



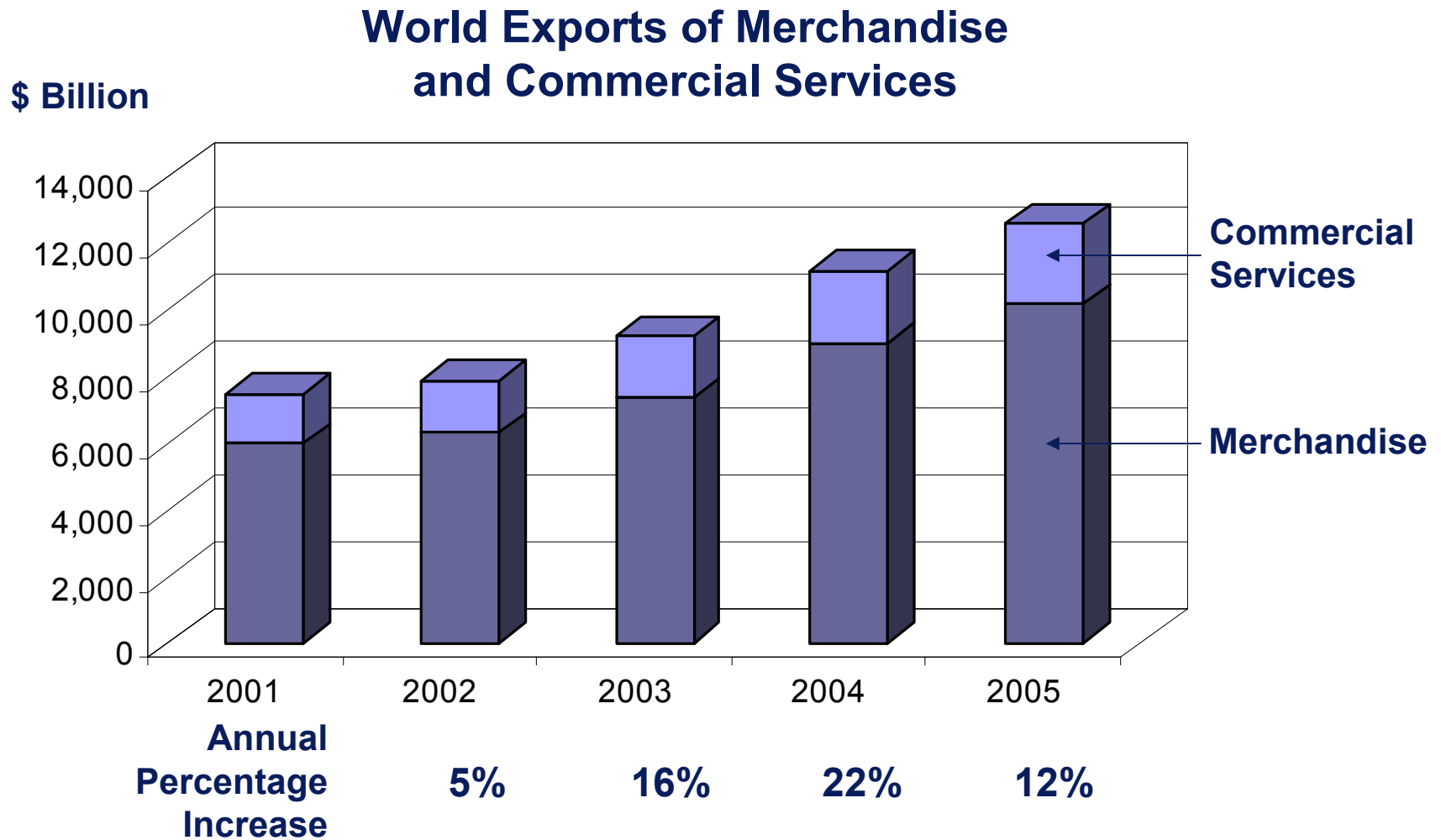
International Taxation – How Companies’ International Activities Hit Home

Tim Tuerff

Introduction

- **International Tax:** Tax rules addressing cross-border transfers of goods, services, intellectual property, and capital
 - Once a transaction crosses a border, the international tax implications of the transaction must be considered
- **Today's Objective:** Provide an overview of four major principles of international tax
 - Primarily from a U.S. corporate tax perspective but the same principles apply in many foreign jurisdictions

Growth in international trade



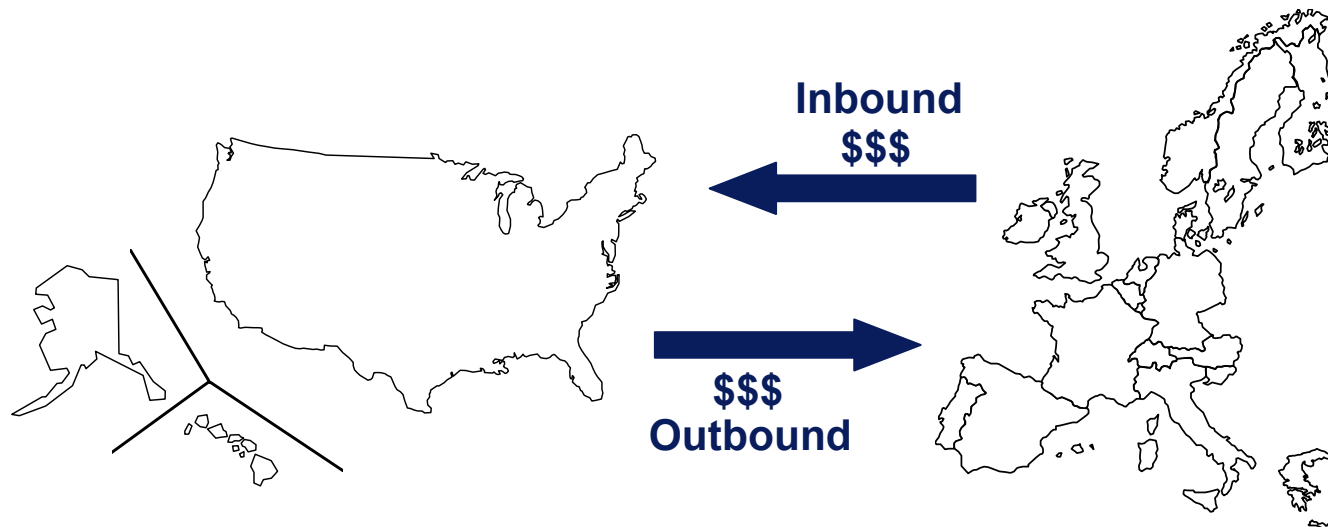
Source: WTO International Trade Statistics 2006

Agenda

- Inbound taxation versus outbound taxation
- Principles of U.S. inbound taxation
 - Taxation of a foreign company's business activities within the U.S.
 - Withholding taxes on a foreign company receiving certain types of income from U.S. sources (e.g., dividends, interest, etc.)
- Principles of U.S. outbound taxation
 - Taxation of a U.S. company operating through foreign subsidiaries
 - Tax credit for foreign taxes paid by a U.S. company's foreign subsidiaries
- Q&A

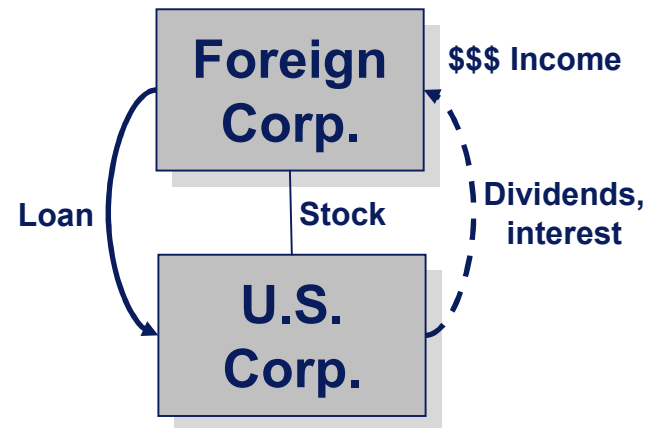
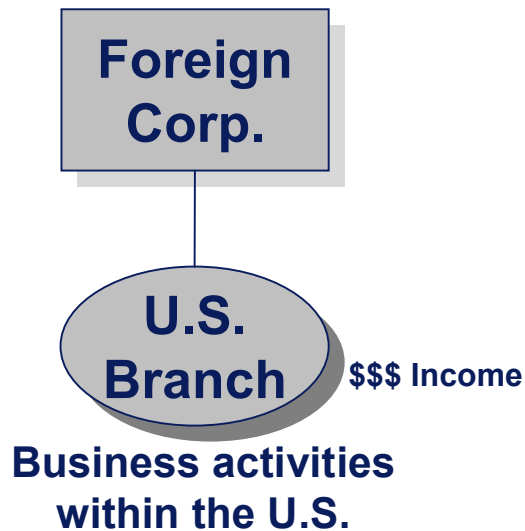
Inbound versus outbound

- **First Question:** What is the difference between “inbound” and “outbound” taxation?
 - Refers to investment flow (i.e., foreign investment into the U.S. versus U.S. investment abroad)



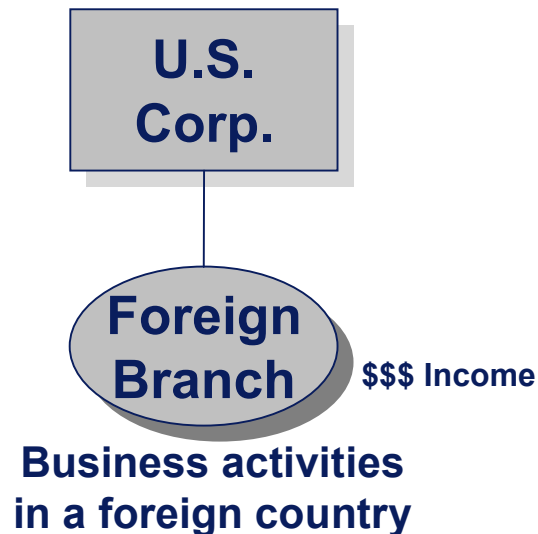
Inbound versus outbound (cont.)

- **U.S. Inbound Taxation:** U.S. taxation of a foreign corporation either
 - doing business directly in the U.S., or
 - earning income from investments in the U.S.



Inbound versus outbound (cont.)

- **U.S. Outbound Taxation:** U.S. taxation of a U.S. corporation doing business in a foreign country
 - through a foreign branch, or
 - through a foreign subsidiary corporation



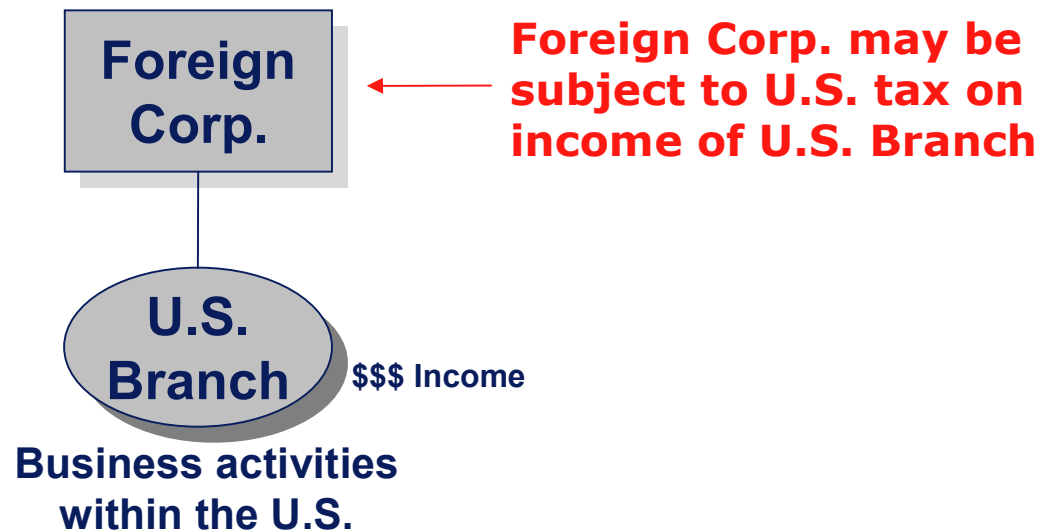
Poll question

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

Inbound principle #1

- A foreign company may be subject to U.S. tax on income which is effectively connected to its U.S. trade or business (“effectively connected income” or “ECI”)



Inbound principle #1 - Example

- **Example:** A Canadian company sends employees to the U.S. to sell products in the U.S.
- **Questions:**
 - At what point does the Canadian company have a taxable presence in the U.S.?
 - What portion of the Canadian company's profits are taxable in the U.S.?
 - If the sales income is taxable in the U.S., what rate of tax applies?

U.S. trade or business

- A foreign corporation is taxed by the U.S. on income from its “U.S. trade or business”
 - “U.S. trade or business” is not defined in the Code or the regulations
 - Defined by case law as profit-oriented activities that are “regular, substantial and continuous”
 - Does the Canadian company engage in regular, substantial and continuous activity in the United States?

Effectively connected income

- If the Canadian corporation engages in a U.S. trade or business, does it earn income that is effectively connected with the U.S. trade or business?
- Different effectively connected rules apply depending on whether the income earned by the corporation is from U.S. sources or from foreign sources
- Income that is from U.S. sources is more likely attributed to the U.S. trade or business and subject to tax; however, certain foreign source income may also be taxed if there is a close connection to the business

Effectively connected income (cont.)

- Effectively connected income is taxed at normal graduated tax rates and deductions are allowed
- Even minimal activities in the U.S. can expose a foreign corporation to significant U.S. tax

Treaty implications

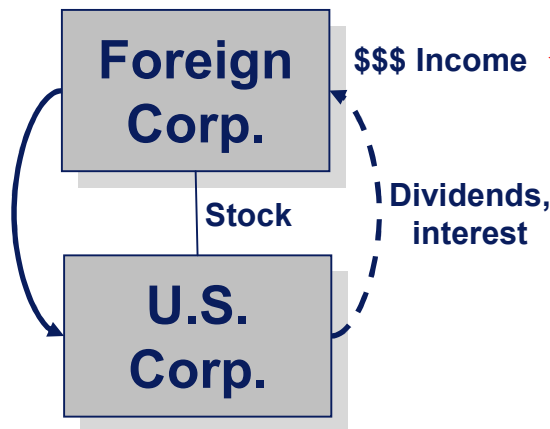
- Under U.S. tax treaties, the U.S. has agreed to apply a higher threshold for taxing business profits of a foreign corporation
 - The U.S. has over 100 tax treaties in effect, including a treaty with Canada
- Under an income tax treaty, the U.S. agrees to tax business profits of a treaty resident only if the profits are attributable to a “permanent establishment” (“PE”) in the United States
- A PE is a fixed place of business through which business is wholly or partly carried on
- An agency relationship may create a PE

Inbound principle #1 - Example

- **Example:** A Canadian company sends employees to the U.S. to sell products in the U.S.
- **Analysis:**
 - Income from the sale of products through a fixed place of business in the United States will be subject to U.S. taxation as income effectively connected with a U.S. trade or business
 - Canadian company is taxable on its taxable net income at graduated corporate tax rates up to 35%

Inbound principle #2

- A foreign company may be subject to U.S. withholding tax on certain types of U.S. source investment income



Foreign Corp. may be subject to U.S. withholding tax on dividends and interest

Inbound principle #2 - Example

- **Example:** A Chinese company loans money to a U.S. corporation and receives interest income on the loan
- **Questions:**
 - Is the Chinese company subject to tax on the interest?
 - What rate of tax applies?

U.S. source investment income

- A foreign corporation's U.S. source income that is not attributable to a U.S. trade or business and is not capital gain income is generally subject to a flat rate of withholding tax of 30%
 - Income subject to 30% withholding tax includes interest, dividends, rents, and other types of “fixed or determinable annual or periodical” income (“FDAP income”)
- Withholding tax applies to the gross amount of FDAP income
 - In contrast to the tax on ECI, the 30% withholding tax is applied to gross income with no deductions allowed

U.S. source investment income (cont.)

- Withholding tax mechanism for collecting 30% tax on U.S. source investment income
 - Withholding of the tax occurs at the source of payment; the party paying the income is required to withhold the tax and remit payment to the IRS before the cash leaves the U.S. taxing jurisdiction
- Many U.S. tax treaties provide for a reduced rate of tax on investment income
 - Reduced rate of tax on interest, dividends, and royalties generally ranges from 0% to 15%
 - The U.S.-China Income Tax treaty reduces the withholding on interest to 10%

Inbound principle #2 - Example

- **Example:** A Chinese company loans money to a U.S. corporation and receives interest income on the loan
- **Analysis:**
 - Interest paid by a U.S. corporation represents U.S. source FDAP income
 - U.S.-China treaty provides for a reduced 10% rate of withholding on interest
 - Chinese company subject to 10% withholding tax on gross amount of interest; U.S. corporation paying the interest must remit 10% withholding tax to IRS

Inbound takeaways

- A foreign company conducting any business activities, however minimal, may be subject to U.S. tax
- A foreign company that conducts no activities in the U.S. may still be subject to U.S. withholding tax on income from a U.S. corporation or resident including dividends, interest, rents and royalties

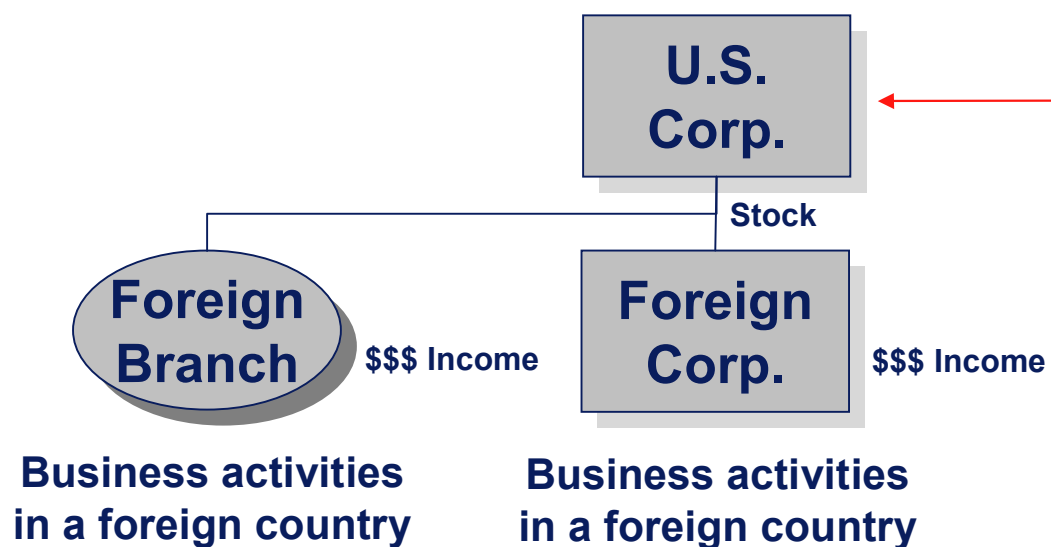
Poll question

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.

Outbound principle #1

- A U.S. company is subject to tax on its worldwide income, including income of a foreign branch. Income of a U.S. company's foreign subsidiaries is generally not subject to tax unless it is distributed or deemed distributed to the U.S. company.



U.S. Corp. subject to U.S. tax on income of Foreign Branch

U.S. Corp. generally not subject to U.S. tax with respect to income of Foreign Corp. unless dividends are distributed to U.S. Corp

Outbound principle #1 - Example

- **Example:** A U.S. corporation wholly owns an Irish subsidiary. The Irish subsidiary purchases products from its U.S. parent corporation for resale to customers throughout Europe.
- **Question:**
 - When is the U.S. corporation subject to U.S. tax on the profits of its Irish subsidiary (i.e., are such profits subject to current U.S. taxation or is the income deferred from current U.S. taxation?)

Models of taxation

- Two models of taxation
 - Worldwide Taxation / Deferral Regime: A resident corporation is taxed on its worldwide income; the earnings of a foreign subsidiary are taxed when cash is distributed to resident parent corporation
 - Exemption Regime: Resident corporation not subject to tax on earnings of foreign subsidiaries
- U.S. imposes a worldwide taxation / deferral regime
 - U.S. corporations (and U.S. citizens) are subject to tax on worldwide income
 - A U.S. corporation is generally taxed on a foreign subsidiary's earnings only when such earnings are distributed in the form of dividends

Exception to deferral

- Certain types of income of a “controlled foreign corporation” (referred to as subpart F income) are subject to current U.S. taxation, even though the earnings are not distributed to the U.S. parent company
 - “Controlled foreign corporation” or “CFC” is a foreign corporation more than 50%-owned by U.S. shareholders that own at least 10% of the corporation’s stock
- The U.S. tax rules seek to eliminate deferral in cases where income is easily manipulated

Subpart F income

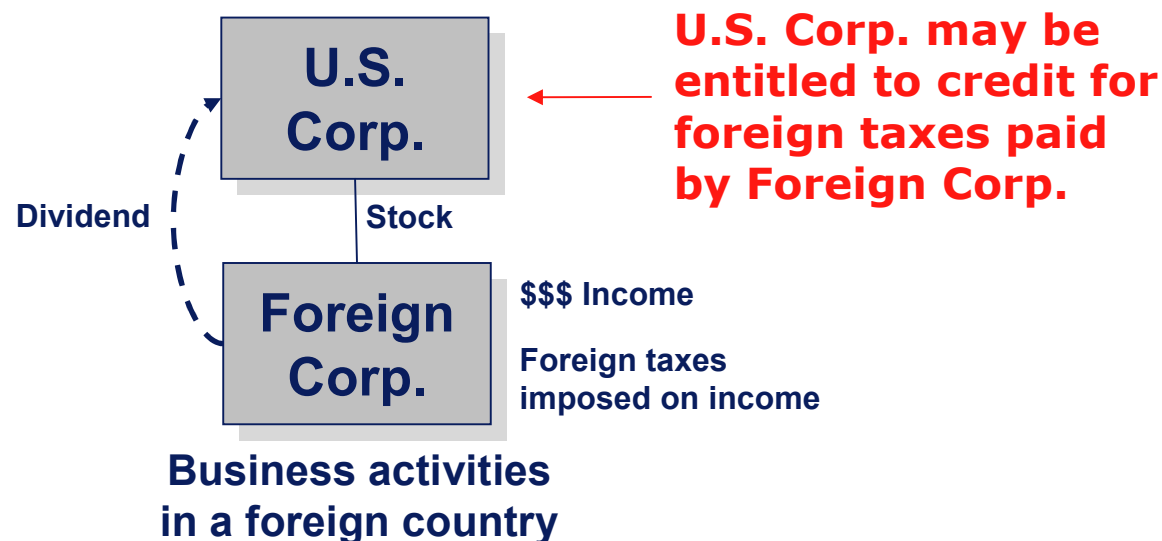
- Subpart F income includes:
 - Certain types of passive income (e.g., dividends, interest, rents, royalties)
 - Certain income derived from the sale of personal property purchased from, or sold to, a related person
- Exceptions to subpart F:
 - Highly taxed income
 - Certain income received from related parties
 - Income from the sale of products manufactured by the subsidiary

Outbound principle #1 - Example

- **Example:** A U.S. corporation wholly owns an Irish subsidiary. The Irish subsidiary purchases products from its U.S. parent corporation for resale to customers throughout Europe.
- **Analysis:**
 - The U.S. corporation is generally subject to tax only when the subsidiary pays dividends
 - However, income from the sale of products purchased from the U.S. parent, a related person, and sold to customers outside of Ireland represents subpart F income and is subject to current U.S. taxation

Outbound principle #2

- A U.S. company may be eligible for a U.S. tax credit for foreign taxes paid or accrued by its foreign subsidiaries



Outbound principle #2 - Example

- **Example:** A German subsidiary wholly-owned by a U.S. corporation earns \$100 of income, pays \$25 of German tax, and pays a dividend of \$75. Assume the applicable U.S. tax rate is 35%.
- **Question:**
 - Given that the U.S. corporation is subject to U.S. tax on the dividend income at a 35% U.S. tax rate, what is the group's effective tax rate on the \$100 of income (including foreign taxes)?

Foreign tax credit

- Worldwide taxation regimes generally provide a credit mechanism to prevent double taxation
- The U.S. allows a foreign tax credit for:
 - Foreign income taxes paid directly by U.S. corporation (imposed as withholding taxes or on operating branches)
 - Foreign income taxes attributable to dividends paid from 10% or more owned foreign subsidiaries

Dividend gross up

- In the case of taxes paid by foreign subsidiaries, dividend income is “grossed-up” for the amount of foreign income taxes paid
 - For example, assume a U.S. corporation receives a dividend from a foreign subsidiary of \$75 and the foreign subsidiary paid foreign income taxes of \$25 on the earnings to which the dividend relates
 - The U.S. corporation’s dividend income is \$100 and it is deemed to have paid \$25 of foreign taxes

Foreign tax credit limitation

- A U.S. corporation's foreign tax credit is limited to the U.S. tax on income from foreign sources
 - Sourcing rules discussed earlier apply
 - For example, assume a U.S. corporation earned \$100 of U.S. source income; earned \$100 of foreign source income; and paid (or is deemed to have paid) \$50 of foreign taxes. If the applicable U.S. tax rate is 35%, the U.S. corporation's FTC is limited to \$35 (\$100 of foreign source income x 35%).
 - Limitation is computed separately for certain categories of income and taxes attributed to those categories
 - Carryback and carryforward rules apply

Outbound principle #2 - Example

- **Example:** A German subsidiary wholly-owned by a U.S. corporation earns \$100 of income, pays \$25 of German tax, and pays a dividend of \$75. Assume the applicable U.S. tax rate is 35%.
- **Analysis:**
 - The dividend represents foreign source income
 - U.S. corporation's dividend income is \$100 after gross-up
 - Assuming the U.S. corporation earns no other income, its FTC limitation is \$35 ($\$100 \times 35\%$). Therefore, it can obtain a FTC of \$25 and is subject to residual U.S. tax of \$10 ($\$35 - \25). Its effective tax rate is 35% ($\$10 \text{ U.S. tax} + \25 German tax).

Outbound takeaways

- A U.S. company is subject to tax on its worldwide income; income of foreign subsidiaries is generally taxed when distributed to the U.S. parent company; however, subpart F income is taxable in the U.S. when earned even if it is not distributed
- Double taxation is avoided through the operation of the foreign tax credit for taxes incurred directly by the U.S. company and for indirect foreign taxes attributable to dividends from foreign subsidiaries

Poll 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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