

Structural Changes in Light of BEPS

As is widely known, the Organization for Economic Cooperation and Development (OECD) has issued a number of base erosion and profit shifting (BEPS) proposals that could result in a material increase in the foreign tax costs of U.S.-based companies.¹

The BEPS proposals seek to impose tax on income derived by low-tax or no-tax structures. They recommend changes broadening transfer pricing rules, expanding the definition of a permanent establishment, eliminating tax arbitrage with hybrid financing arrangements, and expanding subpart F rules. It is expected that OECD members will change their tax laws to adopt various proposals after the BEPS recommendations are finalized later in 2015.

One proposal would treat a commissionaire as a permanent establishment. A common supply chain structure is for a principal company to be organized in a tax-favorable country, such as Switzerland, the Netherlands or Ireland. The principal sells products to customers in various European countries using the marketing services of a local company organized as a commissionaire. Title to products passes directly from the principal to the customer, and the principal pays the commissionaire a cost plus service fee. The principal would derive the residual profits for its high value functions, intangible rights and risks.

An important U.S. tax benefit of using a commissionaire structure is that title to the products passes directly from the principal to unrelated customers. Thus, generally the sales income is not subject to Subpart F.²

Countries may adopt the BEPS proposal and expand the definition of a local permanent establishment to include commissionaires. As a result, the principal could be considered as having a permanent establishment in the country where customers are located. In addition, a country may adopt broader transfer pricing rules contained in the BEPS proposals, which could result in a material portion of the principal's profits being considered as earned by the local permanent establishment.

A company with commissionaire structures may consider converting them to limited risk buy-sell structures. A properly structured buy-sell arrangement should avoid a local permanent establishment.

With a buy-sell distributor, the principal would sell products to a related entity, which can result in Subpart F income. This related party sale can be eliminated for U.S. tax purposes by having the principal own the distributor with the distributor disregarded as a separate entity, or having the principal and distributor owned by the same holding company and both disregarded.³ Such disregarded structure, however, can potentially trigger the application of the Subpart F branch rule, which will need to be managed.⁴



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Under BEPS proposals, a significant portion of income derived by an entity that is not subject to tax currently in any country could become taxable under expanded transfer pricing rules. For example, a Dutch CV may own an operating Dutch BV, and receive a royalty from the Dutch BV. Another example is an Irish tax nonresident company deriving royalty income from an Irish disregarded subsidiary.⁵ Under BEPS proposals, a substantial portion of the nontaxed income of the Dutch CV or the Irish nonresident company might be allocated to countries where research and development takes place, manufacturing occurs, or where customers are located.

The BEPS proposals could result in a significant increase in foreign tax costs for U.S.-based multinationals, and therefore it is advisable for a U.S. company to review its global structure and assess whether changes should be made to minimize the impact of countries adopting BEPS proposals.

A company may consider “on-shoring” income derived from intangibles, *i.e.*, move intangible property to a taxable jurisdiction. Taxes in the new country might be substantially reduced by amortization deductions based on a fair market value basis in the intangible property, and though debt financing of the acquisition of the intangible property. The new country may also have a favorable “IP box” regime with a relatively low tax rate. It is desirable to move to a country that overall has been favorable to business, has a good treaty network, and is strong in mutual agreement proceedings. In addition, it will be important to locate in a country where there is functional substance corresponding to the income earned.

For example, intangible property held by an Irish nonresident company may be moved into an Irish entity with a 12.5-percent tax rate. Amortization deductions may be allowed to reduce the tax rate further. Companies are beginning to consider such changes at this time because modifications to supply chains can often take months to implement.

U.S.-based companies are encouraging Congress to consider an IP box regime. In the past a bipartisan bill was introduced in the House of Representatives providing a 10-percent tax rate. The Chairman of the House Ways & Means Committee proposed a 15-percent tax rate on foreign IP related income. If such legislation were passed, U.S.-based companies might consider developing new or next generation intangibles in the United States, and possibly moving intangibles to the United States. Since many U.S.-based companies have substantial management and research and development activity in the United States, owning IP in the United States would be particularly beneficial from a global dispute resolution perspective.

BEPS proposals would also eliminate cross-border arbitrage with hybrid financing arrangements, and some countries have already begun to change their rules. New laws would deny interest deductions where the lender is not subject to taxation in its country, *e.g.*, where the payment is treated as a dividend. Other countries are enacting laws that would tax dividend income where the borrower's country permits a deduction. Nevertheless, it is expected to be some time before countries have implemented rules to eliminate the benefits of all hybrid-financing arrangements.

It is not recommended to abandon hybrid-financing arrangements, but there should be plans for changing them in the event a country adopts rules taxing the return or denying a deduction for the payment.⁶ In addition, companies may consider other tax beneficial structures that rely less on hybrid financing to achieve a low tax rate.

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ENDNOTES

¹ <http://www.oecd.org/ctp/beps.htm>

² Code Sec. 954(d). Yoder, *No Subpart F Income if No Related Party Purchase or Sale of Products*, 40 INT'L TAX J. 3 (July-Aug. 2014).

³ Reg. §301.7701-2(a), (c)(2). Subpart F sales income also can be avoided if the principal is considered as manufacturing the products it

sells by substantially contributing to the manufacture of the products. Reg. §1.954-3(a)(4)(iv).

⁴ See Yoder, *Supply Chain Distribution Structures Outside the Scope of Subpart F*, 42 TAX MGMT. INT'L J. 367 (June 14, 2013).

⁵ Ireland changed its laws beginning in 2015 to no longer allow nonresident companies, and

to treat existing nonresident companies as tax resident beginning January 1, 2021.

⁶ Yoder, *Use of Cross-Border Hybrid Instruments in Light of Recent Developments*, 39 INT'L TAX J. 3 (Mar.-Apr. 2013); Yoder, *Cross-Border Hybrid Financing Arrangements*, 41 INT'L TAX J. 3 (Jan.-Feb. 2015).

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