

Minnesota State Bar Association

**International Joint Ventures:
A Reemerging Option for International
Business**

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A Reemerging Option for International
Business**

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2



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Agenda

- Overview of Joint Ventures
- General Planning
- Governance and Management
- Choice of Entity
- US Tax Considerations
 - Outbound
 - Inbound
 - TCJA
- Local Country Tax Considerations

3



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International Joint Ventures – Overview

Joint Venture Ownership – Some Pros:

- Knowledgeable, equally committed local partner
- Enhanced ability jointly to navigate local laws and customs
- Improved access to financing, distribution channels, customer potentials
- Sourcing advantages, customs/import clearance benefits with sophisticated local partner
- Can achieve early market access, distribution benefits in a rapidly-expanding market
- Equity strength; shared investment costs/risks
- National image enhancement
- Successful working relationship provides possible springboard for other joint activities, joint territorial expansion

4



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Int'l Joint Ventures – Overview (cont.)

Joint Venture Ownership – Some Cons:

- A separate legal entity
- It is “joint” ownership; you are not wholly “in charge”
- JV’s assets are located in a foreign country where U.S. partner does not have the “home field advantage”
- Requires the U.S. partner to commit capital to venture and ‘invest’ in the JV entity itself; when that investment may not otherwise meet hurdle rates, normal strategic objectives, etc.
- The form and amount of such “investment” can vary, plus risks abound in terms substandard profitability, cash flows, changes in market or political environment, supply change, FX, etc.
- Must determine how U.S. partner will control the “brand” and its IP abroad (in JV’s “territory”)
- Financing expansion, governance issues, exit/windup, and control of operations, expansion, administration must be addressed upfront (see “Issues”)

5



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General Planning Matters

- Expansion with a partner should anticipate the symbiotic relationship of the parties, common agreement on the nature of the cooperation, expansion and capitalization commitments, governance, and wind-up matters
- Do *thorough* due diligence on your “partner” – beforehand...
- The parties should also agree on selling, manufacturing, and distribution opportunities, and labor/employment issues.
 - ▶ Cultural and language issues differ
 - ▶ Legal and tax requirements, business registrations, employment/visa, licensing issues
 - ▶ Marketing/advertising materials, brand names, logos, TMs, etc., all need vetting locally first – and protection, registration per local law

6



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General Planning Matters (cont.)

- Duration/nature of investment; cash flow/distribution expectations (sale of JV, payment of dividends/profits, etc.):
 - ▶ How will profits be used? Immediately repatriated to partners, reinvested locally, or made available to other affiliates? Do all partners share common expectations regarding cash/profits?
 - ▶ Is partner a long term participant (receive periodic profits distributions) or is this a short term capital gains play?
 - ▶ Are there expected future investors? Supplemental investment needs? Future dilution issues?
 - ▶ Control of governance structure and key Board/Officer positions?
 - ▶ Is future listing or IPO likely? (Certain types of entities and countries of formation are preferred.)

7



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General Planning Matters (cont.)

- Geographic focus: country specific, regional, or ultimately broader?
 - ▶ Regional expansion/distribution/sales benefits (e.g., EU) vs. exposure to Subpart F income issues in US
 - Possible impact of Brexit?
 - ▶ Will there be multiple lines of business? Possible separate sales functions? Options for later, different ownership structures?
 - Separate affiliates/lines of business, sub-JV's?
 - ▶ Beware of PE “force of attraction” to income from separate divisions, entities or activities within the same country
 - ▶ Limited local licensing issues

8



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General Planning Matters (cont.)

- Staged Expansion, “trial period” for relationship?
 - ▶ How is “success” defined in order to expand?
 - ▶ Agreement upfront: limited geography, limited products/services, minimum profitability or cash flow (per stated period), etc.?
- Employees/Loaned Employee issues
 - ▶ Will U.S. partner’s personnel be assigned to the JV (and reside abroad, even temporarily)?
 - ▶ Must evaluate visa requirements and work limitations, as well as employee/employer taxes
- Funding/Capital Investment Issues
 - ▶ How does each JV partner fund – and value – their share?
 - ▶ Are Debt/Equity financing levels agreed?
 - ▶ What if one partner refuses/is unable to contribute prorata share in future?

9



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General Planning Matters (cont.)

- Analyze ALL the tax issues and potential consequences first (the Five Prisms); account for future growth, flexibility
- Avoid an inadvertent Permanent Establishment (business “nexus” abroad) that results in required local tax reporting, payments
- Be prepared with Transfer Pricing Documentation (if there are, or are likely to be, *any* transactions or relationships with related parties – including between partners and JV)
- Utilize Tax Treaties, Foreign Tax Credits when possible
- Get your money out (and be prepared for FX conversion and approval delays)

10



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Governance and Management

- Ownership Issues
 - ▶ How are equity, voting rights, cash flows/preferences split?
 - ▶ Use SPV to hold equity (especially if licensing in technology, IP from affiliated licensor)?
 - ▶ Should you hold equity interest through U.S. or non-U.S. entity?
 - ▶ Is there (or should there be) an “international holding company” for the U.S. partner’s similar/future JV arrangements?
- Governance
 - ▶ Board control, constitution of Board, representation of owners
 - ▶ Board and shareholder voting requirements
 - ▶ Class voting and negative control rights? (If so, which issues/thresholds?)
 - ▶ What happens in case of deadlock or irretrievable breakdown/diversity of interests?
 - ▶ Differences between Board and Shareholder voting matters?

11



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Governance and Management (cont.)

- Appointment of key officers—who gets to appoint which ones?
 - ▶ Scope of officer authorities? Duration of terms?
 - ▶ Do appointments rotate between JV partners? Are qualifications consistent?
 - ▶ Authority of U.S. partner to designate or appoint key officers does not, per se, create “control” in possible CFC ownership situation
 - ▶ Who appoints advisors (statutory auditors, tax return preparers, other consultants)?
 - ▶ NOTE: U.S. persons with signature authority over a foreign JV’s financial accounts must *personally* file FBARs for such accounts
 - ▶ Foreign persons serving as officers/employees of U.S. JV must comply with U.S. visa and tax reporting rules

12



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Governance and Management (cont.)

- Exit/Termination Issues - Time Certain, Stated Event or Deadlock?
 - ▶ Dispute resolution: negotiation of principals, then arbitration / litigation?
 - ▶ How do JV's IP, inventory, assets, and customer lists get allocated?
 - ▶ Do separate contracts of partners have separate termination rights, cross default provisions?
 - ▶ Buy-Sell (or put) of ownership interests vs. actual liquidation of JV entity?
 - ▶ Reconciliation, distribution of cash/property obligations at termination
 - ▶ Liquidation process, timing; local legal requirements
 - ▶ Consequences of previous or final tax return filings if disputed by tax authority?
- Dispute Resolution
 - ▶ Concern about local partner's "home court" advantage, applicable law?
 - ▶ Arbitration vs. Litigation; enforceability of judicial judgments...
 - ▶ Arbitrate in agreed neutral country, with neutral arbitrators?

13



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Choice of Entity - Outbound

- Projections (i.e., profit vs. loss, timing, etc.)
- Repatriation of earnings vs. reinvestment
- Limited liability needs
- Foreign country taxation
- Types of income to be earned in the foreign location
- U.S. foreign tax credit position
- Treaty protection
- Business objectives
- Need to partner with foreign third parties
- IP protection

14



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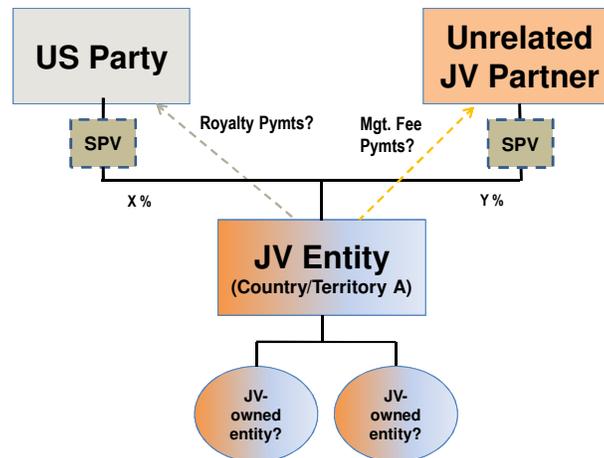
Choice of Entity - Inbound

Foreign investment into the U.S. is typically accomplished through the use of a C corporation as a “U.S. blocker.” Some impacts:

- ▶ Foreign investor(s) avoid having to file personal nonresident or foreign corporate U.S. income tax returns.
- ▶ Application of the branch profits tax
- ▶ The creation of a hybrid entity (e.g., a flow-through type entity for US tax purposes that is classified as a corporation under foreign law).
- ▶ The requirement to comply with the US branch accounting rules.



Choice of Entity – Structure Concepts



U.S. Tax Considerations

➤ Key Tax Issues

- ▶ Will foreign JV be a partnership? CFC? PFIC?
- ▶ If U.S. JV, foreign partner exposed to U.S. tax reporting, payments
 - Partnership triggers K-1 income, current reporting by foreign owner
 - Distributions of cash may be subject to Code § 1446 withholding
 - Sale of U.S. partnership interest now taxable under Code § 864(c)(8)
- ▶ CTB election for JV or not? (Explanations/assurances for partner)
- ▶ CTB election for SPV (if one holds the JV equity interest) or not?
- ▶ Type, origin of income earned by JV: FBCI/"Subpart F" income risk?
- ▶ Debt/Equity funding ratios – initial agreement? Future capital needs?
- ▶ Watch out for "equalization" of cash flows (e.g., royalty to U.S. partner matched by management services agreement to local partner)
- ▶ Contracts between/among partners and JV entity may be subject to "related party" transfer pricing review, substantiation, local language reports, disclosure requirements, etc.

17



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"U.S. Tax Considerations (cont.)

➤ Foreign "JV" Entities - Outbound

- ▶ "Per Se" foreign corporation (treated as a "corp" for U.S. tax)
 - ▶ Listed by country in Treas. Reg. § 301-7701(b)-2(b)(8)
- ▶ Actual "partnership" (under foreign law)
- ▶ An "eligible foreign corporation" (a limited liability entity locally regardless of U.S. tax status) may make U.S. "check the box" election:
 - If it is a non-"per se" foreign limited liability company that makes CTB election, it is treated as a flow-through for U.S. tax (i.e., a "partnership" if it has two/more owners, a DRE if only one owner)
 - For foreign country's corporate/employment/labor/tax law purposes, it is a (still) a "corporation"
 - For application of a tax treaty, it is a "corporation" for foreign country purposes; hence, owners are shareholders, distributions are "dividends"
 - Preempts/avoids classification as CFC or PFIC for U.S. tax purposes
- ▶ Transfer pricing rules may apply for transactions (a) between/among "partners" and (b) with the JV entity

18



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U.S. Tax Considerations - CFC/PFIC

- Reporting rules, deemed income apply to ≥ 10% U.S. Shareholders
 - ▶ Individuals, companies *and* flow-throughs that own stock directly, indirectly or constructively
- “CFC” exists if USSs own or control *more than* 50% by vote *or* value:
 - ▶ “Control” includes power to elect or appoint majority of Board, cast tie-breaker vote; or when shareholder voting agreement grants U.S. “control”
 - ▶ “Control” does not include “negative control,” supermajority voting/approval requirements, or ability to appoint officers
- Existence of a CFC triggers two principal consequences:
 - ▶ Requires reporting of ownership relationship by USSs, and
 - ▶ Deemed U.S. taxation to USSs based on actual and indirect ownership for various types of tainted income earned by CFC (now including GILTI)

19



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U.S. Tax Considerations – CFC/PFIC (cont.)

- CFC rules (and deemed income inclusions under “Subpart F”) apply only to income, not losses
- Deemed income taxed, per Code § 951 *directly* to USSs under “hopscotch” rule, regardless of which lower-tier CFC earns the income
 - Subpart F Income later distributed up the CFC chain is not again taxed; it is tracked as “previously-taxed income”
- **BEWARE:** check for “Passive Foreign Investment Company” (PFIC) classification if entity is not a CFC:
 - ▶ At least 50% asset value is passive or at least 75% G.I is passive income
 - ▶ No minimum stock ownership required...
 - ▶ “Once a PFIC, always a PFIC” during that shareholder’s ownership

20



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U.S Tax Considerations (cont.)

- U.S. “JV” Entities - Inbound
 - ▶ “C” corporation (JV partners are actually shareholders)
 - ▶ Actual “partnership” (under state law)
 - ▶ LLC entity (a U.S. limited liability entity regardless of tax status):
 - It’s a “partnership” with two/more owners (and no CTB tax election)
 - It is taxed as a “corporation” for U.S. tax (and treaty) purposes if it makes a U.S. “Check the Box” election
 - Different U.S. tax treaties may treat entity (and owners) differently under “fiscally transparent entity” provisions
 - ▶ Foreign partners of U.S. tax partnerships (actual partnerships or LLCs *without* CTB election) are exposed to direct U.S. tax filing/payments (Code § 875(1))
 - ▶ Transfer pricing rules may apply for transactions (a) between/among “partners” and (b) with the JV entity

21



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U.S. Tax Considerations – TCJA

- Lowered U.S. corporate tax rate to 21%
- Implement a territorial regime for non-U.S. earnings (dividends received by ≥ 10% U.S. corporate owners of foreign corporations): not subject to tax, but no FTCs
 - ▶ N/A to income otherwise taxed to such USS’s from CFCs
- Apply a minimum tax Global Intangible Low-Taxed Income (“GILTI”) to earnings in a foreign jurisdiction (CFCs only)
- Provide a 37.5% deduction for Foreign-Derived Intangible Income (“FDII”) for U.S. income:
 - ▶ From sales of property to, licensing of U.S. IP to, or foreign-performed services fees paid by, foreign persons
- Apply U.S. tax to certain cross-border, outbound payments to foreign affiliates (Base Erosion and Anti-Abuse Tax (“BEAT”))
- Foreign sales of U.S. partnership interests subject to ECI tax

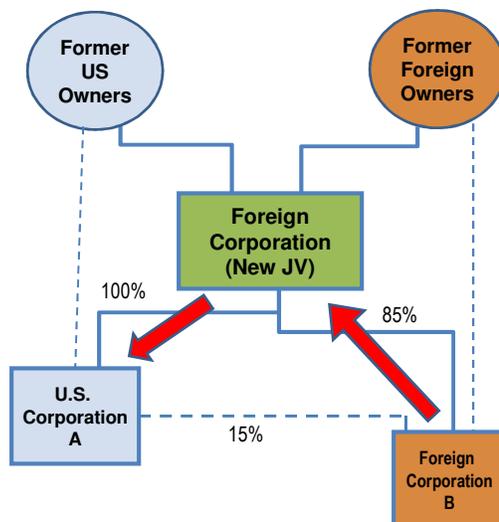
22



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U.S. Tax Considerations - Example of “Downward Attribution” and US Ownership



23



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Local Tax Issues: Permanent Establishment

- “Permanent Establishment:” existence of a PE may unexpectedly result in local tax nexus, tax reporting and tax payment obligations:
 - ▶ Office/fixed place of business/branch
 - ▶ Rep offices with expanded powers or actual business conduct
 - ▶ Employees having and habitually exercising contracting authority (e.g., traveling salesmen—or executives), even if there is no office or contact locally
 - ▶ Company-owned server installed in the foreign country
 - ▶ Using an affiliate company’s offices to conduct business by parent entity or other affiliate
 - ▶ Natural resource extraction or construction projects lasting longer than specified time periods (e.g., one year)
- PE subjects “parent” to unlimited legal liability for local actions...
- NOTE: “PE” is technically a treaty term; absence of treaty means local law determines “doing business” or “tax nexus”, plus tax filing obligations and transfer pricing rules/disputes

24



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Local Tax Issues: PEs (cont.)

- “Permanent Establishments” and local tax nexus (cont.):
 - ▶ Certain U.S. tax treaties (U.S./China, US/Canada) have PE for performance of services for > 183 cumulative days (for the same/connected project) during any 12 month period
 - ▶ U.S./India includes a > 90 day “services PE” rule within any 12-month period AND a separate provision that a PE is present if services are performed “for a related enterprise” (without any stated time duration...)
 - ▶ Business activities, income may be attributed to PE and taxed locally, even if operationally unconnected (the “force of attraction” principle)
 - ▶ PE treated as a separate taxpayer – files its own return, substantiates its expenses, income
 - Failure in previous years to file PE tax returns can leave many years “open” under local statutes of limitation
 - ▶ Presence of PE can lead to disputes involving transfer pricing, profit margins, valuation, and licensing



Thanks!

