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War Games: Tax, Trade, Tariffs & The Supply Chain

Eversheds Sutherland Philadelphia
International Tax and Transactions Seminar

November 19, 2019

Agenda

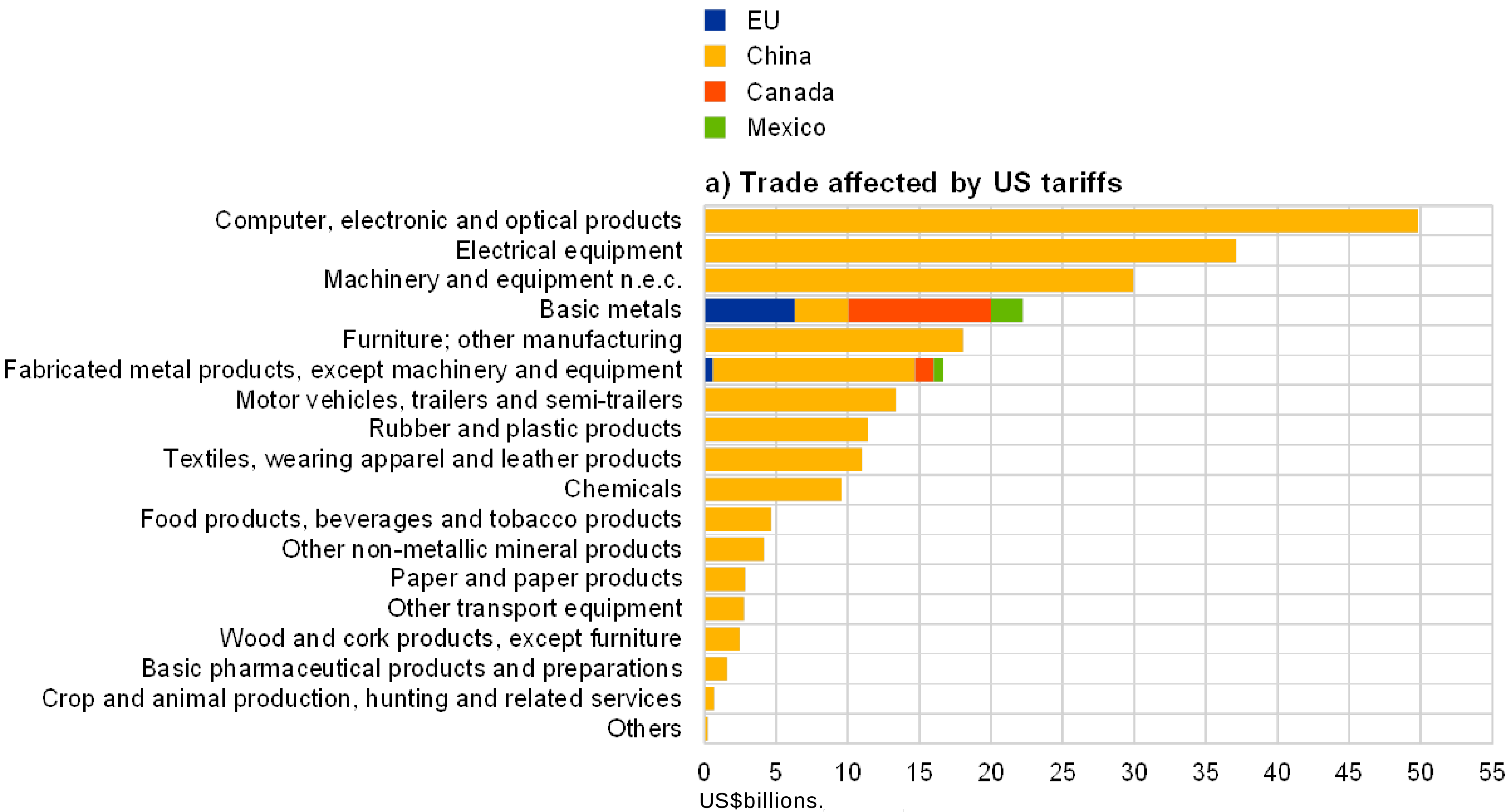
- Geopolitical Drivers for Business Operations
  - Protectionism
  - Political populism
  - Tax reforms
  - New markets
- The Impact on Operating Structures and Supply Chain
  - Practical considerations for movement of supply chain operations to new markets
  - Uncertainty and a more deliberate approach to large scale structural changes
- Q&A

Geopolitical Drivers for Business Operations

Rising protectionism

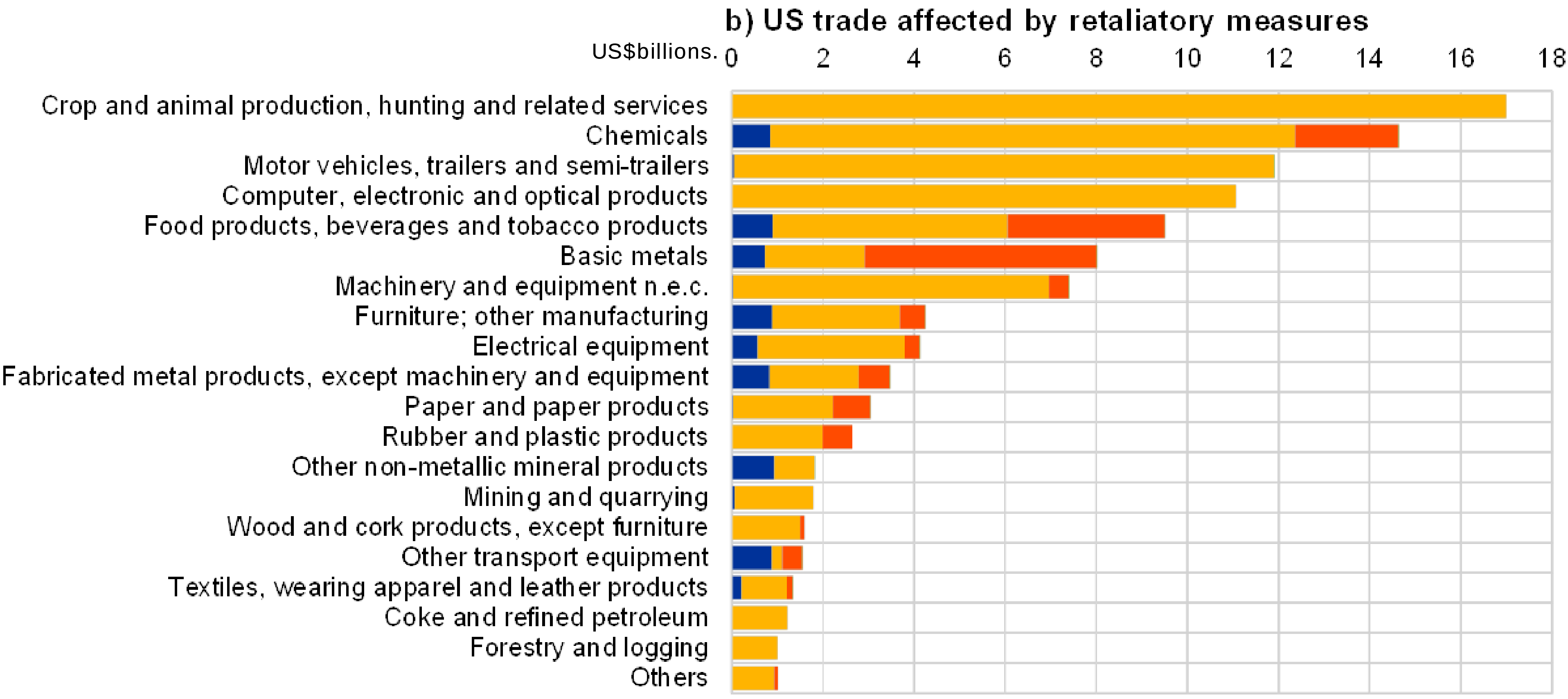
- Drive towards economic integration that characterised previous decades has faded - evident in the slower pace of trade growth in recent years
- Full impact of recent protectionist patterns yet to be seen – companies still focussed overseas for new markets, raw materials, talent and lower cost bases
- However, we can see:
  - outbound investment from China continuing to decline (down 23% YOY since peak of 2016) - countries such as China progressively moved from being assemblers of foreign inputs to relying increasingly on domestic inputs
  - territorial barriers increasing, leading to changes in trade flows (e.g. China investment moving to Europe, Taiwan, Cambodia);
  - anti-trust laws being weaponized - large deals taking longer to close, including Monsanto/Bayer (746 days), Linde AG/Praxair (681 days) and Time Warner/AT&T (601 days), or being withdrawn entirely in the case of Qualcomm/Broadcom (China to US), NXP/Qualcomm (US to China) and Ant Financial/MoneyGram;

Rising protectionism – trade wars



Sources: World Bank World Integrated Trade Solution (WITS), WTO and Comtrade.

Rising protectionism – trade wars continued



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Political populism

- Causing shifts in the supply chain
- Global pattern of protectionism:
  - Brexit:
    - control over borders, negotiated trade deals and deregulation;
  - US and China:
    - Increased activity and intervention by the Committee on Foreign Investment in the U.S. (CFIUS);
    - Very public political tensions leading to tariff wars;
    - China to US M&A investment down from US$66.4bn in 2016 to US$13.2bn last year – significant diversion of investment in to Europe and neighbouring countries;
    - New China Foreign Investment Law from 1 January 2020 – introduction of "the "Negative List" – and strict foreign exchange regulation regime (all funds inflow and outflow require SAFE approval - registration success rate varies significantly across different locations)

Tax reforms and digital tax

- US Tax Reform: Companies continue to evaluate the impact of US tax reform on their businesses
  - Significant questions remain with respect to application of new U.S. tax provisions to international operations:
    - **GILTI** - Proposed GILTI high tax exception could materially reduce US tax cost of GILTI, particularly where foreign tax credits are not available
      - Treasury wrestling with appropriate basis on which to determine "high tax"—recognition that any approach has winners and losers
    - **FDII** - Proposed regulations on application of FDII outstanding, leaving open questions as to how to determine location of sales of products and use of services, especially where there are third parties in the supply chain
      - Ability to obtain data from third party suppliers and B2B customers may impact availability of FDII benefit
    - **BEAT** – Payments to related foreign parties may give rise to BEAT liability
      - Implications for characterization as COGS, and increase in related party payments

Tax reforms and digital tax

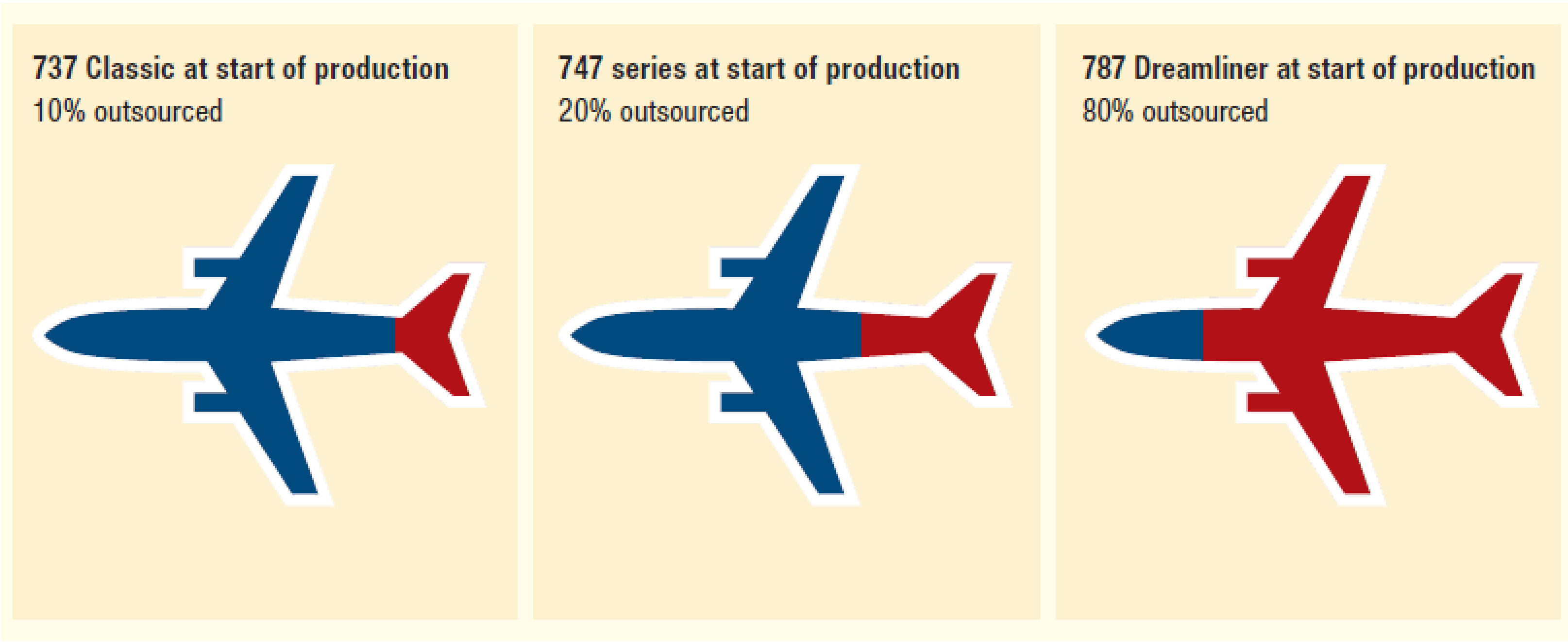
- International Reforms and Digital Tax Proposals
  - Effective tax rate uncertainty, exacerbated by proliferation of taxes targeted at "digital" businesses
    - France, UK, Italy and others in Europe have introduced digital services taxes, targeting digital revenue generated in the local jurisdiction
    - OECD proposal would reach **all consumer businesses**, not just digital businesses
  - Potential modifications to taxable presence standards may increase the number of jurisdictions in which a company is subject to tax
    - Adding new countries to the supply chain to address trade and tariff costs may expose company to new taxes
  - Blurring lines between tax and tariffs, and between income taxes and transaction taxes
    - US proposals to respond to French DST with tariffs on French goods
    - Companies stating publicly that DST will be passed on to customers

New markets

- Customers, suppliers and people
- Sophisticated customers driving demand
- Trade flows continue, however the focus of markets is shifting, i.e.:
  - China to neighbouring countries - US withdrawal from Trans-Pacific Partnership is driving Chinese firms south, with Vietnam and Malaysia being the largest beneficiaries
  - Hong Kong, India, Mexico and Ireland, in particular, have risen significantly among the tip 20 traders of goods and services in the world (source: WTO) in the past decade
  - developing economies had a 44% share in world merchandise trade last year and a 34% share of world trade in commercial services there are more markets available than ever before
- Global nature of customer bases
- Information and communication technology recorded the highest export growth (15 per cent) among services sectors in 2018, led by computer services (source: WTO)

New markets – trade volumes

– Value chains are continuing to become increasingly fragmented, leading to increasing trade volumes. Boeings approach to sourcing and manufacture exemplifies these trends:



Source: International Association of Machinists and Aerospace Workers; Boeing; Reuters; McKinsey Global Institute

The Impact on Operating Structures and the Supply Chain

Uncertainty and a more deliberate approach to large scale structural changes

Overall Structural Changes

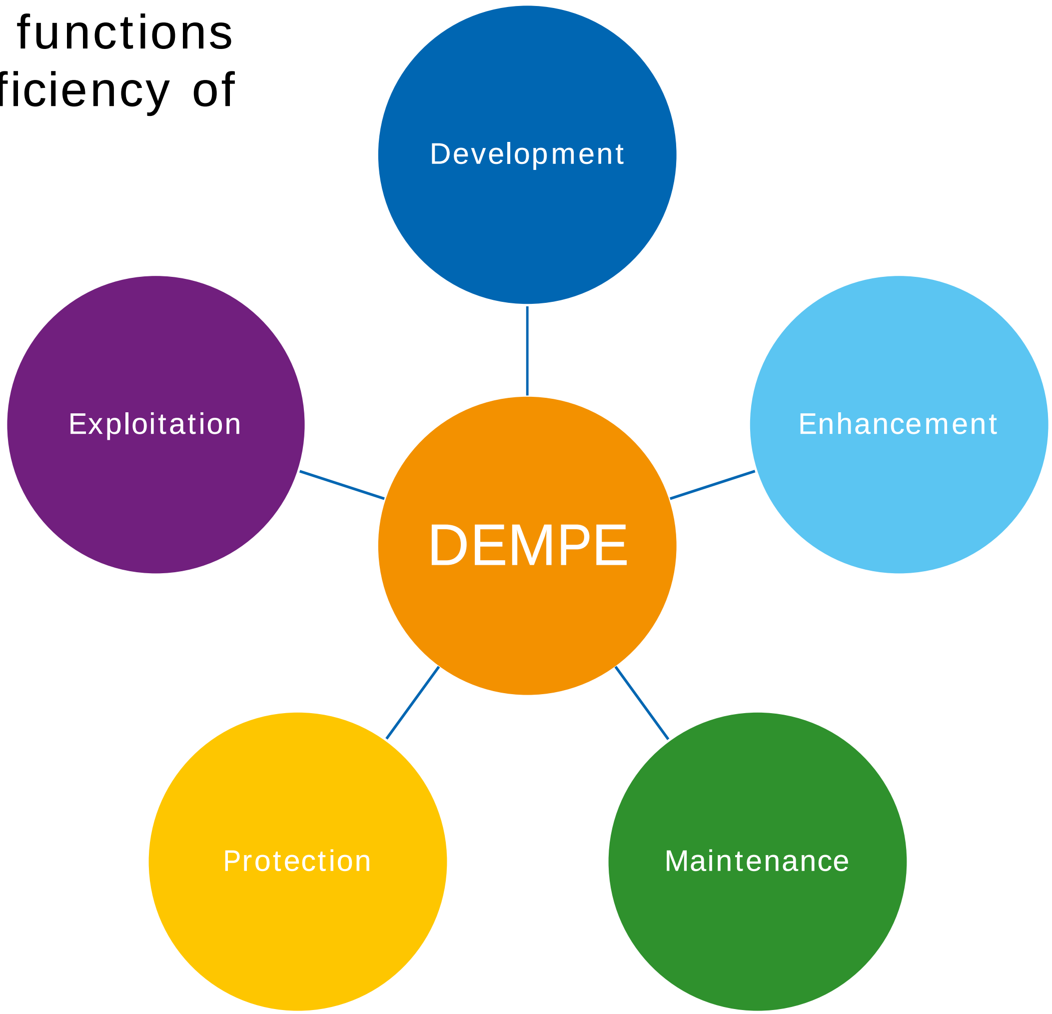
- Tax and trade changes also can warrant larger scale structural changes
  - Restructuring of tax regimes to address BEPS considerations may require restructuring (e.g., changes to Irish non-resident tax rules)
  - Incentives and favorable tax law changes (e.g., reduced U.S. tax rate) may support centralizing high value activities in home jurisdiction
  - Needs to be balanced with continued uncertainty around unilateral measures

Overall Structural Changes

- Rethinking ownership of intellectual property
  - U.S. and European tax reforms warrant reconsideration of existing operating and IP holding company structures
    - BEPS initiatives and particularly transfer pricing emphasis on DEMPE functions
    - US transfer pricing cases and EU state aid challenges to existing European tax regimes
    - Lower international tax rates and the availability of tax incentives (e.g., FDII, maybe?)
    - OECD efforts toward formulary apportionment and global minimum taxes minimize incentives for tax planning
- Needs to be balanced with continued uncertainty around unilateral measures

Overall Structural Changes

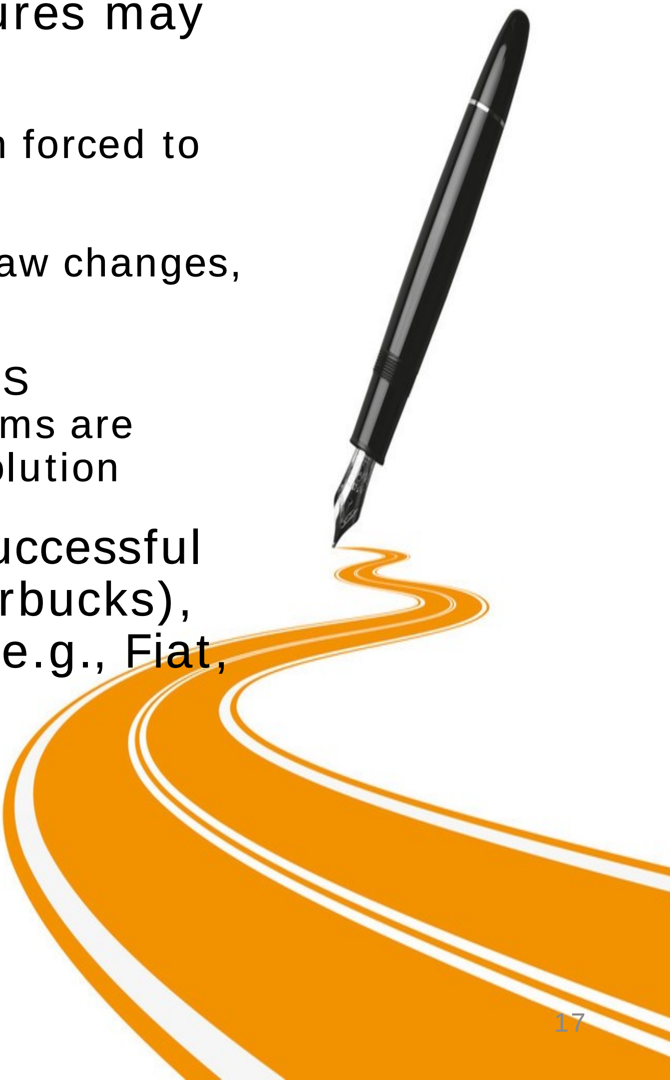
- Location of DEMPE functions is central to the efficiency of any structure



Overall Structural Changes

– US Transfer Pricing and EU State Aid Cases

- International challenges to existing structures may warrant structural changes
  - Traditional tax favorable jurisdictions have been forced to modify their tax regimes
  - Although many taxpayers have addressed tax law changes, still seeking permanent solutions
  - Reduction in US tax rate changes analysis for US companies, but uncertainty as to whether reforms are permanent impacting decision on permanent solution
- Even though some taxpayers have been successful in rebutting challenges (e.g., Amazon, Starbucks), cases are costly and success is uncertain (e.g., Fiat, Altera)



Overall Structural Changes

— Lower tax rates and the availability of incentives

- Reduction in US tax rate to 21%, with intangible income subject to tax at 13.25% rate puts it on par with Ireland and other European jurisdictions
  - Cost to repatriation—
    - Transfer generates “tested income” that would be subject to GILTI rules
    - Local tax costs
  - Amortization benefits are BEAT payments, which may result in residual U.S. tax
  - Uncertainty around continued viability of US tax rates
  - May be alternatives to “migrate” intangibles over time (e.g., termination of cost sharing arrangement), although creates transfer pricing uncertainty
- UK delayed implementation of 17% tax rate—is this the end of the race to the bottom?

Overall Structural Changes

- OECD efforts toward formulary apportionment and global minimum taxes minimize incentives for tax planning
  - Pillar one is focused on allocation of taxing rights between jurisdictions and seeks to review the profit allocation and nexus rules
    - Expansion to all consumer facing businesses
    - Economic nexus and revised profit allocation rules make the location of intangible assets arguably less important
  - Pillar two Global anti-Base Erosion proposal or ("GloBE") addresses, on a "without prejudice" basis, taxing rights that would "strengthen the ability of jurisdictions to tax profits where the other jurisdiction with taxing rights applies a low effective rate of tax to those profits
    - Application of GILTI on a global level
- Although much is left to be determined, inherent uncertainty created by these efforts may warrant a hold on material structural changes not necessitated by business operations

Practical considerations for movement of supply chain operations to new markets

Movement of Supply Chain Operations

- As suppliers move to new, lower-cost jurisdictions, it is important to understand your contracts and how legal and tax consequences may differ in the new jurisdiction

Taxable Presence

– "Taxable presence" and "permanent establishment" are frequently used interchangeably, but there is a difference

– Before you get to the permanent establishment question, you must first determine if there is a tax residence in the local jurisdiction

  - Under U.S. principles, for example, a corporation that is engaged in a U.S. trade or business is subject to tax on its income that is effectively connected with that trade or business

  - The determination of whether a corporation is engaged in a U.S. trade or business is made based on facts and circumstances, which are similar but not identical

Movement of Supply Chain Operations

– Activities in new jurisdictions could give rise to taxable presence:
  - Storage of goods;
  - Travel to jurisdiction by company employees for R&D and/or oversight;
  - Rights to access third party locations
  - Agency considerations

Movement of Supply Chain Operations

- Availability of treaties can be significant in minimizing taxable presence risk
  - Under most tax treaties, the business income of foreign corporation is taxable only if that corporation has a “permanent establishment” in the taxing jurisdiction
- But, remember
  - more limited treaty networks with developing jurisdictions (e.g., no current US tax treaties with Vietnam or Malaysia); and
  - Even in treaty countries “tax residence” determination is important as there may be filing and similar obligations to obtain treaty benefits

Movement of Supply Chain Operations

- The types of activities that give rise to risk of taxable presence can generally be grouped as follows:
  - Activities that provide a contracting entity with a fixed place of business, or access to physical space, in another jurisdiction;
  - Activities that involve the performance of services by employees of the contracting entity in another jurisdiction; and
  - Activities that involve the use by the contracting entity of an agent in another jurisdiction
- These activities do not, by definition, give rise to a taxable presence, but, they are indicative of the need for further diligence

Movement of Supply Chain Operations

- Even if taxable presence in foreign jurisdiction does not result in local tax, there can be US tax implications for US companies
  - Foreign branch activities are in a separate basket for US tax purposes and not eligible for FDII
  - DCL considerations for foreign branch activities
- OECD proposals look to allocate income among all jurisdictions in which a company has an economic presence, which may argue for minimizing contacts with new jurisdictions
  - Obviously, has to be balanced with business needs

Movement of Supply Chain Operations

Transaction Tax Risks and The Benefits of Tax Clauses

- Allocates responsibility
- Manages costs
- Ensures appropriate documentation is provided
- Limits exposure

Movement of Supply Chain Operations

- **Indirect Taxes:** In the case of indirect taxes, such as transactional taxes, tax clause typically allows counterparties to charge legally applicable sales, use and value added taxes, provided they are stated on a valid invoice and the company has not otherwise established an exemption

- If there is uncertainty as to whether a payment is subject to a tax, the parties can agree on an allocation of this risk specifically

- Where payments are subject to indirect tax, consideration should be given as to whether this tax is recoverable by the entity against whom it is charged and ensure the business is aware of any potential costs

- **Digital Taxes:** Uncertainty resulting from digital tax efforts may warrant provisions to address change in tax law
  - Inherent difficulty in allocating responsibility before specifics of tax are known

Movement of Supply Chain Operations

- **Withholdings and Deductions:** In addition to indirect and transactional taxes on net income, many jurisdictions impose withholding taxes on payments of certain types of income
  - Generally, withholding taxes differ from indirect and transactional taxes in that they are imposed in lieu of income taxes, typically on payments made to a party that is not tax resident in the jurisdiction from which the payment is made
    - Occasionally, withholding taxes may apply to transactions within a single jurisdiction (e.g., employment withholding)
- Like indirect taxes, withholding taxes can impact pricing and therefore should be allocated between the parties when negotiating a transaction

Movement of Supply Chain Operations

- Although withholding tax typically applies to passive income, consideration must be given to where services are performed
  - Countries are increasingly looking at alternatives to tax services that are performed remotely
  - Consideration should be given to changes in sourcing rules
- Although the tax is imposed on the recipient, the primary obligation generally is imposed on the party making the payment
  - Payee may also be separately liable, but if the payee is outside the taxing jurisdiction it may be difficult for tax authorities to enforce against the recipient

Movement of Supply Chain Operations

– Considerations in Changing Jurisdictions

- **What is the character of the payments?**
  - Important to ensure that the parties agree on any withholding taxes that may be imposed at the outset
  - If moving jurisdictions, be certain that the new jurisdiction has the same character
- **Difficulties in claiming treaty benefits.**
  - Where there is a withholding tax, it may be possible to reduce or eliminate the withholding tax through a claim of treaty benefits, but treaty claims bear their own burdens

Movement of Supply Chain Operations

– Considerations in Changing Jurisdictions

- **Taking into account credits and offsets and refunds.**
  - If a party is able to offset the burden of the tax cost through a tax credit, refund or offset in its local jurisdiction, there is no economic cost to that party in bearing a withholding or transaction tax
- **Plan for changes in law.**
  - Even if there is no transaction today, with increasing uncertainty brought on by unilateral taxing measures it is important to allocate change in law risk
  - At a minimum, agree that the parties will revisit if there is a change in law that results in material additional tax

Q&A

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