

**Taxes and Business Strategy (15.518)**  
**Sloan School of Management**  
**Massachusetts Institute of Technology**  
**Fall 2002**

**Problem Set 4 - Due Lecture #17**

- 1.** Parent (a US corporation) owns 100% of the stock of Foreign, a foreign corporation doing business in the Czech Republic. Assume that the corporate tax rate in the Czech Republic is 25%, and that the US corporate tax rate is a flat 35%. Foreign makes a dividend distribution to Parent of \$100,000 during the year. What is the US tax that Parent pays on the dividend?
  
- 2.** Domestic Corporation (a US corporation) is considering opening a branch in Asia. They have narrowed their choices down to two countries. One choice is South Korea, with a tax rate of 30%, and the other choice is Vietnam, with a tax rate of 10%. Domestic expects that the Korean branch would generate \$1,000,000 of pre-tax earnings each year. They feel that there would be substantially more costs associated with operating in Vietnam, so they expect only \$900,000 of pre-tax earnings from a Vietnamese branch. Assume that Domestic faces a flat 35% US tax rate. Based solely on tax reasons, which country should Domestic open the branch in, and why?
  
- 3.** USCorp is a US multinational corporation. For 2001, USCorp had \$100 million of taxable income (\$40 million foreign source and \$60 million domestic source). USCorp paid \$16 million in foreign income taxes in 2001 on its foreign source income. Assume that the US corporate tax rate is a flat 35%.

  - a.** What is USCorp's US federal income tax for 2001?
  
  - b.** Assume that USCorp borrows money and incurs \$20 million of interest expense. The interest expense is allocated 40% as a foreign source deduction (\$8 million) and 60% as a US source deduction (\$12 million). Foreign taxes paid are still \$16 million. Compute the reduction in USCorp's federal income tax because of this interest expense.

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4. A U.S. corporation facing a 40% domestic tax rate owns 100% of a foreign subsidiary that faces a 25% local (foreign) tax rate. The subsidiary was capitalized by a loan that has been repaid and has \$150 million of earnings and profits that have already been taxed at 25%. There are no withholding taxes on repatriation of dividends from the foreign country.

a. How much U.S. taxable income will result if the subsidiary pays the parent a \$150 million dividend?

b. How much additional U.S. tax will be due after taking into account the additional income and the deemed paid foreign tax credit?

c. How would the net repatriation (that is, the dividend less U.S. tax on repatriation) be affected if a 10% withholding tax were levied by the foreign government on the dividend? Note that withholding taxes are eligible taxes for the foreign tax credit.

d. Suppose the \$150 million could be invested in active business projects (i.e., not Subpart F) at 13% before tax (9.75% after local tax) in the foreign country, or could be invested in the U.S. at 15% before tax (9% after U.S. tax).

1. Would you prefer to repatriate or reinvest if your investment horizon is: 1, 5, 10, or 20 years? Why?

2. How would your answer to (d)(1) change if the host country imposed a 10% withholding tax on the dividends? Show calculations for the four holding periods.

3. Suppose the U.S. tax rate is known to increase to 45% next year and the after tax returns on funds invested in the U.S. will drop correspondingly to 8.25%. How would your answer to (d)(1) change? Show calculations for the four holding periods.

4. Suppose the U.S. tax rate is 40%, as before, but the foreign investments generate Subpart F income that is taxed to the U.S. parent as earned (since the foreign subsidiary is a controlled foreign corporation, or CFC). The U.S. investment continues to earn 15% before tax returns. Assume the original \$150 million of earnings and profits was not Subpart F income and hence has not been subject to U.S. tax. How does this affect your answer to (d)(1)? Show calculations for the four holding periods.