ISRAELI - US TRANSFER PRICING SEMINAR

US - Israel Perspectives: Digital Economy and Intangibles

*This presentation is offered for informational purposes only, and the content should not be construed as legal advice on any matter.
BEPS timeline

1997
The EU Code of Conduct for business taxation

1998
Harmful Tax Competition: An Emerging Global Issue (OECD)

2000
Progress in Identifying and Eliminating Harmful Tax Practices (OECD)

2010
Addressing Tax Risks Involving Bank Losses (OECD)

2011
Corporate Loss Utilisation through Aggressive Tax Planning (OECD)

2011
Tackling Aggressive Tax Planning Through Improved Transparency and Disclosure (OECD)

2012
European Commission Action Plan to strengthen the fight against tax fraud and tax evasion

2013
Addressing Base Erosion and Profit Shifting (OECD)

2013
Action Plan on Addressing Base Erosion and Profit Shifting (OECD)

2015
Delivery of final deliverables
Avoidance of PE (Action 7): What is the issue?

The permanent establishment is the cornerstone of the international tax system

Fragmentation of activities to preclude the establishment of a PE
- Relies on the preparatory and auxiliary exclusion
- Precludes the local tax authority asserting taxing rights over income from its jurisdiction
- Need for greater recognition of significant activity of intermediaries

Proliferation of commissionaire arrangements
- Move away from full-risk distribution
- Interpretation of treaty rules on dependent agency PE allows for transactions to be substantially negotiated and concluded without the profits from corresponding sales being taxed locally
Avoidance of PE (Action 7): What is the issue?

OECD follows its initial Option B which states:

[W]here a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts, or negotiates the material elements of contracts, that are

- in the name of the enterprise or
- **for the transfer of the ownership of**, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use or
- for the provision of services by that enterprise

that enterprise shall **be deemed to have a permanent establishment** in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provision of that paragraph.
Avoidance of PE (Action 7): What is the issue?

Commissionaire Arrangements

- Zimmer France sells goods to customers as undisclosed agent of UK principal. UK principal regularly fulfils Zimmer France’s contracts.
- Held: Zimmer France not an Article 5(5) agent PE under France – UK treaty, because it did not conclude contracts in the name of Zimmer UK.
- Note transfer pricing advantages of the commissionaire – reduces profit level of French entity as compared to a full risk or limited risk distributor.

Diagram:

- French Customers
- Zimmer France SAS
- Contracts of Sale in name of Zimmer France
- $ Minus Commission
- Zimmer UK Ltd
- Fills orders on behalf of Zimmer France
- $
Avoidance of PE (Action 7): What is the issue?

What is the impact on (existing) commissionaire arrangements?

- The revised model commentary to Article 5 explicitly addresses in its new mn 32.8 the use of civil law commissionaire agreements
- This means that the OECD puts an end to the entire discussion about commissionaires by characterizing them as a permanent establishment unless they qualify as independent agents
- The OECD noted that the revised provisions do not reflect the views of the OECD or any country concerning the interpretation of the existing provisions
- However, it can be assumed that many countries will take the position that the revised rules merely confirm the approach they had been taking in the past
Avoidance of PE (Action 7): What is the issue?

What is the impact on (existing) commissionaire arrangements (cont’d)?

Status of commissionaire depends on the particular country involved and local interpretations. For example, several recent cases have addressed the commissionaire:

- *Boston Scientific* (Italy 2012) (not a PE)
- *Dell* (Spain 2012) (commissionaire was a PE)
- *Dell* (Norway 2011), rev’g lower court (not a PE)
- *Zimmer* (France 2010), rev’g lower court (not a PE)
Avoidance of PE (Action 7): What is the issue?

Treaty Provisions – Article 5 Permanent Establishment

- Articles 5(1) and 5(2) – basic test of PE
- Article 5(3) – exceptions for the test: including for preparatory and auxiliary activities
- Articles 5(5) and 5(6) – treatment of agents of NRE
- Article 5(8) – a subsidiary / affiliate is not in itself a PE of related parties

Treaty Provisions – Article 8 Business Profits

- Article 7(1) – only profits attributable to the PE are taxed
- Articles 7(2), 7(3), 7(5) and 7(6) – apply as quasi-arm’s-length approach to determining profits attributable to a PE
- Article 7(4) – no profits attributable to purchasing activity
Avoidance of PE (Action 7): What is the issue?

Basic Definition and Agency PE

- Article 5(1) - the term “permanent establishment” means a fixed place of business through which a resident of one of the Contracting States engages in industrial or commercial activity.

- Articles 5 (8) provide that the fact that a resident entity is owned or controlled by the NRE shall not be taken into account in determining whether either company has a PE in the other state. A subsidiary is not in itself a PE; however, its activities may give rise to a PE under the same standards applicable to an unrelated party.

- Article 5(5) provides that where a person, other than an agent of independent status, acts on behalf of the NRE and has and habitually exercises in the contracting state an authority to conclude contracts that are binding on the NRE, then the NRE will have a PE in respect of the agent’s activities, unless the agent’s activities are preparatory or auxiliary.

- Article 5(6) provides an exception for activities of a broker, general commission agent, or other agent of independent status acting in the ordinary course of business.

- A Subsidiary is per se a dependent agent, as a matter of planning, so key question will be whether the subsidiary exercises contracting authority.
Avoidance of PE (Action 7): What is the issue?

The agency PE test has several key elements:

- **Authority to conclude contracts** – key is negotiation and conclusion of binding agreement; more than merely participating in negotiations; but signing contract is not necessary or sufficient

- **Habitually exercise authority in the state** – no bright line rules. However, activities must be performed in the state of source

- **Agent of independent status** – two-part test to determine independence: (1) legally independent and free from control and (2) economically independent and bearing business risk

- **More than preparatory / auxiliary activities** – *e.g.*, agent whose activities are limited to solely purchasing goods on behalf of the NRE is OK
Avoidance of PE (Action 7): What is the issue?

Spectrum of source country activities

- Little or no contracts
  - No direct activities
  - Remote activities
- Extensive contracts
  - Transitory activities
  - Limited function office
  - Full office

- License IP to subsidiary or third party
- Sell to local customers over internet
- Traveling employees
- Local office for promotion & market intelligence
- Sales activity
- Earn investment returns
- Advertise locally
- Site/ customer visits
- “Rep office”
- Manufacturing
- Trade shows
- Management
Avoidance of PE (Action 7): What is the issue?

Digital economy

- Different business models to bricks and mortar businesses
- The concept of permanent establishment has not kept pace with the development of the digital economy
- Need to ensure that core activities cannot inappropriately benefit from the exceptions from the definition of PE
Avoidance of PE (Action 7): What is the issue?

Recent cases and administrative rulings

- *Ebay (India Oct. 2012).* Indian tribunal ruled that *Swiss company did not have PE in India on income earned from use of online marketing platform in India.* Local subsidiary provided marketing and support services, but did not negotiate and conclude contracts on behalf of the Swiss NRE. Reversing lower court, the tribunal held that Indian marketing sub’s activities related to online sales did not include contracting in name of NRE, and thus did not create a PE. NRE’s non-Indian personnel concluded all contracts with end-users. It appears that the server was located outside of India

- *Dell (Spain 2012).* Irish principal sold products through online store managed and operated out of France. Spanish sub marketed and supported sales to mid- and large-sized customers. *Spanish court found online store to be a Spanish PE,* despite lack of servers or physical facilities in Spain. Court also found that Spanish Sub’s activities such as trading, selling, and delivery of products, gave rise to an agency PE. Court dismissed taxpayer’s reliance on OECD commentary
Avoidance of PE (Action 7): What is the issue?

Recent cases and administrative rulings (cont’d)

- **Canadian ruling (2012-0432141R3).** US Parent formed Canadian subsidiary to own and operate a data center for its online business. Canadian Sub employed data center personnel and charged USP an arm’s length service fee. Held: US Parent did not have a permanent establishment. Note US Parent employees’ ability to remotely access the servers to install software, monitor software and hardware performance, etc., did not place servers at USP’s disposal.

- **Swedish Tax Board ruling (2013).** Foreign Parent Y formed Foreign Subsidiary X. X leased premises and operated a server in Sweden. X used the server to store software applications belonging to Y. The operation was fully automated and controlled remotely by non-Swedish employees. Held: X had a PE in Sweden consisting of using servers to provide storage services. Y, however, did not have a PE. The Swedish tax authorities are appealing this ruling.
Avoidance of PE: Israel Draft Circular on PE and digital economy

Establishes a wide range of activities/facts that can create a PE. States that the Israeli PE will be according to its own criterion with no regard to any specific Israeli tax treaty

- If, in addition to the facility in Israel, the foreign corporation operates a website adapted for Israeli customers (language, publications, style, currency, etc.)
- If the website connects Israeli customers with Israeli suppliers/service providers
- If the website is highly popular among Israeli users
- If the profitability of the website increases with the number of users and the scope of their activity
- If representatives of the foreign corporation in Israel, assisted by the Israeli facility, are involved in customer recruitment or data collection
- Customer Relations Management – if an ongoing relationship exists between the representatives of the foreign corporation, assisted by the Israeli facility, and Israeli customers (e.g., organizing customer conferences, creating opportunities to present new products, development of the service provided to the customer, providing feedback to the foreign corporation with respect to its performance in the local market, etc.)
- If there are significant marketing and support services provided in Israel through a representative of the foreign corporation
- If the foreign corporation bears business risks in Israel
Avoidance of PE: Israel Draft Circular on PE and digital economy

Effectively widens the Israel: tax net for both PE purposes and VAT purposes

- A foreign entity establishing an Internet site in Hebrew effectively creates a PE and an obligation to register as business for VAT purposes
- If the level of marketing and support activities are “substantive” as performed by the foreign connecting agent
- Reliance on the OECD Guidelines, and in particular functions, assets and risks (FAR)
  - Look to significant people functions
  - Looking at attribution of profits (*i.e.*, profit split)
  - Cost plus if the profit split does not work
Avoidance of PE: Israel Draft Circular on PE and digital economy

Effectively widens the Israel: tax net for both PE purposes and VAT purposes

- Failure to register as an Israeli business can be subject to criminal penalties
  - Clear that for VAT, severe implications
  - For transfer pricing, a need for good functional analysis
- VAT is a central issue for digital economy PE assessment
- ITA is requesting profit split analytics on all issues pertaining to PE and digital economy
Transfer Pricing Aspects of Intangibles/Cost Contribution Arrangements:
OECD Guidelines, Israel and the US
OECD approach on intangibles (intangibles, business restructuring and cost contribution agreements)

Focus on ensuring that transfer pricing outcomes are in line with value creation

Rules to prevent BEPS by moving intangibles among group members

- No true clear definition of intangibles – note that not according to accounting rules or even business rules
- Ensure profits associated with transfer and use of intangibles are appropriately allocated in accordance with value creation, and with risks
- Update guidance on cost contribution arrangements
OECD approach on intangibles: capital and risk

Per Discussion:

- Financial capacity to bear risk is relevant – but not a determinative factor – for considering whether a controlled party should be allocated a risk return. Both “control” and “financial capacity”

- Because MNE groups can control legal structure, capital structure, ownership of assets, and contractual arrangements, arm’s length nature of resulting transactions linked to whether or not arrangements among the parties are arm’s length

- Transfer rules that rely on actual functions performed in relation to assets may result in determination that:
  - Little or no return is attributable to the asset-rich, asset-owning company and (in some cases)
  - Resulting intra-group transactions relating to the company’s assets should not be recognized

- Situations where arm’s length principal difficult to apply – e.g., allocation of excess returns to capital-rich, asset-owning company
OECD approach on intangibles: capital and risk

Risk bearing vs. intangibles

- Risk bearing is core business for banks and insurance companies
- BEPS guidance broadens the definition of intangibles and makes it easier for tax authorities to assess economic ownership of intangibles
- Separation of returns attributable to intangibles vs. returns attributable to risk-bearing
- A comparison of return on assets over time indicates that intangible-rich companies (pharmaceutical, technology) consistently earn a significantly higher return on assets than banks

- Suggests that pharmaceutical and technology companies are earning returns from assets not on the balance sheet
- Banks earn (modest) returns on balance sheet assets
OECD approach on intangibles: intangibles

New transfer pricing guidelines chapter: special considerations for intangibles

- Goodwill/ongoing concern value
  - Not defined, but "importantly and monetarily significant part of the compensation" in asset transfers
  - Purchase price allocation residual not necessarily appropriate measure

- Overview of valuation techniques
  - Forecasts are important
  - Discount rates (WACC not necessarily the appropriate measure)
  - Life of technology
OECD approach on intangibles: intangibles

Action Item Report is somewhat disappointing as so much remains to be finalized

Definition of intangible concerns:

- “[S]omething which is not a physical asset or a financial asset which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.”
- Does not correspond with a legal or even an accounting definition
- Very broad:
  - Ownership is not the only means by which an intangible will be recognized for transfer pricing purposes
  - Controlling an intangible for commercial use will also result in transfer pricing considerations
Israel adoption of OECD Action on intangibles and on OECD business restructuring action

Issuance of business restructuring circular that deals with IP transfers in the context of acquisitions/restructurings

- Note the “intangible assets that are transferred, bestow an appropriate platform on the Receiving Company for the continuation of its activities and the right to the cash flows from those assets. In the framework of this transfer, ownership rights to existing assets are transferred, such as: existing technology, protected and/or unprotected as a patent, technological know-how, technology in various stages of development and future rights to the technology (goodwill of the future technology), marketing assets such as copyrights and trademarks, contacts of existing and future customers (goodwill of future customers), etc.”

Israeli business restructuring is more pertinent to Chapter VI intangibles movement

- Their perspective pertains to high-tech companies where true risk restructuring has yet to be worked on because the product is still in development
Israel adoption of OECD Action on intangibles and on OECD business restructuring action

Look at latest Israel RFP

Note the assessment of risk requalification, synergies, and goodwill

- Not exactly in coordination with OECD
- Is it in coordination with U.S.? How would a Competent Authority discussion play out?
  - Items 8 iv. and 8 v.: OECD labels these both as synergies. ITA desires to make 8 iv. pertain to the acquired entity
  - Are synergies or other market specific characteristics per OECD “intangibles” that can be transferred?
- Winner’s curse (control premium….)
- Valuation concepts of going concern and goodwill are different, and ITA merging them
Criteria of Israel RFP on business restructuring

Israel statements that not necessarily in line with OECD

- The share purchase price – in a transaction between unconnected parties – is the single arm’s length price—ITA argues that this price is a Comparable Uncontrolled Price – opines that the purchase price represents the total value of the company’s assets etc.
  - Winner’s Curse?
  - Founder premiums?
- The “goodwill” in the PPA is not generally analogous to “goodwill” for tax purposes in Israel, nor to “goodwill” which is defined in Chapter VI. The value attributed to reputation and to a “going concern” cannot be separately transferred, but is necessarily transferred at the time of the transfer of the enterprise
- Items 8 iv. and 8 v.: OECD labels these both as synergies. ITA desires to make 8 iv. pertain to the acquired entity
  - The price reflects the value of expected cash flow from the acquired enterprise. To the extent that the acquisition creates cash flow within the purchaser’s system … this is an integral part of the acquired assets. ... (if) the purchasers could not foresee the specific synergistic effects on the purchaser – the amount paid in the transaction does not include consideration in respect of these effects
- …it is said that success of an acquired enterprise later on is assisted by know-how, brands, and the marketing, organizational, and managerial infrastructure, of the multinational company …it is said that the ability to financially support the continued operations of the acquired enterprise belongs to the purchasing group. …the position of the OECD as well as the Tax Authority’s position, the existence of synergy is a comparative factor which has an effect on the value of the functions, assets, and risks in the purchased company...and of the functions, assets, and risks transferred at the time of the change in business model
ISRAELI - US TRANSFER PRICING SEMINAR

US – Israel Business Restructuring Case Study

*This presentation is offered for informational purposes only, and the content should not be construed as legal advice on any matter.
Case study

- You are the tax director of Global Video, Inc., a publicly traded U.S. MNE in the field of broadcast video and media technologies. Market cap of $10 billion. You have a cost sharing agreement in place between US and Switzerland (covering IP in the rest of the world)

- Your M&A team has placed a bid on a smaller but growing Israeli parent company in your industry with promising technology and a strong workforce. This company, Bcast Ltd., is a public company on AIM with a market cap of $230 million

- An Israeli tax investigation into Bcast has been going on already for 3 years, based on an IP migration of its Israeli technology to the Swiss company. Your company bid $250 million, but this potential liability arose and you are being asked to assess the potential liability for purposes of renegotiating the deal

- **Goal:** Provide an assessment of the potential tax liability based on the due diligence TP work to be presented to you herein by the DLA Piper and Economics Partners TP professionals
Case study facts

- Bcast has been assessed with a $193 million income adjustment based on a business restructuring (i.e., IP movement, and transfer of risks). Bcast in Israel has an approved enterprise status at 16% tax rate.

- At time of the restructuring (last qtr 2008), market cap was $230 million.

- Bcast had distribution entities throughout Europe and in North America. Goal is to move into Middle East and Asia. Argued that an Israeli IP entity creates business friction. Declining royalty over six years that averages 10% over period based on forecasts. Life of technology deemed to be 6 years.

- Company value drivers include manufacturing know-how (uses outsource provider), technological IP, customer relations (distribution), trade name, strategic management.

- Swiss entity in 2008 had one relatively senior person. As of today, one senior R&D person and four senior sales and marketing persons. Sales and marketing is driving the technological innovation today.

- EP an DLA Piper provide some analyses for you to then assess the liability for a reduction in purchase price.
Data relied on (and actuals)

### Bcast Forecasts as of 2008 for Study that performed

<table>
<thead>
<tr>
<th>In $000</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$29,966</td>
<td>$68,409</td>
<td>$77,644</td>
<td>$90,441</td>
<td>$101,658</td>
<td>$104,708</td>
</tr>
<tr>
<td>COGS</td>
<td>$1,875</td>
<td>$4,279</td>
<td>$4,856</td>
<td>$5,656</td>
<td>$6,358</td>
<td>$6,549</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>$28,091</td>
<td>$64,130</td>
<td>$72,788</td>
<td>$84,785</td>
<td>$95,300</td>
<td>$98,159</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>$6,577</td>
<td>$15,011</td>
<td>$17,037</td>
<td>$19,845</td>
<td>$22,306</td>
<td>$22,975</td>
</tr>
<tr>
<td>SG&amp;A</td>
<td>$12,986</td>
<td>$29,202</td>
<td>$32,569</td>
<td>$37,618</td>
<td>$41,459</td>
<td>$42,703</td>
</tr>
<tr>
<td>Operating Profit</td>
<td>$8,528</td>
<td>$19,917</td>
<td>$23,182</td>
<td>$27,322</td>
<td>$31,535</td>
<td>$32,481</td>
</tr>
</tbody>
</table>

### Actual Results

<table>
<thead>
<tr>
<th></th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$14,983</td>
<td>$34,205</td>
<td>$38,822</td>
<td>$45,221</td>
<td>$50,829</td>
<td>$52,354</td>
</tr>
<tr>
<td>COGS</td>
<td>$938</td>
<td>$2,140</td>
<td>$2,428</td>
<td>$2,828</td>
<td>$3,179</td>
<td>$3,274</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>$14,046</td>
<td>$32,065</td>
<td>$36,394</td>
<td>$42,393</td>
<td>$47,650</td>
<td>$49,080</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>$6,577</td>
<td>$11,258</td>
<td>$11,074</td>
<td>$10,915</td>
<td>$11,153</td>
<td>$11,488</td>
</tr>
<tr>
<td>SG&amp;A</td>
<td>$12,986</td>
<td>$29,202</td>
<td>$32,569</td>
<td>$37,618</td>
<td>$41,459</td>
<td>$42,703</td>
</tr>
<tr>
<td>Operating Profit</td>
<td>-$5,518</td>
<td>-$1,095</td>
<td>$893</td>
<td>$7,026</td>
<td>$15,768</td>
<td>$16,241</td>
</tr>
</tbody>
</table>
ITA approach

- ITA looks at forecasts, and relies on discount rate to derive the market cap of the company (discount rate 15%). ITA then looks at total forecasted profits and deducts routine profits for R&D and distribution. The residual profit is used to create a value of the IP transferred, i.e., $193 million. [What was transferred per ITA was IP, and market risks that were borne by Bcast-IL]
- ITA argues that the IP was “sold,” so a capital gains tax should be applied, rather than the approved enterprise tax rate
- Case is at second level of ITA review and an assessment has been leveled, and preparation for court is beginning
- Swiss entity has no “substance” per BEPS. Main persons in Israel

<table>
<thead>
<tr>
<th></th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forecast Operating Profit</td>
<td>$8,528</td>
<td>$19,917</td>
<td>$23,182</td>
<td>$27,322</td>
<td>$31,535</td>
<td>$32,481</td>
</tr>
<tr>
<td>Normative Contract R&amp;D Return</td>
<td>7%</td>
<td>$460</td>
<td>$1,051</td>
<td>$1,193</td>
<td>$1,389</td>
<td>$1,561</td>
</tr>
<tr>
<td>Normative Distribution Return</td>
<td>3%</td>
<td>$899</td>
<td>$2,052</td>
<td>$2,329</td>
<td>$2,713</td>
<td>$3,050</td>
</tr>
<tr>
<td>Residual Forecast Profit - Bcast IP</td>
<td>$7,169</td>
<td>$16,814</td>
<td>$19,660</td>
<td>$23,220</td>
<td>$26,924</td>
<td>$27,732</td>
</tr>
<tr>
<td>Percent of Sales</td>
<td>23.9%</td>
<td>24.6%</td>
<td>25.3%</td>
<td>25.7%</td>
<td>26.5%</td>
<td>26.5%</td>
</tr>
<tr>
<td>Net Present Value on Residual Forecast Profit</td>
<td>$6,922</td>
<td>$14,119</td>
<td>$14,355</td>
<td>$14,743</td>
<td>$14,865</td>
<td>$13,314</td>
</tr>
<tr>
<td>Terminal Value</td>
<td>0.25</td>
<td>1.25</td>
<td>2.25</td>
<td>3.25</td>
<td>4.25</td>
<td>5.25</td>
</tr>
<tr>
<td>Bcast IP Transferred</td>
<td>$193,215</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Copyright 2016; All Rights Reserved

www.dlapiper.com
Bcast arguments

- IP has a discrete life of 5 to 6 years. IP needs to continually be modified and renewed

- Royalty payment entered into to ensure that appropriate compensation was to be made to Bcast-IL, and actual results provided Bcast-IL with above normal profits

- Bcast has other value drivers that ITA has failed to value (trade name, customer relationships, strategic management)

- IP needed to be moved or the company could not continue to grow based on geopolitical issues

- Company did not perform as expected due to severe market competition and difficulty in convincing potential customers to adapt to a more advanced product (a conservative industry that is slow to adapt to change regardless)
DLA Piper and EP Economic assessments

- Acquisition price method
  - Argue that not truly appropriate. We are measuring only the Israeli IP. ITA argues that Bcast-Ltd. is the primary entity in the group and we need to compute its “going concern” value, which includes goodwill that it computes
  - Two APM models. Each allocates residual goodwill among the value drivers. Difference in two models is in the life of the technology (second model accords to ITA that there is some “lasting” life at 2% of sales for the technology “platform”)
  - Complete ITA approach adjusted with other Bcast value drivers yields IP value of $115 million. Adjusting ITA argumentation that the royalty needs to decline after 6 years to a “platform” rate yields an IP value of approximately $90 million

<table>
<thead>
<tr>
<th>According to ITA with Indeterminate Life</th>
<th>Adjusted APM with Goodwill</th>
<th>Not Interminable Life for technology</th>
<th>Adjusted APM with Goodwill</th>
</tr>
</thead>
<tbody>
<tr>
<td>APM</td>
<td></td>
<td>APM</td>
<td></td>
</tr>
<tr>
<td>Company Value</td>
<td>$230,000</td>
<td>Company Value</td>
<td>$230,000</td>
</tr>
<tr>
<td>Customer List (Distribution)</td>
<td>$38,372</td>
<td>Customer List (Distribution)</td>
<td>$38,372</td>
</tr>
<tr>
<td>Normative R&amp;D Return</td>
<td>$19,646</td>
<td>Normative R&amp;D Return</td>
<td>$19,646</td>
</tr>
<tr>
<td>Strategic Mgmt</td>
<td>$15,744</td>
<td>Strategic Mgmt</td>
<td>$15,744</td>
</tr>
<tr>
<td>IP @ 10%--terminal life</td>
<td>$74,072</td>
<td>IP @ 10%--terminal life</td>
<td>$74,072</td>
</tr>
<tr>
<td>Residual</td>
<td>$82,166</td>
<td>Residual</td>
<td>$82,166</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$115,241</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>$116,872</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>$0</td>
<td></td>
</tr>
</tbody>
</table>
DLA Piper and EP Economic assessments

- License argument – NO adjustment or mild adjustment

  - DLA and EP argue that the 10% royalty is arm’s length and the life is arm’s length. No adjustment at all is warranted

  - If there is an adjustment, it would be on the “platform” payment that Bcast-Swiss needs to continue to pay a 2% platform royalty. We can pay via license or simply outright buy it for $17.6 million (see previous slide)

  - DLA and EP admit to an issue with Swiss substance, at least in the beginning
DLA and EP Economic assessments

BEPS Economically Viable Alternatives

- The arm’s length principle requires an evaluation of the conditions made or imposed between associated enterprises, at the level of each of them. The fact that the cross-border redeployment of functions, assets and/or risks may be motivated by sound commercial reasons at the level of the MNE group, e.g., in order to try to derive synergies at a group level, does not answer the question whether it is arm’s length from the perspectives of each of the restructured entities.

- The reference to the notion of options realistically available is not intended to create a requirement for taxpayers to document all possible hypothetical options realistically available….when undertaking a comparability analysis, there is no requirement for an exhaustive search of all possible relevant sources of information. Rather, the intention is to provide an indication that, if there is a realistically available option that is clearly more attractive, it should be considered in the analysis of the conditions of the restructuring.

- EP and DLA Show according to realistic available options that looking back, the license agreement was the best option for Bcast-IL.

<table>
<thead>
<tr>
<th>Actual Results</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$14,983</td>
<td>$34,205</td>
<td>$38,822</td>
<td>$45,221</td>
<td>$50,829</td>
<td>$52,354</td>
</tr>
<tr>
<td>COGS</td>
<td>$938</td>
<td>$2,140</td>
<td>$2,428</td>
<td>$2,828</td>
<td>$3,179</td>
<td>$3,274</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>$14,046</td>
<td>$32,065</td>
<td>$36,394</td>
<td>$42,393</td>
<td>$47,650</td>
<td>$49,080</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>$6,577</td>
<td>$11,258</td>
<td>$11,074</td>
<td>$10,915</td>
<td>$11,153</td>
<td>$11,488</td>
</tr>
<tr>
<td>SG&amp;A</td>
<td>$12,986</td>
<td>$21,902</td>
<td>$24,427</td>
<td>$24,452</td>
<td>$20,730</td>
<td>$21,351</td>
</tr>
<tr>
<td>Operating Profit</td>
<td>-$5,518</td>
<td>-$1,095</td>
<td>$893</td>
<td>$7,026</td>
<td>$15,768</td>
<td>$16,241</td>
</tr>
</tbody>
</table>

| IL Royalty Received       | 10%    | 3,746  | 6,841  | 5,823  | 4,522  | 2,541  | 1,047 |
| Royalty %                 | 25%    | 20%    | 15%    | 10%    | 5%     | 2%     |
| IL Income as Percent of Total Income Earned | 74%    |
**DLA and EP Economic assessments**

**Individual group assessment**

<table>
<thead>
<tr>
<th>Approach</th>
<th>Income Adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td>ITA</td>
<td>$193,215</td>
</tr>
<tr>
<td>Revised ITA</td>
<td>$115,241</td>
</tr>
<tr>
<td>Alternative Revised ITA</td>
<td>$80,035</td>
</tr>
<tr>
<td>License Argument</td>
<td>$17,640</td>
</tr>
<tr>
<td>Realistic Options Argument</td>
<td>$0</td>
</tr>
</tbody>
</table>

**Group by group assessments**

- For the deal, what is the most realistic “settlement” number on which to negotiate a reduction in acquisition price?
  - What is the tax rate to be charged? Assume based on your “proposed” tax adjustment without interest and penalties (25% or 16%) – see Appendix A and speak to advisors

- If there is an acquisition, you will need to make a Fin 48 reserve. What will that reserve be?
  - Provide assessment of future strategies for negotiations, or even other alternatives to potentially present as arguments to ITA as preparation for court
  - Compute a “weighted” Fin 48 reserve based on the above
Appendix 1: ITA business restructuring income characterization

- A business conversion is likely to influence the tax obligations of the transferring company on a number of levels, as set forth hereunder:

- **Capital gains in respect of the assets that have been transferred** – As stated, the Income tax ordinance defines a sale, *inter alia*, as any activity or event, as a result of which an asset leaves a person’s possession in any way whatsoever. As described and set forth above, in the framework of a business conversion, all the activities and/or the ‘living business’ and/or tangible assets and/or the intangible assets, whether registered in the books of the Israeli company or not, leave the possession of the Israeli company. This move falls within the scope of a sale that requires a report to be made about the capital gains, pursuant to the provisions of the ordinance.

- In cases that have been brought to our attention, Israeli Companies that have made business conversions did not file any report at all nor did they file a report about a “selective transfer” of assets; *i.e.* specific assets that were sold to the related company, so that the report did not reflect all the assets that were transferred as part of the business conversion.

- **Royalties in respect of the assets that have not been sold** – In so far as intangible assets, that have not been transferred, remain under ownership and/or control of the Israeli company, and the Israeli company confers a right on the receiving company and/or on other related companies in the group to the use thereof, whether an agreement exists or not, income from royalties must be attributed to the Israeli company. In other words, with respect to the assets that remain in the hands of the Israeli Company, which are used by the related company, the Israeli Company is entitled to receive royalties from the receiving company that makes use of the these assets for its operations.

- **Dividend in kind** - Dividend in kind is a dividend that is paid in assets and not in cash. When the Israeli company removes assets from its possession, including intangible assets, as stated above, such a move must be deemed a distribution of the Israeli Companies assets to its shareholders, which will be classified as income from dividends in the hands of shareholders (in addition to the capital event in the hands of the transferring company). In such a case, the taxable income level among the shareholders is the market value of the assets that were removed from Israeli Company without reporting on capital gains, as stated above.
ISRAELI - US TRANSFER PRICING SEMINAR

Recent Significant Issues for Fast-Growing Companies

*This presentation is offered for informational purposes only, and the content should not be construed as legal advice on any matter.
Transfer pricing issues

- Who owns the IP?
  - Substance – legal v. economic ownership
  - Location, location, location
  - Functions, activities and risks
  - Business/operational needs – who can negotiate and sign contracts with customers
  - Other considerations: value to potential buyer

- Identify the inter-company transactions

- Selecting the appropriate model
  - Services (cost plus)
  - Low risk distributor
  - Minimize tax leakage
Transfer pricing issues

- Parent is the owner of the IP, the business entrepreneur and the ultimate risk taker
- Sub 1 provides services to be compensated on a cost plus basis / hourly rate
- Sub 2 acts as a low-risk distributor, and may enter into contract with customers on its behalf
- Special attention to the following:
  - Nature and scope of services provided
  - Authority to negotiate and conclude contracts
  - Location of senior management
Transfer pricing issues

- Arm’s length transfer pricing?
  - Service provider or distributor losses
  - Arm’s length returns
  - Startup years profit levels
  - Intercompany agreements

- Stock options on cost plus
  - Recent Israeli case law development essentially adopting the ITA’s approach that equity-based compensation should be included on the transfer pricing markup
Avoidance of PE

Basic definition and Agency PE

- Article 5(1) - the term “permanent establishment” means a fixed place of business through which a resident of one of the Contracting States engages in industrial or commercial activity

- Articles 5 (8) provide that the fact that a resident entity is owned or controlled by the NRE shall not be taken into account in determining whether either company has a PE in the other state. A subsidiary is not in itself a PE; however, its activities may give rise to a PE under the same standards applicable to an unrelated party

- Article 5(5) provides that where a person, other than an agent of independent status, acts on behalf of the NRE and has and habitually exercises in the contracting state an authority to conclude contracts that are binding on the NRE, then the NRE will have a PE in respect of the agent’s activities, unless the agent’s activities are preparatory or auxiliary

- Article 5(6) provides an exception for activities of a broker, general commission agent, or other agent of independent status acting in the ordinary course of business

- A Subsidiary is per se a dependent agent, as a matter of planning, so key question will be whether the subsidiary exercises contracting authority
Avoidance of PE

The agency PE test has several key elements:

- **Authority to conclude contracts** – key is negotiation and conclusion of binding agreement; more than merely participating in negotiations; but signing contract is not necessary or sufficient

- **Habitually exercise authority in the state** – no bright line rules. However, activities must be performed in the state of source

- **Agent of independent status** – two-part test to determine independence: (1) legally independent and free from control and (2) economically independent and bearing business risk

- **More than preparatory / auxiliary activities** – e.g., agent whose activities are limited to solely purchasing goods on behalf of the NRE is OK
# Avoidance of PE

## Spectrum of source country activities

<table>
<thead>
<tr>
<th>Little or No Contracts</th>
<th>Extensive Contracts</th>
</tr>
</thead>
<tbody>
<tr>
<td>No Direct Activities</td>
<td>Full Office</td>
</tr>
<tr>
<td>Remote Activities</td>
<td>Transitory Activities</td>
</tr>
</tbody>
</table>

- **License IP to subsidiary or third party**
- **Sell to local customers over Internet**
- **Traveling employees**
- **Local office for promotion & market intelligence**
- **Sales activity**
- **Earn investment returns**
- **Advertise locally**
- **Site/ customer visits**
- **“Rep office”**
- **Manufacturing**
- **Trade shows**
- **Management**
BEPS implications

- Even for startup companies, a need to be aware of BEPS
  - Functional and people organizational charts
  - Business plan
- Lack of planning can lead to significant exposures
Stock options

- US *Altera* cost sharing ruling and its implications

- Three recent Israel district tax court cases on inclusion of stock options
  - Inclusion
  - Expense not deductible
  - Reasonable cost plus
# Stock options – example

<table>
<thead>
<tr>
<th>cost plus</th>
<th>8%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Revenues</td>
<td>$1,620,000</td>
</tr>
<tr>
<td>2 Salaries</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>3 Other Expenses</td>
<td>$500,000</td>
</tr>
<tr>
<td>4 Stock Options</td>
<td>$300,000</td>
</tr>
<tr>
<td>5 Operating Profit</td>
<td>($180,000)</td>
</tr>
</tbody>
</table>

\[
\frac{(5 + 4)}{(2 + 3)} = \text{Net Cost Plus No Options} = 8.0\%
\]

### ITA Approach--Tax Return

| 1 Revenues | $1,944,000 |
| 2 Salaries | $1,000,000 |
| 3 Other Expenses | $500,000 |
| 4 Stock Options | $300,000 |

\[
1 - 2 - 3 = \text{Operating Profit-- Per Tax} = $444,000
\]

\[
\text{Net Cost Plus} = 29.6\%
\]
Stock options (approaches)

- Dual approach

  - Time and material (CUP)
    - How are stock options treated
    - Time invested
    - Billing rates

  - End-of-year transfer pricing adjustment
    - Tax return adjusted CPM
    - End of year adjustment
    - Relies on the “other” section of Israeli tax code
Definitions – losses

- Critically important to define your entities from a “functional” and “risk” perspective

- A factor to consider in analyzing losses is that business strategies may differ from MNE group to MNE group due to a variety of historic, economic, and cultural reasons. Recurring losses for a reasonable period may be justified in some cases by a business strategy to set especially low prices to achieve market penetration “OECD Guidelines 1.72”

- Startup entities lose money – should your marketing entity truly be earning money in the beginning?

- For contract service providers, is it really essential that the contracting entity earn money from the outset? Does a loss imply that it is “owning” IP?
**Losses and business restructuring-ITA**

- Distribution entity that has lost money for multiple years
  - Israeli market is small, and management has overcommitted on multi-year engagements
  - MNE begins to face global difficulties
  - MNE’s pricing to all subsidiaries are consistent
  - Israel affiliate has significant losses

- MNE gets acquired. New entity decides to implement new TP policy
  - Desires to provide low and positive compensation to all distributors, including Israeli affiliate
    - Have we transferred “risk” from Israel to abroad?
    - If so, does this transfer have a positive value? Does risk always have a positive value?
      - Viable alternatives per OECD
      - How would IRS deal with this versus ITA?
Appendix A – avoidance of PE

General mitigating operating guidelines

To mitigate withholding tax issues, the intercompany agreement should provide that:

- Distributor is designated as a reseller of principal/parent’s services
- Normal commercial documentation should be generated to reflect the nature of the transactions – e.g., ideally distributor will issue purchase orders to and receive invoices from principal/parent
- No substantial IP, including any source code, is being transferred to distributor, except perhaps for a limited royalty-free license to facilitate the distribution of principal/parent services. principal/parent should remain the sole owner of the core IP
- Distributor is not granted any copyrights in the software, source code or any other product of principal/parent’s services (e.g., the right to copy, the right to prepare derivative works)
- Distributor does not have access to the source code
- Distributor is not the owner of, does not control, and does not have any economic or possessory interest in, the source code and any resulting product of the services
- Principal/parent and its affiliates are responsible for the maintenance and operation of the product of the services and the source code
- Principal/parent has the sole right to update and replace the source code and any product or the services
Appendix A – avoidance of PE (cont’d)

General mitigating operating guidelines
A PE concern may exist if principal/parent’s corporate officers, participate in Distributor’s day-to-day management activities, or if distributor personnel have the authority to negotiation and conclude contracts on behalf of principal/parent. To mitigate these risk:

- Principal/parent officers activities with respect to Distributor should be limited to Board-level strategic decisions and general supervision and consulting/advisory
- Distributor should each have its own CEO/country manager and corporate officers. Principal/parent officers should not be employed by distributor (and vice versa)
- Principal/parent officers should not have the authority to negotiation and conclude contracts on behalf of distributor, nor should they hold themselves out as having such authority (and vice versa). Agreements entered into between distributor directly with customers should be negotiated independently and entered under distributor’s name and without the need for approval from principal/parent
- Principal/parent officers should not maintain and regularly exercise authority over distributor bank accounts. Principal/parent should generally not be authorized to draw on any of distributor’s bank accounts
- Distributor should not maintain a permanent work space at its offices for principal/parent officers or employees
- Separate and independent corporate identities principles and formalities should be respected and followed (e.g., separate business cards, bank accounts, books and records, regular corporate/Board meetings, actions and governing procedures/documents, telephone and other communication listings, etc.)
- Distributor contract with customers should not expressly or implicitly bind or mention principal/parent
- Distributor and principal/parent should enter into a distributor/reseller agreement
- Distributor should maintain a proper arm’s length profit margin for its reselling activities in accordance with the transfer pricing rules under Section 482 and the regulations thereunder
ISRAELI - US TRANSFER PRICING SEMINAR

Preparing for Tax Examinations or Due Diligence

*This presentation is offered for informational purposes only, and the content should not be construed as legal advice on any matter.*
Transparency

- Transfer pricing studies

- Tax opinions on structure and tax exposures

What should these documents contain?
- Disclosure of the supply chain
- Valuation studies
- Financial Information, including allocation keys where necessary
- Identification of trade or marketing intangibles, technological IP
- Intercompany agreements
- Ledgers and records of intercompany transactions and payments
How has scrutiny from tax authorities increased?

- Intellectual property data, such as:
  - IP portfolio
  - Ownership – legal and economic (many Israeli companies do not seek patents for secrecy)
  - Brand development and exploitation policies and strategies
- Functional and people organizational charts for all supply chain entities
- Intercompany agreements and licenses
- Customs data
- **Israel-specific issues**: many Israeli startups establish an empty US holding company through which investments are made and where they cost plus the Israeli R&D. In an acquisition, is the IP US owned or not?
Need for more diligent preparation

- Protecting existing structures
- Role of documentation
- How relevant are inter-company agreements
- Role of jurisprudence
- Will MAPs / APAs/ arbitration be more attractive
- Global consistency versus local risk management
- With intangibles, recommended to include tax and even transfer pricing personnel on an acquisition team
  - Audit PPA documentation should have tax professionals involved to offer input (e.g., multiple levels of technology in PPA, hesitation on use of the MPEEM and reliance on RfR)
Other areas of focus

- Review corporate structure and supply chain
- Consider financial statement risks and reserves (reserves and opinions are important)
  - For private companies, 409A stock option consistency
  - Reserves for transfer pricing exposures
- Make sure you have an IT Team to be able to retrieve necessary data
  - GAAP and IFRS coordination
  - Understand risks, such as currency, manufacture, marketplace and financial factors
- Assure IP ownership: legal vs. economic
- Focus on confidentiality
How have tax audits challenged?

- Larger teams for audits
- Rigid procedures for discovery
- Aggressive tax adjustments
- Heavy focus on:
  - Business restructuring
  - Stock options to be included in the cost plus even for a subsidiary that does not buy the options and where the costs are not deductible
  - Trademark ownership – legal and economic
  - Trademark development costs
  - Market subsidies
  - Intangible value
  - Distributor models
  - Israeli disclosure of tax opinions
ISRAELI - US TRANSFER PRICING SEMINAR

New Proposed Section 385 Regulations

*This presentation is offered for informational purposes only, and the content should not be construed as legal advice on any matter.
Agenda

- Introduction
  - Section 385
  - Scope of Treasury’s Authority
- Debt instruments treated as partly debt, partly stock
- Minimum documentation requirements
  - Preparation requirement
  - Maintenance requirement
- Disfavored transactions
  - General rule
    1. In a Distribution
    2. In exchange for expanded group stock
    3. In exchange for property in an asset reorganization
  - Safe harbors / exceptions
  - Consolidated groups
  - Deemed exchange
  - Anti-avoidance and no affirmative use rules
- Effective dates
Introduction – Section 385

Treatment of certain corporate interests as stock or indebtedness

- **Section 385(a):** The Secretary is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness (or as in part stock and in part indebtedness)

- **Section 385(b):** The regulations prescribed under this section shall set forth factors which are to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists…..

The Proposed Regulations provide rules for when certain related-party interests in a corporation may be treated, for federal tax purposes, in whole or in part, as stock rather than debt
Scope of Treasury’s authority

The preamble to the Proposed Regulations notes that when Congress enacted Section 385, it authorized the Treasury Department and the IRS to establish factors to indicate “for a particular factual situation whether a debtor-creditor relationship exists or a corporate-shareholder relationship exists.”

Senate Finance Committee Report on the Tax Reform Act of 1969, explained the Sec. 385 grant of authority to Treasury as follows:

“In view of the uncertainties and difficulties which the distinction between debt and equity has produced in numerous situations . . . the committee further believes that it would be desirable to provide rules for distinguishing debt from equity in the variety of contexts in which this problem can arise. The differing circumstances which characterize these situations, however, would make it difficult for the committee to provide comprehensive and specific statutory rules of universal and equal applicability. In view of this, the committee believes it is appropriate to specifically authorize the Secretary of the Treasury to prescribe the appropriate rules for distinguishing debt from equity in these different situations.” (emphasis added)
Scope of Treasury’s authority

The IRS and Treasury have interpreted their authority under Section 385 broadly to alter decades of established case law and guidance on which cross-border planning is based

- Rather than adopting common law principles included in Section 385, the Proposed Regulations would treat debt that is clearly debt under common law principles as equity based solely on the common ownership of the issuer and holder

- The proposed rules do not distinguish debt from equity in the “variety of contexts” in which the problem can arise

- General federal tax principles would still determine an instrument’s debt or equity character except where the proposed rules would automatically treat a debt instrument as stock

- The proposed rules serve the purpose of curtailing inversions and earnings stripping rather than the legislative purpose of Section 385 – to distinguish debt from equity
Debt instruments treated as partly debt partly stock

- Section 385(a) authorizes the Secretary to treat an interest in a corporation as in part debt and in part stock

- Proposed § 1.385-1(d) would invoke this authority in the case of any debt instrument where the issuer and the holder are members of the same “modified expanded group,” which would be based on 50%-or-greater direct or indirect ownership

- The proposed rule would allow the IRS to treat a debt instrument as part debt, part stock to the extent an analysis of the relevant facts and circumstances under general tax principles at the time of issuance resulted in a determination that such treatment were proper

- The proposed rule offers no standards for determining when an instrument would be so treated

- As a result, substantial discretion would probably rest with IRS examining agents
Minimum documentation requirements

- Proposed § 1.385-2 would impose threshold documentation requirements that would have to be satisfied in order for certain related party debt instruments to be respected as debt.

- If the requirements were not satisfied, the instrument would automatically be treated as stock, subject to a reasonable cause exception. Debt-equity factors traditionally considered by courts would be irrelevant.

- Taxpayers could not affirmatively use the rule to reduce tax liability.

- The minimum documentation requirements would apply to expanded group instruments (EGIs).

- The minimum documentation requirements will only apply to (1) any member of the expanded group of which is publicly traded, or to (2) taxpayer whose assets are reported on financial statements with either total assets exceeding $100 million or total revenue exceeding $50 million.
Minimum documentation requirements

For an EGI to be respected as debt, written documentation would have to be prepared within 30 days of the date the EGI is issued, and establish that:

1. The issuer has entered into an unconditional and legally binding obligation to pay a sum certain on demand or at one or more fixed dates

2. The holder has the rights of a creditor to enforce the obligation, and that

3. As of the date the EGI were issued the issuer’s financial position supported a reasonable expectation that the issuer intended to, and would be able to, meet its obligations under the instrument.

This documentation could include: cash flow projections, financial statements, business forecasts, asset appraisals, determination of debt-to-equity ratios and other relevant financial ratios of the issuer in relation to industry averages.

And in addition…
Minimum documentation requirements

4. **Ongoing written documentation** evidencing the parties’ **conduct** over the life of the debt instrument would need to be prepared and maintained.

- This would include written **evidence of payments** of interest and principal, such as wire transfer records or bank statements. If the issuer did not make a payment of interest or principal that was due and payable, or if any other event of default occurred, written documentation would need to be prepared evidencing the holder’s **reasonable exercise** of the diligence and judgment of a creditor.

  - This could include evidence of the holder’s efforts to assert its rights, the parties’ efforts to renegotiate the terms of the EGI or mitigate the breach of an obligation under the EGI, and any documentation detailing the holder’s decision to refrain from pursuing any actions to enforce payment.

  - The ongoing documentation would need to be prepared **within 120 days of each date a payment of interest or principal were due**, and any other date a default occurred (e.g., if the issuer failed to maintain applicable financial ratios or violated other covenants).
Minimum documentation requirements

Special rule for revolving credit agreements and similar agreements

- Apply to arrangements under which, for example, an increase in the initial principal balance of an EGI does not trigger issuance of a new note, such as in the case of a revolving credit agreement or an omnibus agreement governing open account obligations.

- The special rule requires that the documentation evidencing an unconditional and legally binding obligation to pay a sum certain (the first minimum documentation requirement), must include all relevant enabling documents, including, for example, board of directors’ resolutions, credit agreements, omnibus agreements, security agreements, or agreements prepared in connection with the execution of the legal documents governing the EGI, as well as any relevant documentation executed with respect to an initial principal balance or increase in the principal balance of the EGI.
Minimum documentation requirements

Special rule for cash pooling arrangements

- Apply to EGIs issued under cash pooling arrangements, such as internal banking service issuances, account sweeps, revolving cash advance facilities, overdraft setoff facilities, operational facilities, or similar features

- The special rule requires that the documentation evidencing an unconditional and legally binding obligation to pay a sum certain (the first minimum documentation requirement) must include material documentation governing the ongoing operations of the arrangement, including any agreements with entities that are not members of the expanded group. The documentation must contain the, relevant legal rights and responsibilities of any entities (both members and nonmembers of the expanded group) in conducting operations of the arrangement

- In the case of cash pooling/sweeps arrangements, having to provide and maintain documentation for each separate loan made pursuant to the arrangement seems burdensome and woefully inadequate
Minimum documentation requirements

A few observations:

- Do you engage in this level of analysis or diligence when issuing, extending, or modifying an intragroup debt?

- Large corporate groups should start considering the people, processes and systems they will need to put in place to ensure they can satisfy the documentation requirements.

- Consider whether to take any action now with respect to existing EGIs – extending a debt now might be less painful than extending it once the rules take effect.

- All parts of the minimum documentation would need to be maintained for all taxable years that the EGI were outstanding, and until the expiration of the statute of limitations for any return for which the treatment of the EGI were relevant.
Minimum documentation requirements

A few observations (cont’d):

- All members of a consolidated group would be treated as one corporation for purposes of the Section 385 regulations
  - Thus, an intercompany obligation within the meaning of § 1.1502-13(g) would not be considered an EGI, and the documentation requirements would not apply

- If an EGI with a partnership or disregarded entity as the issuer were treated as equity due to a failure under the documentation requirements, the EGI would be treated as an equity interest in the partnership or disregarded entity, as the case may be. In the case of a disregarded entity, this treatment seemingly could cause the disregarded entity to have a second owner, thereby causing it to become a partnership

- The documentation requirements would apply to any debt instrument issued or deemed issued on or after the date final regulations are published, and to any obligation issued or deemed issued before the date final regulations are published by reason of a check-the-box election filed on or after that date
Disfavored transactions – summary

- **Prop. Reg. §1.385-3** identifies specific transactions under which debt instruments issued by one member of the “expanded group” to another member of the “expanded group” are *per se* characterized as stock for tax purposes:

  1. **Distributions.** Intercompany distributions of debt made by one group member to another

  2. **Exchanges.** Debt issued in exchange for expanded group member stock (except for certain exempt exchanges)

  3. **Internal asset reorganizations.** Debt issued in exchange for property in an asset reorganization (e.g., a C reorganization or D reorganization), if a shareholder of the group immediately receives the debt instrument with respect to its stock in the transferor corporation

- **Current E&P safe harbor.** For distributions or acquisitions that do not exceed current E&P

- **Funding rule.** The basic rules above are backstopped by the so-called “funding rule”
Scope. The preamble clarifies that “distribution” is broadly defined as any distribution by a corporation to a member of the corporation’s expanded group with respect to the distributing corporation’s stock, regardless of whether the distribution is treated as a dividend within the meaning of Section 316.

Example

The US subsidiary of foreign parent issues a debt instrument of the US Subsidiary to the parent as a dividend.

The debt instrument would automatically be treated as stock (assuming the current E&P exception did not apply).

This is a classic example with earnings stripping potential that the proposed regulations are intended to shut down.
Disfavored transactions – exchanges

- **Scope.** This category applies to debt instruments issued in exchange for expanded group stock

- **Exceptions.** Asset reorganizations are generally exempted from this rule. Those transactions are covered under the separate, internal asset reorganization rule

- **Example.** Prop. Reg. §1.385-3(g)(3), Example 3
  - US subsidiary issues a note to foreign parent in exchange for 40% of the stock of another foreign subsidiary. Assume US subsidiary has no E&P
  - Absent the proposed regulations, this would be a Section 304 transaction
  - But under the proposed regulations, the debt instrument is treated as stock. There is no exchange for “property.” So instead perhaps this is a Section 351 transaction or B reorganization
Disfavored transactions – internal asset reorganizations

- **Scope.** Applies to reorganizations that qualify as (A) / (C) / (D) / (F), or (G) reorganizations. Specifically, where a debt instrument is issued in exchange for property in an asset reorganization, if, pursuant to a plan, a shareholder that is a member of the group immediately before the reorganization receives the debt instrument with respect to its stock in the transferor corporation.

- **Example**

  In a D reorganization, CFC 2 transfers substantially all of its assets to CFC 3 in exchange for stock and debt of CFC 3. Then CFC 2 liquidates (or elects to be a disregarded entity), distributing the stock and debt to foreign parent.

- **Example**

  Under the proposed regulations, this is an internal asset reorganization. The debt of CFC 3 is treated as stock for tax purposes in the hands of foreign parent.
Funding rule

Under the “funding rule,” a debt instrument also would generally be treated as stock to the extent it were issued by a corporation (the “funded member”) to a member of its expanded group in exchange for property, with “a principal purpose” of funding any one or more of the following transactions

1. a distribution of property by the funded member to a member of its expanded group
2. an acquisition of expanded group stock by the funded member from a member of its expanded group or
3. an acquisition of property by the funded member in an asset reorganization

Importantly, a per se rule would impute a bad principal purpose if the debt instrument were issued within 36 months on either side of the distribution or acquisition, subject to an ordinary course exception. Thus, any intragroup borrowing within 36 months on either side of one of the above transactions would automatically cause the debt instrument evidencing the borrowing to be treated as stock. If the borrowing and the “funded” transaction were more than 36 months apart, facts and circumstances would determine whether a bad principal purpose existed
**Funding rule**

- **Scope.** Applies generally to treat a debt instrument as stock if it is issued by a corporation (funded member) to a member of the funded member's expanded group in exchange for property with a principal purpose of funding one of the three identified transactions (the funding rule).

- **Example**
  - CFC 1 loans cash to CFC 2. CFC 2 then pays a cash distribution to US Parent. The CFC 1 loan was made with a principal purpose of funding the distribution.
  - The CFC 2 note is re-characterized as stock of CFC 2.
  - Note that the distribution to US parent is still treated as a cash distribution.
Safe harbors / exceptions

- **Current E&P.** Distributions and acquisitions that do not exceed current year E&P of the distributing or acquiring corporation are not treated as distributions or acquisitions for purposes of the general rule or the funding rule. Distributions and acquisitions are attributed to current year earnings and profits in the order in which they occur.

- **Note:** Current year E&P may not be known at the time that the debt instrument is issued. It is often not calculated until the following year.

- **Threshold exception for smaller taxpayers.** A debt instrument would not be treated as stock if, immediately after the instrument were issued, the expanded group’s total debt instruments that otherwise would be treated as stock does not exceed $50 million.

- **Funded acquisitions of subsidiary stock by issuance.** An acquisition of expanded group stock will not be treated as an acquisition under the funding rule if (i) the acquisition results from a transfer of property by a funded member (the transferor) to an issuer in exchange for stock of the issuer, and (ii) for the 36-month period following the issuance, the transferor holds, directly or indirectly, more than 50 percent of the vote and value of the stock of the issuer.
Consolidated groups

- All members of a consolidated group would be treated as one corporation for purposes of the Section 385 regulations

- As a result, debt between members of a consolidated group would not be subject to the three disfavored transaction rules or the funding rule

- But note that a loan to one consolidated group member occurring within 36 months of a distribution or acquisition by another consolidated group member may cause the loan to be re-characterized as equity under the funding rule. This is because the single corporation may be viewed as engaging in both transactions
FP owns US parent, the parent of a US consolidated group. US Sub 1 is also a member of the group.

FP makes a loan to US Sub 1 to fund an acquisition or to fund working capital.

For 36 months before or after the FP loan to US Sub 1, the entire US parent consolidated group would be at risk of triggering the funding rule if a member acquires stock of an expanded group member or if the loan is repaid (subject to any relevant exception, e.g., the current E&P safe harbor).

This may require additional, long-term monitoring of related party loans and potential funded distributions and acquisitions occurring among all of the various members of a consolidated group.
Deemed exchange

- Proposed Treas. Reg. § 1.385-1(c) governs the consequences of a deemed exchange of debt for stock

- This becomes particularly relevant when the rules cause debt to be treated as stock (in whole or in part) at some time after its issuance. For example, this could happen if the $50 million threshold exception ceased to apply

- The rules generally prevent the holder from recognizing gain or loss and prevent the issuer from recognizing COD income. The holder is treated as having realized an amount equal to its adjusted basis in the portion of the debt to be treated as stock, and the issuer is treated as having retired that portion for an amount equal to its adjusted issue price. Neither the issuer nor the holder would account for any accrued but unpaid qualified stated interest or for any FX gain or loss on such interest

- But note that any FX gain or loss with respect to principal may be recognized, and any interest that is not qualified stated interest (e.g., OID) may need to be taken into account
Anti-avoidance and no affirmative use rules

- A debt instrument would be treated as stock if it were issued with a principal purpose of avoiding the application of the proposed rules.

- The same would be true for similar arrangements that are not technically debt instruments, for example, a Section 483 contract.
  - But what about other non-debt instruments?

- Taxpayers could not make affirmative use of the proposed rules to reduce tax liability.
Effective dates

Treas. Reg. Sec. 1.385-1 and -2:
- The general provisions and documentation requirements apply to any applicable instrument issued or deemed issued on or after the date these regulations are published as final and to any applicable instrument treated as indebtedness issued or deemed issued before the date these regulations are issued as final if and to the extent it was deemed issued as a result of an entity classification election filed on or after the date these regulations are final.

Treas. Reg. Sec. 1.385-3 and -4:
- The “automatic equity rules” are proposed to apply to any debt instrument issued on or after April 4, 2016, and to any debt instrument treated as issued before April 4, 2016 as a result of an entity classification election filed on or after that date.

Transition rules:
- A distribution or acquisition occurring before April 4, 2016, other than a distribution or acquisition that is treated as occurring before April 4, 2016 as a result of an entity classification election that is filed on or after April 4, 2016, is not taken into account.
- If a debt instrument issued before final regulations are published is re-characterized as stock under the proposed rules, the instrument nonetheless would be treated as debt until the date that is 90 days after final regulations are published. If, on that date, the instrument were still held by a member of the expanded group, the debt would be deemed to be exchanged for stock.
Contacts

Idan Netser
Partner
idan.netser@dlapiper.com
2000 University Avenue, East Palo Alto, California, 94303-2214, United States
T: +1 650 833 2150  F: +1 650 687 1105

Jonathan Lubick
Senior Consultant
jonathan.lubick@econpartners.com
38 Hativat Golani Street, Raanana Israel, 43333
Office: 972-9-772-4233  Mobile: 972-54-473-6347