BASIC INTERNATIONAL TAX PRINCIPLES DEALING WITH INTANGIBLES

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Some International Tax Concepts

- Jurisdiction to tax
  - Personal=Residence=Place of incorporation
    - Taxation on net basis, receipts less deductions
  - Source=series of international conventions, partly economic, partly legal
    - Usually taxed on gross basis, withholding tax
- Worldwide taxation versus territorial taxation
- Relief of double taxation
  - Foreign tax credit
  - Exemption of foreign (active) income

Some International Tax Concepts

- Branch taxation
  - Current taxation, varied tax consequences on "transactions" between branch and head office
- US Parent and foreign subsidiary
  - US tax on subsidiary profits deferred until distribution
  - Foreign tax credit to relieve double taxation, credit calculated on US rules and up to the amount of the US tax
- Controlled foreign corporation rules
  - Current US tax to Parent on income of subsidiary in some situations

Some International Tax Concepts

- “Check the box” rules allows great flexibility in avoiding/reducing foreign and US tax
  - Tax arbitrage with entities and transactions treated in different ways by two jurisdictions, resulting in tax reduction
- Role of tax treaties
  - Reduction of source country taxation, especially withholding taxes
  - “Dutch sandwich” routes profits through Netherlands to avoid withholding taxes

Transfer Pricing

- “Arms’ length method” to determine prices between members of MNEs
  - Based on OECD Transfer Pricing Guidelines, currently being revised, focused on Functions, Assets and Risks
  - The determination of the ALP establishes the income taxable in each of the jurisdictions
  - Respect of form of transaction; hard to deal with “theory of the firm” synergies

Current state of play

- Transfer of intangible returns to low tax jurisdictions through a variety of complex transactions
  - Taxpayer disaggregates business into separate entities
  - Establishes low risk, low reward entities in high tax jurisdictions and through transfer pricing has the residual income, typically on intangibles, in the low tax jurisdiction
  - Profits for tax purposes removed from jurisdictions where economic activities tax place
  - “lockout effect” of low tax profits being held offshore

Implications for taxation of intangibles

- Low taxation of intangible income coupled with generous RD treatment of costs results in negative tax rates on intangible income
- Possible reactions
  - Change basic system: unlikely
  - Current US tax on “excess” intangibles return
  - Current US “minimum” tax on offshore profits
  - US adoption of so-called “patent box” providing special lower US tax rate for intangible income to encourage keeping income in US