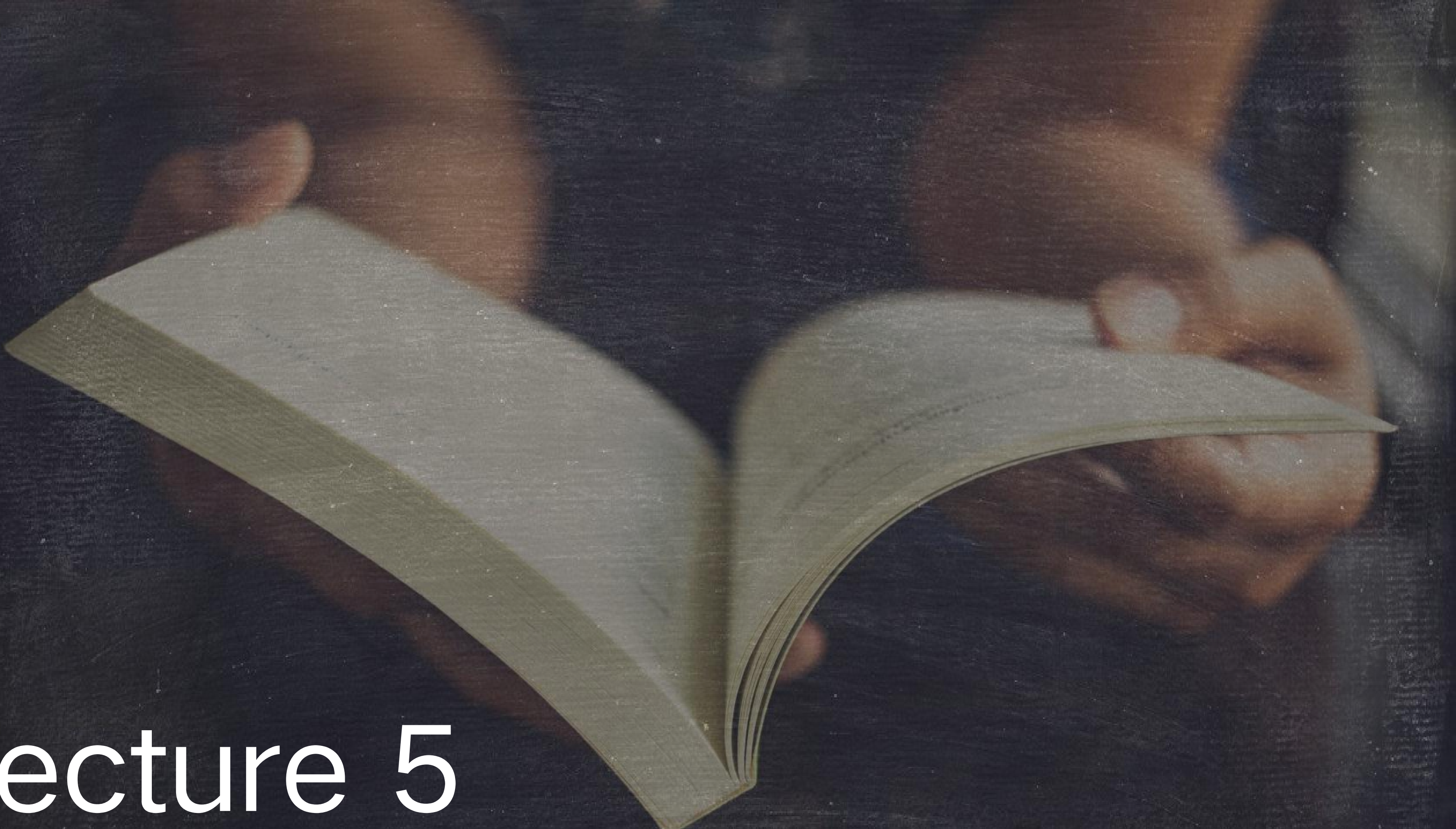


Lecture 5

10/17/2024

Topics covered last time

Nationality
- Taxing Jurisdiction
- Cook v. Tait (1924)

Residence

The Residence of U.S. Citizen
- Bona fide test
- Physical presence test

The Residence of Foreign Nationals
- Green card test
- Substantial presence test

Topics of Today

The Residence of Corporation

- Corporation Situs
- Different Forms of Business Abroad

Foreign Tax Credit

- Participation Exemption
- Credit，Exemption，and deduction
- FTC Calculation

Residence of Corporation

Corporation

In the U.S. tax system there is no characteristic of entities that corresponds exactly to the "nationality" or "residence" of individuals. However, there is at least a place––or at least a distinct legal environment––that establishes their existence and identity. This place, also called an entity's "situs," bears importantly on its taxation.

Corporation

- Any corporation incorporated under the laws of any state of the United States or the District of Columbia counts as a U.S. corporation.

- Corporations not incorporated in the United States generally are treated as foreign corporations.

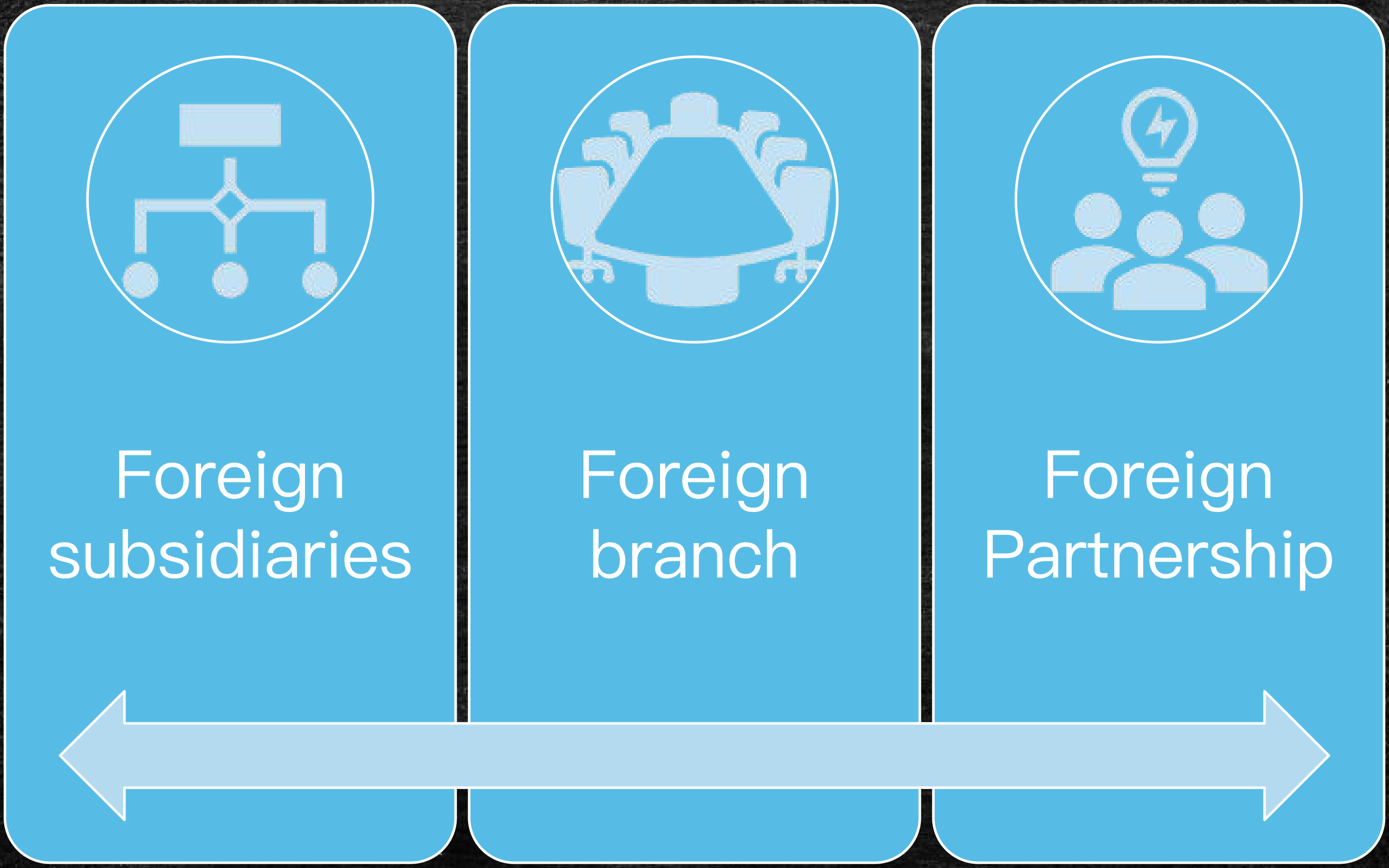
Corporation

A domestic corporation organized in the United States under the laws of the United States or of any State subjects to U.S. tax on its worldwide income.

Situs?

"Just because their business is online doesn't mean they should not pay taxes in the countries where they operate and from which their profit derives," the treasury chiefs of France, Germany, Italy, and Spain said in a joint statement in the G7 conference 2022. "**Physical presence has been the historical basis of our taxation system**. This basis has to evolve with our economies gradually shifting online."

Different Forms of Business abroad



Foreign Subsidiaries

Foreign Subsidiaries

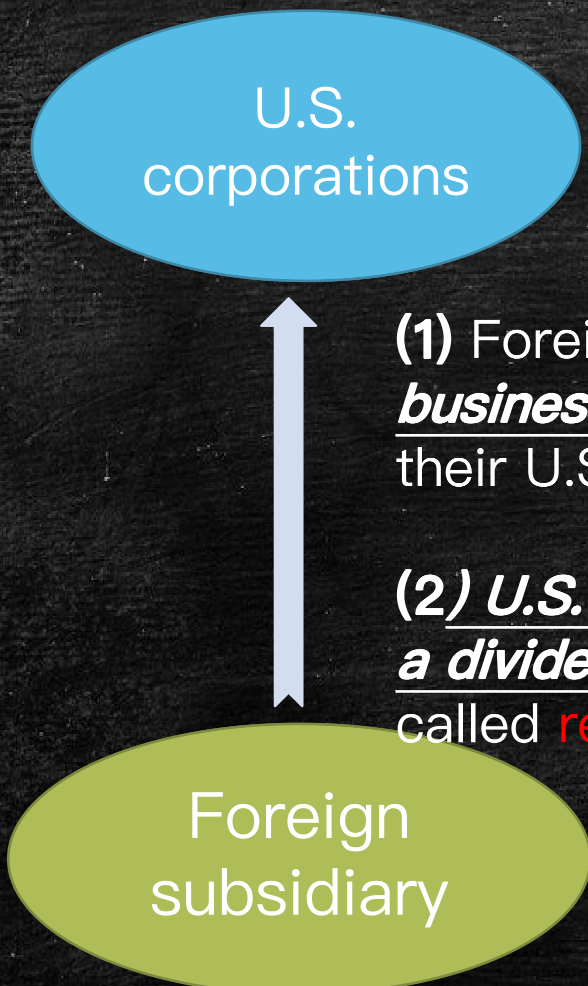
- Most multinationals are collections of subsidiaries, many of which may be incorporated in foreign countries.
- Corporations not incorporated in the United States generally are treated as foreign corporations.
- Foreign corporations with a U.S. trade or business are taxed directly by the United States on their U.S. income.

Subsidiaries

- When, if ever, is the foreign income earned by a foreign subsidiary taxed by the United States?
- U.S. shareholders are taxed when they receive a dividend from a foreign corporation.

  Consider a U.S. parent corporation that has a number of U.S. subsidiaries and a wholly owned Italian subsidiary. The income of the U.S. parent and its U.S. subsidiaries will be subject to worldwide taxation, and these entities most likely will file a consolidated U.S. tax return. However, the Italian subsidiary will not be part of the U.S. tax consolidation and its income generally will not be subject to U.S. taxation until it pays a dividend up to its parent, which is called **repatriation**. At the time of repatriation the income is reported on the U.S. parent's tax return.

Foreign Subsidiaries



(1) Foreign corporations ***with a U.S. trade or business*** are taxed directly by the United States on their U.S. income.

(2) ***U.S. shareholders*** are taxed when ***they receive a dividend*** from a foreign corporation, which is called repatriation.

Deferral of Taxes Due on Foreign Earnings

Active Earnings of **foreign** corporations

reinvest →

Not subject to U.S. taxation

↓ **Only when distributed to U.S. persons** as dividends

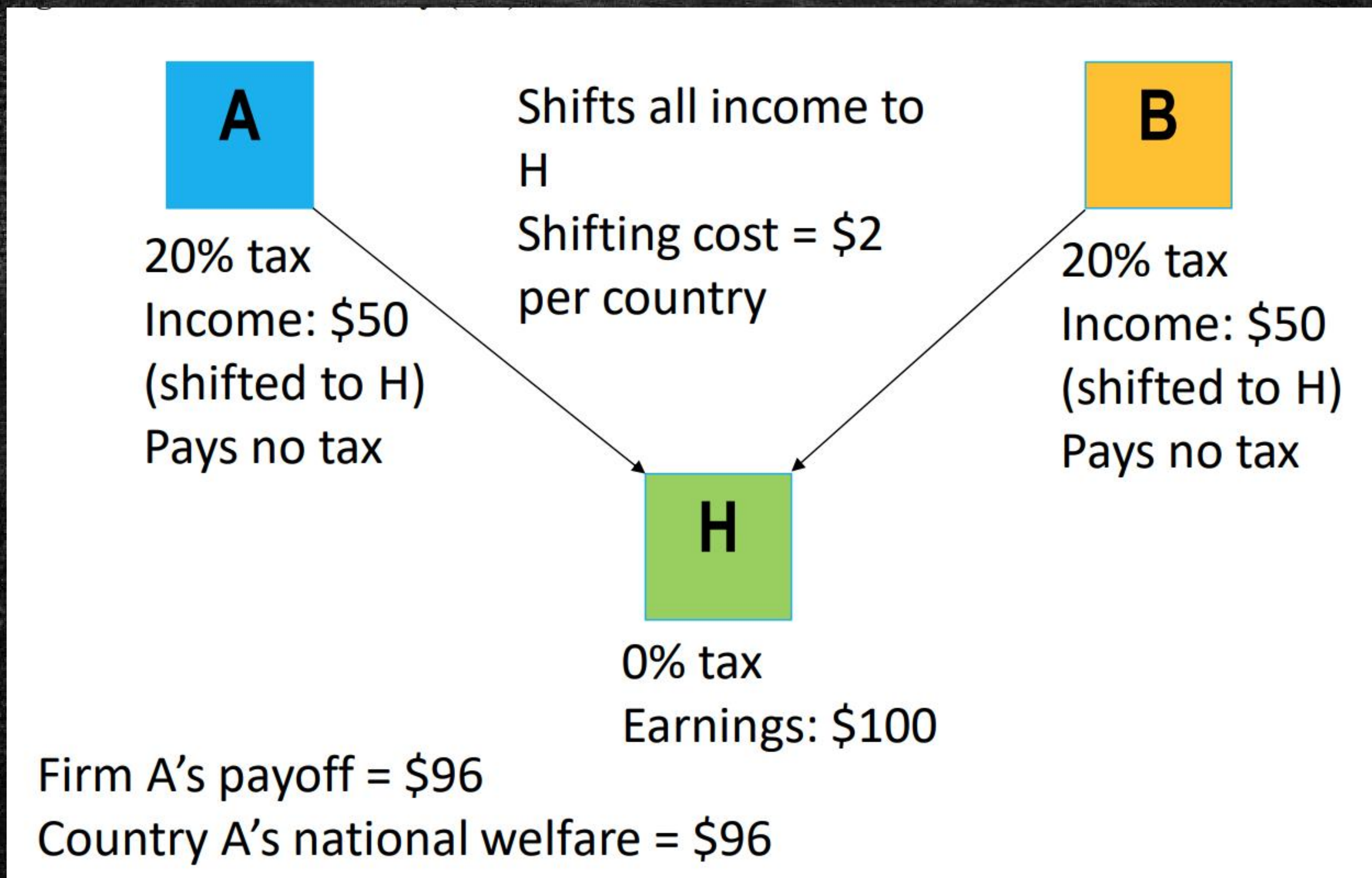
subject to U.S. taxation

Given that the distribution of a dividend is mainly optional, deferral can go on indefinitely.

Consider the following tax strategy

A highly profitable U.S. corporation sets up a wholly owned subsidiary in a tax haven through which it invests its excess funds in passive investments. Recall the general rule is that income of foreign subsidiaries is not taxable to the U.S. parent until it is repatriated.

No CFC Rules


A
Shifts all income to H
Shifting cost = $2 per country
B
20% tax
Income: $50
(shifted to H)
Pays no tax
20% tax
Income: $50
(shifted to H)
Pays no tax
H
0% tax
Earnings: $100
Firm A’s payoff = $96
Country A’s national welfare = $96

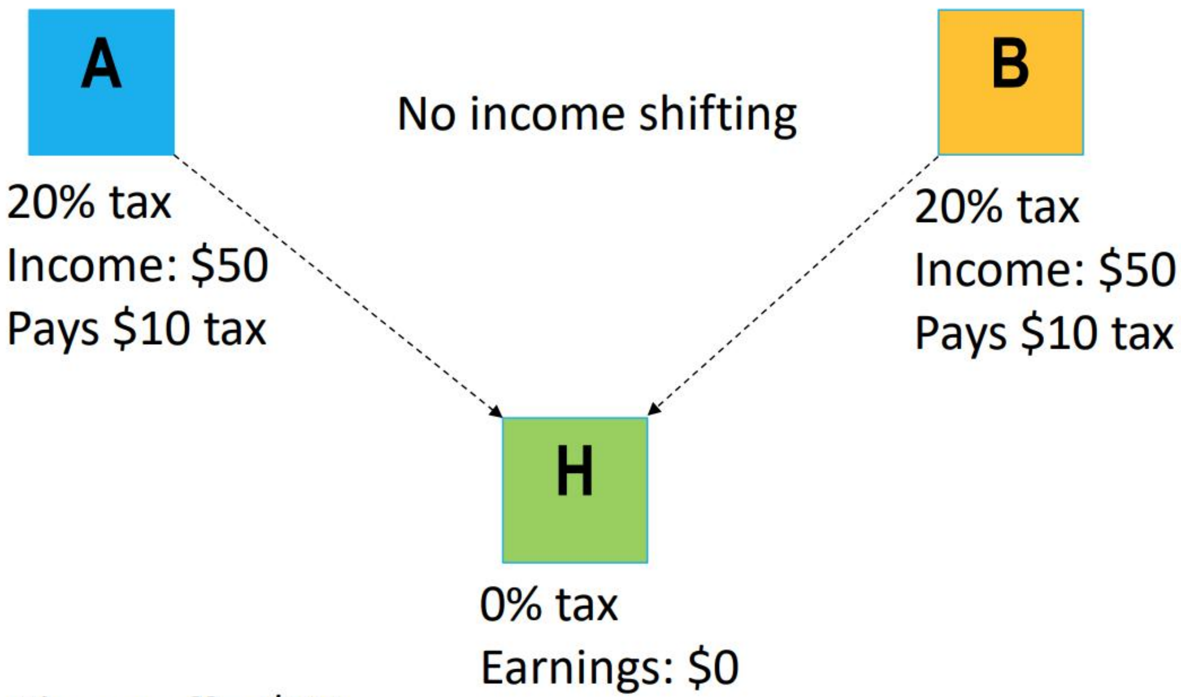
CFC rules

- The Subpart F and CFC provisions are designed to mitigate the tax benefits from forming paper foreign corporations in tax havens to record certain types of income.
- The rules tend to focus on easily movable income such as dividends, interest, rents, and royalties.

CFC rules

- In general, these rules work by subjecting Subpart F income to U.S. taxation as if the income was repatriated to the U.S. parent when the income is earned, rather than when the subsidiary distributes cash to the parent.
- Foreign income of CFC is "deemed distributed" whether or not remittance actually occurs.

With CFC Rules



Firm A’s payoff = $80

Country A’s national welfare = $90

(↓ due to increased foreign tax payments)

CFC rules

- A foreign corporation is a CFC for a particular year if on any day during such year U.S. **shareholders** own

(1) more than **50%** of the total combined **voting power** of all classes of the corporation's stock entitled to vote **(voting test),** or
(2) more than **50%** of the total **value** of all classes of the corporation's stock **(value test).** I.R.C. § 957

- A U.S. shareholder is a U.S. person **who owns 10% or more of the total combined voting power** of all classes of stock entitled to vote of such foreign corporation.

Subpart F Income

➢ **FBCI** **include its pro-rata share of the CFC's FBCSI、FBC、FPHCI in income currently**

- **FBCSI**

(Foreign Base Company Sales Income)
When a CFC either **buys or sells tangible personal property**

1. from/to (or on behalf of) a **related person**,
2. and the property is **manufactured, produced, constructed, or extracted** outside the country where the CFC is incorporated,
3. and the property is **purchased/sold for consumption or disposition** outside the country where the CFC is incorporated,

FBC Services Income
(Foreign Based Company Services Income)

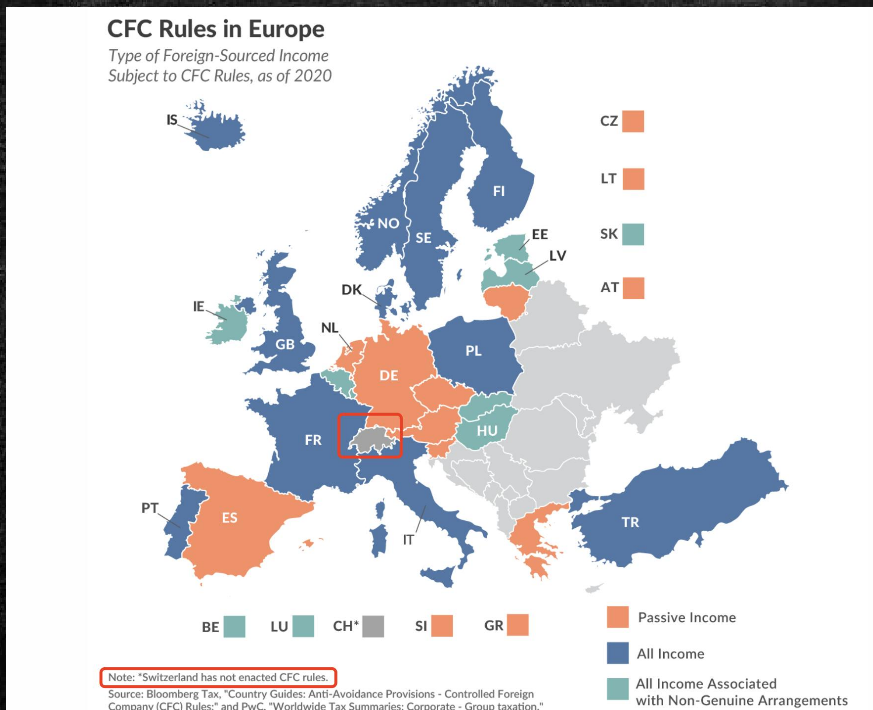
- when the CFC derives this income by **rendering services** to a related person or on behalf of a related person rendered or performed **outside the CFC**'s country of incorporation.
- technical, industry-specific, engineering or technical, and other similar services

FPHCI
(Foreign Personal Holding Company Income)

- where a CFC has portfolio types of investments, or where the CFC is merely passively receiving investment income, there is no competitive justification to defer the tax until the income is repatriated
- dividends, interest, annuities, rents, royalties, and net gains on dispositions of property, and many more.

➢ **INSURANCE INCOME**
Any insurance income **taxed in subchapter L** of the IRC. if a domestic insurance company derived the income provided that such income is **not "exempt insurance income."**

CFC rules in Europe



- ✓ Passive income: Austria, the Czech Republic, Germany, Greece, Lithuania, the Netherlands, Slovenia, and Spain.
- ✓ Both active and passive income : Denmark, Finland, France, Iceland, Italy, Norway, Poland, Portugal, Sweden, Turkey, and the United Kingdom.
- ✓ All income associated with non-genuine arrangements: Belgium, Estonia, Hungary, Ireland, Latvia, Luxembourg, and Slovakia.
- ✓ Switzerland is the only country covered that has not enacted CFC rules.

CFC rules in China

企业所得税

中国

《企业所得税法》第六章

- **第四十五条** 由居民企业，或者由居民企业和中国居民 **控制的**设立在实际**税负明显低于**本法第四条第一款规定税率水平的国家（地区）的企业，并非由于合理的经营需要而对利润不作分配或者减少分配的，上述利润中应归属于该居民企业的部分，应当计入该居民企业的当期收入。

第四条 企业所得税的税率为25%

“Check the box”

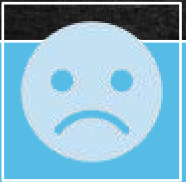
Foreign Branch

Foreign Branch

- For tax purposes, a foreign branch arises when the U.S. taxpayer has direct ownership of business operations located outside the United States.
- From a nontax perspective, foreign branches are simple to set up because they do not require the creation of a new legal entity.
- The major tax feature of a branch relative to a foreign subsidiary is that the U.S. owner of a branch enjoys **no deferral** of foreign income.
- The foreign profits and losses of a branch are reflected immediately on the tax return of the U.S. entity that owns the branch.

Pro and Cons of Branch Classification

- Losses from foreign operations are immediately deductible against U.S. domestic income, which is especially important for start-up operations that can reasonably be expected to generate losses.



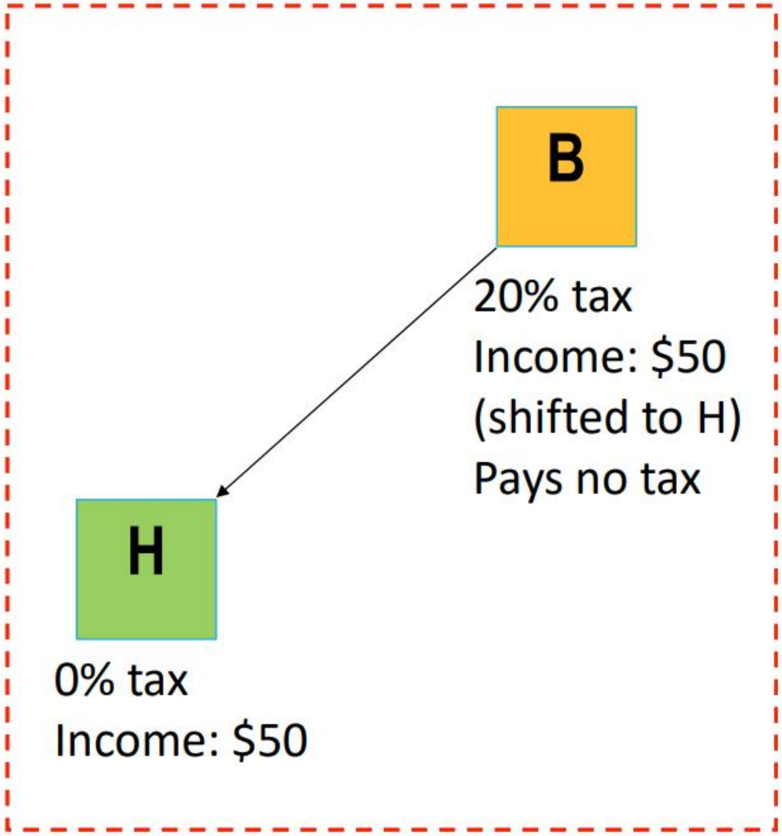
- U.S. tax on the earnings of the branch cannot be deferred.

"Check-the-Box"

- The classification of foreign entities and branches for U.S. federal income tax purposes as branches, partnerships, or corporations has no bearing on their classification by foreign tax authorities.
- The U.S. tax rules for classifying entities, the so-called "check-the-box" regulations, give firms considerable flexibility in selecting how their foreign entities will be treated for U.S. tax purposes. The election is made by checking a box on a special form filed with the Internal Revenue Service (IRS).

How come the “check-the-box” rule becomes a helpful tool for multinationals to escape tax?

CTB



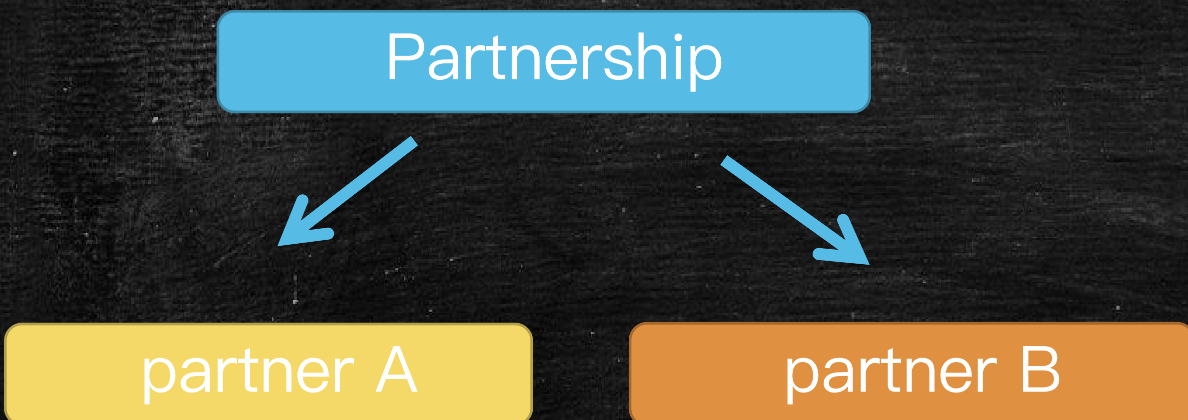
Pre-CTB: Income shifted from B to H taxed by the US under Subpart F
Post-CTB: MNC can elect to treat H affiliate as a branch of affiliate B for US tax purposes, avoiding Subpart F

Foreign
Partnership

Foreign Partnership

- A foreign partnership is a partnership organized under the laws of another country.
- Because partnerships are flow-through entities under U.S. tax law, U.S. partners in a foreign partnership are taxed on their share of the partnership income.

Residence of Partnerships



Partnership does not pay corporate income tax. It "Passes through" any profits or losses to its partners.

It is the nationality or residence of the individual partners that governs the taxation of the partnership income.

Example: Partnership

CooperSterling is an advertising company in partnership. During the year of 2017, the company earned $750,000 from the US, and $500,000 from France. Mr. Cooper is a US citizen, owning 40% of the firm. Mr. Sterling, a French citizen, has 60% share of the firm. He is not a U.S. residence for the year of 2017. Assume the company occurred $150,000 cost of revenue in the US and $100,000 in France. The statuary tax rates for individuals in U.S. and France are 35% and 30%, respectively. What are the taxable incomes for each partner in the US? What is the worldwide tax for Mr. Cooper in 2017?

Example: Partnerships

CooperSterling

40% Mr. Cooper
a US citizen

60% Mr. Sterling
a French citizen

	US	France
Revenue	$750,000	$500,000
cost	$150,000	$100,000

***The statuary tax rates for individuals in U.S. and France are 35% and 30%**

What are the taxable incomes for each partner in the US?
What is the worldwide tax for Mr. Cooper in 2017?

Example: Partnerships

	U.S.	France
Revenue	$750,000	$500,000
cost	$150,000	$100,000
Profit	$600,000	$400,000

For US:
Cooper: 40% * (600000+400000) =400,000
Sterling: 60% （600000） =360000

Cooper’s Worldwide Tax Burden：
400000*35% +160000* 30% –FTC(160000*30%) = 140,000

Topics of Today

Foreign Tax Credit

- Participation Exemption
- Credit， Exemption， and deduction
- FTC Calculation
- Indirect FTC
- Excess vs Deficit Credit

Relief for double taxation

- Exemption
- Deduction
- Credit

Foreign Tax Credit

FTC

If a foreign country (the source country) imposes tax on an item of income earned within its jurisdiction by a resident of another country, that person uses the foreign tax credit in his home country (the residence country) to reduce his home country's tax on that item of income.

Through the mechanism of the foreign tax credit, the United States declines to collect residence-based tax and allows foreign countries to preserve their source-based tax. The residence-based tax thus acts as a default or residual tax — it is only imposed to the extent no corresponding foreign tax is imposed.

Credit vs Exemption

- A credit system is not sufficient to put multinational firms on an equal footing with competitors in foreign markets, and that an exemption system is needed to level this playing field.
- An exemption system would make domestic firms uncompetitive and drive firms offshore, and that a foreign tax credit system is needed to ensure a (slightly different) level playing field between domestic and multinational firms.

Credit vs Deduction

- Under § 901(b)(1), a credit against tax may be taken by a United States citizen and a domestic corporation for foreign and possession "income, war profits, and excess profits taxes."
- A taxpayer must select either the credit or the deduction. The election is made on an annual basis. Thus, the taxpayer may alternate annually between the credit and the deduction depending upon which is more favorable.
- In most cases, the § 901 **credit is more advantageous than the deduction** because a credit reduces tax on a dollar-for-dollar basis, while a deduction merely reduces the amount of income upon which the tax will be

Foreign Tax Credit

U.S. taxpayers generally can elect to either receive a credit for foreign taxes paid or deduct the foreign taxes paid against their U.S. income.

A dollar of tax credit ($1) > **A dollar of deduction ($\$1 \times \tau$)**

Eligible	**foreign taxes imposed on income and withholding taxes on the repatriation of income**
Not eligible (unless an exception is made under a tax treaty)	**foreign value-added taxes (VAT taxes), property taxes, and excise taxes**

Amount of Tax Paid

Regulation § 1.901-2(e) restricts the types of payments that are creditable, precluding credit for refundable amounts, subsidies, multiple levies, and non-compulsory payments. As this Regulation provides, "an amount is not tax paid to a foreign country to the extent that it is reasonably certain that the amount will be refunded, credited, rebated, abated,." Only those taxes that result from a "reasonable approximation" of one's final liability under the foreign tax law are creditable taxes. Anything in excess of that standard constitutes a non-compulsory amount for which the credit is not available.

Example

- A's initial income tax liability under country X law is 100u (units of country X currency). However, under country X law *A's* initial income tax liability is reduced in order to compute its final tax liability by an investment credit of 15u and a credit for charitable contributions of 5u. The amount of income tax paid by *A* is 80 u.

Foreign Tax Credit

- Even when a foreign tax is classified as an income tax for U.S. purposes that does not automatically mean that the U.S. corporation receives an immediate **foreign tax credit** equal to the **foreign income tax**.
- In some countries the income tax rate exceeds the U.S. tax rate, and in such cases the United States will not give credit for more in taxes than would have been paid had the income been earned in the United States.
- These rules that prevent U.S. taxpayers from getting too much tax relief in the eyes of the tax authorities from foreign tax credits are known as the **foreign tax credit limitation rules**.

26 U.S. Code § 904 - Limitation on credit

(a) LIMITATION

The total amount of the credit taken under section 901(a) shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer’s taxable income from sources without the United States (but not in excess of the taxpayer’s entire taxable income) bears to his entire taxable income for the same taxable year.

Limitation of FTC

After the amount of creditable foreign taxes has been ascertained under § 901 and 903, the taxpayer must examine the limitations which are imposed upon the credit. The object of the limitation is to protect the United States' ability to tax the domestic source income of its own taxpayers.

The overall limitation of § 904(a) can be expressed in formula form as follows:

$$\text{Maximum foreign tax credit} = \frac{\text{Foreign source taxable income}}{\text{Worldwide taxable income}} \times \text{United States tax on worldwide income}$$

Foreign tax credit limitation

The foreign tax credit limitation is equal to the U.S. tax rate times the foreign source income.

PRACTICE

Illinois Steel is a specialty steel manufacturer that does business in the United States, Canada, and Brazil. Illinois Steel is organized as follows. The parent, Illinois Steel, is incorporated in Illinois and had pretax income from its U.S. operations of $5 million. Illinois Steel has a Brazilian branch, which reported pretax income of $3 million. Illinois Steel also has a Canadian branch, which recorded pretax income of $10 million. Assume the tax rates in the countries are United States, 21%; Canada, 15%; Brazil, 34%. What is Illinois Steel's U.S. tax liability after foreign tax credits?