



Dbriefs U presents:

# Deferral of Foreign Earnings — Its Purpose and Proposed Changes

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# Agenda

Worldwide taxation

Foreign tax credit and deferral to the rescue

Territorial tax system

Policy considerations

Proposed legislative changes

Wrap-up

# Poll question #1

The U.S. corporate tax rate is one of the highest tax rates in the world.

- True
- False

# Poll answer #1

The U.S. corporate tax rate is one of the highest tax rates in the world.

- True
- False

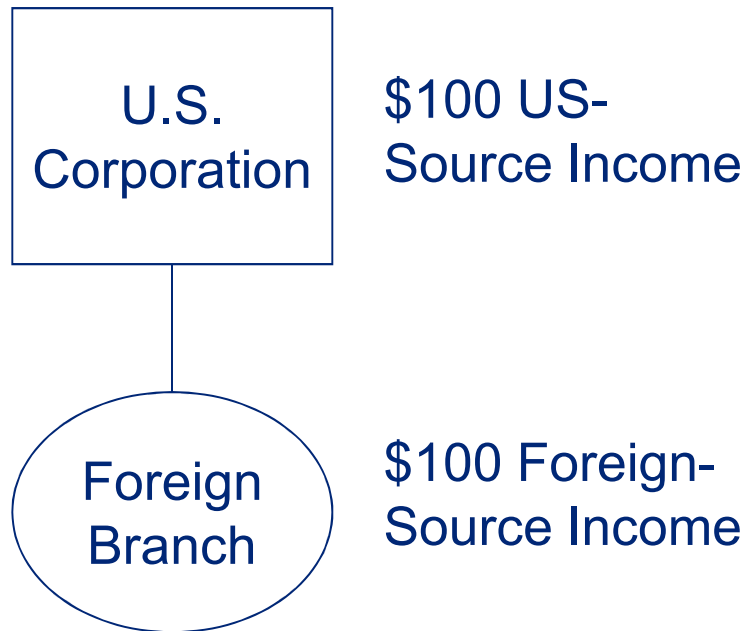
# Worldwide taxation

## In general

- Generally, the United States taxes a U.S. corporation's domestic and foreign source income at a rate of 35% (i.e., worldwide taxation)
- The 35% corporate tax rate is currently one of the highest in the world. Most European countries' rates are between 16% and 33%

# Worldwide taxation

## Example 1



### Facts

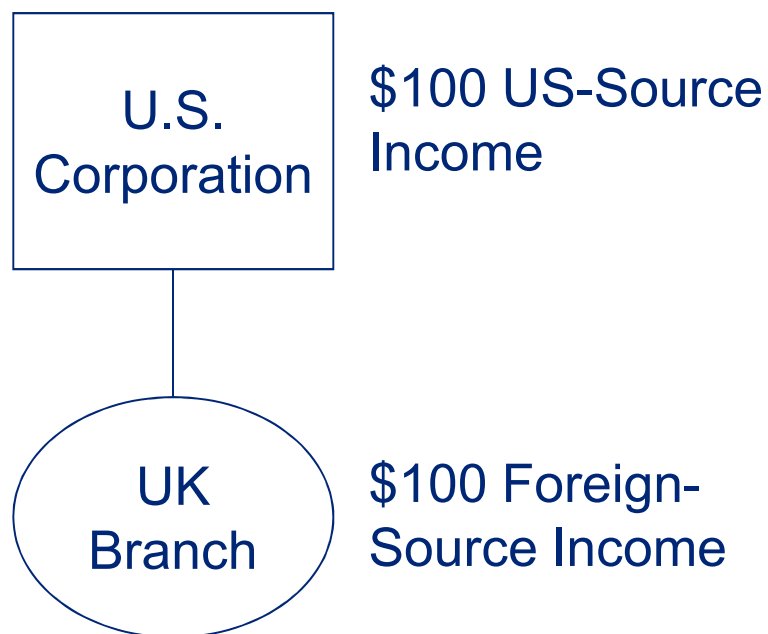
- U.S. Corporation earns \$100 of income in the United States (i.e., \$100 of U.S. source income)
- U.S. Corporation earns \$100 in a foreign country through a branch (i.e., \$100 of foreign source income)
- The foreign branch income is not subject to foreign tax

### Result

- The United States imposes a tax of 35% on a corporation's worldwide income of \$200
- U.S. Corporation owes \$70 of U.S. tax for the year ( $\$200 \times 35\% = \$70$ )

# Worldwide taxation

## Example 2



### Facts

- Same facts as Example 1, except that the foreign branch is in the UK
- The UK taxes UK corporations and UK branches at a rate of 28%

### Query

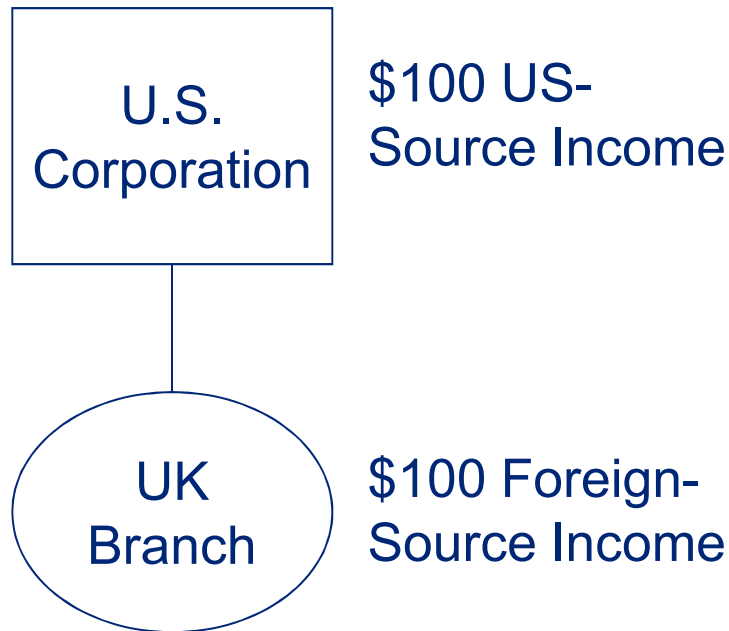
- Is U.S. Corporations UK branch income subject to a total of \$63 of tax ( $(\$100 * 35\% \text{ in U.S.}) + (\$100 * 28\% \text{ in UK})$ )?
- If the U.S. Corporation's UK Branch is subject to 63% total tax but a UK corporation, conducting the same activities in the UK is subject to 28% tax, would the U.S. Corporation be competitive?

# Foreign tax credit to the rescue

- Double taxation would indeed decrease the competitiveness of U.S. corporations' foreign branches
- In order to prevent double taxation, the United States generally provides a credit for foreign income taxes paid by a U.S. corporation (or a foreign branch of a U.S. corporation)

# Foreign tax credit (“FTC”)

## Example 3



### Facts

- Same facts as Example 2

### Result

- The UK tax on the UK Branch income is \$28.
- The total U.S. tax on the UK Branch income is \$7, computed as follows:
  - Pre-FTC U.S. tax =  $\$100 * 35\% = \$35$
  - FTC for UK Tax = \$28
  - U.S. tax after FTC =  $\$35 - \$28 = \$7$

### Query

- Is the UK Branch competitive with UK corporations?
- What if the tax rate on the foreign branch earnings was 16% (e.g., Hungary)

# Deferral to the rescue

## Overview

- U.S. corporations are generally not taxed on business income of their foreign subsidiary corporations until the earnings are either repatriated in the form of dividends to the United States or realized by the U.S. owner of the foreign subsidiary in the form of gains from the sale of shares
- This system of U.S. taxation is commonly referred to as “deferral”
- As illustrated in the following example, deferral is intended to “level the playing field”: A foreign subsidiary’s earnings are only subject to local country tax (at least until the earnings are repatriated to the United States)

# Deferral of foreign earnings

## Example 4



### Facts

- U.S. Corporation earns \$100 of income in the United States
- UK Corporation earns \$100 of business income in the UK

### Result

- The UK Corporations income is subject to UK taxation at a rate of 28% and is not currently subject to any U.S. tax
- If the UK Corporation pays a dividend to the U.S. Corporation, that dividend would be subject to U.S. tax (but may be reduced by an FTC)

# Deferral of foreign earnings (cont.)

## Exceptions

- Although deferral is a lynchpin of U.S. competitiveness in foreign markets, Congress has decided that deferral is inappropriate for certain types of income –
  - Certain interest, dividends, rents, royalties and other passive type income
  - Income from certain sales of property between related parties
  - Income from certain services performed for or on behalf of a related party
- These types of income are treated as having been paid as a dividend to the U.S. corporation in the year earned

# Deferral of foreign earnings (cont.)

## Impact on financial statements

- For U.S. income tax purposes a U.S. corporation is not taxed on business income of its foreign subsidiaries until repatriated to the U.S. shareholder
- However, for financial statement purposes, generally a deferred tax liability must be booked for any additional taxes incurred upon repatriation of the earnings from a foreign subsidiary to the U.S. parent corporation
- A deferred tax liability is not booked, however, if the U.S. parent corporation's investment in the foreign subsidiary is essentially permanent pursuant to APB 23

# Does worldwide taxation make sense?

- As illustrated above, deferral “levels the playing field” by not imposing current U.S. tax on a foreign corporation’s earnings
  - The current tax is only the local country tax
  - However, if the earnings of the foreign corporation are distributed to the U.S. corporation, U.S. tax is imposed
  - Companies must choose between incurring an incremental tax cost of repatriating low-tax earnings or reinvesting those earnings in foreign operations
- How do other countries tax foreign earnings?

# Territorial tax system

- Many countries (including Canada, Germany, France, Italy, Spain and the Netherlands) tax corporations based upon a territorial system, that is, taxation is limited to income from sources within the country's boundaries. Specifically, dividends from foreign subsidiaries to locally organized parent corporations are 100% or 95% exempt from taxation in the home country
- Unlike the deferral of taxation of foreign earnings in the United States, a territorial tax system will permanently exempt dividend distributions from foreign corporations
- In addition, Japan has recently enacted, and the United Kingdom is in the process of transitioning to, a territorial tax system

## Poll question #2

In the context of this discussion, which of the following describes “deferral”?

- A system of U.S. taxation in which a U.S. corporation is not taxed on business income of its foreign subsidiaries until repatriated to the U.S. shareholder
- A leave of absence from a college course for a specified period of time
- A system in which taxation is limited to income from sources within the country’s boundaries, no matter who derives the income

# Poll answer #2

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# Policy considerations

## Worldwide taxation v. territorial taxation

### Worldwide taxation

- The philosophy behind deferral with a tax credit system for foreign dividends is to allow international businesses to operate under the same conditions as domestic enterprises. If a business ventures abroad, it must pay tax on all of its foreign earnings, when remitted, at the parent company's tax rate

### Territorial taxation

- Territorial taxation with an exemption system for foreign dividends allows resident companies to venture outside their domestic environment and compete on a level playing field with their foreign competitors.
- In other words, corporations doing business in the country will be taxed the same

# Proposed changes to deferral

## In general

- On February 26, 2009, President Obama released an outline of his budget proposal for the 2010 fiscal year, which included a tax proposal to “reform” deferral
- On May 11, 2009, the Treasury Department released additional details regarding the Administration’s proposals as well as seven new international tax proposals
- There are at least two provisions in the Treasury Department’s release that could impact deferral: (1) restricting foreign deductions and (2) taxing more foreign income currently

# Proposed changes to deferral (cont.)

## Restrict foreign deductions

- Under current law, a U.S. corporation that incurs expenses that relate to foreign-source income may deduct those expenses currently
- Under the proposal, a U.S. corporation would be unable to deduct certain foreign expenses to the extent the expenses are related to unrepatriated foreign earnings

# Proposed changes to deferral (cont.)

## Restrict foreign deductions – Is this reform?

- Is the deferral of deductions a “reform” or simply a tax increase on U.S. corporations with foreign subsidiaries?
- The proposal does not change the treatment of deferred earnings; it raises the cost of engaging in operations outside of the United States

# Proposed changes to deferral (cont.)

## End deferral on certain earnings

- Under current law, a U.S. corporation with foreign subsidiaries may move earnings between foreign subsidiaries through various means and (as described above) not pay U.S. tax until the earnings are distributed to the U.S corporation
- The proposal would repeal certain rules that facilitate these foreign-to-foreign payments of interest, dividends, rents and royalties between foreign affiliates

# Proposed changes to deferral (cont.)

End deferral on certain earnings – Is this reform?

- As described above, deferral facilitates U.S. competitiveness in foreign markets
- Why should deferral end when earnings are moved between foreign subsidiaries?

# Poll question #3

Which of the following changes to deferral are included in President Obama and Treasury's 2010 budget proposal?

- Eliminate deductibility of certain foreign expenses to the extent the expenses relate to unrepatriated foreign earnings
- Repeal deferral of all foreign earnings subject to current U.S. taxation
- All of the above
- None of the above

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Which of the following changes to deferral are included in President Obama and Treasury's 2010 budget proposal?

- **Eliminate deductibility of certain foreign expenses to the extent the expenses relate to unrepatriated foreign earnings**
- Repeal deferral of all foreign earnings subject to current U.S. taxation
- All of the above
- None of the above

# Wrap-up

- The United States currently taxes a U.S. corporation's worldwide income at a relatively high rate of tax
- Certain types of foreign earnings are subject to current U.S. tax and business income is deferred until repatriated
- President's Obama's current proposals will defer current deductions (representing a tax increase) and reduce a U.S. corporation's ability to defer earnings
- Congressional debate will likely focus on whether the deferral of deductions and reduction of deferral will help or harm the U.S. economy

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