



Dbriefs U

Supplemental Material

The Four Cornerstones of International Taxation

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About the Supplemental Material

Each Dbriefs U webcast is accompanied by teaching material including discussion or homework questions, a learning activity, and related resources. Visit the Dbriefs U Faculty Resources Web site to download this material. For access to the site and more information, contact dbriefsu@deloitte.com.

To request the solutions for this material, email dbriefsu@deloitte.com.

Discussion / Homework Questions

To request the solutions for this material, email dbriefsu@deloitte.com.

1. Explain the importance of international taxation in today's business environment?
2. Explain the difference between U.S. inbound and U.S. outbound taxation and why it is important to understand both.
3. Explain the four cornerstones of international taxation (e.g., two for inbound taxation and two for outbound taxation).
4. Explain a step-by-step process a foreign corporation would follow to analyze whether an item of income is subject to U.S. taxation. Cover the following concepts: source of income, U.S. trade or business, effectively connected income, U.S. source investment income (e.g., FDAP income), and treaty implications.
5. Explain the difference between a worldwide taxation / deferral regime and a territorial taxation / exemption regime.
6. Explain why the U.S. allows a foreign tax credit to reduce U.S. tax on foreign source income. Explain the rationale in the context of a simple example in which a U.S. corporation earns income through its foreign subsidiary.

Activity

To request the solutions for this material, email dbriefsu@deloitte.com.

Overview

Case Study: Subpart F Income, U.S. Tax Treaties, and Foreign Tax Credit

Length: 45 minutes

Type: Individual or team activity

Materials: Internal Revenue Code, Treasury Regulations, Internet, Activity Sheet and Solution

Learning Objectives: Understand the rules that apply to Subpart F income, the application of U.S. tax treaties, and the indirect foreign tax credit computation.

Activity: Given a set of facts about a U.S. company and its foreign subsidiary and using the Internal Revenue Code, Treasury Regulations, and resources provided on the IRS Web site, the student will answer three questions related to the companies' tax burden.

Activity

Case Study: Subpart F Income, U.S. Tax Treaties, and Foreign Tax Credit

Facts

U.S. Corporation (“USCo”), a calendar year taxpayer, formed Foreign Corporation (“FCo”), an Italian corporation, on 09/30/09. USCo wholly owns FCo. FCo regularly buys products from USCo which are manufactured by USCo within the United States. FCo then sells the products to customers for use in Italy and to other customers for use in France.

FCo’s 2010 earnings and profits before taxes, calculated under U.S. principles, were \$800,000. All of such earnings and profits represent income derived from the resale of the products FCo purchases from USCo. During 2010, assume FCo was subject to an Italian combined effective tax rate (consists of National and Local rate) of 31.4% on such income (i.e., FCo paid corporate income taxes in Italy totaling \$251,200).

On 10/30/10, FCo paid a dividend of \$100,000 to USCo. Assume the \$100,000 dividend is USCo’s only income for the year.

Like the U.S., Italy imposes a withholding tax on dividends paid by a resident corporation to a non-resident corporation (e.g., Italy imposes a withholding tax on dividends paid by an Italian corporation to a U.S. corporation).

Assume the applicable U.S. tax rate is 35%, the maximum rate of tax specified in Internal Revenue Code section 11.

Questions

1. Subpart F income includes “foreign base company income,” a subset of which is “foreign base company sales income” defined in Internal Revenue Code section 954(d). Review Internal Revenue Code sections 954(b)(4) and (d). Also review Treasury Regulations section 1.954-1(d). Considering the definition of “foreign base company sales income” and applicable exceptions, does FCo have Subpart F income resulting from the resale of the products it purchases from USCo?
2. Go to www.irs.gov/businesses/international and follow the links to the U.S.-Italy income tax treaty (1999). Review Article 10 of the U.S.-Italy tax treaty. Under the U.S.-Italy tax treaty, what is the rate of withholding tax imposed by Italy on the dividend from FCo to USCo? Assume the dividends are not effectively connected with a permanent establishment of USCo in Italy.
3. Compute USCo’s foreign tax credit with respect to the \$100,000 dividend and compute USCo’s net U.S. tax. Ignore the alternative minimum tax.

Activity (Supporting Materials)

Case Study: Subpart F Income, U.S. Tax Treaties, and Foreign Tax Credit

Question #1 – Internal Revenue Code Section 954(b)(4) and Sections 954(d)(1) and (3)

Section 954(b) EXCLUSIONS AND SPECIAL RULES.

* * *

(4) EXCEPTION FOR CERTAIN INCOME SUBJECT TO HIGH FOREIGN TAXES. For purposes of subsection (a) and section 953, foreign base company income and insurance income shall not include any item of income received by a controlled foreign corporation if the taxpayer establishes to the satisfaction of the Secretary that such income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in section 11. The preceding sentence shall not apply to foreign base company oil-related income described in subsection (a)(5).

* * *

Section 954(d) FOREIGN BASE COMPANY SALES INCOME.

(1) IN GENERAL. For purposes of subsection (a)(2), the term “foreign base company sales income” means income (whether in the form of profits, commissions, fees, or otherwise) derived in connection with the purchase of personal property from a related person and its sale to any person, the sale of personal property to any person on behalf of a related person, the purchase of personal property from any person and its sale to a related person, or the purchase of personal property from any person on behalf of a related person where --

(A) property which is purchased (or in the case of property sold on behalf of a related person, the property which is sold) is manufactured, produced, grown, or extracted outside the country under the laws of which the controlled foreign corporation is created or organized, and

(B) the property is sold for use, consumption, or disposition outside such foreign country, or, in the case of property purchased on behalf of a related person, is purchased for use, consumption, or disposition outside such foreign country.

For purposes of this subsection, personal property does not include agricultural commodities which are not grown in the United States in commercially marketable quantities.

* * *

(3) RELATED PERSON DEFINED. For purposes of this section, a person is a related person with respect to a controlled foreign corporation, if—

(A) such person is an individual, corporation, partnership, trust, or estate which controls, or is controlled by, the controlled foreign corporation, or

(B) such person is a corporation, partnership, trust, or estate which is controlled by the same person or persons which control the controlled foreign corporation.

For purposes of the preceding sentence, control means, with respect to a corporation, the ownership, directly or indirectly, of stock possessing more than 50 percent of the total voting power of all classes of stock entitled to vote or of the total value of stock of such corporation. In the case of a partnership, trust, or estate, control means the ownership, directly or indirectly, more than 50 percent (by value) of the beneficial interests in such partnership, trust, or estate. For purposes of this paragraph, rules similar to the rules of section 958 shall apply.

* * *

Question #1 (cont.) – Treasury Regulations Sections 1.954-1(d)(1) and (2)

Treas. Reg. Section 1.954-1(d) *Computation of adjusted net foreign base company income or adjusted net insurance income* –

(1) *Application of high tax exception.* Adjusted net foreign base company income (or adjusted net insurance income) equals the net foreign base company income (or net insurance income) of a controlled foreign corporation, reduced by any net item of such income that qualifies for the high tax exception provided by section 954(b)(4) and this paragraph (d). Any item of income that is foreign base company oil related income, as defined in section 954(g), or portfolio interest, as described in section 881(c), does not qualify for the high tax exception. See paragraph (c)(1)(iii) of this section for the definition of the term item of income. For rules concerning the treatment for foreign tax credit purposes of amounts excluded from subpart F under section 954(b)(4), see § 1.904-4(c). A net item of income qualifies for the high tax exception only if –

(i) An election is made under section 954(b)(4) and paragraph (d)(5) of this section to exclude the income from the computation of subpart F income; and

(ii) It is established that the net item of income was subject to foreign income taxes imposed by a foreign country or countries at an effective rate that is greater than 90 percent of the maximum rate of tax specified in section 11 for the taxable year of the controlled foreign corporation.

(2) *Effective rate at which taxes are imposed.* The effective rate with respect to a net item of income shall be determined separately for each controlled foreign corporation in a chain of corporations through which a distribution is made. The effective rate at which taxes are imposed on a net item of income is –

(i) The United States dollar amount of foreign income taxes paid or accrued (or deemed paid or accrued) with respect to the net item of income, determined under paragraph (d)(3) of this section; divided by

(ii) The United States dollar amount of the net item of foreign base company income or insurance income, described in paragraph (c)(1)(iii) of this section, increased by the amount of foreign income taxes referred to in paragraph (d)(2)(i) of this section.

* * *

Question #2 – 1999 U.S.-Italy Income Tax Treaty

Article 10 Dividends

1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.
2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:
 - a. 5 percent of the gross amount of the dividends if the beneficial owner is a company which has owned at least 25 percent of the voting stock of the company paying the dividends for a 12 month period ending on the date the dividend is declared;
 - b. And 15 percent of the gross amount of the dividends in all other cases.

This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

3. The term "dividends" as used in this Article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founder's shares, or other rights, not being debt-claims, participating in profits, as well as income which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.
4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State, of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such case, the dividends are taxable in that other Contracting State according to its own laws.
5. Where a company which is a resident of a Contracting State and not a resident of the other Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, except as provided in paragraph 6, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.
6. A corporation that is a resident of one of the States and that has a permanent establishment in the other State or that is subject to tax in the other State on a net basis on its income that may be taxed in the other State under Article 6 (Income from Immovable Property) or under paragraph 1 of Article 13 (Capital Gains) may be subject in that other State to a tax in addition to the tax allowable under the other provisions of this Convention. Such tax, however, may be imposed on only the portion of the business profits of the corporation attributable to the permanent establishment and the portion of the income referred to in the preceding sentence that is subject to tax under Article 6 (Income from Immovable Property) or under paragraph 1 of Article 13 (Capital Gains) that, in the case of the United States, represents the dividend equivalent amount of such profits or income and, in the case of Italy, is an amount that is analogous to the dividend equivalent amount.
7. The tax referred to in paragraph 6 may not be imposed at a rate in excess of the rate specified in paragraph 2(a).

8. Notwithstanding paragraph 2, dividends shall not be taxed in the Contracting State of which the company paying the dividends is a resident if the beneficial owner of the dividends is a resident of the other Contracting State that is a qualified governmental entity that holds, directly or indirectly, less than 25 percent of the voting stock of the company paying the dividends.
9. Subparagraph (a) of paragraph 2 shall not apply in the case of dividends paid by a United States Regulated Investment Company (RIC) or a United States Real Estate Investment Trust (REIT). In the case of dividends from a RIC, subparagraph (b) of paragraph 2 shall apply. In the case of dividends paid by a REIT, subparagraph (b) of paragraph 2 shall apply only if:
 - a. the beneficial owner of the dividends is an individual holding an interest of not more than 10 percent in the REIT;
 - b. the dividends are paid with respect to a class of stock that is publicly traded and the beneficial owner of the dividends is a person holding an interest of not more than 5 percent of any class of the REIT's stock; or
 - c. the beneficial owner of the dividends is a person holding an interest of not more than 10 percent in the REIT and the REIT is diversified.
10. The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the shares or other rights in respect of which the dividend is paid to take advantage of this Article by means of that creation or assignment.

Question #3 - Suggested Solution Format

A. Compute direct credit available

Direct credit (withholding tax) \$

B. Compute indirect credit available

Total profits	\$	
Foreign taxes paid	\$	
Net profits (E&P)	\$	

Indirect Credit Available = Foreign Taxes Paid x [Dividend / E&P] \$ _____

Total foreign tax credit available \$ _____

C. Compute U.S. tax before credit on USCo's dividend income

Dividend received		\$
Section 78 gross up		\$ _____
Dividend income		\$
35% tax rate		35%
U.S. tax before credit		\$ _____

D. Compute U.S. tax after foreign tax credit

U.S. tax before credit		\$
Foreign tax credit (limited to U.S. tax on foreign source income)		\$ _____
U.S. residual tax (after credit)		\$

Related Resources

To access these materials, visit www.deloitte.com/us/dbriefsu.

Deloitte International Tax Publications (www.deloitte.com/us/tax/newsletters)

- *World Tax Advisor*
- *Arm's Length Standard*

Deloitte International Tax and Business Guides (www.deloittetaxguides.com)

Internal Revenue Code:

- Source of income: Sections 861-865
- Taxation of foreign corporations: Sections 881-885
- Subpart F and controlled foreign corporations: Sections 951-964, 898, 1248
- Foreign tax credits: Sections 901-908, 515, 841, 853

Subscription Required:

Tax Analysts' Worldwide Tax Treaties (www.taxanalysts.com)

Tax Analysts' Worldwide Tax Daily (www.taxanalysts.com)

International Tax Review (www.internationaltaxreview.com)

Webcast Poll Questions

Question

A U.S. corporation conducting business activities outside of the U.S. must understand the fundamental concepts of:

- Inbound taxation
- Outbound taxation
- Both inbound and outbound taxation

Question

A foreign corporation which is resident in a country with a U.S. tax treaty that contains a PE clause is subject to U.S. tax if it has:

- A U.S. trade or business but no effectively connected income
- A U.S. trade or business but no PE in the U.S.
- Income attributable to a PE in the U.S.

Question

The subpart F anti-deferral regime only applies with respect to:

- ECI (effectively connected income)
- PEs (permanent establishments)
- FDAP income (fixed or determinable annual or periodical income)
- CFCs (controlled foreign corporations)
- FTCs (foreign tax credits)

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