34th Annual TEI-SJSU High Technology Tax Institute

Panel: Transfer Pricing Transformations

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Introduction & Background

The current transfer pricing environment

Transfer Pricing Transformations
Current TP Environment

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?

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.

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”)

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.

TCJA Refresher: Impact on Transactions & Valuations

- 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-• Codification of aeiiaioa-0.6a<</MCID 50 >>B5.1(i0i)-1.2(o)-0.6c4on of rlucp r ea

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 <u>before</u> January 1, 2022.
    - Including certain depreciation and amortization deductions (tax EBIT) for tax years <u>after</u> December 31, 2021.
- Excess limitation interest expense can be carried forward indefinitely

- Introduction of US taxation on a US shareholder on the current year aggregate GILTI

- Potential new deduction for “new” category of US income earned from foreign user sources.
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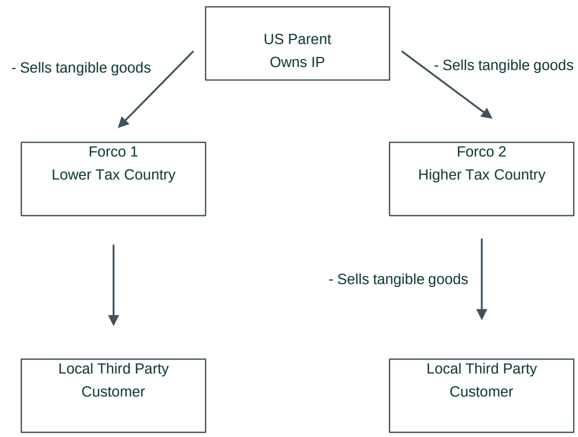
TCJA Refresher: Impact on Transactions & Valuations

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)

Transfer Pricing Transformations

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

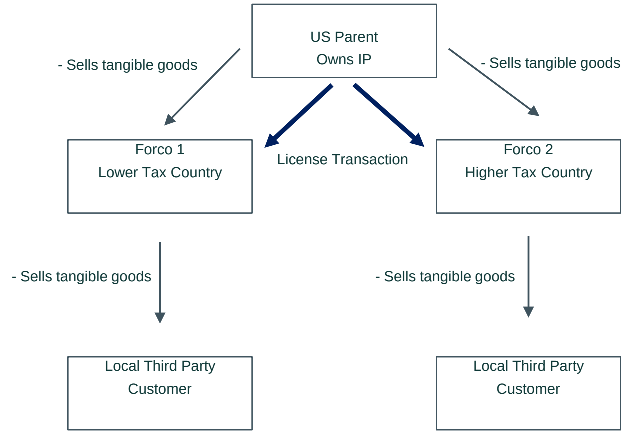
- US Parent has two subsidiaries
- US Parent is manufacturer and owns IP
- US Parent sells to both subs with a target return (OM)
- Overall foreign tax is 30%
- Since greater than 13.125% protected from GILTI
- However need to consider FTC Limitation
- Excess credits in the GILTI basket are lost



Transfer Pricing Transformations

Global Intangible Low-Taxed Income ("GILTI") and Transfer Pricing

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



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.

Transfer Pricing Transformations

Global Intangible Low-Taxed Income ("GILTI") and Transfer Pricing

Key Points on GILTI and TP

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Transfer Pricing Transformations

Deduction for Foreign Derived Intangible Income ("FDII")

FDII Maximization versus FDII Optimization

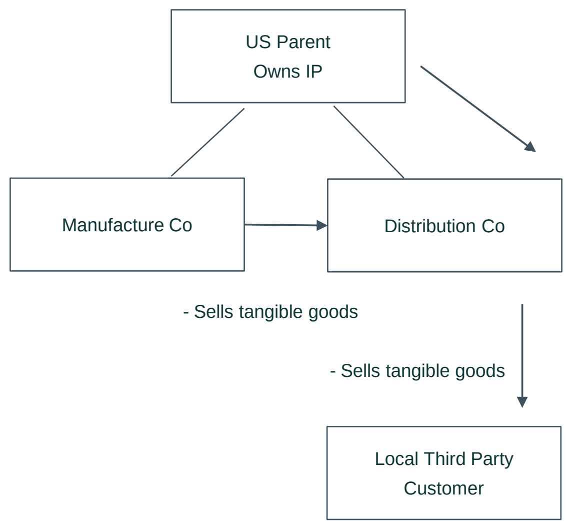
- FDI maximization increases the FDII deduction without considering other implications such as GILTI, foreign taxes and FTC's
- FDII optimization finds the optimal FDII deduction while at the same time considers the connection between GILTI, foreign taxes and FTC's

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

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



Transfer Pricing Transformations

Transfer Pricing Transformations

FDII Case Study (Services)

- US Parent Co owns two Distribution Companies 1 and 2
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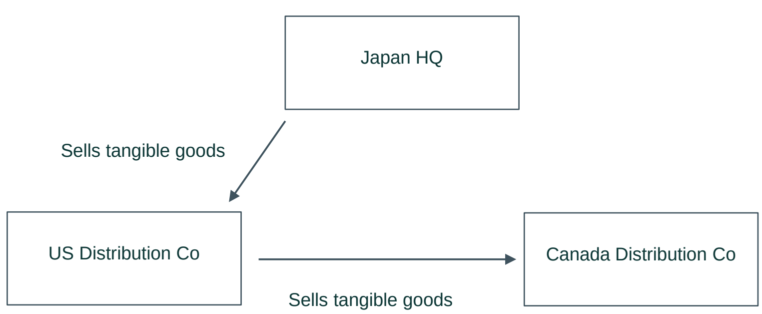
Transfer Pricing Transformations

FDII Case Study (Services)

- tUS Parent Co owns Distribution Co 7 (a r) - F 2 . 9 2 T m 3 6 ( ) 9 . 1 (C
- US Parent Co performs manufacturing and sells tangible goods to Distribution Co for sale at cost plus 5%
- US Parent Co considering increa8(n)-0.6( )9.1.6( )23(S)-0.6( )-pF-1.2(e)-0.1( )0.6(p)-5.1(r)-1.3(3)-0.6(l)-1.2(e)-0.8

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



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 noBDC 0Sv(6nl)-8(n)230s
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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")

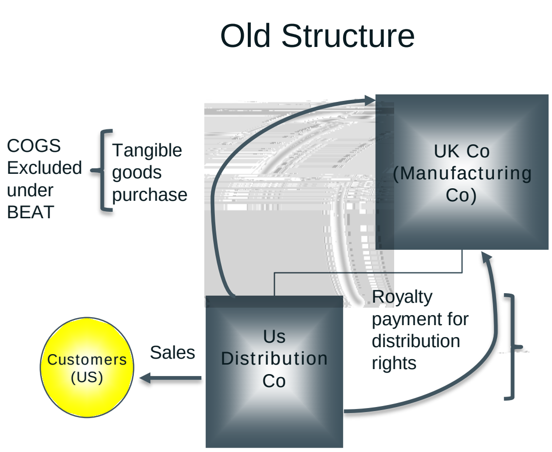
Modified Taxable Income ("MTI") means taxable income determined without regard to:

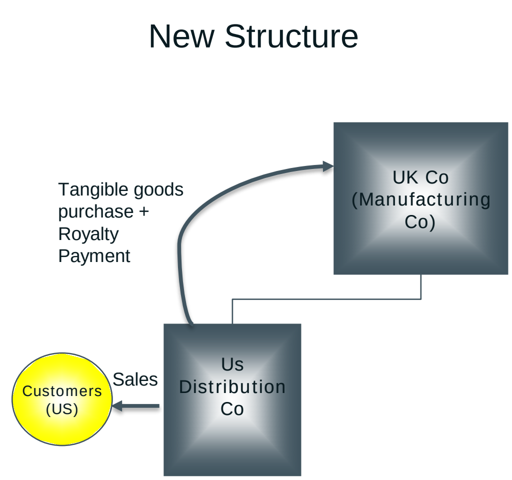
- Any deduction **(base erosion tax benefit)** allowed for the taxable year with respect to any **base erosion payment**, and the **BEP** of any net operating loss ("NOL") under Section 172

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

Transfer Pricing Transformations

Transfer Pricing Transformations
BEAT Case Study





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)

Transfer Pricing Transformations

Other Planning Opportunities Under BEAT

- Check the box on CFCs where US is paying for services.
- Considerations
  - All E&P is picked up
  - May be able to avoid BEAT
  - 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

- Foreign IP Co of a CSA pays the CFCs for services rather than US
- Considerations
  - Need to modify contractual arrangements
  - IRS may propose Regs that disallow this treatment

Transfer Pricing Transformations

Restructuring Consideration