



International
Taxation

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*Finance: Theory into
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Overview

Chapter 20

International Taxation and Foreign Investments



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Multiple Taxation vs. Tax Neutrality

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Issue #1: Disagreements on the tax basis

Issue #2: Excess tax credits

The exclusion method as applied to a branch/PE

Issue #1: Incomplete exclusion

Issue #2: Disagreements on the tax base

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◇ **Managerial perspective:**

- ▷ **Fact:** you need some competitive advantage, skill, to overcome the foreigner's inherent handicaps
- ▷ **How?**
 - exports
 - international product marketing
 - cooperative agreements: Mgt contract, tech assistance, licensing, franchising
- ▷ **Strategies are often combined**
 - tax reasons—see this chapter
 - political risk—see capital budgeting chapter
 - risk (re)distribution between partners—see JV chapter

◇ **Corporate-law perspective**

- ▷ independent agent
- ▷ dependent agent
- ▷ branch
- ▷ wholly owned subsidiary (WOS)



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Tax principles: not any excuse to tax will do

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▷ residence principle

- who? all residents of the country—*de iure* or *de facto*
- tax basis? usually worldwide income

▷ source principle

- who? anybody earning an income in the country
 - from an activity
 - from a property
 - physical (e.g. real estate)
 - financial (e.g. bond)
 - intellectual
- tax basis? income earned in the host country

Example: wholly-owned subsidiary (wos)

	who	whom?	basis?	excuse?
WOS makes profit	host? home?			
WOS pays dividend	host? home?			



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Where does the residence principle apply?

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Example: Icelandic parent (IS), Vanuatu host (VU)

	VU activity?	(why) does VU tax IS?
independent agent	physical presence? key activity?	
direct exports	physical presence? key activity?	
passive dependent agent	physical presence? key activity?	
“permanent establishment”	physical presence? key activity?	
full-monty WOS in VU	physical presence? key activity?	



Double Taxation—Example

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Definition: IS allows no relief for VU taxes, except that the latter are recognized as a business expense

Example: tax rate 30% in VU, 40% in IS

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	Double Taxation	Exclusion Method	Credit Method
<i>Vanuatu</i>			
Branch profit	100	100	100
(-) 35 % tax (a)	<u>(-) 35</u>	<u>(-) 35</u>	<u>(-) 35</u>
Net profit	65	65	65
<i>Iceland</i>			
Net Vanuatu profit	65		
Gross-up	<u>n.a.</u>		
Taxable income	65		
Tax due (40%)	26		
Tax credit	<u>n.a.</u>		
Tax really due (b)	<u>26</u>		
<hr/>			
Total taxes (a) + (b)	61		



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Plan A: Capital import neutrality

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“VU branch should be taxed the same way as a purely VU entity (that is, at 35%)” ⇒ **exclusion method**

Example: tax rate 30% in VU, 40% in IS

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<i>Vanuatu</i>			
Branch profit	100	100	100
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Net profit	65	65	65
<i>Iceland</i>			
Net Vanuatu profit	65	65	
Gross-up	<u>n.a.</u>	<u>n.a.</u>	
Taxable income	65	0	
Tax due (40%)	26	0	
Tax credit	<u>n.a.</u>	<u>n.a.</u>	
Tax really due (b)	26	0	
<hr/>			
Total taxes (a) + (b)	61	35	



Plan A: Capital import neutrality

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<i>Iceland</i>			
Net Vanuatu profit	65	65	
Gross-up	<u>n.a.</u>	<u>n.a.</u>	
Taxable income	65	0	
Tax due (40%)	26	0	
Tax credit	<u>n.a.</u>	<u>n.a.</u>	
Tax really due (b)	26	0	
<hr/>			
Total taxes (a) + (b)	61	35	



Plan B: Capital export neutrality

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“Taxes should be the same whether the firm earns its income in IS or VU (*i.e.* at 40%) \Rightarrow **credit method**”

Example: tax rate 30% in VU, 40% in IS

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Branch profit	100	100	100
(-) 35 % tax (a)	<u>(-) 35</u>	<u>(-) 35</u>	<u>(-) 35</u>
Net profit	65	65	65
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Net Vanuatu profit	65	65	65
Gross-up	<u>n.a.</u>	<u>n.a.</u>	<u>(+) 35</u>
Taxable income	65	65	100
Tax due (40%)	26	0	40
Tax credit	<u>n.a.</u>	<u>n.a.</u>	<u>(-) 35</u>
Tax really due (b)	26	0	5
<hr/>			
Total taxes (a) + (b)	61	35	40



Plan B: Capital export neutrality

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Will taxes ever be fully neutral? no

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◇ Why taxes will never be fully neutral

- ▷ tax rates differ across host and home, so exclusion and credit methods will diverge
- ▷ tax basis differs across host and home, so exclusion and credit methods will diverge even at same tax rate
- ▷ professed philosophy rarely applied in all its implications—see sections below

◇ The row to hoe

	credit system	exclusion system
branch/PE	Section 3	Section 4
WOS	Section 6	Section 7



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Issue #1: disagreements on the tax basis



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Need to determine VU sales, direct expenses, **indirect expenses (allocated overhead)**. Rules of thumb may conflict:

Example

	Iceland	Vanuatu	Total
<i>Management Accounting System</i>			
Sales	1.200	400	1.600
(-) Direct cost	(-) 700	(-) 300	(-) 1,000
(=) Contribtn	500	100	600
(-) Overhead	-	-	(-) 300
(=) Gross Inc	-	-	300
<i>Tax returns</i>			
Sales	1.200	400	1.600
(-) Direct cost	(-) 700	(-) 300	(-) 1,000
(-) Allocated ovrhd	$\frac{700}{700+300} 300 = (-) 210$	$\frac{400}{1200+400} 300 = (-) 75$	(-) 285
(=) Taxable	290	25	315

Issue #2: Excess tax credits (1)



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◇ Compensate internationally?

Example

	Case 1		Case 2	
<i>Host country</i>	Vanuatu	Hong Kong	Vanuatu	Hong Kong
tax rate	50%	25%	50%	25%
Sales	220	200	220	100
(-) Cost	<u>(-) 120</u>	<u>(-) 100</u>	<u>(-) 120</u>	<u>(-) 60</u>
(=) Branch profit	100	100	100	40
(-) Taxes	<u>(-) 50</u>	<u>(-) 25</u>	<u>(-) 50</u>	<u>(-) 10</u>
(=) Net profit	50	75	50	30
<i>Iceland</i>				
Net profit	50	75	50	30
Gross-up	<u>50</u>	<u>25</u>	<u>50</u>	<u>10</u>
Taxable	100	100	100	40
Total txbl for'n inc		100+100 = 200		100+40=140
Tax due		80		56
(-) Credit		50+25= (-) 75		50+10= (-) 60
Net tax due		5		0
Unused tax credit		0		4
Total taxes paid		80		60
Total tax, as %		80/200 = 40%		60/140 = 43%



Issue #2: Excess tax credits (2)

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◇ **Compensate over time?**

▷ carry back

- capped at total taxes paid on foreign income at home during past *n* years (“n-year carry-back”)
- within these bounds, this is like getting a refund

▷ carry forward

- limited over time, e.g. max 5 yrs (“5-year carry-forward”)
- this is like getting a *possible, future* refund

◇ **Reallocate costs (pseudo transfer pricing)**

Example overleaf: let HK deliver a service to VU worth 40

- ▷ Limitation 1: import or export duties (on goods)
- ▷ Limitation 2: arm’s length principle, so risk of rejected costs, and fines

if VU’s extra 40 expense is rejected as fictitious, this income is taxed twice!



Issue #2: Excess tax credits (2)

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◇ **Compensate over time?**

- ▷ carry back
 - capped at total taxes paid on foreign income at home during past *n* years (“n-year carry-back”)
 - within these bounds, this is like getting a refund
- ▷ carry forward
 - limited over time, e.g. max 5 yrs (“5-year carry-forward”)
 - this is like getting a *possible, future* refund

◇ **Reallocate costs (pseudo transfer pricing)**

Example overleaf: let HK deliver a service to VU worth 40

- ▷ Limitation 1: import or export duties (on goods)
 - ▷ Limitation 2: arm’s length principle, so risk of rejected costs, and fines
- if VU’s extra 40 expense is rejected as fictitious, this income is taxed twice!



Issue #2: Excess tax credits (2)

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Example

<i>Host country</i>	before		after	
	Vanuatu	Hong Kong	Vanuatu	Hong Kong
tax rate	50%	25%	50%	25%
Sales	220	100	220	140
(-) Cost	<u>(-) 120</u>	<u>(-) 60</u>	<u>(-) 160</u>	<u>(-) 60</u>
(=) Branch profit	100	40	60	80
(-) Taxes	<u>(-) 50</u>	<u>(-) 10</u>	<u>(-) 30</u>	<u>(-) 20</u>
(=) Net profit	50	30	30	60
<i>Iceland</i>				
Net profit	50	30	30	60
Gross-up	<u>50</u>	<u>10</u>	<u>30</u>	<u>20</u>
Txbl, by branch	100	40	60	80
Txbl for'n inc		100+40 = 140		60+80 = 140
Tax due		56		56
(-) Credit		50+10= (-) 60		30+20 = (-) 50
Net tax due		0		6
Unused tax credit		4		0
Total taxes paid		60		56
Total tax, as %		60/140 = 42.86%		56/140 = 40%



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Issue #1: incomplete exclusion

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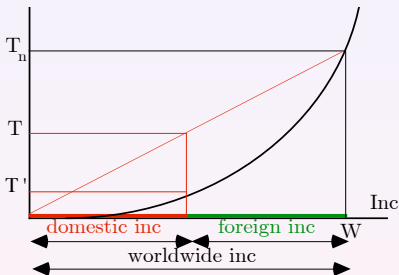
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◇ “Preservation of progressiveness of taxes”



◇ **Partial exclusion** “because parent domestically deducts expenses related to foreign activities”

- ▷ US (domestic dividends): 85% exclusion
- ▷ EU (intra-EU dividends): at least 95% exclusion
- ▷ no or low exclusion for countries with no tax treaty, incl “tax havens”

Issue #2: Disagreements on the tax base



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◇ Disagreements on the tax base

- ▷ may lead to twice-rejected expenses, i.e. double taxation

◇ Closing remarks on Exclusion/branch-PE

- ▷ Taxes saved abroad do not lead to extra tax at home, unlike under the credit system
- ▷ When deciding where to allocate income, look at total tax burden, not just the corporate tax (or tax on non-residents, whatever the name is)

Example: tax France 30%, Italy 35%; Italy grants exclusion

origin of profits	italian	french	
exclusion		100%	75%
profit	100.0	100.0	100.0
(-) fr tx	n.a.	(-) 30.0	(-) 30.0
(=) aftrtx inc	n.a.	(=) 70.0	(=) 70.0
french txbl	100.0	0.0	17.5
(-) fr tx	35.0	0.0	6.1
all tx	35.0	30.0	36.1

Issue #2: Disagreements on the tax base



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◇ **Capital transactions:**

- ▷ subsidiary buys parent's stock, buys back its own stock, lends money, leads A/P or lags A/R in intra-Cy trade
- ▷ no direct income tax repercussions for any of these—but ...
 - for some forms: indirect tax repercussions via later dividends, interest payments; registration tax
 - remittance may be taxed as "disguised" dividends.
 - in some countries, there are objections to cross-holdings.

◇ **Dividends** differ from branch profits in many ways:

- ▷ deferral principle \Rightarrow timing option (unavailable for branch)
- ▷ cumulatively, dividends \leq profits $<$ cash flow (depreciation)
- ▷ withholding tax
- ▷ no tax consolidation of profits/losses across branches

◇ **Non-dividend remittances** (royalties, lease payments, interest, management fees)

◇ **Transfer pricing**



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The “indirect” tax credit

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Special feature: Direct credit for withholding tax, plus
indirect tax credit—“*taxes deemed paid by Parent*”.

Example

	Branch	Full-equity wos	
		100% payout	50% payout
<i>Vanuatu</i>			
Branch profit	100.0	100.0	100.0
(-) Taxes	<u>(-) 35</u>	<u>(-) 35</u>	<u>(-) 35</u>
(=) Net profit	65.0	65.0	65.0
Gross Dividend	...	65.0	32.5
(-) Withholding tax	...	(-) 11.0	(-) 5.5
(=) Net dividend	...	54.0	27.0
<i>Iceland</i>			
Net income	65.0	54.0	27.0
Gross-up (1): direct	35.0	11.0	5.5
Gross-up (2): indirect	<u>...</u>	<u>35</u>	<u>17.5</u>
Taxable	100.0	100.0	50.0
Tax due	40.0	40.0	20.0
Tax credit (1): direct	(-) 35.0	(-) 11.0	(-) 5.5
Tax credit (2): indirect	<u>...</u>	<u>(-) 35.0</u>	<u>(-) 17.5</u>
Net tax due	5.0	0.0	0.0
Unused tax credit	0.0	6.0	3.0

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- ◇ **“Active” v “passive” income:** in many countries, no indirect tax credit for portfolio investment.
- ◇ **Baskets.** US: income classified into many different “baskets”; no transfer of excess credits across baskets
- ◇ **Tax credit non-negative:** capped below at 0 (if dividend when profit is negative)
- ◇ **Partial payout.** If the payment is less than 100%, then in principle the indirect tax credit is computed as

$$\frac{\left[\begin{array}{l} \text{Gross dividend (i.e.} \\ \text{before withholding taxes)} \end{array} \right]}{\left[\begin{array}{l} \text{Corporate profit after} \\ \text{corporate taxes} \end{array} \right]} \times \left[\text{Corporate tax paid} \right].$$

- ◇ **(us:) smooth out fluctuations** by using

$$\text{gross dividend} \times \frac{\text{cumul taxes since 1986}}{\text{cumul profits since 1986}}$$



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Next to compensation over countries and over time: now also across types of remittance

Example

	Full Equity	ISK 40 paid as interest to parent	
<i>Vanuatu</i>			
Branch profit	100	100	
(-) Interest paid to parent		(-) 40	
(=) Taxable	100	60	
(-) Taxes	(-) 35	(-) 21	
(=) Net profit	65	39	
		dividend	interest
Gross paid out	65	39.0	40
(-) Withholding tax	17% (-) 11	17% (-) 6.6	20% (-) 8
(=) Net paid out	54	32.4	32
<i>Iceland</i>			
Net received	54	32.4	32
Gross-up (1): direct	11	6.6	8
Gross-up (2): indirect	35	21.0	...
Taxable	100	60.0	40
Total taxable foreign income	100	100	
Tax due	40	40.0	
Tax credit (1): direct	11	14.6	
Tax credit (2): indirect	35	21.0	
Net tax due	0	4.4	
Unused tax credit	6	0	
Total taxes	46	40	

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◇ **Tax breaks** granted by e.g. DCs ultimately end up in parent's home tax coffers not investors' :

- ▷ (deferral: problem can be postponed)
- ▷ tax sparing clause for deserving DCs: add taxes deemed paid

◇ **Why baskets? (US)**

- ▷ US firm with home-invested liquidities can dump these and buy international bonds instead
- ▷ This transforms domestic income into (low-taxed) foreign income
- ▷ This way, excess tax credits are offset against former domestic income—too clever by far, the IRS thinks

◇ **Summing up: WOS v PE]**

- [+] deferral
- [+] unbundling
- [-] withholding tax on dividends increases tax on regular profits
- [-] loss of tax consolidation

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Unbundling

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- ◇ **Tax breaks** granted by e.g. DCs ultimately end up in parent's home tax coffers not investors' :
 - ▷ (deferral: problem can be postponed)
 - ▷ tax sparing clause for deserving DCs: add taxes deemed paid

- ◇ **Why baskets? (US)**
 - ▷ US firm with home-invested liquidities can dump these and buy international bonds instead
 - ▷ This transforms domestic income into (low-taxed) foreign income
 - ▷ This way, excess tax credits are offset against former domestic income—too clever by far, the IRS thinks

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The credit method as applied to a branch/PE
Issue #1: Disagreements on the tax basis
Issue #2: Excess tax credits

The exclusion method as applied to a branch/PE
Issue #1: Incomplete exclusion
Issue #2: Disagreements on the tax base

Remittances from a Subsidiary: An Overview

The credit method as applied to a wos
Indirect tax credit
Tax planning via unbundling the transfers

The exclusion method as applied to a wos



The exclusion method as applied to a WOS

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- ◇ **Implied loophole:** transform non-dividend income into dividends
 - ▷ pay out royalties to a tax-haven holding cy, which then pays dividends to parent
 - ▷ put your bonds into a Luxembourg mutual fund with a plc charter
- ⇒ see-through rules; or exclusion privilege withdrawn for dividends from tax haven or favorably-taxed cy
- ◇ **Tax planning:** no-holds-barred allocation of income to lowest-tax form—but this is rarely profits÷nds
 - ▷ include all taxes into calculations: corptax host, withh tax, domestic tax—see overleaf



The exclusion method as applied to a WOS

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Comparing total tax burdens: Example

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Data: corptax 25% (host), 33% (home); withhtax 20% on div and royalties; 95% exclusion for dividends, tax credit for royalties.

Computations

	Payout in the form of profits and dividends	Payout in the form of interest or royalties
<i>Host Country</i>		
Branch profit	100	100
(-) Taxes	<u>(-) 25</u>	<u>(-) ...</u>
(=) After tax	75	100
Withholding tax 20%	<u>(-) 15</u>	<u>(-) 20</u>
(=) Net paid out	60	80
<i>Home Country</i>		
Net income	60	80
Gross-up: direct	<u>...</u>	<u>20</u>
Taxable	5% of 60 = 3	100
Tax due (33%)	1	33
Tax credit direct	<u>...</u>	<u>(-) 20</u>
Net tax due	1	13
Total taxes	41	33

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Key ideas from this chapter

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- ◇ The issue of double/triple taxation arises because taxes are levied on both “**residence**” and “**source**” grounds.
- ◇ **Tax-neutrality** cannot be restored unless the whole world adopts the same tax code (tax basis, tax rate); and neither the K-import- nor K-export principles are applied with full consistency.
- ◇ Common issues are the **allocation of overhead**.
- ◇ The main issue under the credit method is **excess tax credits**. These can be avoided by mixing in low-tax countries, by reallocation of profits (risky), and, for a subsidiary, unbundling.
- ◇ Exclusion is typically **partial** only, and often does not apply to dividends from low-tax countries or non-dividend income.