Even in the modern age of globalization, the words of Sun Tzu still ring true. When structuring cross-border deals, the tax practitioner is wise to heed the words above. One who does not understand the international tax ramifications of a transaction may fail to provide a structure that adequately addresses the client’s international tax concerns. Worse yet, the structure might even give rise to additional international tax burdens that may have been avoided if the practitioner had armed himself with the proper tax knowledge.
For the United States tax practitioner, knowing oneself means having a thorough knowledge of the United States tax rules governing international investment. Without this, defeat is almost a certainty.

The more difficult challenge for the practitioner is “knowing the enemy.” In the tax world, this means understanding the tax laws of the jurisdiction, or jurisdictions, where the cross-border deal will take place. At this point, it is important to understand the practical limitations of any tax practitioner when delving into the world of international transactions. The United States tax practitioner is only able to provide legal advice on the United States tax consequences of any transaction. As a general matter, he is not qualified to practice law in any other jurisdiction other than his own.

Therefore, it is important to engage local counsel in each jurisdiction where tax advice under local law is required. Whether this requires utilizing local lawyers from one’s own Firm’s foreign offices or engaging local counsel directly, utilizing local counsel is important from both a practical and a professional standpoint.

Nevertheless, a practitioner should still have a fundamental understanding of the tax rules of the foreign jurisdiction(s) involved in any cross-border transaction. This is where tax treaties become such a valuable tool to any practitioner. Tax treaties provide a set of rules that govern a transaction involving parties resident in two separate countries. In general, most treaties limit the effects of our country’s tax laws on residents of other jurisdictions. By doing so, they limit the nature, scope and impact of the foreign tax laws. They may have the effect of providing the tax practitioner with a limited (but effective) knowledge of the foreign tax laws relevant to the transaction.

A comprehensive tax treaty has the same effect as the famed “hot gates” at Thermopylae, Leveling the playing field to such a degree that the enemy is limited in what it can do. The ground rules have been narrowed to the point that a very rudimentary knowledge of the enemy can be extremely effective in close quarters. In effect, you can know yourself, and enough about your enemy to be victorious in every engagement.

This article will discuss some of the basic rules that are relevant to investment abroad. We will briefly discuss some of the background issues that might affect the method by which a foreign investment might be structured. Then we will focus upon four basic rules that tend to have the greatest impact on any foreign investment. We finish by applying these rules and presenting some general structures that are commonly used for foreign investment in Asia and Europe.

401 BUSINESS BACKGROUND

Knowing oneself requires more than a fundamental understanding of the United States international tax rules. It also requires familiarity with the client and what he hopes to achieve through the investment. Because of the unique circumstances surrounding each and every client, it is impossible to cover each of the variables that impact a particular client’s cross-border investment. However, we raise several issues that typically have significant impacts on a client’s investment. Truly “knowing yourself” may require significant analysis of the following topics at a much deeper level.

401.1 Client’s Organizational Structure

One of the principal factors affecting the landscape of opportunity and exposure will be the client’s pre-existing organizational structure. Other than the case of a newly-organized Greenfield’s venture, international tax planning must generally operate within the fundamental constraints established by the long-standing structural features of the entity. The two structures most commonly encountered are that of a multinational corporate group and that of an investment fund, each presenting its own opportunities and constraints.

A. Multi-National Corporate Group

A multi-national corporate group is of course the traditional structure of many cross-border businesses. Such a group gives up the attribute pass-through and single layer of tax advantages that a fund structure can provide but in return offers the opportunity for deferral of home-country taxation.

1. Deferral Opportunity

In the United States (and in many other OECD countries) deferral opportunities may be limited by controlled foreign...
corporation rules\textsuperscript{1} and similar regimes. Nevertheless, most active business operations conducted in a foreign subsidiary will produce income that is not subjected to home country tax until it is repatriated as a dividend or upon liquidation. Moreover, if such earnings are “permanently reinvested” overseas, the value of such deferral has importance not only for reducing the group’s current home country cash tax bill, but also for financial accounting purposes. In particular, under such accounting principles as APB 23, the group will not be required to reflect for financial accounting purposes the ultimate home country tax burden that would be imposed upon the foreign earnings if they were repatriated. Rather, because such earnings are permanently reinvested outside the home country, the current local tax burden can be shown as the final tax imposed with respect to such earnings. This opportunity will quickly shine a spotlight on the level of foreign tax imposed on such earnings, and will bring into focus the importance of foreign tax reduction.

2. Foreign Tax Reduction

To the extent that the level of foreign tax imposed on deferrable foreign earnings can be reduced below the home country rate, the result may be current cash tax savings plus the accounting benefit of a reduced global effective tax rate. Indeed, the tax rate reconciliation tables in the financial statement footnotes of many U.S.-based multinationals clearly illustrate this phenomenon, as an effective tax rate that is less than the U.S. statutory tax rate will often be attributed to a reduced rate of foreign tax on foreign earnings. Particularly since the introduction of the U.S. check-the-box entity classification rules,\textsuperscript{2} many U.S.-based groups have been able to establish ownership and capital structures for their non-U.S. operations that maximize foreign tax planning opportunities while minimizing the applicability of subpart F. For example, debt financing of operations in a high-tax country with a loan from a low-taxed entity is a straightforward and perfectly legitimate means of reducing the tax burden on the high-taxed operations. While interest payments between controlled foreign corporations would generally give rise to a subpart F inclusion in the hands of the recipient company (absent the applicability of certain narrow exceptions, such as the same country rule), the advent of the check-the-box era facilitated the creation of interest flows that were disregarded for U.S. tax purposes, while remaining fully deductible for local tax purposes. Similarly, other deductible payment flows, such as royalties or management fees, may also legitimately reduce the local tax base in the high-tax jurisdiction, be subjected to little or no tax in the low-tax recipient entity, and be disregarded for U.S. tax purposes. Thus, the combination of deferrable foreign income, check-the-box planning, and foreign tax planning may produce a global effective tax rate that is substantially less than the statutory U.S. rate, in the case of a U.S.-based multinational that permanently reinvests its foreign earnings outside the United States.

On the other hand, various constraints may limit the ability of a U.S.-based company to realize such a benefit. For example, the earnings of its foreign operations may not be eligible for U.S. tax deferral, but may instead be subject to current U.S. taxation under the controlled foreign corporation tax rules of subpart F.\textsuperscript{3} In that case, permanent reinvestment would produce no U.S. accounting benefit, since full U.S. tax would have to be provided for (and paid) in respect of such earnings. Similarly, if operational constraints require the current repatriation of offshore earnings, rather than their permanent reinvestment abroad, then there will be no opportunity to harvest the cash tax and effective rate benefits of deferral. Instead, in such circumstances, ensuring full creditability of foreign taxes paid is likely to become the focus of the group’s international tax planning. Since many companies routinely find it necessary to repatriate at least some of their foreign earnings (or find that the subpart F rules will effectively demand such repatriation for tax purposes), the management of the company’s foreign tax credit position is often an important focus of tax planning for the group.

3. Foreign Tax Credit Management

Foreign tax credit management involves a combination of deferral planning, repatriation planning, and foreign tax reduction, in an effort to ensure that the amount of foreign income recognized for U.S. tax purposes is sufficient to ensure the full creditability of the foreign taxes paid with respect to such earnings, given the constraints imposed by the U.S. foreign tax credit limitation. In general, the U.S. foreign tax credit limitation rules are intended to limit the foreign tax credit to the amount of U.S. tax imposed with respect to the non-U.S. earnings of the taxpayer. In other words, the United States seeks to avoid permitting a foreign tax payment to be credited against U.S. tax liability imposed with respect to U.S. income, since such a result would effectively cede taxing jurisdiction over such income to a foreign country. Managing foreign tax credit will likely require attention to the timing and amount of repatriations from foreign subsidiaries, the timing and amount of other payments from such subsidiaries (such as royalties for the use of intangibles), and the timing and amount of other foreign source income realized by the U.S. group, as well as efforts to reduce the amount of tax paid in high-tax foreign jurisdictions. Again, the flexibility afforded by the U.S. check-the-box rules has been an important element in this type of planning.

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1 For example, the United States has a very complex and well-developed set of rules regarding controlled foreign corporation. See 26 U.S.C. §§ 951-965 (2009).
2 Treas. Reg. § 301.7701.
U.S. foreign tax credit planning was substantially complicated by rules requiring that foreign tax credit limitations be computed separately with respect to several specified categories of income. These separate foreign tax credit “basket” rules were designed to limit the cross-crediting of foreign taxes imposed on high- and low-taxed income. The difficulties presented by these rules have been ameliorated by the general reduction of the applicable foreign tax credit “baskets” to two, one for active income and the other for passive income (with special rules applicable to financial services income). The two baskets still substantially reduce opportunities to cross-credit between differently taxed streams of foreign income, however.

B. Fund Investment

In recent years, investment funds have become significant players in cross-border transactions. Unlike multi-national corporate groups, the investment funds are driven by a different set of economics that significantly alters the tax structure of the investment.

1. Pass-Through of Income and Tax Attributes

One of the most important differences between multi-national corporate groups and investment funds is the use of pass-through entities to avoid corporate level taxes. Because investment funds are typically made up of individuals or tax-exempt entities, the pass-through structure avoids corporate level taxes thus increasing the overall after-tax yield on the investment. The investments are typically structured by using pass-through entities that do not incur direct taxation. The introduction of the check-the-box rules has provided United States investors added flexibility because they can use corporate entities in addition to pass-through entities under local law. However, the tax advantages of the pass-through entity are offset by the lack of deferral that a corporate structure typically provides.

2. Consideration of Upper Tier Investors

Unlike the multi-national corporation, the investment fund must be more acutely aware of its investors. The use of pass-through entities may subject the investors of the fund to direct taxation on particular types of income that are not permissible. Many investors in funds are tax-exempt entities or other specialized entities (e.g., real estate investment trusts) that may not directly receive any type of business income. As a result, these entities typically inquire about the insertion of a corporate “blocker” structure to prevent the direct attribution of impermissible income streams. However, the need for a corporate structure is counterbalanced by the existence of individual investors. These investors do not have any prohibitions on the direct attribution of any income and are sensitive to any structures that would insert an additional layer of entity level taxation. In addition, individual investors are generally afforded specialized tax treatment of gains and losses from investments that are not afforded to corporate taxpayers. As a result, the investment fund may require the tax exempt entities to invest through “blocker” entities rather than putting a corporate entity into the investment structure at a lower level. The path is riddled with different motivations from different investors and investor groups. Ultimately, a fund will end up being structured with several layers of pass-through entities (and possibly some corporate entities), and there is very close monitoring of the type of income that might arise by virtue of the cross-border investment.

401.2 Form of Cross-Border Investment

There are many ways a taxpayer can make a cross-border investment. The type of investment will have an impact on the taxes imposed by both the source country and investor’s own country of residence. There are times when the taxes imposed by a particular country dictate the form of the investment as opposed to situations where the form of the investment controls. Regardless, we present some of the investment forms and potential issues that might arise by virtue of the particular form of investment.

A. Acquisition

The most common form of investment involves an acquisition of most, or all of a foreign business. Whether the investment involves an acquisition of business assets, a stock purchase, or a merger may depend upon what is permissible under the corporate laws of the particular jurisdiction. In fact, the tax laws may actually dictate which form of acquisition is utilized because the particular tax laws of the jurisdiction might provide for better treatment in one situation or another. If the transaction is structured as an acquisition, the taxpayer must consider the taxation of the acquired company under foreign


5 We note that the income streams of many investment funds constitute passive income. As a result, the controlled foreign corporation rules may prevent deferral of income. This negates the advantages of using a corporate entity to obtain deferral and further encourages the use of pass-through entities for investment funds.

6 United States individual taxpayers are entitled to a lower tax rate on capital gains for investments held over one year, 26 U.S.C. § 1(h) (2009).
law and whether the taxation will be altered by virtue of the ownership change. As discussed below, the type of entity or business that is being acquired and how it is required to impact the holding structure. For example, the taxpayer may wish to form a holding company in the target jurisdiction to purchase assets rather than purchase assets directly through a foreign corporation. Much of the decision rests upon the type of income produced by the acquired entity and the tax burdens (e.g., withholding taxes) imposed by the foreign jurisdiction (both are discussed below).

B. Joint Venture

Unlike a typical acquisition of an existing entity (or the business assets of an existing entity), the joint venture typically involves the formation of a newly created entity by the investor and another third-party investor. There are many reasons that an investor might choose to invest in a joint venture rather than make an acquisition. For example, local law may require that the investor have a domestic partner if they choose to operate certain types of business entities. Another reason for a joint venture would be the need to team up with another investor that has the necessary financing, intellectual property or other specialized assets or knowledge to best support the business endeavor. Since the joint venture involves the creation of a new entity, the investor may have more flexibility in structuring the joint venture vehicle from a tax perspective. However, the investor may not be able to take full advantage of the tax advantages if the other investor is from a different jurisdiction and is pushing for different structuring to take best advantage of the tax laws of his own jurisdiction. Finally, the amount of the investment, as well as the make up of other significant investors might trigger the controlled foreign corporation rules. 7

C. Debt

Although most cross-border investments involve an acquisition of equity, investments can be made in the form of debt financing.

1. Debt as the Investment Vehicle

Although one commonly thinks about senior lenders financing investments, many cross-border investments are financed with secondary financing. In fact, many investments begin as some form of convertible debt that later ripens into an equity investment. However, in the pre-conversion period, it is still a debt instrument.

The use of debt instead of equity gives rise to a different income stream. The investment returns interest income instead of dividends and/or capital gains. The taxation of income, the rate at which the income is taxed, and amounts of withholding tax may be different for interest income.

2. Role of Debt Financing

Although not a separate form of investment, we note that any acquisition, joint venture or other investment may require significant debt financing. Thus, the taxation and deductibility of interest is an important consideration in any tax structure. 8

D. License Arrangement/Royalty

The investment may also be in the form of a type of license/royalty arrangement. As noted above with debt, royalties may be taxed in a different manner or at a different rate (by either jurisdiction) and may attract different withholding taxes. Thus, an investor who wishes to structure an investment as a license must be aware of the separate and distinct tax consequences in each jurisdiction of the license. If the investment involves the development of intellectual property, there are also specialized cost-sharing rules that may be relevant and must be considered. 9

E. Acquisitions of Minority Interests

Whether a joint venture or an acquisition of equity in an existing entity, there are special considerations if a United States investor in a foreign company or other structure acquires less than 50% of target foreign company stock. One key consideration is that the controlled foreign corporation rules will not apply. However, if the foreign entity generates significant passive income, the passive foreign investment company (PFIC) rules must be considered. 10

If the company has active income, foreign tax credits would be available if earnings are distributed currently. But if earnings are reinvested, and gain realized later upon disposition of shares, no United States tax benefit would arise for the foreign tax credits.

8 This might include the need to allocate and apportion the interest deductions among various companies in a multi-national group. 26 U.S.C § 861 (2009).
9 See, e.g., Treas. Reg. § 1.482-7.
burden, effectively resulting in double taxation, given inapplicability of section 1248 to the minority position.

401.3 Type of Cross-Border Income

The type of income stream that will be generated by the cross-border investment has just as much impact on the tax structuring as the client’s organizational structure and the form of the investment. It is another factor that, when thoroughly considered, will provide the practitioner with the “knowledge of self” to structure an investment that is as advantageous as possible from a tax perspective. Many jurisdictions, like the United States, have anti-deferral regimes that differentiate between “active” and “passive” income. The taxation of the investor may shift radically depending upon whether income can be classified as active or passive.

A. Active Income

1. Deferral Opportunity

As noted above, deferral of tax can be limited by controlled foreign corporation rules and similar anti-deferral regimes. However, those rules are typically aimed at preventing deferral of passive income streams. Thus, if the income generated by the foreign investment produces active business income, typically the operations conducted in a foreign subsidiary will not be subject to any home country tax until the income they produce is repatriated as a dividend or upon liquidation. What types of income qualify as active income may vary from jurisdiction to jurisdiction. In addition, pay careful attention to particular regimes that pick up income that would generally not be viewed as passive income to the untrained investor. For example, the United States has rules that prevent deferral of what would normally be viewed as active sales income. Section 954(d) prevents deferral in situations where sales are made by a particular foreign subsidiary to purchasers in another jurisdiction and a portion of the sales chain involves a related party. This rule also may apply to related party services income.11

It is important that the practitioner inquire about the income stream that will be generated by the foreign investment and plan accordingly.

2. Foreign Tax Minimization

Foreign tax minimization is a very important consideration for an investor. Although active income is generally subject to the tax laws of the source country, that does not prevent the tax practitioner from finding ways to minimize the foreign tax burden. As noted above, the availability of foreign tax credits in the investor’s home-country is of critical importance. The tax practitioner needs to analyze whether there are tax credits available, and more importantly, whether the taxpayer will be able to fully utilize the tax credits under the tax rules (which can be quite complicated). In addition, it is important to study the client’s current financials to see if tax credits will provide maximum value.

3. Repatriation Strategies

Finally, it is important to note that any active income that is deferred from home country taxation may need to be repatriated. As a general matter, the repatriation of income will trigger home country taxation. However, it may also attract source country withholding taxes. It is important for the tax practitioner to be aware of the tax burden at both levels and maximize any foreign tax credits that might be available by virtue of the repatriation of foreign income.

In addition, a tax practitioner should look for special opportunities to repatriate income. The American Jobs Creation Act of 200412 added new section 965 to the Code. Section 965 provided a special one-year temporary deduction (equal to 85 percent) on qualifying cash dividends repatriated by a United States shareholder of a controlled foreign corporation. There have been rumblings that the United States Congress may pass another piece of special legislation to allow repatriation at reduced rates. This may also be part of legislation in other countries looking to bring foreign income back into the home country system.

B. Passive Income

Passive income typically consists of interest, dividends, rents, royalties and gains from the sale of real or personal property.13 The controlled foreign corporation rules require United States shareholders of controlled foreign subsidiaries to include

12 P.L. No. 108-357.
13 See, e.g., 26 U.S.C. § 871(a)(1)(A) and (B) (2009).
passive income earned by the foreign subsidiaries in the United States shareholders gross income. In non-controlled situations, the passive foreign investment company rules require the United States shareholders to either include the passive income in their gross income on an annual basis or pay additional taxes and interest upon any later sale or distribution of income from the foreign subsidiary. In either case, the rules are designed to prevent a United States shareholder from deferring passive income earned by foreign subsidiaries.

As a result of anti-deferral regimes (both in the United States and other jurisdictions), it is critical for the tax practitioner to identify the income streams that will be produced by the foreign investment and determine whether they will qualify as passive income subject to the anti-deferral rules. As noted above, the definition of “passive income” may vary from jurisdiction to jurisdiction, and it is possible that certain types of income streams that are commonly believed to be passive income may be included or excluded under the specific tax rules. For example, the United States rules on controlled foreign corporations have special exemptions for same country dividends and royalties as well as specialized exemptions from certain types of active leasing, banking, insurance and other types of income.

If an investment is going to produce income streams that are subject to any anti-deferral regimes, the tax practitioner might forego using a corporate structure that offers deferral in favor of a pass-through regime.

402 BUILDING BLOCKS —
FOUR KEY VARIABLES IN INTERNATIONAL TAX STRUCTURING

Understanding the rules of the foreign country you intend to invest in is extremely important. As noted above, practical limitations prevent most practitioners from dispensing advice about foreign tax laws, even if they have some familiarity with them. That does not prevent the tax practitioner from effectively structuring the investment in a tax efficient manner without completely deferring to foreign counsel (who does not have the ability to dispense United States tax advice).

Below, we discuss four of the basic building blocks when structuring an international investment. Although there are numerous factors that have an impact on any investment, we concentrate on four of the key building blocks that tend to influence transactions most often and to the greatest extent. We will briefly discuss each of the building blocks: tax treaties, permanent establishment, withholding taxes, and the taxation of capital gains. Since there are numerous excellent articles that cover these topics, we will avoid an in-depth discussion of each building block and instead focus upon how these building blocks practically impact investment in Asia and Europe.

402.1 Building Block # 1 — The Effects of Tax Treaties

The most important building block is the availability of a tax treaty. It is important because it effectively sets the rules of engagement for any cross-border transaction. While the tax treaty serves several purposes, its key purpose is to eliminate the double taxation of a multi-national business. To achieve its purpose, a tax treaty is designed to determine which country has the primary right to tax income — the country in which income arises (the source country) or the country in which the taxpayer is resident (the residence country) — and otherwise establish terms for the taxation of cross-border income between the signatory countries. Thus, the first thing any tax practitioner must do is determine a tax treaty is applicable. Because most tax treaties are bilateral arrangements between two countries, in multi-jurisdictional investments, a practitioner may need to look at multiple tax treaties and the interplay between them.

A. Practical Tip #1 — Understand the General Structure of Tax Treaties

Tax treaties generally follow a common pattern based on the Organisation for Economic Co-operation and Development (OECD) Model Treaty, and thus establish a more or less consistent set of rules between most major trading partners. The United States has also produced a model treaty that serves as the basis for most United States bilateral tax treaties. As a result, understanding the basic framework of treaties will help the practitioner analyze most treaties very quickly and allow the practitioner to identify the situations where a particular treaty departs from the norm.

18 Id.
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Instead of analyzing each article of the treaties in detail, we instead point out the starting point for any treaty analysis. The first few articles of any treaty typically discuss the scope of taxes covered by the treaty and the individuals or entities that are eligible for treaty benefits. With respect to the scope of taxes, it is very important to note that most tax treaties are “income tax” treaties. Because other countries have different names for their taxes, it is important to review the opening sections of any tax treaty and determine what types of taxes are covered. The key to remember is that most treaties are generally limited to taxes that are imposed on net income (or income calculated in a similar manner). Most tax treaties do not cover transfer taxes, sales and use taxes, or value added taxes. Thus, it is important for a practitioner to mention to a client that there are other types of taxes (e.g., real estate transfer taxes) that might be imposed that will have to be paid regardless of what types of exemption are granted for income taxes under a treaty. In addition, gift and estate taxes are not covered by most tax treaties and are generally covered in separate treaties of their own.

B. Practical Tip # 2 — Utilize Holding Company Structures

As the key building block in any tax structure, a practitioner should first identify if the country where the investment is made has a bilateral tax treaty with the country where the client is ultimately situated. The United States has over 50 bilateral tax treaties with different jurisdictions. The United Kingdom also has an even wider range of bilateral treaty partners.

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21 This fact becomes clear after looking at Article 2 of almost any major bilateral tax treaty. See also Kuntz & Peroni, ¶ 4.01[3].
22 See e.g., Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on estates, inheritances, gifts and generation-skipping transfers, U.S. - Austria, June 21, 1982, TIAS 10570 (Austria); Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on estates, inheritances and gifts, U.S. - Fr., Nov. 24, 1978, 32 UST 1935 (France); Convention and protocol for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on the estates of deceased persons, U.S. - Gr., Feb. 20, 1950, 5 UST 12 (Greece). It is interesting to note that the United States has comprehensive Estate Tax Treaties with many European countries but only one Asian country (Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on estates, inheritances, and gifts, U.S. - Japan, Apr. 16, 1954, 6 UST 113 (Japan)).
23 See IRS Publication 901.
24 http://www.hmrc.gov/uk/international/in_force.htm (HM Revenue & Customs website).
Thus, there is a very good possibility that an investor will have the benefits of a tax treaty when investing abroad.

However, there are countries where your client’s home country has not concluded a bilateral tax treaty. For example, the United States lacks bilateral tax treaty with most South American nations. Investment in a jurisdiction that lacks a comprehensive tax treaty potentially exposes the investor to the full effects of the foreign jurisdiction’s tax system without protection. As a result, some alternative structures for investment may be needed.

More often, there may be a tax treaty in place but it does not have provisions that are as favorable to the investor as provisions in another bilateral tax treaty. The sections below provide several examples where certain tax treaties provide significant advantages and disadvantages in the treatment of certain items of income. Thus, even an investment in a jurisdiction with a tax treaty may still require the need for some alternative tax structuring.

Many tax structures utilize intermediate holding companies in various jurisdictions other than the jurisdiction where the ultimate investment lies. Holding companies serve a number of corporate and administrative purposes, but they are also utilized by tax practitioners to obtain favorable treaty benefits. For example, a company located in Country A wishes to invest by purchasing shares in a company incorporated in Country B (assuming it will receive dividend distributions and may eventually sell the stock at a significant profit). Assume that there is no tax treaty between Country A and Country B (or that the treaty does not have favorable provisions). However, there is a comprehensive tax treaty between Country A and Country H, and between Country B and Country H. Both of these treaties effectively eliminate any withholding taxes on dividend payments to foreign persons in the two countries and exempt capital gains from source based taxation. It would be more favorable for the investor to form a holding company in Country H that would purchase and hold the shares of the company incorporated in Country B. Practitioners repeatedly place such holding companies in the same jurisdictions. That is no accident. Those jurisdictions tend to have favorable tax rates, low administrative tax burdens, and a wide range of treaties available. Some common countries for holding companies include Hong Kong, Luxembourg, Belgium, and the Netherlands. The examples provided below utilize these countries because of the excellent benefits they provide from a tax standpoint and a treaty standpoint.

C. Practical Tip # 3 — Make Sure to Look for any “Limitation on Benefits” Provision

Access to some treaties may be limited either by domestic laws or by virtue of specialized articles that appear in certain bilateral tax treaties. Thus, it is imperative that the tax practitioner examine whether limitation on benefits is an issue when using a holding company or back-to-back payment structure.

Access to treaty benefits increasingly complicated by limitation on benefits rules.

Qualification for treaty benefits under limitation on benefits rules:

- Derivative benefits
- Mixed ownership

402.2 Building Block # 2 — Permanent Establishment

Once it has been determined that a bilateral tax treaty exists (or does not exist), the practitioner should consider the role of foreign taxes. The OECD Model Treaty and all U.S. bilateral tax treaties include provisions that cover the taxation of “business” or “industrial and commercial” profits earned by an enterprise. The general rule under these provisions is that a country has the right to tax the business profits of an enterprise, even if earned by a resident of another country, if the enterprise maintains a “Permanent Establishment” in that country. However, the country is only entitled to tax business profits of the enterprise, to the extent those profits that are “attributable to” that Permanent Establishment. Permanent Establishment is a key building block because it determines whether the business operations will be subject to the general income tax rules of a particular jurisdiction.

25 With the exception of Venezuela, the United States does not have any bilateral tax treaties with any South American nation (Argentina, Bolivia, Brazil, Chile, Columbia, Ecuador, Paraguay, Peru or Uruguay). See Department of the Treasury, Internal Revenue Service Publication 901 “U.S. Tax Treaties” (Rev. April 2008).

26 See ¶ 103.

27 It is important to understand the impact of the Permanent Establishment rules, even in the absence of a bilateral tax treaty. The laws concerning taxation of business interests in most countries are generally based upon the same principles at the Permanent Establishment rules. For example, the United States uses the term “engaged in a United States trade or business” as a substitute for Permanent Establishment and the rules under section 864 are somewhat similar (although slightly more expansive). In addition, the United States has a concept of “Effectively Connected Income” under section 864 that is similar in nature to the “attributable to” language found in the business sections of most bilateral tax treaties.

For example, assume that a company in Country A wishes to expand its sales activities into a foreign Country B. If the company avoids being deemed to have a Permanent Establishment, then the company will not be subject to general County B income taxes on its sales activities. The company would only be subject to its County A taxes as usual. Country B would be limited to taxing the company under other specialized articles (e.g. withholding taxes) where the nature and scope of the Country B taxes is minimized.

Conversely, if the sales activities in Country B rise to the level of a Permanent Establishment, then the company will be subject to Country B income tax (like any other Country B business operation) on all profits attributable to the Country B operations. Since Country A still retains jurisdiction to tax the company, the company is now forced to rely on the foreign tax credit system of Country A to ameliorate the impact of the Country B taxes it must pay. To the extent that the Country A tax credit system is unable to provide a full credit for the taxes paid to Country B, the company is essentially paying “double tax” on its sales income in Country B.

In addition, the company, although resident in Country A, is now subject to Country B taxes and is probably required to file income taxes in Country B. It may also be subject to jurisdiction and liability in Country B. In many instances, if Permanent Establishment is unavoidable, practitioners should form an entity under the laws of Country B to handle all of the business activities in Country B. This limits the Permanent Establishment to the Country B entity and generally limits Country B taxation to the Country B entity. The company resident in Country A is now only concerned with potential withholding taxes on dividend distributions from its subsidiary in Country B.

It is clear that understanding the impact of the Permanent Establishment rules in any jurisdiction is a critical gate-keeping step in any cross-border investment structure. Below are some of the key differences in the interpretation of Permanent Establishment under certain tax treaties and how these differences may affect tax structuring in the relevant jurisdictions.

A. Practical Tip # 4 — Examine How Expansively the Scope of

Permanent Establishment is Defined by the Source Country Permanent Establishment is generally defined in most treaties as a “fixed place of business through which the business of an enterprise is wholly or partly carried on.” The OECD Commentary offers additional guidance for interpreting the term “fixed place of business.” The Commentary explains that the requirement that a place of business be “fixed” in order to constitute a Permanent Establishment is determined both by “location” and by “time.” The business location must be geographically fixed and must be “permanent” to some degree.

After laying out the general rule requiring a “fixed place of business,” most treaties then include a specific (but not exclusive) list of types of business locations that qualify as a Permanent Establishment. This list generally provides examples of what qualifies as a Permanent Establishment under the particular tax treaty.

It is important to note that most tax treaties have a list that is relatively similar to the list provided in the U.S. Model Treaty and older versions of the OECD Model Treaty. Article 5(2) of the U.S. Model Treaty lists some examples of “places of business,” which include:

- a “place of management”
- an office
- a workshop
- a branch
- a factory
- a mine, an oil or gas well, or any other place of extraction of natural resources

Although meeting one of the above definitions is not conclusive, it is generally accepted by practitioners that the company has triggered the Permanent Establishment rules and would be subject to the general income tax rules of the foreign country on their income.

A survey of most bilateral tax treaties between the United States and most European countries would demonstrate that the United States and its European treaty partners have closely followed the U.S. Model Treaty. For example, Article 5(2) of the United Kingdom - United States Income Tax Treaty reads as follows:

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29 See, e.g., OECD Model Tax Treaty Article 5(1).
31 Id.
32 Most treaties also include a list of exceptions that generally include a fixed place of business used for: storage, display, delivery, processing of goods, purchasing goods, collecting information, and other auxiliary activities.
The United States tax treaties with Germany, France, Switzerland and Italy all look substantially similar in their definition of Permanent Establishment. This provides fairly solid footing for what would meet the definition of a Permanent Establishment in Europe. We are cognizant that each European jurisdiction is unique and has its own distinct set of tax laws. However, the similarity between tax treaties and the cooperation that exists between members of the European Union provide a general framework for Permanent Establishment issues in Europe. Thus, even where the Permanent Establishment implications of a certain business arrangement have yet to be adjudicated in a particular jurisdiction, a foreign investor may be able to look to examples from other European jurisdictions where the issue has been vetted to get a good sense of the possible result.

Conversely, investment in Asia and its developing nations provides a far greater challenge when dealing with issues of Permanent Establishment. Several United States bilateral tax treaties with Asian countries include more expansive definitions of Permanent Establishment. For example, one commentator notes:

It is sometimes observed that the United States and other countries that are commercially developed or are large exporters of capital and goods generally prefer a high threshold for existence of a Permanent Establishment. This allows them to remain the primary beneficiaries of taxation of the often significant foreign activities of their own enterprises. Other countries, mainly developing countries that import capital, have a stronger interest in taxing income derived by foreign-based enterprises from local operations. Such countries tend to favor a lower threshold for Permanent Establishments.

In fact, the OECD has made changes to the Permanent Establishment rules in its Model treaty and the relevant commentary in the last few years. The changes, which have been aimed at lowering the threshold for triggering Permanent Establishment, have formed the basis for more aggressive interpretation of the Permanent Establishment rules by developing jurisdictions.

Contrast the list from Article 5(2) of the U.S. Model Treaty and most European treaties with the list from Article 5(2) of the U.S.-India tax treaty. The term “permanent establishment” includes especially:

(a) a place of management;
(b) a branch;
(c) an office;
(d) a factory;
(e) a workshop;
(f) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources;
(g) a warehouse, in relation to a person providing storage facilities for others;
(h) a farm, plantation or other place where agriculture, forestry, plantation or related activities are carried on;
(i) a store or premises used as a sales outlet;

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34 See generally Article 5(2) of the Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital and to certain other taxes, with a related protocol, exchanges of notes and memorandum of understanding, U.S. - Ger., Aug. 29, 1989, 1708 UNTS 3 (Germany); Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital, with exchanges of notes, U.S. - Fr., Aug. 31, 1994, 1963 UNTS 67 (France); Convention for the avoidance of double taxation with respect to taxes on income, with protocol U.S. - Switz., Oct. 2, 1996, 1996 U.S.T. LEXIS 74 (Switzerland); Convention with protocol for the avoidance of double taxation with respect to taxes on income and the prevention of fraud or fiscal evasion, with exchange of notes, U.S. - Italy, Apr. 17, 1984, TIAS 11064 (Italy).


36 Id.
(j) an installation or structure used for the exploration or exploitation of natural resources, but only if so used for a period of more than 120 days in any twelve month period;

(k) a building site or construction, installation or assembly project or supervisory activities in connection therewith, where such site, project or activities (together with other such sites, projects or activities, if any) continue for a period of more than 120 days in any twelve month period;

(l) the furnishing of services, other than included services as defined in Article 12 (Royalties and Fees for Included Services), within a Contracting State by an enterprise through employees or other personnel, but only if:

(i) the services are performed within that State for a period or periods aggregating more than 90 days within any twelve month period; or

(ii) the services are performed within that State for a related enterprise (within the meaning of paragraph 1 of Article 9 (Associated Enterprises)).

It is quite clear that India has taken a far more aggressive approach in defining Permanent Establishment. The result is that many investments into India (and other Asian jurisdictions) are far more likely to qualify as a Permanent Establishment and trigger foreign taxation. In addition, as noted below, India is also taking an aggressive stance with respect to agency and other Permanent Establishment issues.

Although the definition of a “fixed place of business” concentrates upon the location of the business activity, the time period for the business activity is also relevant. There are certain areas where the timing of the business location may qualify it for Permanent Establishment status even though the project is temporary. For example, in the area of construction activities, a project will qualify as a Permanent Establishment if it extends beyond a specific period of time.37 The amount of time varies according to the particular tax treaty. For example, the U.S. Model Treaty sets forth special rules applicable to building sites, construction or installation projects, and installations, drilling rigs, or ships used for the exploration of natural resources if the “site, project, or activity continues for more than a specified period, such as 12 months.”38 We note that Article 5(3) of the United States - United Kingdom treaty has a similar provision:

A building site or construction or installation project constitutes a permanent establishment only if it lasts for more than twelve months.39

Contrast that with the same article in the United States - China tax treaty which provides a far more expansive and oppressive definition of Permanent Establishment for construction projects:

The term “permanent establishment” also includes:

(a) a building site, a construction, assembly or installation project, or supervisory activities in connection therewith, but only where such site, project or activities continue for a period of more than six months;

(b) an installation, drilling rig or ship used for the exploration or exploitation of natural resources, but only if so used for a period of more than three months; and

(c) the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only where such activities continue (for the same or a connected project) within the country for a period or periods aggregating more than six months within any twelve month period.

It is quite clear that China is far more aggressive in asserting Permanent Establishment than the UK or other European jurisdictions. The example above is not an isolated example. Several treaties are now including more expansive definitions of Permanent Establishment. The key issue to take away from this discussion is that it is important to get a fundamental understanding of what constitutes a Permanent Establishment under the general rules (as proposed by the Model Tax Treaties). By knowing these rules, a practitioner can immediately spot tax treaties with more expansive definitions of Permanent Establishment and can caution clients accordingly. Especially in Asia, it is of critical importance to discuss Permanent Establishment issues with local counsel and to structure client’s investment accordingly.

37 See, e.g., U.S. Model Tax Treaty Article 5(3).
38 2006 U.S. Model Tax Treaty Art. 5(3). The corresponding provision of the OECD Model Tax Treaty applies only to building sites and construction or installation projects. OECD Model Tax Treaty Art. 5(3).
40 U.S. - China Income Tax Treaty, Article 5(3) (emphasis added).
B. Practical Tip # 5 — Be Careful Not to Trip Agency Attribution

Even if a business entity does not meet the definition of a Permanent Establishment, it may nonetheless be deemed to have a Permanent Establishment. The activities of a dependent agent may be attributed to an enterprise and it may be deemed to have a Permanent Establishment even though it does not directly conduct any of the activities that would normally give rise to a Permanent Establishment.

For example, a company located in Country A wishes to expand its manufacturing and sales activities into Country B. Wishing to avoid Permanent Establishment issues, the company does not build a manufacturing plant or send its own salesmen into Country B. Instead, the company contracts with another company located in Country B to manufacture the products and hires “independent contractors” located in Country B to sell products for the company on a commission basis in Country B. If the company located in Country A exerts enough control over the activities of the manufacturing company and the “independent contractors” located in Country B, the manufacturing company and the salesmen may be viewed as “agents” of the company. As a result, the activities of these Country B entities and persons may be “attributed” to the company and it will be deemed to have a Permanent Establishment.

In effect, the agency rules effectively extend the scope of Permanent Establishment beyond the simple list of items that meet the general physical presence test. The key determination of whether an agent’s Permanent Establishment should be attributed to the principal or not turns upon whether the agent is “independent” or “dependent.”

Both the OECD and the U.S. Model treaties generally set forth the requirements for an agency Permanent Establishment:

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person - other than an agent of independent status to whom paragraph 6 applies - is acting on behalf of an enterprise and has and habitually exercises in a Contracting State an authority to conclude contracts that are binding on the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities the person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 that, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

In effect, an agent must both (a) lack independent status and (b) have the authority to conclude contracts on behalf of the principal. If both requirements are met, then all of the activities of the dependent agent will be attributed to the principal for purposes of testing Permanent Establishment. This would generally subject the principal to Permanent Establishment and full taxation under the laws of the source country.

The definition of an independent agent is fairly limited in scope:

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent, or any other agent of independent status acting in the ordinary course of business as independent agents.

It would appear that agency attribution is quite limited in scope by merely looking at the definition in the treaty. The commentary to the US Model Treaty provides more color. Whether the agent and the enterprise are independent is essentially a factual determination. Relevant factors to consider include: (a) the extent to which the agent operates on the basis of instructions from the enterprise; (b) the extent to which the agent bears business risk; and (c) the extent to which the agent is economically independent or acts exclusively or nearly exclusively for the principal. The OECD Commentary

41 2006 U.S. Model Tax Treaty Arts. 5(5), see also OECD Model Tax Treaty Arts. 5(5).
43 The commentary notes that an agent that is subject to detailed instructions regarding the conduct of its operations or comprehensive control by the enterprise is not legally independent. Id.
44 The commentary notes that business risk refers primarily to risk of loss. An independent agent typically bears risk of loss from its own activities. In the absence of other factors that would establish dependence, an agent that shares business risk with the enterprise, or has its own business risk, is economically independent because its business activities are not integrated with those of the principal. Conversely, an agent that bears little or no risk from the activities it performs is not economically independent. Id.
45 The commentary notes that an exclusive or nearly exclusive relationship may indicate that the principal has economic control over the agent. A number of principals acting in concert also may have economic control over an agent. The limited scope of the agent’s activities and the agent’s dependence on a single source of income may indicate that the agent lacks economic independence. It should be borne in mind, however, that exclusivity is not in itself a conclusive test; an agent may be economically independent notwithstanding an exclusive relationship with the principal if it has the capacity to diversify and acquire other clients without substantial modifications to its current business and without substantial harm to its business profits. Thus, exclusivity should be viewed merely as a pointer to further investigation of the relationship between the principal and the agent. Each case must be addressed on the basis of its own facts and circumstances. Id.
similarly states that in order to be independent, an agent must be both “legally” and “economically” independent. According to the Commentary, legal independence depends on the degree of control that the principal exerts over the agent, and economic independence depends on who bears the entrepreneurial risk of the agent’s business.

In addition, judicial decisions play a significant role in determining a specific jurisdiction’s view on the scope of agency within the meaning of a bilateral tax treaty. Recent decisions in various jurisdictions have alerted practitioners to more stringent views of agency and Permanent Establishment in general.

C. An Example of the Expanding Scope of Permanent Establishment — the Noose Tightens in India

In general, Indian tax treaties closely follow the OECD Model treaty. However, as demonstrated above, India’s tax treaties tend to broaden the scope of the Permanent Establishment rules beyond the OECD Model. As a result, some activities that would not create a Permanent Establishment in other OECD treaties result in a Permanent Establishment in India.

A number of recent rulings from the Indian taxing authorities concerning the scope of Permanent Establishment the extent of income attribution in India arising from the Permanent Establishment have demonstrated a more aggressive approach.

In Morgan Stanley & Co. Inc. v. Director of Income Tax, Mumbai (292 ITR 416), the Supreme Court ruled that deputation of personnel can give rise to a Permanent Establishment. Morgan Stanley sent staff to its wholly-owned captive Indian business process outsourcing unit. The Supreme Court held that where a foreign enterprise uses its employees to furnish services within India, then a Permanent Establishment is created. The Court drew a distinction between services that related to the “stewardship” of the wholly-owned enterprise and services that related to the day-to-day business operations and management of the wholly-owned enterprise; in the latter case, a Permanent Establishment was created (but not in the former).

In Galileo International Inc. and Maruthi Info and Tech Centre v. DCIT (19 SOT 257) (447-ITAT-DEL), India’s Income Tax Appellate Tribunal ruled that a U.S. company that provided online reservation services to business customers in India had an Indian Permanent Establishment and that part of the company’s income was taxable in India.

Galileo International was based in the United States and had its master computer system in the United States. The system was connected to travel agents in India through a network provided by a third party. The tribunal decided that Galileo had an Indian Permanent Establishment under the 1989 India-United States Tax Treaty, through computer hardware installed by Galileo on the premises of travel agents over which it exercised a certain level of control. While the appellant argued that the computers were merely preparatory or auxiliary in nature, the tribunal held that the computers formed an essential part of the business and constituted a fixed place of business through which Galileo carried on its business.

Both of the above cases illustrate a relatively low threshold for creating a Permanent Establishment in India.

Two other recent cases which illustrate the competitive nature of the Indian tax authorities are Clifford Chance v. DCIT, Income Tax Appeal Nos. 181 & 182 of 2002, dated December 19, 2008 (“Clifford Chance”), and Vodafone International Holdings B.V. v. ADIT, Writ Petition No. 2550 of 2007, dated December 3, 2008 (“Vodafone”). Vodafone is dealt with below at 402.4D

In Clifford Chance, a UK based law firm provided legal services to a joint venture involving Indian companies and foreign companies. In the course of providing the professional services, Clifford Chance partners had an aggregate presence in India in excess of 90 days. The Indian tax authorities sought to tax Clifford Chance on all of the fees relating to the joint venture whether the fees related to services rendered in India or not, contrary to Article 15 of the India-UK Tax Treaty. The Court found for the law firm and held that the income earned from the rendering of independent personal services would be taxable in India only to the extent that it was attributable to services rendered by the partners of Clifford Chance while in India.

402.3 Building Block # 3 —Withholding Taxes (Interest, Dividends and Royalties)

Even if Permanent Establishment is avoided, that does not mean that a foreign investor is free from foreign income tax liability on its investments. There are generally withholding taxes on certain types of passive investment income streams.

49 Section A.2. (above); see also Article 5 of the OECD Model Tax Treaty and Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, U.S. - India, Sep. 12, 1989, 1989 U.S.T. LEXIS 236 (India).
earned in a foreign jurisdiction. Payments generally subject to withholding taxes include: interest, dividends, rents, royalties, and certain gains from the sale of real and personal property.

For example, a company located in Country A lends income to persons in Country B and earns dividends on stock it owns in companies incorporated in Country B. It is unlikely that the mere lending of money or holding corporate stock will give rise to a Permanent Establishment in Country B. Thus, this income is not taxed at typical Country B income tax rates and the company is not required to file tax returns in Country B. However, the company may still be subject to certain taxes on the income that are imposed as withholding taxes.

Unlike the more complicated provisions in tax treaties, the sections on passive income tend to be straightforward. They generally define what constitutes a particular type of income stream and then place a limitation on the extent to which a country can tax a foreign investor’s passive income stream of that type.

Generally, the maximum rate is considerably lower than the general rate of tax. For example, the United States typically taxes payments of passive income to foreigners at 30 percent. However, most bilateral tax treaties reduce the rate on payments to 15 percent or less. This is generally much lower than the general 35 percent rate of tax that would apply if the foreign investor was deemed to have a Permanent Establishment. Typically, most tax treaties do not provide a lower rate of tax on income earned by a Permanent Establishment.

A. Practical Tip #6 — Comparison Treaty Rates on the Potential Income Streams Relevant to Your Client’s Investment

The maximum rate varies according to the income stream in question: rates on interest can be different from rates on dividends or royalties. For example, the maximum rate of withholding on interest payments may be more beneficial than the rates on dividends or royalties. Thus, it might be more beneficial to structure an investment as a debt instrument than an equity instrument or license arrangement.

In addition, the rates on any type of income can vary depending on the particular bilateral treaty.

<table>
<thead>
<tr>
<th></th>
<th>United Kingdom</th>
<th>Germany</th>
<th>Switzerland</th>
<th>China</th>
<th>Korea</th>
<th>India</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>10</td>
<td>12</td>
<td>15</td>
</tr>
<tr>
<td>Dividends</td>
<td>5/15</td>
<td>5/15</td>
<td>5/15</td>
<td>10</td>
<td>10/15</td>
<td>15/25</td>
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<td>0</td>
<td>0</td>
<td>10</td>
<td>15</td>
<td>10</td>
</tr>
</tbody>
</table>

The representative sample above demonstrates the differences in maximum rates on certain income streams that can be imposed under various tax treaties. The bilateral tax treaties with European countries have significantly lower rates and have special provisions that can virtually eliminate any withholding taxes by the source country. Conversely, United States treaties with most Asian countries merely reduce source-based withholding to a reduced rate, at best, that is still higher than the taxation of a similar investment in a European country.

The withholding taxes are important in determining how much of his proceeds the client will collect on an after-tax basis. As noted above in the discussion of Permanent Establishment, the investor will have to look to the credit provisions of his own tax laws to try to recover the foreign taxes paid under the withholding regime.

The lack of treaty protection on certain streams of income might push a practitioner towards proposing a particular income stream that has more favorable rates. More commonly, the practitioner looks for alternative tax treaties (“Treaty Shopping”) that might provide better rates.

B. Practical Tip #7 — Remember to Check Local Law First

Before looking to other treaties for more beneficial tax treatment, we caution you to look to the tax laws of the source country. Just because a tax treaty limits the amount of interest paid to a particular rate, that does not mean that the investor may not be eligible for a more beneficial rate under the general tax laws of the jurisdiction as applied to foreign investors.

51 See Department of the Treasury, Internal Revenue Service Publication 901 “U.S. Tax Treaties” (Rev. April 2008).
For example, the maximum withholding rate that may be imposed on interest payments is 12 percent.\textsuperscript{52} Thus, a United States investor who receives interest payments from a Korean company will only have to pay a 12% withholding tax on the interest rather than the full 27.5% Korean tax rate. Similarly, a Korean investor would be able to avail himself of the tax treaty to lower the tax on interest payments from a United States company from the 30% tax rate under section 871(a) to 12%. However, if the Korean investor was eligible for the “portfolio interest exemption,”\textsuperscript{53} then the interest payments would not be subject to income tax under United States law. In effect, the Korean investor would not have to rely upon the tax treaty because the general tax laws of the United States provide a more beneficial tax rate. You would not want to counsel a Korean client that the withholding rate on a United States debt obligation is 12% based upon the treaty, when the actual rate may be zero.

This is also true of other types of income streams and in other jurisdictions. For example, Mexico does not impose any withholding tax on dividends. Thus, the bilateral provisions in most Mexican treaties are not needed to limit Mexican taxes; instead they are geared to protect Mexican investors who are investing in corporations abroad. Several European countries have a “participation exemption,” which under local law provides that certain types of dividends are not taxed in the hands of shareholders.\textsuperscript{54}

One significant area of law that is important is the effect of the European Union and the specialized tax directives that have been agreed upon by the Member States. For example, the Parent-Subsidiary Directive attempts to eliminate double taxation by establishing a common system of taxation applicable to parent companies in one European country and their subsidiaries in different European countries. Under the Parent-Subsidiary Directive, when a subsidiary in one Member State distributes a dividend to its parent company in another Member State, the country of the parent company may not tax the dividend (in some circumstances it may grant a credit).\textsuperscript{55} In addition, the European Union has also enacted a similar Directive that exempts payments of interest and royalties.\textsuperscript{56} Thus, the movement of capital between European countries is almost seamless. This can be important in structuring an investment abroad.

The key issue is that tax treaties help establish the maximum rate of withholding taxes on certain investments; however, practitioners should make sure that there is a local withholding tax that needs to be limited by treaty.

C. Practical Tip #8 — Consider the Holding Company Structure (again) to Reduce Withholding Taxes

If it has been established that the local law will impose taxation and the practitioner has located the treaty provision that might minimize the impact of the taxation, the next step is to determine if there is a better result that may be obtained under another tax treaty.

For example, assume that a company in Country A wishes to license certain intellectual property to another company in Country B. Country B has a 30% withholding tax on any royalty payments to a foreign person. The tax treaty between Country A and Country B limits the rate on royalties to 15%. Thus, a payment of a $100 royalty will result in a $15 withholding tax.

Assume that there is a tax treaty between Country A and Country C, as well as a tax treaty between Country B and Country C. Both of these treaties effectively eliminate any withholding taxes on dividend payments to foreign persons in the two countries. Therefore, Country A could license the intellectual property to a newly-formed subsidiary in Country C, which in turn licenses to the company in Country B. Under the more favorable tax treaty between Country B and Country C, Country B cannot withhold on the interest payment of $100 to the subsidiary in Country C. The subsidiary in Country C may now make a payment of the royalty to its parent in Country A without any withholding tax under the tax treaty between Country A and Country C. As long as the taxable income paid in Country C is less than $15, it is worth it to the company to route the license through Country C for tax purposes.

This is the essence of treaty shopping. By looking to the various tax treaties between the country of your client and other countries and the country of investment and other countries, there is a possibility of structuring the investment through a third jurisdiction and utilizing tax treaties to minimize the impact of withholding taxes on distributions of income. This can be an effective tool when structuring cross-border investments.

\textsuperscript{52} See Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and the encouragement of international trade and investment, with related notes, U.S. - Korea, June 4, 1976, 30 UST 5253, Article 13(2).


We note that some jurisdictions have implemented specific tax rules aimed at preventing treaty shopping. For example, the United States typically includes a “Limitation on Benefits” article (described above) that limits the ability to use the treaty of the country where the ultimate investment. In addition, the United States has, under its domestic laws, prevented the application of treaty shopping arrangements in a number of judicial decisions. However, most bilateral tax treaties involving countries other than the United States do not have limitation on benefits or any similar type of provision. Furthermore, many of these countries have yet to impose any restrictions on treaty shopping (either by statute or by judicial decree), leaving the practitioner with the flexibility to structure an investment through a third jurisdiction to reduce or eliminate any withholding tax burdens.

402.4 Building Block # 4 — Taxation of Capital Gains

In many respects, the taxation of capital gains could be categorized as another form of withholding tax. However, capital gains taxes can be analyzed separately for several reasons. First, the taxation of capital gains tends to differ from the taxation of other types of passive income streams in many bilateral tax treaties. In addition, capital gains taxes are extremely important because the amounts at issue may be far more significant than general distributions because it involves a disposition of the entire investment in the foreign entity. Many investments by equity funds are limited to the purchase and sale of a foreign entity. The parties do not expect any income to be distributed during the life of the investment, so the only potential for taxation will occur upon an exit event (i.e., disposition, public offering, etc.).

For example, an investment fund in Country A purchases shares in a company incorporated and doing business in Country B. After the value of the Country B company has increased significantly, the investment fund sells the shares of the company resident in Country B. Query, is the investment fund located in Country A subject to capital gains taxes in Country B?

A. Practical Tip # 9 — If the Exit Strategy Involves the Sale of Shares, Check the Taxation of Capital Gains Under Local Law and Under the Relevant Tax Treaty

In many jurisdictions, including the United States, gain from the sale by a foreign resident of shares of a domestic corporation is not generally subject to tax. Whereas section 861 specifically lists interest, dividends, royalties and real property sales as United States source income, section 865 sources income from the sale of personal property to the country of residence. In effect, the United States will not impose withholding tax upon a non-resident who sells personal property, even if located in the United States. This allows foreign investors to purchase shares of United States corporations and sell the shares without the burden of United States capital gains taxes.

As a result, many United States bilateral tax treaties have Capital Gains provisions that essentially source gains from the sale of personal property to the residence of the seller. For example, Article 13(6) of the U.S. Model Treaty provides:

6. Gains from the alienation of any property other than property referred to in paragraphs 1 through 5 shall be taxable only in the Contracting State of which the alienator is a resident.

In effect, the sale of shares of stock by a non-resident who does not have a Permanent Establishment is not subject to taxation. This is very important because many other countries do not exempt foreign investors from capital gains taxes on sales of shares of corporations incorporated in that jurisdiction. If the other country imposes capital gains taxes on the sale of shares of a domestic corporation, the United States investor would need to rely upon the tax treaty to ensure that it was not subject to capital gains taxes and that the purchaser would not be required to withhold taxes under local law.

A look at most United States bilateral tax treaties would reveal a capital gains provision that follows the Model treaty to the letter. This provision is included in most United States bilateral tax treaties to put a United States investor in a foreign

63 Assuming the investor is not resident in the United States for more than 183 days or is engaged in a United States trade or business. 26 U.S.C. § 871(a) (2) (2009).
64 Sales of real property are treated as United States source income under domestic law. 26 U.S.C. §§ 861(a)(5) and 897. The U.S. Model Treaty has a separate article that sources all capital gains to the location of the real property rather than the residence of the seller. See U.S. Model Tax Treaty, Articles 6(1) and 13(1).
jurisdiction on the same footing as a foreign investor who invests in the United States. This trend can be seen in most United States tax treaties with European countries.

For example, a typical treaty that provides the complete exemption from capital gains taxes would look as follows:

*Article 13 (from the United States - United Kingdom Tax Treaty)*

**Gains**

5. Gains from the alienation of any property other than property referred to in the preceding paragraphs (i.e., real property and gains attributable to a Permanent Establishment) of this Article shall be taxable *only* in the Contracting State of which the alienator is a resident.

Contrast that with the capital gains articles from the bilateral tax treaties between the United States and Asian jurisdictions that imposes capital gains taxes on foreigners who sell shares of a domestic corporation. For example, the capital gains article from the bilateral tax treaty between China and the United States provides:

*Article 12 (from the United States - China Tax Treaty)*

**Gains**

5. Gains from the alienation of shares other than those mentioned in paragraph 4 representing a participation of 25 percent in a company which is a resident of a Contracting State may be taxed in that Contracting State.

The above article effectively taxes a United States person who invests in shares of a Chinese company if they own more than 25% of the shares. This seriously changes the method by which United States investors would normally structure investments in most of Europe when they venture into China.

We note that India has an even more draconian capital gains provision:

*Article 13 (from the United States - India Tax Treaty)*

**Gains**

1. Except as provided in Article 8 (Shipping and Air Transport) of this Convention, each Contracting State may *tax* capital gain *in accordance with the provisions of its domestic law.*

In effect, Article 13 allows each jurisdiction to impose capital gains taxes without limitation. Unlike a sale of shares of a United States corporation by a foreign resident, a sale by a United States resident of shares in an Indian corporation (regardless of the amount of the investment) generally attracts a capital gains tax in India. And unlike most other bilateral tax treaties, there is no capital gains article to protect the United States investor from being subject to Indian capital gains taxes. Thus, the lack of this exemption has a significant impact on the structuring of any United States investment in India or China.

The inability to avoid capital gains taxes in particular countries (e.g., India and China) poses significant structuring problems. To minimize or eliminate the impact of the capital gains taxes, many practitioners use one of two strategies.

**B. Practical Tip #10 — Consider the Holding Company Structure (again) to Eliminate Capital Gains Tax**

The practitioner should treaty shop and find a bilateral tax treaty between the Country of investment and a third Country that has a more favorable capital gains provision than the United States. For example, Mauritius has a tax treaty with India that has advantageous capital gains tax provisions. Most importantly, a sale of Indian shares by a Mauritius company is not subject to Indian capital gains. Mauritius used to have a tax treaty with China that provided the same exemption, but that...
Thus, a United States investor could form a subsidiary corporation in Mauritius, which in turn would invest in the Indian corporation. When the United States investor wanted to exit the investment, the Mauritius subsidiary would sell the shares of the Indian company and would invoke the protections in the India-Mauritius tax treaty to avoid Indian capital gains tax. This has been the preferred method for United States investment in India for years.

As noted above, treaty shopping has its limitations. Even if the tax treaty provides beneficial treatment, the Indian taxing authority might appeal to the judicial system to prevent abuse of the Mauritius tax treaty. Several decisions over the years have imposed increasing “substance” requirements on the Mauritius entity claiming treaty benefits. However, it has been somewhat easy and formula driven to qualify for treaty benefits (no limitation on benefits articles like those in US tax treaties). In fact, many trust companies that assist in setting up Mauritius holding companies provide a comprehensive check-list of the necessary requirements to ensure treaty benefits.

Commentators have claimed that India was going to “shut the door” on the Mauritius loophole for almost 20 years... yet, the opportunity to invest through Mauritius still exists and has yet to be foreclosed upon by the Indian taxing authorities.

There are other beneficial treaty arrangements that exist involving other Asian countries. For example, the tax treaty between Korea and Belgium has a favorable capital gains provision that prevents Belgian investors from paying Korean capital gains taxes. However, the exemption has recently been under attack by the Korean taxing authorities.

It is valuable to check to see where the most benefit lies, but be cautious since treaties (e.g., China-Mauritius) are subject to re-negotiation more freely in Asia than in the United States or Europe.

**C. Practical Tip #11 — Consider Utilizing a Holding Company in a Tax Haven to Eliminate Capital Gains Tax**

The second method typically utilized by tax practitioners for avoiding capital gains taxes is the insertion (or “stacking”) of an extra holding company in a tax haven jurisdiction. At the time of disposition, the investor will avoid the direct sale of the shares of the target corporation by instead selling the shares of the holding company.

For example, an investor in Country A wishes to invest in shares of a company incorporated in Country B. Country B imposes a capital gains tax on the sale of shares of a domestic corporation and there is no relief under the bilateral tax treaty between Country A and Country B. The investor in Country A forms a Cayman Islands corporation to invest in and hold the shares of the company in Country B. At the time of disposition, the investor sells his shares of the Cayman Islands corporation (the Cayman Islands does not impose any capital gains taxes). Since there was no direct disposition of shares of the Country B entity, there is no capital gains transaction that would be subject to taxation by Country B.

Thus, direct sales of Indian and Chinese companies are typically avoided by forming a holding company in a third jurisdiction which will be the ultimate entity that will be sold by the investor. The sale of the holding company effectively avoids the capital gains taxes in those jurisdictions. The jurisdiction where the holding company resides is typically a jurisdiction that does not impose an income tax (e.g., the Cayman Islands) so that there is no additional tax burden by virtue of selling the holding company shares. However, if the investment requires placing a holding company in a jurisdiction that imposes tax, investors tend to favor jurisdictions that impose minimal taxes (e.g., Mauritius) or have a system of taxation that exempts capital gains taxes (e.g., Hong Kong).

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70 Mauritius is tax favorable because of low tax rates (generally, the effective tax rate is less than 3%). Thus, there is little “tax cost” for structuring the investment in India through Mauritius.


74 Convention Between the Republic of Korea and the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Belg. - Kor., Sep. 19, 1979, 1196 UNTS 189, Reg No. 19004, Article 13. In addition, Article 16 of the Korea - United States tax treaty also provides for a complete exemption from Korean capital gains tax on a sale of Korean corporate shares by a United States resident.

D. An Example of an Attack on Entity Stacking — The Vodafone Case

A recent case in India has attracted the attention of the international tax community. In the landmark case of *Vodafone International Holdings B.V. v. Union of India et al.*\(^\text{76}\) the Indian taxing authorities have attempted to assert jurisdiction over the sale of a company holding shares in an Indian entity. A win by the Indian taxing authorities could completely change how capital investment is conducted in India. In addition, the case may have wider ramifications because other developing nations may use the case to expand their own abilities to impose capital gains taxes on foreign investment.

The Vodafone case involves the sale of a controlling stake in India-based Hutch-Essar. Rather than sell the shares of the Indian corporation, Vodafone (through a Dutch subsidiary) purchased the shares of an intermediate holding company that owned a 67% stake in Hutch-Essar from Hong Kong-based Hutchison Essar. Because the transaction did not involve the purchase and sale of any Indian shares, Vodafone and Hutchison took the position that Indian taxes did not apply, and Vodafone did not withhold any capital gains taxes on the payment to Hutchison. Vodafone asserts that India does not have jurisdiction to tax transfers of ownership of a foreign corporation in another jurisdiction. This represents the general thinking of most international tax practitioners who structure investments by forming holding companies in other jurisdictions to hold the shares of Indian companies.

The Indian taxing authorities have asserted that the transaction was subject to Indian capital gains taxes and that Vodafone should have withheld 2 billion in taxes. The Indian taxing authorities are taking the broader position that the holding company merely held shares of the Indian corporation, so that the transaction was really an indirect transfer of an Indian capital asset. Although the case has yet to be decided on substantive merits, Vodafone has lost on several procedural grounds and may have to try the case in the Indian courts. Obviously, a loss on the substantive merits would potentially allow India to assert tax on any transfer of shares of any corporation anywhere in the world if the entity’s underlying asset is shares of an Indian corporation. Tax practitioners are closely monitoring this case.

403 PRACTICAL STRATEGIES FOR SELECTED CROSS-BORDER INVESTMENTS: CURRENT PRACTICES AND PITFALLS

403.1 Investment in Asia

Although every investment is unique and requires an independent look at the facts involved, the structure of many investments into Asia look very similar. Investment in Asia is clearly driven by the four key variables described above. The availability of tax treaties (or lack thereof) is very important. In addition, the expanded definition of Permanent Establishment, the increased withholding rates, and the inability to exempt capital gains taxes have a significant effect on Asian investment structures. Below, we examine a typical Asian investment structure and explain how the four key variables drive the basic tax structure.
A. The Impact of Tax Treaties

The proposed structure above shows a typical investment into China and India by a United States investor. Although limited to these jurisdictions, the general rules below can be used to help structure similar investments into other Asian jurisdictions. As noted above, the United States has entered into bilateral tax treaties with both India and China. However, these are two of the least favorable bilateral tax treaties and there are other countries that have more favorable tax treaties with China and India. Thus, it is rare that a United States entity will invest directly into China or India.

B. The Impact of Permanent Establishment

The best method for analyzing the investment structure is to work from the bottom of the diagram. The creation of an operating entity in China, India or any other Asian jurisdiction is typically a direct response to the aggressive stance both countries have taken with respect to Permanent Establishment. It is very difficult to conduct business activities in a manner that avoids Permanent Establishment in either of these countries. In addition, there are various laws that limit the ability of foreign entities to engage in certain business activities. For example, China has a list of “restricted” and “prohibited” businesses that may only be engaged in by Chinese entities (and in certain instances, must meet domestic ownership thresholds). In addition, recent changes to the law require all real estate projects to be housed in a Chinese entity. As a result, the typical investment structure usually involves the formation of a foreign entity in the source country jurisdiction. Thus, the United States partnership would either (a) form a Chinese or Indian corporation to conduct business in China or India, or (b) purchase shares in an existing Chinese or Indian corporation.

C. The Impact of Capital Gains Taxation

The next item that factors into Asian tax structuring is the taxation of capital gains. Because many emerging countries are taxing capital gains, it is imperative that the tax structure provide the flexibility to dispose of the foreign investment without attracting capital gains taxes. Many developing countries in Asia have yet to conclude tax treaties with the United States or other developed nations. As a result, there is no protection from the source country imposing capital gains taxes on the disposition of domestic corporate shares. In addition, the tax treaties with India and China do not provide the requisite exemption from capital gains taxes that exists in most United States bilateral tax treaties with European nations. As a result, most structures require the insertion of a holding company in either (a) a country with a favorable tax treaty with the country where the ultimate investment lies or (b) a tax-free jurisdiction. This allows the investor to sell the shares of the upper tier holding company and avoid capital gains taxes in the country of investment. The most common structure utilizes a Cayman Islands holding company that is typically sold when the investor decides to exit the investment. Of course, this structure is currently in limbo as tax practitioners around the world wait with baited breath to see the result in the Vodafone decision.

D. The Impact of Withholding Taxes

Some investments may involve nothing more than the purchase and sale of shares in a particular entity. In that scenario, direct investment through a Cayman Island company may be sufficient. However, there tends to be income that is distributed over the life of a typical investment, whether it involves dividends, interest, royalties or other income. As noted above, most countries have not concluded any tax treaties with any of the tax haven jurisdictions. Thus, any distributions from a subsidiary to a parent corporation in a tax haven will typically be subject to full withholding taxes (for example, 30% for a payment from a United States subsidiary to a Cayman Islands parent) without any tax treaty relief.

The best method for ameliorating the impact of the withholding taxes is to go treaty shopping and find a country that has a favorable tax treaty with the source jurisdiction. Most importantly, a treaty country that has favorable limitations on the type of income stream that is most likely to be relevant in the particular business arrangement. In addition, it is important to select a jurisdiction that will impose little or no tax on the income stream to prevent the income tax in the holding company jurisdiction from completely wiping out any advantage that is gained by reducing the withholding tax from the source country.


78 For example, the United States does not have tax treaties with Malaysia, Singapore, Cambodia, Vietnam or Hong Kong.
In the above structure, the United States investor takes advantage of the tax treaties between (a) Mauritius and India, and (b) China and Hong Kong. Mauritius and India\(^79\) have a tax treaty that is far more favorable to taxpayers than the tax treaty between the United States and India.

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<th>Interest</th>
<th>Dividends</th>
<th>Royalties</th>
<th>Capital Gains</th>
</tr>
</thead>
<tbody>
<tr>
<td>India-United States</td>
<td>15</td>
<td>15/25</td>
<td>10</td>
<td>30</td>
</tr>
<tr>
<td>India-Mauritius</td>
<td>No Limitations</td>
<td>5/15</td>
<td>15</td>
<td>0</td>
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</table>

In addition, the cost of doing business in Mauritius is minimal. The tax rate is generally less than 3%, which typically is worth the savings from Indian tax that one enjoys by avoiding taxes on direct investment.

Similarly, China and Hong Kong have a tax treaty that is more favorable to taxpayers than the tax treaty between China and the United States.

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<th>Interest</th>
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<th>Royalties</th>
<th>Capital Gains</th>
</tr>
</thead>
<tbody>
<tr>
<td>China-United States</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>No Limitations*</td>
</tr>
<tr>
<td>China-Hong Kong</td>
<td>7</td>
<td>5/10</td>
<td>7</td>
<td>No Limitations*</td>
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* assuming investment over 25%.

The benefit of doing business through a Hong Kong holding company is that Hong Kong has a territorial taxation system. Therefore, income that is derived in another country is not taxed in Hong Kong. As a result, distributions of interest, dividends, royalties and other gains from a foreign subsidiary are not subject to tax in Hong Kong.\(^80\) Thus, it is unlikely that an investor will pay any tax in Hong Kong by virtue of establishing a holding company there. Even if there is operational income that may be sourced to Hong Kong, the general tax rate of 17.5% is much lower than the income tax rates of most developed nations.

The above example is only representative of general transaction structures and is not a substitute for specific tax planning that reflects the intricacies of the client, the investment, and the specific country of investment. However, it demonstrates the

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\(^79\) The type of investment may dictate whether Mauritius is the most favorable location for a holding company. For example, the India-Cypress Tax Treaty has a 10% limitation on interest payments, making it a more favorable jurisdiction for debt-based investments than Mauritius.

impact of the basic building blocks on a typical investment and provides a road map for practitioners to approach any foreign investment in Asia or anywhere else in the world.

### 403.2 Investment in Europe

As noted with regard to Asia, while every investment is unique, there nevertheless remain basic strategies that can be deployed to successfully mitigate the impact of taxation on operating profits and profit repatriation. In each instance the tax practitioner is seeking to ensure that withholding taxes do not apply to interest or dividend payments made on an investment, that foreign taxes on operating profits are minimized, and that capital gains on the eventual disposal of an investment are repatriated without being subjected to foreign tax if possible.

The first task when advising a client who is investing in Europe is to consider whether the client should be investing directly into the target European jurisdiction or whether it is preferable to establish a holding company in a tax beneficial European state. In either case, the tax adviser should be considering the incidence of withholding taxes on profit and interest distributions and the impact of capital gains tax in the target jurisdiction. The terms of the tax treaty between the US and the target jurisdiction will dictate this, together with whether or not the target jurisdiction imposes capital gains tax on non-residents.

For the purposes of this paper, and to illustrate some European investment techniques, we will assume that the tax adviser is advising a US based company that intends to invest on a pan-European basis and that for commercial reasons a European holding company is desirable.

There are a number of jurisdictions within Europe that provide good locations to establish holding companies; for example Cyprus, the Netherlands, Switzerland — even Denmark and Spain have their merits. Perhaps the most commonly used are Luxembourg and the Netherlands. The diagram below illustrates a structure in which a Luxembourg holding company acquires a French operating company by establishing a French holding company and finances part of the acquisition through shareholder loans.

![Diagram of a Luxembourg holding company structure](image)

In the case of Luxembourg there is no withholding tax on interest payments, and since 1 January 2009 there is no withholding tax on dividends where those dividends are paid to an eligible entity established in a jurisdiction that has concluded a tax treaty with Luxembourg.81 The exemption from dividend withholding tax is subject to the condition that at the time of the distribution, the parent company must have held (or committed to continue to hold), for an uninterrupted

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81 Prior to the exemption for withholding tax on dividends, it was common to use hybrid instruments such as convertible preferred equity certificates or profit participating loans to extract profit from Luxembourg. Such instruments have the benefit of being treated as debt in Luxembourg with the result that payments under them are not treated as dividends and so are paid free of withholding tax; in addition, they can frequently be structured so as to be treated as equity from the holder’s point of view. Payments under hybrid instruments will also create a tax deduction in Luxembourg that can be set against profits that are not themselves shielded by the Luxembourg participation exemption. It will remain common to use hybrid instruments in Luxembourg structures where not all of the investors in the structure can meet the terms for the dividend exemption.
period of at least 12 months, (i) a shareholding of at least 10% in the Luxembourg dividend-paying subsidiary, or (ii) a shareholding with an acquisition cost of at least EUR 1.2 million.

The LuxCo will not be subject to capital gains in France on an eventual disposal of the shares in French HoldCo by virtue of Article 7 of the tax treaty concluded between France and Luxembourg which gives the taxing rights to Luxembourg.

LuxCo will not be subject to tax in Luxembourg on dividends received from French HoldCo, nor on an eventual disposal of the shares in French HoldCo provided that the terms of the Luxembourg participation exemption are met.

The Luxembourg participation exemption regime applies provided that (i) at the date on which the dividend is paid LuxCo holds, or commits itself to hold, during an uninterrupted period of at least 12 months a direct shareholding of at least 10% in the distributing company or the acquisition cost of the participation is at least EUR 1.2 million; and (ii) the distributing company is: a qualifying European Union resident corporation, a Luxembourg resident corporation fully liable to Luxembourg tax, or a non-resident corporation liable to a tax corresponding to the Luxembourg corporate income tax. For that purpose, a taxation rate of at least 11% on a basis comparable to the Luxembourg basis is usually required by the Luxembourg tax authorities. The holding period condition mentioned above does not need to be satisfied on a share-by-share basis. Accordingly, once the threshold of 10% (or EUR 1.2 million acquisition cost) is achieved, no holding period condition needs to be satisfied with respect to the part of the shareholding that exceeds 10% (or EUR 1.2 million acquisition cost).

Under the terms of the European Union Council Directive 90/43/EEC (the “Parent/Subsidiary Directive”) dividends paid between a parent company and its subsidiary, in this case French HoldCo and LuxCo, are paid free of withholding tax. Similar provisions apply to withholding taxes on royalties and interest under the Interest and Royalties Directive 2003/49/EC, so that in this case no withholding tax will apply to interest payments made on the loan between LuxCo and French HoldCo.

French HoldCo and French OpCo form a consolidated group for tax purposes in France so that the interest expense on the shareholder loan and third party bank debt used to acquire French OpCo can be set against the profits of French OpCo. The interest expense on the shareholder loan will only be deductible to the extent that the loan is on arm’s length terms (so as not to infringe transfer pricing rules) and the debt to equity ratio does not breach French thin capitalization legislation.

In order for LuxCo to avoid being subject to tax on the interest receipts from French HoldCo, a matching deduction is created through a back-to-back shareholder loan from the Non-EU Parent. Subject to certain conditions (mainly, the absence of bad debt and foreign exchange risks), the Luxembourg tax authorities require that a profit is made in Luxembourg on the interest receipt and usually agree that a taxable spread of between 0.25% and 0.125% is sufficient for annual average amounts borrowed and on-lent of between EUR 25 million and EUR 175 million. The “profit” made on the spread is subject to Luxembourg taxes at a composite effective rate of 28.59%.

404 EPILOGUE: THE ART OF TAX

The purpose of this article was to provide some practical tips on how to structure foreign investment in light of the complicated web of tax laws, tax treaties and other international agreements. In effect, the practitioner should now be armed with a plan and methodology for analyzing a cross-border investment. However, providing tips, plans or basic methodology for analyzing the problems is no substitute for a practitioner rolling up his or her sleeves and carefully studying the particular facts and law relevant to the client’s specific transaction. With that, we leave you with one final quote from the illustrious Sun Tzu:

“To rely on rustics and not prepare is the greatest of crimes; to be prepared beforehand for any contingency is the greatest of Virtues.”

Sun Tzu — The Art of War