

## **Structuring Israeli/U.S. Intercompany Relationships to Minimize (Eliminate) U.S. Taxes by Lewis J. Greenwald and David H. Kaplan<sup>1</sup>**

There are countless Israeli companies that exploit the U.S. market through a wholly-owned U.S. subsidiary. Having represented numerous Israeli companies that do business in the U.S., we have found that the amount of U.S. taxes (income taxes or withholding taxes) paid by the U.S. subsidiary is largely dependent on the legal relationship that the U.S. subsidiary has with its Israeli parent. For example:

- Is the U.S. subsidiary a cost-plus marketer on behalf of its Israeli parent or is it a buy/sell distributor?
- Have the U.S. subsidiary's start-up losses been financed with debt or equity?
- If software is being transferred from the Israeli parent to U.S. subsidiary, is the transfer a license, lease or sale?

The form of the legal relationships between the Israeli parent and the U.S. subsidiary drives the U.S. tax results. In that regard, the Israeli company is in complete control in determining the legal relationships and, thus, in complete control of the U.S. tax results. However, we have found that the key to success in minimizing or eliminating U.S. taxes is:

- Establishing the desired intercompany relationships from the beginning;
- Documenting those relationships with the requisite intercompany agreements; and
- Conducting the business (and accounting) in accordance with those intercompany agreements.<sup>2</sup>

All that said, we have found numerous cases where no consideration has been given to the intercompany relationships (not from the beginning, and often, for many years thereafter). The Israeli parent is incurring start-up losses, the U.S. subsidiary is incurring start-up losses, and no one has the time (or the patience) to structure the relationships as they should be.

This article is meant as a guide for striking the desired intercompany relationships, whether from the beginning or sometime thereafter.

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<sup>1</sup> Lewis J. Greenwald is a U.S. international tax partner, and David H. Kaplan is a U.S. international tax associate, in the Boston office of ZAG/S&W. Both have significant experience with Israeli companies that do business in the U.S.

<sup>2</sup> This also pre-supposes that the transfer pricing is right. Economic analysis/transfer pricing studies are needed in the U.S. to make that claim.

## **Cost-Plus Marketer or Buy/Sell Distributor**

When the Israeli parent forms its U.S. subsidiary, the first question that must be answered is how will the U.S. market be exploited. More specifically, should the U.S. subsidiary act as a cost-plus marketer on behalf of its Israeli parent or should it act on its own behalf as a buy/sell distributor?<sup>3</sup> A cost-plus service agreement looks very different from a buy/sell distribution agreement.

As a cost-plus marketer, the U.S. subsidiary enters the U.S. market and looks for clients on behalf of its Israeli parent. When a U.S. client is identified, the Israeli parent contracts directly with that U.S. client and supplies the goods (or services) accordingly. As such, the U.S. subsidiary is a service provider (to its Israeli parent), and not the U.S. entrepreneur/risk taker. Therefore, the U.S. subsidiary must earn a small, guaranteed income (say, 3% - 5%) from the very beginning. By definition, the U.S. subsidiary (as a cost-plus marketer) cannot generate U.S. tax losses.

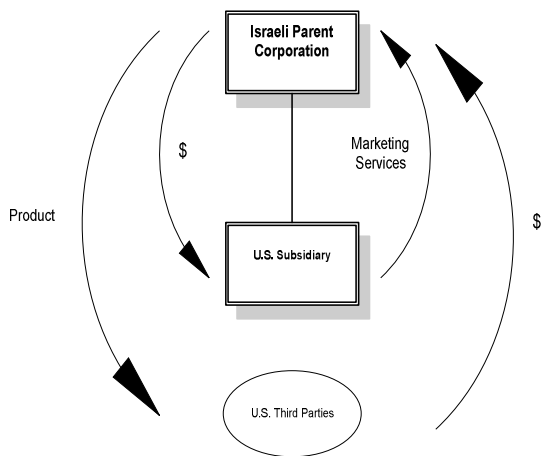
In very general terms, as a buy/sell distributor, the U.S. subsidiary buys product or services from its Israeli parent and sells those product or services in the U.S. market in its own name. Here, the U.S. subsidiary is U.S. entrepreneur/risk taker.<sup>4</sup> As such, it may have start-up losses (say, for the first three years), but over its lifetime, the U.S. tax authorities will expect that the buy/sell distributor to earn more income than the cost-plus marketer.

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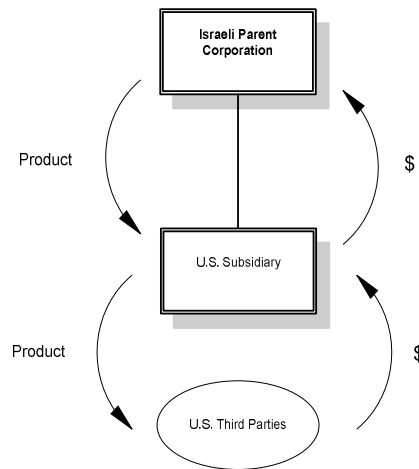
<sup>3</sup> As noted above, sometimes this important question is answered on the formation of the U.S. subsidiary, sometimes it is not.

<sup>4</sup> In fact, there are different types of buy/sell distributors, depending on the risks they bear. You can have a full-fledge buy/sell distributor that bears inventory risk, credit risk, and foreign exchange risk. You can also have a stripped-risk buy/sell distributor that does not bear those risks – those risks are borne by the Israeli contract. Who bears what risks is one the subject matters of the intercompany agreement by and between the Israeli parent and the U.S. subsidiary.

**Cost Plus Marketer:**



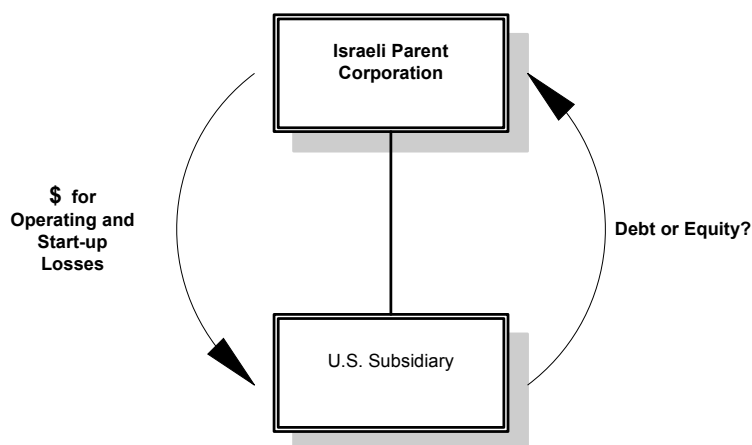
**Buy/Sell Distributor:**



If the Israeli parent has tax losses, it may make sense to shift as much profit to Israel as possible. As such, the cost-plus model may be appropriate. Similarly, if the Israeli parent has certain Israeli tax advantages (agreement(s) with the Office of Chief Scientist, operations in enterprise zones, etc.), the cost-plus model may be appropriate. If, on the other hand, nominal upfront U.S. taxes are intolerable, the buy/sell model (which allows start-up losses) may be more appropriate.

**Funding the U.S. Subsidiary’s Start-up Losses – Debt or Equity**

Assume for arguments sake, that the buy/sell model has been adopted (or no model has been adopted) and the U.S. subsidiary generates losses in its first three years of operations. Those losses have been funded by the Israeli parent through the transfers of cash and/or product to the U.S. subsidiary. Are those transfers equity contributions or loans?



The determination of whether the transfers are debt or equity for U.S. tax purposes is determined by a complex weighing of numerous common law factors called the “Mixon

factors.”<sup>5</sup> The major Mixon factors used in analyzing advances made by a parent to its subsidiary include:

- The name given to the transfer by the parties;
- The presence or absence of a fixed maturity date;
- The status of the advances in relation to third-party creditors;
- The intent of the parties;
- Whether the recipient of the advance is adequately capitalized; and
- The ability of the corporation to obtain loans from a third-party bank.

If the transfer(s) are characterized as debt for U.S. tax purposes, the payment(s) of interest is subject to U.S. withholding tax of 17.5%.<sup>6</sup> The repayment of principal is not subject to U.S. withholding tax.

If the transfer(s) are characterized as equity for U.S. tax purposes, the payment(s) of a dividend is subject to U.S. withholding tax of 12.5%.<sup>7</sup> withholding, respectively. The return of equity is not subject to U.S. withholding tax.<sup>8</sup>

If, as described above, the U.S. is in a start-up/loss phase, equity characterization is usually preferable because transfers from the U.S. subsidiary to its Israeli parent are characterized as returns of capital until such time as the U.S. subsidiary has earnings. As such, these transfers are made without the imposition of U.S. withholding tax. Equity characterization can be achieved by “baking” equity elements into the intercompany financing agreements.

Oddly, oddly enough, the debt/equity determination is often made many years after the facts.

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<sup>5</sup> Estate of Mixon v. U.S., 464 F.2d 394 (5th Cir. 1972).

<sup>6</sup> Assuming that the Israeli parent is eligible for the benefits of the U.S./Israel Income Tax Treaty and provides proper documentation to its U.S. subsidiary.

<sup>7</sup> Again, assuming that the Israeli parent is eligible for the benefits of the U.S./Israel Income Tax Treaty and provides proper documentation to its U.S. subsidiary. A distribution by a U.S. company is a dividend for U.S. tax purposes only if the company has current or accumulated earnings. If it does not, the payment is first characterized as a return of capital and then as capital gain.

<sup>8</sup> Unlike many jurisdictions, the U.S. does not have significant restrictions on when or how much capital may be withdrawn from a company. Very generally, and if structured properly, so long as the company remains solvent, it may distribute capital to its parent freely.

## Software Transfers: License or Sale

As is often the case, the Israeli parent is a software developer, and it is that software that it seeks to sell in the U.S. As above, the form of the transaction (sale, license, lease) drives the U.S. tax results.

In very general terms, for U.S. tax purposes, a software transfer is classified as either a transfer of a “copyright right” or a transfer of a “copyrighted article.”<sup>9</sup> The transfer of a copyright right is further characterized as the license of a copyright right or the sale of a copyright right. The transfer of a copyrighted article is further characterized as the lease of a copyrighted article or the sale of a copyrighted article.

A transfer of software is the transfer of a copyright right if one of the following copyright rights is transferred:

- The right to duplicate for purposes of distribution to the public;
- The right to prepare derivative programs;
- The right to make a public performance; and
- The right to public display.

Whether the transfer of a copyright right is a license or a sale depends on whether there has been a transfer of all substantial rights in the copyright. If so, the transfer is characterized as a sale for U.S. tax purposes. If not, the transfer is characterized as a license for U.S. tax purposes.

If there has not been a transfer of a copyright right, then the software transfer is characterized as a transfer of a copyrighted article. Whether the transfer of a copyrighted article is a lease or a sale depends on whether the benefits and burdens of ownership have been transferred. If so, the transfer is characterized as a sale for U.S. tax purposes. If not, the transfer is characterized as a lease for U.S. tax purposes. For this purpose, the medium of the copy (disk, on the hard drive of a computer) is irrelevant for characterizing the transfer.

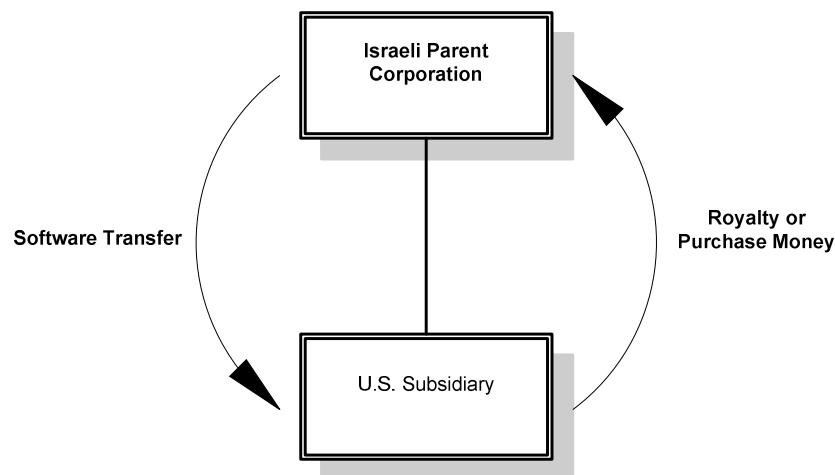
- If the transfer is the sale of a copyright right, there is no U.S. withholding tax on the payment of the purchase price by the U.S. subsidiary;

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<sup>9</sup> In fact, a software transfer can also be classified as the provision of services or the provision of know-how. That said, the vast majority of software transfer are either the transfer of a copyright right or the transfer of a copyrighted article.

- If the transfer is the license of a copyright right, there is 10% or 15% U.S. withholding on each royalty payment under the license by the U.S. subsidiary;<sup>10</sup>
- If the transfer is a sale of a copyrighted article, there is no U.S. withholding tax on the payment of the purchase price by the U.S. subsidiary;
- If the transfer is the lease of a copyrighted article, there is 10% or 15% U.S. withholding on each lease payment under the lease by the U.S. subsidiary;<sup>11</sup>

If the U.S. end-user does not require a copyright right (usually the right to duplicated and distribute to the public), characterizing the transfer(s) from the Israeli parent to the U.S. subsidiary as the sale of copyrighted articles is usually preferable. In that regard, the intercompany agreement would be very specific that no copyright rights are being transferred. A provision would be included in the intercompany agreements that would iterate the intention of the parties that the Israeli/U.S. transfer be treated as the transfer of copyrighted articles (as that term is defined in the U.S. Treasury Regulations).



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<sup>10</sup> Assuming that the Israeli parent is eligible for the benefits of the U.S./Israel Income Tax Treaty and provides the proper documentation to its U.S. subsidiary.

<sup>11</sup> Again, assuming that the Israeli parent is eligible for the benefits of the U.S./Israel Income Tax Treaty and provides the proper documentation to its U.S. subsidiary.

- Conducting the business (and accounting) in accordance with those intercompany agreements.<sup>12</sup>

In addition, when setting up a U.S. subsidiary and structuring its relationship with the Israeli parent, two important principles need to be remembered. First, the U.S. characterization of the intercompany relationship or transfer does not drive the characterization for Israeli tax purposes. For example, an Israeli Capital Note may be equity for U.S. tax purposes but debt for Israeli tax purposes. Likewise, the transfer of software may be the sale of copyrighted articles for U.S. tax purposes but may be a license for Israeli tax purposes.

Secondly, the intercompany relationship that is desirable at the beginning, may not be so desirable in later years. That is O.K. – relationships can change over time. What is important in restructuring the relationship to achieve the desired results (the minimization/elimination of U.S. taxes) is that the old intercompany agreements be terminated, the new intercompany relationships be documented with new intercompany agreements, and the business (and accounting) be conducted in accordance with the new intercompany agreements.

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<sup>12</sup> Again, this pre-supposes that the transfer pricing is right. Economic analysis/transfer pricing studies are needed in the U.S. to make that claim.