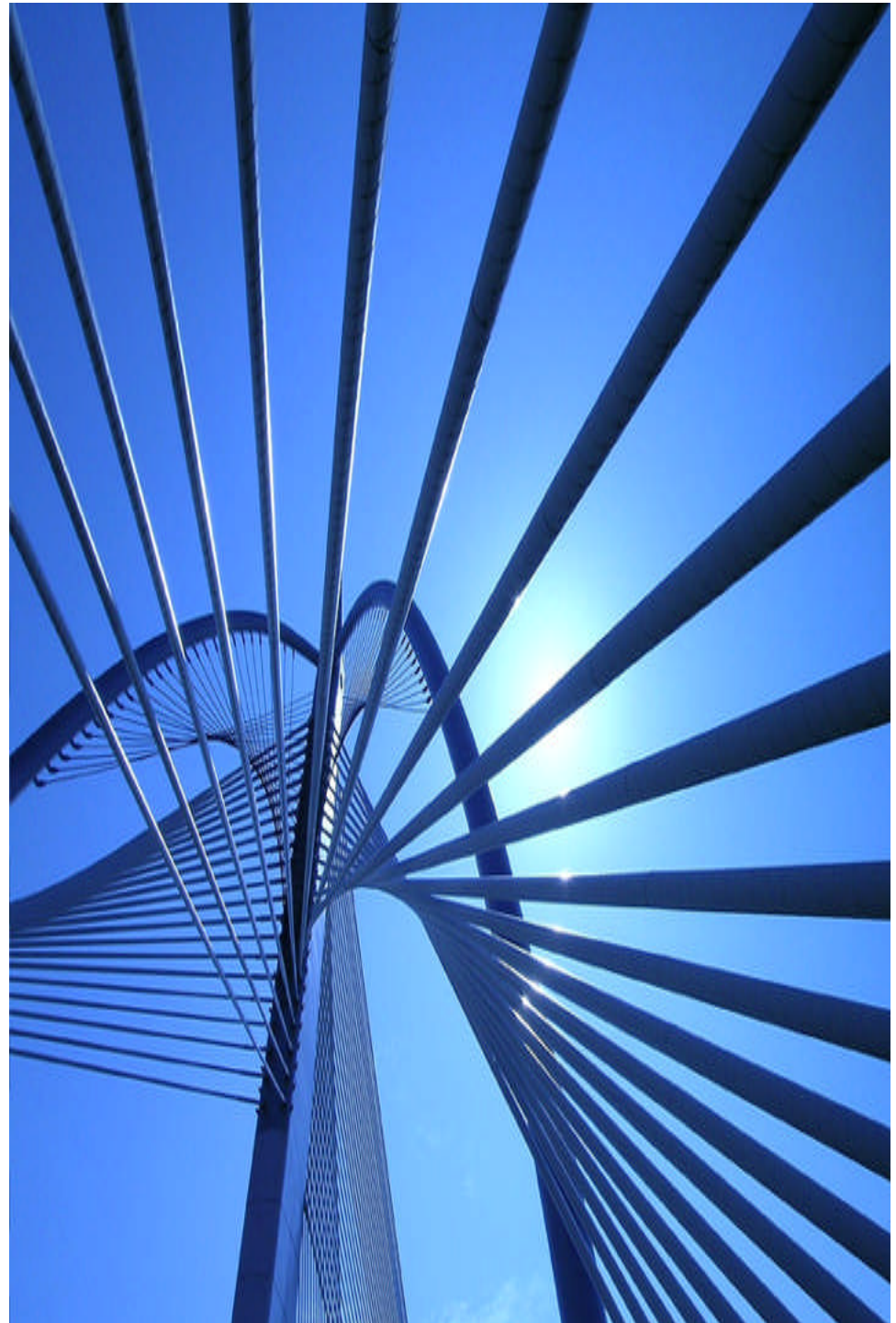
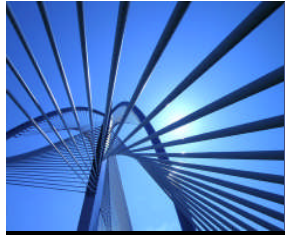


## U.S. TAX SEMINAR

The Life Cycle of an Israeli Investment  
in the U.S. – Selected Tax Issues

Dan Hotel, Tel Aviv • June 27, 2006

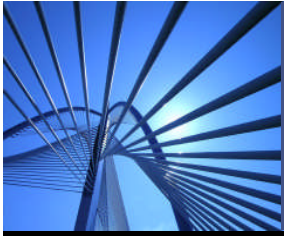




## Panel Members

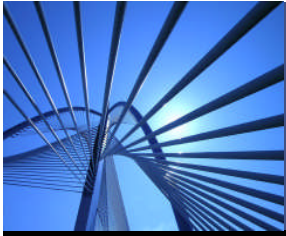
- Moderator: GERRY SELIGMAN, International Tax Partner  
Head of Tax Department  
PricewaterhouseCoopers, Tel Aviv – Kesselman & Kesselman,  
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- Part I Building Blocks for U.S.-Inbound Investments
- Part II Investing in the U.S.
- Part III On-Going Maintenance of U.S. Investments
- Part IV Divesting of U.S. Investments
- Part V Recent Legislative & Treaty Developments
- Part VI Planning Ideas



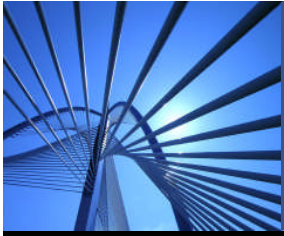
# **PART I**

## **BUILDING BLOCKS FOR U.S. INBOUND INVESTMENTS**



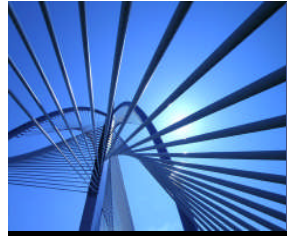
## Part I – Building Blocks of U.S.-Inbound Investments

- Framework of U.S. International Tax System
- Taxation of Foreign Persons with U.S.-Sourced Income
  - Withholding Tax Regime
  - Trade or Business / PE Regime
- Financing
- Tax Treaties
- Transfer Pricing – Introduction



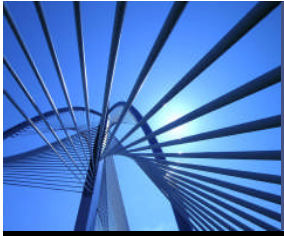
## U.S. International Tax Framework

- The U.S. uses a combination taxing system related to cross-border income/taxpayers.
  - Worldwide/Credit System
    - Applicable to U.S. persons.
    - Worldwide income subject to tax.
    - Potential double taxation mitigated with a foreign tax credit.
  - Territorial System
    - Applicable to non-U.S. persons.
    - Only certain income earned within the U.S. is subject to U.S. taxation.



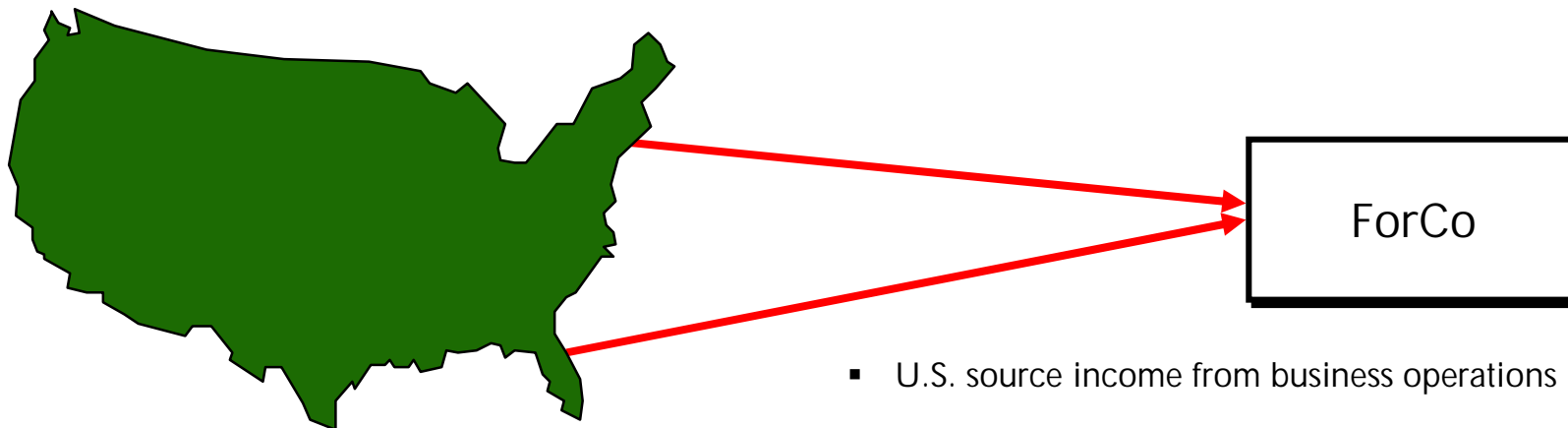
## Taxation of Foreign Persons with U.S. Income

- U.S. Source Investment Income
  - Taxed on gross income with no deductions permitted.
  - Taxed at a 30% rate via withholding unless reduced by a tax treaty.
  
- U.S. Source Trade or Business Income
  - Deductions are permitted.
  - Taxed at progressive rates.
  - Potential branch level taxes



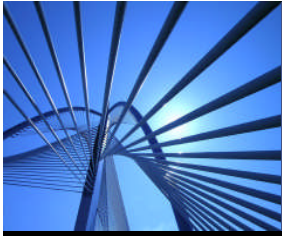
## Taxation of Foreign Persons with U.S. Income: Inbound Taxation

- U.S. source investment income
  - U.S. withholding tax
  - Local country income tax



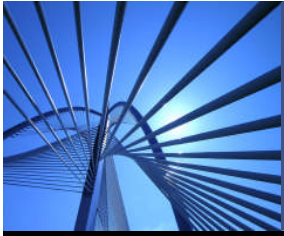
- U.S. source income from business operations
  - U.S. income tax
  - U.S. branch level taxes
  - U.S. withholding taxes
  - Local country income tax





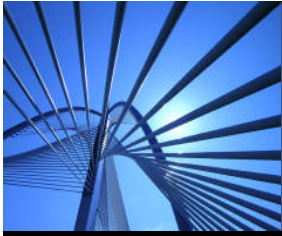
## U.S. Source FDAP Income Taxation

- U.S. Source FDAP income is either taxed through withholding, tax exempt or subject to a reduced rate of tax (under a treaty or statute), or taxed as income effectively connected to a U.S. trade or business (§§871 and 881).
- FDAP taxed on gross income (no deductions).
- Tax rate is 30% (or lower treaty rate) collected via withholding.
- Major exceptions:
  - Portfolio interest.
  - Certain bank deposit interest.
  - Short-term OID.
  - Interest and dividends from “80/20” companies.
  - Dividends from certain foreign corporations with U.S. income.
  - FDAP income effectively connected to U.S. business activity.



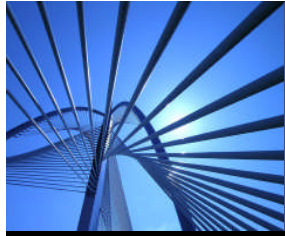
## U.S. Taxation of Business Income of Foreign Persons: Key Issues

- Do the activities constitute a “trade or business” carried on within the U.S.?
- Are the items of income of the foreign person “effectively connected” to that U.S. “trade or business”?
- If a tax treaty applies, do the activities carried out in the U.S. give rise to a PE? If so, what income is “attributable to such a PE?”

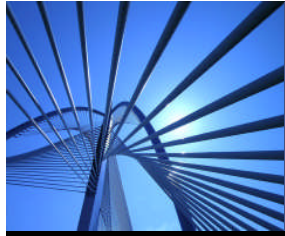


## Definition of U.S. Trade or Business

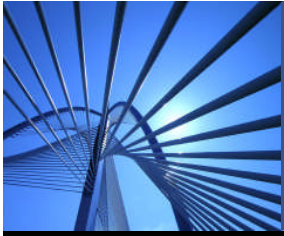
- A Trade or Business exists if Foreign person's activities within the U.S. are considerable, continuous, and regular.
- No statutory definition in the Code. Test based on facts and circumstances.
- Several statutory exceptions:
  - De minimis exception for performance of personal services.
  - Trade or business does not include certain trading in stock, securities, or commodities.
- Activities of independent agent (e.g., U.S. distributor) generally not imputed to the foreign principal. Activities of dependent agent (e.g., employee) are imputed to the foreign principal.
- Each partner (including any foreign partners) is considered to be engaged in a U.S. trade or business (§875).
- The activities of a U.S. subsidiary (even wholly-owned) is generally not imputed to a foreign parent corporation.



- Where a tax treaty applies, the relevant concept is a PE, rather than a Trade or Business. The term PE is narrower and better defined than Trade or Business.
- A PE is defined as a fixed place of business through which the business of an enterprise is wholly or partly carried on.
- A PE does not include:
  - Facilities used solely to store, display, or deliver goods belonging to enterprise.
  - Maintenance of a stock of goods solely for purpose of storage, display or delivery, or processing by another enterprise.
  - Maintenance of a fixed place of business solely to purchase goods, collect information, or any other activity of a "preparatory or auxiliary" nature.
- Subsidiary
  - Simply owning control of a subsidiary corporation does not create a PE for parent corporation in the subsidiary country.
  - The activities of a subsidiary could create a PE for parent if the subsidiary is considered a dependent agent and habitually exercises an authority to conclude contracts in the parent's name.

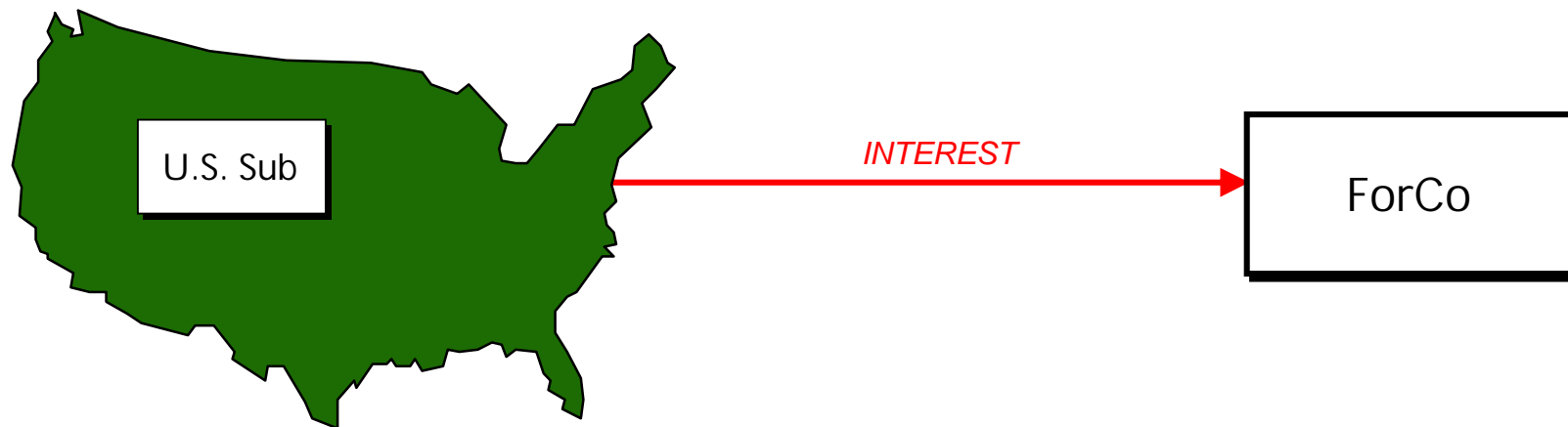


- Independent Agents
  - Doing business through an independent agent does not create a PE, provided the agent is acting in the ordinary course of its business as an independent agent.
  
- Dependent Agents
  - Dependent agent can create a PE if the agent habitually exercises an authority to conclude contracts that are binding on taxpayer.

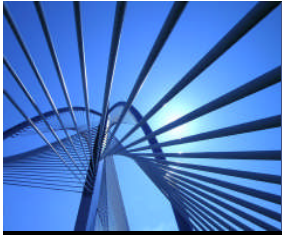


## Debt vs. Equity Factors: PLR 9024001 & Laidlaw

- Timing of Payment
  - Certainty of Interest Payments
  - Rights in the Event of Default
  - Participation in Earnings
  - Subordination
  - Rights to Participation in Management
  - Name of the Instrument
- 
- Security
  - Sinking Fund
  - Proportionality
  - Thin or Inadequate Capitalization
  - Use of the Funds Advanced
  - Source of Payments
  - Independent Creditor Test



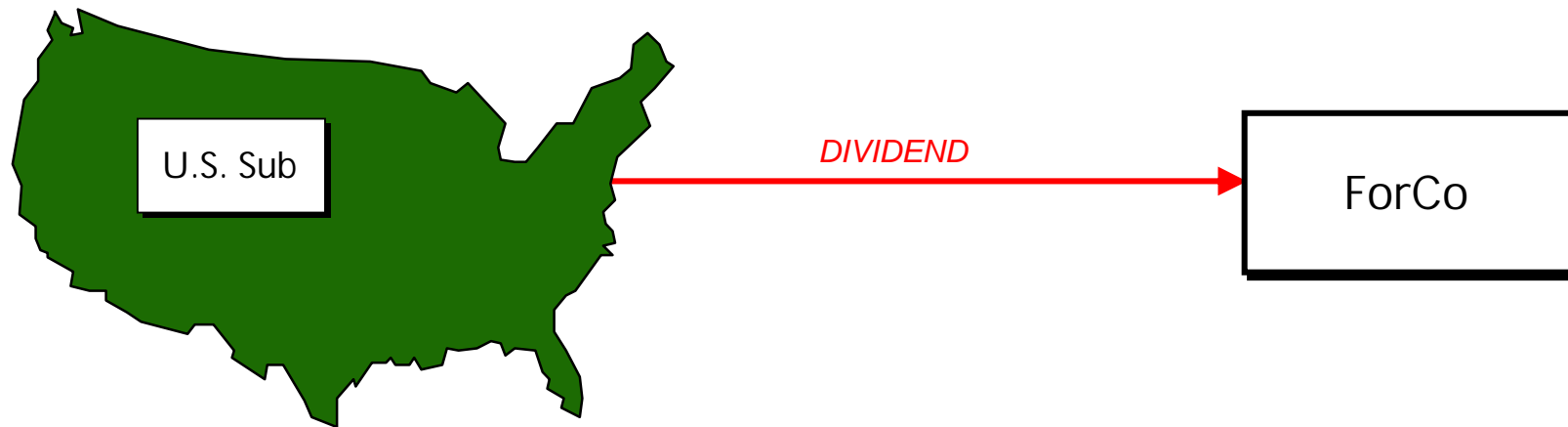
- ForCo may not be subject to U.S. tax on interest via reduced withholding.
- Payment of interest to foreign parent reduces U.S. tax liability of U.S. Sub.
- Sec. 163(j) will limit the ability of U.S. Sub to deduct interest.
- Generally limited to 50% of U.S. Sub's "adjusted taxable income".
- Rules not applicable if U.S. Sub debt-to-equity ratio < 1.5:1 or recipient fully subject to U.S. tax.



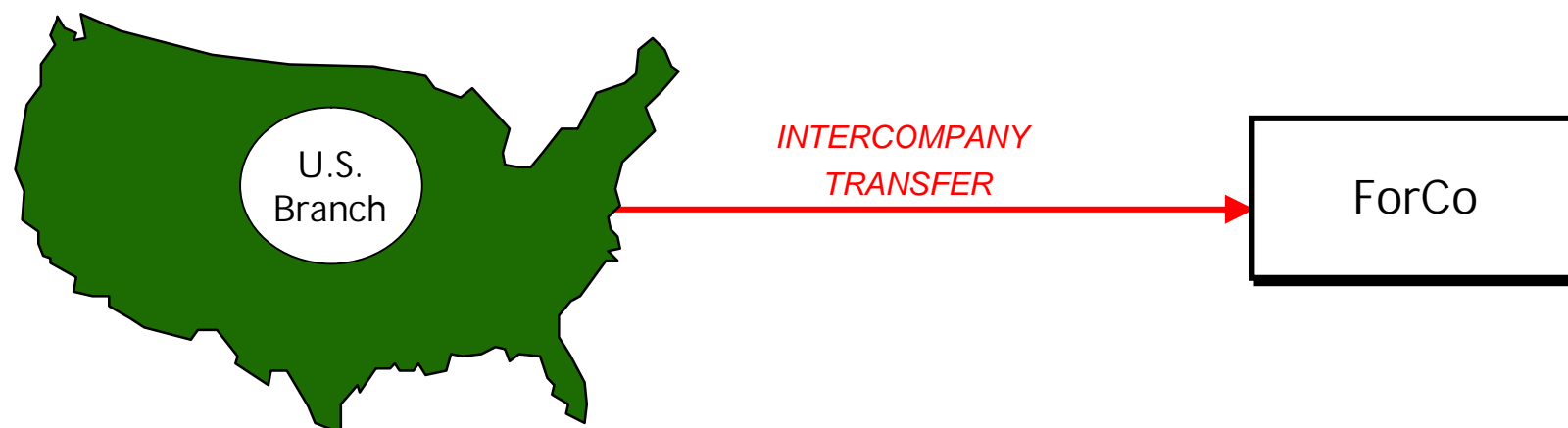
## §163(j) Limitation on Interest Deductions

- No deduction is allowed under §163 (j)(1) for “disqualified interest” paid or accrued by a corporation during the taxable year.
- The amount disallowed shall not exceed the corporation’s “excess interest expense” for the taxable year.
- §163(j) applies only if debt-equity ratio of payor exceeds 1.5 to 1.
- Disallowed interest expense may be carried forward and deducted in subsequent years to the extent “excess limitation” exists in the carryforward year; excess “limit” can be carried forward 3 years.
- §163(j) rules applied before at-risk and passive activity loss rules.

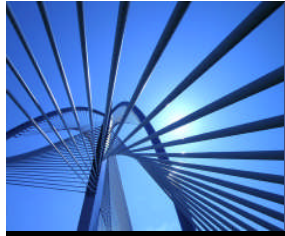




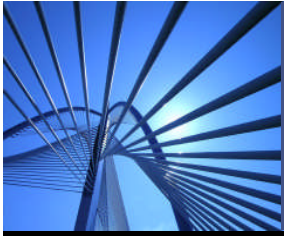
- Subject to withholding tax as FDAP income paid to foreign person.



- Subject to Branch Profits Tax (equivalent to withholding tax) in order to equate branch and sub treatment (similar rules for interest paid by branch).
- Requires determination of Dividend Equivalent Amount (based on E&P and change in net U.S. assets).

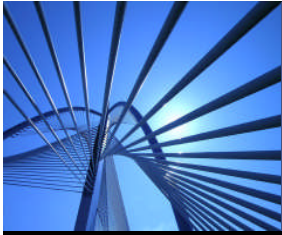


- The U.S. has 55 double tax treaties in force, including with most major European and Asian economies, as well as Israel.
- Benefits vary significantly from one treaty to another.
- Recent Trend of concluding protocols with major trading partners which allow for 0% withholding tax on dividends.
- Access to most treaties may be difficult for Israeli MNCs due to elaborate LOB provisions.
- Israeli MNCs may potentially access U.S. treaties with LOB provisions pursuant to:
  - Active Trade or Business Test
  - Ownership / Base Erosion Test
- There are still a number of treaties left which do not include LOB provisions (Hungary, Poland, Iceland) – but the U.S. is pressing to renegotiate these treaties.
- Even if treaty applies, a number of U.S. rules need to be taken into account, including:
  - Anti-conduit regulations
  - 894(c) regulations

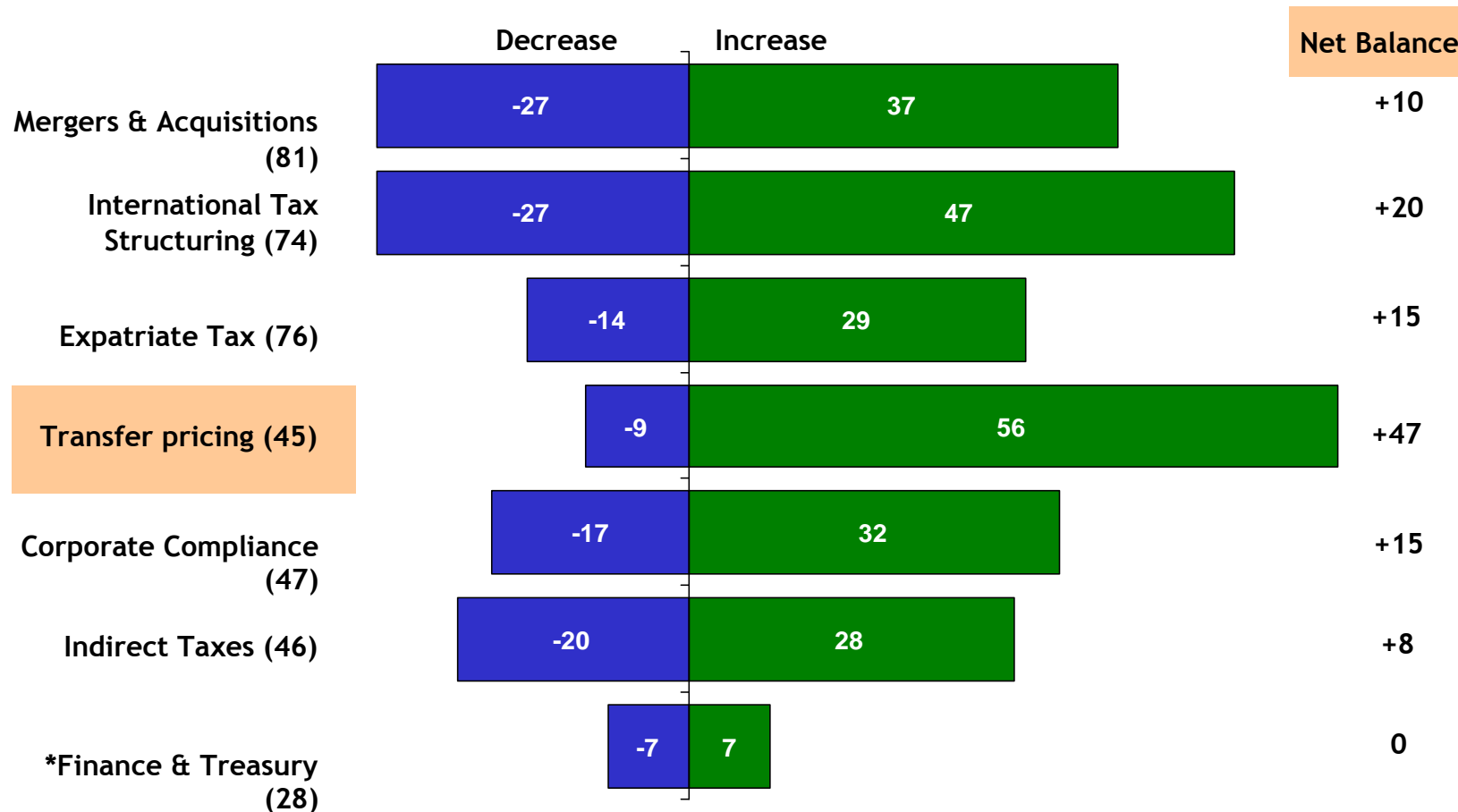


## Transfer Pricing – Overview: Basic Principles

- Explosion of countries with:
  - Specific transfer pricing rules.
  - Documentation requirements.
  - Disclosure requirements.
- Increasing number of countries with penalty provisions.
- Pricing and regulatory constraints.
- Increase levels of cooperation between tax administrations.
- Transfer pricing planning trends.

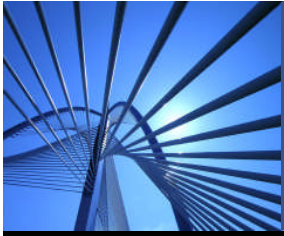


## Overview: Areas Likely to Grow or Decline over the Next 12 Months



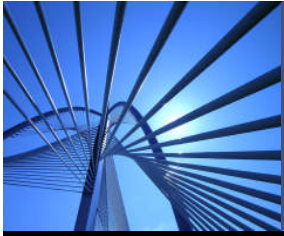
Base: All claiming tax needs likely to increase/ decrease.

\* Caution low base size.



## Overview: Basic Concepts & Fundamentals

- The arm's-length principle.
- Methods of evaluation vs. methods of implementation.
- Functional or transactional comparability.
  - Characteristics of the operation
  - Functions, risk and assets employed
  - Contractual terms
  - Economic circumstances
  - Business strategies
  - Intangible property
- The "Best Method" rule.



## Overview: Typical Requirements

- Arm's-length standard
- Contemporaneous documentation
- Information return

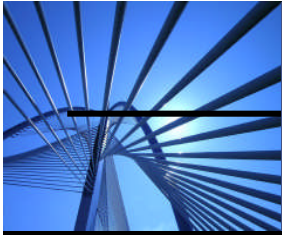


*For the taxpayer*

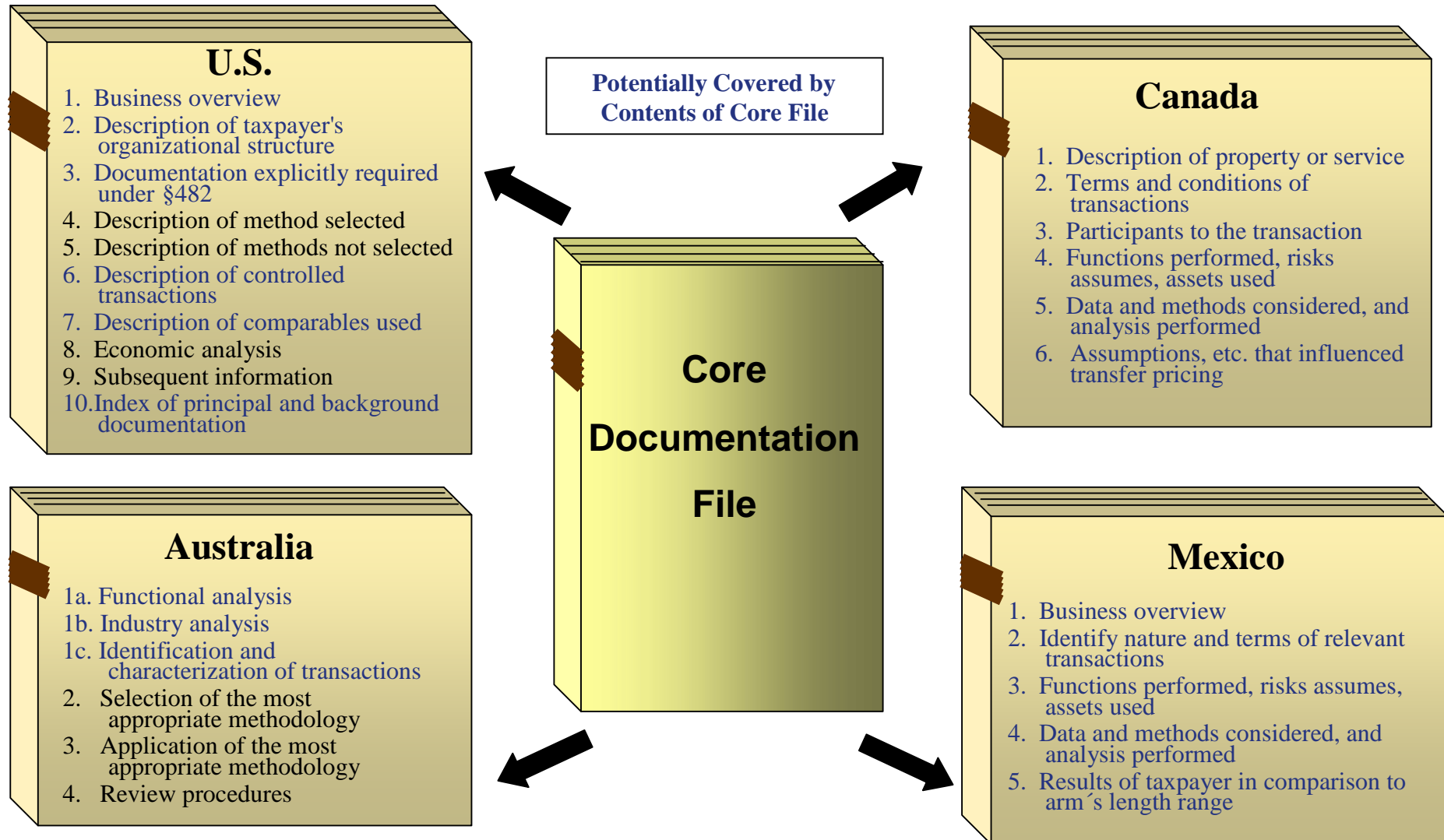
- Disclosure



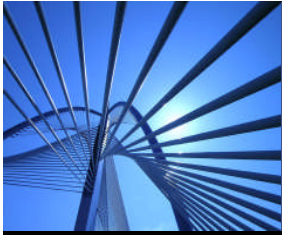
*For the statutory auditor*



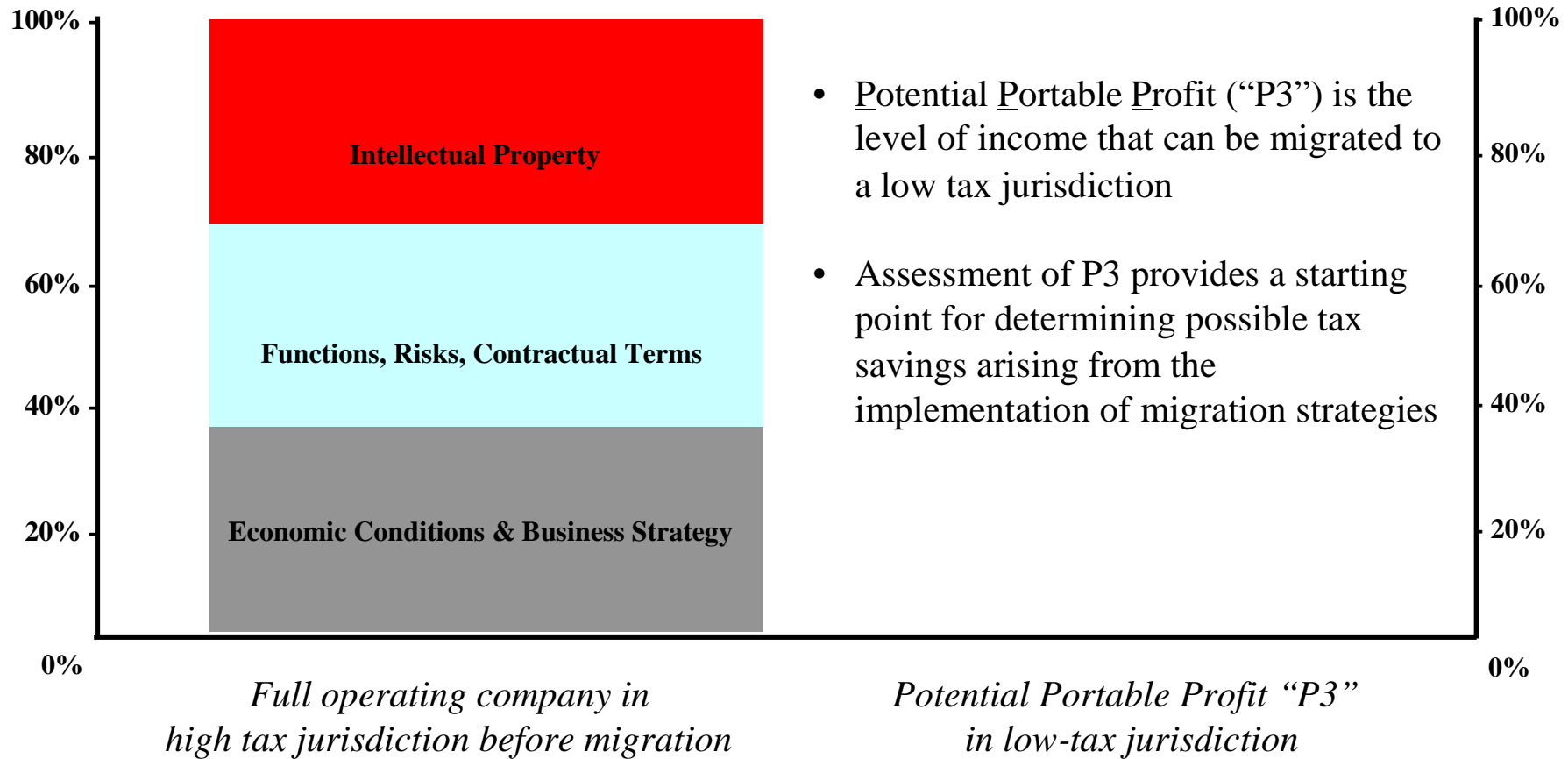
# Overview: Basic Principles – Documentation Requirements

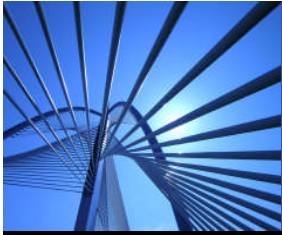




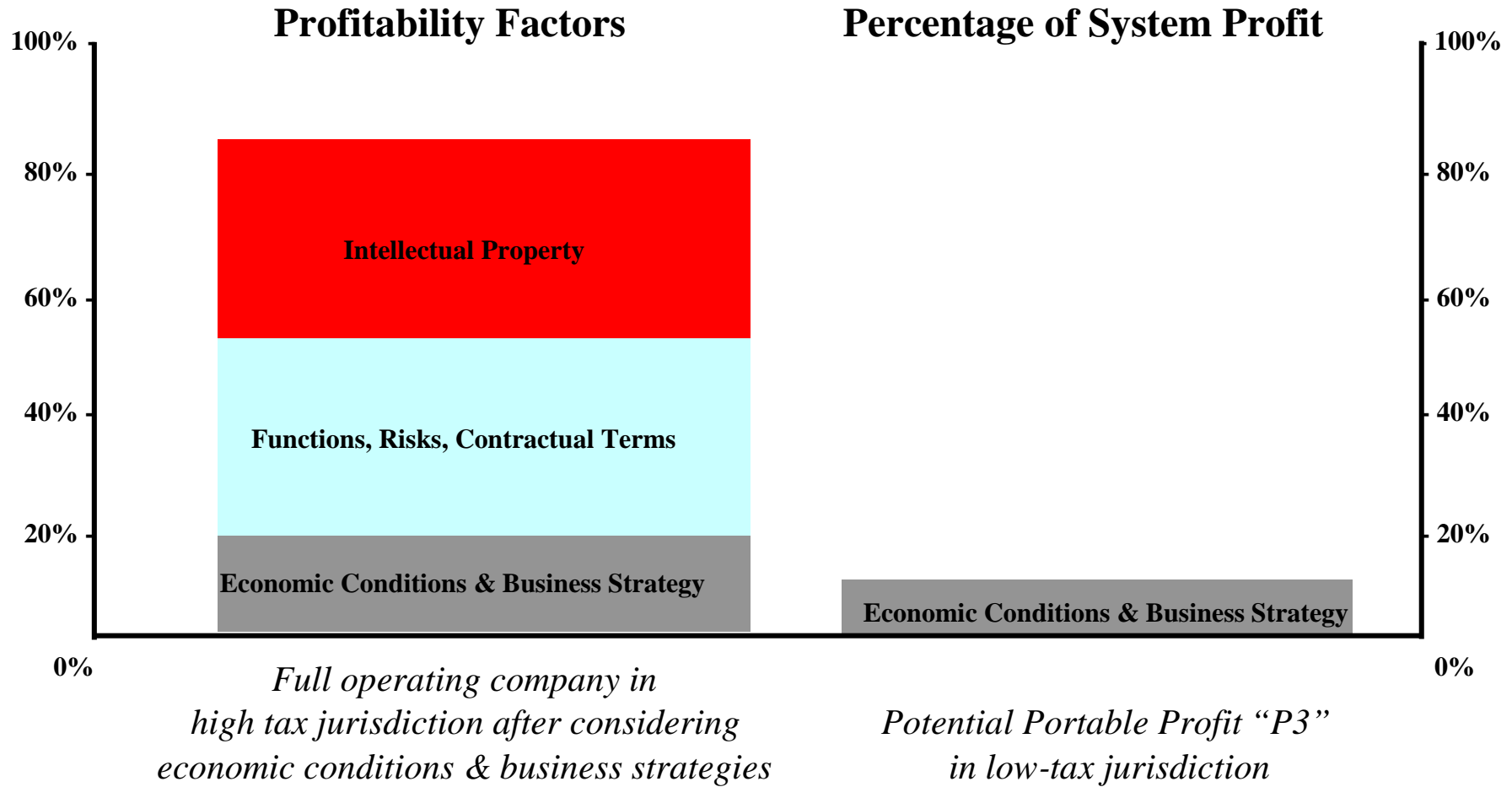


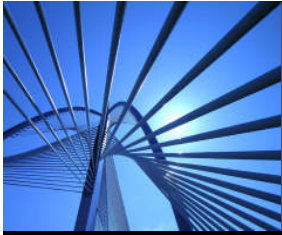
## Overview: Functional Analysis & Profitability Factors



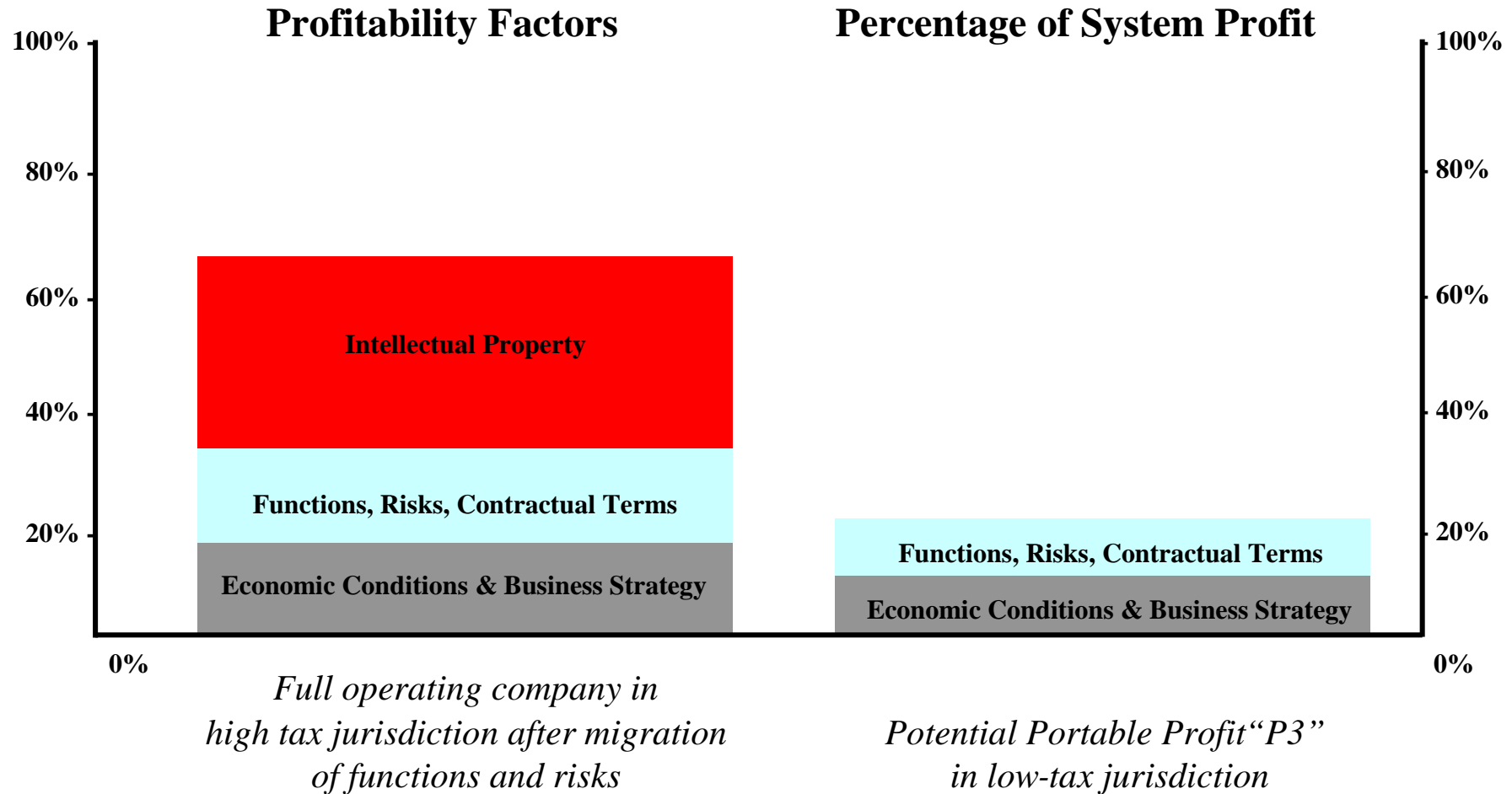


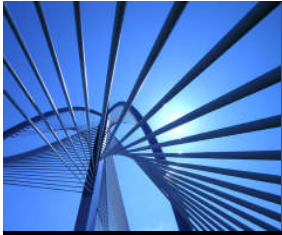
# Overview: Functional Analysis & Profitability Factors





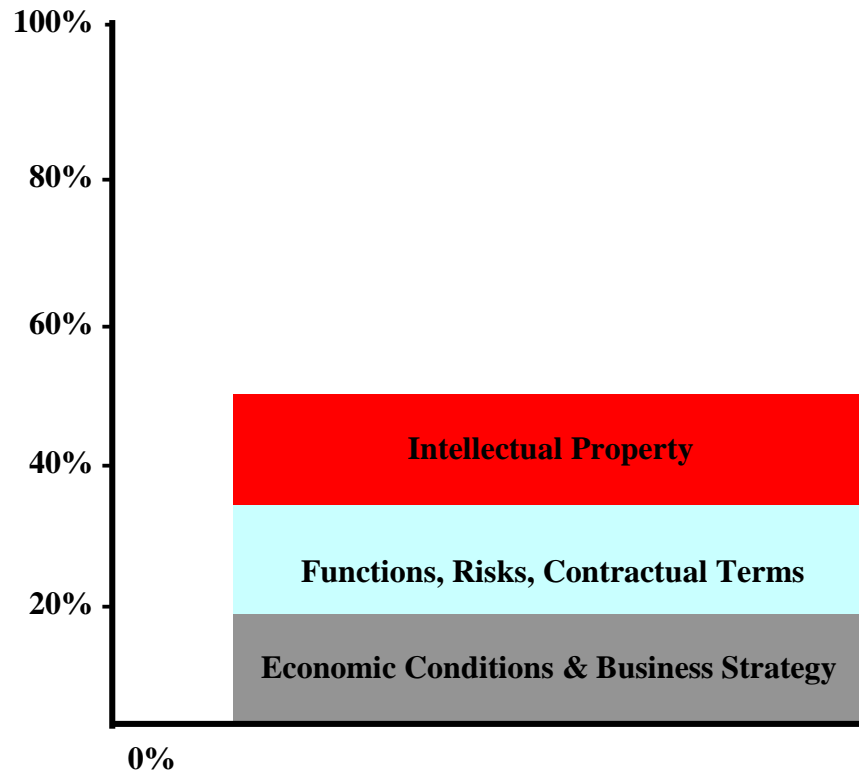
# Overview: Functional Analysis & Profitability Factors





# Overview: Functional Analysis & Profitability Factors

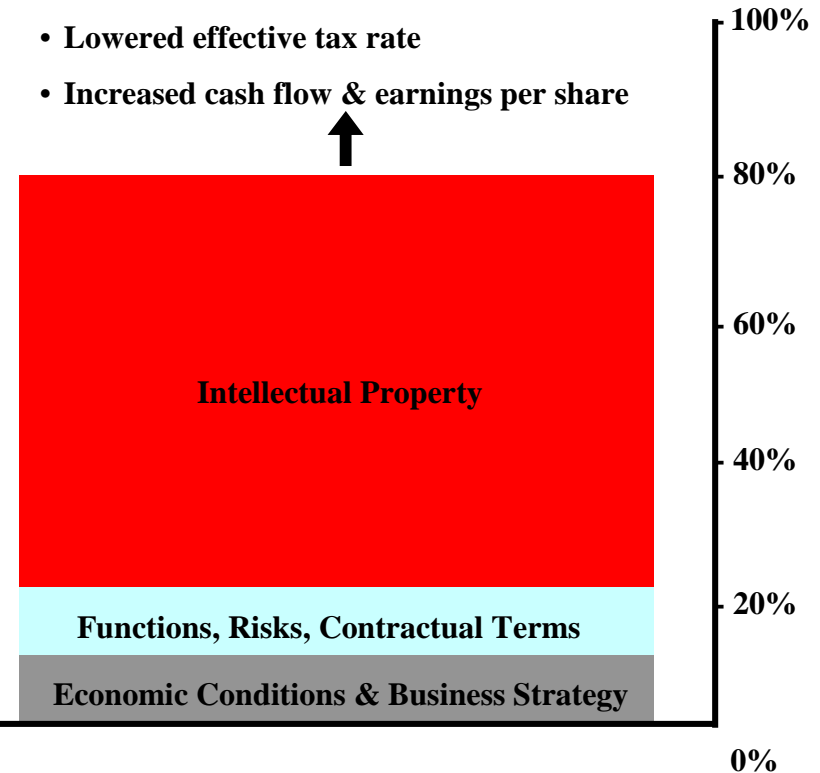
## Profitability Factors



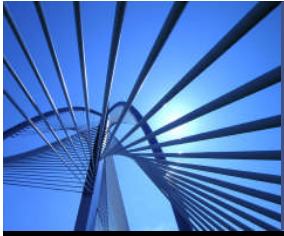
*Full operating company in high tax jurisdiction after migration of functions, risks, and IP*

## Percentage of System Profit

- Lowered effective tax rate
- Increased cash flow & earnings per share

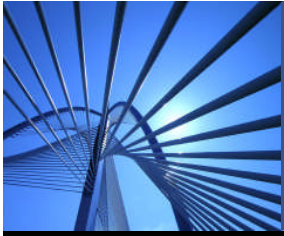


*Profit Portability Potential "P3" in low-tax jurisdiction*



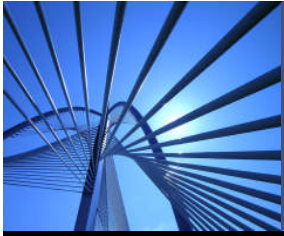
### COMPARABLE UNCONTROLLED PRICE (“CUP”)

- Rarely are direct third-party prices available.
- Those that are available must be “scrubbed”.
  - Often for smaller volumes than intercompany transactions.
  - Often are not transacted as frequently.
    - Transaction date may affect price.
  - Often “unique” transactions.
    - e.g., sale of product to utilize excess capacity.
- How many adjustments of what magnitude can be applied before the method is no longer reliable?



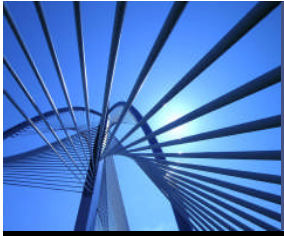
## Application of Methods: Comparable Profits Method Reg. §1.482-5(a)

“The comparable profits method evaluates whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances.”

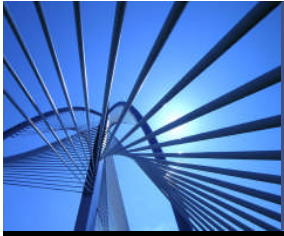


## Application of Methods: Comparable Profits Method Reg. §1.482-5(a)

- A variety of PLIs can be calculated, including:
  - Return on Sales
  - Return on Capital Employed
  - Gross Profit to Operating Expenses
- PLIs can be used to determine routine returns.



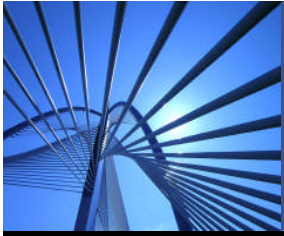




# **P**ART II

## **INVESTING IN THE U.S.**

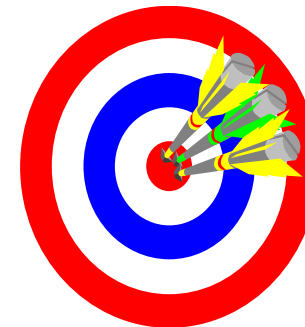
- Initial Set-Up of U.S. Presence
  - Issues to Consider Prior to Investment
  - Objectives of Structuring
  - Forms of Doing Business
  - Transfer Pricing
  
- Acquisitions of U.S. Companies
  - Recent Trends in Inbound M&A
  - Tax Due Diligence – Main Issues
  - Stock Acquisition vs. Asset Acquisition – Comparative Analysis
  - Utilization of Tax Attributes (Goodwill, NOLs)
  - Transfer Pricing
  - Global Structure Alignment (CFC Extraction)
  - Planning Ideas

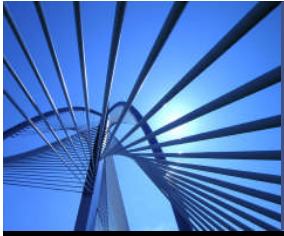


## Issues in Structuring U.S. Inbound Operations

- Global tax optimization and effective tax rate management.
- Form of doing business.
- U.S. trade or business or PE and tax exposure.
- Tax implications of creating entities or transferring assets into and out of the U.S.
- Planning for repatriation of profits.
- Regulatory issues.
- Local country tax issues.

- Global Tax Optimization (subject to business goals).
- Where do we want to put our profit?
- Profit Drivers:
  - Capital
  - Function
  - Know-How (intangibles)
  - Risk
- Which drivers attract the most profit?

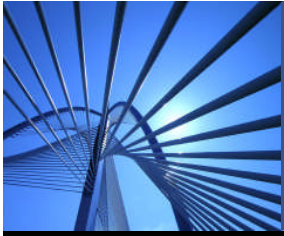




## Major Structuring Questions

- What entity form(s) to use?
- How to finance the entity(s)?
- How do we access our profits?
- How do we get out?

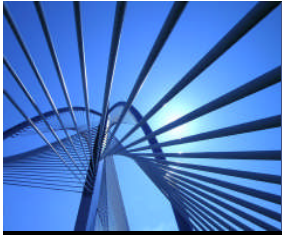




## Criteria for Selection of Entity

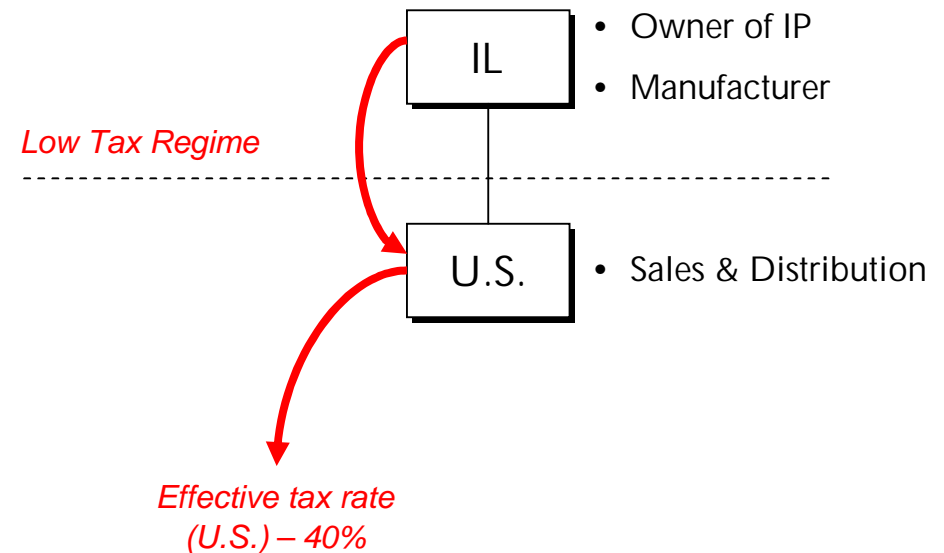
- Entity choice often the result of a "growth process".
- Key factors:
  - Projection of operating results.
  - Expected repatriation demands.
  - Type of income to be earned.
  - Availability of treaty benefits.

- Import only.
- Licensing agreement (indirect operation).
- Branch.
- Partnership.
- Domestic subsidiary.
- Foreign Subsidiary with U.S. branch.
- Hybrids (e.g., LLC, LLP, “Check-the-Box” entities).

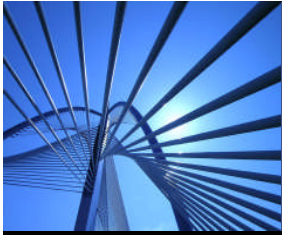


## Transfer Pricing – LRD Model

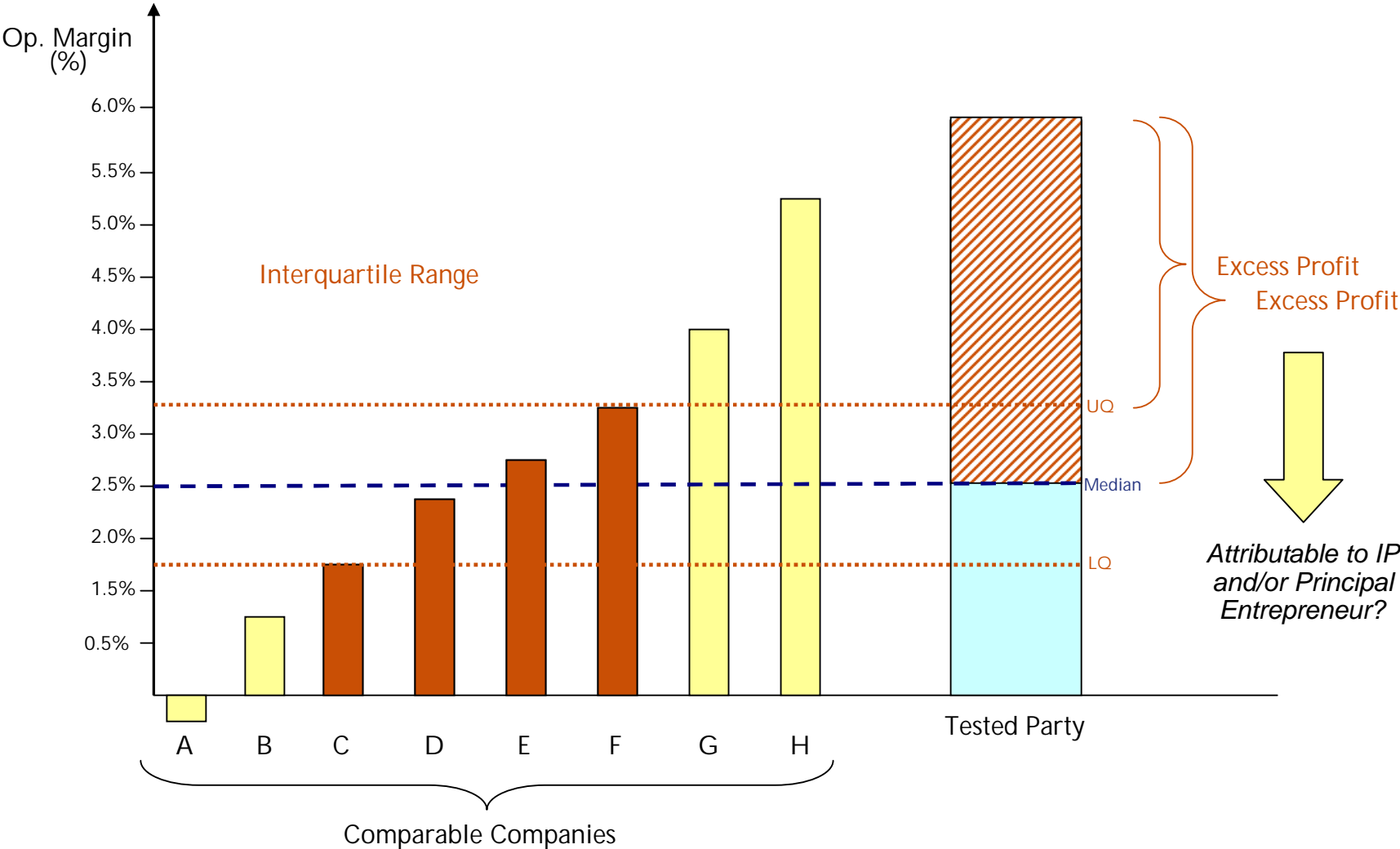
- Many of the Israeli companies enjoy tax incentives with respect to their Israeli sourced income under the “Approved Enterprise” regime.
- In contrast, the applicable tax rate for U.S. sourced income is usually around 40% (Federal, State and Local taxation).
- In order to allocate a significant portion of the group’s profits to Israel, and enjoy the applicable reduced tax rates, many Israeli entities operate in the U.S. under the Low Risk Distribution (“LRD”) model. This model is further discussed below.

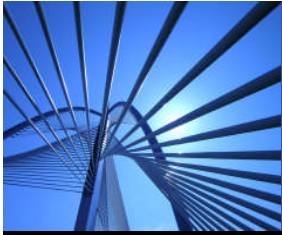






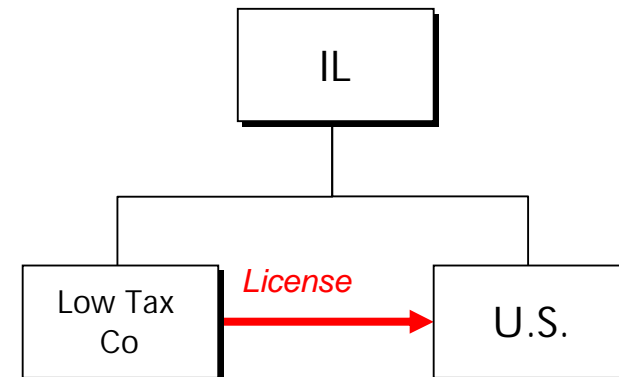
# Application of Methods: Application of CPM for LRD

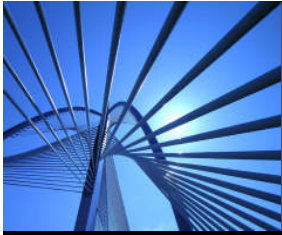




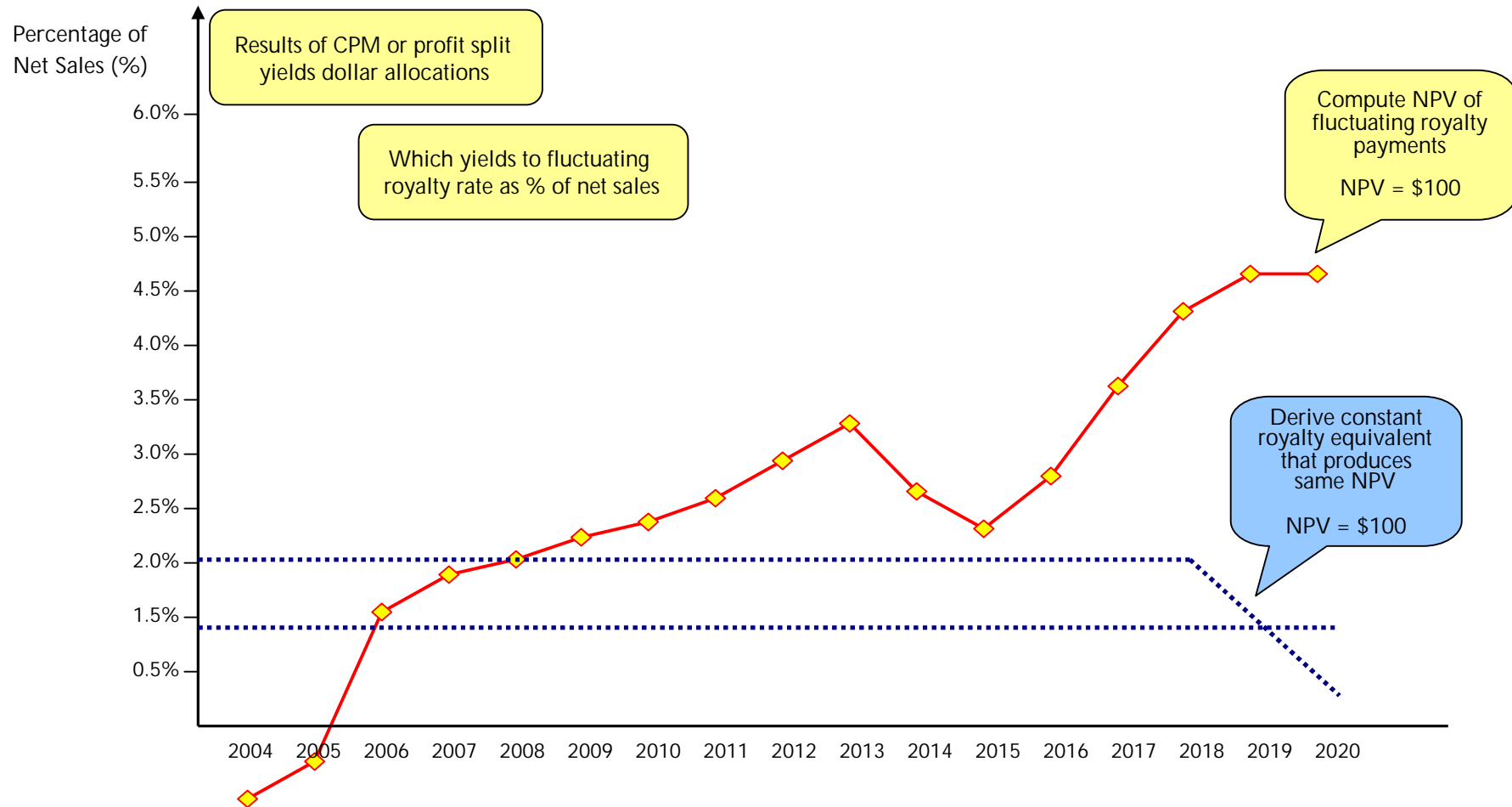
## Transfer Pricing – Royalties for Use of IP

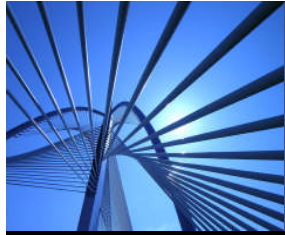
- Where the Israeli MNC does not enjoy preferential tax treatment under the Approved Enterprise regime, it may make sense to hold IP in a low tax environment and license the use of the IP to the U.S. (provided tax treaties apply).





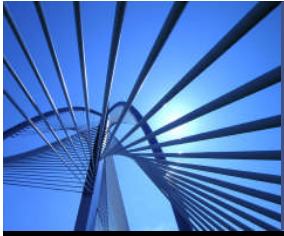
# Application of Methods: Derivation of Royalty Rate





## Application of Methods: Implementing a Limited Risk Distributor Model “LRDM”

- Conduct a functional analysis to identify baseline facts.
- Shift risks and functions from sales companies to one centralized location.
  - Inventory, accounts receivable, and foreign exchange risks.
  - Key point: LRD can be implemented on a product-line basis or on a company-wide basis.
- Address implementation issues.
  - Potential PE risk.
  - New decision-making and approval processes.
    - Reimburse significant marketing expenses to avoid ownership of marketing IP.
- Goal: LRDs have limited risks and intangible assets → transfer pricing implementation yields consistent low profitability over the long-term.



## Application of Methods: LRDM Typical Activities of the Entrepreneur

### Assets

- Ownership/licenses of:
  - Patent rights, know-how and technology
  - Group's relevant brand name(s) and trademarks
- Systems, processes and tools
- Control of human resources
- Training
- Contractual arrangements with supply chain

### Risks

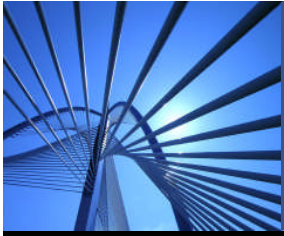
- Market risks
- Product liability risks
- Bad debts
- Foreign exchange risks
- Price protection
- R&D and marketing expenditure

Note: Mechanism effected through margin protection of local Marketer

Note: Some risks could be with Marketer depending on business drivers

### Decision-Making/ Functions

- Regional/Enterprise wide P&L responsibility
- Setting of parameters
- Exception reporting
- Product introductions
- Strategic approaches to market place and IP creation
- Brand management
- Budgeting
- Key account management
- Goodwill and international marketing efforts
- Setting of standards (QC, etc.)



## Application of Methods: LRDM Typical Activities of the LRD

### Assets

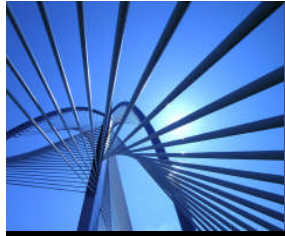
- Human resources
- Knowledge of local marketplace
- Customer lists/contacts

### Risks

- Bears minimal market risk
- Minimal inventory risk
- Bears credit risk
- Overrun of budgeted cost
- Poor sales performance

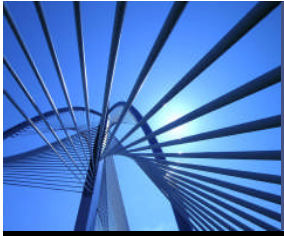
### Decision-Making/ Functions

- Performance of local marketing functions
- Negotiation and conclusion of sales contracts with local customers
- Performance of services required to meet local government regulations
- Invoice of customers in own name
- Implementation of quality control



## Application of Methods: LRDM – Limited Risk Distributor Objectives

- The LRDM centralizes the IP, risks, certain functions, P&L account results of and the key decision-makers for the LRD in a single entrepreneur entity. The LRDs will be selling product in their own names but in a manner and with a reward that reflects their limited risks and functions.
- Furthermore, the LRDM model aligns with the developing market driven centralization and globalization trend in operations of many multinationals by:
  - Providing a fiscal/legal framework to pursue direct sales/global or pan-Regional and other regional contracts/deliveries of services.
  - Providing a framework for local companies to pass certain risks to the Entrepreneur.
  - Increasing the transparency and accountability for revenue growth and operating performance.
  - Providing a legal/framework for significantly reducing inter-company transactions and cross charges.

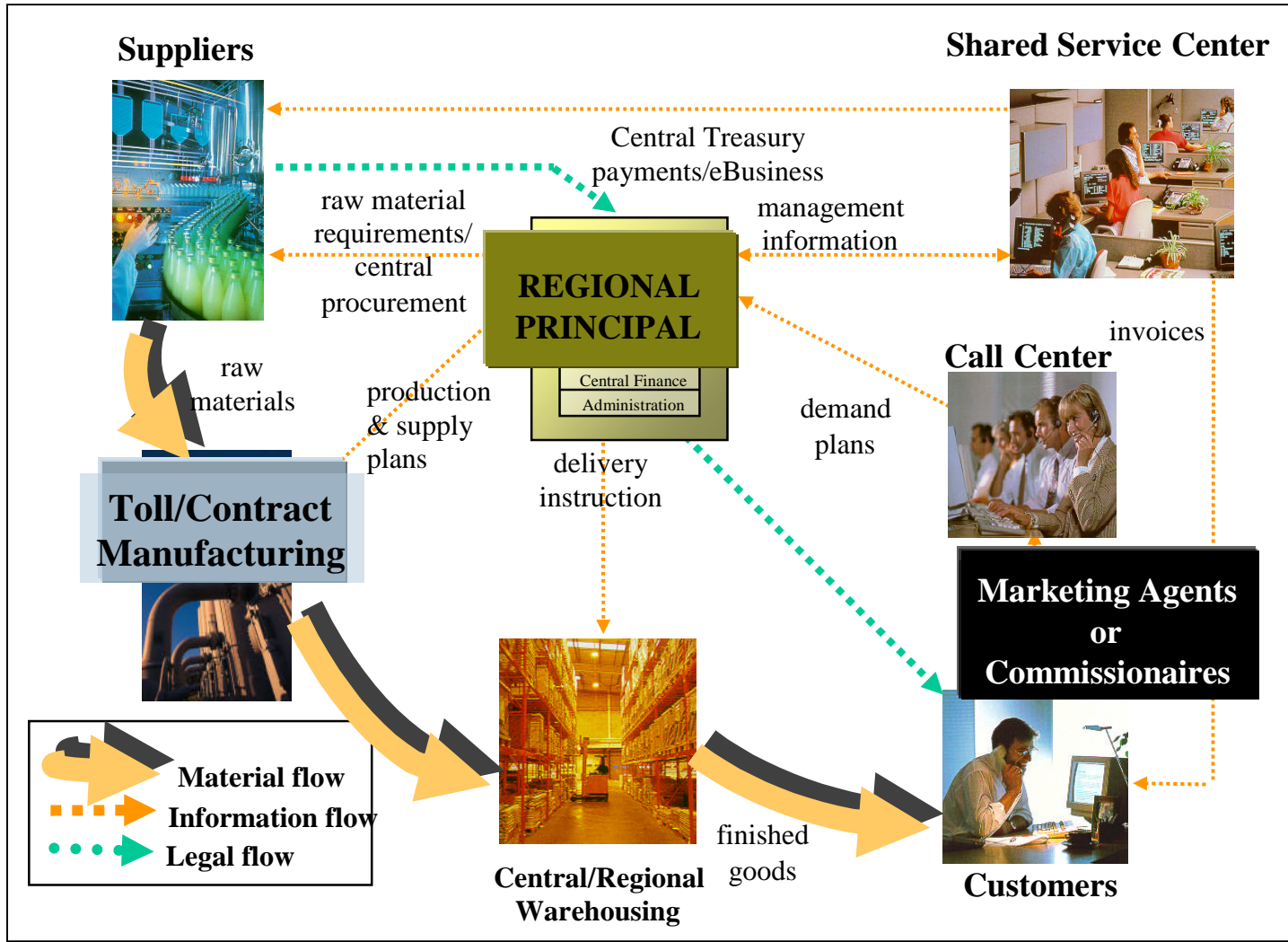


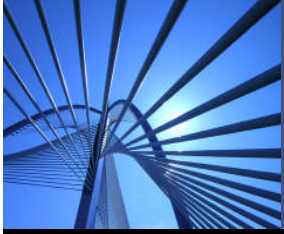
## Application of Methods: LRDM – Typical Contractual Arrangements between Entrepreneur & LRD

- The Entrepreneur enters into a LRD Agreement with each of the LRDs. This contract typically allows the following:
  - The Entrepreneur provides LRD with management services (e.g., headquarters, stewardship, strategy, direction and control, etc.).
  - The Entrepreneur bears certain risks relating to LRD's business (e.g., credit management risk, bad debt risk, delivery risk, foreign exchange risk, etc.).
  - The Entrepreneur grants LRD the right to use the IP without which LRD cannot perform contracts it enters into with customers in its respective jurisdictions.
  - Product pricing is set so that the arm's-length reward for LRD is targeted, and all excess profit is retained by the Entrepreneur.
- These contracts are usually accompanied by contract R&D agreements, tolling/supply agreements, and management services agreements.



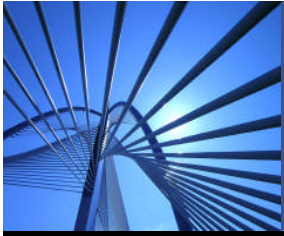
# Application of Methods: LRDM – Supply Chain Optimization





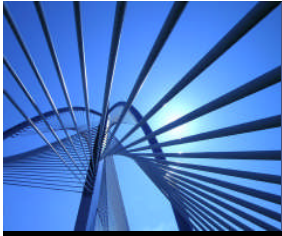
## M&A: Issues Influencing Deal Making in 2006

- Private equity groups have the clout to compete with large corporations for virtually any deal they want.
- Hedge funds have sufficient pools of capital to initiate, co-invest or compete with private equity funds for deals.
- An IPO market with both the sustained strength and industry diversification necessary to provide a viable exit for portfolio investments, even though direct sales to strategic buyers remain the preferred exit for most private equity investors.



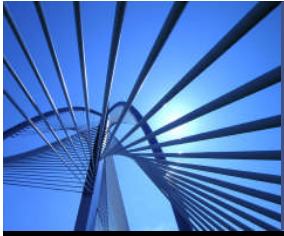
## Potentially Active Deal Sectors in 2006

- Retail
- Energy
- Utilities
- Technology
- Financial Services
- Healthcare/Medical Devices



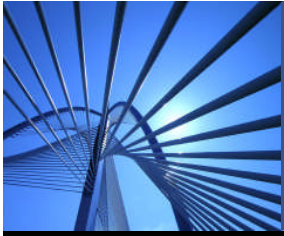
## Other factors Influencing M&A Activity in 2006

- Cash glut. Cash available for deployment at the S&P 500 and the top 50 private equity firms totaled \$1.9 trillion, an increase of \$147 billion or 8.5 percent since the end of last year.
- The default rate. With senior debt lending multiples at 4.1x EBITDA, up from 2.4x in 2002, and total lending approaching 6-7 x EBITDA, there's plenty of cash to do acquisitions.
- A third class of funds. Historically, hedge funds primarily invested in shorter-term, more liquid exchange-traded opportunities while private equity did private, long-term control deals. But today, firms in each group are entering the traditional domain of the other.



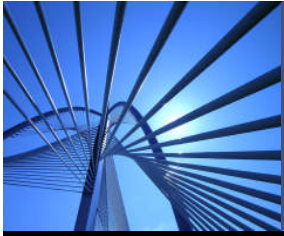
## Other Factors Influencing M&A Activity in 2006

- More IPOs likely.
- Interest in Asia, especially China.
- European companies and private equity firms remain focused on attractive deals in their domestic markets and across Europe, as demonstrated by the fact that in 2005, Europeans invested more than ten times as much in Europe as in the U.S. In total European acquisitions of U.S. companies totaled approximately \$65- \$70 billion in 2005.
- The total value of announced deals involving U.S. targets exceeded \$1.1 trillion.



### STOCK ACQUISITION

- This typically requires a “full scope” due diligence, which focuses on identifying tax exposures from prior years (federal, state and foreign).
  - Legal entity continues.
  - Exposures for all prior year tax liabilities remain with Target.
  - Deferred tax assets and liabilities generally carryover; however, may change due to push down accounting for book purposes.
  - Limitations on tax attribute carry-forwards.

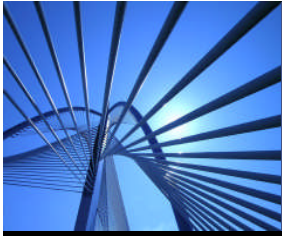


### ASSET ACQUISITION

- Not a typical due diligence – Normally results in limited scope due diligence for U.S. Some foreign still have prior year liabilities remaining with Target.
  - Old entity is not acquired.
  - Exposures for all prior year tax liabilities generally stay with seller of assets.
    - Exception for sales taxes and unemployment/disability insurance liabilities.
  - Tax attributes remain with seller.
  - Transfer taxes may arise, creating an obligation for the purchaser.

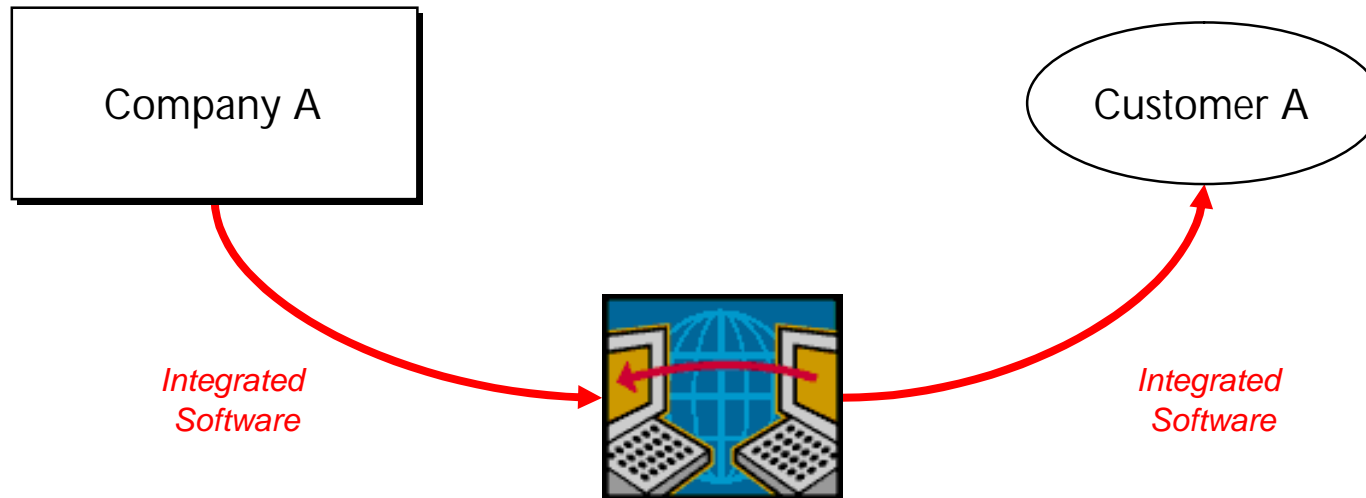
- Federal Income Taxes
  - Statute of limitations generally 3 years from date of filing.
  - If Target is part of larger consolidated group need to review consolidated return OR gain lock down indemnity.
  - Treas. Reg. 1.1502-6 causes target to take all prior year tax exposures of entire consolidated group (several while a member of the group).
  
- State/Local Income/Franchise Tax
  - Companies often take position that they have insufficient “nexus” (taxable connection) with a particular state to require filing.
  - States are generally aggressive.



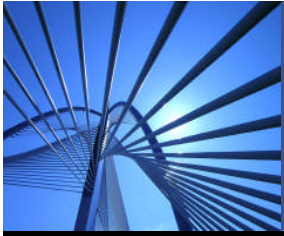


## Due Diligence – Other Taxes

- Sales Tax: Ensure Target's compliance with the collection and remittance of sales taxes. Exemptions exist for certain activities or operations (e.g., sales for resale, Healthcare).
- Use Tax: Arises when company purchases property without paying sales tax and then uses that property in its operations (not in manufacture of property for resale).
- Payroll Tax: Companies must withhold income, FICA and FUTA taxes for all employees and must file appropriate federal and state payroll tax returns. Typical area of exposure is classification of employee vs. independent contractor.
- Property Tax: Not often an area of exposure. Review work papers to ensure taxes have been properly accrued and paid.
- Excise Tax.
- Transfer Tax.

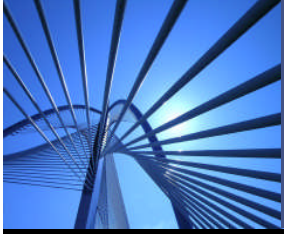


- **Applicable Authority:** Each state taxes sales in a different manner. Typically sales of “canned” software (e.g. non-customized software) is subject to sales tax. Some states exempt such sales if the software is transmitted electronically while others do not.
- **Potential Exposure:** Company A, has \$10m of sales each year attributable to “canned” software which is transmitted electronically. Company A does not charge sales tax on such sales. Based on facts specific to Company A a portion of such sales may be subject to sales tax. Assuming 50% of such sales are subject to a 6% sales tax, the potential exposure could be \$900,000 (three years) plus penalties and interest.



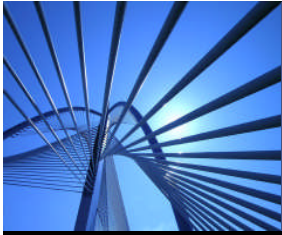
## Taxable Acquisitions – Tax Objectives of Seller

- 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.

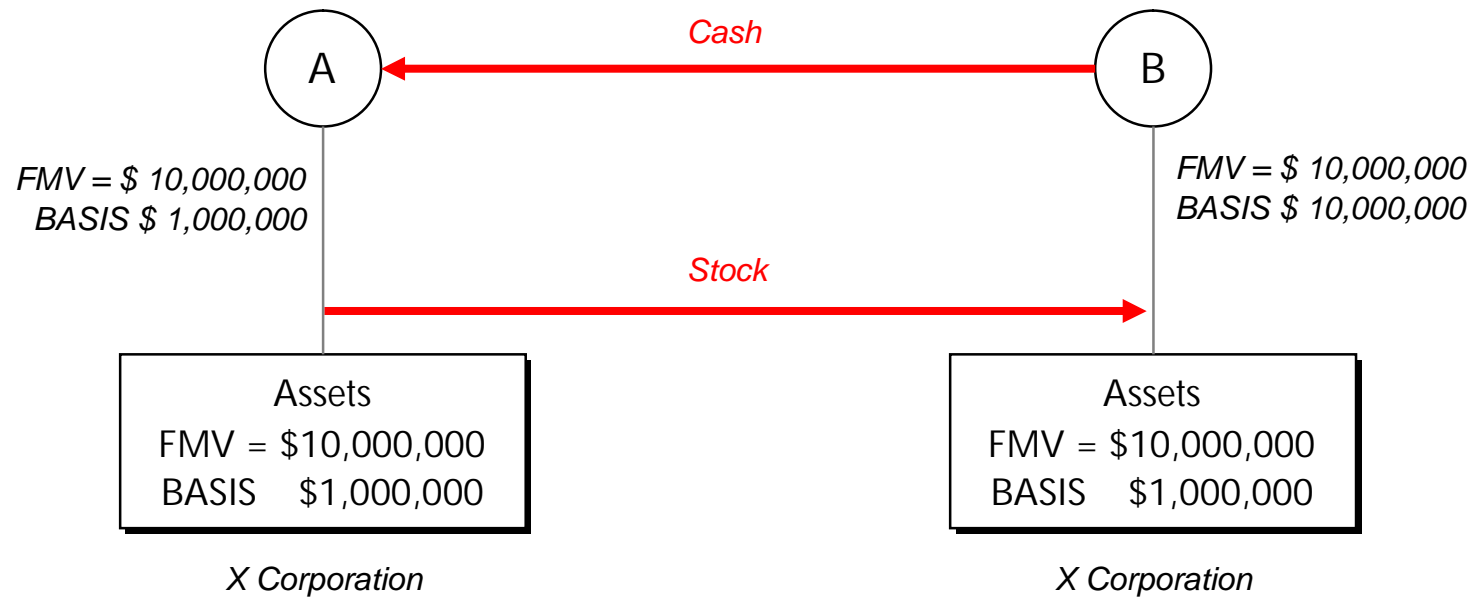


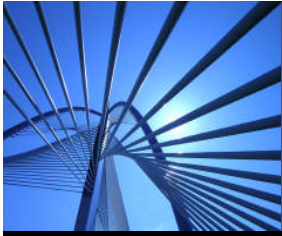
## Taxable Acquisition – Tax Objectives of Buyer

- 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



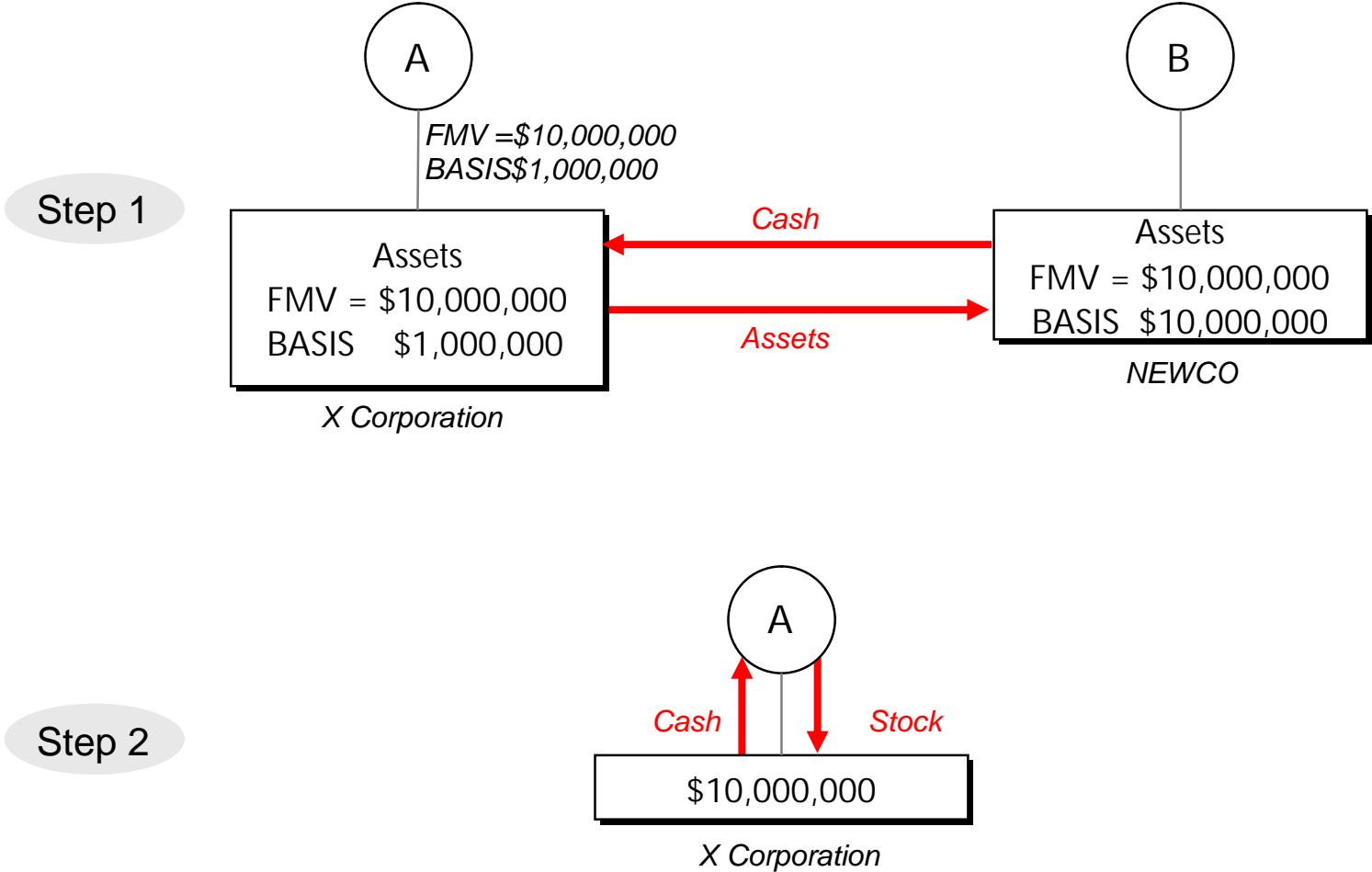
## Typical Stock Purchase (with No Section 338 Election)

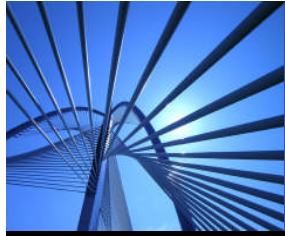




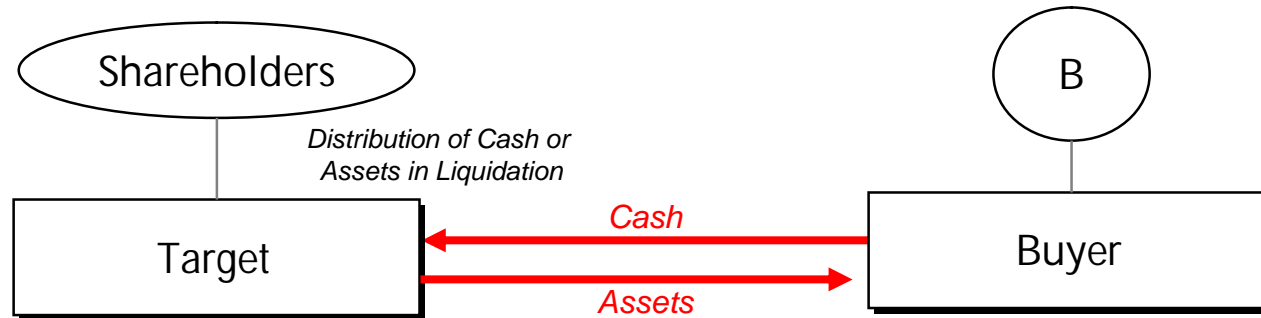
## Typical Stock Purchase (with No Section 338 Election)

- 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.





# 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

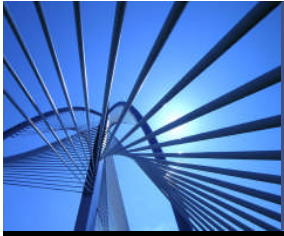
Compare:

After-tax Proceeds of Stock Sale

Proceeds:	\$100
Tax:	(20)
	\$80.00

\* 20% individual rate (15% federal long-term capital gain rate for individuals, plus assumed state tax rate of 5%) x \$65 proceeds distributed after corporate rate.

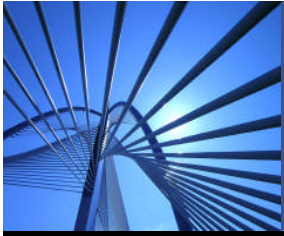




## Target Companies Where Double Tax Can Be Avoided

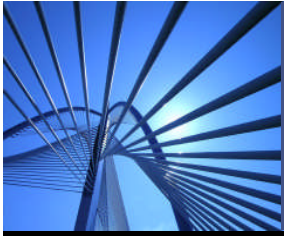
- S Corporations
  - Unless built-in gains tax applicable
- 80% owned subsidiary
- Partnerships
- LLCs

- 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.



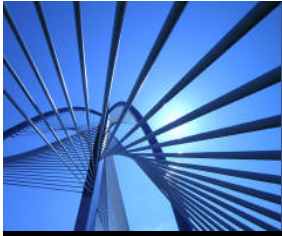
## Section 197 Amortization of Goodwill & Other Intangibles

- 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



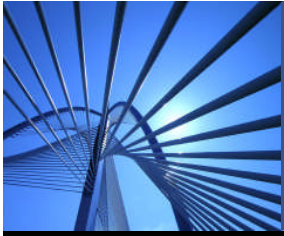
## Net Operating Losses (“NOLs”)

- 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 through 2005.
  - 5 years back
  - 20 years forward



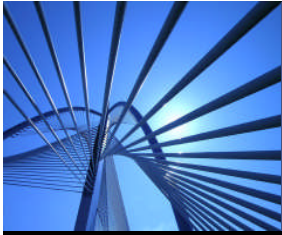
## Net Operating Losses (“NOLs”)

- 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).

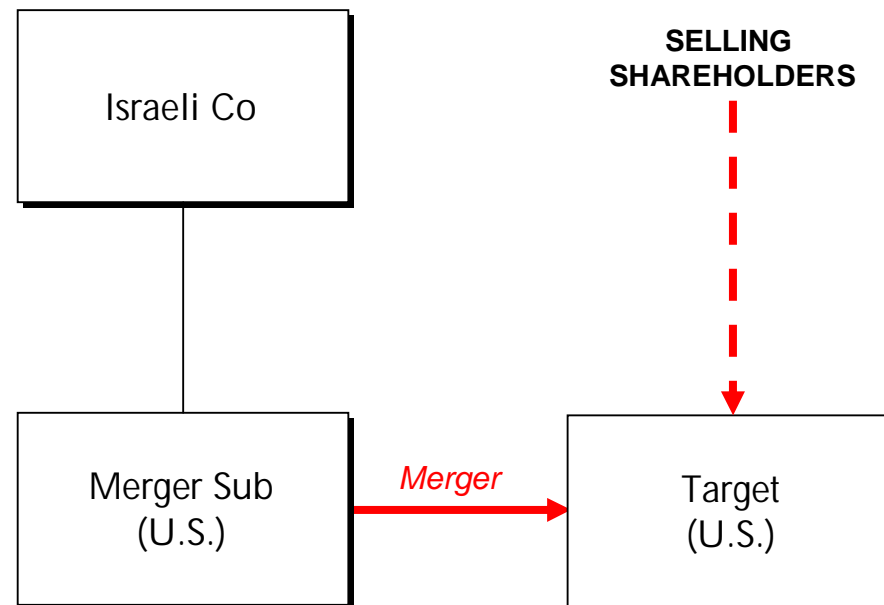


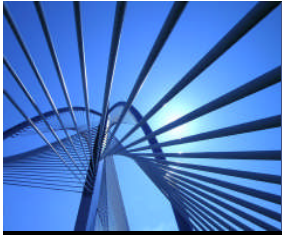
## Net Operating Losses – Section 382 Limitation

- 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.
  - $\$100\text{m} \times 5\% = \$5,000,000$ : 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.



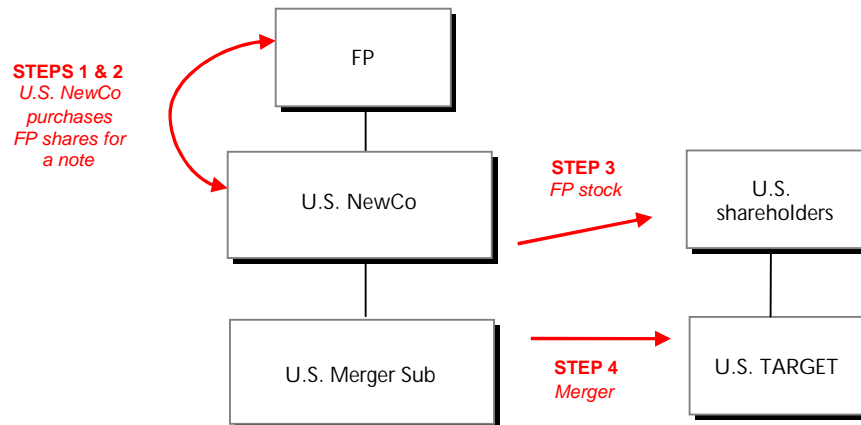
## Typical Israeli Acquisition of U.S. Target – Reverse Triangular Merger



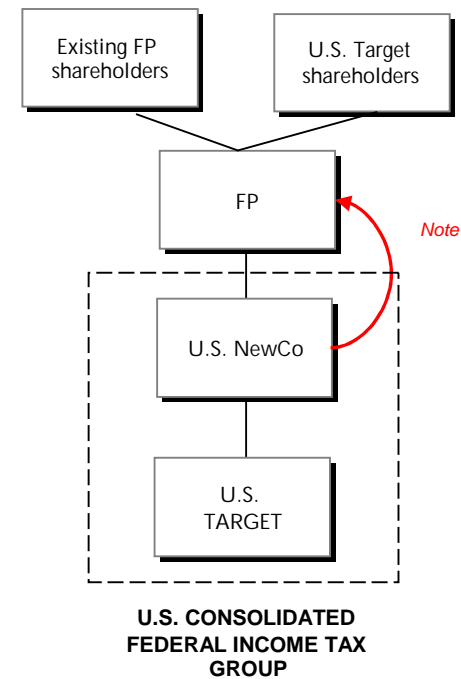


# Basic Tax-Free Acquisition of U.S. Target With Debt Insertion

## ACQUISITION STRUCTURE

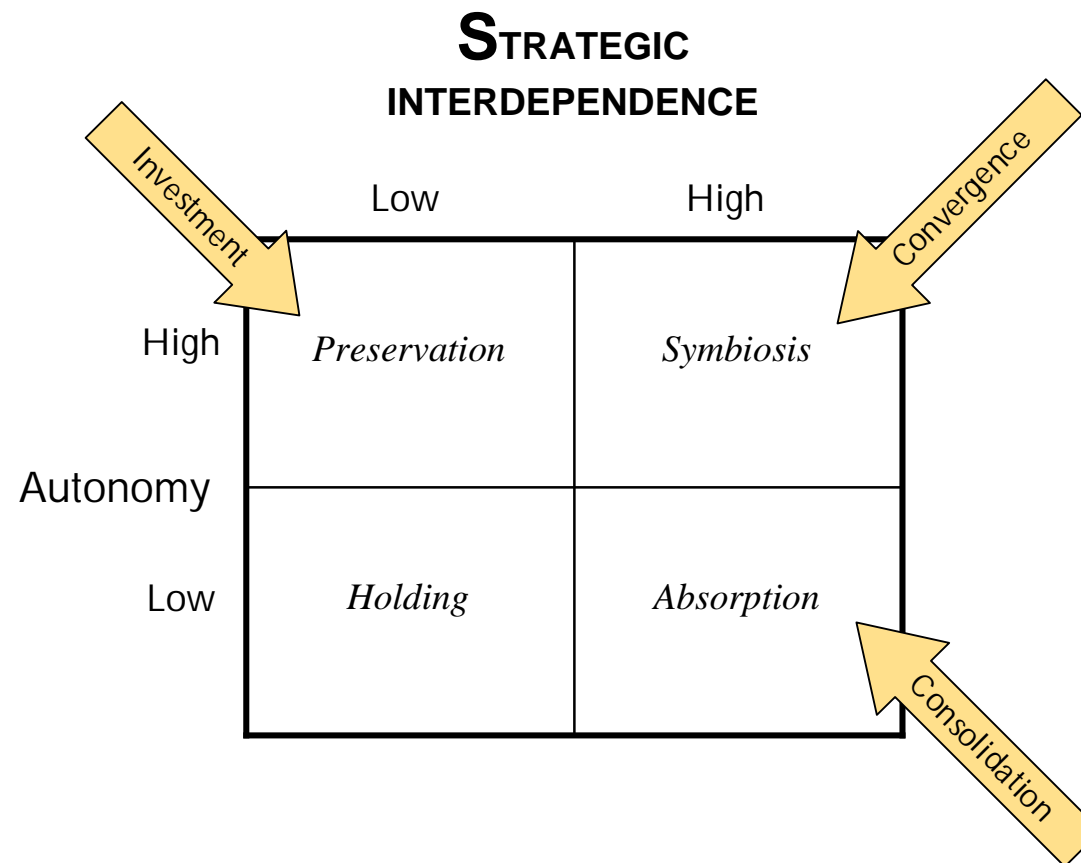
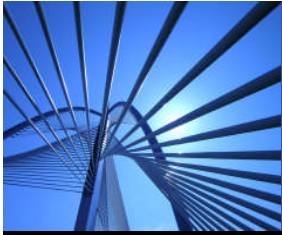


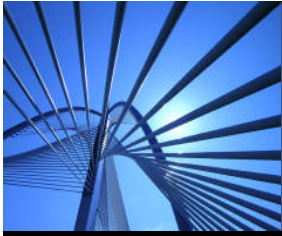
## RESULTING STRUCTURE





- Many firms are developing and acquiring the necessary IP and skills to perform this new functions through multiple and complex deals.
- Management must be ready to deal with the IP & Tax challenges open innovation presents:
  - Transfer pricing documentation
  - Economic analysis
  - IP structuring and integration
  - Legal ownership





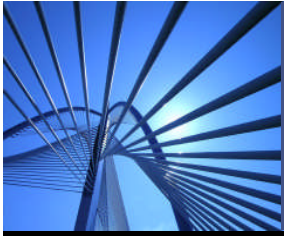
## Merger Integration is the Key Challenge

“We don’t want to be like a tiny snake that swallowed a big rabbit...  
you go to sleep for a long time when you do that”

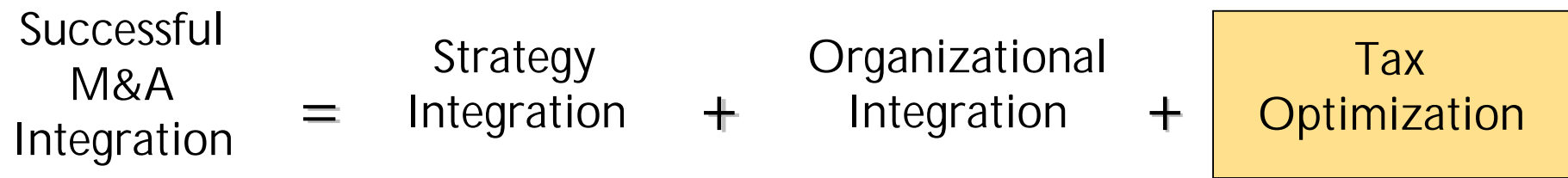
“The consolidation and convergence models calls for a very different  
post-merger integration capabilities”

“You want to customize every integration, but you don’t want  
to start from scratch each time”

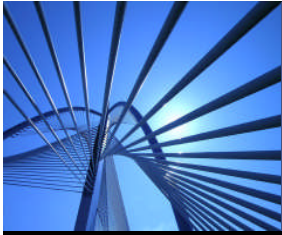
Pharma Marketer, 2003



## Tax Planning May Increase the Chances for a Successful M&A Integration

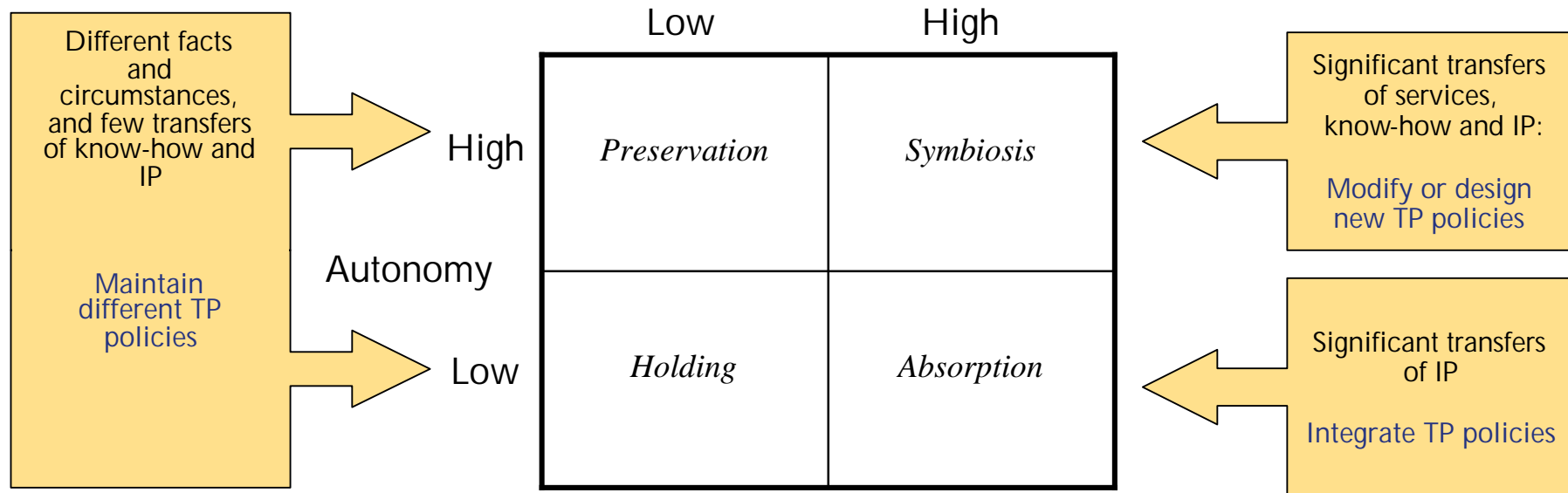


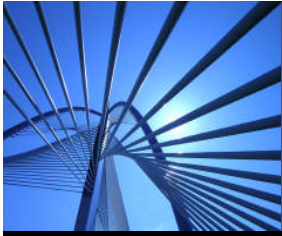
- Success happens when the acquiring organization and target organization are integrated appropriately.
- For tax purposes this means maintenance or reduction of ETR, with low maintenance costs and management disruption.



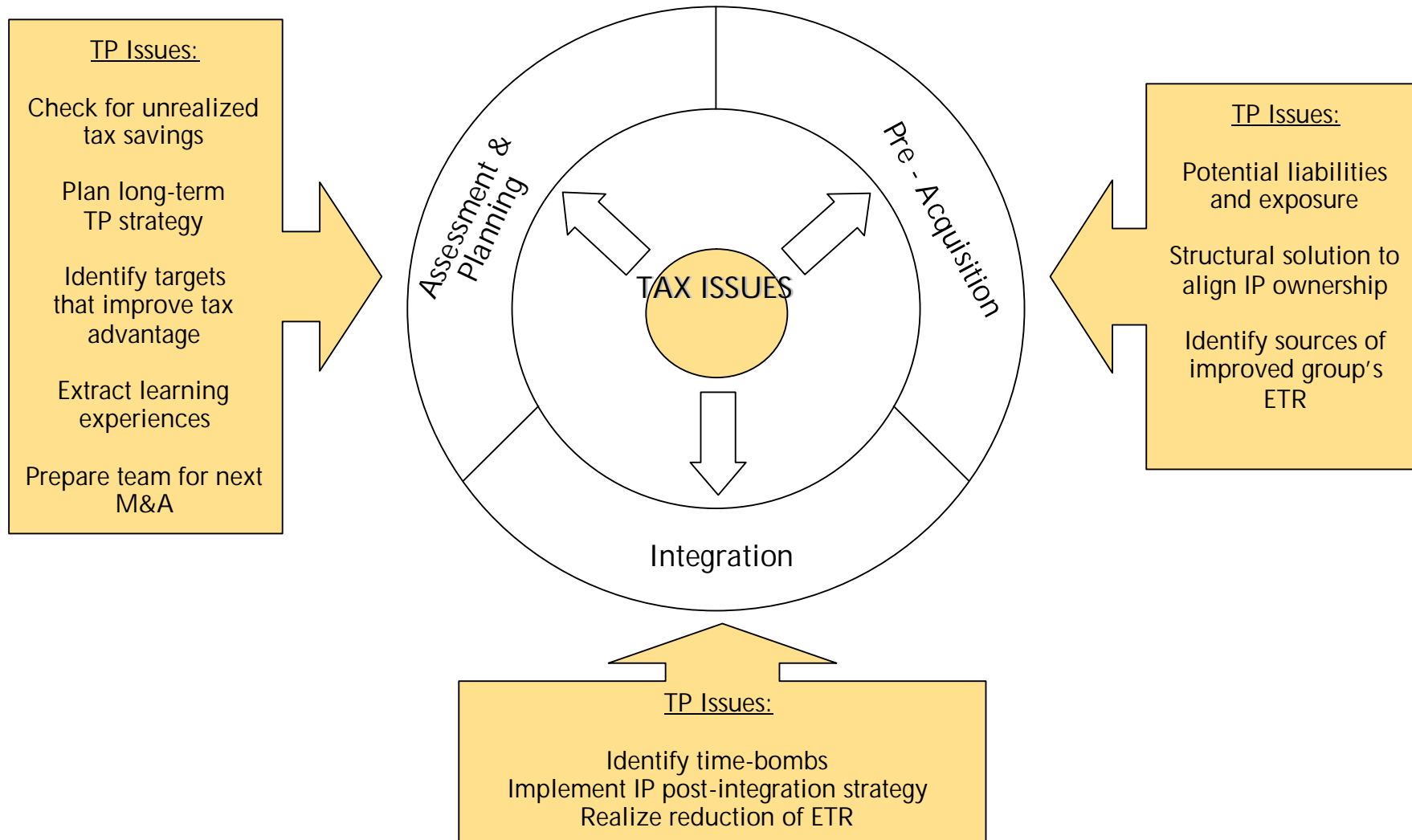
## Transfer Pricing Approach Depends on Type of Integration

### STRATEGIC INTERDEPENDENCE





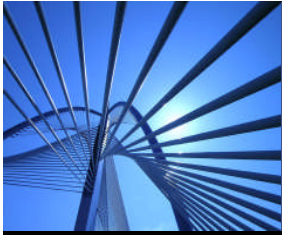
# Tax M&A Tax Team Must Be Fully Involved in All Stages of the Deal



- In the past few years many countries have enacted stringent transfer pricing rules and documentation requirements.
- If properly applied and aligned with business functions and strategies, transfer pricing can deliver enormous benefits.
- Transfer pricing can result in significant controversies, double taxation, penalties and damage the brand image of MNCs.
- Implementing an LRDM structure provides centralization of IP, risks, and management services and generally an overall lower ETR.
- APAs serve as an effective dispute resolution mechanism.
- Good transfer pricing analysis is essential to ensure the reliability of financial statements.

- Tax authorities and international organizations are increasingly focusing their attention to the integral role that services play in developing intangibles, managing risk, manufacturing operations and producing value.
- M&As may continue to accelerate in many industries as more companies embrace “Open Innovation”.
- Tax teams will be challenged to keep up with “knowledge brokers and scouts” and achieve successful integrations.
- M&A tax teams should focus on IP ownership, transfer pricing strategy integration to add business substance to pre-existing structures and maximize planning opportunities.
- Most successful tax planning will incorporate third-party IP, and be aligned with business operations and strategies.





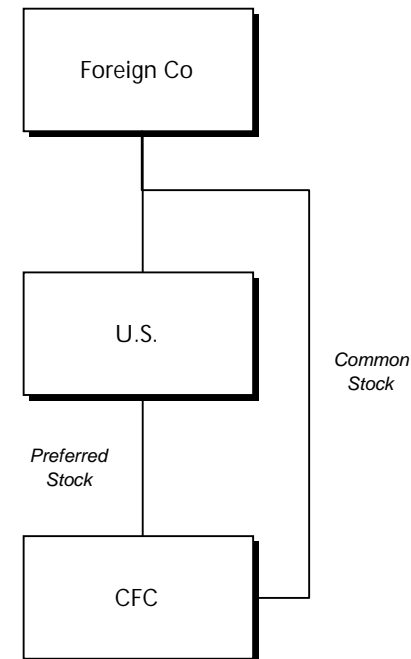
## Global Structure Alignment Preferred Stock Freeze

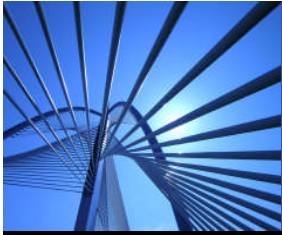
### TRANSACTION STEPS

1. U.S. exchanges all or part of its common stock in CFC for preferred stock of equal value in a recapitalization transaction.
2. Foreign Co, a foreign parent acquires (by purchase or distribution) CFC common stock.

### CONSIDERATIONS

- Business purpose required.
- Foreign appreciation related to CFC inures to the benefit of Foreign Co.
- The preferred stock generally should pay fixed dividends. Hence, any Subpart F income derived by CFC should not be taxed to U.S. in excess of its preferred dividend entitlement.
- The preferred stock generally should be structured to avoid classification as Section 351(g) non-qualified preferred stock, fast-pay stock, or Section 305 or 306 stock.
- The recapitalization is intended to qualify for tax-free Section 368(a)(1)(E) treatment.
- Common stock held in CFC must be substantial in relation to U.S.' preferred stock.
- If CFC's CFC status is lost, Section 367(b) issues may arise.





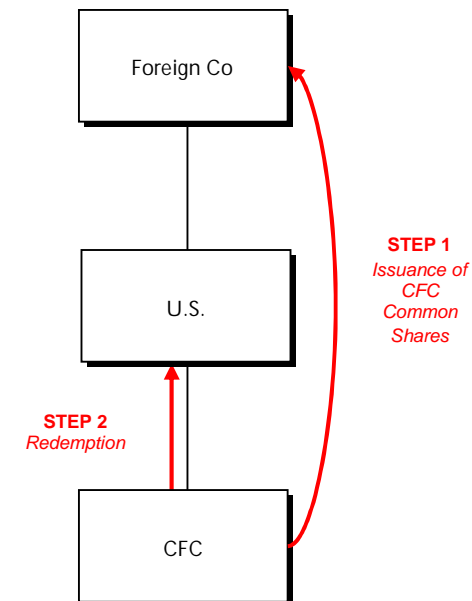
# Cash Contribution with Redemption

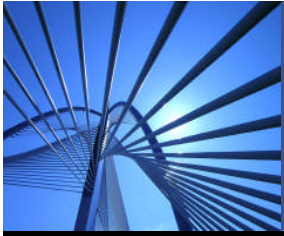
## TRANSACTION STEPS

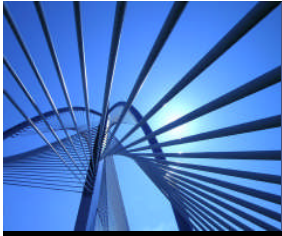
1. Foreign Co contributes cash to CFC in exchange for CFC common shares.
2. Periodically, CFC redeems shares held by U.S.
3. If decontrol or a freeze is desired, CFC issues non-voting preferred stock to U.S.

## CONSIDERATIONS

- Business purpose required.
- Redemption should be taxed as a distribution under Section 301, i.e., as a dividend to the extent of the E&P of CFC (potentially carrying deemed paid credits), reduction in basis to the extent in excess of E&P, and gain subject to Section 1248(c) rules (potentially accessing lower-tier E&P) upon exhaustion of basis.
- CFC recognizes Section 311(b) gains upon distribution of appreciated property.
- U.S.'s ability to claim FTCs may be affected by existing OFLs and future Section 861 allocations.
- Retention of cash may raise PFIC issues.

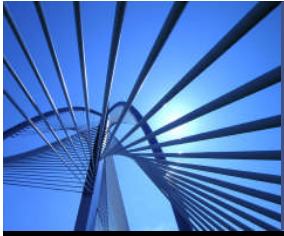






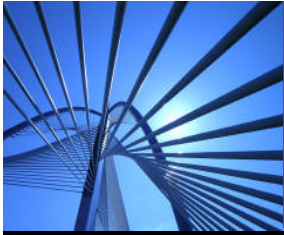
# **PART III**

## **ON-GOING MAINTENANCE OF U.S. INVESTMENTS**



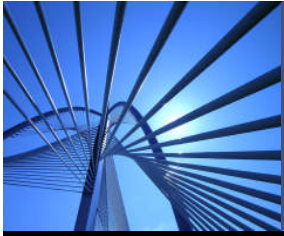
## Part III – On-Going Maintenance of U.S. Investments

- PE Risk Management
- Transfer Pricing – Dispute Resolution
- Filing Issues

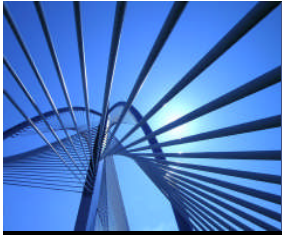


### The dilemma – to file or not to file? That is the question!

- If no “protective” return is filed:
  - Unless a “protective” return is filed, an IRS determination that a PE exists might result in:
    - Denial of deductions and credits.
    - Various penalties.
- If a return is filed:
  - The IRS recently conducted specialty training for international agents to examine “Protective” Income tax returns filed by foreign corporations.
  - 160 returns have been selected for examination, out of over 1000 reviewed. If substantial issues are identified, the IRS will most likely expand the protective return examination program.
  - IRS decided to take another look at this area due to increased activity by foreign governments raising PE issues on U.S. companies.

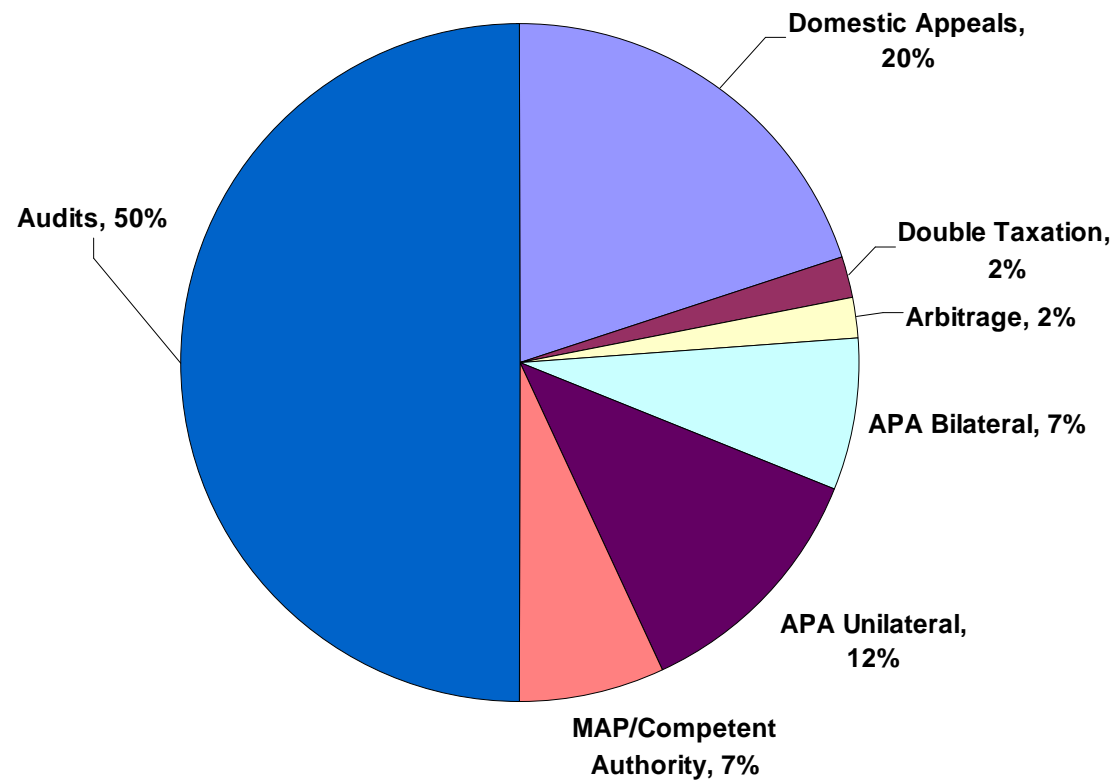


- PwC is able to advise clients on whether their U.S. activities reach the threshold of having a PE by conducting a compliance review.
- A Compliance Review is a proactive approach for foreign taxpayers to identify, strategize, and address potential permanent establishment exposure matters before the issue is raised by the IRS.
- PwC will apply similar audit techniques used by the IRS to recognize activities/ transactions that may be deemed as a U.S. trade or business/permanent establishment.
- The compliance review will consist of:
  - Review of legal structure of foreign multinational and the U.S. subsidiaries or other business entities operating in the U.S.
  - “functional analysis” to gather information about the foreign taxpayer in terms of its functions, risk and intangibles, in order to identify how these are allocated between the companies involved in the transactions identified for review.
  - Interview of key employees to discuss topics such as manufacturing, marketing, and distribution functions at the various entities.

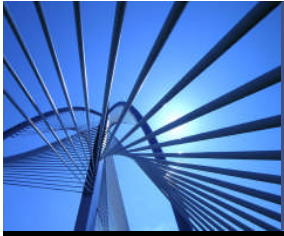


## Dispute Resolution & Controversies: Current Trends

### THE MAJORITY OF ALL DISPUTES ARE RESOLVED IN THE FIELD

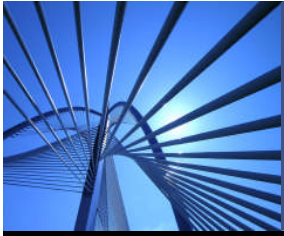






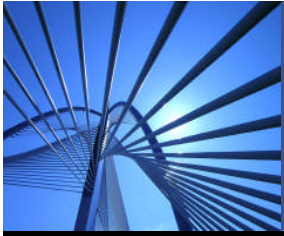
## Dispute Resolution & Controversies: Current Trends

- Recent trends in transfer pricing audits include:
  - Disagreement on the value of marketing vs. manufacturing intangibles.
  - Increased reliance on third party data.
  - Challenge of the deductibility of management service fees in foreign jurisdictions.
  - Multiple challenges to use of Transactional Net Margin Method (“TNMM”).
  - Challenge of the aggregation of transactions.
  - Challenge of consistency of methods over multiple transactions (particularly important post-merger/acquisition).
  - Absence of contemporaneous documentation leading to large assessments.
  - Challenge of financial transactions (particularly factoring).



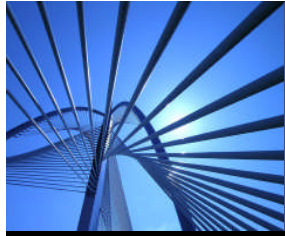
## Dispute Resolution & Controversies: Current Trends

- IDR: Primary documentation/background documentation.
- Audit leading to a 30-day or 90-day letter.
- 30-day letter taken to Appeals.
- If not settled, a 90-day letter will be issued.
- 90-day letter taken to Court.
- Pay tax and sue for refund in Claims or District Court.
- Go directly to Tax Court to challenge the assessment – often sent back to Appeal to try for settlement.



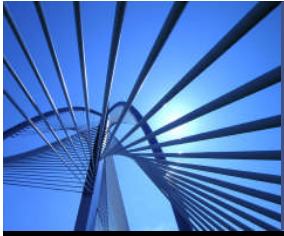
## Dispute Resolution & Controversies: MAP & APA Possibilities

- After the “damage” is done:
  - Mutual Agreement Procedure under Treaty.
  - EU Arbitration Convention.
  - or other “agreements” with the tax authorities.
- Before the “damage” is done:
  - Advance Pricing Agreements: unilateral, bilateral, multilateral.



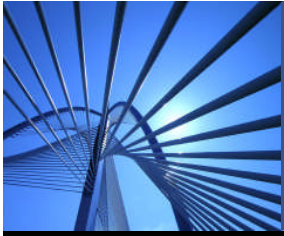
### **A**DVANCE PRICING AGREEMENTS

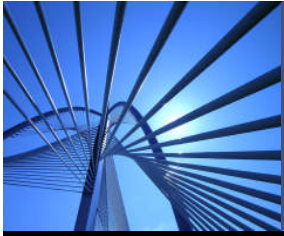
- Provisions in domestic legislation (USA, Japan, Australia, U.K., Spain, Belgium, the Netherlands, Canada, Mexico, China, etc) → growing number of countries are introducing APA provisions in their legislation.
- Possible under the Mutual Agreement Procedure of the double tax treaties (bilateral APAs).
- Informal agreement with the tax authorities (unilateral).



## Dispute Resolution & Controversies: When an APA Should be Considered

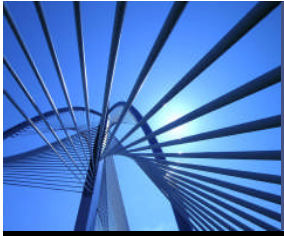
- Complex TP issues (integrated businesses, intangibles, ...).
- New business operations.
- Resolution of an existing dispute (if rollback possible).
- Prior investigation has been difficult.
- In all cases: ready to full transparency.
- Intra-EU transactions: quicker results through APA than through EU arbitration.





# **P**ART IV

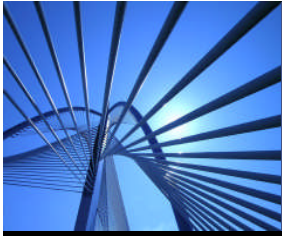
## **DIVESTING OF U.S. INVESTMENTS**



## Part IV – Divesting of U.S. Investments

- Exit Strategies
  - Corporate level considerations
  - Shareholder level considerations
- Liquidations

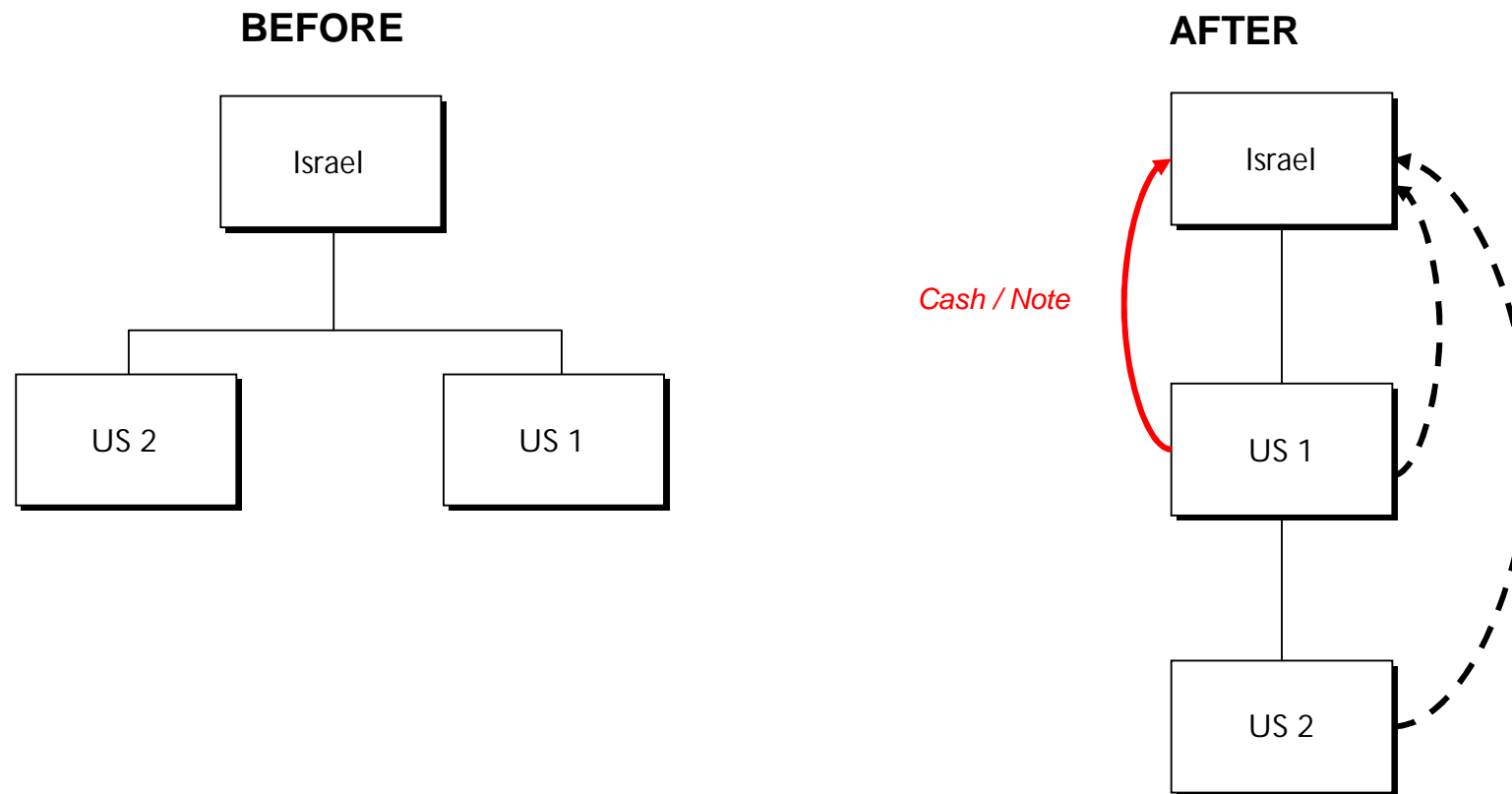




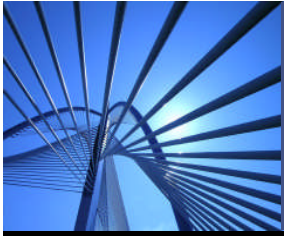
## Disposition of U.S. Property

- General Rule – Sale by a foreign (non-U.S.) person of U.S. property is not taxable in the U.S. because gain / loss is considered to be sourced outside the U.S.
- Main Exceptions:
  - Sale of inventory and depreciable property.
  - Gain attributable to U.S. Trade or Business / PE.
  - Sale of U.S. Real Property Interests, including stock of U.S. Real Property Holding Company.
  - Sale of intangibles.
  - Section 304.

- Corporate Level
  - Liquidation of U.S. subsidiary of foreign corporate shareholder is generally taxable at the corporate level, and is treated as a sale of the assets at FMV. Subject to the following exceptions:
    - Distribution of property used in a U.S. trade or business for the following 10 years.
    - Distribution of a directly owned (80% of vote and value) of another U.S. subsidiary.
    - Distribution of certain U.S. real property interests.
- Shareholder Level
  - Liquidation of U.S. subsidiary is treated at the shareholder level as a disposition of the stock of the U.S. subsidiary, and therefore is generally not taxable in the U.S. to a foreign shareholder, unless:
    - Liquidating corporation is a U.S. holding company which has not been in existence for at least 5 years.
    - Shareholder of the liquidating U.S. corporation is a CFC of another U.S. corporation.
  - If liquidation is taxable to the shareholder, distribution to shareholder is treated as a dividend to the extent of the liquidating corporation's "Earnings and Profits", potentially triggering U.S. withholding tax.

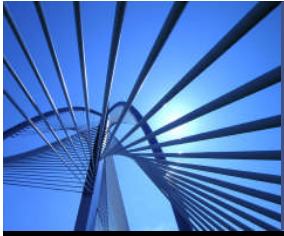


- Israel Co Sells US 2 to US 1 for cash / note.
- Cash / note treated as a distribution in redemption of the stock of US 1 (i.e., as a dividend to the extent of US 1's E&P and then US 2's E&P) potentially triggering US withholding tax!



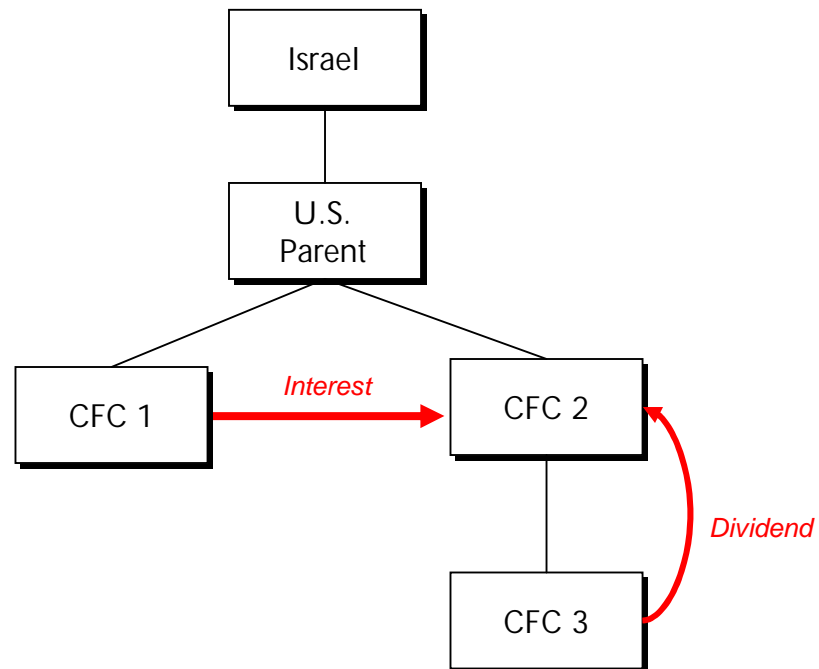
# **PART V**

## **RECENT LEGISLATIVE & TREATY DEVELOPMENTS**



## Part V – U.S. Legislative & Treaty Update

- CFC Look-Thru Legislation
- U.S. Earnings Stripping
- Corporate Residency Rules
- Inversion Rules
- Fundamental Tax Reform
- Other International Provisions in TIPRA

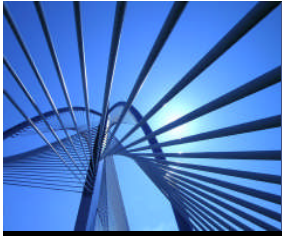


## BEFORE

- Interest and dividend income received by CFC 2 generally constitutes subpart F income taxable currently in the hands of U.S. Parent.

## NEW LAW

- The interest and dividend income received by CFC 2 not subpart F income to extent attributable to non subpart F earnings of CFC 1 or CFC 3, respectively.
- New rule applies to dividends, interest, rents and royalties.
- Automatic expiration after 3 years (2005-2007).
- Anti-abuse provision.
- Potential opportunities for Israeli MNCs acquiring U.S. companies to extract CFCs using the new law.



## Earnings Stripping Rules – Update

- Treasury Administration proposal:
  - Reduce 50% ATI limitation to 25%.
  - Repeal 1.5 to 1 debt-equity safe harbor
  - Reduce indefinite carryforward period to 10 years.
  - Repeal 3-year excess limitation carryforward period
- Treasury study – due out this year.
- Potential legislative action – more limitations on interest deductions?

### **O**BSERVATION

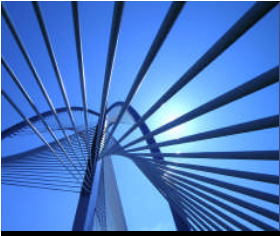
***MAY NOT BE FURTHER PROPOSALS ON EARNINGS STRIPPING UNTIL 2007***

- Perceived Abuse:
  - Companies incorporating or relocating headquarters outside the U.S., but retaining management in the U.S.
- U.S. Proposals:
  - Apply a “place of management and control” test to foreign incorporated companies.
  - More complex than rules employed by other countries – Not where board of directors meets.
  - Very complex facts and circumstances test looking to management activities through subsidiaries of the group.
- Impact:
  - If Israel multinationals have a significant amount of management presence in the U.S., the Israeli parent could be treated as a U.S. corporation for all U.S. tax purposes.

### **OBSERVATION**

**NON-U.S. MULTINATIONALS WITH GLOBAL BUSINESS LINES MANAGED  
OUT OF THE U.S. NEED TO REVIEW THESE PROPOSALS**

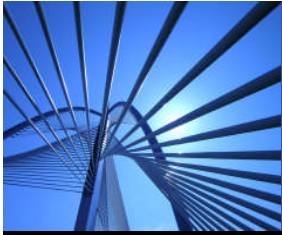




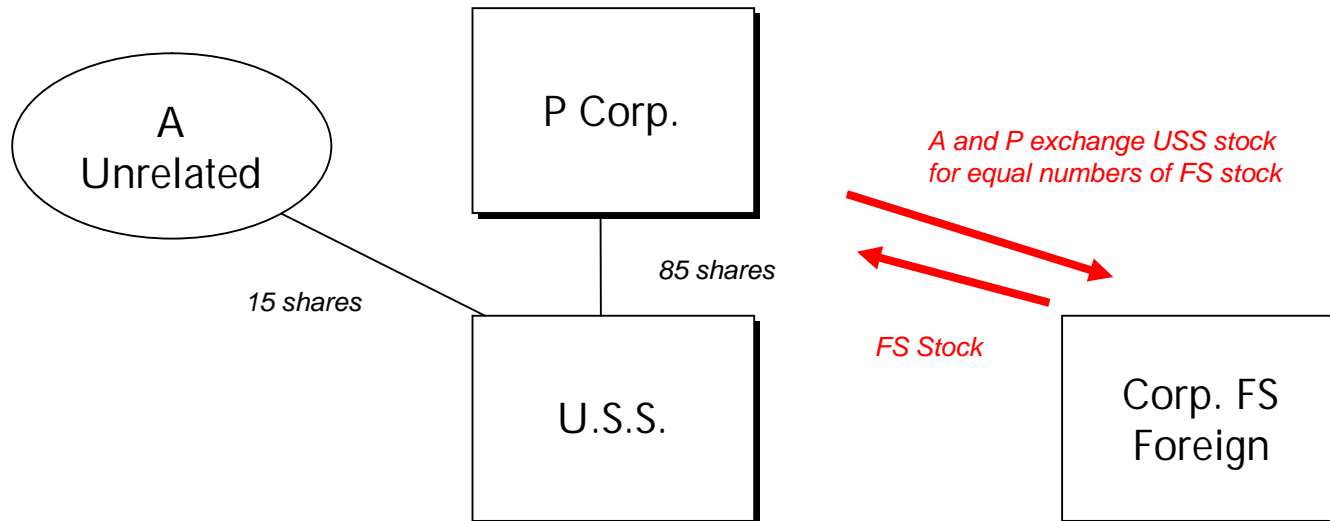
- Anti-Inversion legislation enacted in 2004 to freeze the migration of U.S. companies locating overseas to avoid U.S. tax rules (including U.S. CFC rules).
- The anti-inversion legislation is too broad and potentially applies to internal restructuring and joint venture transaction that were never thought of as inversions.
  - If the legislation applies, it could treat a foreign acquiror of a U.S. company as a U.S. company for all U.S. Federal tax purposes.
- 2 new sets of IRS inversion regulations:
  - First set provides relief for certain internal restructuring transactions.
  - Second set provides certain safe harbor exceptions where a foreign acquiror is located in a country with substantial business activities.

### **O**BSERVATION

***THE NEW IRS GUIDANCE CAN PROVIDE SIGNIFICANT RELIEF FROM THE BROAD ANTI-INVERSION RULES AND SHOULD BE CONSIDERED IN CROSS BORDER M&A TRANSACTIONS***



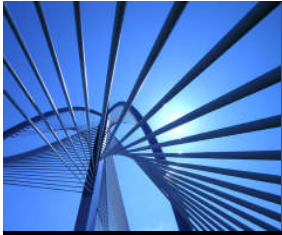
## Anti Inversion Rules – Intra-Group Restructuring; Less than Wholly-Owned Corporation



- Joint Committee Report recommended a foreign dividend exemption system.
  - Contains many unfavorable features compared to dividend exemption systems of other countries.
- President's Tax Reform Panel recommended a similar exemption system.
- Treasury Study – Future direction of international tax policy.

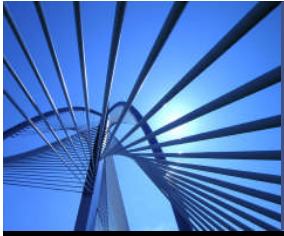
### **OBSERVATION**

***U.S. INBOUND COMPANIES SHOULD MONITOR THE U.S. TAX REFORM DEBATE TO DETERMINE WHAT OPPORTUNITIES AND DETRIMENTS MIGHT RESULT FOR THEIR CURRENT STRUCTURES***



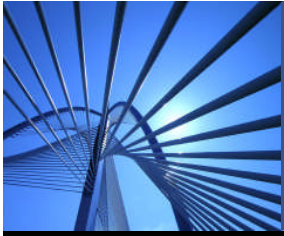
## Treaty Update: Treaty Negotiations

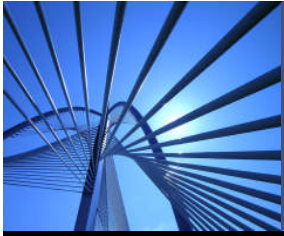
SIGNED	IN NEGOTIATION	BEGINNING NEGOTIATION	SUBSTANTIALLY COMPLETED	OTHER POSSIBILITIES
<ul style="list-style-type: none"> <li>▪ Denmark</li> <li>▪ Finland</li> <li>▪ Germany</li> </ul>	<ul style="list-style-type: none"> <li>▪ Canada</li> <li>▪ Chile</li> <li>▪ Hungary</li> <li>▪ Iceland</li> <li>▪ Korea</li> <li>▪ Belgium</li> </ul>	<ul style="list-style-type: none"> <li>▪ Bulgaria</li> <li>▪ Poland</li> </ul>	<ul style="list-style-type: none"> <li>▪ Norway</li> </ul>	<ul style="list-style-type: none"> <li>▪ Brazil</li> <li>▪ Taiwan</li> <li>▪ Italy</li> </ul>



- Classic U.S. treaties with no Limitations on Benefits clause (e.g., Hungary, Iceland, and Poland).
  - These treaties are either under negotiation or will be soon.
- The big trend in U.S. tax treaties is to go to zero U.S. tax on certain direct investment dividends.
  - U.K., Australia, Mexico, Japan, the Netherlands, Sweden.
  - Finland, Germany signed.
  - More expected.

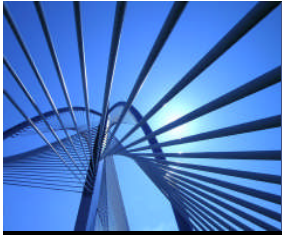
***OBSERVATION: THIS TREND GIVES ISRAELI MNCs MORE FLEXIBILITY TO POTENTIALLY ACCESS THESE TREATIES WITH RESPECT TO U.S. INVESTMENTS.***





# PART VI

## PLANNING IDEAS

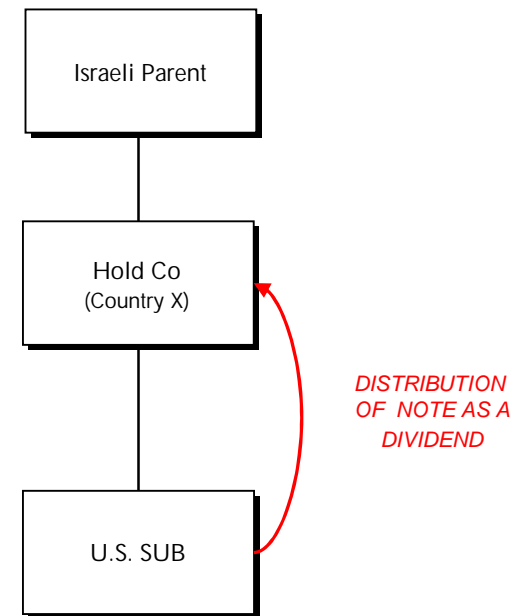


# U.S. Debt Push-Down Solutions

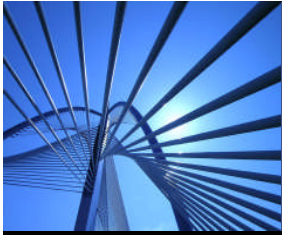
## *Distribution of Note*

### TRANSACTION STEPS

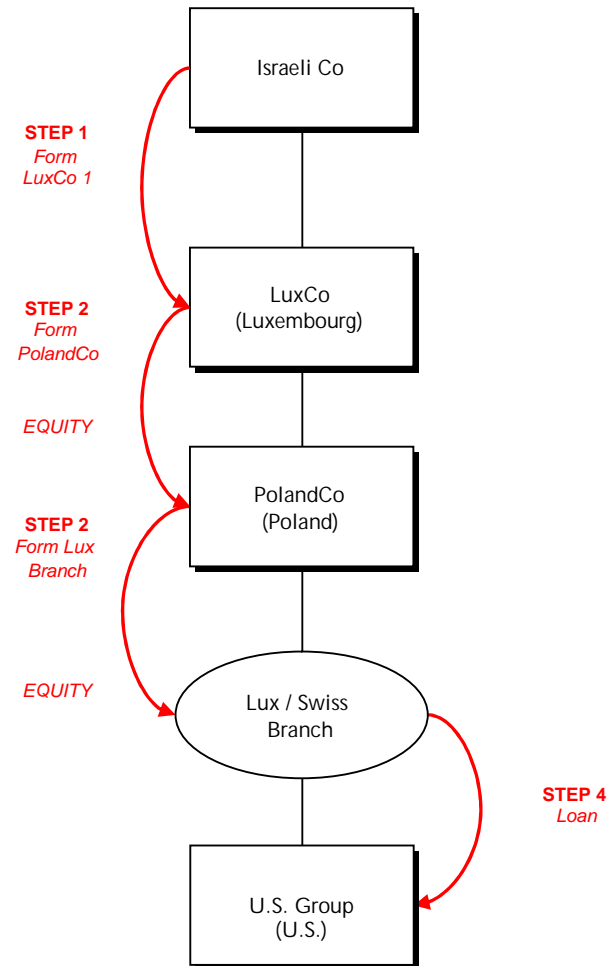
- U.S. Sub distributes a note (as a dividend distribution) to Foreign Hold Co.
- The distribution of the note may be subject to withholding tax to the extent of the earnings and profits of the U.S. Sub. Thus, it is important to determine the amount of E&P of the U.S. Sub.
- Consider foreign tax consequences of note distribution – efficient if dividend is not taxed in foreign jurisdiction (e.g., participation exemption)
- Consider Israeli CFC implications.

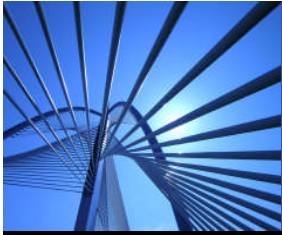




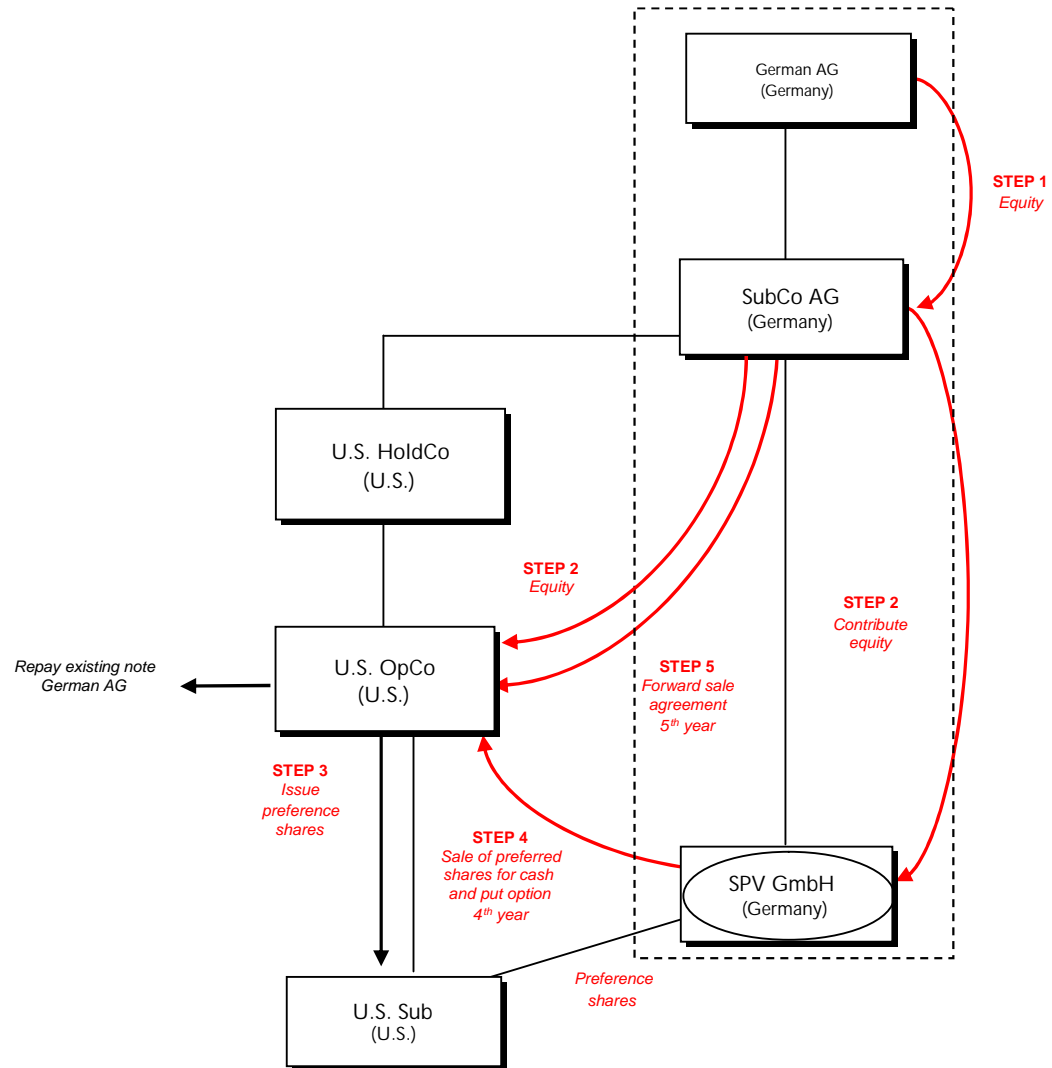


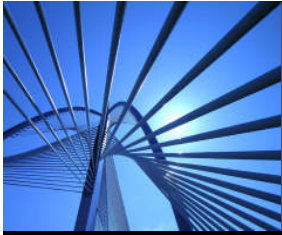
## Use of Poland – Luxembourg Branch to Hold the U.S. Group





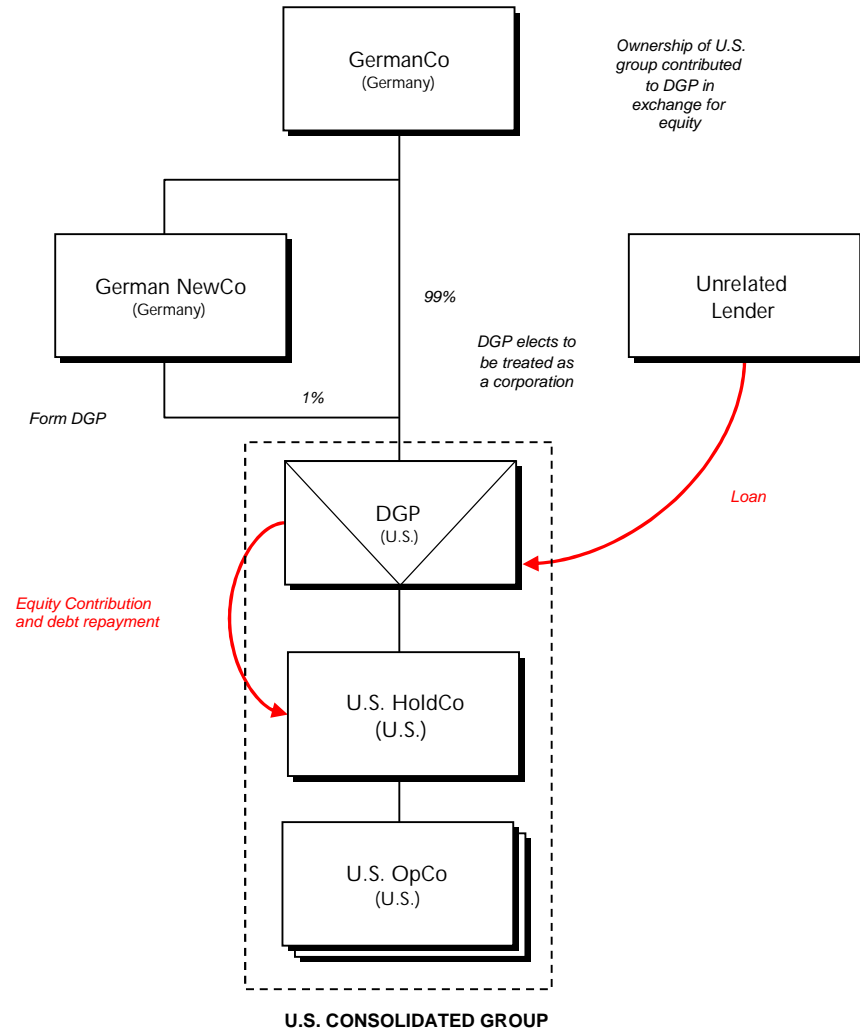
# Efficient U.S.-Inbound Financing REPO Structure (Germany as an Example)





# Efficient U.S.-Inbound Financing

## Domestic Reverse Hybrid with Outside Financing



THIS DOCUMENT WAS NOT INTENDED OR WRITTEN TO BE USED, AND IT CANNOT BE USED, FOR THE PURPOSE OF AVOIDING TAX PENALTIES THAT MAY BE IMPOSED ON THE TAXPAYER.

