

## Chapter 17

### Taxes & Multinational Corporate Strategy

- 17.1 The Objectives of National Tax Systems
- 17.2 Types of Taxation
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### The objectives of tax neutrality

- **Domestic tax neutrality** - incomes arising from domestic and foreign operations are taxed similarly by the domestic government
- **Foreign tax neutrality** - taxes imposed on the foreign operations of domestic firms are the same as those facing local competitors in the host countries

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### Violations of tax neutrality

Taxes vary on income from different sources

- **Tax jurisdictions:** foreign or domestic
- **Organizational forms:** foreign branches or incorporated subsidiaries
- **Asset classes:** interest, dividends, or capital gains
- **Financing instruments:** tax deductibility of interest on debt

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### Forms of taxation

- **Explicit taxes**
  - Corporate and personal **income** taxes
  - **Withholding** taxes on dividends, interest and royalties
  - **Sales** or **value-added** taxes
  - **Property** or **asset** taxes
  - **Tariffs** on cross-border trade

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### Forms of taxation

- **Implicit taxes**
  - The law of one price in after-tax form  
“**Equivalent assets sell for the same after-tax expected return**”
  - Countries with low tax rates tend to have low before-tax expected and required returns

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### The effect of implicit taxes on required returns

- **Example**
  - **Country f**  
 $T^f = 50\%$  and  $i^f = 20\%$  yield a return of  $i^f(1 - T^f) = 20\%(1 - 0.5) = 10\%$  **after-tax**
  - **Country d**  
If  $T^d = 20\%$ , what is  $i^d$  in equilibrium?

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## The effect of implicit taxes on required returns

- > Equal after-tax returns means

$$i^f(1-T^f) = i^d(1-T^d)$$

$$20\%(1-0.5) = i^d(1-0.2) = 10\%$$

$$\Rightarrow i^d = 10\% / (1-0.2) = 12.5\%$$

A 20% return at a 50% tax rate is equivalent to a 12.5% after-tax return at a 20% tax rate.

## Taxes on foreign-source income

Two basic types of taxation systems

- > A **worldwide tax system** taxes foreign-source income as it is repatriated to the parent company.
- > A **territorial tax system** levies a tax only on domestic income. Taxes on foreign-source income are only paid in the country in which they are earned.

## U.S. taxation of foreign source income

In the worldwide tax system of the United States...

- > income from foreign subsidiaries is taxed as it is repatriated to the parent
- > income from foreign branches is taxed as it is earned

## The organizational form of foreign operations

- > Most manufacturing firms conduct their foreign operations through foreign subsidiaries
  - Incorporation in the host country limits the parent's **liability**
  - Incorporation avoids host country **disclosure requirements** on the parent's worldwide operations
  - Foreign branches can be used for **start-up operations** that are initially expected to lose money

## The organizational form of foreign operations

- > Foreign branches are sometimes used by financial institutions

### Advantage

- Foreign tax credit (FTC) limitations can be less binding for foreign branches than for foreign subsidiaries

### Disadvantages

- Foreign branches can be tax disadvantaged if the foreign branch is in a low-tax country
- Foreign branches can expose the MNC to legal liabilities

## FTC limitations in the U.S.

### Tax statements as single subsidiaries

	Canada	Israel	Italy
a Dividend payout ratio (%)	100	100	100
b Foreign div withholding rate (%)	5	5	5
c Foreign tax rate (%)	26	36	40
d Foreign income before tax (\$s)	1000	1000	1000
e Foreign income tax (d*c)	260	360	400
f After-tax foreign earnings (d-e)	740	640	600
g Declared as dividends (f*a)	740	640	600
h Foreign div withholding tax (g*b)	37	32	30
i Total foreign tax (e+h)	297	392	430
j Dividend to U.S. parent (d-i)	703	608	570

## FTC limitations in the U.S.

### Tax statements as single subsidiaries (continued)

	Ireland	Italy	France
k Gross foreign inc before tax (d)	1000	1000	1000
l Tentative US tax (k*35%)	350	350	350
m FTC - Foreign tax credit (i)	297	392	430
n Net US tax payable (MAX[l-m,0])	53	0	0
o Total taxes paid (i+n)	350	392	430
p Net amount to U.S. parent (k-o)	650	608	570
q Total taxes separately ( $\Sigma$ o)		\$1,172	

## FTC limitations in the U.S.

### Parent's consolidated tax statement

r Overall FTC limitation ( $\Sigma$ k*35%)	\$1,050
s Total consolidated FTCs ( $\Sigma$ i)	\$1,119
t Additional U.S. taxes due (MAX[0,r-s])	\$0
u Excess FTCs (MAX[0,s-r]) (carried back 2 years or forward 5 years)	\$69

### Overall FTC limitation

$$= (\text{total foreign-source income})(\text{U.S. tax rate})$$

## Additional FTC limitations

- Income baskets
- Subpart F income
- Income and expense allocation

## Effect of shifting sales to low-tax countries

### Tax statements as single subsidiaries

	Canada	Israel	Italy
a Dividend payout ratio (%)	100	100	100
b Foreign div withholding rate (%)	5	5	5
c Foreign tax rate (%)	26	36	40
d Foreign income before tax (\$s)	2000	1000	0
e Foreign income tax (d*c)	520	360	0
f After-tax foreign earnings (d-e)	1480	640	0
g Declared as dividends (f*a)	1480	640	0
h Foreign div withholding tax (g*b)	74	32	0
i Total foreign tax (e+h)	594	392	0
j Dividend to U.S. parent (d-i)	1406	608	0

## Effect of shifting sales to low-tax countries

### Tax statements as single subsidiaries (continued)

	Canada	Israel	Italy
k Gross foreign inc before tax (d)	2000	1000	1000
l Tentative US tax (k*35%)	700	350	(0)
m FTC - Foreign tax credit (i)	594	392	0
n Net US tax payable (MAX[l-m,0])	106	0	(0)
o Total taxes paid (i+n)	700	392	(0)
p Net amount to U.S. parent (k-o)	1300	608	0
q Total taxes separately ( $\Sigma$ o)		(\$1092)	

## Effect of shifting sales to low-tax countries

### Parent's consolidated tax statement

	Original	Shifted
r Overall FTC limitation ( $\Sigma$ k*35%)	\$1,050	\$1,050
s Total consolidated FTCs ( $\Sigma$ i)	\$1,119	\$986
t Additional U.S. taxes due (MAX[0,r-s])	\$0	\$64
u Excess FTCs (MAX[0,s-r]) (carried back 2 years or forward 5 years)	\$69	\$0

### Overall FTC limitation

$$= (\text{total foreign-source income})(\text{U.S. tax rate})$$

## Offshore finance subsidiaries

- The Tax Reform Act of 1986 removed the tax advantages for U.S. firms of **tax-haven affiliates**
- Many MNCs retain off-shore finance subsidiaries as **re invoicing centers**
- **Reinvoicing centers** should be in countries with
  - **Developed infrastructure** including banking, transportation, and communication facilities
  - **A stable and convertible currency** with access to the international currency and Eurocurrency markets
  - **Low tax rates** (income and withholding)
  - **Low political risk**

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## Transfer pricing and tax planning

- MNCs have a tax incentive to
  - Shift revenues to low-tax countries
  - Shift expenses to high-tax countries
- Most national and international tax codes require that transfer prices be set as if they are **arms-length transactions between unrelated parties**

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## Transfer pricing and tax planning

- **An example of the games people play**
  - A U.S.-based MNC produces beef in Argentina for export to Hungary
  - Revenues are \$10,000 in Hungary
  - Production expense is \$3,000 in Argentina
  - \$1,000 of fixed expense in each country
  - The income tax rate in Argentina is 35%
  - The income tax rate in Hungary is 18%

**At what price should the transfer from Argentina to Hungary be made?**

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## Transfer pricing and tax planning

	Transfer price					
	Market-based			Cost-plus		
	Arg	Hun	Both	Arg	Hun	Both
Tax rate	35%	18%		35%	18%	
Revenue	8000	10000	10000	5000	10000	10000
COGS	3000	8000	3000	3000	5000	3000
Other expenses	1000	1000	2000	1000	1000	2000
Taxable income	4000	1000	5000	1000	4000	5000
Total taxes paid	1400	180	1580	350	720	1070
Net income	2600	820	3420	650	3280	3930
Effective tax rate on foreign operations	31.6%			21.4%		

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## Transfer pricing and tax planning

- **Aggressive transfer pricing can be advantageous when a firm has**
  - **Operations in more than one tax jurisdiction**
  - **High gross operating margins** (such as in electronics and pharmaceuticals)
  - **Intangible assets** resulting in intermediate or final products for which there is no market price (e.g., patents or proprietary production processes)

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## MNC competitive position relative to foreign competitors

		Host country tax rate	
		Low	High
Tax status of US buyer	Excess FTCs	neutral	neutral
	No excess FTCs	unattractive	attractive

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