Chapter 20

International Taxation and Foreign Investments
Overview

Forms of Foreign activity

Multiple Taxation vs. Tax Neutrality

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
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Remittances from a Subsidiary: An Overview

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▷ **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 capter
  - 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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- **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)

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Where does the residence principle apply?

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

<table>
<thead>
<tr>
<th>Form of Foreign Activity</th>
<th>VU activity?</th>
<th>(why) does VU tax IS?</th>
</tr>
</thead>
<tbody>
<tr>
<td>independent agent</td>
<td>physical presence?</td>
<td>key activity?</td>
</tr>
<tr>
<td>direct exports</td>
<td>physical presence?</td>
<td>key activity?</td>
</tr>
<tr>
<td>passive dependent agent</td>
<td>physical presence?</td>
<td>key activity?</td>
</tr>
<tr>
<td>“permanent establishment”</td>
<td>physical presence?</td>
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Double Taxation—Example

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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Plan A: Capital import neutrality

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

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Will taxes ever be fully neutral?  no

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

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The exclusion method as applied to a WOS
**Issue #1: disagreements on the tax basis**

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

### Example

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<tr>
<td><strong>Management Accounting System</strong></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>1,200</td>
<td>400</td>
<td>1,600</td>
</tr>
<tr>
<td>((-)) Direct cost</td>
<td>((-)) 700</td>
<td>((-)) 300</td>
<td>((-)) 1,000</td>
</tr>
<tr>
<td>(=) Contribtn</td>
<td>500</td>
<td>100</td>
<td>600</td>
</tr>
<tr>
<td>((-)) Overhead</td>
<td>-</td>
<td>-</td>
<td>((-)) 300</td>
</tr>
<tr>
<td>(=) Gross Inc</td>
<td>-</td>
<td>-</td>
<td>300</td>
</tr>
</tbody>
</table>

|                |         |         |        |
| **Tax returns** |         |         |        |
| Sales          | 1,200   | 400     | 1,600  |
| \((-)\) Direct cost | \((-)\) 700 | \((-)\) 300 | \((-)\) 1,000 |
| \((-)\) Alloctd ovrhd | \(\frac{700}{700+300} = \frac{210}{300} = (-) 75\) | \(\frac{400}{1200+400} = \frac{25}{315} = (-) 75\) | \((-)\) 1,000 |
| \(=\) Taxable | 290     | 25      | 315    |
Issue #2: Excess tax credits (1)

-compensate internationally?

<table>
<thead>
<tr>
<th>Host country</th>
<th>Case 1</th>
<th>Case 2</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Vanuatu</td>
<td>Hong Kong</td>
</tr>
<tr>
<td>Sales</td>
<td>50%</td>
<td>25%</td>
</tr>
<tr>
<td>Cost</td>
<td>(−) 120</td>
<td>(−) 100</td>
</tr>
<tr>
<td>Branch profit</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Taxes</td>
<td>(−) 50</td>
<td>(−) 25</td>
</tr>
<tr>
<td>Net profit</td>
<td>50</td>
<td>75</td>
</tr>
</tbody>
</table>

-Iceland-

| Net profit     | 50      | 75        | 50      | 30        |
| Gross-up       | 50      | 25        | 50      | 10        |
| Taxable        | 100     | 100       | 100     | 40        |
| Total taxable for’n inc | 100+100 = 200 | 100+40 = 140 |
| Tax due        | 80      | 56        |         | 56        |
| Credit         | 50+25= (−) 75 | 50+10= (−) 60 |
| Net tax due    | 5       | 0         | 5       | 0         |
| Unused tax credit | 0     | 4         | 0       | 4         |
| Total taxes paid | 80    | 60        |         | 60        |
| Total tax, as % | 80/200 = 40% | 60/140 = 43% |
Issue #2: Excess tax credits (2)

◊ 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!
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## Transfer pricing

### Example

<table>
<thead>
<tr>
<th>Host country</th>
<th>before</th>
<th>after</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Vanuatu</td>
<td>Hong Kong</td>
</tr>
<tr>
<td>tax rate</td>
<td>50%</td>
<td>25%</td>
</tr>
<tr>
<td>Sales</td>
<td>220</td>
<td>100</td>
</tr>
<tr>
<td>(~) Cost</td>
<td>(~) 120</td>
<td>(~) 60</td>
</tr>
<tr>
<td>(=) Branch profit</td>
<td>100</td>
<td>40</td>
</tr>
<tr>
<td>(~) Taxes</td>
<td>(~) 50</td>
<td>(~) 10</td>
</tr>
<tr>
<td>(=) Net profit</td>
<td>50</td>
<td>30</td>
</tr>
</tbody>
</table>

### Iceland

<table>
<thead>
<tr>
<th></th>
<th>Vanuatu</th>
<th>Hong Kong</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net profit</td>
<td>50</td>
<td>30</td>
</tr>
<tr>
<td>Gross-up</td>
<td>50</td>
<td>10</td>
</tr>
<tr>
<td>Txbl, by branch</td>
<td>100</td>
<td>40</td>
</tr>
<tr>
<td>Txbl for’n inc</td>
<td>100+40 = 140</td>
<td>60+80 = 140</td>
</tr>
<tr>
<td>Tax due</td>
<td>56</td>
<td>56</td>
</tr>
<tr>
<td>(~) Credit</td>
<td>50+10= (~) 60</td>
<td>30+20 = (~) 50</td>
</tr>
<tr>
<td>Net tax due</td>
<td>0</td>
<td>6</td>
</tr>
<tr>
<td>Unused tax credit</td>
<td>4</td>
<td>0</td>
</tr>
<tr>
<td>Total taxes paid</td>
<td>60</td>
<td>56</td>
</tr>
<tr>
<td>Total tax, as %</td>
<td>60/140 = 42.86%</td>
<td>56/140 = 40%</td>
</tr>
</tbody>
</table>
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Forms of Foreign activity

Multiple Taxation vs. Tax Neutrality

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

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Issue #1: incomplete exclusion

◊ “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”
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Issue #2: Disagreements on the tax base

◊ 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

<table>
<thead>
<tr>
<th>origin of profits</th>
<th>Italian</th>
<th>French</th>
</tr>
</thead>
<tbody>
<tr>
<td>exclusion</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>profit</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>(–) fr tx</td>
<td>n.a.</td>
<td>(–) 30.0</td>
</tr>
<tr>
<td>(=) after tx inc</td>
<td>n.a.</td>
<td>(=) 70.0</td>
</tr>
<tr>
<td>french tbl</td>
<td>100.0</td>
<td>0.0</td>
</tr>
<tr>
<td>(–) fr tx</td>
<td>35.0</td>
<td>0.0</td>
</tr>
<tr>
<td>all tx</td>
<td>35.0</td>
<td>30.0</td>
</tr>
<tr>
<td></td>
<td></td>
<td>36.1</td>
</tr>
</tbody>
</table>
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<tr>
<th>origin of profits</th>
<th>italian</th>
<th>french</th>
</tr>
</thead>
<tbody>
<tr>
<td>exclusion</td>
<td>100%</td>
<td>75%</td>
</tr>
<tr>
<td>profit</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>(–) fr tx</td>
<td>n.a.</td>
<td>(–) 30.0</td>
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<td>(=) after inc</td>
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<td>30.0</td>
</tr>
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<td></td>
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International Taxation

P. Sercu, *International Finance: Theory into Practice*

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<table>
<thead>
<tr>
<th>origin of profits</th>
<th>italian exclusion</th>
<th>french 100%</th>
<th>french 75%</th>
</tr>
</thead>
<tbody>
<tr>
<td>profit</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>(−) fr tx</td>
<td>n.a.</td>
<td>(−) 30.0</td>
<td>(−) 30.0</td>
</tr>
<tr>
<td>(−) aftrtx inc</td>
<td>n.a.</td>
<td>(−) 70.0</td>
<td>(−) 70.0</td>
</tr>
<tr>
<td>french txbl</td>
<td>100.0</td>
<td>0.0</td>
<td>17.5</td>
</tr>
<tr>
<td>(−) fr tx</td>
<td>35.0</td>
<td>0.0</td>
<td>6.1</td>
</tr>
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<td>35.0</td>
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<td>36.1</td>
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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 ⇒ timing option (unavailable for branch)
  ▶ cumulatively, dividends ≤ profits < cash flow (depreciation)
  ▶ withholding tax
  ▶ no tax consolidation of profits/losses across branches

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The “indirect” tax credit

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

<table>
<thead>
<tr>
<th>Example</th>
<th>Branch</th>
<th>Full-equity WOS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Vanuatu</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Branch profit</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>(–) Taxes</td>
<td>(–) 35</td>
<td>(–) 35</td>
</tr>
<tr>
<td>(=) Net profit</td>
<td>65.0</td>
<td>65.0</td>
</tr>
<tr>
<td>Gross Dividend</td>
<td>...</td>
<td>65.0</td>
</tr>
<tr>
<td>(–) Withholding tax</td>
<td>...</td>
<td>(–) 11.0</td>
</tr>
<tr>
<td>(=) Net dividend</td>
<td>...</td>
<td>54.0</td>
</tr>
<tr>
<td><strong>Iceland</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td>65.0</td>
<td>54.0</td>
</tr>
<tr>
<td>Gross-up (1): direct</td>
<td>35.0</td>
<td>11.0</td>
</tr>
<tr>
<td>Gross-up (2): indirect</td>
<td>...</td>
<td>35</td>
</tr>
<tr>
<td>Taxable</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Tax due</td>
<td>40.0</td>
<td>40.0</td>
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<tr>
<td>Tax credit (1): direct</td>
<td>(–) 35.0</td>
<td>(–) 11.0</td>
</tr>
<tr>
<td>Tax credit (2): indirect</td>
<td>...</td>
<td>(–) 35.0</td>
</tr>
<tr>
<td>Net tax due</td>
<td>5.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Unused tax credit</td>
<td>0.0</td>
<td>6.0</td>
</tr>
</tbody>
</table>
Notes on the indirect tax credit

◊ **“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

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

◊ **(US:) smooth out fluctuations** by using

\[
gross \ dividend \times \frac{\text{cumul taxes since 1986}}{\text{cumul profits since 1986}}
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  \]
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  \]
Tax planning via unbundling the transfers

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

<table>
<thead>
<tr>
<th></th>
<th>Full Equity</th>
<th>ISK 40 paid as interest to parent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vanuatu</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Branch profit</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>(−) Interest paid to parent</td>
<td>100</td>
<td>(−) 40</td>
</tr>
<tr>
<td>(=) Taxable</td>
<td>100</td>
<td>60</td>
</tr>
<tr>
<td>(−) Taxes</td>
<td>(−) 35</td>
<td>(−) 21</td>
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<tr>
<td>(=) Net profit</td>
<td>65</td>
<td>39</td>
</tr>
<tr>
<td>Gross paid out</td>
<td>65</td>
<td>dividend 39.0 interest 40</td>
</tr>
<tr>
<td>(−) Withholding tax</td>
<td>17% (−) 11</td>
<td>17% (−) 6.6 20% (−) 8</td>
</tr>
<tr>
<td>(=) Net paid out</td>
<td>54</td>
<td>32.4</td>
</tr>
<tr>
<td>Iceland</td>
<td></td>
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<tr>
<td>Net received</td>
<td>54</td>
<td>32.4</td>
</tr>
<tr>
<td>Gross-up (1): direct</td>
<td>11</td>
<td>6.6</td>
</tr>
<tr>
<td>Gross-up (2): indirect</td>
<td>35</td>
<td>21.0</td>
</tr>
<tr>
<td>Taxable</td>
<td>100</td>
<td>100</td>
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<tr>
<td>Total taxable foreign income</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Tax due</td>
<td>40</td>
<td>40.0</td>
</tr>
<tr>
<td>Tax credit (1): direct</td>
<td>11</td>
<td>14.6</td>
</tr>
<tr>
<td>Tax credit (2): indirect</td>
<td>35</td>
<td>21.0</td>
</tr>
<tr>
<td>Net tax due</td>
<td>0</td>
<td>4.4</td>
</tr>
<tr>
<td>Unused tax credit</td>
<td>6</td>
<td>0</td>
</tr>
<tr>
<td>Total taxes</td>
<td>46</td>
<td>40</td>
</tr>
</tbody>
</table>
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  - 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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  - [+]: deferral
  - [+]: unbundling
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  - [-]: loss of tax consolidation
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Outline

Forms of Foreign activity

Multiple Taxation vs. Tax Neutrality

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
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- **Implied loophole:** transform non-dividend income into dividends
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  - 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

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  - include all taxes into calculations: corptax host, withh tax, domestic tax—see overleaf
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### Comparing total tax burdens: Example

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

<table>
<thead>
<tr>
<th>Host Country</th>
<th>Payout in the form of profits and dividends</th>
<th>Payout in the form of interest or royalties</th>
</tr>
</thead>
<tbody>
<tr>
<td>Branch profit</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>(−) Taxes</td>
<td>(−) 25</td>
<td>(−) ...</td>
</tr>
<tr>
<td>(−) After tax</td>
<td>75</td>
<td>100</td>
</tr>
<tr>
<td>Withholding tax 20%</td>
<td>(−) 15</td>
<td>(−) 20</td>
</tr>
<tr>
<td>(−) Net paid out</td>
<td>60</td>
<td>80</td>
</tr>
</tbody>
</table>

| Home Country                          |                                           |                                           |
| Net income                            | 60                                         | 80                                         |
| Gross-up: direct                      | ...                                        | 20                                         |
| Taxable                               | 5% of 60 = 3                              | 100                                        |
| Tax due (33%)                         | 1                                          | 33                                         |
| Tax credit direct                     | ...                                        | (−) 20                                     |
| Net tax due                           | 1                                          | 13                                         |
| Total taxes                           | 41                                         | 33                                         |
Key ideas from this chapter

- 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.