Basics of International Tax - Earning Income from Cross-Border Activities

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Speakers

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Alison Maxwell (DLA Piper) concentrates her practice in international tax with a focus on global expansion, operational structuring, cross-border mergers and acquisitions, legal entity rationalization, and post-acquisition integration. Alison has assisted a wide range of clients, from startups to multibillion-dollar multinationals, in global expansion, structuring acquisitions, cross-border financing, integrating legal entities and ensuring that the final international structure can efficiently meet both US and foreign compliance requirements. She is head coach of her sons' Little League teams.

Dave Macklin (EY) has spent 14 years with EY specializing in international tax matters, and is currently a member of EY Seattle's International Tax and Transaction Services Practice. Immediately prior to taking his role in Seattle, Dave was a member of EY Miami's International Tax Services Practice. Dave was also a member of EY's US Tax Desk in Hong Kong for a term of 4 years. In this role, Dave covered the Asia Pacific region and provided US Tax advice to Asia Pacific companies investing in the US. Dave began his career with EY's Cincinnati office where he joined EY's International Tax Services Practice.

Agenda

1. **International Tax Overview**

2. **US Taxation of US Multinational Companies**
   - Introduction
   - Subpart F Income
   - Global Intangible Low-Taxed Income (“GILTI”)

3. **Foreign Taxation of US Multinational Companies**
   - Introduction
   - US Parent Corp Subject to Foreign Taxation
   - Foreign Subsidiaries Subject to Foreign Taxation

4. **Transfer Pricing and Intercompany Agreements**

1. International Tax Overview

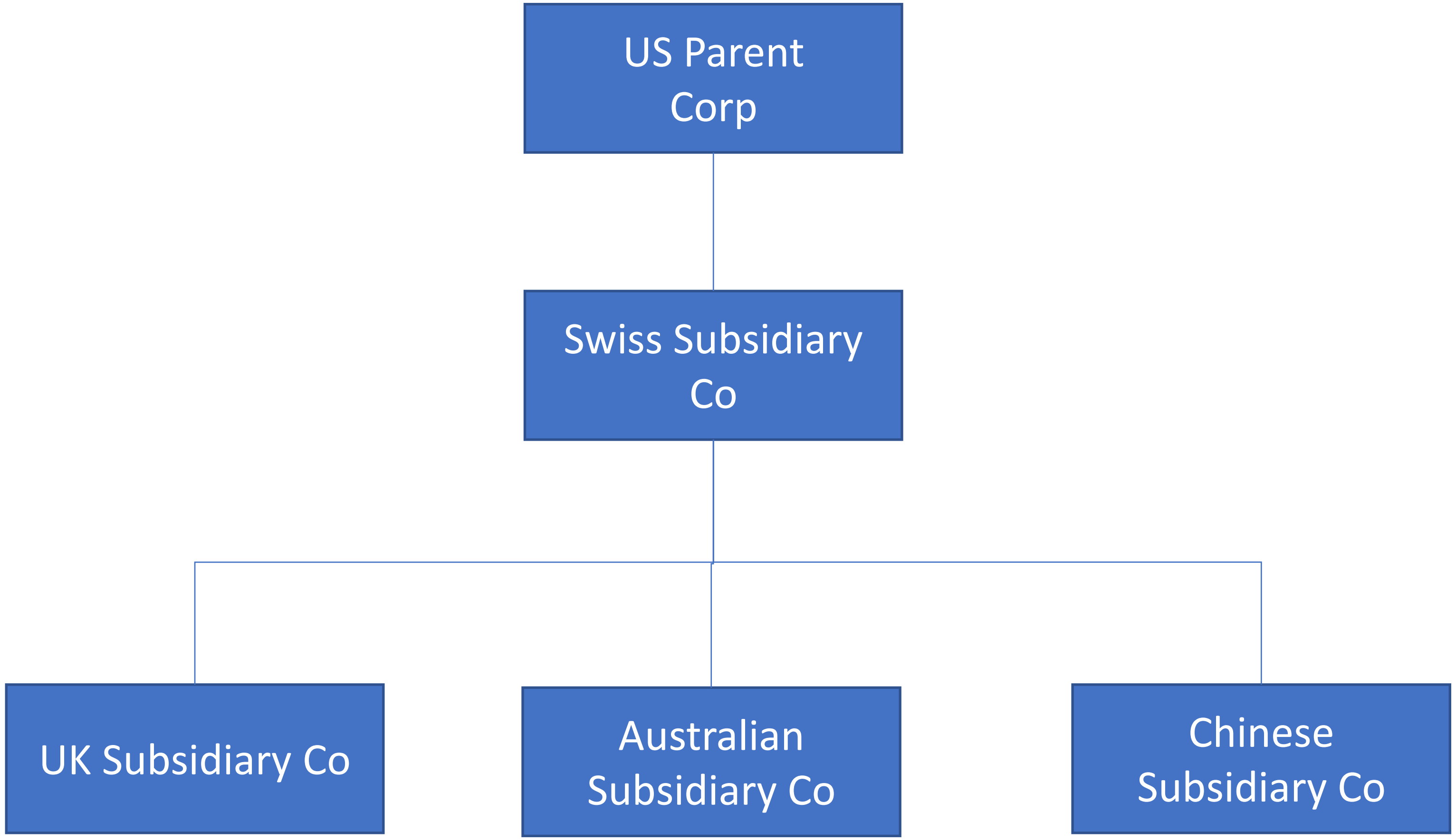
International Tax Overview
Introduction

Which country gets to levy tax?

How do taxpayers avoid double tax?

International Tax Overview

Today's Focus – US Multinational



2. US Taxation of US Multinational Companies

The "Old" US International Tax System

- High corporate tax rate – 35%
- Deferral of foreign corporate earnings (unless subpart F)
- Ability to base erode US companies through interest and other payments
- US companies incentivized to earn income overseas and leave such income overseas
- Inbound investors incentivized to lower US tax base through base eroding payments

The "New" US International Tax System

- **Rate Reduction**: 35% to 21%
- **Anti-deferral**: Global intangible low-taxed income (GILTI)
  - Income from intangible assets earned by related foreign entities will be subject to tax at a 10.5% to 13.125% rate (13.1% after 2025)
- **Export incentive**: Foreign derived intangible income (FDII)
  - Deduction allowed equal to 37.5% of FDII (21.875% after 2025)
- **Dividends Received Deduction**: Dividends received deduction available for untaxed foreign earnings
- **Anti-base erosion**: Base erosion anti-abuse tax (BEAT) and Interest deductibility limitations
  - BEAT of 10% (5% for 2018, 12.5% after 2025) of modified taxable income, i.e., taxable income with deductions involving payments to related foreign persons added back
- **Interest Deduction Limitations**: Interest deductions limited to 30% of adjusted taxable income

International Tax Overview

Key TCJA International Tax Provisions

IRC Section	Topic	High-Level Description
§59A	Base Erosion and Anti-Abuse Tax (“BEAT”)	Imposes a tax on deductible payments to foreign related parties
§163(j)	Earnings stripping	Limits the annual deduction for net interest expense to 30% of adjusted taxable income
§245A	100% DRD for foreign dividends	Permits a deduction for 100% the foreign-source portion of dividends received from 10%-owned foreign corporations
§250	Special deduction for foreign-derived intangible income (“FDII”) and global intangible low-taxed income (“GILTI”)	Permits a domestic corporation a deduction for the sum of – • 37.5% of FDII, and • 50% of its GILTI inclusion Limited to taxable income
§267A	Anti-hybrid rules	Denies a deduction for certain hybrid payments of interest and royalties to related parties
§863(b)	Sourcing income from inventory sales	Requires sourcing of income from inventory sales to be determined solely with reference to production activities
§904(d)	Foreign tax credit baskets	Establishes additional foreign tax credit baskets for – • GILTI inclusions, and • Foreign branch income
§951A	GILTI inclusion	Requires current inclusion of a US shareholder’s pro rata share of CFC net tested income
§965	Transition tax	One-time tax on deferred foreign income at reduced rates (15.5% / 8% for liquid and non-liquid assets, respectively)

US Taxation of US Multinational Companies Abroad

Overview

- In general, income earned by foreign subsidiaries is not subject to immediate US taxation
- Special rules exist, however, whereby sometimes US shareholders of foreign subsidiaries will be subject to immediate US tax on certain income earned by foreign subsidiaries
  - Relevant factors
    - How much of the foreign subsidiary is owned by US shareholders (i.e., whether the foreign subsidiary is a Controlled Foreign Corporation (CFC) or a Passive Foreign Investment Company (PFIC))
    - Type of income the foreign subsidiary earns
    - Characteristics of the US shareholder (i.e., partnership, corporation, individual, etc.)
- US shareholders of CFCs:
  - Subject to immediate US tax on Subpart F and GILTI income
  - Effective tax rates differ depending on tax classification of shareholder and availability of tax attributes
  - Dividends of foreign-source earnings generally exempt for 10% corporate US shareholders

US Taxation of US Multinational Companies Abroad

CFC Definition

- **Controlled Foreign Corporation (CFC)**
  - A CFC is—
    - Any foreign corporation if
      - More than 50% of the total combined voting power of such corporation’s voting stock OR
      - More than 50% of the value of the corporation’s stock
    - Is directly or indirectly owned, or constructively owned
    - By “US shareholder”
    - On any day during the taxable year of such foreign corporation
  - US shareholder is any US person who owns 10% or more of the foreign corporation, by vote or value

- **Consequences of CFC status**
  - Subject to US anti-deferral regimes - Subpart F and GILTI

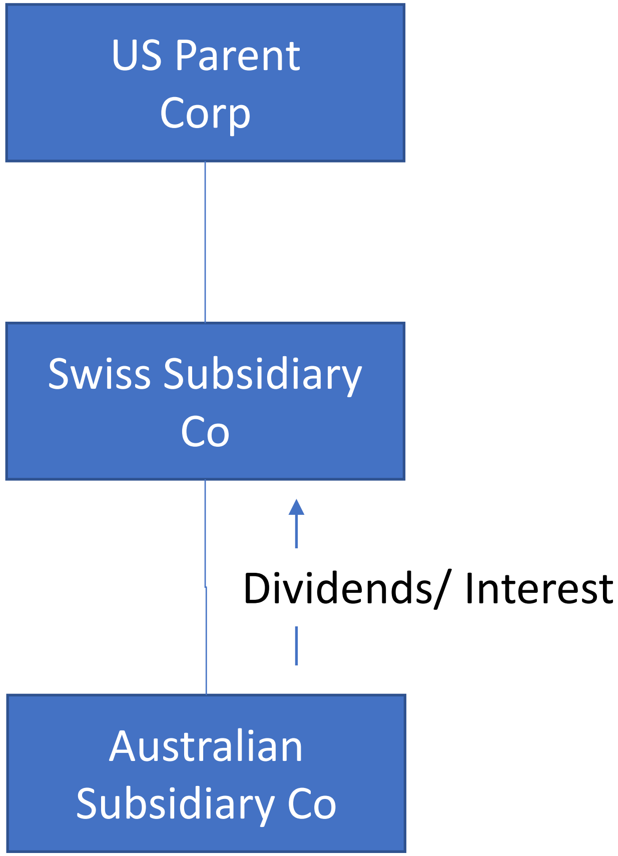
US Taxation of US Multinational Companies Abroad

Anti-deferral Regime – Subpart F

- **Overview**
    - Subpart F was enacted in 1962 in an effort to avoid improperly encouraging foreign investment by US investors
    - The provisions provide that US shareholders in CFCs will be taxed currently on certain (tainted) undistributed income of such foreign corporation whether or not distributed
        - Foreign tax credits available to help offset US tax
- **Types of income subject to Subpart F**
    - Easily shifted passive income – e.g., dividends, interest, royalties
    - Related party transactions and
        - CFC does not manufacture property
        - Customers are not inside CFC country
        - Services not performed within CFC country
- **Exceptions exist** (e.g., high tax exception)

US Taxation of US Multinational Companies Abroad

Foreign Personal Holding Company Income

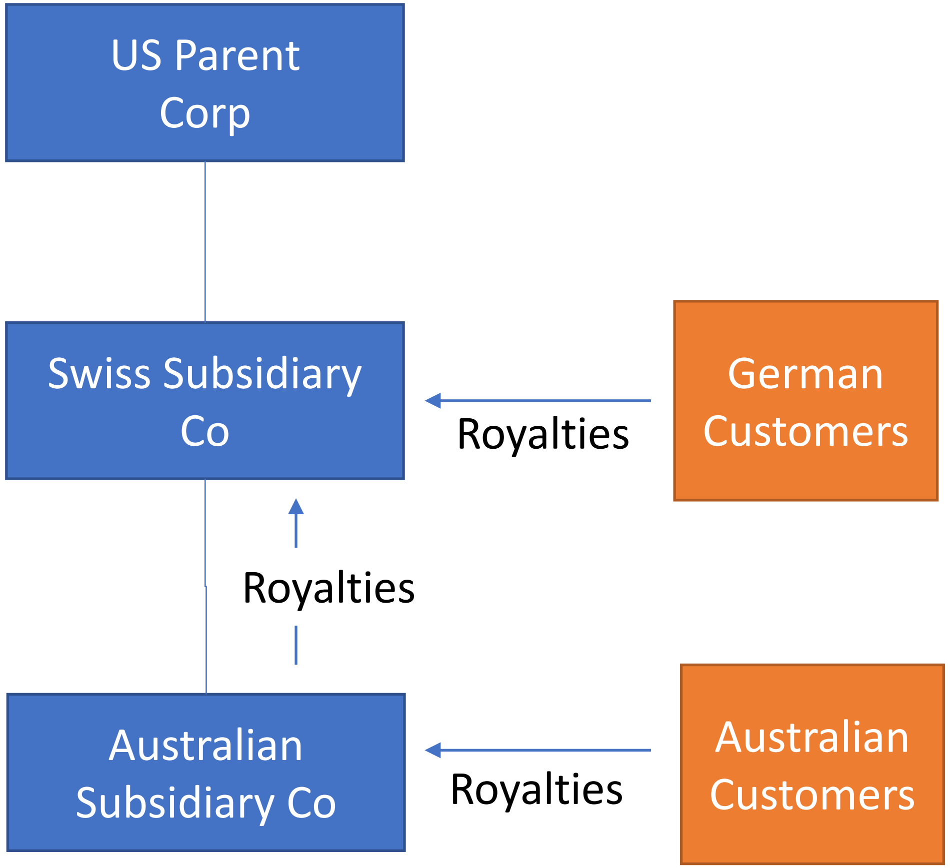


Passive Income

- **Dividends** - Australian Subsidiary Co pays dividend to Swiss Subsidiary Co
- **Interest** - Swiss Subsidiary Co makes loan to Australian Subsidiary Co and Australian Subsidiary Co pays interest to Swiss Subsidiary Co

US Taxation of US Multinational Companies Abroad

Foreign Personal Holding Company Income *(Continued)*

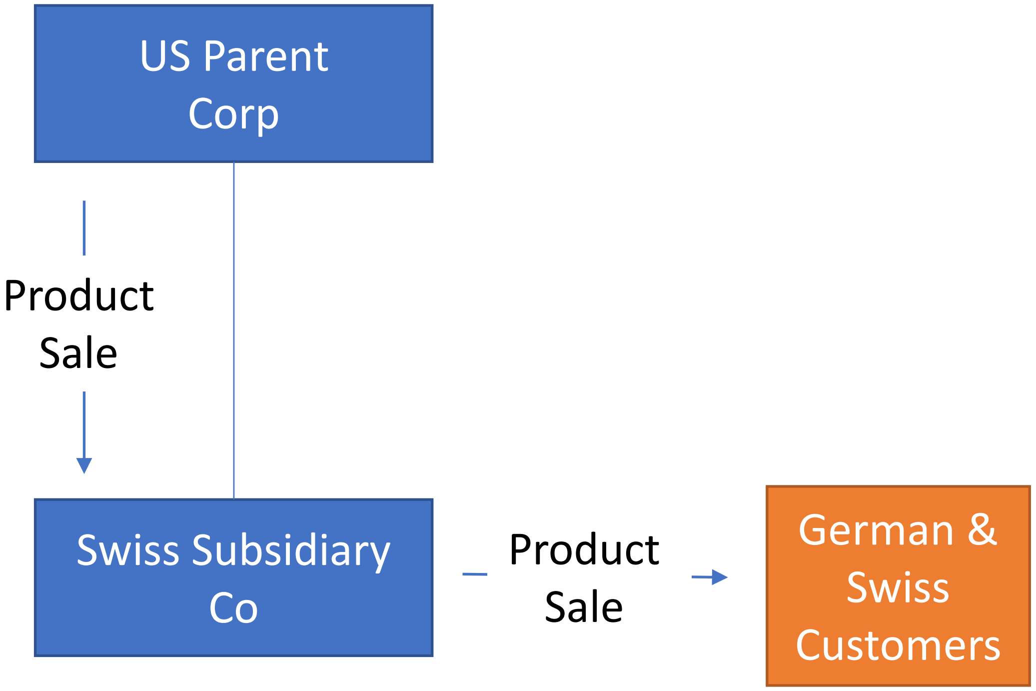


Passive Income

- **Royalties**
  - Swiss Subsidiary Co licenses IP, that it owns and actively developed, to German Customers and Australian Subsidiary Co in exchange for royalties
  - Australian Subsidiary Co licenses IP to Australian Customers in exchange for royalties

US Taxation of US Multinational Companies Abroad

Foreign Base Company Sales Income

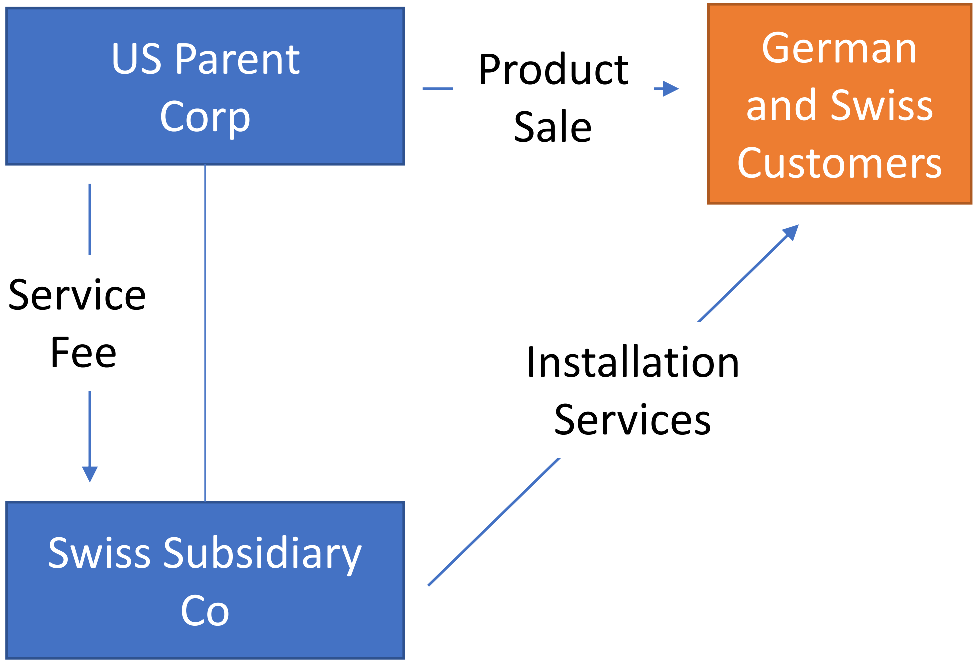


Sale of Goods

- US Parent Corp manufactures product in the US
- US Parent Corp sells product to Swiss Subsidiary Co
- Swiss Subsidiary Co re-sells product to German and Swiss customers

US Taxation of US Multinational Companies Abroad

Foreign Base Company Services Income



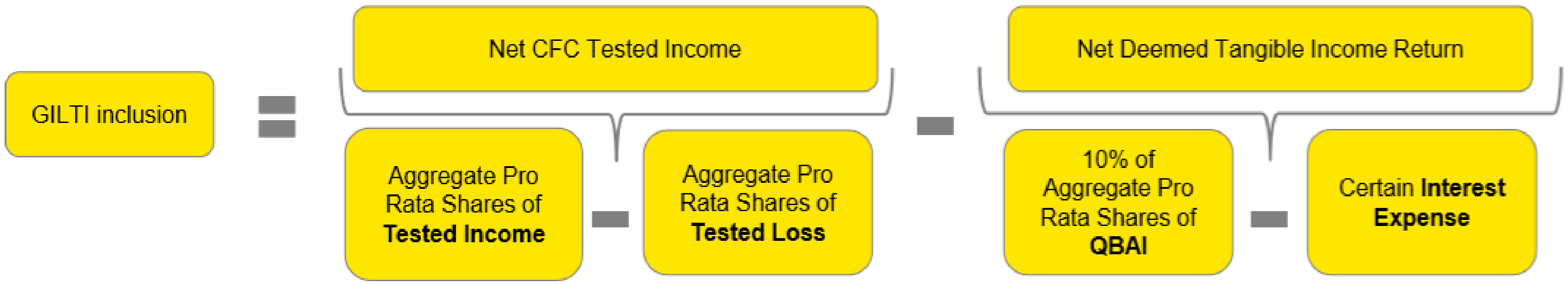
Provision of Services

- US Parent Corp manufactures products and sells to German and Swiss Customers
- US Parent Corp engages Swiss Subsidiary Co to install the products in Germany and Switzerland in exchange for a service fee

US Taxation of US Multinational Companies Abroad

Global Intangible Low-Taxed Income (GILTI)

- A US shareholder of any CFC for any taxable year must include in gross income its GILTI for such taxable year.

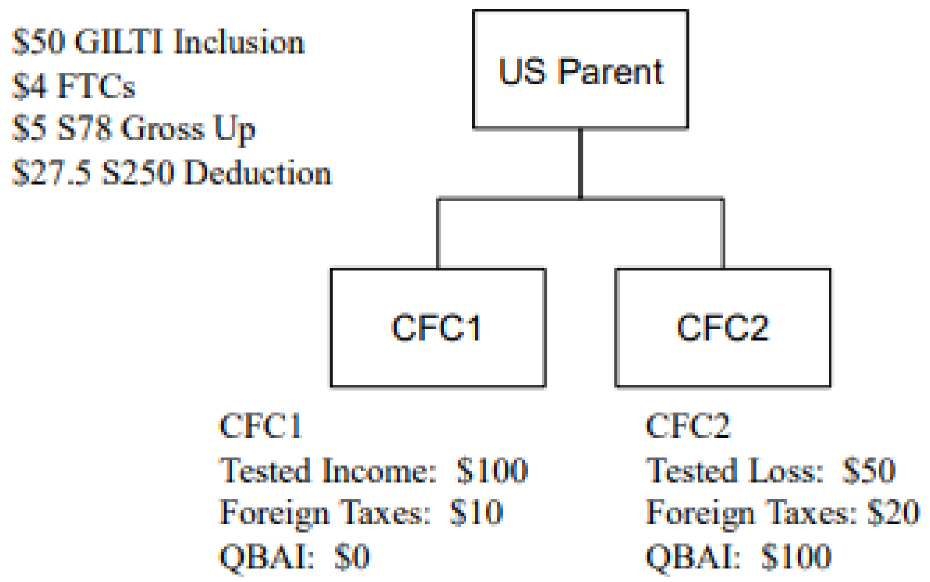


- GILTI inclusion (and consequences) are similar to subpart F income inclusions.
- Effective for tax years of foreign corporation beginning after December 31, 2017, and for tax years of US shareholders in which or with which such tax years of foreign corporations end.

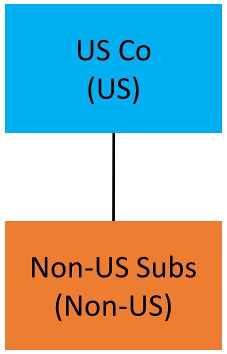
US Taxation of US Multinational Companies Abroad

GILTI Example

- Tested losses offset tested income
- Foreign taxes of tested loss CFCs are left behind
- QBAI of tested loss CFCs is left behind



Illustrative Example – GILTI



- Local Country Income – 1,000
- Tangible Depreciable Assets - 0

	Local Rate > 13.125%	Local Rate < 13.125%	Local Rate = 13.125%	Local Rate = 0
Local Country Income	1,000	1,000	1,000	1,000
Local Country Tax	150	50	131	-
Tested Income	850	950	869	1,000
QBAI	-	-	-	-
QBAI Return Rate	10%	10%	10%	10%
Deemed QBAI Return	-	-	-	-
Net Tested Income	850	950	869	1,000
Section 78 Gross Up	150	50	131	-
Gross GILTI Inclusion	1,000	1,000	1,000	1,000
GILTI Deduction	(500)	(500)	(500)	(500)
Net GILTI Inclusion	500	500	500	500
US Tax Rate	21%	21%	21%	21%
US Tax Pre Credit	105.00	105.00	105.00	105.00
US FTC at 80%	(120)	(40)	(105)	-
Net US Tax	-	65	-	105
Total Tax	150	115	131	105
Total ETR	15.00%	11.50%	13.125%	10.500%

What is FDII?

- A domestic corporation's FDII (Foreign Derived Intangible Income) is the amount that bears the same ratio to the **Deemed Intangible Income** of such corporation as the **Foreign-Derived Deduction Eligible Income** of the corporation bears to the **Deduction Eligible Income** of the corporation.

- The FDII can be depicted as:

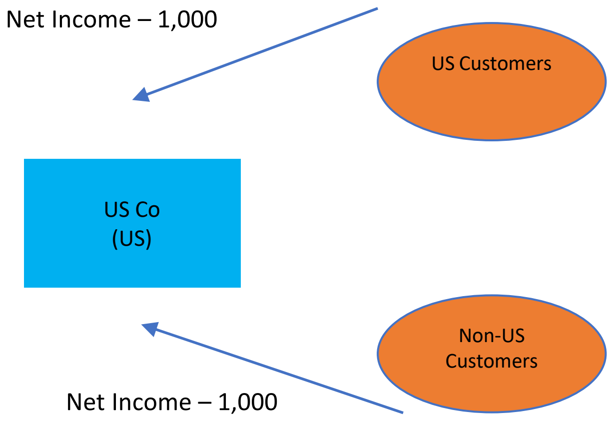
$$\text{FDII} = \frac{\text{Foreign-Derived Deduction Eligible Income}}{\text{Deduction Eligible Income}} \times \text{Deemed Intangible Income}$$

What is FDII?

- Or more simply, as:

$$\text{FDII} = \frac{\text{Gross income from property sold to non-US persons for use outside the US, or services provided to any US person not located in the US (not including certain items of gross income)}}{\text{Gross income (not including certain items of gross income) minus properly allocable deductions}} \times \left(\text{Gross income (not including certain items of gross income) minus properly allocable deductions} - \text{10\% of QBAI} \right)$$

Illustrative Example – FDII



	US QBAI	No US QBAI
Deduction Eligible Income	2,000	2,000
US QBAI	10,000	-
US QBAI Return Rate	10%	10%
US QBAI Return	1,000	-
Deemed Intangible Income	1,000	2,000
Foreign Derived Intangible Income	1,000	1,000
Foreign Ratio	50%	50%
Deemed Intangible Income	1,000	2,000
Foreign Derived Intangible Income	500	1,000
Deduction Percentage	37.5%	37.5%
FDII Deduction	**(188)**	**(375)**

US Taxation of US Multinational Companies Abroad

GILTI and Foreign Derived Intangible Income Deduction

Section 250 deduction = 50% of (GILTI + Section 78 gross-up) + 37.5% of FDII

- A domestic corporation is allowed a deduction equal:
  - 37.5% of its foreign-derived intangible income (FDII), plus 50% of the sum of its GILTI inclusion and the associated GILTI Section 78 gross-up*
- Section 250(a)(2) taxable income limitation
  - The Section 250 deduction is limited if the domestic corporation's taxable income (not taking into account the Section 250 deduction) is less than the sum of its GILTI and FDII

** The percentages are reduced to 37.5% and 21.875% for taxable years beginning after December 31, 2025, respectively.*

3. Foreign Taxation of US Multinational Companies

Foreign Taxation of US Multinational Companies

Introduction

- US multinational companies can be subject to foreign tax in a variety of ways –
  - US Parent Corp subject to foreign taxation
    - If have taxable presence or permanent establishment (PE) in a foreign country
    - Withholding tax
  - Foreign subsidiaries subject to foreign taxation
    - In country of incorporation or place of management and control
    - If have taxable presence or PE in another country
    - Withholding tax

Foreign Taxation of US Multinational Companies

US Parent Corp Subject to Foreign Taxation

- Taxable Presence / PE
  - US Parent Corp must have a taxable presence or PE in another country in order to be subject to income tax there
  - Historically, a physical presence in another country is required in order to have a taxable presence / PE
    - Office / fixed place of business
    - Dependent agent
    - Contract negotiation / execution
  - Whether a taxable presence / PE exists depends on (a) income tax treaty, or (b) local law (if no treaty is in place)
  - OECD and other local country initiatives are expanding this, however – US Parent Corp may be subject to tax in other countries now without a physical presence (e.g., digital tax initiatives)

Foreign Taxation of US Multinational Companies

US Parent Corp Subject to Foreign Taxation *(Continued)*

- Withholding Tax
  - Withholding tax applies on certain cross-border payments – e.g., royalties, dividends, and interest
  - Withholding tax rate may be reduced by income tax treaties and other directives

Foreign Subsidiaries Subject to Foreign Taxation

- Foreign Subsidiaries subject to tax in their **country of incorporation**
  - Some countries also tax companies if the company is managed and controlled in a given country
- Foreign Subsidiaries also subject to tax where they have a **taxable presence or PE** (see prior slides)
  - In order to be eligible for treaty benefits, Foreign Subsidiaries must generally have substance (e.g., people, functions performed in country)
- As with US Parent Corporation, **withholding tax** also applies on certain cross-border payments (e.g., dividends, interest, royalties) paid to Foreign Subsidiaries
  - Again, withholding tax rate may be reduced by treaty (see above substance requirements)

4. Transfer Pricing and Intercompany Agreements

Transfer Pricing and Intercompany Agreements

Basic Principles

- US Parent Corp and Foreign Subsidiaries must treat each other as if they are unrelated and on an **arm's length basis** for tax purposes
    - For example, the fee that UK Subsidiary earns from US Parent Corp for the performance of R&D services must be similar to the fee it would earn for performing the same services for an unrelated party
- Benchmarking studies, or **transfer pricing** analysis, must be conducted to determine the pricing to be used on transactions between related parties
- **Written reports** are required to justify and support the pricing used
    - For example, in the US, a written transfer pricing report must be prepared and available at the same time that the tax return is filed
- **Written and executed intercompany agreements** should be prepared to document the arrangement between related parties, the pricing to be used, etc.

Questions & Answers