PRICEWATERHOUSECOOPERS

# US Tax Seminar

## Legislative update and US inbound planning opportunities for Israeli multinationals, in view of the American Jobs Creation Act 2004

David Intercontinental, Tel Aviv,
January 2005

# Agenda

- Part I - Legislative Update - American Jobs Creation Act of 2004, and other recent legislation;
- Part II - Planning ideas and considerations for Israeli multinationals with US activities and for Israeli subsidiaries of US groups in view of the American Jobs Creation Act;
- Part III - Updates in US M&A;
- Part IV – Panel discussion, "Best Practices" building blocks for Israeli companies investing into the US;
  - Financing Structures
  - Treaties
  - Captive Insurance
  - Global Structure Alignment
  - State and Local Tax Issues
  - Transfer Pricing

# Panel Members

- Host: Gerry Seligman, International Tax Partner

  Kesselman and Kesselman, PricewaterhouseCoopers (Tel Aviv)

  gerry.seligman@il.pwc.com

- Oren Penn, Partner

  PricewaterhouseCoopers LLP (Washington, DC)

  oren.penn@us.pwc.com

- Jules Reich, Partner

  PricewaterhouseCoopers LLP (New York)

  jules.reich@us.pwc.com

- Oscar Teunissen, Partner
  PricewaterhouseCoopers LLP (New York)

  oscar.teunissen@us.pwc.com

- Omri Yaniv, Manager

  PricewaterhouseCoopers LLP (New York)

  omri.yaniv@us.pwc.com

PRICEWATERHOUSECOOPERS

# Part I
# Legislative Update
# American Jobs Creation Act
# Of 2004

# Legislative Update – American Jobs Creation Act

- American Jobs Creation Act of 2004 (the "Act") enacted on October 22, 2004
- Intended to end a long-running trade dispute between the United States and the European Union over certain U.S. export tax incentives.
- Most significant US international tax legislation in almost 20 years and includes significant provisions affecting both inbound investments into the US as well as outbound investments by US companies

# Legislative Update – American Jobs Creation Act

- Provisions of the Act of particular relevance to Israeli companies are:
  - Extraterritorial Income ("ETI") repeal and transition
  - New US domestic manufacturing deduction
  - Temporary incentive to repatriate certain non-US earnings
  - Anti-inversion legislation
  - Foreign tax credit reform
  - Potential taxation upon liquidation of a US holding company
  - Limitations on use of losses
  - No earnings stripping provision (Treasury study required)
  - Deferred compensation and other compensation provisions
  - Tax shelter disclosure penalties
  - Inbound investment incentives

# American Jobs Creation Act of 2004 - Summary

| | |
|---|---|
| Domestic Manufacturing Deduction | ($76.5 billion) |
| International Tax Reform | ($42.6 billion) |
| State Sales Tax Deduction | ($5 billion) |
| Other Relief Provisions | ($12.8 billion) |
| | |
| ETI Repeal with Transition Relief | $49 billion |
| Leasing Reform | $27 billion |
| IRS and Customs User Fees | $19 billion |
| Fuel Tax Evasion | $9 billion |
| Ethanol Excise Tax | $6 billion |
| Patent Donations | $4 billion |
| Tax Shelter Penalties | $2 billion |
| Other Revenue Provisions | $21 billion |
| | |
| Net Total | $0 |

# Extraterritorial Income ("ETI") Repeal and Transition

- The Act concludes several years of deliberations by the US Congress, in response to the European Union ("EU") challenge before the World Trade Organization ("WTO")
- The EU first challenged the Foreign Sales Corporation ("FSC") regime and subsequently challenged the ETI regime which replaced it
- Both provisions were held to be prohibited export subsidies
- The WTO authorized the EU to impose up to $4 billion a year in regulatory trade sanctions on US exports
- Enactment of ETI repeal is expected to lead to the termination of the EU trade sanctions (however, issues remain over ETI transition relief)
- Timing of a response by the EU is not certain. The EU must act affirmatively to remove the sanctions

# ETI Repeal and Transition (continued)

- ETI repealed for transactions after 2004
- Two years of transition relief (2005-2006):
  - 2005 – 80%
  - 2006 – 60%
  - 2007 & thereafter – 0%
- Relief for binding contracts before September 18, 2003.
- Interaction between phase-out provisions of ETI repeal and phase-in of domestic manufacturing deduction should be reviewed carefully by taxpayers that export domestically manufactured products - it may be possible in some circumstances to obtain tax benefits under both provisions

# US Manufacturing Relief

- US manufacturing deduction is intended to compensate for repeal of ETI and to provide an incentive for manufacturing activities in the US
- The Act provides a 9% deduction for income from US manufacturing activities, phased in as follows:
  - 2005-2006– 3%
  - 2007-2009 – 6%
  - 2010 & thereafter – 9%
- Effect of the deduction is to tax US manufacturing income at a 32% rate, rather than the regular 35% corporate tax rate
- Deduction cannot exceed 50 percent of annual wages paid
- Other limitations

# US Manufacturing Relief (continued)

"Domestic Production Gross Receipts"

Less:

- Allocable Cost of Goods Sold
- Directly Allocable Deductions
- Ratable Allocation of Other Deductions Not Directly Allocable to Another Class of Income

---

= Qualified Production Activities Income ("QPAI")

x 3% (6% in 2007-2009, 9% in 2010 and later)

---

= Qualified Production Activities Deduction

# US Manufacturing Relief (continued)

- Eligible activities include:
  - Tangible Personal Property
  - Computer Software
  - Sound Recordings
  - Motion Picture or Television Productions
  - Electricity, Natural Gas, or Potable Water Production
  - Construction
  - Engineering or Architectural Services

# US Manufacturing Relief (continued)

- No global production haircut
- Issues presented?

# International Tax Reform

- Most significant international tax reform since 1986
- Numerous opportunities <u>and</u> new traps for the unwary
- Primary objectives are:
  - Improve global competitiveness
  - Simplify complex tax rules
  - Address perceived abuses
- Various effective dates for the international provisions
- Important to focus on interactions of new provisions

# Incentive to Repatriate Foreign Earnings

- Normally, dividends received by US corporations are taxed at the regular corporate tax rates (35%), with a foreign tax credit ("FTC") permitted, subject to limitations.

- The Act permits an 85% dividends-received deduction for certain controlled foreign corporation ("CFC") dividends received by certain US corporate shareholders during a one-year period (2004 or 2005, for calendar year taxpayers)

- Deduction equates to approximately a 5.25% tax rate on dividends

- The dividends-received deduction generally applies to cash dividends in excess of historic repatriation levels (base period amount)

- The deduction is subject to numerous limitations:
  - Base period amount
  - Financial statement limitation
  - Domestic reinvestment plan
  - Anti-abuse rule for related party debt

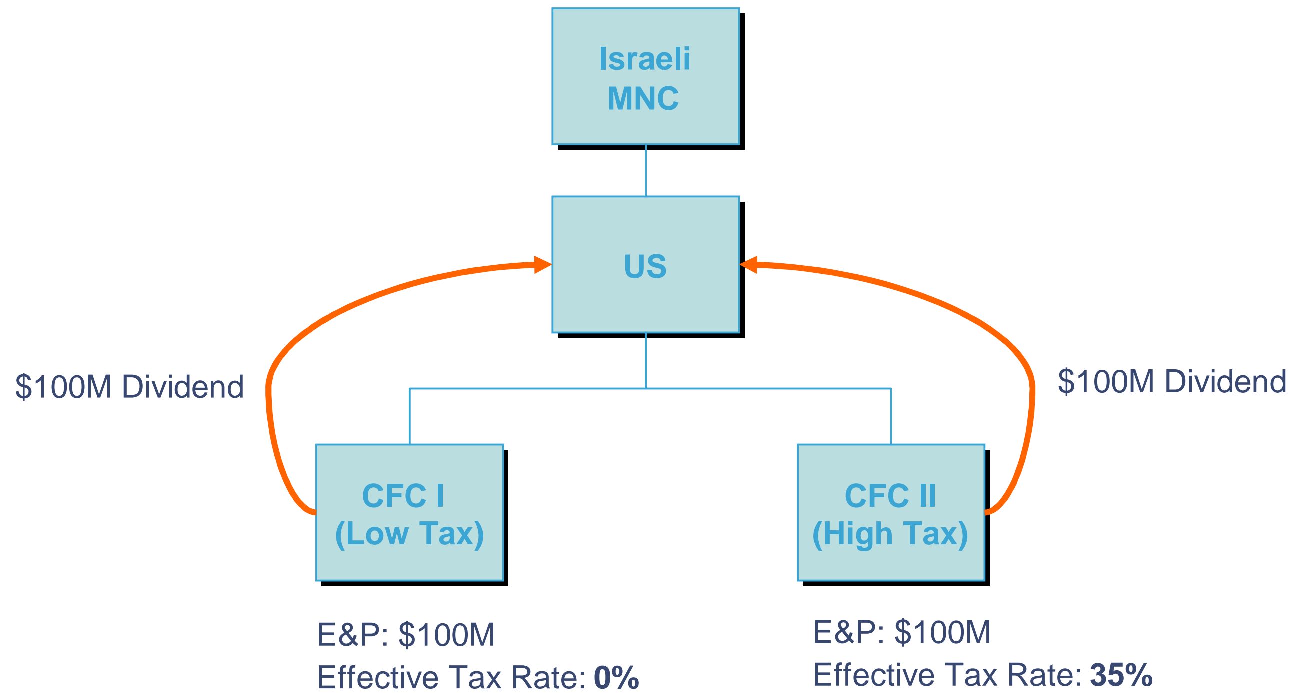
# Incentive to Repatriate Foreign Earnings (continued)

Base period amount

The deduction applies to cash dividends that exceed a base period amount, defined as:

- annual average of dividends received from all CFCs
- during the five most recent tax years ending on or before June 30, 2003 (i.e., 1998 to 2002 for calendar year taxpayers),
- excluding the years with highest and lowest amounts of dividends

# Incentive to Repatriate Foreign Earnings (continued)




| | Alternative 1 | | Alternative 2 | |
|---|---|---|---|---|
| | CFC I | CFC II | CFC I | CFC II |
| Base Dividend | 50 | 50 | 0 | 100 |
| Extraordinary Dividend | 50 | 50 | 100 | 0 |
| Total Dividend | 100 | 100 | 100 | 100 |

***For illustrative purposes only***

# Incentive to Repatriate Foreign Earnings (continued)

<u>Financial statement limitation</u>

The amount of dividends eligible for the dividends received deduction is limited to the greater of:

- $500 million, or
- Earnings reported as permanently reinvested outside of the US (under APB 23) in the most recent audited US financial statement certified on or before June 30, 2003
- If APB 23 amount is not reported but the US tax liability related to permanently reinvested earnings is reported, equivalent amount of the earnings is determined by dividing the US tax liability on permanently reinvested earnings by 35%

# Incentive to Repatriate Foreign Earnings (continued)

Domestic reinvestment plan

Dividends must be invested in the US pursuant to a domestic reinvestment plan

- President, chief executive officer or comparable company official must approve the plan before the dividend is paid, and
- Board of directors' must also subsequently approve the plan
- Possible uses of reinvested amounts include, but are not limited to:
  - Worker hiring and training
  - Research & development
  - Capital investments
  - Financial stabilization of the company for job retention or creation
- Possible uses cannot include:
  - Executive compensation

# Incentive to Repatriate Foreign Earnings (continued)

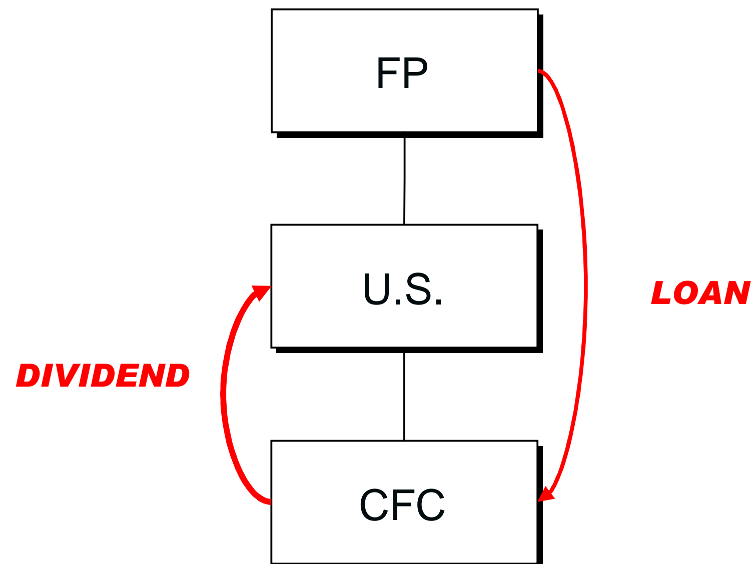
Anti-abuse rule for related party debt

Dividends eligible for the deduction are reduced by any increase in the related-party debt of CFCs between October 3, 2004 and the close of the tax year in which the election is made

- Debt between related CFCs is disregarded - all CFCs are treated as one CFC

# Incentive to Repatriate Foreign Earnings (continued)

## CFC Related Party Debt Rule



# Corporate Expatriations - Anti-Inversion Legislation

- The ability of US companies to expatriate and become foreign corporations has been severely limited by new anti-inversion legislation in the Act
- Anti-inversion provisions of the Act are extremely broad and could apply to non-inversion corporate structuring and restructuring transactions
- Earlier Senate proposed legislation included an exception for nonpublicly traded stock. This provision was not included in the Act.
- An excise tax on stock-based compensation of corporate insiders may be imposed
- The provision is effective for transactions after March 4, 2003
- Effects of the provision should be evaluated by Israeli multinational companies considering reorganization of their US group

# Corporate Expatriations - Anti-Inversion Legislation (continued)

- Two different types of inversion transactions are affected. The Act establishes different consequences for each type of transaction.

- The first type of inversion is a transaction in which:

    - a foreign incorporated entity acquires (directly or indirectly) substantially all of the properties of a U.S. corporation or partnership after March 4, 2003,
    - the former shareholders (or partners) of the U.S. corporation (or partnership) hold 80% or more (by vote or value) of the stock of the foreign incorporated entity after the transaction, and
    - the foreign incorporated entity does not have substantial business activities in the entity's country of incorporation.

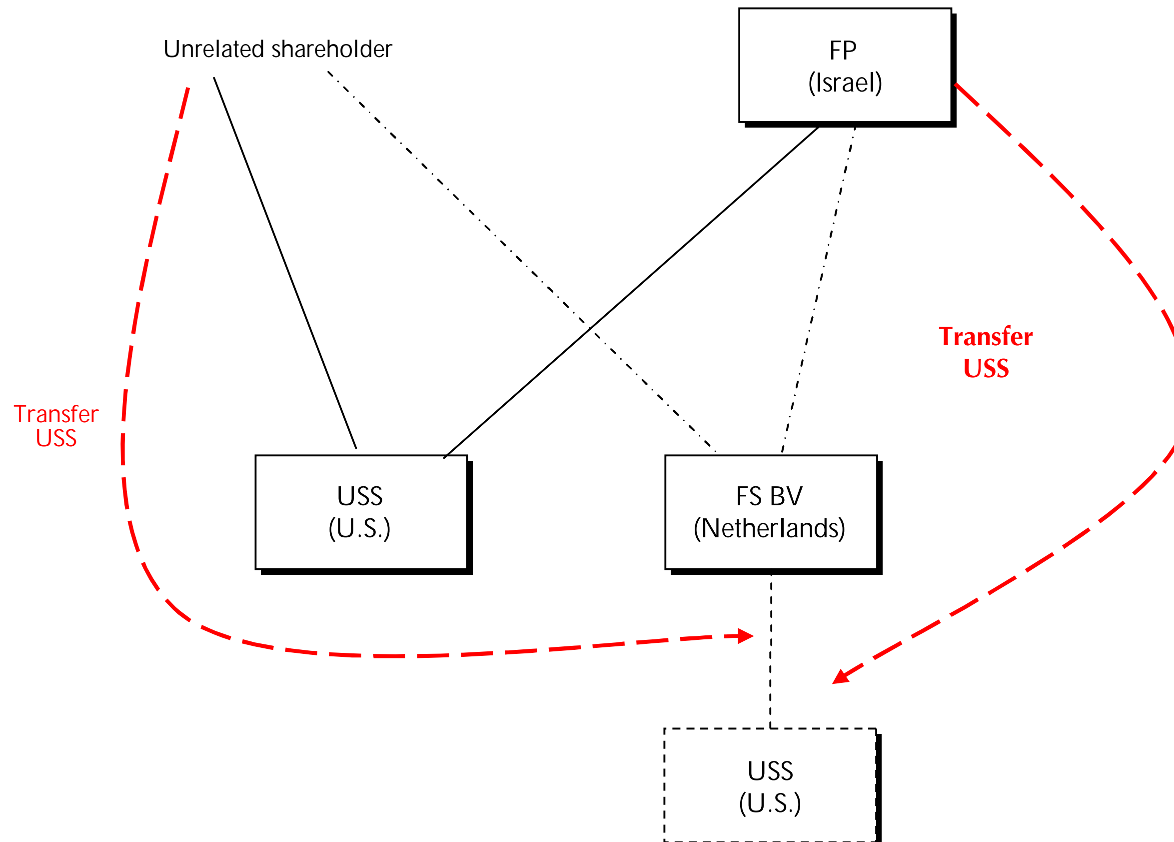
- Under this type of inversion, the Act treats the acquiring foreign corporation as a US corporation

- This treatment explicitly overrides US tax treaties that may provide a different result.

# Corporate Expatriations - Anti-Inversion Legislation (continued)

- The second type of inversion is a transaction that applies under the same conditions above, except that the ownership threshold is between 60% and 80%
- In this case the foreign corporation is treated as foreign for US tax purposes, but any applicable corporate-level exit or “toll charges” for establishing the new foreign structure may not be reduced by items such as net operating losses or foreign tax credits

# Corporate Expatriations - Anti-Inversion Legislation (continued)



# Foreign Tax Credit Reforms

- Extend foreign tax credit carryforward period from 5 to 10 years (date of enactment)
- Reduce limitation baskets from 9 to 2 (after 2006)
- Eliminate 90% alternative minimum tax limitation (after 2004)
- Reform interest expense allocation (after 2008)
- Recharacterize overall domestic loss (after 2006)

# Foreign Tax Credit Reform

Foreign Tax Credit Carryover Period

- The Act extends the foreign tax credit carryforward period from five to 10 years, and reduces the carryback period from two years to one year
- The carryforward extension is effective for excess foreign tax credits that may be carried to tax years ending after October 22, 2004; the carryback reduction is effective for excess foreign tax credits arising in tax years beginning after October 22, 2004

# Foreign Tax Credit Reform

Foreign Tax Credit Limitation Baskets

- The Act reduces the current nine foreign tax credit “baskets” under section 904(d) to two: a general basket and a passive basket
- Income in the current baskets will be assigned to one of these two baskets, as appropriate
- This reduction in the number of baskets is effective for tax years beginning after 2006
- The Act provides a transition rule that permits pre-effective date credits that are carried into post-effective date years to benefit from the reduction in baskets with respect to such taxes

# Foreign Tax Credit Reform

Limitation on AMT Foreign Tax Credits

- The Act eliminates the 90 percent limitation on the use of foreign tax credits against the alternative minimum tax
- The provision is effective for tax years beginning after 2004
- This provision addresses yet another long-standing inequity, under which taxpayers could not fully utilize credits for foreign taxes actually paid simply because they were in an alternative minimum tax position
- This may affect the level of valuation allowances required for financial reporting purposes

# Foreign Tax Credit Reform

Reform of interest expense allocation

- The Act replaces the present-law method with a worldwide fungibility approach
- The provision is effective for tax years beginning after 2008
- The act provides for a one-time election to allocate and apportion third-party interest expense to US members of an affiliated group for foreign tax credit purposes as follows:

$$\left[ \text{Worldwide Interest Expense} \times \frac{\text{Group's Foreign Assets}}{\text{Group's Worldwide Assets}} \right] - \left[ \text{Third party interest expense incurred by foreign group members} \right]$$

# Foreign Tax Credit Reform

<u>Recharacterization of overall domestic loss</u>

- The Act applies a re-sourcing rule to US source income where a taxpayer's foreign tax credit limitation has been reduced as a result of an overall domestic loss
- The amount recharacterized as foreign source income in succeeding tax years is equal to the lesser of:
  - The amount of unrecharacterized overall domestic losses for previous years, or
  - 50% of the taxpayer's US source income in such succeeding year
- The provision is effective for tax years beginning after 2006

# Subpart F Reforms

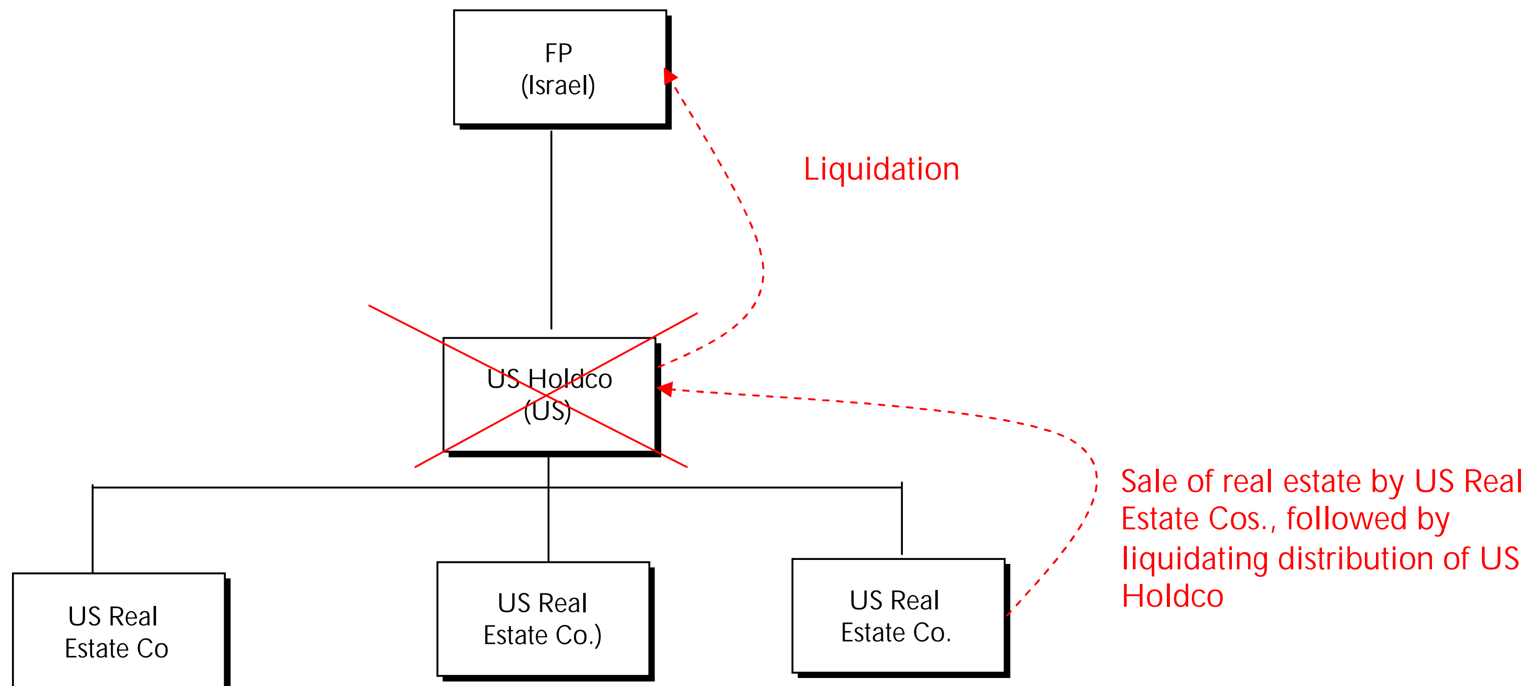
- Provide look-through for sales of partnership interests
- Repeal foreign personal holding company rules
- Repeal foreign investment company rules
- Repeal foreign base company shipping income
- Modify exception for commodities
- Modify exception for active financing income

# Gain Recognition on Liquidation of US Holding Company

- Previously, a liquidating distribution to a foreign parent company could be exempt from US tax (subject to certain anti-abuse rules)
- Under the Act, a liquidating distribution by a US holding company to a foreign parent corporation will be treated as a taxable dividend distribution if:
  - The holding company is a US corporation that is a common parent of an affiliated group,
  - Substantially all of the assets of the US holding company consist of stock in other members of the affiliated group, and
  - The US holding company has not been in existence at all times during the 5 years immediately preceding the liquidation
- Immediate Focus: Effective for distributions in complete liquidation occurring on or after October 22, 2004

# Gain Recognition on Liquidation of US Holding Company (continued)

Provision may prevent popular tax planning previously utilized by many Israeli and other non-US investors (e.g., in US real estate), designed to avoid US withholding tax upon liquidation:



# Prevention of duplication of economic losses - Importation of Built-in Loss Assets

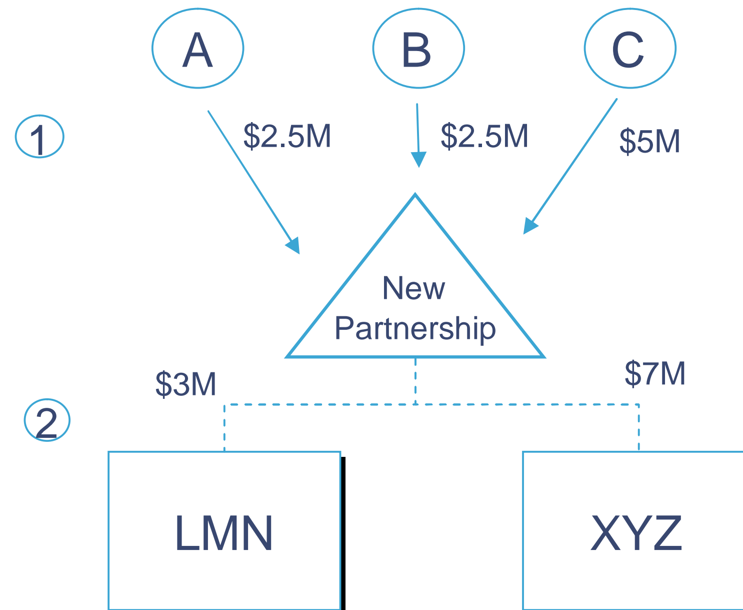
- If net built-in loss assets are imported into the U.S in a tax-free reorganization from persons not subject to U.S. tax, the basis for US tax purposes of property transferred generally will be reduced to fair market value
- Also applies to certain domestic tax-free transfers
- No corresponding rule to increase basis to fair market value for the importation of built-in gain property, when gains have accrued outside of U.S. taxing jurisdiction
- Effective for transactions after October 22, 2004

## Prevention of duplication of economic losses - Disallowance of Certain Partnership Loss Transfers

- A built-in loss in property contributed to a partnership can only be taken into account by the contributing partner
- A distribution to a partner that results in a substantial basis reduction to the remaining partners requires the partnership (except securitization partnerships) to decrease the basis of partnership assets for the amount of that loss
- A transfer of a partnership interest where partnership has a substantial built-in loss in its assets, requires the partnership to step down the transferee partner's share of the basis of the partnership's assets
- Exception for electing investment partnerships and securitization partnerships
- The provision applies to contributions, transfers, and distributions after October 22, 2004

# Disallowance of Certain Partnership Loss Transfers

## Distribution Example:



# Earnings Stripping Rules (Section 163(j))

- Legislative proposals included significant amendments to the so-called "earnings stripping" provisions
- Ultimately, the Act did not include changes to the earnings stripping provisions
- The Act requires the submission of a Treasury study to Congress by June 30, 2005 on the effectiveness and economic impact of the earnings-stripping rules

# Earnings Stripping (continued)

Present Law – What is "Earnings Stripping"?

- Interest paid by a U.S. person to a foreign related party that is not subject to U.S. federal tax on the income (e.g., under an applicable income tax treaty) is not deductible when paid to the extent the net interest expense exceeds 50% of the "adjusted taxable income" ("ATI")
    - ATI is intended to approximate the payor's available cash flow
    - Also applies with respect to interest paid on third-party debt that is guaranteed by the parent.
- Limitation only applies if payor's debt-to-equity ratio exceeds 1.5:1
- "Excess interest" (interest expense > ATI) can be carried forward indefinitely
- Any "excess limitation" (ATI > interest expense) can be carried forward for 3 years.

# Earnings Stripping (continued)

## RELATED INTEREST EXPENSE

### Excess Interest Expense

[ Net interest expense (interest paid or accrued for the year less interest includible in gross income) ] – [ 50% of the issuer's adjusted taxable income (taxable income computed without regard to net interest expense, NOL carryovers or depreciation amortization deductions plus other "cash equivalency" adjustments) + Excess limitation carryover, if any. ]

# Earnings Stripping (continued)

- "Excess interest expense" = excess of "net interest expense" over sum of 50% of "adjusted taxable income" + "excess limitation carryforward"
  - Adjusted taxable income = taxable income without regard to deduction for net interest expense, NOLs, depreciation, amortization, etc.
  - Net interest expense = excess of interest paid or accrued over interest includible
    in gross income for taxable year
  - Excess limitation carryforward = excess of 50% of adjusted taxable income over net interest for 3 prior years
- Safe harbor. Debt to equity ratio < 1.5 to 1

# Earnings Stripping Proposals – A Summary

| 2002 HOUSE WAYS AND MEANS BILL APPROACH H.R. 5095 | 2003 HOUSE WAYS AND MEANS BILL APPROACH H.R. 2896 | 2004 SENATE FINANCE BILL APPROACH S. 1637 | FY 05 ADMINISTRATION APPROACH |
|---|---|---|---|
| ▪ Eliminate debt-equity safe harbor.<br>▪ Alternative test to permanently disallow interest on related party debt to the extent the US group's debt-to-equity ratio exceeds the worldwide group's debt-to-equity ratio.<br>▪ Reduce percentage threshold from 50% to 35%<br>▪ Reduce interest expense carryforward to 5 years. | ▪ Eliminate debt-equity safe harbor.<br>▪ Drop worldwide test.<br>▪ Reduce percentage threshold from 50% to 25% (35% for 2004) for related party interest.<br>    ▪One-time election to apply 30%.<br>▪ Generally, maintain 50% threshold for guaranteed interest.<br>▪ Reduce interest expense carryforward to 10 years. | ▪ Eliminate debt-equity safe harbor.<br>▪ Reduce percentage threshold from 50% to 25%.<br>▪ Applies only to inversions. | ▪ Eliminate debt-equity safe harbor.<br>▪ Reduce percentage threshold from 50% to 25%. No mention of 35% phase-in.<br>▪ Generally, maintain the 50% threshold for guaranteed interest.<br>▪ Reduce interest expense carryforward to 10 years.<br>▪ No mention of the 30% one time election. |

# Nonqualified Deferred Compensation

- New restrictions on deferral elections & distributions and use of certain trusts to fund arrangements

- If requirements not met, participant subject to:

  - Accelerated taxation
  - Enhanced underpayment interest charges
  - Additional 20% penalty tax

- Applies to amounts deferred after 2004 (pre-10/3/04 plans grandfathered, with limitations)

# Nonqualified Deferred Compensation

## Deferral Elections

- Initial Election
  - Prior to Year Earned
  - If Performance-Based, 6 Months Before End of Year
  - Distribution Date
  - Form of Payment
- Subsequent Elections
  - 12 Months in Advance
  - 5-Year Deferral

## Distributions

- Separation From Service
- Death
- Specified Time
- Fixed Schedule
- Change in Control
- Unforeseeable Emergency
- Participant Disability
- No Acceleration

# Other Compensation Provisions

- Employment tax exclusion for incentive stock options and employee stock purchase plan stock options
- Supplemental wage withholding for payments in excess of US$1million
- Personal use of company aircraft and other entertainment expenses
- Minimum cost requirement for transfer of excess pension assets
- Basis rules in retirement plans for nonresident aliens

# Tax Shelter Disclosure Penalties

Failure to Disclose

- "Listed" Transactions
  - $100,000 (Individuals)
  - $200,000 (Non-Individuals)
  - No Waiver
  - SEC Disclosure
- Other Reportable Transactions
  - $10,000 (Individuals)
  - $50,000 (Non-Individuals)
  - Limited IRS Waiver Authority

Accuracy-Related

- "Listed" and "Reportable Avoidance" Transactions
- Adequately Disclosed
  - 20% Penalty
  - Limited Waiver
- Not Adequately Disclosed
  - 30% Penalty
  - No Waiver
  - SEC Disclosure

# Other Tax Shelter Disclosure Provisions

- Revised substantial understatement penalty for transactions other than reportable transactions
- Expanded statute of limitations for non-disclosed listed transactions
- Denial of interest deduction on certain tax shelter deficiencies
- Tax shelter exception to confidentiality privilege
- Penalty for failure to report foreign financial accounts

# Inbound Investment Incentives

- Exemption from US withholding tax for certain mutual fund (RIC) dividends earned by a foreign person, if arising from certain types of interest (mainly bank deposit interest and "portfolio interest") or from net short-term capital gains
- Effective for RIC taxable years beginning after December 31 2004 and before December 31 2007
- Exemption from withholding tax for capital gains distributions from 5% or less – owned interests in certain US publicly-traded Real Estate Investment Trusts (REITS)
- Effective for taxable years beginning after October 22, 2004

# Key Provisions Not Included in the Act

## Tax Relief

- Look-Thru for Payments Between Related CFCs
- Extension of 5-Year NOL Carryback Period to 2003

## Revenue Raisers

- Codification of Economic Substance Doctrine
- CEO Tax Return Declaration Signature
- Denial of Deduction for Fines & Penalties
- Guaranteed Rewards for IRS "Whistleblowers"
- Earnings-Stripping

# Pending Reports & Studies

| | | |
|---|---|---|
| Research Credit | Treasury Department | -- |
| APA Process | Senate Finance Committee | -- |
| Puerto Rico* | GAO/JCT | -- |
| Nonprofits* | Independent Sector | February/Spring 2005 |
| Earnings Stripping | Treasury Department | June 30, 2005 |
| Tax Treaties | Treasury Department | June 30, 2005 |
| Transfer Pricing | Treasury Department | June 30, 2005 |
| Corporate Inversions | Treasury Department | December 31, 2006 |

# Dividend Law
## In General

- The dividend law establishes a maximum 15% rate of tax for certain dividends paid to individual U.S. shareholders
  - The rate applies to dividends from U.S. corporations and "qualified foreign corporations"
  - Under prior law, dividends were taxed as ordinary income at marginal rates as high as 38.6%

  Note: The inclusion of dividends from foreign corporations is a victory for foreign-based multinationals, and recognizes that U.S. individuals invest in both U.S. and foreign companies
- The new dividend law is effective as of January 1, 2003. The provision expires in the year 2009.

# Dividend Law
## Qualified Foreign Corporations

- A qualified foreign corporation is defined to include a foreign corporation that meets one of three qualifications:
  - Treaty Test: The foreign corporation is eligible for the benefits of a comprehensive U.S. income tax treaty that the Treasury Department determines to be satisfactory and which includes an exchange of information program,
  - US Securities Market Test: Dividends paid by the foreign corporation if the stock with respect to which the dividend is paid is readily tradable on an established securities market in the U.S., or
  - US Possession Test: The foreign corporation is incorporated in a U.S. possession (e.g., Puerto Rico, Guam, American Samoa, the Northern Mariana Islands)

  Note: Dividends paid by passive foreign investment companies ("PFIC"), foreign personal holding companies ("FPHC"), and foreign investment companies ("FIC") do not qualify for the reduced rate

# Dividend Law
## Treaty Test

- Under the new dividend law, a foreign corporation will be considered to be a qualified foreign corporation if it is eligible for the benefits of any comprehensive U.S. income tax treaty with an exchange of information program (with the exception of the U.S.-Barbados treaty)
- The US Tax Authorities treat all current U.S. income tax treaties as acceptable treaties for this purpose, with the exception of the U.S. tax treaties with:
  - Bermuda (not a comprehensive treaty);
  - Netherlands Antilles (not a comprehensive treaty);
  - The countries of the former U.S.S.R. (no exchange of information provision); and
  - Barbados (this may change due to new treaty protocol).
- The U.S.-Israel income tax treaty is an acceptable treaty for these purposes.

# Dividend Law
## Readily Tradable Test

- A foreign corporation is treated as a qualified foreign corporation with respect to any dividend paid by such corporation if the stock with respect to which the dividend is paid is readily tradable on a U.S. established securities market
- The U.S. tax authorities treat ordinary or common stock, or an American depository receipt in respect of such stock, as readily tradable on an established securities market in the United States if it is listed on certain U.S. securities exchanges (like the New York Securities Exchange or the NASDAQ Stock Market).

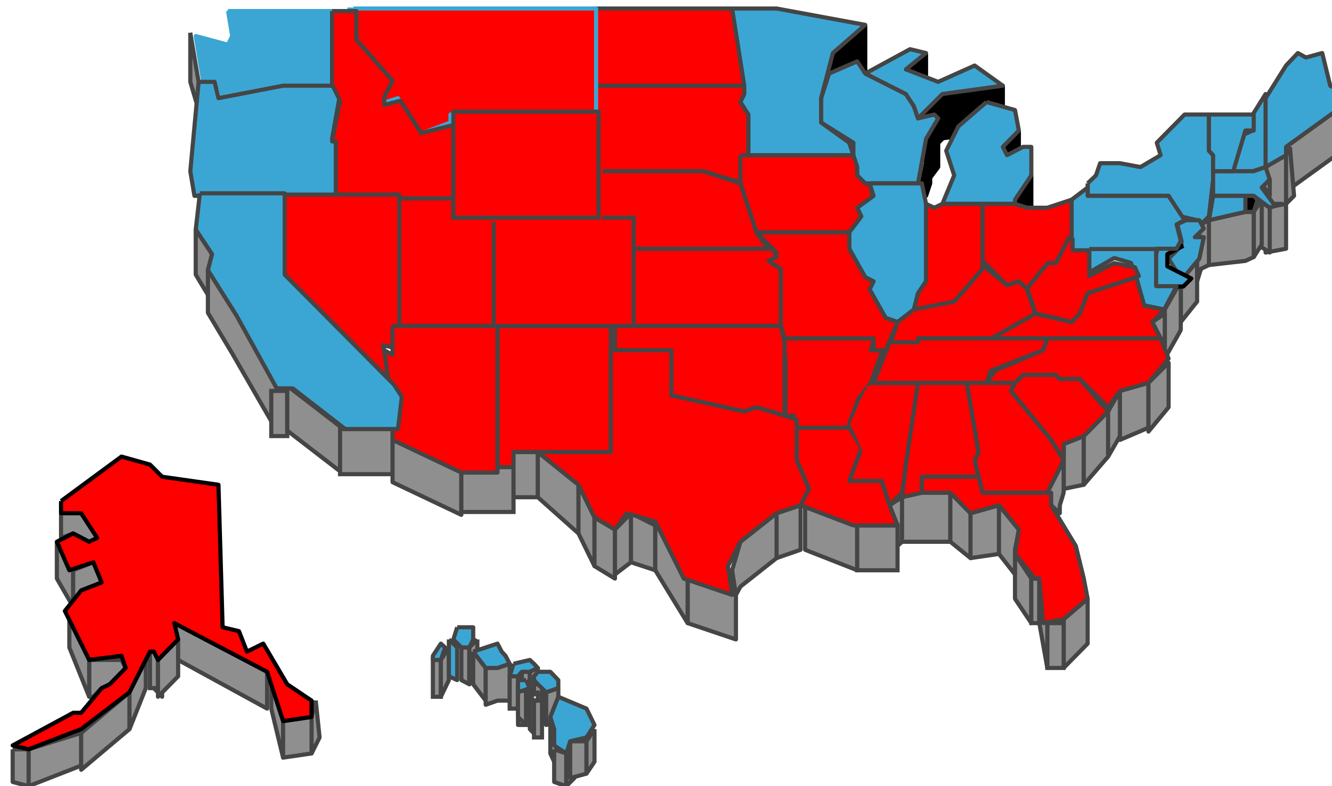
  Note: At present, shares traded on the OTC Bulletin Board or on the electronic pink sheets are not covered. The US Tax Authorities are considering whether for future years shares traded on these other markets will qualify, and whether conditions will be imposed to determine qualification (e.g., trading volume, number of market makers, maintenance of quotation data, etc.)

  Note: At present, preferred stock is not covered. Future guidance may address the treatment of dividends on these types of shares.

# Dividend Law
## Reporting Procedures

- For 2003, simplified reporting procedures applied to determine whether a foreign corporation's dividends qualify for the reduced tax rate.
- The simplified reporting procedures were extended for 2004.
- For 2005 and future years, it anticipated that the US tax authorities will issue regulations requiring foreign corporations to make certain certifications in order for their dividends to be eligible for the reduced rate.
  - This may involve some type of certification as to QFC status, or eligibility for the reduced rate for particular shares.
  - The content and requirements for these certifications are not yet known.

# 2004 Presidential Election Results



# 2004 Presidential Election Results

| | ✓Bush | Kerry | Nader |
|---|---|---|---|
| Electoral Vote | 286 | 252 | 0 |
| +/- (from 2000) | +15 | -15 | 0 |
| Popular Vote | 59,459,765 | 55,949,407 | 400,706 |
| # of States* | 31 | 20 | 0 |
| +/- (from 2000) | +1 | -1 | 0 |
| % Popular Vote | 51 | 48 | 1 |

# Balance of Power: 2004 Election Results

| | Senate* | +/- | House** | +/- |
|---|---|---|---|---|
| Republican | 55 | +4 | 231 | +4 |
| Democrat | 44 | -4 | 200 | -5 |
| Independent | 1 | 0 | 1 | 0 |
| Undecided | 0 | -- | 3 | -- |

# Presidential Election: Bush Tax Plan

- Permanent 2001 & 2003 Tax Cuts
- Savings Tax Incentives (LSA/RSA)
- Tax Reform

# Bush Tax Plan – Tax Reform

- President Reagan (1984):
  - "Let us go forward with an historic reform for fairness, simplicity and incentives for growth."
- George Bush (2004):
  - "a simpler, fairer, pro-growth" tax system
- President Bush to appoint bipartisan commission to make recommendations on revenue-neutral reform

# Tax Reform: Principles

- Revenue Neutral
- Reward Investment
- Fair & Uncomplicated
- Preserve Charitable & Mortgage Interest Deduction
- Close Loopholes

# Tax Reform: Options

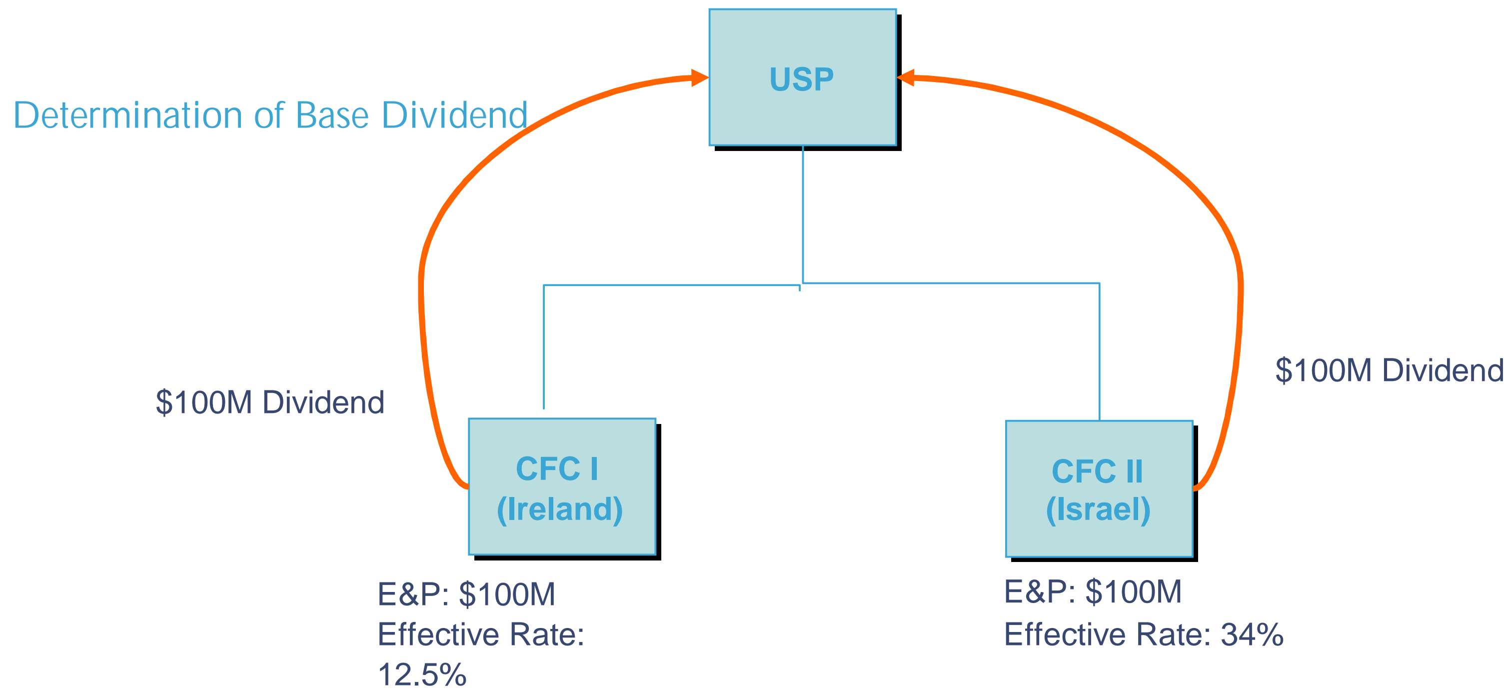
- Flat Tax
- National Sales Tax
- Value-Added Tax (VAT)
- Modified Flat Tax
- Return-Free System

# Part II
# Planning Ideas / Considerations
# For Israeli Investors / Subsidiaries
# In relation to Jobs Creation Act of 2004

# Incentive to Repatriate Foreign Earnings – "Israeli" Considerations

- Election to repatriate profits at the reduced US rate generally may not be favorable where there is an Israeli subsidiary which is subject to regular Israeli corporate tax rates, in view of the relatively high corporate tax rate;
- Where the Israeli subsidiary within the group is subject to corporate tax at regular rates, it may play a role in determining the "base dividends" and the "eligible" dividends within the group.

# Incentive to Repatriate Foreign Earnings – cont.




| | Alternative 1 | | Alternative 2 | |
|---|---|---|---|---|
| | CFC I | CFC II | CFC I | CFC II |
| Base Dividend | 50 | 50 | 0 | 100 |
| Extraordinary Dividend | 50 | 50 | 100 | 0 |
| Total Dividend | 100 | 100 | 100 | 100 |

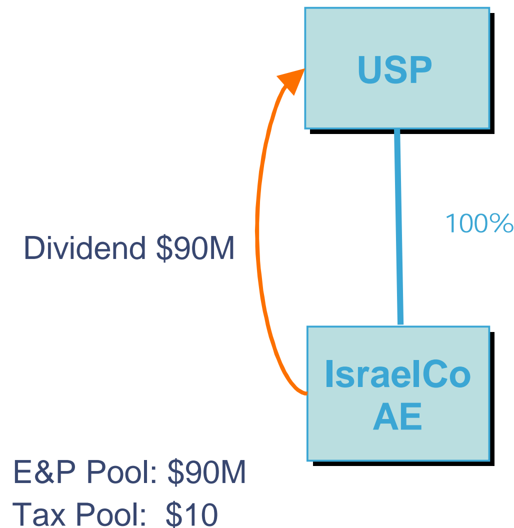
*For illustrative purposes only*

# Incentive to Repatriate Foreign Earnings – "Israeli" Considerations – cont'd

- Election may be beneficial where the Israeli subsidiary is eligible for a reduced tax rate or a tax holiday, by virtue of an "Approved Enterprise" status.
- Under section 51(h) of the Law for the Encouragement of Capital Investments, any amount given by the owner of an enterprise to its "related person", to any person that controls it; or to a corporate entity in their control – is generally deemed to be a dividend distributed by the owner of the enterprise – triggering Israeli withholding tax and corporate tax claw-back to the extent of income previously exempt under a "Tax Holiday".
- To the extent that it is intended to distribute Approved Enterprise earnings in the foreseeable future, it may make sense to distribute and make the election – resulting in a reduced overall Effective Tax Rate. Otherwise – planning strategies are available to utilize US benefit without triggering Section 51(h).

# Incentive to Repatriate Foreign Earnings – Cont'd

***Simplified Example – Israeli Sub with AE***




| | Without election | With election |
|---|---|---|
| Dividend | 90 | 90 |
| Taxable Dividend | 90 | 13.5 (15%*90) |
| Gross Up | 10 | 1.5 (15%*10) |
| US Taxable Income | 100 | 15 |
| US Tax @ 35% | 35 | 5.25 |
| FTCs | | |
| Direct (§901) | <13.5> | <2.02>(15%*13.5) |
| Indirect (§902) | <10> | <1.5> (15%*10) |
| US Tax | 11.5 | 1.73 |
| Total Tax | 35 | 25.2 |
| | | |

For simplicity, assume:

- Base dividend is zero
- No expenses are allocable or apportionable to USP's foreign source income
- IsraelCo has an AE subject to 10% corporate tax rate and 15% withholding tax rate upon distribution

# Incentive to Repatriate Foreign Earnings – cont.

Transaction Steps

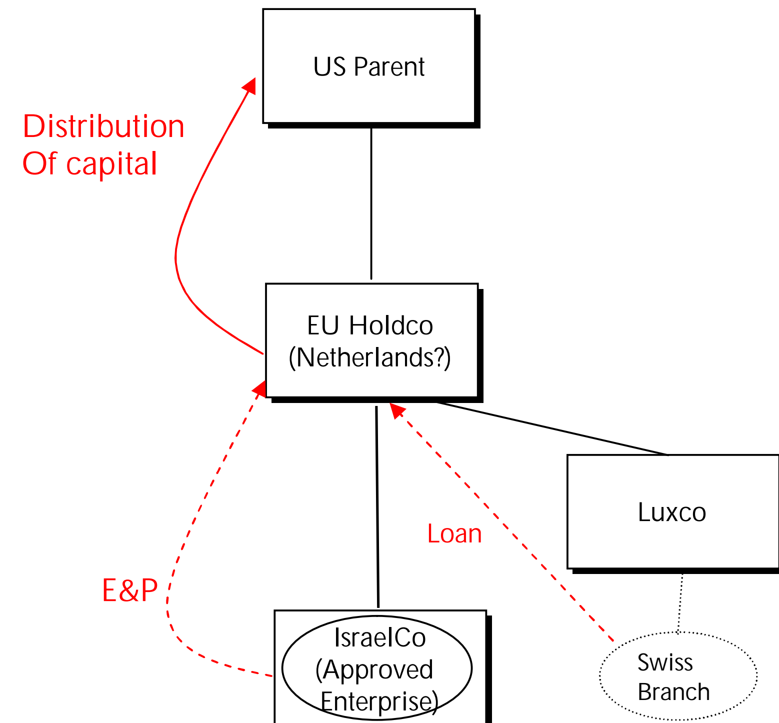
- If US Parent presently holds IsraelCo directly, US Parent contributes IsraelCo to a new or existing EU holding company in an appropriate jurisdiction (e.g., the Netherlands);
- IsraelCo "checks the box" to be disregarded for US tax purposes;
- If necessary, EU Holdco borrows funds from other group companies (e.g., treasury center);
- EU Holdco makes a distribution of capital to US parent.

Benefits

- For US tax purposes, Check the Box election treated as a tax-free Section 332 liquidation of IsraelCo. Consequently, IsraelCo's tax attributes (including E&P) "flow up" to EU Holdco;
- With appropriate planning, it should be possible for EU Holdco to make a distribution out of capital, i.e. – without triggering withholding tax.
- From an Israeli perspective, nothing happens. Cash is repatriated to US Parent without triggering Israeli withholding tax and/or Section 51(h) corporate tax claw-back.

Considerations

- Contribution of IsraelCo to EU HoldCo should qualify under section 104A, but requires ITA approval since contributee is foreign company.
- Distribution by EU Holdco should not be financed by debt from US Parent.
- Dutch capital duty exemption; thin capitalization issues



# Incentive to Repatriate Foreign Earnings – cont.

## Transaction Steps

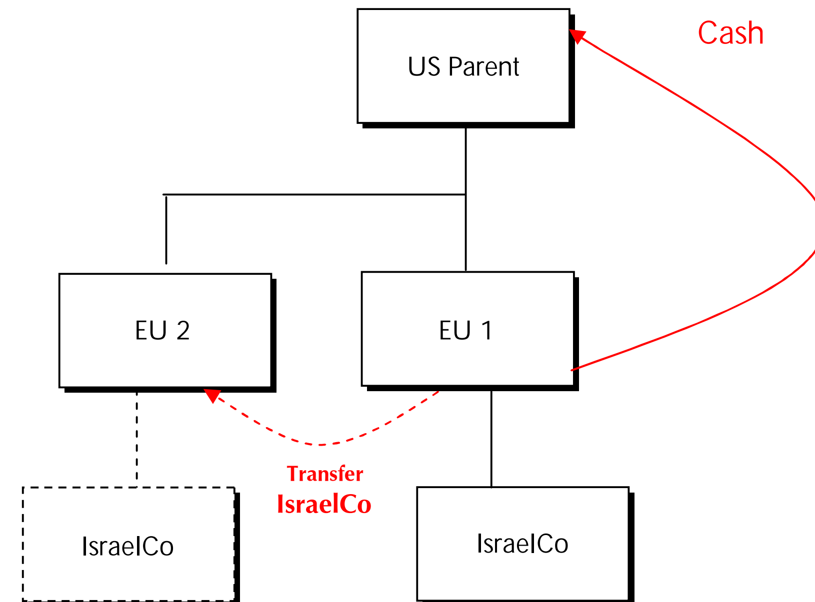
- EU 1, resident in a treaty country which exempts from Israeli CGT (e.g., Netherlands), sells stock of IsraelCo to EU 2 (also resident in treaty jurisdiction) for cash.
- EU 2 can finance the acquisition, if necessary, by borrowing cash from group treasury center or from third party. Loan should not be guaranteed by US parent.

## Benefits

- Sale of IsraelCo from EU 1 to EU 2 should not trigger CGT under Participation Exemption.
- For US tax purposes, consideration for transfer of IsraelCo stock treated as a dividend to the extent of: (i) EU 2's E&P; (ii) IsraelCo's E&P.
- Cash is repatriated to US Parent without triggering Israeli withholding tax and/or Section 51(h) corporate tax claw-back.

## Considerations

- Change of ownership of IsraelCo may require approval from Investment Center and/or CSO;



# Manufacturing Relief

- Manufacturing deduction must be considered by Israeli MNC's with US-based manufacturing operations (whether self-developed or as a result of an acquisition)
- The definition of "manufacturing" for this purpose is broad enough to encompass activities such as:

➢ electricity production;

➢ software development;

➢ construction and engineering services

# Dividend Law

- 15% tax rate on dividends paid by Israeli companies to US – resident individuals is not available if company making the distribution is a PFIC;
- A PFIC is a foreign corporation which meets either an "asset" test or an "income" test;
- Low market prices over recent years might have turned some of the Israeli multinationals into PFICs;
- In view of the "Once a PFIC, always a PFIC" rule, it is important to ensure that the company was not a PFIC in any given tax year;
- Lack of clear representation on SEC filing (e.g., 20 – F) that company is not a PFIC might deter potential US investors for a number of reasons, including the fact that QDI treatment may not be available.

# Inversions

- Broad scope of new inversion legislation must be considered by Israeli multinationals considering re-organizations, so as to prevent "accidental inversions";
- Types of potential inversions:

(i) To Israel

(ii) To low-tax jurisdiction

- The new legislation specifically provides that it overrides tax treaties to which the US is a party, i.e. – even if the inversion is to a treaty jurisdiction (e.g., Israel) – the United States will treat the new top-tier entity as a US corporation.
- Interaction with Competent Authority mechanism in US / Israel treaty?

# Employee Compensation

Israeli Multinationals with US subsidiaries should carefully examine the impact of the new provisions dealing with employee compensation on the group's employees who are subject to US taxation

- Nonqualified Deferred Compensation Plans
- Advisable to undertake review of existing compensation arrangements that may result in the deferral of payment of compensation to employees;
- Take immediate action to modify existing plans to conform to new law;
- Take note of record-keeping requirements in new law;

# Employee Compensation – Cont'd

- Qualified Stock Options
- Qualified Stock Options include Incentive Stock Options (ISO's) options received under an Employee Stock Purchase Plan (ESPP);
- Under new act, remuneration on account of a transfer of stock pursuant to an exercise of an ISO or ESPP option, or on account of a disposition of stock acquired through such an exercise – is excluded from the definition of wages;
- Consequently, FICA (Social security contributions) does not apply to this remuneration;
- Legislation clarifies that employers are not required to withhold tax from gains resulting from a disqualified disposition of stock.

# Other Provisions

Additional Provisions Affecting Israeli individuals and corporations:

- Repeal of AMT FTC limitation – relevant, among others, to US employees of US MNC's who work in Israel and earn compensation above a threshhold;
- Exemption from US withholding tax on certain dividends distributed by US RIC's – relevant for Israeli investors wishing to invest in RIC's;

# Part III

## Updates in US M&A / General US M&A Tax Principles

# 2005 – Year of the Deal ("Business Week" January 10, 2005)

- U.S. Economic Recovery – Firmer Footing
- Higher Stock Valuations – Deal Consideration
- U.S. Companies Have Significant Cash
- Financing Sources Moved From 2.25 Times EBITDA to 5-Plus Times EBITDA

# Historic Trend

## Deal Volume and Value

| Year | Value of Deals (Billions of Dollars) | # Deals |
|---|---|---|
| 1999 | 1,865.1 | 12,253 |
| 2000 | 1,692.5 | 12,130 |
| 2001 | 883 | 8,324 |
| 2002 | 450.5 | 7,541 |
| 2003 | 603.7 | 8,154 |
| 2004 (11 mos.) | 790.3 | 8,054 |

# Historic Trend

**Deal Multiples Rising:**
**Average EBITDA**

12
10
8
6
4
2
0

8.5x
9.3 x
11.4 x

Q3 '02
Q3 '03
Q3 '04

# Forecast for 2005*

- Moderate Rise in Overall Deal Volume
- Inbound Cross-Border Deals Expected To See Most Activity
- Deal Drivers in 2005
  - Cost Savings
  - Growth Potential
  - Economies of Scale

* Provided by PricewaterhouseCoopers Transaction Services

# Issues Influencing Deal Making in 2005

- Bargain Hunting by Oversees Investors
- Acquisitions to Boost Growth
- Possibly the Best IPO Market since 2000

# Additional Reasons for Increase in Israeli Cross-Border Acquisitions

- Shekel Strengthening (at 3 year high against dollar)

- Israel Economic Comeback

    - 20% Increase in Exports
    - Tourism Up
    - Interest Rates Lower
    - Stock Market Up (TA 25 Index up 12.4% in 2004)

- € - Euro Very Strong / $ - Dollar Weak

# Potentially Active Deal Sectors in 2005

- Financial Services
- Healthcare
- Technology
- Consumer Products
- Automotive

# General US M&A Tax Principles

# Taxable Acquisitions - Tax Objectives of Seller

- Maximize after-tax proceeds
- Avoid recognition of gain at more than one level
- Pay tax on capital gains rather than ordinary income
- Minimize state taxes
- Defer tax to another year

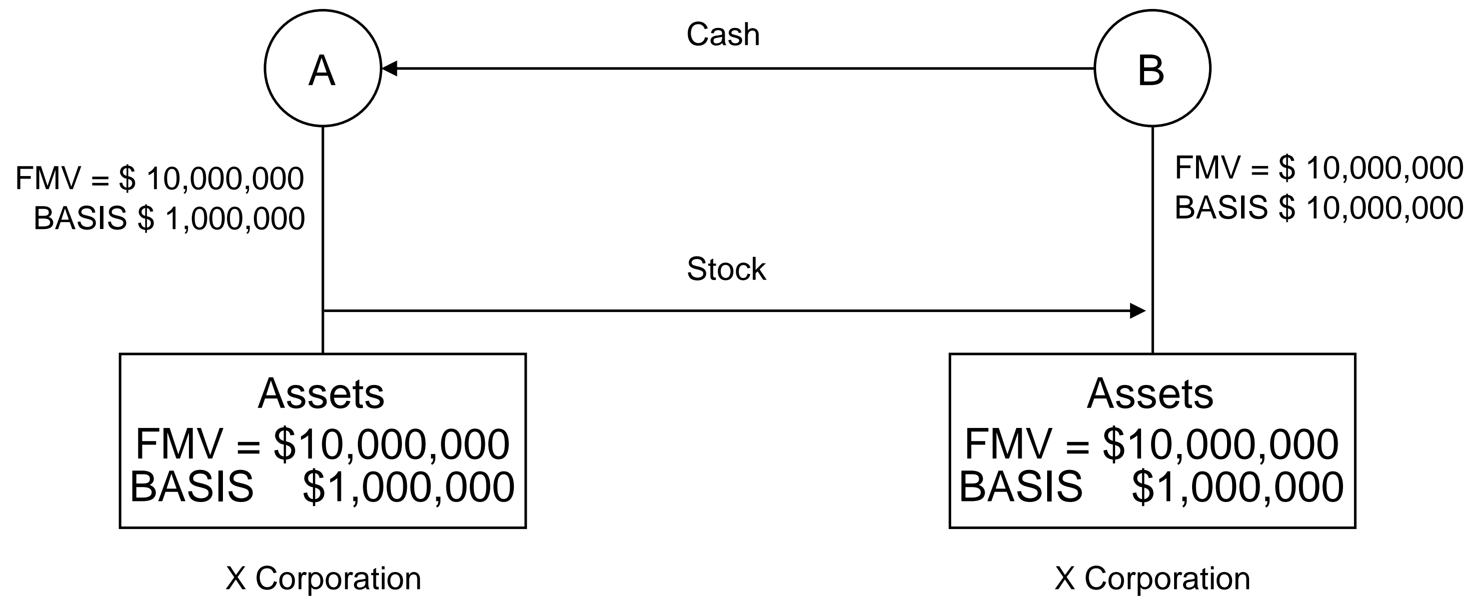
# Taxable Acquisition - Tax Objectives of Buyer

- Minimization of post-acquisition taxes

- Step-up in tax basis equal to purchase price
  - Increased basis may be depreciated or amortized
  - Reduction in gain on disposition of unwanted assets

- Alternatively, acquire Target's tax attributes:
  - NOLs
  - Capital losses
  - Credits
  - Built-in losses/deductions

# Typical Stock Purchase (with No Section 338 Election)

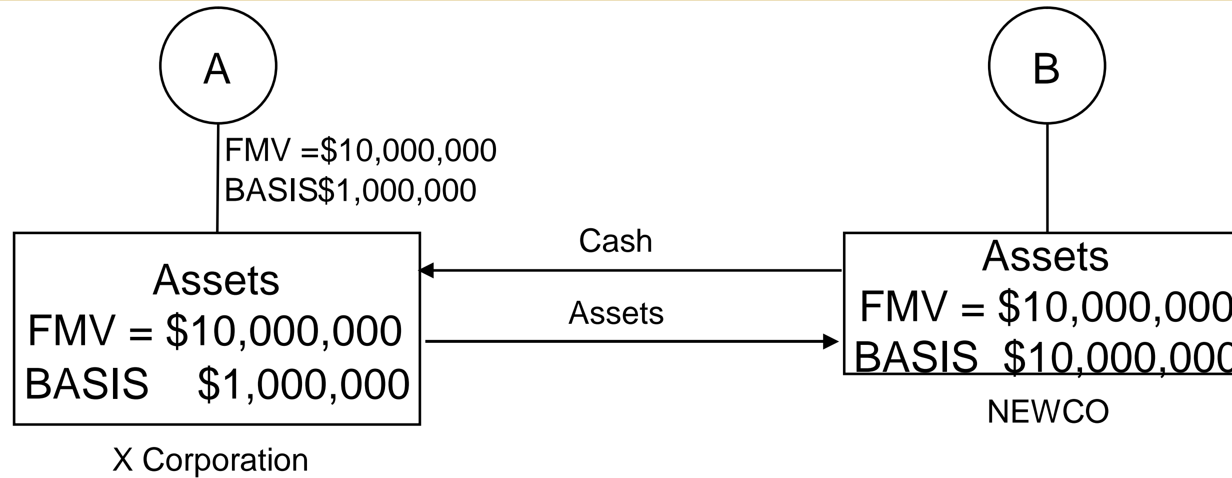


# Typical Stock Purchase (with No Section 338 Election) – Summary of Tax Consequences

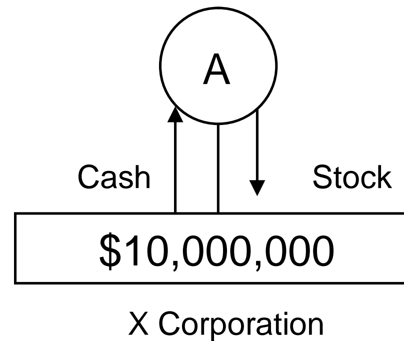
- Seller's gain based on tax basis in stock (i.e., "outside basis")
- Buyer does not obtain a step-up in tax basis (absent a Section 338 election)
- Under purchase accounting, book basis step-up recorded with no corresponding tax step-up. The book/tax disparities on depreciation and amortization can negatively impact earnings
- Buyer inherits all of Target tax attributes (may be subject to limitation)
- Disposition of unwanted assets may result in tax cost

# Asset Purchase

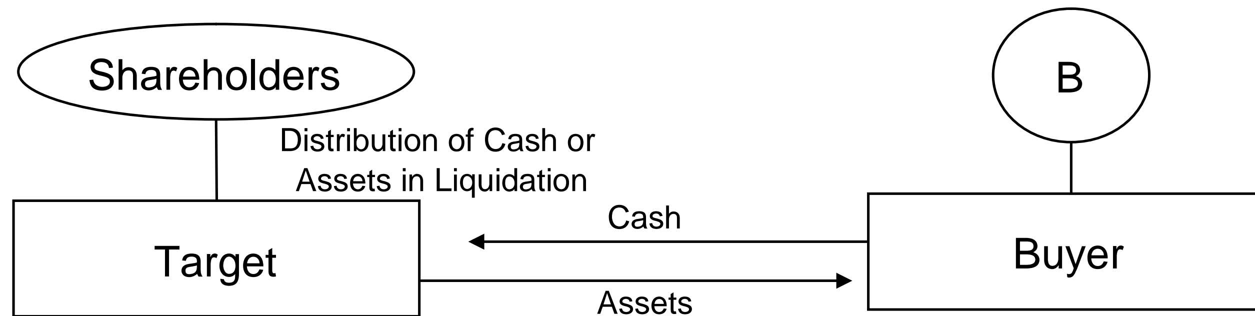
**Step 1**




**Step 2**



# Tax Cost of Asset Deal




| | |
|---|---|
| Shareholders' basis in T Stock: | $0 |
| T Basis in Assets: | $0 |
| Fair Market Value of T Assets: | $100 |
| | |
| Gross Proceeds to T: | $100 |
| Tax to T: | (35) |
| Tax to Shareholders: | (13.0)* |
| After-Tax Proceeds to Shareholders: | $52.00 |

Compare:

After-tax Proceeds of Stock Sale

| | |
|---|---|
| Proceeds: | $100 |
| Tax: | (20) |
| | $80.00 |

** 20% individual rate x $65 proceeds distributed after corporate rate*

# Target Companies Where Double Tax Can Be Avoided

- S Corporations
  - Unless built-in gains tax applicable
- 80% owned subsidiary
- Partnerships
- LLC's

# Section 338(h) (10) Election

- What is it?
  - Joint election by buyer and seller
  - Treats seller of stock as having sold assets in a taxable transaction
  - Seller therefore recognizes gain or loss on deemed asset sale
  - Buyer gets "stepped-up" basis in assets and therefore additional future tax deductions
- When is it available?
  - Must be a Qualified Stock Purchase – at least 80% of Target's stock must be purchased by another corporation during a 12-month period in a taxable transaction
  - Target may be an S or C corporation.
  - C corporation must be a subsidiary with at least 80% of its stock owned by another domestic corporation.

# Section 197 Amortization of Goodwill and Other Intangibles

- Permits the amortization of the cost of certain intangibles over a 15 year period
- Generally, the intangible must have been acquired in connection with the acquisition of a trade or business (generally) through an asset acquisition
- Intangibles included under Section 197 include:
  - Goodwill and going concern value
  - Core Deposits
  - Workforce in place
  - Customer lists
  - Patents, copyrights, formulas, etc.
  - Covenants not to compete

# Acquisition of Partnership/LLC Interests

- Tax basis step-up is available when "shares" are purchased
- Buyer step-up has no impact on Seller
- LLC presumed to be taxed as pass-through, owners may elect corporate treatment under "check-the-box" rules

# Net Operating Losses

- NOL results when allowable tax deductions exceed gross income
- No regular tax, but may incur Alternative Minimum Tax ("AMT")
- General carryback and carryforward rules
  - 2 years back
  - 20 years forward
- NOLs generated in 2001 thru 2005
  - 5 years back
  - 20 years forward

# Net Operating Losses

- NOLs limited on changes of more than 50 percent in ownership of corporation (Section 382)
- Limitation based on value of company times long-term tax-exempt rate
  - Limitation computed only once, not annually
  - Unused limitation can carry over from year to year
  - States may impose additional limitations on use of NOLs
  - Special rules for companies emerging from bankruptcy
- Other limitations can impact NOL utilization (e.g., SRLY)

# Net Operating Losses - Section 382 Limitation

- X corporation has $50 million of NOLs and its stock is acquired for $100 million. The long term tax exempt rate is 5% when the stock is acquired
  - $100m x 5%=$5,000,000: No more than $5,000,000 of NOLs can be used annually
  - If not used, the limitation carries over to the next year increasing the amount of NOLs that can be utilized
  - Exception for built-in items (e.g. increase in limitation from amortization of Net Unrealized Built-In Gains ("NUBIG"))
  - Reduction of equity value for additional debt

# Consolidated Returns

- In the US, several corporations can consolidate

- Key Aspects:
  - Current losses can offset income of other members and reduce current regular tax or Alternative Minimum Tax (AMT)
  - Operating and capital loss carryovers of one member may be used to offset income of other members
  - Taxation of intercompany dividends may be eliminated
  - Income and losses on intercompany transactions are deferred
  - Basis in stock owned in lower tier entities is increased (reduced) if income (losses) from the subsidiary are reported
  - Certain tax credits can be better utilized when subject to limitations of overall group rather than individual members
  - Additional reporting requirements exist, and additional administrative procedures are necessary

# Consolidated Returns - Example

U.S. Federal Consolidated Taxable Income $0

Federal Income Tax $0

**U.S. Parent P**

P Taxable Loss $(50)
P State Income Tax $0

**U.S. subsidiary A**

A Taxable Income $50

A State income Tax $3

**U.S. subsidiary B**

B Taxable Loss $(100)

B State income Tax $0

**Foreign Subsidiary (UK)**

UK Taxable Income $30
UK income tax $9

# Basic Tax-Free Cross Border Acquisition of US Target With Debt Insertion

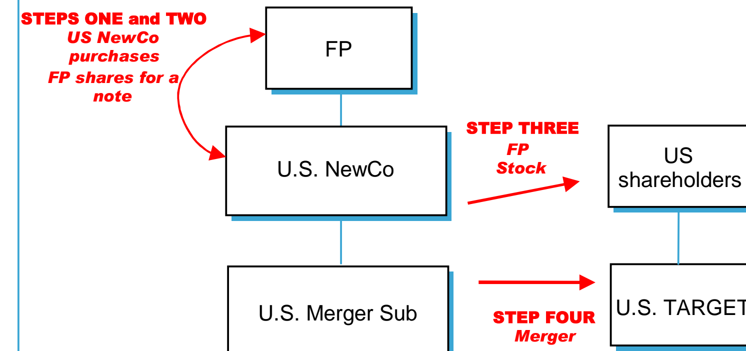
STEPS

1. Foreign acquirer ("FP") sets up a new US corporation (US NewCo) which, in turn, sets up another US subsidiary (US Merger Sub).
2. US NewCo purchases the requisite amount of FP voting stock for a note.
3. US NewCo. then transfers the FP voting stock to the shareholders of the US target ("US Target") in exchange for all of US Target stock.
4. US Merger Sub merges into US Target.

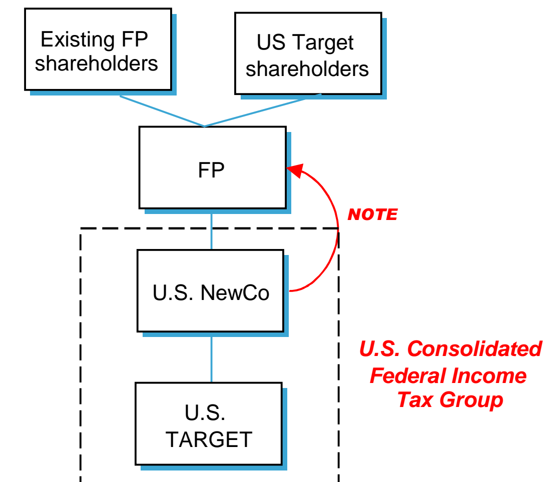
U.S. TAX CONSIDERATIONS

- The acquisition by US NewCo of all the shares of US Target in exchange for FP voting stock is intended to qualify as a reorganization under section 368(a)(1)(B). The various requirements of a tax-free merger must be met.
- Allows debt to be inserted into the US group in a cashless acquisition without U.S. federal withholding tax liability.
- Foreign parent may transfer its stock directly to US Target shareholders if local law does not allow subsidiaries to own parent stock.
- However, Section 367 regulations make transfers of stock of a domestic corporation by a US person to a foreign corporation taxable unless:
  - US transferors receive 50% or less of vote and value of the foreign acquirer,
  - Tainted "controlled group" shareholders own 50% or less of the vote and value of the foreign acquirer corporation after the transaction,
  - Either: (i) US person owns less than 5% of the vote and value of the foreign acquiring corporation immediately after the acquisition or (ii) U.S. persons owning five-percent or more of the acquirer after the transaction enter into 5-year gain recognition agreements; and
  - An "active trade or business test" is met.

**ACQUISITION STRUCTURE**




**RESULTING STRUCTURE**



# Part IV
# US Inbound Planning
# Strategies to reduce ETR

# Inbound "Building Block" – Financing Considerations

- Debt / equity rules
- Earning stripping → future changes – OECD?
- Treaties → withholding taxes – 0% withholding
  - LOB Provisions
  - Interaction of treaty provisions with U.S. domestic law
- Creation of debt
- Hybrid financing

# Cross-Stream "D" Reorganization

**OBJECTIVE**

- In order to align the group structure with its business and management objectives, a company could implement a cross-stream "D" reorganization when it has multiple U.S. consolidated groups it wishes to efficiently combine.
- A "D" reorganization is a tax-free transaction which involves the transfer of substantially all assets and liabilities in exchange for stock of the acquiror.

**BENEFITS**

- Ideal for entities with multiple US groups it wishes to consolidate.
- Allows for debt placement in US entity having current/accumulated E&P without US withholding tax.

**CONSIDERATIONS**

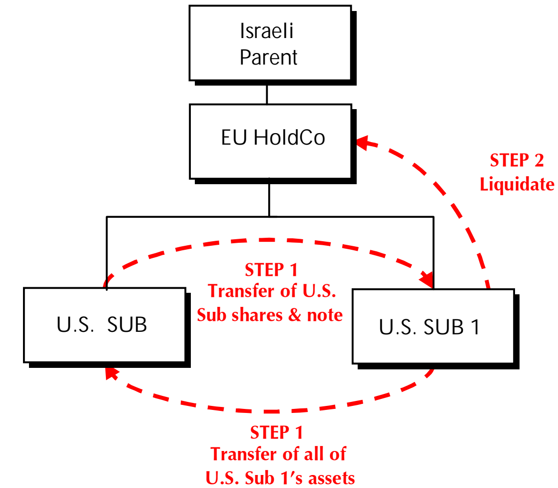
US

- Must qualify as a good reorganization in order to avoid gain on assets/ dividend.
- Future disposition of any of the businesses may lead to U.S. tax consequences.

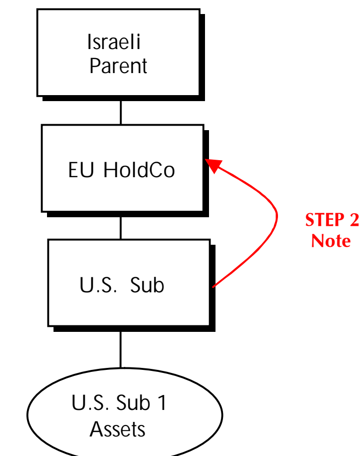
Israel

- Israeli CFC rules might apply to gain generated by EU Holdco upon liquidation of US Sub 1 – depending on the jurisdiction in which EU HoldCo is incorporated.

**CURRENT STRUCTURE**




**RESULTING STRUCTURE**



# U.S. - UK Hybrid Financing

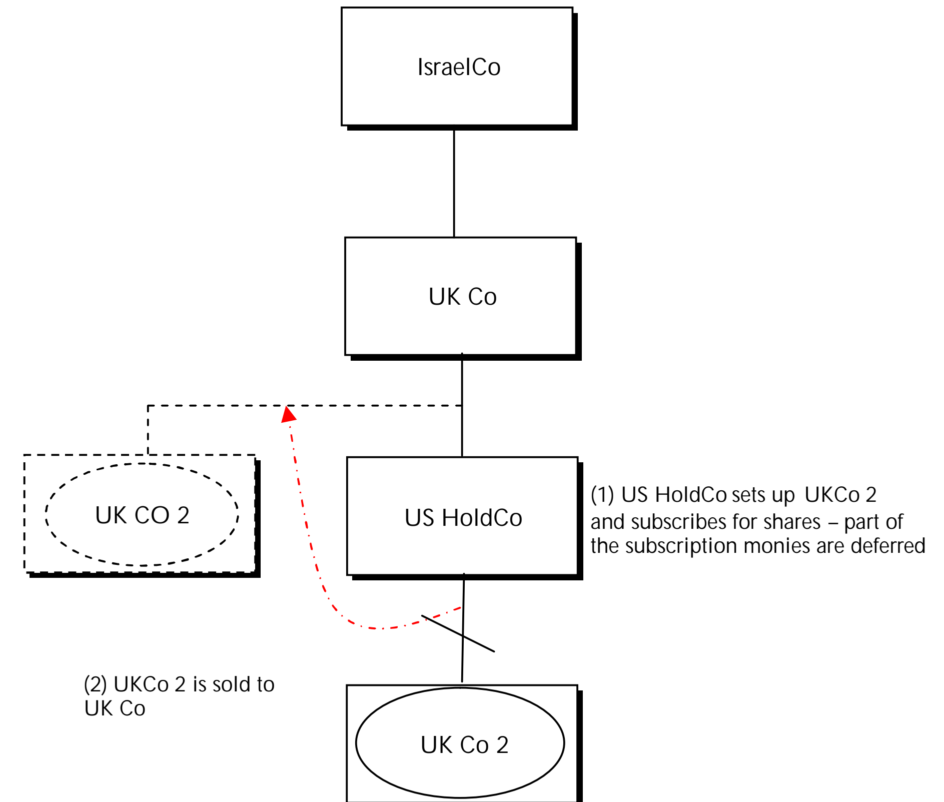
**OBJECTIVE**

- The US / UK treaty provides for a 0% withholding tax on interest, as well as dividends (under appropriate circumstances).
- Various planning ideas can be utilized to create a deduction in the US with 0% withholding tax, and at the same time no taxable income in the UK ("Double Dip").
- One possible strategy which may be utilized if ultimate parent is an Israeli company is a Deferred Subscription agreement.

**CONSIDERATIONS**

- If the UK company is ultimately owned by an Israeli company, benefits of the US / UK treaty will generally be available only if the "active trade or business" test is met;
- In view of UK anti-abuse provisions, some strategies might only be viable if the Israeli parent company is publicly traded on a UK stock exchange or other EU stock exchange.
- Israeli CFC rules – consideration should be given to ensure that the Israeli parent company is not required to include a "deemed dividend" income under the CFC rules.

Deferred Subscription



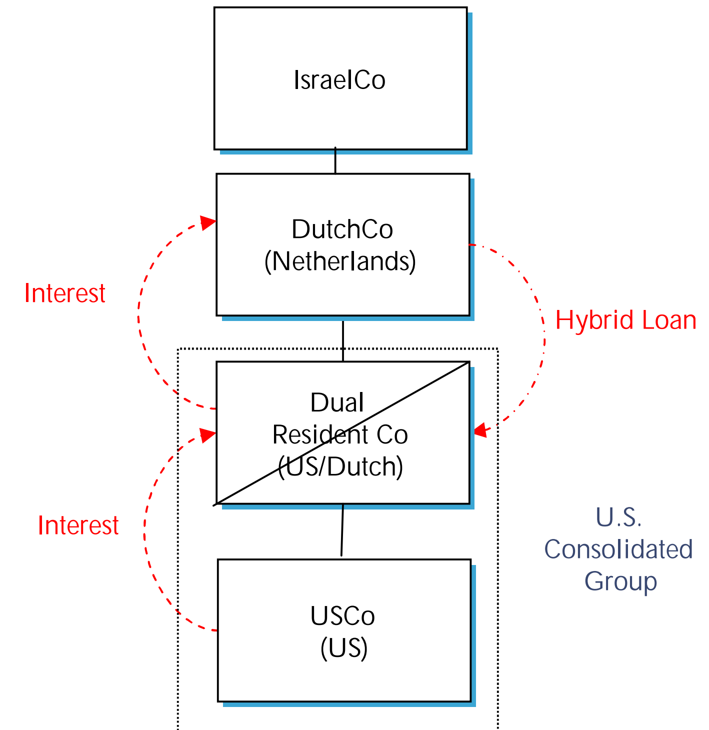
# Dutch Hybrid Loan

RESULTS

- For Dutch tax purposes a hybrid loan qualifies for participation exemption.
- For US tax purposes the DRC and USCo file as a US consolidated group, therefore an interest deduction is also received in the US.
- Withholding tax of 5% possible on interest payments from the US to the Netherlands.

ISSUES

- 10(1)(d) loan will need to be structured to ensure that US tax authorities characterize the 10(1)(d) loan as debt for US tax purposes.
- In general payments of interest on 10(1)(d) loans are contingent upon profitability. If the payment is considered to be a dividend payment then dividends are exempt from withholding tax, however the dividends may not qualify for exemption from withholding under the derivative benefits test. To extent a dividend, may qualify for nil withholding.
- Ensure availability of treaty benefits to DutchCo assuming ultimate parent is Israeli corporation. Generally, treaty benefits will be available only if DutchCo meets the "active trade or business test" in the US / Netherlands treaty.
- Israeli CFC provisions – may apply to DutchCo. If applicable – IsraelCo will be taxed on current basis at 25% rate on deemed dividends from DutchCo. CFC can be avoided to the extent that not more than 50% of DutchCo's income and profits in the taxable year are considered "passive", or based on the "business company" exception.



# Polish Finance Company with Swiss / Lux Branch

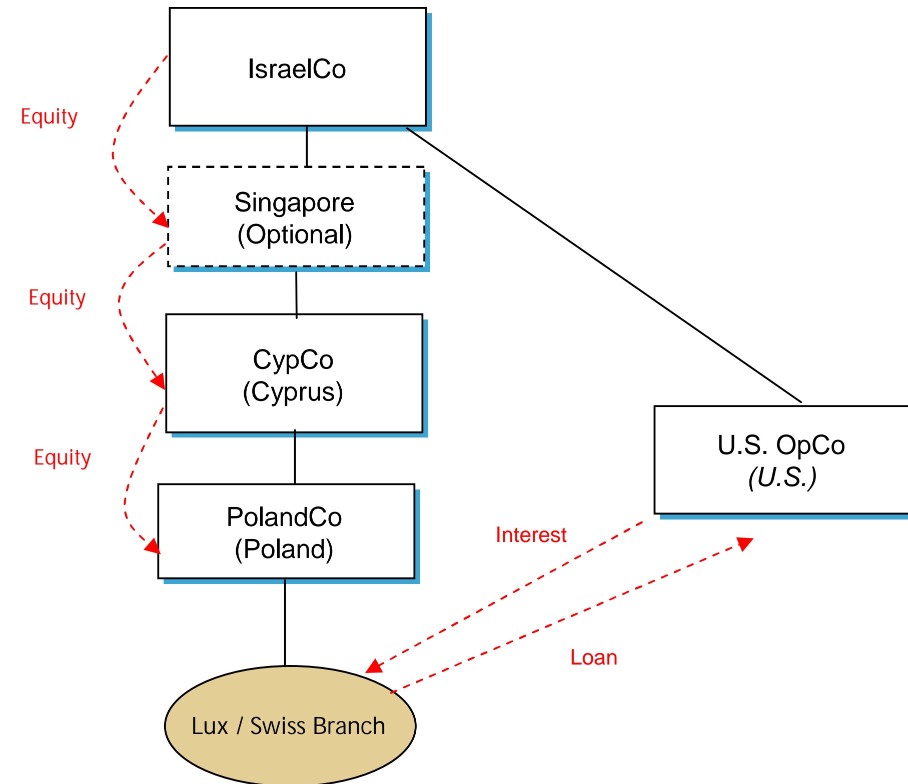
POTENTIAL BENEFITS

- Interest income should be deductible in the U.S. at full rates.
- Interest income should be taxable in PolandCo's Luxembourg branch at a favorable rate.
- Dividends paid by Poland to Cyprus should be subject to 0% withholding. Dividends received by Cyprus should not be taxed in Cyprus, and should not be subject to withholding tax on distribution to Singapore.
- No additional tax in Singapore. Until 2007, no additional tax in Israel on dividends from Singapore. Gerry – do we need to use a shelf company?
- PolandCo should achieve a reduced level of taxation (0.95%). Combined tax rate of approximately 3.5%

CONSIDERATIONS

- Polish capital tax (0.5%) can be managed.
- No LOB provision in the Poland-U.S. Tax Treaty.
- Need to get rulings from Poland taxing authorities. Legislation in Poland was signed into law on July 22, 2004 that allows binding rulings in Poland beginning in 2005.
- US treasury has announced its intention to begin renegotiation of current tax treaties that do not contain a limitation of benefits clause, including the U.S.-Poland income tax treaty.
- Israel/ Singapore treaty benefits available for limited time. Without Singapore, incremental Israeli tax @25%.

Similar structures can be implemented with Iceland and Hungary, instead of Poland



# U.S. - German REPO Structure

**TRANSACTION STEPS**

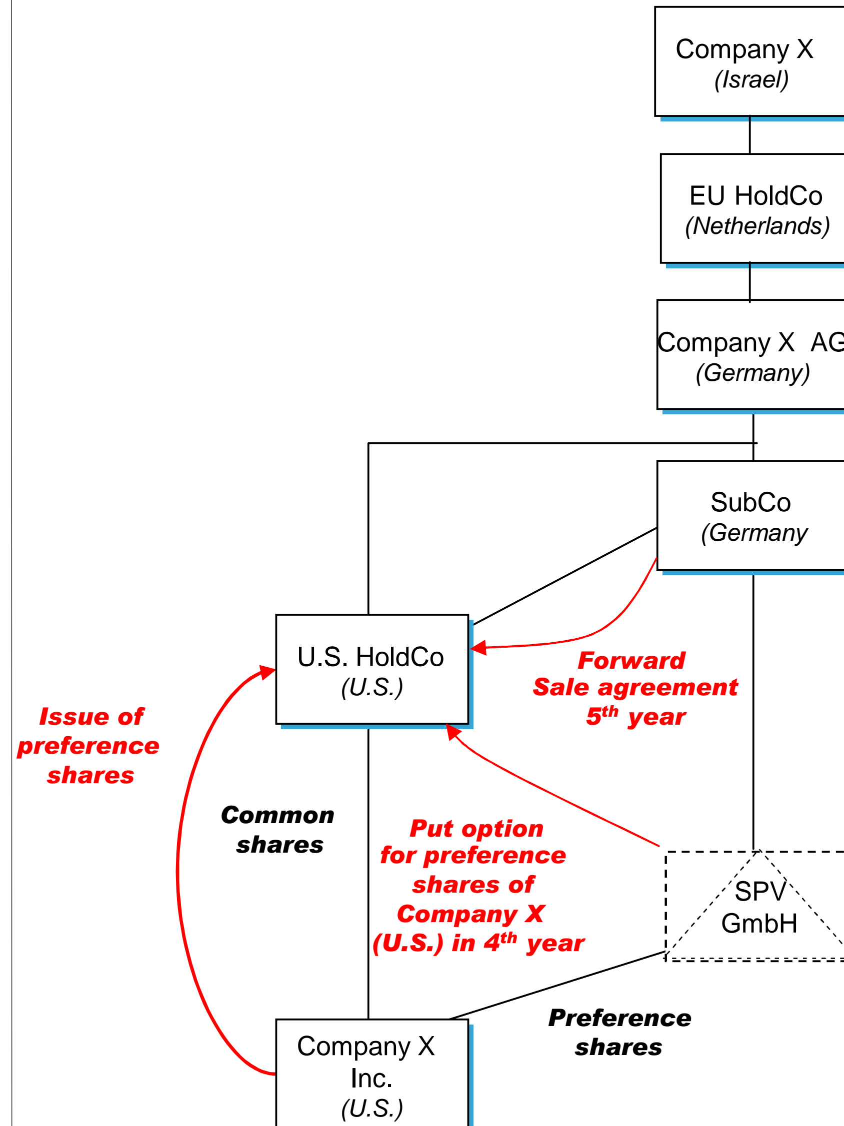
1. Company X SubCo forms SPV GmbH.
2. Company X North America Inc. grants Preference Shares to U.S. HoldCo.
3. U.S. HoldCo sells the Preference Shares to SPV and grantsSPV the right to enforce the sale of the Preference Shares in 4 years to U.S. HoldCo (Put-Option).
4. Simultaneously, Company X SubCo (Germany) agrees to sell its shares in SPV to U.S. HoldCo at a point in time in 5 years (Forward Sale Agreement).

TAX CONSEQUENCES

- For U.S. HoldCo, the transaction is seen as a true securities sale and repurchase agreement which for tax purposes is treated as a loan. Dividend payments on the Preference Shares are deductible as interest expense.

CONSIDERATIONS

- The Preference Shares should represent equity at the level of SPV GmbH.
- Payments to SPV GmbH under the REPO arrangement should constitute tax-exempt (95%) dividends received for German income tax purposes.
- Depending on further details of the structure, consider potential impact of new Government legislation, particularly in the area of thin capitalization, domestic dividend received, and capital gains taxation.
- From an Israeli perspective, SPV GmbH should not be a CFC, given the mechanics of the German participation exemption regime.
- Qualification of SubCo Germany to benefits of the US/ Germany treaty?



# Inbound "Building Block" - Treaties

## TREATY UPDATE

### Barbados Protocol

- On October 10, 2004, the Senate approved a protocol to the U.S.-Barbados income tax treaty. The Protocol updates the existing Convention to bring it into close conformity with current U.S. tax treaty policy and to ensure that the Convention cannot be used inappropriately to secure tax reductions in circumstances where there is no risk of double taxation. The Protocol modernizes the Convention's anti-treaty-shopping provision. The protocol has entered into force and is generally effective for taxable years beginning on or after January 1, 2005. For withholding taxes the protocol is effective as of February 1, 2005.

### Netherlands Protocol

- On November 17, 2004, the Senate approved a protocol to the U.S.-Netherlands income tax treaty. The protocol provides for a zero withholding rate on certain intercompany dividends, coordinates pension plans, and updates the exchange of information provisions. The protocol entered into force on December 28, 2004, and is generally effective as of January 1, 2005. For withholding taxes the protocol is effective as of February 1, 2005.

# LOB Provision

- Traditional treaties that contain a Limitation on Benefits (LOB) provision are: Switzerland, Luxembourg, and the U.K.
- Treasury has stated that a key continuing priority is updating the few remaining U.S. tax treaties that provide for low withholding tax rates but do not include the limitation of benefits provisions needed to protect against the possibility of treaty shopping.
- Example of current treaties with no LOB provision: Hungary, Iceland, Poland
- The LOB provision in the Israel /US treaty is relatively relaxed. In the case of a corporate shareholder, It only requires that 50% or more (vote and value) of the Israeli / US company would not be held (directly or indirectly) by individuals who are residents of a third jurisdiction. The limitation does not apply to publicly traded companies and to companies carrying on an "active trade or business" in the other jurisdiction.
- The Israel/ US treaty provides a 12.5% withholding tax rate on dividends for corporate shareholders, and a 17.5% withholding tax rate on interest.

# New Policy on Zero Withholding

- The new zero withholding on dividends measure not only furthers sound U.S. tax policy goals on cross-border investments, but it also facilitates cross-border financing and restructuring transactions that in the past have had to address the cost of a (typically) 5% U.S. withholding tax and frequently forced multinational groups to use less than optimal means to avoid the unnecessary withholding tax cost of achieving legitimate business and tax goals.
- The challenges of confronting the dividend withholding tax are quickly being supplanted by the challenges of fitting within the intricate set of rules for qualifying for the exemption

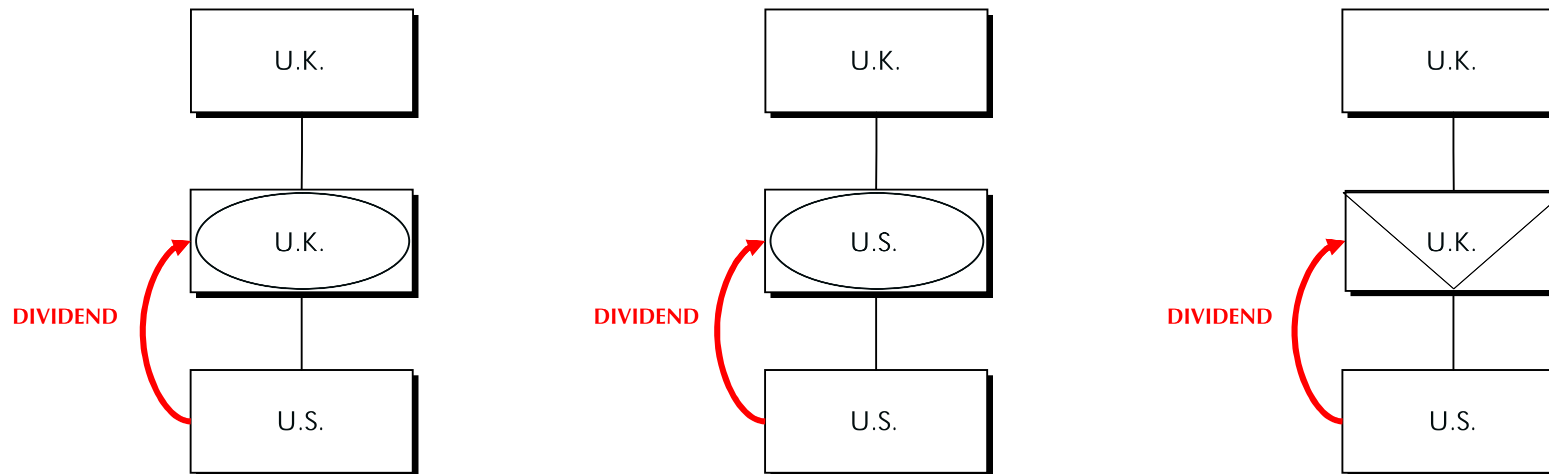
# Getting to Zero

- In its simplest description, the exemption from withholding ordinarily will apply to dividends paid by a U.S. subsidiary to its UK* parent as long as the parent owns 80 percent or more of the company paying the dividends.
- However, this statement is deceptively simple.  Amongst the issues that need to be considered are:
  - The Preliminaries (i.e., before turning to the specific criteria of Article 10(3)) and
  - Specific Criteria of Article 10(3)

*** For ease of discussion we are using the U.S.-U.K. income tax treaty as a model. This is useful also because the UK does not impose withholding tax on dividend distributions to non-residents, which makes the UK attractive for Israeli MNC's**

# Interpretive Issues – Illustration #1

## WHO IS THE "BENEFICIAL OWNER" OF THE DIVIDEND?




- The term "beneficial owner" is not defined in the U.S.-U.K. income tax treaty, and is, therefore, defined as under the internal law of the country imposing tax (i.e., the source country). The beneficial owner of the dividend for purposes of Article 10 is the person to which the dividend income is attributable for tax purposes under the laws of the source State.

# Inbound "Building Block" – Captive Insurance Company

**DESCRIPTION**

- This strategy allows for deductions in the U.S. for payments made to CaptiveCo.

**TRANSACTION STEPS**

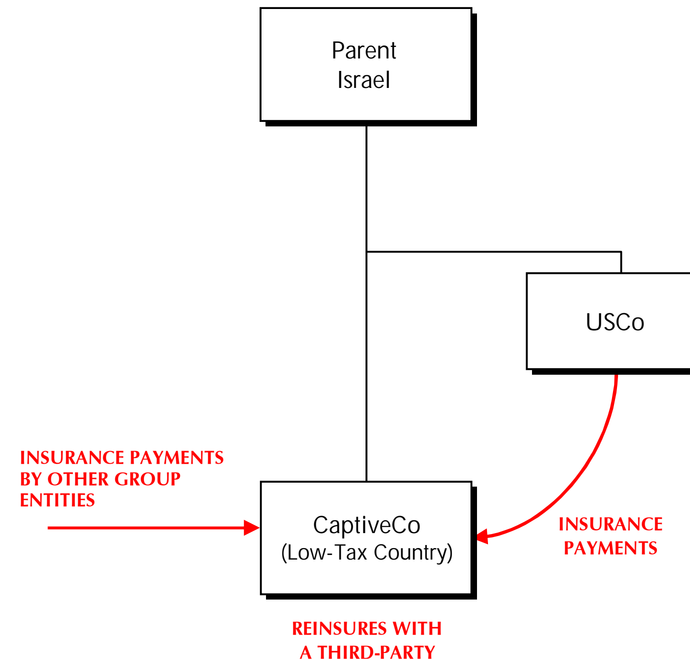
1. Establish a direct captive insurance operation or a re-insurance captive in low-tax jurisdiction.
2. U.S. Group companies will pay insurance premiums to CaptiveCo.

**BENEFITS**

- Insurance premiums paid to the captive by group companies are generally deductible at high tax rates (e.g., U.S.), while taxable income of captive is taxed at low rates.
- Israeli taxation is deferred, since CaptiveCo should not be a CFC (income is "active")
- There are significant risk management benefits, including administrative coordination, stabilization of insurance capacity and cost, as well as the potential for additional negotiating leverage with commercial insurers.

**CONSIDERATIONS / RISKS**

- Enhancing the benefits of captive market by shifting "additional risks" to the captives. Examples of these risks include receivables and installment note, credit risk, contract premium risk, hardware and software warranties, inventory (shrinkage and devaluation), environmental exposure, litigation costs, certain restructuring reserves, etc.
- Consider treaty analysis as it relates to federal excise tax on insurance premiums.
- Consider use of low-tax captive or a re-insurance captive ruling.
- Consider use of Ireland, Switzerland as alternative captive locations. Ireland has direct access to the European insurance market and has the ability to write insurance businesses in other EU states without further authorization from these states. Other alternative locations include, Barbados, Bermuda, Luxembourg and Hungary.
- Consider U.S. Supreme Court cases regarding deductibility of insurance premiums in the U.S. FSA 200105014 - "deductions for payments made to a "brother/sister" subsidiary may qualify as deductible payments.
- Consider whether the offshore captive entity will be deemed to be engaged in the conduct of a trade or business in the U.S. depending on the facts and circumstances of how the captive actually operates.
- Consider insurance regulatory provisions.



# Business Benefits of a Captive Insurance Company

- Risk Management Advantages from Captive Insurance Company
- Achieve economies of scale by centralizing volume based activities and support systems
- Ability to obtain tailored coverage
- Access to reinsurers as conditions warrant
- Establishing a Captive in a domicile such as Bermuda or Vermont will provide access to experienced captive managers and access to information regarding the use of captives from an international perspective
- The Captive may retain other 3rd party insurance coverages such as extended warranty and employee benefits
- Obtain greater control over the cost of insurance at the subsidiary level which allows local management to focus more freely on real business issues

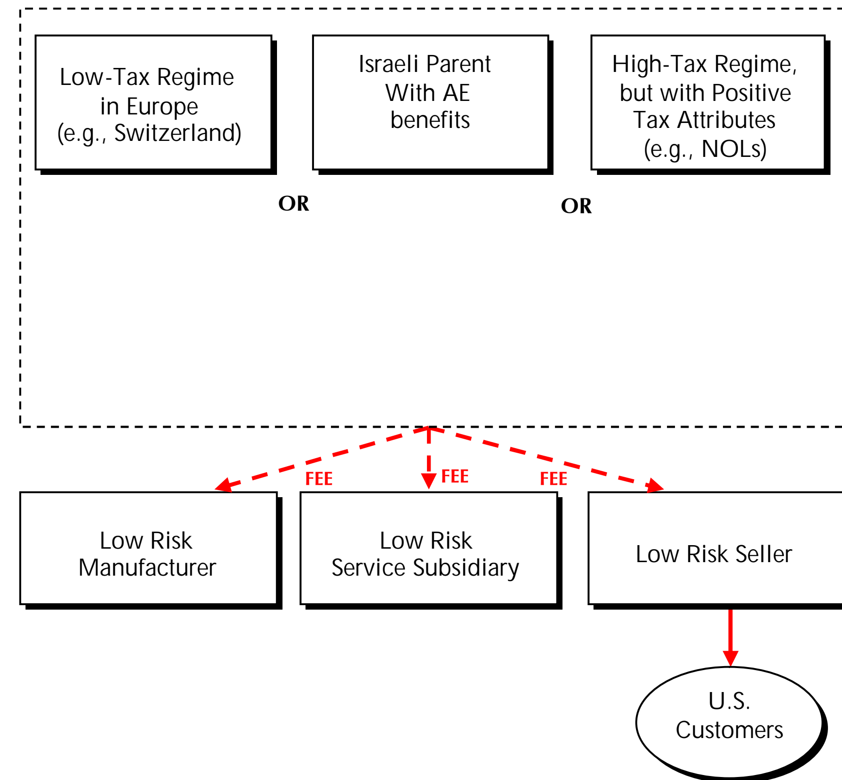
# Inbound "Building Block" – Global Structure Alignment

**TABLE OF CONTENTS**


- Manufacturing and Sales Structures
  - Permanent Establishment
  - OECD Discussion Draft on the Attribution of Profits to Permanent Establishment
  - Manufacturing Structures
    - Contract Manufacturing ("Buy-Sell")
    - Toll Manufacturing
  - Sales Structures
    - Limited Risk Buy / Sell Distributor / U.S. Distribution Center for Export Customers
    - Commissioned Agent
- Services
  - Shared Services
  - Core Services

# Global Structure Alignment – Inbound Location of the Foreign Principal

- A key question is whether to establish a new foreign principal for the North American region or to "piggyback" onto an existing foreign principal.
- Business considerations may constrain the use of an existing foreign principal that is not located in the Americas.
- If business considerations or the lack of an existing foreign principal somewhere within the group dictate the creation of a new foreign principal for the American region, a second key question will be where to locate this foreign principal.
- The core and strategic nature of the functions performed by the foreign principal will mean that pragmatic commercial considerations will be emphasized when choosing its location.
- A threshold tax consideration in choosing the location of a foreign principal is the existence of a low-tax regime or the presence of significant or recurring positive tax attributes e.g. net operating losses ("NOLs").



# Inbound "Building Block" – State & Local Tax Issues Affecting U.S. Inbound Companies

- Nexus
- Permanent Establishment
- Add-Back Legislation

# Inbound "Building Block" – Transfer Pricing Developments

- Proposed regulations on ownership of intangibles and intercompany services.
- Upcoming proposed regulations regarding compensation for the transfer of intangibles ("buy-in" regulations)
- Proposed regulations replace current ones that have been in place since the 1960s.
- Current regulations provide that where one party performs services for the benefit of, or on behalf of a related party, an arm's length amount must be charged
- Proposed regulations adopt OECD standard – benefit tested at the recipient level
- Taxpayers must focus on distinguishing between direct and indirect benefits. Indirect, remote, generalized or non-specific benefits do not qualify as a benefit to the recipient.
- Proposed regulations do not address cost contribution arrangements
- Narrower definition of stewardship costs

PRICEWATERHOUSECOOPERS

# US Tax Seminar

## Legislative update and US inbound planning opportunities for Israeli multinationals, in view of Jobs Creation Act 2004

David Intercontinental, Tel Aviv,
January 2005