The University of Queensland
Australia
CREATE CHANGE

Lecture 11: International Tax Issues

Reading: Eun & Resnick Ch.21 (10th ed.)

The Objectives

- The twin objectives/principles of taxation are:
  – Tax neutrality
  – Tax equity
- The different taxes MNCs pay
- Foreign Tax Credits
- Transfer Pricing
- Corporate Inversions

International Taxation

- Ways in which profits of foreign entities of domestic (Australian) firms can be treated for tax purposes

	Double Taxation	Exclusion Method	Credit Method
Singapore			
Branch profit	100	100	100
Tax (17%) **(a)**	17	17	17
Net Profit	83	83	83
Australia			
Net Singaporean profit	83	83	83
Gross Up	0	0	17
Taxable Income	83	0	100
Tax (30%)	24.9	0	30
Tax Credit	0	0	17
Net Tax Due **(b)**	24.9	0	13
Total Taxes (a) + (b)	41.9	17	30
Net Income	58.1	83	70

Tax Neutrality

- A tax scheme is *tax neutral* if it meets three criteria:
  - **Capital import neutrality** (exclusion method): the tax burden on an MNC subsidiary should be the same regardless of where in the world the MNC in incorporated.
  - **Capital export neutrality** (credit method): the tax scheme does not incentivize citizens to move their money abroad.
  - **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.

Tax Equity

- Tax equity means that regardless of the country in which an MNC affiliate 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.

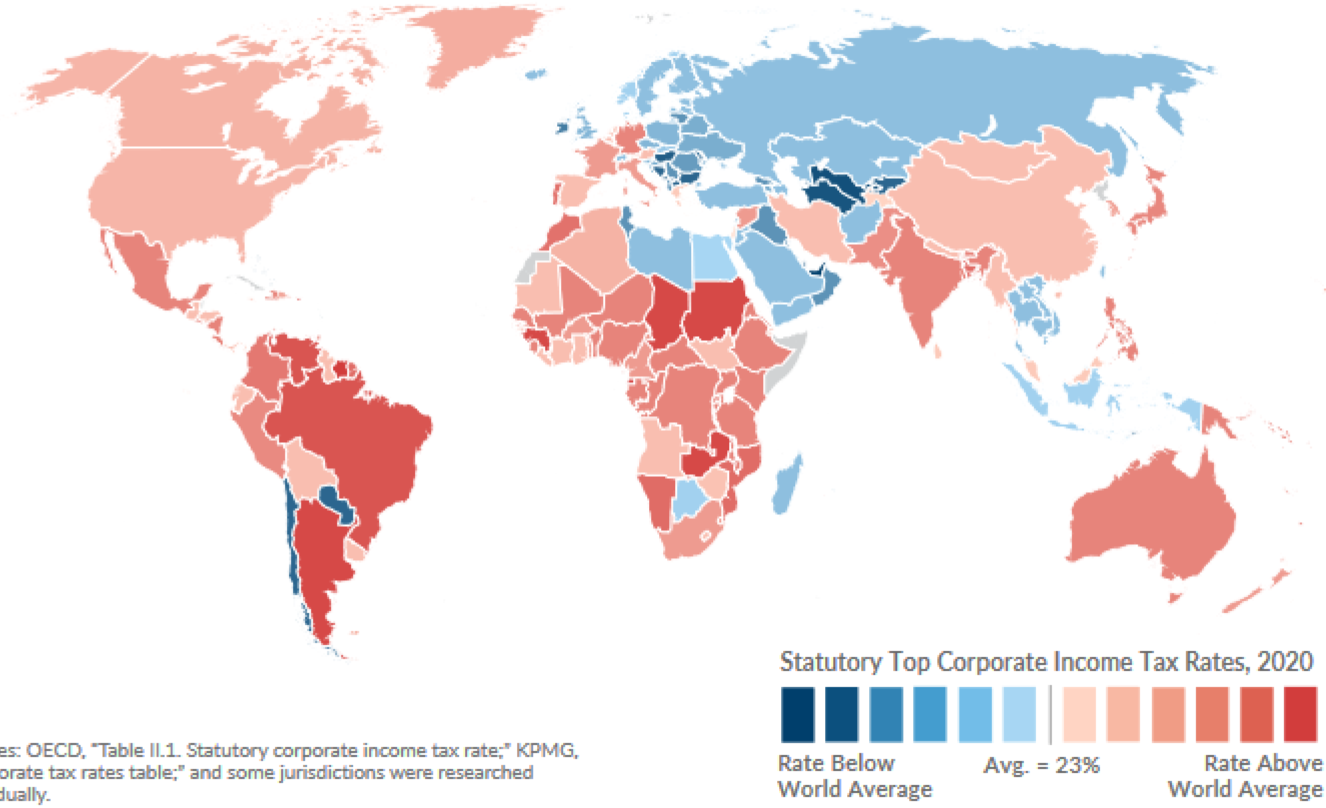
Types of Taxation

- (Corporate) Income tax
  - An income tax is a *direct tax*, or a tax that is paid directly by the taxpayer upon whom it is levied.
- Withholding tax
  - Tax on passive income like dividends, interest, royalties
    - Tax treaty between Australia & US means, American investors are subject to 10% withholding tax on dividends they receive. This tax would be rebated as a tax credit in their home jurisdiction (i.e., the US).
- Value-added tax/Goods & Services Tax
  - An *indirect* tax

FIGURE 1.

Corporate Tax Rates around the World

Statutory Top Corporate Income Tax Rates, 2021



Sources: OECD, "Table II.1. Statutory corporate income tax rate;" KPMG, "Corporate tax rates table;" and some jurisdictions were researched individually.

Australian Corporate Tax Rate

- The **corporate tax** rate is 30 percent. The corporate income tax rate applies to both resident and non-resident companies.

  A resident company is liable to corporate income tax on its worldwide income and capital gains. A non-resident company is liable to corporate income tax on its Australian-source income only, and on capital gains from the disposal of an asset that is taxable Australian real property (TARP). Broadly, TARP will include Australian real property and certain indirect interests in Australian real property.

  The Australian tax system provides taxation relief against international double taxation by granting foreign tax offsets in some circumstances and in others, by exempting the foreign income from Australian tax. The corporate income tax rate applies to income earned during the period from 1 July to 30 June of the following year.
- **Indirect tax** There has been no changes to the GST rate of 10 percent since it was introduced.

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 income from dividends and interest, royalties, patents, or copyrights.
  - In Australia, the tax on dividends is 15% (may depend on tax treaty), on royalties/patents/copyright it is 5%
- A withholding tax is an *indirect tax*.

Value-Added Tax

- A value-added tax (e.g. GST in Australia) is an indirect national tax levied on the *value added* in production of a good or service.
- It is an indirect tax.
- In terms of incentives, GST/VAT differs from corporate taxes
  - An income tax has the incentive effect of discouraging work.
  - A GST/VAT has the incentive effect of discouraging consumption (thereby encouraging saving.)
  - GST is easier to administer. It is 10% in Australia.

Value-Added Tax Calculation

- Assume the tax rate is 15%. Suppose that stage one is the sale of raw materials to the manufacturer, stage two is the sale of finished goods to the retailer, and stage three is the sale of inventory from the retailer to the consumer.

Production Stage	Selling Price	Value Added	Incremental GST	
1	\$100	\$100	\$15	$= \$100 \times 0.15$
2	\$300	\$200	\$30	$= \$200 \times 0.15$
3	\$380	\$80	\$12	$= \$80 \times 0.15$
		Total GST	\$57	$= \$380 \times 0.15$

National Tax Environments

- Worldwide taxation
  - Residents of a country are taxed on their worldwide income, no matter in which country it was earned.
- Territorial taxation
  - Residents of a country are taxed based on where the taxable event occurred.
- Foreign tax credits

Foreign Tax Credits

- Allow taxpayers to recover somewhat from *double taxation*.
- It’s a direct reduction of taxes that would otherwise be due and payable.
- *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.

FTC Example

- Assume that an Australian firm has a subsidiary in the UK. UK (Australian) corporate tax rate is 19% (30%).

		Without Foreign Tax Credits
A	**Before tax foreign income**	10000
B	Less foreign Tax (19%)	1900
C	**Available to parent as dividend**	**8100**
D	Less additional parent country tax (30%)	2430
E	Less Incremental Tax (after credits)	-
F	**Profit after Taxes**	5670
G	Total Taxes in both Jurisdictions (B+D)	4330
H	Effective Overall Tax Rate (Total taxes paid (G)/Foreign Income (H))	43.3%

Branch vs Subsidiary Income

- An overseas affiliate of a 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.

Transfer Pricing

- 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.
  - See Lecture **8** example (worksheet “Payments to Parent”)
- It is a method of transferring funds out of the foreign subsidiary
  - 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.

Transfer Pricing (2)

- The pricing of goods, services and technology transferred enter directly into the cost of goods sold component of the subsidiary's income statement.
- The price should be one that a willing seller would charge a willing *unrelated* buyer.
- Managers should address several issues
  - Fund positioning effect
  - Income tax effect (see example in next slide)
  - Managerial incentives
  - The effect of joint ventures

Transfer Pricing – An Example

- St Lucia is operating in France, a relatively high tax country, and in Australia. Tax in France (Australia) is 33% (30%).

		St Lucia Mycology		St Lucia Mycology (French Subsidiary)
Low-Markup Policy				
Sales		1400		2000
Less Cost of Goods Sold*		1000		1400
Gross Profit		400		600
Less Operating Expenses		100		100
Taxable Income		300		500
Less Income Taxes	30%	90	33%	165
Net Income		210		335
High-Markup Policy				
Sales		1700		2000
Less Cost of Goods Sold*		1000		1700
Gross Profit		700		300
Less Operating Expenses		100		100
Taxable Income		600		200
Less Income Taxes	30%	180	33%	66
Net Income		420		134

* sales of the Australian firm is the cost of goods sold for the European subsidiary

Cross-Crediting

- The ability of cross-credit is valuable
  - It involves offsetting foreign tax *credits* with foreign tax *deficits* in the same period

Mycology (Ireland)

Declares a dividend to its Aust. parent

Withholding tax of 0% (due to tax treaty)

Has paid **less** than the Aust. tax requitement of 30%

$\tau_c = 12.5\%$

Deficit Foreign Tax Credit

Mycology (UAE)

Declares a dividend to its Aust. Parent.

No withholding tax

Has paid **more** than the Aust. tax requitement of 30%

$\tau_c = 55\%$

Excess Foreign Tax Credit

Mycology (Aust.)
Pays taxes of 30%

Offset *deficit* tax credits against *excess* tax credits

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 an MNC to establish a shell company.
- Most countries are clamping down on it use
  - In the US, 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.

Corporate Inversion

- A Corporate inversion is the changing of a country's country of incorporation.
  - By reincorporating in a lower-tax jurisdiction firms reduce their global tax liabilities.
  - All it is is a new corporate home.
- Rules have been put in place to prevent *naked inversions*. They allow for inversions when
  - Substantial business presence
  - Merger with a larger foreign firm
  - Merger with a smaller foreign firm

International Tax

- Taxes matter
- The three basic types of taxation are income tax, withholding tax, and value-added tax.
- Nations often tax the worldwide income of resident taxpayers and also the income of foreign taxpayers doing business within their territorial boundaries.
- If countries simultaneously apply both methods, double taxation will result unless a mechanism is established to prevent it. Foreign tax credit eliminates double taxation.
- Transfer pricing is a means to reposition funds within a MNC and a possible technique for reducing tax liabilities.