34th Annual TEI-SJSU High Tech Tax Institute
November 5 - 6, 2018

Locating Intangibles ð Generating and Using Foreign Derived Intangible Income ("FDII")

11/5/18

[see last page for names of presenters]

Agenda

Changing Landscape of International Tax & Transfer Pricing

FDII – Overview and Calculation

Generating and Maximizing FDII

FDII and Intangibles - The Interaction of FDII and GILTI: The New International Tax Reality

Changing Landscape of International Tax & Transfer Pricing

OECD BEPS and Related Legislation

Transfer Pricing for Intangibles

DEMPE functions approach

Anti-hybrid rules

General anti-avoidance rules

EU tax ruling decisions

"Double Irish" legislation

EU ATAD

Other

Changing Landscape of International Tax & Transfer Pricing

US Tax Reform

Is FDII prohibited by the WTO?

The WTO's 1994 Agreement on Subsidies and Countervailing Measures includes in a list of prohibited export subsidies: “the allowance of special deductions directly related to exports or export performance, over and above those granted in respect to production for domestic consumption, in the calculation of the base on which direct taxes are charged.”

The WTO and its predecessor have already struck down similar U.S. tax provisions. The Domestic International Sales Corporation enacted in 1971, the Foreign Sales Corporation (FSC) enacted in 1984, and the Extraterritorial Income (ETI) regime enacted in 2000 were all found to be “prohibited” provisions.

The EU has not yet formally mounted a WTO complaint against the new U.S. tax law. In February, the European Commission took the first step toward filing a complaint when it asked EU companies to provide information on how they were affected by U.S. corporate tax changes.

FDII will face a challenge from the WTO. But does the US still care about the WTO?

Key Themes and Considerations

Substance and Location of Functions (e.g., DEMPE)

Aligning Tax and Operations

Onshoring of intangibles

- Bring IP back to US or move to onshore foreign jurisdiction

If IP currently in US, any merit to

Overview of FDII

FDII may be seen as US answer to patent box or innovation regimes

Supplements rather than replaces ability to credit certain R&D expenditures

Alternatively, it may be viewed as a replacement for the Section 199 Domestic

The Calculation – Practical Approach

- QBAI – Qualified Business Asset Investment
  - Used to compute the amount that's disallowed in computing the deduction
    - Having domestic QBAI is thus detrimental
    - Deduction Eligible Income (DEI) (see prior slide) reduced by 10% of QBAI = Deemed

The Calculation – Practical Approach

How much is my deduction before limitation?

DEI less (10%x QBAI) = Deemed Intangible Income

Foreign Derived Intangible Income Percentage =

$$\frac{\text{FDDEI (e.g, Foreign Sales/Services Income)}}{\text{DEI (All income less exclusions)}}$$

FDII Percentage * Deemed Intangible Income = FDII

FDII * .375 (pre-2026 years) = Your deduction

0.0002 n/GS13 gs0.565 0.761 0.149 rg0 0 m0 224.04 laalc

Generating and Maximizing FDII

Foreign Use Requirement

For the purposes of FDII, income is considered to be foreign-derived when it is derived in connection with

- property sold by the taxpayer to any person who is not a US person and that the taxpayer establishes to the satisfaction of the IRS is for a foreign use, or
- services provided by the taxpayer that the taxpayer establishes to the satisfaction of the IRS are provided to any person, or with respect to property, not located within the United States.

A "sale" includes any lease, license, exchange, or other disposition of property.

Property is "sold" for a foreign use if it is used, consumed, or disposed of outside the United States.

Sales to related foreign parties do not qualify as for a foreign use unless the property is ultimately sold, or used in connection with property that is sold or the provision of services, to an unrelated foreign person, and the taxpayer establishes to the satisfaction of the Secretary that the property is for a foreign use.

Sales to domestic intermediaries are not considered to be foreign use.

- However, regulations may treat a consolidated group as a single entity, which would disregard certain intercompany transactions that would otherwise disqualify the corporation from utilizing the FDII deduction.

Sale of Tangible Property

Sale of Tangible Property (continued)

- If IP is located offshore, consider licensing IP from the IP holding company and then selling from the domestic corporation.
  - Any potential Subpart F exposure is limited to the markup on the royalty.
- Bundled Transactions (i.e. transactions that include elements of multiple types of transactions, such as sales and services) – A sourcing rule analogy can be found in the Subpart F regulations (Treas. Reg. 1.954-1(e)):
  - If a single transaction can be appropriately characterized as more than one type of income, the income must be bifurcated.
  - However, if the different types of income cannot be separately determined, then the predominant character of the transaction should be determined and then the income must be characterized accordingly.

Foreign Use – Licensing and Sale of Intangible Property

Sourcing rule analogies for intangible property can be found in the general income sourcing rules and the foreign personal holding company rules:

General income sourcing rules - Rental and royalty income is sourced based on whether the income

Foreign Use – Services (continued)

Transportation services

Expense Allocation

Cost of Goods Sold Allocation

An analogy can be found in the former Treas. Reg. 1.199-4, which provides that a reasonable method could be used for the allocation of cost of good sold.

Allocation of Deductions - Senate version provided that gross income is reduced by deductions “properly allocable to such income under rules similar to the rules of Section 954(b)(5).”

Section 954(b)(5) uses the principles of Section 861 (See Treas. Reg. 1.861-8) to allocate expenses.

A simplified expense allocation method may be made available to smaller taxpayers.

State and Local Taxation

State conformity to FDII is mixed. There are several variables to consider:

- Whether state has rolling vs. fixed conformity
- Whether state determines state taxable income using federal taxable income before or after the application of special deductions
- Potential changes in state tax law (e.g., to decouple from FDII or to modify the state's apportionment formula to account for it)

After taking into account the combined federal + state income tax rate, a taxpayer may obtain a lower effective tax rate by using a foreign entity.

FDII and Intangibles The Interaction of FDII and GILTI: The New International Tax Reality

Where to Locate Intangibles

- Basic Issues: to cost share or not? Repatriate?
- More Difficult Problems: FDII/GILTI/QBAI interaction
- Open Questions and Issues:
  - Lack of current FDII guidance
  - International tax planning in an uncertain global environment

FDII – Context with GILTI

- The GILTI and FDII provisions together create a theoretical worldwide minimum tax on “deemed intangible income” intended to reduce incentives for companies to move their IP and the related profits offshore.
- US multinational corporations serving foreign markets should theoretically pay approximately the same effective tax rate on their intangible income regardless of where it is located:
  - IP Offshore serving foreign customers – subject to GILTI (between 10.5% and 13.125%)
  - IP in the US serving foreign customers –

FDII – Fabless Chip Company

FDII vs. GILTI: Fabless Chip Company

FDII Alternative #2: "Check-the-Box" on Cayman

The difference in ETR between alternatives 1 and 2 is a result of the US MF profit.

This structure fails if Cayman / Hong Kong are treated as a QBU. Also, if global sales exceed $500M, BEAT may reduce benefits.

FDII v. GILTI – SaaS Example

Cost Sharing with Global/US Sales Split 50/50

Base Facts:	
US Profit =	1,000x
Irish Profit =	1,000x
Irish Corp Tax (12.5%) =	125x
Tax Computation:	
GILTI (w/ Sec. 78 GU)	1,000x
Section 250 Deduction (FDII)	(500x)
Net	500x
US Income	1,000x
Total US Taxable	1,500x
Federal Income Tax (21%)	315x
80% FTC	(100x)
Net US FIT	215x

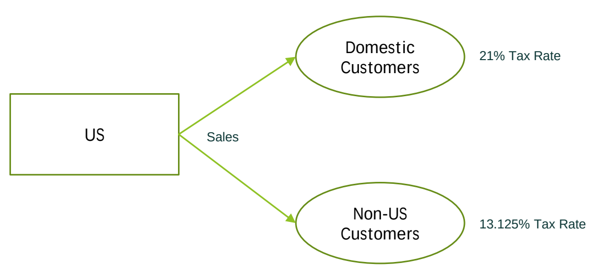
Global ETR = (215x+125x)/2,000x = 17.0%

FDII v. GILTI – SaaS Example w/Limited Risk Distributor

Minimize Foreign Profit / LRD Model

Base Facts:

FDII v. GILTI – Distribution/e-Commerce



B2C Platform

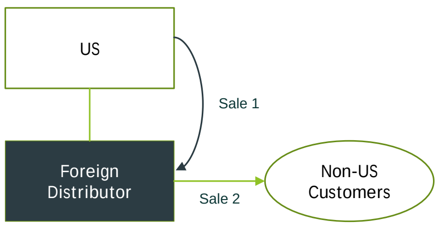
Safe to presume foreign buyers

Does not seem to matter whether product is produced in the US.

What about BEPS?

FDII v. GILTI – Distribution/e-Commerce

Use of Related Party Re-seller



Potential that Sale 1 is eligible for FDII and Sale 2 is subject to GILTI

Related Party Sale Problems:

- **Section 250(b)(5)(C)(i)(ii): the sale must satisfy the Secretary's definition of**

Easier proving foreign use with third-party distributor?

FDII – Extra Credit

	Pass-through with IC-DISC*	C-Corp with IC-DISC*	FDII Only
Export Profit	1,000x	1,000x	1,000x
IC-DISC Commission	(500x)	(500x)	0x
FDDEI	500x	500x	1,000x
Less: Section 250 Ded.	0x	(188x)	(375x)
Taxable Income	500x	312x	625x
Federal Tax Rate	32%	21%	21%
US Tax	160x	65.5x	131.25x
Dividend Tax (50%)	119x	119x	-
Dividend Taxax (50%)			

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Additional Issues, Options, and Problems

- Increase in GILTI/FDII effective rates after year 2025 = increase in tax rate of foreign intangible income
- Highly uncertain political environment in the US, OECD, and elsewhere
- Impact of State and Local Taxes (possibly minimized through tax deferral structures)
- General Definitional Issues:
  - Sales vs. Services
  - Foreign Destination
  - Sourcing Rules

Presenters

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