International Taxation – Overview of Key Concepts for Tech Companies

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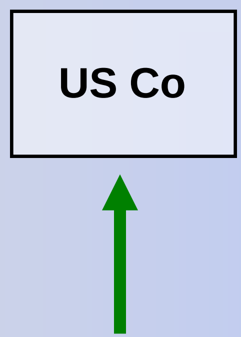
Introduction to U.S. International Taxation

- U.S. taxation of U.S. persons on worldwide income.
- The U.S. alleviates double taxation by allowing a foreign tax credit for foreign income taxes paid, or deemed paid, by the U.S. person.
- The U.S. foreign tax credit is subject to a foreign tax credit limitation.

$35 U.S. Corporate Tax
-<u>$10 Foreign Tax Credit</u>
$25 Net U.S. Tax Due



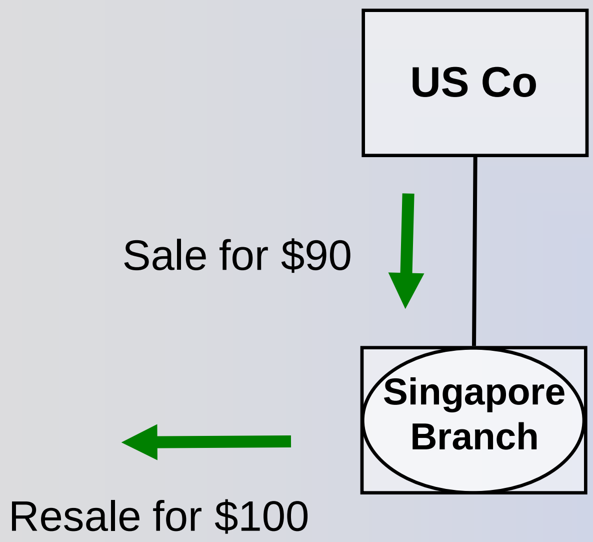
$100 Foreign Source Income
($10) Foreign Tax

Check-the-Box Regulations

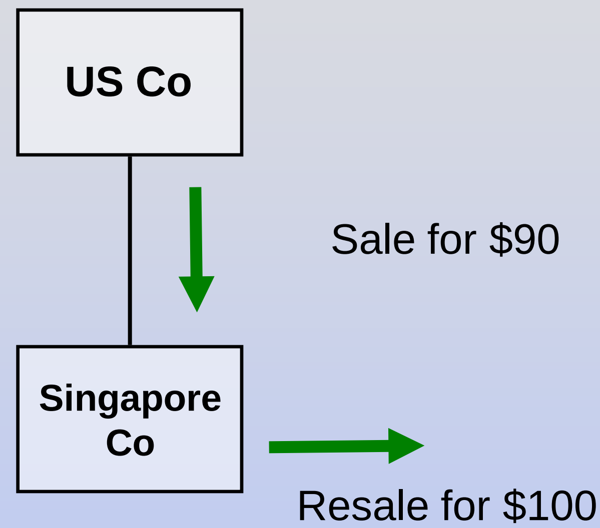
- Treas. Regs. §§ 301.7701-1 through 3 provide rules for classifying business entities as <u>corporations</u>, <u>partnerships</u>, or <u>disregarded entities</u> for Federal income tax purposes.
- Certain types of entities ("per se entities") are required to be taxed as corporations. *See* Treas. Reg. § 301.7701-2(b).
- Other entities may elect their classification as corporations or flow-through entities by filing Form 8832 (entity classification election).
- Transactions between a disregarded entity and its owner are generally disregarded for tax purposes.

Example of Check-the-Box Election

<u>Foreign Disregarded Entity</u>



<u>Foreign Corporation</u>



<u>Results</u>:

- $90 sale is disregarded
- US Co includes branch's $100 of gross receipts and expenses on its Federal income tax return.

<u>Results</u>:

- US has $90 of sales income
- Absent Subpart F, Singapore Co's net income is not taxable in the United States.
- Singapore Co.'s expenses are not deductible by U.S. Co.

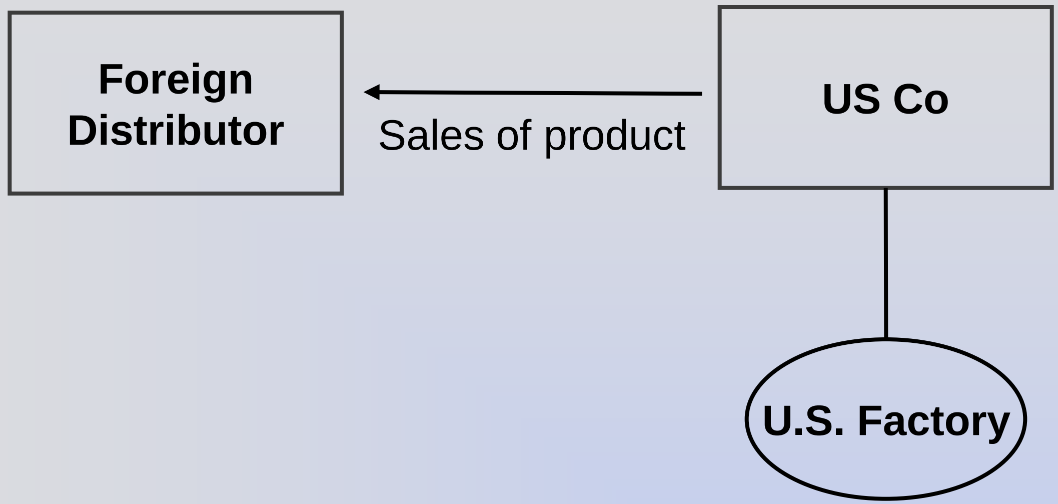
Foreign Tax Credit Limitation

- **Section 904** provides a **foreign tax credit limitation:**

$$\frac{\text{Foreign Source Gross Income} - \text{Foreign Source Expenses}}{\text{Worldwide Taxable Income}} \times \text{U.S. Tax Liability} = \text{FTC Limit}$$

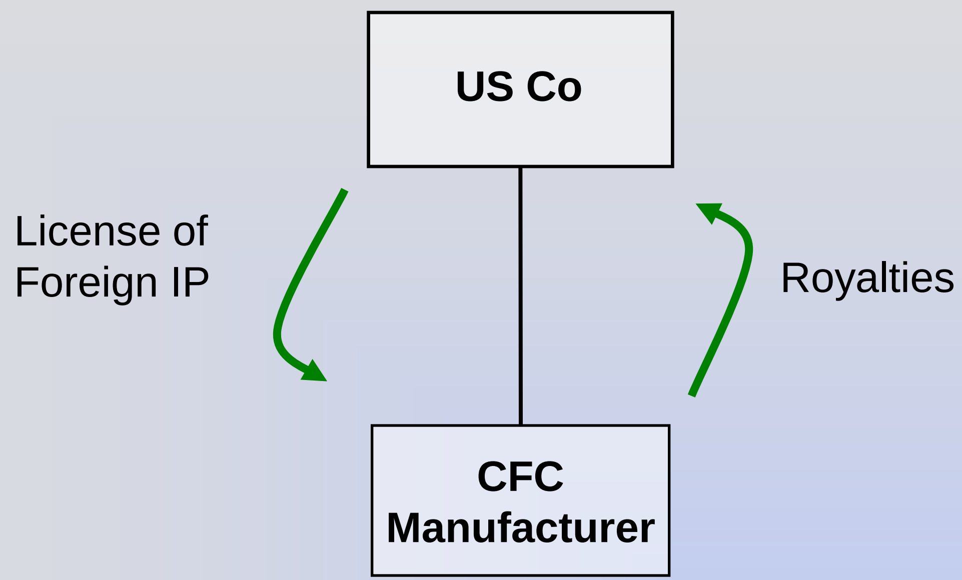
- To calculate the limitation, gross income must be sourced to United States or foreign sources.
- Expenses must be allocated and apportioned between U.S. and foreign sources.
- “Excess credit” vs. “excess limitation.”

Source of Income – Title Passage Rule



- Income from the sale of inventory is sourced to the place where title and ownership of the goods pass. *See* §§ 861(a)(6) and 862(a)(6); Treas. Reg. § 1.861-7(c).
- “50/50 Rule” for manufactured property. *See* § 863(b).
- Title passage is important for both U.S. and foreign taxpayers.

Source of Income – Royalties



- Royalties for the use of patents, copyrights, secret processes or formulas, trademarks and other intangible property outside the United States constitute foreign source income. *See* § 862(a)(4).
- Most countries subject royalty payments to withholding tax, which may be reduced by a tax treaty.

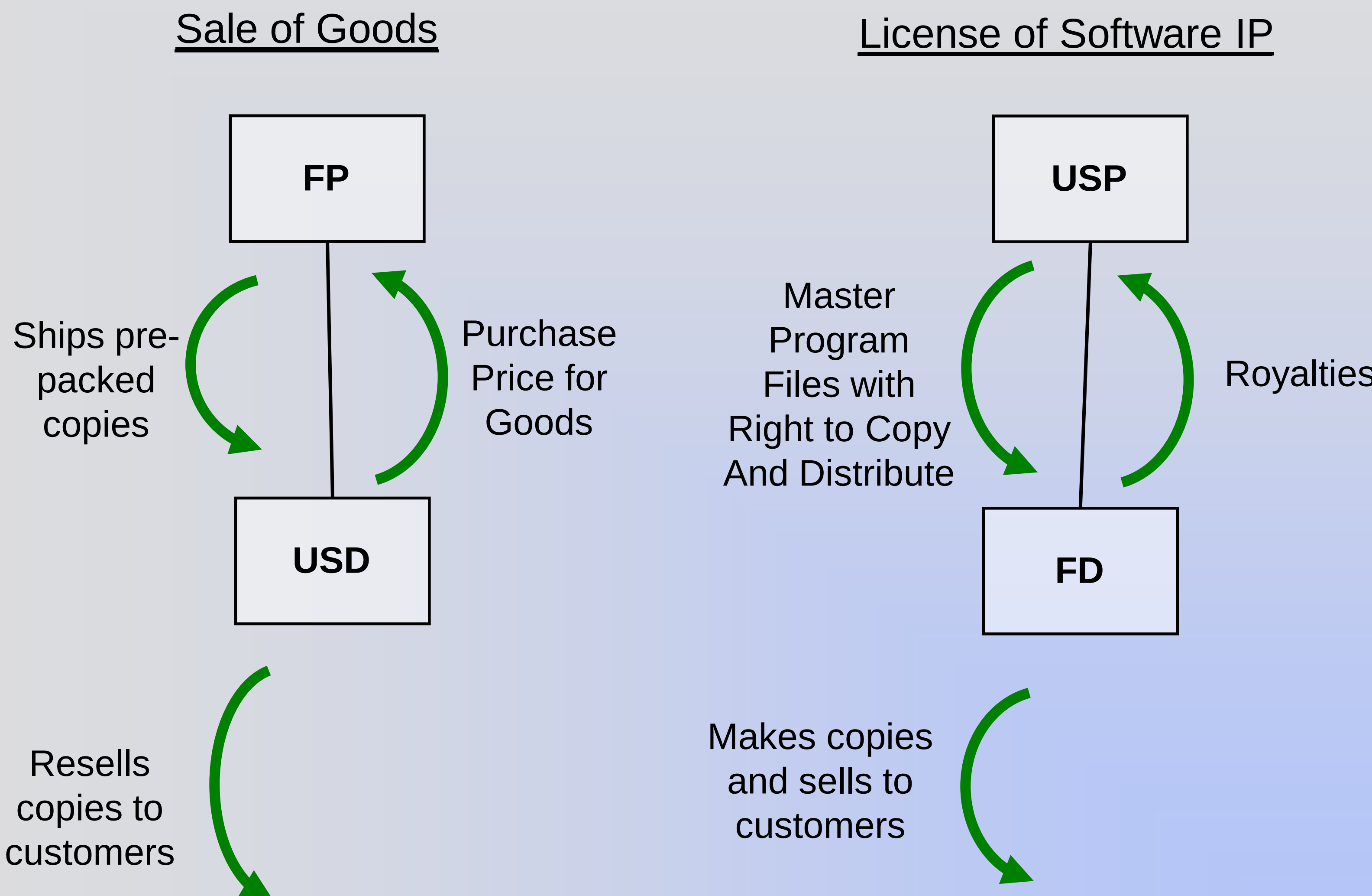
Source of Income – Other Rules

- Source rules for other common types of income:
  - Sale of non-inventory property – generally, residence of seller, but several exceptions. *See* § 865.
  - Personal services – place where services are performed §§861(a)(3) and 862(a)(3).
  - Dividends and interest – residence of payor / obligor. *See* §§ 861(a)(1), (a)(2) and §§ 862(a)(1) and (a)(2))
- Source of income depends on how income is *characterized* for tax purposes – service v. license, service v. lease, sale of property v. lease.

Source of Income – Software Regulations

- Treas. Reg. § 1.861-18 provides rules for characterizing income from certain transactions involving computer programs:
  - Transfer of one or more EULAs, with no rights to reverse engineer or copy and distribute to the public = sale of goods.
  - Transfer of OEM-type rights = royalty-bearing license.
  - EULA with a limited term = lease of tangible property.
- The regulations do not provide specific guidance on several software / e-commerce transactions (e.g., cloud computing, software maintenance agreements).

Software Regulations – Distribution Example



Foreign Tax Credit – Allocation and Apportionment of Expenses

- Example 1: U.S. taxpayer has $500 of taxable income

U.S. Source:	Foreign Source:
$350 gross income	$350 gross income
$100 expenses	$100 expenses
$250 taxable income	$250 taxable income

- Assume U.S. tax liability prior to the foreign tax credit is $175.
- Assume that foreign government levies taxes totaling $97.

$250 Foreign Source Income / $500 Worldwide Income	x	$175 Tentative U.S. Tax Liability	=	$87 FTC Limit

- The taxpayer's FTC is limited to $87, leaving the taxpayer with **$10 of unused FTC**. The taxpayer's U.S. tax liability is $88 following the application of § 904 ($175 - $87).

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Foreign Tax Credit – Allocation and Apportionment of Expenses

- Example 2: Same facts, but assume instead that only $130 of expenses is allocated to U.S. source income, and $70 of the expenses is allocated to foreign source income.

U.S. Source:	Foreign Source:
$350 gross income	$350 gross income
$130 expenses	$70 expenses
$220 taxable income	$280 taxable income

$280 Foreign Source Income / $500 Worldwide Income	x	$175 Tentative U.S. Tax Liability	=	$98 FTC Limit

- The taxpayer is able to fully utilize its creditable foreign taxes paid of $97, and avoid double taxation with respect to its foreign source income. The taxpayer’s U.S. tax liability is $78 ($175 - $97).

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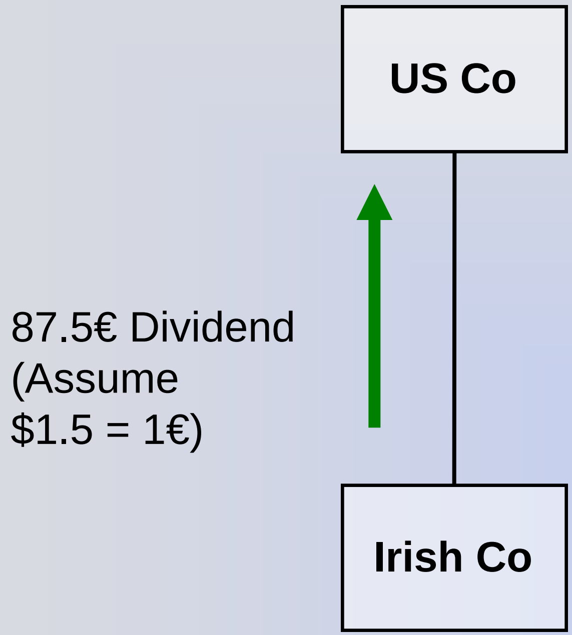
Earnings & Profits and Tax Pools

- Foreign corporations compute and maintain their "earnings and profits" according to the U.S. tax principles applicable to domestic corporations. *See* § 964(a).

- When a foreign corporation pays a dividend, a 10% domestic corporate shareholder is entitled to claim a "deemed paid" foreign tax credit for a proportionate amount of the foreign corporation's foreign income taxes. *See* § 902.

- Taxes and earnings are calculated and maintained in multi-year pools covering all post-1986 years of the foreign corporation under U.S. ownership.

Earnings & Profits and Tax Pools – Example of Section 902 Credit

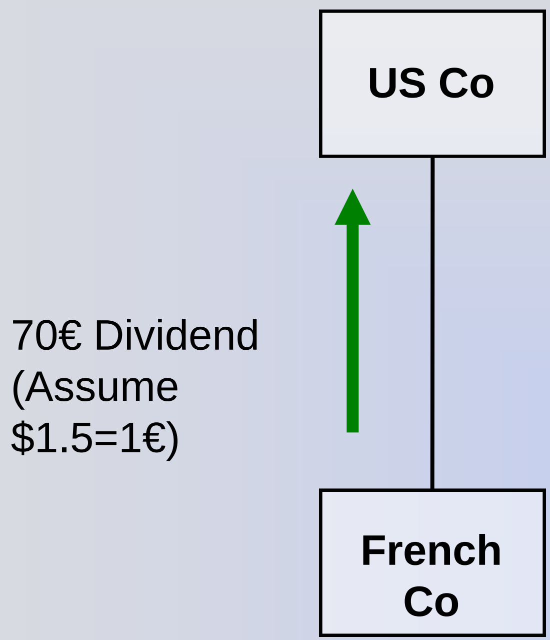


Section 902 calculation:

Dividend income	$131
Section 78 "gross-up"	$18.7
Total income	$149.7
Tentative U.S. tax	$52.5
Section 902 Credit	($18.7)
Net U.S tax	$33.8

Profits before tax	Irish taxes	Post-1986 E&P	Post-1986 Taxes
1,000 €	125 €	875 €	$187.5

Earnings & Profits and Tax Pools – Example of Section 902 Credit



<u>Section 902 calculation:</u>

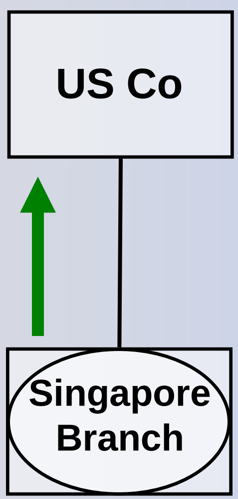
Dividend income	$105
Section 78 “gross-up”	$45
Total income	$150
Tentative U.S. tax @ 35%	$52.5
Section 902 Credit	($45)
Net U.S tax	$7.5

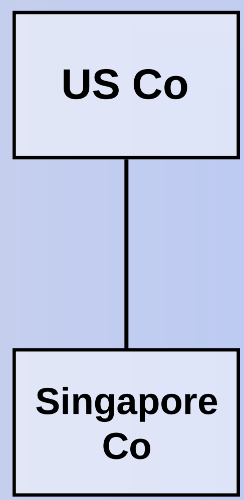
Profits before tax	French taxes	Post-1986 E&P	Post-1986 Taxes
1,000 €	300 €	700 €	$450

Subpart F – Background

- U.S. taxation of U.S. persons on worldwide income.
- Absent subpart F, a foreign subsidiary's earnings are not subject to U.S. tax until distributed to the U.S. shareholder.
- Subpart F was enacted by Congress to limit the deferral of U.S. taxation of certain income earned outside the U.S. by foreign corporations controlled by U.S. persons (controlled foreign corporations or CFCs).

Income earned by Singapore Branch flows into US return





Interest, dividends, rents and royalties.

Certain sales income.

Certain service income.

Subpart F – Key Definitions

- <u>Controlled foreign corporation ("CFC")</u>
  - Any foreign corporation if, on any day during its taxable year, U.S. shareholders own <u>more than 50 percent</u> of the total combined <u>voting power or value</u> of all of the corporation's stock. (§ 957(a))

- <u>United States shareholder</u>
  - Any U.S. person who owns (within the meaning of § 958(a)) or is considered as owning by applying the constructive ownership rules of § 958(b), ***10% or more*** of the total combined ***voting power*** of all classes of stock entitled to vote of the foreign corporation. (§ 951(b))

- <u>Foreign base company income</u> consists of—
  - **foreign personal holding company income (§ 954(c))**
  - **foreign base company sales income (§ 954(d))**
  - foreign base company services income (§ 954(e))
  - foreign base company oil-related income (§ 954(g))

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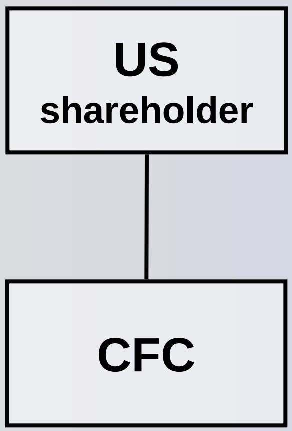
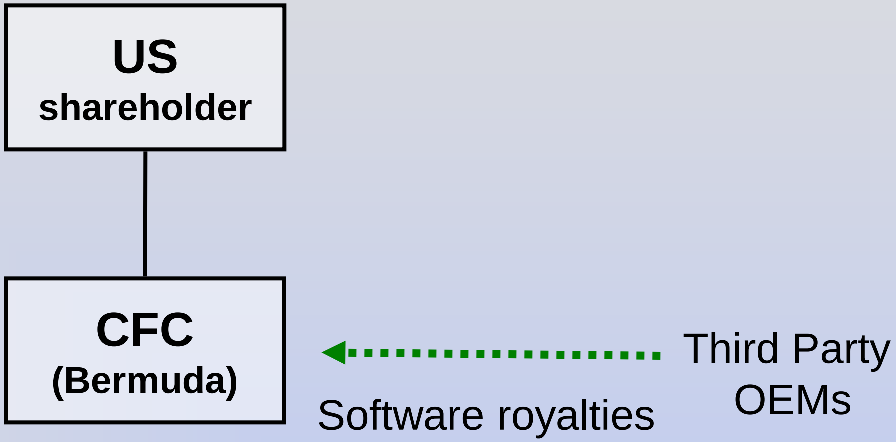
Foreign Personal Holding Company Income



Passive income

- Section 954(c) – Foreign personal holding company income includes many types of passive income:
  - Dividends, interest, royalties, rents, and annuities
  - Certain property transactions (generally, gains from the sale of property which (i) gives rise to passive income, (ii) is a partnership interest, or (iii) which does not give rise to income)
    - Generally excludes property that is used in a trade or business.
  - Commodities transactions, foreign currency gains, etc.

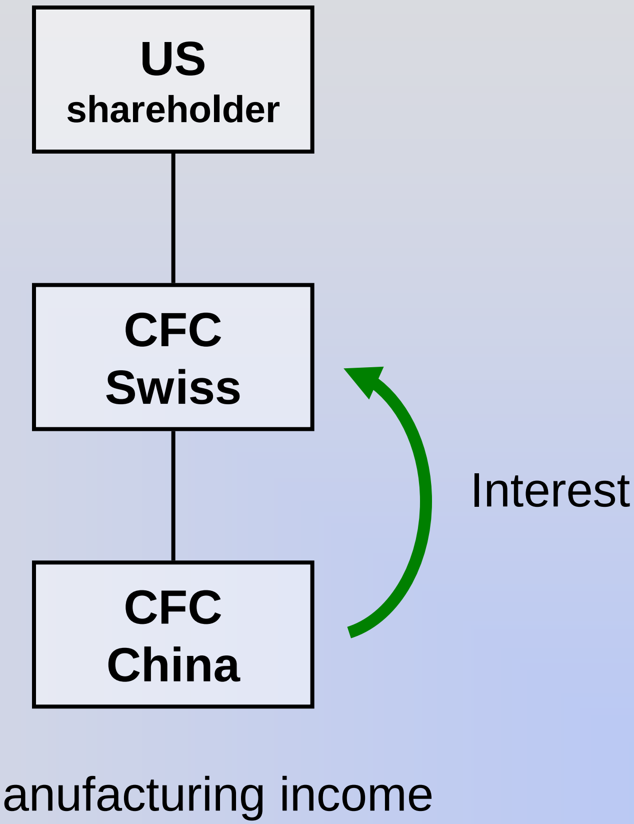
Example of FPHC Income



- Royalty income generally constitutes FPHC income.

- Exceptions for licensing IP actively developed by the CFC or licensing IP through a substantial marketing organization located overseas. *See* § 954(c)(2)(A); Treas. Reg. § 1.954-2(d).

FPHC Income – Section 954(c)(6) Exception



- Interest, dividends, rents and royalties from related CFCs generally are not subpart F income under § 954(c)(6) (the CFC "look-through rule").

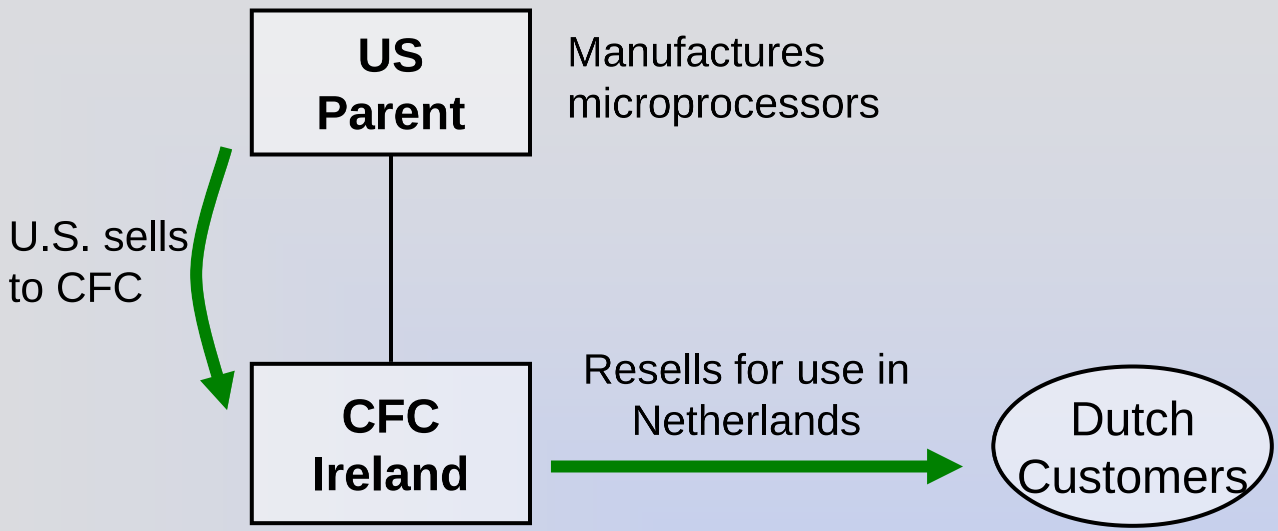
Foreign Base Company Sales Income

- Section 954(d)(1) – Foreign base company sales income means
  - **Income derived in connection with any of the following**:
    1. The purchase of personal property from a related person and its sale to any person,
    2. The sale of personal property to any person on behalf of a related person,
    3. The purchase of personal property from any person and its sale to a related person, **or**
    4. The purchase of personal property from any person on behalf of a related person
  - **Where the following conditions exist:**

    (i) The property is manufactured outside the CFC's country of organization, **and**

    (ii) The property is sold for use outside the CFC's country of organization

Foreign Base Company Sales Income

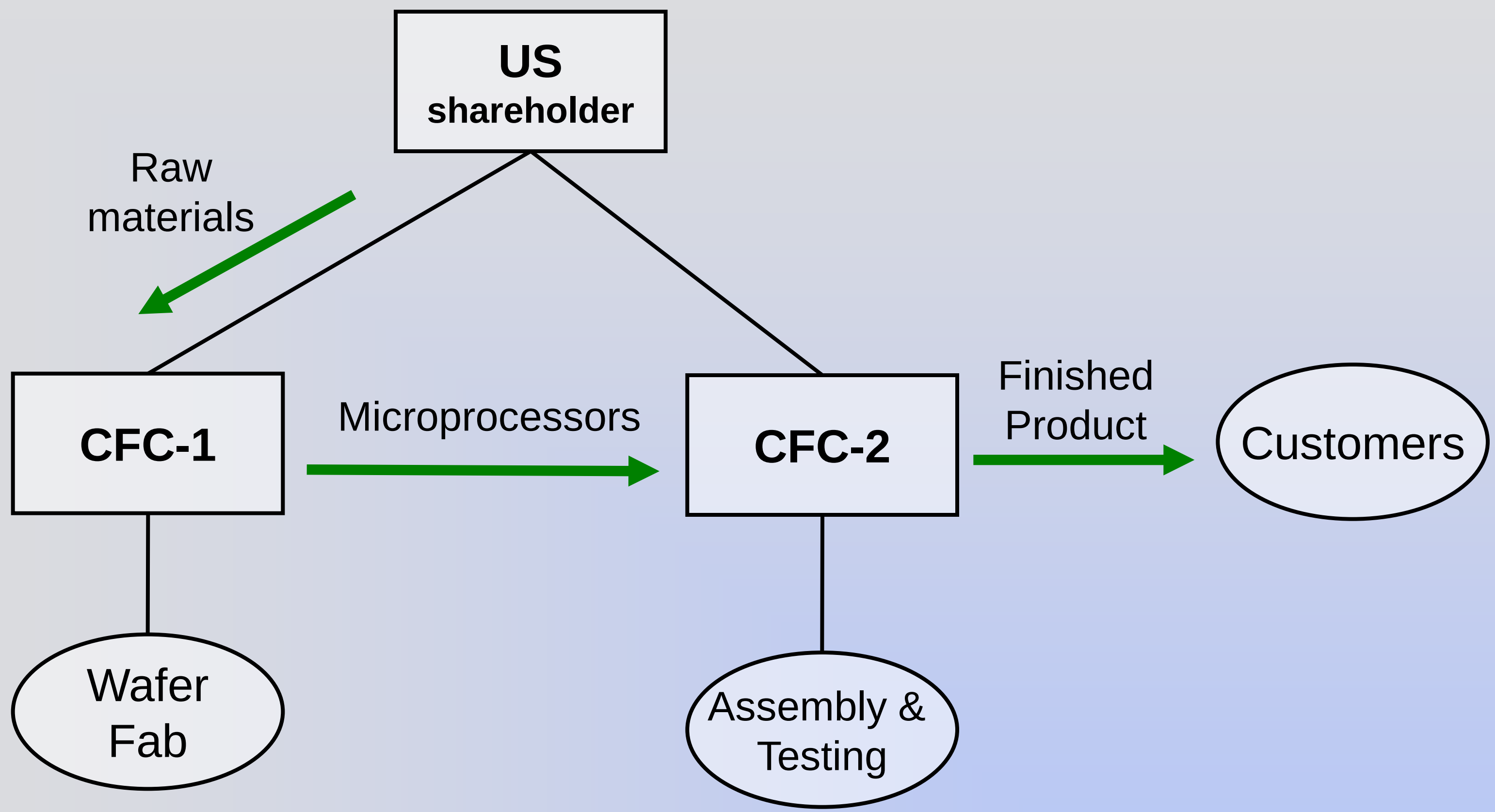


- CFC has FBCSI since the income is derived from the purchase of personal property from a related person, the property is *sold for use outside* of Ireland and the property is *manufactured outside* of Ireland.

Foreign Base Company Sales Income – Manufacturing Exception

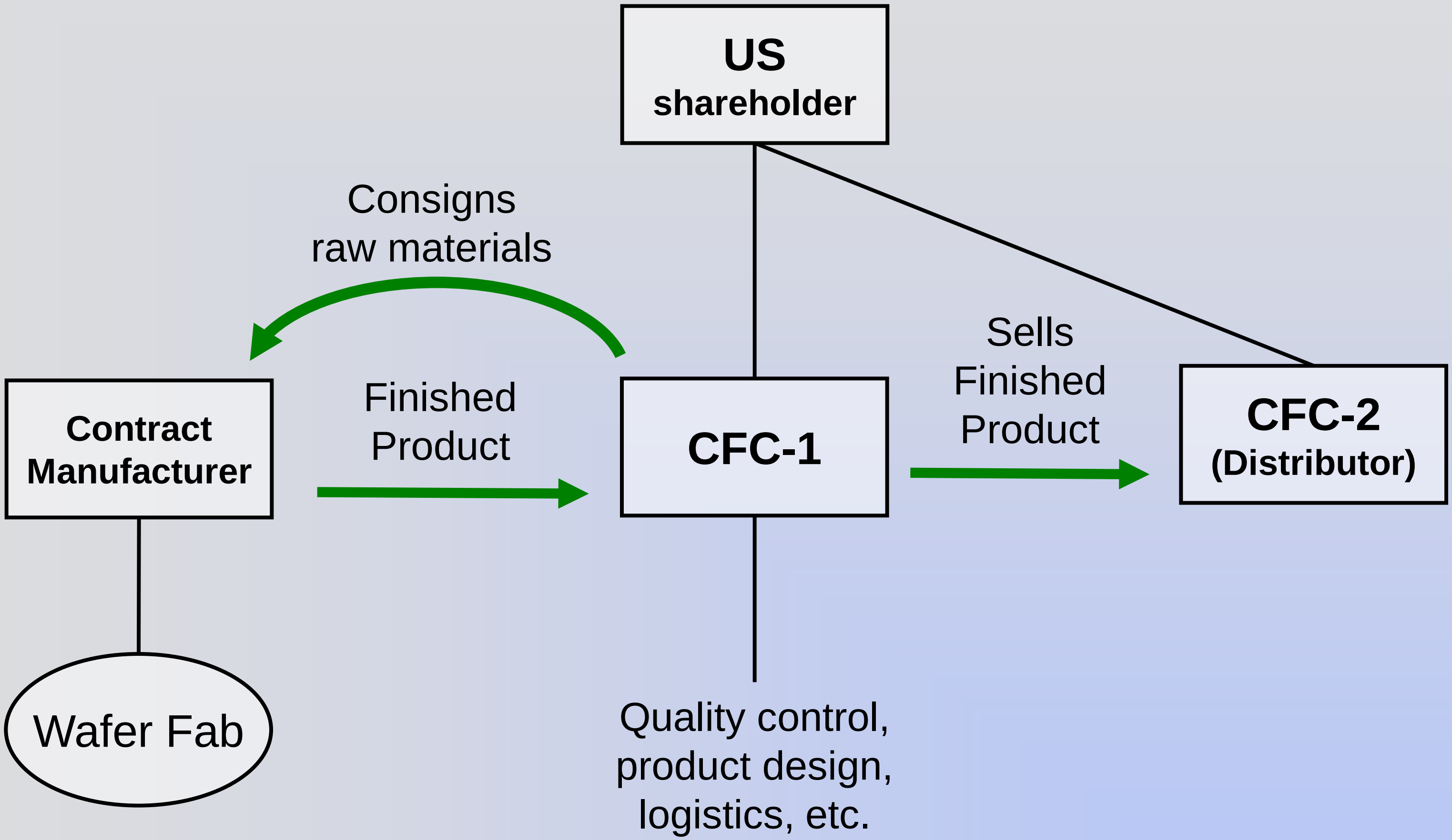
- Income that would otherwise be FBCSI is excluded from subpart F income if the CFC deriving the income satisfies the manufacturing exception, through one of three tests:
  1) Substantial transformation of the property by the CFC;
  2) The CFC performs manufacturing activities that are (1) substantial in nature and (2) generally considered to constitute manufacturing;
  3) The CFC's own employees make a "substantial contribution" to the manufacture of property by another person.
- The intent is that subpart F should not apply where the CFC's own activities add substantial value to the property being sold.

Example of Manufacturing Exception



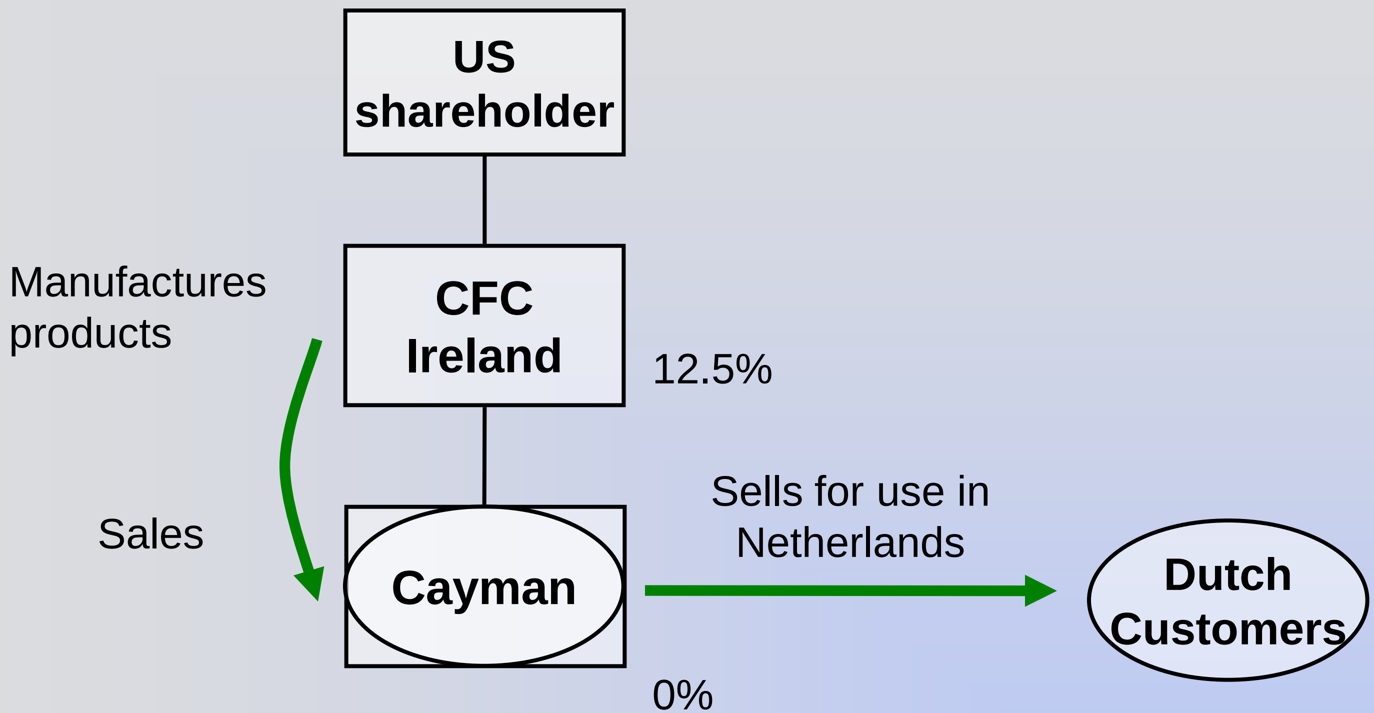
- CFC-1 would qualify under the "<u>substantial transformation</u>" test and not have subpart F income.
- CFC-2 might qualify for the exception for activities that are <u>substantial in nature</u> and <u>generally considered to constitute manufacturing</u>.

Example of Contract Manufacturing



- CFC-1 would not have subpart F income if CFC-1's employees make a "substantial contribution" to the manufacturing of property by the contract manufacturer.

Subpart F "Branch Rule"



- Under the tax rate test, the selling of products by the Cayman branch has substantially the same tax effect as if the Cayman branch were a subsidiary corporation.
- Under § 954(d)(2), the Cayman branch is treated as a separate CFC and has Foreign Base Company Sales Income.

Subpart F – Section 956 Investments

- Section 956 is intended to prevent a CFC from indirectly repatriating earnings to its U.S. shareholders without incurring residual U.S. tax.

- Section 956 treats investments by a CFC in certain “United States property” as giving rise to a deemed dividend:
  - Obligations of related U.S. persons
  - Stock in related U.S. persons
  - Most tangible property physically located in the U.S.
  - U.S. real property
  - Intangible property acquired or developed for use in the U.S.

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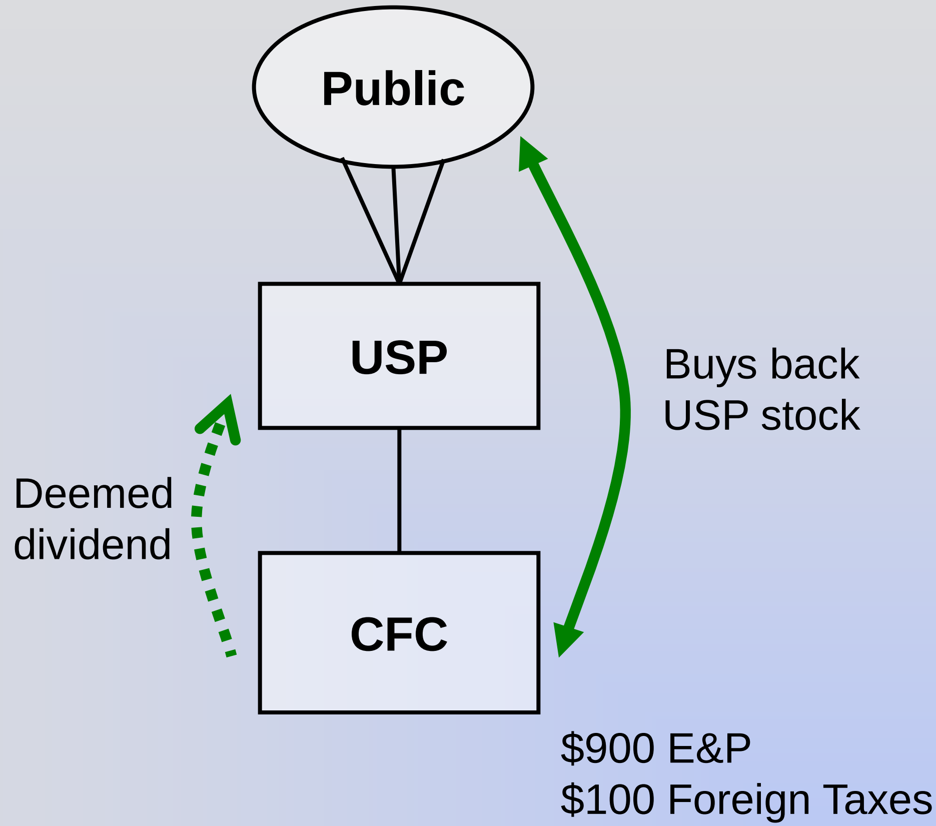
Example of Section 956



- CFC’s acquisition of U.S. Parent stock would cause it to hold a U.S. property investment that is taxable under section 956.

- USP would include earnings and be liable for residual U.S. tax (i.e., 25% of the deemed dividend).

Former § 965 - Repatriation Holiday

- Under the 2004 American Jobs Creation Act (“AJCA”), Congress enacted § 965 to provide for a temporary 85% dividends-received deduction for certain dividends paid by CFCs.

- Reduced tax-rate on repatriation was tied to use of repatriated funds in a “domestic reinvestment plan” to stimulate job growth in the United States.

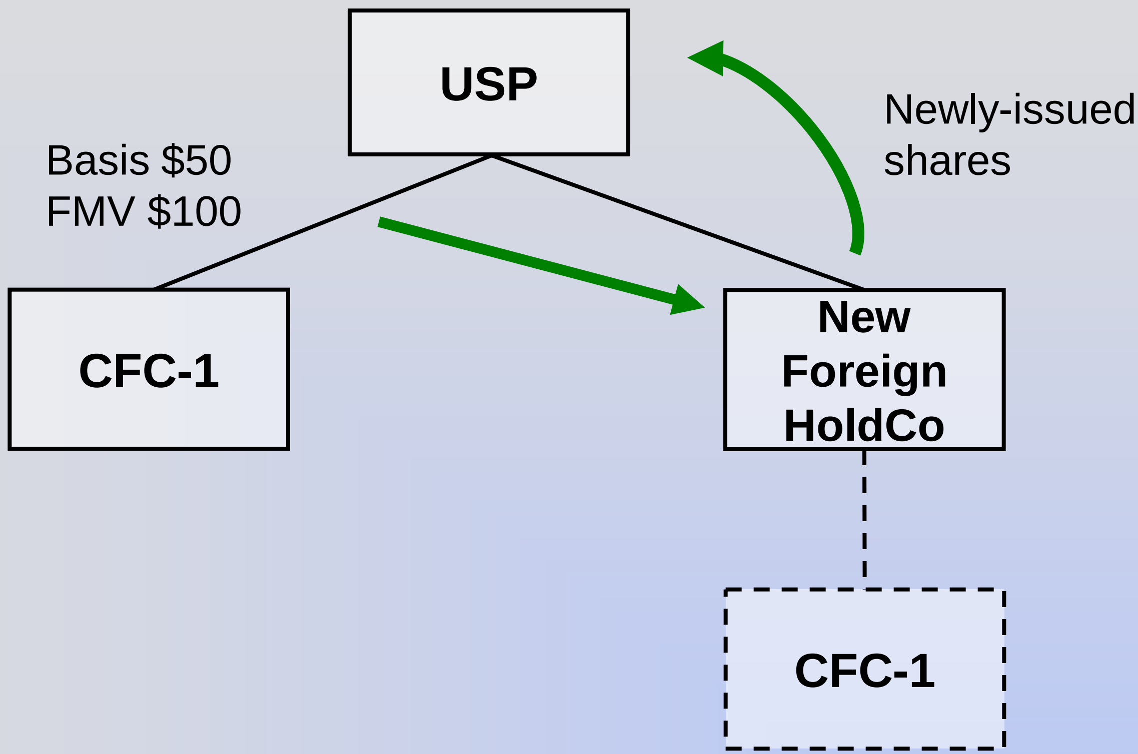
- High technology firms accounted for a large share of total repatriations under old § 965:
  - Computer and electronics manufacturing firms $52 billion
  - Software and telecommunications $7.4 billion
  - Total repatriation under the Act (all industries) $246 billion

  See Pinson & Shanley, Tax Notes (Aug. 22, 2011).

International M&A—
Tax-Free Reorganizations

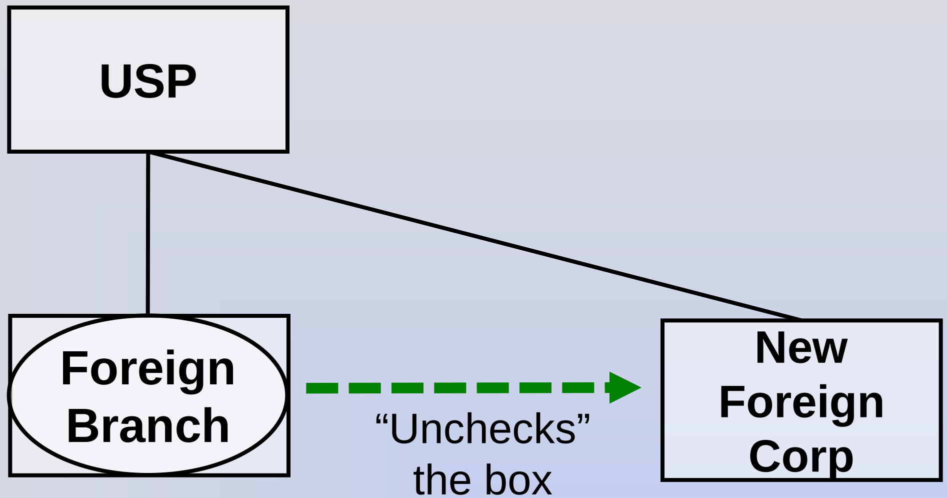
- Tax-free reorganizations involving a cross-border element (i.e. both a U.S. and foreign person) are subject to the rules of §367:
  - Section 367(a) – "outbound" transfers by a U.S. person to a foreign corporation
  - Section 367(b) – "inbound" reorganizations and foreign-to-foreign reorganizations
  - Section 367(d) – IP transfers by U.S. persons to foreign corporations
  - Section 367(e) **–** "outbound" liquidations and spin-offs of U.S. corporations **(rare)**
  - Section 7874 – anti-"inversion" rules.

Section 367(a) – Example of an “Outbound” Stock Transfer



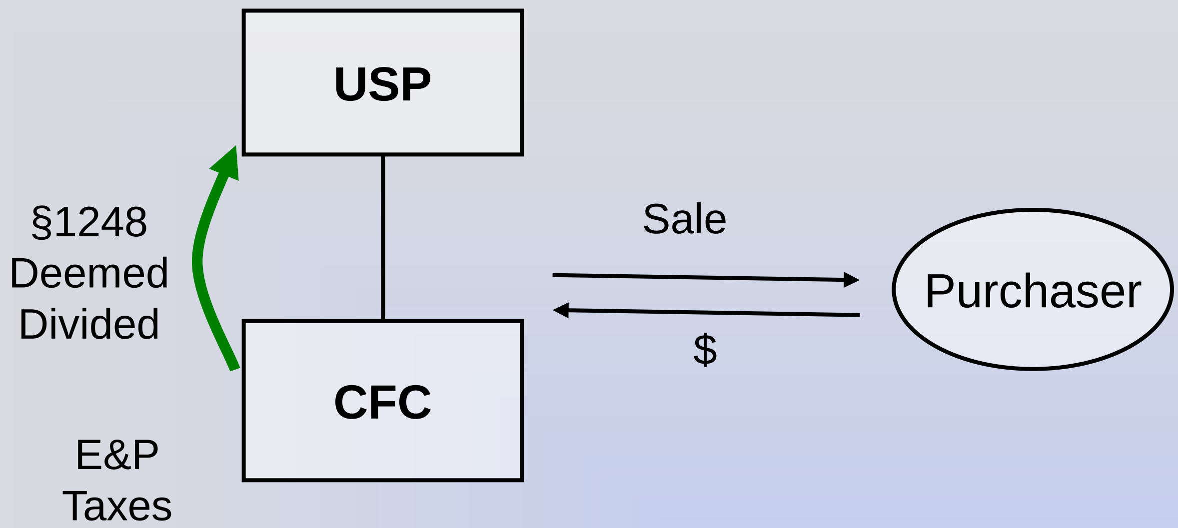
- USP must enter into a “gain recognition agreement” (GRA) to avoid recognizing gain on the transfer of CFC-1 stock.
- If no GRA is filed, § 367(a) will override tax-free treatment under §§ 351 and 368(a)(1)(B).

Section 367(a)—
Outbound Asset Transfer



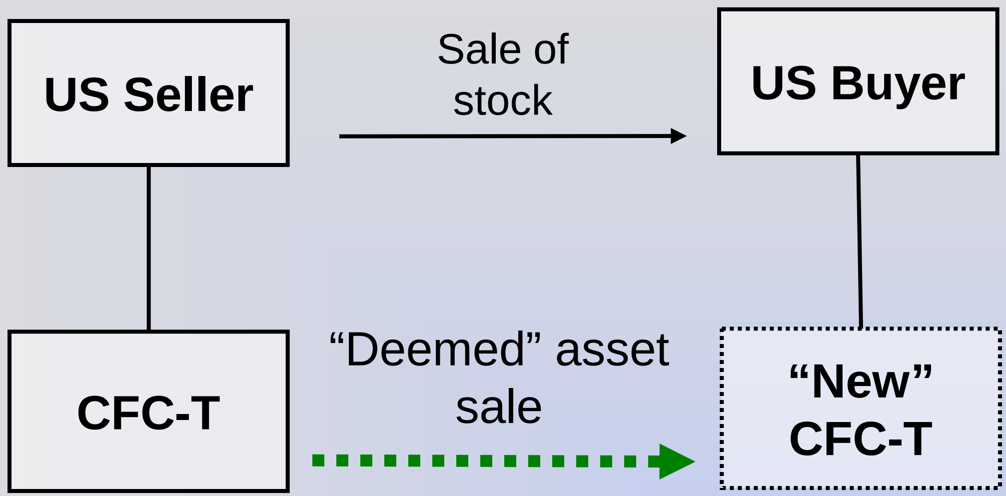
- Transfer of active foreign business assets generally is not taxable under § 367(a), but there are exceptions for:
  - Loss recapture rules
  - "Hot" assets
  - Section 367(d) intangibles

International M&A—
Sales of CFC Stock



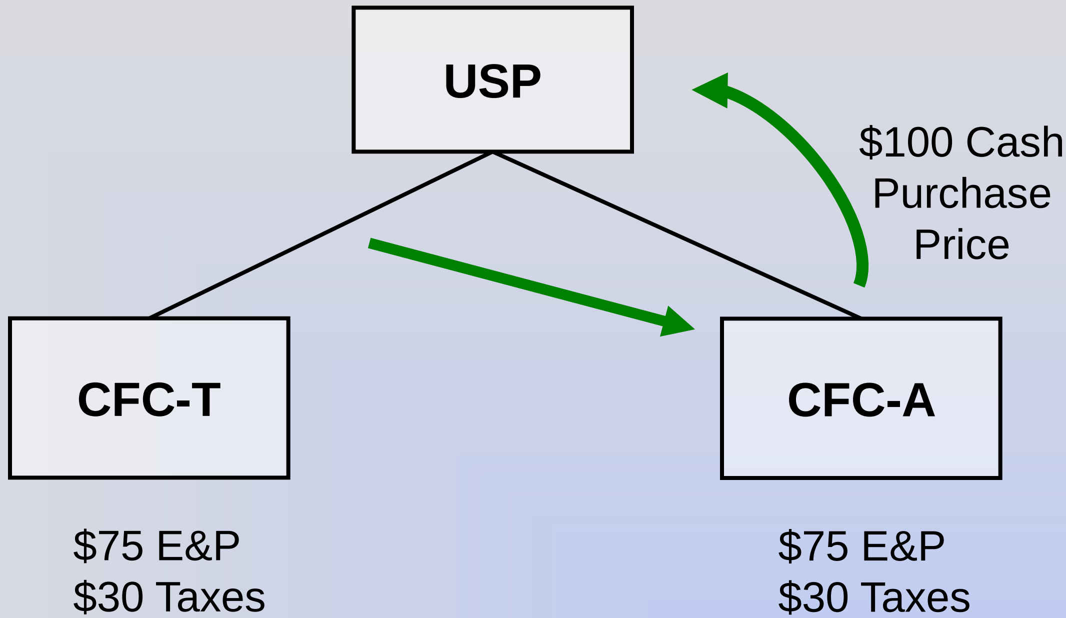
- Section 1248 re-characterizes gain from the sale of CFC stock as a dividend, allowing the shareholder to claim deemed-paid foreign tax credits from CFC’s historic E&P and tax pools.
- The deemed dividend under section 1248 is referred to as the “section 1248 amount.”

International M&A— The § 338 Election



- The Buyer may elect under § 338(g) to treat the purchase of CFC-T’s stock as a purchase of assets by New CFC-T.
- New CFC-T takes a stepped-up basis in its assets, “clean” tax history, etc. *But see* § 901(m).

International M&A— Section 304 Transactions

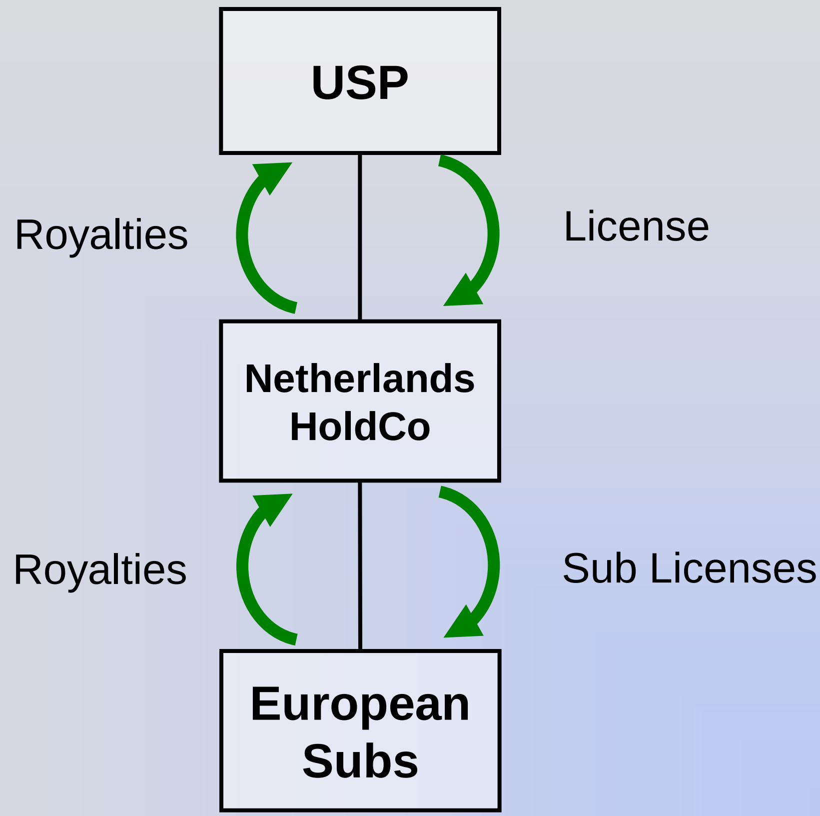


- Section 304 treats the $100 as a deemed dividend from FA’s, and then FT’s earnings and tax pools.
- Commonly used for cash repatriation and internal restructurings.

Withholding Taxes

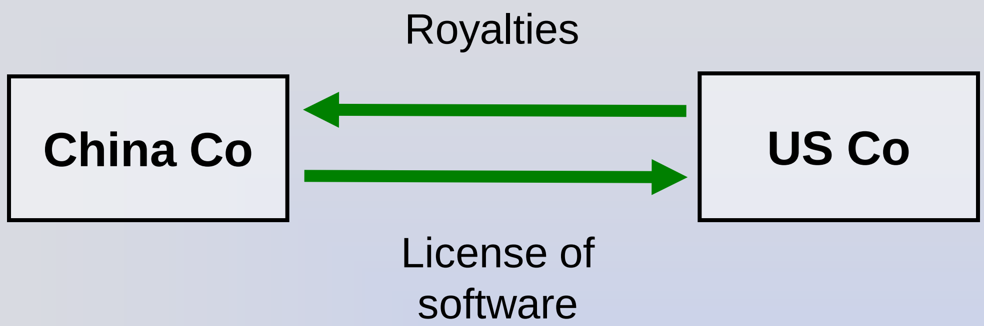
- To preserve their domestic tax base, most countries impose a withholding tax on interest, royalties, dividends, and similar payments made to foreign persons. *See, e.g.*, § 881(a).
  - Tax is imposed on the gross amount of the payment.
  - Rate of withholding tax may be reduced or eliminated by an income tax treaty.
- Any person with control, custody or possession of the payment is legally liable for the withholding tax. *See* §§ 1441 and 1461.

Example of Use of Tax Treaties



- Netherlands’ tax treaties with local countries may provide for a lower rate of withholding tax on royalties than applicable U.S. tax treaties with European subsidiaries’ jurisdictions.

Example of Withholding Agent



- U.S. Co. would be required to withhold tax on royalties paid for use of software in the United States.
- China treaty would generally provide for a reduced rate of withholding if China Co provided a properly completed IRS Form W8-BEN.

Questions?

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