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Supply Chain Planning

A Changing Landscape and its Impact on Structuring and Operations

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Agenda

- BEPS, Brexit, Tax Reform – a shifting environment and its impact on the Supply Chain
- Buy-Sell conversions
- Distribution IP and Digital Services
- LB&I Inbound Distributor Campaign
- Subpart F challenges
- § 482 changes targeting business opportunities
- Beyond BEPS
- U.S. tax reform implications for the Supply Chain
- State and Local Tax ("SALT")

BEPS, Brexit, Tax Reform

Shifting Tax Landscape – Pressure on the Supply Chain

- BEPS
- Brexit
- US Tax Reform

Buy-Sell Conversions

Response to PE and Related Challenges

Do Nothing

- Could be effective for countries that do not adopt PE standard changes
- Factually intensive analysis: limit local activities to avoid “principal role”
- Result influenced by proximity of solicitation to sale
- Granting signing authority or wide powers to negotiate and bind non-resident would likely be sufficient to create a PE
- No changes to current subpart F structure

Declare a PE

- Principal company (or a master reseller) files tax return reporting a PE
- Profits attributed to the local entity limited to the profits of the PE, avoiding discussions under Diverted Profit Tax
- May be challenging to reconcile the TP results for the local sales agent with the profit attribution analysis for the PE
- May not impact current regulatory or VAT positions
- May increase risk for prior year return when filing a PE return
- May reduce risk of penalties and criminal liability
- Varying financial data / reporting necessary to file a PE return

Convert to Branch

- Eliminates exposure from undisclosed PE under sales agent model
- Consider potential WHT on royalty from NR to principal
- If branch has royalty expense, potential WHT as no treaty available
- Consider existence of a Diverted Profit Tax or similar legislation
- Must create / register branch and transfer employees
- Maintain separate statutory accounts in some countries
- Register for VAT compliance, among others
- Customer contract assignment / notification / billing / monitor

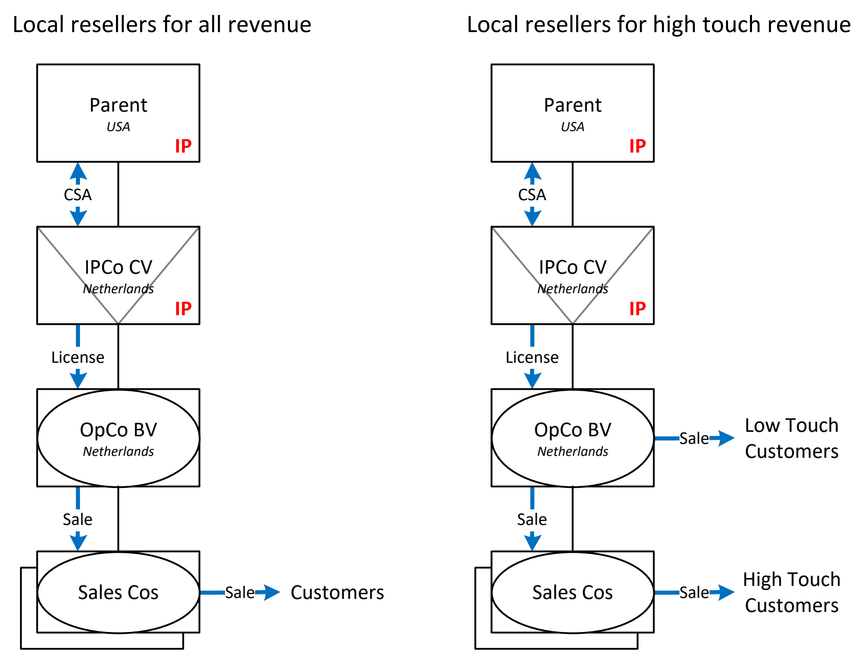
Convert to Reseller

- Art. 5 Commentary appears to favor reseller
  - Flash title and “LRD” structures expressly included
  - Must be effective to avoid PE
- Complete freedom to local employees
- Consider commercial law, revenue recognition, user agreements
- Simpler TP - more comparables
- Consider “blocker” reseller and/or separate sales channels
- Consider any subpart F consequences of related party services

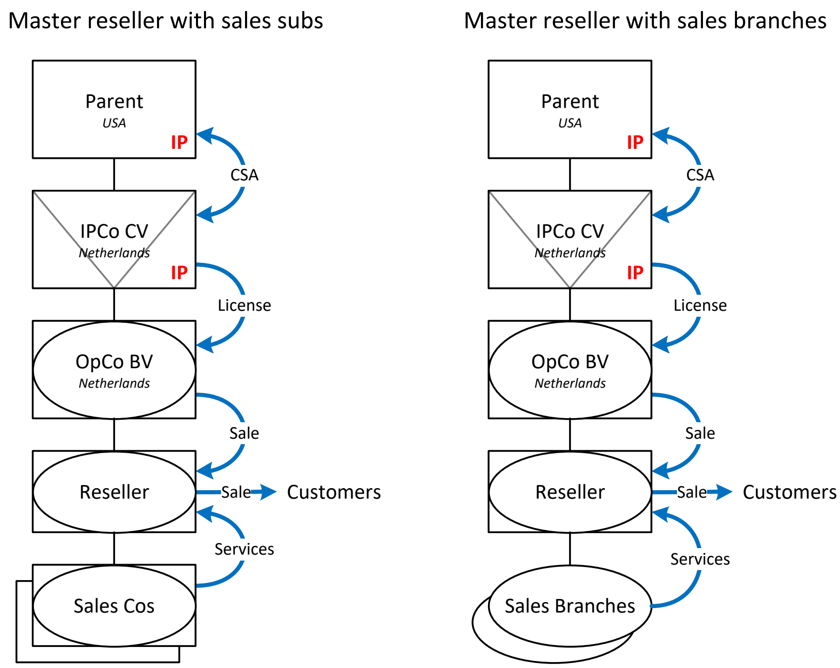
Reseller Defense

- Reseller structure in principle insulates the nonresident supplier
- Person who concludes contracts "on its own behalf" is not acting "on behalf" of another
- Note caveats added to BEPS Action 7 Final Report, which were not discussed at any Consultation
  - does not act, "for example, as an agent"
  - distributor "would derive a profit from that sale as opposed to a remuneration in the form, for example, of a commission"
- Questions raised on resale of services

Local Reseller Structures



Master Reseller Structures



Challenges of Reseller Conversion

- Systems set up / conversion; invoicing
- Sale of existing inventory / VAT on bulk sale to new reseller
- Demos, spares, parts, repair stock
- Review of deferred revenue accounts
- Customer contract assignment (including ToS for digital companies)
- Customs and VAT compliance / change in importer of record
- IP protection / address “first sale” issues
- Implementation costs, including local income and other taxes

Subpart F Treatment of Reseller Structures

<u>Sale of Goods</u>

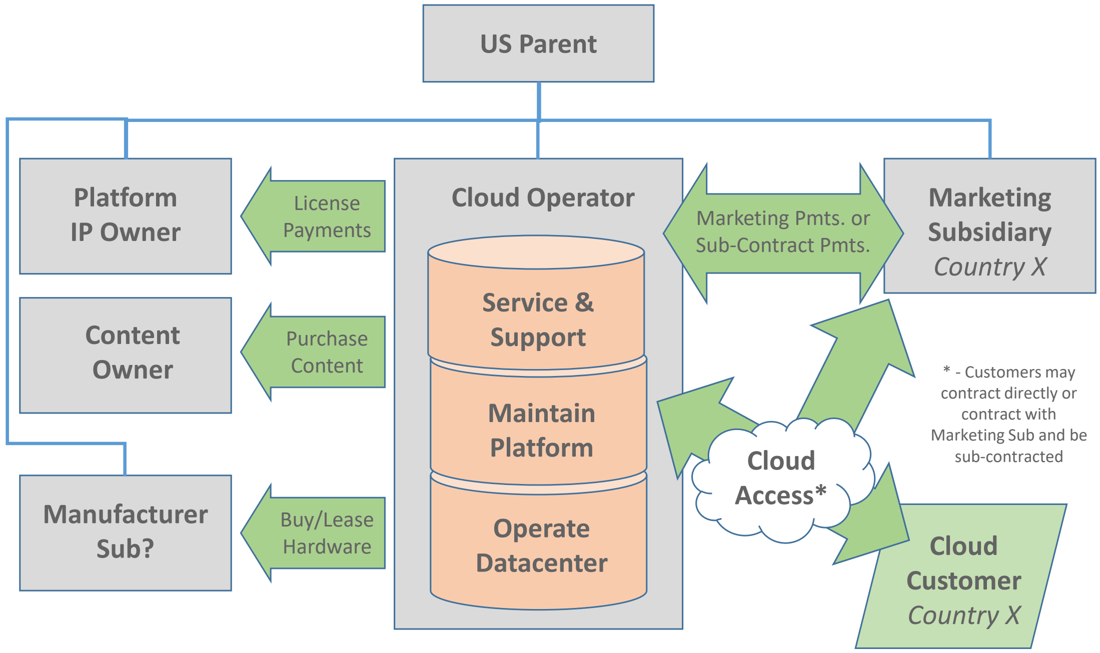
- Regarded reseller may get same-country exception; but master reseller likely not
- Principal likely has subpart F on regarded sale to reseller unless manufacturing exception applies; e.g., substantial contribution
- Disregarded sale to DRE reseller should fare better, but the branch rule can still be an issue

<u>Services</u>

- Regarded sale of services creates subpart F for principal unless same-country performance; reseller okay
- Attribution issues under *Miller* and *Le Beau Tours*
- Disregarded sale to DRE reseller will fare better

Distribution IP and Digital Services

Example Transaction Flow



IRS Targeting Inbound Distributors

IRS Targeting Inbound Distributors

- LBI Campaign Approach – first announced in September 2015 as part of the IRS Large Business and International ("LB&I") Division restructuring
- According to LB&I:
  - ➢Campaigns are a fundamental change to the way LB&I has previously selected and performed audit work
  - ➢Campaigns will allow LB&I to focus limited resources to "drive specific compliance objectives"
  - ➢Goal is not to audit more returns, but to respond with a variety of treatments to maintain high compliance across the LB&I filing population

IRS Targeting Inbound Distributors

- On January 31, 2017 LB&I identified 13 campaigns as part of its move to issued-based examinations
  - ➢Maximizing shrinking resources with targeted audits
  - ➢LB&I developing focused training and internal performance metrics for each of the campaigns
- The initial list of campaigns includes the "Inbound Distributor" Campaign

IRS Targeting Inbound Distributors

- The Inbound Distributor Campaign is transfer pricing focused – stated goal of verifying whether inbound distributors receive an arm's length return rather than incurring losses or small profits
  - ➢Are profits commensurate with the functions performed and the risks assumed by the U.S. distributor?

IRS Targeting Inbound Distributors

- The current campaign grew out of the "Inbound Distributor Project" pilot program, in which the IRS apparently concluded there is widespread practice of undercompensating inbound distributors in the middle market
  - ➢IRS officials have stated the campaign is intended to primarily target the "mid-market" segment
- Initial rollout was followed by a series of information webinars
  - ➢Typically general overviews with limited details
- What is the current status?

Subpart F Challenges

Subpart F Challenges

- Substantial Contribution and the Global Workforce
  - ➢The "manufacturing" exception of Treas. Reg. § 1.954-3 remains one of the central Subpart F exceptions relevant to the U.S. tax management of the foreign supply chain
  - ➢Treas. Reg. § 1.954-3 generally provides that for purposes of § 954(d) Foreign Base Company Sales Income ("FBCSI") does not include income of a CFC derived in connection with the sale of personal property manufactured, produced, or constructed by the CFC.
    - − The "Manufacturing Exception"

Subpart F Challenges

- Substantial Contribution and the Global Workforce
  - ➢Treas. Reg. § 1.954-3(a)(4) applies three alternative tests to determine if a CFC is considered to have manufactured personal property sold by the corporation only if such corporation, through the activities of its employees, satisfies one of the following three tests:
    - Substantial Transformation
    - Substantial Activities: activities that are substantial in nature and generally considered to constitute manufacturing
    - Substantial Contribution

Subpart F Challenges

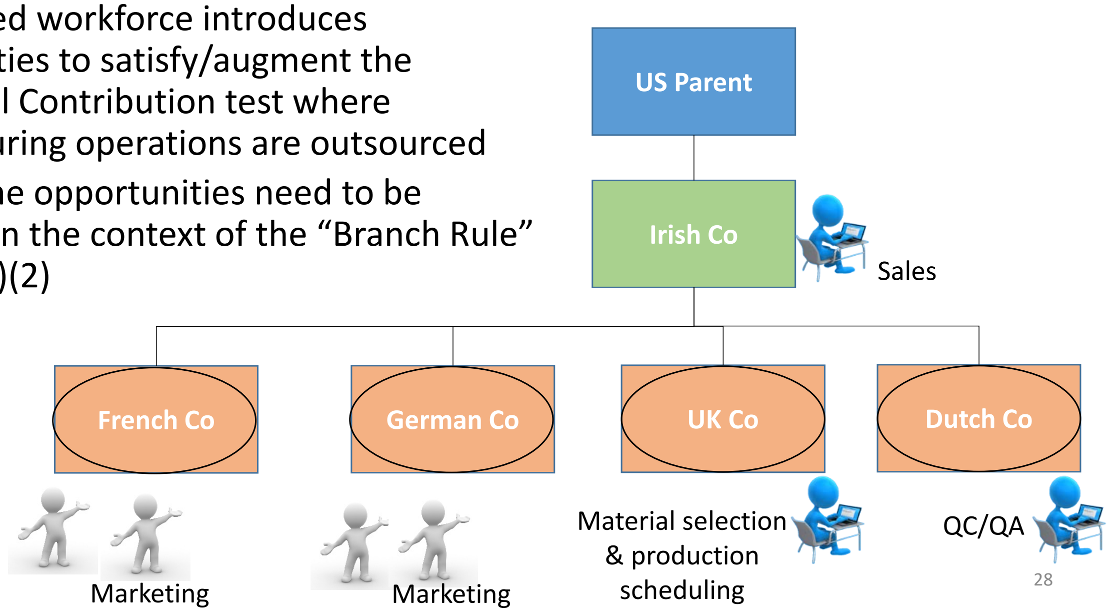
- Substantial Contribution and the Global Workforce
  - ➢Treas. Reg. § 1.954-3(b) sets forth a nonexclusive list of 7 activities to be considered in determining whether the CFC makes a substantial contribution through its employees to the manufacture of the property in question. Those activities include:
    1. Oversight and direction of the activities that lead to substantial transformation or constitute substantial activities
    2. Activities associated with the manufacturing process
    3. Material selection, vendor selection, or control of the raw materials, work-in-process or finished goods
    4. Management of manufacturing costs or capabilities (e.g., managing the risk of loss, cost reduction or efficiency initiatives associated with the manufacturing process, production scheduling, or hedging raw materials costs)

Subpart F Challenges

- Substantial Contribution and the Global Workforce
  - ➢Treas. Reg. § 1.954-3(b), cont.:
    5. Control of manufacturing related logistics
    6. Quality control (for example, sample testing or establishment of quality control standards)
    7. Developing, or directing the use or development of, product design and design specifications, as well as trade secrets, technology, or other intellectual property for the purpose of manufacturing, producing, or constructing the personal property

Subpart F Challenges

- Substantial Contribution and the Global Workforce
  - ➢A globalized workforce introduces opportunities to satisfy/augment the Substantial Contribution test where manufacturing operations are outsourced
  - ➢Those same opportunities need to be managed in the context of the “Branch Rule” of § 954(d)(2)



Subpart F Challenges

- The Branch Rule of § 954(d)(2) generally provides:

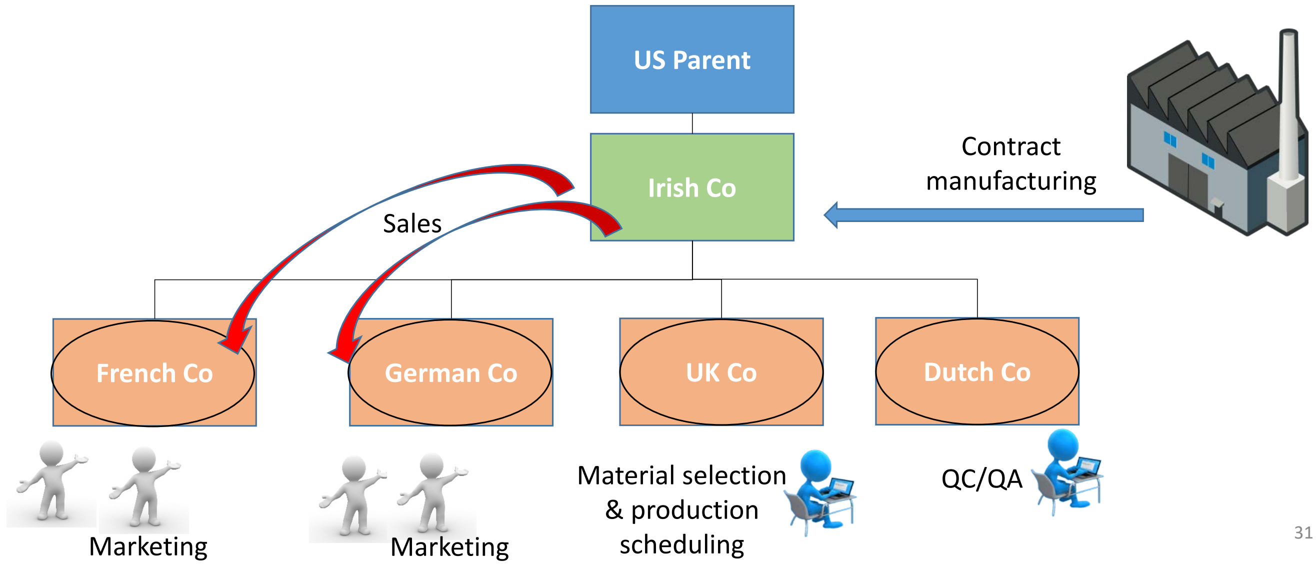
  "For purposes of determining foreign base company sales income in situations in which the carrying on of activities by a controlled foreign corporation through a branch or similar establishment outside the country of incorporation of the controlled foreign corporation has substantially the same effect as if such branch or similar establishment were a wholly owned subsidiary corporation deriving such income, under regulations prescribed by the Secretary the income attributable to the carrying on of such activities of such branch or similar establishment shall be treated as income derived by a wholly owned subsidiary of the controlled foreign corporation and shall constitute foreign base company sales income of the controlled foreign corporation." (emphasis added)

Subpart F Challenges

- Branch Rule regulations at Treas. Reg. § 1.954-3(b) applies two tax rate differential tests to determine if the use of a branch has "substantially the same effect" as if the branch were a CFC:
  - Sales Branch Rule: triggered if the income of the sales or purchasing branch is subject to an effective rate of tax that is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that is applied in the CFC's country of incorporation
  - Manufacturing Branch Rule: triggered if the income allocated to the "remainder" (i.e., not the manufacturing branch) of the CFC is subject to an effective rate of tax that is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would apply in the country of the manufacturing branch
  - Also consider the various multiple branch rules

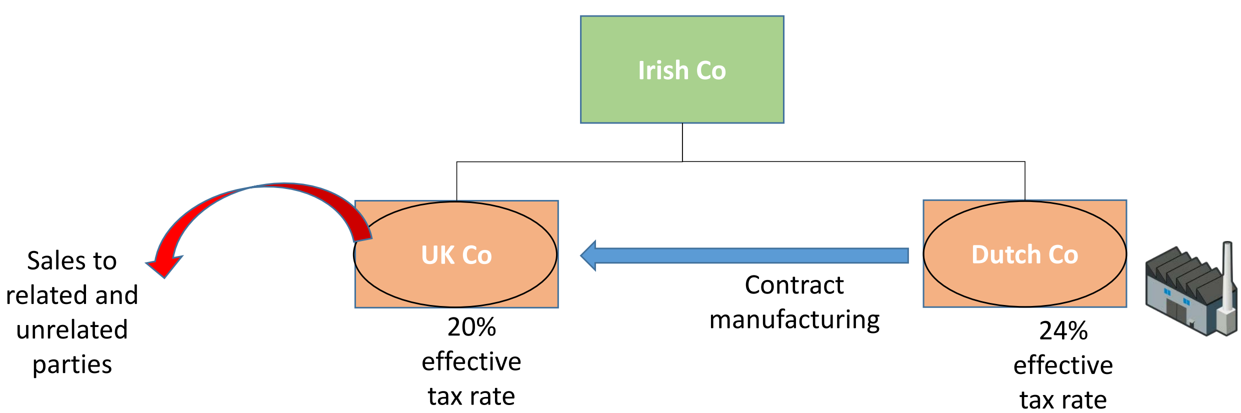
Subpart F Challenges

- Substantial Contribution and the Global Workforce
  - ➢The Branch Rule requires careful monitoring of effective tax rates and location of activates performed in the supply chain



Subpart F Challenges

- The Branch Rule and Falling Corporate Rates
  - ➢Trend of falling corporate rates in Europe can present challenges managing Branch Rule exposures
    - For example, steady decline of UK corporate rate: 20% in 2016, 19% for 2017, and proposed to drop to 17% in 2020



§ 482 Changes Targeting Business Opportunities

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- Business decisions concerning sales and contracting opportunities raise questions concerning the transfer of potentially valuable business opportunities
  - ➢Is a business opportunity an intangible property right subject to the application of §§ 367 and 482?

§ 482 Changes Targeting Business Opportunities

- Treas. Reg. § 1.482-7(b) defines the term "intangible" as an asset that comprises of any of the following items and has substantial value independent of the services of any individual -
  - Patents, inventions, formulae, processes, designs, patterns, or know-how;
  - Copyrights and literary, musical, or artistic compositions;
  - Trademarks, trade names, or brand names;
  - Franchises, licenses, or contracts;
  - Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and
  - Other similar items

§ 482 Changes Targeting Business Opportunities

- TD 9738 issued effective 9/14/15
  - Text of temporary regulations serve as the text of the proposed regulations
- Effective Date: applicable to <u>taxable years ending on or after</u> 9/14/15
  - Note retroactive effect for tax years that straddle 9/14/15 (or end on that date)
- The Preamble states the regulations are intended to "clarify" the coordination of § 482 and the regulations thereunder with other Code and regulatory provisions
  - Despite the term "clarify," the temporary regulations introduce material changes

§ 482 Changes Targeting Business Opportunities

- New "All Value" rule – Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(A) provides in relevant part:

  "(A) In general. All value provided between controlled taxpayers in a controlled transaction requires an arm's length amount of compensation determined under the best method rule of § 1.482-1(c). Such amount must be consistent with, and must account for, all of the value provided between the parties in the transaction, without regard to the form or character of the transaction." (emphasis added)

§ 482 Changes Targeting Business Opportunities

- New "All Value" rule – Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(A)
  - Issues:
    - The "all value" concept is not predicated on a transfer of property or the provision of services
    - Value is a characteristic, not a separate property right transferred or service provided
    - Is the "all value" concept consistent with the arm's length standard
      - According to the Preamble it is
    - Is the "all value" concept consistent with § 367(d) and Hospital Corp. of America v. Commissioner?

Beyond BEPS

Virtual and Forced PEs

- UK, Australia, New Zealand, France (proposed): DPT and MAAL
- Turkey: “Electronic place of business” (proposed)
- Israel: Circular interpreting PE in current treaties
- Italy: Proposed deemed PE
- Indonesia: OTT and MoT regulations
- “Significant economic presence” option in final Action 1 report

Taxing Software and Online Services

- India: Equalisation levy
- Malaysia: Withholding tax on software, content and services
- Austria, Hungary: Tax online advertising targeting local market
- Canada: Proposed denial of deductions for online advertising
- “Alternative levy on electronic sales” in 2018 “interim” TFDE report?

EU: Taxing the Digital Single Market

- Where to Tax?
- What to Tax?
- Permanent Establishments
- Transfer Pricing
- Solutions under Consideration
  - Equalisation tax on turnover of digitalised companies
  - Withholding tax on digital transactions
  - Levy on revenues generated from the provision of digital services or advertising activity

US Tax Reform

Comparison of Key Provisions

House W&M Committee		Senate Finance Comm		
Description	Eff. Date	Comparable provision	Eff. Date	Key Differences
100% corporate DRD for foreign dividends	Distributions after 2017	same	Tax years of foreign corps beginning after 2017	• hybrid dividends • required holding period • applies to 951 inclusions of 964(e) amounts
Add deferred earnings to subpart F income; US tax rate 14% (cash) and 7% (remainder) ("Transition Tax")	Foreign corp's last tax year beginning before 2018	same	same	• 10% rate for cash • 5% rate for remainder • measurement dates for deferred earnings and for cash • scope of affected deferred earnings • Claw-back of rate reduction if inverted within 10 subsequent years
USSH of CFCs includes 50% of Foreign High Return Amount; FTC for 80% of allocable foreign taxes	Tax years of CFCs beginning after 2017	USSH of CFCs includes Global Intangible Low Taxed Income (GILTI); FTC for 80% of allocable foreign taxes; 37.5% deduction for Foreign-derived Intangible Income (FDII)	same	• definition of tested income • deduction for FDII applies to USSH's own income • US tax on repatriation IP determined using CFC's basis in IP rather than FMV

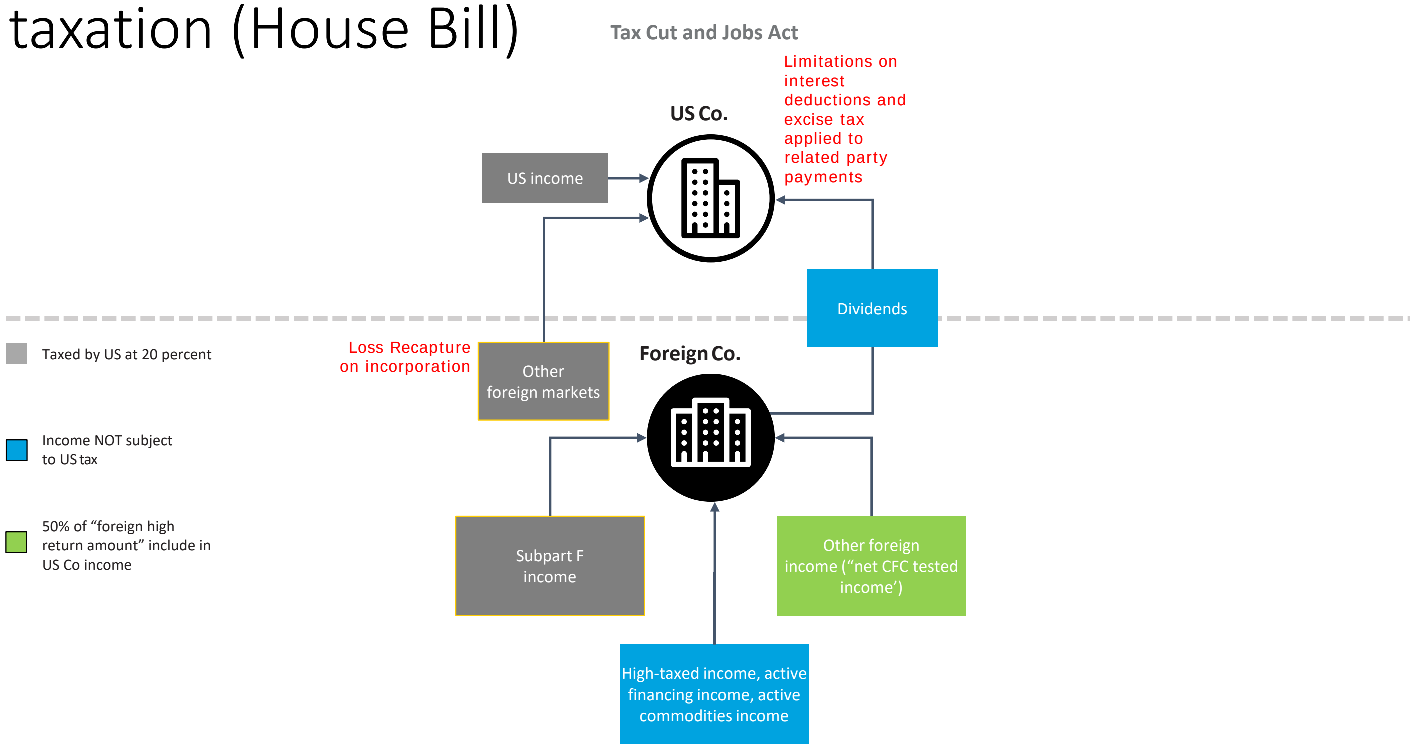
*This chart does not include all international tax provisions

Comparison of Key Provisions (continued)

House W&M Committee		Senate Finance Comm		
Description	Eff. Date	Comparable provision	Eff. Date	Key Differences
110% and 30% limits on interest deductions	**Tax years beginning after 2017**	**same**	**same**	• **110% limitation based on US vs. worldwide group <u>debt/equity (D/E) ratios</u>, rather than US vs. worldwide group <u>EBITDA and reported net interest expense</u>** • **Indefinite c/f period for disallowed deductions**
Excise tax on "specified amounts" / Election out via ECI taxation	**Amounts paid or incurred after 2018**	**"Base Erosion and Anti-abuse" minimum tax**	**Amounts paid or accrued after 2017**	• **Not applicable if base erosion tax benefits < 4% of deductions** • **If applicable, federal income tax will be at least 10% of taxable income plus base eroding payments (BEPs), less research credit** • **"BEPs" a generally narrower category than "specified amounts" (excludes COGS except when paid to foreign parent of inverted company, but does not exclude ECI or interest)**
		Disallowance of deductions for interest and royalties in hybrid transactions (or involving hybrid entities)	**Tax years beginning after 2017**	• **Applies to extent there is no corresponding inclusion to the related party under its residence-country tax law , or the related party allowed a deduction w/r/t the amount under such tax law** • **Reg authority to cover conduit arrangements; foreign branches; "certain structured transactions"; preferential foreign tax regimes, participations exemptions, or other exclusions; tax residence determinations; exceptions**

*This chart does not include all international tax provisions

International tax reform – scope of US international taxation (House Bill)



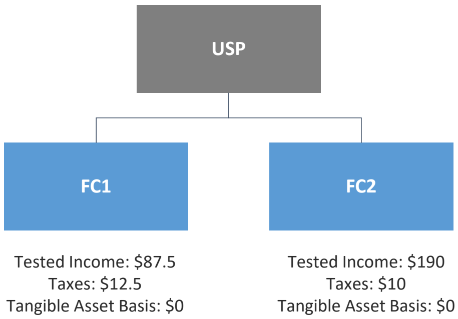
Foreign High Return Amount

New Category of Un-deferred Income: High Return Category

- In General: Each person who is a US Shareholder of any CFC for any taxable year shall include in gross income for such taxable year 50% of such shareholder's "foreign high return amount" for such taxable year.
- Foreign High Return Amount:
  - "Net CFC Tested Income" over
  - "Applicable Percentage" of aggregate of shareholder's pro rata share of "Qualified Business Asset Investment" for each CFC *less* interest expense taken into account in computing net CFC tested income.
- High return category appears to require both separate CFC calculations and global CFC calculations

* *Ultimate Impact: To the extent foreign income taxes on tested income are imposed at an average global effective rate of 12.5% or greater, and assuming timing rules for US and foreign tax purposes are the same, no additional US income tax need result*

Illustration



******Total Global ETR: $34.5/$300 = 11.5%*

- **Analysis**
  - Foreign High Return Amount:
    - Net CFCs Tested Income = $87.5 + $190 = $277.5
    - Foreign High Return Amount = $277.5 – ($0 Asset Basis) = $277.5
  - High Return Category Inclusion Pre-FTC calculation:
    - 50% of $277.5 = $138.75
  - FTC Calculation:
    - Foreign High Return Percentage = $277.5/$277.5 = 1
    - Aggregate Taxes = $12.5 + $10 = $22.5
    - Deemed Paid Credit = 80% * 1 * $22.5 = $18
    - §78 Gross-Up
    - §78 Gross-Up = 100% * 1 * $22.5 = $22.5
  - Total High Return Category Inclusion:
    - Grossed-Up Foreign High Return Amount = $277.5 + $22.5 = $300
    - Total High Return Category Inclusion = 50% of $300 = $150
  - Residual U.S. Tax:
    - $150 * 20% = $30
    - Less FTC = $18
    - Residual Tax = $12

FHRA (New sec. 951A) Observations

- While many could have an inclusion, few US corporations may have significant residual US tax
  - No US tax on FHRA if effective foreign tax rate on tested income is 12.5% or more
  - As the foreign tax rate falls below 12.5%, it is not entirely replaced by an equal amount of of US tax on the FHRA (if there were no foreign tax at all, only 10% US tax would be imposed)
  - Most super pools have a pool rate of 7-12%
  - Consider pulling high tax income out of FHRA into subpart F income if pool sufficiently high taxed.
  - However, ensure appropriate mix of high tax and low tax CFCs under a U.S. shareholder because FHRA is not determined on a consolidated group basis.
- Consider additional foreign planning if inclusion remains subject to residual U.S. tax to drive to increase foreign rate.

Excise Tax on Related Party Payments

New Excise Tax

- House bill generally imposes a 20% excise tax on certain amounts ("specified amounts") paid or incurred by domestic corporations (and foreign corporations with a U.S. trade or business) to related foreign corporations
  - Both parties must be members of an "international financial reporting group" (IFRG)
- No excise tax where recipient pays US tax on the payment as ECI
- Specified amount is generally any amount that is, with respect to the payor,
  - deductible
  - includible in COGS, or
  - includible in the basis of a depreciable or amortizable asset.
- Exceptions:
  i. Interest
  ii. Amounts to acquire of certain actively traded securities or commodities
  iii. Amounts taxed under § 881(a) at 30% (or a proportionate amount if taxed at a lower positive rate)
  iv. Amounts for services if there is no markup over cost
    - Payor must've elected the services cost method under § 1.482-9
    - Does not explicitly cover payment of cost share under § 1.482-7 cost sharing agreements

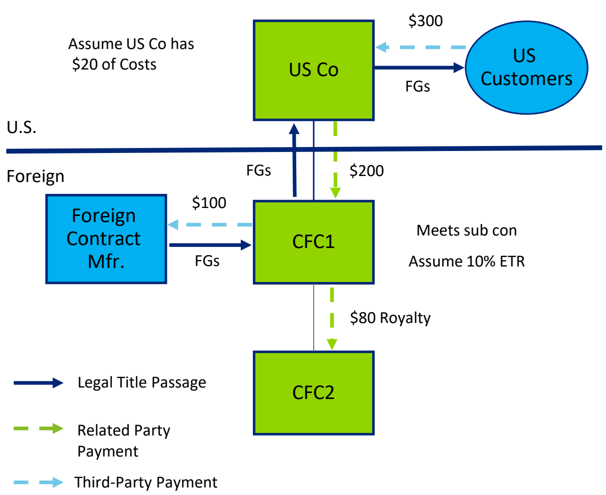
Foreign corporate recipient election to treat specified amount as ECI—new § 882(g)

- Calculation of ECI in the Case of the Election:
  - Recipient must treat the specified amount as ECI attributable to a US PE
  - In computing taxable ECI, only "deemed expenses" taken income account
  - Recipient allowed 80% of § 906 FTC
  - Deemed expenses are those giving recipient a "net income ratio" = the IFRG's net income ratio for the reporting year w/r/t the "product line" to which the specified amount relates
  - Net income ratio: Net income (without regard to interest and taxes) ÷ Revenues
    - determined by reference to the financial statements, taking into account only foreign group members' revenue and expenses from unrelated persons and US corps in the IFRG

Key Point: This provision applies in both the inbound and outbound context.

Supply chain considerations

Foreign principal companies



Tax Reform considerations

- The $300 received by US Co from US Customer is included in its taxable income at a 20% rate
- Under the excise tax, the $200m payment to CFC is subject to a 20% excise tax ($40), unless CFC1 elects to treat the payment as ECI.
  - If the CFC1 elects to treat the payment as ECI, the effectively connected net income *is not* $100m and deemed paid credit *is not* the actual tax incurred by CFC1
  - CFC1 deemed expenses limited to $100m because net income ratio of the IFRG does not take into account $80 royalty from CFC1 to CFC2
  - §906 credit is limited to 80% of foreign taxes paid by CFC1
  - Excise tax as a result of §882(g):

	200 (ECI)
-	100 (Deemed Expenses)
	100
x	20% U.S. tax rate
	20
	-1.6 FTC
	18 U.S. tax

State Tax Considerations

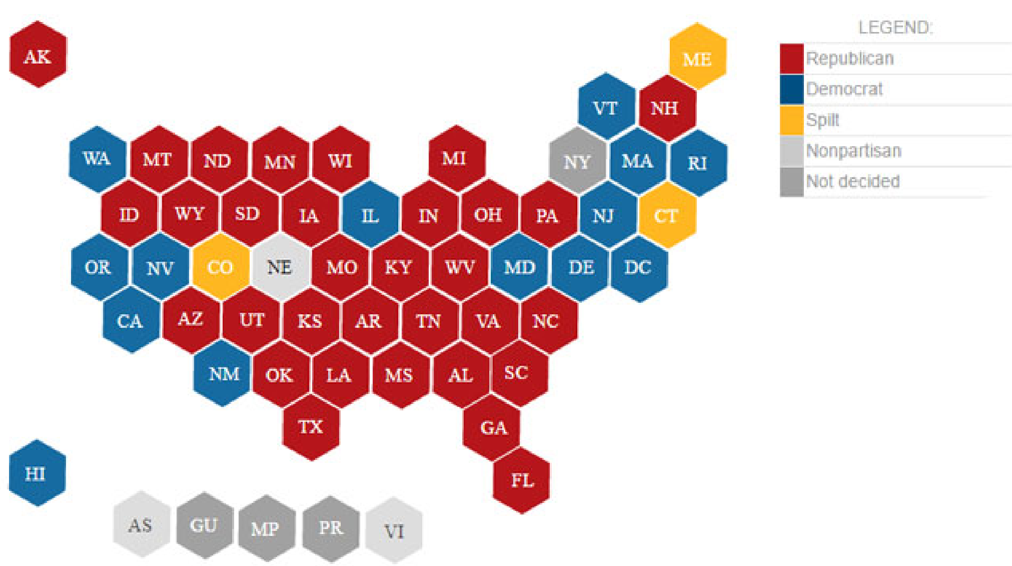
State Tax Considerations of Tax Reform

- Due to state conformity with federal tax laws, changes at the federal level flow to state level.
- Rates, however, are unaffected (repatriation?)
- As a result, federal legislation may increase or decrease state tax revenues.
- States may diverge from federal tax law via state "decoupling" modifications (capital expenses)
- Taxpayers must separately track, monitor, and implement state modifications to federal provisions.

State Impact Based on Conformity to Federal Tax Law

Federal	States
Tax rate reductions	States have own rates
Broadened tax base	State conformity
Eliminated or limited deductions	State conformity
Fully expensed investments	State partial conformity
Reduced repatriation rate	Modest impact
Territorial tax regime	Minimal conformity

The Political Road Map
2016 Post- Election State Legislative Control



Source: National Conference of State Legislatures

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