

# 34<sup>th</sup> Annual TEI-SJSU High Technology Tax Institute

## Panel: Transfer Pricing Transformations

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### Presenters:

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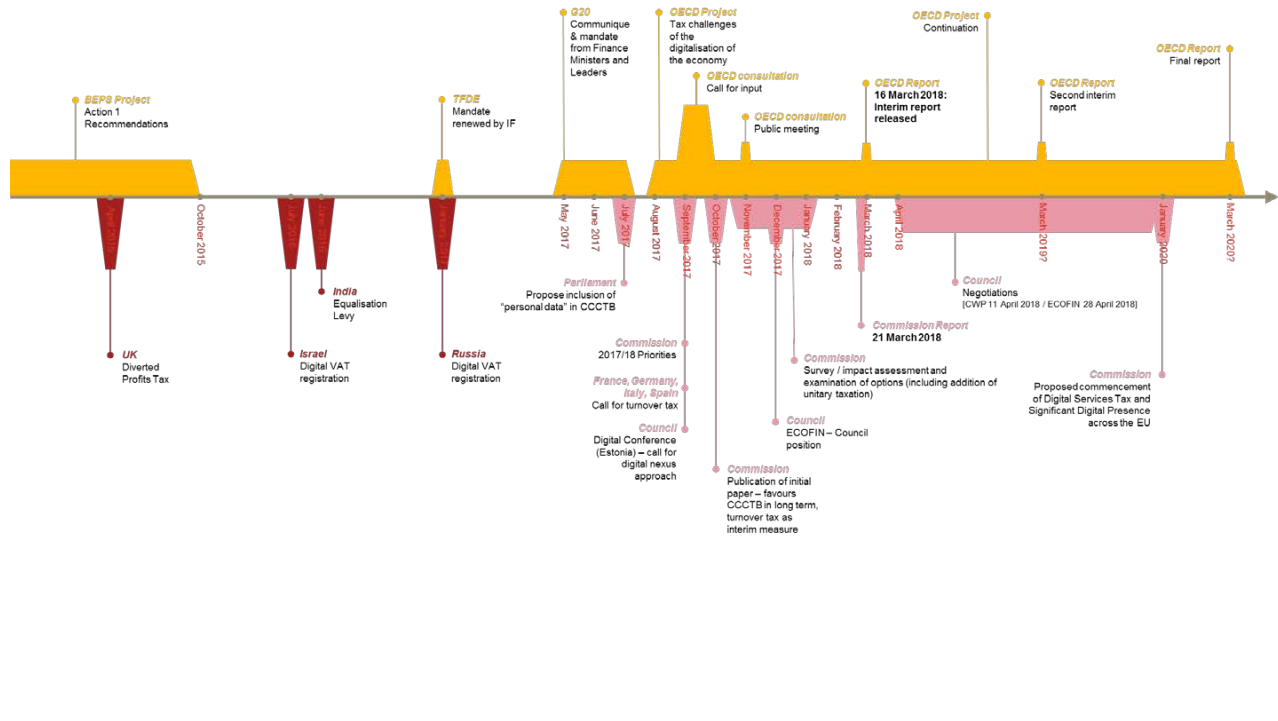
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## Introduction & Background

The current transfer pricing environment

# Transfer Pricing Transformations

## Current TP Environment



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# Transfer Pricing Transformations

## The Global TP Environment – A Brief Timeline

### October 2015: OECD BEPS Project Final Reports – DEMPE, Value Chain, Master File/Local File and CbC Reporting

- DEMPE – control of risks, risk-free returns and impact on operating models (clarification?)
- Value Chain – often cited but undefined (profit splits?)
- Country by Country Reporting – access to country level data on a global basis (revenue, tax paid, employees, etc.)
- Master File/Local File – disclosure of APA's, value creation, supply chain, management structure, etc.

### European Commission State Aid Investigations

- A new Transfer Pricing standard?

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## Transfer Pricing Transformations

The Global TP Environment – A Brief Timeline

### Digital Economy Measures – Proliferation

- OECD – difficulty of consensus, profit splits and impact
- European Commission – interim 3% turnover tax and longer term measures
- Other unilateral measures – India, Italy, Australia, Germany, UK, etc.
- Relationship to DEMPE and onshoring?

### And finally.... U.S. Tax Reform

- Reduced U.S. tax rate, pseudo-territorial regime and repatriation
- Uncertainty around long term sustainability, policy changes, WTO challenges, etc.

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## Impact of US Tax Reform

Refresher on the TCJA and Impact on  
Intercompany Transactions and Valuations

## TCJA Refresher: Impact on Transactions & Valuations

- Lower Corporate Tax Rate
- Net Operating Losses (NOLs)
- Capital Expenditure Expensing
- Research & Experimental Expenditures
- Statutory Changes to the Definition of Intangibles
- Interest Expense Limitations
- Global Intangible Low-Taxed Income (“GILTI”)
- Foreign Derived Intangible Income (“FDII”)
- Base Erosion and Anti-Abuse Tax (“BEAT”)

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## TCJA Refresher: Impact on Transactions & Valuations

### Lower Corporate Tax Rate

- New Federal Tax Rate of **21%**
- State tax rates have not changed, but state taxable income may or may not conform to Federal changes depending on the state.

### Net Operating Losses (NOLs)

- For NOL's arising after Dec 31, 2017, a tax payer's ability to utilize **NOLs is limited to 80%** of taxable income
- Unused NOLs can be carried forward indefinitely.

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## TCJA Refresher: Impact on Transactions & Valuations

### Capital Expenditure Expensing

- **Temporary 100%** expensing for **qualified property** after September 27, 2017 and before January 1, 2023 is allowed; immediate benefit ramping down over time to 20%.

### Research & Experimental Expenditures

- Immediate expensing of R&E expenditures, including **software development**, will end in 2021.
- After 2021, these R&E expenses must be capitalized and amortized ratably over:
  - **5-year** period if research is conducted within the U.S.
  - **15-year** period if research is conducted in a foreign country
- More of a cash flow and timing issue than an elimination of the research credit
- Questions as to what is “foreign” R&D expense especially in cost sharing

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## TCJA Refresher: Impact on Transactions & Valuations

### Statutory Definition of Intangibles

- Revised Section 936(h)(3)(B) modifies the definition of intangible assets to explicitly include goodwill (both foreign and domestic), going concern value and workforce in place.
  - Revised definition also applies for Section 367(d) and Section 482
- Codification of aggregation of IP -when an aggregate basis achieves a more reliable result than an asset-by-asset approach.
- Codification of realistic alternative principles to determine valuation with respect to intangible property transactions

### Interest Expense Limitation

- Limitation on deductibility of **ANY** interest expense
- Interest Expense (net of interest income) is limited to **30%** of adjusted taxable income, where adjustable taxable income is defined as;
  - Excluding certain depreciation and amortization deductions (tax EBITDA) for tax years before January 1, 2022.
  - Including certain depreciation and amortization deductions (tax EBIT) for tax years after December 31, 2021.
- Excess limitation interest expense can be carried forward indefinitely

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## TCJA Refresher: Impact on Transactions & Valuations

<b>Global Intangible Low-Taxed Income (GILTI)</b>	<ul style="list-style-type: none"> <li>• Introduction of US taxation on a US shareholder on the current year aggregate GILTI earned by all its 10% owned CFC's (new category of Subpart F income)</li> <li>• GILTI taxed at standard corporate tax rates after certain adjustments for previously US taxed income, a gross up for foreign taxes, etc..</li> <li>• Intangible income is derived as excess after a charge of 10% of the tax NBV of certain qualified assets (QBAI). QBAI is reduced by net interest charges.</li> <li>• GILTI also generates a new potential income deduction which may lower the US effective tax rate on GILTI:             <ul style="list-style-type: none"> <li>• 50% of GILTI for tax years beginning after 12/31/2017 and before 1/1/2026 (i.e., a minimum US ETR on GILTI of 10.5%)</li> <li>• 37.5% of GILTI for tax years beginning after 12/31/2025 (i.e., a minimum US ETR on GILTI of 13.125%)</li> <li>• However, GILTI deduction is subject to a general limitation with FDII deductions</li> <li>• Current Year NOLs may offset GILTI liability</li> <li>• Deduction is lost if unused in year</li> </ul> </li> <li>• Foreign tax credits and allocated US expenses to this new FTC bucket</li> </ul>
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## TCJA Refresher: Impact on Transactions & Valuations

<b>Foreign Derived Intangible Income (FDII)</b>	<ul style="list-style-type: none"> <li>• Potential new deduction for “new” category of US income earned from foreign user sources.</li> <li>• This FDII deduction is available to domestic corporations that are taxed as C corporations</li> <li>• FDII is also determined after certain exclusions and expense allocations.</li> <li>• 10% QBAI reduction of FDII for non-intangible earnings also applied without interest charge reduction.</li> <li>• Up to <b>37.5%</b> of FDII may be treated as a deduction to US income (Potential minimum US ETR <b>13.125%</b>)</li> <li>• Certain conditions for “foreign” use have to be proved to Commissioner's satisfaction.</li> <li>• FDII deduction is subject to an overall limitation (with formula including GILTI deduction)</li> <li>• FDII deductions are also lost if unused in the year.</li> <li>• FDII future uncertain:             <ul style="list-style-type: none"> <li>• Trading partners have already expressed concern that FDII regime may challenges at WTO</li> </ul> </li> </ul>
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# TCJA Refresher: Impact on Transactions & Valuations

## Base Erosion and Anti-Abuse Tax (BEAT)

- Effectively an AMT
- New tax on profits effectively shielded by payments to related parties
- Affects companies
  - >\$500m in tax gross receipts for past 3 years, and
  - Ratio of BEAT payments to all payments of >3% (>2% for financial institutions)
- BEATable payments exclude cost of good sold payments and certain other exempt payments
- BEATable payments include payments for intangibles, services, certain property / assets, etc.
- BEAT taxable income determined by a “with” vs “without” BEAT payments comparison of taxable income, including an allocation of NOLs.
- BEAT income tax rate **10%** for tax years after 12/31/2018 (**5%** before)

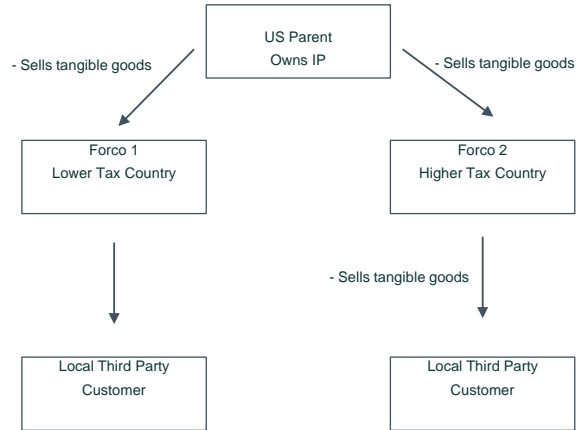
## TCJA: GILTI and FDII

### Planning for Key Provisions of the TCJA

# Transfer Pricing Transformations

## Global Intangible Low-Taxed Income (“GILTI”) and Transfer Pricing

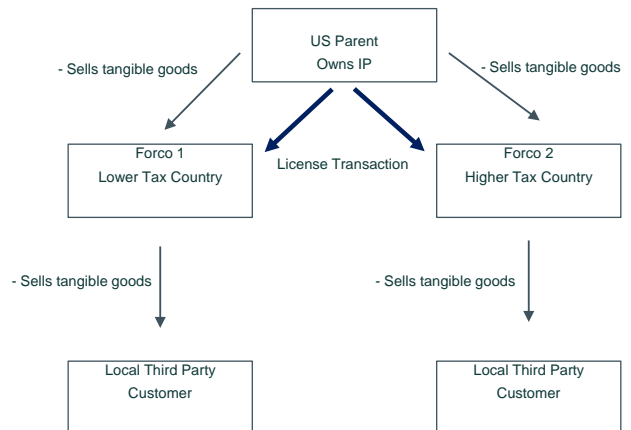
- US Parent has two subsidiaries
- US Parent is manufacturer and owns IP
- US Parent sells to both subs with a target return (OM)
- Overall foreign tax is 30%
- Since greater than 13.125% protected from GILTI
- However need to consider FTC Limitation
- Excess credits in the GILTI basket are lost



# Transfer Pricing Transformations

## Global Intangible Low-Taxed Income (“GILTI”) and Transfer Pricing

- US parent may consider changing the nature of the transaction and the transfer prices between entities
- One potential strategy is to separate the price of the tangible good and the IP related to both subs
- Could create a low tax foreign source general basket income which could be blended with certain high tax income currently in the GILTI basket through non TP planning such as affirmative Subpart F

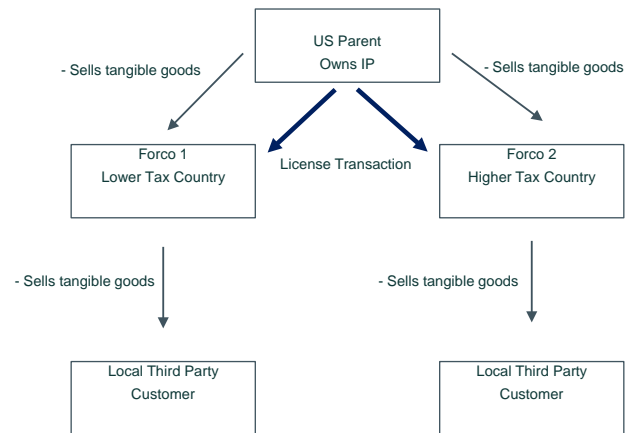




## Transfer Pricing Transformations

### Global Intangible Low-Taxed Income (“GILTI”) and Transfer Pricing

- Non-GILTI considerations associated with a separate royalty include:
  - Withholding taxes
  - Foreign deductibility on royalty payment
  - Customs
  - FTC expense allocations

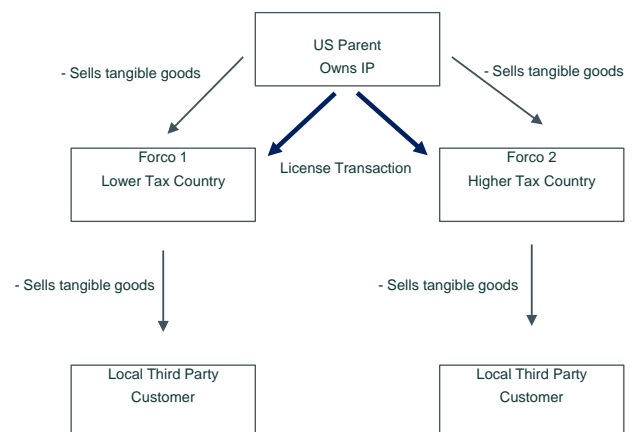


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## Transfer Pricing Transformations

### Global Intangible Low-Taxed Income (“GILTI”) and Transfer Pricing

- Increasing FTC utilization is key
- Key to tax planning are the amounts of:
  1. GILTI effective tax rate
  2. Excess credits in the GILTI basket
  3. Excess limitation in the general basket
- Any transfer pricing adjustment will change the amount of GILTI, effective foreign tax rate, foreign taxes paid etc. This will effectively change the planning



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## Transfer Pricing Transformations

### Global Intangible Low-Taxed Income (“GILTI”) and Transfer Pricing

#### Key Points on GILTI and TP

- FTC Planning requires robust and defensible transfer pricing policies to achieve a stable income stream
- Any transfer pricing adjustment could upset the whole structure

#### TP Considerations

- A CFC ETR greater than 13.125% is not a guarantee there is no GILTI residual U.S. tax
- Foreign source income is a key determinant of the FTC limitation
- Expense allocations for FTC limitation purposes are critical
- The depreciable tangible property of a CFC with a tested loss is excluded from the GILTI computation

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## Transfer Pricing Transformations

### Deduction for Foreign Derived Intangible Income (“FDII”)

#### FDII Maximization versus FDII Optimization

- FDI maximization increases the FDII deduction without considering other implications such as GILTI, foreign taxes and FTC’s
- FDII optimization finds the optimal FDII deduction while at the same time considers the connection between GILTI, foreign taxes and FTC’s

#### Key FDII interdependences (foreign taxes and GILTI)

- Increasing the FDII deduction by increasing transfer prices to low tax foreign entities may be non beneficial on a system wide basis
- Increasing the FDII deduction by increasing transfer prices that decrease foreign source income/increase U.S. source income (e.g., increase services charges from the U.S) may have a negative impact on the ability to avoid residual tax on GILTI

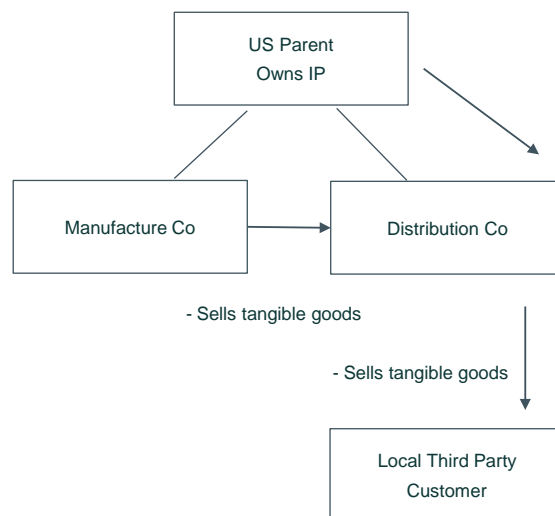
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## Transfer Pricing Transformations

### FDII Case Study (Intangibles)

- US Parent Co wholly owns Manufacture Co and Distribution Co. Both foreign
- US Parent Co owns IP
- Distributor Co pays a royalty to US Parent Co 5% of third party sales
- US Parent Co considers increasing the royalty rate on the basis that global profit margins have increased significantly over time yet the royalty has remained as 5% of third party sales



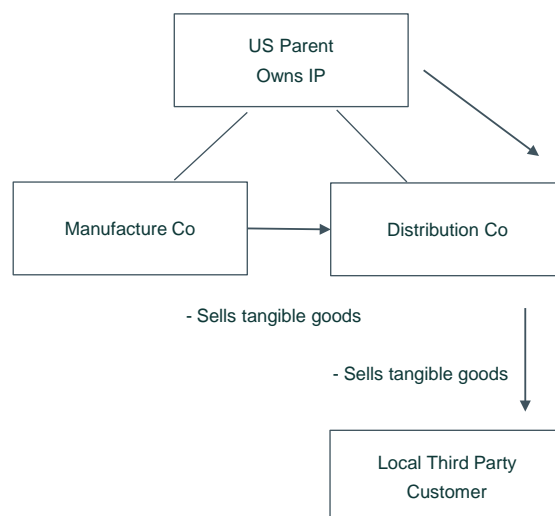
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## Transfer Pricing Transformations

### FDII Case Study (Intangibles)

#### Key Considerations

- Increases pre FTC U.S. tax
- Decreases foreign tax
- Decreases GILTI
- Increases general limitation foreign source income
- May impact FTC expense allocations
- Increase withholding tax (potentially)



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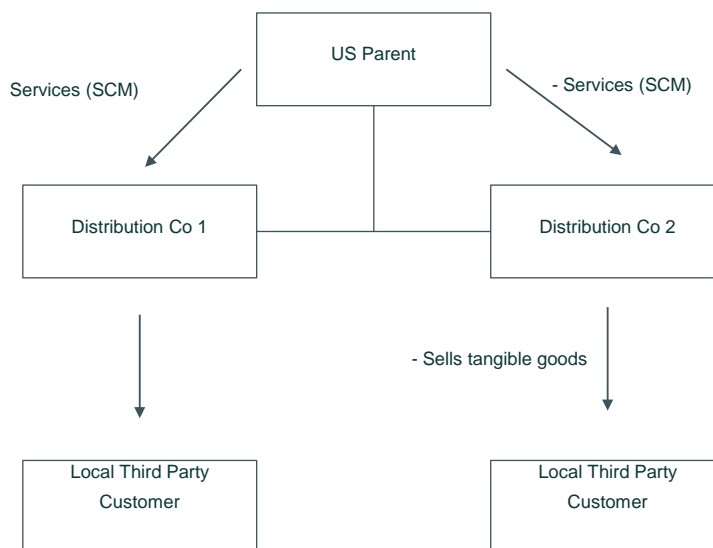
## Transfer Pricing Transformations

### FDII Case Study (Services)

- US Parent Co owns two Distribution Companies 1 and 2
- US Parent Co performs services for the benefit of Distribution Co 1 and 2 at cost (SCM)
- US Parent Co is considering charging a mark-up as SCM is optional under 482-9

#### Key Considerations

- Increases pre FTC U.S. tax
- Decreases foreign tax
- Decreases GILTI
- Decreases foreign source income
- May impact FTC expense allocations



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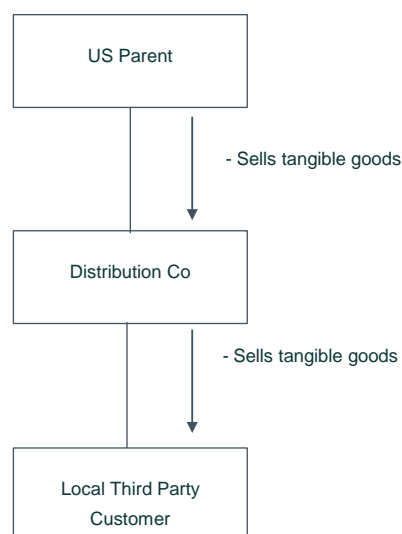
## Transfer Pricing Transformations

### FDII Case Study (Services)

- US Parent Co owns Distribution Co
- US Parent Co performs manufacturing and sells tangible goods to Distribution Co for sale at cost plus 5%
- US Parent Co considering increasing the price on tangible goods

#### Key Considerations

- Increases pre FTC U.S. tax
- Decreases foreign tax
- Decreases GILTI
- Decreases foreign source income
- May impact FTC expense allocations
- Increases customs costs (potentially)

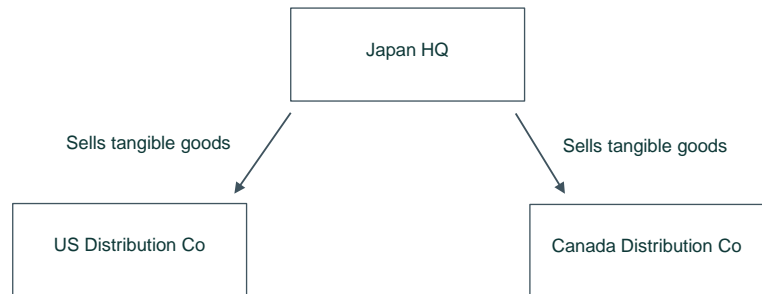


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## Transfer Pricing Transformations

### FDII Case Study (Tangible Goods)

- Japanese Parent sells tangible goods directly to its wholly owned sub in the US and Canada
- Both wholly owned sub distribute to third party customers

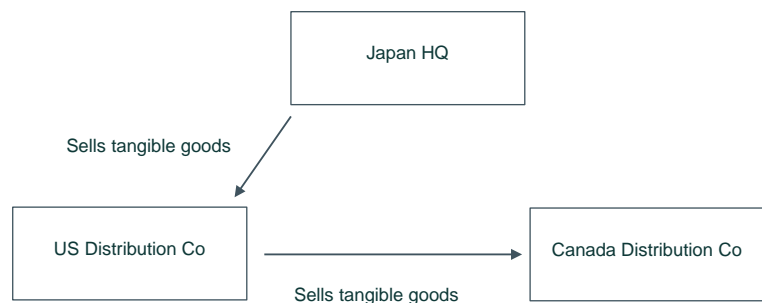


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## Transfer Pricing Transformations

### FDII Case Study (Tangible Goods)

- Instead of selling from Japan to Canada. A potential strategy would be to sell to the US then subsequently sell to Canada
- Potential FDII benefit



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## Transfer Pricing Transformations

### Deduction for Foreign Derived Intangible Income (“FDII”)

#### Key FDII TP Considerations

- Foreign Derived Intangible Income is deceptive as it applies to exports of tangible goods, services and intangibles
- FDII maximization and FDII optimization are not the same
- Increases FDII may not be overall beneficial to interactions with FTCs and other factors
- FDII expense allocations – How expenses are allocated to “foreign derived deduction eligible income” is critical – Transfer Pricing modelling can help with this

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## The Base Erosion & Anti-Abuse Tax

### Planning for BEAT transactions

## Transfer Pricing Transformations

### The Base Erosion and Anti-Abuse Tax (“BEAT”)

#### Overview of the BEAT

- Under IRC section 59A, additional minimum tax is imposed on U.S. companies having certain deductible ‘base erosion payments’ made to related foreign companies
  - Tax years beginning in 2018 at a **5% rate**
  - Tax years in 2019- 2025 at a **10% rate**
  - Tax years beginning after 12/31/2025, **12.5% rate**
- Application for base erosion payments made in taxable years beginning after 12/31/17
- Minimum tax liability:
  - Excess of 10% (or other rate) of the U.S. company’s “modified taxable income” (“MTI”) over its regular U.S. tax liability reduced by certain allowable credits (but not R&D and certain other credits)
- MTI is taxable income plus certain “base erosion payments” and NOLs attributed to such payments

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## Transfer Pricing Transformations

### The Base Erosion and Anti-Abuse Tax (“BEAT”)

In general, the liability is calculated as follows:

$$\begin{array}{r}
 \text{5\% of} \\
 \text{\underline{modified}} \\
 \text{\underline{taxable}} \\
 \text{\underline{income} for the} \\
 \text{taxable year}
 \end{array}
 - \text{Regular tax liability for the taxable year reduced (but not below zero) by the} \\
 \text{excess, if any, of credits allowed under Chapter 1 over the sum of (i) the} \\
 \text{credit allowed under section 38 (general business credits) allocable to the} \\
 \text{research credit plus (ii) \underline{applicable section 38 credits} (not to exceed 80\% of} \\
 \text{the lesser of such credits or the base erosion minimum tax determined} \\
 \text{without taking into account such applicable section 38 credits)}$$

- Tax rate increased to 10% after the first year
- For years beginning after December 31, 2025, the tax rate is increased to 12.5% and regular tax liability is reduced by an amount equal to all credits allowed under Chapter 1

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## Transfer Pricing Transformations

### The Base Erosion and Anti-Abuse Tax (“BEAT”)

Modified Taxable Income (“MTI”) means taxable income determined without regard to:

- Any deduction (**base erosion tax benefit**) allowed for the taxable year with respect to any **base erosion payment**, and the **BEP** of any net operating loss (“NOL”) under Section 172

$$\text{BEP} = \frac{\text{aggregate base erosion tax benefits}}{\text{sum of the aggregate deductions allowable under Chapter 1}}$$

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## Transfer Pricing Transformations

### The Base Erosion and Anti-Abuse Tax (“BEAT”)

Base Erosion Payments include:

- Any amount paid or accrued by the taxpayer to a related foreign person, and with respect to which a deduction is allowable (e.g., interest, services)
- Any amount paid or accrued to a related foreign person for the acquisition of depreciable / amortizable property
- Any premium paid or accrued to a related foreign person for certain reinsurance payments

Base Erosion Payments exclude:

- **Cost of goods sold (“COGS”)**: generally excluded *unless* paid to a newly inverted companies
- Any amount paid or accrued for **services eligible for the services cost method (“SCM”)** under Section 482
- Qualified derivative payments
- Amounts taxed under Sections 871 or 881 and withheld under Sections 1441 or 1442

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# Transfer Pricing Transformations

## The Base Erosion and Anti-Abuse Tax ("BEAT")

### What can be capitalized in COGS?

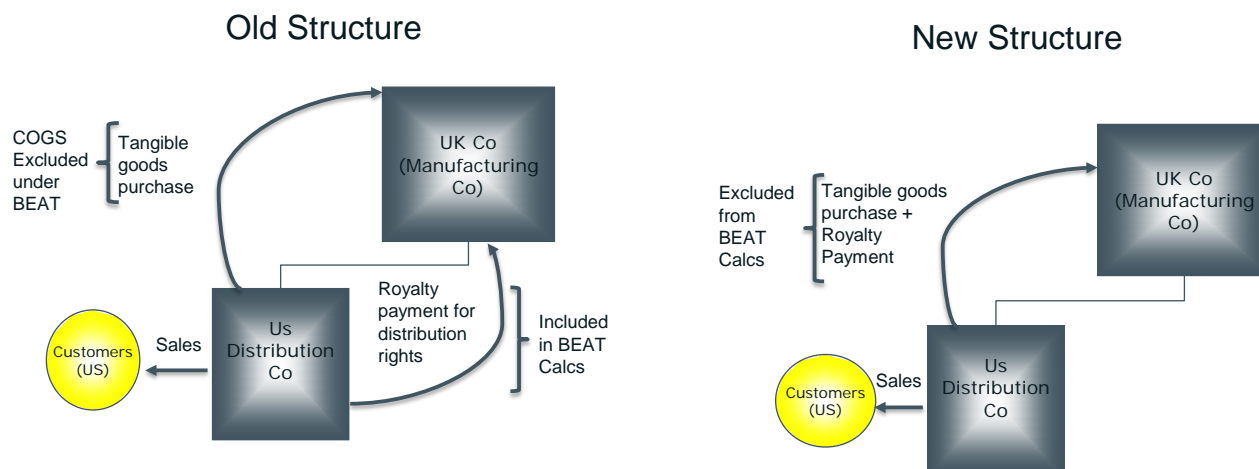
- Direct and indirect costs that directly benefit or are incurred by reason of the performance of inventory production or resale activities are properly capitalizable to the inventory property

Potentially capitalizable	Generally non-capitalizable	Elective capitalization
<ul style="list-style-type: none"> <li>▶ Invoice price of inventory</li> <li>▶ Direct production labor</li> <li>▶ Certain license and franchise fees, including royalty costs</li> <li>▶ Certain shared services               <ul style="list-style-type: none"> <li>▶ Inventory procurement</li> <li>▶ Inventory supply chain</li> <li>▶ Engineering costs (not allowable as Section 174 costs)</li> <li>▶ Accounting (partial)</li> <li>▶ IT (partial)</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>▶ Marketing expenses</li> <li>▶ Selling costs</li> <li>▶ Advertising costs</li> <li>▶ Distribution costs</li> <li>▶ Section 174 expenses</li> <li>▶ Interest (unless certain requirements are met)</li> </ul>	<ul style="list-style-type: none"> <li>▶ Certain period costs if some portion of the cost is properly allocable to property produced</li> <li>▶ <i>However, such elective capitalization is disallowed if it would result in a material distortion of income</i></li> </ul>

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# Transfer Pricing Transformations

## BEAT Case Study



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## Transfer Pricing Transformations

### The Base Erosion and Anti-Abuse Tax (“BEAT”)

#### Services Cost Method

A base erosion payment does not include any amount paid or accrued by the taxpayer for services if:

- The services are eligible for use of the services cost method (SCM) under Section 482, without regard to the requirement that the services not contribute significantly to the fundamental risks or business success or failure; and
- Such amounts constitutes the total services cost with no markup component

Services eligible for the SCM are limited to:

- Services that are **not** “excluded activities” under Treas. Reg. § 1.482-9(b)(4) **and**
  - “Specified covered services” as identified by Rev. Proc. 2007-13, **or**
  - “Low margin covered services”
    - » Low margin covered services are “controlled services transactions” for which the comparable markup on total services costs is 7 percent or less
  - Controlled services transactions include the performance of functions, assumptions of risks, or use by a renderer of tangible or intangible property or other resources, capabilities, or knowledge that results in a benefit. Treas. Reg. § 1.482-9(l)(1)

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## Transfer Pricing Transformations

### Other Planning Opportunities Under BEAT

- Check the box on CFCs where US is paying for services.
- Foreign IP Co of a CSA pays the CFCs for services rather than US
- Considerations
  - All E&P is picked up
  - Need to modify contractual arrangements
  - May be able to avoid BEAT
  - IRS may propose Regs that disallow this treatment
  - Will need to keep track of separate branch FTCs (FTC limited to income generated by branches)
  - May need to track foreign currency gains/losses IRC Section 987

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# Transfer Pricing Transformations

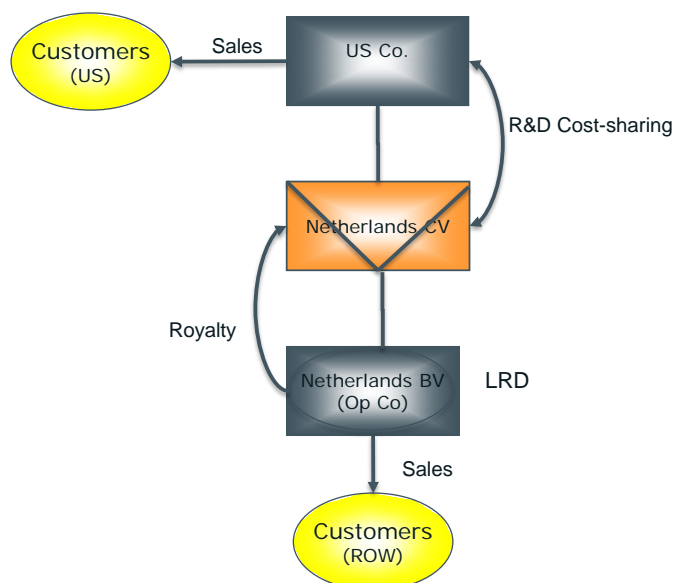
## Restructuring Consideration

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### Transfer Pricing Transformations

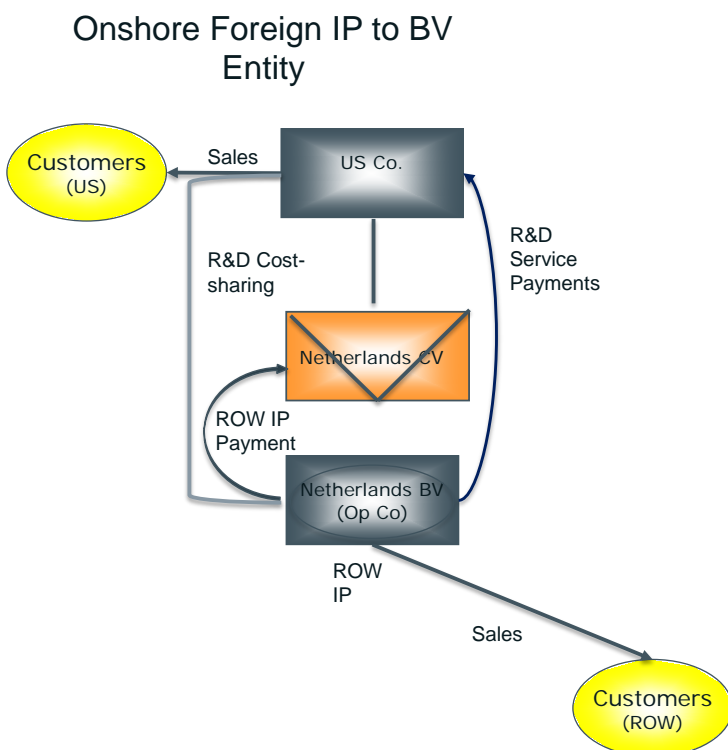
#### Restructuring Consideration

##### Example of Current Structure



## Transfer Pricing Transformations

### Restructuring Consideration



#### Considerations:

##### US

- US continues to own US IP rights
- Any payment subject to BEAT will be picked up in GILTI calculations
- No increase of E&P or gain recognition for either Sub F or GILTI

##### Netherlands

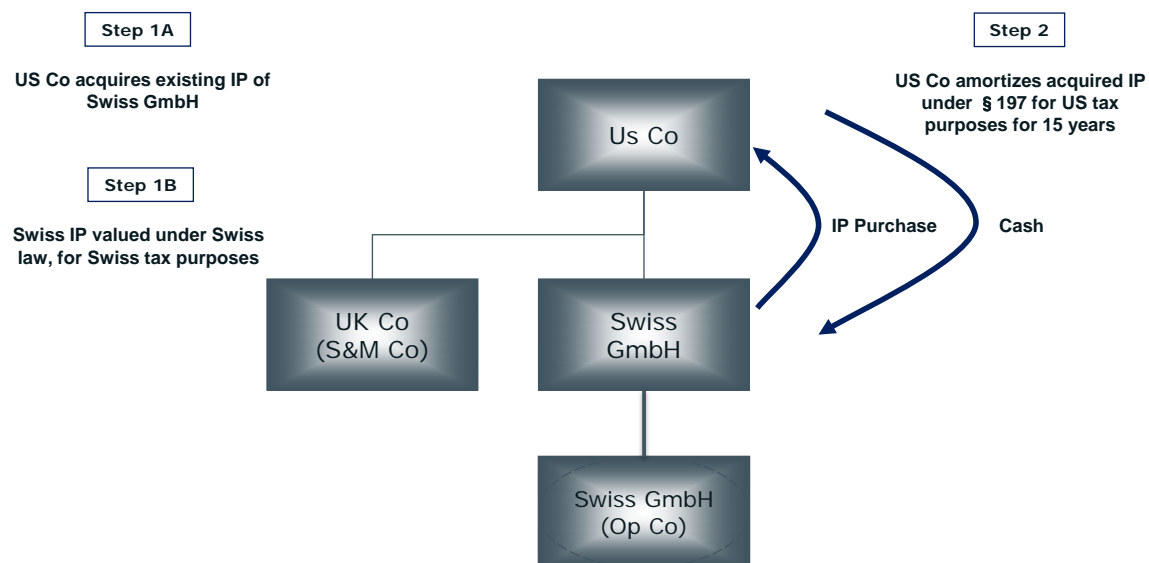
- IP transfer from CV to BV
- IP transfer treated as a sale transaction
- BV owns ROW IP
- BV has amortization expense from ROW IP purchase
- Requires IP valuation
- No tax on gain on sale from CV to BV

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## Transfer Pricing Transformations

### Restructuring Consideration

#### US IP Acquisition

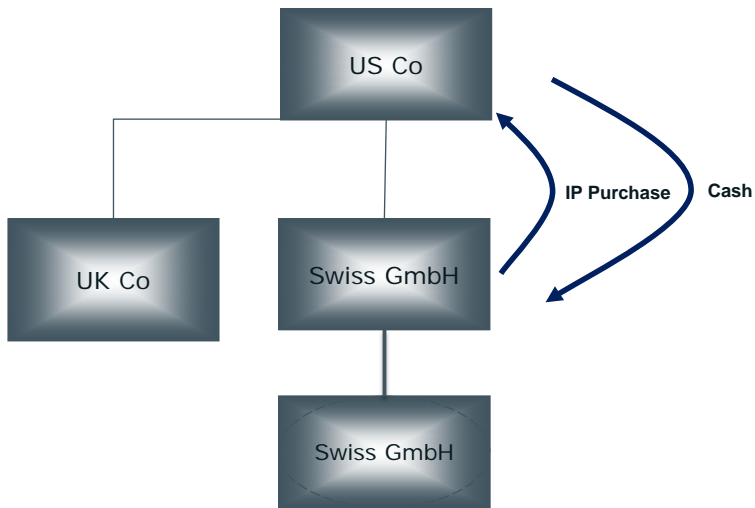


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# Transfer Pricing Transformations

## Restructuring Consideration

### US IP Acquisition



#### Considerations:

##### US

- Owns worldwide IP and exploitation rights
- Develops all IP in US
- Books worldwide income on US books
- Benefit of FDII on foreign sales
- Section 197 amortization, 15 years – IP basis
- Need to consider GILTI implications on gain on Swiss IP sale
- BEAT does not apply since US Co does not have more than \$500M in gross receipts

##### Switzerland

- Results in Swiss tax on IP sale to US
- Gain on sale: 9% - 13% - no Royalty withholding
- Requires IP valuation – either via Swiss tax negotiations (best), or transfer pricing analysis
- Changing sales contracts from Swiss to US