10 Chapter 10: Multinational Tax Planning: There are no true “international” tax rules. In this Chapter, we will look at the U.S. tax rules applicable to cross-border transactions. “Outbound” transactions are those in which a U.S. taxpayer makes an investment in a foreign country while “inbound” transactions are those in which a non-U.S. taxpayer makes an investment in the U.S. A cross-border investment can be “direct” or “indirect”: a direct investment is an investment in some hard assets such as a factory while an indirect investment is an investment (equity or debt) of a corporation located in the destination country.

10.1 Fundamental Issues in International Tax: When a firm makes a cross-border investment, there are at least two countries that might seek to tax the investment return: the “source” jurisdiction (that is, the country where the income is generated) and the residence jurisdiction (that is, where the investor is domiciled or incorporated). Countries that offer an attractive environment including enforcement of property rights, an educated, English-speaking work force, and good transportation options generally can impose higher tax rates. Countries that do not have such an environment often offer much lower tax rates (i.e., they become tax havens) and often encourage investments in intellectual property that can be owned in one jurisdiction but exploited in other jurisdictions.

10.2 Increasing Pressures on Tax Systems Posed by Cross-Border Commerce: Cross-border trade has increase significantly (see Figure 10.1 at page 10-3). When supply lives cross multiple borders, it can be difficult to determine the “source” country of the income. In addition, with the increase in importance of intangible assets (e.g., trademarks such as Microsoft, Google, and Caterpillar), it becomes easy to locate income-producing assets in countries far from customers and hard assets such as factories.

10.3 Overview of International Taxation: Most countries employ a territorial system of taxation in which income earned within the country is taxed whether earned by a domestic or foreign taxpayer. Until 2018, the US employed a worldwide system in which the worldwide income of citizens, domestic corporations, and resident aliens was taxed along with income of nonresident aliens earned within the United States. Note that actual collection of a tax imposed on nonresidents can be very difficult: the US generally imposes a withholding obligation on payors of taxable income to nonresident aliens to ensure that the tax is collected before the income leaves the jurisdiction. Most other countries impose their taxes on nonresidents in the same manner, that is, by imposing a withholding obligation on the payor.

10.3.1 Operating as a Branch, Partnership, or a Foreign Subsidiary

10.3.1.1 A foreign corporation for purposes of US taxation is any corporation not classified as a domestic corporation, where a "domestic corporation" is any corporation incorporated under the laws of any state, of the US, or of the District of Columbia. Note that under generally accepted accounting principles ("GAAP"), a US corporation must consolidate the tax activities from all controlled subsidiaries, both domestic and foreign.

10.3.1.2 A foreign partnership is an entity formed in a foreign country but classified as a partnership under US tax principles. (Note that the entity may or may not be classified as a partnership under the laws of the country in which it was formed. Entities classified differently under the laws of the US taxation authority and a foreign taxing authority are called "hybrid" entities.) Under US tax laws, each partner of a partnership must include its share of the partnership's income each year. Thus, investment in a foreign partnership is taxed the same as a foreign branch. On the other hands, if the partnership has net losses, those losses can be reported immediately.

10.3.1.3 A foreign branch is a direct investment in off-shore business assets without imposition of a foreign entity. For example, a US corporation may purchase or lease a building, hire workers, and sell goods and services without forming a foreign entity. Any profits and losses of the foreign branch will be treated as profits and losses of the US corporation because, in fact, the assets are owned by the US corporation and the workers and employees of the US corporation.

10.3.1.4 Entity Classification: An entity, foreign or domestic, will have its US tax status determined under the Elective Classification Regime, usually called the "Check-The-Box" regulations. Under these rules, any domestic corporation and any foreign equivalent are classified for US purposes as a corporation. (Note that the Treasury publishes a list of foreign entities automatically treated as corporations.) Other per se corporations include highly-regulated entities such as insurance companies and banks along with entities owned by the US government or by a state. If an entity is not automatically classified as a corporation, then it is called an "eligible entity" and can elect to be classified as a corporation or, if it has two or more owners, as a partnership. An eligible entity that does not elect corporate classification but that has a single owner is treated as a branch of its parent.

10.3.2 Foreign Tax Credits and the Participation Exemption:

10.3.2.1 The “participation exemption” allows US parent corporations of foreign subsidiaries to deduct 100% of dividends received from most foreign corporations. As a result, the only tax imposed on earnings generated by most foreign corporations having a US parent is the tax, if any, imposed by the source country.

10.3.2.2 Until 2018, most earnings of foreign subsidiaries were taxed to the US parent when repatriated by the foreign subsidiary (where “repatriation” includes both the payment of dividends to the US parent and investment in US assets). When repatriation occurred, taxation was imposed at the standard US corporate rate of 35% less any allowable foreign tax credit arising from payment of a foreign income tax to the source country imposed on the repatriated earnings (This was called the "indirect" foreign tax credit because it was based on foreign taxes paid not by the US taxpayer but by the foreign subsidiary.)

10.3.2.3 Under this regime, a US parent could enjoy indefinite deferral by allowing foreign earnings to remain offshore. When the 2017 Tax Act largely replaced to US worldwide tax system to a territorial tax system (via the participation exemption), it allowed repatriation of earnings generated under the old rules at a one-time rate of either 15.5 (if held in cash) or 8% (if held in non-liquid form).

10.3.2.4 The foreign tax credit ("FTC," formerly called the "direct FTC) is only allowable for foreign *income* taxes.

10.3.2.4.1 While a tax can be creditable without being identical to the US federal income tax system, it must nevertheless use income (or profit) as its tax base rather than some other measure such as value or gross receipts. If a foreign tax is imposed on a US taxpayer but the foreign tax is not creditable because it is not an income tax, then the tax is deductible as a business expense. Recall that the after-tax value of a deduction equals the amount of the deduction times the taxpayer's marginal tax rate while the after-tax value of a tax credit equals the dollar amount of the credit.

10.3.2.4.2 The foreign tax credit is limited to the US income tax rate on the foreign income. This limitation is intended to ensure that foreign income is taxed at the higher of the source tax rate or the US tax rate. For example, if the foreign rate is 25% and the US rate is 35%, the entire foreign tax (generally) will be credited, so each $100 of foreign income the taxpayer will pay $25 to the foreign country and $35 less the $25 credit to the US. Conversely, if the foreign rate is 45% and the US rate is 35%, on each $100 of foreign income the foreign tax of $45 will only be credited to the extent of $35, so that no tax is paid to the US.

10.3.3 Country-by-Country FTC Limitations: As the example summarized in Table 10.1 shows, if foreign taxes paid in a high-tax jurisdiction can be combined with foreign-taxes paid in a low-tax jurisdiction, the high-tax portion of the credit effectively can substitute for an excess credit on low-taxed income. A US parent that has a foreign tax credit from highly-taxed foreign income that cannot be used against the income that generated the credit is said to be in a "credit-limited position." To minimize this effect, many countries impose a country-by-country limitation on the use of FTCs.

10.3.4 Separate Basket Limitations: The US does not impose a country-by-country limitation on the FTC but instead requires that foreign income be allocated to separate baskets (currently, four baskets), and the FTC generated by one basket of income cannot be used by income in other baskets. Note that the FTX is relevant only for direct investments: the participation exemption eliminates us tax on most indirect investments.

10.4 Base Erosion and Income Shifting Across Countries

10.4.1 Transfer Pricing: When related parties deal with one another, they have an incentive to adjust their business affairs in ways that minimize their aggregate income tax obligations. So, for example, interest on a loan might be set artificially high if the debtor is in a high-tax jurisdiction (because interest paid generally is deductible) and the lender is in a low-tax jurisdiction (because interest received is includible in income). Section 482 authorizes the government to reallocate prices paid between related parties to more closely resemble arm's-length dealing. Multinationals and the IRS can agree to an advance pricing agreement (an "APA") that sets forth in advance how prices paid between related parties should be paid with respect to a particular transaction or set of transactions. For example, if Microsoft transfers its intellectual property (including the tradename "Microsoft") to a foreign subsidiary, what is a fair price for US Microsoft to pay for use of that tradename?

10.4.2 Subpart F Income and Controlled Foreign Corporations (CFCs): The complex rules of Subpart F applicable to controlled foreign corporations (CFCs) cause subpart F income of a CFC to be treated taxed immediately as US taxable income. In addition, gain to the US parent from selling the stock of the CFC is treated as ordinary income to the extent not already taxed in the US under the Subpart F and CFC rules.

10.4.2.1 A "controlled foreign corporation" is a foreign corporation with at least 50% ownership by US shareholders.

10.4.2.2 We will only consider CFCs that are wholly-owned by a US parent corporation. Income included to the parent by reason of the Subpart F rules is reduced by the allowable FTC, just like branch profits of a US corporation. Because the US parent is taxed when the CFC earns the Subpart F income, there is no further tax imposed on the parent when the Subpart F income is repatriated.

10.4.2.3 The most important categories of Subpart F income are (1) interest, dividends, and other passive income (called "foreign personal holding company income") and (2) income from the sale of property purchased from a related party if the property is manufactured and used for use outside the CFC's country of incorporation (called "foreign base company sales income"). For example, a Cayman CFC might purchase equipment from its US parent that is then sold for use in the EU. Note that there is no obvious business reason for this sale to go through the hands of a Cayman corporation. If the product were manufactured by a related part in, say, France, the sale gain would still be foreign base company sales income although there is no US connection to the income.

10.4.3 Congress BEATs the (allegedly) GILTI

10.4.3.1 An immediate tax is imposed on the "global intangible low-taxed income" of a CFC. Surprisingly, such income is not limited to income from intangibles, although the mobility of intangibles is what gave rise to the GILTI rules.

10.4.3.1.1 The GILTI rules and the Subpart F rules can overlap. When they do, the income if Subpart F and not subject to GILTI.

10.4.3.1.2 GILTI income of a CFC includes most foreign income in excess of 10% of the CFC's investment in its tangible business property. Thus, a 10% return on hard assets is considered normal and any excess is treated as improperly shifted income.

10.4.3.1.3 Only 50% of the GILTI income is taxable, and the half that is taxable is reduced by 80% of the applicable FTC. For example, if the source country imposes no income tax, then the GILTI income is taxed at 10.5% to the US parent (because half is excluded at the rest is taxed to the US parent at 21%, for an effective tax rate of 10.5%).

10.4.3.1.4 Suppose a CFC earns $200 of GILTI income, and creditable foreign taxes of 13.125% (i.e., $26.25) were paid to the source country. Before accounting for the FTC, the US tax to the parent would be $21. That is reduced by 80% of $26.25, and because 20% of $26.25 equals $21, there is no US tax imposed on the GILTI income. Accordingly, the total foreign and US income tax imposed on GILTI income should be between 10.5% and 13.125% (unless GILTI income is generated other than in a low-tax jurisdiction).

10.4.3.2 The base erosion and anti-abuse tax ("BEAT") is an alternative tax imposed on large US corporations. Currently, the BEAT rate is 10%. It is imposed on deductible payments (such as interest and royalties) by large US corporations to related entities. Corporations subject to the BEAT must pay the greater of their regular US income tax liability or their BEAT obligation.

10.4.4 Individuals Avoiding U.S. Taxation: US citizens who renounce their citizenship will pay an exit tax on their built-in gains. Further, if they spend too much time in the US in any year, they will be taxed in the US on their worldwide income. US citizens who stash their assets off-shore and then fail to report their total worldwide income are committing a felony.

10.5 How Taxes Affect the Location and Structure of Investments

10.5.1 A Tax Holiday for Repatriations: In 2004 when US corporations were taxed on their worldwide income without a participation exemption, Congress enacted a one-time special rule subjecting the repatriation of earnings held abroad to a tax rate of only 5.25%. Many companies assumed there would be subsequent "one-time" repatriation holidays and so continued to accumulate large amounts of cash offshore.

10.5.2 Inversion Transactions: An inversion involves the creation of a foreign corporation that will become the parent corporation of a group of foreign and domestic corporations. The effect of an inversion transaction was to ensure that foreign profits generally would not be subjected to US taxation. Note that the inversion transaction did not reduce the tax imposed on profits generated in the US.

10.5.3 Attempts to Encourage Exports and Domestic Production

10.6 U.S. Taxation of Foreign Investors: It is virtually to collect an income tax directly from nonresidents. Accordingly, the US imposes a "withholding tax" on payments to otherwise non-US taxpayers from US sources. This tax is creditable against the tax liability imposed on the foreign investor if that foreign investor files a US income tax form, something few foreign investors are willing to do. This withholding tax rate often is reduced significantly by treaty for many types of income.

10.7 Questions (page 16)

10.7.1 Question 1: The purpose of the foreign tax credit is to mitigate double-taxation of foreign income.

10.7.2 Question 2: The benefit to a uniform set of tax laws across countries would be increased neutrality and decreased compliance costs. Tax neutrality is a desirable goal for international tax policy because it allows capital to flow where it has the highest return, resulting in an economically efficient usage of resources. The deadweight loss of tax distortions would decrease. There are at least two costs to uniformity across countries, however. First, legislatures of different countries have different agendas and therefore desire different tax policies. Uniformity requires compromise. Second, the power to set tax policy is one of the primary signs of sovereignty, and national pride can make giving up that power to a supra-national agency difficult.

10.7.3 Question 5: Income from a foreign subsidiary is not subject to U.S. taxation until it is repatriated or deemed to be repatriated (i.e., Subpart F) to the U.S. parent. Income from a foreign branch is currently subject to U.S. taxation regardless of whether its income is repatriated. The main advantage of the foreign subsidiary is that when repatriated, the foreign income might not be subject to additional U.S. tax because of the participation exemption. The main advantage of the branch is that if the foreign operations are generating losses, the losses can offset the income of U.S. operations. Also, repatriations from foreign branches are sometimes exempt from foreign withholding taxes.

10.8 Problems (page 16)

10.8.1 Exercise 13

10.8.1.1 Part (a): $232.5 million ($200 + 10 + 0.75*(30)).

10.8.1.2 Part (b): $210 million ((200 + 10).

10.8.2 Exercise 15:

10.8.2.1 Part (a): $20 million.

10.8.2.2 Part (b): $27 million (because of subpart F).

10.8.3 Exercise 17: US = (1 – 0.21)*20% = 15.8%; Ireland = (1 – 0.10)*18% = 16.2%; Mexico = (1 – 0.15)* 18%=15.3%. The highest return is from Ireland.

10.8.4 Exercise 18: U.S. tax before FTC = 0.21($5m +$3m + $10m) = $3.78m. Foreign tax paid = 0.34($3m) + 0.15($10m) = $2.52m. Foreign tax credit limitation = 0.21($3m + $10m) = $2.73. FTC is the lesser of $2.52m and $2.73m, or $2.52m. U.S. tax after FTC = $3.78m - $2.52m = $1.26m.