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US Tax Reform as a Chess Puzzle

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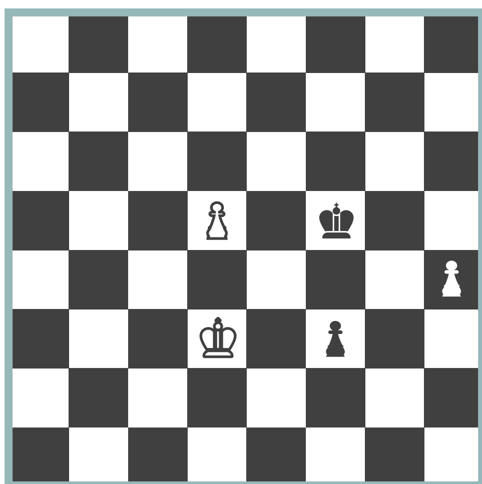
As with global tax strategists, chess players routinely practice against hypothetical opponents to prepare themselves for real contests. Now is the time for the tax community (“taxpayers” below) to similarly prepare for US tax reform (“USTR”).

Taxpayers (White) must act now not knowing what taxing authorities (Black) will do next. Some rules (e.g. BEPS (the OECD Base Erosion and Profit Shifting counter-measures)) are known. Some Black moves (e.g. BEPS implementation) may be anticipated with some reliability. Other potential Black gambits (e.g. the course of US tax reform) are more speculative as of this writing. Chess puzzles often allow White to make a “forcing move” that compels Black’s doom, or perhaps at least allow White to protect itself from defeat by finding a stalemate. Taxpayers moving today do not have that option – all they can do is position themselves as far as possible to achieve favorable outcomes under the most likely variety of taxing authority moves.



White to move and mate in three.

For today’s practice session, let’s try a couple of starting positions for White. These examples do not address comprehensive tax strategies; rather, they focus on selected nuances of common planning. White is a typical US multinational corporation (“MNC”). Two situations it should be thinking about:

- Forced repatriation of offshore earnings under USTR.
- BEPS driven supply chain restructuring with USTR implications.

Offshore Earnings under USTR

Although details are wide open, there is a high probability that USTR will include forced repatriation of MNC offshore earnings (“CFC E&P”). Let’s assume that the US tax cost, instead of the current rate of 35% deferred indefinitely, is to be 10% on CFC E&P invested in cash and cash equivalents but only 5% for other E&P amounts. Let’s also assume that the defining date for the determination is the December 31, 2017 balance sheet. Let’s further assume that potential spread of the repatriation tax over time doesn’t have a meaningful impact because of up front financial statement impact and because today’s low interest rates mean that CFC’s with lots of cash don’t consider time value of money meaningful.

This, of course, involves broader global treasury considerations. What is White to do? What are White's investment options for transforming offshore cash:

- Build inventory. Easy to control for some businesses.
- Build accounts receivable.
- Prepay payables.
- Buy stuff. Avoid selling stuff.
- Convert leased facilities to owned facilities.
- Pay dividends sheltered by foreign tax credits.
- Take losses to reduce E&P.

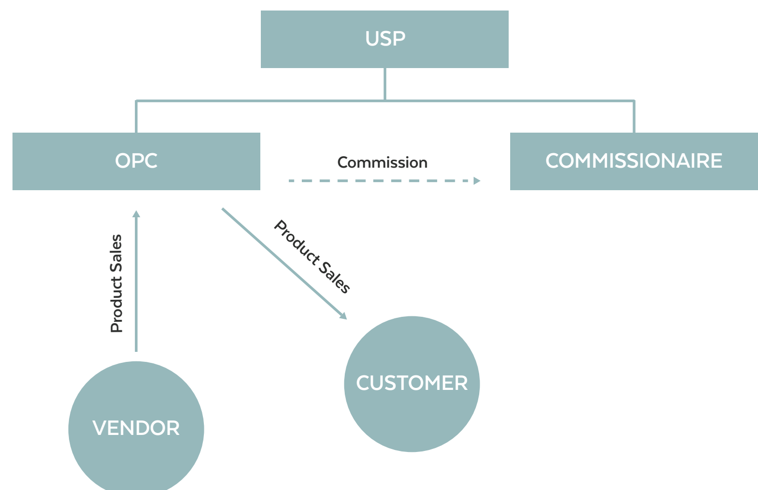
With only weeks (as of publication) before the potential determination date, many of these items need to be processed immediately. Some have economic and/or financial statement impacts that can be significant. Is 5% tax savings worth the costs and other impact? Does a VP of International Tax want to risk his credibility with the C Suite on a mad scramble that might not materialize? What if the USTR chooses a determination date of June 30, 2017 (or June 30, 2018, as long as we're speculating, or even averaging of balance sheets over multiple dates) instead?

A suggested approach might be:

1. Identify the liquid asset pools that are most likely to be problematic.
2. Review the options above as well as others that might be implemented in the time available.
3. Compute potential savings against economic and financial costs.
4. Address these with C Suite on an urgent basis.

BEPS and USTR

BEPS has been adopted by most countries (significantly excluding the US), albeit with varying timetables and many reservations (particularly reservations required to address the hundreds of bilateral tax treaties that must be modified). A full discussion is beyond any reasonable scope for an article of this type. However, for a second puzzle let's address the supply chain structure adopted by many MNC's – the offshore principal company ("OPC") selling in local markets via a commissionaire affiliate.



In its simplest form, the OPC is a tax-efficient means for an MNC to provide supply chain flexibility. The OPC is endowed with cash, IP and management to source product from related and unrelated vendors as requirements change over time, and provide that product to local distribution outlets (again, related and unrelated) as customer needs change over time. Assuming there is profit from the business, some of that should end up in the OPC. A clever MNC might choose a tax favored location for the OPC. Such an MNC also might maximize the share of profits in the OPC by using pricing between the OPC and its distribution affiliates which allocates more risk and therefore more profit to the OPC.

For US MNC's, the related party transaction rules of Subpart F add complexity. Foreign base company sales income rules (here, simplified) cause immediate US tax to the MNC US parent on OPC earnings if the product is produced outside of the OPC's country of incorporation and sold to a related distribution entity located outside of the OPC's country of incorporation. Under a commissionaire arrangement, the local distributor is merely a commission agent for the OPC, which in law is selling to the unrelated end customer in a transaction outside of the CFC rules. Thus OPC's income is not taxed to USP under the CFC rules before it is distributed by OPC.

Historic arm's-length pricing approaches and treaty definitions related to permanent establishments in the distribution country focused more on contractual terms and less on other substance in allocating profits to the OPC. BEPS places pressure on these structures in a number of ways. Under BEPS Action 7, commissionaire structures are more likely to create permanent establishment, and therefore, distribution country tax exposure for OPC, defeating the foreign tax reduction planning for an OPC. US MNC's must address the BEPS concerns through structural changes.

While they are doing this, US MNC's may be able to simplify their structures. IF USTR includes a general repeal of CFC rules (rules not needed if the future is mandatory repatriation), US MNC's may tune their OPC structures to minimize foreign taxes without adversely impacting their US tax rate.

Here is where the puzzle comes in: BEPS response is required now. USTR could be years in coming together and/or in implementation. What moves does White make while Black's intentions are still unclear?

A suggested approach might be:

1. Identify material BEPS structural issues and the timeline required for effective response.
2. Sort out the higher value responses, with and without current CFC implications.
3. See whether optionality can be built into optimum responses to account for possible courses of USTR.
4. Build strong transfer pricing support into the implementation.

Conclusion

Taking the two examples above together, the common thread is that the Taxpayer should be acting immediately to identify the critical components of its structure. The US Government's moves are only partially predictable, but the Taxpayer is best served by sorting out its various potential responses to those moves and positioning itself for the highest value outcome. Foresight and preparatory numerical analysis will be the keys.

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