

International Tax Environment

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Chapter Objective:

This chapter provides a brief introduction to the international tax environment.

Chapter Outline

- The Objectives of Taxation
- Types of Taxation
- The National Tax Environments
- Organizational Structures for Reducing Tax Liabilities

The Objectives of Taxation

- The twin objectives of taxation are:
 1. Tax Neutrality
 2. Tax Equity

Tax Neutrality

A tax scheme is *tax neutral* if it meets three criteria:

- 1. **Capital Export Neutrality:** the tax scheme does not incentivise citizens move their money abroad.
- 2. **National Neutrality:** taxable income is taxed in the same manner by the taxpayer's national tax authorities regardless of where in the world it is earned.
- 3. **Capital Import Neutrality:** the tax burden on a MNC subsidiary should be the same regardless of where in the world the MNC is incorporated.

Tax Equity

- Tax Equity: regardless of the country in which an affiliate of a MNC earns taxable income, the same tax rate and tax due date should apply.
- The principal of tax equity is difficult to apply; the organizational form of the MNC can affect the timing of the tax liability.

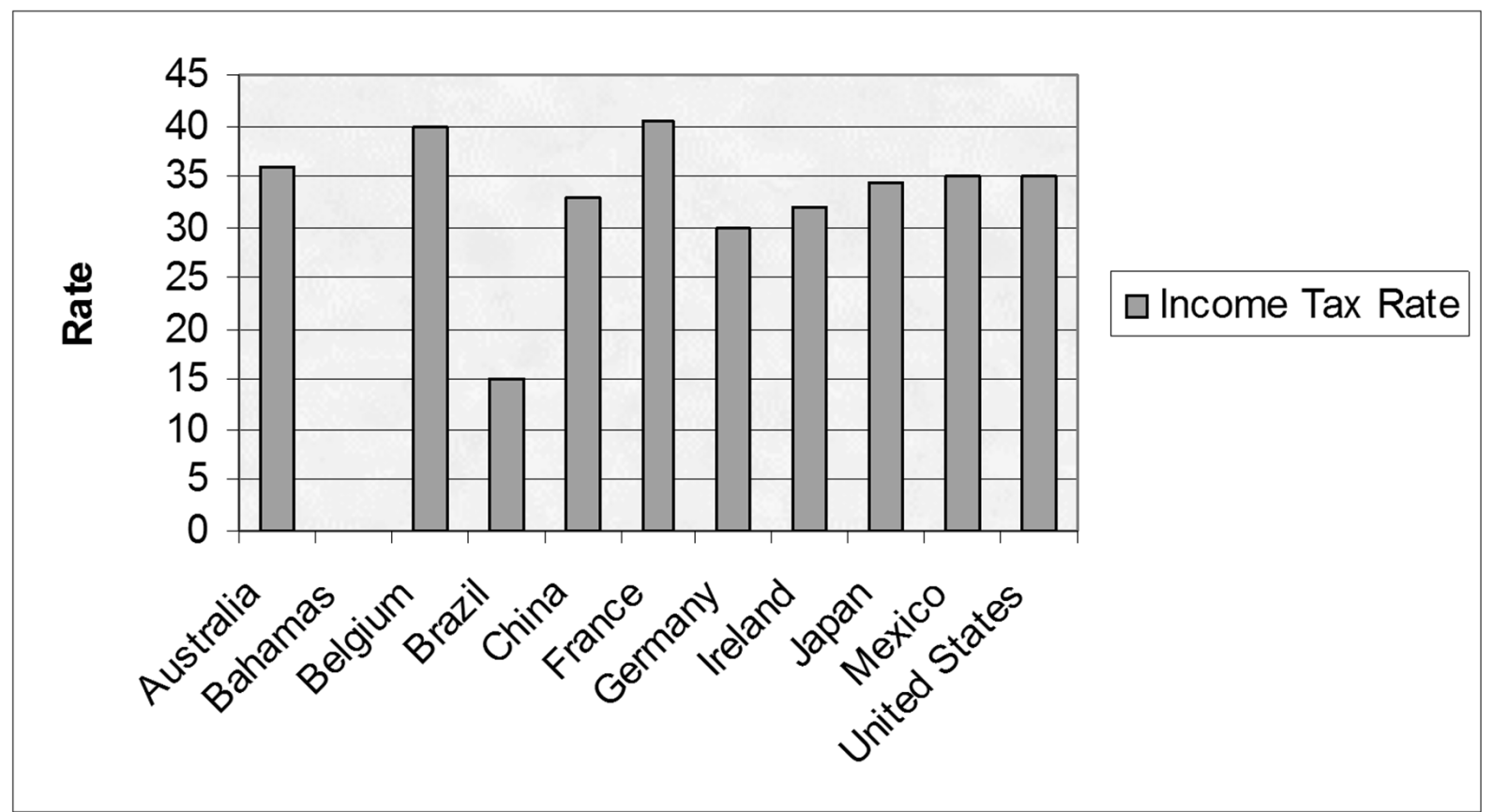
Types of Taxation

- Income Tax
- Withholding Tax
- Value-Added Tax

Income Tax

- An income tax is a tax on personal and corporate income.
- Many countries in the world obtain a significant portion of their tax revenue from income taxes.
- An income tax is a *direct tax*, that is one that is paid directly by the taxpayer upon whom it is levied.

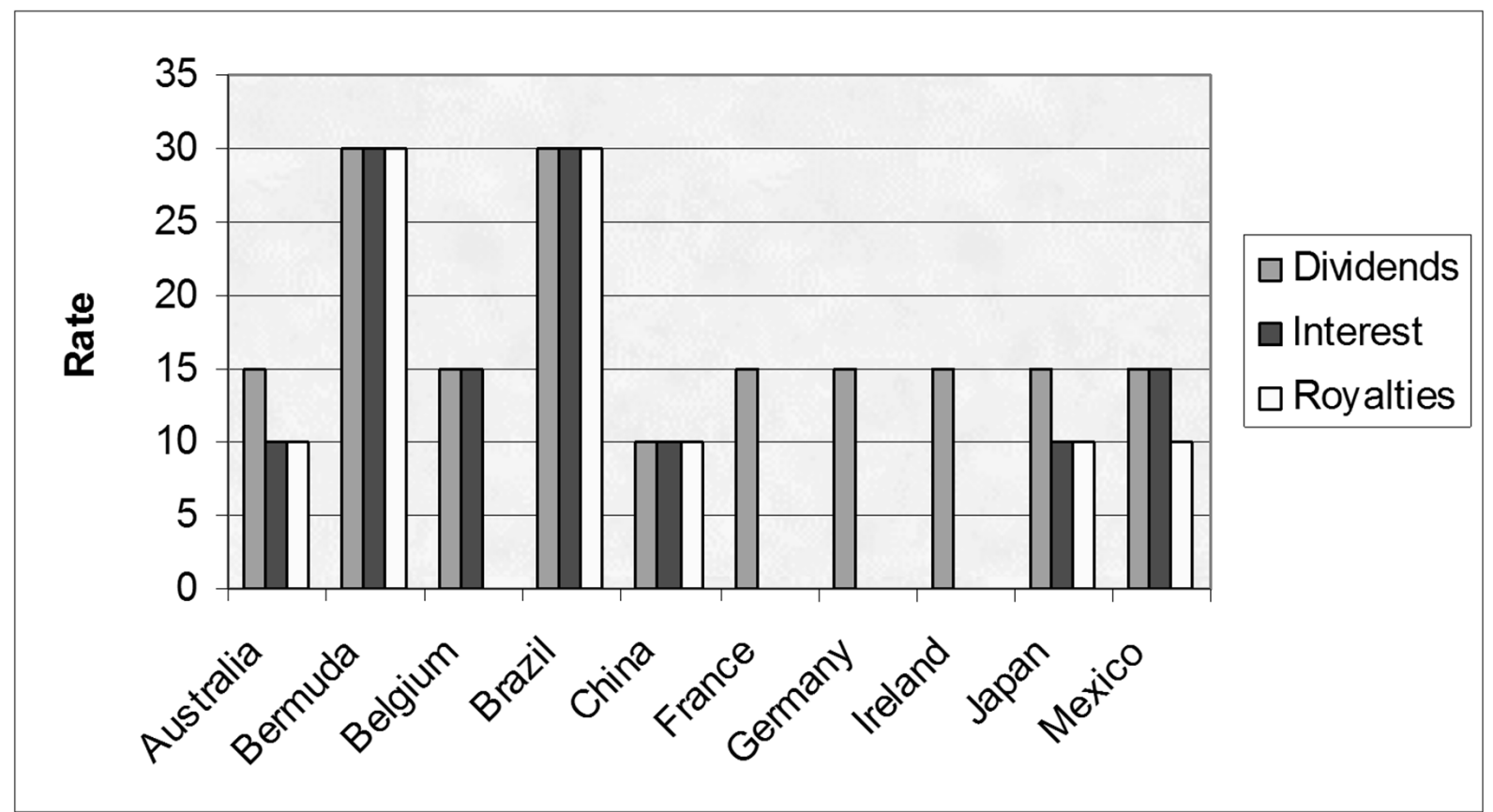
Income Tax Rates in Selected Countries



Withholding Tax

- Withholding taxes are *withheld* from the payments a corporation makes to the taxpayer.
- The taxes are levied on **passive income** earned by an individual or corporation of one country within the tax jurisdiction of another country.
- Passive income includes dividends and interest income, income from royalties, patents, or copyrights.
- A withholding tax is an indirect tax.

U.S. Tax Treaty Withholding Rates Selected Countries



Value-Added Tax

- A value-added tax is an indirect national tax levied on the *value added* in production of a good or service.
- In many European and Latin American countries the VAT has become a major source of taxation on private citizens.
- Many economists prefer a VAT to an income tax because the incentive effects of the two taxes differ sharply.

Value-Added Tax

- An income tax has the incentive effects of discouraging work.
- A VAT has the incentive effect of discouraging consumption (thereby encouraging saving).
- VATs are easier to administer as well. While taxpayers have an incentive to hide their income, producers have an incentive to make sure that their upstream suppliers in the production process declare the value added (and pay the tax!).

Value-Added Tax Calculation

<i>Production Stage</i>	<i>Selling Price</i>	<i>Value Added</i>	<i>Incremental VAT</i>	
<i>1</i>	€100	€100	€15	= €100 × .15
<i>2</i>	€300	€200	€30	= €200 × .15
<i>3</i>	€380	€80	€12	= €80 × .15
		Total VAT	€57	= €380 × .15

In this example, the tax rate is 15 percent. Suppose that stage one is the sale of raw materials to the manufacturer; stage two is the sale of finished goods to a retailer; stage three is the sale of inventory from the retailer to the consumer.

Other Types of Taxation

- A wealth tax is a tax levied not on income but on the wealth of a taxpayer. Property taxes are an example.
- A poll tax is a tax on your existence. It is so called because it was collected from those who wished to vote.

The National Tax Environments

- Worldwide Taxation
- Territorial Taxation
- Foreign Tax Credits

Worldwide Taxation

- Tax national residents of the country on their worldwide income no matter in which country it was earned.

Territorial Taxation

- Territorial taxation tax residents based upon *where* the taxable event occurred.

Foreign Tax Credits

- Allows taxpayers to recover somewhat from *double taxation*.
- *Direct foreign tax credits* are computed for direct taxes paid on active foreign-source income of a foreign branch of a U.S. MNC or on withholding taxes withheld from passive income.
- *Indirect foreign tax credits* are for income taxes deemed paid by the subsidiary.

Organizational Structures for Reducing Tax Liabilities

- Branch & Subsidiary Income
- Payments to and from Foreign Affiliates
- Tax Havens
- Controlled Foreign Corporation
- Foreign Sales Corporation

Branch & Subsidiary Income

- An overseas affiliate of a U.S. MNC can be organized as a branch or a subsidiary.
- A foreign branch is not an independently incorporated firm separate from the parent.
 - Branch income passes directly through to the parent's income statements.
- A foreign subsidiary is an affiliate organization of the MNC that is independently incorporated.
 - Income may not be taxed in the U.S. until it is repatriated, under certain circumstances.

Payments to and from Foreign Affiliates

- Having foreign affiliates offers transfer price tax arbitrage strategies.
- The transfer price is the accounting value assigned to a good or service as it is transferred from one affiliate to another.
- If one country has high taxes, don't recognize income there—have those affiliates pay high transfer prices. If one country has low taxes, recognize income there—have those affiliates pay low transfer prices.

Tax Havens

- Tax havens are countries with low corporate income tax rates and low withholding tax rates on passive income.
- Tax havens were once useful as locations for a MNC to establish a shell company.
- The Tax Reform Act of 1986 greatly diminished the need for and ability of U.S. corporations to profit from the use of tax havens.

Controlled Foreign Corporation

- The Tax Reform Act of 1986 created a new type of foreign subsidiary: *the controlled foreign corporation*.
- A *controlled foreign corporation* is a foreign subsidiary that has over half of its voting stock held by U.S. shareholders—even if these shareholders are unaffiliated.

Controlled Foreign Corporation

- The undistributed income of a minority foreign subsidiary of a U.S. MNC is tax deferred until it is remitted via a dividend.
- This is not the case with a controlled foreign corporation—the tax treatment is much less favorable.
- The result is that foreign tax credits are unlikely to be completely used.

Foreign Sales Corporation

- A *foreign sales corporation* is a foreign corporation established as an affiliate of a U.S. corporation for the purpose of buying from a U.S. corporation property for use or resale abroad. They can be used to lower taxes paid by the U.S. MNC in two ways.
 - A *portion* of the total foreign trade income of a FSC is exempt from U.S. taxation (the remaining portion is fully taxable).
 - The second benefit is that the transfer price between the FSC and the U.S. MNC does *not* have to be an “arms length” price. Transfer pricing can be used to shift income between the FSC and the U.S. MNC

End Chapter Twenty