International Taxation

1. Jurisdiction

- Each country has its own tax rules.
- Rules differ in tax rates, income bases (i.e., what is taxed), timing of income recognition and “structure” (i.e., approach to taxation).
- Every corporation and person is a resident of at least one country.
- Most countries tax their residents on their worldwide income and tax non-residents on their income earned within the country.
- Therefore, a resident of one country earning income in another country will find himself/herself/itself potentially subject to tax on the same income both in the home country and in the country of business. When the same income is taxed twice, it is called double taxation.

2. Goals of Taxation

- A neutral tax system would have no distortionary impact on economic decisions. It would simply raise revenue to finance government expenditures without inducing agents to change their behavior to reduce their tax payments. Such a tax is sometimes called non-distortionary. Tax neutrality in an international environment is requires:
  - Domestic neutrality: U.S. persons must be treated equally whether they are investing in the U.S. or abroad.
  - Foreign neutrality: foreign subsidiaries of U.S. corporations are treated the same way as foreign corporations.

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• Several factors make tax neutrality impossible:
  – sovereign nations have different goals
  – definition of taxable income differs across countries
  – direct tax rates differ across countries
  – indirect tax rates differ across countries
  – investment tax credits (ITCs) are not always given for foreign investment
  – foreign tax credits (FTCs) are limited
  – special incentives may be provided to (i) promote exports, (ii) attract investment from abroad, or (iii) promote domestic investment.
  – taxation of subsidiaries is deferred

3. Treaties

Most developed and many less developed countries have tax treaties with each other. These treaties override domestic law and are intended to reduce or eliminate the effects of double taxation. Treaties normally follow a model suggested by the OECD. They normally place limitations on one country’s right to tax residents of the other country. One important limitation is that a company doing business in another country is not subject to tax in that other country unless the company has a permanent establishment in that country. Thus, a company can export into a particular country without being subject to income taxes in that country provided the company does not set up an office or fixed place of business in the country. Avoiding a permanent establishment where practical is often part of a good tax plan.

Treaties also normally set upper limits to withholding tax rates. Since each tax treaty is different, the withholding rates can vary, depending on which countries are involved. For example, interest paid by a Canadian resident to an American resident is subject to a 15% withholding tax; but interest paid by a Canadian resident to a British resident is only subject to a 10% withholding tax.

4. Types of Entities—Subsidiaries and Branches

• The basis of taxation will depend on the legal entity involved.
• If a corporation sets up an entity that is incorporated in a foreign country, it is a foreign subsidiary. The foreign subsidiary is a separate legal entity from the parent.

• If a corporation operates directly within a foreign country without incorporating, the foreign operation is a branch. A branch is not separate from the parent; it is part of the same entity.

• Other legal forms include partnerships and joint ventures. However, what businesspeople call a joint venture is usually incorporated. Therefore, “joint ventures” are usually subsidiaries.

• Generally, tax is imposed on an entity basis. If a Canadian company sets up a subsidiary in Chile, and the Chilean subsidiary (a resident of Chile) does not do business in Canada, then only Chile taxes the earnings of the Chilean subsidiary. If instead, the Canadian company sets up a branch in Chile, then the earnings of the branch are subject to both Canadian and Chilean tax. (Of course, if losses are expected in the early stages, it may be a good idea to set up a branch, since the losses could be used to reduce Canadian taxes.) There are exceptions to the general rule of taxing only on an entity basis.

5. Taxation of MNCs’ Earnings from Abroad

• Each country has its own approach to taxing a MNC’s dividends from its foreign subsidiaries.

5.1 Worldwide Tax Systems (e.g., U.S. and U.K.)

• For example, the US and the UK essentially tax the dividends as though the parent earned the foreign income directly, and then offer a foreign tax credit with respect to income taxes paid by the subsidiary (plus withholding taxes paid on the dividend payment). That last statement, however, is a gross simplification; the tax rules on these earnings are very, very complex.

• Since home-country taxes are owed when dividend is paid, there may be “payment delay” benefits associated with shifting profits to affiliates in low-tax countries.
• Most American MNC’s have what is called a “foreign tax credit problem”. Their foreign taxes exceed the amount of foreign tax credit they can claim on their American tax returns. In effect, then, foreign tax rates (including dividend withholding rates) will be the relevant tax burden to consider when evaluating foreign business opportunities.

5.2 Territorial Systems (e.g., Canada)

• Canada’s approach is quite different. The treatment of dividends paid into Canada depends on the degree of ownership, the type of income and on which country the income comes from.

• Dividend income on portfolio investments are subject to regular Canadian tax. A foreign tax credit can be claimed with respect to the foreign withholding taxes paid.

• The rules, however, are different for dividends received from foreign affiliates (foreign corporations in which the investor owns at least 10% of any class of shares).

• Income from an active business earned in a treaty-country (i.e., a country with which Canada has a tax treaty) is exempt from Canadian tax. Suppose, for example, Northern Telecom sets up a subsidiary in Portugal (which is a treaty-country). The subsidiary sells NT products (which is an active business) and then pays dividends to Northern Telecom Canada. That dividend income is totally exempt from Canadian income tax.

• Income from an active business earned in a non-treaty country is subject to tax when a dividend is paid. The amount included in income is reduced by a special deduction based on the taxes the foreign company paid in the foreign country. The net effect will be that the foreign taxes plus the Canadian taxes will approximately equal the total taxes that would have applied if the income had been earned directly by the Canadian company. For example, suppose Northern Telecom sets up a subsidiary in Taiwan (a non-treaty “country”). The subsidiary sells NT products and pays a 25% income tax. Suppose NT Canada’s normal Canadian tax rate is 40%. Upon receiving a dividend from Taiwan, it will pay some Canadian tax on that income. The Canadian tax will be such that the total taxes on the business income will add up to 40%. Of that amount, Taiwan received 25%, and Canada receives
15%. However, the Canadian tax does not apply until the income is repatriated to Canada.

- Investment income earned by a controlled foreign affiliate is taxed in Canada when earned by the foreign affiliate. Suppose, for example Northern Telecom sets up a subsidiary in the Cayman Islands (a tax haven) to earn investment income. Suppose also that the subsidiary does not pay a dividend up to NT Canada for the time being. That income is subject to tax in Canada, even though NT Canada has not yet received the income.

6. U.S. Foreign Tax Credits

- The general principle in international taxation is that income is taxed at the source, i.e., in the country where the income is generated.

- For multinational corporations (MNCs), this creates several problems (and sometimes opportunities). The parent and its foreign affiliates are taxed at different rates. More importantly, income repatriated to the parent risks getting taxed twice.

- To reduce double-taxation, the U.S. (and other countries using a world-wide system of taxation) give a credit for taxes paid abroad which can be used to offset U.S. taxes. Suppose the U.S. corporate tax rate is 34%. If the foreign tax rate is lower, $T_F < 34\%$ the parent pays a tax of $(34 - T_F)\%$ on income from foreign affiliate. If the foreign tax rate exceeds 34%, $T_F > 34\%$ the residual can be used to offset U.S. taxes owed on other foreign source income.
  - High taxes offset low taxes.
  - There is, however, an overall limitation on the FTCs, corresponding to:

$$\text{Maximum FTC} = \frac{\text{Consolidated foreign profits and losses}}{\text{Worldwide taxable income}} \times \text{Tax liability}$$

- If this limit binds, the U.S. parent can either carry back excess FTCs two years or carry forward five years.
• Direct FTCs are given for taxes based on income and withholding taxes on dividends, rents, and royalties.

• If the U.S. parent owns more than 10% of the foreign corporation, an additional indirect FTC is given on dividends received from the unit covering the amount of corporate taxes paid.

• In the case of dividends, “underlying” taxes paid on business income by the subsidiary might be eligible for foreign tax credit, depending on the country. The USA and the UK offer foreign tax credits for such underlying taxes. Canada does not.

6.1 Complications

6.1.1 Baskets

• The definition of foreign-source income is not unambiguous. In 1986, the IRS imposed additional limitations on FTCs for controlled foreign corporations (CFCs). A foreign affiliate is a CFC if U.S. parent holds more than 50% of voting power or U.S. shareholders each with more than 10% together reach the 50% limit.

• Five additional baskets were created for income distributed from a CFC to its U.S. parent
  – passive income
  – financial services income
  – shipping income
  – high withholding-tax interest income
  – dividends from 10% to 50%-owned foreign subsidiaries

• The result is a reduction in the opportunities for MNCs to use averaging of low tax income with high tax income to lower the overall tax payments. Assuming corporations do not change their tax filings or operating decisions in response to the tax law change, this results in more tax revenue for the IRS.

• Another feature of the 1986 Tax Reform Act, the so called “look-through rules” reduce the flexibility of a MNC in choosing the classification of payments from CFC to parent. The IRS will recharacterize remittances from a CFC according to the nature of the underlying income of the CFC. Thus, the MNC cannot arbitrarily relable flows to reduce taxes.
• Dividends from a non-CFC will be treated on a per-corporation basis for FTCs.

6.1.2 Sources of Income Rules

• Despite the limitations on FTCs, the IRS believes MNCs are still too free to allocate income and expenses over its operations.

• The effect of the allocation of expenses to foreign affiliates is to reduce foreign-source taxable income and thus reduce FTCs. More taxes will be paid in the U.S.

• Unfortunately, not all foreign tax authorities allow deductions for such allocated expenses. Then, the total tax bill will go up for the MNC as a result.

• What can a MNC do to reduce its tax bill? Since current U.S. corporate tax rates are low in an international comparison, the aim must be to reduce the foreign tax bill (avoid excess FTCs) by:
  – shifting expenses abroad,
  – focusing on tax-deductible remittances (e.g., interest, rents, royalties, management fees), and
  – increasing income in low-tax countries to consume FTCs.

6.1.3 U.S. Tax Incentives for Foreign Trade

• To promote exports, certain tax-favorable forms of organization have been constructed.

• Foreign Sales Corporation (FSC) - A U.S. firm can create a FSC in a foreign country or a U.S. possession (excluding Puerto Rico) for sales of exported products (made in the U.S.).

• Small FSCs and U.S. possession corporations are other similar tax favored organizational forms.

6.1.4 Passive Income

• Additional restrictions apply to CFCs. So called subpart F income has to be separated out from foreign-source income. Such income includes:
foreign base company income, foreign holding company income, foreign based company sales income, foreign base company services income
income from insurance of U.S. risks
increase in earnings invested in U.S. property
income during international boycotts
sum of illegal foreign bribes

After some relief provisions are applied, the residual subpart F income is considered dividend paid to parent and taxed yearly in the U.S. whether or not the funds are remitted.

7. Withholding Taxes

• In addition to applying business income tax rates to business income, most countries impose withholding taxes on certain types of payments out of the country.

• Payments subject to withholding taxes usually include dividends, interest, royalties and management fees.

• Withholding taxes can potentially trigger double taxation in two ways:
  – Business income that is repatriated to a parent is taxed first at business income tax rates and then again on the payment of the dividend.
  – All the payments subject to withholding taxes are also subject to regular income tax in the country of the recipient.

8. Other Tax Planning Issues

8.1 Transfer Pricing

• Another way of affecting the overall tax bill for a MNC is to judiciously use transfer-pricing.
  – non-interest-bearing loans
  – services without charge or charged below market
  – transfer of machinery or equipment without charge (rent imputed)
– transfer of intangible property (assess value through income flow)
– sale of inventory

The IRS tries to prevent such tax-strategies by adjusting prices for certain intercompany transactions. Also, the IRS attempts to enforce use of arm’s length transactions prices.

• Whenever one entity sells a good or service to another entity, there must be a price. When the entities are related corporations, the price is called a transfer price.

• Transfer pricing is an issue in the sale of goods, the provision of services by head office, and royalty charges between related corporations.

• When the corporations are related, there is potential for abuse, since the firms could potentially select a price that minimizes total taxes, but does not reflect economic reality.

• Tax law therefore requires that prices be at fair market value.

• Unfortunately (or fortunately for tax planners), fair market value for internal transactions is usually difficult to determine. Usually, there is a range of prices which could reasonably be considered fair.

• The United States believes that Japanese companies’ American profits are far too low to be reasonable. As a result, the US has recently introduced more specific rules on how to compute transfer prices. It has also established severe penalties for failure to properly document how transfer prices were determined. (Historically, many companies set an arbitrary price and then waited until the auditor knocked on the door before bothering to figure out how to justify the price. Moreover, penalties for using inappropriate prices had previously been light.)

• Despite these rules, transfer prices cannot be determined without some subjective judgment. As a result, there can be considerable disagreement over what the fair price should be. Resolving disagreement usually involves negotiation.

• Resolving a transfer price problem can be problematic since a MNC may need to negotiate with two or more governments. One government will want a high price and another government will want a low price, and the MNC is caught in the middle.
In the past, it had been fairly easy for a MNC to push prices towards a tax-optimal result. The MNC generally had an advantage in negotiation in that it knew its own business very well, while the government knew very little. Governments have recently recognized the enormous potential for tax dollars in the area, and have significantly increased focus and expertise in auditing transfer prices.

Despite the opportunities and risks associated with transfer pricing, many MNC’s continue to use simple mark-ups without adequate justification or thought. These MNC’s believe the benefits of a careful study do not exceed the costs.

Transfer pricing has other consequences besides lowering tax liabilities. It impacts evaluation of affiliate performance, may shift profits to lower foreign exchange risk or to circumvent restrictions on profit repatriation. It also may be used to lower import duty and excise tax costs. What are the optimal transfer price to achieve the above-mentioned goals?

8.2 Thin Capitalization

One obvious way of minimizing tax when investing in a high tax country is to finance the subsidiary with debt rather than equity. That way normal earnings will be taxed in the home country rather than in the country where the income is earned. Most high tax countries (such as Canada) therefore have a thin capitalization rule. If the debt-equity ratio of a foreign parent’s investment in a Canadian subsidiary exceeds 3:1, part of the interest expense is not deductible.

Foreign parents will therefore normally try to finance their Canadian operations with a debt-equity ratio of just under 3:1.

8.3 Tax Havens

Bermuda and the Cayman Islands have no business taxes, while Panama and Liberia do not tax income from foreign sources.

The use of tax havens to avoid taxes is probably less prevalent than is widely supposed.

Successful use of tax havens is quite difficult. When governments of developed countries discover loopholes by which a tax haven can be used, they typically change the rules to shut the loophole down. Moreover,
Canada has recently introduced a general anti-avoidance rule, designed to reverse any abusive tax transaction.

- Some companies have successfully and legally used tax havens to set up captive insurance companies, offshore financing companies, or central purchasing houses. The idea is to shift profits to affiliates in tax haven countries. For example, Canco sets up a financing company in the Cayman Islands that provides a loan to Canco’s affiliate in the U.S. The interest payment to the Cayman Island affiliate lowers the taxable income of the U.S. affiliate and is not taxed in the Cayman Islands.

- Undoubtedly, tax havens are also used illegally. A person could invest in a tax haven and simply not report that income in the home country. This, of course, is a crime.

8.4 Executives on Foreign Assignment

- When a company sends an executive on foreign assignment, that executive will be subject to local taxes and often also home country taxes. (American citizens must file American returns and may be subject to American tax, no matter where they reside.)

- Many MNC’s will tax protect or tax equalize the executive.

- Tax protection involves reimbursing the executive for any increased tax burden the executive faces due to working abroad. If, however, the executive’s tax burden is reduced by working abroad, a company providing tax protection does not recover the executive’s tax savings.

- Tax equalization works both ways. The company reimburses any increase in tax burden, but also recovers any decrease in tax burden.

- Tax equalization is more prevalent than tax protection. Companies justify tax equalization by arguing that they do not want to favor one executive sent to a low tax country (like Hong Kong) over another executive sent to a high-tax country (like France).

9. Non-tax Factors

- Clearly, the corporate tax rate is not the sole factor on which to decide location of foreign direct investment.
- political stability
- indirect taxes
- tax treaties
- exchange controls
- legal system
- banking system
- infrastructure

- Several countries have considerable tax breaks for foreign firms which might affect locational choice.
  - Caribbean: no income/capital gains/gift/estate taxes,
  - British V.I., Netherlands Antilles: low taxes,
  - Hong Kong, Panama: tax income from domestic but not foreign sources,
  - Ireland, Puerto Rico: special tax privileges,
  - Others tax-favored jurisdictions include: Switzerland, Netherlands, Liechtenstein

10. Summary

- Worldwide foreign tax rules affect investment incentives in important ways. The parent company should not only consider the after tax return in foreign market compared to the after tax return on domestic investment. It also has to consider the tax implications of remitting that foreign income back home.

- If the foreign tax rate exceeds the domestic one, foreign investment is preferred if and only if the after tax return on foreign investment is higher than the domestic one.

- If the domestic tax rate instead exceeds the foreign one, additional taxes have to be paid at repatriation so the investment horizon will matter. For short horizons, the foreign investment might be disfavored despite having a larger after (foreign) tax return.