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I. INTRODUCTION

This article discusses the income tax considerations relevant to a decision to incorporate a business abroad. The article provides an overview of some of the more important aspects of the corporate income tax laws of France, the Federal Republic of Germany, and the United Kingdom. The provisions of the countries' respective tax codes are contrasted and compared; included in this comparison are analogous provisions contained in the Internal Revenue Code of the United States.

Due to the ever-changing character of the provisions of the countries' respective tax codes, this article is not an exhaustive study of any

one country's tax laws or the policies underlying those laws. Rather, this article is a framework for review of the tax considerations relevant to a determination to incorporate a business in one of the named countries and highlights some of the distinctions and similarities between the countries' corporate income tax laws.

In addition to the tax considerations described within the article, the decision to incorporate abroad will also be affected by several tax/nontax considerations not discussed in this article. For example, flexibility and liquidity to allow repatriation of capital to the head office or parent corporation; group loss relief/consolidation; transferability of intangibles—rights, patents and licenses; local regulations affecting direct foreign investment; exchange controls; and other (nonincome) taxes and duties (e.g., a value added tax or customs duties) are a few of the relevant tax/nontax considerations not discussed in this article.

The relative weight assigned to each tax consideration will vary according to the nature of the business to be incorporated. For purposes of this article, the business to be incorporated abroad ("Newco") is a manufacturing enterprise which converts a raw product into a finished product to be sold locally. Access to the European Common Market is a major reason for incorporation abroad. The enterprise requires a substantial capital investment for machinery essential to the conversion process. A plant (or land on which to build a plant) must be acquired through purchase or lease. Very little labor is needed, other than managers or supervisors to monitor the machinery used in the conversion (manufacturing) process. This article addresses the various tax considerations for the incorporation of Newco under general headings as follows.

II. Taxation of Corporations Generally

A. France

Jurisdictional Rules. The French tax system is based on the principle of territoriality; the tax law is not applicable beyond French territorial limits. For corporate income tax purposes, France is defined as Metropolitan France (excluding Monaco), Corsica, and the overseas departments of Guadeloupe, Martinique, Guyana, Reunion, and Saint Pierre et Miquelon.

For corporate taxpayers, foreign source income is defined as that income arising from the regular conduct of industrial or commercial activities outside France. Net profits earned by a foreign-based subsidiary, branch, or permanent establishment of a French company, which are ef-

fectively connected to the entity's "business activity" abroad,[1] are not subject to French tax until these profits actually have been paid into France and distributed by the French company to its shareholders (i.e., the foreign source income remains tax-exempt in the hands of the resident company until it is redistributed by the resident company to its own individual shareholders and *précompte* is due).[2] Losses incurred in foreign operations that constitute a complete business cycle (whether incurred through a permanent establishment, branch, subsidiary, or joint venture) are excluded from calculation of French taxable income.[3]

Types of Taxes Imposed. The most significant direct tax imposed on companies is the corporate income tax (*impôt sur les sociétés*), currently imposed at a fifty percent rate (forty-five percent on non-distributed income, provided it is entered into a special reserve).[4] A fifteen percent rate applies to net long-term capital gains (twenty-five percent for capital gains from dispositions of land for construction).[5] Relief from double taxation at the shareholder level is granted in the form of a dividend-received income tax credit (*avoir fiscal*) equal to fifty percent of the amount of the dividend actually paid.[6]

Where the distributed profits have not borne corporate income tax at the full fifty percent rate (e.g., long-term capital gains, foreign source income, income which has not been taxed because of net operating loss carryovers, and other such items), or where the distributed profits were earned before January 1, 1965, or over five years before distribution, an equalization tax (*précompte*) is imposed at a rate of thirty-three and one-third percent of the grossed-up dividend (i.e., grossed-up by the applicable tax credit).[7]

Dividends paid to a nonresident are subject to a twenty-five percent withholding tax (or lower rate, provided by treaty).[8] No withholding tax is applicable to dividends paid by a resident company to another resident company.[9] Branches of foreign companies are also subject to a "deemed" distribution withholding tax of twenty-five percent (or lower

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1 CODE GÉNÉRAL DES IMPÔTS [CGI] art. 120. References to French tax laws are to the General Tax Code of 1950, as amended.

2 CGI art. 209.

3 2 GUIDE TO EUROPEAN TAXATION, THE TAXATION OF COMPANIES IN EUROPE *France* 43 (International Bureau of Fiscal Documentation 1985) [hereinafter EUROPEAN TAXATION *France*].

4 CGI art. 219-I.

5 CGI arts. 205, 210.

6 CGI arts. 158 *bis*, 209 *bis* (1).

7 CGI arts. 223 *sexies*, 679 *ter*.

8 CGI arts. 119 *bis* (2), 187.

9 CGI art. 119 *bis* (2).

rate, provided by treaty) on profits net of corporate income tax, whether or not remitted to the foreign head office.[10]

Types of Company Taxpayers. There are three bases upon which corporate income tax liability of resident entities may arise: legal form, doing business, or election.

The following entities are subject to corporate income tax by virtue of their formation in France (i.e., their French legal form alone):

(a) a stock corporation (*société anonyme*—SA);
(b) a limited liability company (*société à responsabilité limitée*—SARL);
(c) a limited partnership with shares (*société en commandite par actions*); and
(d) a limited partnership (undisclosed partners only) (*société en commandite simple*).[11]

Corporate income tax liability also attaches to other legal entities carrying on business or profit-making activities, including public institutions, state organizations with financial autonomy, and departmental or local government organizations.[12]

The following entities may elect, before April 1 of each year, to be subject to corporate income tax: general partnerships, limited partnerships, joint ventures, and civil companies.[13] Such an election is irrevocable and may not be made if these entities originate from the transformation of an SA, SARL, limited partnership with shares, or other "*société de capitaux.*"[14]

Nonresident companies are subject to corporate income tax only if they conduct business in France. Even if management, control, or coordination functions are performed in France for the benefit of nonresident companies, the nonresident companies are not subject to French corporate income tax.[15]

Under French tax treaties, a foreign company will be subject to corporate income tax liability if it has a permanent establishment, as defined by the particular treaty with France.[16] A permanent establishment is, in

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10 CGI arts. 115 *quinquies*, 187.

11 CGI art. 206(1), (4).

12 CGI art. 206(1).

13 CGI arts. 206(3), 239.

14 *Id.*

15 CGI art. 218A.

16 The definition of a permanent establishment in recent French tax treaties generally follows the one found in the MODEL CONVENTION FOR THE AVOIDANCE OF DOUBLE TAXATION WITH RESPECT TO TAXES ON INCOME AND CAPITAL (Organization for Economic Cooperation and Development 1977), *reprinted in* TAX TREATIES (CCH) ¶ 151 [hereinafter OECD MODEL CONVENTION]. However, the relevant tax treaty should be consulted for the particular definition used.

principle, any industrial or commercial organization established on a permanent and autonomous basis. In nontreaty circumstances (i.e., under internal tax law), a permanent establishment is not itself sufficient for corporate income tax liability to arise. The permanent establishment must be an autonomous place of business through which business activities of a profit-making nature are carried on.[17] The tax consequences of the creation of a permanent establishment by a nonresident company in France are both a corporate income tax liability and a "deemed" distribution withholding tax liability on the permanent establishment's profit after deduction of corporate income tax.[18]

B. Germany

Jurisdictional Rules. The Federal Republic of Germany is divided into ten states, each with its own government and parliament. The City of West Berlin is in many respects treated as if it were a state. Although West Berlin is not part of the territory of the Federal Republic, most Federal tax laws have been adopted by the West Berlin city council. The laws of the Federal Republic do not apply to the Eastern Zone of Germany (i.e., the German Democratic Republic).[19]

Types of Taxes Imposed. The most important tax imposed on companies in Germany is the corporate income tax (*Körperschaftsteuer*). In general, it is levied on undistributed profits at the rate of fifty-six percent[20] (subject to some exclusions and reductions in the case of businesses located in West Berlin) and on distributed profits at the rate of thirty-six percent.[21] Thus, a distribution will normally result in a refund of the difference between the fifty-six percent and thirty-six percent rates, but may lead to a further tax charge if untaxed income (i.e., tax-free or certain foreign source income) is distributed. Resident shareholders claim the thirty-six percent corporate income tax paid by the company with respect to their dividend as a credit against their personal income (or corporate income) tax liability.[22] Any excess credit, whether in the

17 CGI art. 115 *quinquies.*

18 CGI arts. 115 *quinquies,* 119 *bis* (2).

19 Unless otherwise indicated, "Germany" or "German" refer herein only to the Federal Republic and West Berlin.

20 KÖRPERSCHAFTSTEUERGESETZ [KStG] § 23(1); BUNDESGESETZBLATT [BGBl] I S.217 (1984). References to German corporate income tax laws are to the Corporate Income Tax Law of 1977, as amended.

21 KStG § 27.

22 EINKOMMENSTEURGESETZ [EStG] §§ 20(1)3, 36(2)3, BGBl.I S.977 (1985). References to German income tax laws are to the Income Tax Law of 1979, as amended.

hands of the distributing company or the resident shareholder, is refundable in cash.

Types of Company Taxpayers. German corporate income tax law distinguishes between taxpayers subject to "unlimited" and "limited" tax liability. This distinction generally corresponds to the difference between "resident" and "nonresident." Corporate taxpayers with unlimited tax liability are subject to taxation on income from both German and foreign sources.[23] Conversely, limited tax liability applies only to German-source income of nonresident enterprises,[24] and also covers corporations, associations, and estates and trusts not subject to unlimited tax liability having sources of income in Germany subject to withholding tax.[25]

Unlimited corporate income tax liability applies to the following entities:

(a) a stock corporation (*Aktiengesellschaft*—AG);
(b) a limited liability company (*Gesellschaft mit beschrankfer Haftung*—GmbH); and
(c) a partnership limited by shares (*Kommanditgesellschaft auf Aktien*—KGaA).[26]

The important provisions of the corporate income tax law generally apply only to such "companies" (*Kapitalgesellschaften*); other entities which are or may be liable for corporate income tax come under different tax rules and rates.[27]

The corporate income tax law creates two types of taxpayers with limited tax liability:

(1) nonresident companies, unincorporated associations, and estates and trusts which have neither their domicile nor place of management in Germany. These nonresident entities include branches which are taxable only on German-source income; and
(2) domestic companies, unincorporated associations, and estates and trusts which are not subject to unlimited tax liability. Such entities are subject to taxation on any German-source income (usually investment income) from which tax is deducted at the source.[28]

In determining resident or nonresident status, the place of management or the corporate domicile (and not the place where business is conducted) is of prime importance.[29]

The maintenance of a permanent establishment in Germany by a

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23 KStG § 1(2).
24 KStG § 2(1).
25 KStG §§ 2(2), 5(2)1.
26 KStG § 1(1)1.
27 KStG §§ 7, 8.
28 KStG § 2.
29 KStG § 1(1).

nonresident gives rise to limited tax liability.[30] Profits earned by a limited liability taxpayer resident abroad through a German branch or other form of permanent establishment are subject to corporate income tax at a flat rate of fifty percent.[31] No reduction of this rate is granted with respect to transfers to the foreign head office; on the other hand, such transfers are not subject to withholding tax.[32]

C. United Kindgom

Jurisidictional Rules. United Kingdom tax jursidiction extends to England, Wales, Scotland, and Northern Ireland.[33] The Isle of Man and the Channel Islands (Jersey, Guernsey, and Sark) maintain separate jurisdiction over their taxes. The source or place of residence (central management and control), rather than the place of incorporation, determines whether an entity is chargeable with United Kingdom corporation tax and capital gains tax.[34]

Types of Taxes Imposed. Corporation tax is charged on the worldwide profits (income and capital gains) of companies resident in the United Kingdom, and on the profits of nonresident companies related to a trade carried on in the United Kingdom through an unincorporated branch, agency, or permanent establishment.[35] The rate of corporation tax for a financial year ending March 31 normally is not announced until March or April at or following the end of the financial year. The Finance Act of 1984, in addition to imposing a rate of corporation tax for the year ended March 31, 1984 (fifty percent), introduced the different decreasing rates for the years ending March 31, 1985 (forty-five percent), 1986 (forty percent), and 1987 (thirty-five percent).[36] The United Kingdom-source income of a nonresident company which is not related to a United Kingdom branch, agency, or permanent establishment is liable

30 KStG § 2.

31 KStG § 23(2); 2 GUIDE TO EUROPEAN TAXATION, THE TAXATION OF COMPANIES IN EUROPE *Germany* 40 (International Bureau of Fiscal Documentation 1985) [hereinafter EUROPEAN TAXATION *Germany*].

32 KStG §§ 2(1), 23(2); TAXATION IN THE FEDERAL REPUBLIC OF GERMANY, HARVARD LAW SCHOOL WORLD TAX SERIES (CCH) §§ 5/6.2c, 11/3.3d (2d ed. 1984) [hereinafter TAX IN FRG].

33 2 GUIDE TO EUROPEAN TAXATION, THE TAXATION OF COMPANIES IN EUROPE *United Kingdom* 37 (International Bureau of Fiscal Documentation 1985) [hereinafter EUROPEAN TAXATION *United Kingdom*].

34 *Id.* at 38.

35 Income and Corporation Taxes Act, 1970, ch. 10 [ICTA] § 238. The relevant United Kingdom tax laws are contained primarily in the Income and Corporation Taxes Act, 1970, ch. 10, as modified by subsequent Finance Acts.

36 Finance Act, 1984, ch. 41, § 18(3).

for income tax at a flat rate of thirty percent.[37]

Type of Company Taxpayers. Companies resident in the United Kingdom (wherever incorporated) are charged corporation tax at a single rate on their total worldwide profits for each accounting period, whether or not the profits are distributed or remitted to the United Kingdom.[38] United Kingdom resident companies (from April 6, 1984) may also be taxed on a portion of the undistributed profits of certain United Kingdom-controlled, nonresident companies in which the resident company has an interest (e.g., tax haven companies).[39] Capital gains are assessed at a lower effective rate than is general business income.[40]

For this purpose, the term "company" comprises not only entities incorporated under the companies acts or a company created by letters of patent or in pursuance of an Act of Parliament (whether limited or unlimited), but also unit trusts authorized by the Department of Trade and any unincorporated association other than a partnership.[41] A corporate member of a partnership is subject to corporation tax on its share of the partnership profits as part of its total taxable profits for the related accounting period.[42]

A company is resident in the United Kingdom and taxable on its worldwide profits if its central management and control are situated there.[43] The primary test of residence is the location of the directors' meeting, irrespective of where the company is incorporated or where the physical activities of the business are carried on.[44] Thus, a company incorporated in the United Kingdom with its central management and control situated outside of the United Kingdom is not a resident company for United Kingdom tax purposes. It is essentially a question of fact where and by whom the central management and control of the company's business is exercised and hence where it is resident for tax purposes.

The extent of United Kingdom tax liability of a nonresident company is determined in most cases by the relevant double taxation treaty. In general, treaties limit the taxation of industrial and commercial activities in the United Kingdom to the profits attributable to a permanent

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37 EUROPEAN TAXATION *United Kingdom, supra* note 33, at 37.
38 ICTA § 238.
39 Finance Act, 1984, ch. 41, §§ 82, 87.
40 EUROPEAN TAXATION *United Kingdom, supra* note 33, at 37.
41 ICTA § 526(5), (6).
42 ICTA § 155.
43 EUROPEAN TAXATION *United Kingdom, supra* note 33, at 38.
44 *Id.*

establishment in the country. Where a nonresident company is so taxable, the computation of liability on the chargeable profits of the permanent establishment corresponds generally to that of a United Kingdom resident company.[45]

A nonresident company is liable for United Kingdom corporation tax only if it carries on a trade in the United Kingdom through a branch or agency. Subject to the terms of a relevant double taxation treaty, the tax is then chargeable on:

(a) any trading income arising directly or indirectly through or from the branch or agency, and any income from property or rights used or held by or for the branch or agency; and
(b) any capital gains arising on the disposal of assets situated in the United Kingdom and used or acquired for use in the trade carried on through the branch or agency.[46]

D. United States

Jurisdictional Rules. United States taxing jurisdiction depends on the type of taxpayer and the geographical source of the income involved in the transaction. United States citizens and residents are subject to taxation on all income from whatever source derived.[47] The United States taxes foreign corporations on the basis of the source of the income sought to be taxed. Thus, United States citizens and residents are taxed on their worldwide income regardless of its source; foreign corporations are taxed only on income derived from sources within the United States.[48] The United States is geographically defined by the tax code to include only the fifty states and the District of Columbia.[49]

Types of Tax Imposed. Domestic corporations are taxed on their worldwide income at regular corporate income tax rates, which include graduated rates (fifteen to forty percent) for the first $100,000 of taxable income and an effective tax rate of forty-six percent of taxable income in excess of $100,000.[50] If for any taxable year a corporation has a net capital gain, it may elect to exclude that gain from total taxable income and be taxed at the lower effective rate of twenty-eight percent of the net capital gain.[51]

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45 ICTA § 246.
46 *Id.*
47 I.R.C. § 61(a). References to United States tax laws are to the Internal Revenue Code of 1954, as amended.
48 I.R.C. §§ 881, 882.
49 I.R.C. § 7701(a)(9).
50 I.R.C. § 11(b).
51 I.R.C. § 1201(a).

Foreign corporations are taxed at regular corporate income tax rates on income effectively connected with a United States trade or business.[52] Foreign corporations that receive income not effectively connected with the conduct of a United States trade or business, such as interest, dividends, rents, royalties, and other fixed or determinable annual or periodic income from sources within the United States, are subject to tax at the flat rate of thirty percent to be withheld at the source.[53]

Type of Company Taxpayers. Corporations created or organized in the United States or under the laws of the United States or of any state or territory (domestic corporations)[54] are taxable on their worldwide income at regular corporate income tax rates.[55] Foreign taxes on income are allowed as a deduction from income or as a credit up to a certain limit against the United States tax that is payable on the foreign source income;[56] special credits and exemptions are permitted in limited circumstances.[57] Few distinctions are made between domestic and foreign income in the context of a domestic corporation's calculation of taxable income.

A nonresident company is generally termed a "foreign corporation" under United States tax law. A foreign corporation is any corporation which is not a domestic corporation.[58] A foreign corporation is subject to United States corporate income tax on income effectively connected with the conduct of a United States trade or business.[59] A foreign corporation must have been engaged in a United States trade or business during the year in which the income is received in order for the income to be deemed effectively connected with its United States trade or business.[60]

Two tests have been established to determine whether income realized on the sale or exchange of capital assets is effectively connected with the conduct of a United States trade or business for the taxable year. The principal tests to be applied are the "asset-use" test[61] and the "business-activities" test.[62] Under the asset-use test, income derived from assets which are used in or held for use in the conduct of a United States trade

52 I.R.C. § 882(a).
53 I.R.C. § 881(a).
54 I.R.C. § 7701(a)(4).
55 I.R.C. §§ 11, 7701(a)(4).
56 I.R.C. § 904 .
57 *See, e.g.*, I.R.C. § 902.
58 I.R.C. § 7701(5).
59 I.R.C. § 882(a).
60 Treas. Reg. § 1.882-1(b)(2)(i) (1985).
61 Treas. Reg. § 1.864-4(c)(2) (1985).
62 Treas. Reg. § 1.864-4(c)(3) (1985).

or business is likely to be viewed as income effectively connected with the conduct of that United States trade or business. Under the business-activities test, if the business activities of the foreign corporation in the United States are a material factor in the generation of income, that income will be held to be effectively connected with the foreign corporation's United States trade or business.[63]

If a foreign corporation is not engaged in a United States trade or business, its passive income (i.e., fixed or determinable annual or periodic income) received from sources within the United States will generally be subject to tax at the source at a flat rate of thirty percent, or a lower treaty rate.[64] A permanent establishment located within the United States is governed by the same set of tax rules affecting foreign corporations, unless the relevant double taxation treaty provides otherwise.

E. Comparison

The application of corporate income tax liability is consistently limited to "corporate entities," while "partnerships" are generally viewed as conduits through which items of income, gain, loss, deduction, or credit pass (retaining their tax characteristics) to the partners which are subject to personal or corporate income tax.[65] The countries vary on the classification schemes they use to determine corporate status for taxation purposes; among the various factors taken into consideration are the presence of associates, a profit-making motive, centralized management, free transferability of interests, and to a lesser extent, continuity of life and limited liability.

Once an entity is determined to be a corporation, the next consideration is whether the corporation is a resident for taxation purposes. Generally, the legal form of the entity as well as the location of the physical activities of the business are relevant to the determination of residence (i.e., the fact that the entity has been organized under the domestic corporate laws). The United Kingdom is unique in its characterization of corporate residence. In the United Kingdom, the primary test of residence is the location of directors' meetings, regardless of where the company is incorporated or where the physical activities of the business occur.

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63 Treas. Reg. § 1.864-4(c)(1)(i) (1985).

64 I.R.C. § 881(a). *But see* I.R.C. § 881(c), which repeals the thirty percent withholding tax on interest paid by a United States borrower on certain portfolio debt investments where the interest is received by a foreign corporation or individual.

65 *See* W. DIAMOND, FOREIGN TAX AND TRADE BRIEFS 55 (France), 70 (Germany), 225 (United Kingdom) (1985); I.R.C. § 702(b).

The concept that a country may tax the profits generated by corporations or permanent establishments operating within the territorial limits of the country is readily acknowledged in the tax laws of the countries under discussion. The countries' tax laws diverge on the issue of whether the taxing jurisdiction should extend beyond the country's territorial limits and whether external transactions should be subject to the domestic corporate income tax.

At one end of the spectrum is the French corporate income taxation scheme, exempting all income arising from the regular conduct of industrial or commercial activities outside of France from French corporate income taxation. At the other end of the spectrum are the United States, United Kingdom, and German corporate income tax systems, taxing all of the profits of resident companies on a worldwide basis and taxing nonresident companies on domestic trade or business income. The German corporate income taxation system is unique in that it distinguishes between corporate taxpayers subject to "unlimited" or "limited" corporate income tax liability. This distinction, however, generally corresponds to the difference between "resident" and "nonresident" as used in the United Kingdom and the United States corporate tax systems.

Thus, the jurisdictional tax consideration for Newco is of relatively minor importance as most countries tax profits of resident companies on a worldwide basis. France limits its taxing jurisdiction, but this apparent advantage is minimized when it is recognized that worldwide taxing regimes generally allow for a credit or deduction for foreign taxes paid.

The rates of corporate income tax imposed by the three European countries are similar (France, fifty percent; Germany, fifty-six percent; and the United Kingdom, forty percent). At present, the United Kingdom offers the lowest effective rate of corporate income tax on taxable profits. Further, the United Kingdom Finance Act of 1984 provides for the automatic reduction of the corporate income tax rate to thirty-five percent in 1987. Assuming the calculation of taxable income is generally the same in the named countries, Newco would minimize its tax liability by incorporating in the United Kingdom. Note, however, that the United Kingdom bases its residence determination on where management and control of the company is exercised, not its place of incorporation or location of its physical business activities. Newco must be managed and controlled in the United Kingdom to be recognized by the United Kingdom as a resident corporation.

III. Taxation of Corporate Distributions

Over the past several years a number of countries have changed

their system of corporate income taxation. The change to a new system has been dictated by domestic policy considerations, as well as international investment and profit flows. There has been a steady worldwide movement away from the type of corporate income tax system employed by the United States as set out in the Internal Revenue Code. The United States corporate income tax system is a "separate corporate income tax system." A consequence of a separate corporate income tax system is that little or no distinction is made between the taxation of retained and distributed corporate profits. The United States form of taxation has been abandoned by many of the major Western industrialized countries in favor of an "imputation system."

A. The Imputation System

The imputation system of corporate/shareholder income taxation is designed to alleviate the burden of economic double taxation—whereby the same profits are taxed at both the corporate and the shareholder levels, by attributing or imputing to the shareholder some or all of the taxes paid by the corporation. The imputation system provides for full taxation of profits at the corporate level, whether they are retained or distributed. When a corporate distribution is made, the recipient shareholder is entitled to an imputation tax credit with respect to some portion of the corporate taxes paid. This credit is computed as a percentage of the distribution. The shareholder must gross-up the distribution by the amount of the imputation credit in order to compute the initial tax liability against which the credit is applied.[66]

Example:

The corporate and individual income tax rates are fifty percent. An imputation tax credit is available to the shareholder and is computed as fifty percent of any distribution made. The corporation has one hundred units of taxable income and distributes all of its after-tax earnings to its sole shareholder.

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66 Rosensweig, *United States International Tax Treaty Policy With Respect to Foreign Imputation Systems of Corporate-Shareholder Taxation*, 13 N.Y.U.J. INT'L L. & POL. 729, 731-32 (1981).

Corporation's taxable income	100
Corporate income tax at fifty percent	50
Maximum distribution	50
Imputation tax credit (fifty percent of the distribution)	25
Shareholder's taxable income after the gross-up (distribution plus credit)	75
Shareholder's income tax at fifty percent	37.5
Imputation tax credit	25
Shareholder's income tax due	12.5
Net distribution to shareholder	37.5

France, Germany, and the United Kingdom have sought to relieve some (or all) of the burden of double taxation on company profits paid out as dividends through their respective corporate income tax systems. These countries have adopted various forms of the imputation system. Each country has emphasized its desire to encourage diversification of investments in corporate equity and maximize efficient allocation of funds in the corporate sector.[67]

The imputation system provides a strong incentive for the distribution of corporate earnings, since the benefits of the system are triggered only upon distribution. The incentive for increased corporate distributions would tend to make investments in corporate equity (as opposed to corporate debt) equally if not more attractive, since the shareholder can expect not only consistent returns on an investment, but also to share in the corporation's growth, i.e., capital appreciation. The increase in the frequency of distributions also provides the shareholder with greater liquidity and an incentive to periodically evaluate the investment portfolio in order to direct funds to equity interests in those corporations which offer the most attractive, profit-maximizing return.

On July 23, 1975, the Commission for the European Communities submitted to the Council a proposal for a directive calling for the introduction in Member States of a common system of corporate and shareholder taxation.[68] This common system of corporate and shareholder taxation consists of full taxation at the corporate level with a credit imputed on the income tax payable by shareholders with respect to dividends received. A uniform dividend withholding tax is also proposed.

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[67] *See generally* ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, COMPANY TAX SYSTEMS IN OECD MEMBER COUNTRIES (1973).

[68] Proposal for a Council Directive Concerning the Harmonization of Systems of Company Taxation and of Withholding Taxes on Dividends, 18 O.J. EUR. COMM. (No. C 253) 2 (1975).

The Commission chose an imputation system which is generally similar to the imputation systems already in force in several Member States, but which differs in varying degrees from Member States' systems on technical points. The purpose of the proposed directive is to harmonnize several of the features of the existing imputation systems and to replace Member State legislation which does not provide for the establishment of the common (imputation) system. The Commission's reasons for preferring a common imputation system were stated as follows:

(a) neutrality with regard to various forms of company financing;
(b) neutrality with regard to various legal forms of undertakings;
(c) fairness of taxation;
(d) elimination of tax avoidance by persons with large tax liabilities; and
(e) development of the share market.[69]

Although the directive has not become officially binding, it has substantial persuasive force inasmuch as it reflects the thinking of the majority of the European Communities Member States.

B. France

France imposes a tax of fifty percent on most types of corporate income.[70] An individual French shareholder who receives a distribution from a French corporation is entitled to a tax credit equal to fifty percent of the distribution (*avoir fiscal*).[71] Thus, fifty percent of the corporate-level tax is imputed to the shareholder. The shareholder's taxable income on the distribution is computed by grossing-up the dividend by the amount of the credit. If the French tax payable is less than the credit, the difference is refundable. If the tax liability exceeds the credit, there is tax due.

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69 Explanatory Memorandum of the Proposal for a Council Directive Concerning the Harmonization of Systems of Company Taxation and of Withholding Taxes on Dividends, 10 EUR. COMM. BULL. 5 (Supp. Oct. 1975).

70 CGI art. 219.

71 CGI art. 158 *bis*.

Example:

Corporation's taxable income	100
Corporate income tax at fifty percent	50
Distributable amount	50
The French shareholder declares:	
Dividend received	50
Gross-up with *avoir fiscal* (fifty percent of distribution)	25
Taxable income	75
Personal income tax due (at top rate of sixty percent)	45
Avoir fiscal (tax credit)	25
Personal income tax due	20
Net distribution to shareholder	30

A French corporate shareholder who owns less than ten percent of the shares of the distributing corporation is treated much the same as an individual shareholder. However, when the imputation credit exceeds the corporate shareholder's tax liability, no refund is permitted.[72] The tax credit is virtually unavailable to a French parent corporation, i.e., a corporation that owns at least ten percent of the distributing corporation. Such a distribution is effectively excluded (ninety-five percent) from the income of the recipient (parent) corporation and, to that extent, no tax credit is available.[73] In terms of the taxable portion (five percent), it is grossed-up by a deemed fifty percent *avoir fiscal*, so that the amount added to taxable income equals seven and one-half percent of the gross dividend received.

When a French corporation distributes untaxed or partly taxed earnings, a compensatory tax (*précompte*) is levied as an advance deduction on the distribution at the corporate level at a rate of fifty percent of the net distribution (thirty-three and one-third percent of the distribution grossed-up by the fifty percent *avoir fiscal*).[74] *Précompte* is generally applicable to the distribution of long-term capital gains, foreign source income, income which has not been taxed because of net operating loss carryovers, and other such items. In addition, *précompte* will be levied at the fifty percent rate on all earnings which were retained for a period greater than five years, since retained earnings do not otherwise carry an

72 CGI art. 209 *bis* (1).
73 CGI arts. 145(1), 216.
74 CGI art. 223 *sexies*.

imputation credit.[75]

Distributions to corporations which own at least ten percent of the distributing corporation (i.e., parent corporations) are ninety-five percent tax-exempt in the hands of the recipient corporation. When these distributions are redistributed, *précompte* is due but can be offset by the amount of imputation credit which remained unused at the first distribution, provided the second distribution is made within five years.[76]

Foreign-source income, when earned by an overseas subsidiary from "business activity" abroad, is exempt from taxation in France. When the foreign-source income is later distributed by the overseas subsidiary to its French parent, such income remains tax-exempt until the French parent redistributes the income to its own individual shareholders and *précompte* is due at a fifty percent rate.[77] However, when a French corporation receives a distribution from an overseas subsidiary located in a country with which France has entered into a tax treaty, *précompte* due on the redistribution of this income by the French parent may be offset by the foreign withholding tax imposed on the overseas subsidiary's distribution.[78]

In addition, the French parent may apply to the French government for the right to have the subsidiary's earnings consolidated with its own. If the application is approved, French tax will be imposed on the subsidiary's foreign-source income, with allowance for a foreign tax credit. When this foreign-source income is redistributed by the French parent, no *précompte* will be levied.[79]

The *avoir fiscal* is normally not available to nonresident shareholders. However, a number of double taxation treaties grant the benefit of the *avoir fiscal* to nonresident shareholders; the United States is among the many Western countries to receive such treatment.[80] The *avoir fiscal* is granted to individual residents of the United States and to United States companies owning less than ten percent of the share capital of the French distributing company. The result is a partial reimbursement

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75 *Id.*

76 CGI arts. 146(2), 223 *sexies* (1).

77 CGI art. 223 *sexies* (1).

78 *See, e.g.*, Convention Between the United Kingdom of Great Britain and Northern Ireland and France for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, May 22, 1968, art. 24(b)(ii), 725 U.N.T.S. 3, 34.

79 CGI arts. 209 *quinquies*, 209 *sexies*.

80 Convention Between the United States of America and the French Republic with respect to Taxes on Income and Property, July 28, 1967, art. 9(5), 19 U.S.T. 5280, 5294, T.I.A.S. No. 6518. Other Western countries which have concluded double taxation treaties with France granting the benefit of the *avoir fiscal* to their residents include Belgium, Finland, Germany, Luxembourg, Netherlands, Norway, Spain, Sweden, Switzerland, and the United Kingdom.

from the French tax authorities to the United States shareholder of the corporate tax paid by the French distributing company.[81]

Example:

Corporate distribution	100
Avoir fiscal	50
Total amount of distribution	150
Dividend withholding tax at fifteen percent	22.5
Net distribution to United States shareholder	127.5

The withholding tax on dividends may be refunded to nonresident shareholders when domiciled in a country bound by a tax treaty with France, provided these shareholders are not entitled to the *avoir fiscal* on such dividends.[82]

C. Germany

An imputation system of corporation income tax has been in effect for business (fiscal) years ending on or after January 1, 1977. Under this system, the double economic tax burden resulting from taxation on both the corporate and the shareholder level is totally alleviated.[83]

In simplified form, the system works as follows. The regular German corporate income tax rate is fifty-six percent.[84] This is reduced at distribution to thirty-six percent of the distributed amount before tax.[85] The receiving domestic shareholder grosses-up his net receipt by the corporate income tax and dividend withholding tax when filing an income tax return.[86] The shareholder is then entitled to credit the corporate income tax and dividend withholding tax imposed on the distribution received against the personal income tax due.[87]

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81 *See* Taylor, *U.S. Tax Treaties and Common Market Corporate Tax Systems*, 28 TAX LAW. 73 (1974).

82 CGI art. 115 *quinquies*.

83 KStG § 27 *et seq.*

84 KStG § 23(1).

85 KStG § 27.

86 EStG § 20(1)3.

87 EStG § 36(2)3.

Example:

Profits before tax (corporation's taxable income)		100
Corporate income tax at fifty-six percent		56
Profits after tax		44
Corporate income tax reduction at maximum distribution		20
Distributable amount		64
Dividend withholding tax at twenty-five percent		16
Net dividend received		48
The German shareholder declares:		
Net dividend received		48
Gross-up with dividend withholding tax		16
Gross-up with corporate income tax attached to distributable amount		36
Taxable income		100
Personal income tax due (at top rate of fifty-six percent)		56
Creditable corporate income tax	36	
Creditable dividend withholding tax	16	
		52
Personal income tax due		4
Net distribution to shareholder		44

Although the idea of the system is very simple, the provisions in the German tax law are very detailed and complicated. The consequence of granting a shareholder (a domestic shareholder, whether a legal entity or an individual) the right to credit the corporation tax of thirty-six percent attached to the dividend received is that, in fact, the corporation must have had an effective tax burden of at least thirty-six percent on the distribution.

To facilitate control over the tax burden on distributions, a special account was created in which the corporation's distributable net worth is itemized according to the effective German tax burden it has borne (fifty-six percent, thirty-six percent or zero).[88] Distributions reduce this special account. The item with the highest tax burden must be reduced first; subsequently the other categories are reduced.[89] The different categories are increased by annual profit according to the effective tax burden.

[88] KStG § 30.
[89] KStG § 28(2).

Only the effective German tax burden is of importance to the imputation system. Foreign taxes paid, even if qualifying for a credit against the corporate income tax, play no role in calculating the corporate income tax due or the credit allowed.

D. United Kingdom

The corporate tax of the United Kingdom, often referred to as the "mainstream" tax, is currently imposed at a forty percent rate with respect to most types of corporate earnings.[90] When a dividend is distributed by a company resident in the United Kingdom, advanced corporation tax ("ACT") must be paid by the distributing corporation. The ACT is approximately three-sevenths of the net amount of the distribution.[91] ACT is creditable against the corporation's mainstream tax liability, though the amount credited may never exceed the amount of the corporation's liability under the basic rate of the corporate income tax in any year.[92]

Excess ACT, which cannot be credited against mainstream tax in the year in which paid, may be carried backward six years or carried forward indefinitely until used.[93] The corporation is not entitled to a refund of excess ACT unless the result of the carryback is the discovery that the mainstream tax for the relevant year has been overpaid, in which case the amount of the overpayment will be refunded.

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90 Finance Act, 1984, ch. 41, § 18(3).

91 Finance Act, 1985, ch. 41, § 35. However, under the Finance Act of 1986, the basic rate of income tax is reduced for 1986-87 from 30% to 29%. The reduction took effect on April 6, 1986. For dividends paid on or after April 6, 1986, companies pay ACT at the rate of 29/71 of the dividend. The tax credit is a similar proportion of the dividend and satisfies the income tax liability of the shareholder at the new basic rate of 29%.

There is no change in respect to dividends paid on or before April 5, 1986. Companies pay ACT at the rate of 3/7 of the dividend. The tax credit is a similar proportion of the dividend and satisfies the present 30% basic rate.

For illustration purposes, the ACT is calculated at the rate of 3/7 of the dividend. The result is nearly the same whether the ACT rate is 3/7 or 29/71.

92 Finance Act, 1972, ch. 41, § 85(1), (2).

93 Finance Act, 1972, ch. 41, § 85(3), (4).

Example:

Corporation's taxable profits		240
Distribution made		210
ACT payable at 3/7 proportion	90	
Corporation tax at forty percent		96
Maximum ACT set-off	72*	72*
Mainstream corporation tax due		24
Surplus ACT (carried back or forward)	18	

* ACT set-off in any period cannot exceed thirty percent of taxable profits (240 × .30 = 72).

ACT is imposed notwithstanding the existence of a foreign tax credit with respect to the income distributed. Thus, on a distribution of foreign-source income, the corporation may suffer a higher effective tax rate because of excess foreign tax credits, which under United Kingdom tax law may not be carried forward or back.[94]

A United Kingdom corporation need not pay ACT on a distribution to a resident corporate shareholder which owns fifty-one percent or more of the shares of the distributing corporation. Furthermore, a parent corporation (a corporation with a fifty-one percent or greater shareholding) may transfer any portion of its ACT to its subsidiaries.[95]

A United Kingdom resident individual who receives a distribution from a United Kingdom corporation that has been subject to ACT is entitled to a tax credit equal to three-sevenths of the net distribution received. The recipient of a distribution is liable for income tax on the aggregate amount of the distribution and the related tax credit, but the credit will be an offset against tax liability. When the credit exceeds the tax liability, the recipient is entitled to a refund.[96]

[94] ICTA § 501; Rosensweig, *supra* note 66, at 748-49.
[95] Finance Act, 1972, ch. 41, § 92.
[96] Finance Act, 1972, ch. 41, § 86.

Example:

Corporation's taxable income	100
Corporate income tax at forty percent	40
Distributable amount	60
The United Kingdom shareholder declares:	
Dividend received	60
Gross-up with ACT (3/7 of distribution)	26
Taxable income	86
Personal income tax due (at top rate of sixty percent)	51.5
ACT (tax credit)	26
Personal income tax due	25.5
Net distribution to shareholder	34.5

Distributions received by United Kingdom corporate shareholders owning less than fifty-one percent of the distributing corporation's shares are generally exempt from United Kingdom tax.[97] When these dividends are distributed by a corporation that has borne ACT, they are categorized as "franked investment income" and may be distributed by the recipient corporation without further payment of ACT.[98] When franked investment income is redistributed, the recipient shareholder grosses-up the dividend and receives a tax credit.

E. United States

The corporate income tax and individual income tax are independent of each other in the United States. Generally, the rate of corporate income tax is the same for retained and distributed profits. The individual income tax on dividends received by a shareholder is assessed at that shareholder's marginal rate; distributions received are taxed in the same way as any other income of the shareholder.[99]

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97 ICTA § 239.

98 Finance Act, 1972, ch. 41, §§ 88, 89.

99 I.R.C. § 61(a)(7).

Example:

Corporation's taxable income	100
Corporate income tax at forty-six percent	46
Distributable amount	54
The United States shareholder declares:	
Dividend received	54
Personal income tax due (at top rate of fifty percent)	27
Net distribution to shareholder	27

Certain exceptions to the separation of corporate and individual tax liability should be noted:

(a) upon receipt of a dividend from a domestic corporation, an individual shareholder is permitted to exclude from taxable income $100 of dividend income received ($200 for a joint return of husband and wife);[100]

(b) dividends received by corporate shareholders from domestic corporations are excluded from taxable income to the extent of eighty-five percent (one-hundred percent in a group that could elect to file a consolidated return);[101]

(c) certain corporations (subchapter S corporations) with 35 or fewer shareholders (individual shareholders who are not nonresident aliens), having one class of stock and conducting an active trade or business, may choose to be taxed in a way similar to a partnership. In a partnership, all items on the partnership return retain their tax character and are carried through to the individual return;[102] and

(d) certain corporations can qualify as regulated investment companies, and are permitted generally to avoid corporate income tax if all (or almost all) of their income is distributed to their shareholders.[103]

However, two penalty provisions can apply if excessive amounts are retained at the corporate level: a personal holding company tax provision (potentially applicable to companies that hold passive investments);[104] and an accumulated earnings tax provision (potentially applicable to active companies that accumulate excessive amounts of liquid assets or which make loans to shareholders).[105]

Nonresident corporate taxpayers are classified on the basis of whether they are engaged in a trade or business in the United States. If

100 I.R.C. § 116(a).
101 I.R.C. § 243(a).
102 I.R.C. §§ 1361-1379.
103 I.R.C. §§ 851-855.
104 I.R.C. § 541.
105 I.R.C. § 531.

they are engaged in a United States trade or business, their income will be subject to United States graduated corporate tax rates.[106] If they do not fulfill this condition, they are subject to tax withheld at the source on the gross amount of dividends, interest, and other fixed or determinable annual or periodic income received from sources within the United States (generally a flat statutory rate of thirty percent, or a lower treaty rate, if applicable).[107]

F. Comparison

France and the United Kingdom have adopted an imputation system with respect to the taxation of corporate distributions. In both countries the system provides that, upon the receipt of a corporate distribution, the shareholder is entitled to an imputation credit with respect to some portion of the corporate income tax paid. The German corporate income tax system is also a variation of an imputation system. However, it allows for a reduction in the rate of tax imposed at the corporate level upon the distribution of profits to the shareholder (i.e., a separate corporate tax rate is applicable to corporate distributions). The German system further allows the resident shareholder a credit for the withholding tax and corporate income tax paid. The result achieved by the three corporate income tax systems is the effective mitigation of the burden of economic double taxation—elimination of taxation of the same profits at both the corporate and shareholder levels.

In contrast, the United States corporate income tax system is completely separate from the personal income tax system (aside from a $100 deduction from an individual's taxable income for dividends received). Thus, the same profits (distributed) will be taxed at both the corporate and shareholder levels. The result is that a greater amount of tax revenue will go into the United States government fisc and the recipient shareholder will pay a larger percentage of that revenue.

Although France, Germany, and the United Kingdom have adopted some form of an imputation system, Germany's corporate distribution tax system allows for a higher net dividend to be received by the resident shareholder (i.e., a lower overall tax burden on corporate distributions). However, under the scenario as described, Newco's shareholders are United States residents or United States corporations. Assuming Newco's activities generate substantial earnings and profits and Newco desires to repatriate these earnings and profits through the payment of dividends to its United States shareholders, it becomes necessary to re-

106 I.R.C. § 882(a).
107 I.R.C. § 881(a), (c).

view the relevant double taxation treaties as well as the countries' tax laws.

In Germany, the United States shareholder will not be allowed any credit for the fifteen percent German withholding tax and corporate income tax paid with respect to the (dividend) income received. The German corporate income tax on the income distributed is reduced from fifty-six percent to thirty-six percent.

In the United Kingdom, the United States shareholder will be allowed a credit equal to fifty percent of the ACT paid on the income distributed. The United States shareholder grosses-up its net dividend by the amount of the tax credit and then pays a five percent withholding tax on this gross amount.

In France, the United States shareholder is granted the *avoir fiscal* like a French resident shareholder. The net distribution is grossed-up by the *avoir fiscal* and a fifteen percent withholding tax is imposed on this gross amount.

Under the circumstances, Newco will minimize its tax cost on the payment of dividends to its United States shareholders if it incorporates in the United Kingdom.

Example:

	France	Germany	United Kingdom
Profits before tax	100	100	100
Corporate income tax (at top rates)	50*	56	40**
Profits after tax	50	44	60
Corporate income tax reduction at distribution (Germany only)	--	20	--
Distributable amount	50	64	60
Gross-up with tax credit	25	--	13
Total amount of distribution	75	64	73
Dividend withholding tax	11	9.5	4
Net distribution to United States shareholder	64	54.5	69

* The compensatory tax (*précompte*) is reflected in this amount, if applicable.

** ACT paid by the distributing corporation is credited against the corporation's mainstream tax liability.

IV. Capital Gains and Losses

A. France

Under French tax law, short-term capital gains are gains realized on the sale of fixed assets held for less than two years and the portion of gains on the sale of fixed assets held for two years or more that represents the recapture of depreciation on the assets, which has already been deducted from taxable income.[108] Short-term capital losses are losses on the sale of nondepreciable fixed assets held for less than two years and all losses on the sale of depreciable fixed assets whatever the period held.[109]

Short-term gains and losses are netted at the year-end. The resulting gain or loss is treated as ordinary taxable income subject to corporate income tax at the fifty percent rate or as an ordinary loss, which is available for offset against profits. The company may elect to have one-third of the gain taxed in the year it is realized and one-third in each of the two following years, except on a liquidation or where the gain relates to securities.[110]

Long-term capital gains consist of gains on the sale of nondepreciable fixed assets held for two years or more and gains on the sale of depreciable fixed assets held for two years or more to the extent that such gains exceed recaptured depreciation. Long-term capital losses consist of losses on the sale of nondepreciable fixed assets held for two years or more.[111]

Long-term gains and losses are netted at year-end. A net gain is taxed at a reduced rate of fifteen percent, but the remaining eighty-five percent of the gain must be credited to a special reserve. A net loss may be set off against long-term gains arising in the next ten years or against the special reserve arising from previous gains. This reserve remains tax-free unless distributed as a dividend. Upon distribution, *précompte* (representing the balance of tax on the original net gain) is imposed.[112]

B. Germany

Capital gains and losses are generally treated as ordinary business income (or loss) and are taxed at the regular corporate income tax rates. This treatment applies to the sale of business assets, including assets used by a partnership. Losses on the sale of business assets are deductible.[113]

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108 CGI art. 39 *duodecies* (2).
109 CGI art. 39 *duodecies* (4).
110 CGI art. 39 *quarterdecies.*
111 CGI art. 39 *duodecies* (3), (5).
112 European Taxation *France, supra* note 3, at 94-95.
113 KStG § 33. *See* Tax in FRG, *supra* note 32, at § 9/7.1.

The important distinction in German taxation of capital gains is not between capital and noncapital assets, but between business property and nonbusiness property.[114] This is because gains or losses on business property are taxable or deductible in the ordinary way, while gains on the sale of nonbusiness property are taxable only if the property is disposed of within certain time limits.[115] Capital gains on the sale of certain business assets are partially deferrable under specified conditions.[116]

C. United Kingdom

A company's chargeable gains are not charged the capital gains tax separately. Instead, they are subject to an allowance for capital losses accrued in the same period (or brought forward from earlier periods) and included in the total profits on which corporate income tax is paid.[117] Thus, chargeable gains of a company are reduced before charging corporate income tax thereon. The reduction is one-third of the total gains; the effective rate of corporate income tax on chargeable gains is thirty percent.[118]

Chargeable gains and allowable losses are computed in accordance with principles applying the capital gains reduction after April 6, 1965. Capital losses can be set off only against similar gains, either from the year of the loss or subsequent years.[119]

D. United States

A capital gain occurs if the property sold or exchanged is a capital asset or "section 1231 property" (i.e., generally depreciable property used in a trade or business). In such a case the gain is a capital gain. If there is a net capital gain, it is subject to tax at a twenty-eight percent rate except to the extent that all or a portion of the gain (e.g., recapture of depreciation) is specifically treated as ordinary business income.[120]

A long-term capital gain results from the sale or exchange of a capital asset the taxpayer has held for more than six months; a short-term capital gain results from the sale or exchange of a capital asset held for not more than six months. Long-term capital gains for each taxable year are offset by the long-term capital losses realized during the year to

114 TAX IN FRG, *supra* note 32, at § 9/7.0.
115 EUROPEAN TAXATION *Germany*, *supra* note 31, at 71.
116 TAX IN FRG, *supra* note 32, at § 7/2.11.
117 ICTA § 265.
118 EUROPEAN TAXATION *United Kingdom*, *supra* note 33, at 71.
119 *Id.* at 64-66.
120 I.R.C. § 1201(a).

achieve net long-term capital gain or loss; short-term capital gains are offset by that year's short-term capital losses to achieve net short-term capital gain or loss.[121]

Capital gain net income occurs if there is an excess of gains from sales or exchanges of capital assets over the losses from such sales or exchanges. If the net long-term capital gain for the taxable year is in excess of net short-term capital loss for the year, the result is a net capital gain that, if recognized by a corporate taxpayer, is subject to tax at a rate of twenty-eight percent. If long-term capital losses for the taxable year exceed short-term capital gains for the year, the result is a net capital loss that is subject to carryback and carryover rules.[122]

E. Comparison

France, the United Kingdom, and the United States apply preferential rates to the taxation of capital gains. Only Germany treats capital gains generally as ordinary business income. Various reasons have been given for preferential rates of taxation on capital gains, such as encouraging taxpayers to sell their investments and thus efficiently allocate resources throughout the economy. Other possible justifications include encouraging private savings, investment and risk-taking, relieving the burden of progressive rates on bunched income, adjusting for illusory inflation income, and compensating for a perceived double tax on (or other discrimination against) saving.

Regardless of the specific purpose behind preferential rates of taxation on capital gains, the countries have viewed preferential rates of capital gains taxation as appropriate. Over time, few changes have been made to the relevant capital gains tax provisions of the respective countries' tax systems. Although the German tax law does not provide for preferential rates of taxation on capital gains, it does allow for the deferral of tax on certain capital gains—generally, where a replacement asset is purchased within the statutory period following an involuntary or voluntary conversion of the fixed asset.

In short, the four countries have regarded gains from fixed (capital) assets as entitled to some sort of preferential tax treatment and have built this perception into their respective income tax systems. As the nature of the business to be incorporated is manufacturing and sales, it is not anticipated that Newco will sell fixed (capital) assets (e.g., machinery, stocks, securities) on a regular basis. Even if Newco should make isolated sales

121 I.R.C. § 1222.
122 *Id.*

of capital assets, the countries' tax treatment of capital gains is generally similar. Thus, the tax treatment of capital gains should not be a significant consideration for Newco in selecting its country of incorporation.

V. Interest, Dividends, and Royalties

A. Domestic Source

Interest, dividends, and royalties received by a resident taxpayer from domestic sources constitute taxable income and are subject to income tax at the normal rates. However, as previously described, the countries have made special provision within their respective corporate income tax systems to mitigate the effects of double taxation on distributions by domestic corporations to resident shareholders (i.e., the elimination of taxation of the same profits at both the corporate level and the shareholder level).

The French, German, and United Kingdom corporate tax systems contain provisions which require taxation of profits at the corporate level, but allow the recipient a tax credit with respect to some portion of the corporate income tax paid (usually a percentage of the distribution). Special rules apply to distributions received by a corporate shareholder from a domestic corporation in France and the United Kingdom. Further differences in tax treatment result if the receiving and distributing corporations are in a parent/subsidiary relationship.[123]

The United States, unlike other countries, does not allow the recipient shareholder a tax credit with respect to the corporate tax paid on the income distributed. Instead, the United States has sought to reduce the effects of double taxation on corporate distributions by allowing the recipient shareholder a deduction for dividends received.[124] A corporate shareholder upon receipt of dividends from domestic corporations may deduct from income eighty-five percent of the dividends received (one-hundred percent in a group that could elect to file a consolidated return).[125]

Neither France nor the United States require a withholding tax on interest, dividends, or royalties paid to resident taxpayers. While Germany does not require tax to be withheld on interest and royalties paid to resident taxpayers, it does require tax to be withheld on all dividend distributions whether paid to resident or nonresident shareholders.[126] Resi-

123 *See supra* notes 70-98 and accompanying text.
124 I.R.C. § 116(a).
125 I.R.C. § 243(a).
126 KStG § 50.

dent shareholders, however, are allowed a credit against taxable income in the amount of the dividend withholding tax.[127] The United Kingdom does not require a withholding tax on interest or royalties paid to resident taxpayers. Although not termed a withholding tax, the ACT functions similarly to a withholding tax on dividend distributions. The United Kingdom allows a credit against taxable income for ACT paid (if any) when a resident shareholder receives domestic corporate distributions.[128]

All countries require a withholding tax (or its equivalent) on interest, dividends, and royalties paid to nonresident individuals and corporations. Often times, the rates of withholding tax are reduced or eliminated by tax treaties between the respective countries.

B. Foreign Source

In France, interest, dividends, and royalties received by a resident taxpayer from foreign sources constitute taxable income. The gross amount (including the foreign tax paid) is included in the French tax base. If a double taxation treaty is applicable, the resident taxpayer will be allowed a credit for the foreign tax paid with respect to the foreign-source income. If no tax treaty is applicable, the resident taxpayer will be allowed a deduction from taxable income in the amount of the foreign tax withheld (without any tax credit being available).[129]

France is unique in its taxation of foreign-source income in that the corporate tax system is based on the principle of territoriality. Interest, dividends, and royalties received by a resident company from a permanent establishment abroad are exempt from French tax upon receipt if the income was effectively connected to the permanent establishment's "business activity" abroad. Such foreign-source income will remain tax-exempt in the hands of the resident company until it is redistributed to the resident company's individual shareholders, then *précompte* is due.[130] Also, if the receiving and distributing companies are in a parent/subsidiary relationship, foreign- source income (regardless of whether it is effectively connected to "business activity" abroad) will be ninety-five percent exempt in the hands of the recipient (parent) company. The foreign-source income, however, will be subject to *précompte* upon redistribution to the parent company's individual shareholders.[131]

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127 KStG § 52; EStG § 36(2)3.
128 Finance Act, 1972, ch. 41, § 86.
129 CGI art. 122.
130 CGI arts. 120, 209.
131 CGI art. 223 *sexies*.

Germany taxes interest, dividends, and royalties received by a resident taxpayer from foreign sources at regular income tax rates. The gross amount received from foreign sources (including the foreign tax paid) is included in the German tax base. If a double taxation treaty so provides, the resident corporate taxpayer may exclude from taxable income the full amount of the foreign source income. Thus, the foreign-source income is tax-exempt in the hands of the resident corporate taxpayer. If the foreign-source income is subsequently distributed by the resident corporate taxpayer to its shareholders, it will be subject to an additional charge to establish the imputed corporate income tax at the rate of thirty-six percent. The corporate tax paid, however, will be creditable against the tax liability of the resident shareholder. Some tax treaties concluded by Germany do not adopt the exemption method and instead allow a credit for the foreign tax paid with respect to foreign-source income. If no tax treaty is applicable, the resident taxpayer will be allowed a credit for the foreign tax paid (as described above), or a deduction from taxable income in the amount of the foreign tax paid.[132]

The United Kingdom and the United States tax interest, dividends, and royalties received by resident taxpayers from foreign sources in the same manner. Regardless of whether a double taxation treaty is applicable, the gross amount received (including the foreign tax paid) by the resident taxpayer is included in that taxpayer's income for tax purposes. The taxpayer may then credit against taxable income the foreign tax paid with respect to the foreign-source income. Alternatively, the resident taxpayer may elect to deduct from taxable income the amount of the foreign tax paid.[133]

In summary, all the countries tax interest, dividends, and royalty income generated within their tax jurisdictions or received by their residents. At the same time, the countries recognize the potential for double taxation (when separate countries have a tax nexus and exercise jurisdiction to tax the same income) and provide within their respective corporate income tax systems for the alleviation of the effects of double taxation. The resulting tax liability on interest, dividend, and royalty income received by Newco will, therefore, generally be the same in all the countries described.

VI. Depreciation

Depreciable assets are all tangible or intangible, fixed or movable,

132 KStG § 26.

133 ICTA § 248; I.R.C. § 164(a)(3).

new or used assets which are used in the conduct of business activities for the production of income and which necessarily diminish in value over time and have a limited working life of more than one year.[134] With respect to assets of a minor value which fall within the above definition (e.g., certain tools and office supplies), their costs are deemed to be current expenses in the year in which they are incurred.

The basis of depreciation is the cost of acquiring or manufacturing the asset. Immovable assets are, as a rule, depreciated by using the straight-line method. In the case of movable capital assets, straight-line or declining-balance methods are permitted. Generally, one of these two methods is chosen and capital allowances are calculated accordingly.

Under the straight-line depreciation method, the depreciable amount will be the depreciable base of an asset divided by the number of years representing its normal useful life. Under the declining-balance method, the depreciable amount is determined by multiplying the usual straight-line depreciation rate of the particular asset by a prescribed coefficient. This declining-balance rate is then applied to the depreciable base of the asset for the relevant year. If the depreciable amount calculated in this manner is at any time less than the depreciable base divided by the remaining number of years of useful life of the asset, then this latter amount instead will be taken as the depreciation deduction.

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134 *See generally Comparative Analysis of Fiscal Depreciation and Investment Allowance Facilities Available to Corporate Entities in the European Economic Community, Part III*, 11 EUR. TAX'N 186 (1971).

Example:

An asset is acquired on January 1, 1986, for 120,000 units and its normal useful life is ten years. The prescribed declining-balance coefficient is 2.5. The straight-line rate of depreciation is ten percent (or a 12,000 annual depreciation deduction). Depreciation deductions under the declining-balance method are calculated as follows:

Year	Depreciable Base		Rate	Depreciable Amount
1986	120,000	(10 x 2.5)	25%	30,000
1987	90,000		25%	22,500
1988	67,500		25%	16,875
1989	50,625		25%	12,656
1990	37,969		25%	9,492
1991	28,477		25%	7,119
1992	21,358		25%	5,339
1993	16,019		1/3	5,339
1994	10,680		1/2	5,340
1995	5,340		1	5,340

Note: In 1993, 1994, and 1995 the depreciable amount is calculated by dividing the depreciable base by the remaining number of years of useful life since this amount exceeds the amount that would be obtained by applying the twenty-five percent rate to the depreciable base of the asset for those years.

All four countries' tax systems contain provisions for computing depreciation deductions under the straight-line or declining-balance methods. Additional methods may also be permitted by the respective countries' tax systems. Of greater interest is the comparison of the accelerated or special depreciation allowances available under the various countries' tax systems and the reasons given for those incentive measures.

A. France

Depreciation is utilized by the French government to implement general economic policy. Special depreciation allowances are granted in certain cases where investments are considered particularly beneficial to the French economy. The following allowances are currently in effect.

New buildings in less developed regions. A twenty-five percent special depreciation allowance in the year of completion is granted on the cost of newly constructed industrial or commercial buildings, the construction of which was started by December 31, 1984 (subject to ministerial approval). The residual book value is then depreciated over the remaining useful life of the building. This special allowance is intended to apply to the creation, transfer, or extension of business in the less de-

veloped regions of France and in essential industries such as food and agriculture.[135]

Buildings used for research and subscription of research company shares. A fifty percent special depreciation allowance in the year of investment is granted on the cost of acquisition or construction of a building used solely for scientific and technical research. The residual book value is then depreciated over the remaining useful life of the building. This fifty percent allowance also applies to the purchase price of shares in government-approved research companies and organizations and may be taken in the year subscription is paid.[136]

B. Germany

Special depreciation is allowed on certain types of assets and assets in certain locations.

Fixed assets serving scientific research and development activities. Fixed assets acquired between May 18, 1983, and January 1, 1990, for research and development purposes will qualify for accelerated depreciation, provided they are retained in a German permanent establishment of the taxpayer for at least three years. The initial allowance is forty percent for plant and machinery if used more than two-thirds for research and development purposes, and fifteen percent for buildings used more than one-third for research and development.[137]

Fixed assets for small- and medium-sized businesses. Small- and medium-sized businesses may claim an allowance of ten percent of the cost of new fixed assets which are acquired or manufactured after May 18, 1983. Small- and medium-sized businesses are defined as those whose total taxable net asset value does not exceed 120,000 DM and whose trade capital for purposes of the trade tax does not exceed 500,000 DM in the fiscal year of acquisition or manufacture of the assets. The allowance may be claimed only in the year of acquisition and it is available only if the assets are kept in the business in Germany by the taxpayer for at least one year.[138]

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135 CGI art. 39 *quinquies* (D); EUROPEAN TAXATION *France, supra* note 3, at 75.

136 CGI arts. 39 *quinquies* (A), 40 *sexies*; EUROPEAN TAXATION *France, supra* note 3, at 75.

137 EUROPEAN TAXATION *Germany, supra* note 31, at 58.

138 *Id.* at 57.

C. United Kingdom

The timing of tax depreciation allowances for qualifying capital expenditures has changed significantly. Initial allowances on industrial buildings and first-year allowances on machinery and equipment were phased out, effective March 31, 1986.

Industrial buildings. For the cost of construction of industrial buildings which are used by the owner or by a tenant to carry on a qualifying industrial trade, there was an initial allowance of seventy-five percent, if incurred before March 14, 1984. If the cost was incurred between March 14, 1984, and March 31, 1985, the initial allowance was fifty percent, reduced to twenty-five percent through March 31, 1986, and eliminated thereafter.[139]

Plant and machinery. A first-year allowance was available for plant and machinery at the rate of one-hundred percent of the qualifying expenditure, if incurred before March 14, 1984. For expenditures incurred between March 14, 1984, and March 31, 1985, the first-year allowance was reduced to seventy-five percent, further reduced to fifty percent through March 31, 1986, and eliminated thereafter. The plant may be new or used. The taxpayer may forego the first-year allowance, or may claim such allowance reduced to an amount specified.[140]

Scientific research. A one-hundred percent allowance is available for capital expenditure incurred on scientific research in connection with a trade and is granted in the year the expenditure is incurred.[141]

D. United States

The United States does not provide special depreciation allowances for certain investment "items." The United States accelerated depreciation system applies to a broad "classification" of investment items. The United States government introduced this accelerated depreciation system to address overtaxation of capital investment resulting from inflation, by providing for more rapid depreciation deductions.[142]

The Accelerated Cost Recovery System ("ACRS") was established by the Economic Recovery Act of 1981 and generally governs deprecia-

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139 EUROPEAN TAXATION *United Kingdom, supra* note 33, at 53.

140 *Id.* at 50-51.

141 *Id.* at 54.

142 The President's Proposal to the Congress for Fairness, Growth, and Simplicity 135 (U.S. Government Printing Office) (May 1985).

tion allowances for tangible property placed in service after 1980. ACRS assigns all "recovery property" to a class with a specified recovery period and depreciation schedule. In general, recovery property is defined to include all depreciable property placed in service after 1980, except intangible property, property subject to amortization, and property for which the taxpayer properly elects a method of depreciation (such as the units of production method) that is not expressed in terms of years.[143]

ACRS differs from other depreciation methods in many important respects. ACRS recovery periods are not based directly on the useful economic lives of assets and, for most assets are significantly shorter than under other methods. ACRS classifies all personal property (other than public utility property) as three-year or five-year property.[144] Automobiles, light trucks, and research and experimentation property are the principal three-year property items, while most other personal property, including machinery and equipment, is recovered over five years.

The United States also allows a credit against income tax liability for a taxpayer's investment in certain depreciable property.[145] Subject to a long list of exceptions, the following classes of property qualify for the investment credit: (1) tangible personal property (other than air conditioning or heating units); (2) certain other tangible property (excluding buildings and their structural components); (3) elevators and escalators; (4) single purpose agricultural or horticultural structures; (5) rehabilitated buildings; (6) certain timber property; and (7) storage facilities (excluding buildings and their structural components) used in connection with the distribution of petroleum or certain petroleum products.[146]

The investment tax credit was introduced originally and modified periodically to serve two principal purposes: to prevent capital consumption allowances based on historical cost from being eroded by inflation; and to stimulate increased levels of investment.

In general, the credit is equal to ten percent of qualified investment in property that is placed in service during the taxable year.[147] In the case of ACRS three-year recovery property, the applicable credit rate is generally six percent.[148] All qualifying costs for new property are eligible for the credit; in the case of used property, the qualifying costs that may be taken into account are generally limited to $125,000 for each taxable

143 I.R.C. § 168.
144 *Id.*
145 I.R.C. §§ 38, 46.
146 I.R.C. § 48(a)(1).
147 I.R.C. § 46(b).
148 I.R.C. §§ 46(b), 46(c)(7)(B).

year.[149] The investment tax credit is not available for property which is expensed.

The basis of depreciable property for which an investment tax credit is taken is reduced by fifty percent of the amount of such credit. A taxpayer may elect a two percent reduction in the investment tax credit in lieu of a basis reduction. If property for which an investment tax credit was taken is disposed of prior to the end of its recapture period, a portion of the credit previously allowed will be recaptured and added to the tax due in the year of disposition.[150] The amount of tax liability that may be offset by investment tax credits in any year may not exceed $25,000 plus eighty-five percent of the tax liability in excess of $25,000.[151] Credits in excess of this limitation may be carried back three years and forward fifteen years.[152]

Significant changes to accelerated depreciation and elimination of the investment tax credit are proposed in the Tax Reform Act of 1985,[153] which has not been enacted at the date of this writing.

E. Comparison

Depreciation allowances should reflect the fact that, on average, the economic value of assets decline over time due to a variety of factors, including declining productivity, wear and tear, and obsolescence. If depreciation allowances understate real economic depreciation of a particular asset, income from the investment is overtaxed and a tax disincentive is created which impairs capital formation and retards the economy's productive capacity. Similarly, if depreciation allowances exceed real economic depreciation, incentives are created for investment in depreciable property.

Several special depreciation allowances available in the respective European countries have been discussed in the preceding paragraphs. Inherent in all of these special depreciation allowances is the ability to accelerate depreciation allowances such that they exceed real economic depreciation and provide an incentive for investment in the particular type of property to which they are applicable. In contrast, the United States provides that accelerated depreciation allowances are applicable to a broad class of depreciable property rather than specific items.

Different economic, social, and fiscal policies of the countries dictate

149 I.R.C. §§ 46(c), 48(c).
150 I.R.C. § 47(a).
151 I.R.C. § 38(c)(1).
152 I.R.C. § 39(a).
153 H.R. 3838, 99th Cong., 1st Sess. §§ 201, 211, 131 CONG. REC. H12,589-95, H12,597 (1985).

which specific depreciable property items are granted special, accelerated allowances. However, certain items have received favorable treatment in more than one country; this suggests that the countries have similarly determined that investment in certain items should be encouraged.

Scientific research and development activities. All of the countries have made special provision for accelerated depreciation allowances for buildings and assets used for scientific research and development activities.[154] The special depreciation allowances for research and development activities must be intended to create an incentive for technological innovation; substantial benefit results to a country from such innovation. Oftentimes market rewards to those who take the risks of research and development are not sufficient to support an optimal level of such activity. The special depreciation allowances are a means to reward those engaged in research and development of emerging technologies. Regardless of the specific policy reasons underlying the respective countries' decision to encourage research and development activities, it is apparent that each of the four countries subscribe to the belief that investments in research and development are beneficial.

Small- and medium-sized business assets. Germany (and at one time the United Kingdom) has provided for special depreciation allowances to be afforded to small- and medium-sized businesses.[155] Given the exponential growth of large, multinational enterprises, countries have, on occasion, enacted provisions with a view to protect small- and medium-sized businesses operating within their country. Germany has extended added protection to small- and medium-sized businesses by providing them with accelerated depreciation allowances for assets and buildings used in such businesses.

Buildings and assets in less-developed regions. France (and Germany) has sought to address the problem of over-development and congestion in certain industrial and commercial regions. The incentive used is an allowance for accelerated depreciation of buildings and assets employed in less-developed regions[156] (e.g., by enterprises situated along the Eastern border of Germany).

Perceiving the need to address specific problems or encourage growth and investment within certain sectors of the economy, the countries have used accelerated depreciation allowances as a means to achieve

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154 *See supra* notes 135-41 and accompanying text; I.R.C. § 168(c)(2)(A)(ii).

155 *See supra* text accompanying note 138.

156 *See supra* note 135 and accompanying text.

desired goals. The use of accelerated depreciation allowances as a mechanism for achieving increased investment in specific economic sectors has produced mixed results. These results are often difficult to assess, given the intervention of other factors.

As evidenced by continued use of accelerated depreciation allowances, the countries generally regard the results as satisfactory to direct private investment and to encourage economic growth. Nevertheless, many countries are eliminating accelerated depreciation allowances. For example, the United Kingdom has phased out several initial or first-year accelerated depreciation allowances in various sectors of its economy.[157] It is unclear why the United Kingdom has chosen to eliminate many of its first-year accelerated depreciation allowances. Some of the more obvious reasons may be ineffectiveness or over-effectiveness in achieving desired results, resolution of previously targeted problems, or an overly large revenue drain on the government fisc caused by accelerated depreciation allowances.

The potential tax advantages to be gained from accelerated depreciation allowances can be substantial, but are unique to specific activities, assets, and construction. Depreciation allowances may be a significant tax consideration for Newco, but can only be determined upon a comprehensive review of the specific operating assets (and activities) of Newco.

Since Newco's activities are primarily manufacturing raw products into finished products, it may be entitled to accelerated depreciation allowances on its plant and machinery. Certainly, any research and development activities by Newco will receive favorable tax treatment. Given the countries' movement away from accelerated depreciation allowances as a means to influence business investment and expansion, it is unlikely that Newco will be able to benefit substantially from accelerated depreciation allowances in any of the named countries.

VII. LIQUIDATION

A. France

When a company is liquidated, all previously untaxed income becomes taxable and deferred depreciation and loss carryovers outstanding are applied against taxable income.[158] The corporate income tax rules govern, but all untaxed income is added into taxable income (e.g., deferred capital gains).

The liquidation surplus generated by the liquidation of the corpora-

157 *See supra* text accompanying note 139.
158 CGI arts. 201(1), 209.

tion is taxable to the shareholders. Liquidation surplus is defined as the difference between net assets (for tax purposes) and contributed capital which has not been reimbursed prior to liquidation. The shareholders are exempt from income tax or corporate income tax up to the amount of contributed capital. The liquidation surplus is treated as a dividend distribution, taxable to the shareholders.[159]

The tax credit (*avoir fiscal*) on dividends received is applicable for French shareholders and those foreign portfolio shareholders granted the credit by tax treaty. Any part of the liquidation surplus which has not borne the full corporate income tax, or which represents profits made in years ending more than five years prior to distribution of the surplus, is subject to equalization tax (*précompte*).[160]

The liquidation of a branch of a foreign corporation is governed by the same rules. Foreign shareholders, however, also bear withholding tax on the liquidation surplus. Individual shareholders may elect income spreading, if the liquidation surplus exceeds the average taxable income of the three years prior to receipt.[161]

Independent of the taxation of the liquidation surplus, a corporate shareholder may realize capital gain or loss as a result of a liquidation.[162] If the shares have a book value exceeding the amount of the liquidation distribution, a capital loss results. If the book value is less than the nominal value or amount of the liquidation distribution, there is a capital gain. For a nonresident, such gain or loss is not within the French taxing jurisdiction.[163]

B. Germany

The taxable income of a company in liquidation is equal to the difference between the value of the net assets (for tax purposes) at the beginning of the liquidation period and the value of the net assets distributed or available to the shareholders (or the value of the consideration received if the net assets are transferred to a party other than the shareholders). Profits of preceding taxable years included in the net assets at the beginning of the liquidation period and which were distributed during the course of the liquidation period are eliminated in computing the taxable income of liquidation. Taxable income is subject to corporate

159 CGI art. 161.

160 CGI art. 223 *sexies*.

161 CGI art. 163.

162 EUROPEAN TAXATION *France*, *supra* note 3, at 152.

163 *Id.*

income tax at the regular rate applicable to business income.[164]

The object of the German tax law is to ensure the full corporate income taxation of the accumulated profits of a company.[165] Taxable gain on liquidation is the increase in the net worth of a company from the beginning to the end of the taxable period. This gain is calculated according to the rules for determining current taxable income.[166]

Under the German corporate income tax system, distributed profits are taxed at the reduced rate of thirty-six percent on the corporate level. Further, liquidation gain is treated like a distribution of available net equity (i.e., a dividend distribution), subject to the final thirty-six percent distribution tax on the corporate level, and the withholding tax and the related imputation tax credit are granted to a resident shareholder. The repayment of nominal capital may, however, result in a separate taxable gain or deductible loss.[167]

C. United Kingdom

Profits (income and capital gains) arising during liquidation are subject to corporate income tax at the regular rate. When a company's assets are disposed of in liquidation to third parties (or to shareholders by way of distributions in-kind), they are deemed disposed of for capital gains tax purposes. Shareholders are treated as making a partial disposal of their shares for capital gains tax purposes on each occasion when a liquidating distribution is received. Where assets are distributed in-kind to the shareholders, the amount deemed to be received and the basis in the assets (on a subsequent disposal) is the current fair market value of the assets. Distributions in liquidation are not dividend distributions and therefore do not give rise to a liability for ACT to the company or for income tax to the shareholders.[168]

D. United States

Generally, no gain or loss is recognized on the distribution of property in complete liquidation of a corporation (with some exceptions relating to dispositions of installment obligations and certain inventory items).[169] Such property may also be sold within a twelve-month period pursuant to a plan of complete liquidation without recognition of gain or

164 EUROPEAN TAXATION *Germany*, *supra* note 31, at 119.
165 KStG § 11.
166 KStG § 11(6).
167 EUROPEAN TAXATION *Germany*, *supra* note 31, at 120.
168 ICTA § 245.
169 I.R.C. § 336(a).

loss.[170] Amounts distributed in complete liquidation of a corporation (or redemption of its stock) are treated as full payment in exchange for the shareholders' stock and Internal Revenue Code section 301 (wherein a corporate distribution would be treated as a dividend) does not apply.[171]

The result is that a shareholder normally will realize capital gain or loss, long- or short-term (depending on the holding period), upon the liquidation of the corporation. If property is received by the shareholder in a distribution in complete liquidation and gain or loss is recognized on receipt of such property, the basis of the property in the hands of the shareholder will be the fair market value of the property at the time of the distribution.[172]

Special rules apply to the liquidation of a subsidiary corporation. No gain or loss is recognized to the parent corporation and the basis of the assets (as well as the subsidiary's tax attributes) is carried over unless Internal Revenue Code section 338 is elected.[173] Section 338 allows for certain stock purchases to be treated as asset acquisitions, with a corresponding step-up in the basis of the assets acquired.[174]

A recent change to the United States tax code requires that gain (but not loss) be recognized by a distributing corporation on any ordinary nonliquidating distribution, whether or not it constitutes a dividend of property to which Subpart A (Internal Revenue Code sections 301 to 307) applies, as if such property had been sold by the distributing corporation for its fair market value.[175] However, this provision does not apply to a distribution in complete liquidation of the distributing corporation.

E. Comparison

Although the tax consequences of the liquidation of a business to be incorporated abroad may not seem important prior to incorporation, the ability to tax gain on liquidation is one of the significant tax considerations behind a decision to incorporate in a particular country. The value to shareholders of a profitable business incorporated abroad would be reduced substantially if shareholders were unable to realize their capital appreciation upon liquidation without the imposition of an onerous tax on the corporation or shareholders.

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170 I.R.C. § 337(a).
171 I.R.C. §§ 331, 302(a).
172 I.R.C. § 334(a).
173 I.R.C. §§ 332, 334(b), 381(a)(1).
174 I.R.C. § 338.
175 I.R.C. § 311(d)(1).

France and Germany generally treat the gain realized by the shareholders on liquidation as income recognized in a dividend distribution. The gain is taxable as such under the corporate distribution rules of their respective corporate tax codes. The United Kingdom, like the United States, characterizes the transaction as a disposition by the shareholders of their shares in exchange for cash or property received in the liquidating distribution and subjects the liquidation gain realized by the shareholders to a capital gains tax.

The difference in the tax treatment by the countries of the liquidation gain to the United States shareholder is difficult to appreciate unless described in real terms. France assesses a tax on the United States shareholder's liquidation gain at an effective rate of thirty-six percent, once the *avoir fiscal* has been applied. Germany's effective tax rate on the United States shareholder's liquidation gain is forty-five and one-half percent. The United Kingdom's effective tax rate on liquidation gain (capital gain) is thirty percent. Newco would minimize the tax liability on its liquidation proceeds (to be received by its United States shareholders) if it were to incorporate in the United Kingdom.

VIII. Foreign Operations

A. Resident Companies Operating Abroad

Under French corporate income tax law, foreign-source income of resident companies earned by a permanent establishment (including an overseas entity which is a branch or a subsidiary) from "business activity" abroad is exempt from corporate income tax when earned or received. This is central to the French tax system which is based on the principle of territoriality; the French tax law is not applicable beyond French territorial limits. The foreign-source income will remain exempt from French corporate income tax even upon its distribution by the permanent establishment to its head office or parent corporation. Only when the foreign-source income is redistributed by the French resident company to its own individual shareholders will *précompte* be due.[176]

If the foreign-source income is earned by a subsidiary corporation in such a manner that it is not effectively connected to a "business activity" abroad, it will still be ninety-five percent exempt in the hands of the French parent corporation. This foreign-source income, however, will be subject to *précompte* upon redistribution by the parent corporation to its individual shareholders.[177]

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176 CGI art. 209.

177 CGI arts. 146(2), 223 *sexies* (1).

Finally, if the foreign-source income is not effectively connected with a "business activity" abroad, and there is no parent/subsidiary relationship between the foreign and domestic entities, French corporate tax will be due upon the gross amount of foreign-source income of the resident company. However, the resident company will be allowed a tax credit (or deduction) for the foreign tax paid.[178]

Germany, the United Kingdom, and the United States all exercise worldwide taxing jurisdiction over resident companies with the result that profits of branches generally are subject to corporate income tax in the country of their head office in the year in which such profits are earned (double taxation treaties may, however, provide for taxation of profits in an alternate manner). Foreign tax paid with respect to branch profits will be either credited against the head office's corporate tax liability or deducted from the head office's taxable income.[179]

As a general rule, in Germany, the United Kingdom and the United States, income of foreign subsidiaries is subject to domestic corporate tax (i.e., corporate income tax of the parent corporation's country) only when it is repatriated to the parent corporation. Foreign tax paid with respect to foreign-source income distributed by the overseas subsidiary to its parent will be either credited against the parent's corporate income tax liability or deducted from the parent's taxable income.[180]

B. Tax Havens

Each of the four countries has sought to address the taxability of income of resident shareholders generated in low- or no-tax jurisdictions within their respective corporate income tax systems.[181] Although the provisions contained in the countries' respective tax codes vary in degree of taxation and complexity, they all are designed to reach only those transactions occurring abroad in which a significant reduction in domestic corporate income tax is the predominant motive.

The countries have remedied the situation by attributing to resident shareholders, in actual or effective control of the foreign entity, certain classes of income generated by or received from the foreign entity (regardless of whether this income is repatriated to the resident shareholders). The resident shareholders gross-up this foreign-based income by

178 CGI art. 146(2).

179 KStG § 26 (Germany); ICTA § 498 (United Kingdom); I.R.C. § 901(a) (United States).

180 *See supra* note 179.

181 1980 Finance Law art. 70, J.O. 19 janv. 147, 63 B.L.D. 97 art. 70 (1980) (France); 1972 AUSSENSTEURGESETZ, BGBl.I 1713 (amended 1983) (Germany); Finance Act, 1984, ch. 43, §§ 82-91 (United Kingdom); I.R.C. §§ 951-964 (United States).

the foreign income tax allocable to such income and then receive a foreign tax credit in their own country for foreign tax deemed to have been paid on such income.

C. Foreign Tax Credit

Each of the four countries allows resident taxpayers a tax credit for foreign tax paid on foreign-source income if certain conditions are met. The countries share certain limitations regarding the application of a foreign tax credit to a resident corporate taxpayer's taxable income:

(a) only "resident" corporate taxpayers may claim the credit against their domestic corporate income tax liability;
(b) the foreign taxes creditable must be similar to the domestic corporate income tax;
(c) the foreign tax credit is granted on a per-country basis (the United States is contra; it requires the credit to be calculated on an overall-country basis);
(d) credit for foreign tax paid is limited to the domestic corporate income tax on the same income;
(e) no refund, carryback, or carryforward for excess foreign tax credits (France allows a deduction for excess credits; the United States allows excess credits to carryover); and
(f) instead of taking the foreign tax credit, the taxpayer may deduct foreign tax paid from taxable income.

There are also some distinctions concerning the availability of foreign tax credits among the countries which are worth noting. In the absence of a double taxation treaty, France does not unilaterally relieve foreign-source income from domestic taxation by means of a foreign tax credit under its national tax law. French tax law will allow a deduction of foreign tax paid from taxable income in the absence of a tax treaty. Even when a foreign tax credit is available by virtue of a tax treaty concluded by France, the creditable foreign tax must be attached to interest, dividend, or royalty income.

Germany generally allows a foreign tax credit only for foreign tax paid on certain types of investment income (e.g., dividend, royalty, and interest income) or on income from countries with which Germany does not have a double taxation treaty. Tax treaties concluded by Germany often utilize the exemption method for avoiding double taxation. When a double taxation treaty exists, but the exemption method has not been adopted, a limited tax credit is made available for resident taxpayers.[182]

Finally, only France and the United States have provided in their corporate tax systems for utilization of excess (unused) foreign tax cred-

[182] KStG § 26.

its. France allows a deduction for excess credits;[183] the United States allows excess credits to carryover.[184] Only the United States currently requires that foreign tax credits be calculated on an overall-country basis, as opposed to a per-country basis.[185]

D. Nonresident Companies' Operations

Branches of nonresident companies generally are subject to domestic corporate income tax at the normal rate on any income effectively connected to a trade or business activity in the domestic country. In France, in addition to the domestic corporate income tax, a branch is liable for withholding tax at a general rate of twenty-five percent on distributable income net of corporate income tax (whether or not this income is distributed to the foreign head office).[186]

Branches of nonresident companies are not recognized as separate legal entities; thus, they cannot benefit from imputation tax credits or tax treaties. Germany provides that the rate of corporate income tax payable on the taxable income of a branch be reduced to fifty percent.[187]

Subsidiaries of nonresident companies are viewed as distinct legal entities, generally subject to tax at the regular corporate income tax rates as resident companies. Interest, dividend, and royalty income distributed by a subsidiary to its foreign parent is subject to withholding taxes collected by the domestic country at the source. France and the United Kingdom have concluded double taxation treaties that allow the foreign parent a tax credit on dividends received, which may be paid directly by the subsidiary to the parent and the subsidiary's domestic corporate tax liability correspondingly reduced.[188] Further, under certain circumstances, the countries have allowed the foreign parent a "deemed paid" credit for domestic corporate income tax paid by the subsidiary in proportion to its shareholding in the subsidiary.[189]

Under the scenario as described, Newco will not be carrying on any business activities outside of its country of incorporation during its initial stages of operation. However, as Newco's earnings and profits grow and

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183 CGI art. 146(2).

184 I.R.C. § 904(c); Treas. Reg. § 1.904-2 (1985).

185 Treas. Reg. § 1.904-1 (1985).

186 CGI arts. 115 *quinquies*, 187.

187 EUROPEAN TAXATION *Germany*, *supra* note 31, at 40.

188 Convention Between the United Kingdom of Great Britain and Northern Ireland and France for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, May 22, 1968, art. 24(a)(ii), (b)(ii), 1970 Gr. Brit. T.S. No. 6 (Cmd. 4253), 725 U.N.T.S. 3, 32-34.

189 *See, e.g.*, KStG §§ 26(2)-(5), I.R.C. § 902(a).

its business expands, it may be prudent to consider establishing an office, branch, or subsidiary in a country outside of its country of incorporation. This section has been included to present some of the tax considerations relevant to expanding a business into another country. Newco will need to examine these tax considerations in light of its specific business requirements at the time of such contemplated expansion.

IX. Double Taxation Treaties

A double taxation treaty is an agreement between the government of one country and the government of another country for the avoidance of international double taxation and the prevention of tax avoidance and evasion, along with the promotion of economic cooperation and trade. All governments have treaty-making power under international law; treaty rules supercede domestic law provisions.

Most treaties concluded or amended since 1963 are based on the Model Double Taxation Convention of the Organization for Economic Cooperation and Development ("OECD Model Convention"),[190] which has produced considerable uniformity in treaty language. Generally, the rationale of these bilateral tax treaties is either to empower only one of the countries to tax a specific category of income or to share this taxing power; one country is given limited taxing power, whereas the other country has full taxing power but recognizes a tax credit for taxes imposed by the source country.

The tax treaties concluded by France, Germany, the United Kingdom, and the United States generally follow the standard form of the OECD Model Convention. Some significant provisions of these tax treaties are discussed below. However, the following discussion is meant to serve only as an introduction to double taxation treaties.

A. Taxes Covered

Most treaties specifically cover personal income taxes and corporation profits taxes; additionally, taxes unique to the specific country but substantially similar to income taxes are covered.[191]

B. Fiscal Residence

While the definition of residence varies, it is normally based on provisions in the tax laws of the respective countries. A resident is generally defined as any person subject to tax by reason of his domicile, residence,

190 OECD Model Convention, *supra* note 16.
191 *See, e.g.*, OECD Model Convention art. 2.

or place of management (or place of incorporation, in the United States). This can lead to dual residence. A number of treaties lay down rules to establish in such circumstances which claim of residence is to prevail.[192]

C. Permanent Establishment

A permanent establishment normally means a branch, factory, office, place of management, workshop, or other fixed place of business operated by a resident of one country in the country of the other party to the treaty. It includes mines and other workings of natural resources and any construction or assembly project which exists for more than a stated period (usually twelve months).

An agency normally constitutes a permanent establishment where the agent has general authority to negotiate or conclude contracts or holds a stock of merchandise from which the agent regularly fills orders on behalf of the principal. A permanent establishment does not include business transacted through a broker or an independent agent, nor does it include a fixed place of business maintained exclusively for the purchase of goods. It normally also excludes warehouse, stockholding, information, advertising, and ancillary scientific research facilities.[193]

D. Industrial and Commercial Profits

Industrial and commercial profits are taxable in the country where the permanent establishment is situated only to the extent that they can reasonably be attributed to the permanent establishment.[194]

E. Individual Services

Individual services are normally taxable in the country where the work is performed. However, most treaties grant the sole right to impose tax to the country of residence in cases where:

(a) the stay in the the territory is only temporary (i.e., the individual's stay in the country where the work is performed is less than 183 days);
(b) the individual is remunerated by an employer who is a resident of the first country and the remuneration is not charged to a permanent establishment maintained by the employer in the other territory.[195]

F. Competent Authority

Many treaties provide that, where a taxpayer shows proof that the

192 *See, e.g.*, OECD MODEL CONVENTION art. 4.
193 *See, e.g.*, OECD MODEL CONVENTION art. 5.
194 *See, e.g.*, OECD MODEL CONVENTION art. 7.
195 *See, e.g.*, OECD MODEL CONVENTION art. 15.

action of the tax authorities will ultimately result in double taxation contrary to the provisions of tax treaties, the taxpayer shall be entitled to present a case to the competent authority of the taxpayer's country. Should the taxpayer's claim be deemed worthy of consideration, the competent authority shall endeavor to come to an agreement with the competent authority of the other country party to the treaty with a view to avoidance of double taxation.[196]

G. Exchange of Information

An exchange of information between the treaty partners on relevant taxation matters is provided in most tax treaties. According to this provision, the tax authorities of the treaty countries shall exchange such information as is necessary for carrying out the provisions of the treaties or for the prevention of fraud or for the administration of statutory provisions against legal avoidance, in relation to the taxes regulated in the treaties.[197]

X. CONCLUSION

Under the circumstances particular to the scenario as described, it would appear that Newco should incorporate in the United Kingdom. Newco's effective corporate income tax rate in the United Kingdom would be forty percent (as opposed to fifty percent in France, and fifty-six percent in Germany or thirty-six percent on distributed income in Germany). Higher net dividends, resulting from a lower overall United Kingdom tax burden on corporate distributions, would be received by Newco's United States shareholders. Upon the liquidation of Newco, the United Kingdom would impose the lowest effective rate of tax on the liquidation gain (thirty percent).

The countries' taxation of capital gains and interest, dividends, and royalties would not have a significant impact on Newco's decision regarding its country of incorporation, as this tax treatment is generally similar in the three European countries. The countries' taxation of Newco's foreign operations, should it expand its activities into another country, would be relevant at a later time. Depreciation allowances do not appear to be a significant tax consideration for Newco given its specific assets and activities; it is not likely that Newco will be able to benefit substantially from accelerated depreciation allowances in any of the named countries.

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196 *See, e.g.*, OECD MODEL CONVENTION art. 25.

197 *See, e.g.*, OECD MODEL CONVENTION art. 26.

Though it has been determined that Newco should incorporate in the United Kingdom for the tax reasons given, Newco must still consider several tax/nontax considerations not discussed in this article but alluded to at its inception, e.g., a value added tax, repatriation of capital, etc. Further, certain United States tax laws must be considered. For example, a transfer of technology or intangibles by a United States resident or United States corporation to a foreign corporation (Newco) will trigger application of Internal Revenue Code section 367(d) or section 1491 and possible application of a "toll charge" or excise tax. Finally, Newco must also make general business decisions of which taxes are only one factor: for example, acquisition of a plant or land on which to build a plant, selection of management, training of operational personnel, and transfer or acquisition of essential machinery.

In sum, even after evaluating the important tax considerations, Newco will still need to address many other considerations before choosing its country of incorporation. Nonetheless, Newco's examination of the countries' tax laws and double taxation treaties is a significant step forward to incorporation abroad and an essential step to effective tax planning.