Fundamentals of International Tax Planning

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CHAPTER 5

CATEGORIZING INTERNATIONAL TAX PLANNING

5.1. General

While globalization has resulted in a greater exchange of information, technology and knowledge, a more efficient allocation of production factors, a more extensive range of goods available and a reduction in the costs of capital and transport, it has also had another noteworthy effect: a significant increase in international tax planning. Although there is a bewildering variety of corporate cross-border tax planning techniques available to the modern tax planner, in this chapter an attempt is made to categorize the various techniques.

5.2. Three species

Depending on the results, international tax planning can be subdivided in the following three species:

1. no (or lower) double taxation;
2. no (or lower) single taxation; and
3. negative taxation.

The scope for international tax planning in these areas varies from one company to another and one state to another, as well as over time as a result of counter-measures taken by the local tax administrations to counteract practices deemed to be unacceptable. The three species are discussed in more detail below.

1. No (or lower) double taxation

This first species is obvious, by almost everybody considered as non-harmful and in line with both the aims of the European Community and the OECD. The examples of no (or lower) double taxation are several, such as taxpayers achieving that a participation exemption or credit system is applied more efficiently.
5.3. Temporary versus permanent tax savings

Another distinction that can be made in tax planning techniques is the distinction between tax deferral or temporary tax savings (i.e. an effort to pay tax later in time) on the one hand, and permanent tax savings (i.e. an effort to avoid the payment of tax altogether) on the other. Tax deferral planning is de facto income deferral planning, since the deferral of taxation is a consequence of the deferral of income recognition for tax purposes. In deferral scenarios, there is therefore no income for tax purposes, although there is typically income for accounting purposes.

A simple example of tax deferral planning in a domestic scenario is the sale of an asset between a parent and a subsidiary in the same jurisdiction. For (non-consolidated) accounting purposes, such sale may result in income at the level of the seller where the fair market value of the asset exceeds its book value. However, in case both the parent and the subsidiary are treated as a consolidated group for corporate income tax purposes, such transfer may not result in taxable income. Consequently, as long as the consolidated group remains intact and the asset is not transferred to a party outside the group, no tax will be triggered at the level of the seller. In the case at hand, the consolidated group is de facto a tax deferral instrument.

In an international setting, tax deferral techniques can be found in several varieties. For example, tax planning scenarios in the majority of countries that have a credit system for the avoidance of double taxation are often based on tax deferral planning. Consequently, tax planning that relates to, for instance, Ireland, Japan, the United Kingdom and the United States is often tax deferral planning. This planning is based on the fact that a person who conducts operations abroad through a separately incorporated foreign corporation generally pays no domestic tax on the foreign corporation’s earnings until those earnings are repatriated back to the parent company through a dividend or otherwise (the “deferral” principle).

Obviously, the longer the period of time of the deferral, the more valuable the tax planning technique for the underlying taxpayer and the smaller the difference between permanent and temporary tax savings. Consequently, the distinction between tax planning involving temporary versus permanent tax savings disperses over time. A temporary tax saving scenario that can be used indefinitely is in fact a permanent tax saving scenario.

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43. Art. 25 of the Dutch Corporate Income Tax Act and Art. 10 of the Dutch Dividend Withholding Tax Act have been changed in this respect.
5.4. Substantive versus formal tax planning

Another distinction we can make in tax planning techniques is the one between substantive and formal tax planning. Substantive tax planning alters the pattern of the economic activity. For example, if the effective corporate tax rate is relatively high in a certain jurisdiction, a multinational company may either leave the jurisdiction or it may not start operations in the high-tax jurisdiction in the first place.

On the other hand, formal tax planning retains the substance of the activity though, having the possibility of achieving the same result in different ways, it does so in the most tax-efficient manner. For example, a company pertaining to a multinational group and operating in a high-tax jurisdiction may (subject to certain limitations) be financed entirely with equity or entirely with debt. In the first case, the remuneration paid to the party providing the funds is not deductible, whilst in the latter case it is. It follows that the arbitrage is created by the system itself that leaves the taxpayer free to choose the legal form through which finance the activities, and the different legal form has an impact on the tax consequences.

Although formal tax planning comes in many forms and varieties, the reduction of the taxable income may be both the most typical and the most widespread form of formal tax planning. In these cases, tax minimization is achieved through profit shifting whereby the profits earned by a company in a high-tax jurisdiction are diverted to another entity whose tax burden is lower.

On the other hand, substantive tax planning goes typically hand in hand with the reduction of operating costs, the redesigning of business functions, the re-engineering of flows of goods and services or the expanding into new markets. Three different forms of substantive corporate tax planning are identified below.

The transfer of a tax subject

Taxpayers in countries with a relatively high level of taxation may be tempted to avoid being subjected to tax in their own countries by changing their tax residence, leaving, however, (most of) the income-generating assets in the high-tax jurisdiction. For this reason, the transfer of a tax subject from a high-tax jurisdiction to a low-tax jurisdiction includes the migration of a tax subject (typically a legal person) from one state to another.

Although the income-producing asset remains in the high-tax country, the transfer of the tax subject determines other benefits, e.g. the non-application of anti-avoidance legislation at the level of the tax subject, or no or lower withholding taxes on inbound and outbound flows, and in some cases a better treaty network.

The transfer of a tax subject is depicted in Table 4.

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<th>High Tax Country</th>
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<td>Tax Subject</td>
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The primary issue here is to reduce or eliminate any tax charge imposed in the exit jurisdiction upon the transfer. In addition, shifting of tax residence raises special difficulties in the case of companies, as company residence can be a difficult concept to define, and especially to verify where the place of effective management of a company is, and whether it has actually been moved. Finally, it is important to note that in the present state of law, companies are creatures of national law: it is the local legislation that determines the requirements for both the formation and the functioning of a company. Consequently, a company that exists according to the laws of one jurisdiction may not be automatically recognized in the other jurisdiction and thus its existence depends on whether the other state is prepared to recognize it as a corporate entity (in an EU scenario these difficulties may be overcome today through the use of an SE, which is a legal form regulated at EU level).

The transfer of a tax object

In contrast to the aforementioned, in this scenario a tax object is moved from a high-tax jurisdiction to a low-tax jurisdiction. The residence of the
taxpayer itself does not change. The transfer can be in part or in full and includes the transfer of intellectual property rights or capital from a high-tax jurisdiction to a low-tax jurisdiction. The tax object may, for instance, create a permanent establishment in the low-tax state, income of which may be wholly or partly tax exempt in the high-tax jurisdiction, or the tax object may be moved to a separate entity in the low-tax jurisdiction. The transfer of a tax object is depicted in Table 5.

Table 5: Transfer of a tax object

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<th>High Tax Country</th>
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<tr>
<td>Tax Subject</td>
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Although an issue of immediate taxation arises in the high-tax country upon the transfer, the benefit of having the income generated by the tax object in the low-tax country normally outweighs it.

The transfer of the tax subject and of the tax object

In this scenario both the tax subject and the tax object are transferred from a high-tax jurisdiction to a low-tax jurisdiction. The avoidance of full tax liability and shifting from one tax jurisdiction to another presents the same special problems mentioned before. This is depicted in Table 6.

Table 6: Transfer of a tax subject and tax object

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<tr>
<th>High Tax Country</th>
<th>Low Tax Country</th>
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<tr>
<td>Tax Subject</td>
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In its most extreme form, all relationships with the high-tax country are broken, whereby all attachments to the territory of the exit state will be wound up. The full emigration to another jurisdiction is unlikely to take place unless it offers a better environment or at least one equivalent to that left behind. However, although there may be more convenient ways to save tax than through the emigration of both the tax subject and the tax object, tax motivation is sometimes the main reason and sometimes even the only reason for emigration of both the tax subject and the tax object. Also in the above-mentioned scenario, the primary issue will be to reduce or eliminate any tax charge imposed in the exit jurisdiction upon the transfer.

5.5. Double tax treaty versus non-tax treaty planning

Another noticeable distinction in international tax planning is the distinction between cross-border tax planning that does and cross-border tax planning that does not involve the use of double tax treaties. A simple example of tax planning that does involve a tax treaty is the scenario whereby a taxpayer (whether or not resident of a contracting state), acts through a legal entity created in another state so that it obtains treaty benefits that would not be available to the taxpayer directly. A simple example of tax planning that does not (necessarily) involve a tax treaty is a base erosion scenario whereby the taxpayer contributes cash in a low-taxed subsidiary and re-obtains the contributed funds in the form of a loan.
Chapter 5  – Categorizing International tax planning

5.6. Concluding remarks

The variety of corporate international tax planning techniques that is available to the modern tax planner is bewildering. And although the tax planning jungle seems sometimes inaccessible, it is quite possible to distinguish and categorize the various tax planning techniques.

In this regard, it is possible to identify three tax planning species to every tax planning scenario worldwide. Moreover, it is possible to distinguish tax planning depending on whether it has a temporary or permanent effect. Also, it is possible to make a distinction between formal and substantive tax planning and between tax planning techniques that do or do not make use of double tax treaties. All these distinctions can be combined. As a result of the aforementioned, it is possible to set up a framework whereby each and every tax planning technique can be categorized.

The use of the aforementioned framework has more than a pure academic value. If brought into play, it may provide information on the tax planning techniques that are most commonly used in and between certain jurisdictions, on the tax havens that are typically involved and on the tax treaties that are frequently (ab)used. Consequently, it may be of benefit for corporate taxpayers and their advisers since it clearly shows what type of tax planning technique the respective corporate taxpayer entered into or, alternatively, did not enter into (yet). In addition, the framework may be of benefit to governments. It may perfectly show which corporate tax loopholes exist in a certain jurisdiction and trigger action accordingly.