(d)(3)(B).

[197]U.S. Tax Code section 904(d)(3)(D).

[198]This process is accomplished in several steps. First, each element of the controlled foreign corporation's gross income is identified and put into an appropriate basket. The second step is the matching of controlled foreign corporation expenses to income in each category. The United States rules for allocating interest expense is important here. Interest expense which was allocated earlier against interest income under the anti-abuse rule remains that way. The remaining interest expense is allocated to each basket by the asset method. The value of assets generating the income as a proportion of the value of total assets is used to allocate interest. U.S. Treas. Reg. section 1.861(e)(2) in Lindsay (1987, 113).

At the third step, taxable income is calculated for each basket. The fourth step is the allocation of actual foreign taxes to each basket in proportion to the taxable income in each one. The procedure for this allocation is found in U.S. Treas. Reg. section 1.904-4(d). Lindsay (1987, 114).

The last step is deduction of foreign taxes from foreign taxable income in each basket. This gives the earnings and profits attributable to each basket whose sum should equal total earnings and profits calculated by tax accounting rules of the United States. Because the model is limited to one year's activity, the complexities of the post-1986 pooled approach to dividends is ignored here. U.S. Tax Code section 902(c)(1).

[199]U.S. Tax Code section 904(f)(5)(B).

[200]U.S. Tax Code section 904(f)(5)(C).

[201]U.S. Tax Code section 904(d)(2)(F).

[202]Lindsay (1987, 120-121).

[203]U.S. Tax Code section 904(c).

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