# “Peeling the Apple”
## (International tax)

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# Objectives

By the end of this course you will:

- Gain an understanding of the US tax laws of global operations for US MNCs
- Discover how other countries may seek to tax local activities
- Explore the planning opportunities that may be available between the interplay of the US tax rules and the tax rules of other countries

# Agenda


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# Tax framework

# U.S. international tax framework

The US uses a “hybrid” taxing system related to cross-border income/taxpayers

- **Worldwide Income/Tax Credit System**
  - Applicable to US persons
  - Worldwide income subject to tax
  - Potential double taxation primarily mitigated with a foreign tax credit
- **Territorial system**
  - Applicable to non-US persons
  - Only certain income earned from US activities is subject to US taxation

# Other countries tax framework

- Residency
  - Tax on residency
  - Central management and control
    - US looks to place of incorporation
- Territorial
  - Tax on activities within the territory
- Participation exemption
  - Exemption from dividends and capital gains

# Tax rationale

- Governments generally use tax systems to punish, reward or incentivize behavior
- Tax rates
- Tax holidays
- Tax rulings
  - Lower tax rates
  - Exemptions

# Comparative corporate tax rates

| 1999 | | 2013 | |
|---|---|---|---|
| Australia | 36% | Australia | 30% |
| Canada | 42.9% | Canada | 26.1% |
| France | 40% | France | 34.4% |
| Germany | 52% | Germany | 30.2% |
| Greece | 40% | Greece | 26% |
| Italy | 37% | Italy | 27.5% |
| Japan | 40.9% | Japan | 30% |
| UK | 30% | UK | 23% |
| USA | 39.4% | USA | 39.1% |

# Other corporate tax rates – 2013

| | |
|---|---|
| Brazil | 34% |
| China | 25% |
| India | 33.66% |
| Ireland | 12.5% |
| Mexico | 30% |
| Singapore | 17% |

# International tax considerations

# Tax treaties

- PE
  - Exceptions to PE
    - Warehouses for distribution
    - Activities that are prepatory and auxiliary
- Force of attraction
- Lower rates of withholding

# Transfer pricing

- Assets, risks and functions
- Art vs. science
- Tax avoidance?

# General tax issues

- Concluding and signing contracts
- Research and development – double dipping

# Tax accounting

- ASC 740
- APB 23
- ETR?
- Cash taxes?
- Deferred taxes vs. current taxes
- US system of double taxation

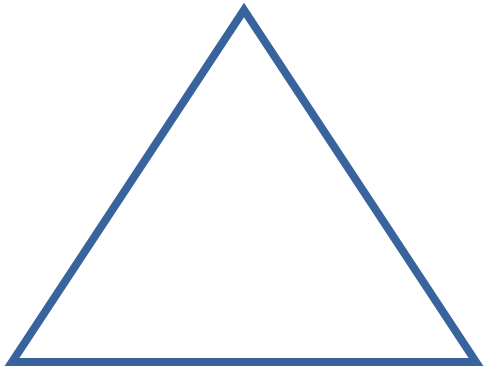
# International tax drawings

# Corporation

- Corporation for both US and foreign purposes

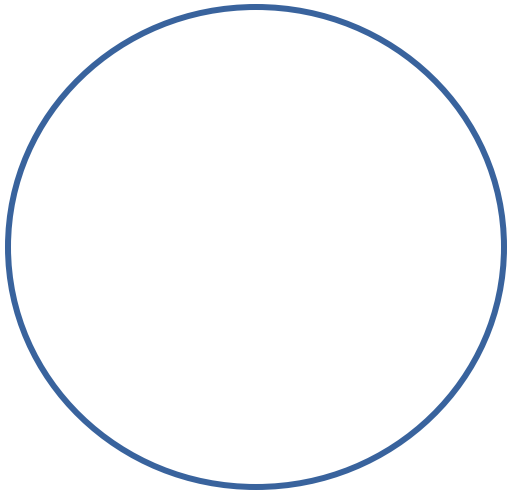
# Partnership

- Partnership for both US and foreign tax purposes



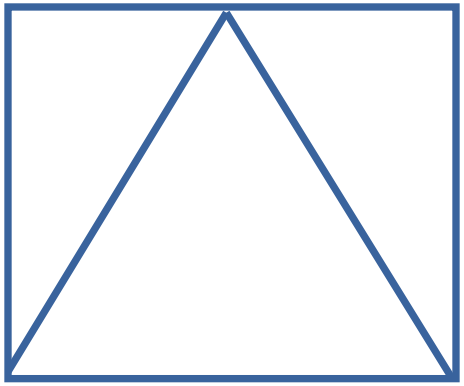
# Branch

- Branch (i.e., unincorporated activity) for both US and foreign purposes



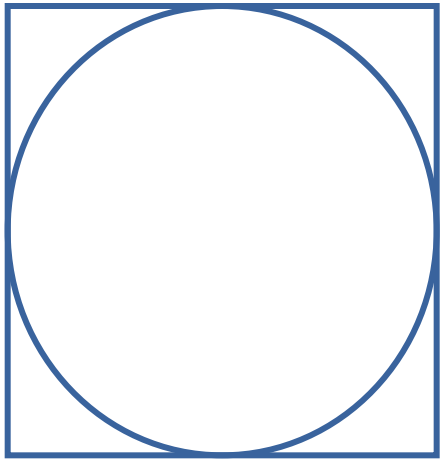
# Hybrid – partnership

- Partnership for US tax purposes
- Corporation for foreign tax purposes



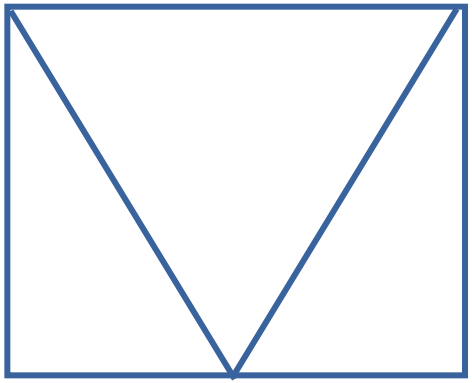
# Hybrid – Branch or Disregarded Entity

- Branch (disregarded single member entity (SME)) for US tax purposes
- Corporation for foreign tax purposes



# Reverse hybrid

- Corporation for US tax purposes
- Partnership/branch for foreign tax purposes



# Subpart F

# Potential abuse targeted by Subpart F

- Use of foreign "base company" in low-tax jurisdiction allows US company to place some of profits otherwise associated with foreign sales inside foreign corporation, which absent Controlled Foreign Corporation ("CFC") rules would not be taxed in the US unless repatriated

- This type transaction can be attacked in two ways:
  - Transfer Pricing (what is the correct price to be charged between the US company and it's foreign subsidiary)
  - **Subpart F** (because the foreign corporation is a CFC, certain income it earns is Subpart F ('tainted') and triggers immediate tax to the US shareholder

# Foreign base company income

- Foreign personal holding company income (“FPHCI”)
- Foreign base company sales income (“FBCSI”)
- Foreign base company services income (“FBCSvI”)

# FPHCI – examples

- Dividends, interest, royalties, rents, and annuities
- Net gains from certain property transactions
- Certain foreign currency gains

# FPHCI exceptions

- Rents & royalties earned in active trade or business
- Same country exception

# Active Trade or Business Exception

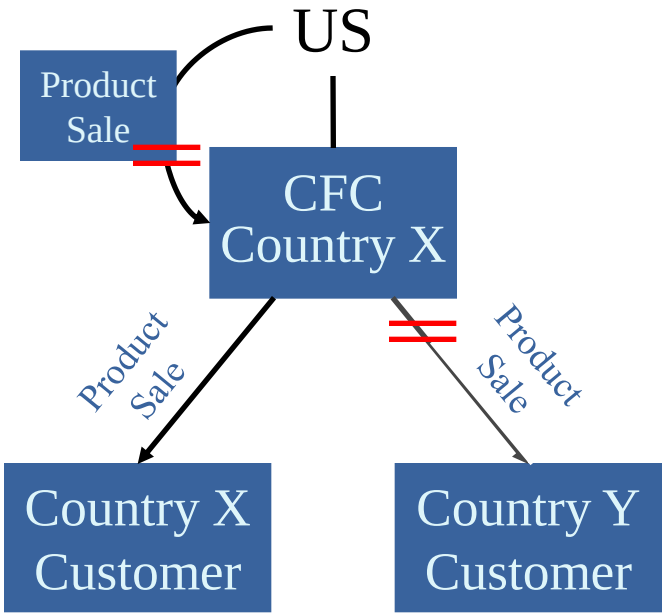
- FPHCI does not include rents or royalties received from an unrelated person derived in the active conduct of a trade or business

# Same country exception

- Interest & dividends
  - FPHCI does not include dividends and interest received from a related corporation created or organized in same country as CFC
- Rents & royalties
  - FPHCI does not include rents or royalties received from a corporation that is a related person for the use of, or privilege of using, property within the country in which the CFC is created or organized
- Exception to same country exception
  - The same country exception does not apply to the extent that the payment reduces payor's Subpart F income

# FBCSI

- General Framework: FBCSI is earned by a CFC (which does not manufacture the property), the property crosses two borders after manufacturing, and has a related party participant on one side of transaction



# Foreign Base Company Sales Income

- Three requirements for treatment as FBCSI
  1. Personal property purchased from and/or sold to a related person
  2. The personal property is manufactured, produced, grown, or extracted <u>outside</u> the country in which the CFC is created or organized
     - FBCSI does not include income from the sale of property "manufactured" by the CFC (even if outside the CFC's country). [Contract manufacturing regulations issued in late 2008 significantly change the determination of what constitutes "substantial contribution"].
  3. The personal property must be sold for use, consumption, or disposition <u>outside</u> the country in which the CFC is created or organized

# FBC Service Income

- Income derived from the performance of personal services by a CFC
  - for, or on behalf of, a related person
  - outside the country in which the CFC is organized

- Personal services include technical, managerial, engineering, architectural, scientific, industrial, commercial, or similar

# US MNCs – tax examples

# U.S. MNC – branch

EXAMPLE One –

US Corporation with foreign branch operations


Assumptions:

Total Income = $200
US tax rate = 35%
Foreign tax rate = 20%

| | | US | | FOR | TOTAL |
|---|---|---|---|---|---|
| Income | | 200 | | 100 | |
| Tax rate | x | 35% | x | 20% | |
| Tax b/4 cr. | | 70 | | 20 | 90 |
| FTC | | <20> | | <20> | <20> |
| | | 50 | | 20 | 70 |

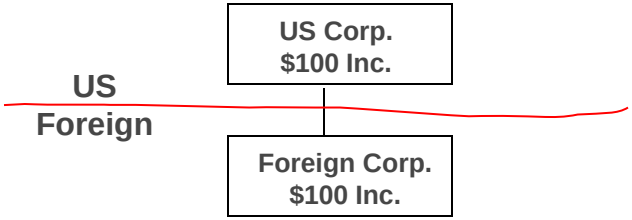
**Effective tax rate analysis:**

| Tax | ÷ | income | = | ETR |
|---|---|---|---|---|
| 70 | ÷ | 200 | = | 35% |

# US MNC – subsidiary

EXAMPLE Two –

US Corporation with Foreign Subsidiary Operations




Assumptions:

Total Income= $200

US tax rate = 35%

Foreign tax rate = 20%

Year One –

| | US | FOR | TOTAL |
|---|---|---|---|
| Income | 100 | 100 | |
| Tax Rate | 35% | 20% | |
| | 35 | 20 | 55 |

Year of dividend payment –

| | | | |
|---|---|---|---|
| Income | 100 | | |
| Tax rate | 35% | | |
| | 35 | | 35 |
| FTC | <20> | | <20> |
| | 15 | | 15 |

**Effective tax rate (Year One):**

| Tax | ÷ | income | = | ETR |
|---|---|---|---|---|
| 55 | ÷ | 200 | = | 27.5% |

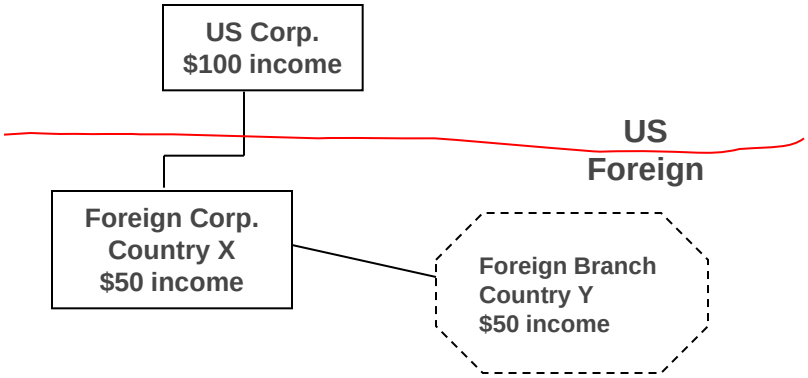
**ETR (Cumulative):**

| Tax | ÷ | income | = | ETR |
|---|---|---|---|---|
| (55 + 15) | ÷ | 200 | = | 35% |

# US MNC – subsidiary with branch

EXAMPLE Three –

US Corporation with Foreign Subsidiary
with Operations conducted in foreign branch




| Year One – | US | FOR | FB | TOTAL |
|---|---|---|---|---|
| Income | 100 | 50 | 50 | |
| Tax rate | 35% | 20% | -0- | |
| | 35 | 10 | -0- | 45 |

| Year of Div.– | US | FOR | FB | TOTAL |
|---|---|---|---|---|
| Income | 100 | | | |
| Tax rate | 35% | | | |
| | 35 | | | 35 |
| FTC | <10> | | | <10> |
| | 25 | | | 25 |

**Effective Tax Rate (Year One):**

| Tax | ÷ | income | = | ETR |
|---|---|---|---|---|
| 45 | ÷ | 200 | = | 22.5% |

**ETR (Cumulative):**

| Tax | ÷ | income | = | ETR |
|---|---|---|---|---|
| (45 + 25) | ÷ | 200 | = | 35% |

# So how to “peel” the apple?

# Amazon

- Where are sales made?
- Transfer pricing
- Warehouses
  - Treaty countries?

# Starbucks

- Transfer pricing
  - Where are sales made?
  - Who purchases the beans?
  - Who owns the IP?

- “Voluntarily” pay taxes?

# Google

- Where are sales made?
  - Activities of sales personnel?
  - Where are contracts approved, concluded and signed?

# Apple

- IP company location
  - Local tax rules
- Sub F rules
- R&D tax credit
- Sales companies

# Questions?

# Conclusion

You should now have:

- Gained an understanding of the US tax laws of global operations for US MNCs
- Discovered how other countries may seek to tax local activities
- Explored the planning opportunities that may be available between the interplay of the US tax rules and the tax rules of other countries

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Narelle MacKenzie is a well known international tax consultant, located in San Diego. She has over 25 years experience working in international taxes, having spent most of her career working with, or for, multinational companies. Ms. MacKenzie is an International Tax lecturer at San Diego State University, first appointed in 2007.

Narelle seeks to understand the business operations and drivers to ensure that the global tax planning and compliance works in synergy with the business, and maximizes the returns to shareholders, whilst ensuring such tax planning is done to the highest ethical standards.

She has worked in both public accounting and industry for employers such as Goodrich Corporation (a Fortune 500 company that was acquired by United Technologies), PricewaterhouseCoopers LLP, and Toyota Australia. Her business experience has covered diverse industries and activities, including supply chain activities and initiatives, identification and implementation of new manufacturing facilities, establishing representative offices, secondment arrangements, customer sales and support initiatives and general cross-border issues.

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Ms. MacKenzie is an Australian CPA and a Californian CPA.