NATIONAL CHENGCHI UNIVERSITY

Subject: International Taxation

Basic International Tax Planning

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What is International Tax Planning

- It is the art of arranging cross-border transactions with the knowledge of international tax principles to achieve a tax effective and lawful routing.
- Prime objective is to receive the after-tax flows of overseas income lawfully at minimal cost and risk.
- International tax planning deal with the different tax systems in the world.
- The tax plan must meet the business objective at minimal tax and administrative costs but also at an acceptable level of risk.
- There is no ideal or risk-free solution.
- To distinguish acceptable tax planning from unacceptable tax avoidance is difficult.
What is International Tax Planning (Cont)

- The difference normally depends on the political and economics policies of each country.
- International tax planning must always be based on the legally acceptable use of the tax laws and tax treaties of the countries where the business is transacted.
Need for International Tax Planning

- Tax is not usually a primary or overriding factor in the decisions to engage in overseas business activities or to invest abroad.
- The decisions are based on commercial, economics, and even social and political considerations.
- Once the initial decision has been made, tax often becomes an important business consideration.
- Cross-border activities suffer a higher tax liability on a worldwide basis than domestic or one-country transactions.
- The tax payer often has to cope with inconsistent tax laws, erratic tax administration and high taxes in various jurisdictions.
- Proper tax planning is essential in an international business to reduce the distortions that arise due to the lack of harmonization in domestic tax systems.
Opportunities for International Tax Planning

Three levels of tax impact on cross-border transactions:

- The source or host country
- The intermediary country
- The residence or home country
Opportunities for International Tax Planning (Cont)

The taxation in the source country may be reduced through:

- Local tax planning that optimizes the use of tax deductions, incentives, tax losses and special tax concessions available under the domestic law and tax treaties.

- Tax-exemptions from the break or facture of the connection tax factors with either the source or the residence State (or both).

- The use of various planning techniques to ensure that the taxable profits arise outside the country.
opportunities for international tax planning (cont)

the intermediary country taxation on remitted income flows may be reduced through:

- the use of tax treaties to reduce the withholding taxes in the host country.
- the proper selection of the offshore financial centers to minimize or avoid the corporate and withholding taxes.
- the arbitrage through a change in the nature or character of the payments made to the home country.
- the use of various tax concessions, e.g. participation exemption, EU P-S Directive for holding companies, headquarters or services companies, etc.
- the retention of funds offshore for reinvestment abroad or to achieve a tax deferral on remittances made to the home country.
The taxation on profits repatriated to the home country may be reduced through:

- The use of appropriate global corporate structures that avoid, reduce or defer the tax liability.
- The optimal use of available foreign tax credits and exemptions to reduce domestic tax liabilities.
International Tax Planning Techniques

Some common tax planning techniques using these principles are listed below:

- The review of tax provisions and compliance rules under the domestic law ("domestic law")
- The reduction of the pre-tax profits through deductible expenses ("tax deductions")
- The use of special tax concessions for foreign capital, technology, etc. ("tax incentives")
- The optional use of the tax loss carry-over ("use of tax losses")
- The provision of special deductions or exemptions to qualifying dividends ("economic double taxation")
- The split of pre-tax profits among the various tax beneficial jurisdictions through source allocation ("profit diversion")
- The extraction of pre-tax profits from high tax countries through legitimate tax-deductible charges or expenses ("base erosion")
International Tax Planning Techniques (Cont)

- Some common tax planning techniques using these principles are listed below (cont):
  - Tax deferral of foreign profits ("tax deferral")
  - The optimal use of foreign tax credits ("tax credits")
  - The review of exchange gains and losses in cross-border transactions ("exchange risks")
  - The exemption of taxable income due to the lack of a connecting factor with a tax jurisdiction ("connecting factors")
  - The use of appropriate legal structure to achieve the business and tax objectives ("legal form")
  - The use of the optimal form of financing to minimize taxation ("debt or equity")
  - The use of tax treaties to avoid or reduce taxation ("treaty planning")
  - The use of "third country" tax treaties to reduce taxes ("treaty shopping")
Some common tax planning techniques using these principles are listed below (Cont):

- The availability and use of advance tax rulings ("tax rulings")
- The selection of tax-beneficial form of transaction or re-characterization ("tax arbitrage")
- The review of the cross-border transactions from host to home jurisdiction ("holistic planning")
- The effective use of advisors on tax laws and practices in various jurisdictions ("tax advisors")
- The compliance with domestic tax law and antiavoidance measures in various jurisdictions ("anti-avoidance measures")
International Tax Planning- a Methodology

Step One: Analysis of existing database
- Determine fully the host-to-home transaction
- Review the domestic law and the tax treaties in each jurisdiction
- Compute the tax liability and other costs
- Perform cost-benefit analysis

Step Two: Design of tax planning options
- Introduce multilateral or global tax planning
- Identify suitable foreign intermediary countries
- Select the form of transaction, operation, or relationship
- Examine relevant non-tax factors
- Check the availability of advance rulings
- List all tax planning options

Step Three: Evaluate the plan
- Determine the tax savings and non-tax costs if
  - The plan is not adopted,
  - The plan is adopted and succeeds, and
  - The plan is adopted and fails.
- Compute the total costs from host-to-home
- Select the best tax option
International Tax Planning- a Methodology (Cont)

Step Four: Debug the plan
- Get local advice on tax laws and practice
- Obtain advance rulings, wherever possible
- Check the applicability of treaties and protocols
- Determine validity of entities in the jurisdictions
- Check compliance with anti-avoidance rules
- Evaluate any significant risks or disadvantages
- Review the long term benefits and costs

Step Five: Update the plan
- Review regularly changes in tax laws, treaties and tax practices
- Amend the plan accordingly
International Tax Structures

- The Use of Intermediary Entities
  - Use a holding company in a treaty country to own investments offshore.
  - Use an intermediary structure for a financing company that provides finance and/or treasury services to group companies. Its funds may be provided by the parent company or borrowed externally.
  - Transfer intellectual property rights to a licensing company in a nil-tax jurisdiction.
  - Set up a management services or headquarters company offshore to co-ordinate or supply various services to group companies at a cost plus the profit mark-up.
  - An offshore company may act as a repacking, distribution or a “turnaround” company to move some of the profits from the high-taxed onshore companies to an offshore center.
International Tax Structures (Cont)

- Some examples of such tax planning measures are given below:
  - Incorporate a company in a country where the sole requirement for tax residence is the location of management, and then management the company from a country where the residence is based only on incorporation.
  - Avoid unintended residence of a foreign subsidiary in a tax jurisdiction.
  - Trade with a country that has a tax treaty.
Foreign Presence without Foreign Taxes

- The tax treaties provide that no source tax is levied on active business income unless the enterprise has a permanent establishment in that country.

- The OECD MC Article 5 defines a “permanent establishment” as a fixed place of business through which the business of an enterprise is wholly or partly carried on.

- Tax planning involves the effective use of the exemptions under this Article to maintain a foreign presence without a permanent establishment.
Form of Business Entity

- Agency
- Licensing Arrangement
- Franchising
- Representative Office
- Branch
- Company
- Partnership
Financing of Overseas Entities

- Two key financing questions:
  - Should the investment be financed by equity or debt?
  - What should be the debt to equity ratio?

- Several additional considerations, such as:
  - Who should provide the debt?
  - What should be the currency of the debt financing? Should it be denominated in the host, home or a third currency?
  - Can the financing costs to acquire the subsidiary be paid out of the subsequent profits of the foreign subsidiary?
  - What are the anti-avoidance rules relating to thin capitalization and transfer pricing?
Financing of Overseas Entities (Cont)

- Equity financing may be more favorable in certain circumstances, e.g., a dividend receipt may be preferable to interest income if there is a nil or low withholding tax on dividend in the host country and the foreign dividends are tax-exempt at home.
- Under normal circumstances, debt is preferable to equity.
- As a dividend is distributed from taxed profits and the interest is paid from pre-tax profits, the borrower can reduce his taxes by financing primarily through debt (as opposed to equity capital).
- The parent company should normally provide debt finance to its subsidiaries abroad, if
  - (a) it pays little or no taxes on the interest income received at home,
  - (b) the foreign withholding tax on the interest is creditable, and
  - (c) the interest costs are deductible in the host country.
Financing of Overseas Entities – Equity or Debt (Cont)

- A common tax-planning objective is to claim a deduction for the interest expense on the funds borrowed for the acquisition of a foreign subsidiary against the income flows generated by the funds.

- A foreign subsidiary can generally borrow funds for its use, but not for its own acquisition.

- Foreign currency debt poses currency risks on the repayment of the principal and interest.