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Year End Planning and other Issues

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Year End Planning

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Scope and Limitations

- 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.
- This document was not intended or written to be used, and it cannot be used, for the purpose of avoiding any U.S. federal, state or local tax penalties.

Year End Tax Planning Tips – Federal Tax

- *Taxable income* for U.S. tax purposes differs from financial statement (book) net income as a result of various book/tax adjustments that are required to be made under U.S. tax law.
- These adjustments can be used as an important tax planning tool in accelerating deductions and deferring income (or visa versa, if desired)
- The following slides cover areas of financial reporting, which should be reviewed before year end.

Year End Tax Planning Tips – Federal Tax (cont.)
Bad Debt

- In general, book reserves recorded for bad debt/doubtful debt, (usually a percentage of accounts receivable) are not recognizable as an expense for US tax purposes
- However, where specific debt (receivable) is entirely or partially worthless, and is "charged off" (by recording a specific reserve for the worthless debt), a loss may be recognized for U.S. tax
- Companies should review their bad debt reserves with the purpose of identifying amounts that may be currently deductible.

Year End Tax Planning Tips – Federal Tax (cont.)
Disputed Income

- Many companies include a provision for disputed income (defective products, erroneously shipped products, etc) as part of their allowance for bad debt.
- In general, allowance for bad debts are not deductible for US tax purposes
- However, under certain circumstances, disputed income may be excluded from revenue for U.S. tax purposes.
- Companies should check for overbillings due to clerical error, as well as billings for wrong goods, excess goods and defective goods, in order to exclude these from revenue.

Year End Tax Planning Tips – Federal Tax (cont.)
Deduction of Severance

- In general, reserves set aside for corporate "restructuring" are not deductible for US tax purposes
- However, the part of the restructuring reserve that represents a severance liability may be deductible, provided that the exact amount is fixed and determinable at year end and that the amounts are paid 2.5 months after the year-end
- Companies should review restructuring reserves to identify potentially deductible amounts.

Year End Tax Planning Tips – Federal Tax (cont.)

Lower of Cost or Market (LCM) Inventory Method

- In general, book reserves made to account for the fluctuation in inventory value (generally adjusted to market selling price), are reversed for US tax purposes.
- However, US tax rules allow taxpayers who keep their inventory according to FIFO to adjust inventory for the lower of costs or *market*.
- *Market* for US tax purposes is calculated by reference to reproduction or replacement cost (i.e., if the replacement cost is lower than the original cost, an adjustment is allowed).
- Companies should consider how they are currently accounting for inventory fluctuations for US tax purposes, and consider ways in which an adjustment can be made.

Year End Tax Planning Tips – Federal Tax (cont.)
Unbilled Receivables

- Taxpayers performing long term services pursuant to contractual arrangement often follow book treatment, and recognize revenue as the services are being provided.
- For tax purposes, revenue from services generally are not required to be recognized until the earlier of (1) when the amount is earned (unless the services are divisible) or the incentive fee is earned, (2) when the amount becomes due and payable under contract, or (3) when the amounts are paid
- Under this standard, income that has been recognized for book can often be deferred for tax until the date of billing.
- Companies should analyze long term service contracts and determine the optimal method of income recognition for US tax purposes.

Year End Tax Planning Tips – Federal Tax (cont.) Prepaid Payment Liabilities

- In general, companies capitalize prepaid payment liabilities (e.g., insurance, warranties, permits/licenses, software maintenance) and amortize them over the period to which the items relate.
- For US tax purposes, however, prepaid payment liabilities with a useful life of 12 months or less generally are deductible at the time such amounts are due and paid.
- Companies that prepay expenses should consider changing accounting methods to allow the deduction of certain *prepaids*.

Year End Tax Planning Tips – Federal Tax (cont.)

Advanced Payment / Deferred Revenue

- As a general rule, for US tax purposes, once cash is received, the related income needs to be recognized
- Therefore, companies often recognize advance payments as income in the taxable year of receipt.
- However, certain qualifying advance payments may benefit from a one-year deferral period, until the services are performed/goods provided and the revenue is recognized in the applicable financial statements.
- Companies should analyze their accounting method with respect to advance payments / deferred revenue and consider whether a change in accounting method would allow deferral of income.

Year End Tax Planning Tips – Federal Tax (cont.)

Rebate and returns

- For book purposes, an expense is generally accrued for rebates and returns based on historical data.
- In general, for tax purposes, companies defer the expense until the rebates and returns are paid.
- However, taxpayers may be able to accelerate the deduction by applying the recurring item exception to a refund or rebate liability, assuming it is fixed and determinable at the year end.
- Companies should analyze its rebate and return policy to determine if they can benefit from this exception.

Year End Tax Planning Tips – Federal Tax (cont.)

* ***Important***

- Depending on your current method, implementing the above changes may be considered an accounting method change.
- Some accounting method changes require advance consent of the IRS and must be filed on or before the last day of the taxable year ("non-automatic"), while other changes are required to be filed with taxpayer's timely filed tax return (including extensions) ("automatic").

Year End Tax Planning Tips – Federal Tax (cont.)

Fixed Asset Depreciation

- "Small Business Jobs Act of 2010" extends bonus depreciation and extends and expands Section 179.
- Bonus Depreciation – Additional 50-percent first-year deduction available for qualified property acquired and placed in service during 2010.
- Bonus depreciation is the default; an election is required to prevent bonus from being applied (election-out).
- Section 179 - Maximum Section 179 deduction increased to $500,000 and the phase-out amount was raised to $2 million.

Year End Tax Planning Tips – Federal Tax (cont.)
Checklist

- ✓ Project *Taxable Income,* take steps as needed
  - Review accounting method; can be used to accelerate income or defer income as needed
  - Fixed assets; Section 179 and bonus depreciation (consider electing out, if need be)
  - Consider Section 267
  - Estimated taxes
- ✓ Review corporate structure to identify foreign reporting requirements
- ✓ Review inter-company balances
- ✓ NOL limitations
- ✓ TP update/ inter-company agreements/implementation
- ✓ Prepare for new UTP schedule
- ✓ State taxes
  - Nexus ; takes steps to minimize
  - Review corporate structure for existence of "unitary group"
  - Consider making *Water's Edge* Election

Year End Planning and other Issues

December 7, 2010

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Other Issues

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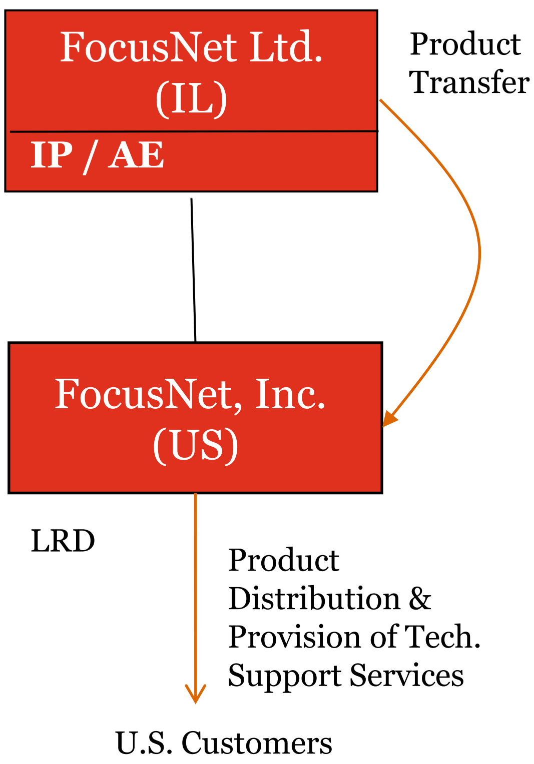
Case Study

Facts

- FocusNet Ltd. is a publicly-traded corporation established in 2003 under the laws of Israel.
- FocusNet Ltd. designs and develops advanced management software which improves performance of mission critical applications, increases efficiency and reduces costs within corporate organizations (the "Products").
- FocusNet Ltd. has incurred significant losses over the past years.
- FocusNet Ltd. holds the status of an Approved Enterprise ("AE") in Israel.
- So far, FocusNet Ltd. has focused its marketing efforts on promoting the products mainly to Israel and the European market. However, the company has recently decided that it wishes to expand its business activities and penetrate the U.S. market.
- Accordingly, FocusNet Ltd. established a wholly-owned U.S. subsidiary, FocusNet, Inc., through which it intends to distribute its Products in the United States and to provide (tier 1 & 2) technical support services to U.S. customers.
- It is expected that employees of FocusNet Ltd. will travel to the U.S., for a few days each time, to provide installation services/ (tier 3&4) technical support.
- In addition, sales personnel of FocusNet Ltd. will likely visit the U.S. approximately twice a year, to provide FocusNet, Inc. /potential customers updated product catalogues and answer questions.



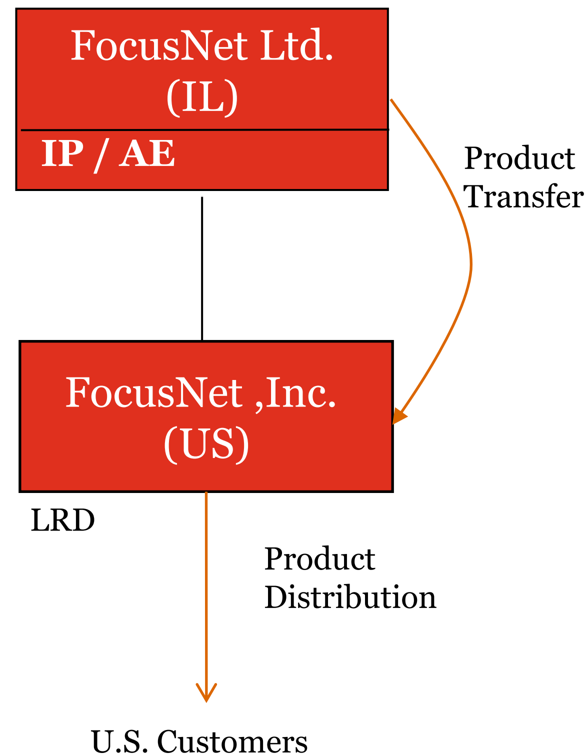
Case Study
Tax Considerations

<u>Israel</u>

- Approved Enterprise

<u>US</u>

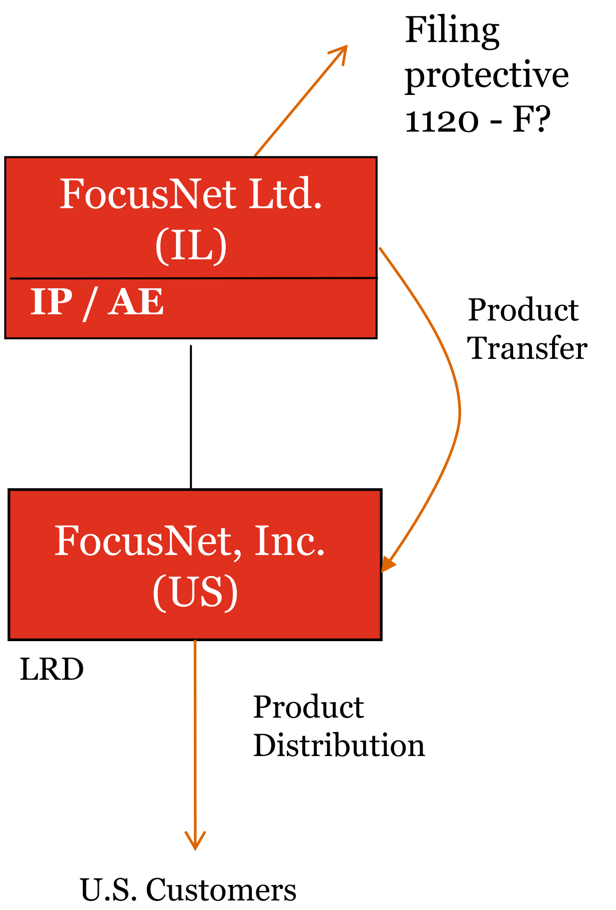
- Activity performed within the U.S. by IL Parent → **Permanent Establishment**
- Intercompany Financing
- **TP** –FocusNet, Inc. as a Low Risk Distributor (LRD)
- **US Withholding Tax** – classification of intercompany transactions as sale, rent or license



Case Study

U.S. Federal Tax Considerations – PE in the US

- Foreign corporations that have a U.S. tax nexus (a U.S. trade or business or PE in case of a treaty) must file a U.S. tax return, including Form 8833, on an annual basis to determine the foreign corporation's U.S. tax liability.
- Whenever there is a question whether the foreign corporation has such tax nexus, the foreign corporation may wish to file a "protective" 1120-F. Such filing would generally:
  - Preserve the right to claim deductions in computing the taxable income for U.S. tax purposes.
  - Start statute of limitations.
- **Generally, no deduction (except for COGS) would be allowed for a foreign corporation which failed to file a return within 18 months* of the due date.**
- Withholding tax obligation might be imposed on FocusNet Ltd. with respect to wages of its employees whose aggregate stay in the U.S. amounts to 183 days per year or more.



(*) A foreign corporation may generally file its tax return up until the 15th day of the sixth month following the close of its taxable year. Treasury Regulations state that for purposes of computing a foreign corporation's taxable income, deductions will be allowed only if a return is filed by the foreign corporation within 18 months following the due date of the return (i.e., 18 months after the 15th day of the sixth month after the close of the taxable year).

Case Study

Tax Considerations – Intercompany Financing

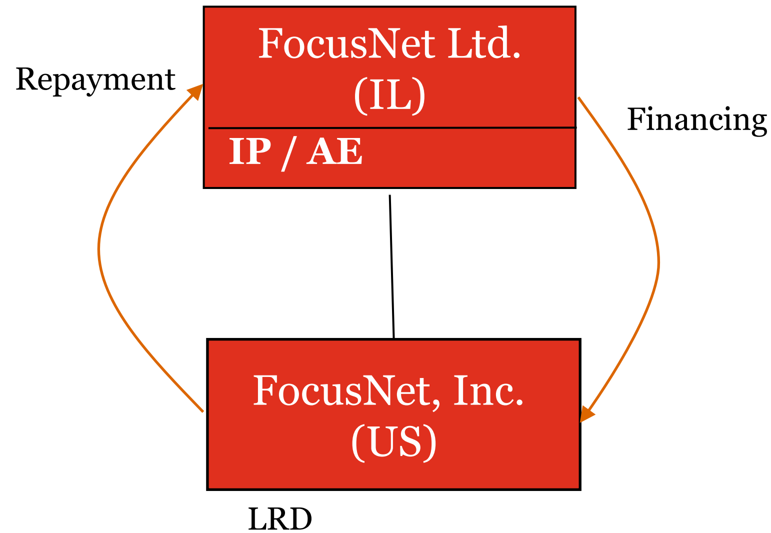
As long as FocusNet Ltd. is in a loss making position, consider Financing FocusNet Inc. with a long-term hybrid instrument (*e.g.*, non interest-bearing capital note).

<u>Israel</u>

- May be classified as debt for Israeli tax purposes .
- Consider applicability of Section 85A.

<u>US</u>

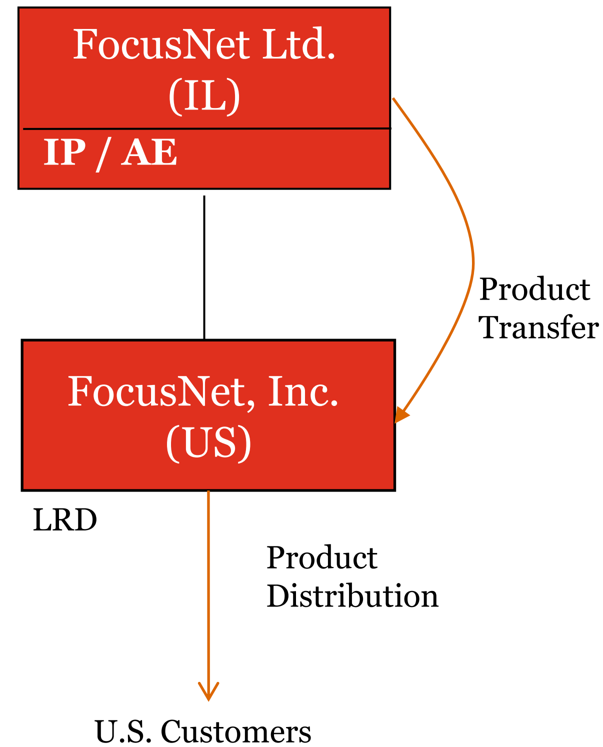
- May be classified as equity for U.S. federal tax purposes .
- Ensure consistency in reporting (*e.g.*, form 5472).



Case Study

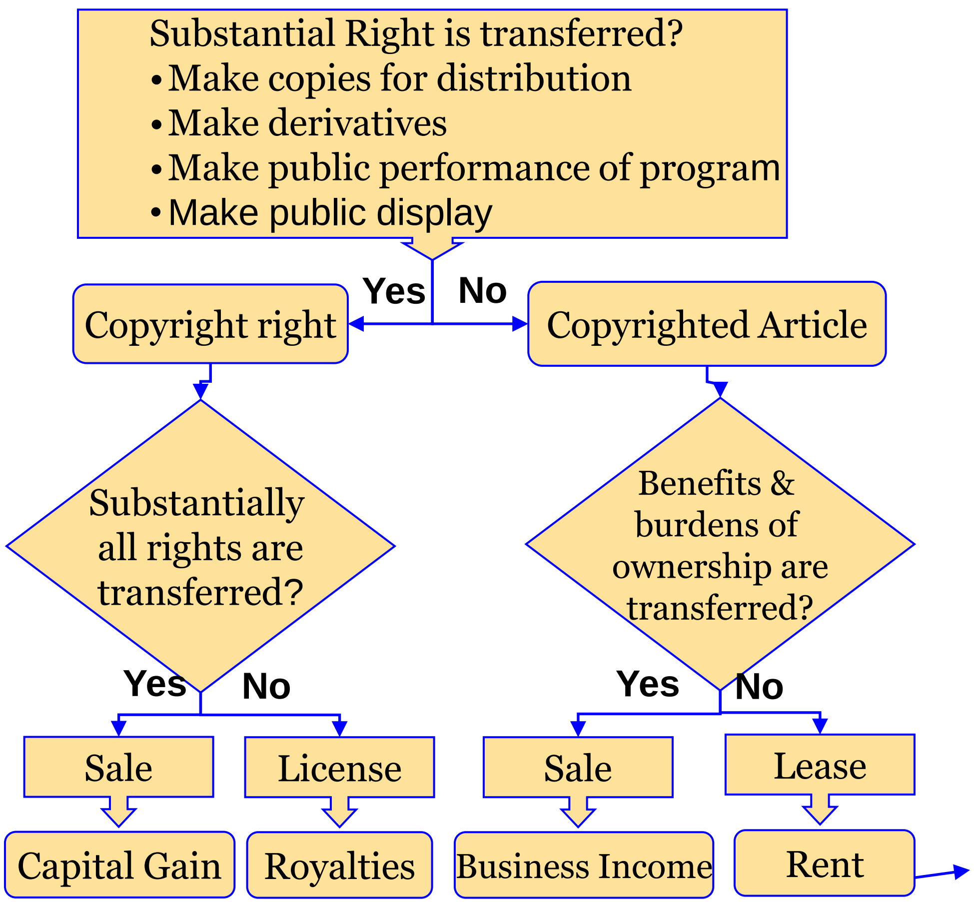
Tax Considerations – Transfer Pricing

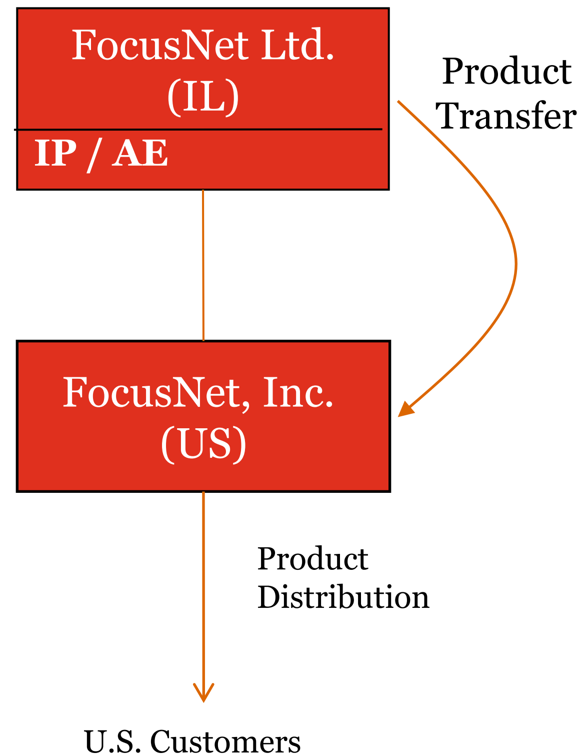
- FocusNet, Inc. acts as an LRD.
- The intercompany agreement between FocusNet Ltd. and FocusNet, Inc. should satisfy the applicable TP rules.
- For distribution – the typical model used to determine the appropriate compensation is CPM => requires FocusNet, Inc. to earn an operating profit calculated as percentage of net sales.
- For technical support services – the typical model used to determine the appropriate compensation is Cost Plus.



Case Study

U.S. Federal Tax Considerations - U.S. Withholding Tax



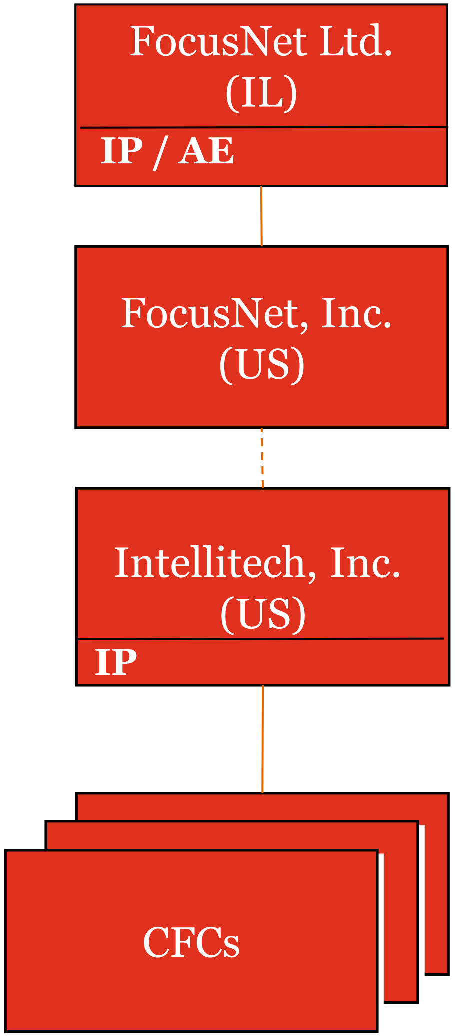


Characterization of rental income as business income under the US/Israel treaty and possible exemption if no PE.

Case Study

Facts – A few years later.....

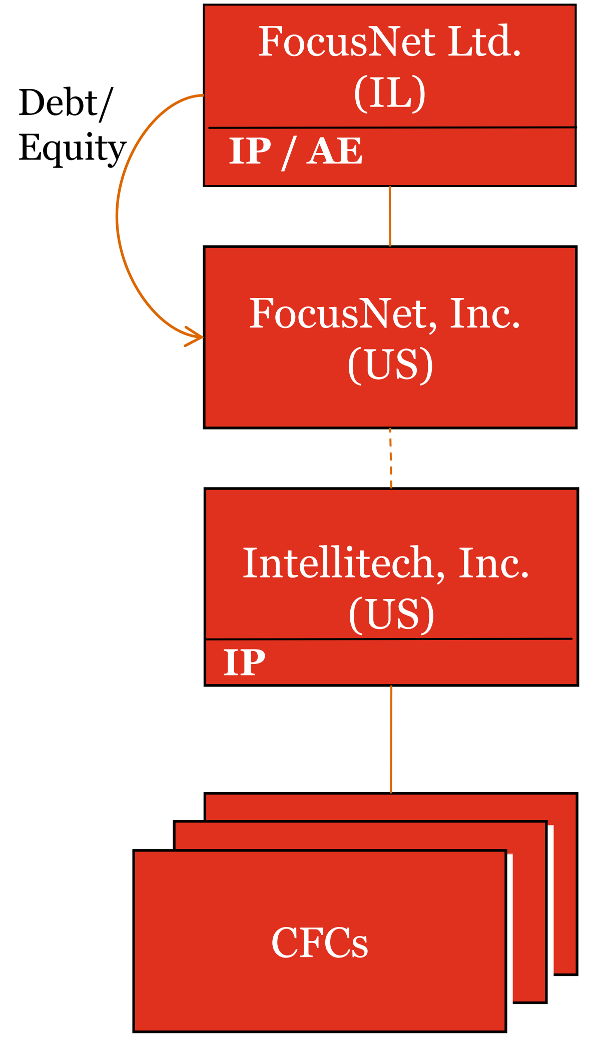
- The FocusNet Group has been operating for several years and has recently become profitable.
- As part of the Group's business expansion, the Group is contemplating the acquisition of a U.S. high-tech company, Intellitech, Inc. for $50 million in cash.
- Intellitech, Inc. is the parent corporation of several operating companies located in various jurisdictions.
- Intellitech, Inc. has approximately $30 million of NOLs.
- Based on purchase price allocation, it appears that Intellitech, Inc. has a built-in gain with respect to its IP of $20 million.
- The long-term tax exempt rate was 2.5% at the time of the acquisition.



Case Study

U.S. Federal Tax Considerations

- Debt pushdown into the U.S. (sections 163(j), 267).
- Debt/equity classification.
- Change in ownership – section 382 – limitations on NOLs utilization.
- CFC rules and compliance (e.g., Form 5471).



Case Study

U.S. Federal Tax Considerations – Limitation on Loss Utilization

Change in ownership – Section 382 – limitations on NOLs utilization:

- Section 382 limitation equals $ 1.25 million

Intellitech, Inc.'s FMV ($ 50 million)	X	Long-term Tax Exempt Rate (2.5%)

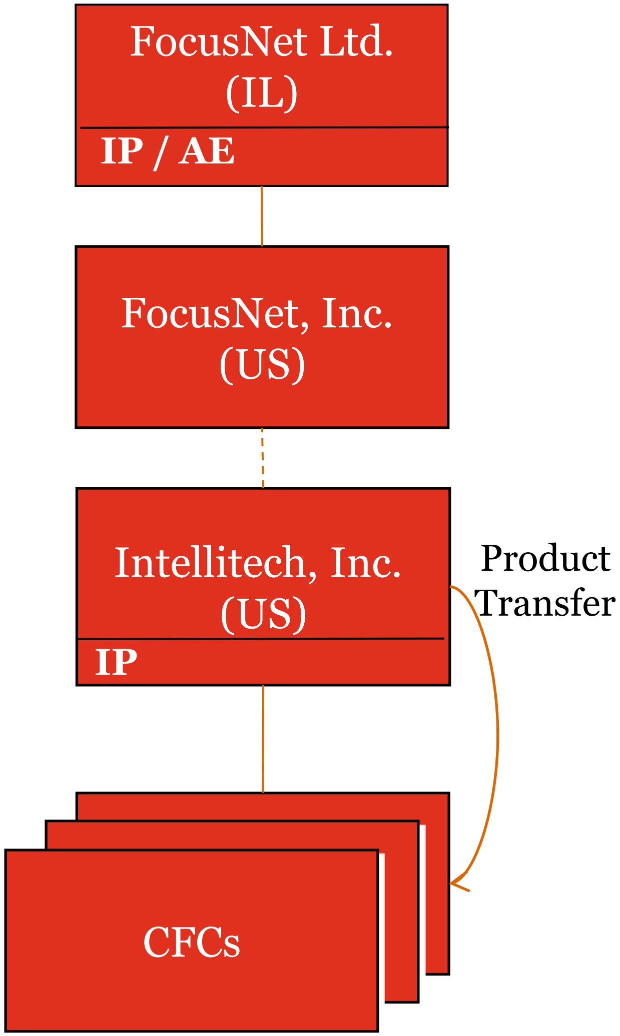
- If Intellitech, Inc. would sell its IP within 5 years – limitation would be increased by $20 million.
- Any pre-acquisition net unrealized built-in losses (NUBIL) in Intellitech, Inc.'s assets would be subject to the limitation if realized within 5 years.

Case Study

U.S. Federal Tax Considerations – CFC Rules

<u>General</u>

- Intellitech, Inc. must include in income certain profits derived by the CFCs (Subpart F income)
- Treated as deemed dividend to Intellitech, Inc.
- Deemed dividend limited to current year E&P (but subject to recapture as Subpart F income in future years)
- Intellitech, Inc. may be entitled to deemed-paid FTC
- Income becomes Previously Taxed Income - not taxed again on distribution



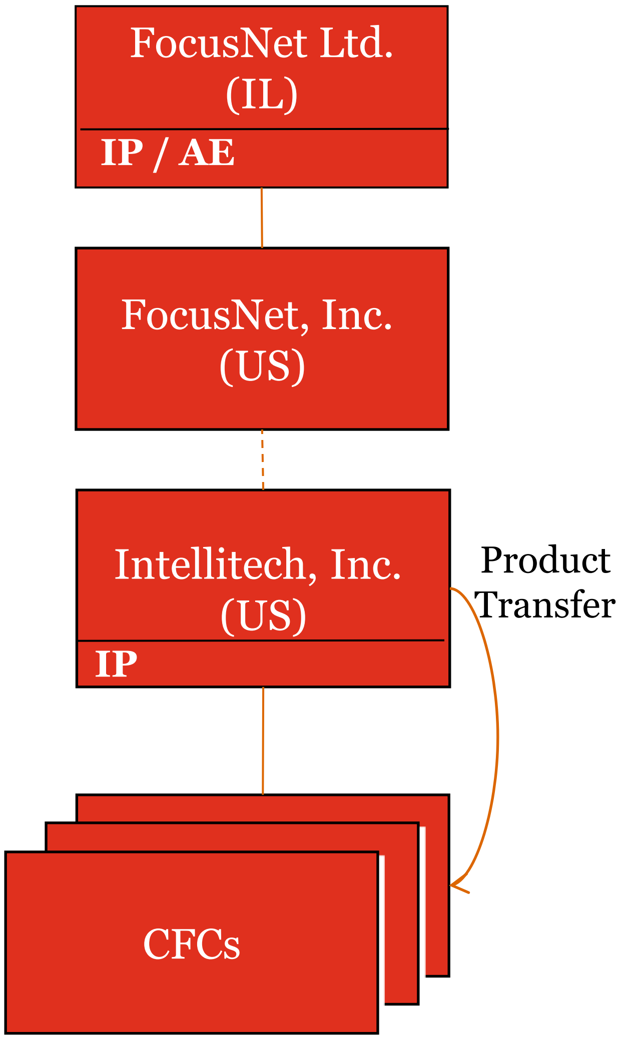
Case Study

U.S. Federal Tax Considerations – CFC Rules

<u>Foreign Base Company Sales Income</u>

1. Personal property purchased from and/or sold to a related person
2. The personal property is manufactured, produced, grown, or extracted <u>outside</u> the country in which the CFC is created or organized
   - FBC sales income does not include income from the sale of property "manufactured" by the CFC (even if outside the CFC's country).

- The personal property must be sold for use, consumption, or disposition outside the country in which the CFC is created or organized



Thank you