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# INTERNATIONAL TAXATION

## Study Countries That Exempt Foreign- Source Income Face Compliance Risks and Burdens Similar to Those in the United States



GAO

Accountability \* Integrity \* Reliability



Highlights of [GAO-09-934](#), a report to The Committee on Finance, U.S. Senate

## Why GAO Did This Study

A debate is underway about how the United States should tax foreign-source, corporate income. Currently, the United States allows domestic corporations to defer tax on the earnings of their foreign subsidiaries and also gives credits for foreign taxes paid, while most other developed countries exempt the active earnings of their multinational corporations' foreign subsidiaries from domestic tax. The debate has focused on economic issues with little attention to tax administration. GAO was asked to describe for a group of study countries with exemption systems: (1) the rules for exempting foreign-source income, and (2) the compliance risk and taxpayer compliance burden, such as recordkeeping, of the rules. The study countries, selected to provide a range of exemption systems, are Australia, Canada, France, Germany, and the Netherlands. For these countries GAO reviewed documents; interviewed government officials, academic experts, and business representatives; and compared tax policies, compliance activities and taxpayer reporting requirements.

## What GAO Recommends

Because changing the United States system of taxing foreign-source income is a policy decision, GAO is not making recommendations related to tax reform. GAO does recommend that the Secretary of Treasury annually report, using already available data, the revenue generated by taxing foreign-source corporate income. The Secretary agreed with our recommendation.

[View GAO-09-934](#) or [key components](#). For more information, contact Jim White at (202) 512-9110 or [whitej@gao.gov](mailto:whitej@gao.gov).

## INTERNATIONAL TAXATION

### Study Countries That Exempt Foreign-Source Income Face Compliance Risks and Burdens Similar to Those in the United States

#### What GAO Found

The study countries exempt some corporate income, such as dividends received from foreign subsidiaries, from domestic tax. However, the study countries tax other types of foreign-source income such as royalties.

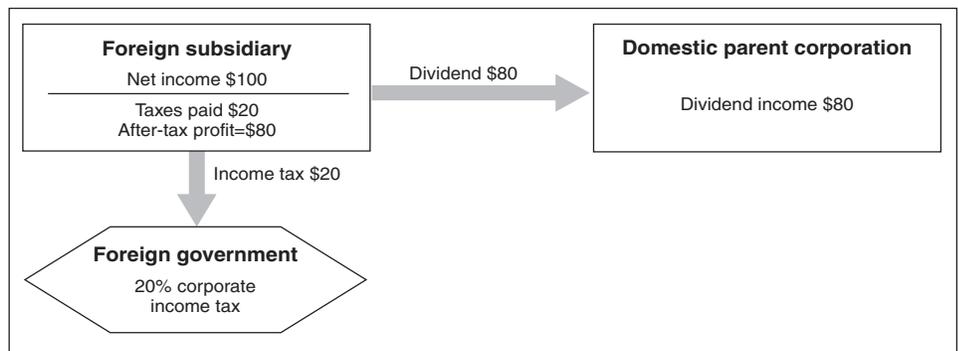
Multinational corporations present a compliance risk because they can use subsidiaries to convert taxable income into tax-exempt or lower taxed income, eroding the domestic tax base. Although quantitative estimates of noncompliance do not exist, tax experts interviewed by GAO identified sources of compliance risk and taxpayer burden in each of the study countries. These issues, particularly the ones below, have also been identified as sources of compliance risk and burden in the United States.

**Transfer prices**—the prices for transactions between related parties—can be manipulated to shift profits. Tax experts in the study countries said the growing importance of intangible property such as trademarks and patents is making international transactions more susceptible to transfer pricing abuse. In response, the study countries have all increased their scrutiny of transfer prices, including increased demands for documentation and more audits, resulting in increased compliance burden for taxpayers. Cooperative efforts between taxpayers and tax agencies to reduce audits, such as Advanced Pricing Agreements, received mixed reviews in the study countries.

**Anti-avoidance rules** prevent taxpayers from moving passive income (interest and royalties are often passive income) to a foreign subsidiary in order to avoid domestic tax. Generally, the rules make such passive income, even if moved, taxable. Tax agencies and taxpayers reported difficulties in obtaining information from other countries to make complex determinations about whether the anti-avoidance rules apply or not.

The United States does not report taxes paid on foreign-source income. Treasury officials said it would be feasible to do so. Such reporting would make more explicit the role international tax rules play in raising revenues and protecting the domestic tax base. All experts we spoke with on this topic agreed.

#### Simple Example of Dividend Exemption



Source: GAO.

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United States Government Accountability Office  
Washington, DC 20548

September 15, 2009

The Honorable Max Baucus  
Chairman  
The Honorable Charles E. Grassley  
Ranking Member  
Committee on Finance  
United States Senate

One hallmark of the global economy is greater mobility of income and economic transactions. As technology advances and globalization continues to eliminate barriers to conducting business across countries, companies routinely earn income in several countries. For example, U.S. corporations reported \$205 billion in foreign-source income for tax year 2003, the latest year currently available.<sup>1</sup> This is about half of the \$425 billion of total worldwide income (foreign plus domestic) earned by U.S. corporations in that year.<sup>2</sup> Often income is not earned directly by a domestic corporation, but rather through wholly or partially owned subsidiaries incorporated in other countries.

Foreign-source income, especially when earned by multinational corporations (MNC), presents challenges for income tax design and administration. These challenges include ensuring tax law compliance, minimizing tax induced distortions of businesses decisions about where to locate investment, avoiding the double taxation of income earned in one country by companies located in another country, and minimizing unnecessary taxpayer compliance burden, such as recordkeeping.

There are two general approaches to taxing foreign-source corporate income. Under both approaches, a corporation pays any tax due in the foreign country where the income is earned. The approaches differ in how the corporation is taxed domestically, that is, in the corporation's home country. One approach—called worldwide taxation—taxes all income earned by a corporation regardless of where the income is derived. Under this approach, double taxation is addressed through foreign tax credits

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<sup>1</sup>These are U.S. corporations that claimed foreign tax credits on IRS tax forms. This may not include all U.S. corporations.

<sup>2</sup>Internal Revenue Service, *Corporate Foreign Tax Credit, 2003*, Statistics of Income Bulletin. Fall 2007.

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(FTC). The FTC is a credit, usually subject to limits, against domestic tax for foreign taxes paid. A corporation would pay domestic tax on foreign-source income only to the extent that the domestic tax on that income exceeds the foreign tax credit.

The other approach—called territorial taxation—only taxes the corporation’s income derived within the taxing country’s borders, irrespective of the residence of the taxpayer. Thus, unlike worldwide taxation, foreign-source income earned by a domestic corporation is exempt from residence-country tax. The exemption generally eliminates the possibility of double taxation.<sup>3</sup>

In practice, large developed countries do not use a pure worldwide or pure territorial approach when taxing foreign-source corporate income. Instead, they use hybrid approaches. Most developed countries, especially after recent policy changes in Japan and the United Kingdom, now lean toward a territorial approach but are not purely territorial—in part, because they place significant limitations on what types of income are eligible for exempt treatment.<sup>4</sup> The United States and a few other countries, on the other hand, lean toward a more worldwide approach but are not purely worldwide—in part, because taxation can be deferred on certain qualifying income until it is actually paid to the domestic corporation by subsidiaries as dividends. Basic features of the U.S. tax system result in the ability of some MNCs to defer domestic taxation until it is actually paid to a domestic part of the MNC.<sup>5</sup>

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<sup>3</sup>Under a worldwide approach, domestic corporations generally face the same total income tax liability regardless of whether an investment is located at home or abroad (assuming the foreign tax rate is the same or lower than the domestic rate), so investment location decisions are not distorted by the tax. However domestic corporations may not necessarily pay the same tax on a foreign investment as a foreign competitor. Under a territorial approach, domestic corporations earning foreign income only pay foreign tax, ensuring that they do not face a greater tax liability on that income than foreign competitors in the same country. However, this means that a domestic corporation could face different tax liabilities for foreign and domestic investments.

<sup>4</sup>See appendix V for additional details on the tax treatment of foreign-source income in Japan and the United Kingdom.

<sup>5</sup>In general, the U.S. tax system does not tax income until it is actually earned. The U.S. also generally imposes its corporate income tax at the corporate entity level. Deferral is a result of these basic features: anti-avoidance rules generally create exceptions to these principles in specific circumstances.

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In the United States, proposals have been developed to reform the taxation of foreign-source income.<sup>6</sup> The proposals differ, with some designed to move the United States toward more territoriality and others intended to maintain a more worldwide approach. An extensive body of literature debates the economic merits of these proposals, including the effects of taxes on competitiveness and the location decisions of firms. While some research shows that taxes change location incentives, the existing research does not reach definitive conclusions about important economic effects such as the impact of foreign investment by U.S. corporations on U.S. employment.

Compared to the extensive examination of economic effects, little has been done to study whether there are important differences between worldwide and territorial systems in terms of tax administration and, more specifically, in terms of compliance by taxpayers and taxpayers' compliance burden (recordkeeping, reporting, and other costs). In the context of foreign-source income, at least two broad compliance issues exist. One is ensuring that domestic corporations pay the tax due on foreign-source income. The other is ensuring corporations do not erode the domestic tax base by illegally shifting domestic income abroad.

Because of the ongoing debate about the taxation of foreign-source income and because of the limited information available on administering a worldwide system versus a territorial system, you asked us to report on other countries' experience administering territorial systems. Based on your request, our objectives are to (1) describe, for select case study countries that take a territorial approach, what types of foreign-source income the countries exempt and the rules governing those exemptions; and (2) describe, to the extent information is available, the compliance risks and taxpayer compliance burdens that the taxation of foreign-source corporate income presents for each of these countries.

To address our objectives, we selected five countries—Australia, Canada, France, Germany, and the Netherlands—to study based on several criteria, including range of rules governing the taxation of foreign-source income, unique tax system features, and Organization of Economic Cooperation and Development (OECD) membership. To provide assurance that all of

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<sup>6</sup>For examples see Department of the Treasury, *Leveling the Playing Field: Curbing Tax Havens and Removing Tax Incentives for Shifting Jobs Overseas* (TG-119) (May 4, 2009); and President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* (Washington, D.C., November 2005).

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the information used in this report is sufficiently reliable, we used data from commonly used and cited sources of statistical data, such as the OECD, and other publicly available reports from international government agencies. Additionally, we performed an in-depth literature review on all of the study countries, including government documents, private sector studies, and academic publications. We collected and analyzed data on the countries and their systems for taxing foreign-source corporate income, including tax policies, administrative mechanisms, compliance activities, and taxpayer reporting and documentation requirements. We interviewed knowledgeable government officials from the study countries, including officials from the tax agencies. We also interviewed U.S. tax agency officials, international tax experts, including academic and private-sector experts, and members of a number of professional services organizations that represent and serve MNCs that have large numbers of foreign subsidiaries under their control. We provided the tax agencies of our study countries a copy of our report to verify data and specific factual and legal statements about the tax treatment of foreign-source income in those countries. We did not conduct a formal legal review of the tax laws and rules in other countries, but relied on the information supplied by tax agency officials in those countries. We made technical corrections to our report based on these reviews. A more detailed discussion of our methodology is in appendix I.

We conducted our work from June 2008 to September 2009 in accordance with all sections of GAO's Quality Assurance Framework that are relevant to our objectives. The framework requires that we plan and perform the engagement to obtain sufficient and appropriate evidence to meet our stated objectives and to discuss any limitations in our work. We believe that the information and data obtained, and the analysis conducted, provide a reasonable basis for any findings and conclusions in this product.

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## Background

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### Multinational Corporations and Foreign-Source Income

Corporate income tax is levied on business entities that organize and operate as corporations, as defined by each individual country's tax rules and laws. Generally, corporations are individual business entities that issue shares and can make distributions to shareholders, such as dividend payments.

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Corporations can be shareholders in other corporations, both domestic and foreign. The amount of control the corporate shareholder has over the other corporation can vary depending on the percentage of shares owned and other factors. At the low range of corporate ownership, portfolio shareholding allows a corporate shareholder to invest in a business but does not involve maintaining a controlling stake in the firm. At greater levels of ownership, corporations can own a sufficient percentage of shares to gain partial or total control of major business decisions, such as the level and timing of dividend distributions and investment and pricing strategies. For this report, we will call the controlling firm a parent corporation and the controlled firm a subsidiary.<sup>7</sup> Parent-subsidiary relationships can be complicated, involving a corporation owning multiple subsidiaries, subsidiaries being controlled by multiple parents, or tiered arrangements with subsidiaries owning subsidiaries of their own. When these relationships involve entities in more than one country, these corporations are referred to as multinational corporations (MNC).

MNCs are groups of separate legal entities, which can include corporations, partnerships, trusts, and other legal entities, that operate and generate income in multiple countries, and different parts of an MNC may have different domestic jurisdictions. MNCs may also have branches—domestic, foreign, or both—as part of a corporation’s internal organizational structure.<sup>8</sup> In general, each corporate entity that is part of the MNC is taxed as an individual taxable entity by the relevant governments, unless the corporation is allowed to and chooses to file a consolidated return.

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## Different Types of Foreign-Source Income

Corporations can earn a variety of different types of income from foreign sources. This income can be generated from transactions with either unrelated parties, such as retail customers located abroad, or related parties, such as foreign subsidiaries or other parts of the same MNC. Corporations can earn foreign-source income from active and passive activities with foreign parties. While countries vary somewhat in their

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<sup>7</sup>There is no standard definition of a subsidiary. For the purposes of our report, we use the term subsidiary loosely to refer to a chain of ownership whereby a parent corporation exercises a degree of control of another corporation. The level of ownership which determines control differs by individual circumstances. We discuss these scenarios later in the report.

<sup>8</sup>In general, branches of U.S. corporations are not regarded as separate legal entities for tax purposes.

definitions of active and passive income, generally speaking, active income is considered to be the income generated through the primary business activities of the corporation. Passive income, in contrast, is income that is not earned through primary business activities. Interest earned, rental income, and royalty payments from foreign sources are generally considered passive income. However, for some companies, such as financial services companies, these types of income may constitute the primary business and be considered active income under the tax laws of some countries. Additionally, corporations can purchase shares of foreign companies and receive dividend distributions based on the earnings of those companies. Table 1 below lists some general examples of different types of income that can be generated from foreign-sources.

**Table 1: Select Examples of Types of Income That Can Be Generated from Foreign Sources<sup>a</sup>**

Type of income	General definition	Example of foreign-source income in a parent-subsidiary relationship
Capital gains	The gain realized from the appreciated value between the purchase and sales price of an asset, such as shares in a corporation. Investments that have not yet been sold, but would yield a profit if they were sold have unrealized capital gains.	A domestic parent sells shares it held in a foreign subsidiary for \$50. The domestic parent had bought the shares for \$20. The realized capital gain is the \$30 difference.
Dividends	A payment distributed by a company to its shareholders. Dividends are usually given out in the form of cash, but can also be given out as stock or other property.	A domestic parent company owns 10,000 shares of a foreign subsidiary. The foreign subsidiary makes a dividend payment of \$1 per share to all shareholders, including \$10,000 to the parent.
Interest	Payments received as compensation for lending money.	A domestic parent makes a 10-year, 5 percent loan for \$1 million to a foreign subsidiary. The subsidiary makes semi-annual interest payments of \$25,000 to the domestic parent.
Rent	Compensation for the use or occupation of property.	A domestic parent owns a factory in a foreign country. A foreign subsidiary makes monthly payments to the domestic parent for occupation and use of the factory.
Royalty	Income generated from licensing the use of property, such as intellectual property.	A foreign subsidiary pays a domestic parent firm for the right to use trademark logos on goods produced and sold.

Source: GAO

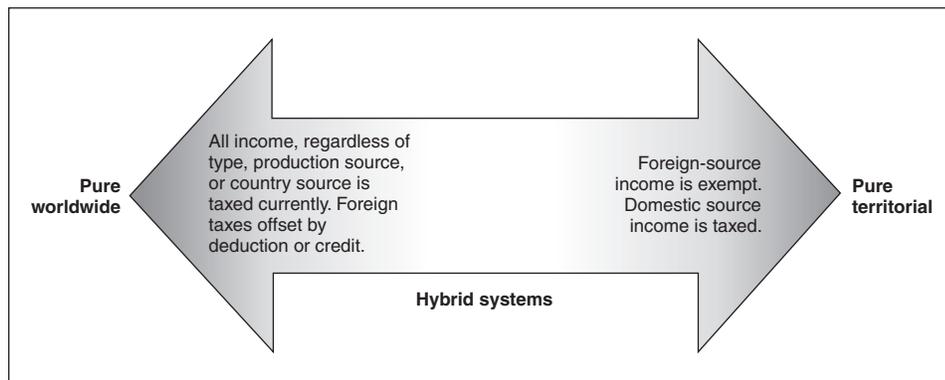
<sup>a</sup>The definitions in this chart reflect how we use these terms for the purposes of this report. Other definitions exist for these terms but are outside the scope of this report.

## Most Countries Take a Hybrid Approach to Taxing Foreign-Source Income

In practice, countries combine elements of worldwide and territorial approaches to taxing foreign-source income. One approach, generally referred to as deferral, deviates from the worldwide model and taxes the domestic corporation on all of its income, including income and dividends received from foreign subsidiaries, but defers taxation until the income is

repatriated. Another approach, generally referred to as dividend exemption, is closer to the territorial model and permits the tax-exempt repatriation of the dividends distributed by foreign subsidiaries, but may limit the extent to which some income is exempt. In either system, foreign-source income is taxed first in the source country; under a deferral system, a residual tax is then imposed only when the income is repatriated. Figure 1 shows a continuum of tax treatments for foreign-source corporate income with hybrid systems ranging between the pure worldwide and territorial models.

**Figure 1: Continuum of Tax Systems of Foreign-Source Corporate Income**

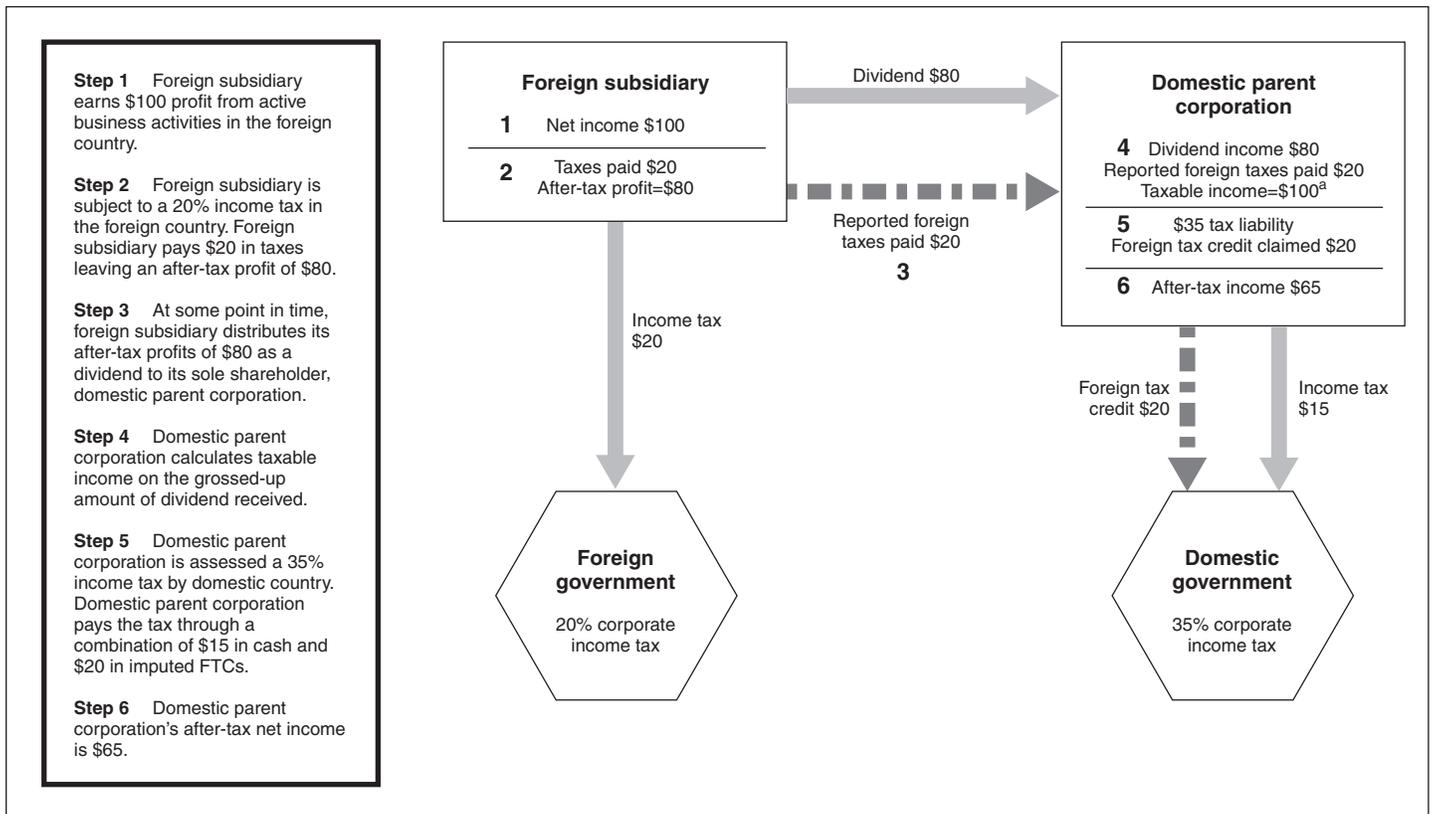


Source: GAO.

**Worldwide System with Deferral**

The current tax system in the United States is an example of a worldwide system with deferral, which taxes domestic corporations on their worldwide income, regardless of where the income is earned and gives credits for foreign income taxes paid. Income unrelated to a U.S. trade or business earned by foreign corporations is not taxed domestically until it is distributed to a domestic shareholder, such as a domestic parent corporation, which allows deferral of taxation on income of foreign subsidiaries. Special rules may exist that tax certain shareholders, such as a parent corporation, currently on the income of certain subsidiaries in order to protect the domestic tax base. To reduce the double taxation of income, corporate taxpayers can offset, in whole or in part, the domestic tax owed on the foreign-source income through a FTC. In certain circumstances, a parent corporation may claim FTCs for foreign taxes paid by a subsidiary. Figure 2 shows how a dividend payment is generally taxed under a worldwide tax approach that permits deferral.

**Figure 2: Simple Example of Deferral**



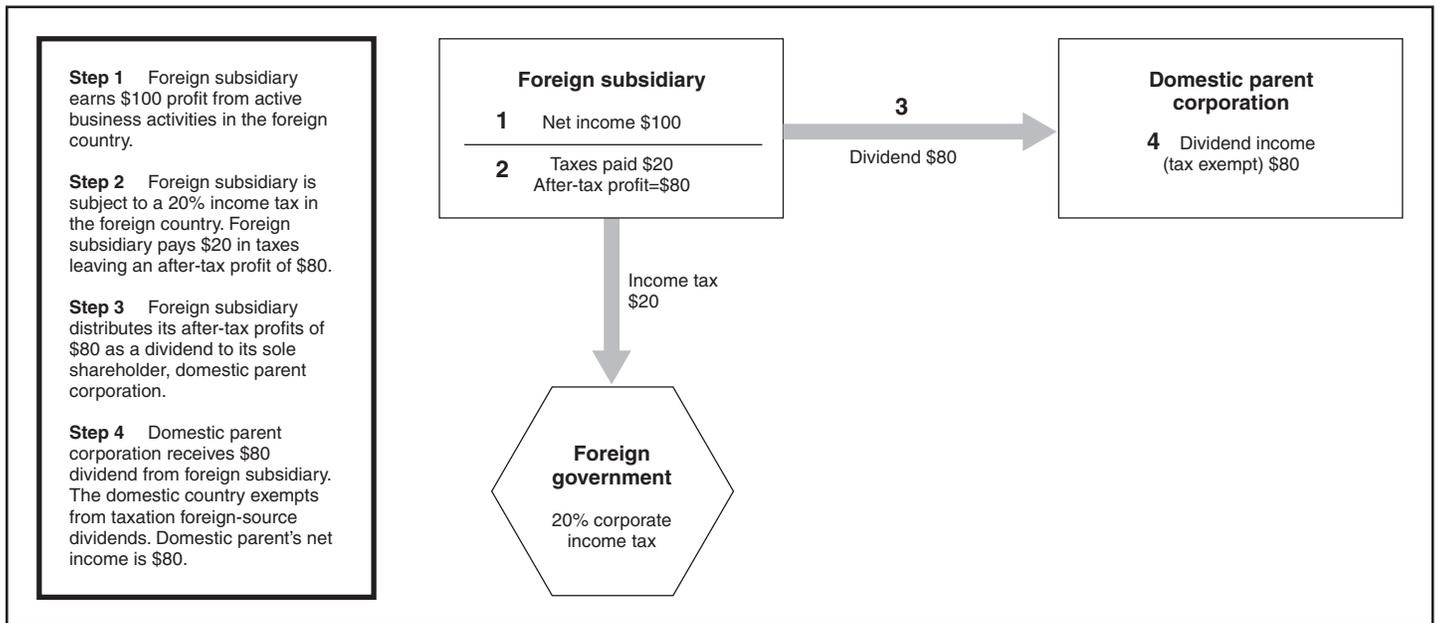
Source: GAO.

<sup>a</sup>Domestic tax liability is based on the grossed-up value of the dividend plus the amount of foreign income tax paid on the associated earnings.

## Exemption Systems

Many OECD countries exempt some types of foreign-source corporate income from domestic tax. Exemptions are commonly granted in these countries for dividends paid by a foreign subsidiary. As shown in figure 3, which is a simplified example of an exemption system, the domestic corporation does not incur a tax liability by receiving the dividend income from its foreign subsidiary. However, similar to the worldwide systems with deferral that were described earlier, exemption systems may disallow the tax advantages of foreign-source income under certain circumstances to protect the domestic tax base.

**Figure 3: Simple Example of Dividend Exemption**



Source: GAO.

## Study Countries Vary in the Types of Foreign-Source Income Exempted from Domestic Tax and in the Rules Governing Those Exemptions

Our study countries—Australia, Canada, France, Germany, and the Netherlands—have hybrid tax systems that exempt some types of foreign-source income and tax others. All of the study countries tax domestic corporations on income earned through rental payments and royalties. Such payments may be made by unrelated parties or by subsidiaries and are generally expenses of the payee in the foreign country but are received as income by the domestic corporation. Subject to an extensive list of exceptions, the study countries generally exempt, but to varying extents, income of domestic corporations received as foreign-source dividends from foreign subsidiaries, sales by foreign branches, and the gains from the sale of shares in foreign subsidiaries. For example, all of the study countries permit domestic corporations to receive dividends that meet certain qualifications as tax-exempt income, but differ in the rules they use in determining which dividends are qualified. In addition, Canada does not allow domestic corporations to earn tax-exempt, foreign-source income through foreign branches and taxes up to half of the capital gains on the

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sale of foreign subsidiary shares while the other study countries generally exempt income from these sources.<sup>9</sup>

In addition to the rules above covering income payments received by domestic corporations, all study countries also have rules that tax domestic corporations on some income at the time it is earned by foreign subsidiaries, regardless of when or if the foreign subsidiary distributes a dividend. These rules, generally referred to as anti-avoidance rules, attribute certain earnings of related foreign entities to domestic corporations in order to limit the tax benefits of holding certain types of income offshore.

Table 2 presents a brief overview of the tax treatment for different types of foreign-source income in our study countries. All rows except the last show the tax treatment of income payments received by a domestic corporation. The last row shows the tax treatment of income at the time it is earned by a foreign subsidiary that is subject to certain anti-avoidance rules regardless of whether the income was distributed as a dividend.

While data was not available for most of our study countries, in Canada, at least 76 percent of foreign-source dividends received by Canadian taxpayers from foreign affiliates from 2000 to 2005 were qualified foreign-source dividends and, therefore, were tax exempt.<sup>10</sup>

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<sup>9</sup>As shown in table 2, France and Germany effectively exempt 95 percent of capital gains from the sale of foreign subsidiary stock from domestic tax.

<sup>10</sup>As measured by the Canadian dollar value of total dividends received from foreign affiliates. Advisory Panel on Canada's System of International Taxation, *Enhancing Canada's International Tax Advantage* (December 2008).

**Table 2: General Domestic Tax Treatment of Different Types of Foreign-Source Income**

	<b>Australia</b>	<b>Canada</b>	<b>France</b>	<b>Germany</b>	<b>Netherlands</b>
<b>Rent, royalty, and interest income paid by</b>	<b>Foreign subsidiaries</b>	Taxable	Taxable	Taxable	Taxable
	<b>Unrelated third parties</b>	Taxable	Taxable	Taxable	Taxable
<b>Nonqualifying foreign-source dividends</b>	Taxable	Taxable	Taxable	Taxable	Taxable
<b>Qualified foreign-source dividends</b>	Exempt	Exempt	Effectively 95% exempt <sup>a</sup>	Effectively 95% exempt <sup>a</sup>	Exempt
<b>Active foreign branch income</b>	Exempt	Taxable with FTC	Exempt	Taxable with FTC under domestic law but generally exempt through tax treaty	Generally exempt
<b>Capital gains from the sale of foreign subsidiary shares</b>	Generally exempt	50% to 100% Exempt	Effectively 95% exempt <sup>a</sup>	Effectively 95% exempt <sup>a</sup>	Exempt
<b>Attributable foreign earnings subject to anti-avoidance rules</b>	Taxable with FTC	Taxable with FTC	Taxable with FTC	Taxable with FTC	Taxable

Source: GAO analysis of country information.

Note: This table shows general treatments. It does not present all of the details, exceptions, or rules that govern the tax treatment of foreign-source income for our study countries.

<sup>a</sup>For France and Germany, the exempt amount of qualified foreign-source gross dividends and capital gains is effectively 95 percent due to rules that tax 5 percent of the income as nondeductible expenses. This is discussed in more detail later in this report.

### Study Countries Use Different Criteria to Qualify Foreign-Source Dividends for Domestic Tax Exemption

Our study countries all have certain criteria that, when met, allow domestic corporations to receive tax-exempt income in the form of dividend payments, called qualified foreign-source dividends in table 2. In each of the countries, all of the criteria must be met for the domestic corporation to receive the foreign-source dividend tax-exempt. If any of the conditions are not met, then the dividend does not qualify for the tax exemption and is, therefore, taxable. Our study countries applied up to three criteria when determining which income is tax-exempt: domestic ownership type and level of foreign subsidiaries; the type of income (active versus passive) distributed as a dividend; and the presence of a tax treaty or similar agreement between the domestic and foreign government where the subsidiary is located and income is earned.

All of our study countries except Germany require the domestic corporation to have a minimum ownership stake in a foreign subsidiary in order to qualify for the benefits of exemption. In general, these minimum ownership level stakes mean that income from portfolio or portfolio-like

investment is not exempt. Each country takes a different approach in determining the type of shares that qualify dividend income for exemption with distinctions made on the type of shares and the length of time the shares are held. For example, while Canada requires domestic corporations to own 10 percent or more of any class of shares in the foreign subsidiary, France requires its corporations to own at least 5 percent of a foreign subsidiary's shares.<sup>11</sup> The requirements for each country are summarized in table 3.

**Table 3: Dividend Qualification Criteria—Required Domestic Ownership Type and Level of Foreign Subsidiary to Qualify for Tax Exemption of Foreign-Source Dividend Income**

	<b>Australia</b>	<b>Canada</b>	<b>France</b>	<b>Germany</b>	<b>Netherlands</b>
<b>Domestic ownership of foreign company</b>	Direct shareholding of at least 10%	Direct ownership of 1% and direct or indirect ownership of at least 10%	At least 5% ownership	None	In principle a shareholding of at least 5%
<b>Foreign company share type</b>	Shares must have a voting interest	Any type	Ownership or participating shares	Any type	Any type
<b>Ownership duration</b>	None	None	2 years	None	None

Source: GAO analysis of country information.

Note: This table shows general treatments. It does not present all of the details, exceptions, or rules that govern the tax treatment of foreign-source income for our study countries.

In addition to the criteria above, Canada also makes a distinction between dividends distributed from active and passive income, while the other study countries do not, as shown in table 4.

<sup>11</sup>To qualify for the tax exemption, the French corporation must hold or intend to hold the shares for 2 years.

**Table 4: Dividend Qualification Criteria—Domestic Tax Treatment of Foreign-source Dividend Income Distributed from Active and Passive Income**

	<b>Australia</b>	<b>Canada</b>	<b>France</b>	<b>Germany</b>	<b>Netherlands</b>
<b>Dividends distributed from active income</b>	Exempt	Exempt	Effectively 95% exempt <sup>a</sup>	Effectively 95% exempt <sup>a</sup>	Exempt
<b>Dividends distributed from passive income</b>	Exempt	Taxable with FTC eligibility <sup>b</sup>	Effectively 95% exempt <sup>a</sup>	Effectively 95% exempt <sup>a</sup>	Exempt

Source: GAO analysis of country information.

Note: This table shows general treatments. It does not present all of the details, exceptions, or rules that govern the tax treatment of foreign-source income for our study countries.

<sup>a</sup>In France and Germany, the gross dividend amount exempt from domestic tax is effectively 95 percent due to rules that tax 5 percent of the gross dividend amount as nondeductible expenses. This is discussed in more detail later in this report.

<sup>b</sup>Income that was previously taxed under anti-avoidance rules may be tax exempt upon repatriation.

Of all our study countries, currently only Canada requires that the foreign subsidiary be located and earn active income in a designated treaty country in order to qualify for the dividend tax exemption that was shown in table 2. For Canada, a designated treaty country is a country with which Canada either has a tax treaty or a tax information exchange agreement (TIEA). As was noted earlier, at least 76 percent of dividends received by Canadian taxpayers from foreign affiliates between 2000 and 2005 were tax exempt.

### Study Countries Limit Tax Advantages of Earning Foreign-Source Income under Certain Conditions

As was shown in the last row of table 2, all study countries have anti-avoidance rules that limit the tax advantages of earning certain types of income abroad. In general, these rules are intended to protect the domestic tax base by preventing taxpayers from avoiding domestic tax on passive or other specific types of income by moving to or holding these types of income in a foreign country. When triggered, these rules require a domestic shareholder to be taxed currently on its pro rata share of certain types of income earned by certain foreign subsidiaries, regardless of when or if that income is distributed to the shareholder.<sup>12</sup> Anti-avoidance rules exist in both worldwide and territorial tax systems, and are in effect in each of our study countries and the United States (commonly known as Subpart F in the United States).

<sup>12</sup>Income taxed under anti-avoidance rules may, in some cases, be distributed to the domestic parent corporation as tax-exempt dividends.

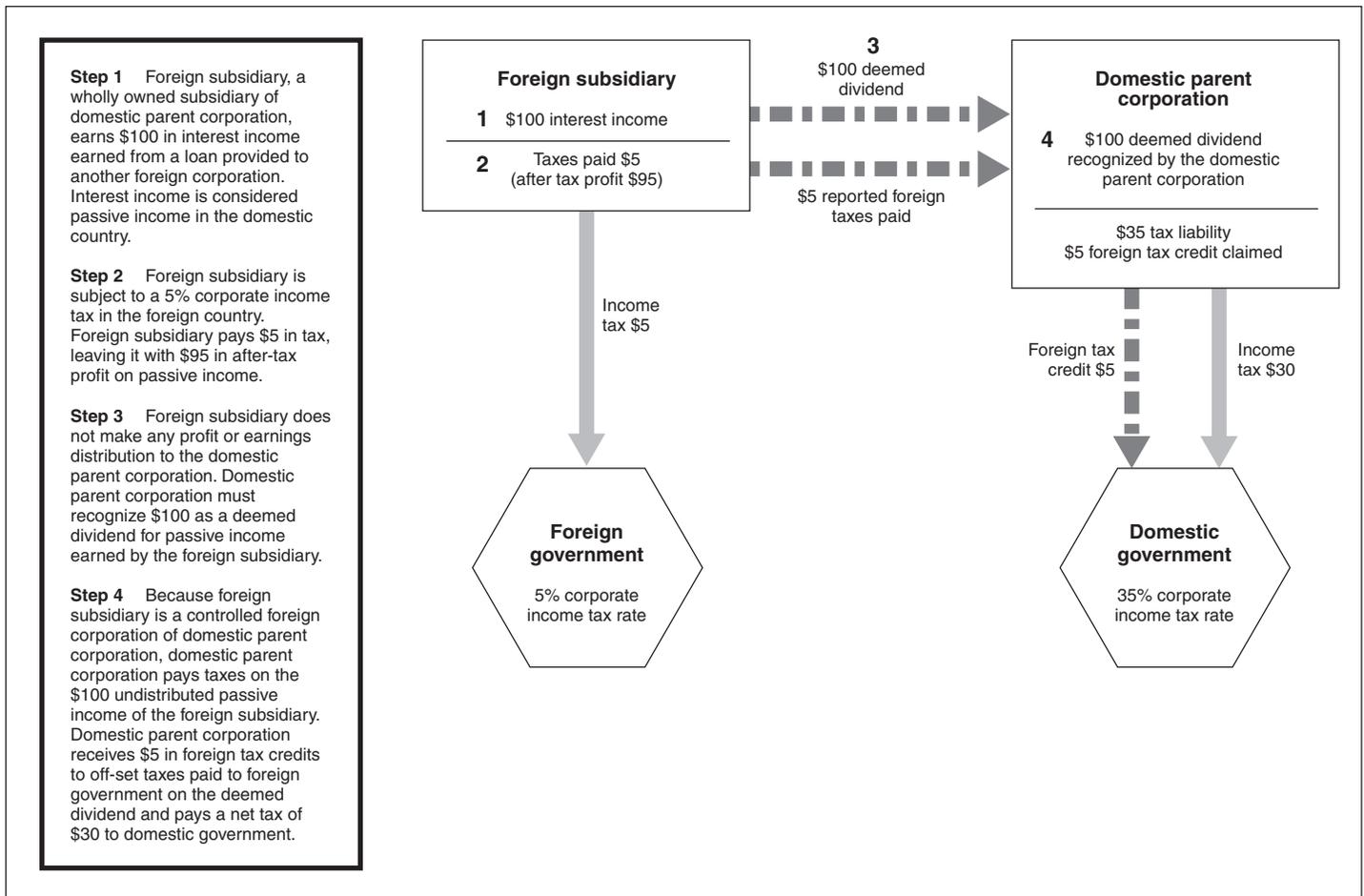
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A prominent anti-avoidance rule used by all study countries except the Netherlands applies to controlled foreign corporations (CFC).<sup>13</sup> Each country's CFC rules vary, but they generally tax domestic shareholders, including shareholding corporations, currently on certain types of income earned by foreign corporations that qualify as controlled by domestic shareholders. This is illustrated in figure 4. This means that the domestic corporation may be taxed on income that it has not received from the foreign corporation (called a deemed dividend in figure 4). This income is taxable when earned by the subsidiary, although CFC rules generally permit the domestic taxpayer to offset some or all of their domestic tax liability through credits on the foreign taxes paid on the income.

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<sup>13</sup>We use the term controlled foreign corporation (CFC) to describe foreign subsidiaries that are controlled by a domestic parent company as defined by each country. Some of our study countries use similar terms, such as controlled foreign company or controlled foreign affiliate, which we include in our use of the term controlled foreign corporation. Although this term has a specific technical meaning in several jurisdictions, including in the United States, we do not use this term in any of its technical senses, but as a generic description of these types of rules in various countries.

**Figure 4: Simple Depiction of CFC Rules**



Source: GAO.

Generally, study countries establish criteria in three areas that, when met, define a domestic shareholder’s tax liability for certain types of income earned by a foreign corporation under the CFC rules. First, countries define when a foreign corporation is controlled by domestic shareholders. For example, Australia defines a controlled foreign corporation as any foreign corporation that meets either of the following definitions: (1) where five or fewer Australian residents effectively control the foreign corporation or own more than 50 percent of the foreign corporation; or (2) where one Australian entity has an individual ownership of 40 percent or more of the foreign corporation not controlled by another corporation.

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Second, countries generally set a minimum level of ownership in the foreign corporation that domestic shareholders must meet before being taxed on the foreign corporation's earnings. For example, under Canada's CFC rules, a Canadian shareholder must own at least 10 percent of the foreign corporation to be taxed on certain types of income earned by the foreign corporation. Third, the controlled foreign corporation generally must earn certain types of income that are specified in each country's CFC rules. For example, Germany requires that a CFC earn passive income that is taxed at an effective rate of 25 percent or less by the foreign country before a domestic corporation is required to pay tax on the CFC's earnings.

Once the criteria above are met, domestic shareholders are taxed currently on certain types of attributed income earned by the CFC. Some countries, like Canada, generally limit the taxable foreign earnings to the domestic corporation's pro rata share of passive income.<sup>14</sup> Other countries, like France, tax domestic corporations on their pro rata share of all earnings by the foreign corporation. Table 5 presents a simplified overview of the CFC rules used by our study countries. Additional details on other types of anti-avoidance rules can be found in appendix IV.

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<sup>14</sup>In Canada, this income taxed currently is known as foreign accrual property income (FAPI). FAPI income includes categories of income that may not meet all definitions of passive income.

**Table 5: General Overview of CFC and Other Anti-avoidance Rules**

	<b>Australia</b>	<b>Canada</b>	<b>France</b>	<b>Germany</b>	<b>Netherlands</b>
<b>Criteria a foreign entity must meet to be considered a CFC</b>	Either: (1) five or fewer Australian residents control or own more than 50% of the foreign entity; or (2) When one Australian resident owns 40% or more of the foreign entity	Five or fewer Canadian residents, including parties that do not deal at arm's length with them, own greater than 50% of the foreign entity	(1) The foreign entity is located in a country with an effective tax rate that is 50% or less than that of France; (2) French residents own 50% or more; (3) Intragroup income is greater than 20%, or passive income and intra-group services income is greater than 50%	(1) German residents own 50% or more; (2) The foreign entity earns passive income; (3) Passive income is taxed at an effective rate less than 25%	N/A
<b>Domestic shareholder ownership level necessary</b>	10% or greater	10% or greater	Directly or indirectly hold 50% or greater	Any level of ownership	N/A
<b>Foreign earnings subject to current taxation</b>	Pro-rata share of passive earnings in most countries	Pro-rata share of passive earnings	Pro-rata share of all earnings	Pro-rata share of passive earnings	N/A
<b>Additional features of CFC rules</b>	CFCs resident in "listed" countries—those with similar tax systems to Australia— have fewer types of income that may be attributed to domestic corporations		CFC rules do not apply if the foreign subsidiary is located in another EU country and does not exist solely to avoid French taxation	CFC rules do not apply if the foreign subsidiary exists in another EU or European Economic Area country and conducts genuine economic activities	
<b>Additional Anti-avoidance Rules</b>	Foreign investment fund rules	Offshore investment fund rules	Abuse of law doctrine	General anti-avoidance rule	Low-taxed passive shareholding rules

Source: GAO analysis of country information.

Note: This table shows general treatments. It does not present all of the details, exceptions, or rules that govern the tax treatment of foreign-source income for our study countries.

<sup>a</sup>The percentage ownership by the domestic shareholder corresponds to the type of shares that were presented in table 2.

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## Study Countries Face Areas of Compliance Risk and Burden Known to Exist in the United States

Differences in tax rates across countries and differences in the taxation of different types of income may create incentives to avoid tax by shifting income from a high tax jurisdiction to a lower taxed jurisdiction or by converting income from a taxable type to tax-exempt type. Such efforts to reduce taxes may sometimes be legal tax avoidance, but may also be illegal noncompliance.

Tax experts identified four areas as sources of compliance risk or taxpayer compliance burden in our study countries. None of our study countries were able to provide quantitative estimates of the extent of noncompliance with their tax laws governing foreign-source income or the amount of compliance burden placed on taxpayers. Furthermore, an exhaustive list of all sources of compliance risk and burden does not exist. However, four areas that tax experts, including tax agency officials, tax practitioners, and academics identified were:

- transfer pricing,
- anti-avoidance rules,
- foreign tax credits, and
- domestic expense deductions.

These areas are also viewed by the Internal Revenue Service (IRS) or other tax experts as sources of compliance risk or compliance burden in the United States.

While countries establish rules in these four areas to serve a variety of policy goals, including maintaining economic competitiveness and avoiding double taxation, one important consideration is protecting the domestic tax base. One unique tax administration challenge that MNCs present is that they can shift income and assets among related entities in different countries to convert taxable income, either foreign or domestic, to tax-exempt or lower-taxed foreign-source income. The laws and regulations in these four areas are intended, in part, to protect the domestic tax base by preventing MNCs from mispricing transactions, relocating domestic passive income, misusing foreign tax credits, or reallocating expenses in ways that inappropriately reduce domestic taxes. These laws also create compliance burden, often requiring taxpayers to maintain detailed records and conduct complex analyses of international transactions.

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## Transfer Pricing, Particularly for Intangible Property, Is a Major Compliance Risk and Source of Compliance Burden in all of the Study Countries

Many tax agency officials we met with stated that transfer pricing was the most significant compliance risk they face in the area of international taxation. Similarly, many business representatives said complying with transfer pricing rules was often the most burdensome aspect of international taxation. Transfer prices are the prices of goods and services transferred among related entities within an MNC. These prices create compliance risks because MNCs can sometimes deliberately manipulate them to shift income from one related entity to another in order to reduce tax liability. For example, a parent corporation that charges a foreign subsidiary a below-market price for a good or service lowers the parent corporation's taxable income and raises the subsidiary's taxable income. Depending on tax rates and rules governing exemption and deferral, shifting income in this way may reduce an MNC's overall tax liability. An above-market price would shift taxable profits from the subsidiary to the parent.

Because transfer prices can shift taxable income from one country to another, all of our study countries have focused attention on transfer pricing with emphasis on stringent documentation requirements and audits. Generally, the study countries require taxpayers to provide evidence that transfer prices meet an arms-length standard, which means pricing transactions as if they occurred between unrelated parties. Establishing an arms-length price can be difficult when there is no comparable market price, such as for a unique good, service, or intangible property.

Although comprehensive data were not available, several experts, including the OECD, have noted that a significant amount of trade occurs between related parties.<sup>15</sup> Trade in services in the United States, while not a measure of overall U.S. trade, provides an example. According to the U.S. Bureau of Economic Analysis, trade in services between CFCs and related parties increased (in nominal dollars) from approximately \$38.4 billion in 1999 to approximately \$178.7 billion in 2006.<sup>16</sup>

The changing nature of international trade, particularly the growing trade in intangibles, is making international transactions more susceptible to

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<sup>15</sup>OECD Observer, *Transfer Pricing: Keeping it at Arm's Length*, July 3, 2008.

<sup>16</sup>U.S. Bureau of Economic Analysis. *U.S. International Services: Cross-Border Trade 1986-2007, and Services Supplied Through Affiliates, 1986-2006*.

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transfer pricing abuse.<sup>17</sup> Tax experts repeatedly identified intangible property as a particular challenge when attempting to establish a transfer price that meets the arm's length standard. The unique nature of many intangible assets, such as patents, trademarks, copyrights, and brand recognition, means that it is difficult or impossible to identify comparable transactions for transfer pricing purposes. The revenue risk posed by mispricing intangibles can be significant because it can result in a company converting taxable income into tax-exempt or lower taxed income. For example, a parent corporation can license a patented computer technology to a foreign subsidiary and charge a below-market royalty, which is taxed in the domestic country. The subsidiary, which is in a low-tax country, uses the technology to generate a profit. The subsidiary then pays a tax-exempt dividend to the parent corporation. The parent corporation's country loses tax revenues because the tax-exempt dividend received is inflated and the taxable royalty is reduced. Conversely, the subsidiary's country receives additional tax revenues because the subsidiary's income is higher than it should be, as the smaller royalty payment is a deductible expense. In the aggregate, however, the MNC reduces its tax liability because the tax rate in the subsidiary's country is lower than the tax rate in the parent corporation's country.

Because identifying comparable prices for intangibles is often difficult, tax agencies and taxpayers often rely on a profit-split approach. The goal is to determine the percentage of profit attributable to buyers and sellers in different countries. Company officials consistently reported that making these determinations often requires costly special studies done by outside technical experts. In Australia, for example, to help protect against penalties, it is recommended that companies document that they followed a four-step process including selecting and justifying a transfer pricing methodology and then conducting an analysis based on that methodology to determine an arm's-length price. Appendix II provides details on the transfer pricing documentation and filing requirements for all of our study countries. One company official further said that even after making these investments, tax authorities may disagree with the results because of differences in opinion about the assumptions that had to be made. A

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<sup>17</sup>This is a significant issue for tax authorities because of the growing significance intangibles play in the global economy. Although there is currently no complete measure of the amount of income generated globally, or even in the United States, from investment in intangible assets, one indicator is the amount of income generated through royalty payments. According to Treasury tax files, royalties paid by the top 7500 CFCs of U.S. parent corporations increased 68 percent (\$22.4 to \$37.6 billion) from 1996 to 2002.

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number complained about transfer pricing reviews turning into disputes between countries over the distribution of tax liabilities. This can occur because, in many transfer pricing disputes, there are at least three interested parties, the taxpayers and two tax agencies. When a taxpayer reaches an agreement with one government on a price it can result in a lower tax payment for the other government.

On the other hand, tax agency officials repeatedly told us that they needed detailed information on the pricing methodologies used in order to verify that companies' prices satisfy the arm's-length standard. Tax agency officials said documentation of the data used and analysis conducted are critical to conducting independent determinations of the appropriateness of transfer prices. As one example of the importance tax agencies place on this documentation, the Australian Tax Office (ATO) has a system for rating the documentation quality. Under this system, poorly documented transfer pricing decisions are more systematically identified, allowing better targeting of audits.

Transfer pricing abuse is also known to be a significant problem in the United States. For example, IRS lists transfer pricing abuse as a high-risk compliance area because of the large number of taxpayers and significant dollar risk.

While there is agreement that transfer pricing is a major compliance risk in both our study countries and the United States, there is no consensus among the tax experts we met with about whether the compliance risks are greater in our study countries' exemption systems or in the United States' deferral system. Some argued that the tax benefits for an MNC from manipulating transfer prices are potentially larger under an exemption system than a deferral system. They argue that gains from transfer pricing abuse are larger if income can be made tax-exempt rather than tax-deferred. However, other experts pointed out that transfer pricing abuse is already a significant problem in the United States. Some of these experts noted that the incentives to avoid or evade tax under a deferral system can be quite large because tax can be deferred indefinitely. One of these experts also pointed out that there is no empirical evidence supporting the claim that countries with exemption systems face greater noncompliance with transfer pricing rules.

### Study Countries Have Placed Greater Emphasis on Enforcing Transfer Pricing Rules

According to tax agency officials and outside tax experts, all study countries are placing greater emphasis on transfer pricing when auditing MNCs. For example, a tax practitioner in France said that the overwhelming majority of the audit issues he faces are transfer-pricing

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All Study Countries Use  
Advanced Pricing Agreements  
to Address Compliance Risks

related. Another tax practitioner made the same observation about Germany, saying that there is a general perception that the burden for complying with transfer pricing has increased in recent years. These and other company representatives we spoke with said that time spent determining and documenting transfer prices in accordance with country requirements is a primary source of burden. These findings are echoed in the research of others. For example, according to a survey of 850 MNCs, 65 percent of respondents believe that transfer pricing documentation is more important now than it was 2 years ago.<sup>18</sup> Similarly, two-thirds of those respondents said they increased their resources on transfer pricing experts and studies in the last 3 years.

All of the study countries have developed advanced pricing agreement (APA) programs that allow taxpayers and tax agencies to resolve transfer pricing issues before tax returns are filed and without the need for time consuming and expensive audits. Tax experts' opinions on APA participation varied, but often these experts did not consider them an efficient use of resources for addressing transfer pricing issues. Due to the time and resources required to obtain an APA, some taxpayers only pursue them for high-value transactions. Guidance provided by the Australian Tax Office illustrates the time and extensive documentation that can be required for an APA. The document, included in appendix III, lists requirements such as numerous meetings with agency officials, details of the transfer pricing methodology, and data supporting that methodology. The amount of time needed to complete an APA can be greater when it involves multiple countries. According to statistics from some of our study countries, APAs may take a year, or multiple years, to finalize. Between 1992 and the end of 2007, Canada finalized 153 APAs.

Some tax practitioners said that the decision to use APAs can also depend on the perceived risk that a transaction is likely to be subject to audit. Some taxpayers determine that APAs are less burdensome than going through an audit.

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<sup>18</sup>Ernst & Young, *Global Transfer Pricing Survey 2007-2008*. We did not validate the information reported in this study.

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## Complying with and Enforcing Anti-avoidance Rules, both CFC and Other Rules, Presents Challenges in All of Our Study Countries

According to taxpayers and tax officials we spoke with from the study countries, rules limiting the tax advantages of earning certain types of income offshore can serve as a source of taxpayer compliance burden and can be subject to compliance risk. As shown earlier in table 5, all of our study countries with the exception of the Netherlands use CFC rules as a primary method to limit the exemption or tax-deferral of certain income held offshore.<sup>19</sup> In addition, all of our study countries, including the Netherlands, have additional anti-avoidance rules that may apply and disallow tax advantages on specific types of income earned offshore. See appendix IV for details of other anti-avoidance rules in our study countries and in the United States. The study countries were not able to provide us with statistics on the number of subsidiaries subject to these anti-avoidance rules, the amount of income earned by them, or the residual tax revenue they generated.<sup>20</sup> Government officials we spoke with in several countries estimated the revenue generated from these rules to be low. However, some tax experts we spoke with stated that these rules played an important role in preventing MNCs from avoiding domestic taxes by earning income through CFCs.

When CFC rules are triggered, it can result in an increase in the MNC's tax liability. As a result, some of the tax practitioners we talked to said that structuring subsidiaries to avoid CFC rules requires careful planning and continuous monitoring. It is even possible that the actions of others could change a foreign subsidiary's CFC status. For example, as shown in table 5, one way a subsidiary of an Australian MNC can be a CFC is if five or fewer Australian investors own more than 50 percent of its shares. Consequently, a subsidiary that is not currently a CFC could become one if other Australian investors increase their ownership share.

Some tax practitioners told us that the complexity of the requirements for determining whether CFC rules applied and the amount of information needed to support a determination created considerable burden. For example, a French tax professional said that France's CFC rules are burdensome because they require the taxpayer to make a series of

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<sup>19</sup>As stated previously, we use the term CFC to generally describe foreign subsidiaries that are controlled by a domestic company as defined by each country. We do not use the term in any of its technical senses, but as a generic description of these types of rules in our study countries.

<sup>20</sup>Some of this data is available for U.S. MNCs based on corporate tax returns. For example, for tax year 2004, IRS reported the existence of 74,676 CFCs that earned \$362.2 billion before income taxes. These CFCs paid \$69.3 billion in income taxes worldwide.

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complex determinations (these were summarized in table 5)—such as whether the foreign tax liability of a subsidiary is greater or less than 50 percent of what it would be had the income been earned in France—in order to decide whether the subsidiary is a CFC. Given differences in accounting and tax rules between France and a foreign subsidiary’s home country, these calculations can become complicated. German CFC rules require similar comparisons of actual taxes paid to theoretical taxes owed in determining whether the subsidiary will be taxed as a CFC. Australia takes a different approach, providing a list of countries where CFCs can be located and have fewer types of income that may be attributed to domestic corporations. It is not clear the extent to which this reduces burden in comparison to the other study countries.

Tax experts in Canada also said that acquiring information for documentation requirements related to CFC rules is particularly burdensome. For example, a Canadian firm with a 10 percent holding in a foreign subsidiary is required to provide the Canada Revenue Agency (CRA) with detailed tax and operations information from the foreign subsidiary. With only a 10 percent ownership stake, the Canadian firm may find it challenging to obtain such information in a timely manner, or at all.

Generally, CFC rules intend to limit an MNC’s ability to shift income, especially passive income, to foreign jurisdictions to avoid or postpone domestic tax. Enforcing these rules could be difficult if the tax agency is not present in the foreign jurisdictions. For example, some officials in France and Canada said they may not be able to obtain and validate information needed to enforce these rules. One French official stated that it is difficult to see if a foreign subsidiary located in a low-tax jurisdiction thousands of miles away was an active business or being used to shelter income.

While the Netherlands does not have specific CFC rules, taxpayers and tax officials stated that the compliance burden associated with other anti-avoidance rules can be significant. According to tax professionals we spoke with, the Netherlands has low-taxed passive shareholding rules, another type of anti-avoidance rule. Overall, the tax practitioners and experts we spoke with agreed that the compliance burden related to anti-avoidance rules in the Netherlands could be significant.

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## Exemption of Foreign-Source Income Reduces the Need for Foreign Tax Credits, but They Can Still Serve as a Compliance Risk

The study countries all have FTC systems; however, according to both tax agency officials and tax practitioners FTCs play less of a role in these countries than in the United States because of the extent to which foreign-source income is exempt. For exempt income, taxpayers do not have to track and report foreign taxes paid. However, FTCs still exist as the study countries use them to avoid double taxation on foreign-source income that is not exempt, such as income subject to anti-avoidance rules. Most study countries were not able to supply data on the amount of FTCs that are claimed by domestic parent corporations in their countries. However, some tax experts said that the extent to which FTCs are generated varies by country, the type of industry in which the MNC conducts business, and the overall structure and location of the MNC's subsidiaries. For example, according to one German tax practitioner we spoke with, FTCs in that country tend to be generated mainly by businesses in the financial and insurance industries or where CFCs are involved.

As shown in table 6, the study countries vary in the rules they apply to FTCs. Many of these rules address the extent to which companies are allowed to accumulate FTCs and use them to offset other types of income. For example, Australia requires that all FTCs must be used in the taxable period in which they are recognized by the taxpayer on their tax filing. Any FTCs that a company has accumulated that are in excess of the amount of domestic tax actually paid on that income are lost. Canada, on the other hand, allows companies to carry excess FTCs back into the previous 3 years or forward up to 10 years. The United States allows companies to apply accumulated FTCs across different types of foreign-source incomes, across multiple countries, and over multiple years. For example, FTCs accumulated for foreign taxes paid on royalty income can be combined with FTCs accumulated on dividend income.

**Table 6: Overview of Rules Governing FTCs in the Study Countries and the United States**

Country	FTC allowed	Some limits on the use of FTCs	FTC carryover	
			Back	Forward
Australia	Yes	Domestic tax liability on the foreign-source income	None	None
Canada	Yes	Domestic tax liability on the foreign-source income by country	3 years	10 years
France	Yes <sup>a</sup>	Generally only allowed for withholding taxes paid to eligible tax treaty countries	None	None
Germany	Yes	Domestic tax liability on the foreign-source income by country	None	None
Netherlands	Yes	Domestic tax liability on the foreign-source income	None	None
United States	Yes	Domestic tax liability on the foreign-source income by broad category of income (general or passive)	1 year	10 years

Source: GAO analysis of country information.

Note: This table shows general treatments. It does not present all of the details, exceptions, or rules that govern the tax treatment of FTCs for our study countries.

<sup>a</sup>French domestic law, generally, does not allow FTCs; income subject to foreign tax and not exempt from French tax is taxable net of foreign tax paid. However, most French tax treaties provide for a tax credit that generally corresponds to withholding taxes on passive income.

Some practitioners said there was some burden in tracking FTCs, but generally these rules were much less burdensome than complying with transfer pricing and anti-avoidance rules. One tax practitioner from Germany pointed out that in instances where MNCs have numerous subsidiaries subject to anti-avoidance rules it generally results in more instances where income is subject to tax in two countries, thus creating additional burden to identify and track FTCs.

**Canada’s Rules for Determining if Dividend Income Is Taxable, with FTCs Allowed, or Exempt Is a Compliance Challenge and Imposes Significant Taxpayer Burden**

Tax agency officials, taxpayers, and tax experts agreed that Canada’s rules for tracking foreign-source income and determining whether the income qualifies for tax exemption are complex and challenging for taxpayers and tax officials. As discussed earlier in this report, Canada’s rules for determining whether or not dividend income received from foreign subsidiaries is exempt from domestic taxation include ownership requirements, location and business activities in a treaty country, and evaluating what type of earnings (e.g., capital gains, passive income, or active income) the subsidiary is distributing as a dividend. Canadian corporations receiving dividend income that does not qualify for exemption are taxed on that income, although FTCs may be applied to offset domestic tax. Canadian corporations are responsible for tracking all foreign earnings to ensure appropriate taxation once the income is received by the Canadian corporation. Taxpayers said these rules are burdensome, in part, because they require information only available from

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The Generation of Inappropriate Foreign Tax Credits Was Identified as a Compliance Risk in Canada but the Risk Was Uncertain for the Other Study Countries

foreign subsidiaries, complex calculations and adjustments to income based on Canadian rules, and monitoring ownership changes for the foreign subsidiary. Tax agency officials said the rules are a compliance risk because of their complexity and difficulty of validating adherence.

One area identified by tax officials as a source of compliance risk in Canada is the generation of abusive FTCs to offset overall tax liability. Often termed FTC generators, these activities, for example, allow taxpayers to take advantage of definitions of debt and equity in two countries by setting up a subsidiary for the purpose of holding assets and generating an income stream in such a way that the income stream is subject to foreign tax but also receives an offsetting deduction so that there is no net foreign tax. The taxpayer then tries to claim a domestic tax credit against this foreign tax paid while ignoring the offset.

Tax agency officials in Canada told us that FTC generators are considered a significant compliance risk in their country. CRA officials said they were currently auditing a number of domestic corporations to determine the extent to which Canadian companies are participating in these types of schemes. Because there is often no economic purpose to such a transaction, one company generally pays the other a fee for participating in the transaction. CRA officials said, so far, they have identified a substantial amount in avoided Canadian tax from 2001 to 2005.

Several experts we spoke to with knowledge of the other study countries said they did not think FTC generators were a significant issue in those countries. For example, a tax practitioner in Germany told us that since the majority of repatriated income to Germany is tax exempt FTCs are not produced in many instances. Similarly, Australian tax agency officials said that since Australian rules require FTCs to be used immediately in the year they are recognized, it reduces the ability to exploit the FTC generator scheme. However, some experts also pointed out that there is always a possibility that taxpayers could structure specific transactions to produce improper FTCs.

FTC generators are also known to be a significant problem in the United States. For example, IRS lists them as a high-risk compliance area because of the large number of taxpayers and significant dollar risk that these types of schemes present.

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## Study Countries Differ in How They Limit Domestic Deductions for Expenses in Order to Prevent Erosion of the Domestic Tax Base

Using sometimes indirect methods, all study countries limit the domestic deductibility of some expenses associated with earning foreign-source income. Tax experts said that methods resulted in fewer compliance risks and burdens as compared to more direct methods. The deductibility of expenses incurred to earn foreign-source income is an issue because of the effect on revenue. If domestic deductibility is allowed under an exemption system, then MNCs are able to deduct expenses even though the resulting income is not subject to domestic tax.

France and Germany provide an example of an indirect approach to limiting expense deductions. As shown in table 2, they require corporations to add 5 percent of their gross tax-exempt dividends to their domestic taxable income (making dividends effectively 95 percent exempt) as an offset for deductible expenses incurred to earn the dividends. In our interviews with tax officials and members of the business community, this approach was cited as being less burdensome than tracing or allocating domestic expenses to tax-exempt income. Tracing would involve matching specific expenses to actual income generated. Some tax experts that we spoke to generally agreed that tracing would be ineffective. Many of the domestic expenses incurred by domestic corporations to invest or maintain an investment in a foreign subsidiary are general to the domestic corporation. These expenses include general management expenses, interest expense on borrowed money, and other administrative expenses. Because these expenses are general to the corporation, they are difficult to trace to the income items.

One alternative to tracing, mentioned by several experts we talked to, is allocating overhead expenses to income sources according to formulas. Rather than tracing expenses to actual income items, this alternative would allocate expenses according to a rule. Although not used in our study countries, allocating overhead expenses in this way could be made less burdensome than tracing. However, some experts stated that this approach would create compliance risks and burdens that do not currently exist. Several experts pointed to the United States as an example of this. In general, the United States requires U.S. corporations to allocate their expenses to a class of gross income and then, if a statutory provision requires, apportion deductions between the statutory grouping and the residual grouping. IRS officials stated that these rules were a compliance risk because corporations sometimes do not apply them appropriately. Some tax experts said these rules were a significant compliance burden because they are complex, requiring considerable time to conduct detailed calculations.

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Another approach taken by all of our study countries is to limit the amount of interest expense that domestic corporations may deduct. Without limits on interest rates and amounts, corporations could shift income offshore and artificially increase domestic interest expenses, eroding the domestic tax base. The rules vary by country and in many cases apply to all corporations, not just multinationals. For example, Germany and France require that interest rates be equivalent to arm's-length terms; the amount of expense that exceeds those terms is generally nondeductible.<sup>21</sup> Germany also has a rule disallowing interest expenses that exceed 30 percent of the corporation's adjusted earnings. Canada has a rule that targets interest paid to a foreign related-entity with a limit based on debt-to-equity ratios. With a few exceptions, tax professionals generally stated that the general types of interest expense rules described above did not pose much of a compliance burden.

The approaches taken by the study countries do not disallow all domestic deductions for expenses incurred with respect to foreign-source dividend income. However, some experts thought that the indirect approaches for limiting the deductibility of overhead expenses were more administrable and less burdensome than more targeted alternatives.

Australia, France, and Germany exempt active foreign-source income earned through foreign branches, but generally disallow domestic deductions for direct expenses attributable to earning the tax-exempt income. Direct expenses, like the cost of inventory, can be traced more easily to the income generated than more general expenses, like interest or other overhead costs.

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## Study Countries and the United States Do Not Regularly Report Basic Information about the Revenues Generated by Taxing Foreign-Source Corporate Income

In addition to lacking data about compliance and compliance burden for their foreign tax rules, our study countries lack data on the amount of tax revenues generated from the foreign activities of domestic corporations. This is also the case for the United States. Several federal agencies consistently report on the business activities of U.S. MNCs, but tax revenues are not included in these reports. For example, the Bureau of Economic Analysis reports on the foreign direct investment activities of U.S. MNCs and IRS reports data on the amount of income U.S. MNCs earn through CFCs.

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<sup>21</sup>These requirements are related to transfer pricing rules in that they both aim to set the prices involved in certain related-party transactions at arm's length.

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U.S. international tax experts, including noted academics with multiple publications who we spoke to on this topic all agreed that regularly and consistently reporting U.S. tax revenue from foreign-source corporate income would be useful. They said that this information would help inform the debate about how to tax foreign-source income and potentially improve understanding of the role international tax rules play in the U.S. tax system. For example, one of these experts pointed out that it was not widely understood how little domestic revenue is actually raised from taxing foreign-source income and that the tax regime governing foreign-source income plays a role in protecting the domestic tax base.

Treasury officials and the experts we talked to noted that producing regular revenue reports is feasible. A few academic papers and a recent release from the Secretary of the Treasury on international tax issues have reported estimates.<sup>22</sup> However, the experts said that these reports from different sources are not as useful as they could be because they are irregular, incomplete, and lack transparency. The experts felt that consistent and transparent reporting by a reputable government source that clearly describes the methodology used to produce the numbers and any limitations would be superior to the current occasional reports that sometimes lack much explanation. IRS and Treasury officials said IRS already collects the necessary data through corporate income tax returns to make the necessary calculations. Therefore, the tax experts said there should not be significant additional cost to the government to provide this information.

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## Conclusion

The United States, like our study countries, does not report the taxes collected by the United States on foreign-source income. Such basic information about the U.S. system would not be costly to provide and could contribute to the ongoing debate about the direction of U.S. policy. Such reporting would make explicit to policy makers, and perhaps to the general public as well, how little residual revenue is received by the United States from taxing foreign-source corporate income. Doing so could help

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<sup>22</sup>Altshuler and Grubert reported U.S. corporations paid \$12.7 billion in U.S. taxes on foreign-source corporate income reported in tax year 2000 in “Corporate Taxes in the World Economy: Reforming the Taxation of Cross-border Income” in *Fundamental Tax Reform: Issues, Choices, and Implications*, edited by John W. Diamond and George R. Zodrow (2008). The Department of the Treasury reported about \$16 billion in revenue for tax year 2004 in *Leveling the Playing Field: Curbing Tax Havens and Removing Tax Incentives for Shifting Jobs Overseas* (TG-119) (May 4, 2009).

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highlight the important role that international corporate tax rules play in protecting the domestic tax base.

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## Recommendation for Executive Action

We recommend that the Secretary of the Treasury use currently collected information to report annually on the revenue to the United States Treasury from taxing foreign-source corporate income. To enhance usefulness, such reports should describe the methodology and important limitations.

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## Agency Comments

We requested comments on a draft of this report from the Secretary of the Treasury. Treasury agreed with our recommendation. The Acting Assistant Secretary (Tax Policy)'s letter is reprinted in Appendix VI. Treasury and IRS staff also provided technical comments, which we have incorporated as appropriate.

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As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after its date. At that time, we will send copies to the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. This report will also be available at no charge on GAO's Web site at <http://www.gao.gov>.

If you or your staff has any questions, please contact me at (202) 512-9110 or [whitej@gao.gov](mailto:whitej@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in Appendix VII.



James R. White  
Director, Tax Issues  
Strategic Issues Team

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# Appendix I: Objectives, Scope, and Methodology

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The objectives of this report were to (1) describe, for select case study countries that take a territorial approach, what types of foreign-source income the countries exempt and the rules governing those exemptions; and (2) describe, to the extent information is available, the compliance risks and taxpayer compliance burdens that the taxation of foreign-source corporate income presents for each of these countries.

To address our objectives, we selected five countries—Australia, Canada, France, Germany, and the Netherlands—to study based on several criteria, including range of tax treatments for foreign-source corporate income, unique tax system features, and Organization for Economic Cooperation and Development (OECD) membership. To gather information related to our selection criteria, we interviewed a number of corporate income tax experts, including academics, corporate tax practitioners, corporate taxpayers, officials at the OECD, and government officials. We contacted those experts that we identified through our literature review, which is described immediately below, along with experts that were recommended by other experts. Our literature review consisted of academic articles and books, national government publications, OECD and other multinational-organization publications on worldwide and territorial tax systems, and private sector research pertaining to various international aspects of corporate income tax systems and administration.

To describe the corporate income tax systems of our study countries, we consulted with corporate taxpayers, business representatives, government tax officials, and academic experts. We performed an in-depth literature review on each country's corporate income tax system, focusing on the rules governing international taxation. We also reviewed research-based publications produced by professional services organizations, academic experts, and international organizations. In general, we relied on information provided by tax officials from the study countries as well as published documents to summarize and characterize the corporate income tax systems for each country. We collected and analyzed data on the countries and their systems for taxing foreign-source corporate income, including tax policies, administrative mechanisms, compliance activities, and taxpayer reporting and documentation requirements. We did not conduct a formal legal review of the tax laws and rules in other countries, but relied on the information supplied by tax agency officials in those countries. We also provided the tax agency officials in our study countries a copy of our report to verify data and specific factual and legal statements about the tax laws in their country.

To address our second objective, we searched for publicly available data that quantified taxpayer compliance risk and burden for each of our study countries. In addition, we interviewed tax practitioners, taxpayers, government tax officials, business representatives, and officials from the OECD. We analyzed the information gathered through interviews as well as published documents to identify and describe the common sources of taxpayer compliance risk and compliance burden across the study countries. When available, we used publicly available data obtained from governments, private sector research, and academics to support evidence provided in the interviews. In addition, we provided tax agency officials from each of the study countries with a statement of facts that were presented in the report for their review and comment. Technical corrections were made to this report based upon country responses. This report shows general tax treatments and does not present all of the details, exceptions, or rules that govern the tax treatment of foreign-source income in our study countries and the United States.

We conducted our work from June 2008 to September 2009 in accordance with all sections of GAO's Quality Assurance Framework that are relevant to our objectives. The framework requires that we plan and perform the engagement to obtain sufficient and appropriate evidence to meet our stated objectives and to discuss any limitations in our work. We believe that the information and data obtained, and the analysis conducted, provide a reasonable basis for any findings and conclusions in this product.

# Appendix II: Transfer Pricing Documentation Requirements in the Study Countries

Country	Documentation requirements	Time at which documentation should be prepared	Time to fulfill formal requests made during an audit
<b>Australia</b>	<p>Documentation should evidence that the taxpayer has followed the following four-step process in setting and reviewing its transfer prices:</p> <p><b>Step 1:</b> Accurately characterize the international dealings between the associated enterprises in the context of the taxpayer's business and document that characterization;</p> <p><b>Step 2:</b> Select the most appropriate transfer pricing methods and document the choice;</p> <p><b>Step 3:</b> Apply the most appropriate method, determine the arm's length outcome and document the process; and</p> <p><b>Step 4:</b> Implement support processes. Install review process to ensure adjustment for material changes and document these processes.</p>	Contemporaneous. However, generally only required to be submitted to the revenue authority following a specific notification, such as through an audit	28 days
<b>Canada</b>	Contemporaneous documentation required for cross border, related party transactions. Form T-106 required to be filed annually asks for reporting of non-arms-length transactions.	Must exist at the time of tax filing	3 months
<b>France</b>	Taxpayers are not required to keep any transfer pricing documentation but are expected to cooperate with the tax agency in transfer pricing audits.	No formal contemporaneous documentation requirement.	60 days, but could be extended an additional 30 days
<b>Germany</b>	Documentation that shows the type and content of business transaction to related parties, including general information about (1) the group and ownership structure, (2) business relations to related parties, (3) analysis of functions and risks, and (4) transfer pricing analysis.	Contemporaneous for exceptional business transactions only	60 days
<b>Netherlands</b>	Documentation must show the arm's length nature of the transfer price that was applied.	Generally expected to be available at the time when the transaction occurs	4 weeks, but up to 3 months for certain complex transactions

Source: Organization for Economic Cooperation and Development and Ernst & Young.

# Appendix III: Example from Australia of the Process for Obtaining an Advanced Pricing Agreement

## Step 1: Pre-lodgment meetings

The purpose of pre-lodgment meetings is to:

- discuss the suitability of an APA
- allow a business to provide a broad outline of the proposed transfer pricing methodology
- discuss whether the APA will be unilateral or bilateral
- discuss the required documentation and analysis
- determine whether independent expert advice is required
- discuss Tax Office audit activity (if an APA is to flow on from audit)
- agree on a date for lodging a formal application
- agree on the APA timetable, and
- discuss the process for evaluating the application.

Pre-lodgment meetings do not bind either party to the APA program.



## Step 2: Lodgment of formal application

If proceeding with the APA, a business will be required to lodge a formal application.

The APA application should include:

- details of the proposed transfer pricing methodology, supported by relevant information
- terms and conditions governing the application of the transfer pricing methodology
- data showing that the transfer pricing methodology will produce arm's length results
- a discussion and analysis of the critical assumptions, and
- a suggested period of time for which the APA will apply.

For bilateral APAs we normally advise the treaty partner's tax authority once the application has been accepted.



## Step 3: Analysis/evaluation

We evaluate the data submitted and other relevant information, and seek additional information where necessary. We normally have numerous meetings with a business.



## Step 4: Negotiation and agreement

For a bilateral APA, the relevant tax administrations exchange position papers outlining the acceptability of the proposed transfer pricing methodology. A written confirmation of the concluded agreement is provided to the business.

For a unilateral APA, we provide written confirmation of the agreement we reach with the business.



## Step 5: Concluded APA

A concluded APA contains at least the following information:

- the transactions, agreements or arrangements covered by the APA
- the period and tax years covered by the APA
- the agreed transfer pricing methodology and the critical assumptions on which it is based
- the definition of key terms that form the basis of the methodology (for example, sales, operating profit)
- if applicable, a range of arm's length results, and
- the business's obligations as a result of the APA.

Source: Australian Tax Office.

# Appendix IV: Examples of Other Anti-avoidance Rules in the Study Countries and the United States

Table 7 provides some examples of non-controlled-foreign-corporation (CFC) anti-avoidance rules. This is not a complete list of the anti-avoidance rules in these countries. The consequences of falling under these rules are not necessarily the same as the CFC rules, but those consequences are beyond the scope of this table.

**Table 7: Examples of Additional Anti-avoidance Rules by Country**

Country	Regime	General definition of anti-avoidance rules
Australia	Foreign Investment Fund (FIF) rules	Certain Australian shareholders are subject to annual taxation on a deemed return on their pro rata shares of foreign investment funds if: <ul style="list-style-type: none"> <li>(a) the foreign company or trust is not controlled by Australian residents; and</li> <li>(b) the taxpayer's shareholding is more than 10% of the total value of the taxpayer's interest in foreign companies and trusts; and</li> <li>(c) the foreign company or trust engages in "blacklisted" activities, such as certain financial intermediary, insurance, and banking transactions; and</li> <li>(d) the taxpayer holds the interest at the end of the taxable year.</li> </ul>
Canada <sup>a</sup>	Offshore Investment Fund (OIF)	Canadian shareholders of an OIF are taxed currently on an imputed return basis where the investment in the OIF is established to be motivated by tax avoidance
France	Abuse of Law doctrine	General anti-avoidance law that permits the tax authorities to take action against legal arrangements or particular transactions when those arrangements and transactions were fictitious or undertaken for solely tax reasons.
Germany	General Anti-Avoidance Rule	General anti-avoidance rule, re-written in 2007, that prevents taxpayers from establishing legal forms or structures for the sole purpose of obtaining a tax advantage. Tax authorities may disregard structures for tax purposes in these situations.
Netherlands	Low-Taxed Passive (LTP) Shareholding	The Dutch shareholder that holds 25% or more, alone or together with an affiliate, of the shares in a (foreign) entity has to value its shareholding at market value in case the following conditions are met: <ul style="list-style-type: none"> <li>(a) At least 90 percent of the assets of the subsidiary are, directly or indirectly, of a portfolio nature;</li> <li>(b) The foreign tax paid on profits is less than 10 percent of tax on profits if calculated under Dutch tax law; and</li> <li>(c) more than 50 percent of the carrying value of its property is not investment property.</li> </ul>
United States	Passive Foreign Income Companies (PFIC)	A foreign corporation is a PFIC if: <ul style="list-style-type: none"> <li>(a) 75 percent of the corporation's income is passive income; <b>or</b></li> <li>(b) 50 percent of the corporation's assets (by value) are held for production of passive income.</li> </ul> <p>Unlike a CFC, a PFIC does not have any minimum stock ownership requirement. Each U.S. shareholder of a PFIC can choose to be taxed in one of two ways (or, in the case of marketable stock, one of three) ways.</p>

Source: GAO analysis of country information.

<sup>a</sup>A more comprehensive 'foreign investment entity' (FIE) regime is proposed but not yet enacted. Under these proposed rules, Canadian investors in a FIE would be taxed currently on an imputed return basis, except where qualifying investors elect for accrual or mark-to-market treatment instead.

# Appendix V: Description of Dividend Exemption Systems in Japan and the United Kingdom

Japan and the United Kingdom both adopted dividend exemption systems in 2009. These countries previously taxed dividends received from foreign subsidiaries but allowed for foreign tax credits (FTC) for foreign taxes paid. Like our study countries, Japan and the United Kingdom have specific rules used to determine whether a dividend qualifies for exemption. Table 8 describes these rules.

**Table 8: Required Domestic Ownership Type and Level of Foreign Subsidiary to Qualify for Tax Exemption of Foreign-Source Dividend Income**

	Japan	United Kingdom
<b>Domestic ownership of foreign company</b>	Direct shareholding of at least 25% <sup>a</sup>	Direct or indirect
<b>Foreign company share type</b>	Any type	Most types
<b>Ownership duration</b>	6 months	None

Source: GAO analysis of country information.

Note: This table shows general treatments. It does not present all of the details, exceptions, or rules that govern the tax treatment of foreign-source income in these countries.

<sup>a</sup>If the foreign company is a resident in a country with which Japan has concluded a tax treaty that provides for the allowance of an indirect FTC on qualifying dividends for a shareholding percentage of less than 25 percent, then the exemption can be applied in those cases.

Like the study countries, both Japan and the United Kingdom have anti-avoidance rules, including controlled foreign corporation (CFC) rules, which limit the tax advantages of earning or holding certain types of income in relatively low-tax jurisdictions. Japan revised their rules at the same time the dividend exemption system was implemented. The United Kingdom plans to address reforms to their CFC rules in future years. However, the United Kingdom did introduce a worldwide debt cap rule that limits the extent to which debt expenses can be deducted by corporations in the United Kingdom. One goal of this rule is to prevent situations in which businesses in the United Kingdom borrow excessively in order to invest internationally to produce exempt dividends. This is similar to some of the interest expense limitation rules we identified in the other study countries.

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# Appendix VI: Comments from the Department of the Treasury

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DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

SEP 03 2009

Mr. James R. White  
Director, Strategic Issues  
U.S. Government Accounting Office  
Washington, DC 20548

Dear Mr. White:

Thank you for the opportunity to comment on GAO's draft report entitled "International Taxation: Study Countries That Exempt Foreign-source Income Face Compliance Risks and Burdens Similar to Those in the United States" (GAO-09-934).

The draft report recommends that "the Secretary of [the] Treasury annually report, using already available data, the revenue generated by taxing foreign-source corporate income." As a result of our discussions with GAO, we have asked the Statistics of Income Division of the Internal Revenue Service to include additional data available from corporate income tax returns in its annual article in the *Statistics of Income (SOI) Bulletin* on the corporate foreign tax credit. We believe that this additional reporting will provide public information regarding the tax revenue attributable to foreign source income.

We also have technical comments on the draft report, which we will discuss with your staff.

Thank you again.

Sincerely,

A handwritten signature in black ink, appearing to read "Michael F. Mundaca".

Michael F. Mundaca  
Acting Assistant Secretary (Tax Policy)

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# Appendix VII: GAO Contact and Staff Acknowledgments

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## GAO Contact

James R. White, (202) 512-9110 or whitej@gao.gov

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## Staff Acknowledgments

In addition to the contact named above, José Oyola, Assistant Director; Brian James; Ed Nannenhorn; Danielle Novak; Chhandasi Pandya; Matthew Reilly; A.J. Stephens; and Charles Veirs IV made significant contributions to this report.

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# Related GAO Products

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*Cayman Islands: Review of Cayman Islands and U.S. Laws Applicable to U.S. Persons' Financial Activity in the Cayman Islands, an E-supplement to [GAO-08-778](#), [GAO-08-1028SP](#).* Washington, D.C.: July 2008.

*U.S. Multinational Corporations: Effective Tax Rates Are Correlated with Where Income Is Reported.* [GAO-08-950](#). Washington, D.C.: August 12, 2008.

*Tax Administration: Comparison of the Reported Tax Liabilities of Foreign- and U.S.-Controlled Corporations, 1998-2005.* [GAO-08-957](#). Washington, D.C.: July 24, 2008.

*Business Tax Reform: Simplification and Increased Uniformity of Taxation Would Yield Benefits.* [GAO-06-1113T](#). Washington, D.C.: Sept. 20, 2006.

*Understanding the Tax Reform Debate: Background, Criteria, and Questions.* [GAO-05-1009SP](#). Washington, D.C.: September 2005.

*Tax Administration: Comparison of the Reported Tax Liabilities of Foreign- and U.S.-Controlled Corporations, 1996-2000.* [GAO-04-358](#). Washington, D.C.: Feb. 27, 2004.

*Tax Administration: IRS' Advanced Pricing Agreement Program.* [GAO/GGD-00-168](#). Washington, D.C.: Aug. 14, 2000.

*Tax Administration: Foreign- and U.S.-Controlled Corporations That Did Not Pay U.S. Income Taxes, 1989-95.* [GAO/GGD-99-39](#). Washington, D.C.: Mar. 23, 1999.

*International Taxation: Transfer Pricing and Information on Nonpayment of Tax.* [GAO/GGD-95-101](#). Washington, D.C.: Apr. 13, 1995.

*International Taxation: IRS' Administration of Tax-Customs Valuation Rules in Tax Code Section 1059A.* [GAO/GGD-94-61](#). Washington, D.C.: Feb. 4, 1994.

*International Taxation: Taxes of Foreign- and U.S.-Controlled Corporations.* [GAO/GGD-93-112FS](#). Washington, D.C.: June 11, 1993.

*International Taxation: Problems Persist in Determining Tax Effects of Intercompany Prices.* [GAO/GGD-92-89](#). Washington, D.C.: June 15, 1992.

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