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International Taxation or International Tax Planning

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Abstract

With the globalization and expansion of business, the adjective "international" is applied widely to many things – international institutions, international waters, international relations, international business, international transactions, international taxation, etc. The latest can be discussed with numerous pros and cons. This paper will address the contradiction in terminology, as when we discuss International Taxation, we generally mean International Tax Planning. To implement international taxation, we need an international institution for levying taxes. Taxation was, is, and will be, at least for the near future, a national matter – closed in the borders of the countries. However, compliance with different tax structures, tax institutions, and tax rates led to the development of International Tax Planning. The paper will emphasize the differences between these two points by examining internationalization in tax matters in the largest Union – the European Union; the type of internationalization in the USA, including the existence of federal taxation; treaties for avoiding double taxation between countries; and the future of international tax planning.

Introduction

Economic development at the end of the 20th century has brought about numerous new requirements and challenges in the field of tax policy. The openness of economies, the creation of economic unions, and globalization have increased external influence on the sovereignty of taxation. Although "international taxation" has become a suitable expression, it does not have any substantial content. In modern democratic societies, people are simultaneously taxpayers and voters. The biggest dilemma for any congressman or senator is how to generate more revenue from taxpayers without harming the voters. This unity makes it very important that every voter should speak to the taxpayer and vice versa. This unity and contradiction give the basis that there will never be international taxation if there are no international elections.

The primary goal of this paper is to draw a line of distinction between the issues of international taxation and international or multinational tax planning. The paper is divided into two basic parts: introduction and conclusion. The first one provides an overview of the literature in the field of international taxation, considering the European Union and the United States as examples of international taxation. It also addresses some typical issues in international taxation, including tax competition, double taxation, tax reforms, and tax harmonization. The second part is dedicated to multinational tax planning and its components, including costs, foreign tax credit, transfer pricing, and advance pricing.

Part I: Issues of International Taxation

International taxation in the literature

Taxation and especially income taxation is considered the most sovereign part of the government policy of any country. Although most authors writing on international taxation do not extend their analysis beyond national borders, they often focus on the "home" treatment of foreign companies, regardless of which country they are in.

A brief review of the literature will reveal the “roots” of international taxation. Most of the authors (Isenbergh, 2005; Rohatgi, 2001; Doemberg 2004, Avi-Yonah, Ring, and Brauner 2005; Daniel, Ault, and Repetti 2005) and others state the basic elements of international taxation – US Taxation of International Settings, Nationality and Residence for Taxation and discusses international aspects of tax systems originating in national environments. It focuses on U.S. taxation as applied to economic activity with an international element.

Courses around Universities on International Taxation usually cover US taxation of foreign companies or foreign persons or entities doing business in the US, the latter is not so often met. These courses are based on the same or similar books mentioned above. What they often deal with is related to any of the following:

- domestic tax laws, rules, and practices and how they conflict with cross-border transactions;
- bilateral tax treaties and their role in resolving international tax conflicts;
- the use of offshore financial centers in international tax structures and how to choose them;
- anti-avoidance measures imposed by national taxation authorities;
- the application of national judicial decisions and interpretations of national authorities; and
- International tax guidelines and interpretations of bodies such as the Organization for Economic Cooperation and Development (OECD) and the International Fiscal Association (IFA).

Each of them describes each or all of these elements, weaving them into practical planning guidance that provides a fundamental understanding of the subject. Moreover, it explains the principles of international tax planning that fully account for the costs and risks of international taxation, thereby optimizing the after-tax returns on cross-border transactions.

There is much controversy in the term – international taxation. Of course, it is a matter of terminology, and it is also a matter of principles, because still only the government has the sovereign power to levy taxes, and this power extends over either the territory or/the citizens of the country. It does not matter if the country uses “the territorial tax system” (for example France, Belgium, the Netherlands, Norway etc.) under which they do not tax income generated outside their borders, or “ worldwide residence basis” (USA, Japan and the UK), so they tax the total worldwide income of their residents and citizens. In both systems, taxpayers and voters often coincide, and taxes and elections are closely related. This makes the taxes a more national issue than an international one.

European Union as an international tax jurisdiction

In the European Union (EU), multinational companies can efficiently operate across all 27 member states of the European Union. The tricky part is navigating through all of the different tax rates and paperwork that needs to be filled out. Compliance issues arise because corporate tax law is more complicated than individual tax law. It also consumes a significant amount of company resources and time, as officials must engage in extensive tax planning to ensure that only one government taxes each unit of income. This convoluted system of multiple tax returns based on different rules has led some industry representatives to propose harmonizing the tax base and establishing a universal definition of taxable income. Tax harmonization is just one aspect of the drive to a single market within the EU.

To achieve tax harmonization, the EU Council is working to avoid counterproductive economic consequences. In most cases where higher tax rates stifle tax competition, it hinders the efficient allocation of capital and labor, ultimately leading to a slowdown in overall economic performance. There are other initiatives that international governments are pursuing to build some tax harmonization.

It is not easy to know the direction in which Europe will take. High-tax European welfare states, such as Germany and France, are significant supporters of tax harmonization. These countries also want a European-wide tax imposed and collected by Brussels, along with harmonization of personal and corporate income tax rates. Other European nations can certainly understand their argument about indirect forms of tax harmonization, such as the EU savings directive, but are not as keen on harmonizing rates. If a savings directive is implemented, it could go along way in helping Europe’s high-tax nations cripple tax competition. Additionally, as new nations join the EU, many jurisdictions will adopt tax laws designed to stimulate growth and attract economic activity. This will place pressure on Europe’s welfare states because many investors will shift their capital to take advantage of more favorable laws. Additionally, as more nations join, it will become much harder to achieve tax harmonization due to the new voting power. These new members believe that lower taxes help them catch up with the rest of the EU by creating new businesses, rather than by increasing tax rates.

Tax competition versus tax harmonization

"The priority is to reduce the tax burden EU-wide. Moreover, do not even attempt to harmonize national tax systems across the board… The EU is already pledged to eliminate harmful tax competition. However, a reasonable degree of tax competition would not be harmful at all: it would lead to a market-driven convergence towards lower tax rates…" (Frits Bolkenstein, Commissioner for the Internal Market, 2001)[1]

The debate over whether to pursue tax competition or tax harmonization has been ongoing within the European Union since its formation. This debate has primarily focused on the impact of corporate tax rate differentials on the location of foreign direct investment and the tracking and taxation of flight capital. Over the past couple of years, European governments have engaged in a process of tax competition by strategically lowering tax rates in order to lure businesses, investments, and cross-border shoppers. In contrast to tax harmonization, tax competition forces governments to be more efficient and facilitates economic growth by encouraging them to adopt sensible tax policies. With the entry of the new European Union members, who on average have 10 percent lower corporate tax rates than older E.U. members, even more light will be shed on the subject of tax competition. The European Union will decide whether to embrace or turn its back on tax competition, which will ultimately determine its economic strength in comparison to the rest of the world.

Issues surrounding the harmful tax competition of some EU member states, which aims to lure businesses into their countries, are prompting many within the EU to call for a harmonized corporate tax policy. Specifically, Ireland and Britain have been criticized for administering anti-competitive tax subsidies to businesses that structure their permanent enterprises there. This leads to inefficiencies that distort the concept of a free market by allowing companies with no real competitive advantage to remain in business and by hindering the development of businesses that would truly flourish in that location in the future.

The European Union is attempting to establish a system of tax harmonization among all member states to prevent tax arbitrage. There has been some agreement on a method of tax base consolidation for companies in the EU; however, total harmonization is rejected by most, who refer to this as an unnecessary approach to eliminating tax obstacles.

The European Commission has devised three different approaches in an attempt to bring the European Union in the direction of a single market: Home State Taxation (hereafter HST), Common Consolidated Corporate Tax Base (hereafter CCBT), and Harmonized European Tax System. (HETS)

All approaches are targeted at the corporate tax structure, as this is the area that would impose the least risk. "On average across the EU, only 6% of total tax revenue comes from the direct taxation of companies, compared with the 24% of tax revenue that comes from personal tax." (International Tax Review, 2004) Furthermore, companies do not vote in political elections and, therefore, the effects of any assessment would not influence any candidate's campaign.

The benefits of corporate harmonization will be a definite sign of positive progress within the EU. Specifically:

- Businesses will see a significant reduction in compliance costs, which result from doing business within a smaller number of tax systems as well as costs associated with transactions-based transfer pricing rules within the member states.
- Businesses will be able to offset losses occurring in one member state with profits gained in another.
- Businesses will face greater simplification by having to comply with only one tax system
- Anti-competitive tax arbitrage would not control where firms choose to locate.
- Double taxation would be lessened
- Increased tax competition among EU states may result in lower tax liabilities

Currently, the EU is using a separate accounting and arm's length standard to compute the income of the corporate group and "source rules" to apportion income to each of the group's member states where that income is said to have originated.

[1] The Economist, Feb. 10, 2001, p. 52, citing Frits Bolkenstein, EU Commissioner for the Internal Market

This system is highly complicated and entails constantly tracking and computing income between the corporate groups.[2]impeding the desire to establish a single market. Therefore, the European Commission's strategy when devising the different approaches toward harmonization has resulted in a formula-based approach for computing the group's corporate tax base, rather than separate accounting.

The HST proposal is considered to be easy and quick to implement, and therefore has been aimed at small and medium enterprises (SME)[3] Since large amounts of revenues are not necessary for compliance, the corporate groups' income would be computed by the income tax rules of the home state (where the headquarters are located). Consequently, foreign operations are treated as if they occurred in the home state. "Profits then would be allocated according to a formula to other EU countries in which their affiliates operated, thereby eliminating the need to determine profits based on arm's-length prices" (Tobin, 2004). Finally, each country would apply its own tax rates to the allocated profits. The result of HST would be to simplify tax compliance by using a single tax base and operating within a unified tax system.

The best way to show the effects of the approach is by example. A group with its headquarters in Italy and a subsidiary in France would calculate its taxable income in accordance with Italian tax rules. A uniform formula would be used to apportion the tax base between the member states of the group, and the individual member states would apply the tax rate in their country to their share of revenue.

It is essential to note that only EU-based companies will be included in the HST plan. "Non-EU-sourced income of any group member would fall outside the scope of HST and would be added to the income of the group member that earned the income after apportionment." (Tobin, 2004) The plan will be monitored by the home state's taxing authorities through audits, to identify any issues with the plan and measure its success.

The HST plan is extremely beneficial for small and medium sized companies, but the Commission does not believe it provides a long-term tax solution for optimal harmonization. They are primarily designed for implementing the Common Consolidated Corporate Tax Base approach.

Unlike the HST plan, the CCBT is aimed at all Multinational groups and entails establishing a new, standard set of EU rules for calculating the tax base of the group, rather than relying solely on the home state rules. The country where the group is headquartered would administer the tax. The tax base would then be apportioned between the group members, who would then apply their rates. The result of this plan would be a Common base that would reduce compliance costs for companies.

Again, an example would best demonstrate the effects. A group with headquarters in Italy and a subsidiary in France would compute the tax base in both Italy and France with a standard tax code. Both calculations are submitted to the Italian tax authorities for approval of the tax base. The approved base is then apportioned to both Italy and France, which would apply their tax rates to their respective shares of the income.

The European Commission is deciphering whether to use International Accounting Standards as a neutral starting point for the establishment of the rules for a common tax base. It reached a consensus that "accounting dependency is the key to the concept of a common tax base" (International Tax Review, 2004)

Tax competition and tax reforms

Tax competition arises when countries strategically utilize their tax policies to compete for mobile factors. Theory suggests that this competition leads to a tendency to abandon capital taxes. Furthermore, to maintain the level of public expenditure, governments must raise taxes on immobile factors, particularly labor.

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[2] Group activities of commonly owned corporations can be "combined" for state tax purposes only if the affiliates are engaged in a "unitary business" (McLure, 2004)

[3] Small and Medium Enterprises - A small company is relatively small. If the universe of companies to which HST applied were limited to them, the test would not likely be of great interest to international tax planners. However, a medium-sized enterprise is defined as a corporation with up to 250 personnel and a sales turnover of up to 50 million euros (about $61.5 million) or a balance sheet total of up to 43 million euros (Tobin, 2004)

As far as international tax policy is concerned, the race to the bottom reasoning is the background behind initiatives to avoid the consequences of 'harmful' tax competition. In the European Union, for instance, tax harmonization has been a topic of discussion for many years. *Small open economy* models of tax competition assume a large number of identical countries that are unable to influence the world interest rate. Within each jurisdiction, fully competitive firms produce a homogeneous good using capital and an immobile factor of production. The world capital stock is fixed and perfectly mobile across countries. The immobile factor, which may be referred to as labor in our context, is elastically supplied by the country's households. The output is either a final good consumed by the households or an intermediate good for the government that transforms it into public goods. Finally, governments impose *source-based* taxes on both capital and labor to finance the production of public goods.[4] For the first time in the 2001 election campaign, the tax cuts were mentioned as an issue in the program of the National Movement Simeon II. In 2001, the dipole model of Bulgarian political life was broken, and a new player emerged – The National Movement Simeon II. This was a strange creation organized under the rule and the name of the former king of the country, and most of the yuppies that has studied in Western countries (sons or relatives of ex-communist leaders or financed for their education from underground firms also owned by communists). Having received their education in Western countries, where they acquired the fundamental principles of democracy, the yuppies advocated for a 0% corporate tax and a drastic reduction in personal income tax. These and some other counterfeit promises secured them a majority in the Parliament. Bulgaria was one of the strangest countries in terms of its political life – it has a socialist (ex-communist) as its President and a king as its Prime Minister. However, the most important thing was that taxes were introduced to the voters for the first time as a choice. Despite the lower tax literacy in the country and the significant evasion, which has been a government policy throughout the years, taxpayers in Bulgaria saw themselves as voters who could change their burden; they believed they could move the scales in their desired direction. The country has drawn closer to the Western democracies.

Bulgaria, like most countries in transition, follows a model typical of Continental and Southern Europe, where democracy was established at a later period. One of the first laws, adopted by the first democratic parliament in 1990, was the law on political parties. This law was not doing a good job of regulating the property and financing of parties. It took more than a decade and four different parliaments to develop the current regulations, which, again, do not adequately address the issue. What is typical of Bulgaria is a strong ruling class that monopolizes all power resources and excludes the opposition. Moreover, in an election campaign, huge promises are always dominant, which will never be fulfilled.

In contrast to a small country, a *large open economy* has some market power in the sense that it can influence the world interest rate through its tax policy. Analytically, this situation is modeled using a framework of asymmetric tax competition between two countries that differ in size, as measured by the number of residents. In this setting, the small country is faced with higher capital supply elasticity.

Taxes on capital should vanish in a world of increasing capital mobility. This is perhaps the most often noted result of standard tax competition theory. Further, tax competition should induce a shift of tax burden from mobile capital to immobile tax bases, especially labor. These effects should be particularly noticeable in small, open economies.

In a 1997 report entitled *The Package to Tackle Harmful Tax Competition,* the ECOFIN Ministers of the European Community wrote, "There is a pressing need to… ensure a more effective co-ordination of taxation policies … Tackling the issue of harmful tax competition, which threatens both to reduce revenues and to distort taxation structures, should be central to the process. (ECOFIN Ministers of the European Union)" What makes tax competition so harmful? Tax competition should not be viewed as harmful, because it is entirely consistent with fundamental tax reform. Writer and Economist Daniel J. Mitchell, in his article "The Economics of Tax Competition", wrote a few examples:

- "Tax reform envisions a system in which income is taxed only once. Tax competition promotes tax reform by helping to eliminate double taxation of income that is saved and invested."

[4] See Bucovetsky and Wilson (1991) for the analysis of tax competition with residence-based taxation. Administratively, the residence principle needs a full exchange of information and is therefore nearly impossible to enforce (see, e.g., Gordon, 1992). Razin and Sadka (2004) have demonstrated that capital taxes will vanish in the equilibrium even if the enforcement of residence-based taxation is feasible.

- "Tax reform envisions a system with low tax rates on productive behavior. Tax competition promotes tax reform by helping to drive down marginal tax rates."
- "Tax reform envisions a system in which governments do not tax income earned in other nations. Tax competition promotes tax reform by rewarding territorial taxation, the common-sense notion that governments tax only income earned inside national borders."
- "The tax harmonization agenda, however, is a distinct threat to the right of nations to reform their tax codes and enact single-rate, consumption-based tax systems. This agenda makes a tax reform very unlikely."

The OECD launched a "harmful tax competition" initiative. This program identifies tax havens and threatens these jurisdictions with financial protectionism if they do not agree to weaken their tax and privacy laws, allowing high-tax nations to track and tax flight capital easily. There is also a plan in place called the "savings tax directive". This indirect form requires member nations to impose a special tax on non-resident investors or to get information regarding investment earnings of non-residents and pass it along to their respective governments. Finally, a third initiative would require the creation of an International Tax Organization. This would grant the authority to override the tax policies of sovereign nations and would be specifically responsible for preventing tax competition. Although these initiatives have been discussed, it is highly unlikely that they will ever materialize. This is because many countries want to retain the right to tax and control the taxation of economic activity within their borders. Countries that favor tax competition feel that it is consistent with fundamental tax reform. They believe that it promotes tax reform by lowering the marginal tax rate, eliminates double taxation of income saved and invested, as income is taxed only once, and promotes a system in which governments do not tax income earned in other nations, thereby avoiding territorial taxation.

The United States is an international tax jurisdiction

The only tax jurisdiction that can qualify to be called an international tax jurisdiction is the US. This is because there are 50 different tax jurisdictions with their own tax laws and compliance requirements. Besides all this, 50 states are holding their local elections, and again, one of the primary concerns is taxes and the tax burden. The candidates for power are competing to promise a reduction in either the state income tax or the overall tax burden. The interstate competition for economic development widely influences the state tax policy. Political leaders in all states have viewed state tax policy as a key means of encouraging economic development and job creation. Tax benefits are used to stimulate corporations to either stay in the state or relocate to it. There have been numerous studies on interstate competition for economic development over the years, as demonstrated by the written works on different aspects of competition among state and local governments (Lynch, 1996; Schweke, Rist, and Dabson 1994; Brunori, 2001).

The American federal structure is the root of the state's never-ending battle for tax competition and, hence, economic development. Moreover, above all, we have the Federal government with its federal structure of income taxation. There is, therefore, an institution that levies taxes on a supra-state level. This makes the US itself appear to be an international tax jurisdiction. The states can govern as they wish within the limits imposed by the federal and state constitutions. They have the power to tax and to spend within extensive parameters. Moreover, this raises the issue of double taxation – a key concern in international tax competition.

The issues of double taxation

Any business operation in today's integrated world inevitably encounters the problem of double taxation. This is due to the specific treatment of the different activities of the national tax systems. With international flows of capital and goods, each flow may be subject to taxation in two jurisdictions. In nature nothing can be lost so an export in one place is import in another, income from one person is expense for another and if these activities are in different tax jurisdictions the possibility of double taxation is real and has far reaching implications for the direction and magnitude of the flows of capital and goods in the world.

Such double taxation may also apply to exports and imports of goods and services, especially for countries (states) that apply sales taxes. Since the sales tax in the US is a cascading type of tax, unlike the existing value-added tax in the EU.

There are two common principles in dealing with double taxation issues. The residence principle is related to the country of origin, and the source principle is related to the country of source. Both of them are related to the tax treatment of income in the two countries (states).

Double taxation creates problems whenever conflicts occur between tax authorities. The characteristic feature of double taxation in this sense is that comparable taxes are imposed on the same taxpayer concerning the same subject matter for identical periods by two or more tax authorities. Usually, double taxation results from a conflict of law and falls into two categories:

Internal and international. Both can result in horizontal and vertical double taxation.

The internal is typical for countries that implement the classical system of taxation, taxing capital income at both the corporate level and the individual level. This is also called internal vertical double taxation. Moreover, since it can also occur on the international stage, there is an international double taxation issue. Something more in the US federal and state tax system can be fourth time taxation, as double taxation on the federal level is duplicated on the state level as well.

The issues of internal double taxation, whether vertical or horizontal, are matters that national or local tax jurisdictions should address. For example, in 2003, Congress passed, and President Bush signed into law, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). The central component of this legislation was a sharp reduction in the double tax placed on dividends and a cut in the long-term capital gains rate. However, these provisions are set to expire on December 31, 2008, and without making the provisions permanent, taxpayers, investors, and businesses will not have the certainty to make the necessary investments in the U.S. economy.

There is a horizontal double taxation when applying the same tax to the same tax base by different tax jurisdictions, parallel to each other —a typical example of state taxation. Although the state's tax laws are somewhat harmonized, there is still a theoretical risk of double taxation. Let us say a person lives in a leap year, each half in two neighboring states or even countries. According to the 183-day presence rule, mainly used for taxing non-residents, an individual is considered a resident of both states and countries, as a leap year has 366 days.

To mitigate international double taxation, countries usually enter into treaties to avoid double taxation by using different forms of foreign tax credit.

Part II - the multinational tax planning

The existence of a tax system gives rise to various costs. All these costs are elements of the tax system and are inevitable when considering any market transaction, although some of them are not often issues in tax planning. Relatively high compliance costs may put the national economy at a competitive disadvantage compared to other countries. A comparatively high price level will hinder exports, for example, and high compliance costs may deter foreign enterprises from investing or setting up subsidiaries. Sometimes it is not the tax itself that turns investors away, but the high compliance costs and the consequences that follow. All the costs mentioned above, together with the tax itself, can be examined as a transaction cost in the different market transactions. For example, if a decision needs to be made regarding investment allocation, the tax issue will be considered seriously before the legal entity makes any allocation. On the other hand, if an employee wants a specific job, they should want to know what it is going to cost them, so they can determine how much of their income they will share with the government. All these issues are closely related to tax planning and transaction costs.

Since the transaction cost is the running cost of an economic system, the cost of effecting an exchange or other economic transaction, which varies from one economic system to another, it can be stated that the tax itself can be examined as the cost (price) of the income that should be received. Income taxation can be viewed from transaction-costs economics, which, as O. Williamson (1985, 1995) stated, is "an interdisciplinary undertaking that joins economics with aspects of organization theory and overlaps extensively with contract law. It is the modern counterpart of institutional economics and relies heavily on comparative analysis."

This definition of transaction-cost economics provides an opportunity to apply it to income taxation and reveal another side of tax theory. It could be a good way to combine the law and economics on the principle of explanation of legal institutions, procedures, decisions, and the like in terms of economic theories.

Usually, authors Hall and Jorgenson (1991) assume that income taxes rest where they are put, and hence the burden is reckoned to lie on the factors of production, and on the other hand, that indirect taxes are passed forward. Hence, the burden is estimated to be on the consumers of the product.

The differences in costs, primarily compliance, as well as the diversification of rates, along with treaties and credits, are strong motivators for companies to engage in international (multinational) tax planning.

Tax planning often represents a significant part of doing business. In some cases, taxes are one of the most important aspects in structuring a transaction.

“Taxes are only one of the many factors that people and organizations consider when making decisions. In some cases, taxes are a dominant factor, while in others, tax considerations play a minor role. Good decision makers generally seek to manage taxes on every transaction. One way to measure how well a firm is managing its taxes is to look at its effective income tax rate. A firm’s effective tax rate is the sum of total taxes paid by the firm, divided by its (before-tax) net income. Often, firms’ effective tax rates exceed 40%. This is not surprising for multinational firms operating in the U. S. because they usually are subject to a 35% rate on U.S. income plus an assortment of international, state, and local taxes.”

For example, using data aggregated from more than 500 multinational tax returns, Grubert and Mutti (2000) found that "average effective tax rates have a significant effect on the choice of locations and the amount of capital invested there. A lower tax rate that increases the after-tax return to capital by one percent is associated with about 3 percent more real capital invested if the country has an open trade regime." Based on these results, they predict that if taxes were not a motivating factor, approximately one-fifth of U.S. capital abroad would be in a different location.

In another study of corporate tax sensitivity, economists analyzed the investments of U.S. manufacturing firms in 58 countries. They found that not only are multinationals highly sensitive to host country tax rates, but that they were twice as sensitive in 1994 as they were just a decade earlier. The study’s authors report, "These results are consistent with increasing international mobility of capital and globalization of production."

Foreign tax credit and other credits – tools in international tax planning

Companies in the United States recognize that to participate in the global economy and achieve success, they cannot simply remain domestic U.S. corporations but must evolve into multinational corporations with operations worldwide. There is considerable evidence of the increasing number of U.S. corporations entering foreign markets and establishing operations, joint ventures, and subsidiaries in these countries. A U.S. multinational corporation will require and most likely create employment opportunities or foreign assignments in foreign countries for U.S. citizens or resident aliens of the U.S. to work and live abroad during their period of employment with the U.S. or foreign corporation in the foreign country or countries. Because U.S. citizens and resident aliens of the U.S. are taxed on their worldwide income no matter where there residence is or the source of their income it becomes apparent that they must consider what effect being employed and living in a foreign country or countries will have on their personal U.S. federal income tax liability and what tax planning opportunities are available to limit or reduce their tax liability. Under IRC section 901, U.S. taxpayers can elect to take a foreign tax credit for income tax paid (on their foreign earned income) to a foreign country against their income tax liability in the U.S. on their worldwide income, or they may choose to deduct on their U.S. income tax return the foreign income taxes paid. Each year, the U.S. taxpayer can choose between taking the foreign tax credit or foreign tax deduction.

This method of foreign tax credit is considered to be a unilateral exclusion. It is not widely practiced around the world, even in countries that apply a global tax system. There are two other methods of relief from double taxation, which are usually subject to treaties for avoiding double taxation.

The first one relies more on the ratio between the income earned abroad and the total taxable income, without considering the amount of taxes paid in the foreign country. This approach is very suitable for personal income taxation, as all countries have different tables and schedules, and it is not easy to equalize them in a treaty. As for corporate income taxation, the most suitable way for establishing a foreign tax credit is the system of marginal tax credit. As most corporate rates are proportional, this is a very convenient way of establishing a tax credit. In this case, it is essential to consider both the amount of foreign income and the local tax rates. Finding the marginal tax credit provides the framework for deducting taxes paid in foreign countries.

Marginal tax credit (MTC) = Foreign Income (FI) x Domestic Tax Rate (DTR)

If DTR is higher than the tax rate in the foreign country, then the company or the person can deduct the whole amount of the taxes paid in another tax jurisdiction. If DTR is lower, then the issue of double taxation is much higher, as in this case, the MTR cannot offset all the taxes paid abroad.

Based on this, companies are orienting themselves to use countries with higher income tax rates for their home countries, so they can have a higher marginal tax credit to offset all the taxes they have paid in countries with lower tax rates. These types of tax credits are mainly established by treaties to avoid double taxation or by the so-called international part of national tax laws. Other aspects of national tax policy influence various types of activities and provide nations with advantages. The credit for increasing research activities allows a credit against U.S. tax for incremental research and experimentation costs, exceeding the taxpayer's historic levels, incurred in connection with the taxpayer's trade or business. The research and experimentation activities must take place in the United States for the expenses to be eligible for the credit. To qualify for the credit, the expenses must be incurred as part of a process of experimentation for a purpose of discovering information of a technological nature (i.e., information that relies on the physical or biological sciences, engineering or computer science) that would be useful in developing a new or improved business product, process, formula, technique or invention. Included as research and experimentation costs are all costs related to the development or improvement of the function, performance, reliability, or quality of a product, including the costs of obtaining a patent. Given the incremental nature of the credit, firms initiating new or expanded research programs, in particular, may obtain significant benefits from the credit if they plan to use the[5] research results in a future trade or business.

Ownership of the various intangibles, i.e., any patents, know-how, trademarks and other marketing or manufacturing intangibles, is an important tax issue because, under U.S. tax rules, the amount of a royalty that must be paid by a licensee that is related to the owner of the intangible must reflect not merely a market rate, but an amount that is "commensurate with the income" generated by the intangible throughout the license term. Under this requirement, the amount of the royalty payment that a U.S. licensor must report for tax purposes as received for its non-U.S. affiliates' use of intangibles in most cases must be adjusted throughout the license term to reflect the income earned from the sales of the product for which the royalty is paid. A similar rule applies to sales of intangible rights by U.S. taxpayers to related foreign purchasers.

Generally, where a multinational group holds intangibles that may be used both within and outside the U.S., it is best from a U.S. perspective to have a U.S. company own outright the U.S. rights to the intangibles and have a foreign company own the non-U.S. intangible rights. This structure is likely to reduce the group's global effective tax rate on income attributable to intangibles, minimize cross-border transfer pricing issues, and avoid withholding taxes imposed on royalty payments from or to residents of countries without tax treaties with the U.S. that eliminate those taxes.

Tax minimization strategies

There are many techniques multinational firms can employ to minimize their worldwide tax burdens. One method some studies have identified is the aggressive use of "transfer pricing" – the price a parent company charges its overseas affiliate for a product, component, or trademark. Although complicated in practice, the simple goal of this technique is to book higher expenses in a high-tax country, thereby minimizing after-tax profits, and book the profits in a lower-tax country, where they can be deferred.

Tax practitioners note that transfer pricing is no longer the issue it once was, as most revenue authorities – especially in the U.S. – have tightened their rules to curb tax avoidance. However, during the 1990s, James R. Hines found "The pretax profitability of foreign affiliates is negatively correlated with host country tax rates, which is suggestive of tax-motivated transfer pricing…" As Goodspeed and Witte (1999) explain, "If the subsidiary is providing the parent with an input, there is an incentive to charge a very high price for the input. Since this will result in high revenue in the low-tax country and high costs in the high-tax country, the effect will be to transfer profits from the high-tax to the low-tax country."

Another method firms use to minimize their global taxes is to shift the balance of tax-deductible debt and royalty payments between countries with high and low tax rates. For example, the tax codes of many countries, including the United States, offer a tax advantage to debt-financed expansion by allowing firms to deduct the interest costs of their loans from their taxable income. However, there is no similar preference for equity-financed investments. Similarly, royalty payments are tax-deductible, but dividend payments are not.

[5] U.S. Tax Planning for Multinational Pharmaceutical Companies | Buchanan Ingersoll & Rooney PC. https://www.bipc.com/u.s.-tax-planning-for-multinational-pharmaceutical-companies

Because of these incentives, many parent firms will lend capital to their foreign subsidiaries (especially those in high-tax nations), which allows the subsidiary to deduct the interest payments made back to the parent, thereby lowering its taxable income. For the parent, the interest payments are taxed as income, but presumably at a lower tax rate than would be the profits earned by the subsidiary in the higher-taxed country.

There is considerable evidence that multinational firms are sensitive to the taxes they pay on repatriated profits through dividends. However, some studies suggest that this sensitivity is only evident when effective tax rates fluctuate frequently, rather than when rates are stable. A 1990 study by Hines and Hubbard (1990) found that only 16 percent of foreign subsidiaries of American firms paid dividends to the parent company in 1984, and those that did had a particular tax advantage. They conclude that "a one percent decrease in the repatriation tax is associated with a four percent increase in dividend payout rates."

Similarly, a more recent study by Desai, Foley, and Hines (2001) asserted that "One percent lower repatriation tax rates are associated with one percent higher dividends. This implies that repatriation taxes reduce aggregate dividend payouts by 12.8 percent, and, in the process, generate annual efficiency losses equal to 2.5 percent of dividends." These efficiency losses have the same effect as an additional tax placed on multinational firms and their shareholders, workers, and customers.

As Gordon and Hines (2002) sum up the empirical literature, "The reported profitability of multinational firms is inversely related to local tax rates, a relationship that is at least partly the consequence of tax-motivated use of debt financing, the pricing of intrafirm transfers, royalty payments, and other methods."

In other words, tax rates matter. Moreover, countries with higher tax rates will typically see a higher incidence of tax minimization strategies among multinationals than those with lower tax rates.

Transfer pricing in multinational tax planning

Transfer pricing is the practice of charging prices for the supply of goods or services to a related entity (usually wholly owned) in such a way as to repatriate profits or affect tax or duty bills in your favor. In today's global business world, it is a reality that has become increasingly difficult to avoid. Although transfer pricing is not a new concept, as the global market expands, transfer pricing has become increasingly important to tax authorities around the world.

Appraisal Economics has extensive experience in international transfer pricing and tax planning. This experience has been obtained from working with some of the largest multinational corporations in nearly every corner of the globe.

As international transfer pricing evolves into one of the most significant and complex tax issues that modern businesses must address, the demand for qualified expertise increases. As it is becoming an essential part of business planning, taxation authorities are investigating transfer pricing arrangements with increased vigor. When it comes to this complex analysis, Appraisal Economics Inc. supplies both high-quality information and expertise that withstands the toughest scrutiny.

Foreign tax strategies can be a boon to multinationals: opportunities abound for multinational companies to take advantage of low-tax foreign jurisdictions to structure tax-advantaged programs. Several countries offer significant incentives to attract businesses to their borders.

It has always been appropriate to organize business transactions to minimize a company's tax burden. Tax consequences, however, are not always entirely clear, and where there are uncertainties, they must be appropriately addressed in a company's financial statements. With the passage of the Sarbanes-Oxley Act, there has been an even greater emphasis placed on evaluating the tax provision in the financial statements and on a corporation's tax planning and associated tax benefits.

Moreover, in July 2005, the Financial Accounting Standards Board (FASB) issued an Exposure Draft under FASB 109 regarding the valuation of certain tax positions. The draft is intended to establish consistent standards for evaluating the recognition of tax benefits and the reversal of previously recorded items. These new and existing accounting and legal standards should not, however, preclude a U.S.-based multinational from structuring its operations under tax laws to achieve the best results.

Admittedly, tax law has areas that are unclear and difficult to interpret. In some cases, the outcome of a given structure or position may not be entirely clear, even where there is enough support in the law to justify its legitimacy. When a U.S. multinational is faced with this situation and the outcome is not sufficiently specific to avoid adverse financial reporting, an assessment must be made to determine whether the benefits of a given structure or position outweigh the risks, if any.

A U.S. multinational should, nevertheless, be able to continue structuring its business affairs and transactions to maximize tax savings and achieve the most efficient tax result (as opposed to engaging in tax evasion). Well-thought-out and properly documented tax planning techniques will generally meet the standards for a supportable and legitimate tax position within regulatory, accounting, and tax standards.

Consider, too, that the overall effective corporate tax rate has a direct impact on the value of a company's stock. The financial markets recognize that the savings generated by a lower effective tax rate generally translate into larger cash resources, lower-cost financing of operations, and increased dividends. In some cases, if operations or particular transactions are not structured to achieve the best tax result, the costs may be so severe that such a transaction would not be worth undertaking. It is imperative, then, that a U.S. multinational avails itself of legitimate tax planning--properly aligned with the business objectives and properly documented--or find itself at a disadvantage relative to its competitors.

U.S. multinationals have increased opportunities to lower their effective tax rate by moving profits from higher-taxed jurisdictions to lower-taxed ones.

Advance pricing agreements

Multinational groups that engage in intercompany transactions involving the sale or lease of property or the provision of services are potentially subject to disputes, not only with tax authorities, but between tax authorities, as to the appropriate transfer price payable in such transactions. Entering into a bilateral Advance Pricing Agreement ("APA") with the relevant tax authorities can be a valuable tool for preventing tax audit issues and potential double tax problems during the manufacturing and sales phase of operations.

As the name suggests, an APA is a ruling, in advance of a tax return filing, from a tax authority that the transfer pricing method used by a taxpayer in one or more transactions with its affiliates will be acceptable for income tax purposes. Although the IRS does issue unilateral APAs in certain situations, much greater certainty of results can be obtained through bilateral APAs, under which the IRS and the country in which the affiliate is resident agree on the appropriate transfer price method.

APAs, particularly bilateral APAs, may not be available in every situation and require an intensive and often time-consuming analysis of the intercompany transactions at issue. In appropriate cases, however, the time and effort involved in securing an APA may be justified by the savings in time and money that result from avoiding the need to defend a transfer pricing audit or a dispute between U.S. and foreign tax authorities.

Conclusion

The concept of international taxation itself is somewhat of an acronym, a misnomer, and it serves as a convenient expression for the national treatment of different international transactions with respect to reducing international double taxation and mitigating harmful tax competition. Based on this, we can distinguish between tax harmonization and tax competition in large economic Unions, Such as the EU and the USA, as well as some issues related to treaties for avoiding double taxation worldwide.

The real battle between tax competition and tax harmonization is about the government's control over factors of production. The supporters of tax harmonization aim to prevent the flow of workers and investments from high-tax nations to low-tax nations. They feel there is a need for governments to have the ability to track and tax flight capital. Countries like Germany and France refuse to cut their tax rates because they acknowledge that they are already in breach of the EU policy to keep their deficits to less than 3% of the GDP. They also say that many of the new EU members are getting billions of Euros in infrastructure, agricultural, and other subsidies from the Brussels budget. It is unlikely these new members will cave in to France and Germany’s pressures. While there is growing pressure in Europe for a common tax base, it is unclear which approach will prevail. For European businesses bogged down with the escalating costs of 25 different tax regimes and operating across the EU’s 25 nations, a harmonized tax base has great appeal.

However, simplicity should not overshadow all other options, and it definitely should not take precedence over tax competition, which is a desperately needed force for liberalization in Europe. Fortunately, European companies do not need to sacrifice competition in the name of simplicity.

The new nations that joined the European Union in May 2004 dealt a severe blow to the battle to move away from tax competition within the Union. The new nations included many with tax regimes specifically designed to attract economic activity and boost growth. The new member nations, including Cyprus, Hungary, and Slovenia, have features of their tax system that are sure to lure and attract investment (such as Poland's 19 percent tax rate on corporate income and Bulgaria's 15 %). Other new members, such as Lithuania, Latvia, and Slovakia, have flat tax regimes.

With the addition of these new nations to the European Union, much more pressure will be placed on Europe's welfare and high-tax states. Businesses and investors are likely to shift economic activity to take advantage of the more favorable tax laws provided by the new nations. Equally important, it will be much more difficult to pass any tax harmonization now that the 10 new nations have voting rights.

The argument that tax competition is bad stems from the belief that it will undermine the ability of governments to raise taxes, but as Hrab (2004) states, tax competition is "nothing to fear… A small quantity of intra-EU tax competition seems like just the thing to make sure the EU as a whole remains tax-competitive relative to North America and Asia." With the new low-tax countries entering the European Union, the process of tax competition was thrust upon the rest of the European Union. It not only forced the high-tax countries of the EU to be more efficient and competitive with other European countries, but also with other non-European jurisdictions. Trying to "harmonize" corporate tax rates throughout the European Union will lessen the strength of the European economies. It will likely hinder the European chances of accomplishing its goal of one day becoming an economic powerhouse.

Double taxation, unresolved tax disputes, uncertainty in the application of international tax rules, and heavy compliance burdens can all act as barriers to the expansion of cross-border trade and investment. These risks, combined with today's more competitive fiscal environment, have led to international tax considerations being an increasingly important focus of the tax debate in many OECD countries.

The OECD's Committee on Fiscal Affairs, in collaboration with business, has developed internationally accepted tax norms for many years to address these issues, including mechanisms to monitor their implementation and resolve disputes that may arise.

To illustrate the multinational tax planning problem, the following example can be used: a multinational company structure with a US holding company and three subsidiaries based in Germany, China, and Australia.

The financial flows between these companies with which we are concerned can be classified into three categories for tax purposes:

- Income and expenditures (using the transfer pricing methods)
- dividends (paid to parent and shareholders);
- royalties (e.g., paid on a license for a production process); and
- interest (on loans).

When a financial flow falls into one of these categories and occurs between two companies in different countries, the treatment of that flow for tax purposes (i.e., the amount taken in tax in each country) is governed by a *tax treaty* between the two countries. Different pairs of countries have different tax treaties, which immediately raises the possibility of paying a different amount of tax depending on the route the financial flow follows and using different foreign tax credits.

For example, an interest payment from the German subsidiary directly to the US holding company may be more favorable for tax purposes than if that interest payment is made to the China subsidiary. Then the China subsidiary makes an interest payment to an Australian company, which in turn pays royalties to the US holding company.

In this case, it can also be easy to route a financial flow through several well-known "tax havens," such as the Bahamas and Bermuda. For example, the interest payment from Germany to Australia and then to the US holding company can go via a Bahamas-based company. As far as multinational tax planning is related with increment of profits and maximizing the after tax returns, it is evident that routing financial flows through any number of countries to get the most advantageous tax treatment and "changing" the type of a particular financial flow (e.g. an interest flow to one country passed on as a royalty flow to another) to get the most advantageous tax treatment by choosing a "permanent" company structure (cross shareholdings, loan arrangements, etc) to get the most advantageous tax treatment.

Whilst tax treaties and national tax systems are very complex and can not be wholly reduced to a set of formulae that can be used in a model, yet. Some progress has been made using dynamic programming. There are computer packages for limited transactions that primarily relate to two countries and can be utilized in multinational tax planning across various sectors of the economy. The development of the internet brought numerous new business-type models that made this task even more complicated.

One thing is sure, though, that international taxation has no future until countries elect national politicians, because taxes are a key factor in winning elections. International tax planning is the one that tempts companies and decision-makers to maximize profits and minimize income tax.

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