Group tax planning in cross-border business

- Fiscal and liability consequences of cross-border business -

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It is becoming ever easier for companies to internationally market their products. The common currency, the EURO, seems to make the idea of a common market tangible. The forthcoming accessions of further member states in spring next year will even add to this trend. Despite all euphoria, it must be pointed out that neither the tax laws nor civil laws of the countries affected have been brought into line with each other in the same way as their currencies have.

When a company is doing business on an international level, planning with regard to tax law and liability is therefore indispensable. Entrepreneurs must thus consider the export and import of their goods very thoroughly.

The simplest case of foreign business is the direct transaction, i.e. the entrepreneur purchases or sells directly from their location without having a permanent establishment abroad. The taxes on earnings are levied and collected by the country of corporate domicile. As far as civil law is concerned, however, the liability regulations of the country of destination are applicable. Such liability “crosses the border” from the country of sale to the entrepreneur’s country of production.
If, in addition, the entrepreneur has a fixed place of business abroad which, however, is not legally independent, this is termed a permanent establishment. The profit of a permanent establishment is subject to the foreign taxation on earnings. The disadvantage is that often also the other country is of the opinion that the profit is to be taxed not only via the permanent establishment abroad but that it is actually attributable to the parent firm. In order to establish that, the permanent establishment has to do another accounting under the provisions of determination of profits of the country where the parent firm is incorporated in and pay taxes on parts of the profit there. Double taxation conventions are to resolve this problem, but they often do so only inadequately. The different countries often have different opinions as to when one can speak of a permanent establishment and the double taxation conventions again define this term differently. Even assembly work on a building site in the other country may constitute a permanent establishment. With regard to civil law and liability, the provisions of the country of production prevail anyway; in that respect, the permanent establishment has no “shielding effect”. In the two aforementioned cases the entrepreneur has to face risks resulting from foreign law.

Ranking one level above the permanent establishment, there is the foreign partnership. The consequences regarding tax law and liability primarily depend on the foreign law. An often applying principle is that in terms of taxation the partnership is regarded as transparent; this means ascertainment of profits at company level but payment of taxes at partner level. Some countries, like for example Spain (“Sociedad colectiva/en comandita"), treat partnerships as legal entities. Since some countries regard the partnership as transparent, conflicts may arise over how to categorize the partnership with the discussion about double taxation. At the same time shifts may result regarding the question according to which rules (accounting principles) the profit is to be determined.
The foreign partnership may initially be answerable abroad with regard to civil law and liability. In the end, however, the partners are liable without limitation and therefore the

company has to reckon with foreign losses also in the country of production. These losses are often not even tax-deductible.

An interesting alternative is to carry on the foreign business via a local corporation. The latter is legally independent and effectively protects the parent firm against foreign liability claims by limiting liability to its own capital. It has to do the books only under the law of the country in which it operates.
In terms of taxation, the corporation provides the shielding effect, as it is called, towards the fiscal authorities in the country of the parent company. Only in so far as the profits are distributed to the shareholders, they are subject to the partners' personal tax in the other country.

Owing to their legal independence, foreign corporations can often be used better for tax optimization than other business forms; common are models like the "tax credit mixer" or "dividend routing".
Common are also models of shareholders' debt financing, i.e. endowing the foreign corporation with loans of the parent company in order to extract the profits via interest.
With a proposal of the Federal Government, the German tax administration is currently trying to counteract this result by amending Section 8a KStG (Corporation Income Tax Act) in conformity with European law . Also in other countries there are corresponding regulations against the manipulation of the profit with controlled foreign companies (cfc rules).
The seemingly easy handling of export with possibilities of insuring the goods or even the consideration makes the entrepreneurs sometimes forget that business is only good if they don't have to pay double tax on profits. Only a certified attorney at tax law can help with the preparatory planning of a group's activities with regard to tax law.