Supply Chain Planning – EU, Latin America, India and China

TEI-SJSU High Tech Tax Institute

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Panelists

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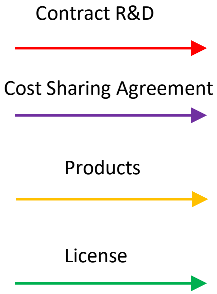
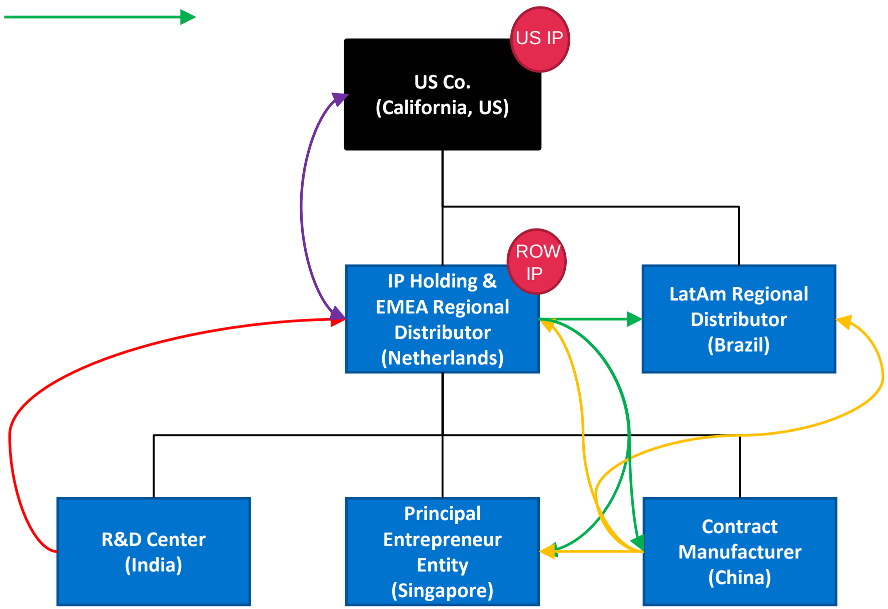
Agenda

- Case Study
- US Tax Planning Considerations
- EU / Netherlands Tax Planning Considerations
- Contract Manufacturer
  - India Tax Planning Considerations
  - China Tax Planning Considerations
- Regional Distributors
  - Brazil Tax Planning Considerations
- Q&A

CASE STUDY

Case Study





San Jose Founders goals in going global:

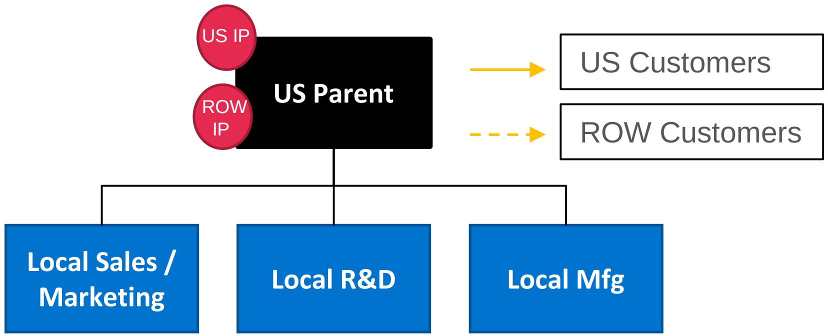
- Expand the group's manufacturing and sales capacity to cater for global markets.
- Achieve the lowest effective tax rate (ETR) for financial statements disclosures.
- Maximize the Group's after-tax earnings and secure the best return for Founders' investment.

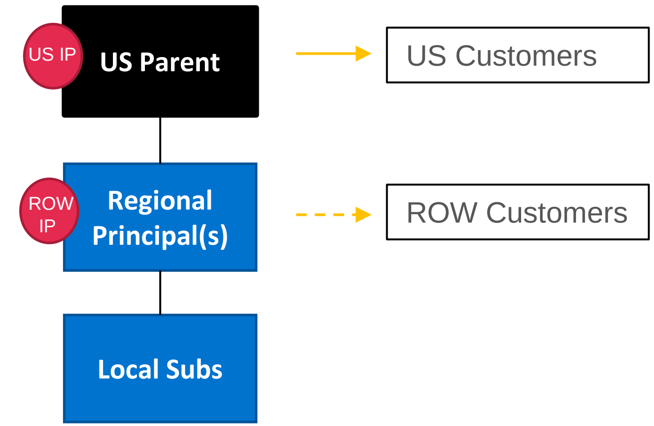
Tax concerns when pursuing a cross-border supply chain model

- Choosing the most optimal location for functions and assets to minimize tax costs in foreign countries.
- Minimize foreign WHT, ECI subject to US taxation, Permanent Establishment nexus outside the US.
- Reduce exposure to anti-deferral and anti-avoidance devices (Subpart F, GILTI inclusions, BEAT).
- Avoidance of double taxation and securing access to tax relief methods in Treaties and Domestic law.
- Branch rules resulting from check-the-box elections.
- What if all the activities were conducted directly from the US? The entire revenue would be subject to U.S. tax. So, what about the FDII regime?

US TAX CONSIDERATIONS

U.S. Tax Planning Considerations





More competitive US CIT rate on revenue from US transactions

FDII rate benefit on revenue from ROW transactions

- Direct customer revenue?
- License to local/regional principal company?
- Longevity? Tax rate increases?

BEAT

- Exceptions for SCM or COGS?
- CTB to eliminate payment?
- Convert to reseller from service provider?

Foreign Tax Credits

- Section 901 vs. GILTI vs. Subpart F
- Increased relevance under digital economy proposals?

GILTI benefit over FDII benefit for revenue from ROW transactions

- FTC limitations under GILTI
- Subpart F planning - FTCs
- Longevity compared to FDII? Tax rate expectations compared to US?

Subpart F

- Foreign base company sales or services income
- Contract manufacturing

BEAT

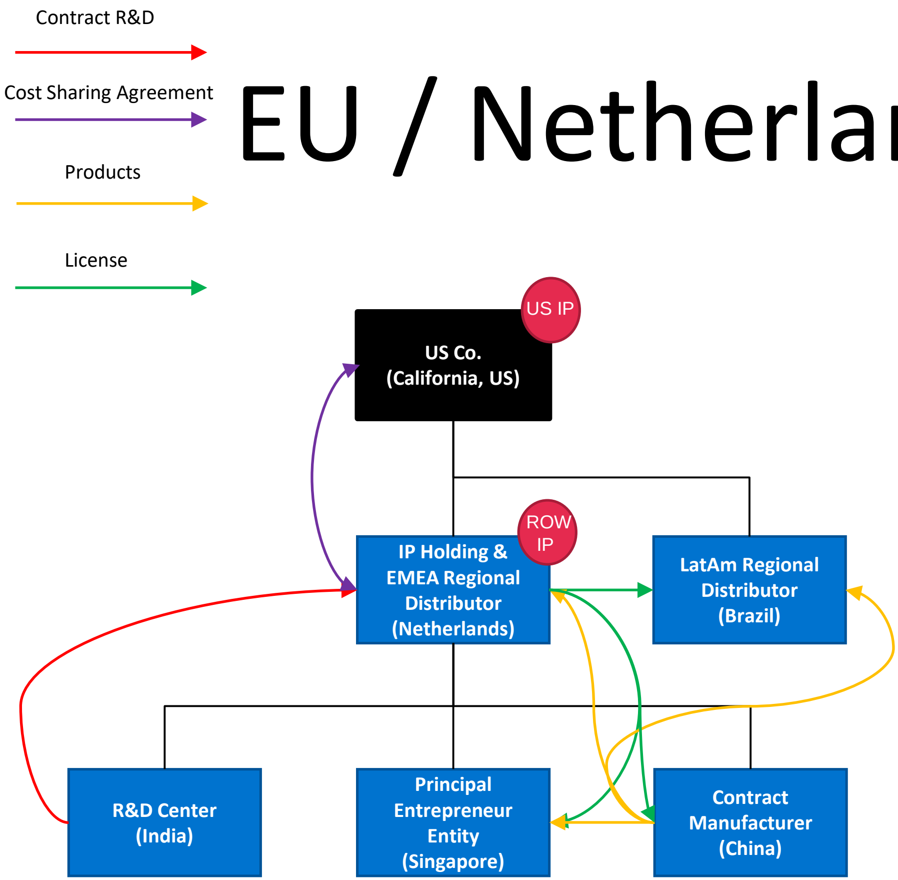
- Better profile

IP Development

- Allocation of risk respected for transfer pricing? CSA vs. licensing?
- DEMPE profile

EU / NETHERLANDS
TAX CONSIDERATIONS

EU / Netherlands Considerations



Recent international tax developments

- Multilateral instrument.
- New taxing rights OECD (Pillar I).

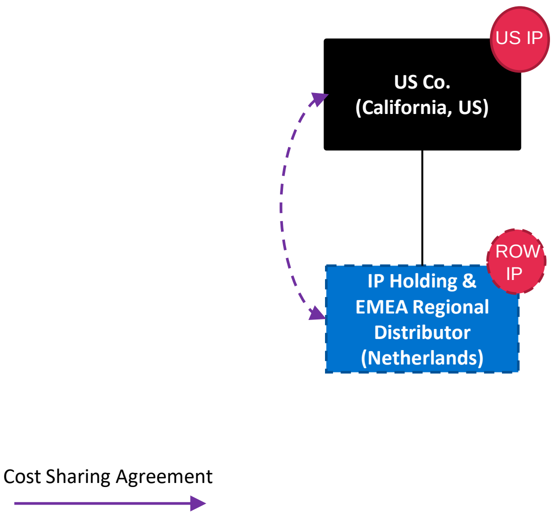
Recent European tax developments

- Anti-Tax Avoidance Directive I implemented by EU Member States on January 1, 2019.
- Anti-Tax Avoidance Directive II to be implemented by EU Member States by January 1, 2020.
- Mandatory Disclosure Directive.
- EU State Aid cases.

Recent relevant Dutch tax developments

- New ruling policy as of July 1, 2019.
- Conditional withholding tax on intra-group interest and royalty payments to low tax jurisdictions and in certain abusive situations.
- Amendment of anti-abuse rules in the corporate income tax and dividend withholding tax.

IP Transfer – Dutch Tax Considerations



IP Transfer

- U.S. and NL entities entering into a Cost Sharing Agreement (CSA) that combines resources towards the creation of a common intangible asset to which the CSA participants would be sharing rights over a piece of it and subject to geographical delimitation whereby the U.S. entity retains the IP commercial rights for the U.S. and the NL entity obtains commercial rights for the “Rest of the World”.
- Platform contribution under which the NL entity makes a buy-in payment for the existing U.S. intangibles transferred to the CSA subject to transfer pricing valuation.

IP Transfer: Dutch tax considerations

- Final Report on BEPS Action 5 "Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance": Modified Nexus Approach.
  - Monitoring and Approval of IP Regimes by European Code of Conduct Group
  - Netherlands Innovation box.
- Step-up to fair market value of the contributed/bought IP.
- Funding acquisition: debt versus equity.
- Ruling

IP Transfer: US tax considerations

- Transferring of IP subject to proverbial IRC sections 367(d) and 482.
- Commensurate-with-Income method. Post-TCJA, Aggregation and Realistic Alternatives methods applicable to outbound transfer of intangibles.

CONTRACT MANUFACTURER

INDIA

India: Tax Reform

- In September of 2019, the Indian Finance Minister announced tax reform measures targeted at reducing the Indian corporate tax rates, supporting the “Make in India” initiative and to bolster foreign investment.

- New Indian corporate tax rates are now competitive for the APAC region and seek to attract manufacturing investments given the US-China trade war and overall disruptions to global supply chains

A quick snapshot of the concessional tax regimes and the prior rates:

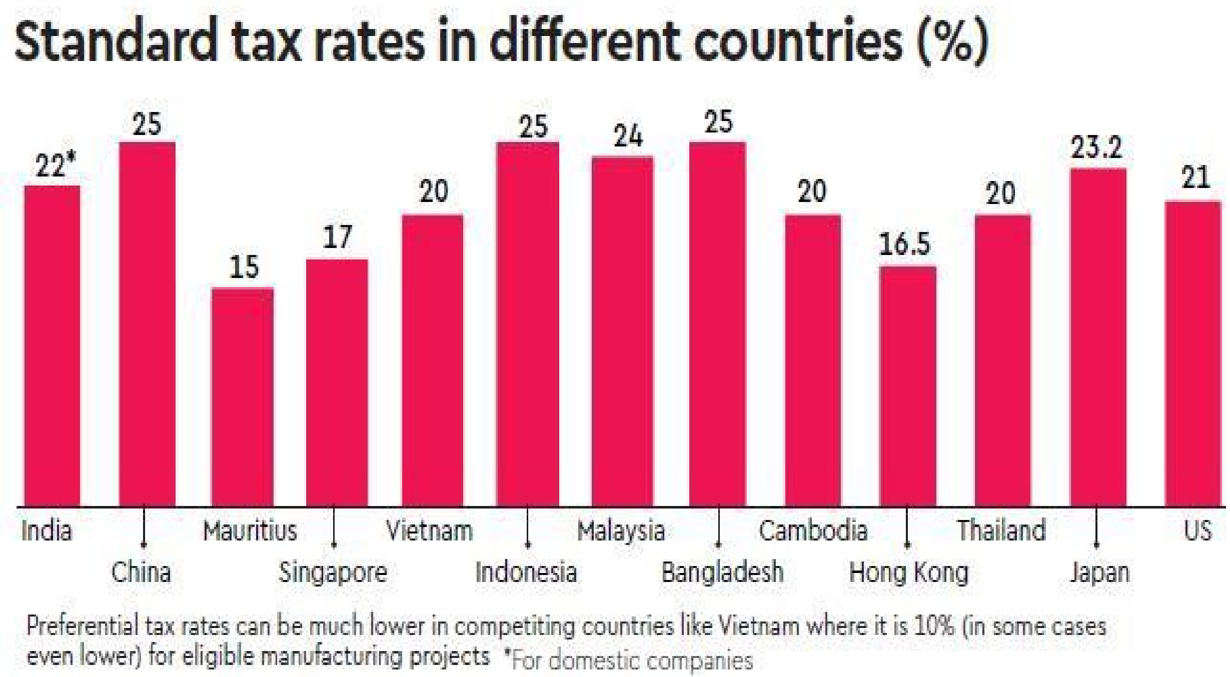
Section	Applicability	Effective Tax Rate
Section 115BA	Domestic manufacturing companies (set up on or after March 1, 2016)	29.12%
Section 115BAA	All Domestic companies	25.17%
Section 115BAB	New manufacturing companies (set up and registered on or after October 1, 2019)	17.16%

Prior regime	Domestic companies where turnover did not exceed INR 4000 mn in FY 2017-18	29.12%
	Domestic companies where turnover exceeded INR 4000 mn in FY 2017-18	34.94%

India: Tax Reform - Distributor vs Manufacturer

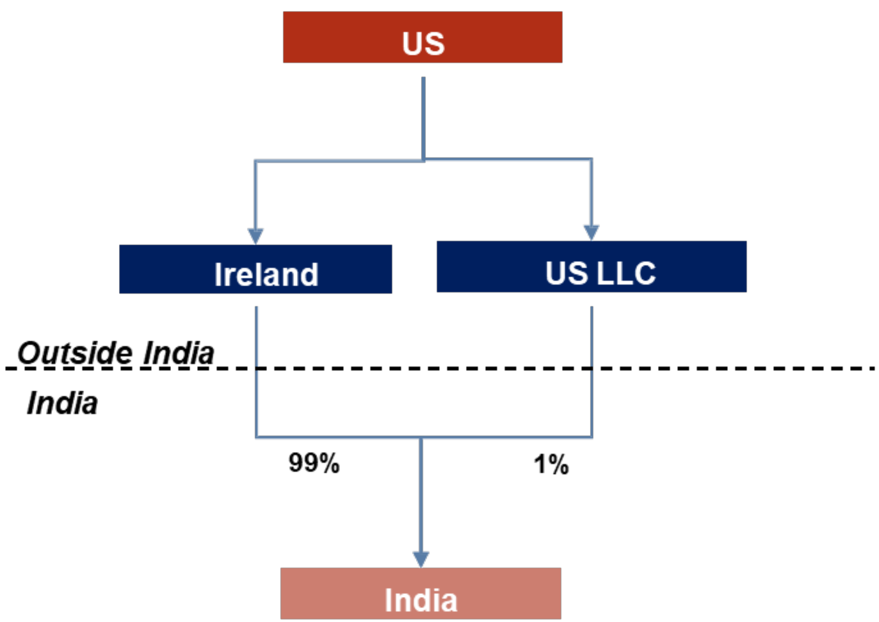
	Section 115BAA	Section 115BAB
Coverage	• All domestic companies	• New domestic company should be engaged in manufacture or production AND R&D or Distribution
Tax Rate	• Headline- 22% • Effective tax rate- 25.17%	• Headline- 15% • Effective tax rate- 17.16%
Eligibility criterion	• No eligibility criteria	• Company **set-up** and registered on or after October 1, 2019 and has commenced manufacturing on or before March 31, 2023
MAT applicability	• Inapplicable	• Inapplicable
Option to be exercised	• **In any year** on or before due date for filing ITR • Not reversible	• **In the first** of the returns filed, before due date for filing ITR • Not reversible
Other restrictions	• No capital and profit linked incentives / deductions • No set off for c/f losses attributable to above deductions	• Same as applicable to section 115BAA • Anti-abuse conditions provided – no splitting or reconstruction, limits on used Plant and Machinery • Domestic Transfer Pricing to apply • What constitutes "manufacturing" for the tech industry

India: Tax Reform – Global Comparison



India: Supply Chain – SaaS License Fee Model

Current relevant group structure

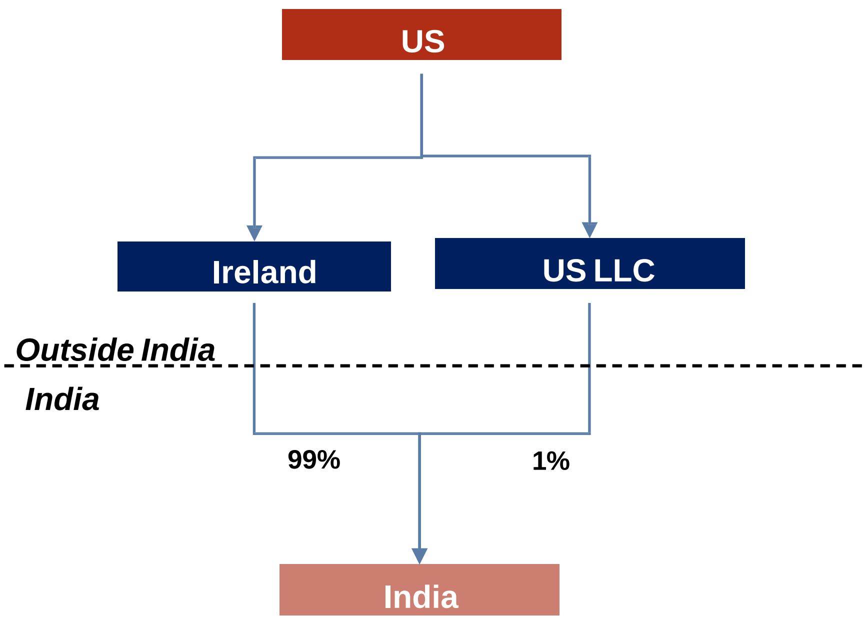


SaaS License Fee Model

- India Private Limited ("India") is engaged in the following businesses:
  - Software development and R&D - India has entered into a software development with the US or Ireland depending on where ROW economic IP rights are held
  - Sales & Marketing for the India market
- India begins transacting directly with India customers and pays a royalty back to the US or Ireland depending on where the Indian IP rights are held

India: Supply Chain – SaaS License Fee Model

Current relevant group structure



SaaS License Fee Model

- Tax Considerations:
  - 10% WHT on royalty payments
  - FDII for US based corporate IP holder
  - FTC
  - DDT
  - GST Considerations (18% for IT/online content and 12% for all other goods):
    - For the royalty payment, the place of supply is India and GST is required to be paid under a reverse charge
    - Cost plus approach can be used for valuing the royalty (if not stated)
    - Place of supply for R&D and SaaS services would be the location of the service recipient and thus, GST is not payable
    - If India can access US/Irish cloud for access or download, 18% likely required under reverse charge
    - GST on transactions with end user – utilize input tax credits

India: Repatriation Structuring

Snapshot of the tax regimes			
Section	**Applicability***	**Tax rate****	**Applicability of dividend distribution taxes**
New tax regime	All domestic companies	25.17%	Yes
Existing regime	Domestic companies where turnover did not exceed INR 4000 mn in FY 2017-18	29.12%	Yes
	Domestic companies where turnover exceeded INR 4000 mn in FY 2017-18	34.94%	Yes
LLP	All LLPs	34.94%	No

	Notes	New regime Section 115BAA	Companies with Turnover < than INR 4000 mn	Existing/New LLPs
Headline tax rate (%)	A	25.17%	29.12%	34.94%
Profit before tax	B	100	100	100
Less: Tax	C = A*B	25	29	35
Profit after tax	**D = B – C**	**75**	**71**	**65**
Less: DDT @ 20.56%	E = D*20.56/120.56	13	12	-
Funds received by Ireland	F = D – E	62	59	65
Tax cost for repatriation	**G = C + E**	**38**	**41**	**35**
Effective tax cost on repatriation (%)	**H = G/B**	**37.93%**	**41.21%**	**34.94%**
Preferred option		**II**	**III**	**I**

India: Manufacturing – LLP vs Company

	Notes	Rationalized tax regime	LLPs
Headline tax rate (%)	**A**	**17.16**	**34.94**
Profit before tax	B	100	100
Less: Tax	**C = A*B**	**17.16**	**34.94**
Profit after tax	D = B - C	82.84	65.06
Less: DDT	**E = D*20.56/120.56**	**14.13**	**0.00**
Dividend received by the shareholder	F = D - E	68.71	65.06
Tax on dividend received by shareholder	**G = F*14.25%**	**9.79**	**0.00**
Total taxes paid by entity	**H = C + E**	**31.29**	**34.94**
Total taxes paid (entity plus owners)	**I = G + H**	**41.08**	**34.94**
Cash in hand	**B - I**	**58.92**	**65.06**

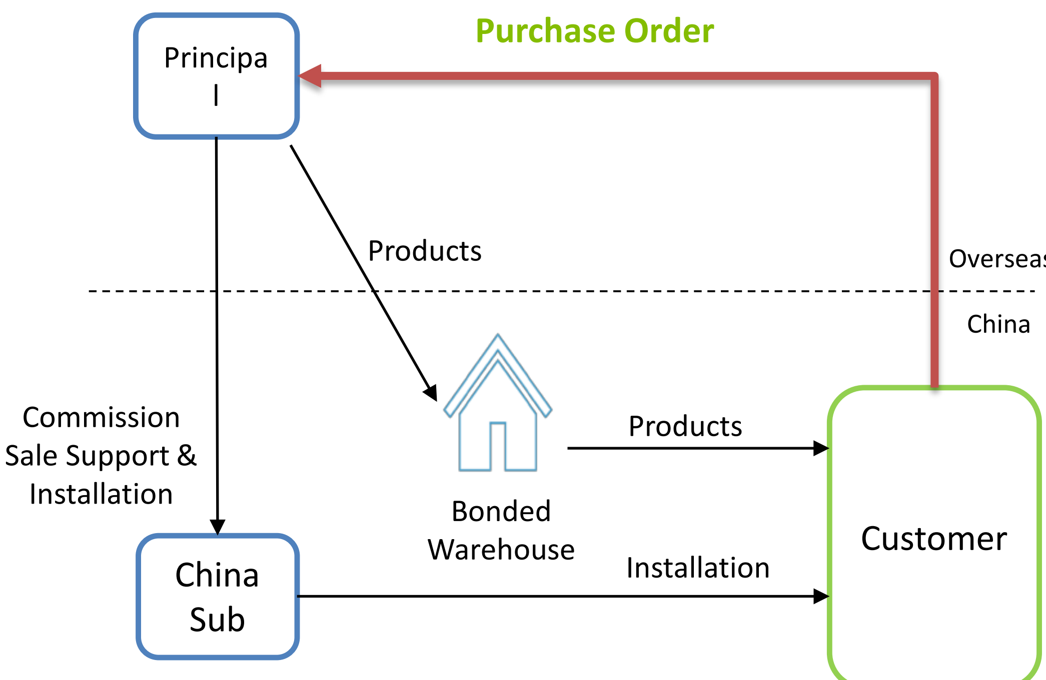
CHINA

Contract Manufacturer

Contract Manufacturer: China tax considerations

Input VAT

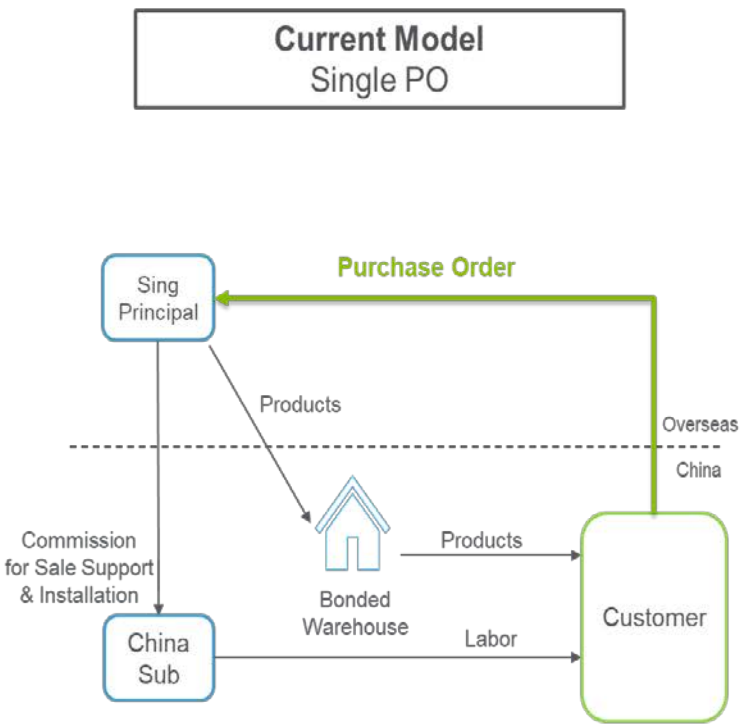
- Non-China entity VAT registration
  - Theoretically possible, not in practice
- Unrecoverable taxes represent competitive disadvantage

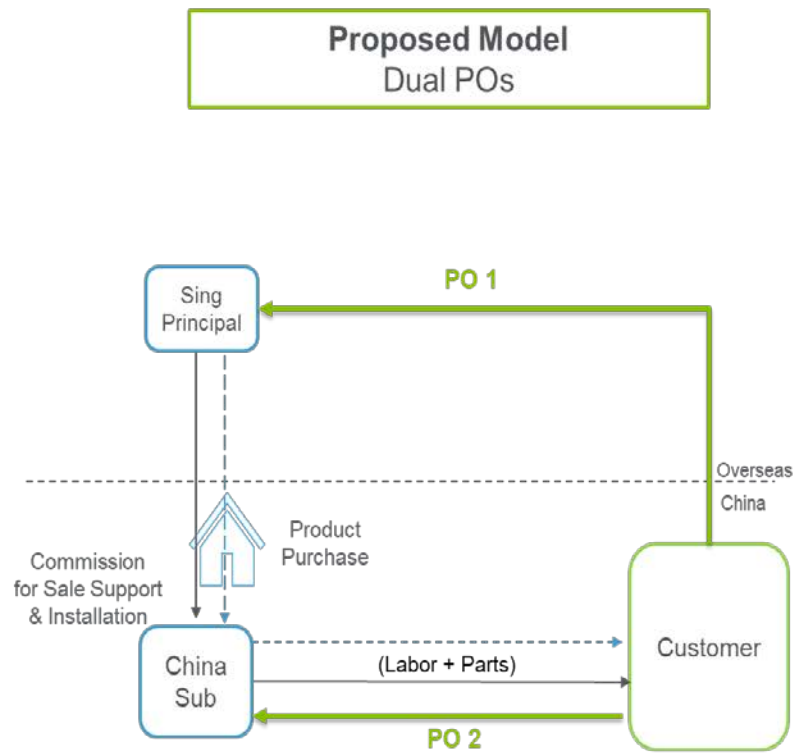


Contract Manufacturer

Contract Manufacturer: China tax considerations

Current and proposed model





Contract Manufacturer

Contract Manufacturer: China tax considerations

Expected benefits

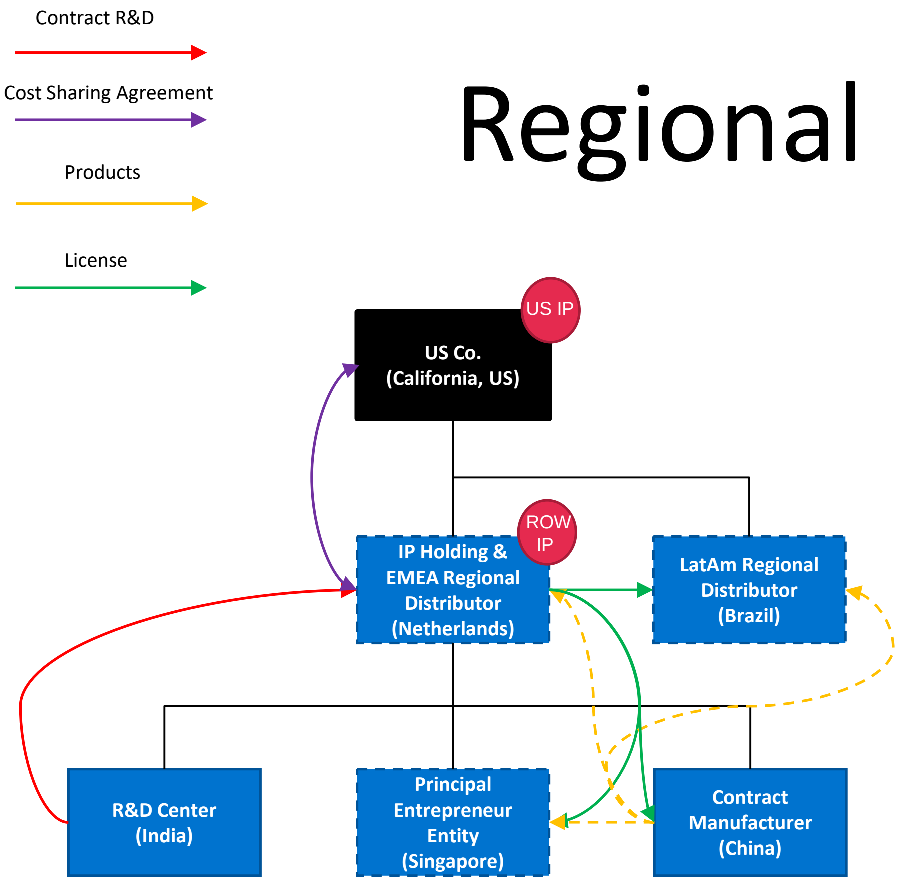
- Pass on VAT without cost increase for customer.
- Lessen Customs import valuation pressure.
- Withholding tax elimination.

Challenges

- Double PO complexities.
- Currency change.
- IT investment.
- Cash build-up in China.

REGIONAL DISTRIBUTORS

Regional Distributors



Regional Distributors

- Regional distributors will be risk limited from lack of success from marketing and advertising activities, unrecoverable accounts receivables, obsolescence of inventory and other commercial terms (e.g., risks for fulfilling "output" and "requirement" type of customer contracts).
- The limited scope for these risks affects the pricing to be charged to the Principal. Leaving enough profit margins at the local distributor's books to operate the routine distributorship activities by transferring those risks to the Principal. Typically, the Buy/Sell intercompany pricing to be set by using Resale Minus. The value for the risks can be charged by the Principal in the royalty for the licensing. This would leave the corresponding profit subject to tax in the Principal's country. In certain countries, EMEA could still operate under a "commissionaire" model subject to Cost-Plus method.

Regional Distributors: Dutch tax considerations

- Dutch distribution activities to be remunerated on an operating margin basis.
- Substance required.
- Possible to confirm operating margin in a ruling.

Regional Distributors: Singapore tax considerations

- Tax incentive regime
- Singapore response to international tax developments
- Withholding tax
- Amortization (writing down allowances)
- Audit scrutiny

BRAZIL

Regional Distributors: Brazil

- Brazil’s role has proven critical and challenging for tech companies willing to enter and develop marketplaces in Latin American countries.

- Brazil is an important provider of inputs, raw materials and internal market demand and strategic commercial gateway to access other countries in the region (e.g., Mercosur trade agreement). **However**, Brazil remains at the edge of major global value chains due to tax and transfer pricing rules that prevent a higher level of integration to more sophisticated models.

- There is one thing for sure: the vast majority of key players in the Silicon Valley’s tech sector are present in Brazil, and in most cases through the use of regional distributorship “buy/sell” models.

- That’s why Brazil is always there when talking about global supply chains.

Regional Distributors: Brazil

Indirect Taxes challenges:

- Brazil’s tax system is characterized by a “HIGHLY” complex and dispersed number of indirect taxes administered by three levels of government.
  - e.g., IPI, ICMS, ISS, IOF, CIDE, etc., etc.

- These taxes do not qualify for Foreign Tax Credits under IRC Sections 901(b) and 903. Therefore, incremental cost of operation.

- Brazil’s Tax Policy of trade-offs: Reducing burden of some indirect taxes if MNEs manufacturing and employment is placed in Brazil. This leads to “tax battlefield” between states and municipalities competing against each other.

- *Things to consider* …

Regional Distributors: Brazil

Tax	Description	Rate
Federal Excise Tax (IPI)	This tax is charged to manufacturer's selling to another manufacturer or retailers on behalf of their customers at the time of sale. Input credit system applies to sales between manufacturers.	Rates are identified by tariff codes and range from 5% to 15% (in some cases rates can be over 300%).
ICMS (State VAT)	State-level tax chargeable on the sales of goods, electric power, rendering of interstate and intermunicipal transportation services, and communications. Similarly to VAT, ICMS is subject to input and output credit system.	Rates could vary from 17% to 20% with certain exceptions, e.g., Interstate sales of imported goods are subject to 4%.
Municipal Service Tax (ISS)	Municipal-level tax chargeable to the rendering of certain services. Import of services (services from a supplier located abroad) are chargeable and collected by the domestic customer.	Rates vary between 2% and 5%, depending on the service.
Importation of Goods and Services Tax (PIS/COFINS)	These two taxes are generally imposed on the Brazilian entity or individual (the importer of records of goods or services), and charged separately from custom duties.	Import of goods rates: 2.1% (PIS) and 9.65% (COFINS), but higher rates apply to specific items. Import of services rates: 1.65% (PIS) and 7.6% (COFINS).
Tax on Financial Operations (IOF)	Tax charged to financial transactions, e.g., loans, foreign exchange operations, insurance, and securities and foreign exchange instruments	Rates are variable, however zero rate may apply for remittances of interest on net equity and dividends relating to foreign investments and remittances favoring foreign exchange balance.
Federal Contribution for Intervention in Economic Domain (CIDE)	Federal contribution on remittances made by corporate taxpayers for royalties, administrative and technical services provided by non-residents. Since the tax liability is borne by the Brazilian payor, no FTC is available for US taxpayers.	Rate is 10%. CIDE is not levied on payments related to software licenses, unless the source code of the software is provided to the payor (in which case the agreement is considered technology transfer (Courts have interpreted that CIDE is imposed regardless of technology transfer).

Regional Distributors: Brazil

Another challenge to Supply Chains: Income Tax and WHT
No Double Taxation Treaty signed with the United States > <u>Therefore</u>, no treaty relief to Withholding Taxes charged from Brazilian sources.

Corporate Income Tax	Statutory Corporate Income Tax rate: 15%. However, additional surcharges: (i) 10% on annual income > BRL 240,000, (ii) 9% social contribution tax. **Total combined Corporate Tax rate = 34%**
Withholding taxes (IRRF)	Cross border payments of royalties or fees under intellectual property agreements are subject to 15% WHT, but if the beneficiary is domiciled in a low-tax jurisdiction, as defined by Brazilian tax law, the WHT is 25%.

Regional Distributors: Brazil

Possibilities for Future Tax Reform

With the new Brazilian Government under President Jair Bolsonaro, there are separate proposals to reform the Indirect Tax system that would consolidate dispersed taxes into a single Federal VAT.

- *No. 45/2019 introduced by the Lower Chamber*
- *No. 110/2019 introduced by the Senate*

However, these proposals are still in Congressional pipeline.

Also, there is a plan to propose reforms to Federal Income Tax to reduce the CIT rate and changes in the tax base.

Regional Distributors: Brazil

Another challenge for Supply Chains: Transfer Pricing
Brazil transfer pricing rules have been in force since 1996, and its transfer pricing methods historically differ from OECD's recommendations: <u>**NOT**</u> **based in arm's length principle (ALP)**.

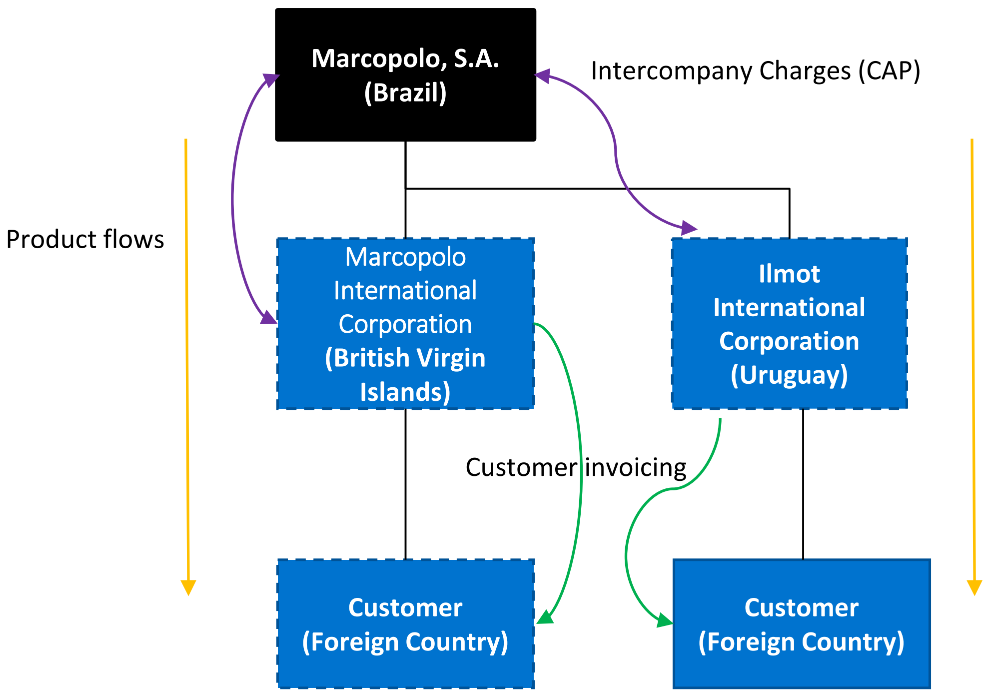
Brazil TP rules do not reflect profits that otherwise would have been made between independent enterprises in comparable transactions and comparable circumstances. Brazil transfer pricing is based on predetermined profit margins. This wreaks havoc with globally integrated transfer pricing planning for any MNE. Brazil is one of a kind in transfer pricing.

Two most common Brazil methods: cost-plus method (CAP) and resale price method (PRL), but transactional methods are available, e.g., Export sales price method (PVEx), Quotation price on export method (PCEX), etc.

CAP	**weighted-average acquisition or production costs, plus taxes and contributions charged in Brazil on exports and a 15% profit margin on the sum of costs, taxes and contributions (Cost plus 15%).**
PRL	**weighted arithmetic mean of the goods, services or rights resale prices in Brazil, calculated in accordance with a formula that compares the imported input percentage in the cost of the goods and apply such percentage to the sale price of the finished goods, services or rights. Any difference is profit subject to fixed profit margin range (20% to 40%). One of the most controversial issues when applying the PRL method is the actual price calculation.**

The Brazilian tax administration published Normative Instruction RFB 1.870/19 (29 January 2019) clarifying transfer pricing rules.

Regional Distributors: Brazil



Brazil transfer pricing rules in supply chain – case law

Brazilian case law provides examples of tax enforcement and judicial interpretation on the impact of transfer pricing in supply chain structures.

Regional Distributorship model of Marcopolo, S.A.

Marcopolo, S.A., an automotive industry company based in Caxias do Sul, Brazil had set up a cross border distributorship model to deploy the Marcopolo products by using two foreign subsidiaries organized in British Virgin Islands (BVI) and Uruguay. When completing foreign market sales, Marcopolo, S.A. issued an intercompany invoice to its foreign distributors using the CAP (cost plus 15%) method. The foreign distributors then invoiced the foreign customers at end-sale.

Regional Distributors: Tax and Transfer Pricing considerations

This type of distribution structure became the centerpiece of disposition in two separate Court cases that resulted from tax enforcement by the Brazilian tax administration.

In these two cases the Brazilian tax administration found that the roles performed by the foreign subsidiaries were reduced to mere re-billing centers that lacked of any value or genuine economic participation in Brazil. For this purpose, the tax administration relied on Brazil legal equivalent to U.S. anti-avoidance doctrines of economic substance and sham transaction.

Court Opinion in case #1, the Brazilian Superior Chamber of Tax Appeals (*Câmara Superior de Recursos Fiscais, CSRF*) decided in favor of the taxpayer by concluding that the taxpayer had sufficient business purpose to validate the transactions conducted through its subsidiaries.

Court Opinion in case #2, the Tribunal concluded that the fact that the taxpayer had complied with Brazil's transfer pricing rules after using the predetermined margin method of CAP (cost plus 15%) is sufficient to satisfy any anti-avoidance rules and would not be required to further demonstrate whether cross border transactions carried out through foreign subsidiaries had substantive value.

Marcopolo case takeaway: Transfer Pricing could be conclusive to validate business models.

Regional Distributors: Brazil

Brazil Transfer Pricing, current domestic rules and perspective for OECD membership

On May 2017, the Brazilian Government first initiated its request to accede to the Organization for Economic Cooperation and Development (OECD) membership. Brazil is current participant in the "Inclusive Framework" for OECD/G20 BEPS initiatives.

Getting to know each other better, on February 2018, OECD's Transfer Pricing team publicly announced to have joined forces with the Brazilian tax administration to assess the Brazilian Transfer Pricing approach and identify areas where alignment is needed (**the OECD-Brazil Transfer Pricing Project**).

On July 11, 2019, during an event hosted by the *Confederação Nacional da Indústria*, a joint statement about the outcomes of the Project was publicly released where the OECD identified key transfer pricing issues that constitute gaps and divergences from OECD's transfer pricing standards ("**gap analysis**"), this document is visible at: http://www.oecd.org/tax/transfer-pricing/joint-statement-oecd-brazil-transfer-pricing-project-july-2019.pdf.

Regional Distributors: Brazil

Some of the discrepancies in Brazil's transfer pricing rules identified by OECD [Part I]

Despite Brazil's participation as member of OECD/G20 BEPS "Inclusive Framework", it has not implemented new guidance resulting from BEPS Action Plans 8-10 (i.e., transfer pricing actions).

Brazil does not apply its transfer pricing rules to royalties, fees for technical assistance and scientific and administrative fees.

Transfer pricing rules are not applicable to domestic transactions (only to cross-border transactions).

Does not recognize *transactional profit methods*, such as the profit split method (PSM) and transactional net margin method (TNMM).

Allowing the taxpayer to freely select its method of preference (even if it is not the most appropriate).

Lack of an *appropriate functional* and *comparability analysis* based on the arm's length standard.

Comparability adjustments in Brazil's transactional methods (i.e., PIC, PVEX, PCI and PECEX) are too narrow and complex.

Taxpayers must determine the transfer price of each product, service or right on "*item-per-item approach*" rather than "*package deal*" *approach.*

Regional Distributors: Brazil

Some of the discrepancies in Brazil's transfer pricing rules identified by OECD [Part II]

No simplified approach for low value-adding intragroup services, which allows a standard profit mark-up, without requiring a separate benchmarking [no similar Service Cost Method rule].

No specific considerations for high value-added services, such as R&D services, manufacturing and production services, purchasing and distribution activities and no guidance on cost contribution arrangements involving intangibles and only limited administrative guidance on cost sharing arrangements.

No transfer pricing rules for hard-to-value intangibles applicable to transfer of intangibles among group members. therefore, unable to give adequate answers to the intangible challenges of the modern digital economy.

No transfer pricing guidance for business restructurings.

Transfer pricing compliance does not require master file and local file, departs from OECD's three-tiered approach to transfer pricing documentation.

No rules for attribution of profits to permanent establishments.

No available advance pricing agreement programs (APAs) for certainty to cross-border investments.

Regional Distributors: Brazil

Changing winds in Brazil’s transfer pricing?

What’s the latest in Brazil’s accession to OECD membership?

The Brazilian Government organized a Council to handle the formal preparation for OECD’s membership accession process (Decree No. 9,920, July 18, 2019).

According to recent national news, President Trump has already backed Brazil for its OECD membership (NYT, October 10, 2019).

Whether the OECD accession will bind Brazil to fully embrace OECD’s TP Guidelines and the Arm’s Length Principle (ALP)?

Contrasting opinions, but the OECD’s alternatives are crystal clear: (i) immediate alignment to the OECD TP Guidelines with a transitional period for adaptation; or (ii) gradual alignment to the OECD TP Guidelines based on category of taxpayers.

This is something that remains to be seen …

Regional Distributors: Brazil

Changing winds in Brazil's?
BEPS 2.0 – Pillar 1

The tension of Brazil's longstanding policy against ALP becomes more relevant after OECD's October 2019 release of a "unified" approach for **Pillar 1** under **BEPS 2.0 (Taxation of the Digitalized Economy)** that retains ALP for purposes of determining routine activity elements within the context of digital global profit allocations, i.e., A and B amounts.

This means that ALP is likely to survive the BEPS 2.0 upheaval, and Brazil as participant of the Inclusive Framework should probably adapt to the new "World Tax Order" to result from BEPS 2.0. *Time will tell* …

Q&A