

B.E.P.S. FROM THE U.S. PERSPECTIVE

ANALYZE LOCALLY THINK
GLOBALLY

TAX SPECIALIST GROUP
TORONTO, CANADA
JANUARY 20, 2014

Stanley C. Ruchelman, Robert G.
Rinninsland, & Armin Gray

Ruchelman P.L.L.C
150 East 58th Street, 22nd Floor
New York, New York 10155

ruchelman@ruchelaw.com

rinninsland@ruchelaw.com

gray@ruchelaw.com

U.S. CENTRIC CONSIDERATIONS

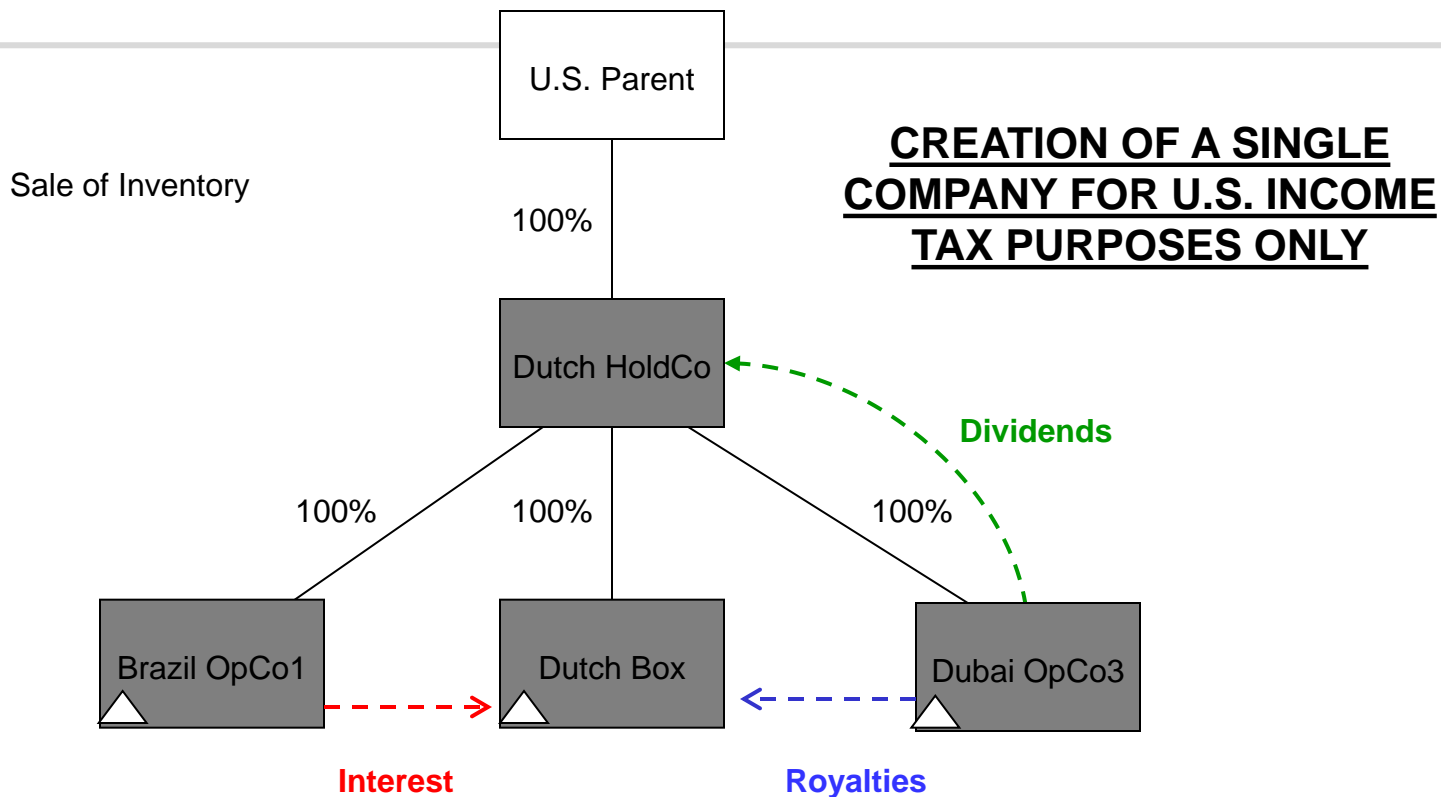
Key Components of U.S. International Tax Planning

- Entity Classification
 - Pass-through or C-corp.
- Identify Items to be Transferred
 - Stock
 - Assets
 - IP
- Identify Relevant Tax Attributes
 - Dual Consolidated Losses
- Determine Cash Repatriation Strategies
 - U.S. Anti-deferral regimes
- Base Erosion and Profit Shifting Initiatives

Check-the-Box Elections

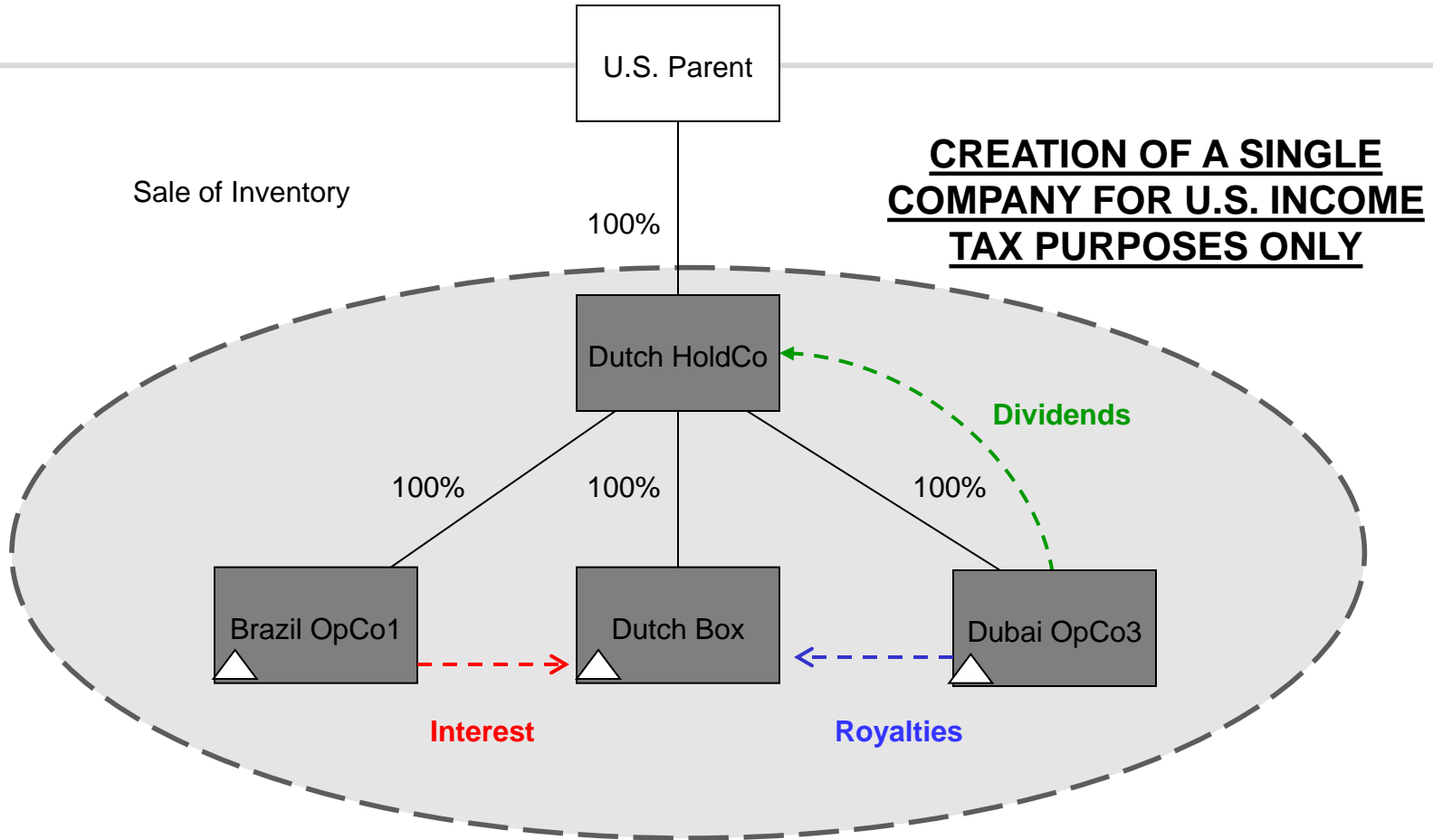
- ❑ In domestic context, CTB election identifies the taxpayer and promotes creation of JVs
- ❑ In international context, CTB election can achieve a wider range of goals
 - ❑ An acceleration of U.S. tax under Subpart F for a transaction that reduces foreign tax
 - ❑ Allowing a U.S. or a foreign person to access an income tax treaty to obtain tax benefits in the U.S. or a foreign country
 - ❑ Allowing U.S. individuals to claim foreign tax credits for corporate income taxes paid abroad by foreign business entities formed as corporations
 - ❑ Allowing U.S. individuals to claim reduced rates of U.S. tax for dividends paid by a business located in a non-treaty foreign jurisdiction
 - ❑ Turning an outbound transfer of stock of a foreign corporation into a foreign-to-foreign D-reorg
 - ❑ Eliminating effect of Code §367(d) – outbound transfer of IP
- ❑ **NB** -- All planning is subject to concepts of economic substance and partnership anti-abuse rules, where applicable

Subpart F Income Planning



△ Means flow-thru for U.S. tax purposes

Subpart F Income Planning

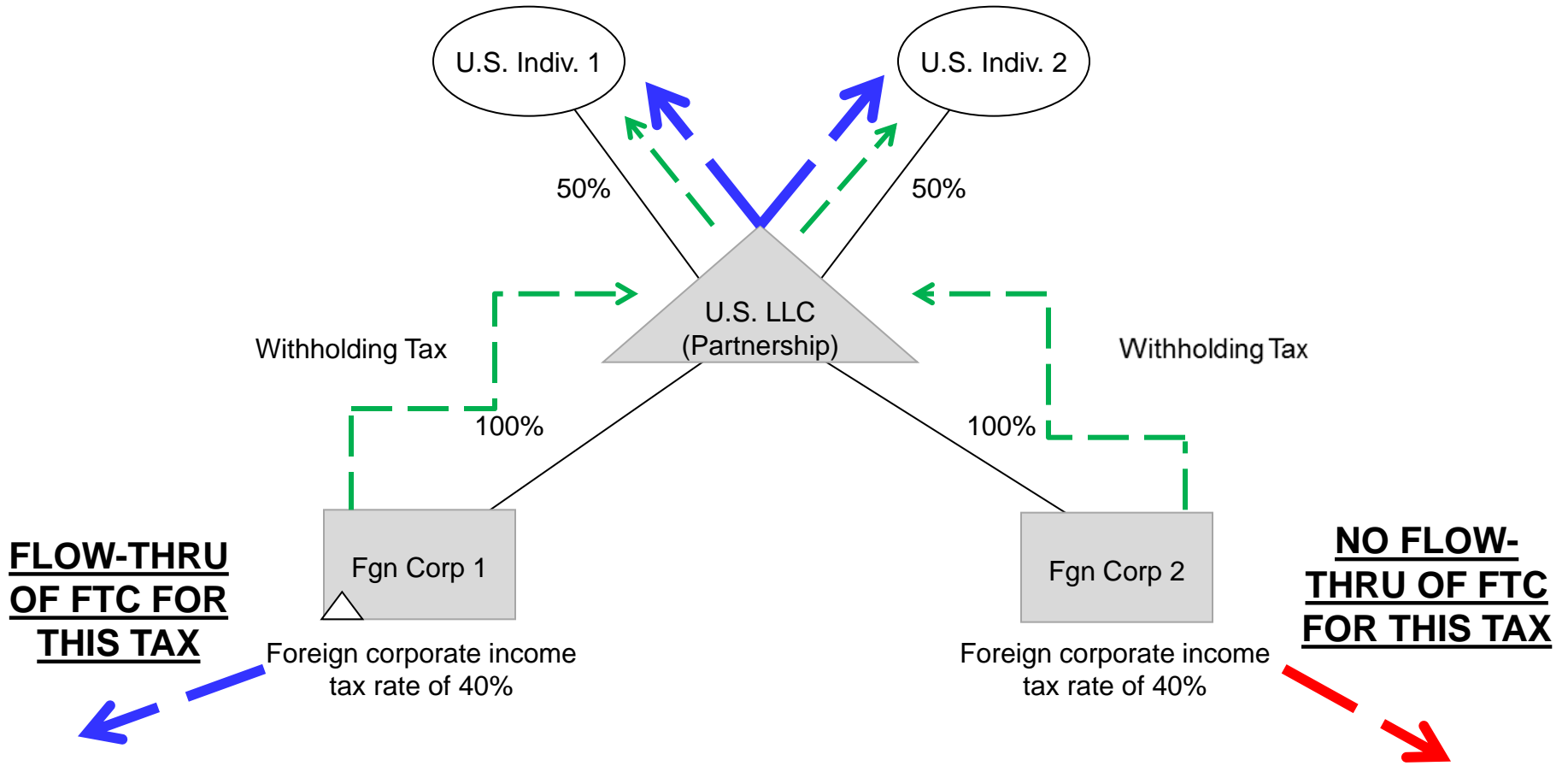


CREATION OF A SINGLE COMPANY FOR U.S. INCOME TAX PURPOSES ONLY

△ Means flow-thru for U.S. tax purposes

Foreign Tax Credit Planning

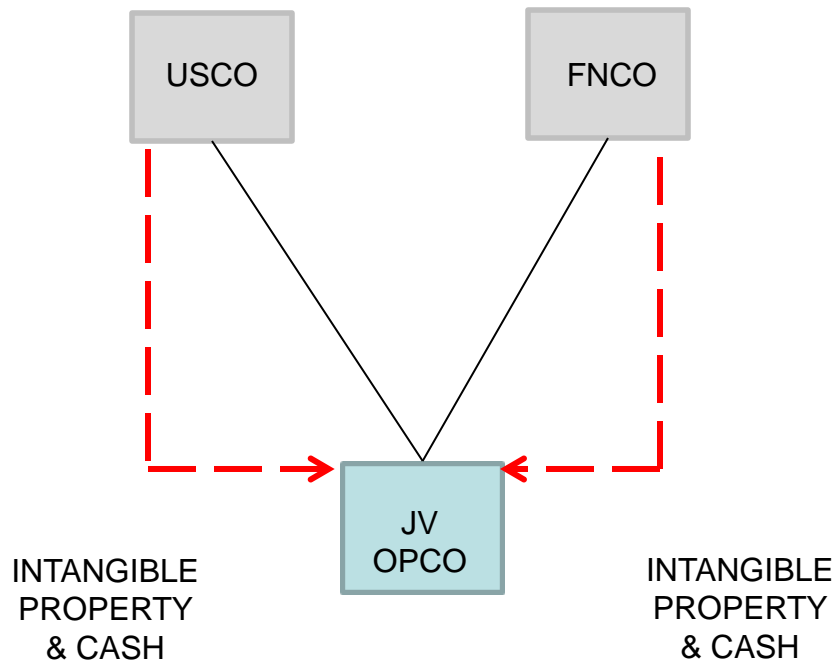
– Converting 902 tax to 901 tax



△ Means flow-thru for U.S. tax purposes

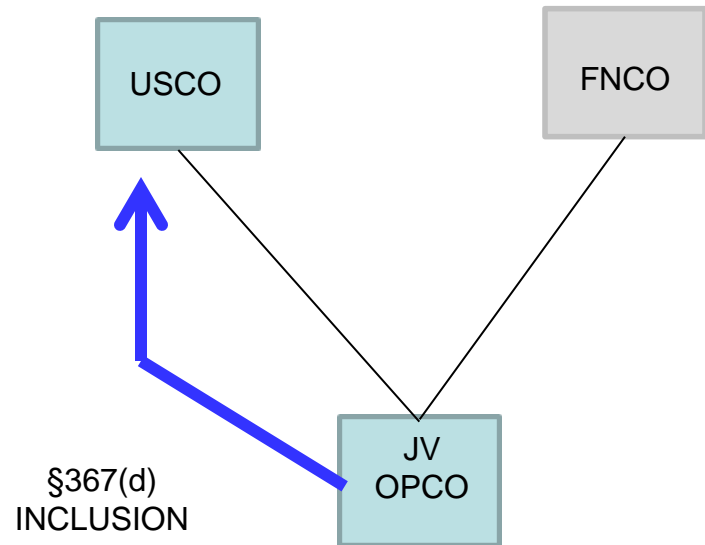
International Joint Venture

BUSINESS TRANSACTION



- TWO COMPANIES WITH IP
- JOINT DEVELOPMENT AGREEMENT
- CONTRIBUTION OF CASH & IP
- FOREIGN LAW REQUIRES LOCAL OPCO

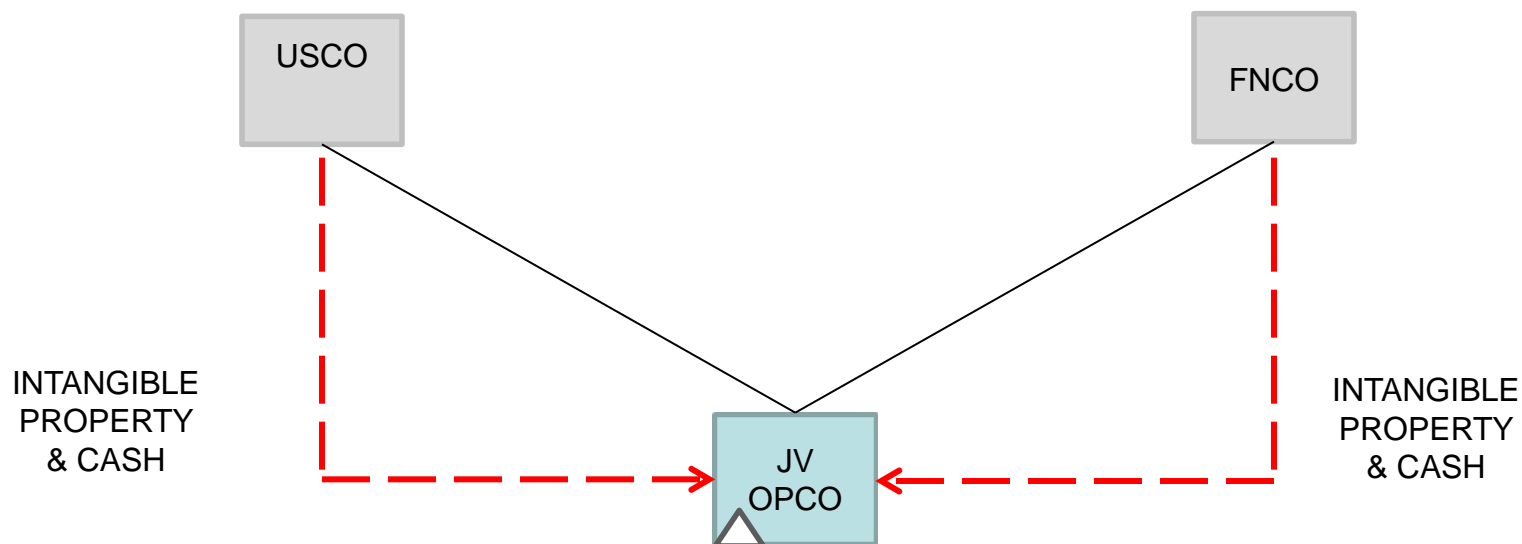
U.S. TAX TRANSACTION



- RESTRUCTURED UNDER § 367(d)
- SALE OF IP FOR CONTINGENT CONSIDERATION

International Joint Venture

SOLUTION

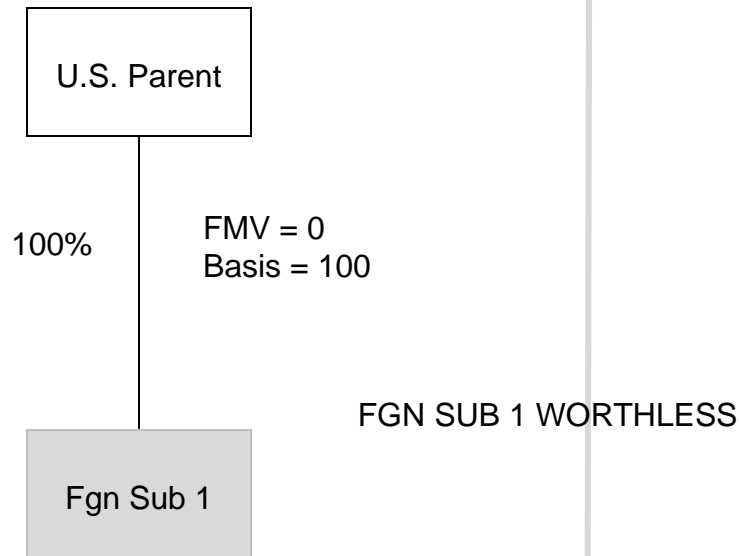


- CODE §367(d) DOES NOT APPLY TO PSHP
- EXCEPTION IF BUILT-IN GAIN WOULD BE ALLOCATED TO FOREIGN PARTNERS
- FORM 8865 SCHEDULE O

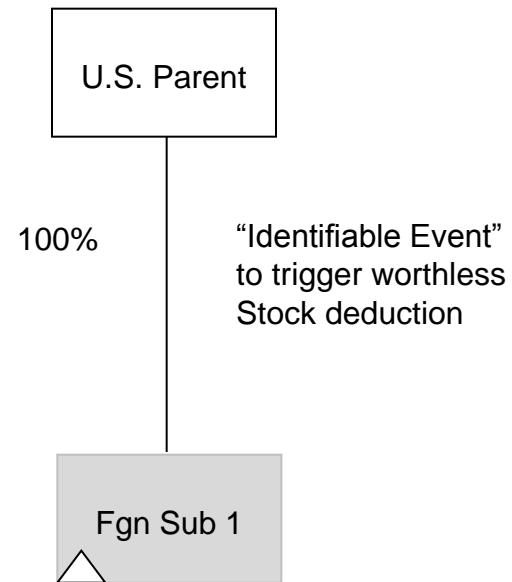
△ Means flow-thru for U.S. tax purposes

Loss Triggering – Worthless Stock

PROBLEM



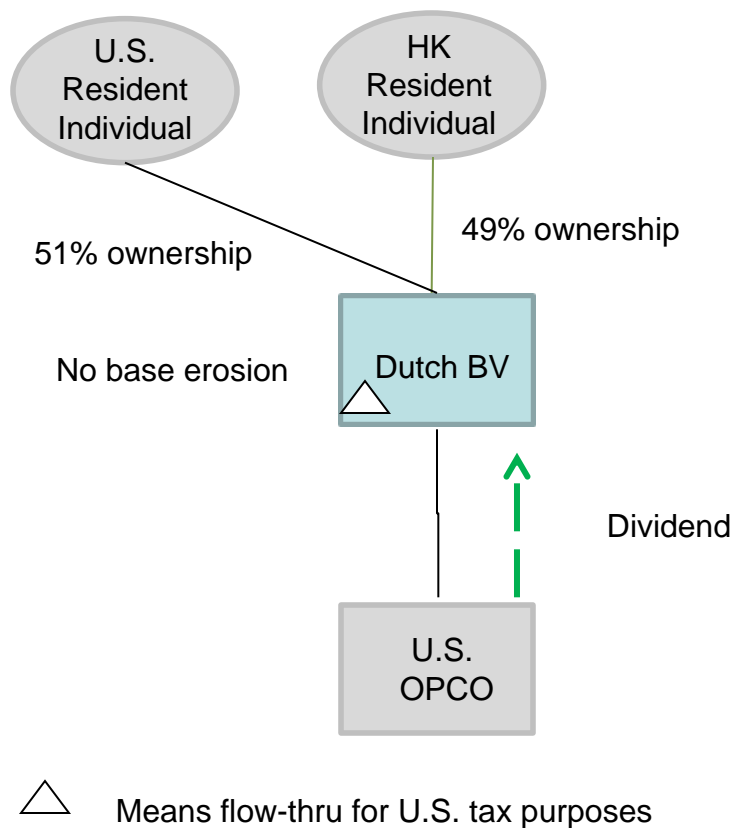
SOLUTION



- §332 LIQUIDATION – NONRECOGNITION OF LOSS
- WORTHLESS STOCK DEDUCTION IS ALLOWED IF SUB IS INSOLVENT
- PLR 9610030 PERMITS W/S DEDUCTION FOR ACTUAL CONVERSION
- LOSS IS GENERALLY ALLOCABLE TO DOMESTIC SOURCE INCOME

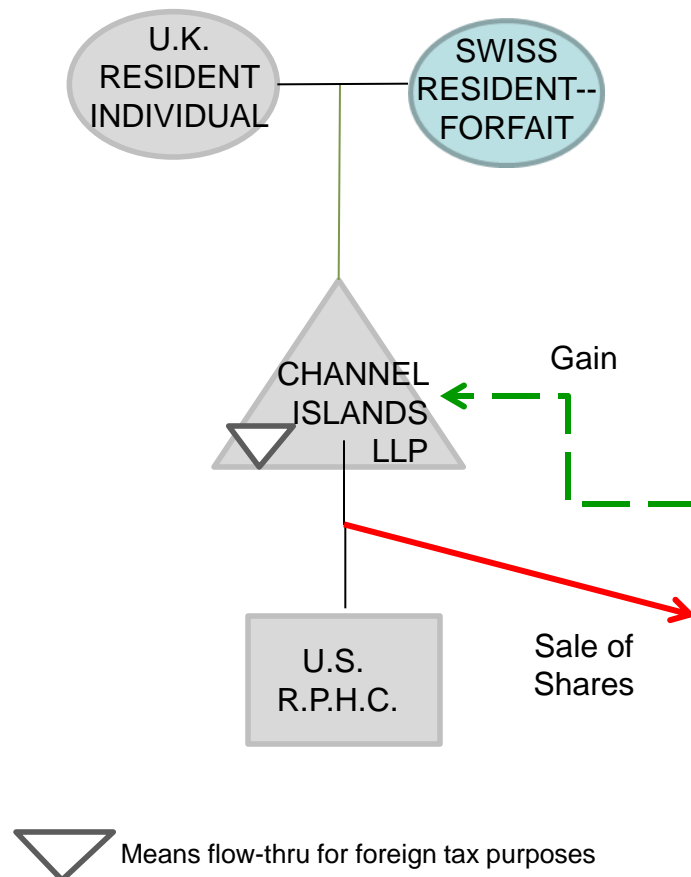
△ Means flow-thru for U.S. tax purposes

Inbound – Treaty Withholding Rates



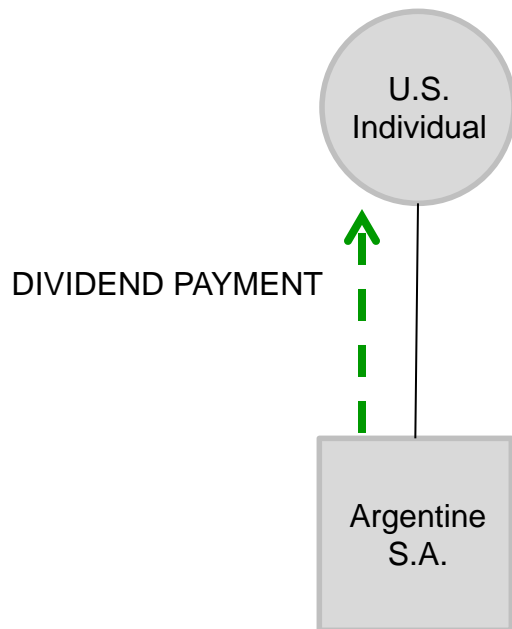
- When CTB election is made, Dutch BV is flow thru for U.S. person
- U.S. resident individual can treat dividend as qualified dividend subject to 15% tax
- Dutch BV is entitled to treaty benefits under the LOB Article
- 49% of dividend qualifies for reduced rate under the treaty
- W-8IMY and W-8BEN must be submitted by Dutch BV

Inbound – Identifying the Taxpayer



- Sale of shares of U.S. R.P.H.C. is effectively connected income
- Channel Islands LLP categorized as an association if no C-T-B election is made
- In U.K., Channel Islands L.L.P. is tax transparent
- In Switzerland, the individual is not taxed
- No C-T-B- election is made
- What is the rate of tax on the gain from the sale of shares? 34/35% under Code §11 or 20% under Code §1(h)

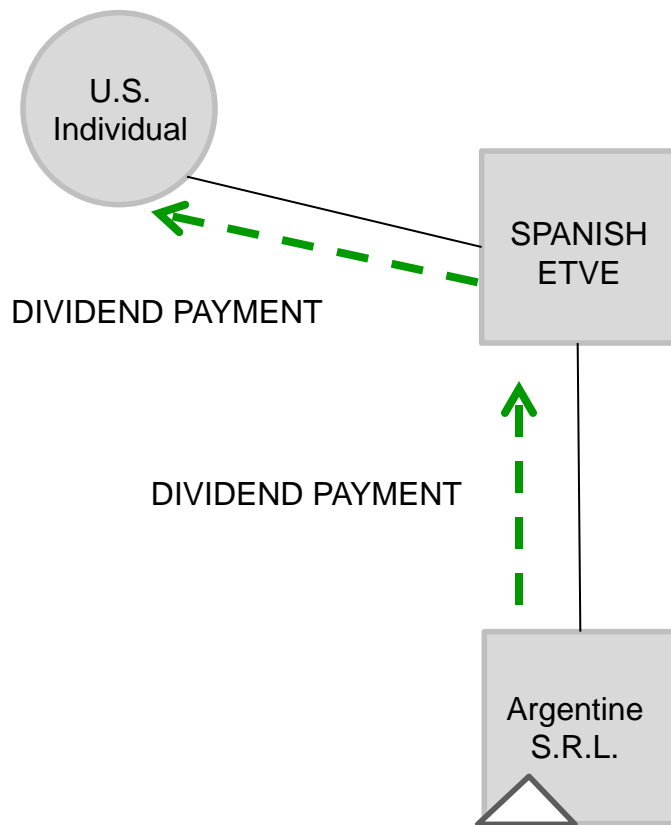
Accessing Code §1(h)(11)



POTENTIAL TAX ISSUES

- No income tax treaty between U.S. and Argentina
- Domestic withholding tax on dividends
- Potential tax on gains
- Dividend taxed at 35% in the U.S.

Accessing Code §1(h)(11)



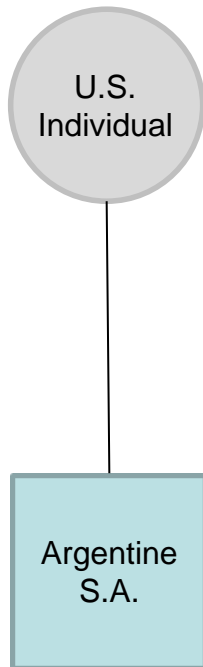
Means flow-thru for U.S. tax purposes

POTENTIAL SOLUTIONS

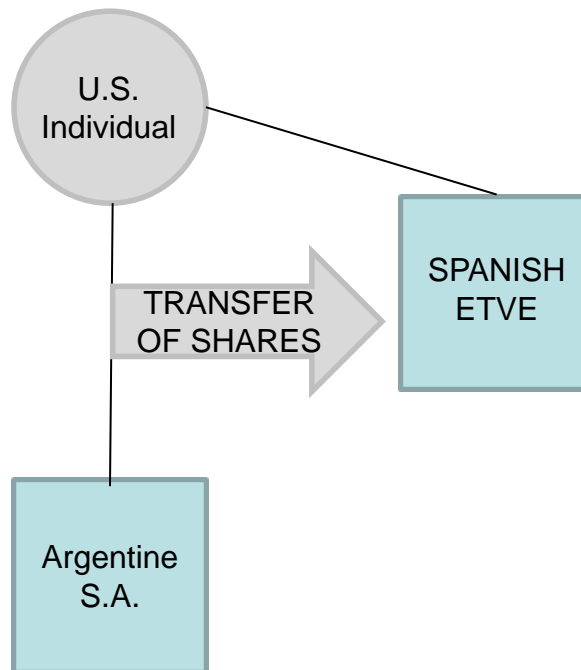
- An income tax treaty exists between U.S. and Spain
- An income tax treaty exists between U.S. and Argentina
- Argentine S.A. converted into S.R.L.
- CTB election made for Argentine S.R.L.
- No Spanish tax on receipt of dividend
- No Subpart F income on receipt of dividend by Spanish ETVE
- No Spanish W/H tax on dividend payment
- Potentially qualified dividend income for U.S. individual

Code §367(a) & (b) – Legal Steps of Reorganization

STEP 1



STEP 2



STEP 3

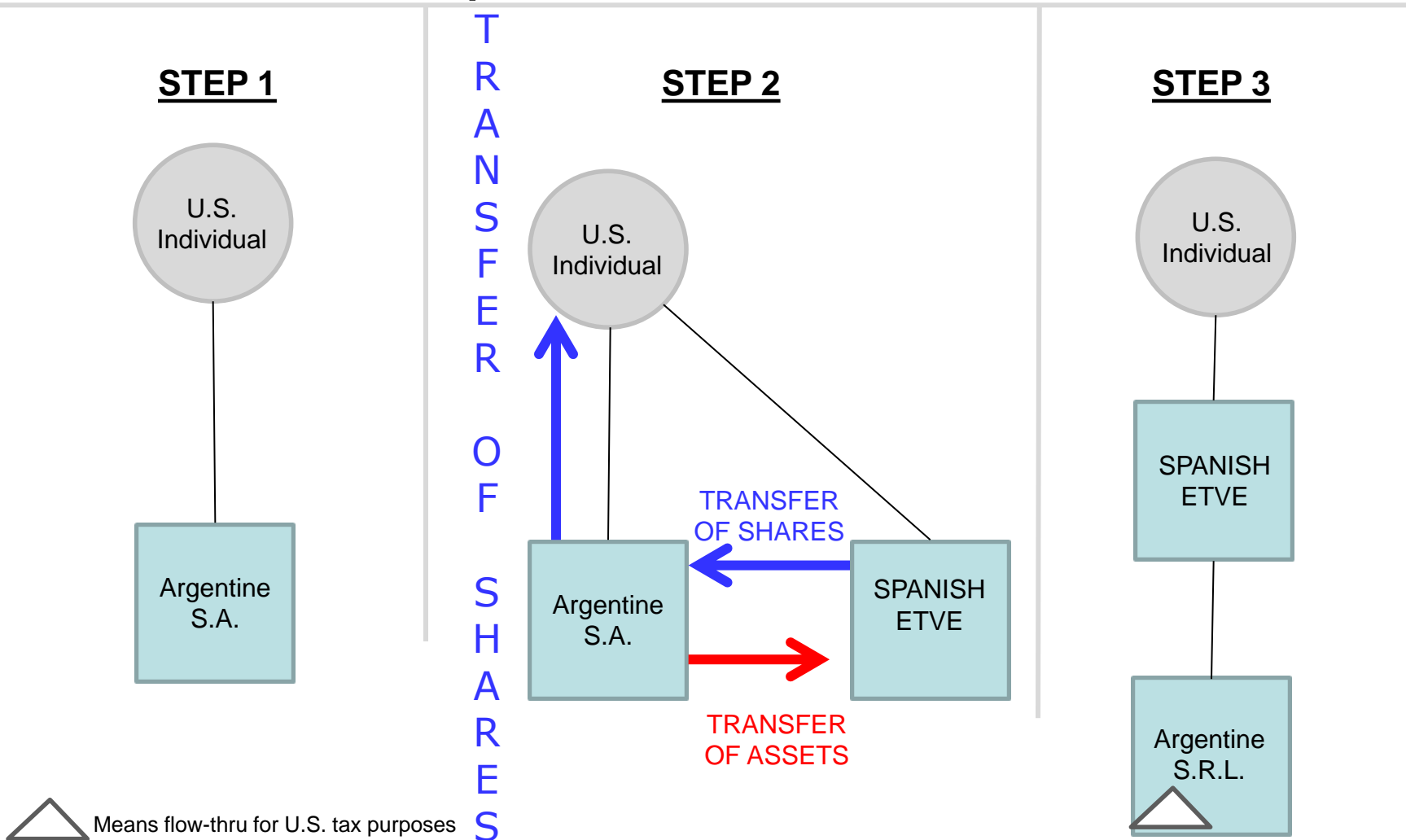


Means flow-thru for U.S. tax purposes

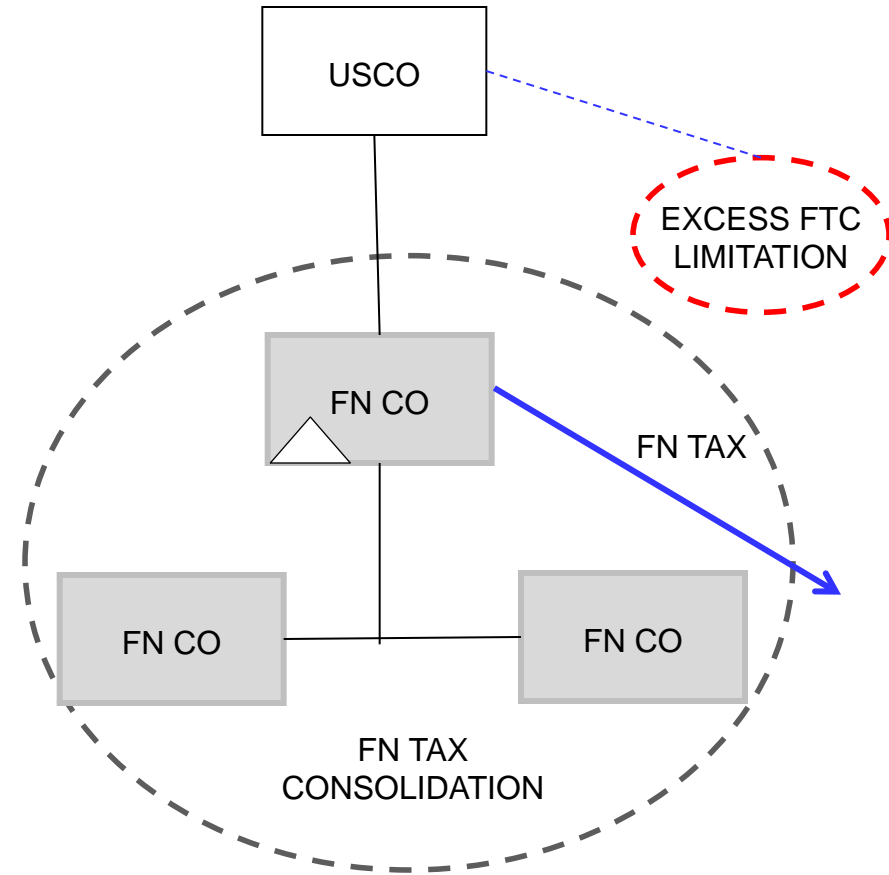
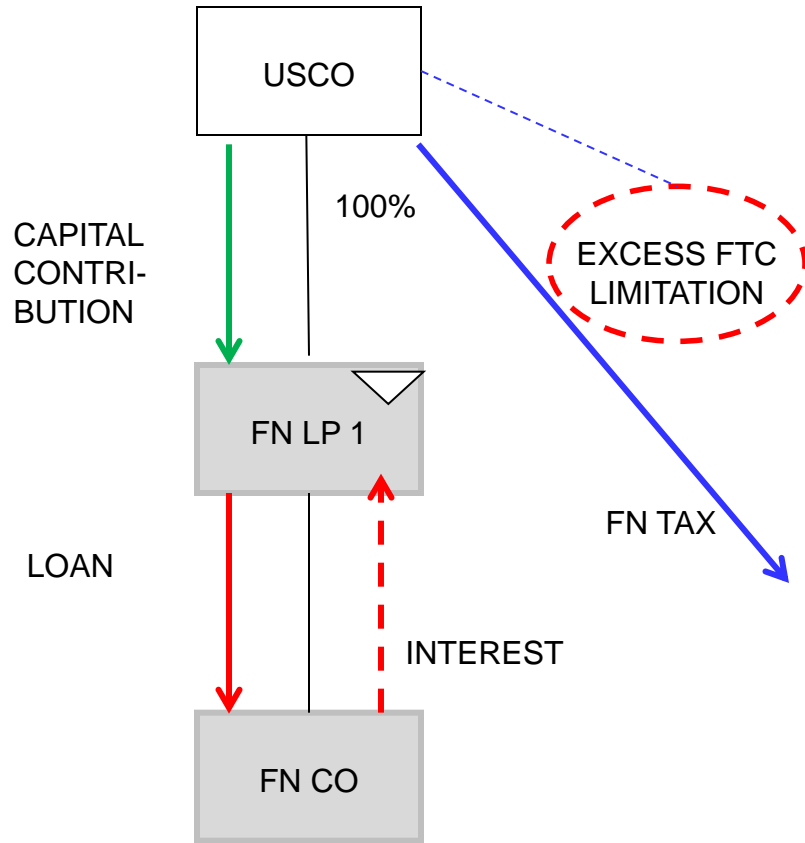
Code §367(a) & (b)

- ❑ The form of the first step is an outbound transfer of shares
 - ❑ §367(a) applies and generally gain is recognized
 - ❑ However, Regs. §1.367(a)-3(b)(1) provides for an exemption if the transfer is covered by §351 and a 5-year GRA is entered
- ❑ If the outbound transfer of shares is followed by a liquidation of the target, the I.R.S. position is that the transaction is an asset transfer by the target, followed by its liquidation -- Rev. Rul. 78-130, 1978-1 CB 114
 - ❑ This is a foreign-to-foreign C-reorg or D-reorg
 - ❑ Regs. §1.367(b)-4(b) provides of §1248 toll charge only if there is a shift of direct or indirect ownership

Code §367(a) & (b) –Steps of Reorganization for U.S. Tax Purposes



Foreign Tax Credit Splitters –

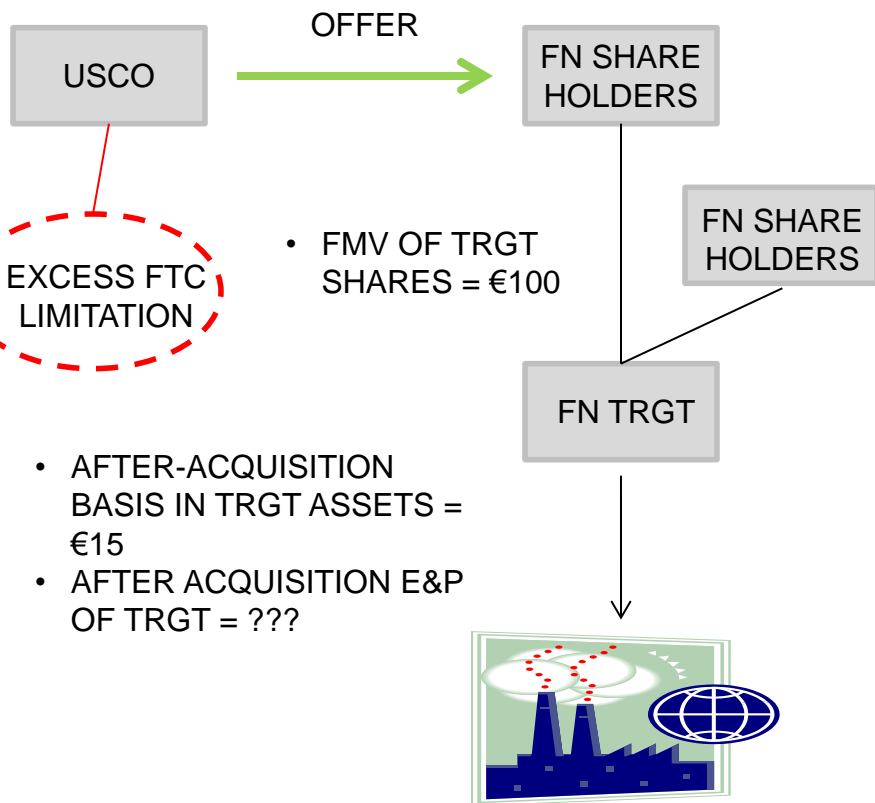


▽ Means flow-thru for foreign tax purposes

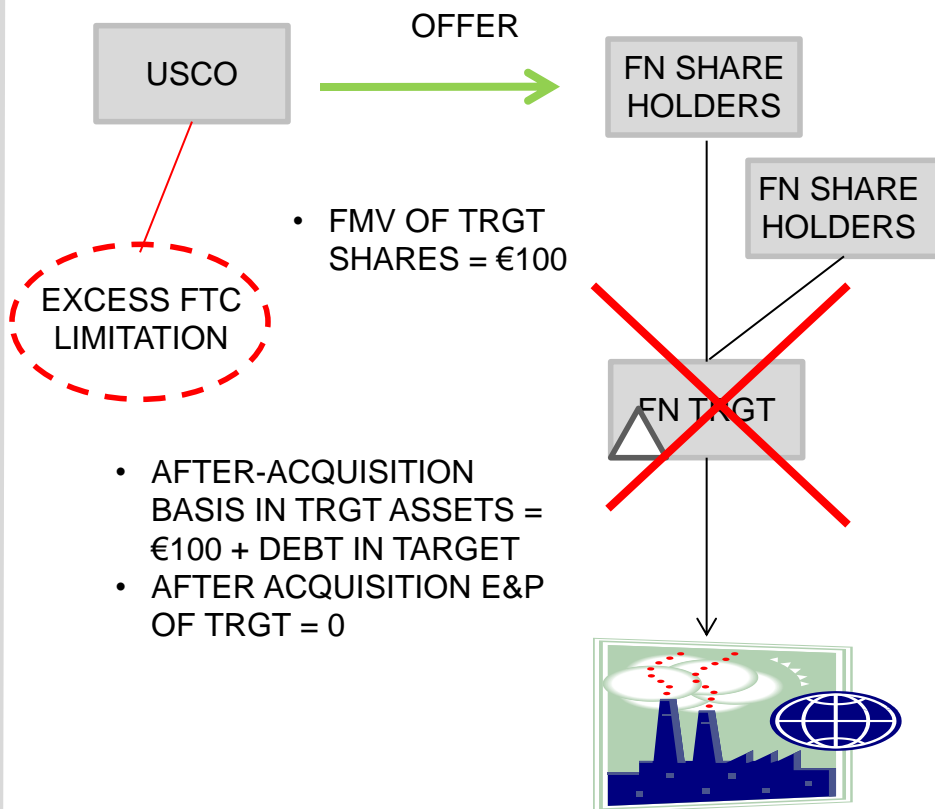
△ Means flow-thru for U.S. tax purposes

Basis Step-Up

LEGAL TRANSACTION



EFFECT OF CTB ELECTION



Means flow-thru for U.S. tax purposes

Sophisticated Planning – IS IT EVIL?

United States

- Sept. 2012 - Senate Permanent Subcommittee on Investigations report and hearing on Offshore Profit Shifting and the U.S. Tax Code.
- Tax directors and advisors of Microsoft and Hewlett-Packard testified with national media coverage.
- Report focused on how U.S. multinationals –
 - Transfer intellectual property and profits offshore.
 - Reduce financial statement tax expense by permanently reinvesting earnings abroad.
 - Effectively bring use offshore funds to expand operations outside U.S. without incurring U.S. tax.

United States

- *President's Framework for Business Tax Reform* cites income shifting as a significant concern
- House Ways & Means Committee International Tax Reform Discussion Draft offers several alternatives to address base erosion

United States

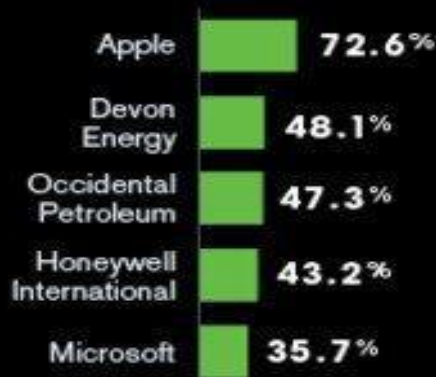
Offshore Profits Avoid IRS Reach

Corporate profits earned offshore are not subject to U.S. taxes as long as they remain offshore. General Electric leads all U.S. companies with \$108 billion in non-U.S. profits.

Top U.S. companies by accumulated offshore profits, Dec. 2012



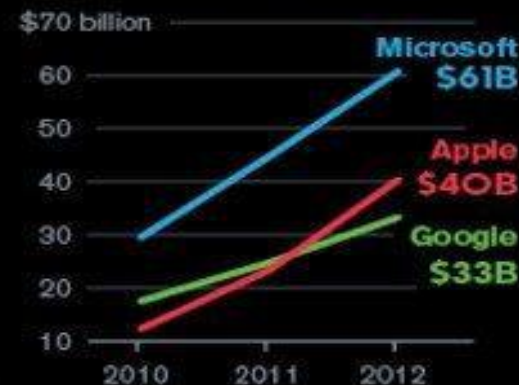
Top U.S. companies by percent increase in offshore profits, 2011-2012



Big offshore tech profits

Microsoft, Apple and Google all raised offshore holdings in 2012.

Accumulated non-U.S. profits



Source: Company data compiled by Bloomberg; graphic by Dave Merrill / Bloomberg Visual Data

Focus on Multinational Corporations

- Growing scrutiny of low tax rates of US multinationals
- In context of domestic tax reform debate and concern over earnings escaping US tax through alleged “loopholes”
- Example: “active business” exceptions from Foreign Personal Holding Company Income rules
- Foreign multinationals are outside the scope of analysis

New Section 7701(o) – Clarification of Economic Substance Doctrine

- In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if--
 - The transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position and
 - The taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction

New Section 7701(o) – Clarification of Economic Substance Doctrine

- An assertion that a transaction was entered into for profit requires a showing that the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected
- Fees and other transaction expenses are to be taken into account as expenses in determining pre-tax profit
- Regulations are authorized requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases

New Section 7701(o) – Clarification of Economic Substance Doctrine

- State or local income tax effect which is related to a Federal income tax effect will be treated in the same manner as a Federal income tax effect.
- Achieving a financial accounting benefit will not be treated as a purpose for entering into a transaction if the origin of the financial accounting benefit is a reduction of Federal income tax.

New Section 7701(o) – Clarification of Economic Substance Doctrine

- Notice 2010-62
 - The law will be applied literally
 - Once it is determined that economic substance is relevant, both prongs of the legislative economic substance test must be met
 - Application of existing case law that applies only one leg of the new test will be challenged

New Section 7701(o) – Clarification of Economic Substance Doctrine

- Section 6662 penalty is 40% percent where any portion of an underpayment is attributable to one or more non-disclosed non-economic substance transactions.
- The penalty is 20% where the non-economic substance transaction is disclosed.

WHAT ABOUT B.E.P.S.?

O.E.C.D. B.E.P.S.

- Base erosion and profit shifting (“B.E.P.S.”)
 - Tax planning strategies that exploit loopholes in tax rules to make profits disappear for tax purposes.
 - Shifting profits to locations where there is little or no real activity with low tax and resultant little or no corporate taxation.

O.E.C.D. B.E.P.S.

- **Cause of B.E.P.S. Report**
 - Unbalance of Direct and Indirect Tax Revenues
 - VAT increases to Offset Income Tax Revenue Decreases
- **Financial Crisis**
 - With the acceptance of Government Bailouts, Governments want payback of higher taxes from those who have profits but relatively little taxes
- **Perceived Multinational Enterprise Abuses Result in:**
 - June 2012 G-20 Meeting Declaration
 - November 2012 G-20/O.E.C.D. Collaboration
 - February 2013 B.E.P.S. Report

O.E.C.D. B.E.P.S.

- B.E.P.S. strategies take advantage of the interaction between the tax rules of different countries.
- A single country, acting alone, cannot fully address B.E.P.S.
- A need to provide an internationally coordinated approach:
 - Facilitate and reinforce domestic actions to protect tax bases.
 - Provide comprehensive international solutions.
- Concern that unilateral and uncoordinated actions by governments responding in isolation could result in the risk of double and possibly multiple taxation for business, resulting in a tax protectionism.
- The B.E.P.S. project is thus part of the O.E.C.D.'s ongoing efforts to ensure that the global tax system is “equitable and fair”

O.E.C.D. B.E.P.S.

- June 2013 Action Plan
 - Identify actions needed to address B.E.P.S.
 - Set deadlines to implement these actions.
 - Identify the resources and needed and the methodology to implement these actions.
 - Consider the best way to implement in a timely fashion the measures governments can agree upon.
 - Consider a comprehensive approach to consider possible improvements to eliminate double taxation, such as increased efficiency of mutual agreement procedures and arbitration provisions.

O.E.C.D. B.E.P.S.

- Identified abuses:
 - Profits to low tax jurisdictions/Expenses to high tax jurisdictions
 - Transfer Pricing
 - What are the value drivers?
 - Headcount but no ownership of IP?
 - IP but no need for headcount?
 - Value of markets?
 - Hybrid Entities or Instruments
 - Pass-thru entities used to eliminate C.F.C. rules
 - Debt/Equity mismatches
- Conduit Entities and Treaty Shopping
- Derivatives/Swaps
- Use of Tax Attributes-NOL's Credits etc.
 - Foreign tax credit generators
 - Acquisition of a target with significant credits
- Digital Economy (Google, Apple, eBay, Facebook)
 - Global sales, limited presence to Ireland and other low tax jurisdictions

Unilateral Action: Anti-Avoidance Actions in Europe

- Taxation authorities expand the permanent establishment concept
 - French Report on Digital Economy involving virtual PE for information gleaned from digital consumers in France
 - *Roche Vitamins* case in Spain involving a Spanish sub of Swiss Pharma
 - Spanish sub transformed from local country manufacturer and distributor to a contract manufacturer and non-binding commission agent of product, moving IP profits to Swiss Pharma.
 - The dual arrangement held to be a P.E. under agency rules.
 - Italian P.E. position regarding limited role of local sub in license negotiation between affiliated foreign licensor and Italian licensee resulted in a P.E. and full taxation of royalty payments.

Anticipated Next Steps

- February 2014 OECD discussion draft on country by country TP reporting
- U.S. tax reform proposals-drafters state they will not wait for BEPS
- September 2014 timing for transfer pricing in Re: IP
 - Discussion drafts/working groups/hearings in the interim
- Competent Authority issues?
- U.K. and Russia set BEPS as priorities
 - Anticipated legislative/regulatory action
- Tax advisors-increased KYC type obligations to avoid “advising tax fraud”
- January 23rd OECD Update

WHAT SHOULD WE ANTICIPATE?

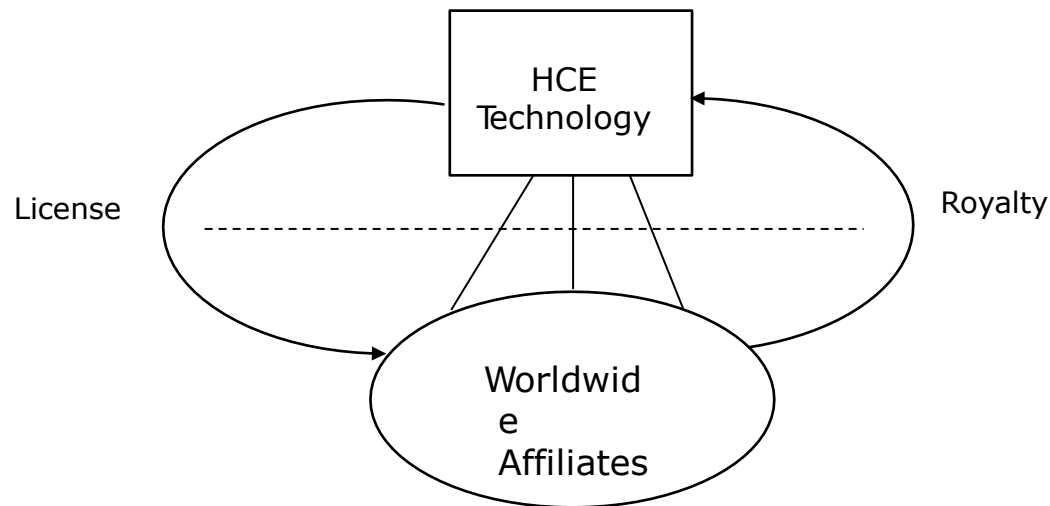
Introduction

– What is acceptable tax planning?

- Globalisation of business
- The spectrum of tax planning:
 - Tax evasion?
 - Money-round-in-a-circle tax structures?
 - Exploiting tax arbitrage opportunities?
 - Locating activities in tax efficient locations?
 - Taking tax into account in business decisions?

Base Case

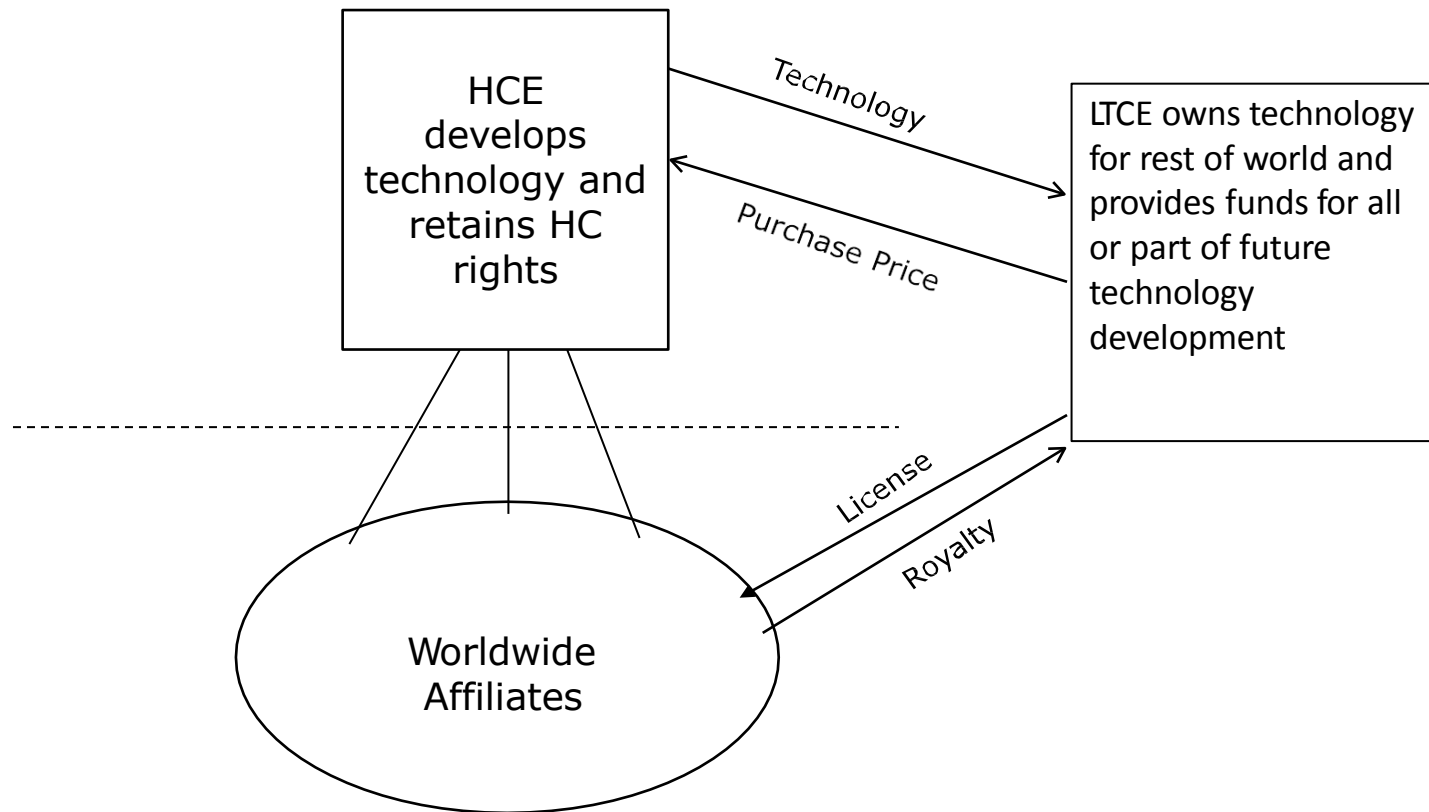
1. Host country entity (HCE) long engaged in trade or business as parent of multinational group.
2. Technology developed in host country and/or funded by HCE, and owned by HCE.
3. HCE receives royalties from manufacturing and risk taking distributing affiliates worldwide



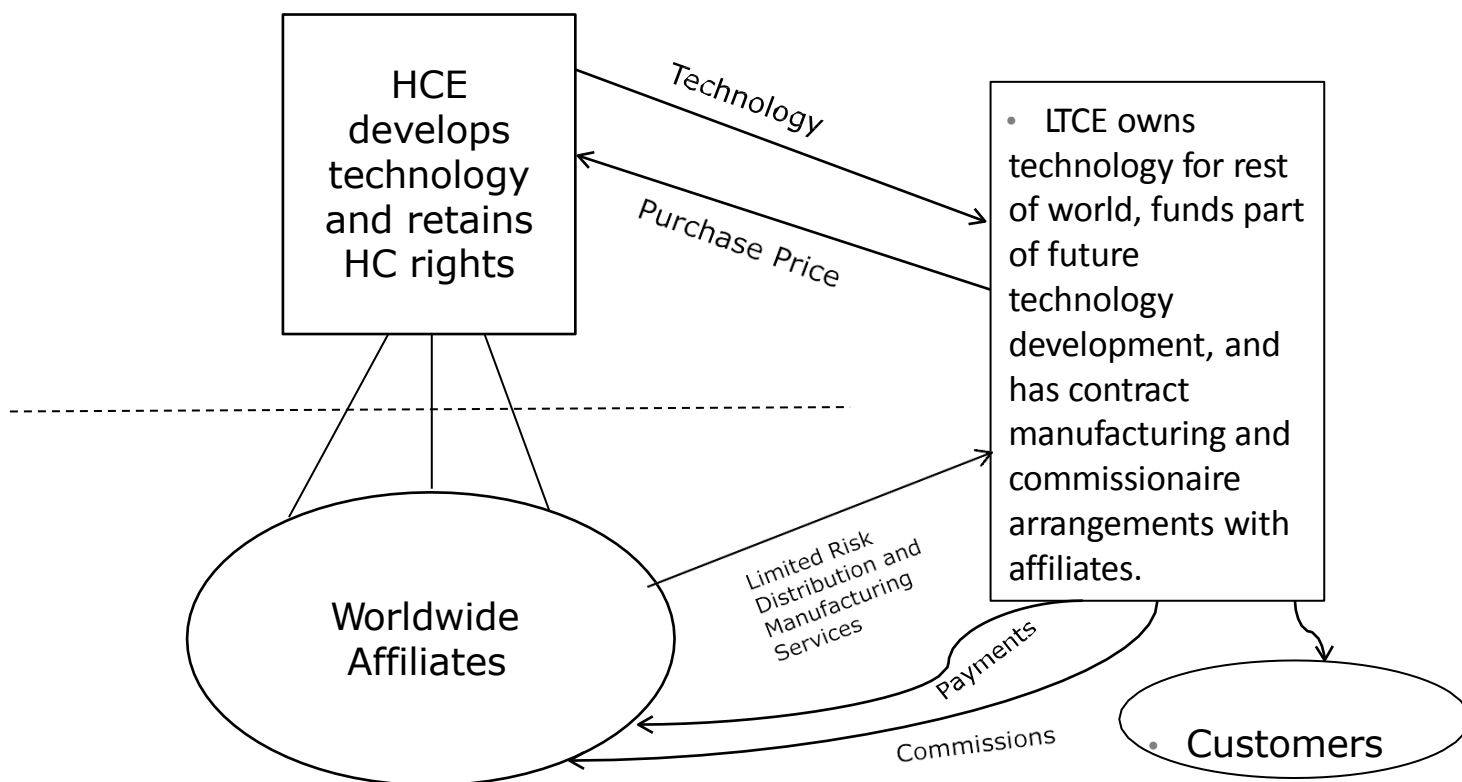
Base Case

- Main features:
 - No double non-taxation concern
 - No novel P.E. issues
 - Potentially involves difficult to value intangibles.
- How do tax authorities address taxpayers' key concerns:
 - Risk of double taxation
 - Consistency of approach between jurisdictions
 - Consistency of approach between inbound and outbound flows
- How effective are mutual assistance and arbitration provisions in income tax treaties?
- Have recent concerns over more aggressive structures affected how tax authorities view the base case?

Base Case Moving to Low Tax Country Entity/Entrepreneur (“LTCE”) and Offshore Funding



LTCE in Full Operation with Manufacturing Directly (but at a Minimal Level) or Through Contract (Toll) Arrangements and Distribution Risks Through Commissionaire Arrangements



Full Operation LTCE

- Potential for double non-taxation if the “incorrect” amount of income is earned by LTCE
- Does the arm’s length principle work here?
 - Imbalance of information
 - Difficult valuation in any case
 - “Group” income that can reside anywhere
- May manufacturing and marketing profits be transferred to LTCE purely on the basis of contractual allocation of risk and funding?

Full Operation LTCE Transfer Pricing

- What developments have there been in applying arm's length transfer pricing principles?
- Is there a sense of frustration and, if so, why?
 - Non-taxed income that structurally should not be taxed?
 - Non-taxed income that is improperly escaping tax?
- Can our case study result in B.E.P.S. and still be perfectly legal? If so, is O.E.C.D. work expected to affect this?

Full Operation LTCE P.E.

- Should P.E. principles be applied aggressively to tax LTCE? To the extent LTCE takes on more functions does it also take on more P.E. issues?
- Is maintaining bright line tests for P.E. status as important now, or is the loss of bright line rules acceptable in favor of avoiding base erosion?
- How are permanent establishment issues identified?
- Are information tools adequate to the task?

Full Operation LTCE Disputes

- Are potential disputes in the pipeline for situations involving situations like an LTCE of concern?
- Will they have to be resolved by litigation? by rules or regulations?
- Will resolution of some key disputes resolve significant uncertainties of base erosion?

Full Operation LTCE International Cooperation

- Is international cooperation sufficient to deal with our case study?
- Is MAP or advanced pricing agreements entailed in dealing with our case study?

Next Steps: Developing a Global Action Plan

- Work revolving around the 6 pressure areas will be conducted in 3 main clusters :
 - Countering base erosion
 - Jurisdiction to tax
 - Transfer pricing
- Consult with business and civil society
- Challenges:
 - Substance: addressing all aspects but comprehensively
 - Process: being inclusive but efficient

Next Steps: Developing a Global Action Plan

- Cluster 1 - Countering Base Erosion
 - Review effectiveness of anti-avoidance measures and suggest minimum standards when adopting them
 - Changes to treaties to effectively prevent treaty abuse
 - Assessment of / or guidance on rules aimed at limiting the deductibility of interest
 - Model legislation for mandatory disclosure rules
 - Refocus the work on harmful preferential regimes

Next Steps: Developing a Global Action Plan

- Cluster 2 - Jurisdiction to Tax
 - Impact of the digital economy on current rules
 - Definition of permanent establishment
 - Source taxation on passive income
 - Definition of residence
 - C.F.C. rules

Next Steps: Developing a Global Action Plan

- Cluster 3 – Transfer Pricing
 - Continuing viability of the arm's length principle
 - Options to revise Model Tax Convention and Transfer Pricing Guidelines, as well as measures and approaches that can be included in domestic laws
 - Proposals for introducing Multilateral MoUs on safe harbours / evolved arm's length pricing
 - Transfer pricing aspects of financial transactions
 - Administrative issues, including those related to transfer pricing documentation

--THE END --

NEW YORK

Ruchelman P.L.L.C.
Architects and Designers Building
150 East 58th Street, 22nd Floor
New York, New York 10155
Tel. 212-755-3333

TORONTO

Ruchelman P.L.L.C.
The Exchange Tower, P.O. Box 233
130 King Street West, Suite 2300
Toronto, Ontario M5X 1C8
Tel. 416-350-2026

Circular 230 Statement

This presentation has not been written as a formal opinion of counsel. Accordingly, IRS regulations require us to advise you that any statement contained herein is not intended or written by us to be used, and cannot be used by the recipient of this communication, for the purpose of avoiding tax panalties