SILESIAN UNIVERSITY
SCHOOL OF BUSINESS ADMINISTRATION IN KARVINA

INTERNATIONAL TAX PLANNING

Ing. Šárka Sobotovičová, Ph.D.
INTERNATIONAL TAXATION AND TAX SYSTEMS/NPMZD

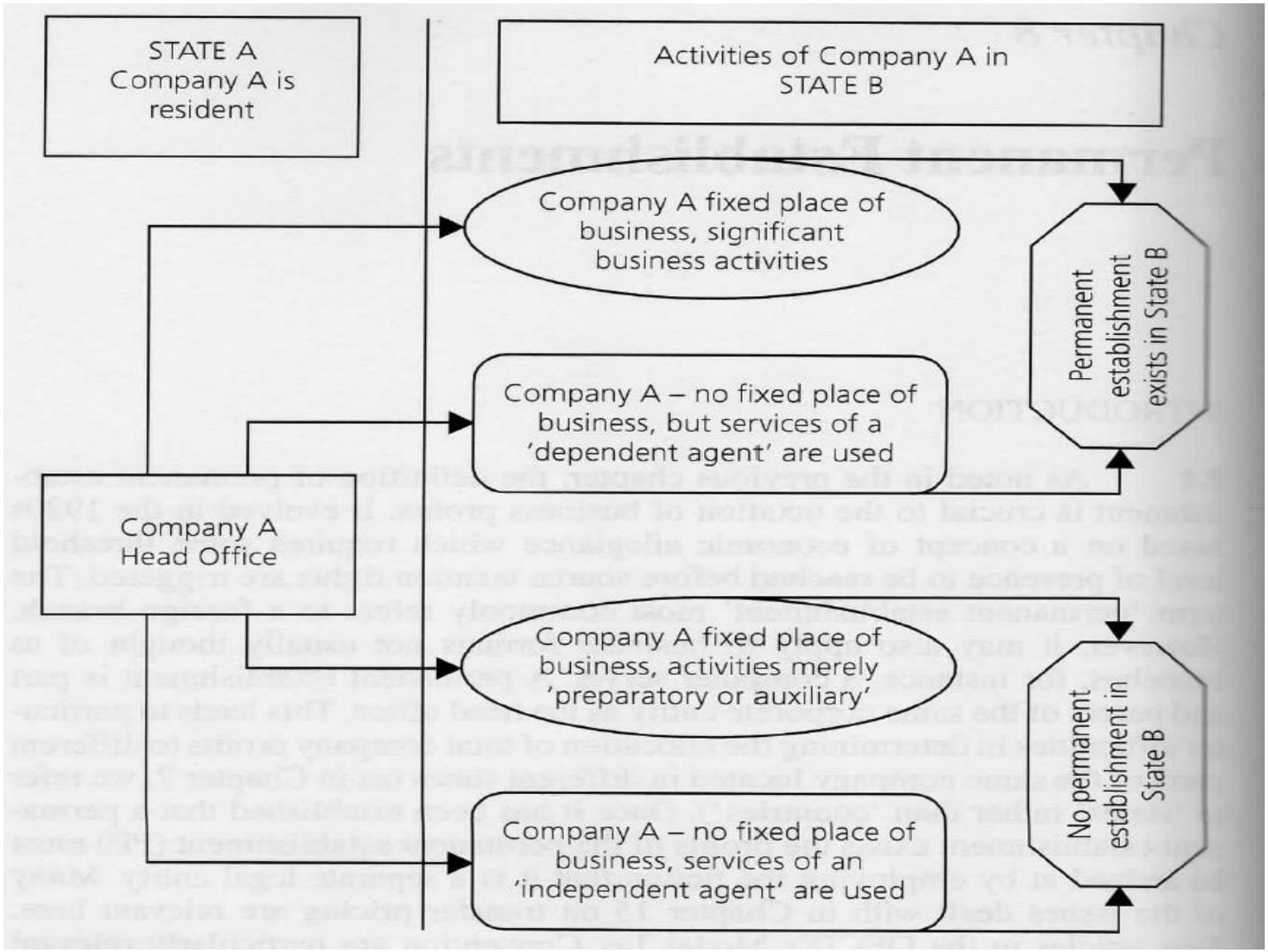
OUTLINE OF THE LECTURE

1. PERMANENT ESTABLISHMENT
2. TAXATION OF CROSS-BORDER SERVICES
3. OVERSEAS EXPANSION - STRUCTURING
4. TRANSFER PRICING
5. TAX HAVENS

PERMANENT ESTABLISHMENT

- It evolved in the 1920s based on a concept of economic allegiance which requires some threshold level of presence to be reached before source taxation rights are triggered. The term most commonly refers to a foreign branch. A permanent establishment is a part and parcel of the same corporate entity as the head office.
- The concept of a PE is very important for the taxation by the host state of the business profits of non-residents. The concept of a PE and the taxation of business profits is set in Articles 5 and 7 OECD Model Tax Convention.
- The term “permanent establishment” will normally be defined in a state’s domestic law and the domestic law definition will be used in cases where there is now double tax treaty with the state of residence of the foreign entity.

PERMANENT ESTABLISHMENT



PERMANENT ESTABLISHMENT OECD MODEL

- The term PE means a **fixed place** of business through which the business of an enterprise is wholly or partly carried on.
- A PE as defined in Article 5 broadly includes a:
  - Place of management
  - Branch
  - Office
  - Factory
  - Workshop
  - Mine, oil well, gas well, etc.
  - Buildings and construction sites lasting more than 12 months.

- The term PE means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

FIXED PLACE OF BUSINESS

- There are three basic requirements for a fixed place of business to exist:
  - There must be a place of business: premises, or possibly machinery or equipment
  - This place of business must be fixed: established at a distinct place, with a certain degree of permanence
  - The business of the enterprise must be wholly or partly carried on there: the business of the enterprise must be conducted from this place by persons who are dependent on the enterprise: generally this means personnel.

PERMANENT ESTABLISHMENT UN MODEL

- The main differences:
  - A building site, construction or installation project need only exist for 6 months.
  - The list of activities which will not give rise to a PE is restricted in that delivery activities are omitted.
  - There is a provision for a services PE in the text of the UN Model.

- The UN Model also deems a permanent establishment to exist where the non-resident provides services in the other state, even without a fixed place of business.

TAX IN THE STATE WHERE THE PE IS LOCATED

- If a company resident in State A has a PE located in State B then State B is entitled to tax the profits attributable to the PE. This doesn't mean that State B can tax all of the profits of the company that arise from business which it carries on in State B but rather only so much as it attributable to the PE.
- In 2008 the OECD published final report setting out how profits of an enterprise are to be attributed to a PE and thus taxable by the host state.
- The PE must be viewed as a functionally separate entity. As a single legal entity cannot trade with itself, this is the fiction (Article 7 gives guidance).
- The profits of PE could be distinguish:
  - from dealing between PE and an independent third parties
  - from dealing with other parts of the same enterprise (this will be determined by using rules laid down in the OECD's Transfer Pricing Guidelines).

THE TAXATION OF CROSS-BORDER SERVICES

- The services sector represented 70% of worldwide GDP in 2012.
- The General Agreement on Trade in Services (GATS) was signed in 1995. The GATS lays down a framework within which pair of groups of countries can enter into trade-liberalization arrangements in respect of services. The GATS is important for two main reasons:
  - It provides impetus for trade liberalization in services which should lead to further increases in the international trading of services.
  - It introduces a raft of definitions and reporting conventions covering trade in services and has brought about a vast improvement in the nature and scope of reporting of trade in services within the national accounts in many countries.

THE FOUR GATS MODES OF SUPPLY

Mode	Description	Examples
Mode 1	**Cross-border supply** services flows from the territory of one country into the territory of another country	Telecoms Services supplied by post
Mode 2	**Consumption abroad** the consumer crosses the border to the supplier's state	Tourism Repair of machinery
Mode 3	**Commercial presence** service supplier of one country establishes a territorial presence,	A foreign subsidiary or branch (domestic subsidiaries of foreign insurance companies)
Mode 4	**Movement of natural persons** employees or persons in business on own account	Accountants, doctors or teachers

THREE TYPES OF TREATMENT (GATS)

1. Services income is treated as business profits and thus not taxable by the customer state (the host state), unless the service provider has a PE in the host state. The definition of PE contains no specific references to services, so that the income to be taxable by the host state the service provider would either have to have a fixed place for business in the host state from which the business was wholly or partly carried on, or would have to have a dependent agent in the host state. In any case, the taxation would be computed on the net basis.
2. Services income is treated as business profits but the definition of PE includes the provision of services, without the need for a fixed place of business or a dependent agent. The definition would normally specify that services must be provided for periods totaling at least 183 days in any tax year, although there are many variation on this. Income from the provision of services which does not breach the threshold would not be taxable by the host state. Any taxation would be on the net basis in accordance with the provision of Article 7.

THREE TYPES OF TREATMENT (GATS)

3. Services income is dealt with either as part of the royalties article or in a separate article and withholding tax on the gross amount is permitted up to a maximum specified rate. Again, many variations are found.

- The first category of treatment is usually the most favourable for the services provider and the last is the least favourable.

OVERSEAS EXPANSION - STRUCTURING

- A key issue when deciding how to structure a new foreign venture is whether to set it up as a branch of the parent company, or as a separate subsidiary. These are by no means the only choices – foreign ventures can be structured as partnerships or joint ventures or various types as well. The choice of vehicle is often influenced by the variety of rules found in different countries as to which types of legal entity are recognized there for tax purposes and which are considered transparent.
  - If a partnership arrangement is considered **transparent**, the effect will be that the foreign government will tax the partners (two or more companies) as if they each had separate PE.
  - If a tax authority considers the partnership to be a taxable entity on its own right, ie **opaque**, then it will levy tax on the partnership rather than on the individual partners.

A FOREIGN BRANCH

- A branch is a permanent establishment, which generally confers taxing rights in the country where the branch is located, on the source principle. A branch isn't a separate legal entity, it remains a part of the company which established it.
- This has important consequences for **tax** purposes. If the country of residence of the company that establishes a branch operates a world-wide system and therefore taxes all income of profits of the company whenever earned, the profits of the branch will fall to be taxed as part of the company's overall taxable income in the country of residence. On the other hand, if the residence country operates a territorial system so that the foreign income is generally exempted, then this might also apply to branch profits.
- If a branch makes a **loss**, relief will be given for the loss immediately in the course of aggregating the company's income and profits for the purpose of world-wide residence taxation. This is often consider to be the key advantage of setting up a foreign operation by way of a branch.

A FOREIGN BRANCH

- The transfer of assets to and from a branch will generally not attract any capital taxes in either the home or host jurisdictions (there is no change of legal ownership).
- Remittance of profits from the branch to the head office company will often also no attract tax in the country of source.

- In many countries, there are either prohibitions on the use of branches by foreign corporations or else such branches do not enjoy the full range of investment incentives which are offered to subsidiary companies.

SEPARATE FOREIGN SUBSIDIARY

- Often establishing a subsidiary company may be necessary in order to access tax incentives offered by the host country.
- Losses of a subsidiary will probably not be available for offset against the profits of the parent company for tax purposes. They will be trapped within the subsidiary, although the host country may well provide some mechanism for relieving the losses.
- If the subsidiary is profitable, it will be subject to tax in the host country, but as a general rule those profits will not be subject to tax in the hands of the parent company until such time as they are remitted, either as dividends or some other form of payment such as interest.
- This is because the parent company and the subsidiary are separate legal entities for tax purposes.
- This deferral of parent company tax on the foreign profits provides an advantage compared to a branch operation and if the subsidiary is located in jurisdiction with a lower tax rate, represents a tax saving for the worldwide group of companies.

CORPORATE INVERSIONS

- This is the process by which a multinational group of companies relocates its holding company to another jurisdiction, this is also referred to as migration or re-domiciliation.
- The overall aim is to divert foreign income away from the current holding company location to a lower tax location. Typically, shares in foreign subsidiaries will be transferred into the ownership of the holding company.
- The location chosen for the new holding company will not only be low tax - crucially, it will also lack controlled foreign company rules (Bermuda, Cayman Island have been popular choices, as they don’t tax overseas income). Thus the tax authority in the current holding company location is no longer able to tax the group’s foreign income, except that earned directly by the resident company. The best it can do is to try to impose exit charges on the sale of the shares in foreign subsidiaries to the new holding company.

TRANSFER PRICING

- The term means pricing of business transactions between associated persons. For tax purposes, transfer pricing becomes a problem because of the need to establish the amount of taxable profit for each taxable entity. This will usually be a single company as most country don’t tax groups of companies as a single entity.
- Most tax authorities will have legislation aimed at protecting their tax base from manipulative transfer pricing practices by deeming that intra-group transactions must be accounted for (for tax purpose) at market value using the “arm’s-length principle”. However, establishing open market value is not easy. Governments are anxious to ensure that the profits reported by members of multinational groups reflect a fair commercial level of profit. Transfer pricing disputes between taxpayers and tax authorities common and usually settled by negotiation rather than litigation.

TRANSFER PRICING – THE ROLE OF THE OECD

- In 1979, the OECD issued a landmark report Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations".
- The OECD firmly rejected global methods of profit allocation or the use of predetermined formulae to allocate the profits of multinationals between the various host countries in which they operate.
- In 1994 the OECD Guidelines were reissued. New chapters were added dealing with transfer pricing of intangibles and cost-sharing agreements. A further revised set of Guidelines was issued in 2010 with some substantial modifications.
- The OECD has historically recommended the use of transactions-based methods, rather than any method of allocating the profits of multinational groups to different countries.

THE METHODS RECOMENDED BY THE OECD

- Comparable uncontrolled price,
- Resale price minus,
- Cost plus,
- Profit split,
- Transactional net margin method.

- All these methods are based on establishing an arm's-length price for a transaction. The inherent problem with this requirement is that internal prices within companies and within groups of companies are invariable different to those which would be charged between indepenent enterprises.

TAX HAVENS

- Characteristic of tax haven:
  - Low or nil tax on some or all types of income and capital.
  - Secrecy: banking and commercial. This provides opportunities not only for tax avoidance but for tax evasion.
  - Absence of exchange controls.
  - Provision of offshore banking facilities.
  - Good communication facilities.
  - Political stability. (Offshore investors in Panama had a nasty shock in 1988 where there was a crisis involving the president being indicted of narcotics offences.)
  - Opportunity for multilateral tax planning.
  - Favorable disposition to foreign capital.
  - Availability of professional advisers.
  - Handy location, decent climate for communications and to attract staff.

OFFSHORE FINANCIAL CENTRES

- The term offshore has a particular meaning in this context and usually means any shifting of funds out of the country of taxpayer residence for tax planning or tax evasion purposes. The distinction between tax haven and an offshore financial centre can be difficult but it is probably true to say that whilst all tax havens are offshore financial centres, not all offshore financial centres are tax havens. For instance London is an important offshore financial centre but it is not tax haven. Offshore financial centres are jurisdictions in which transactions with non-residents far outweigh transactions related to the domestic economy. They have some or all attractions: favourable tax regime, favourable legal environment, and a favourable regulatory system.

THE TYPES OF TAX HAVENS

Base havens

- Base havens are those with no very low taxes on all business income - these are usually colonies or former colonies of onshore jurisdictions.
- These are sometimes referred to as **sham havens**.
- More often base havens are small islands with a few natural resources and limited labour (most of Caribbean and Pacific tax havens fall into this category).
- These havens do not usually have many double tax treaties so they are unsuitable for intermediate holding companies because of payments to the tax haven would incur high withhold taxes.
- Most base havens are also secrecy havens although some countries with substantive tax systems (Switzerland, Luxembourg) also act to some extent as secrecy haven.

THE TYPES OF TAX HAVENS

Production havens

- Real activity is transferred to the tax haven: things are made there and there is tangible value added.
- Ireland, with it 12.5% corporation tax rate is a good example. Ireland has attracted a great deal of foreign investment in manufacturing through its tax policy.

Treaty havens

- These are countries, such as Netherlands, with very favourable networks of double tax treaties.
- They are particularly suitable for intermediate holding companies.
- The benefits of treaty havens are low withholding taxes on money flowing into and out of the haven, often no tax while it remains there and no withholding tax when it flows back out again.

THE TYPES OF TAX HAVENS

Concession havens

- This term applies to countries offering particular tax incentives or benefits (Swiss branch, Netherlands company).
- These have increased in popularity in recent years and now present a real problem for the major trading nations In their attempts to curb the use of tax havens.
- There are many types of concession haven and in fact the Belgian example might come under a subset of concession havens, would-be head-quarters' havens.
- Thus a country may have a proper tax system but still act as a haven.
- Most countries operate as concession havens to some extent, even the UK and the US.
- However, some countries offer more concessions that others. It may be argued that the Netherlands is a good example of a concession haven.

ANTI-HAVEN LEGISLATION

- The use of tax havens in international tax planning increased considerably in the latter part of the twentieth century and became the focus of government tax policy initiatives. Tax haven abuse can potentially be controlled by a number of means.

- ***Pressure from supranational bodies such as the OECD and EU*** – members can band together to threaten tax havens with economic and trade sanctions.
- ***Use of information-gathering powers*** – against a country's own residents.
- ***Amnesties to persuade residents to "own up" to using tax havens and cease doing so in future*** – this effectively tries to put the tax havens out of business by depriving them of customers.

ANTI-HAVEN LEGISLATION

- ***Exchange controls*** – to prevent residents investing or transferring funds overseas. Controls may prevent direct transfer to havens, but cannot adequately control indirect transfers.
- ***Transfer pricing rules*** – can be used to limit tax haven abuse, however they only apply to non-arm's-length transactions, and therefore don't cover all types of haven abuse. Transfer pricing rules also do not adequately control address indirect transfers.
- ***Company residence rules*** – it is arguable that tax haven abuse is largely the result of a failure by governments adequately to define company residence for tax purposes. If a definition of residence which looked to the residence of the shareholders where used, some of the problems of tax haven abuse could be overcome.

ANTI-HAVEN LEGISLATION

- ***Controlled foreign companies legislation*** **–** it will be the most effective method of eliminating deferral. The domestic controllers of foreign companies must pay tax currently on their pro rata share of the income of the foreign company. The effect of these rules is to bring forward the timing of the liability for domestic tax from the time of distribution of the foreign company's profits to its shareholders to the time at which it is derived by the foreign company.