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GILTI as Charged: The New Rules for Noncorporate US Shareholders

Digital Economy Taxation

Peculiarities in The US Tax Treatment of Cross-Border Services

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FROM THE Editor

Benjamin Franklin stated "nothing can be said to be certain, except death and taxes." That must have been a simpler age as taxation is now anything but certain. Traditional manufacturing is being rivalled by the service and digital economies, and governments are attempting to tax businesses that may be only tangentially related to a country. Add to this the constantly evolving world of cryptocurrency and the challenge of taxing assets that don't actually exist, and all certainty evaporates. A thorough understanding and clear thinking are the only antidotes to the confusion.

Once tax liabilities have been unraveled, and the choppy seas of international employment law have been successfully navigated, there are a number of opportunities at the moment for bold investors. The recent meetings between the US and North Korean leaders have potentially opened up North Korea as a new market. And the Indian health care sector is a very attractive target for private equity.

Please contact me if you have any comments on our articles or would like to discuss any of the issues raised.

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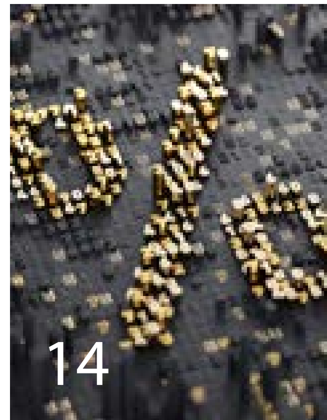

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Health Care Private Equity Investments in India

HAMID YUNIS AND SHASHANK KRISHNA

A flurry of recent private equity (PE) investments in the Indian health care sector demonstrates strong investor appetite and opportunities.

CONTINUED >

India is one of the fastest growing health care markets in the world, estimated to grow at a 22 per cent compound annual growth rate to $372 billion by 2022, according to an ASSOCHAM-RNCOS report.

ACTIVE MARKET

The recent health care deal flow has been impressive. Advent has invested in Care Hospitals. Quadria has invested in a number of single specialty Indian health care assets. TPG is the market leader for health care investments in India, where its portfolio includes Manipal Hospitals, Sai Life Sciences and Quality Care India. TPG has also invested in Asia Health Care Holdings (AHH), a health care operating and investment platform. The AHH portfolio includes Cancer Treatment Services International, a network of cancer hospitals; and Rhea Health Care, which operates a network of hospitals for women and children under the Motherhood brand. TPG's other health care investments in India have included Sutures India, a manufacturer and exporter of medical consumables, from which it successfully exited in 2018.

There are a number of factors driving this growth and the consequent PE deal flow.

FAVOURABLE MACRO INDICATORS

India is now the world's sixth largest economy, with US$2.6 trillion gross domestic product (GDP).

According to the International Monetary Fund's (IMF) April 2018 World Economic Outlook, the Indian economy is expected to grow at an annual rate of 7.4 per cent in 2018 and 7.8 per cent in 2019, making it one of the fastest growing large economies in the world. This has led to a rise in disposable income and an increase in prosperity, particularly for the Indian middle class, which HSBC estimates will increase to 550 million by 2025.

> “Moodys has upgraded India's sovereign rating to Baa2 with a stable economic outlook.”

All the elements for investment opportunities are in place. India's population is growing and is currently at 1.3 billion. The demographics are favourable to business, with nearly 50 per cent of its population under the age of 25. The political environment is reasonably benign, interest and inflation rates are stable, and the fiscal deficit is steadily declining and is expected to further reduce to 3.2 per cent of GDP. India is benefitting from a sustainable and predictable growth.

The recent legal and regulatory reforms have also led to higher investor confidence, reflected by India's improved ranking in the World Bank's ease of doing business category, where it jumped 30 places to move into the top 100.

As a result of these factors, Moody's has upgraded India's sovereign rating to Baa2 with a stable economic outlook.

Investor confidence in India has also grown as a result of legal and regulatory reforms and the government's drive to reduce the nonperforming assets in the economy. The recent push towards growing the formal economy, increasing the tax base, and simplifying and unifying India's indirect tax laws through the introduction of the national goods and services tax, have further helped in this regard.

These economic and political factors, coupled with the rise of the middle class and growing incidence of lifestyle diseases, have led to an increase in health awareness and consequential demand for health care services and infrastructure.

DEMAND/SUPPLY GAP

The Indian health care sector, while growing, remains under-funded. For example, according to a recent PwC report, the Indian health care system will require an investment of around US$245 billion over the next 20 years. The PwC report also estimates that India needs to add 3.6 million beds, 3 million doctors and 6 million nurses in the next 20 years.

ACTIVE PE INTEREST AND OPPORTUNITIES

There are a number of barriers in the way of local investment: local debt financing costs are high, the domestic debt market is constrained, government budgets are limited, and the health care sector remains fragmented. This creates an opportunity

for PE to provide growth capital, plus India would benefit from an injection of international experience and best practices from other parts of the world.

Global PE funds are focusing on Asia in general, as a result of strong interest from institutional investors and other clients, and Asia's growing importance as a driver of the world economy. India, China and Japan, being Asia's largest economies, benefit from this general increase in interest in Asia.

According to Bain & Company, in 2017 India was an attractive destination for investments, with India-focused funds increasing 48 per cent in aggregate to US$5.7 billion, reaffirming the potential for investments in the Indian market. Health care, in particular, remains a bright spot for PE investments in the country.

NO FOREIGN INVESTMENT LIMITS OR RESTRICTIONS

India maintains a favourable foreign investment regime for health care, with generally no limits on foreign ownership in the health care sector, or the need to obtain any foreign investment approval requirements.

BENIGN REGULATORY ENVIRONMENT

As one would expect, the health care sector is subject to a number of laws and regulations and approval requirements. While there have been some limited instances of price caps being introduced in some parts of the health care sector, the private sector continues to play a major role in providing health care services. The government is generally supportive of their involvement and, in fact, welcomes and supports private sector investment in health care.

PROVEN EXIT OPPORTUNITIES

India has a large and reasonably liquid domestic capital market that continues to provide exit opportunities. There have been a number of successful and heavily over-subscribed health care IPOs in the last decade. The number of secondary and strategic sales are also expected to increase in the next few years, given the timing of the investment cycle and fund life. The vibrancy in the capital markets and strategic mergers and acquisitions have enabled PE investors to undertake successful exits.

HIGHER-MARGIN RETAIL HEALTH CARE AND CONSOLIDATION OPPORTUNITIES

A number of Indian health care establishments are fragmented, with a wide range of health care providers, which provides an attractive opportunity for PE to undertake platform acquisitions, and "roll up" and unlock value by standardising and replicating services across multiple locations.

> "India is one of the fastest growing health care markets in the world."

In fact, PE investors are now the main driving force for consolidation in health care and other high-growth sectors in India, while providing much needed growth capital.

As the market is generally reliant on self-paying patients, the sector relies more on consumer choice than insurance reimbursements, which is helpful from a PE perspective. In particular, single-speciality chains and diagnostic laboratories are expected to be the main focus areas, as they are easy to set up and expand.

INCREASE IN INSTITUTIONAL INTEREST

A key driver for growth has been interest from institutional investors who are particularly looking for investment opportunities in small hospital chains and specialised treatment facilities. This growth is expected to increase in the next few years.

THE NEW NATIONAL INSURANCE SCHEME

This year, India introduced a new national health insurance plan to cover 500 million people, in what is expected to be the largest public funded health protection plan in the world. The Ayushman Bharat insurance scheme (often referred to as Modicare, after Prime Minister Narendra Modi) will provide insurance cover for the 100 million poorest households. The plan is expected to bring 500 million people into the health care mainstream. The plans will allow beneficiaries to receive "cashless" in-patient care at government hospitals or approved private facilities.

The operational guidelines for the plan are under development, but it is expected to further drive up demand for health care services across the country, and a number of industry experts expect the plan to trigger a surge in health care investment in India.

THE PROPOSED INTEGRATED DIGITAL HEALTH CARE SYSTEM

The Indian Government has proposed a new integrated digital health care system—National Health Stack—as the country's first health care information system, available for use across public and private sectors. This is to ensure that the digital health records of all citizens are digitised by the year 2022. The system is expected to improve the affordability of, and access to, health care; facilitate national health programmes; and boost medical research and analysis. It will also enable on-time payments for service providers, while reducing fraud and operational costs.

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Cautiously Optimistic: Commercial Opportunities in North Korea

PAUL KIM, RAYMOND PARETZKY AND ANDREW KIM

Investors should start planning now and begin exploring the possible opportunities that await in North Korea once sanctions are removed.

The future for investment in North Korea is tentative but bright. US President Donald Trump and Chairman Kim Jong-Un of the Workers' Party of the Democratic People's Republic of Korea held an unprecedented summit in Singapore this summer. The summit came after two equally historic inter-Korean meetings between Chairman Kim and President Moon Jae-In of the Republic of Korea.

The US and North Korean leaders signed a joint statement after a day of talks expressing Pyongyang's commitment to denuclearise. While it is unclear what will result from follow up meetings, North Korea may finally open for business.

COMMERCIAL HISTORY

When the two Koreas had a more friendly relationship, Mount Geumgang resort and the Kaesong Industrial Complex (KIC), both located in the North, were funded by companies in the South. The KIC generated US$560 million in wages, and two million tourists visited Mount Geumgang, which had assets worth US$440 million. They were shut down, however, when the Seoul-Pyongyang relationship fell apart.

The North has had other partners outside the Korean peninsula. According to the 2016 trade report repared by the South Korean government, North Korea's trade with China amounted to US$6 billion, and other trade partners that year included Russia, India, Thailand and the Philippines. The appetite for foreign trade is certainly in place.

OPEN FOR BUSINESS?

The biggest hurdles to Western companies doing business in North Korea are United Nations (UN) and US sanctions. UN Security Council resolutions 1718 and 1874 explicitly prohibit any member country from providing funds that may support Pyongyang's nuclear programme. Other UN sanctions include an arms embargo, asset freezes, and bans on exports to and/or imports from North Korea of various items, including certain natural resources, luxury goods, seafood, textiles, fuel, condensates and natural gas liquids, and crude oil and refined petroleum products in excess of stated amounts.

US sanctions are more comprehensive than the United Nations'. The United States imposes a complete ban on imports from, and exports and investments into, North Korea. A list of "blocked persons" is also maintained and published by the US Treasury Department's Office of Foreign Assets Control (OFAC). Engaging in transactions with any "blocked person" (which may be an individual, corporation or other legal entity) is banned. US sanctions further hold third parties, including non-US entities and individuals, accountable for certain activities with North Korea. A violator may be sanctioned by having its US assets frozen and being prohibited from doing business with anyone in the United States.

Because OFAC is notoriously aggressive in enforcing its sanctions regime, including extraterritorially, even non-US companies planning investments in North Korea would incur considerable risk if they acted in violation of applicable US sanctions. The risk is real. OFAC published a lengthy alert in July 2018 advising businesses of the potential risks of trading with North Korea. The alert advises businesses to "be aware of deceptive practices employed by North Korea in order to implement effective due diligence policies, procedures, and internal controls to ensure compliance with applicable legal requirements across their entire supply chains."

PRECEDENTS

If and when the sanctions are removed, there are some precedents that can guide foreign companies as to what industries may initially benefit. Vietnam, for example, provides a potential template.

When sanctions against Vietnam were lifted in 1994, the situation was remarkably similar to North Korea. The United States asked Vietnam to sign a peace agreement with Cambodia, settle issues regarding American remains and

prisoners of war and address human rights violations. Once sanctions were removed, Vietnam experienced strong economic growth, and remains a lucrative target for investment, with a 6 per cent growth rate since 2000.

If Pyongyang follows Vietnam's example, it will introduce a series of reforms that liberalise the market from state control, encourage agricultural development, support light industrialisation and ultimately increase openness to trade and foreign investment. Indeed, Washington has publicly urged North Korea to follow the Vietnam model, which Pyongyang has likely studied closely.

China also sets a precedent. China's modernisation began with rural economic development followed by urban reforms and privatisation, and eventually a wholesale market liberalisation. Of particular interest for Pyongyang will be China's successful market transformation without regime change.

> "North Korea has a cheap, well-educated labour force and a large amount of natural resources."

WHAT THE FUTURE MAY HOLD

South Korean companies are already studying the North. Major businesses have set up task forces to research and evaluate projects, Samsung Securities published a North Korean investment strategies report in June 2018, and leading telecommunications companies have expressed strong interest. One potential path to profiting from the North Korean economic development is therefore investing in and doing business with South Korean companies geographically close to, and familiar with, North Korea.

Businesses should also be aware of the industries that will likely be prioritised. In 2016, Pyongyang announced its first five-year development plan since the 1980s. The plan highlights three goals: improvement of the lives of its citizens, land restoration and trade invigoration. To meet these goals, the plan emphasises stabilising energy supply, rebuilding light industries, increasing exports and expanding tourism.

Special Economic Zones (SEZs) are also an attractive option. SEZs have partial autonomy and are insulated from the rest of the country, allowing for easy control. To date, there are 24 SEZs in North Korea, each with specific development goals and varying degrees of freedom.

The Rason SEZ was the first zone, developed in 1991 with administrative autonomy to transform the port city into a trade hub in northeast Asia by leasing its harbours to China and Russia. It ultimately failed owing to sanctions. Mount Geumgang and the KIC were also SEZs with independent management. The former focused on tourism, and the latter aimed at developing manufacturing, trade, commerce and finance. SEZs may be preferred by Pyongyang over a completely open economy as they allow for targeted and controlled development.

PRACTICAL CONSIDERATIONS

Despite the successful summits and recent developments, investors and businesses should remain cautious. North Korea has reneged on its promises to denuclearise in the past, and political and military tensions resulted in assets being expropriated, such as those in the KIC and Mount Geumgang. Creating a business-friendly environment will take time and, during that time, Washington and Pyongyang's relationship may deteriorate.

Even if Pyongyang opens its doors, there will be major challenges. For example, North Korean infrastructure needs substantial improvement. Roads are generally unpaved and severely deteriorated, 70 per cent of the railways were built before the Korean War in 1950, and decrepit harbours and marine transport make maritime trade nearly impossible. Corruption is also rampant. In 2017, Transparency International ranked North Korea as ninth from the bottom in its Corruption Perceptions Index. State authorities often make demands outside business contracts or refuse to return investment profits to foreign companies.

Although businesses would be well-advised to wait until sanctions are relaxed or removed before taking any financial action, they should start examining the opportunities for investment in North Korea. Advisors who are familiar with the history, culture and language of the two Koreas, the North Korean model of economic development, its changing legal and economic structure, and the political, government and business climate, will be best positioned to provide expert legal and business counsel.

North Korea has a cheap but well-educated labour force and a large amount of natural resources. These factors, coupled with its strategic location between China, Japan, Russia and South Korea, some of the biggest markets in the world, make the opportunities available almost endless.

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Making a Splash in the Global Employment Pool: The Challenge of Multiple Employment Laws

MICHELLE STROWHIRO AND MARJORIE SOTO

US businesses expanding abroad, and international businesses moving into the United States, can find the differences between employment laws both unexpected and costly.

Companies of all sizes are eager to expand their businesses, and their workforce, into new markets. US employers already know that operating in multiple states can feel like operating in different countries because of state- and locality-specific employment laws. But if operating in California versus Wyoming is comparing pools to puddles, then operating in the United States versus other countries is comparing puddles to oceans.

US-based companies looking to expand abroad, and foreign companies opening their first US locations, must proceed with caution before jumping in. One error can commit a business to employing its workforce until retirement, cost months and a small fortune to terminate the employment relationship, or keep it embroiled for years in class action litigation.

AT-WILL EMPLOYMENT

In the United States, employees are typically "at-will." In theory, this means that US companies can fire an employee for poor performance, poor behaviour, budget shortfall, or any other reason, as long as that reason is lawful. Of course, in practice, there are expansive state and federal employee protections that mean US employers must still be very careful when terminating employees.

Termination outside the United States is generally more difficult. At-will employment does not exist in other countries, and unilateral termination is not generally permitted. For example, in the Netherlands, there are only four ways to terminate an employee. These are

1. By mutual consent
2. With permission from the Dutch Employment Insurance Agency (the UWV)
3. Through dissolution of the contract by a court
4. Through summary dismissal for urgent cause, such as serious misconduct, including theft, fraud or endangerment.

In many cases, the employee is also entitled to statutory severance pay under a government-defined formula. These obstacles and expenses are the rule, not the exception, outside the United States.

PROBATIONARY PERIODS

In most countries, probationary periods are a common and effective practice. During these periods, which may last from several months to a year, the company has extra authority to terminate the employee without the hassle of mutual assent or having the termination approved by a works council or court. Probationary periods are therefore extremely useful where permissible.

In the United States, aside from legitimate distinctions related to benefit entitlements, probationary periods are largely a fallacy, since an at-will employee can be terminated at any time.

EMPLOYMENT CONTRACTS

One of the key differences between countries' employment law regimes is whether they apply a common law system or a civil law system. Under a civil law system, statutes, rather than case law, determine how an employment contract is interpreted. Contracts in civil law countries therefore tend to have much broader language and contain fewer mandatory provisions.

Outside of C-suite and other high-level executives, it is common for US employees to have either no employment contract, or only a short "offer letter"

that outlines just a few key terms. Employment is governed by company policies that are subject to unilateral company modification and exist outside any personal contract an employee may have.

In other countries, employment contracts are mandatory. China, for example, requires employment contracts with certain specific terms to be entered into within the first month of employment, or earlier, depending on the region. Failure to do so may create an "open term" employment contract and entitle the Chinese employee to employment until retirement.

PAID HOLIDAY

There are some exceptions in certain US states and localities that require employees to be given paid leave for specific purposes such as sick pay but, in general, US employees are not paid for time off.

Outside the United States paid time off is a given. Austrian employees are entitled to at least 25 days of annual paid leave and 13 paid holidays. UK employees are entitled to 5.6 weeks paid holiday leave per year from their first day of employment.

In addition, many European employers also participate in the custom of providing significant time off during the summer months, sometimes the whole of August.

SEVERANCE PAY

The cost of terminating employment outside the United States is typically based on formulas set by the country of operation, which tend to include total salary as a factor.

The United States does not require severance pay, although it is not uncommon for companies to establish a general formula or guideline to use when determining a discretionary severance offer to a departing employee, usually in exchange for a release.

OVERTIME

Overtime laws vary across the United States. While US federal law requires overtime pay for hours worked over 40 in a work week, several states go further and regulate hours in more detail. In California, for example,

- Overtime pay is owed for work in excess of eight hours up to and including 12 hours in any workday, and for the first eight hours worked on the seventh consecutive day of work in a work week.
- Double time is owed for each hour worked over 12 in a workday, and for all hours worked over eight on the seventh consecutive day of work in a work week.

> "In general, employees in the United States are not paid for time off."

Meanwhile, in France, the threshold for overtime is a flat 35 hours. In Italy, overtime is owed for hours over 40 in a week, with a cap at 48 hours, after which companies must inform the labour inspectorate and provide justification. In China, employees who work on weekends or holidays are entitled to a rate of pay higher than their usual rate.

Companies moving into new jurisdictions must carefully follow the relevant wage and hour laws when establishing pay practices and making job offers to avoid exposure to time-consuming and expensive class-wide litigation and liability.

DISCRIMINATION

The avoidance of discrimination seems like a fairly straightforward concept. But this is where the impossibility of a universal company policy is arguably most obvious.

The US Equal Employment Opportunity Commission mandates that employers maintain and enforce policies prohibiting discrimination on the basis of a plethora of protected classes including sex, race, religion, colour, national origin, age, disability and genetic information. Many states maintain more expansive lists, and violation of anti-discrimination laws may lead to protracted employment litigation.

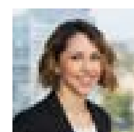
Although this seems pretty comprehensive, a universal company Equal Employment Opportunity policy will fall short globally. Some countries actually require companies to discriminate. Saudi labour law, for example, requires employers to positively discriminate in favour of Saudi nationals.

COLLECTIVE BARGAINING

Finally, a similarity in a sea of differences. One thing remains consistent internationally: employees have the right to organise.

The US National Labor Relations Act provides employees with the right to organise and to bargain for the terms of their employment. Employers are prohibited from threatening employees if they engage in protected concerted activity.

Likewise, many countries, such as Germany, actually make it a criminal offence to prevent employees from forming groups of employees and management. Negotiating with these works councils is an integral part of doing business in Germany. Employers must be aware of applicable labour laws and provide employees with the opportunity to provide input within the bounds of those laws.



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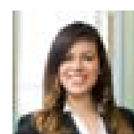

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Nowhere to Hide: The UK Transparency Register

SIMON GIBB AND ASTRID OWEN

The United Kingdom has become a world leader in the drive for tax transparency.

The United Kingdom has introduced several transparency initiatives: registers of persons with significant control (PSC) for UK companies, and the trust register established the UK tax authority, HMRC.

COMMON REPORTING STANDARD

The UK was an early adopter of the Common Reporting Standard (CRS). This requires UK financial institutions to identify the ultimate beneficial owners of all "accounts" (from investment accounts to beneficial interests in trusts) and their values. That information is provided to HMRC to share with tax authorities in countries where beneficial owners are tax resident.

PSC: UK COMPANIES

The PSC regime was introduced to identify individuals who control more than 25 per cent of a company or who have the right to exercise significant influence or control over a UK company, or the trustees of trusts which directly or indirectly own or control the company. UK companies must create and maintain a register identifying their PSCs, including information such as the individual's name, date of birth, nationality, service address, country or state of usual residence and the nature of their control over the company.

The majority of this information is publicly available, and the entire register is available to UK Government agencies. The only permitted reason for not appearing on the register is by court order on the basis that there is a real risk of physical harm to the individual or persons living with them.

PSC: LAND OWNERSHIP

The United Kingdom intends to extend the PSC obligation to non-UK companies that own UK land. The register will be held at Companies House and need to be updated annually. It will be the first of its kind in the world and will directly affect all legal entities that hold, or intend to hold, UK property.

Without a registration number, the entity would not be able to register as the owner of property at the Land Registry, which could prevent the sale or lease of the land. It is also proposed that the purchaser would not receive full legal property interest in the land.

> "The United Kingdom intends to extend the PSC obligation to non-UK companies."

TRUST REGISTER

The trustees of UK tax-relevant trusts must register extensive information about their trusts with HMRC. A trust is registrable where it is either UK tax resident or the trustees are directly liable for UK taxes. The registrable information includes the identity of the settlor, trustees, actual and potential beneficiaries and/or the class of beneficiaries. Information is also needed on the trust's assets, including the market value of the assets when first settled and the details of any land directly held by the trust.

It is highly likely that these last three requirements will be broadly copied in the European Union and further afield. It is therefore vital that trusts are structured with all applicable disclosure regimes in mind and the correct information disclosed.

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GILTI as Charged: The New Rules for Noncorporate US Shareholders

SANDRA MCGILL, STEVEN HADJILOGIOU AND MICHAEL BRUNO

The tax impact of Global Intangible Low Taxed Income (GILTI) rules on noncorporate US shareholders is particularly harsh unless planning is undertaken to mitigate the impact. CONTINUED >

Following the recent enactment of the Tax Reform and Jobs Act (the Act), any US person who is a US shareholder of a foreign corporation that is more than 50 per cent owned by US shareholders, known as a controlled foreign corporation (CFC) will be annually subject to US tax on its share of a CFC's undistributed GILTI, including the CFC's undistributed active business income.

The GILTI rules, which are effective for tax years starting after 31 December 2017, apply to all US shareholders, both corporate and noncorporate, *e.g.*, individuals and trusts, partnerships, or S corporations with individual and trust members. In addition to adding the GILTI rules, the Act also expanded the definition of a CFC and a US shareholder of a CFC, so more US persons are now subject to US tax on GILTI.

GENERAL GILTI RULES

The GILTI rules expressly refer to "intangible low-taxed income", suggesting that they are intended to subject to US tax only low taxed income of a CFC that owns intangibles. In fact, they are drafted to encompass much more of a CFC's income.

GILTI is essentially defined to include all income of a CFC that is not otherwise subject to tax as Subpart F income, or which would have been taxed as Subpart F income without the Subpart F high tax exception, or as income effectively connected to a US trade or the CFC's business. A CFC's GILTI is reduced by an amount that equals 10 per cent of the CFC's tax basis in its depreciable tangible property. GILTI therefore includes services income, sales income and other types of business income that were not subject to US tax prior to the Act.

> "More US persons are now subject to US tax on GILTI."

Corporate US shareholders of CFCs are entitled to reduce their GILTI by 50 per cent and are therefore subject to US tax on only 50 per cent of their GILTI. In addition, corporate US shareholders are entitled to a credit against their corporate US tax liability of 21 per cent, subject to the general limitation rules, equal to 80 per cent of their share of the foreign taxes paid by the CFC. The result of the 50 per cent reduction in GILTI and the foreign tax credit is that, without expense allocation rules that may impact the foreign tax credit limitation amount, corporate US shareholders of CFCs subject to a foreign tax rate of 13.125 per cent or higher should not generally be subject to any US tax on their share of GILTI.

For both corporate and noncorporate US shareholders, GILTI is required to be included in gross income on the last day of the US shareholder's tax year in which the CFC tax year ends. This means that GILTI planning must be in place by the last day of the US shareholder's tax year.

GILTI AND NONCORPORATE US SHAREHOLDERS

Noncorporate US shareholders of CFCs are subject to a higher rate of US tax on their share of a CFC's GILTI than corporate US shareholders, unless they plan effectively. The reasons for this are

- Noncorporate US shareholders are not entitled to reduce their GILTI by 50 per cent.
- Noncorporate US shareholders are not entitled to a credit for foreign taxes paid by the CFC.
- The US tax rate for noncorporate US shareholders is 37 per cent at the highest effective rate, which is higher than the 21 per cent corporate rate.

EXPANDED DEFINITION OF US SHAREHOLDER

Prior to the Act, only US persons who owned 10 per cent of the voting stock of the CFC were treated as US shareholders. Under the GILTI rules, in general, a US shareholder is defined as a US person who owns (directly, indirectly or constructively) at least 10 per cent of the vote or value (*authors' emphasis*) in a foreign corporation. By expanding the definition of US shareholder to include US persons who own 10 per cent by value of a CFC, more US persons will be treated as US shareholders, which may also increase the number of CFCs.

REPEAL OF DOWNWARD ATTRIBUTION RULE

The Act also eliminated a provision in the Subpart F rules, which prevented downward attribution of stock from certain foreign persons such as foreign estates, trusts, partnerships and corporations to US persons for the purpose of determining whether or not the US shareholder and CFC tests are satisfied. As a result of this change, it is very important to carefully review ownership structures to ascertain whether or not a US person may be treated as a US shareholder of a foreign corporation through attribution from a foreign related entity.

For example, assume Foreign Co. is 40 per cent owned by US person A and 60 per cent owned by non-US person B, who also owns 100 per cent of US Co. Prior to the Act, Foreign Co. would not be a CFC because it would be only 40 per cent owned by US person A. As a result of the repeal of the downward attribution rule, however, US Co. is treated as constructively owning the 40 per cent Foreign Co. stock owned by non-US Person B, and is therefore treated as a US shareholder of Foreign Co. Consequently, Foreign Co. is now a CFC.

ELIMINATION OF THE CFC 30 DAY RULE

The Act also eliminated the requirement that a US shareholder must control a foreign corporation for an uninterrupted 30-day period for it to be treated as a CFC. Under the new rules, a foreign corporation is a CFC even if it is only a CFC for a single day in a tax year.

GILTI PLANNING FOR NONCORPORATE US SHAREHOLDERS OF CFCS

The new GILTI rules combined with the new expanded definitions of US shareholder and CFC means that more noncorporate US shareholders will have to navigate the GILTI rules and determine how to minimise their impact before the end of their 2018 tax year.

> “GILTI planning must be in place by the last day of the US shareholder's tax year.”

One option is for a noncorporate US shareholder to contribute its CFC stock to a domestic corporation. If the foreign corporation pays at least 13.125 per cent of foreign taxes, the domestic corporation should generally not be subject to any additional US federal income tax, resulting in a complete deferral of US tax, and US tax on distributions to the noncorporate US shareholder at a reduced US income tax rate of 20 per cent under the qualified dividend rules.

Note, however, that if the domestic corporation were to sell the CFC stock, the gain would be subject to two levels of US tax. This would necessitate some planning, *e.g.*, by selling the US company instead.

Another possible planning alternative is for the noncorporate US shareholder to make a Section 962 election. This allows a noncorporate US shareholder that directly or indirectly owns 10 per cent of the stock of the CFC to be treated as if it were a corporation solely for purposes of taxing its share of the CFC's GILTI and Subpart F income. It also allows the noncorporate US shareholder to claim a credit for the foreign taxes paid by the CFC and allows the GILTI to be taxed at a lower 21 per cent rate until foreign corporation declares a distribution to the individual shareholder. At that point, the full amount of the distribution, less the corporate tax paid, will be subject to US individual tax.

It should be noted, however, that without further guidance, it is not clear that the 50 per cent reduction in GILTI applies to a noncorporate US Shareholder that makes a Section 962 election.

A noncorporate US shareholder may elect to treat its CFCs as pass throughs for US tax purposes, *e.g.*, through "check the box" elections, which would allow them to fully claim the foreign taxes paid as a credit against their US tax liability. This alternative is primarily beneficial where the foreign corporation is paying a relatively high rate of foreign tax.

Deciding which alternative to use will require a detailed analysis of the facts in question and modelling of the alternatives. Taxpayers should consult with their advisors on all the options available to them.

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Digital Economy Taxation

CYM LOWELL, JAMES ROSS AND SARAH GABBAI

Over the past five years, governments and international bodies have been developing measures in response to base erosion and profit shifting (BEPS) concerns arising from highly digitalised businesses.

In its 2015 Final Report, Addressing the Tax Challenges of the Digital Economy - Action 1, the Organisation for Economic Co-operation and Development (OECD) identified three broad direct tax challenges associated with digitalisation:

1. How nexus is determined
2. How value is attributed to data and content generation
3. How payments made in the context of digital business models should be properly characterised for tax purposes.

To address these challenges, Action 1 considered a nexus-based "significant economic presence" rule, a withholding tax on digital transactions and an equalisation levy. These are interim proposals with the ultimate aim of taxing remote online sales to customers in market jurisdictions.

Since Action 1 was released, there have been significant developments both nationally and internationally to address concerns over BEPS exacerbated by digitalisation.

At an international level, 77 countries so far have signed a Multilateral Instrument (MLI) implementing various anti-BEPS treaty-related measures. Multinational enterprises (MNEs) have responded to the impact of the MLI by aligning their transfer pricing positions with, and relocating their intangibles to, the situs of the MNE's real economic activity.

The European Union has enacted two Anti-Tax Avoidance Directives requiring Member States to introduce, amongst others, controlled foreign company (CFC) rules and anti-hybrid measures, and has put forward two Directive proposals for an interim 3 per cent "digital services tax" and a longer-term corporate income tax on a "significant digital presence", for implementation by Member States by 2020. At a national level, some OECD/G20 member countries have begun to implement their own national measures.

NATIONAL MEASURES

United States

US tax reforms adopted in late 2017 are intended to impose a minimum level of taxation on the global income of US-based MNEs and US source income of non-US-based MNEs. Although a provision seeking to impose US tax on outbound payments (the BEAT see more on the BEAT on p.16) has been cited by the OECD as one of the tax policy developments potentially relevant to digitalisation, the BEAT does not fit neatly into any of the Action 1 proposals, perhaps because it is not specifically aimed at digital businesses. All MNEs are evaluating their effective tax rate structures in view of the these and other developments, with digital simply being one element of the overall process.

The US Supreme Court ruled on 21 June in *South Dakota v Wayfair* that state and local governments could begin collecting sales tax from online retailers, overturning the precedent set by *Quill v North Dakota* in 1992. While the Court held that a physical presence was no longer required in order for out-of-state sellers to collect in-state sales tax, it stopped short of formally declaring that the South Dakota sales tax statute was valid under the Commerce Clause in the absence of *Quill* and *Bellas*

Hess standards, leaving the question to be resolved by the South Dakota Supreme Court. Meanwhile, South Dakota is expected to pass legislation on 12 September to expedite remote sales tax collection, with other States following suit.

United Kingdom

The United Kingdom introduced its own nexus-based rule in the form of its "diverted profits tax" (DPT) regime in the Finance Act 2015. Broadly, the rule applies a 25 per cent tax, for accounting periods beginning on or after 1 April 2015, to non-UK companies with an "avoided permanent establishment" (PE) in the United Kingdom, or to UK companies that engage in related party transactions with insufficient economic substance.

The regime is not specifically aimed at digital businesses, unlike the proposals put forward by HM Treasury in its November 2017 and March 2018 position papers on corporate tax and the digital economy. These proposals seek to reform the international tax framework based on the nexus concept, citing the need to recognise user participation as an important value driver for certain businesses and to identify the profits attributable to that user-created value. In these respects, the UK position is similar to that of the European Union, which also views user participation as a key value creator.

Australia

Australia enacted its own DPT regime in April 2017 to complement its existing Multinational Anti-Avoidance Law, which targets a specific type of "deemed PE" structure. Under this structure, an overseas company concludes sales contracts entered into by local employees for supplies of products and services to Australia-based customers, A 30 per cent withholding tax also applies to any royalties paid by the deemed PE. The regime applies a punitive 40 per cent corporate income tax charge to the amount of tax benefit secured by a transaction or arrangement, the principal purpose of which is to secure that tax benefit.

The rule mainly targets cross-border IP transfers or licensing arrangements within MNEs.

Italy

Italy's digital transactions levy is expected to become effective from 1 January 2019. The levy applies a 3 per cent tax on consideration (net of VAT) for digital services supplied electronically by resident and non-resident enterprises to Italian business customers and operates in a similar fashion to the equalisation levy described in Action 1.

With the exception of US state tax on interstate e-commerce transactions, such as that considered in *Wayfair*, these taxes are examples of some of the national-level tax policy developments that influenced the OECD's thinking in its Tax Challenges Arising From Digitalization - Interim Report 2018. The Interim Report also considers countries that have targeted specific types of digital services, such as online advertising (India and Hungary) and online video-on-demand services (France).

INTERNATIONAL MEASURES

Chapter 2 of the Interim Report identifies the salient characteristics of highly digitalised business models as

- The ability to achieve cross-jurisdictional scale without mass
- Heavy reliance on intangibles
- Heavy reliance on data and user-generated content.

These characteristics challenge nexus and profit allocation on the basis that they create outcomes that do not align the country in which profits are taxed with the country in which the "real" economic activities occur.

At the heart of this tension lies the concept of value creation, which the OECD views as a highly complex area that does not have any obvious "one size fits all" definition. This as-yet-unknown definition of value creation underpins the present difficulty in reaching a global consensus on a revised international tax system to suit the digital economy. Given that the OECD is not expected to conclude its work in this area until 2020 at the earliest, it seems that the European Union and other countries have jumped the gun ahead of the OECD with no obvious justification for doing so other than to take political aim at the larger tech MNEs.

WHAT'S NEXT?

To resolve the perceived misalignment between the taxing jurisdiction and the jurisdiction in which value is created, the OECD intends to analyse in greater depth the value contributions of these characteristics, as well as those of digitalisation more broadly, with a view to "stress testing" the impact of such value contributions against any proposed new nexus and profit allocation rules. A further update is expected in 2019, with the OECD's final conclusions expected to be published in a final report in 2020.

At the EU level, it seems unlikely that the proposed 3 per cent digital services tax will receive the necessary approval owing to the perceived negative political and economic consequences.

From a long-term perspective, one solution may be the expansion of the PE threshold to include digital transactions. The means of allocating income between countries could evolve as a formulary matter by reference to, *e.g.*, downloads or other measurable elements, potentially limiting the relevance of the arm's length standard for transfer pricing purposes.

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Peculiarities in the US Tax Treatment of Cross-Border Services

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US tax rules aren't built for the service industry, and there are a number of pitfalls that businesses should be aware of.

For many years, the service sector has accounted for the vast majority of US gross domestic product and private sector jobs, and the United States consistently runs a large trade surplus in services *vis-à-vis* the rest of the world. Even traditional manufacturers increasingly operate hybrid manufacturing and services businesses, as tangible products increasingly incorporate internet-connected technologies that monitor and manage the performance of the products on a subscription basis.

US tax policy has, however, been slow to adjust to the importance of services to the modern economy. Too often it seems that rules are built primarily with the production and sale of tangible goods in mind, with special adjustments for service transactions being made (and perhaps rushed) later in the process. We're not seeing rules designed with services transactions front-of-mind from the outset. While this has been the case for many years, it became particularly noticeable with the introduction of fundamental changes to the cross-border tax rules in the Tax Cuts and Jobs Act (TCJA) enacted at the end of 2017.

The TCJA introduced three new regimes that operate in ways that are curious when applied to services transactions:

1. The base erosion and anti-abuse tax (BEAT) under new Internal Revenue Code section 59A
2. The global intangible low-taxed income (GILTI) regime under new Code section 951A
3. The special deduction for foreign-derived intangible income (or FDII) under new Code section 250.

All of these rules present difficult issues for taxpayers with services transactions, see p.11 for more on GILTI, but the following focuses on some of the issues presented by the BEAT for both services-sector companies and other companies that rely in part on third-party or related-party services in the operation of non-services-sector business models.

THE BEAT

The BEAT was enacted to limit taxpayers' ability to reduce US tax by making deductible payments, *e.g.*, interest, royalties and service fees, to related foreign parties. The BEAT applies to both US-based and non-US-based multinationals.

For large US corporations making a certain level of deductible payments to related foreign parties, the BEAT effectively imposes a new minimum tax: usually the amount by which 10 per cent of "modified taxable income" (5 per cent for 2018) exceeds regular tax liability. Modified taxable income is determined without regard to deductible amounts paid to related foreign persons.

These amounts also include amortisation and depreciation deductions with respect to property acquired from a related foreign person. They do not include amounts that constitute costs of goods sold (COGS), such as a manufacturer's raw materials costs, or other costs capitalised into inventory under Code Section 263A. These include certain royalties paid to use intangible property in connection with the manufacture and sale of goods.

COGS AND THE VAGARIES OF TAX ACCOUNTING

In the context of a manufacturing business, the COGS exclusion generally operates well to ensure that the BEAT targets base-eroding payments without disrupting ordinary supply chain transactions such as

a cross-border purchase of intermediate inputs by a US manufacturer from a related foreign manufacturer. In the context of services transactions, on the other hand, the availability of a corresponding exclusion for ordinary supply chain transactions is less clear.

For example, if manufacturer USCO buys unfinished widgets from related FCO-1 for US$50, converts them into finished widgets using FCO-2's intangible property, and sells them to unrelated customers for US$100, incurring a US$10 royalty to FCO-2, these ordinary supply chain transactions should not present any BEAT issues for USCO. Both the physical input costs and the royalty should reduce USCO's gross income itself, rather than being treated as deductions allowable against gross income.

If, on the other hand, USCO is a service provider that earns US$100 of service fees from unrelated customers, pays FCO-1 US$50 for services subcontracted to FCO-1, and pays FCO-2 a US$10 royalty for the use of FCO-2's intangible property in providing the services, it is possible that USCO might be treated as making US$60 of BEAT payments. This will depend on the resolution of tax accounting questions that might not have been important in the past but suddenly take on tremendous importance for services transactions under the BEAT: Do these payments reduce gross income itself, or do they instead constitute deductions from gross income allowable in determining taxable income?

From a policy perspective, there is no basis for reaching a different result in the services context from the result reached in the manufacturing context, but the answer is far less clear in the services context.

The statute does provide an exception for payments for services that are eligible for the application of the services cost method (SCM) under the Section 482 regulations (without regard to the requirement under those regulations that the services not contribute significantly to the fundamental risks of business success or failure), to the extent that the amount in question constitutes total services costs, with no mark-up component.

Based on the statute and legislative history, in many cases it should be possible to bifurcate service fees into cost and mark-up components, with the BEAT applying only to the mark-up component. But this is an incomplete solution, as the SCM was originally designed for a very different purpose and, as such, includes restrictions that have no place under the BEAT. These include *per se* exclusions of certain kinds of activities, including research and development. There is also no policy reason to subject even the mark-up component of a subcontracted service fee to the BEAT, if the fee in its entirety constitutes the equivalent of COGS in the services context. In addition, there is no policy reason to treat royalty payments differently between the services and the non-services context.

> "All of these rules present difficult issues for taxpayers with services transactions."

In many cases, it may be possible to address these issues through planning to bolster the case that various core supply chain payments do not constitute deductible BEAT payments.

SERVICES CONTRACTING HUBS

Similar problems may arise even for non-service-economy companies that happen to purchase services from related or unrelated foreign parties.

For example, USCO is developing a new product and requires special studies and regulatory advice to market and sell the product in Japan. USCO's Japanese affiliate, FCO-1, engages and supervises various unrelated companies in Japan to carry out this work. USCO pays FCO-1 a service fee of US$100, of which FCO-1 pays US$80 to the various unrelated service providers. Even though these are core supply chain transactions that clearly are not motivated by any desire to erode the US tax base—and indeed the bulk of the funds in question end up in the hands of unrelated parties —it is possible that the entire US$100 could be treated as a BEAT payment. Again, it may be possible to plan around these problems by modifying the relevant third party and/or intercompany contracting arrangements.

PLANNING TO SUCCEED

Every large multinational group, whether US-based or non-US-based, and whether operating in a services business or merely purchasing services in the course of a non-services business, must be attuned to the peculiarities of the BEAT's treatment of services transactions. In many cases, planning measures may be available to address these problems, while in others a regulatory or legislative solution may be required.

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Taxing Tokens

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Cryptocurrencies and token transactions are under scrutiny by numerous regulatory agencies worldwide. The tax treatment of tokens is particularly fluid and volatile, and the US regime has a very long arm.

Many blockchain-based companies issue tokens that represent digital records entitling the holder to specified assets, services or other functions using the underlying technology. Although originally designed to access the underlying blockchain platform, tokens are also sold during start-up phase as a means to raise capital through an initial coin offering (ICO) in exchange for *fiat* currency or cryptocurrencies.

Each token possesses unique features or rights. Tokens that provide access to the underlying blockchain platform are often referred to as utility tokens. Some tokens may entitle holders to distributions or liquidating proceeds, or the ability to vote on certain company related matters. These tokens are akin to equity interests and are referred to as security tokens.

In the United States, the Internal Revenue Service has issued limited guidance in Notice 2014-21 which treats virtual currencies as property, and not currency, for US tax purposes, but the guidance does not extend to non-cryptocurrency tokens. Under general US tax principles, the tax characterisation of a token should depend on the rights and powers associated with it. A token may be treated as property, prepaid services or an equity interest in the issuer. Importantly, a token's tax classification is not based on other nomenclature or its characterisation for securities or other legal purposes. Different tax classifications lead to different tax results.

If a token is treated as prepaid services, the proceeds received by the issuer will be taxable in the year of receipt, or advance payments for services that can be deferred one taxable year.

> "Complications arise where a token contains more than one feature of these classifications."

If a token is treated as property, the issuer will have a zero tax basis and 100 per cent of the proceeds are taxable. To avoid this onerous result, some issuers pre-sell tokens prior to issuance by entering into a prepaid forward contract (sometimes called a Sale of Future Tokens or SAFT) that permits the issuer to receive payment for tokens under an arrangement to deliver the tokens at a future date. Proceeds received under a prepaid forward contract are not taxable until the property is delivered to the contract holder, enabling the issuer to utilise the proceeds during pre-issuance on a tax deferred basis.

If a token is treated as equity, the issuance should not be taxable to the issuer. Additional tax considerations may be applicable if the issuer was taxable as a partnership.

Complications arise where a token contains more than one feature of these classifications.

Blockchain companies considering an ICO should consider tax structuring opportunities. A US corporate token issuer (issuing property tokens) would be subject to a 21 per cent US federal income tax rate on token issuance proceeds. Despite rumours that a non-US token launch avoids US tax, *all* non-US subsidiary token issuances are subject to US tax.

A reduced rate may be available. For example, a non-US subsidiary is a controlled foreign corporation (CFC) subject to anti-deferral rules for Subpart F income, which taxes passive income and certain other income categories in the United States currently at regular tax rates. Under recent US tax reform, US shareholders are also subject to current taxation on a CFC's Global Intangible Low Taxed Income, (GILTI see more on p.11) which effectively includes all net income of a CFC, with limited exceptions for income representing a fixed return on the CFC's tangible assets. US corporate shareholders are eligible for a 50 per cent deduction to the GILTI inclusion, resulting in a 10.5 per cent tax rate. Foreign tax credits can further reduce the tax.

> "All non-US subsidiary token issuances are subject to US tax."

To be tax advantageous, a non-US subsidiary must be owned by a US corporation and conduct substantial business activities. The token issuance proceeds must not be subpart F income. The tokens must therefore be treated as property used in a trade or business and the token proceeds must be treated as business income.

While non-US issuances may be attractive, the new US tax laws for Foreign Derived Intangible Income (FDII) may permit a lower tax rate (13.125 per cent) for tokens sold by a US issuer to foreign persons. When the rules are developed, the FDII regime may offer US-based blockchain companies considerable opportunity to remain in the United States with a reduced tax burden and without the complexities of an offshore subsidiary.

It is worth noting that the United States may not recognise foreign non-profit status and persons in control may be treated as *de-facto* owners if they have economic benefit or control over the entity's activities.

If cryptocurrency is used to acquire tokens, investors' gains or losses may be recognised for US tax purposes. Non-US investors in US ICOs should consider whether or not token investments are eligible for the trading safe harbor available to avoid US tax.

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