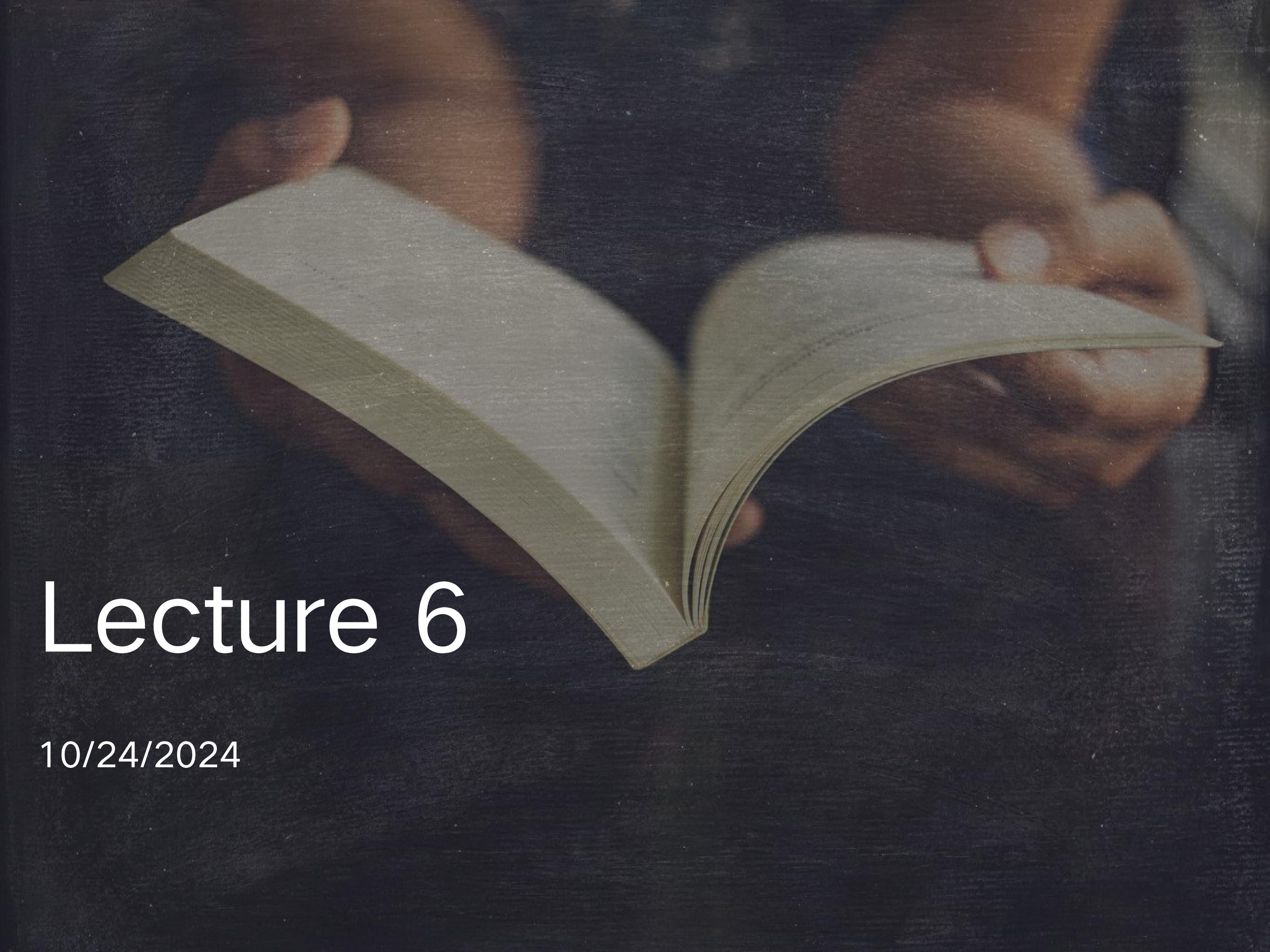


Lecture 6

10/24/2024

Topics of Last Class

The Residence of Corporation

- Corporation Situs
- Different Forms of Business Abroad

Foreign Tax Credit

- Credit, Exemption, and deduction
- FTC limit

Topics of Today

Foreign Tax Credit

- Direct vs Indirect FTC

Tax Consequences of Nationality

- Expatriation
- Tax inversion

Case Study: Stanley Black & Decker

Direct vs Indirect Foreign Taxes

Foreign tax paid by branch

Foreign tax credit is generally allowed only to the taxpayer who paid, or on whose behalf were paid, foreign taxes to a foreign government or possession. If United States corporations always operated in foreign countries via a branch, there would be no impediment to the foreign tax credit — since there would be no separate taxpayer, the United States corporation would be the payor of the foreign tax.

Foreign tax paid by subsidiary

If a United States corporation establishes a foreign subsidiary and the subsidiary earns foreign source income and pays the foreign tax, the subsidiary is not entitled to a foreign tax credit in the United States under § 901 since it is not liable for any United States income tax. In addition, in most cases, the United States parent may not take the foreign tax credit with respect to subsidiary earnings, since the United States parent did not pay the tax.

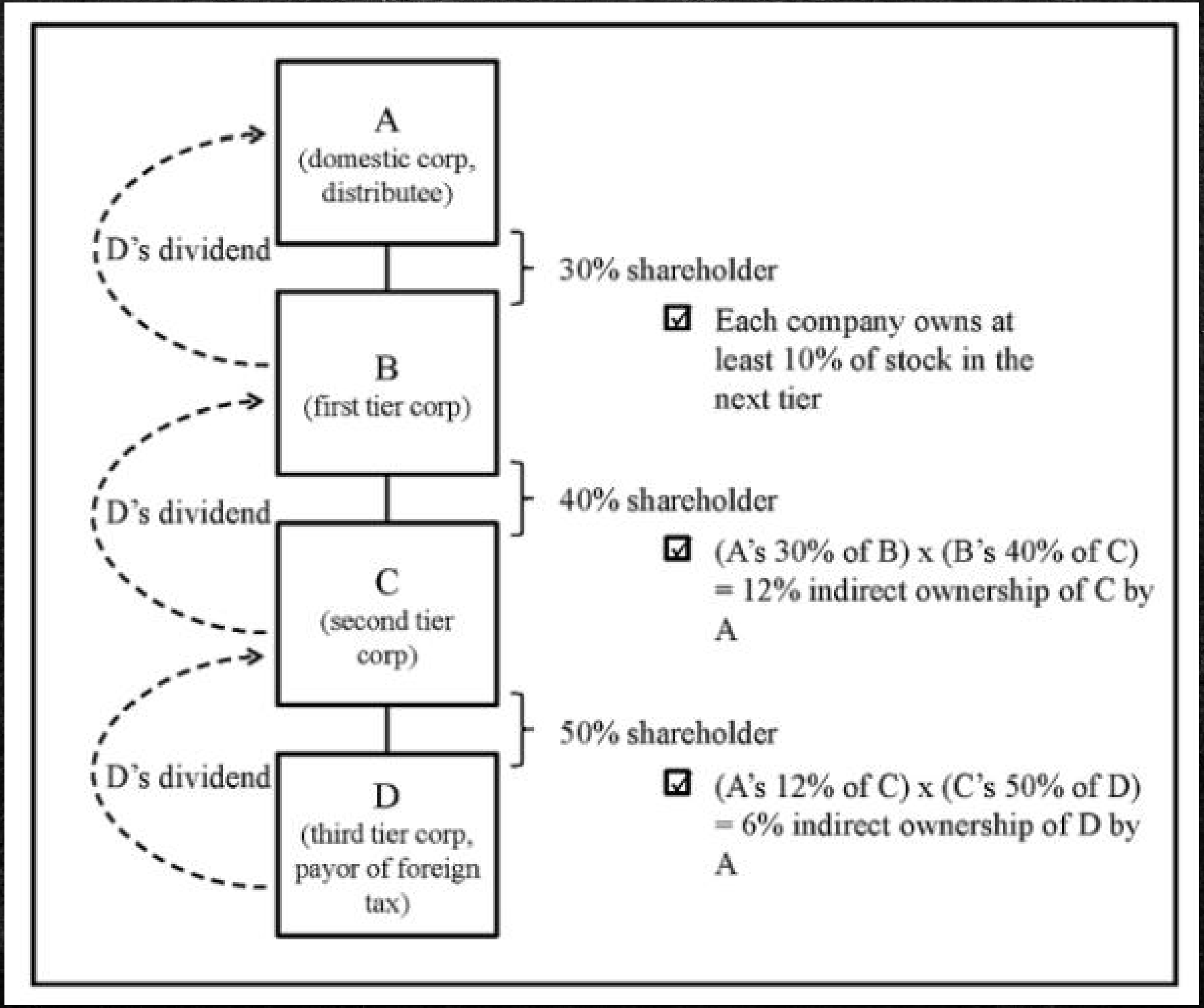
“Deemed Paid” Credit

- Section 902 reduces the aggregate amount of United States taxes by permitting a domestic corporation to claim the credit for foreign taxes paid by certain foreign subsidiaries in respect of earnings distributed to the domestic parent.
- The dividend carries with it an indirect, or “deemed paid,” tax which allows the United States distribute to claim a credit for the taxes actually paid by its subsidiary.

Section 902

- Current law permits a domestic corporation that receives a dividend from a foreign corporation in any taxable year to take a credit for taxes deemed paid if it **owns at least 10 percent** of the voting stock of the foreign corporation.
- In order to claim the credit for lower-tier corporations, the domestic corporate parent must have **at least a five percent** indirect ownership interest in those foreign corporations.
- The deemed paid provisions extend to sixth-tier subsidiaries.

Example: Three-Tiered Ownership Structure For FTC



Direct and Indirect Credit

Direct Foreign Credits	Indirect Foreign Credits
When a taxpayer (in this case the U.S. parent) directly pays foreign taxes, including withholding taxes that are deducted from dividends or other forms of passive income paid to the U.S. parent.	When the U.S. parent gets credit for foreign taxes that were paid on earnings that are repatriated or deemed to be repatriated from foreign corporations.

Participation Exemption

- Participation exemption is an important tax relief provision that became effective in 2018.
- The participation exemption provides for a 100% dividends received deduction for the foreign source portion of dividends from foreign corporations that are at least 10% owned by a U.S. shareholder (such as a U.S. corporation).
- Effectively, the participation exemption results in territorial taxation for the foreign income to which it applies.

Participation Exemption

- As part of adopting the participation exemption, the U.S. imposed a one-time transition tax on the accumulated foreign earnings of foreign subsidiaries that had not previously been subject to U.S. tax.
- The rate was **15.5%** if the foreign income was held in liquid form (e.g., cash) and 8% if held in non-liquid form.
- The transition tax could be paid in installments over an eight-year period.

Does it mean FTC is useless after the tax reform?

FTC Calculation

We assume that a U.S. multinational has established a subsidiary in Australia and one in Ireland. Both subsidiaries earn $100. Assume that the local tax rates on income earned in Australia and Ireland are 30% and 20%, respectively, and that the withholding tax rate on dividends remitted to the U.S. parent is 10% in both Australia and Ireland. That is, each subsidiary must pay to the host government 10% of the dividend it paid to its parent. The remaining 90% of the dividend is remitted to its parent.

EC vs DC firms

Excess Credit	Deficit Credit
• Firms whose foreign tax rate exceeds the U.S. statutory rate	• Firms whose foreign tax rate is less than the U.S. rate

FTC

	Subsidiary		
	A ***Australia Alone***	***B*** ***Ireland Alone***	***Together***
Local taxable income	$100	$100	$200
Local tax (at 30% and 20%)	$30	$20	$50
Withholding tax on dividends (at 10%)	$7	$8	$15
Dividend net of foreign taxes	$63	$72	$135
U.S. taxable income from foreign dividends	$100	$100	$200
U.S. tax at 35%	$35	$35	$70
Foreign tax credit	$35	$28	$65*
Net U.S. tax on foreign dividends	$0	$7	$5
Dividend net of all taxes	$63	$65	$130
Foreign tax credit carryforward	$2	$0	$0

* Notice that the rows do not sum across. The reason has to do with the way the foreign tax limitation is calculated.

Australia

Dividend received	$63	
+ Withholding taxes	7	(Direct tax paid)
+ Indirect foreign taxes	30	(Deemed paid credit)
= Grossed-up dividend	$100	
U.S. tax at 35%	35	
− Foreign tax credit allowed	35	
= Additional U.S. tax due	$0	

FTC = min($7 + $30, $35) = $35

FTC

	Subsidiary		
	***A* Australia Alone**	***B* Ireland Alone**	***Together***
Local taxable income	$100	$100	$200
Local tax (at 30% and 20%)	$30	$20	$50
Withholding tax on dividends (at 10%)	$7	$8	$15
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Foreign tax credit carryforward	$2	$0	$0

* Notice that the rows do not sum across. The reason has to do with the way the foreign tax limitation is calculated.

Ireland

Dividend received	$72
+ Withholding taxes	8
+ Indirect foreign taxes	20
= Total U.S. taxable income (same as column A)	$100
U.S. tax at 35%	35
– Foreign tax credit allowed	28
= Additional U.S. tax due	$7

FTC

	Subsidiary		
	A ***Australia Alone***	***B*** ***Ireland Alone***	***Together***
Local taxable income	$100	$100	$200
Local tax (at 30% and 20%)	$30	$20	$50
Withholding tax on dividends (at 10%)	$7	$8	$15
Dividend net of foreign taxes	$63	$72	$135
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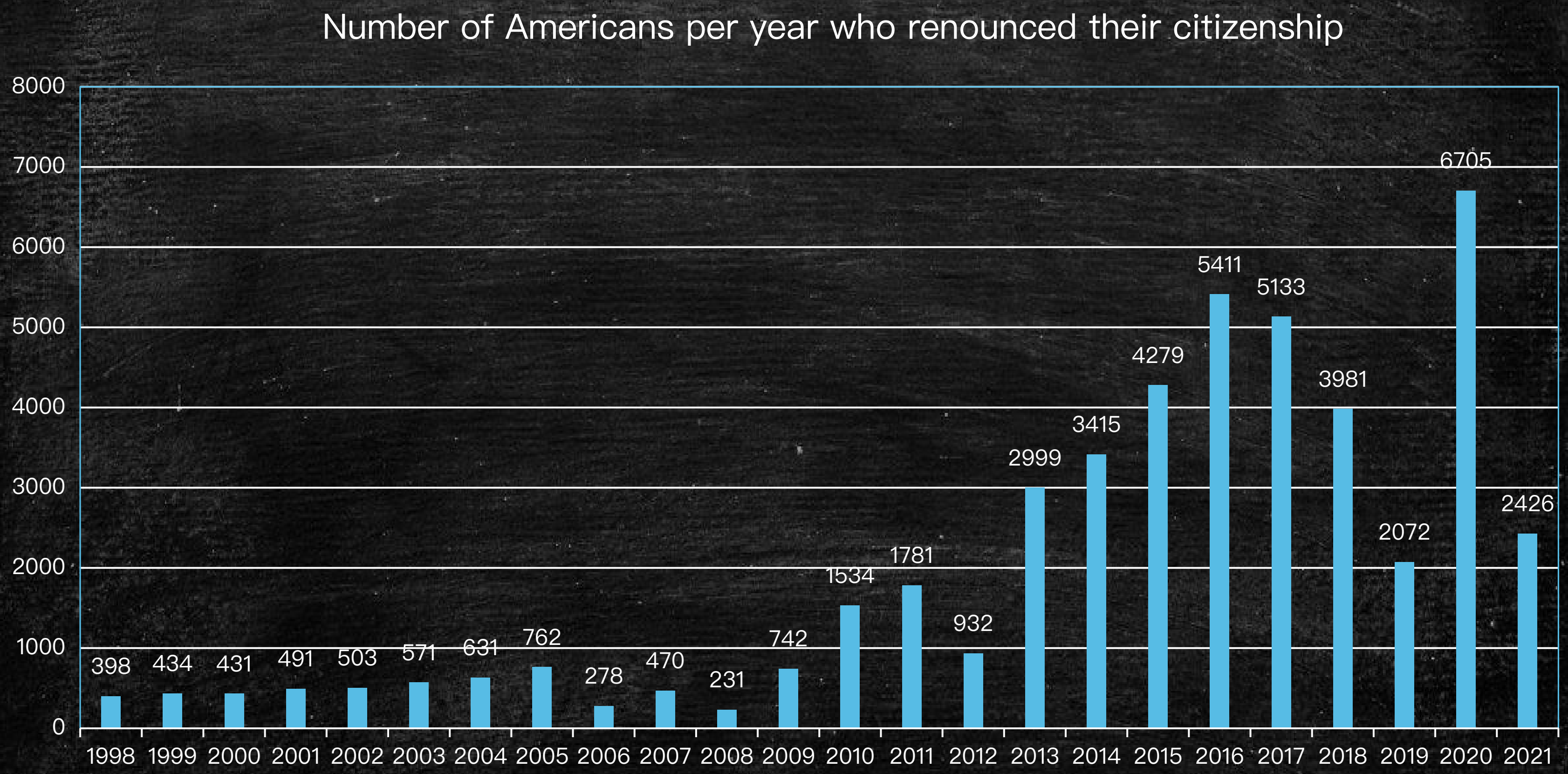
Topics of Today

Tax Consequences of Nationality

- Expatriation
- Tax inversion

Expatriation

Expatriation: Renouncement of U.S. Citizenship



Expatriation to Avoid Tax

We call this renouncement of citizenship expatiation or sometimes reverse immigration

The law imposes a penalty—an "exit tax“ or expatriation tax—on certain people who give up their U.S. citizenship or long-term permanent residence

The taxable income of exit tax is based on the market value on the day before the expatriation date, which usually results in a **capital gain.**

Avoid tax by renouncing their U.S. Citizenship

Expatriation Tax

Expatriation on or after June 17, 2008

If you expatriated on or after June 17, 2008, the new IRC 877A expatriation rules apply to you if any of the following statements apply.

- Your average annual net income tax for the 5 years ending before the date of expatriation or termination of residency is more than a specified amount that is adjusted for inflation ($162,000 for 2017, $165,000 for 2018, $168,000 for 2019, and $171,000 for 2020.
- Your net worth is $2 million or more on the date of your expatriation or termination of residency.
- You fail to certify on Form 8854 that you have complied with all U.S. federal tax obligations for the 5 years preceding the date of your expatriation or termination of residency.

If any of these rules apply, you are a "covered expatriate."

Expatriation Tax

- The expatriation tax provisions §877 and §877A apply to U.S. citizens who have renounced their citizenship and long-term residents (as defined in § IRC 877(e)) who have ended their U.S. resident status for federal tax purposes.
- A U.S. citizen who has abandons U.S. citizenship, or a long-term resident alien who abandons U.S. residence, must recognize gain or loss from all property, wherever located, as though the property had been sold for its fair market value.

Eduardo Saverin

Saverin at the CHINICT conference on May 25, 2012

Born	Eduardo Luiz Saverin 19 March 1982 (age 33) São Paulo, Brazil
Residence	Singapore
Ethnicity	Jewish
Citizenship	Brazilian[1][2] American (Formerly)
Alma mater	Harvard University (B.A., Economics, 2006)

Eduardo Saverin, a co-founder of Facebook, is now ranked #140 on Forbs 400 with $17B net worth in 2022 and #332 in 2023.

He renounced his U.S. citizenship and became a Singapore resident just before Facebook's IPO in 2012.

May 18, 2012 is the IPO date of Facebook. He avoided an estimated $700 million in capital gains taxes.

Tax Inversion

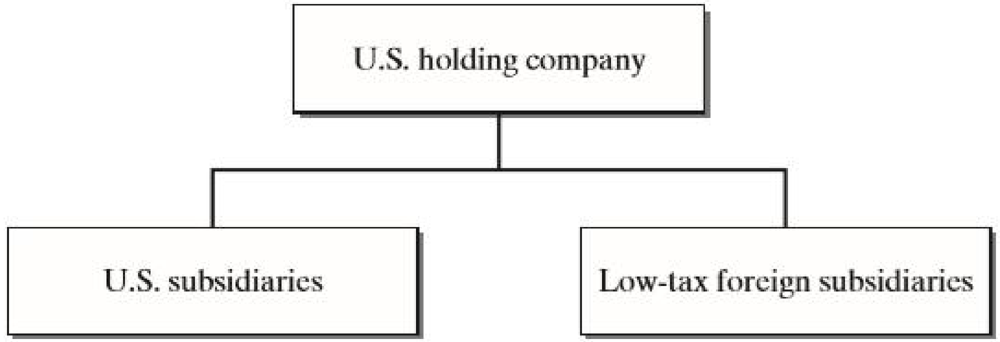
Tax Inversion

Tax inversion, **corporate inversion**, means the relocation of a corporation’s legal domicile to a lower-tax nation, or tax haven, usually while retaining its material operations in its higher-tax country.

Tax Inversion

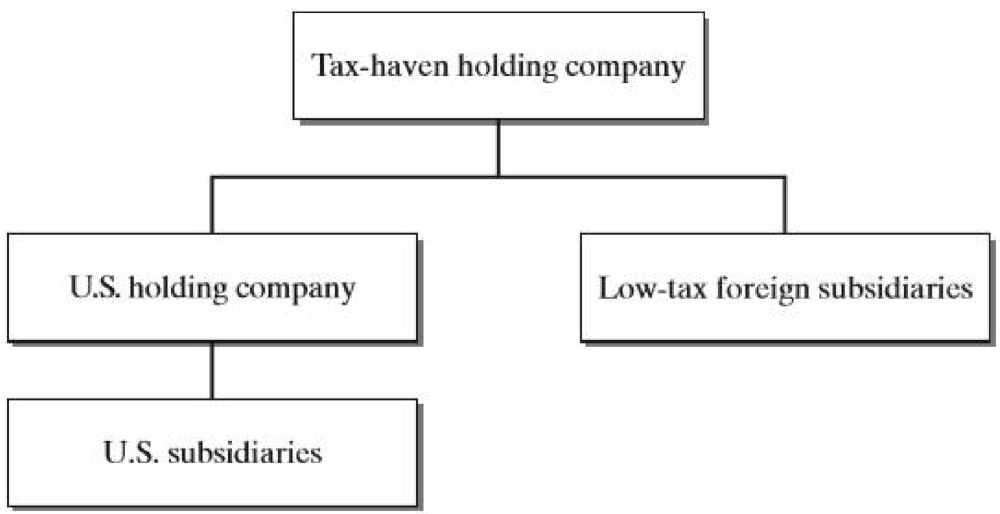
- **Tax inversion**, or **corporate inversion**, refers to the relocation of a corporation's legal domicile to a lower-tax nation, or tax haven, usually while retaining its material operations in its higher-tax country of origin.
- Some U.S. multinationals to consider restructuring their corporate group so that the parent company would be incorporated in a more favorable tax jurisdiction. A common form of this restructuring, known as an inversion transaction, involves placing the former U.S. parent corporation under a newly created foreign parent corporation in a more favorable tax jurisdiction.

Before inversion



Income of low-tax foreign subsidiaries eventually taxed at U.S. rates when income is repatriated or deemed repatriated (i.e., Subpart F) to U.S. parent.

After inversion



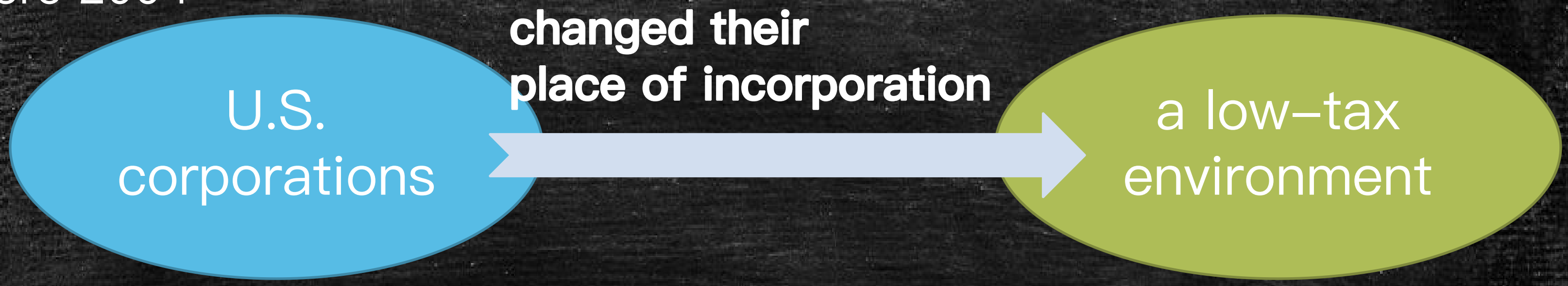
Income of low-tax foreign subsidiaries never taxed at U.S. rates because parent is now located in a tax-haven country; U.S. subsidiaries pay U.S. tax as before.

Anti-Inversion Regulations

- Generally prevent outbound mergers and stock transfers from qualifying for tax-free treatment unless the shareholders of the transferred U.S. corporation receive less than 50% of the shares of the foreign acquiring corporation in the transaction.
- The transaction generally will be taxable (the § 367 "toll charge") to the corporate shareholders if the foreign acquirer is the smaller corporation or is merely a new holding company.

Tax Inversion

Before 2004



More recently

TAX HAVENS

- Tax havens are countries and territories that offer **low tax rates** and **favorable regulatory policies** to foreign investors.
- Tax havens are also known as "offshore financial centers" or "international financial centers," phrases that may carry slightly differing connotations but nevertheless are used almost interchangeably with "tax havens."

Concerns of Tax Havens (OECD, 1998)

- The international reaction to tax havens has focused on the OECD, which in 1998 introduced what was then known as its Harmful Tax Competition initiative (OECD, 1998), and is now known as its Harmful Tax Practices initiative.
- This report sets out the criteria for determining a harmful preferential tax regime in OECD countries and a tax haven.
- The main factors for being a tax haven are a) no or only nominal effective tax rates; b) lack of effective exchange of information; c) lack of transparency; and d) absence of a requirement of substantial activities."

Tax Havens

Andorra
Anguilla
Antigua and Barbuda
Aruba
Bahamas
Bahrain
Barbados
Belize
Bermuda
British Virgin Islands
Cayman Islands
Cook Islands
Costa Rica
Cyprus
Djibouti
Dominica
Gibraltar
Grenada
Guernsey
Hong Kong
Ireland
Isle of Man
Jersey
Jordan
Lebanon
Liberia
Liechtenstein
Luxembourg
Macao
Maldives
Malta
Marshall Islands
Mauritius
Micronesia
Monaco
Montserrat
Nauru
Netherlands Antilles
Niue
Panama
Samoa
San Marino
Seychelles
Singapore
St. Kitts and Nevis
St. Lucia
St. Martin
St. Vincent and the Grenadines
Switzerland
Tonga
Turks and Caicos Islands
Vanuatu

How does an inversion benefit the U.S. corporation?

There are two main tax benefits to an inversion.

- First, the foreign income of the multinational firm is no longer subject to taxation by the United States at the corporate level.
- Second, an inversion increases the tax incentive to engage in income shifting from high tax to low tax jurisdictions, such as by locating intercompany loan in a tax haven to achieve "interest stripping" of income into the tax haven.

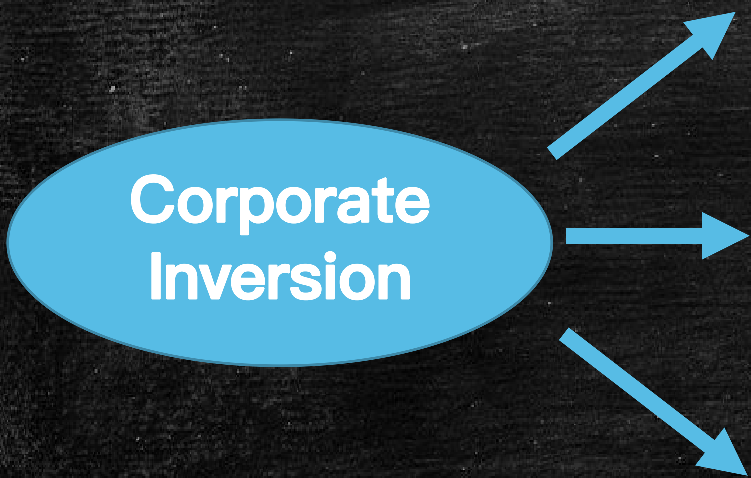
Cause of Corporate Inversions

Corporate Inversions

(1) U.S. corporate income tax rate
> international standards

(2) world-wide income

The Impact of Corporate Inversion on Tax Collections

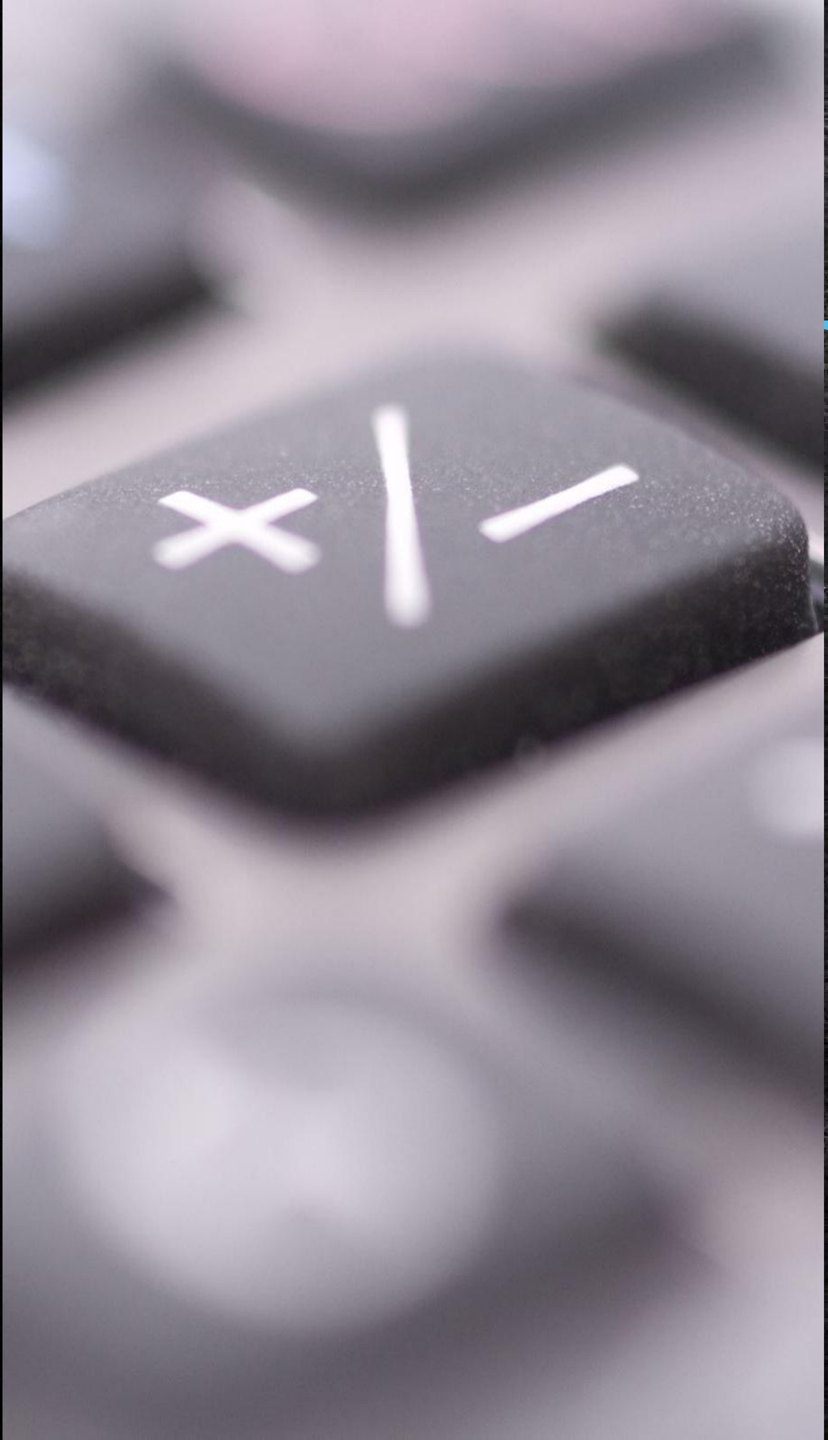


+ An immediate capital gain tax

− A reduction in federal tax collections due to the tax base erosion

+ An increase in federal tax collections over time due to real growth

A Mini-Case Study : Stanley Black & Decker



Before we start our mini-case study…

You need to know:

NPV

NPV Rules

Flow Variable vs. Stock Variable

The Net Present Value (NPV) Rule

Net Present Value (NPV)	Total PV of future CF's + Initial Investment
Estimating NPV	1. Estimate future cash flows: how much? and when? 2. Estimate discount rate 3. Estimate initial costs
Minimum Acceptance Criteria	Accept if NPV > 0
Ranking Criteria	Choose the highest NPV

Stanley Black & Decker, Inc., formerly known as The Stanley Works, is a Fortune 500 American manufacturer of industrial tools and household hardware and provider of security products and locks headquartered in New Britain, Connecticut. Executives of the company felt it necessary to incorporate at least a portion of their business outside the United States in order to compete in today's global marketplace. Like a host of U.S. corporations in various industries, Stanley Black & Decker is considering re-incorporation in another country to reduce tax.

Stanley Black & Decker executives have estimated that the federal government may receive up to $150 million in capital gains taxes immediately as a result of the inversion transaction. Additionally, Stanley accountants estimate that the re–incorporation will save the company (i.e. "cost" the Treasury) $50 million per year. Finally, the company estimates that the inversion will increase the value of Stanley stock as well as earnings by 2 percent each year. As of March 20, 2015, Stanley Black & Decker had a total market capitalization of $15.2 billion. As of Jan 3, 2015, the end of last fiscal year, Stanley had earnings before income taxes of $1084.8 million. Assuming an aggregate effective capital gains tax rate of 15 percent, an income tax rate of 35 percent, and an interest rate of 2.5 percent over the next ten years.

A Mini-Case Study

Questions:

What is the total loss to the treasury as a result of the company's inversion ?

Would you consider the corporate inversion if you were the executive officer of Stanley Black & Decker?

A Mini-Case Study

Consolidated Statements of Operations
Fiscal years ended January 3, 2015, December 28, 2013, and December 29, 2012
(In Millions of Dollars, Except Per Share Amounts)

		2014
Net Sales	$	11,338.6
Costs and Expenses		
Cost of sales	$	7,235.9
Selling, general and administrative		2,575.0
Provision for doubtful accounts		20.9
Other-net		239.7
Restructuring charges and asset impairments		18.8
(Gain) loss on debt extinguishment		(0.1)
Interest income		(13.6)
Interest expense		177.2
	$	10,253.8
Earnings from continuing operations before income taxes		1,084.8
Income taxes on continuing operations		227.1
Earnings from continuing operations	$	857.7
Less: Net earnings (loss) attributable to non-controlling interests		0.5
Net earnings from continuing operations attributable to common shareowners	$	857.2
(Loss) earnings from discontinued operations before income taxes (including pretax gain on HHI sale of $384.7 million in 2012)		(104.0)
Income tax (benefit) expense on discontinued operations (including income taxes associated with the gain on HHI sale of $25.8 million in 2012)		(7.7)
Net (loss) earnings from discontinued operations	$	(96.3)
Net Earnings Attributable to Common Shareowners	$	760.9

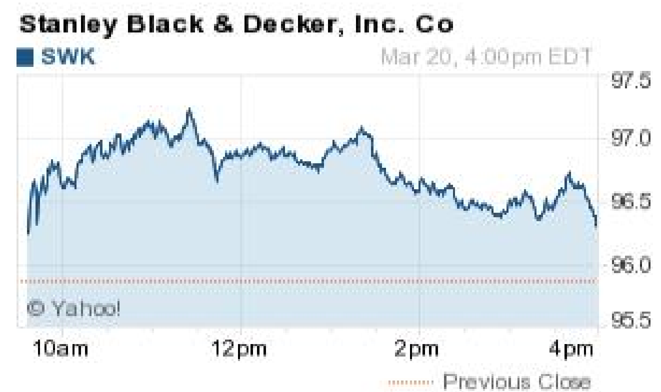
A Mini–Case Study

Stanley Black & Decker, Inc. (SWK) - NYSE ★ **Watchlist** **Add to Portfolio**

96.32 ↑ **0.45(0.47%)** Mar 20, 4:04PM EDT

After Hours : **96.32** 0.00 (0.00%) Mar 20, 7:02PM EDT

Prev Close:	95.87	Day's Range:	96.13 - 97.25
Open:	96.16	52wk Range:	75.90 - 100.44
Bid:	93.04 x 200	Volume:	1,923,789
Ask:	100.00 x 100	Avg Vol (3m):	1,276,400
1y Target Est:	101.45	Market Cap:	15.16B
Beta:	0.95	P/E (ttm):	20.21
Earnings Date:	Apr 22 - Apr 27 (Est.)	EPS (ttm):	4.77
		Div & Yield:	2.08 (2.20%)



1d 5d 1m 3m 6m 1y 2y 5y max

customize chart

People viewing SWK also viewed:

A Mini-Case Study : Stanley Black & Decker

Corporate Inversion

+ The federal government may receive up to $150 million in capital gains taxes immediately

– The re-incorporation will save the company $50 million per year

+ Increase the value of stock as well as earnings by 2% each year

- As of March 20, 2015, Stanley Black & Decker had a total market capitalization of $15.2 billion.
- As of Jan 3, 2015, the end of last fiscal year, Stanley had earnings before income taxes of $1084.8 million.
- Assuming an aggregate effective capital gains tax rate of 15 percent, an income tax rate of 35% , and an interest rate of 2.5% over the next ten years.

Other benefits of Inversion

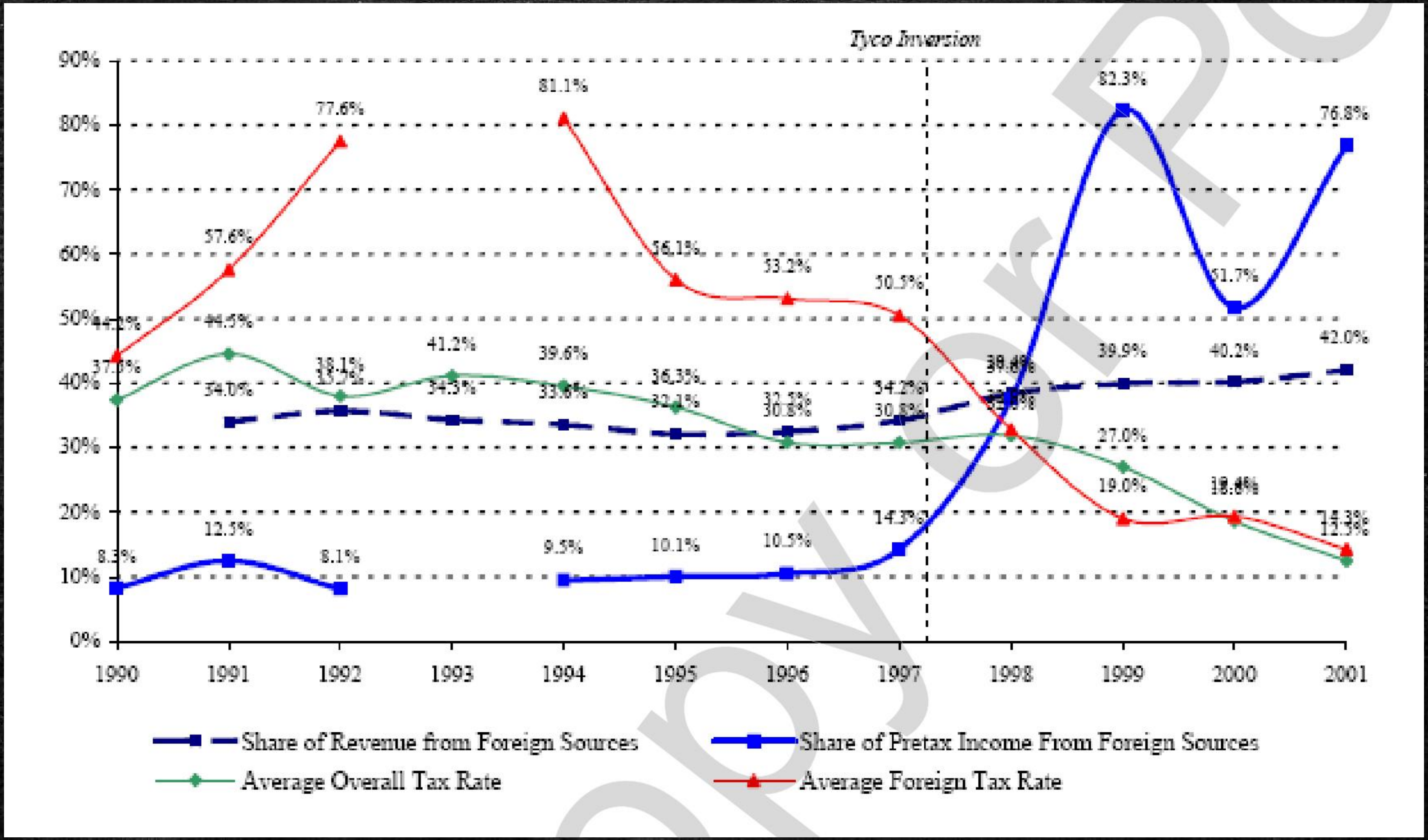
- Anticipation of dramatic growth of foreign investment and profitability
- Possible regulatory benefits
- The expectation of future tax savings associated with domestic operation

What Else?

TYCO Inversion

- Tyco moved its legal domicile to Bermuda in 1997, inverting its corporate as Stanley proposes do.
- Following its inversion, Tyco enhanced its financial performance by using intercompany loans to relocate profits in tax havens.
- Tyco’s foreign source income averaged 10% of total income in the early 1990s, but rose to 82% of total income in 1999.
- Therefore, an alternative explanation for why inversions increase the value of a firm: most of the increase in firm value comes from shipping U.S. income abroad.

TYCO Inversion

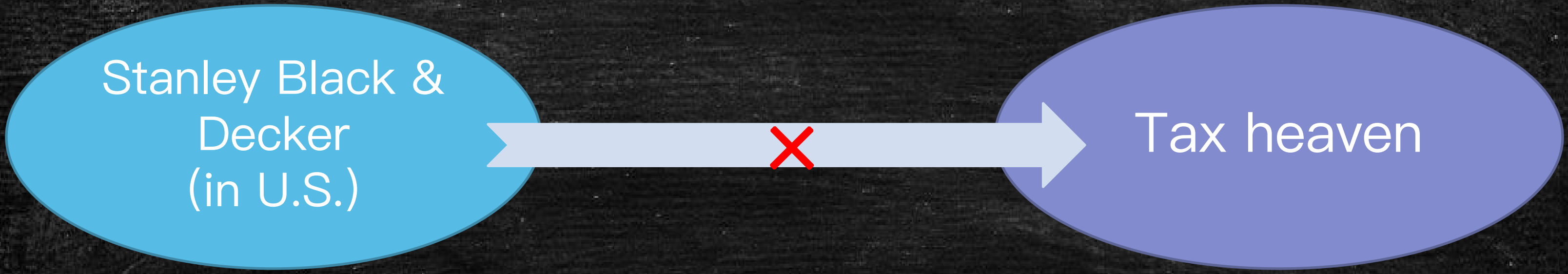


TYCO Inversion

- Tyco's tax avoidance strategies relied on complex structures that made it difficult for analysts and even board members to understand how the company actually worked.
- In 2005, Tyco's CEO Dennis Kozlowski and CFO Mark Swarts were convicted of defrauding Tyco of hundreds of millions.

What is your take of corporate inversion if you are the shareholder? Should Stanley relocate to Bermuda?

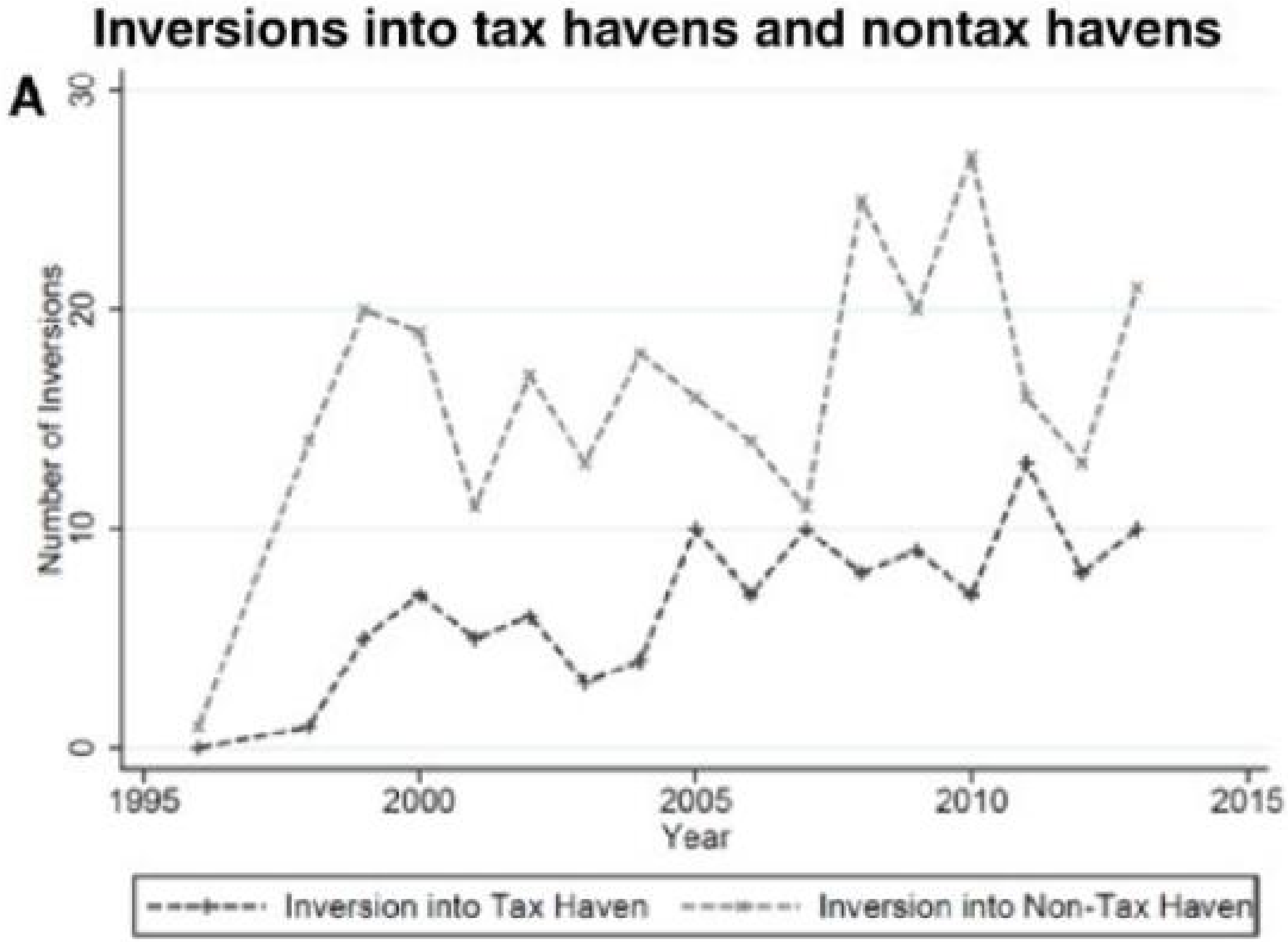
Back to Stanley Inversion

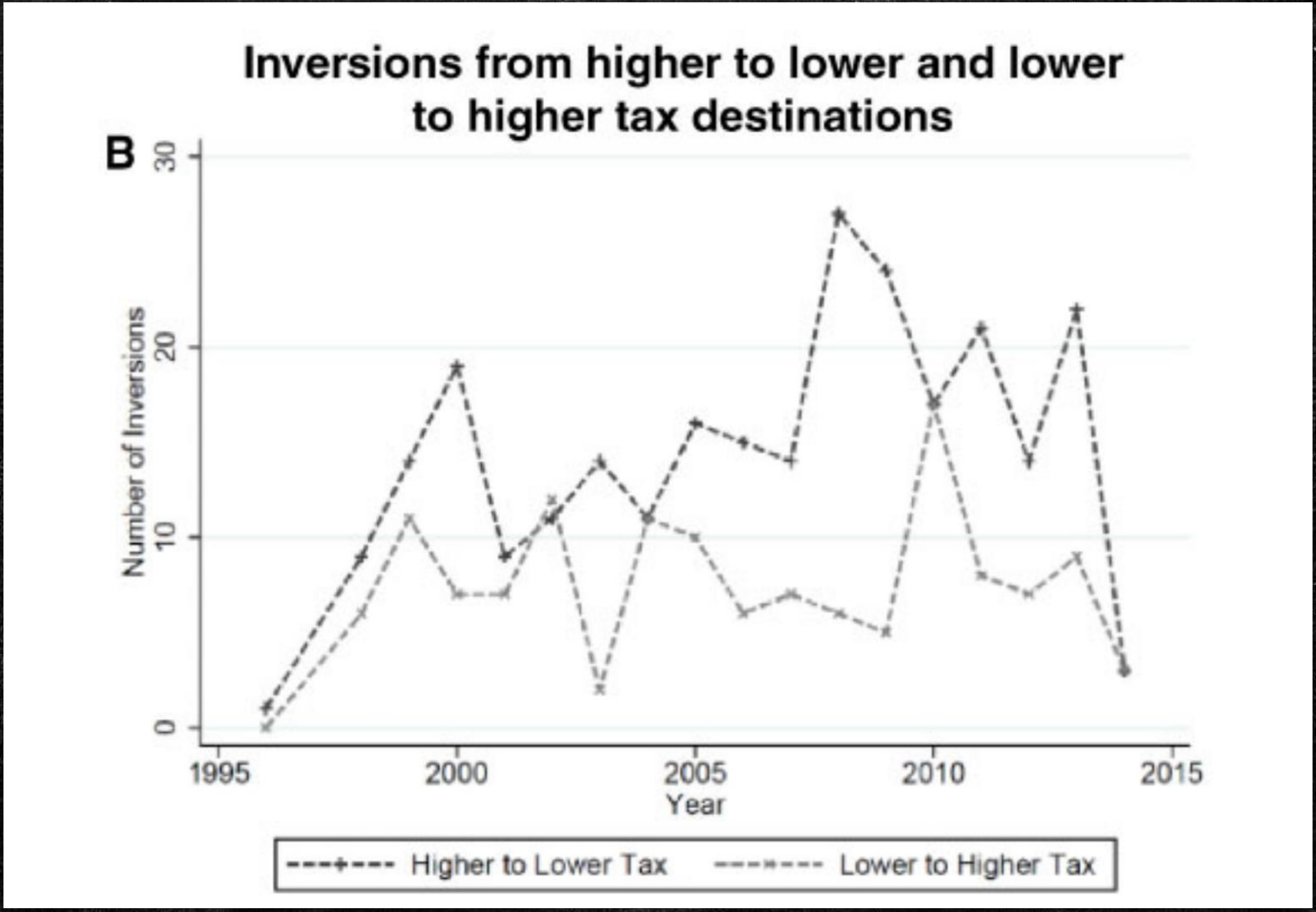


In the end, Stanley decided not to go through with the inversion transaction.

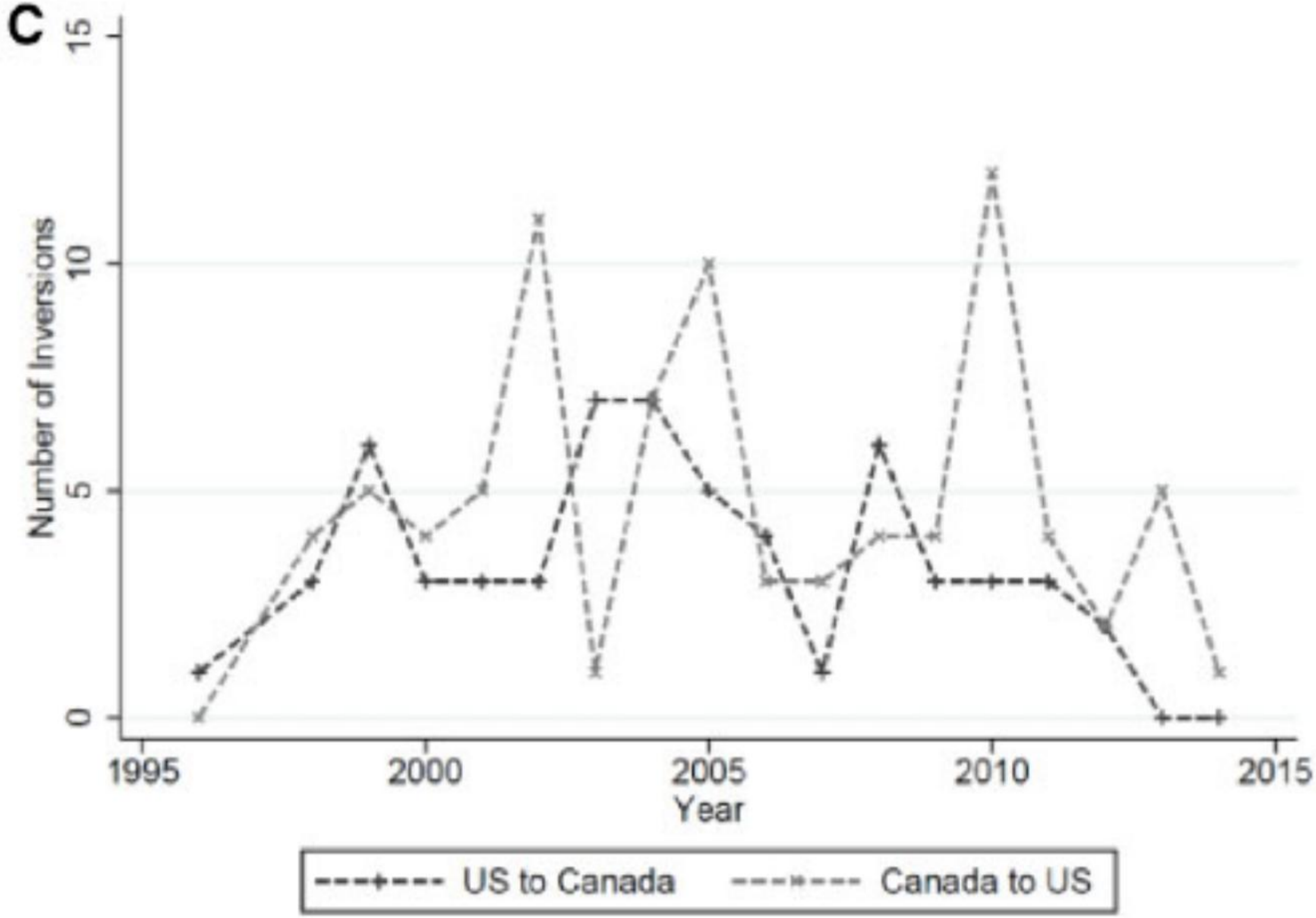
Here is Stanley’s official response :
“Over a year ago the company set out on a course to deal with foreign companies who are advantaged by significantly lower income tax rates. Re-incorporate in Bermuda was then the clearest path to that end. Recently, however, a number of changes have occurred; most positively the U.S. congress has started down a path to deliver comprehensive tax changes that would eliminate the inequities of U.S. international taxation and thereby accomplish Stanley’s original goal.”

Corporate inversions are purely tax driven?


Inversions into tax havens and nontax havens
A
Number of Inversions
0
10
20
30
1995
2000
2005
2010
2015
Year
Inversion into Tax Haven
Inversion into Non-Tax Haven


Inversions from higher to lower and lower
to higher tax destinations
B
30
20
10
0
Number of Inversions
1995
2000
2005
2010
2015
Year
Higher to Lower Tax
Lower to Higher Tax

Inversions between the United States and Canada



Corporate Inversions: Going beyond Tax Incentives

Burcin Col
Pace University

Rose Liao
Rutgers University

Stefan Zeume
UIUC

We study tax and nontax incentives for corporate inversions in a hand-collected data set of 691 inversions out of 11 home countries into 45 host destinations over the 1996–2013 period. Even though lower tax rates generally attract inversions, only 2 of 5 firms invert into tax havens, and two-thirds of firms invert into host destinations with lower statutory tax rates than those faced at home. Moreover, firms invert to geographically close destinations with similar governance standards. Using staggered country-pair-level policy changes as experiments, we find that host-country governance may explain why not all firms invert. (*JEL* G34, H26)

Received December 6, 2018; Editorial decision August 12, 2019 by Editor Andrew Ellul.