# Session 14 - International Taxation

- Provide an overview of the taxation of international tax rules
- Introduce the FTC
- Provide an overview of transfer pricing

# International tax systems

- Territorial - no tax is generally due on income earned outside of the country in which the parent is located
- Worldwide - all income is subject to taxation by the country in which the parent is located
  - US taxes worldwide income of citizens and permanent residents
  - US taxes worldwide income of domestic corporations
  - US taxes the US source income of nonresident aliens
  - US taxes the US source income of foreign corporations

# Withholding

- In addition to taxes imposed on earnings, transfers (interest payments, dividends, royalties, etc.) between a corporation and its foreign shareholders (individuals or corporations) are generally subject to withholding taxes.
- The general withholding rate imposed by the U.S. is 30% of the payment amount. This rate can be reduced by tax treaties between the various jurisdictions

# Some definitions

- A domestic corporation is one incorporated in one of the 50 US states
- A foreign corporation is one that is not a domestic corporation
- We will focus on taxation of corporations rather than individuals or partnerships

# U.S. Framework

- Worldwide taxation
- Elimination of double taxation
- Deferral
- “Arm's-Length” related party transactions
- Business purpose

# Worldwide Taxation

- The U.S. taxes the worldwide income of U.S. corporations (also U.S. individuals, partnerships, estates or trusts) irrespective of where it is earned
- The U.S. corporation is also generally taxed by the other countries where it operates
- In an extreme case, a U.S. corporation could "lose" almost all its profits to taxes (e.g., a U.S. corporate tax rate of 35% and a foreign corporate tax rate of 50%)

# Eliminating Double Taxation

- A method is needed to mitigate double taxation in order for U.S. companies to be competitive
- Two possibilities exist:
  - exempt foreign source income (adopted by territorial regimes), or
  - adopt a foreign tax credit (FTC) (adopted by U.S.)
- The U.S. FTC, subject to numerous limitations, allows a company to credit its foreign taxes paid $ for $ against its U.S. tax liability

# Deferral

- A U.S. corporation that is a shareholder in a foreign corporation can defer current U.S. taxation of certain types of income earned abroad until profits are repatriated
- Allows reinvestment of pre U.S. tax earnings (similar to the deferral allowed U.S. shareholders investing through a C corporation)
- Deferral is not available to U.S. companies operating abroad as a branch or other flow-through entity

# “Arm's-Length” standard - Section 482

- If a company receives $10 from a customer for product “A”, the company should receive $10 for selling the same product to a related entity
- All major industrial countries have adopted the arm's length standard for transfer pricing
- Business purpose
- Transactions can not be merely designed to minimize or eliminate U.S. taxes

# Details - Other

- Foreign subsidiaries can not , in general, be included in a U.S.  consolidated return (advantage of a branch)
- Dividends received deduction generally does not apply to dividends from  foreign corporations

# Methods of Doing Business Abroad: Indirect Methods

- Licensing arrangement - an agreement to transfer to another entity the use of an intangible such as a patent, copyright or trademark in exchange for payments that are generally tied to "use"
- Independent agent or distributor - foreign party does not take title to goods -- rather, it performs services in connection with the sale of goods or services in exchange for a commission or a fee

# Methods of Doing Business Abroad: Direct Methods

- A branch
  - enhanced presence over that of an independent agent or distributor - staffed by employees of U.S. corporation (most common form of operation for banks and insurance companies)
- A foreign subsidiary
  - greatest level of commitment and most complicated from a regulatory and tax perspective

# Branch operations

- A branch is either
  - an unincorporated division of a US corporation, or
  - a partnership interest in a foreign partnership (or joint venture)
- In either case, foreign income is considered earned directly by the US corporation and the US will tax foreign branch income. Since the US firm will pay both foreign income tax and US income tax on the same income, the income is double taxed
- To avoid double taxation, the US (and other countries) allows either
  - a deduction for the foreign tax, or
  - a foreign tax credit (subject to limitation)

# Branch operations

- Advantages
  - Losses from foreign operations are immediately deductible against U.S. income
  - Start-up losses (may be later recaptured)
  - Similar to analysis of flow-through entities versus C corporations
  - Income repatriation from a foreign branch is not a "dividend"
  - Eliminates withholding taxes
  - Property transfers are not taxable events

# Branch operations

- Disadvantages:
  - No deferral of U.S. tax on earnings
  - Important consideration if foreign rate is lower than U.S. rate
  - Many foreign jurisdictions do not allow loss carryforwards or carrybacks to branches
  - Some foreign jurisdictions have special "branch" taxes
  - Liabilities of a branch are not limited

# Structure of corporations

- Most foreign corporations doing business in the US do so through a US subsidiary
- For example, Toyota doesn't directly manufacture automobiles in the US, but does so through Toyota USA, a US subsidiary
- Therefore, the taxation of Toyota's US operations is the same as the taxation of any other US corporation

# Foreign subsidiary of US parent

- The US does not tax the foreign income of foreign corporations
- Therefore, if a US multinational corporation conducts foreign operations using a foreign subsidiary corporation, the US will not tax the foreign income as it is earned
- There is an exception to this rule for what is known as "subpart F" income (discussed later). However, the foreign country will still tax the income of the foreign subsidiary

# Foreign subsidiary of US parent

- When the foreign subsidiary pays a dividend to its US parent it is called "repatriation" and causes the US parent to have taxable income
  - The US will tax the dividend
  - There is no dividend received deduction for dividends received from foreign corporations
  - Therefore, the foreign income has been taxed twice
    - once by the foreign country when earned
    - once by the US when the earnings are paid to the parent as a dividend
- To eliminate this double tax, the US allows a foreign tax credit to the parent for the foreign tax paid by the subsidiary called a "deemed paid credit"

# Why make international investments?

- The decision to invest abroad depends on several factors:
  - After tax rates of return in the U.S. and abroad
  - Length of the investment horizon
  - The proportion of the investment that is represented by retained earnings

# "Subpart F" income

- Under the system of taxation discussed above, one way for US taxpayers to avoid all US tax on their income is to engage in the following strategy:
  - form a foreign corporation and own all of the stock;
  - transfer all your assets to the foreign corporation;
  - have the foreign corporation located in a tax haven country (tax rate = 0)
  - make all your investments through the foreign corporation;
  - make sure that the foreign corporation does not invest in US assets; and
  - never pay yourself a dividend
- To prevent this sort of tax avoidance, the US will tax the US shareholders of "controlled foreign corporations" (CFC) on the corporation's "subpart F" income

# Antideferral Regimes

- The U.S. tax system (and others) contains constraints on U.S. shareholders' abilities to defer taxes on undistributed (unrepatriated) income (generally passive)
- U.S. shareholders must include in their taxable income certain types of income (Subpart F income) earned by controlled foreign corporations (CFCs), regardless of whether or not the income is distributed

# US Shareholders and CFCs

- A "U.S. shareholder" is any U.S. person (including a corporation) who owns at least 10% of the voting stock of a foreign corporation
  - Both direct and indirect ownership are considered in determining whether the 10% threshold is met
- If all "U.S. shareholders" in aggregate own more than 50% of the shares of the foreign corporation for a period of at least 30 days during the taxable year, that corporation is a CFC (most foreign subsidiaries of U.S. companies) and is subject to the Subpart F rules

# Subpart F income

- If a foreign corporation is classified as a CFC, Subpart F income is currently taxed regardless of its distribution status
- Subpart F income has several components, the most important being foreign base company income (5 components):
  - Foreign personal holding company income (dividends, interest, rents, royalties, etc.)
  - Foreign base company sales income - income generated from selling goods that are both made outside of the foreign company's country of incorporation and sold outside to related entities (regional sales and distribution centers)
  - Foreign base company service income
  - Foreign base company shipping income
  - Foreign base company oil-and-gas related income
- De minimis exception -- $1 million or 5% of CFCs gross income whichever is less

# Foreign Tax Credits (FTC)

- FTC's objective is to eliminate double taxation on foreign source income
- FTC limitation is designed to provide this relief while eliminating a company's ability to use high foreign tax payments to shelter domestic income
- The FTC limitation is determined (in its most basic form) as follows:

# Foreign Tax Credits (FTC)

- Ratio of foreign-source income to worldwide income must not exceed 100%
- FTCs can be carried back 2 years or carried forward 5 years
- Taxpayers have the option of deducting their foreign taxes instead of claiming a foreign tax credit
- Given the process by which the FTC limitation is determined, it becomes critical whether income is designated as U.S. source or foreign source
  - Source of income rules
  - Transfer pricing

# The "deemed paid" credit:

- In the case of a FTC for a dividend from a foreign subsidiary, the US parent hasn't actually paid any foreign tax
- In this situation the US parent is considered to have paid the foreign tax actually paid by the subsidiary that relates to the income distributed as a dividend
- The dividend represents only the after-tax amount of the foreign earnings
- The dividend must be "grossed up" to reflect the amount of tax that was paid

# Example

The subsidiary earns $100

pays foreign taxes of $30

distributes a dividend of $70 to the US parent

US parent is deemed to have paid the $30 foreign tax related to the $70 dividend

However, the US parent must include $100 (= 70 + 30) in dividend income rather than just the $70 received

- This is known as the "dividend gross up"

# The foreign investment decision

- Now you understand enough about US taxation of international operations to examine the following question:
  - How does a US corporation decide whether to invest domestically (in the US) or to make a foreign investment?
- As effective tax planners we want to focus on after-tax returns rather than just tax minimization.

# Foreign investment decision: text example

- After-tax returns are equal to:
  - US: 20% x (1-35%) = 13%
  - Foreign: 18% x (1-15%) = 15.3%
- Note: foreign after-tax returns are higher than the US after-tax returns (if this was not the case, there would be no decision to make)
- However, even though foreign after-tax returns are higher, the decision to invest depends on two other factors:
  - the foreign pre-tax rate of return, and
  - the length of the investment horizon

# The dividend repatriation decision

- How is this different from the investment decision?
  - With the initial investment decision there was no immediate tax consequence
  - With the reinvestment decision an immediate US tax will be due upon repatriation
- As the textbook points out, if the after tax rate of return in the foreign country is higher than the after tax rate of return in the US you should reinvest in the foreign country
- What is somewhat surprising is that this result does not depend on the time horizon
- Waiting to repatriate (reinvesting in the foreign country) provides more after-tax cash after only one year, despite the lower pre-tax rate of return

# Transfer Pricing

- What is a transfer price?
- Who cares?
- What's the risk?
- Transfer pricing rules for tangible goods& intangibles
- IRS examination process
- Advance pricing agreements

# What is a transfer price?

- Price paid for an "exchange" between two related entities
- Intercompany transfers
  - Products, services, technology, loans …..
- Related party definition
  - direct or indirect ownership or "control"

# Arm's length standard (Sect. 482)

- Simple idea
  - If a company receives $10 from a customer for product "A", the company should receive $10 for selling the same product to a related entity
- Difficult to implement
  - Market prices are "negotiated"
  - Comparable transactions

# Who Cares?

- Congress
  - In 1993 alone the US lost $33 billion in tax revenue through transfer pricing abuses
- Multinational Corporations (MNCs)
  - A 1997 Ernst & Young survey reports that MNCs regard transfer pricing as the most important international tax issue
  - 80% of MNCs expect to face a pricing audit within the next 2 years

# What's the Risk?

- $30 billion in disputes are pending or have recently settled
  - Apple: $275.3 million
  - Chevron: $204.8 million
  - Exxon: $6.8 billion
  - Hitachi: $13.2 million
  - Nestle: $367.3 million
  - Nissan: $575 million
- Penalties:  up to 40% of underpayment

# Transfer Pricing (Tangible Goods)

- Comparable uncontrolled price method
- Resale price method
- Cost plus method
- Comparable profits method
- Profit split method
  - “Comparable profit” or “Residual profit” split
- Unspecified methods
- “Best method” rule

# Comparable Uncontrolled Price (CUP)

- “Transaction based”
- Facts:
  - Similar geographical region  and market
  - Identical product
- Price that would be  charged in a transfer  between unrelated parties

# Comparability problems

- Quantifiable differences
  - Cost of insurance or freight
  - payment terms
  - Adjustments possible
- Other differences
  - Geographic markets
  - Adjustments very difficult

# Resale Price

- Facts:
  - Market price of $10
  - Distributor gross margin in uncontrolled transactions is 20%
- Price:
  - Market price $10
  - Distributor GM <2>
- ($10 x 20%)
  - ALP $ 8_

# Resale Price Issues

- Purchaser perspective
  - Supplier bears disproportionate amount of risk
- Identifying benchmark companies
  - Functions (e.g., R&D, marketing)
  - Risks (e.g., market risks, foreign currency fluctuations)
  - Contractual terms (e.g., credit terms, warranties)
  - Other (e.g., goodwill)

# Cost Plus

- Facts:
  - “A” & “B” are similar components
  - The cost to ForeignCo of “B” is $75
  - ForeignCo sells “B” to Assembler (IND) for $100
  - The cost to ForeignCo of “A” is $80

# Cost Plus

- <u>Step #1:</u> Determine the gross profit percentage for finished product "B"
- <u>Step #2:</u> Determine the transfer price of product "A" components

# Cost Plus Issues

- Supplier perspective
  - Purchaser bears disproportionate amount of risk
- What's included in “cost”?
  - Overhead allocation
- Identifying benchmark companies

# Comparable Profits Method (CPM)

- CPM is used when the transactional methods can't be applied due to lack of comparable unrelated party transactions
- CPM compares the net profitability of the taxpayer with the profitability of other companies in the same line of business
  - greater comparability than industry averages
  - flexibility in choosing comparable companies

# Profit split methods

- The combined operating profit (or loss) of the related parties is “split” or allocated based on the relative value of each party's contribution to the combined profit (or loss)
  - comparable profit split
  - residual profit split

# Transfer Pricing (Intangible Goods)

- Comparable uncontrolled transaction method
- Comparable profits method
- Profit split method
  - "Comparable profit" or "Residual profit" split
- Unspecified methods

# “Commensurate-with-income” Standard (Intangible Goods)

- Compensation arrangements must be regularly reviewed
  - taxpayer can not rely on its projections at the time the intangibles were transferred
- If intangibles are sold outright, periodic review is still required

# IRS Examination Triggers

- Lack of transfer pricing documentation
- Analysis of financial ratios
  - gross profit/net sales
  - net profit/net sales
  - operating expenses/net sales
  - gross profit/operating expenses
- Financial ratios that vary from industry norms have increased adjustment risk

# Advance Pricing Agreements

- Alternative dispute resolution system in early 90's
- APA represents a contract with IRS regarding pricing methodology
- Eliminates adjustment & penalty risks
- Agreement can cover up to 5 years
- Bilateral agreements becoming more common

# APA Process

- Pre filing conference
  - General discussion of legal issues & IRS pricing practices peculiar to company
  - Meetings can be anonymous
- Formal Process
  - APA Request - Detailed information regarding taxpayer's operations / functions performed
  - Iterative evaluation and negotiation process
- 80% of APA requests result in agreements