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Comparison of Domestic and Foreign Corporate Income Tax Policy

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Senior Honors Project
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Introduction

This paper will assess the current state of the United States income tax policy in comparison to other worldwide tax models. It will focus on the three main elements of the United States tax system that have “encouraged U.S. multinationals to locate assets, economic activity, and earn and realize profit in other countries,” which ultimately have led to the undesirable consequences of “weaker U.S. competitiveness:” corporate income tax rates, tax credits and treatment of foreign-sourced income¹ (*Tax Policy Center*, Entry 3, 2007).

The first section of the paper will define the two types of corporate income tax systems the United States could potentially adopt — a worldwide system, which it has currently, and a territorial system. The second section of the paper will discuss recent events in which two major multinational corporations, Apple Incorporated and Eaton Corporation chose to either not repatriate corporate earnings or to relocate corporate headquarters, partially, because of the current United States income tax policy. This section will include a description of the events, their circumstances, and an analysis of the effects the event has had on the United States.

The third section of the paper will first provide an in-depth analysis of the current United States tax system. Then, it will assess its strengths and weaknesses and then analyze the current tax system of three of the most tax-friendly countries, named last year by *Forbes Magazine* — Canada, China, and Ireland — and what makes those particular tax systems unique. These analyses will include treatment of income including but not limited to dividends, capital gains, and foreign source income, as well as the income deductions and tax credits allowed under each tax regime. The final section of the paper will compare the strengths of the four tax systems,

¹ Foreign-source income is defined by the IRS as income a corporation receives for operations and services performed in a foreign country during a period its tax home is in a foreign country (*IRS International Taxpayers*, 2013).

found in the previous section to derive possible real world solutions and changes to the current United States tax system. The main goals of the proposed changes will be to incentivize corporations to begin repatriating their earnings here and to increase the likelihood for corporations to keep their corporate headquarters here. An additional goal would be to encourage other foreign corporations to relocate to the United States. An increase in relocation to the United States would ultimately help increase the United States' tax revenue.

Types of Tax Systems

Worldwide Tax System – Definition and Context

A worldwide tax system taxes domestically-incorporated companies on their total earnings from activities both domestic and international (*Tax Foundation*, 2013). This means that if a corporation is headquartered in a country that uses a worldwide system, it will be taxed on its earnings made in that country as well as earnings made abroad either immediately or when it chooses to repatriate its earnings. For example², suppose a multinational corporation is headquartered in a country with a worldwide tax system. It is in the 35% tax bracket in its home country and the 20% tax bracket abroad and it earns \$1,000,000 in its home country and chooses to repatriate \$1,000,000 of its foreign earnings. Under a worldwide system, the corporation would owe its home country \$350,000 for its domestic earnings as well as \$350,000 for its foreign earnings, not to mention the \$200,000 it would owe the countries it actually earned the foreign income in. This would make its total tax obligation \$900,000, nearly half of its earnings. Currently, the United States has adopted and practices this system, which is also used in Greece,

² This example is taken from the 2012 Senate Policy Committee's explanation of territorial vs. worldwide tax system to show the difference between these two types of systems.

Ireland, Mexico and South Korea. However, this system is not the norm, with the United States being the “only G-7³ country with a worldwide system” (*Senate Policy Committee*, 2012).

Territorial Tax System-Definition and Context

A territorial tax system is “a tax system that taxes all companies only on the economic activity that occurs within the geographic boundaries of the country, regardless of the location of the company’s incorporation or operations” (*Tax Foundation*, 2013). This means that if a corporation is headquartered in a country that uses a territorial tax system, it will be taxed only on earnings made in that country and most if not all of its foreign earnings would be exempt from taxation. For example, consider the previous example of a multinational corporation that is headquartered in a country but this time, that country follows a territorial tax system. As stated previously, the corporation is in the 35% tax bracket in its home country and the 20% tax bracket abroad and it earns \$1,000,000 in its home country and chooses to repatriate \$1,000,000 of its foreign earnings. Under a territorial system, the corporation would be responsible for \$350,000 in taxes to its home country and \$200,000 in taxes to the countries it is located in abroad. This makes its total tax responsibility \$550,000. As one can see, this is drastically lower than the \$900,000 calculated for this situation using a worldwide tax system. Despite this perceived decrease in taxable income, according to the Senate Policy Committee, most countries have a territorial system including several G-7 nations such as: Canada, France, Germany, Japan, and the United Kingdom. This is mainly done to attract more corporations to locate in their country, bringing revenue to their country and encouraging investment.

³A G-7 country is a country that is a member of “a forum of the world's seven most industrialized economies” (*Ivestopedia*, 2013).

Corporate Response to the Current U.S. Tax System

Recently, several major corporations, including Apple Incorporated and Eaton Corporation, have expressed dissatisfaction with the current United States tax system. The two main reasons corporations have expressed dissatisfaction are the use of the worldwide system's policy for taxing foreign earned income, as established previously, and the extraordinarily high corporate income tax rates. These two attributes have caused both Apple Incorporated and Eaton Corporation to take recent action to derive more favorable tax consequences.

Taxation Issue #1: Treatment of Foreign Earned Income as Seen in Apple Incorporated

Since the company's inception in 1977, there have been only a few multinational corporations that have received an equal amount of publicity, if not more, for the innovation of their tax plans and tactics to minimize tax obligations. Most recently, Apple Incorporated and its current Chief Executive Officer, Tim Cook, have been heavily criticized for the use of tax loopholes in Ireland. This is because Apple Incorporated "has been able to funnel profits into Irish subsidiaries or ghost companies that have no declared tax residency anywhere in the world" (*BBC News*, 2013). In May 2013, the U.S. Senate, headed by Senator Carl Levin and his subcommittee, accused Apple Incorporated of using three of these offshore Irish entities to sidestep U.S. taxes on \$44 billion in offshore income from 2009 to 2012 (*Business Week*, 2013). Apple Incorporated was able to sidestep these taxes by passing income through these entities but then never repatriating the earnings to the United States and therefore, Apple Incorporated never had to pay U.S. income tax on these earnings.

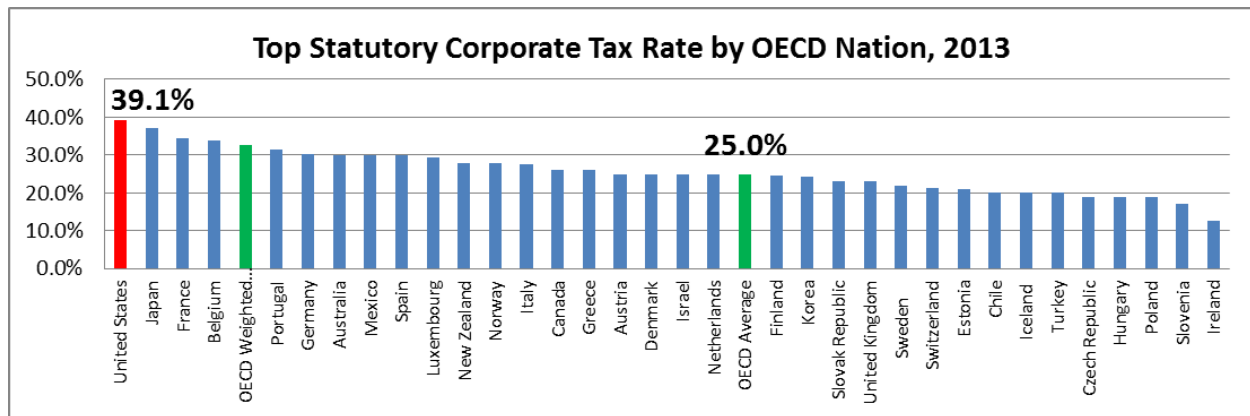
Despite the Senate's claims, Cook holds that Apple Incorporated follows the tax rules in every country in which it operates. Many analysts see no reason to chastise Apple Incorporated for simply taking maximum advantage of the current tax law in each country. Most have come

to the conclusion that “we expect the company to redefine the possible in the devices it makes, so it shouldn’t be a surprise that Apple exerts the same determination when it comes to keeping its money” (*Business Week*, 2013). In addition, many analysts promote a complete overhaul of the current United States tax system in the hope of adopting a more reasonable system for the taxation of corporations both on domestic, but more importantly, on foreign earned income so that companies will actually be encouraged to relocate and repatriate their earnings here.

Taxation Issue #2: High Corporate Income Tax Rates as Seen in Eaton Corporation

Another multinational corporation that has received recent attention from the media for its creative tax planning is the global power management firm Eaton Corporation. In 2012, Eaton decided to reincorporate its world headquarters in Ireland. This caused an intense reaction because this global firm’s headquarters had originally been founded in New Jersey but had been located in Cleveland, Ohio since 1915. This transaction was closed late in 2012, soon after Eaton’s acquisition of Irish electrical equipment supplier, Cooper Industries. Analysts expect that this transaction will allow Eaton to save \$160 million in taxes by 2016 (*International Tax Review*, 2012). Eaton’s management attributes this transaction to the “significant global cash management flexibility and associated financial benefits” (*International Tax Review*, 2012).

However, Eaton Corporation is not the only multinational that is fleeing the United States. In fact, it is only the most recent case in the trend of top companies that has looked to relocate outside the United States including Aon, Google, and Twitter. These decisions are the result of the extraordinarily high corporate tax rate of the United States. At a national tax rate of 35% in 2013, the United States is not lending itself to looking attractive to multinationals. As seen in Figure 1, the United States remains on top in terms of corporate tax rates at almost double some other competitor countries.

Figure 1⁴

Since the United States has done nothing to offset this high tax rate, it continues to drive multinationals away. In turn, this continued high tax rate has led many analysts to suggest a major overhaul in the statutory rate as well as the creation of incentives to offset the high tax rate.

Current Domestic Tax System

Now that it has been established that the United States needs to make some changes to its current tax system, I will explain and assess what the current tax system looks like.

Corporate Tax Rate

Currently, the United States operates on a progressive tax system. The rate used is calculated by a previously established schedule and applied to the remainder of the amount of corporate taxable income⁵ over a certain threshold, in addition to a flat tax amount in each tax bracket. As seen in Figure 2, the tax brackets range from 15% to 39% for the tax year 2013⁶.

⁴ Tax Foundation, 2013

⁵ Corporate taxable income is defined by the IRS in IRC§63 (a) as worldwide gross income minus allowable deductions.

Figure 2

Taxable Income (\$)	Tax Rate
\$0 to \$50,000	15%
\$50,000 to \$75,000	\$7,500 + 25% Of the amount over 50,000
\$75,000 to \$100,000	\$13,750 + 34% Of the amount over 75,000
\$100,000 to \$335,000	\$22,250 + 39% Of the amount over 100,000
\$335,000 to \$10,000,000	\$113,900 + 34% Of the amount over 335,000
\$10,000,000 to \$15,000,000	\$3,400,000 + 35% Of the amount over 10,000,000
\$15,000,000 to \$18,333,333	\$5,150,000 + 38% Of the amount over 15,000,000
\$18,333,333 and up	35%

The 39% rate is used for taxable income between \$ 100,000 and \$335,000 to eliminate the benefit of the 15 and 25% rates. The 38% tax rate is added for taxable income between \$15,000,000 and \$18,333,333 to also eliminate the benefit of the 34% tax rate. These progressive rates ultimately result in the United States having a top federal statutory rate of 39%, and a top average rate of 35%. This is the highest statutory corporate income tax rate in the developed world for the tax year of 2013 (KPMG, 2013).

In addition to the traditional corporate tax rate, most corporations are subject to the alternative minimum tax, also known as AMT. This is a flat tax of 20% that is levied on alternative minimum tax income. AMTI is determined by adjusting the regular federal taxable income amount by specified adjustments and ‘tax preference items’ such as: “substantial accelerated depreciation, percentage depletion, intangible drilling costs or non-taxable income items” (*PWC Tax Summaries*, 2013).

Additional Taxes Levied

In the United States, most corporations are susceptible to several additional governmental taxes. The first additional level is at the state level, on state taxable income or gross receipts⁷.

These tax rates vary from state to state and can be either fixed or progressive. The state tax brackets range from 0% to 12 % (*PwC Worldwide Tax Summaries*, 2013). Some localities also require corporations to pay a municipal tax on municipal taxable income. These tax brackets generally range from 0% to 4 % (*PwC Worldwide Tax Summaries*, 2013).

Other additional taxes that multinational corporations may be subject to are custom duties and import tariffs. All goods imported to the United States are dutiable in accordance with their classification in the Harmonized Tariff Schedule of the United States (*PwC Worldwide Tax Summaries*, 2013). If the goods are found dutiable, an ad valorem rate or a specific rate will be issued on the value of the merchandise.

Multinational corporations are also required to comply with various payroll tax rules. Under this, United States employers are generally subject to a federal unemployment tax of .08% on the first \$7,000 of wages for each employee. In addition, for 2014, employers are required to pay a contribution to social security of 6.2% on the first \$117,000 of each employee's wages as well as a contribution to Medicare of 1.45% on all wages of an employee.

Dividend Income

In general, all dividends, both foreign and domestic, are to be included in taxable income. However, IRC §243 (a) allows for a 100% deduction of domestic dividends received by a small business investment company operating under the Small Business Investment Act of 1958 or in

⁷ Gross receipts are defined the total amounts the organization received from all sources during its annual accounting period, without subtracting any costs or expenses (*IRS Definitions*, 2012)

the case of domestic qualifying dividends⁸. When a corporation receives a qualifying dividend, this means that by the close of day, the corporation receiving the dividend is a member of the same affiliated group as the distributor of the dividend, which was distributed out of the earnings and profits. IRC §243 (a) also allows for a 70% deduction of all other dividends received from a domestic organization. IRC §243 (c) also allows for the 70% deduction granted under IRC §243 (a) to be increased to an 80% deduction if the recipient of the dividend owns at least 20% but less than 80% of the distributing corporation.

IRC §243 (a) allows for no deduction of dividends received from a foreign corporation to discourage foreign investment. However, should the dividends qualify as a 10-percent owned foreign corporation⁹, under IRC §245 (a) (1), the dividends are treated as sourced within the U.S. and the IRC §243 (a) deductions would then apply.

The United States tax code also generally allows for the non-inclusion in taxable income of stock dividends issued to a corporation¹⁰.

Capital Gains

According to the Internal Revenue Service, there are two types of capital gains, short term and long term. Under IRC §1222, a short term capital gain is defined as a gain from the sale of a security or capital asset that has been held for one year or less. In addition, IRC §1222 defines a long term gain as the gain from a sale of a security or capital asset that has been held for more than one year. Corporations are taxed on their net taxable gains, defined as the net excess of capital gains over capital losses¹¹. Net capital losses are only allowed to be used to offset capital gains. IRC §1212 allows for an excess of capital losses to be carried back three

⁸ IRC §243 (b) (1)

⁹ IRC §245 (a) (2) defines a 10%-owned foreign corporation as any foreign corporation, other than a passive foreign investment company, that a taxpayer owns at least 10% of the stock of by value or votes.

¹⁰ IRC §305 (a)

¹¹ IRC §1222

years and carried forward five years to offset capital gains. Corporations are taxed at ordinary income tax rates on their all capital gains, whether the assets are held short term or long term (*PWC Tax Summaries*, 2013).

Foreign Income Treatment

In general, the IRS concerns itself with two types of foreign income: the income earned abroad of domestic corporations and the income of foreign corporations earned in the United States, as defined by IRC §862 (a).

Domestic Corporations

Currently, the United States is on a worldwide system, as stated in IRC §§961-965, so U.S. corporations earning U.S. and foreign-sourced income will be taxed on both sets of income. However, the foreign earnings will only be taxed once they have been repatriated. This exclusion is only available if the American-owned foreign affiliates are separately incorporated subsidiaries in foreign countries. An exception does exist for the income of foreign subsidiaries that are considered controlled foreign corporations under IRC §957 (a). A controlled foreign corporation is defined as a non-US Corporation in which more than 50% of the total combined voting power of all classes of stock entitled to vote or the total value of the stock of the corporation is owned by a U.S. Shareholder on any day during the taxable year of the foreign corporation¹². IRC §§951-964 require that passive income from controlled foreign corporations,¹³ foreign base income¹⁴, and illegal bribes and kickbacks, also known as Subpart F income, be taxed by the United States, regardless of its repatriation status. Generally, Subpart F income includes income that is easily transferred to a low-tax jurisdiction.

¹² IRC §957 (a)

¹³ Passive income is defined by IRC §469 (c) as income that was earned with no material participation, any rental activity and income from working interests in oil and gas property.

¹⁴ The IRS includes foreign personal holding income, foreign base sales income, service income, shipping income and oil related income in foreign base company income.

If the foreign affiliates of domestic corporations are unincorporated and simply branches of the parent American-owned corporation, located in other countries, their foreign-sourced income will be taxed at the same rate as their domestic corporate profits. An exception does apply for domestic financial firms and their branch income. IRC §954 (d) (2) allows for the deferral of taxes by financial firms that conduct foreign operations in the form of branches rather than subsidiaries. This tax break allows these financial firms, with their headquarters in the United States, to treat the income from their branches as if it was from their subsidiaries. So instead of treating this income as being earned in the United States and immediately being taxed at a rate of 35%, the income is instead seen as foreign-earned and the same deferral benefits mentioned earlier can be applied.

Foreign Corporations

Since foreign corporations are not within the tax jurisdiction of the United States, they are only taxed by the United States on their U.S. sourced income, as stated by IRC §882 (a), unless their foreign-sourced income is somehow connected to a U.S. trade or business. The taxation on U.S. sourced income of foreign corporations is the same as the taxation requirements for U.S. sourced income of domestic corporations. In addition to the tax imposed by IRC §882 (a), IRC §884 (a) requires that any foreign corporation be imposed an additional tax equal to 30% of the dividend equivalent¹⁵ amount of the taxable year. IRC §884 (b) requires that the taxable base for this tax be increased or decreased by the corresponding decrease or increase in the U.S. net equity of the branch.

¹⁵ IRC §871(m)(2) defines dividend equivalent as any substitute dividend made pursuant to a securities lending transaction, a sale-repurchase transaction, or a substantially similar transaction that is contingent upon or determined by reference to the payment of a U.S. sourced dividend, any payment made pursuant to a Specified Notional Principal Contract (“Specified NPC”), that is contingent upon or determined by reference to the payment of a U.S. sourced dividend, or any payment substantially similar to the above.

Deductions

Another way that countries try to attract multinationals is to offer several deductions for income tax purposes. IRC§162 allows for the deduction of all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business including but not limited to salaries, travel and rental payments. In addition to these, the United States offers the following deductions to help benefit corporations.

Depreciation Deduction

IRC§167 allows for a depreciation deduction that can be taken on qualifying tangible personal property based on their corresponding useful life by using an accelerated depreciation method of MACRS which corresponds to Table A-1¹⁶.

Table A-1. 3-, 5-, 7-, 10-, 15-, and 20-Year Property
Half-Year Convention

Year	Depreciation rate for recovery period					
	3-year	5-year	7-year	10-year	15-year	20-year
1	33.33%	20.00%	14.29%	10.00%	5.00%	3.750%
2	44.45	32.00	24.49	18.00	9.50	7.219
3	14.81	19.20	17.49	14.40	8.55	6.677
4	7.41	11.52	12.49	11.52	7.70	6.177
5		11.52	8.93	9.22	6.93	5.713
6		5.76	8.92	7.37	6.23	5.285
7			8.93	6.55	5.90	4.888
8			4.46	6.55	5.90	4.522
9				6.56	5.91	4.462
10				6.55	5.90	4.461
11				3.28	5.91	4.462
12					5.90	4.461
13					5.91	4.462
14					5.90	4.461
15					5.91	4.462
16					2.95	4.461
17						4.462
18						4.461
19						4.462
20						4.461
21						2.231

Section 179 Deduction

IRC §179 allows for the ability to elect to expense, up to a statutory amount per year, the cost of certain eligible property used in the active conduct of trade or business. The 2013 tax year allows for a maximum deduction of up to \$500,000 for up to \$2,000,000 in equipment purchases.

¹⁶ University of Central Florida College of Business Administration, 2013

However, in 2014, the statutory deduction limit will be cut to its original amount of \$25,000. In terms of limitation for the deduction, the Section 179 deduction “begins to phase out if more than \$2,000,000 of equipment is purchased - in fact, the deduction decreases on a dollar for dollar scale” once the \$2,000,000 limit has been reached (*Section 179.org*, 2013).

Bonus Depreciation Deduction

In addition to the Section 179 deduction, The American Taxpayer Relief Act of 2012 allows corporations to depreciate 50% of a qualifying asset’s value during the first year of depreciation for the tax year 2013. However, during the 2014 tax year this deduction will no longer be available.

U.S. Manufacturing Deduction

IRC §199, enacted by The Jobs Creation Act of 2004, allows for a deduction equal to 9% of net income produced by qualified production activities income.

Charitable Contributions

IRC §170 allows for the deduction of charitable contributions made by a corporation for up to 10% of taxable income. Deductions that go over this limit may be carried over to the five succeeding years subject to the 10% rule, naturally.

Taxes

IRC§164 qualifies state and local income taxes as deductible expenses.

Credits

A final way that countries try to encourage multinational corporations to invest is to offer direct credits against their income tax bill. Some of the most prominent credits that the United States offers are the foreign tax credit to help offset double taxation, the general business credit

to encourage investment, and the research and development credit to help encourage further scientific and technological developments.

Foreign Tax Credit

To help offset the additional taxes imposed by the United States' worldwide system, IRC§901(a)(1) allows corporations to choose whether to take a credit for all foreign taxes paid¹⁷ or to take a deduction for foreign income, war profits, and excess profit taxes paid or accrued during the tax year to any foreign country or U.S. possession. The foreign tax credit reduces the United States tax bill dollar for dollar, while the deduction reduces the taxable income at the marginal tax rate. The foreign tax credit is subject to limitations under IRC§904, so any unused credits may be carried back one year and if not fully used, carried forward ten years.

General Business Credit

IRC §38 allows for several business credits that promote certain economic objectives. Some of the major components include the investment credit under IRC §46, granted for renewable energy and rehabilitation investment activities, the work opportunity credit, under IRC §51(a), for 40% for the first year of wages of qualified group members such as veterans and ex-felons, and several environment protection oriented credits. These credits are then combined into one general business credit amount. Should the credit go unused, it may be carried back one year and then carried forward twenty years.

Research and Development Credit

IRC §41 grants a research and development credit to corporations for increasing qualified research expenses, as extended as part of The American Taxpayer Relief Act of 2012. A credit for 20% of total qualified research expenses in excess of a base amount as well as payments to

¹⁷ Taxes paid include: direct taxes paid, taxes paid in lieu of a tax upon income, war profits or excess profits, which would otherwise be imposed.

qualified research facilities may be used to offset income taxes. This credit will no longer be available after the tax year 2013.

Unique Elements of the System

One of the most unique and controversial components of the United States tax system is its treatment of foreign income. Tax authorities criticize the worldwide system because “it provides no incentive to repatriate earnings in the United States, which is echoed through the large amount of foreign earnings that have been retained in subsidiaries, instead of being paid as dividends to domestic parent companies (*International Tax Journal*, 2011). *The International Tax Journal* estimates \$1.5 trillion of unrepatriated foreign earnings of domestic corporations exist, which, if remitted at current rates, ignoring foreign tax credits, would yield \$500 billion in tax receipts (2011). This has led many tax experts to conclude that the United States tax system will need a major overhaul if the United States wants to remain competitive in the global market because most companies only want to repatriate foreign earnings to pursue better investment opportunities if no taxes are triggered (*NACD Directorship*, 2013) .

The other unique and highly controversial element of the United States Tax System is its unusually high statutory rate. Since the United States currently has the highest statutory tax rate in the world, in order to meet goals of keeping domestic organizations competitive, Senate Finance Committee chairman Max Baucus asserts that there needs to be a substantial reduction in the tax rate (*Accounting Today*, 2013).

International Tax Systems-Canada

With the current United States tax system in mind, I will now assess the attributes of three foreign systems, beginning with Canada.

Corporate Tax Rate

Currently, Canada operates on a flat tax rate system for public corporations. The basic rate is 38%, however, this is “reduced to give the provinces and territories room to impose Canadian Income Tax” (*PwC Tax Summaries*, 2013). In addition, a general rate reduction or M&P deduction¹⁸ of 13% is also granted to ultimately have a net federal tax rate of 15%. As the *PwC Tax Summaries* explains, “the general rate reduction and M&P deduction do not apply to the first CAD 500,000 of active business income earned in Canada by Canadian-controlled private corporations” (2013).

This low net federal rate has allowed Canada to achieve “its goal of having the most business-friendly tax system of the G-7” (*Tax Foundation*, 2012). The cut in the tax rate on January 1, 2012 was the final installment in a series of cuts initiated in 2006 by Prime Minister Stephen Harper. Before these installments, Canada had an overall corporate tax rate of 33.9% but as the world economy began to take a downward spiral, the Canada Revenue Agency knew it had to do something to keep Canada’s economy going, so it cut its tax rate to 18% in 2010, 16.5% in 2011 and finally, 15% effective January 1, 2012 and now it currently has the lowest corporate tax rate of all the G-7 nations.

Many members of the Canada Revenue Agency were concerned that this new tax rate would drastically decrease revenues. However, the gradual decrease in Canada’s corporate tax rate seems to have resulted in very little tax revenue lost. In fact, “by 2010-2011, federal corporate tax revenue reached CAD 30-billion, substantially more than the average of CAD 25-billion in the last four years of the prior Liberal government: 2002 through 2005” (*Tax Foundation*, 2012).

¹⁸ The M&P deduction is the Manufacturing & Processing rate deduction which allows for a 13% rate reduction on all eligible income (CRA, 2013). Any income not eligible will receive the 13% general rate reduction granted by the CRA.

Additional Taxes Levied

Like the United States, Canada imposes several other types of taxes that corporations must comply with. The first is provincial and territorial taxes. Generally, provinces and territories have two corporate rates, a lower rate and a higher rate. The Canada Revenue Agency applies the lower rate “to the income eligible for the federal small business deduction subject to the business limit¹⁹” (2013). The higher rate then applies to all other income. The lower rates can range from 1% to 4% and the higher rates can range from 10% to 16%, with the provinces of Quebec and Alberta electing to not have corporate tax collections. These added taxes are taken into account by the General Provincial Tax Abatement with the 10% reduction in the federal rate so that corporations are not expected to pay an unreasonable amount to both the federal government and the state.

Another additional tax that corporations are expected to pay in Canada is the tax imposed by custom/duties. Customs and duties are “intended to protect Canadian industry from foreign competition and not as a source of revenue” (*PwC Tax Summaries*, 2013). This has led most rates to be less than 10%. Canada also allows goods coming from both Mexico and the United States to come in duty-free under the North American Free Trade Agreement. Currently, Canada does give preferential treatment to all countries with which it has treaties. Some of these countries include: China, Hong Kong and Thailand to help expand Canada’s presence in Asian markets. These countries also include developing countries, but the “government has announced

¹⁹ “The lower small business rate applies to active business income up to the British Columbia business limit of \$500,000 effective January 1, 2010” (*CRA*, 2013).

that effective January 1, 2015, General Preferential Tariff Treatment will be withdrawn from 72 countries” (*PwC Tax Summaries*, 2013).

The final additional tax that corporations are responsible for in Canada is the additional social security and payroll tax levied. For 2013, employers are required to pay for each employee “government pension plan contributions up to CAD 2,356.20 and employment insurance premiums up to CAD 1,247.57” (*Canadian Revenue Agency*, 2013). Employers that are located in Manitoba, Newfoundland, Ontario, and Quebec are also responsible for payroll taxes. These rates can range from 1.95% to 4.3% of territorial taxable income.

Dividend Income

In general, dividends are treated differently depending on what type they are. For instance, “dividends received by one Canadian corporation from another Canadian corporation can be deducted in full” in the determination of a corporations taxable income (*PwC Tax Summaries*, 2013). However, if these domestic dividends are received by a specified financial institution on certain preferred shares, these are considered an exception and will be taxed at the full corporate rate.

Recipients of dividends on general preferred shares are subject to 10% tax unless the payer elects to pay a 40% tax on the dividend paid instead of a 25% tax paid. Whoever pays this tax can use it to offset the tax liability. This tax is not imposed on the first CAD 500,000 of taxable preferred-share dividends paid, nor does it apply to dividends paid to a shareholder with a substantial interest²⁰ in the payer (*PwC Tax Summaries*, 2013).

²⁰ A substantial interest is a taxpayer “who has actual or potential influence over the management or operation of any organization, association, or other business entity or through the ownership of special voting shares (*Tax Interpretations of Canadian Tax Law*, 2013)

Dividends received by a private Canadian corporation are subject to a special refundable 33.5% tax. This tax is not imposed should the recipient be connected²¹ to the payer. When the recipient pays dividends to its shareholders, the tax is refundable at CAD 1 for every CAD 3 of dividends paid.

Stock dividends are treated the same as cash dividends if the payer is a resident of Canada. According to *PwC Tax Summaries*, “the taxable amount of a stock dividend is the increase in the paid-in capital of the payer corporation because of the payment of the dividend” (2013). Any stock dividends that are received from a corporation that is not a resident of Canada are not exempt and have a cost basis of zero.

Capital Gains

Domestic corporations are taxed on their net taxable gains and net taxable losses are generally only allowed to offset taxable gains. An excess of capital losses over capital gains can be carried back three years and carried forward indefinitely to offset net taxable capital gains. Corporations are taxed at ordinary income tax rates on their capital gains. Non-resident corporations are subject to Canadian income tax on capital gains less 50% of their net capital losses. This means that most non-resident corporations are asked to withhold and remit to the Canadian Revenue Agency 25% of the sales proceeds (*PWC Tax Summaries*, 2013).

Foreign Income Treatment

Domestic Corporations

Formally, domestic Canadian corporations are taxed on their worldwide income. However, Canada has formed treaties with a network of over 91 countries and all its major trading partners, that exempts active income earned by an affiliate if the affiliate resides in a

²¹ The Canada Revenue Agency defines connected to as the recipient owning more than 10% interest in the payer.

country with which Canada maintains a tax treaty, making its system, in practice, a territorial one (*Tax Foundation*, 2012). Many consider it a hybrid system though because any income earned in countries not included in the treaties is taxed on a worldwide basis.

The use of a territorial system decreases the amount of the Canadian tax base. To help combat this erosion, “all passive income²² is treated as Foreign Accrued Property Income” and this classification is modeled after the United States Subpart F income treatment (*Tax Foundation*, 2012). This then means that all passive income received as well as income from certain controlled foreign affiliates is taxable whether or not these earnings have been repatriated.

Foreign Corporations

Since non-resident corporations are not within the taxing jurisdiction of Canada, they are only taxed on Canadian-sourced income unless their foreign sourced income is somehow connected to a Canadian trade or business. The taxation on Canadian income of foreign corporations is the same as the taxation requirements for Canadian income of domestic corporations. In addition to the tax imposed on domestic income, the Canadian Revenue Agency requires that any foreign corporation pay an additional branch tax equal to 25% of after tax profits that are not invested in qualifying Canadian property (*PwC Tax Summaries*, 2013). Many of Canada’s tax treaties either eliminate this branch tax completely or highly reduce it to 5%, 10% or 15%.

Deductions

Like the United States, Canada uses deductions on income to help reduce taxable income as an encouragement for investment from multinational corporations. In general, a corporation

²² Passive income is defined by the Canada Revenue Agency as interest, royalties and rents as well as other passive investment income and income of unincorporated foreign branch income.

may deduct “any reasonable current expense you paid or will have to pay to earn business income” including but not limited to advertising, wages, and travel (CRA, 2013). Canada also offers the following deductions to encourage corporate investment.

Depreciation and Amortization

In general, depreciation can be deducted based on a specified rate depending on the life class. These life classes are limited but are determined using the coinciding rates can be seen in the Figure 3.

Figure 3

Asset Life	Prescribed Depreciation Rate
Furniture & Fixtures	20%
Automobiles	30%
Buildings	4%-10%

In addition, the Canada Revenue Agency allows for capital assets purchased after March 2007 but before January 2016, to be depreciated at a 50% straight line method to accelerate depreciation.

A deduction is also permitted by the Canada Revenue Agency for the amortization of intangible assets such as patents, trademarks, and copyrights. A total of 75% of the capital expenditures made on intangible assets can be amortized at a maximum rate of 7% annually.

Scientific Research and Experimental Development

The Canada Revenue Agency allows a generous deduction for research and development when calculating taxable income. Each year, qualifying research and development costs can be deducted in full up to the amount of taxable income. Should these costs need to be carried forward, they may be carried forward indefinitely.

Mining and Oil and Gas Activity

In order to promote mining, oil, and gas activities, Canada permits several deductions for this sector. The first is a 100% deduction of all exploration costs as well as certain development costs. The other development costs that do not qualify may also be deducted at a 30% rate each year and the remaining costs may be carried forward. The second deduction is an additional depreciation for capital assets purchased while setting up a new mine or major expansion.

Charitable Contributions

The Canada Revenue Agency also allows for the charitable contributions of corporations to be taken as deductions. All charitable contributions may be deducted when computing taxable income up to 75% of taxable income. The remaining amount may be carried forward for five years.

Taxes

The Canada Revenue Agency does not permit any federal, provincial or territorial taxes to be deducted when computing taxable income.

Payments to Foreign Affiliates

The Canada Revenue Agency does allow for the payments of interest, rent, royalties, management fees, and other payments to another related non-resident of Canada to be deductible expenses. However, these expenses may be deducted only so long as they are related to producing income in Canada.

Credits

Canada also offers several credits to help offset income tax liability and encourage investment from multinational corporations. The three most prominent ones are the foreign tax credit to help prevent double taxation, the regional tax credit to help encourage investment in

certain areas of Canada and the scientific research and experimental development credit to encourage investment by firms of this nature.

Foreign Tax Credit

To help combat any Canadian tax owed on foreign-sourced income, the Canada Revenue Agency offers a federal, provincial, and a territorial foreign tax credit to all domestic taxpayers that have any foreign-sourced income. There are generally two types of foreign tax credits, one for business income and one for non-business income. The foreign business tax credit grants that any income taxes paid to foreign governments be eligible to be used as a tax credit against the corresponding taxpayer's income tax due. The limit on this credit is the total amount of income taxes due that year. If there are any remaining credits, they may be carried back three years and then carried forward ten years to help offset future tax owed.

Concerning non-business income, the credit is a bit different. The credit amount is equal to the lesser of the foreign tax paid for the year on non-business income or Canadian tax otherwise payable on foreign source non-business income. This credit is not allowed to be carried over, but any remaining foreign tax expenses not used in calculating the credit may be deducted when computing taxable income.

Regional Tax Credit

The Canada Revenue Agency is currently trying to encourage investment in certain Canadian industries. In order to do this, it has permitted a 10% federal investment credit for any taxpayer that invests in new buildings or manufacturing equipment that will be used in future manufacturing, processing, farming, or fishing.

Certain provinces, including Newfoundland, Nova Scotia, Ontario, and Quebec, offer tax holidays for business that are operating in certain industries. These industries include aviation,

bioscience, and intellectual property. These provinces also offer tax holidays for corporations that meet job creation requirements.

Scientific Research and Experimental Development

In addition to the research and development deduction, the Canada Revenue Agency also offers taxpayers a federal credit for their qualifying research and development expenses. This credit is equal to 20% of qualifying expenditures. Should there be any excess credits, they may be carried back three years and forward twenty years. In addition, if a corporation can meet certain qualifications, it will be considered a Canadian Controlled Private Corporation (CCPC) and an additional 35% research and development credit on its first CAD 3 million of expenditures will be granted. For this purpose, the CRA defines a CCPC a private corporation that meets all of the following conditions:

it is a corporation that was resident in Canada and was either incorporated in Canada or resident in Canada from June 18, 1971, to the end of the tax year; it is not controlled directly or indirectly by one or more non-resident persons; it is not controlled directly or indirectly by one or more public corporations (other than a prescribed venture capital corporation, as defined in Regulation 6700); it is not controlled by a Canadian resident corporation that lists its shares on a designated stock exchange outside of Canada; it is not controlled directly or indirectly by any combination of persons described in the three previous conditions; if all of its shares that are owned by a non-resident person, by a public corporation (other than a prescribed venture capital corporation), or by a corporation with a class of shares listed on a designated stock exchange, were owned by one person, that person would not own sufficient shares to control the corporation; and no class of its shares of capital stock is listed on a designated stock exchange (CRA, 2013).

In addition to federal research and development credits, all provinces and territories offer their own tax credits for qualifying research and development expenditures.

Unique Elements of the System

Territorial System

One of the most unique elements of the Canadian tax system is its treatment of foreign income. As stated in its regulations, formally it taxes income on a worldwide basis. However, its treaty base has expanded to over 91 countries because “it is important to ensure that Canada’s system of international taxation continues to promote the competitiveness of Canadian businesses internationally and to attract new foreign investment to Canada” (*Advisory Panel on Canada’s System of International Taxation*, 2008).

Since “the Canadian system, in practice, is a territorial system” or a hybrid system at the very least, some officials were worried that the decreased revenue inclusion would decrease the tax revenues, but it seems to have done just the opposite and actually promoted economic performance (*Tax Foundation*, 2012). According to *Tax Foundation*, “Canada’s economy has grown at an average real rate of 2.61 % since 1995, which is 0.2 points stronger than the U.S. average and 0.4 point stronger than the OECD average” which clearly shows the system is working (2012). Canada is now reaping the benefits of consistent and constant tax revenues, “even in times of tax cuts and has risen to the top as a place to invest in” (*Tax Foundation*, 2012).

Low Corporate Tax Rate

The other unique component of the Canadian tax system is the extremely low corporate tax rate. In fact, it is one of the lowest in the world. At 15%, many officials also worried that this would decrease tax revenues but the exact opposite has happened as tax revenues have grown faster than GDP (*Tax Foundation*, 2012). The Canadian labor force was not as affected by the 2008 recession as most other countries were. This increase in the amount of jobs in Canada

has been attributed to this lower tax rate. The Canadian Labor Statistics studies on this tax cut suggest that a one percentage point cut in the statutory Canadian income tax rate is associated with a temporary 0.1 –0.2 percentage point increase in the per capita GDP growth rate. This data shows that this cut in the corporate tax rate has definitely paid off.

International Tax Systems-Ireland

Corporate Tax Rate

Ireland's industrial policy has been "firmly focused on attracting and retaining Foreign Direct Investment (FDI) for the last fifty years" (*An Roinn Airgeadais Department of Finance*, 2013). One of the main components of this government strategy to encourage foreign investment is an extremely attractive corporate rate. Under the Irish tax law, corporations are taxed using two different types of corporate rates depending on the income. All corporations are taxed at a standard rate of 12.5% on active "trading" income. This is one of the lowest rates in the world. Although the Irish government has been heavily criticized for encouraging off shore accounts with this low rate, the government remains 100% committed to maintaining the 12.5% corporation tax rate (*Irish Minister of Finance*, 2013).

Corporations are also taxed at a slightly higher rate of 25% on non-trading (passive) income. This non-trading (passive) income includes dividends from non-resident corporations, interest, rents, and royalties. This higher rate is also applied to income from a business that is carried out wholly outside Ireland. Despite this higher rate, the standard rate of 12.5% is continually gaining foreign investment since "over 1,000 multinational corporations have chosen Ireland as their strategic location in Europe," including the multinational firm, Eaton Corporation. (*An Roinn Airgeadais Department of Finance*, 2013).

Additional Taxes Levied

As all other countries do, Ireland also imposes several other types of taxes that corporations will have to comply with. Some of the most influential ones are the Value Added Tax (VAT), customs and duties, an environmental tax, and a local tax.

The Value Added Tax is a common tax in most European countries. The Value Added Tax is charged at a standard 23% rate on the supply of goods and services used during the course of business. However, Ireland offers two reduced VAT rates as well to encourage certain types of businesses in Ireland. An example of this is the “13% rate that applies to most building services, labor intensive services, and domestic fuel and power” (*PwC Tax Summaries*, 2013). An additional reduced rate of 9% applies to supplies used in restaurants, hotels, and entertainment services. Ireland also allows for certain services to be exempt from the VAT tax, some of which include: “banking services, insurance services, medical services” and education and training (*PwC Tax Summaries*, 2013).

All corporations, as in most countries, are also subject to customs and duties on imported goods. In Ireland, however, only goods imported from outside the European Union are subject to these taxes at the common rate provided by the EU’s Common Customs Tariff. Ireland also imposes an excise duty on hydrocarbon oil products, electricity supply, alcoholic drinks and tobacco products imported to Ireland.

The third additional type of tax imposed on corporations in Ireland is an environmental tax. This is somewhat unique in that retailers that operate in Ireland are required to collect 22 Irish cents from all customers who opt for plastic bags instead of paper. The Irish Revenue Agency provides an exemption from this tax should the consumer choose to use an environmentally friendly bag as well.

The final additional tax that Ireland imposes is certain local taxes. These taxes, however, are “not based on income but rather are levied on the occupiers of business property by reference of the deemed rental value,” so it resembles more of a property tax (*PwC Tax Summaries*, 2013). This rate can vary based on a corporation’s location, but no other regional or local taxes are levied based on income.

Dividend Income

Dividend treatment in Ireland varies significantly based on where the dividend comes from. For instance, “dividends from Irish companies are exempt from corporation income tax” (*PwC Tax Summaries*, 2013). This is done so that corporations and individuals are encouraged to invest in Irish companies with the exemption of tax on dividends as just one of the incentives. Should the dividend be from a non-resident company, it then can have two different rates. “Dividends paid from the profits of an EU member” will only be subject to the 12.5% corporate rate (*PwC Tax Summaries*, 2013). Corporations will also be taxed the 12.5% rate if the company is listed in its home country; it is a recognized stock exchange member of the EU; if the corporation owns less than 5% of the stock in the foreign corporation; or, if the Minister of Finance has specifically included the company in the 12.5% rate to avoid double taxation. All other foreign dividends will be subject to the higher 25% rate.

Any stock dividends taken in lieu of cash are taxed in the same manner as cash dividends. This then implies that if the stock dividend is from an Irish company it will not be subject to tax or if it meets any of the exceptions listed above, it will be subject to the 12.5% tax rate. Any other stock dividends are generally non-taxable.

Capital Gains

In Ireland, all resident corporations are subject to a capital gains tax on any capital gain, meaning worldwide gains that arise on the disposal of capital assets. Non-resident corporations are only subject to tax on gains that arise on the disposal of Irish capital assets and assets that are used during business in Ireland. According to *PwC Tax Summaries*, “the resulting gain is taxable at 33 %”(2013). In order to encourage investment in Irish multinationals, a reduced rate of 25% “applies to Irish corporate shareholders investing in Irish funds” (*PwC Tax Summaries*, 2013). Losses can only be used to offset capital gains and can only be carried forward to offset future capital gains, no carry-back option is allowed.

There is a participation exemption from capital gains for Irish resident companies. The first way this could be complied with is if a minimum of five percent of the shares is held for a continuous 12-month period. Another way is if the share sale takes place during the period for which the minimum five percent holding is held. Some of the remaining possible options include: the sale takes place within two years after meeting the holding requirement, the company is a resident of the EU, or if the corporation is a member of a group that has met the holding requirement. This does however mean that any “losses that arise from the disposal that would be exempt under the participation exemption” cannot be used to offset capital gains (*PwC Tax Summaries*, 2013).

Foreign Income Treatment

Domestic Corporations

Like the United States, Ireland is also on a worldwide system. However, the Ireland Revenue Agency only taxes domestic firms on the earnings of their foreign subsidiaries if these earnings are remitted back to Ireland and the Ireland Revenue Agency does not impose any

additional branch income tax. There are also “no controlled foreign company rules to help with anti-avoidance” (*Deloitte International Tax*, 2013).

Ireland has tried to help with this double taxation by establishing treaties with 70 countries. These treaties are designed to ensure that income that has been taxed in one treaty country isn’t taxed again in Ireland (*AngloInfo*, 2013). If a double taxation “agreement does not exist with a particular country there are provisions in the Irish Taxes Consolidation Acts (TCA) of 1997” to grant unilateral relief against double taxation in respect of certain types of income such as capital gains and foreign dividends (*Revenue Cain agus Custaim na hEireann Irish Tax and Customs*, 2013).

Foreign Corporations

Foreign Corporations in Ireland are not under the jurisdiction of the Irish government. In other words, non-resident corporations are only liable for tax on active trading profits of an Irish branch or agency that are repatriated back to Ireland. This means that the operations and management must occur in Ireland for the branch or subsidiary to be taxed.

This “loophole” and Ireland’s other loose foreign income tax policies have opened Ireland up to a world of criticism on their foreign income policy, especially its dealings with Apple Incorporated. *The Los Angeles Times* reports that “from 2009-2012, Apple shifted \$74 billion in income from sales outside of North and South America to Apple Sales International, one of three subsidiaries in Ireland, through complex cost-sharing agreements” and paid less than 1% of tax on those earnings (2013). Irish laws state that a company is only responsible for paying taxes in Ireland if it is managed or controlled in that country. Therefore, this statute makes Apple Incorporated not responsible. This has led many other corporations, such as

Google, to follow suit and take advantage of these loose tax boundaries and other countries, in particular the United States, are paying the price.

As a result, Ireland has earned itself a reputation as tax safe haven, which implies shady business (*Forbes*, 2013). This has not only turned many of their allies against them in anger over Ireland's use of lower tax rates and loose foreign income tax policy to steal jobs and investment, but it is starting to have an effect on multinationals as well. Many feel "they cannot have their regional headquarters located in a jurisdiction that—whether fairly or unfairly—has obtained a reputation for less-than-aboveboard business dealings" (*Forbes*, 2013). The Irish government will need to make some big changes if it wants to avoid being classified as a tax safe haven because the long term effects will be negative.

Deductions

Like the United States and Canada, Ireland also offers several deductions to help decrease the tax burden for multinational corporations. In general, corporations can take "deductions in respect of revenue expenditure - wholly and exclusively incurred for the purposes of its trade - against its profits" (*Revenue-Irish Tax and Customs*, 2013). In addition, Ireland offers these additional tax deductions to encourage even more corporate investment.

Depreciation and Amortization

Depreciation of costs incurred for qualified capital assets put to use in a corporation are permitted as a deduction for the calculation of taxable income, on a straight line basis. As seen in the Figure 4, qualifying capital assets are classified based on their types and depreciated accordingly. The only restrictions that are present are for cars which limit total depreciation to EUR 24,000.

Figure 4

Asset Type	Annual Tax Depreciation Rate
Plant and Machinery	12.5%
Industrial Buildings used for manufacturing	4%
Motor Vehicles	12.5%

As in the United States, Ireland offers an accelerated 100% depreciation deduction for corporations that incur expenditures for approved energy-efficient equipment until December 31, 2014. Some qualifying items include: information and communication technology, lighting, heating, ventilation and electric and alternative fuel vehicles.

Research and Development Costs

The Irish tax law also grants a deduction for any expenditure on scientific research and development as well as payments for acquisition know how. The cost of maintaining patents and renewing trademarks also qualify as expenditures under this deduction.

IP Regime

In order to encourage technological multinational corporations to establish in Ireland, a tax deduction is also granted for the amortization of certain intellectual property assets.²³ This deduction allows for amortization of intellectual property straight line over a 15 year period. Alternatively, a company may elect to amortize its IP capital expenditures in the same method used for financial accounting purposes. Ireland also permits a maximum deduction of up to 80% of qualifying expenses to help offset this income. The other 20% will be subject to the 12.5% corporate tax rate.

²³ IP or Intellectual Property Assets are defined by the Irish government as "creations of the mind for which exclusive rights are recognized" such as trademarks, copyrights, industrial design rights and patents (*Law Journal Press*, 2008).

Charitable Contributions

As in most countries, the Irish government grants corporations a tax deduction for contributions made to qualifying organizations, schools, churches and research foundations. The maximum amount of charitable donations that a corporation can deduct is equal to 75% of its net income.

Taxes

A deduction is also granted for all VAT taxes not recovered and city imposed taxes. A deduction is also allowed for the corporation's share of PRSI contributions, a social tax in Ireland that is similar to the Medicare and social security taxes imposed in the United States.

Payments to Foreign Affiliates

The Irish government grants a deduction, in general, for all royalties, management service charges, and interest charges paid to foreign affiliates. In order to prevent abuse of this deduction, it will only be granted as long as these payments don't exceed what would be paid to unrelated parties.

Credits

As in both the United States and Canada, Ireland also offers various tax credits to directly lower the income tax imposed on corporations. The two major credits offered are the research and development credit to help encourage investment in the science and technology industries and the foreign tax credit to help combat double taxation.

Research and Development Credit

In addition to the 12.5% research and development income deduction, the Irish tax law permits a tax credit of 25% of incremental research and development costs²⁴. An additional and separate research and development credit is also granted for expenditures incurred for the

²⁴ An incremental credit means a credit in the "amount of current year qualifying expenditures over the qualifying expenditures incurred in a base year" in this case, the base year is fixed in 2003 (*PwC Tax Summaries*, 2013). This definition is generally consistent with the United States definition.

construction or refurbishing of a research and development building. This additional 25% credit on the expenditures will only be granted if the building is used 35% or more for research and development. Both of these credits will first be applied to decrease the current year's tax liability and any excess will be carried back to a prior year and then carried forward for three years. The only exception for this credit is that IP expenditures that qualify for the research and development deduction do not qualify for the research and development credit.

Foreign Tax Credit

Another way that the Irish government tries to offset double taxation for foreign income is by granting the Foreign Tax Credit. Domestic corporations will receive a tax credit for the amount of foreign taxes paid directly or withheld on income other than dividends, up to the amount of total foreign taxes paid. Taxes paid on foreign dividends will only be granted a credit if the corporation owns 5% or more of the corporate shareholdings. The Finance Act of 2012 also introduced an additional foreign tax credit for taxes paid on royalties as well as certain dividends received by an Irish company located elsewhere in the European Union. Any unused credits may be carried forward indefinitely.

Unique Elements of the System

In general, the Irish tax system is known for three unique elements, its low tax rate, its transparency of tax law, and its tax reputation.

Low Corporate Tax Rate

The first reason why the Irish tax system is favored by multinationals is because of its extremely low tax rate of 12.5%. The Irish government fully supports this rate and the "2013 budget confirmed that the government's policy in relation to the 12.5% tax rate will remain

unchanged” (*Budget 2013 Speech by Minister for Finance*, 2013). This tax rate is advantageous for Ireland because it significantly reduces the amount of taxes a multinational might pay.

For example, if a U.S. corporation incorporates in Ireland that generates \$10 million in profit, it pays \$1.25 million in Irish taxes instead of the \$3.5 million that it would pay if it were incorporated in the United States, where the federal rate is 35% (*Forbes*, 2013). These tax savings make Ireland extremely attractive as a headquarters for multinationals, as over 1,000 multinationals have already chosen Ireland as their strategic location in Europe and this number will only continue to increase (*Budget 2013 Speech by Minister for Finance*, 2013).

Government Commitment

The second unique factor of Ireland’s tax system that has made it so attractive for multinationals is the government’s complete commitment to making Ireland’s investment policy as competitive as possible. This can be seen by the implementation of several policies aimed at developing the Irish economy, including the renewal of the research and development credit in 2013, the introduction of real estate investment trust benefits, and the implementation of the “three year tax relief for startup companies...to help assist in increasing foreign investment” (*Budget 2013 Speech by Minister for Finance*, 2013). The Irish government, despite the concerns of other nations, is staying committed to maintaining Ireland’s status as the prime location for investment, and it seems to, at least for now, be succeeding.

Reputation

The final element of the Irish tax system that is unique is its overall reputation. Ireland’s tax committee has done several things to help improve its worldwide reputation. As stated earlier, a potential hurdle for Ireland is its reputation as the tax “safe haven” of the world. To pacify other nations and to calm a fear among multinationals of settling in what has been named

as a tax “safe haven,” the government combats this reputation by embarking on a mission to help battle foreign income tax compliance. They started this mission by engaging in the Ireland-US Intergovernmental Agreement to Improve International Tax Compliance. This agreement “aims to combat tax evasion by providing for the automatic exchange of tax information” as well as helping to improve U.S. multinational compliance with Foreign Account Tax Compliance Act (*Budget 2013 Speech by Minister for Finance*, 2013). This agreement is a direct and clear statement from the Irish government that it is committed to helping improve international tax compliance.

These efforts seem to be working because Ireland is continually recognized for its tax system. In fact, the IMD World Competitiveness Yearbook 2012 ranks Ireland 4th in the world for corporate tax rate and 2nd in the world for business legislation open to foreign investors. Ireland was also highlighted in the 2011 IBM Location Trends report and ranked first in the world for inward investment by quality and value (*Budget 2013 Speech by Minister for Finance*, 2013). Despite some past accusations and their accompanying challenges, Ireland stands behind its legislation while also helping to make international taxation as ethical as possible.

International Tax Systems-China

Corporate Tax Rate

Currently, under the Corporate Income Tax Law (CIT) of the People’s Republic of China, the standard rate for corporations is 25%. However, the CIT law grants several opportunities for lower rates of 20%, 15% or even 10% to be applicable for taxable income. Most of these exemptions relate to location or encourage investment in specific industries.

There are only two categories of corporations that can apply to qualify for a reduced rate of 20%. Qualified thin and small-profit organizations²⁵ can apply for this rate. Should annual taxable income be below CNY 60,000, until 2015, the preferential rate will be further reduced to 10%.

There are four categories of corporations that can qualify under CIT law for the preferred income tax rate of 15%. The first category is qualified new and high tech enterprises. It doesn't matter where these enterprises are located, but in order to qualify as a new high tech enterprise, companies are required to:

be established for over one year in China, continuously conduct research and development (R&D) activities and transform intellectual property (IP) developed into products or services, obtain proprietary intellectual property rights of core technology of its main product (service) in the last three years through self research and development, transfer/purchase, donation, merger and acquisition, etc., or through an exclusive license with a term of more than five years, conduct business in a qualified high- and new-technology sector (such as aviation and aerospace, biological and medical, electronic information, new-energy and energy conservation, new-materials, high-tech services, or resources and environmental technology, as well as high and new technologies that transform traditional sectors, engage 10 percent of employees in R&D work, with 30 percent or more having at least an associate degree, invest 3-6 percent of total revenue on R&D and make 60 percent of R&D expenses in mainland China and earn more than 60 percent of total revenue from high- and new-technology products and services. (*The U.S.-China Business Council 3*, 2013)

Another way to qualify for the preferential 15% rate is if a corporation is an integrated circuit production enterprise with a total investment exceeding CNY 8 million or produces

²⁵ Qualified thin and small-profit organizations are defined in the CIT law as a corporation with less than 300 employees and total revenues less than RMB 20 million (*IFC*, 2012).

integrated circuits with a line width of less than 0.25 micrometers. Additionally, a corporation can qualify for the preferential 15% rate if it is a qualified technology-advanced service enterprise located in one of the 21 approved cities such as Beijing or Shanghai. The final category that qualifies for the preferential 15% rate are enterprises located in the Western Region of the People's Republic of China.

The final reduced rate a corporation can qualify for is the 10% bracket. There are also only two categories that can apply for this rate. A corporation may qualify for this rate if it is a key software production enterprise or integrated circuit design enterprise. The government of the People's Republic of China is looking for additional investment from these types of corporations, so the government provides additional incentives in these areas. Other possible corporate income tax exemptions or highly reduced amounts owed can be seen in the following figure.²⁶

Figure 5

Projects and Industries	CIT Incentive	Applicable Periods
Agriculture, forestry, animal-husbandry, and fishery projects	Exemption or 50% reduction in income taxes payable	All years the corporation is engaged in these projects.
Specified basic infrastructure projects	3 years of exemption plus 3 years 50% tax holiday	Starting from the first income-generating year
Environmental protection and energy and water conservation projects	3 years of exemption plus 3 years 50% tax holiday	Starting from the first income-generating year
Qualified new/high technology projects established after 2008 in Shenzhen, Zuhai, Shantou, Xiamen, Hainan, or Pudong	2 years exemption plus 3 years 50% tax holiday	Starting from the first income-generating year
Software enterprises	2 years exemption plus 3 years 50% tax holiday	Starting from the first profit-making year
Integrated circuits design enterprises	2 years exemption plus 3 years 50% tax holiday	Starting from the first profit-making year
Integrated circuit production enterprise with a total investment exceeding CNY 8 million or produces integrated circuits with a line width of less than .25 micrometer, provided its operation period exceeds 15 years	5 years tax exemption plus 5 years 50% tax holiday	Starting from the first profit-making year
Integrated circuit production enterprise with a line width of less than .08 um	2 years exemption plus 3 years 50% tax holiday	Starting from the first profit-making year
Qualified energy saving service enterprises	3 years of exemption plus 3 years 50% tax holiday	Starting from the first income-generating year
Encouraged enterprises located in underprivileged areas of Xinjiang	2 years exemption plus 3 years 50% tax holiday	Starting from the first income-generating year

²⁶ This table was taken from *PwC Tax Summaries*, 2013.

Additional Taxes Levied

In addition to the corporate income tax there are three other taxes that corporations will need to comply with. The first additional tax is the Value Added Tax. This tax is a standard 17% tax on the sales or importation of goods and the provision of repairs, replacement and processing services. A reduced VAT rate of 13% is available for necessity goods²⁷. In order to help resolve the double taxation issue and to help support the local service industries, the Chinese government has implemented a pilot program of reduced VAT rates in the city of Shanghai by expanding the tax base to include transportation services as well. Since the pilot program's inception in 2012, eight other provinces have initiated the program and it is now effective for the entire country and will be completed by 2015.

Another additional tax that corporations must comply with is the general business tax. This tax is imposed on services, transfer of intangible assets, and immovable property in China. Most businesses are only subject to a 3-5% rate, but the entertainment industry is subject to a 20% rate. However, this tax is being phased out because most areas are subject to the VAT tax rather than the business tax.

The final tax that corporations are subject to is the resource tax. This tax is levied upon corporations that exploit crude oil and natural gas. An additional resource tax is levied on a per ton basis for the exploitation of other resources such as coal, salt, raw non-metallic resources, and ferrous materials. This tax is in place to help preserve the environment as China continues to go through its industrialization period while promoting tax incentives to keep corporations conscious of environmental concerns.

²⁷ Necessity goods include: food, water, shelter, books and utilities (*Deloitte International Tax*, 2013).

Dividend Income

In general, dividends, foreign or domestic, are to be included in gross income and are taxed. An exemption is permitted for dividends derived by a tax resident enterprise (TRE)²⁸ from the direct investment in another tax resident enterprise²⁹. This exemption does not apply, however, if the stock owned is on the publicly traded market and is held for less than 12 months. Foreign dividends received are subject to a 10 percent withholding tax. However, China has entered into a number of tax treaties (e.g., with Hong Kong) that provide for a lower five percent withholding tax for qualifying investors (*MWE China Law Offices*, 2007). Stock dividends are treated in the same manner as ordinary dividends.

Capital Gains

In general, capital gains, both foreign and domestic, are netted and treated in the same manner as ordinary income for a tax resident enterprise and will be taxed at the normal corporate rate. No carry-back of losses is permitted but losses may be carried forward for five years.

Foreign Income Treatment

Domestic Corporations

In general, since China supports a worldwide system in its corporate income tax law, all tax resident enterprises, or TREs, are to pay corporate income tax on all foreign income as well as on income of its branches inside and outside China. A corporation is considered a TRE by the Chinese government if it is established in China or if it is established outside China but has a place of effective management located in China. This definition is much broader than most tax

²⁸ “A company will be recognized as a Chinese tax resident enterprise if it is incorporated in China or its place of effective control and management is in China” (*China Tax Guide*, 2012).

²⁹ The Chinese TRE concept was the first of its kind “to deem the offshore holding company as a TRE and impose tax on the direct transfer of the TRE.” This was also the first time a tax authority has challenged offshore indirect equity transfers (*PwC CN*, 2013).

authorities' definition of a tax resident. In fact, "the appointment of any business agent in China to store and deliver goods constitutes an establishment" (*MWE China Law Offices*, 2007).

China also does not allow for the deferral of income taxes on foreign income directly earned or transferred by a TRE, meaning, the earnings don't have to be repatriated to China for income taxes to be paid on them. The launch of the TRE classification is unique in that it classifies foreign offshore investments and direct transfers as taxable in China, so long as the effective management is located there. "It is also the first time to see the Chinese tax authority, taking the initiative to deem a foreign company as a Chinese TRE in order to collect tax" as it poses a possible revolutionary new way to handle tax avoidance (China Tax And Business Advisory, 2013).

In addition to using the TRE classification to battle tax avoidance, China also has a set of Chinese Controlled Foreign Corporation rules as well. Under these rules, "resident companies must include in taxable income their respective share of the undistributed profits of a CFC" (*Deloitte International Tax*, 2013). These rules only apply to Chinese Controlled Foreign Corporations located in a low income tax country³⁰ such as Ireland. These rules also do not apply to Chinese Controlled Foreign Corporations (CCFC) that derive income through active business income or are located in a white-list country.³¹

Foreign Corporations

Should a corporation be considered a non-TRE, it will be considered a foreign corporation. In general, foreign corporations are not under the jurisdiction of the Chinese government so they are only required, under the CIT law, to pay Chinese income tax at a "tax

³⁰ The Chinese government considers a low income tax country to be any country with an effective corporate income tax rate lower than 12.5% (*Deloitte International Tax*, 2013).

³¹ A white list country is a "jurisdiction that has implemented the internationally agreed tax standard – i.e. not considered to be a tax haven by the OECD" (*Pearse Trust*, 2012).

rate of 25 per cent, with respect to their China-sourced income and their global income that has a” relationship with China (*MWE China Law Offices*, 2007). This includes any income from branches established in China. No additional branch tax is imposed, however.

Deductions

In the same manner as the United States, Canada, and Ireland, China also offers several income deductions to help decrease taxable income for corporations. In general, “reasonable and related expenses actually incurred by an enterprise, including costs, expenses, losses and other expenses are deductible in calculating taxable income for CIT purposes (*KPMG*, 2008). In addition, China offers the following deductions to also encourage corporate investment.

Depreciation and Amortization

In general, the CIT law grants corporations a deduction for the depreciation of capital assets with a useful life of 12 months or more. Depreciation is to be calculated on a straight line basis, unless it qualifies as an exception because of change in technology. The specified rates can be seen in the Figure 6.

Figure 6

Assets	Years
Buildings and structures	20
Aircraft transportation vessels, mechanisms and other production equipment	10
Appliances, tools, and furniture	5
Means of transportation other than aircraft	4
Electronic equipment	3
Production-nature biological assets of forestry	10
Production-nature biological assets of livestock	3

Corporations are also granted, under the CIT law, a deduction for the amortization of intangible assets. These include, but are not limited to: patents, trademarks, copyrights, and land use rights. The useful life, however, may not exceed 10 years.

Research and Development

Since the CIT law does not grant a research and development credit, it offers a research and development deduction to help offset some of these costs. Under CIT law, a corporation is allowed to deduct an extra 50% of actual expenses incurred for new technology, new products, or new craftsmanship. This deduction is an incentive for corporations to invest in technology.

Charitable Donations

The CIT law also grants a deduction for charitable donations. However, this deduction is limited to 12% of a corporation's accounting income. This accounting income is not the same as the taxable income, but rather the net income stated on the Profit and Loss Statement.

Payments to Affiliates

The CIT law grants a deduction for certain payments to affiliates. Service fees paid for genuine services provided by affiliates of China located abroad and charged at arm's length as well as payments made at arm's length, such as royalties, are all tax deductible. Management fees for stewardship are not tax deductible in China.

Credits

In the same manner as the United States, Canada, and Ireland, China also offers two important tax credits to directly help offset CIT liability. First is the Investment Tax Credit to help encourage investment in certain industries and second is the foreign tax credit to help offset double taxation.

Investment Tax Credit

In order to encourage environmental conservation and alternative energy, the CIT law grants a credit of 10% of any investment made in purchasing and using equipment specified for

environmental protection, energy and water conservation, or production safety. This credit may be carried forward for five years to help offset future income tax liability.

Foreign Tax Credit

In order to help prevent double taxation on foreign sourced income, the CIT law grants a foreign income tax credit to its TRE corporations. A TRE can claim the “foreign tax credit in relation to foreign income tax already paid overseas in respect to income derived from sources outside China based on a country-basket principle”³² (*PwC Tax Summaries*, 2013). This includes taxes paid by CCFCs. No carry-back option is granted for this credit but it may be carried forward for five years to help offset future income tax liability.

Unique Elements of the System

TRE Concept

Tax Resident Enterprise is a relatively new concept in the CIT Law as it was just passed in 2007 (*PwC Tax Facts and Figures*, 2013). The concept is unique in that it not only includes corporations established in China as TREs, but also foreign enterprises that have effective management in China. This legislation expanded “the scope of authority of China's State Administration of Taxation ("SAT") to allow it to tax the off-shore income of foreign enterprises” which has made many foreign investors obligated to pay a significantly larger tax bill (*Industry Week*, 2007).

TRE specifically targets foreign enterprises that have their management function in China for operations outside the country. This has allowed the law to be extremely effective by capturing indirect transfers from foreign corporations, making them subject to income tax law.

³² The country basket principle is defined as “A selection of countries that are grouped together in order to provide insight into the effect of changing economic conditions. A country basket may track the economies and markets of countries that have similar economic characteristics, such as being part of the G7, that have particular trade characteristics, such as being export-led, or that rely on the production of certain goods, such as oil” (*Investopedia*, 2013).

In fact, it is the first of its kind to have a tax authority specifically targeting these types of transfers. It still has some kinks to work out in implementation, but nevertheless, it is a significant step forward in anti-avoidance efforts.

Tax Rate Reductions

One of the major changes that the CIT regime made to the Chinese corporate tax law was to reduce its effective income tax rate significantly. Since 2007 the rate has dropped from 33% to a unified 25% corporate income tax rate (*Ernst & Young Tax Alert*, 2007). Other preferential tax rates as well as tax holidays have also been used to help encourage specific types of investment in China. These “changes have been brought about largely because Chinese firms were often struggling to compete with their foreign rivals, something the Chinese authorities believed to be unfair, particularly given China’s recent accession to the world trade market” (*China Orbit*, 2007).

These tactics have certainly done their job. These new desirable conditions have increased investment and have had a positive impact on their expansion plan. Also, important cities like Shanghai have experienced a strong demand for business service (*Asia Times*, 2007). In addition, the Chinese economy is rising, making this tactic a major success. Overall, it has helped to increase the competitive advantage and improved the reputation of the Chinese system.

Analysis and Recommendations

Problem: Taxation of Foreign Earnings

After analyzing the United States treatment of foreign earnings it seems to pose two major problems. The first problem is that current multinationals have a major monetary incentive to shift their income out of the United States, which currently has the highest corporate tax rate on foreign earnings, to a lower income tax rate country. Since some of the more

sensational press stories and claims by politicians lead people to believe that U.S. companies pay little or nothing in taxes on their foreign earnings the public has come to think that multinationals' main goal is tax evasion (*Tax Foundation*, 2013). However this is not the case because according to IRS data for 2009, U.S multinational companies paid more than \$104 billion of foreign taxes on \$416 billion of foreign earnings at an average rate of 25%. In addition, these multinationals were then taxed again by the United States on the difference between the United States' tax rate of 35% and the taxes paid abroad. This has caused corporations to engage in tax avoidance and move their operations elsewhere and not invest these foreign earnings in the United States.

The second major problem that the United States treatment of foreign income faces is the repatriation requirement. Currently, corporations are not taxed on their earnings until those earnings are repatriated to the United States. Therefore, in order to defer income tax, firms simply reinvest those earnings in their foreign subsidiaries instead of investing the earnings in the United States. Currently, "United States multinationals report about \$2 trillion of accumulated foreign earnings as indefinitely reinvested abroad" (*Accounting Today*, 2013). Many might view these untaxed non-repatriated foreign earnings as simply "unpatriotic tax avoiders engaged in off shoring jobs" but realistically it is corporations trying to stay competitive in a harsh global market (*Director Advisory*, 2013). "Most companies want to repatriate their earnings to pursue better investment opportunities without triggering taxes" (*Director Advisory*, 2013).

Solution: Introduction of a Territorial System

After considering several solutions, one option that would address both of these problems would be for the United States to adopt a territorial/hybrid system. The United States

government could do this through a total tax reform or they could model Canada's tax system and simply set up additional provisions in current tax treaties with all countries. A change to a hybrid system would help in two ways. First, a study done by the Berkley Research Group showed that the switch would increase corporate tax revenues in the short run of about \$80 billion. This is because under the new system, corporations would now have an incentive to invest both income and operations back to the United States because they would not be taxed twice.

The second way this change would help is that it would help increase the repatriation of foreign earnings. According to the study done by the Berkley Research Group, a change to a hybrid system would reduce the "lock out effect" that the current worldwide system encourages for foreign earnings. The study predicts that should the United States switch to a hybrid system, of the \$2 trillion of foreign earnings currently being permanently reinvested abroad, \$1 trillion of those earnings would then be repatriated. This additional investment would not only increase the U.S. GDP by at least \$208 billion but it would also create 1.46 million more jobs (*Accounting Today*, 2013). The study also predicts that this would help increase future foreign earning repatriation by about \$114 billion per year which would then translate into a \$22 billion annual increase to the U.S. GDP (*Accounting Today*, 2013).

One drawback that officials would need to address when implementing this new system would be the tax base erosion, or decrease in the amount of assets taxed. Due to other issues within the United States tax system there are other incentives to shift income to a lower tax rate country. This has caused tax base erosion, a problem for countries with both a worldwide and territorial system. As a result, in order to prevent tax base erosion, additional measures must be taken for this system to work.

Problem: High Tax Rate

One of the major reasons for the tax base erosion mentioned above is because of the United States' extremely high effective tax rate of 35%. In fact, while other countries around the world are doing everything they can to encourage investment, according to the OECD, the United States currently has the highest statutory rate in the world. This has not only made the United States a non-competitive location, it has also discouraged job creation in the United States, increased investment in research and infrastructure, and has passed increased prices on to consumers. Some say that this is simply a myth but it is hard to ignore when major companies such as Google Incorporated, Apple Incorporated, and Facebook Incorporated, all are "structuring their earnings so that they are moved to low tax jurisdictions" such as the Cayman Islands or Ireland (*Bloomberg*, 2010). This has cost the United States \$3.1 billion in taxes over the last three years from Google Inc. alone.

Solution: Lower the Corporate Tax Rate

In order to address this problem, the United States needs to significantly consider lowering the statutory tax rate. It doesn't need to be reduced as low as Ireland's to 12.5% but enough to make it competitive with the rest of the world. In fact, the Heritage Foundation's Center for Data Analysis (CDA) ran a what if analysis situation in 2011 if the corporate tax rate was reduced to 25%. This analysis showed that the number of jobs in the U.S. would grow on average by 581,000 annually from 2011 to 2020, with 531,000 on average being created in the private sector each year; U.S. real GDP would rise on average by \$132 billion per year; a typical family of four's after-tax income would rise on average by \$2,484 per year; and the U.S. capital stock would grow by an average of \$240 billion more per year. Ultimately, lowering the

corporate tax rate would “make investing in the U.S. by both domestic and international firms more attractive” (*The Heritage Foundation*, 2011).

One way the United States could implement this is by modeling the Canadian system and applying it in a gradual fashion. If the rate was reduced about 5% each year, the drastic change would be greatly softened. Another avenue the United States could consider is to model after the Chinese tax system in providing preferential rates to attract desired industries such as agriculture, technology or alternative energy firms. This would allow an increase in the tax base for the United States without a complete tax code reform.

Problem: Reputation of the United States

The third major problem that has contributed to the tax base erosion of the United States is its reputation. There is no doubt that the United States, whether it is true or not, has received a large amount of criticism for its tax system. Other countries, in particular Ireland, have strategically been working to earn a reputation as a premier tax location. In fact, the Irish Minister of Finance stated in his 2013 budget report that one of Ireland’s major assets was its reputation as a premiere and “transparent corporation tax regime accompanied by a rapidly growing network of international tax treaties with full exchange of tax information” (*Irish Minister of Finance*, 2013). Unfortunately, this is not the case for the United States. The United States only seems to be known in the press for high tax rates, its worldwide system, and complicated tax regulations, none of which corporations are looking for.

Solution: Additional Tax Credits and Incentives

A way to change the United States reputation is to present it to the world as a premiere tax location. This can be done by implementing additional tax credits and other incentives. Currently the United States offers a foreign tax credit as well as the many credits that combine to

make the general business credit. These could be added to by introducing a better and more significant technology credit for up and coming industries such as medical or computer technology advancements. Some of the major companies that are not only the largest and most profitable but are also the companies the United States seems to have the most tax avoidance from are technology companies such as Apple Incorporated and Google Incorporated. If the United States could offer some type of additional technology credit or other incentive such as preferential tax rate to encourage these firms to start investing in the United States, other corporations would follow their lead. Another area the United States should consider offering an additional or larger tax credit or incentive is alternative energy firms. China has established itself as a premiere location for alternative energy firms with the incentives it offers to them. The United States could follow this lead and encourage more and more alternative energy firms to reinvest in the United States by offering a 10-15% of qualified expenses credit for firms that engage in alternative energy sources such as wind power, ethanol or sun panels. Overall, the United States government needs to decide which types of industries it wants to attract and then cater to those industries' needs. In order to fix the United States' current reputation major incentives need to be offered.

Conclusion

No tax regime is without problems but the United States seems to be at the tipping point with its problems. Multinationals are finding every tax loophole possible to avoid the repatriation of earnings or simply moving elsewhere. This has caused for a major reconsideration of the current tax code to be overhauled. Overall, in order to prevent the tax base erosion and increase tax revenues and investment, the United States needs to switch to a hybrid system, lower its corporate tax rates and also reestablish itself as a premiere tax location. Of

course these solutions will not fix every problem but it would be a substantial start towards recovery.