Topic 11 Solutions

Note: All the questions for this topic are from the text (Chapter 21) and the 2021 exam question.

1. Discuss the twin objectives of taxation.
2. Compare and contrast the three basic types of taxation that governments levy within their tax jurisdiction. **(*)**
3. Show how double taxation on a taxpayer may result if all countries were to tax the worldwide income of their residents and the income earned within their territorial boundaries. **(*)**
4. What methods do taxing authorities use to eliminate or mitigate the evil of double taxation?
5. How might a MNC use transfer pricing strategies? How do import duties affect transfer pricing policies? **(*)**
6. What are the various means the taxing authority of a country might use to determine if a transfer price is *reasonable*? **(*)**
7. Discuss how a MNC might attempt to repatriate blocked funds from a host country.
8. Exam Question from 2021 **(*)**

(i) To kick start its economy, Country X is offering subsidised loans to Australian companies willing to set up operations there. The loan is $25 million at 3% when the market interest rate for such an investment is 8%. The loan is to be paid off in equal annual instalments over years.

(a) What is the before tax value of this interest subsidy?

(b) The projected before-tax income from the plant in Country X is $1 million annually with the first set of cashflows arriving at the end of Year 1. The corporate tax rate in Country X is 25% and it also has a 20% dividend withholding tax. Country X confers a (corporate) tax holiday on the plant's income for the first five years. If the Australian firm remits all the dividends that it receives back to Australia, how much is the (corporate) tax holiday, in the form of tax credits, worth to the firm?

Note: The Australian corporate tax rate is 30%. Country X's tax rules does not allow for a tax holiday on dividends.

(ii) The Tax Office of Arcadia (fictitious country) just announced that it would scrap the 20% withholding tax imposed on interest payments to foreign investors holding Arcadian government bonds. Until now, investors from countries with a double-taxation agreement with Arcadia had to wait for two years to claim back a portion of the interest that was withheld. What might be the reason(s) for the Government of Arcadia to eliminate this tax?

PROBLEMS

1. There are three production stages required before a pair of skis produced by Fjord Fabrication can be sold at retail for NOK2,300. Fill in the following table to show the value added at each stage in the production process and the incremental and total VAT. The Norwegian VAT rate is 25 percent. **(*)**

Production Stage	Selling Price	Value Added	Incremental VAT
1	NOK 450		
2	NOK1,900		
3	NOK2,300		
		Total VAT	

2. The Docket Company of Asheville, NC USA is considering establishing an affiliate operation in the city of Wellington, on the South Island of New Zealand. It is undecided whether to establish the affiliate as a branch operation or a wholly owned subsidiary. New Zealand taxes income of both resident corporations and branch operations at a flat rate of 28 percent. New Zealand withholds taxes at 5 percent on dividends for an investor who holds at least 10 percent of the shares in the subsidiary company that pays the dividend; 0 percent if the investor holds 80 percent or more of the shares in the subsidiary company and meets other criteria; 15 percent in all other cases. New Zealand does not withhold taxes on branch income. The United States has an income tax rate of 35 percent on income earned worldwide but gives a tax credit for taxes paid to another country. Based on this information, is a branch or subsidiary the recommended form for the affiliate?

3. Affiliate X sells 10,000 units to Affiliate Y per year. The marginal tax rates for X and Y are 20 percent and 30 percent, respectively. The transfer price per unit is currently set at $1,000, but it can be set as high as $1,250. Calculate the increase in annual after-tax profits if the higher transfer price of $1,250 per unit is used.

MINI CASE: SIGMA CORP.'S LOCATION DECISION

Sigma Corporation of Boston is contemplating establishing a wholly owned subsidiary operation in the Mediterranean. Two countries under consideration are Spain and Cyprus. Sigma intends to repatriate all after-tax foreign-source income to the United States. In the U.S., corporate income is taxed at 35 percent. In Cyprus, the marginal corporate tax rate is 10 percent. In Spain, corporate income is taxed at 30 percent. The withholding tax treaty rates with the U.S. on dividend income paid is 5 percent from Cyprus and 10 percent from Spain.

The financial manager of Sigma has asked you to help him determine where to locate the new subsidiary. The location decision of Cyprus or Spain will be based on which country has the smallest total tax liability.

MINI CASE: EASTERN TRADING COMPANY'S OPTIMAL TRANSFER PRICING STRATEGY

The Eastern Trading Company of Singapore ships prepackaged spices to Hong Kong, the United Kingdom, and the United States, where they are resold by sales affiliates. Eastern Trading is concerned with what might happen in Hong Kong now that control has been turned over to China. Eastern Trading has decided that it should reexamine its transfer pricing policy with its Hong Kong affiliate as a means of repositioning funds from Hong Kong to Singapore. The following table shows the present transfer pricing scheme, based on a carton of assorted, prepackaged spices, which is the typical shipment to the Hong Kong sales affiliate. What do you recommend that Eastern Trading should do?

Eastern Trading Company Current Transfer Pricing Policy with Hong Kong Sales Affiliate	*Singapore Parent*	*Hong Kong Affiliate*	*Consolidated Company*
Sales revenue	S$300	S$500	S$500
Cost of goods sold	200	300	200
Gross profit	100	200	300
Operating expenses	50	50	100
Taxable income	50	150	200
Income taxes (20%/17.5%)	10	26	36
Net income	40	124	164