

Treasury Challenges for Corporates

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Speakers



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Albert Einstein's Quote on Taxes

*The hardest thing in the world to understand
is the taxes.*

*[on filing for tax returns]
This is too difficult for a mathematician.
It takes a philosopher.*

Subsidiary Funding and Taxes

Treasury Objective

- Subsidiary Capital Structure
 - Prefer debt over equity to maximize interest expense deduction
 - Flexibility for debt waiver, debt for equity swaps, or recapitalization
- Inter-company Funding
 - High interest rate for countries with higher tax rate

Tax Considerations

- Thin Capitalization Rules
 - Maximum debt over equity ratio for any legal entity in a country
- Transfer Pricing
 - Arms length interest rates between two related parties
- Double Tax Treaties
 - Implication on reducing withholding taxes
- US Taxes on Global Income
 - CFC/Subpart F rules
- Tax implications of debt waiver, debt for equity swaps, or recapitalization vary by countries

Cash Management and Taxes

Treasury Objective

- Cash Pooling
 - Lend surplus funds from one subsidiary to subsidiary with deficit position
 - Agglomerate and control funds from all countries (where regulations allow) and business units
 - Concentrate funds in a low tax jurisdiction
- Investments
 - Concentrate funds in major financial centers where there are more investment options
 - Invest centrally to maximize interest yield

Tax Considerations

- Interest Deduction
 - Interest expense in non tax paying (deficit) entity whereas interest income in high tax paying entity (group taxes help neutralize)
- Transfer Pricing
 - Arms length interest rates for pooling funds
- Tax Havens
 - Low tax jurisdiction could be classified as tax haven and resulting implications
- US Taxes on Global Income
 - CFC/Subpart F rules
 - Foreign tax credits
- Double Tax Treaties
 - Withholding taxes on interest for cross border fund movement
- Other Taxes
 - Business Taxes on interest in countries such as China

Repatriation (from foreign subsidiaries) and Taxes

Treasury Objective

- Dividends
 - Permanently repatriate subsidiary profits to the holding companies
 - Timing decision based on tax deferral principle – parent companies not taxed on foreign sourced income until they actually receive a dividend
- Long term Upstream Inter-company Loan
 - Need to have a strategy to unwind due to temporary nature of repatriation
 - Homeland Investment Act
 - Potential capex or acquisition from profitable subsidiary

Tax Considerations

- Withholding Taxes
 - Withholding/distribution taxes on dividends
- Double Tax Treaties
 - Location of holding company
 - Implication on reducing withholding taxes
- Tax Havens
 - Holding companies in low tax jurisdiction could be classified as tax haven and resulting implications
- US Taxes on Global Income
 - CFC/Subpart F rules
 - US shareholder taxed on overseas income of the firm when earned rather than deferral until receive dividend

Focus on Tax Issues

- US : Obama Administration's Tax Proposals
 - Overview
 - Check-the-box (“CTB”) elections
 - Deferral of deductions
 - Deferral of foreign tax credits (“FTCs”)
- Japan : 95% Exemption for Foreign Dividends
- UK : Emigration Option
 - CFC rules / Taxation of foreign dividends
 - Marginal tax rate for high income individuals
- Low Tax Regimes / Tax Havens
 - G20 / OECD : “exchange of information”
 - OECD : Draft report on business restructuring
- Treaty shopping

Overview of international tax proposals

- On 26 February 2009, President Obama released an outline of his budget proposal for the 2010 fiscal year. It included a tax proposal to “implement international enforcement, reform deferral, and other tax reform policies”, raising \$210 billion over 10 years, without any greater description. The revenue breakdown (in \$ billions) is:

Obama Budget	2009	10	'11	'12	'13	'14	'15	'16	'17	'18	'19	Total
Feb 26: Implement international enforcement, reform deferral, and other tax reform policies	--	--	10	15	20	25	26	27	28	29	30	210
May 11 Update		2	14	20	21	22	24	2	26	27	29	210

- On 4 May 2009, the President held a news conference to announce additional details of the international tax proposals. The additional detail provided by the Administration accounted for four proposals and \$198.3 billion of the total to be raised
- On 11 May 2009, the Treasury Department released the Greenbook with additional details and six new international tax revenue raisers

Overview of international tax proposals

Provision	10-Year Revenue Estimate (\$billions)
Reform check-the-box rules for foreign entities	86.5
Defer certain U.S. income tax deductions	60.1
Foreign tax credit reform: single pool of §902 credits	24.5
Foreign tax credit reform: matching foreign income and taxes	18.5
Modify foreign tax credit rules for dual capacity taxpayers	4.5
Extend §954(c)(6) and active financing exception	n/a
Expand definition of “intangible property” for §§367(d) and 482 purposes	2.9
Tax repatriation of earnings in certain cross-border reorganisations	0.3
Limit earnings stripping by expatriated entities	1.2
Repeal 80/20 company rules	1.2
Prevent avoidance of dividend withholding taxes in equity swaps, securities loans, repos	1.4
Enforcement proposals (effective beginning after Dec 31 of year of enactment)	8.7
Total	209.8

- Revenue raisers generally effective for tax years beginning after 31 Dec 2010

Classification of foreign entities: Generally

Proposal

- The proposal would treat a foreign eligible entity with a single member as a corporation for U.S. tax purposes except in two instances:
 - The entity and the single member are created or organised in, or under the laws of, the same foreign country; or
 - The single member is a U.S. person, except in the case of "U.S. tax avoidance"
- Effect of conversion from DE classification to corporate status would be determined under current regulations and tax principles; transition relief limited to delayed effective date

Impact

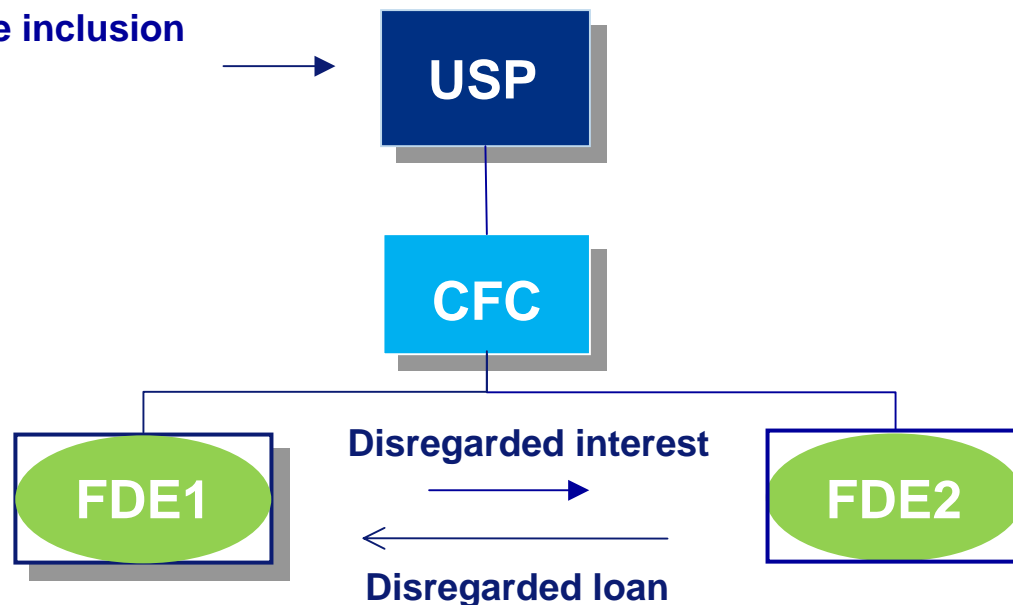
- Previously disregarded transactions are now regarded
- Mandatory conversion may result in deemed contributions, loss recapture, and deemed sales

Policy Considerations

- Restricts efficient cross-border transactions
- Increases tax imposed on U.S. companies owning controlled foreign corporations ("CFCs")

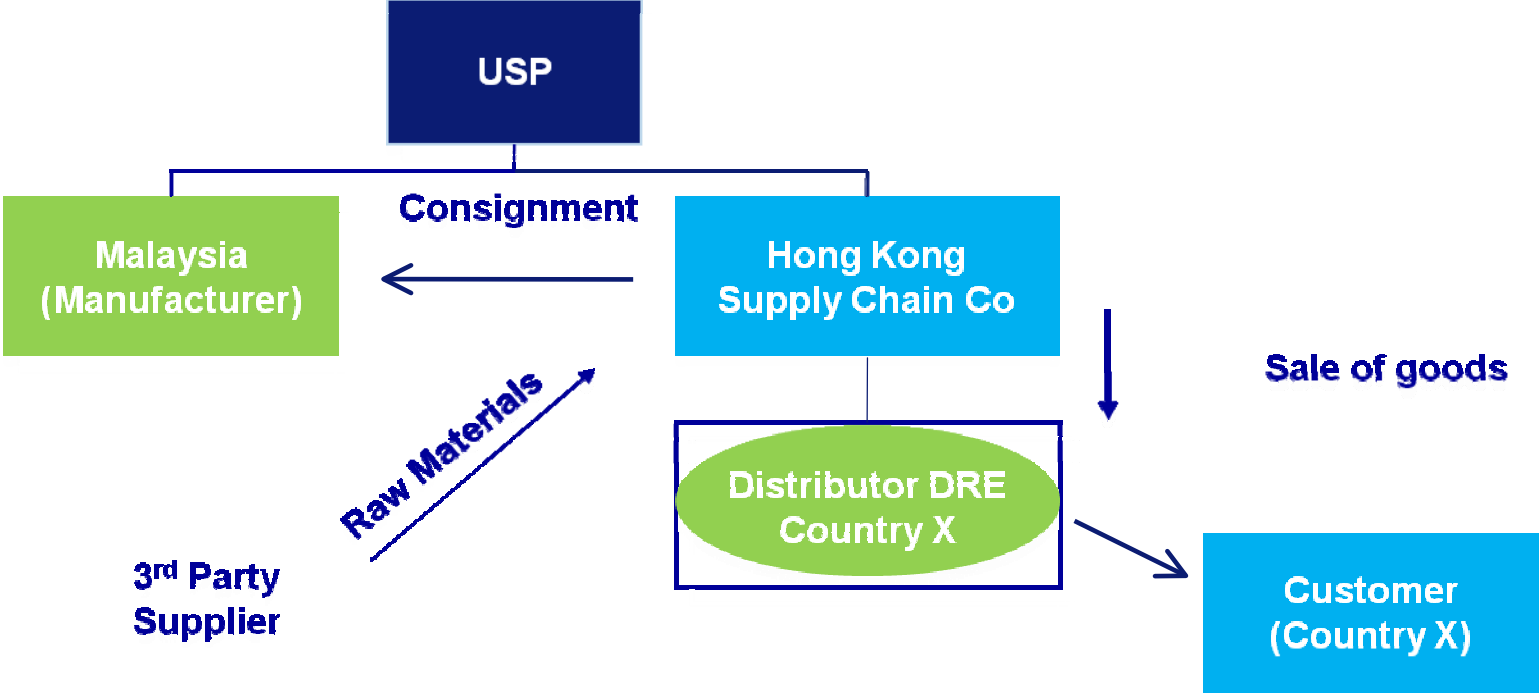
Classification example : Disregarded interest transactions

No Subpart F income inclusion



- If the FDE 1 and FDE 2 are treated as regarded corporations, the interest income earned by FDE 2 will be subpart F income. This proposal increases the U.S. tax imposed on financing subsidiary operations

Classification example : Disregarded sales transactions



- Under the proposal, DRE would be treated as a corporation for U.S. tax purposes
- To maintain deferral, Hong Kong must either sell directly to the customer or satisfy the substantial contribution test for contract manufacturers

Deferral of deductions : Generally

Proposal

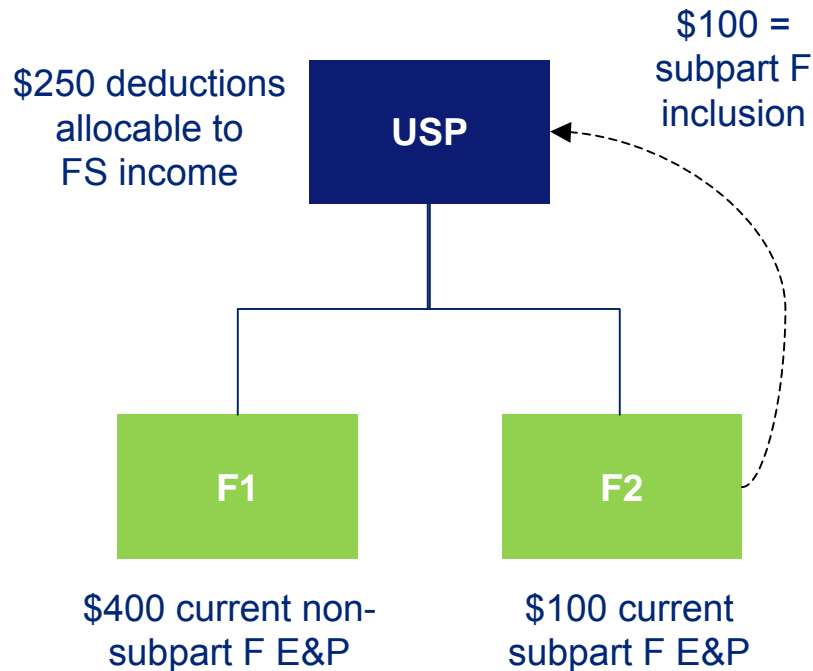
- Foreign related deductions of the U.S. company, other than R&E expenses, would be deferred until foreign earnings attributable to the deductions are subject to U.S. tax

$$\begin{array}{ccc} & & \text{Currently Taxed Foreign Source} \\ & & \text{Income} \\ \text{Foreign Related} & \times & \hline \text{Deductions} & & \text{Currently Taxed Foreign} \\ & & \text{Source Income + Deferred Foreign} \\ & & \text{Earnings} \end{array}$$

Impact

- Loss of deduction to the extent earnings are deferred offshore
- Permanently increases the cost of capital
- Increases cost of performing SG&A in the United States

Deferral of deductions : Example



Facts

- USP is a newly formed US corporation; F1 and F2 are newly formed CFCs; USP incurs \$250 of expenses allocable to foreign source income
- F2 earns subpart F current E&P of \$100
- F1 earns non-subpart F current E&P of \$400
- USP has no income other than \$100 of gross income under §951(a)(1)(A) from F2
- Current foreign source income = \$100;
Deferred foreign income = \$400;
Foreign related deductions = \$250

Results

- Deductions allowed = \$50 (deductions x current inclusion ratio = $\$250 \times 100/500$)
- USP taxable income = $\$100 - \$50 + \$78$ gross-up (if any)
- Deferred deductions = \$200 ($\$250 - \50)
- Deferred deductions carried forward to next year

Foreign tax credit pool : Generally

Proposal

- Foreign taxes paid by foreign subsidiaries are combined into a single pool for purposes of determining the deemed paid foreign tax credit allowed when the foreign corporation pays a dividend to the U.S. shareholder
- As a result, the following formula would likely be applied to determine the deemed paid foreign tax credit:

$$\text{Foreign Taxes} \quad \times \quad \frac{\text{Foreign Earnings Repatriated}}{\text{Foreign Subsidiary Earnings (Current and Deferred)}}$$

Impact

- Increases the cost of repatriating earnings to the United States
- Incentive for companies to retain more earnings abroad
- Uncertainty exists as to post-effective date deferred credits

Transition Considerations

- Consider impact on pre effective date earnings and profits pools

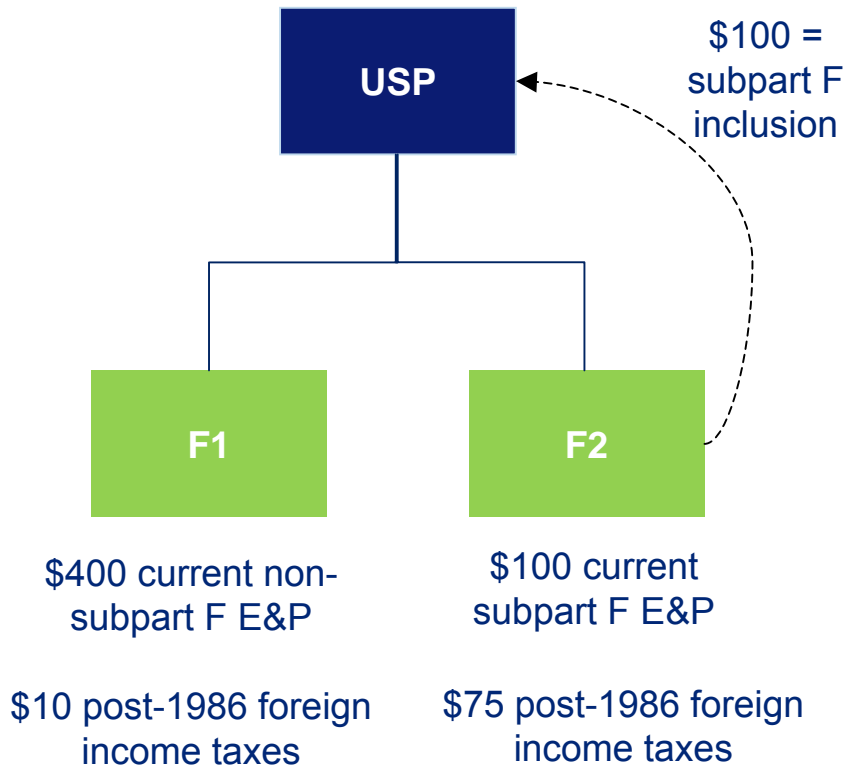
Foreign tax credit pool : Generally (cont.)

Proposal

- Requires distribution from the aggregate post-effective date pool of E&P of all foreign subsidiaries meeting the §902 ownership requirements before accessing pre-effective date E&P and taxes on a company-by-company basis

Post-Effective Date Earnings Pool	E&P and Taxes of all companies meeting the §902 ownership requirements are combined in a single pool
Pre-Effective Date Earnings Pool/Layers	Post – 1986 Pool E&P and Taxes (Deemed paid credit computed on a separate company basis) Pre – 1987 Annual Layers of E&P and Taxes (Deemed paid credit computed on a separate company basis)

Foreign tax credit pool : Example



Facts

- USP is a newly formed US corporation; F1 and F2 are newly formed CFCs
- F1 has non-subpart F current E&P of \$400 and post-1986 foreign income taxes of \$10
- F2 has subpart F current E&P of \$100 and post-1986 foreign income taxes of \$75
- USP has no income other than \$100 of gross income under §951(a)(1)(A) from F2
- FTC inclusion ratio = 20% (100 FSI / 500 E&P)
- Total Foreign Income Taxes = \$85
- Worldwide effective rate of foreign income tax is 14.5% (85 / 585)

Results

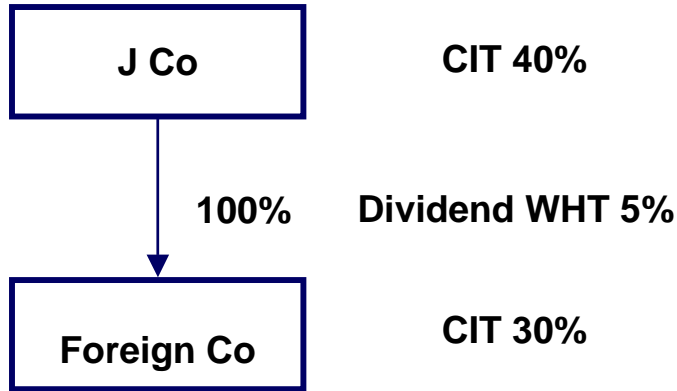
- Credits allowed = \$17 (85 x 20% = Foreign taxes x current inclusion ratio)
- \$17 is 14.5% of USP's currently included foreign source gross income of \$117
- Present law would allow deemed paid taxes of \$75

Japan : 95% Exemption for Foreign Dividends

- 2009 law change : Dividends from foreign subsidiaries will be 95% exempt.
- Previous treatment : Fully taxable, with foreign tax credit.
- Law change should lead to higher levels of dividend repatriation to Japan.

Foreign dividend exemption

Example



Foreign Co Tax

Profit Before Tax	1,000
Tax (30%)	(300)
Profit After Tax	700
Distributable Profits	<u>700</u>

Dividend Paid

Dividend declared	700
WHT (5%)	(35)
Dividend paid	<u>665</u>

Japan Co Tax

	<u>Old Rules</u>	<u>New Rules</u>
Net dividend income	665	665
WHT	35	35
Underlying foreign tax	300	—
Exempt dividend income	—	(665)
Gross dividend income	<u>1,000</u>	<u>35</u>
Tax at 40%	400	14
WHT credit	(35)	—
Underlying foreign tax credit	(300)	—
Tax payable	<u>65</u>	<u>14</u>

Effective Tax Rule

	<u>Old Rules</u>	<u>New Rules</u>
Underlying foreign tax suffered	300	300
Corporate Income Tax	65	14
WHT	35	35
Total tax suffered	<u>400</u>	<u>349</u>
ETR	40%	34.9%

UK : Emigration Option

- Attractiveness of the UK as the location for the parent company of an MNC group
 - Questioned in recent years
 - Steady stream of UK MNCs emigrating – many to Ireland

- Why?
 - UK CFC rules
 - UK taxation of foreign dividends
 - Marginal tax rate for high income individuals

Low Tax Regimes / Tax Havens

- G20 / OECD : “exchange of information”
 - Name & shame initiative
 - Black, white & grey lists
- OECD : Draft report on business restructuring
 - “Supply chain” business restructuring : placing key profit drivers (IP and commercial risk) in low tax countries → “Systemic” reduction in global effective tax rate
 - Fightback by high tax countries – tax audits, OECD study
 - Substance

Treaty Shopping

- Source countries strike back
- “Beneficial ownership” : interest, royalties, dividends
- Substance over form approach : disregard interposed entities – especially for capital gains exemption
- Examples:
 - Korea
 - Lone Star
 - Tax haven blacklist
 - Indonesia
 - Termination of Indonesia / Mauritius treaty
 - Indofood case
 - India
 - Capital gains exemption under India / Mauritius treaty – E* Trade
 - Vodafone case
- Substance

IV. Questions and Answers

Please feel free to engage us and ask questions regarding the treasury related concerns.

Thank you.

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