1996

Comparison and Assessment of the Tax Treatment of Foreign Source Income in Canada, Australia, France, Germany and the United States

Jinyan Li
Osgoode Hall Law School of York University, JLi@osgoode.yorku.ca

Brian Arnold

Nolan Sharkey

Comparison and Assessment of the Tax Treatment of Foreign-Source Income in Canada, Australia, France, Germany and the United States

Brian J. Arnold
Goodman Phillips & Vineberg
Toronto
Jinyan Li and Daniel Sandler
University of Western Ontario

December 1996

WORKING PAPER 96-1

Prepared for the
Technical Committee on Business Taxation

Comparison and Assessment of the Tax Treatment of Foreign-Source Income in Canada, Australia, France, Germany and the United States

Brian J. Arnold
Goodman Phillips & Vineberg
Toronto
Jinyan Li and Daniel Sandler
University of Western Ontario

December 1996

WORKING PAPER 96-1

Prepared for the
Technical Committee on Business Taxation

Comments on the working papers are invited and may be sent to:
John Sargent, Executive Director
Technical Committee on Business Taxation
Department of Finance
Ottawa, Ont. K1A 0G5
Fax: (613) 952-9569
e-mail: Sargent.John@fin.gc.ca

Brian J. Arnold
Goodman Phillips & Vineberg
250 Yonge Street, Suite 2400
Toronto, Ontario
M5B 2M6
Fax: (416) 979-1234

Jinyan Li and Daniel Sandler
Faculty of Law
University of Western Ontario
London, Ontario
N6A 3K7
Fax: (519) 661-3918

For additional copies of
this document please contact:
Distribution Centre
Department of Finance
300 Laurier Avenue West
Ottawa K1A 0G5

Telephone: (613) 995-2855
Facsimile: (613) 996-0518

Also available through the Internet at
http://www.fin.gc.ca/

Cette publication est également disponible en français.

Abstract

This report deals with selected aspects of the tax treatment of foreign-source income in Canada, Australia, France, Germany and the United States. It does not attempt to be comprehensive. It emphasizes the structural features of each country's tax system with respect to the taxation of foreign-source income derived by resident corporations. In particular, the report focusses on the taxation of dividends from foreign corporations, controlled foreign corporation (CFC) rules, foreign investment fund rules, and source of income and expense rules. The description of each country's tax law follows a standard format to facilitate comparisons.

Table of Contents

1. Introduction

This report deals with selected aspects of the tax treatment of foreign-source income in five countries. The report emphasizes the structural features of each country's tax system with respect to foreign-source income; in particular, it focusses on the tax treatment of dividends from foreign corporations, controlled foreign corporation (CFC) rules, and foreign investment funds (FIFs). The geographic source of income and, in particular, the allocation of expenses between domestic and foreign sources, are important considerations. The allocation of expenses affects the taxation of foreign income, whether earned directly or indirectly. Its primary impact is on the treatment of dividends from foreign affiliates, and is therefore discussed in that context. However, it can also affect foreign income earned directly, particularly if such income is exempt from domestic tax.

This report does not attempt to be comprehensive. For example, there is no discussion of the treatment of foreign trusts, imputation systems, or tax treaties except where they have a significant impact in the context of the report. In addition, the primary focus of the report is on the taxation of corporations, not individuals.

To facilitate comparisons among the five countries, the description of each country's laws follows a common format. Moreover, a series of tables is provided at the end of the report summarizing the structural features of the tax treatment of foreign-source income in the five countries. Although the bulk of the report is descriptive, a brief concluding section provides some tentative comparative analysis and assessment.

2. Canada

2.1 Overview of the treatment of foreign-source income

The current Canadian rules for taxing the foreign-source income of residents have been in place, with minor modifications, since 1976, having been significantly revised as part of the 1972 tax reform. Individuals and corporations resident in Canada are taxable on their worldwide income with a credit for any foreign-income taxes payable on income earned in a foreign country. The residence of an individual is determined in accordance with all of the facts and circumstances, although there are a number of specific statutory rules. A corporation is resident in Canada for tax purposes if its central management and control are located in Canada, or if it is incorporated in Canada.

Although residents are generally taxable on their worldwide income, a few specific items of foreign-source income are exempt from Canadian tax:

- up to $80,000 of foreign-source employment income for an individual employed in qualifying activities for more than six months;
- income from offshore banking centres; and
- dividends out of the exempt surplus of foreign affiliates of Canadian corporations.

In addition, residents of Canada are not taxable on income earned indirectly through foreign corporations, unless the foreign accrual property income (FAPI) or offshore investment fund rules apply, as discussed below. Thus, foreign-source income earned through foreign corporations in which Canadian residents own shares is subject to Canadian tax only when the shareholders receive dividends, or when they dispose of their shares in the foreign corporation.

With respect to the relief of international double taxation, residents of Canada are entitled to a credit against Canadian tax payable on foreign-source income for any foreign taxes imposed on such income. In certain circumstances, taxpayers are entitled to an optional deduction for foreign taxes. With respect to dividends received by Canadian corporations from foreign affiliates, Canada uses a combined exemption/credit system to relieve international double taxation.

Canada does not have well-developed source of revenue and expense rules for purposes of the taxation of foreign-source income. Such rules are relevant for purposes of both the direct and indirect foreign tax credit, and for the exemption for dividends out of the exempt surplus of foreign affiliates.

2.2 Foreign-source income earned directly

2.2.1 Branch income

Canadian residents must include in their worldwide income for Canadian income tax purposes any income earned from carrying on business in a foreign country. For the most part, the foreign-source business income is computed in accordance with the same rules that apply to the computation of Canadian-source income.

In general, Canadian residents deriving business income from other countries will also be subject to foreign tax in respect of such income, if the business is carried through a permanent establishment located in the foreign country. Pursuant to Canada's tax treaties, Canada is obliged to give credit for foreign taxes on foreign-source business income only where the Canadian resident carries on business through a permanent establishment located in the foreign country and the foreign tax is levied on income that is attributable to the permanent establishment.

The foreign tax credit is available only in respect of foreign "income or profits taxes." This term is not defined in the legislation, and there is little jurisprudence. The credit is limited to the Canadian tax payable on the foreign-source income computed on a country-by-country basis. The rules to determine source of revenue and expense for this purpose are primitive. Taxpayers appear to have significant flexibility in allocating expenses to foreign-source income. Similarly, there are no specific rules for allocating foreign taxes to foreign-source income.

The foreign tax credit is calculated separately for business and other income. In effect, Canada's foreign tax credit operates on the basis of two "baskets" of foreign income. Foreign business taxes that are not deductible in any year may be carried back for three years and forward for seven years. There is no carry-over with respect to foreign non-business taxes.

Foreign losses incurred by a resident of Canada are deductible in computing the taxpayer's worldwide income. With respect to foreign businesses, it is not surprising, therefore, that standard tax planning often involves the use of a foreign branch during the start-up period and conversion to a foreign subsidiary once the operations begin to generate profits. There is no rule to "recapture" foreign losses from subsequent foreign profits as part of the calculation of the foreign-tax credit.

2.2.2 Portfolio income

Foreign-portfolio income (for example, dividends, interest, rent and royalties) is included in a Canadian resident's worldwide income. Foreign taxes imposed on foreign-portfolio income, whether levied by assessment or by withholding, are creditable against Canadian tax payable subject to the same per-country limitation applicable to foreign-branch income. However, the foreign-tax credit for individuals with respect to foreign-source income from property other than real property is limited to 15 percent; any foreign taxes imposed in excess of 15 percent are deductible in computing income rather than creditable. In addition, foreign taxes on foreign-source portfolio income are deductible rather than creditable at the option of the Canadian taxpayer. There is no carryover for excess foreign taxes on portfolio income; however, such excess is deductible. Foreign-source losses in respect of portfolio investments are deductible in computing a Canadian resident's worldwide income.

2.3 Foreign-source income earned indirectly

2.3.1 Dividends from foreign affiliates

Dividends received by a Canadian corporation from a foreign affiliate are subject to a combined exemption/credit system for relieving international double taxation. A foreign affiliate is a foreign corporation in which a Canadian corporation owns at least 1 percent of the shares of any class, and the corporation and related persons own at least 10 percent. Because this test is based on the number of shares rather than on votes and value, it is relatively easy to determine a foreign corporation's status as a foreign affiliate.

Dividends received by individuals from foreign corporations, irrespective of the size of the individual's interest in the foreign corporation, do not qualify for the special combined exemption/credit system; nor do they qualify for the dividend tax credit. Such dividends are included in income, and the individual recipient is entitled to a foreign tax credit for any foreign withholding taxes on the dividend up to 15 percent. Any foreign withholding taxes in excess of 15 percent are deductible. Similarly, dividends received by a Canadian corporation from a foreign corporation that is not a foreign affiliate are included in income with a credit for any foreign withholding taxes on the dividends.

Dividends paid by a foreign affiliate to a Canadian corporation are deemed to be paid first out of the exempt surplus of the foreign affiliate, then out of its taxable surplus, and finally out of its pre-acquisition surplus. The exempt surplus of a foreign affiliate consists of active business income earned in countries with which Canada has a tax treaty, certain taxable capital gains, the exempt portion (1/4) of all capital gains, interaffiliate dividends received out of the exempt surplus of other foreign affiliates, and certain amounts deemed to be active business income. As a result of recent amendments to the FAPI rules, the concept of active business income for purposes of the foreign affiliate rules has been narrowed with respect to certain real property, licensing, financing, and investment businesses. In general, Canadian source income earned by a foreign affiliate is not considered to be active business income.

The computation of exempt surplus is quite complicated. Usually, active business income of a foreign affiliate is computed in accordance with the tax law of the country in which the affiliate is resident, subject to certain adjustments. The surplus accounts are maintained in the currency of that country or another foreign currency that is reasonable in the circumstances.

Canadian corporations are entitled to a direct and an indirect foreign tax credit in respect of dividends received out of the taxable surplus of a foreign affiliate. Taxable surplus consists of FAPI, active business income earned in non-treaty countries, certain taxable capital gains, and dividends out of the taxable surplus of another foreign affiliate. The foreign tax credit in respect of dividends out of the taxable surplus of a foreign affiliate takes the form of a deduction in computing the Canadian corporation's taxable income. The credit for foreign withholding taxes on dividends paid by a foreign affiliate out of its taxable surplus is limited to one tier. The indirect foreign tax credit applies to the foreign income taxes paid by the foreign affiliate on the earnings out of which the dividend out of taxable surplus was paid. Thus, foreign taxes paid by a foreign affiliate must be allocated between amounts included in taxable surplus and other amounts. No specific rules are provided for this purpose. The indirect credit is available for any number of tiers of foreign corporations, as long as the relevant corporation is a foreign affiliate of the Canadian corporation. The indirect credit is computed separately for each foreign affiliate. It is subject to the same type of per-country limitation as the basic foreign tax credit, and any excess foreign taxes can be carried forward indefinitely. There is no attempt, however, to maintain the limitation when dividends are paid through various tiers of foreign affiliates.

Dividends paid by a foreign affiliate in excess of its exempt and taxable surplus are treated as a return of capital. These dividends out of pre-acquisition surplus are deductible in computing the Canadian corporation's taxable income, but they reduce the cost of the shares of the foreign affiliate.

Certain aspects of the foreign affiliate rules appear to be quite generous (although not necessarily inappropriate) in comparison with the similar rules of other countries:

1) Under paragraph 95(2)(a) of the *Income Tax Act*, amounts such as interest, royalties and rent (which would otherwise be passive income) paid to a foreign affiliate by another foreign affiliate, or by a related non-resident corporation, are deemed to be active business income if, in general, the payments are deductible by the payer in computing its active business income under the tax law of the country in which it is resident. This special rule allows Canadian multinational corporations to use international finance companies, certain international holding companies, international licensing companies, etc.

2) The ordering rule for dividends paid by a foreign affiliate permits Canadian corporations to defer Canadian tax on taxable surplus indefinitely. In addition, the distribution of taxable surplus can be avoided by making a return of capital or an upstream loan.

3) The disposition by a foreign affiliate of the shares of another foreign affiliate whose assets consist almost exclusively of excluded property does not result in the realization of a capital gain included in FAPI. Instead, the taxable capital gain is included in the disposing affiliate's taxable surplus so that it will be subject to Canadian tax only when it is paid as a dividend to the Canadian shareholder. However, dividends out of taxable surplus are rarely paid to a Canadian corporation if there is any Canadian tax payable on the dividend.

4) Under section 93 of the Act, a Canadian corporation can elect to treat a capital gain from the disposition of the shares of a foreign affiliate as a dividend. This election can be used to avoid Canadian tax on a capital gain or FAPI or to avoid foreign withholding taxes.

2.3.2 Allocation of income and expenses

Canadian rules with respect to the determination of the geographical source of revenue and expenses are not well-developed. In most cases, taxpayers appear to be able to allocate income and expenses among Canada and other countries as they see fit, subject only to some vague standard of reasonableness. The allocation of expenses is especially important in light of the exemption for dividends received out of the exempt surplus of foreign affiliates. Expenses incurred by a Canadian corporation that are allocable to such dividends should not be deductible in computing Canadian income. According to Revenue Canada, expenses must be allocated on a factual tracing basis, and only if tracing is impossible is allocation on some other basis acceptable. The most serious problem with the allocation of expenses is the deductibility of interest by Canadian corporations in respect of borrowed funds used to earn dividends out of exempt surplus of a foreign affiliate. Because dividends out of exempt surplus are not technically exempt income, the interest deduction is not denied.

Theoretically, the allocation of expenses is also a problem with respect to the indirect foreign tax credit for dividends paid out of taxable surplus of a foreign affiliate. To the extent that the expenses incurred by the Canadian corporation should be allocated to the foreign-source income out of which the taxable surplus dividends are paid but are not so allocated, the indirect foreign-tax credit will be overstated. Once again, there are no specific rules regarding the allocation of expenses for this purpose. There is also a timing problem with respect to expenses incurred to earn dividends out of taxable surplus. The expenses are deductible currently, whereas the dividends are included in income only when received. Because dividends out of taxable surplus are not often received by Canadian corporations, these are not serious practical problems.

2.3.3 Limitations on deferral

2.3.3.1 FAPI rules

The Canadian FAPI rules are intended to prevent Canadian residents from diverting income to a controlled foreign corporation, or from accumulating certain income in such corporations. The income of foreign corporations that are owned by Canadian residents is not subject to Canadian tax until the shareholders receive dividends from the corporation or sell their shares. This deferral of Canadian tax is advantageous to the extent that the foreign corporation's income is subject to foreign taxes that are lower than Canadian taxes. The effect of the FAPI rules is that certain passive income earned by controlled foreign affiliates of Canadian residents is subject to Canadian tax to the Canadian resident shareholders when the income is earned by the controlled foreign corporation.

The FAPI rules apply only to controlled foreign affiliates, which are defined as those that are controlled directly or indirectly by five or fewer Canadian residents. For this purpose, control means *de jure* control. However, indirect and constructive ownership rules apply for the purposes of determining control. A corporation must be a foreign affiliate in order to be a controlled foreign affiliate. Therefore, the FAPI rules do not apply to any Canadian shareholder that owns less than 10 percent of any class of shares of the foreign corporation. The status of a foreign corporation is determined with respect to each Canadian shareholder. For example, a foreign corporation may be both a foreign affiliate and a controlled foreign affiliate to one Canadian shareholder, only a foreign affiliate to another Canadian shareholder, and neither to other Canadian shareholders.

Only FAPI, which is basically limited to passive investment-type income, is attributed to Canadian shareholders of controlled foreign affiliates. FAPI consists of income from property, income from investment-type businesses, certain capital gains, and certain business income derived from Canadian sources. The definition of FAPI was broadened pursuant to the 1995 amendments, which were directed at obvious abuses of the rules and did not constitute a comprehensive overhaul of those rules. FAPI does not include base company sales and services income. Consequently, Canadian corporations can establish tax haven subsidiaries to sell goods or render services to related parties outside Canada, or to sell goods acquired from the Canadian parent corporation. Perhaps even more important, FAPI does not include certain interest, rent, royalties, or other similar payments received by a controlled foreign affiliate from another foreign affiliate or a related non-resident corporation, to the extent that the payment is deductible in computing the payer’s earnings from an active business in the country in which it is resident. As noted earlier, this provision allows Canadian multinationals to establish international finance, holding, and licensing companies in tax havens and, more generally, to use Canada’s treaty network to convert passive income into dividends out of exempt surplus.

The FAPI rules operate on a transactional basis. Each item of income earned by a controlled foreign affiliate must be characterized as FAPI or as other income. The amount of foreign tax levied on the income is irrelevant. In other words, the Canadian FAPI rules do not operate on a designated jurisdiction basis. The controlled foreign corporation rules of most other countries apply only to designated low-tax countries.

Any FAPI of a controlled foreign affiliate is included in the income of the Canadian shareholders of the affiliate who own at least 10 percent of the shares of any class. The attributed amount is treated as income from a share in the foreign corporation, but not as a dividend. A *de minimis* exemption of $5,000 annually is provided for each controlled foreign affiliate. This *de minimis* rule has become largely irrelevant over time.

Although the FAPI rules are intended to be prophylactic, a number of relief provisions are necessary to deal with situations where they apply. First, a Canadian corporate shareholder is entitled to a credit for any foreign income taxes levied on the FAPI and any foreign withholding taxes levied on dividends paid out of the previously-taxed FAPI within five years of the inclusion of the FAPI in the shareholder's income. Second, dividends received out of previously taxed FAPI are tax-free to Canadian corporate shareholders. Third, pursuant to a system of costs base adjustments, any subsequent capital gain realized on the disposition of the shares of the controlled foreign affiliate are tax-free to the extent of any previously taxed and undistributed FAPI. Any FAPI included in a shareholder's income is added to the adjusted cost base of the shares; conversely, any foreign taxes credited and any subsequent dividends received reduce the adjusted cost base of the shares of the controlled foreign affiliate. Fourth, FAPI losses are not attributable to the Canadian shareholders of the controlled foreign affiliate. However, such losses may be carried forward against FAPI of subsequent years. Until 1995, active business losses of a CFC could be used to offset any FAPI. This provision was used by Canadian corporations to divert passive income to foreign corporations with active business losses, with the effect of making the foreign losses deductible against Canadian source income. The deductibility of active business losses against FAPI was repealed effective for 1995 and subsequent years. In general, FAPI and the relief provisions in respect of FAPI must be calculated and applied to each foreign affiliate separately. However, in certain limited circumstances, a Canadian shareholder may claim a credit in respect of foreign taxes paid by another foreign affiliate pursuant to a foreign consolidation or group relief regime.

2.3.3.2 Foreign investment funds

Because the FAPI rules apply only to CFCs and only to Canadian shareholders who own 10 percent of shares of any class of the foreign corporation, the rules can be easily avoided by having the shares of a foreign corporation widely owned by residents of Canada. Therefore, offshore mutual funds and unit trusts can be used to defer or avoid Canadian tax. Sometimes investments in these funds allow Canadian residents not only to defer Canadian tax, but also to convert ordinary income, such as interest, into capital gains on the disposition of their investments.

Under Section 94.1 of the Act that was introduced in 1984, Canadian residents owning an "offshore investment fund property" must include in income a notional amount equal to the designated cost of the interest multiplied by the prescribed rate of interest. However, section 94.1 applies only if:

- the offshore property derives its value directly or indirectly primarily from portfolio investments in certain types of property; and
- one of the main reasons for the taxpayer's acquiring the interest is to avoid Canadian tax, taking into account all of the circumstances including the nature of the offshore fund, terms and conditions of the taxpayer's interest, the foreign tax paid by the fund, and the extent to which the fund distributes its income currently.

Section 94.1 is an anti-avoidance rule that is intended to be prophylactic. It does not just eliminate the benefits of investing in foreign investment funds (FIFs) as opposed to Canadian investment funds. The imputed income approach used in section 94.1 is arbitrary and may penalize or reward taxpayers where the actual income earned by the foreign fund is less or more than the arbitrary imputed income. For several years, section 94.1 appeared to have the desired *in terrorem* effect. However, it would appear that both taxpayers and Revenue Canada have enormous difficulty in applying section 94.1 except in clearly abusive cases.

2.4 Enforcement and administrative issues

The enforcement of the FAPI and foreign affiliate rules is extremely difficult for two basic reasons. First, it is extremely difficult for Revenue Canada to obtain information concerning a Canadian taxpayer's foreign-source income in order to ensure compliance with the foreign affiliate or FAPI rules. Second, the complexity of the rules makes it difficult for Revenue Canada to develop and retain the necessary expertise.

The importance of international business transactions has increased significantly in the past 25 years. Similarly, the number of Canadian taxpayers with foreign affiliates and controlled foreign affiliates has increased significantly. Revenue Canada appears to have difficulty in auditing FAPI and foreign affiliate issues, or indeed, foreign-source income issues, adequately. The new foreign reporting requirements applying to the ownership of certain foreign property, FAPI, foreign affiliates, and foreign trusts should give Revenue Canada access to most of the necessary information to administer the rules properly. Further, requiring taxpayers to file this type of information annually may impose discipline on Canadian taxpayers with foreign-source income that contributes to improved compliance. However, these new reporting requirements will also impose significant compliance costs on taxpayers.

3. Australia

3.1 Overview of the treatment of foreign-source income

In general, Australian residents are subject to Australian tax on their worldwide income with a credit for any foreign taxes on foreign-source income. In certain circumstances, however, as explained below, certain items of foreign-source income are exempt from Australian tax. The residence of individuals is determined on a facts-and-circumstances basis. Resident individuals must be domiciled in Australia and not have a permanent place of abode outside Australia. This facts-and-circumstances test of individual residence is supplemented by a number of specific statutory rules. Corporations are considered to be resident in Australia if they are incorporated in Australia, or if their place of effective management is located there. A corporation will also be considered to be resident in Australia if it does business there, and more than 50 percent of the voting shares are held by Australian residents. However, this rule is easily avoided through the interposition of a foreign corporation.

Relief for international double taxation depends on the nature of the income and the level of foreign tax imposed on it. Portfolio income derived by Australian residents is included in income subject to a credit for any foreign withholding taxes on the income. Business income qualifies for exemption from Australian tax if it is comparably taxed in the foreign jurisdiction; otherwise, the income qualifies for a foreign-tax credit. Non-portfolio dividends received by an Australian corporation from a foreign corporation qualify for either an exemption or a direct and an indirect foreign tax credit. Foreign-source employment income is exempt from Australian tax if the employee spends at least 91 days outside Australia and the income is subject to tax in the foreign jurisdiction.

Australia's foreign-source income rules are quite recent. The foreign tax credit system, the rules for the treatment of dividends from foreign corporations, and the CFC and FIF rules have all been introduced in the last 10 years. Consequently, the Australians have little experience with the practical operation of their foreign-source income rules.

3.2 Foreign-source income earned directly

3.2.1 Business income

Foreign-source business income derived by an Australian-resident corporation is exempt from Australian tax if the income is subject to tax in a listed country. The list of countries is the same for purposes of the CFC rules, and the exemption for non-portfolio dividends from foreign corporations is discussed in greater detail below. The foreign-source business income must be earned through a permanent establishment in the listed country, and must be subject to tax there. The subject-to-tax requirement means that the income must not qualify for exemption or a tax holiday, but there is no requirement that foreign tax actually be paid on the income.

The exemption for foreign-source business profits also extends to certain capital gains realized by Australian corporations. The exemption applies if:

- the property is depreciable property or real property used to earn income through a permanent establishment in a listed country;
- the gain must be subject to tax in a listed country; and
- the property must not be a "taxable Australian asset" (this concept is similar to "taxable Canadian property").

Capital losses from the disposition of similar property in a listed country are not taken into account for Australian tax purposes. Moreover, any expenses incurred in connection with such property are not deductible for Australian tax purposes.

The exemption for foreign-branch profits and capital gains derived by Australian-resident companies from listed countries reflects the fundamental tax policy decision to treat income earned in listed countries the same, regardless of whether the income is earned directly through a foreign branch or indirectly through a foreign corporation.

Other foreign-source business income, namely, that derived by Australian corporations from unlisted countries, that derived by Australian resident individuals, and that derived from a listed country but not through a permanent establishment located there, are included in the taxpayer's worldwide income, and the taxpayer qualifies for a foreign tax credit. Creditable taxes must be substantially equivalent to Australian income taxes. This general definition is supplemented by specific rules which provide, for example, that "soak-up" taxes or unitary taxes not imposed on a water's-edge basis are not creditable. The limitation on the credit is computed on a worldwide basis for five baskets of income: interest, offshore banking income, certain income from foreign pensions, capital gains, and all other income. Despite the worldwide limitation, the ability to average high and low foreign taxes is limited because of the exemption for business income earned in high tax listed countries. Excess foreign taxes can be carried forward for five years for each basket. Further, excess foreign tax credits can be transferred to other corporations in the same corporate group. For this purpose, a corporate group includes only wholly-owned subsidiaries or corporations that are wholly owned by a common parent.

Foreign-source business losses, even with respect to unlisted countries, cannot be used to offset Australian source income. Instead, such losses are carried forward to reduce foreign-source business income in future years. Special rules prevent taxpayers from diverting passive income to foreign sources to offset active business losses.

3.2.2 Portfolio income

Foreign-source portfolio income derived by an Australian resident taxpayer must be included in income, and qualifies for a foreign-tax credit, as discussed in the preceding section. There is no distinction between portfolio and business income for individuals. Moreover, for Australian resident corporations, the important distinction is between business income earned in a listed country, and other income.

As discussed in the preceding section, certain capital gains realized by an Australian corporation qualify for exemption. Other capital gains, including all gains derived from the disposition of shares of a foreign corporation, are subject to Australian tax with a credit for any foreign taxes on the gain. Consequently, although foreign-branch profits and income earned through a foreign corporation from a listed country are treated similarly, the treatment of capital gains from the disposition of a foreign branch's or corporation's assets, differs from the treatment of capital gains on the disposition of shares of a foreign corporation.

3.3 Foreign-source income earned indirectly

3.3.1 Dividends from foreign corporations

The Australian tax treatment of dividends received from foreign corporations depends on four factors:

- the residence of the foreign corporation;
- whether the Australian taxpayer is an individual or a corporation;
- if the recipient is a corporation, the size of the corporation's interest in the foreign corporation; and
- whether the income of the foreign corporation has been attributed to the Australian shareholder pursuant to CFC rules or FIF rules.

If dividends are received from a foreign corporation by an individual resident in Australia, or by an Australian resident corporation out of income that has been previously subject to Australian tax pursuant to the CFC or FIF rules, the dividends are exempt from Australian tax in order to prevent international double taxation.

If an individual resident in Australia receives a dividend from a foreign corporation, the dividend is subject to Australian tax with a credit for any foreign withholding taxes on the dividend. The same treatment applies to a dividend received by an Australian corporation with an ownership interest of less than 10 percent in the foreign corporation.

Where a corporation resident in Australia receives a dividend from a foreign corporation in which it has at least a 10 percent interest, the dividend is subject to a special combined exemption/credit system. These dividends are referred to as non-portfolio dividends. The 10-percent ownership threshold is computed by reference to an Australian corporation's ownership of shares in the foreign corporation representing at least 10 percent of the voting power, value, or capital of the foreign corporation.

All non-portfolio dividends received by an Australian corporation from a foreign corporation resident in a listed country are exempt from Australian tax. The list of countries for purposes of the exemption for dividends is the same as that for purposes of the Australian CFC rules. Although the use of the same list for both purposes provides simplicity, it is questionable whether it is appropriate. In general, countries have been included in the list if they have corporate tax rates of 25 percent or more. Several countries are included in the list where it is possible for corporations to earn income that is not subject to a rate of tax comparable to the Australian rate (for example, Indonesia, Ireland, Greece, China, Portugal, Spain and Singapore).

Non-portfolio dividends received by Australian corporations from foreign corporations resident in unlisted countries may be either exempt or taxable, depending on the nature of the profits of the foreign companies. Dividends paid by such corporations are considered to be paid *pro rata* out of exempt and taxable profits. Exempt profits are those earned by a foreign corporation resident in an unlisted country from a business carried on in a listed country if the profits are subject to tax in the listed country and do not constitute "designated concession income," dividends received from a foreign corporation resident in a listed country, and income from Australia. Designated concession income consists of certain specified income that is exempt from tax or subject to a low rate of tax in a listed country. For example, income qualifying for the Belgian co-ordination centre incentive and capital gains derived by a New Zealand corporation constitute designated concession income. All other profits derived by a foreign corporation constitute taxable profits.

For non-portfolio dividends received from listed countries, the Australian system is considerably simpler than the Canadian system. All such dividends are exempt; therefore, there is no need for taxpayers to maintain complex surplus accounts. However, for non-portfolio dividends received from unlisted countries, Australian corporations must maintain records concerning the exempt and taxable profits of corporations resident in such countries.

The major deficiency of the Australian rules is that it is possible for Australian corporations to receive exempt non-portfolio dividends from foreign corporations resident in listed countries out of income that has not been subject to foreign tax comparable to Australian tax. The Australian system contains a number of anti-avoidance rules to prevent corporations from taking advantage of this exemption. For example, when a CFC shifts its residence from an unlisted to a listed country, the accumulated profits of the CFC are attributed to its Australian shareholders because once the CFC becomes resident in the listed country, any dividends paid by it will be exempt. This result is inappropriate, because some of the CFC's income may not be low-taxed passive income, which is targeted by the CFC rules. The appropriate theoretical result is that any non-portfolio dividends paid by the CFC once it has become resident in a listed country out of profits accumulated while it was resident in an unlisted country, should be taxable with a foreign-tax credit. However, because the Australian rules lack a system of surplus pots, this theoretical result is impossible. Similarly, where a foreign corporation resident in a listed country that is not a CFC receives a dividend from a foreign corporation in an unlisted country that is not a CFC, the dividend loses its character as taxable, and becomes exempt.

Two other factors are relevant in assessing the Australian system for taxing non-portfolio dividends from foreign corporations. First, there are no upstream loan rules; second, under the Australian imputation system, Australian corporations generally prefer to pay Australian tax rather than foreign tax.

Non-portfolio dividends received from foreign corporations resident in unlisted countries are subject to Australian tax with a direct and an indirect foreign-tax credit. The indirect foreign-tax credit applies to any number of tiers of foreign corporations, as long as the 10-percent ownership requirement is met. The limitation on the indirect foreign-tax credit operates on a worldwide basis, although as mentioned earlier, there is limited opportunity for averaging because non-portfolio dividends from corporations resident in listed countries are exempt from Australian tax.

Australia has a full imputation system. Income subject to Australian corporate tax is credited to a "franking account." Dividends paid out of this account carry a tax credit equal to the Australian corporate tax on the grossed-up dividend. Franked dividends paid to non-resident shareholders are not subject to the normal Australian withholding tax of 30 percent, whereas unfranked dividends are.

As described earlier, foreign-branch profits and non-portfolio dividends from foreign affiliates derived by Australian companies are exempt from Australian tax. Such exempt foreign-source income does not give rise to franking credits. However, in 1995 Australia introduced new rules under which dividends from foreign corporations that are exempt from Australian tax are allocated to a special "foreign-dividend account." Dividends paid by an Australian company to non-resident shareholders out of such an account are exempt from the Australian withholding tax. The account is, however, allocated to all shareholders, not just non-resident shareholders, even though resident shareholders do not derive any benefit from receiving dividends out of the foreign-dividend account.

The exemption from Australian withholding tax for dividends paid out of the foreign-dividend account was introduced as part of a regional headquarters regime designed to make Australia more attractive as a base for multinational corporations. However, the foreign-dividend account regime is available to all Australian resident companies with foreign affiliates, not just companies that qualify as headquarters companies.

3.3.2 Allocation of income and expenses

Australian source rules are undeveloped. Most rules are principally derived from tax treaties and are incorporated into Australian domestic law.

In principle, the Australian rules distinguish between expenses that are attributable exclusively to foreign income, expenses that are attributable to both foreign and domestic source income, and expenses that are not directly related to any source of income. The last expenses are allocated on the basis of net income. There are no statutory rules and little administrative guidance as to how these rules are to be applied. It would appear that most expenses are allocated on a factual tracing basis.

In principle, any expenses incurred by an Australian corporation to earn exempt foreign-source income, including exempt foreign-branch income and exempt non-portfolio dividends from foreign corporations, are not deductible in computing the Australian corporation’s income. However, because the basic Australian approach to interest deductibility is factual tracing, in practice most Australian corporations are able to arrange their affairs so that interest expense is never traced to exempt foreign-source dividends. Apparently, the Australians are currently considering the introduction of interest apportionment rules to govern the allocation of interest to foreign-source income.

3.3.3 Limitations on deferral

3.3.3.1 CFC rules

Australia’s CFC rules are targeted at income earned by foreign corporations that are controlled by Australian residents. Under the original proposals for taxing foreign-source income, which were published in 1988, any Australian resident corporation with a 10 percent or greater interest in a foreign corporation resident in an unlisted country would have been taxable on its *pro rata* share of the corporation’s entire income. This system was theoretically simple, since there was no distinction between controlled and uncontrolled foreign corporations, or between active and passive income. Moreover, the CFC rules and the rules for non-portfolio dividends would have been totally integrated. Non-portfolio dividends from foreign corporations resident in both listed and unlisted countries would have been exempt, the former because their income would have been subject to foreign tax comparable to Australian tax; and the latter because their income would have been previously taxed under the Australian CFC measures.

In 1989, the original proposals were revised to recognize that the CFC rules should be focussed on protecting the Australian tax base from abuse. In contrast, the rules for taxing non-portfolio dividends from foreign corporations are basic taxing rules aimed at eliminating international double taxation.

A foreign corporation is considered to be controlled by Australian residents if, at the end of the CFC's accounting period, five or fewer Australian residents, each of whom must own at least one percent of the shares, own 50 percent or more of the voting shares or the capital, or own shares entitled to 50 percent or more of the corporation's distributable income. In addition, where one Australian resident owns 40 percent or more of the shares of a foreign corporation, and no other single person owns more, that person will be considered to have *de facto* control. Further, if the tax authorities can show that five or fewer Australian residents effectively control a foreign corporation even though they own less than 50 percent of its shares, it will be considered a controlled foreign corporation. The basic control test for purposes of the definition of a CFC includes both indirect and constructive ownership rules.

As noted earlier, the Australian CFC rules are targeted at low-taxed passive income earned by CFCs. The designated jurisdiction approach is used to determine whether a CFC's income is subject to low foreign taxes. The regulations prescribe a list of approximately 60 countries. If a CFC is resident in one of these listed countries, it is presumed that the CFC's income is taxable at a rate that is roughly comparable to the Australian tax rate. Even if a CFC is resident in a listed country, however, if it earns certain "designated concession income" there, such income will be attributed to its Australian shareholders. Designated concession income consists of specific items or general categories of income that are not subject to tax in the listed country. A serious deficiency in the Australian rules is the inclusion of several countries on the list that do not tax all passive income at a rate comparable to the Australian rate.

Not all income earned by a CFC in an unlisted country is attributed to its Australian shareholders. Attributable income includes passive income and tainted sales and services income. For CFCs resident in listed countries, generally only designated concession income is attributable. Where a CFC in an unlisted country is engaged almost exclusively in active business operations, its passive income will not be subject to attribution. To qualify for this active-income exemption, the CFC must carry on business through a permanent establishment in its country of residence, keep accounts in accordance with Generally Accepted Accounting Principles (GAAP), and its passive income must be less than 5 percent of its gross revenue. If a CFC does not qualify for the active-income exemption, only its passive income is attributed to its Australian shareholders. In effect, therefore, the active-income exemption operates as a *de minimis* rule. As such, it allows Australian corporations to divert passive income to a CFC as long as it does not exceed 5 percent of the corporation's gross revenue. The active-income exemption also applies to CFCs in listed countries, but is based on designated concession income and rarely applies.

A *de minimis* exemption applies if the CFC is resident in a listed country and its attributable income is less than A$50 000 or 5 percent of gross turnover.

Where a CFC's income is attributed to an Australian company that owns at least 10 percent of the CFC's shares, that company will be entitled to a credit against the Australian tax payable on the income for the foreign taxes paid by the CFC on its passive income. Other Australian shareholders are entitled, in effect, only to a deduction for foreign taxes in computing the amount of the CFC's attributable income that is subject to Australian tax.

Losses of a CFC may be carried forward indefinitely, although they are quarantined in four separate categories. No consolidation is permitted of the profits and losses of CFCs of the same Australian corporation. However, effective consolidation may be achieved within 100-percent owned corporate groups.

Dividends received out of previously taxed attributed income are exempt and capital gains are reduced to the extent of previously taxed and undistributed attributable income.

As noted, attributable income includes passive income and tainted sales and services income. Passive income includes:

- dividends other than exempt non-portfolio dividends;
- interest and income from factoring but not including offshore banking income;
- income from annuities;
- rent if the property is leased to a related party, if the property is land outside the CFC's country of residence or in respect of which the CFC provides few services, or if the property is a ship or aircraft or container, unless significant services are provided by the CFC;
- royalties, unless the CFC created or improved the intangible property, the royalties are derived from a business and are not received from a related party;
- income from the sale of intangibles;
- income and capital gains from dispositions of "tainted assets"; and
- certain commodity and currency exchange gains.

A tainted asset is broadly defined to include all shares, all interests in partnerships and trusts, all derivative financial instruments, all debts, insurance policies, property held to earn tainted rental income, and all other assets except inventory and those assets used solely in carrying on a business. This definition is considerably broader than the comparable Canadian concept of property other than excluded property (i.e. property the disposition of which results in FAPI).

Tainted sales income includes income from the sale of goods by the CFC if:

1) the CFC acquired the goods from a related party resident or carrying on business in Australia, or if it sold the goods to such a person;
2) the CFC manufactured the goods and acquired the raw materials used to manufacture the goods from a related party residing or carrying on business in Australia, or sold the manufactured goods to such a person; or
3) the CFC produced the goods or manufactured goods from products produced by it and acquired material from which the products were produced from a related party residing or carrying on business in Australia, or sold the products to such a person.

If the CFC substantially alters, manufactures, or produces the goods sold by it, the income is excluded from tainted sales income. In this situation, the income is considered as resulting from the significant activities performed by the CFC rather than as income diverted to it.

Tainted services income includes:

- income from services rendered to a related party or a resident of Australia, or to a non-resident carrying on business in Australia;
- life insurance premiums from policies sold to related parties or to residents of Australia;
- income from the insurance of Australian risks or from insurance of a related party; or
- income from certain reinsurance.

Income from services provided by a CFC is not tainted income if the services are directly related to the goods manufactured, created or substantially altered and sold by the CFC.

3.3.3.2 FIF measures

Because the Australian CFC rules apply only to foreign corporations that are controlled by five or fewer Australian residents and only to Australian shareholders who own 10 percent or greater interests in the foreign corporations, it is relatively easy to avoid the application of them. Therefore, effective in 1993, FIF measures were introduced.

FIF measures apply to any equity interest in a foreign company, trust or life insurance policy, unless the interest qualifies for a specific exemption. In addition, FIF measures apply to interests in FIFs owned by CFCs.

Interests in foreign companies principally engaged in active business are exempt. Two alternative tests are used to determine the application of this exemption. The balance sheet method is based on a detailed examination of the company’s assets. More than 50 percent of the gross value of such assets must be used in carrying on active business. Special look-through rules apply to interests in partnerships and share interests of more than 50 percent. The stock exchange listing method is a proxy for the balance sheet method because most small investors will not have access to the information necessary to apply the former method. Interests are exempt if the foreign company is listed on an approved stock exchange and classified as engaged in active business in accordance with five international sectoral indices that are widely used by brokers. The stock exchange listing method recognizes the interests of taxpayers in simplified compliance.

Exemptions are also provided for:

- widely held, publicly traded foreign banks and insurance companies;
- widely held, publicly traded foreign real property companies engaged in real estate development or commercial sales or leasing;
- conglomerates;

- trust funds established for investment in specified countries that prohibit non-residents from investing directly in companies listed on stock exchanges in those countries;
- *de minimis* holdings of FIF interests of less than A$50 000;
- temporary residents of Australia; and
- interests in foreign pension funds.

If a resident of Australia owns interests in FIFs in excess of the *de minimis* exemption, there are three possible methods of taxation:

- the market value method, under which the taxpayer must include in income the annual increase in value and any distributions received in a year. This method applies if it is "practicable." Market value is determined on the basis of quoted stock exchange prices or redemption prices.
- the calculation method, under which the taxpayer must include his or her *pro rata* share of the income of the foreign company. The major difference between this method and the market value method is that under the former, accrued but unrealized gains in respect of the FIF's property are not taken into account. The calculation method will rarely apply because the taxpayer will not have access to the information required to determine his or her share of the FIF's income.
- the deemed rate of return method, under which the value of the taxpayer's interest is multiplied by the rate of interest on overdue taxes plus 4 percent. This method is similar to the Canadian method under section 94.1. It is the residual method.

The Australian FIF measures contain relief provisions with respect to foreign taxes, subsequent dividends and subsequent capital gains and losses.

3.4 Enforcement and administrative issues

Australia has recently moved to a full self-assessment system. In light of this move, there is a concern about minimizing the compliance burden of complex legislation such as the CFC and FIF rules. Australia does not have comprehensive foreign reporting requirements such as the proposed Canadian rules. Instead, taxpayers are required to maintain appropriate documentation to support their reported taxes, and this information must be provided to the tax authorities during audit on request. There is not yet enough experience with the rules for taxing foreign-source income to know if there are any serious enforcement and administrative problems.

4. France

4.1 Overview of the treatment of foreign-source income

Individuals resident in France are subject to tax on their worldwide income. However, corporations are taxable on a territorial basis, in accordance with which French and foreign corporations are subject to French tax only on income sourced in France. In other words, corporations resident in France are not subject to French corporation tax on foreign-source business or investment income that is ancillary to a business carried on outside France.

There are detailed rules governing the residence of individuals for income tax purposes. Although individuals resident in France are taxable on their worldwide income, foreign-source employment income is exempt from tax if:

- the income is subject to foreign tax of at least two thirds of the French tax otherwise payable on the income; or
- an employee is employed abroad for more than 183 days in any 12-month period in the construction or resource industries, irrespective of the foreign tax on the income.

Although such income is exempt from tax, it is taken into account in determining the rate of tax on other income subject to French tax.

Because French corporations are subject to tax on a territorial basis, a distinction between resident and non-resident corporations is usually unnecessary. In general, income derived by a French corporation directly through a foreign branch operation and dividends derived through a foreign subsidiary are exempt from French corporation tax.

Relief from international double taxation is provided by a deduction of foreign taxes. However, if there is a treaty between France and the foreign county, foreign withholding taxes on dividends, interest and royalties are creditable against French tax. As noted earlier, with respect to the business income of corporations, relief from international double taxation is provided by an exemption for the foreign-source income.

The territorial principle is subject to two exceptions under which French corporations may take foreign-source income and losses into account, subject to the prior approval of the tax authorities. First, a French corporation may elect to be taxed on its worldwide profits (*bénéfice mondial*). Second, a French corporation may elect to be taxed on a worldwide consolidated basis with respect to its French and foreign subsidiaries that are at least 50 percent owned by the French parent company (*bénéfice consolidé*). Only a few of the largest French multinationals have elected to be taxed on either of these consolidated bases. Under the consolidation approach, foreign taxes are creditable against the French corporation tax, subject to a per-country limit. Any excess credit for a year may be carried forward for five years or deducted in computing income.

4.2 Foreign-source income earned directly

4.2.1 Branch income

The profits of a foreign branch of a French corporation are generally exempt from French corporation tax (subject to the consolidation rules noted above). A foreign branch is roughly equivalent to the permanent establishment concept in bilateral tax treaties. However, the exemption also extends to foreign activities that constitute a "complete commercial cycle," even if there is no fixed place of business outside France. There is a significant body of jurisprudence dealing with the source of business income for purposes of applying the territorial principle. In general, to qualify for exemption, foreign-source income must be related to some relatively independent and self-contained activity in the foreign country. The exemption is not conditional on the foreign-source income's being subject to tax in the foreign country.

The territorial principle applies only to business income. Passive investment income derived from foreign sources is subject to French corporation tax, unless the income is effectively connected with a foreign business.

As discussed in more detail below, because foreign-source business income derived by French corporations is exempt from corporation tax, expenses incurred in earning such income are not deductible, and foreign-source business losses are not taken into account. However, in certain limited circumstances involving start-up losses from the establishment of foreign sales offices, research facilities or industrial establishments, a French corporation is entitled to a special reserve in computing its income for French corporation tax. This reserve is available for the first five years of the foreign venture, then is recaptured over the following five to 10 years. The reserve is not available for foreign operations established in certain tax-haven countries. It is available not only for foreign-branch operations, but also for foreign investments through a foreign subsidiary if the French corporation has at least a 10 percent interest in the subsidiary's capital.

4.2.2 Portfolio income

Investment income from sources outside France which is derived by individuals or corporations resident in France is subject to French tax. Similarly, capital gains realized from the disposition of property located outside France, including the shares of a subsidiary corporation, are subject to French tax. In general, foreign withholding taxes on dividends, interest and royalties derived by French residents from foreign sources are deductible only in computing income. If, however, there is a double-taxation treaty between France and the other country, the foreign taxes are creditable against French tax.

4.3 Foreign-source income earned indirectly

4.3.1 Dividends from foreign affiliates

If a French corporation owns at least 10 percent of the voting shares of another corporation, whether French or foreign, any dividends it receives from the other corporation are exempt from French corporation tax. Alternatively, the participation exemption will apply if the French corporation owns shares in a foreign corporation that are worth at least FFr 150 million. The minimum-share ownership requirement must be satisfied at the time of the payment of the dividend, and the French corporation must have originally subscribed for the shares or must undertake to retain them for at least two years. The participation exemption is elective. If the French corporation elects not to have the exemption apply, the dividend will be included in income. For dividends from other French corporations, however, the tax will be offset completely by the tax credit (*avoir fiscal*) that accompanies the dividend. The exemption is always advantageous with respect to dividends from foreign corporations that do not carry any tax credit.

Before 1993, French corporations were precluded from deducting expenses equal to 5 percent of the dividends received. This amount was considered to represent the expenses of holding the shares in the subsidiary corporation. In effect, the participation exemption was limited to 95 percent of the amount of the dividends received from the foreign corporation.

Some French corporations, such as financial institutions and real estate companies, are specifically precluded from the benefit of the participation exemption. Further, the exemption does not apply if the French parent company elects to be taxed on a consolidated basis.

If a French corporation is not subject to tax on dividends received from foreign corporations, it is subject to a compensatory tax called the *précompte mobilier*. The function of this *précompte* is to ensure that the dividend tax credit received by French shareholders of French corporations is supported by the tax paid at the corporate level. The *précompte* is imposed only on dividends paid out of non-taxable profits. The amount of the *précompte* is one third of the dividends received from affiliated companies, plus any withholding taxes on dividends received from foreign corporations resident in treaty countries. Any such foreign withholding taxes are creditable against the amount of the *précompte.* For purposes of the *précompte,* dividends are considered to be paid first out of taxable profits of the immediately-preceding year, then out of taxable profits for the five preceding years, and finally out of non-taxable profits.

4.3.2 Allocation of income and expenses

France does not have any statutory rules dealing with the allocation of expenses to exempt foreign-source income. Under general principles, expenses that are directly related to exempt foreign-source income are non-deductible. Further, as a general proposition, expenses which do not relate to any particular income source may be apportioned between taxable and tax-exempt income. However, interest expense incurred by French corporations earning exempt foreign-source income is fully deductible.

4.3.3 Limitations on deferral

4.3.3.1 CFC rules

The French CFC rules have been in place since 1980. The most striking feature of these rules is that they apply only to French corporations that own, directly or indirectly, 10 percent or more of the shares of a low-taxed foreign corporation at the end of the foreign corporation's year. Consequently, the CFC rules are co-extensive with the participation exemption for dividends from foreign corporations described earlier. When the French CFC rules were originally adopted, they applied to French corporations that owned a 25-percent or greater interest in a foreign corporation. The lower 10 percent ownership requirement became effective in 1992 with a 10-year grace period for existing structures. The CFC rules also apply to investments in foreign corporations exceeding FFr 150 million, even if the French corporation owns less than 10 percent of the share capital. To prevent corporations from circumventing the rules by setting up a branch instead of a subsidiary in a foreign country, the rules also apply to foreign branches, partnerships, and other non-corporate entities in which French corporations have a 10-percent or greater interest.

The system achieves considerable simplicity by making the CFC rules and the participation exemption co-extensive. However, there are clear costs. For example, because the CFC rules do not apply to individuals, there are probably significant avoidance opportunities through the use of CFCs. Also, there is a fundamental question of fairness in subjecting a domestic corporation that owns at least 10 percent of a foreign corporation to current domestic tax on the undistributed income of the foreign corporation, when the domestic corporation does not necessarily have the power to control the distribution of the income.

The minimum ownership requirement is supported by constructive ownership rules to prevent taxpayers from fragmenting the ownership of shares in foreign corporations among related persons. For lower-tier foreign corporations, the taxpayer’s ownership interest is determined by multiplying the interest in the first-tier corporation by its interest in the second tier, and so on.

The French CFC rules apply only to foreign corporations established in a "privileged" tax regime which, by administrative guidelines, is considered to be a country in which the tax is less than two thirds of the French tax. This test is based on a comparison of the actual tax paid by the foreign corporation and the French tax that it would have paid if it were resident in France. There is an unofficial list of tax havens, and it appears that the application of the measures is restricted to foreign corporations established in listed countries.

Unless a CFC is exempt, all of its income is subject to attribution. In other words, the French rules do not distinguish between tainted and other income; instead, they apply on an entity basis. Only French corporations with 10 percent or more of the shares, or shares worth FFr 150 million, are taxable on their share of the foreign corporation’s income, which must be computed in accordance with French tax law. Accordingly, CFCs are entitled to the participation exemption, which means that international holding companies can be used effectively.

A foreign corporation is exempt if more than 50 percent of its revenue is derived from local industrial or commercial activities. Thus, the exemption involves two conditions: the nature of the business activities must be primarily industrial or commercial, and more than 50 percent of the CFC’s total turnover must be derived from industrial or commercial activities in the foreign country. International finance companies cannot qualify for this exemption. However, a foreign corporation that qualifies for the exemption can shelter a considerable amount of passive income.

Where an amount is included in a French corporation’s income in respect of the undistributed income of a CFC, the French corporation is entitled to a credit for any foreign taxes paid by the CFC on its income, and for any foreign withholding taxes on dividends. Subsequent dividends received by a French corporation out of previously taxed income are not taxable (even to the extent not covered by the participation exemption). There is no relief, however, for subsequent capital gains. A CFC’s losses may be carried forward for five years.

4.3.3.2 FIF rules

France does not have FIF rules. The absence of such rules is not surprising given that individuals resident in France are not subject to the CFC rules. Since a French individual can establish a CFC in a tax haven to earn passive income, it is unnecessary to have rules dealing with FIFs that are widely held by such individuals.

France does have other anti-abuse rules that might be applied to tax-haven corporations in which French residents have an interest. However, the need for CFC and FIF rules applicable to individuals resident in France seems clear.

4.3.3.3 Other rules

The French system contains other rules for dealing with the abuse of tax havens. In addition to exchange controls and the abuse of rights doctrine, there are two specific provisions with respect to tax havens:

- amounts paid to a person resident in a tax haven for services rendered in France are taxable in France if the person who actually performs the services is resident in France and certain other conditions are satisfied; and
- interest, royalties and fees for services paid by a resident of France to a resident of a tax haven are not deductible, unless the taxpayer can prove the transaction is genuine and the amount paid is reasonable.

4.4 Enforcement and administrative issues

French corporations that own at least 10 percent of the shares or shares worth FFr 150 million of a foreign corporation resident in a tax haven must file detailed information concerning the income of the foreign corporation and attach the corporation’s financial statements. They must also report the amount of taxes levied and tax credits available, the aggregate CFC profits subject to French tax and the aggregate profits of CFCs distributed to the French corporation. In effect, the French corporation must provide all of the information necessary for the tax authorities to determine whether the active business exemption applies, and whether the foreign country is a tax haven and to determine the amount of the foreign corporation’s income to be included in the French corporate shareholder’s income if the CFC rules apply. The filing requirements apply even if the CFC qualifies for the active business exemption.

5. Germany

5.1 Overview of the treatment of foreign-source income

Individuals and corporations resident in Germany are taxable on their worldwide income. However, this fundamental principle is subject to numerous exceptions. Indeed, the treatment of foreign-source income derived by German residents has developed over time on an *ad hoc* basis, without any consistent underlying tax policy.

An important factor in the German treatment of foreign-source income is the existence of a tax treaty with the country in which the income is earned. Although the significance of tax treaties in the German system goes well beyond the role of the designated treaty country concept in the Canadian foreign affiliate rules, there are some similarities between the approaches of the two countries.

An individual is considered to be a resident of Germany for income tax purposes if the individual's domicile or customary place of abode is in Germany. Both of these broad tests are determined on the basis of all of the facts and circumstances; however, the maintenance of a dwelling in Germany available for the taxpayer's use is usually determinative. Also, if a person is physically present in Germany for more than six months in any 12-month period, that individual will be considered to be resident in Germany.

Corporations are considered to be resident in Germany for income tax purposes if they are incorporated under German law, or if they have their principal place of management or head office there. A corporation's principal place of management for this purpose is considered to be located where the day-to-day decisions concerning the corporation's affairs are made (rather than where the board of directors meets).

Although residents of Germany are subject to tax on their worldwide income, several items of foreign-source income are exempt:

- employment income from specified activities such as construction, exploration and mining, if certain conditions are met;
- income from international shipping is taxable at 50 percent of the usual rate; and
- certain dividends received by German corporations from foreign affiliates in treaty countries.

In general, Germany provides relief from international double taxation by a combined credit/exemption system broadly similar to the Canadian system. The basic element is a foreign tax credit, which is limited to the amount of German tax of the foreign-source income earned in each foreign country. Alternatively, taxpayers can elect to deduct foreign taxes paid to particular countries.

Under German tax treaties, business income of a foreign permanent establishment and dividends from foreign subsidiaries of German companies are usually exempt from German tax. Most of Germany's recent tax treaties limit the exemption for branch profits and intercompany dividends to income derived exclusively, or almost exclusively, from an active business. If the exemption is not available, the foreign taxes are creditable. Since Germany has an extensive tax treaty network, most business income derived by German taxpayers is effectively exempt.

5.2 Foreign-source income earned directly

5.2.1 Branch income

If a German individual or corporation carries on business through a permanent establishment located in a country with which Germany has a tax treaty, the business profits attributable to the permanent establishment are exempt from German tax. The specific requirements for exemption vary from treaty to treaty. In general, there must be an active business carried on in the foreign country and the income derived must be subject to foreign tax. This exemption for business profits often includes interest, dividends, royalties and capital gains that are ancillary to the active business. Similarly, income derived by residents of Germany from real property located in a foreign country with which Germany has a tax treaty is generally exempt from German tax.

If a resident of Germany derives foreign-business income from a branch operation in a country with which Germany does not have a tax treaty, the income is subject to tax with a credit for the foreign taxes on the income. The foreign-tax credit is also available in certain circumstances where a treaty exemption does not entirely eliminate international double taxation. The foreign-tax credit applies only to foreign taxes that are equivalent to German income taxes. The limitation on the credit is calculated on a per-country basis.

In principle, foreign-source business losses are not deductible in computing a German resident's worldwide income, unless the losses are from a business carried on in a non-treaty country. If the business is carried on in a treaty country, the taxpayer can elect to deduct losses from certain specified business activities in determining German source income. However, if the foreign business becomes profitable, the treaty exemption will not apply to the extent of the losses previously deducted, unless the taxpayer can establish that the foreign country does not provide for a carry-over of business losses.

Excess foreign-tax credits for any year cannot be carried forward. Rather than losing the excess foreign taxes, a taxpayer can elect on a per-country basis to deduct all of the foreign taxes paid to that country.

As an alternative to a tax credit, a taxpayer may request that foreign-source income from a particular country or countries be subject to a flat-rate tax of 25 percent. This flat-rate taxation is available in respect of foreign business income from a permanent establishment and also extends to dividends that a German corporation receives from a foreign corporation in which it owns at least 10 percent of the shares.

5.2.2. Portfolio income

The German tax treatment of foreign-source income differentiates between portfolio and business income. The latter is generally exempt if it is derived through a permanent establishment in a treaty country. Portfolio income, on the other hand, is exempt from German tax only if it is ancillary to business income earned through a permanent establishment in a treaty country. Generally, portfolio income is subject to German tax with a credit for any foreign withholding taxes on the income, subject to a per-country limitation. Any excess foreign taxes cannot be carried forward; however, there is an optional deduction for the foreign taxes.

5.3 Foreign-source income earned indirectly

5.3.1 Dividends from foreign affiliates

The tax treatment of dividends received from foreign corporations depends on the percentage share ownership of the German corporation, the existence of a tax treaty between Germany and the foreign country in which the corporation is resident, and whether the foreign corporation is resident in a developing country. Dividends received by German corporations owning less than 10 percent of the shares of a foreign corporation, as well as dividends received by German individuals, are subject to German tax with a credit for any foreign withholding taxes on the dividends, as described earlier. If, however, a German corporation owns 10 percent or more of the shares of the foreign corporation, a combined credit/exemption system similar to the Canadian system applies. If the foreign corporation is resident in a treaty country, the dividend is exempt, subject to the application of an activity proviso in the treaty, as described earlier. If the foreign corporation is engaged almost exclusively in active business in a developing country, the dividends are included in the German corporation’s income, but a foreign tax credit equal to the amount of German tax will be allowed. In effect, such dividends are exempt from German tax.

In all other cases, the dividend is included in the German corporation’s income. Further, the corporation is entitled to a credit for any foreign withholding taxes on the dividend, and for any underlying foreign taxes paid by the foreign corporation on the income out of which the dividend was paid. The indirect foreign tax credit is available only if the foreign corporation is engaged primarily in an active business during the year. The indirect credit is available only for two tiers of foreign corporations, if the 10 percent ownership test is met both directly and indirectly and both corporations are established in the same country or are functionally related. The credit is available only for dividends paid by second-tier affiliates if the dividend is paid in the same year that the first-tier affiliate pays a dividend to the German corporation. There is no credit for any withholding tax on the dividend paid by the second-tier affiliate to the first-tier affiliate. The indirect foreign tax credit is subject to a per-country limitation. No carry-over is available for excess foreign tax credits.

Prior to 1994, any dividends received by a German corporation that were exempt from German tax (and other exempt foreign-source income derived by the German corporation) were subject to a special compensatory tax of 36 percent when distributed in the form of dividends to German shareholders. This compensatory tax was levied in recognition of the dividend tax credit that is available to German-resident shareholders. Non-resident shareholders do not qualify for the dividend tax credit; accordingly, they were entitled to receive a refund of the compensatory tax.

Since 1994, exempt foreign-source income may be passed free of compensatory tax to German corporate shareholders and non-resident shareholders. The latter group remains subject to withholding tax at the rate of 25 percent, subject to reduction by treaty. German individual shareholders must include the dividend in income, but are not entitled to any dividend tax credit.

Corporations are still required to keep detailed surplus accounts in respect of corporate income that has borne different rates of corporate tax, as well as exempt income. Dividends are deemed to be paid first out of income that was subject to the highest rate of German corporate tax. After all surplus that has borne corporate tax has been exhausted, dividends are then deemed to be paid out of four baskets of exempt income. Of these baskets, exempt foreign income is deemed to be paid first.

5.3.2 Allocation of income and expenses

Germany does not have sophisticated rules with respect to the allocation of expenses to foreign-source income. Case law has established that expenses that are "directly connected" to foreign-source income must be allocated to such income for purposes of deductibility and the computation of the limitation on the foreign-tax credit. There are no rules with respect to the allocation of general expenses. Even if expenses are directly connected with exempt foreign-source income, their deduction is disallowed only to the extent of the exempt income. Therefore, in the case of interest expense on money borrowed to finance the purchase of shares of a foreign affiliate, the interest is fully deductible if no dividends are received (or where the foreign affiliate is a CFC, deemed to be received) during the year. The apparent justification for this rule is that the gain on the sale of the shares of the foreign affiliate is subject to full German tax. However, a recent amendment has exempted capital gains on shares of foreign corporations. Apparently, this issue is currently under review in Germany.

5.3.3 Limitations on deferral

5.3.3.1 The CFC rules

The German CFC rules were adopted in 1972 and are broadly patterned on the U.S. Subpart F rules. The policy of the German CFC rules is focussed precisely on tax-haven jurisdictions, rather than on tainted income earned by CFCs in all foreign countries.

A CFC is defined as a foreign corporation in which German residents own more than 50 percent of the number of shares or more than 50 percent of the voting rights attached to the corporation’s shares at the end of its year. There is no minimum ownership requirement, and control does not need to be concentrated in a small group of German residents. The control test is supplemented by indirect and constructive ownership rules.

The tainted income of a CFC for a particular year is attributed to the German shareholders in proportion to their percentage ownership of the shares of the foreign corporation at the end of the year. There is no minimum shareholding requirement for this purpose.

The German CFC rules apply only to CFCs whose income is subject to "low taxation" in the foreign country. Low taxation is considered to exist if the country in which the foreign corporation is resident imposes tax at a rate of less than 30 percent. For this purpose, taxes on the CFC’s income other than its tainted income are ignored, as are taxes paid to other foreign countries. Technically, the 30-percent foreign tax rate test must be calculated after the tainted income is computed in accordance with German tax rules. Therefore, the test is based on the effective rather than the nominal foreign tax rate.

Special rules apply for determining whether dividends received by a CFC are subject to low taxation. If the CFC qualifies for a participation exemption in the foreign country, the dividend is deemed to be subject to low taxation. This deeming rule also applies even if the foreign country in which the CFC is resident allows the CFC an indirect foreign-tax credit in respect of the dividend.

Tainted income of a second- or lower-tier CFC is attributed to its direct corporate parent rather than to the German shareholders. As a result, such tainted income is always considered to be subject to low taxation, since the corporate shareholder has not paid any tax on the income unless its country of residence applies CFC rules. This rule is intended to limit the use of multi-tier corporate structures.

To provide guidance for taxpayers and tax officials, there is a published list of countries whose effective tax rates are considered to be less than 30 percent. This list was published in 1974 and has not been updated since. The list has no binding effect; however, the tax officials rarely go behind or beyond the administrative list.

Only tainted income of a CFC is attributed to the German shareholders. Tainted income is defined negatively as income other than that derived from certain specifically listed active businesses, and certain dividends from active business subsidiaries. It includes passive investment income and certain base company sales and services income. In general, sales income derived by a CFC is not tainted if the goods are both purchased and sold outside Germany. However, even if the goods are either purchased or sold in Germany, the income will not be tainted if the transactions are with unrelated parties, or if the foreign corporation carries on genuine business operations in which the German shareholders and their affiliates do not participate. Similar rules apply to income from services provided by a CFC. Income from financing is considered not to be tainted income if the funds are borrowed by the CFC exclusively on foreign-capital markets and loaned on a long-term basis to active businesses outside Germany. In general, the definition of tainted income is not as broad as that in the United States definition, but it is broader than the Canadian definition of FAPI.

Dividends received by a CFC constitute tainted income except if the CFC owns at least 25 percent of the shares of the payer corporation, and :

- both corporations are established in the same country and the payer corporation derives its income almost exclusively from active business operations; or
- the payer corporation derives its income almost exclusively from active business operations, and the recipient corporation’s interest in the payer corporation is functionally related to an active business carried on by the recipient corporation.

In addition, dividends received by a CFC are excluded from tainted income if they would have qualified for the participation exemption, had they been received directly by the German shareholder.

Tainted income is computed in accordance with German tax rules for each CFC separately.

Tainted income of a CFC attributed to its German shareholders is deemed to be a dividend for purposes of applying the participation exemption in any tax treaty. The tainted income of a second- or lower-tier CFC is not attributed directly to the ultimate German shareholders; rather, it is attributed to the immediate parent company. As explained earlier, such attributable income is always subject to low foreign taxation, with the result that it is attributed to its shareholders.

The German rules provide a *de minimis* exemption for CFCs with passive income not exceeding DM 120,000 or 10 percent of gross income.

In effect, the German CFC rules provide an exemption for tainted income earned by CFCs in some treaty countries. This result follows because the tainted income is treated as a dividend and most of Germany’s tax treaties provide an exemption for dividends that German corporations receive from foreign corporations in which they own at least a 10-percent interest, subject to the activity proviso discussed earlier. Therefore, the CFC rules apply only to CFCs in non-treaty countries, or to those in treaty countries where the participation exemption is restricted to active business income.

Foreign taxes paid by a CFC in respect of its tainted income are deductible for purposes of the German CFC rules, although German shareholders are entitled to elect to credit such foreign taxes. The limitation on this credit is computed on an overall basis in respect of the tainted income of the German taxpayer’s CFCs. Relief for dividends out of previously taxed tainted income is provided by means of a refund. If a shareholder receives dividends from a CFC in excess of the tainted income for the year, the tax paid on tainted income for four prior years will be refunded to the extent of the excess. A similar refund is provided where a German shareholder has previously paid tax in respect of a CFC’s tainted income and then disposes of the CFC’s shares at a gain.

A tainted loss incurred by a CFC in a year may be carried forward against its tainted income in the next five years. A CFC’s tainted income is not reduced by non-tainted losses. There is no provision for consolidating the tainted income and losses of several CFCs, although tainted losses in multi-tier CFCs are essentially consolidated as a result of the manner in which tainted income is calculated.

5.3.3.2 Foreign investment funds

The German tax treatment of FIFs depends on whether the foreign fund qualifies for distribution in Germany. If it is a qualifying fund, it is treated in the same manner as a domestic fund: distributions are included in the German shareholder’s income and a credit is allowed for any foreign withholding taxes on the distribution; distributions of capital gains are not included in income; the FIF’s undistributed passive income (dividends and interest, but not capital gains) is attributed to the German shareholders whether or not the fund is controlled by German residents; and where a shareholder disposes of an interest in the fund during the year, the shareholder must include in income "interim profit income," that is, interest income of the fund that has not previously been taxed as a distribution or deemed distribution. This generous treatment of investments in FIFs is conditional on a number of requirements, including the provision of information to the German tax authorities.

The tax treatment of investments in non-qualifying funds depends on whether the fund appoints a German agent to deal with the German tax authorities. In this case, investments will be entitled to the same treatment as those in qualifying funds, except that taxable distributions, as well as allocated undistributed profit, include capital gains.

Investments in other offshore funds are subject to more onerous taxation. German shareholders of such funds are required to include in their income the actual distributions received from the fund and 90 percent of the increase in the value of their interests in the fund during the year. Even if there has been no increase in value, a minimum of 10 percent of the value at the end of the previous year must be included in income. When the interest in the fund is sold or redeemed, the investor must include in income 20 percent of the sale price or redemption price.

Finally, Germany introduced legislation in 1992 to supplement the CFC rules and to prevent the abuse of the participation exemption in treaties. Under these rules, the treaty exemption for dividends is denied if the foreign corporation earns passive investment income. The legislation applies to foreign corporations that are not controlled by German residents, but only to German shareholders who hold at least 10 percent of the shares of the foreign corporation. In most of Germany's recent treaties, the participation exemption is available only for foreign affiliates engaged almost exclusively in active business. Therefore, the denial of the treaty exemption is generally relevant only with respect to older treaties. The denial applies if more than 50 percent of the foreign affiliate's investment income is passive and the foreign affiliate is subject to foreign tax of less than 30 percent. There are exemptions for foreign affiliates engaged in active businesses and foreign holding companies. An exemption for foreign finance companies was replaced in 1994. The current rule is that 60 percent of income derived from financing foreign permanent establishments or related foreign corporations engaged in an active business is subject to attribution under the combined CFC and FIF rules.

5.4 Enforcement and administrative issues

German taxpayers are under an obligation to disclose all of the facts relevant to the calculation of their tax liability and to produce any relevant documents with respect to transactions or events outside Germany. They must also file a special information return with respect to the establishment or acquisition of any foreign business or investments in foreign corporations of 10 percent or more.

Tax authorities have broad powers to demand information, books and records from German shareholders of foreign corporations. No statutory exceptions are recognized with respect to the shareholder's obligation. However, in practice, it is likely that any demand for information would not be enforceable unless it was reasonable.

6. United States

6.1 Overview of the treatment of foreign-source income

The United States has by far the most complicated and sophisticated rules for taxing the foreign-source income of its residents.

Unlike most countries, the United States taxes both resident individuals and citizens on their worldwide income. An individual is considered to be a resident of the United States for income tax purposes if he possesses a green card or is physically present in the United States for 183 days or more. A supplemental test is based on physical presence over a period of three years, but this test can be rebutted if the individual establishes that his tax home is in another country and he has a closer connection to that country than to the United States. The closer connection test is based on facts and circumstances. For corporations, the United States uses a place-of-incorporation test of corporate residence. A corporation's place of management is irrelevant.

The United States does not consider acquiring residence or giving up residence to be taxable events, although the introduction of such rules is currently under consideration by Congress. However, taxpayers who give up U.S. citizenship to avoid tax continue to be subject to U.S. tax for a period of 10 years. The United States has special rules to prevent dual-resident companies from deducting losses that are also deductible in the foreign country.

The United States is the only country with detailed statutory source of revenue and expense rules. These rules differ depending on whether they are being used for the purpose of computing U.S. source income of non-residents or foreign-source income of U.S. residents for purposes of the foreign tax credit.

6.2 Foreign-source income earned directly

6.2.1 Business income

The United States provides a limited exemption for certain foreign-earned income of individuals. This exemption is available only if the recipient resides or is physically present outside the United States for a substantial portion of a year. This exemption is similar to the Canadian overseas employment exemption.

Apart from this foreign-earned income exemption, the United States uses a credit system to provide relief for international double taxation with respect to foreign-source income earned both directly and indirectly through a foreign corporation. The taxpayer always has the option of deducting rather than crediting foreign taxes. In contrast to most countries that define creditable foreign taxes as generally comparable to domestic taxes, the United States has detailed statutory rules that set out the criteria that a foreign income tax must meet in order to be creditable.

In general, the foreign-tax credit cannot exceed the U.S. tax on the foreign income. The limitation is applied separately to several baskets of foreign income. Within each basket, a worldwide limitation is applied that permits the averaging of high and low foreign taxes on income within the basket. In general, these baskets differentiate between passive income and active business income.

The United States has very complex rules with respect to the treatment of foreign-source losses. An overall loss in any particular basket of foreign-source income is not deductible against U.S. source income if there are positive balances in any of the other baskets. A foreign loss from one basket must be allocated to other baskets with positive foreign-source income proportionately based on the amount in each basket as a proportion of total foreign income. Allocating the loss from one basket to another has the effect of reducing the creditable taxes in the other basket. Special rules are then required to deal with the situation where there is positive income in a subsequent year in a basket whose loss has been allocated to another basket in a previous year. Excess credits in any basket can be carried back two years and carried forward five years within the same basket.

Where a foreign loss reduces U.S. income, a special recapture rule applies, under which foreign-source income for a subsequent year is recharacterized within limits as U.S. source income, thus reducing the foreign-tax credit for the year. Gains on the disposition of foreign business property are also subject to recharacterization as domestic source gains to offset previously deducted foreign-source losses.

If a U.S. taxpayer participates in an international boycott (i.e. agrees not to do business with a particular country), the taxpayer may be subject to special tax penalties, such as the reduction of available foreign-tax credits. Failure to comply with certain foreign information reporting requirements may also result in the loss of foreign-tax credits.

6.2.2 Portfolio income

As indicated earlier, the United States uses a credit system for all types of foreign-source income. Thus, any portfolio income earned by a U.S. resident or citizen from foreign sources will be included in the taxpayer's worldwide income and will be subject to U.S. tax. The taxpayer is entitled to a credit for any foreign taxes levied on the income, subject to the basket limitations discussed earlier. In general, separate baskets are prescribed for portfolio income.

6.3 Foreign-source income earned indirectly

6.3.1 Dividends from foreign corporations

The United States does not provide similar treatment for foreign branches or subsidiaries of U.S. corporations. Foreign-branch income is taxable on a current basis, while income earned by foreign corporations is taxable only when received in the form of dividends, subject to the CFC rules discussed below. Dividends that U.S. residents or citizens receive from foreign corporations are included in income and subject to U.S. tax with a credit for any foreign withholding taxes on the dividends, subject to the basket limitation discussed earlier. However, where a U.S. corporation receives a dividend from a foreign corporation in which it owns 10 percent or more of the voting shares, the corporate shareholder is entitled to an indirect foreign-tax credit in respect of the foreign taxes paid by the foreign corporation on the income out of which the dividend was paid.

The U.S. indirect foreign-tax credit is available only for three tiers of foreign corporations. At each tier there must be a direct interest of at least 10 percent in the voting shares. In addition, the U.S. corporation must have an indirect interest of at least 5 percent at each tier.

The computation of the indirect foreign tax credit in the United States is very complex. Rules are provided to attribute dividends paid by a foreign corporation to the profits of particular years. In addition, foreign taxes paid by the foreign corporation are attributed to dividends pursuant to detailed allocation rules. The rules for co-ordinating the basket limitations on the foreign-tax credit and the rules for computing the indirect foreign tax credit are also extremely complex. The purpose of the rules is to make the basket limitations apply through tiers of foreign corporations. The amount of foreign tax creditable for years after 1986 with respect to any particular dividend is the proportion of the total foreign-tax paid for all years after 1986, to and including the year in which the dividend is paid, that the dividend is of the foreign corporation's undistributed earnings for years after 1986.

6.3.2 Allocation of income and expenses

The United States is the only country with detailed statutory source rules for both gross income and expenses. These rules are used for purposes of the limitation on the foreign-tax credit. In other words, a foreign tax credit is allowed only to the extent that the foreign tax on the foreign-source income does not exceed the U.S. tax payable on that income.

It must be noted that the United States does not attempt to deny the deduction of expenses allocated to foreign-source income. Such expenses are deductible in the year in which they are incurred. Instead, when a dividend is received from a foreign corporation, the expenses are allocated to the foreign-source income for purposes of computing the limitation on the indirect foreign tax credit. Subject to a few narrow exceptions, interest is allocated to all categories of gross income ratably, based on the assumption that capital is fungible; it is then apportioned between U.S. and the various categories of foreign-source income based on the ratio of the tax book value of the taxpayer's assets in each category to the tax book value of all the taxpayer's assets. The result of allocating expenses to foreign-source income is that the amount of the credit is reduced, and this is equivalent to the denial of the deduction of the expenses if the timing aspects of the problem are ignored. The United States does not deal with the timing aspect of the problem, namely, that the interest is deductible in the year in which it is incurred but the dividends from the foreign corporation are included in income only when received.

6.3.3 Limitations on deferral

6.3.3.1 CFC rules

The United States was the first country to adopt CFC rules. The foreign personal holding company rules were adopted in 1937 to deal primarily with the problem of incorporated pocketbooks. In 1962, the United States adopted the Subpart F rules in an attempt to deal more comprehensively with the problem of controlled foreign corporations used to defer or avoid U.S. tax.

U.S. resident shareholders of a foreign personal holding company are subject to U.S. tax on the company's undistributed and distributed income. A foreign personal holding company is a foreign company more than 50 percent of whose shares, by votes or value, is owned by five or fewer U.S. taxpayers, and at least 60 percent of whose income is passive.

The U.S. Subpart F rules apply to foreign corporations if more than 50 percent of the shares, determined by votes or value, is owned by U.S. shareholders at any time in the CFC's tax year. Only U.S. persons who own 10 percent or more of the voting shares of the foreign corporation are taken into account for purposes of determining whether the foreign corporation is a CFC. Indirect and constructive ownership rules apply when determining whether a U.S. person has a 10-percent interest, and whether a foreign corporation is controlled by U.S. persons. The Subpart F rules apply only if the U.S. persons control the foreign corporation for an uninterrupted period of at least 30 days.

The U.S. Subpart F rules operate on a transactional basis similar to the Canadian FAPI rules. Tainted income of a CFC is attributed to its U.S. shareholders irrespective of the amount of foreign tax on the tainted income.

Only U.S. taxpayers who directly or indirectly own at least 10 percent of the voting shares of the CFC at any time in the year and who own shares directly or indirectly in the CFC at the end of the year are taxable on their share of the tainted income of the CFC. Constructive ownership rules apply to prevent taxpayers from fragmenting their shareholdings so they can avoid the 10-percent ownership requirement.

A CFC's tainted income that is attributed to its U.S. shareholders is defined to include the following amounts:

- insurance income other than income from the insurance of risks in the country in which the CFC is resident;
- passive income;
- income from sales and services derived from transactions with related parties outside the CFC's country of residence;
- income from shipping, air transportation, activities in space or on international seas, and income from the distribution and sale of oil and gas;
- certain income attributable to participation in international boycotts and bribes and kickbacks paid by the CFC to foreign governments;
- earnings invested in U.S. property (this rule is equivalent to an upstream loan rule); and
- retained earnings invested in excess passive assets, which are generally assets in excess of 25 percent of total assets.

If a CFC's passive income and foreign base company income exceed 70 percent of its total gross income, all of its income is attributed to its U.S. shareholders. The corresponding *de minimis* rule is not as generous. There is no attribution of a CFC's tainted income if the passive and foreign base company income are less than the lesser of 5 percent of the CFC's gross income or US $1 million.

The only exemption provided by the U.S. Subpart F rules is an exemption for passive income, insurance income, and foreign base company income, other than oil and gas income, that is subject to an effective foreign-tax rate that is at least 90 percent of the U.S. corporate tax rate.

Relief provisions under the Subpart F rules are similar to those under the Canadian FAPI rules. Subsequent dividends received by a U.S. shareholder out of previously taxed CFC income are not taxable. Similarly, capital gains realized on the sale of CFC shares are not taxable to the extent that the gain is attributable to previously taxed CFC income. This relief is provided by way of adjustments to the cost base of the CFC shares. U.S. corporate shareholders of a CFC are entitled to a credit for any foreign taxes that the CFC pays on tainted income included in the U.S. corporation's income. This credit is subject to the same rules that apply to the indirect foreign tax credit discussed earlier. Individuals are entitled only to a deduction for the foreign taxes, unless they elect to be treated as a U.S. corporation. Losses incurred by a CFC with respect to one category of tainted income offset other categories of tainted income. In addition, losses from non-tainted sources are available to offset tainted losses. Losses are eligible for an indefinite carryforward. However, one CFC's losses are not available to offset the tainted income of another.

6.3.3.2 FIF rules

The United States adopted its passive foreign investment company (PFIC) rules in 1986. These rules are designed to supplement the CFC and foreign personal holding company rules, which apply only to foreign corporations controlled by U.S. taxpayers. In contrast, the PFIC rules apply to U.S. taxpayers who own shares in foreign corporations whose income and assets are primarily passive in nature, whether or not the corporations are controlled by U.S. residents.

The purpose of the U.S. PFIC rules is to eliminate the benefits of investing in passive foreign investment companies, namely, the deferral of U.S. tax and the conversion of ordinary income into capital gains. Because the U.S. CFC and foreign personal holding company rules apply only to foreign corporations controlled by U.S. residents, avoidance schemes involving passive foreign investment companies based in tax havens in which U.S. persons hold a minority of the interests were widespread before 1986. The U.S. PFIC rules are significantly more complex than the comparable FIF measures of other countries.

A foreign corporation is a PFIC if 75 percent or more of its gross income is passive, or if assets representing more than 50 percent of the total value of its assets are passive. For this purpose, passive income has broadly the same meaning that it has for purposes of the U.S. CFC rules. Passive income does not include income from an active business. The asset test involves a valuation of the assets of the foreign corporation at the end of each quarter. An asset is considered to be passive if it has generated or is likely to generate passive income. This general rule is supplemented by a number of specific rules with respect to particular types of property. For example, property used in a business is characterized as an active asset; securities are characterized as passive assets unless they constitute inventory; and shares constitute passive assets subject to a special look-through rule where a foreign corporation owns 25 percent or more, by value, of another foreign corporation's shares.

If a U.S. person owns shares in a PFIC at any time, the shares will retain that character as long as that person owns the shares, even if the foreign company ceases to be a PFIC. The only way this rule can be avoided is if the taxpayer makes an election to treat the PFIC as a qualifying electing fund (QEF), as explained below.

Although the U.S. PFIC rules do not provide general exemptions, the definition of a PFIC effectively exempts foreign corporations that are engaged primarily in active businesses. In addition, PFICs that are not QEFs and that distribute their income currently are exempt as a result of the excess distribution concept explained below.

The tax consequences to a U.S. person who owns an interest in a PFIC depend on whether the person makes the election to treat the PFIC as a QEF. If the election is made, the taxpayer must include in income the *pro rata* share of the PFIC's earnings and profits. If no election is made, there is no U.S. tax until distributions from the PFIC are received, or the taxpayer disposes of the PFIC interest; however, an interest charge is imposed at that time to eliminate the benefit of deferral.

If a U.S. taxpayer makes the election to treat the PFIC as a QEF, the method of taxation is similar to the method of taxation under the CFC rules, except that all of the income of the PFIC, not just its tainted income, is attributed to the U.S. shareholders. The QEF election is available only where the taxpayer has access to the information necessary to compute his *pro rata* share of the income of the PFIC and the U.S. tax authorities have access to the PFIC's books and records.

As noted earlier, a U.S. shareholder of a PFIC that is not a QEF is subject to tax only when distributions are received, or when the PFIC interest is disposed of. However, if the U.S. shareholder receives an "excess distribution" or realizes a gain on the disposition of the PFIC interest, the amount of the distribution or gain is deemed to have arisen ratably over the period during which the interest was owned. An excess distribution is one that exceeds 125 percent of the average distributions received over the previous three years. In effect, a PFIC that distributes its income currently will not be subject to the PFIC measures. The interest charge will be imposed only if a PFIC makes an excess distribution in a year, or if the taxpayer disposes of his interest at a gain.

Relief is provided in respect of subsequent distributions out of previously taxed income and subsequent capital gains attributable to previously taxed undistributed income. Foreign withholding taxes on distributions from a PFIC are creditable. Only U.S. corporations that own 10 percent or more of a PFIC's shares are entitled to claim an indirect foreign tax credit. Finally, U.S. tax payable in respect of an interest in a PFIC that is a QEF may be deferred, subject to an interest charge in recognition of the fact that the taxpayer is taxable before receiving the income.

6.4 Enforcement and administrative issues

The United States has stringent reporting requirements for U.S. taxpayers owning foreign property, owning interests in CFCs and FIFs, and engaging in transactions with related foreign corporations. These reporting requirements are buttressed by serious penalties for failure to comply. In addition, the Internal Revenue Service (IRS) devotes considerable resources to auditing U.S. taxpayers with respect to foreign transactions.

7. Conclusion

The foregoing review of the taxation of foreign-source income of residents in the five countries illustrates that, in terms of broad structural features, the Canadian system is in accordance with the international norm. Canada's combined exemption/credit system for dividends from foreign affiliates is restricted to active business income earned in treaty countries, and is similar to the systems in Australia and Germany. Because treaty countries are generally high-tax countries, the exemption system can be seen as a proxy for a credit system such as that used by the United States. Like the other countries, Canada has both CFC and FIF rules. Apart from the United States, none of the countries has adopted rules to deal effectively with the allocation of expenses to foreign-source income.

However, the devil is in the details. Canadian rules for the taxation of residents' foreign-source income have not been subject to a comprehensive review for 25 years. There are several significant flaws in the details of the Canadian system that undermine its structural integrity:

- the deductibility of interest in respect of borrowed funds used to earn dividends out of exempt surplus;
- the ability to earn low-taxed or exempt income in designated treaty countries;
- the irrelevance of the concept of taxable surplus;
- the application of the FAPI rules to controlled foreign affiliates in foreign countries with tax rates as high as Canadian rates;
- the generous rules for payments received by a foreign affiliate from other foreign affiliates or related corporations under paragraph 95(2)(a);
- the exclusion of base company sales and services income from the definition of FAPI;
- the arbitrariness of the FIF rules; and
- the ability to deduct foreign branch losses.

All of these issues are complex and difficult; they deserve serious study.

TABLE 1

	Canada	Australia	France	Germany	United States
Branch income	• taxable with credit for foreign taxes	• exempt if derived in listed country • taxable with credit for foreign taxes if derived in unlisted country	• exempt	• exempt if derived in a treaty country • taxable with credit for foreign taxes if derived in a non-treaty country	• taxable with credit for foreign taxes
Branch losses	• deductible	• not deductible even if derived in unlisted country; subject to carry-forward	• not deductible • special reserve for first 5 years for certain industries subject to recapture over the following 5-10 years	• deductible if derived in a non-treaty country • generally not deductible if derived in a treaty country, although taxpayer can elect deduction, in which case treaty exemption not applicable on future profits of branch to the extent of the losses previously claimed	• only deductible if there is foreign loss on a worldwide basis
Foreign tax credit					
• Creditable taxes	• income or profits taxes	• income taxes "substantially equivalent" to Australian taxes	• not necessary because of exemption of foreign-source income	• foreign taxes equivalent to German taxes	• comparable to U.S. income taxes
• Limitation	• per country with two baskets for business and other income	• worldwide with 5 baskets		• per country	• worldwide based on several baskets • averaging within baskets allowed
• Losses	• losses in one country do not affect credit for another country • no special rule where foreign loss used against domestic income	• passive income does not offset business loss • election to use domestic loss to reduce foreign income		• losses in one country do not affect credit for another country	• losses in one basket reduce income in other baskets, excess reduces U.S. income
• Carry-over	• 7 years forward and 3 years back for foreign business taxes	• 5 years forward		• none, but can elect to deduct foreign taxes on a per country basis	• 5 years forward and 2 years back
Portfolio income	• taxable with credit for foreign withholding taxes • for individuals credit is limited to 15%, excess is deductible	• taxable with credit for foreign withholding taxes	• taxable with deduction for foreign taxes or credit under tax treaties	• exempt only if ancillary to business income earned through a permanent establishment in a treaty country • otherwise, taxable with credit for foreign withholding taxes	• taxable with credit for foreign taxes
Dividends from foreign affiliate • definition	• at least 10% of shares of any class • only for Canadian corporate recipients	• at least 10% of votes, value • only for Australian corporate recipients	• at least 10% of voting shares or shares worth at least FF150 million	• at least 10% of shares of foreign corporation • only German corporate recipients	• at least 10% of voting shares

TABLE 1 (cont'd)

	Canada	Australia	France	Germany	United States
• exemption	• exempt if paid out of active business income earned in treaty countries	• exempt if paid by foreign corporation resident in listed country	• exempt • subject to a compensatory tax "précompte mobilier" under the imputation system, and foreign taxes are creditable against the précompte	• if resident in a treaty country, exempt, subject to activity proviso in treaty • if engaged almost exclusively in active business in a developing country, effectively exempt	• no exemption
• indirect foreign tax credit	• taxable if paid out of active business income earned in non-treaty countries or other income • no limit on number of tiers of foreign affiliates • exempt surplus distributed first	• exempt if paid by foreign corporation resident in unlisted country out of exempt profits • if paid by foreign corporation resident in unlisted country out of taxable profits • *pro rata* out of exempt and taxable profits	N/A	• taxable unless exempt as noted above • limited to 2 tiers; 10% ownership at each tier, directly and indirectly; both foreign corporations established in same jurisdiction or are functionally related	• limited to 3 tiers; 10% at each tier and 5% indirectly
• limitation	• in effect worldwide limitation • of limited practical significance	• worldwide limitation	N/A	• per country	• complex rules to pass limitation through tiers
Allocation of expenses					
• general	• no specific rules	• few rules • any reasonable method • expenses that do not relate to any income are allocated on basis of net income	N/A	• no detailed rules	• detailed rules re: source of expenses
• exempt income	• deductible • serious problem	• in principle not deductible • serious problem	• in general, not deductible • expenses that do not relate to any income are allocated between taxable and tax-exempt income	• not deductible to the extent of exempt income (if no exempt income, fully deductible) • serious problem	• not necessary
• indirect foreign tax credit	• no specific rules	• few specific rules	• not necessary	• few specific rules	• detailed rules • apportionment for interest and R&D

TABLE 2
Summary of CFC Legislation

	Canada	Australia	France	Germany	United States
Policy objectives	1) to prevent the diversion of passive and certain base company income to CFCs 2) to prevent the accumulation of such income in CFCs 3) not to interfere with legitimate foreign business activities of Canadian taxpayers	1) to prevent the diversion of passive and certain base-company income to CFCs in tax havens 2) to prevent the accumulation of such income in CFCs 3) not to interfere with legitimate foreign business activities of Australian taxpayers 4) to eliminate discrimination between foreign branches and subsidiaries	1) to prevent the diversion of passive and certain base-company income from France to foreign corporations in tax havens 2) to prevent accumulation of such income in foreign corporations in tax havens 3) not to interfere with legitimate foreign business activities of French corporations 4) to prevent abuse of the French territorial system of taxation and the participation exemption for dividends from foreign corporations 5) to allow French tax authorities to gather information concerning tax-haven activities of French corporations	1) to prevent the diversion of passive and certain base-company income to CFCs in tax havens 2) to prevent the accumulation of such income in CFCs in tax havens 3) not to interfere with legitimate foreign business activities of German taxpayers 4) to discourage complicated foreign corporate structures (more than two tiers)	1) to prevent the diversion of passive and certain base-company income to CFCs (in conjunction with previously adopted foreign personal holding company rules) 2) to prevent the accumulation of such income in CFCs in tax havens 3) not to interfere with legitimate foreign business activities of U.S. taxpayers 4) to prevent U.S. taxpayers from using CFCs to avoid foreign taxes 5) to prevent accumulation of passive income in CFCs beyond reasonable business needs
Definition of a controlled foreign company (CFC)	1) more than 50% of voting shares held by 5 or fewer Canadian residents or a related group 2) indirect and constructive ownership rules 3) 1% minimum ownership requirement	1) 50% or more of the share capital, voting rights, or rights to distributions owned by 5 or fewer Australian residents or *de facto* control by same 2) rebuttable presumption that Australian resident owning interest of 40% or more has *de facto* control 3) indirect and constructive ownership rules 4) 1% minimum ownership requirement 5) anti-avoidance rules for stapled stock and similar arrangements	1) 10% or more of shares or an investment of FFr 150 million or more, of a foreign corporation 2) also applies to foreign branches and partnerships 3) indirect and constructive ownership rules 4) no minimum ownership	1) more than 50% of voting or profit distribution rights held by German residents 2) indirect and constructive ownership rules 3) no minimum ownership	1) more than 50%, by vote or value, of stock owned by "U.S. shareholders" (citizens, residents and corporations who own at least 10% of voting power); lower limits for insurance CFCs 2) indirect and constructive ownership rules 3) 10% minimum ownership requirement 4) anti-avoidance rule for stapled stock

TABLE 2 (cont'd)
Summary of CFC Legislation

	Canada	Australia	France	Germany	United States
Definition of a tax haven	none	• statutory white list of non-tax haven "comparable tax jurisdictions" • any unlisted country is a tax haven (no grey countries)	Foreign tax less than 2/3 of French tax • unofficial list of tax havens • comparison between actual foreign tax paid and notional French tax on same income	Foreign tax burden on passive income less than 30% • not just nominal rates: exemptions, preferential rates • differences in tax base considered • unofficial list of tax havens and other countries	none
Attributed income	1) passive income and capital gains from passive property 2) income derived by a CFC from the provision of services if the amount paid or payable is deductible (directly or indirectly) by the payor from income derived from carrying on business in Canada and the payor is either a person with respect to which the CFC is a CFC (e.g. its Canadian parent) or is related to that person 3) income of "purchasing affiliates" from the sale of property, the cost of which is deductible, in whole or in part, by non-arm's length Canadians 4) income from the insurance or reinsurance of Canadian risks 5) income from debt and lease obligations (including licences of intangible property) of residents of Canada	1) for CFC resident in an unlisted country, all "tainted" income (defined as passive income and base company income) 2) for CFC resident in a listed country, generally only income from specified concessions under foreign tax law 3) certain income automatically attributed, including: certain categories of trust income; and, for a CFC resident in a listed country, trust amounts and income arising outside that country if they have not been subject to tax in any listed country	All income, as calculated under French tax law	Passive income and certain base company sales and services income from activities with affiliated persons	1) Subpart F income: a) income from insurance of U.S. risks b) foreign base company income • passive income, broadly defined • sales and service income from related-party transactions outside tax haven • income from operation of ships and aircraft, activities on high seas, outer space, etc. • foreign income from extraction or sale of oil and gas

TABLE 2 (cont'd)
Summary of CFC Legislation

	Canada	Australia	France	Germany	United States
Attributed income (cont'd)	6) income from an "investment business," defined as a business carried on by a CFC for the principal purpose of deriving income from property, from insurance or reinsurance of risks, from factoring of accounts receivable or from the disposition of investment property. Special exemptions apply for banks, trust companies, credit unions, and insurance companies				2) certain non-tainted income: • investment by CFC in U.S. property • accumulated profits invested in excess passive assets 3) *de maximis* rule: if more than 70% of CFC's gross income is foreign base company income or insurance income, all net income is tainted 4) items of income described in (1)(a) and (1)(b), above are not attributed if subject to foreign tax of at least 90% of U.S. rate
Domestic taxpayers to whom income of CFC is attributed	1) any taxpayer with at least 10%, directly or indirectly, of any class of shares of CFC at end of year 2) constructive ownership rules	1) any Australian resident with at least 10% direct or indirect interest in CFC at end of year 2) any Australian resident with at least 1% interest in CFC at end of year who is a member of the group that actually controls (*de facto* or *de jure*) the CFC 3) constructive ownership rules	1) any corporation with at least 10% of shares or an investment of FFr 150 million, directly or indirectly, of CFC at end of year 2) constructive ownership rules	1) any German resident shareholder (including certain emigrants treated as residents for 10-year period following emigration) at end of year 2) no minimum ownership or constructive ownership rules	1) any U.S. taxpayer with at least 10% voting power of CFC, directly or indirectly, at any time in the year and who owns shares directly or indirectly in the CFC at the end of the year 2) constructive ownership rules
Exemptions: 1. Distribution	N/A	N/A	N/A	Dividends paid by CFC in a year reduce that year's attributed income	Repealed in 1975

TABLE 2 (cont'd)
Summary of CFC Legislation

	Canada	Australia	France	Germany	United States
2. Industrial and commercial activity	1) income from the sale of property not attributed if: a) the property sold is created in CFC's country of residence; or b) more than 90% of gross revenue is derived from sales to arm's length persons 2) income from insurance of Canadian risks not attributed if more than 90% of CFC's gross premium income is derived from the insurance of non-Canadian risks of arm's length persons	No attribution if 1) CFC has permanent establishment in country 2) tainted income (passive income and base company income) is less than 5% of total gross income; if CFC is resident in listed country, only income from designated concessions is taken into account in applying 5% test 3) accounts kept in accordance with commercially accepted accounting standards	No attribution if CFC does not have the effect of localizing profits in a tax haven; test deemed to be satisfied if more than 50% of revenue comes from local manufacturing, sales, commercial service activities or local purchases of goods	N/A, but only passive income and certain base company income attributed – special rules for companies that directly hold at least 25% interest in subsidiary companies and subsidiary is involved in exempt activities	N/A, but most income arising in normal operation of business not treated as attributed income
	3) income from debt and lease obligations not attributed if more than 90% of such income is derived from arm's length non-residents 4) income from "investment business" is exempt if more than 5 full-time employees, the business is not conducted principally with non-arm's length persons, and the affiliate is engaged in certain activities				

TABLE 2 (cont'd)
Summary of CFC Legislation

	Canada	Australia	France	Germany	United States
3. Motive	N/A	N/A	N/A	N/A	An exemption for income earned with "no tax avoidance motive" was replaced in 1986 with an exemption for insurance or base company income (other than foreign oil-related income) that have borne an effective foreign tax rate of at least 90 percent of the top U.S. rate. In applying this high-tax exemption, certain groupings of income items of the same CFC are required
4. Publicly traded CFC	N/A	N/A	N/A	N/A	N/A
5. *De minimis*	$5,000	For CFCs resident in listed countries if gross tainted income does not exceed lesser of $50,000 and 5% of gross income	None	The lesser of 10% of gross income and DM 120,000	Gross base company income and insurance income of CFC are not taxable under Subpart F if less than 5% of gross income subject to $1 million ceiling
Relief provisions 1. Foreign taxes	Foreign taxes are grossed up and deducted against attributed income (functionally equivalent to foreign tax credit)	1) Australian companies holding at least 10% of CFC (non-portfolio investor) entitled to tax credit for foreign taxes paid 2) portfolio investors entitled to deduct foreign taxes paid in determining amount attributed	Credit allowed against French corporation tax for foreign taxes paid	Foreign taxes deductible or creditable at taxpayer's option; if credit, attributed income must be grossed up by foreign taxes	1) for U.S. corporations (or individuals electing to be taxed as corporation), indirect foreign-tax credit allowable in respect of foreign taxes paid by first-, second-, and third-tier subsidiaries; if credit allowed, attributed income must be grossed up by creditable foreign taxes 2) for persons taxed as individuals, no credit allowable, but amount of foreign taxes is not included in income

TABLE 2 (cont'd)
Summary of CFC Legislation

	Canada	Australia	France	Germany	United States
2. Losses	1) foreign accrual property income (FAPI) is net of FAPI losses and certain other losses (including capital losses from passive income) but not active business losses 2) carry-over of FAPI losses for 5 years 3) no consolidation of profits and losses of all foreign affiliates but limited relief by way of foreign accrual tax	1) CFC's losses carried forward indefinitely 2) losses quarantined in 4 categories 3) no consolidation	1) CFC's losses carried forward for 5 years 2) no consolidation unless French corporation uses consolidation generally (in which case CFC regime not applicable)	1) CFC's losses carried forward for 5 years 2) no consolidation, although losses of second- or lower-tier CFCs may offset tainted income of the first-tier CFC or other second- or lower-tier CFCs in the same multi-tier CFC group	1) CFC's current losses (and, to very limited extent, deficits in accumulated profits) reduce its earnings and profits; losses carried forward indefinitely; losses subsequently recaptured by treating later income as particular category of Subpart F income 2) no consolidation, but very limited netting of earnings and profits of related CFCs in same activity
3. Subsequent dividends	Deductible	Not taxable	Deductible	German tax on previously taxed attributed income refunded if dividend paid in following 4 years	Excluded from income
4. Subsequent capital gains (on sale of shares of CFC)	Relief by way of adjustments to cost base of shares	Proceeds of disposal reduced by previously attributed income	No relief	German tax on previously taxed attributed income refunded if shares sold in following 4 years	Relief by way of adjustments to cost base of shares
5. Income taxed under another country's CFC measures	No relief	Attributed income reduced by such income	No relief, but legislation suggests relief may be available under mutual agreement procedure in relevant tax treaty	Any tax so levied treated as paid by CFC, and therefore creditable against German tax	No relief

TABLE 3
SUMMARY OF FIF LEGISLATION[1]

	Canada	Australia	Germany[2]	United States
Definition of a FIF	Any foreign entity	Any foreign company or trust and certain foreign life insurance policies	A foreign corporation, subject to an effective rate of foreign tax of less than 30%, and more than 50% of whose income is passive	Any foreign corporation if 75% or more of income is passive or if value of passive assets represents 50% or more of total assets
Definition of an interest in a FIF	Any share or debt of any FIF that derives its value primarily from portfolio investments	Any equity interest in a FIF or in a foreign life insurance policy; also indirect interests held through a CFC	Any shareholding of 10% or more in a FIF	Any shares in a FIF even if it ceases to be a FIF subsequently
Exemptions	1) Exempt if none of the main reasons for acquiring an interest in the entity was to avoid tax 2) Exempt if entity is a CFC of the investor 3) Prescribed entities (none so prescribed) 4) Interests acquired from a nonresident by bequest or inheritance	Interests are exempt if: 1) FIF engaged principally in eligible activities; eligible activities do not include banking (unless a widely held publicly traded company), financial intermediation services, life insurance (unless authorized life insurance company and more than 50% of assets used in that business), general insurance (unless a widely held publicly traded company), activities in connection with real estate (unless a widely held publicly traded company engaged in real estate development or commercial sales or leasing) and management of funds 2) FIF is a trust for investing in listed countries that prohibit direct investment 3) Holder is a temporary visitor 4) FIF is a foreign employer-sponsored pension plan	Only passive income of the FIF is attributed. Income not considered passive if: 1) generated in an active business as defined in the CFC rules. Active businesses include agriculture and forestry, manufacturing, mining, trading and certain banking and insurance activities (if FIF is a widely held public company) 2) dividends received from a 25% subsidiary resident in the same country whose gross income is almost exclusively derived from an active business 3) income derived from arm's length fees for services	Exemptions for electing foreign investment companies that distribute virtually all of their income currently

TABLE 3 (cont'd)
Summary of FIF Legislation

	Canada	Australia	Germany	United States
Exemptions (cont'd)		5) CFC or foreign trust provisions apply 6) non-exempt FIF interests are 5% or less of all FIF interests 7) interest is inventory valued at market		
Domestic taxpayers covered	All taxpayers with direct or indirect interests	All taxpayers with direct interests in FIF	German shareholders holding 10% or more of the FIF	All taxpayers owning shares in FIF directly or indirectly
Method of taxation	Income imputed at prescribed rate	1) Annual increase or decrease in market value plus distributions 2) If taxpayer has necessary information, *pro rata* share of FIF's income on simplified Australian rules 3) If no market value and no information, imputed income at specified rate	Undistributed passive income of the FIF is taxed to domestic taxpayers as a dividend; where passive income of the FIF is derived from financing foreign permanent establishments or related corporations engaged in an active business, only 60% of such income is attributed. Taxpayers cannot benefit from any treaty provision exempting dividends from tax in Germany	Tax on distributions and realized gains as ordinary income with interest to eliminate deferral benefit. For certain funds (QEFs) (generally those that provide necessary information), investor may elect to pay tax currently on share of FIF's undistributed income and capital gains
Relief provisions: 1. *De minimis* rule	No	If value of FIF interest at end of year does not exceed $50,000	The lesser of 10% of gross income and DM 120,000	No
2. Foreign taxes	No relief except for foreign withholding taxes on distributions	Effectively deductible; indirect foreign tax credit for Australian companies with 10% or greater interest; credit for foreign withholding taxes on distribution	Deductible or creditable at shareholder's option; if credit, attributed income must be grossed up by foreign taxes	Indirect foreign tax credit for U.S. corporations with 10% or more of the shares of a FIF. Direct foreign tax credit for distributions or gains in respect of FIF that is QEF
3. Subsequent dividends	No relief; current distributions reduce imputed income	Not taxable to extent of previously taxed FIF income	German tax on previously attributed income refunded if dividend paid in following 4 years	Distributions out of previously taxed income of QEF exempt
4. Subsequent capital gain	No	Not taxable to extent of previously taxed FIF income	German tax on previously attributed income refunded if shares sold in following 4 years	Previously taxed income of QEF added to cost

TABLE 3 (cont'd)
Summary of FIF Legislation

	Canada	Australia	Germany	United States
5. Losses	No	FIF loss deductible against holder's income to extent of cumulative FIF income; any excess may be carried forward indefinitely; group relief in accordance with ordinary rules	May be carried forward 5 years	Loss of QEF is not attributed to U.S. shareholders; capital losses of QEF allowed against capital gains and indefinite carry-forward; other losses allowed against other income and indefinite carry-forward
6. Other				Election to defer payment of tax in respect of QEF

[1] France has no FIF legislation.

[2] The German rules summarized in this table relate to the PFIC regime introduced in 1992 to supplement the German CFC regime. Germany also has rules applicable to foreign mutual funds, whereby taxpayers having an interest in such funds are taxed both on distributions from the foreign fund as well as the fund's undistributed passive income. These rules are summarized in section 5.3.3.2 of this report.

Technical Committee on Business Taxation

The Technical Committee was established by the Minister of Finance, at the time of the March 1996 federal budget, to consider ways of:

- improving the business tax system to promote job creation and economic growth,
- simplifying the taxation of businesses to facilitate compliance and administration, and
- enhancing fairness to ensure that all businesses share the cost of providing government services.

The Technical Committee will report before the end of 1997; consultations with the public will follow the release of the report.

The Technical Committee is composed of a panel with legal, accounting and economic expertise in the tax field. The members are:

Mr. Robert Brown
Price Waterhouse
Toronto, Ontario

Mr. James Cowan
Stewart McKelvey Stirling Scales
Halifax, Nova Scotia

Mr. Wilfrid Lefebvre
Ogilvy Renault
Montreal, Quebec

Professor Nancy Olewiler
Department of Economics
Simon Fraser University
Burnaby, British Columbia

Mr. Stephen Richardson
Tory, Tory, Deslauriers & Binnington
Toronto, Ontario

Professor Bev Dahlby
Department of Economics
University of Alberta
Edmonton, Alberta

Mr. Allan Lanthier
Ernst & Young
Montreal, Quebec

Professor Jack Mintz (Chair)
Faculty of Management,
University of Toronto (on leave)
Clifford Clark Visiting Economist
Department of Finance
Ottawa, Ontario

Mr. Norm Promislow
Buchwald Asper Gallagher Henteleff
Winnipeg, Manitoba

The Technical Committee has commissioned a number of studies from outside experts to provide analysis of many of the issues being considered as part of its mandate. These studies are being released as working papers to make the analysis available for information and comment. The papers have received only limited evaluation; views expressed are those of the authors and do not necessarily reflect the views of the Technical Committee.

A list of completed research studies follows. They may be requested from:

Distribution Centre
Department of Finance
300 Laurier Avenue West
Ottawa Ontario K1A 0G5
Telephone: (613) 995-2855
Facsimile: (613) 996-0518

They are also available on the Internet at http://www.fin.gc.ca/

Technical Committee on Business Taxation
Completed Research Studies

☑ **WORKING PAPER 96-1**
Comparison and Assessment of the Tax Treatment of Foreign-Source Income in Canada, Australia, France, Germany and the United States
Brian Arnold (Goodman Phillips & Vineberg)
Jinyan Li and *David Sandler* (University of Western Ontario)

☐ **WORKING PAPER 96-2**
Why Tax Corporations
Richard Bird (University of Toronto)

☐ **WORKING PAPER 96-3**
Tax Policy and Job Creation: Specific Employment Incentive Programs
Ben Cherniavsky (Technical Committee Research Analyst)

☐ **WORKING PAPER 96-4**
The Effects of Taxation on U.S. Multinationals and Their Canadian Affiliates
Jason Cummins (New York University)

☐ **WORKING PAPER 96-5**
The Integration of Corporate and Personal Taxes in Europe: The Role of Minimum Taxes on Dividend Payments
Michael Devereux (Keele University)

☐ **WORKING PAPER 96-6**
International Implications of U.S. Business Tax Reform
Andrew Lyon (University of Maryland)

☐ **WORKING PAPER 96-7**
The Economic Effects of Dividend Taxation
Ken McKenzie (University of Calgary)
Aileen Thompson (Carleton University)

☐ **WORKING PAPER 96-8**
Capital Tax Issues
Peter McQuillan and *Cal Cochrane* (KPMG Toronto)

☐ **WORKING PAPER 96-9**
Compliance Issues: Small Business and the Corporate Income Tax System
Robert Plamondon (Ottawa)

☐ **WORKING PAPER 96-10**
Study on Transfer Pricing
Robert Turner (Ernst & Young, Toronto)

☐ **WORKING PAPER 96-11**
The Interaction of Federal and Provincial Taxes on Businesses
Marianne Vigneault (Bishop's University)
Robin Boadway (Queen's University)

☐ **WORKING PAPER 96-12**
Taxation of Inbound Investment
Gordon Williamson (Arthur Andersen, Toronto)