

Update on relevant U.S. tax developments

May 13, 2008

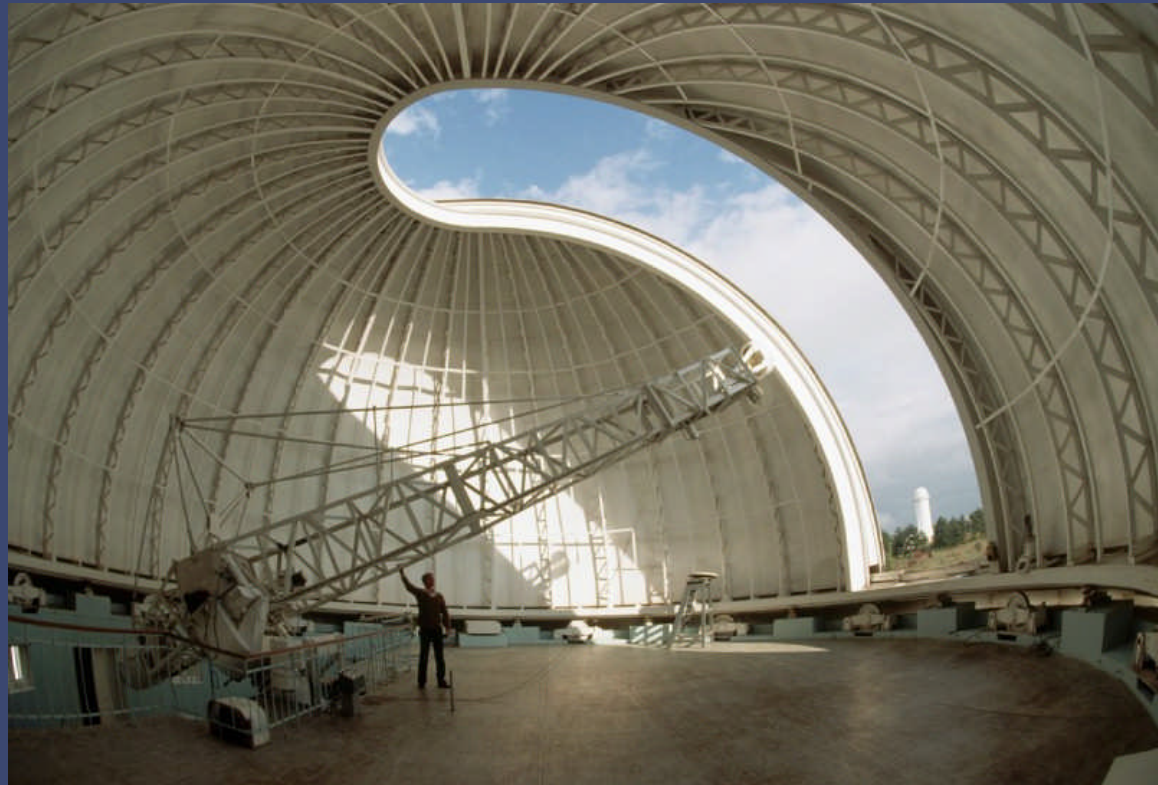
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The information contained in this presentation is for general guidance on matters of interest only. As such, it should not be used as a substitute for consultation with professional tax advisers.

Agenda/Contents

U.S. Tax Outlook

- US Tax Reform Options
- Presidential Candidates' Tax Proposals

Updates

- Foreign Corporation Anti-deferral Regimes:
 - Introduction to CFCs
- Foreign Base Company Sales Income:
 - New Proposed Regulations on the Contract Manufacturing Exception
- Foreign Base Company Services Income:
 - Notice 2007-13
- Extending CFC Look Thru
- Updates on Reporting Requirements
 - Swallows Holding Decision
- Updates on Earning Stripping (Related Party Interest)
- Updates on US Tax Treaties and Protocols

US Tax Reform Options



US Tax Reform Options

Income Tax Reform Options

- Rangel Bill
- Treasury “Approaches to Improve Business Tax Competitiveness for the 21st Century” (December 2007)
 - 28% corporate tax rate (economic depreciation)
 - 31% corporate tax rate (current depreciation)
 - 35% expensing
 - Territorial tax option

Consumption Tax Reform Options

- Treasury Business Activities Tax
- VAT

Rangel Bill (Tax Reduction and Reform Act, HR 3970)

Provision	(10 yr, \$ billion)
Reduction in corporate tax rate to 30.5%	-\$364
Repeal sec. 199	\$115
Repeal LIFO and LCM inventory accounting	\$114
Statutory anti-treaty shopping rule	\$6
Increase sec. 197 amortization period from 15 to 20 years	\$21
Codify economic substance	\$4
Reduce dividends received deduction	\$5
Terminate interest charge DISC	\$1
Defer expenses related to unremitted foreign profits and Impose additional FTC limit based on average foreign rate	\$106

Presidential Candidates' Tax Proposals



Proposals of Presidential Candidates

Proposal	Clinton	Obama	McCain
Corporate tax rate	No proposal.	No proposal.	Lower top rate to 25%.
International tax	<ul style="list-style-type: none"> • Reform deferral. • Address transfer pricing and cross-crediting "abuses" involving low-tax jurisdictions. • Repeal worldwide interest expense allocation. • Address foreign insurers located in low-tax jurisdictions. 	<ul style="list-style-type: none"> • Penalize companies with income from offshore tax havens on "watch" list. • Oppose unspecified "tax breaks" for foreign earnings. 	No proposal.
R&D Credit	Make permanent and enhance.	Make permanent.	Permanent 10% credit for R&D wages
Top rate on individuals	39.6%	39.6%	Permanent 35% rate
Dividends, capital gains	Revert to 2000 law?	Increase rates no more than 1986 levels (28% top rate)	Permanent 15% rate
Estate tax	Freeze at 2009 level (45% top rate, \$3.5 million exemption).	Same as Clinton.	15% top rate, \$10 million exemption.
Other 2001, 2003 tax cuts	Extend "middle class" child tax credit, marriage penalty relief.	Extend tax cuts for low- and middle-income taxpayers.	Make permanent.
AMT	Reform	No proposal.	Repeal.

Foreign Corporation Anti deferral Regimes: Introduction to CFCs



Foreign Corporation Anti-deferral Regimes

- Controlled Foreign Corporations

Potential Abuse:

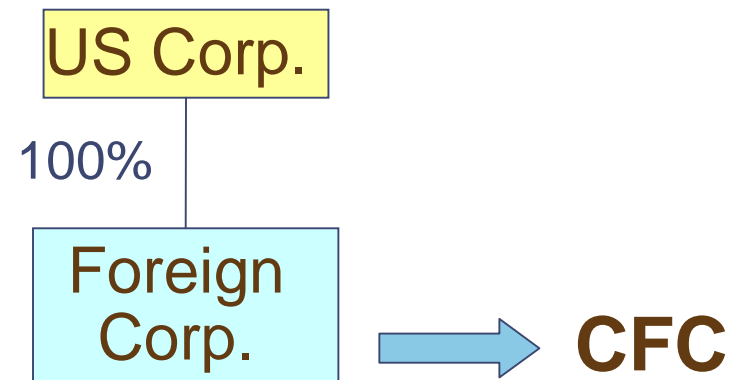
- Use of foreign “base company” in low-tax jurisdiction may allow a US company to place some of the profits otherwise associated with foreign sales inside a foreign corporation which, absent CFC rules, would not be taxed in the US unless and until repatriated.

Legislative Remedy:

- Certain income, primarily “Subpart F” income, earned by CFCs must be currently included in the taxable income of US shareholders, even if the income has not been distributed to the shareholders.
- Income inclusion limited to current year E&P (but subject to recapture as Subpart F income in future years).

Controlled Foreign Corporations (CFC) – Definition

- A foreign corporation in which, on any day of its tax year, greater than 50% of the voting power or value of its stock is owned by U.S. shareholders.
- A U.S. shareholder is any U.S. person who owns 10% or more of the voting power.



“Subpart F” Income – Definition

Subpart F income consists of the following types of income (subject to various exceptions):

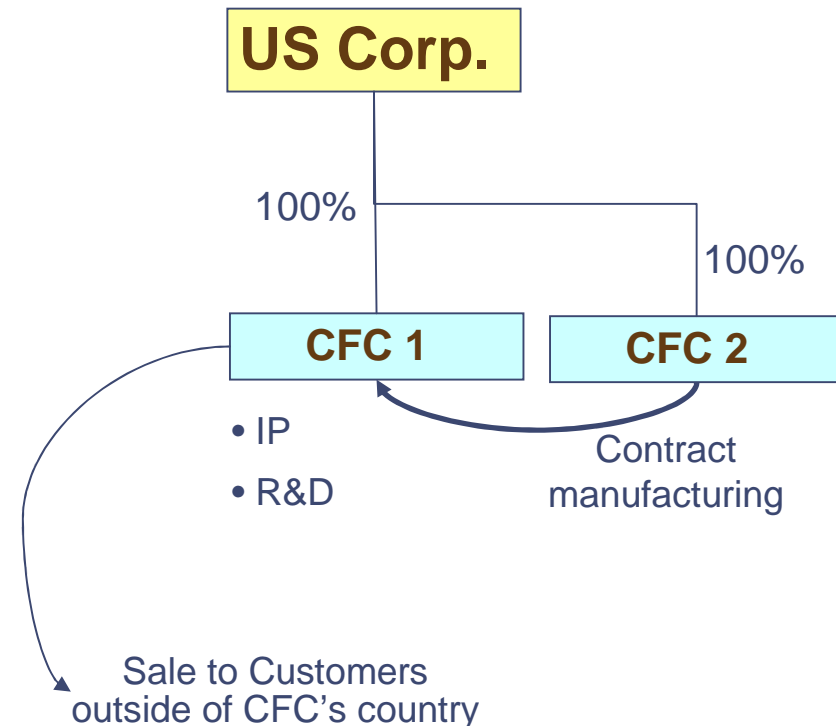
- “Foreign base company” income, which includes:
 - “Foreign personal holding company” income,
 - **“Foreign base company sales” income,**
 - **“Foreign base company services” income,** and
 - Foreign base company oil related income.
- Certain other types of income, including: insurance income, international boycott income, illegal foreign bribes and kickbacks, and, income from any foreign country that the US does not recognize or with which the US has severed diplomatic relations.

Foreign Base Company Sales Income – Definition

Foreign Base Company Sales Income

("FBCSI") is defined as income arising from the purchase or sale of personal property where:

1. The property is both produced outside the CFC's country of incorporation and sold for use, consumption or disposition outside such country; and
2. The property is either bought from a related person and sold to any person, bought from any person and sold to a related person, or purchased or sold on behalf of a related person.



Example of Potential Abuse Targeted by Subpart F – Foreign Base Company Sales Income

US Corp:

Sales Revenue	\$ 700
COGS	(600)
Profit	\$ 100
Tax @ 35%	\$ 35



Foreign Corp:

Sales Revenue	\$ 1000
COGS	(700)
Profit	\$ 300
Tax @ 5%	\$ 15



\$700 Sale of Inventory

\$1000 Sale of Inventory

Foreign Customers
Outside of
CFC's Country

Worldwide Tax Cost (no CFC Rules):

US Tax	\$35
Foreign Tax	+ \$15
Total Tax	\$50

Worldwide Tax Cost (under CFC Rules):

US Tax	\$35 + \$105 (35% x 300)
Foreign Tax	+ \$15
Foreign Tax Credit	- \$15
Total Tax	\$140

FBCSI: Exceptions

- FBCSI does not include income from the sale of personal property that is manufactured, produced or constructed by the CFC from personal property that it has purchased (the “**Manufacturing Exception**”).
- FBCSI does not include income from the sale or purchase of personal property that is manufactured, produced, constructed, grown or extracted in the CFC’s country of organization (the “Same Country Exception”).
- De minimis rule – if gross foreign base company income (plus insurance income) is less than the lesser of:
 - 5% of gross income or
 - US\$1,000,000
- High tax exception
 - If taxed at an effective rate $> 31.5\%$ (90% of top US rate)

Foreign Base Company Sales Income: New Proposed Regulations on the Contract Manufacturing Exception



FBCSI: The Manufacturing Exception

- **The Manufacturing Exception – Existing Test**
 - Under the existing Manufacturing Exception (See slide 14), property is treated as manufactured by the CFC if either:
 - The property is substantially transformed; or
 - The property is used as a component part of personal property and the CFC conducts substantial operations in connection with the purchased property that are generally considered to constitute the manufacture, production or construction of the property
 - Either (i) or (ii), or both, the “Physical Manufacturing Test”

FBCSI: The Manufacturing Exception

- Under the existing test, taxpayers argued that if a CFC purchases property that is later transformed into a different product by way of a manufacturing process conducted by a separate entity, and the CFC later sells the manufactured product to a related party, the CFC does not derive FBCSI from the sale because the manufactured product is not the same as the property originally purchased by the CFC (the so-called “its” argument).
- Taxpayers also argued that to the extent the CFC purchases and is the owner of the raw materials throughout the manufacturing process, it can be argued that a contract manufacturer is merely providing a service (this is referred to as “toll” manufacturing), and therefore the manufacturing should be attributed to the CFC.

Contract Manufacturing – Proposed Regulations Overview

- **The Manufacturing Exception – New Proposed Regulations**
 - On February 27, 2008, proposed Treasury regulations were issued providing that a CFC may qualify for the “**manufacturing**” **exception** to FBCSI if its activities satisfy a new “substantial contribution” (non-physical) test.
 - The proposed regulations also provide that personal property sold by a CFC will be considered to be the property purchased by the CFC regardless of any changes made to the property, thereby rejecting the so-called “its” defense, under which taxpayers took the position that in order to fall within the FBCSI rules, the property sold must be the same as the property purchased.

Contract Manufacturing Proposed Regulations Highlights – “Substantial Contribution” to Manufacturing

- A CFC may generally qualify for the Manufacturing Exception if its employees (directly or through branches) conduct activities that constitute a **substantial contribution to manufacturing** in a contract manufacturing arrangement, even if none of the qualifying physical manufacturing is performed by employees of the CFC.
- Whether a CFC satisfies the substantial contribution test is determined on the basis of its **facts and circumstances**.
- In the absence of sufficient other manufacturing-related activities, a CFC **does not qualify** for the manufacturing exception if it has contractual oversight rights as to the manufacturing process but it **does not exercise its oversight rights** regularly.

Contract Manufacturing Proposed Regulations Highlights – “Substantial Contribution” to Manufacturing

- The location of a manufacturing activity is generally where the CFC makes a contribution through its employees. For example, the location of IP-related activities is not based on formal assignment, but where employees of the CFC develop, protect, and direct the use of the IP.
- Consignment **(toll) and buy-sell** contract manufacturing models are **treated similarly**.
- **No safe harbor** rule is included to address qualification for the manufacturing exception.
- Substantial contribution and manufacturing branch analyses are made on a **product-by-product** basis.

Contract Manufacturing Proposed Regulations – Substantial Contribution to Manufacturing – Non- Exclusive List of Factors

The proposed regulations offer a **non-exclusive list of factors** to consider in determining whether a CFC Principal makes a **substantial contribution** to manufacturing:

1. Oversight and direction of the manufacturing activities or process (including management of the risk of loss)
2. Performance of manufacturing activities that would not satisfy the “physical manufacturing” tests
3. Control of raw materials, work-in-process and finished goods
4. Management of manufacturing profits
5. Material selection
6. Vendor selection
7. Control of logistics
8. Quality control
9. Direction of the development, protection, and use of intellectual property used in manufacturing the product

IRS Official [April 18, 2008]: “**Quality** is probably more important than **quantity** in analyzing whether activities meet the new substantial contribution test.”

Contract Manufacturing Proposed Regulations Highlights – Additional Observations

- The proposed regulations carry over the existing exceptions that apply if a CFC substantially transforms raw materials into finished goods, or converts components into products through activities that are substantial in nature and are generally considered to constitute manufacturing. However, these exceptions apply only if the physical manufacturing is performed by the CFC's own employees.
- The examples make clear that the mere ownership and control of raw materials, work in process, and finished goods, coupled with ownership of the manufacturing intangibles and the contractual rights to direct or supervise the manufacturing process, is not enough to meet the test. Thus, significant activities by the CFC's employees appear to be required.
- The proposed regulations contain a rebuttable presumption that provides that if a branch of a CFC satisfies one of the physical manufacturing tests with respect to personal property sold by the remainder of the CFC, the remainder of the CFC is presumed not to make a substantial contribution to the manufacture of the property.

Contract Manufacturing Proposed Regulations Highlights – Enforcement and Application

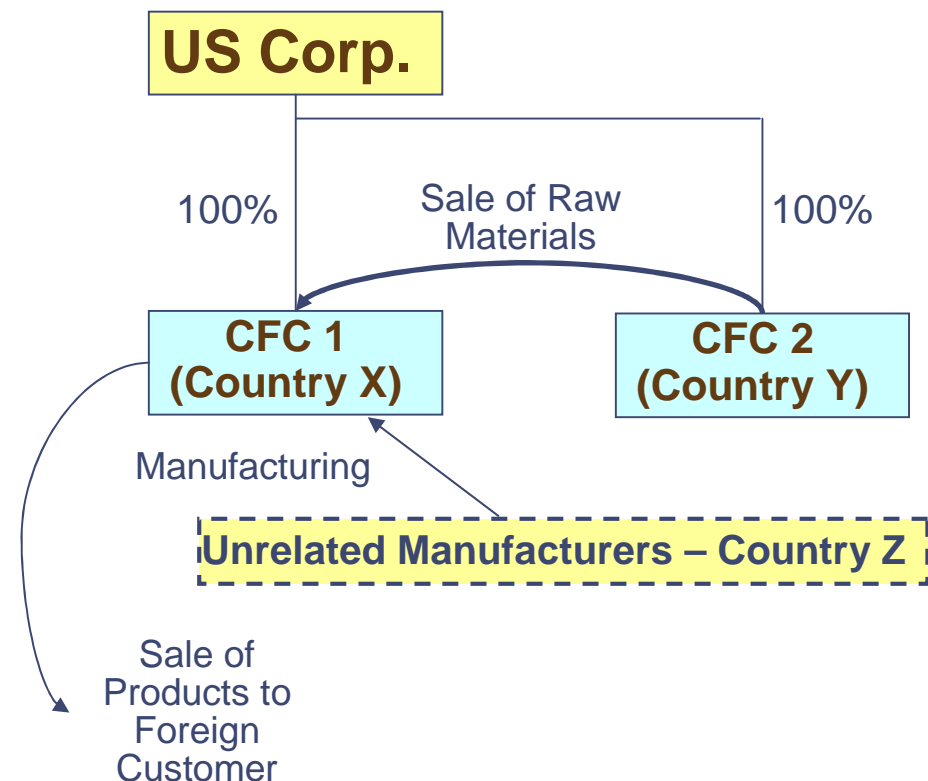
- The proposed regulations provide **some clarity** in structuring contract manufacturing arrangements **but leave open several key issues**.
- New rules and rejection of certain taxpayer positions may increase the **risk of IRS scrutiny**.
- Taxpayers may elect to apply the new regulations **retroactively** for all open years so long as they are applied in their entirety.
- The regulations will be **effective formally** for tax years of CFCs beginning on or after the date the **final regulations are published**, and for taxable years of U.S. shareholders in which such taxable years of the CFCs end.

Contract Manufacturing Proposed Regulations: Example – Substantial Contribution

Facts: At all times, CFC 1 retains control of the raw material, work-in-process, and finished goods, as well as the intangibles used in the conversion process. CFC 1 retains the right to oversee and direct the physical conversion of products by the Unrelated Manufacturers. Under the Proposed Regulations:

Results: If CFC 1 does not regularly exercise, through its employees, its powers of oversight or direction – manufacturing exception does not apply.

If CFC 1 employees regularly exercise the right to oversee and direct the activities of Unrelated Manufacturers in the manufacture of the products – manufacturing exception does apply.



Foreign Base Company Services Income: Notice 2007-13: Substantial Assistance Test



Foreign Base Company Services Income: Definition

Foreign base company services income is defined as income derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which:

1. are performed for or on behalf of any related person; and
2. are performed outside the country under the laws of which the CFC is created or organized.

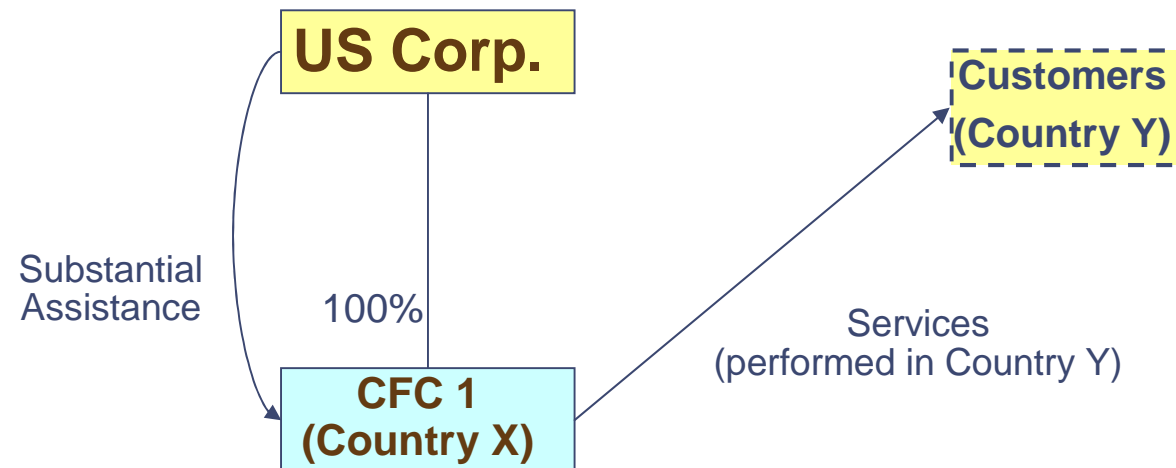
Perceived Abuse: US multinational corp. shifting profits of a CFC via cross border payments for services rendered to related parties.

Foreign Base Company Services Income: Definition

US Treasury Regulations describe the following four situations in which a CFC will be deemed to have performed services "for, or on behalf of, a related person":

- a) Where the CFC is paid by, or otherwise receives substantial benefit from a related person for performing the services;
- b) Where the CFC performs services which a related person is, or has been, obligated to perform;
- c) Where the CFC performs services with respect to property sold by a related person and the performance of such services constitutes a condition or material term of such sale; and,
- d) Where related persons furnish **substantial assistance** contributing to the performance of the services by the CFC.

Foreign Base Company Services Income: Illustration



Foreign Base Company Services Income: Substantial Assistance

Under US Treasury Regulations, a CFC will be deemed to have performed services “for, or on behalf of, a related person” if, among other things, “substantial assistance contributing to the performance of services by a CFC has been furnished by a related person or persons”.

Separate tests apply depending on whether the assistance provided by the related person or persons is in the form of:

- (1) direction, supervision, services or know-how, or
- (2) financial assistance, equipment, material or supplies.

Foreign Base Company Services Income: Substantial Assistance – Former Test

(1) direction, supervision, services or know-how:

Subjective test – assistance provides the CFC with skills which are a principal element in producing the income from the performance of such services by such CFC (the **principal element test**).

Objective test – the cost to the CFC of the assistance furnished by persons related to the CFC equals 50 percent or more of the total cost to the CFC of performing the services performed by such CFC (the **cost test**).

(2) financial assistance, equipment, material or supplies:

Test – assistance only in the amount by which the consideration actually paid by the CFC to the related person for the purchase or use of such item is less than the arm's length charge for such purchase or use.

Notice 2007-13: Guidance on Substantial Assistance Test

Foreign Base Company Services Income

Substantial Assistance – Notice 2007-13, 2007-5 I.R.B. 410

- Drops the subjective “**principal element**” test
- Alters the “cost” thresholds of the objective test to only apply to assistance furnished by related US persons and only when:
 - 80% or more of the CFC’s costs are attributable to assistance furnished by related US persons; or
 - 20% or more of the CFC’s costs are not attributable to its own costs or services performed by related CFCs

Notice 2007-13: Substantial Assistance continued

The 80% test:

- Not clear whether it replaces the 50% test
- Sec. 482 applies, Notice says
- What costs are relevant?
- Query whether financial assistance (other than contributions to capital), equipment, material and/or supplies are substantial assistance regardless that the price paid is arm's-length (in contrast with current regulations)
 - Impact on cost sharing? Buy-in vs. costs?
- Residual benefits of deferral after US related parties are compensated may not be substantial
- Effective for years starting on or after January 1, 2007

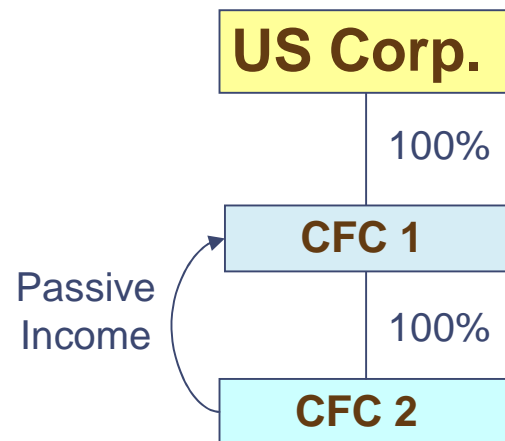
Extending CFC Look Thru



CFC Look Thru: General

CFC Look Thru –

- Dividends, interest, rents and royalties received by one CFC from a related CFC are not Subpart F income to the extent attributable to non-subpart F income of the payor.



CFC Look Thru: Extension

- A related CFC is a CFC that controls or is controlled by the other CFC, or a CFC that is controlled by the same person or persons that control the other CFC. Ownership of more than 50 percent of the CFC's stock (by vote or value) is control for purposes of this rule
- Temporary rule for tax years beginning after 12/31/05 and before 1/1/09
- Does not require same country

Extension:

- President Bush's budget proposal would extend look thru to taxable years of foreign corporations beginning before January 1, 2010.

Update on Reporting Requirements – Swallows Holding



Reporting Requirements – general

- §6038A requires filing by Foreign-owned US Corporations in order to track related party transactions with foreign parent
- Requirements for filing
 - U.S. Corporation, and
 - 25% foreign owned (based on vote or value)
- Failure to file - penalties
 - \$10,000/per year per required 5472
 - Additional penalties if company fails to furnish information after notification



Reporting Requirements – general

- Foreign corporation with US operations must file on annual basis to determine the foreign corporation's US tax liability
- Even without US tax liability (e.g., no US trade or Business), foreign corporation may want to file “**protective**” 1120-F
 - Preserves deductions in computing income of foreign-owned US corporation
 - Extends statute of limitations for timely filing



1120-F Requirements - Swallows Holding Lower-court decision

Swallows Holding, Ltd., 126 T.C. 96 (2006)

- Tax Court rejected IRS disallowance of deductions claimed on certain late filed tax returns by a foreign corporation because the returns were filed after the expiration of the 18-month grace period set forth in US Treasury Regulations.
- The Court held that a timely filing requirement is not found in the Internal Revenue Code and further held that the 18-month timely filing requirement in the Treasury Regulations is invalid and therefore a foreign corporation need not comply with that requirement in order to secure deductions and credits.
- Recommended position after lower court decision - advisable to continue filing forms 1120-F timely, for various reasons.
 - Preserves deductions
 - Extends statute of limitations for timely filing

Swallows Holding 3rd Circuit decision [515 F.3d 163 (3rd Cir. 2008)]

- 3rd Circuit reversed the Tax Court holding that regulation denying deductions for foreign corporations failing to file a return within 18 months of the due date is invalid. The 3rd Circuit reversed and held the regulation to be valid.

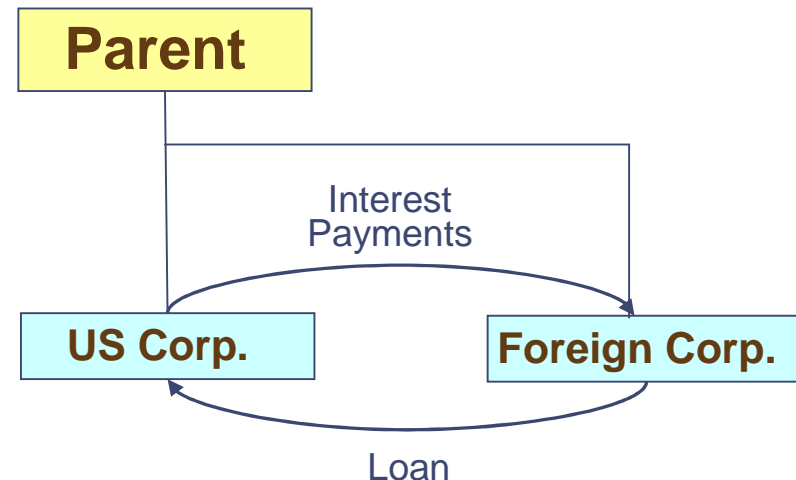
Updates on Earning Stripping



Earning Stripping – General

- Interest paid by a person subject to U.S. net income taxation to a foreign related party that is not subject to tax on the income (e.g., under applicable treaty) is not deductible when paid to the extent the net interest expense exceeds 50% of the “adjusted taxable income” (“ATI”).

ATI = taxable income without regard to deduction for net interest expense, NOLs, depreciation, amortization, etc. – surrogate for the payor’s available cash flow.



Earning Stripping – General

- Earning Stripping rule also applies with respect to interest paid on third-party debt guaranteed by a foreign related party.
- Limitation only applies if payor's **debt-to-equity ratio exceeds 1.5:1** (safe harbor).
- Any “excess interest” (interest expense in excess of ATI) can be carried forward indefinitely.
- Any “excess limitation” (ATI in excess of interest expense) can be carried forward 3 years.

Earning Stripping – Update

- The Bush Administration released its fiscal year 2009 budget on February 4, 2008. As in prior years, the budget contains a tax proposal to tighten the earning stripping rules.
- In contrast to prior administration proposals, the budget limits the scope of the proposal to related party interest paid to “**expatriated entities**” (generally referring to corporate groups that inverted from US-parented to foreign-parented structures). Narrowing the scope of the proposed legislation may increase the likelihood that the current proposal will be enacted.

Earning Stripping – Update

- The Administration’s proposal recommends the following changes to the earning stripping rules for “**expatriated entities**”:
 - Eliminate the current safe harbor (debt-to-equity ratio of 1.5:1 or less);
 - Reduce the limitation on deductible interest from 50% of ATI to 25% (except for 3rd party debt guaranteed by a related party);
 - Create a 10 year carryforward period for disallowed interest (currently indefinite); and
 - Eliminate the three-year carryforward of an excess limitation (can be used to increase a deduction in future years).
- Other proposals have been put forward (e.g., House and Senate proposals), each with its own characteristics. Developments should be monitored.

Updates on US Tax Treaties and Protocols

US Tax Treaties – Update

- Several new income tax treaties and protocols have recently been signed, ratified or are in the final stages of negotiations. The impetus for these changes has been to modernize the treaties to be more in line with the provisions of the updated U.S. Model Treaty as well as other more recent U.S. tax treaties.
- Protocols amending existing tax treaties with **Germany**, **Denmark** and **Finland**, along with a new income tax treaty and protocol with **Belgium**, entered into force on December 28, 2007. All generally apply to tax years beginning on or after January 1, 2008. The effective dates of specific provisions, particularly relating to withholding taxes, may differ.
- A protocol amending the existing tax treaty with **Canada**, a new income tax treaty and protocol with **Iceland**, and a new income tax treaty and protocol with **Bulgaria** were signed in 2007 or early 2008. All are pending the exchange of instruments of ratification.

US Tax Treaties – Update

- In line with the updated U.S. Model Treaty, the provisions of these new tax treaties and protocols include:
 - Elimination of source-country withholding taxes on certain dividends, interest and royalty payments;
 - Modernization of the treaties' limitation on benefits provisions (to be more in line with modern anti-treaty-shopping provisions);
 - **Mandatory arbitration of certain cases that cannot be resolved by the competent authorities within a specified period** (Germany and Belgium). (This is the first time such a provision appears in a U.S. treaty); and
 - Improved exchange of information provisions.
- Income tax treaties that are currently in the final stages of negotiations include the treaty with **Malta**, which was initialed on April 10, 2008, and the treaty with **Hungary**, which was negotiated as recently as February 2008. U.S. government officials have stated that updating the treaty with Hungary with a comprehensive limitation on benefits provision is one of the Treasury's "top priorities."

Thank you

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