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Impact of the TCJA and BEPS on Transfer Pricing Planning

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Worldwide Changes to the International Tax Landscape & Transfer Pricing

The TCJA and U.S. Tax Reform

- U.S. federal corporate income tax rate lowered to 21 percent.
- New rate along with GILTI, FDII, BEAT, and other rules intended to level playing field between U.S. and non-U.S. based multinational corporations.
- May need to rethink approach to transfer pricing and intangibles ownership.

OECD Base Erosion & Profit Shifting ("BEPS") Project

- Generally intended to keep multinational corporations from creating "stateless" income or resulting in "double non-taxation" of income.
- For transfer pricing purposes, goal is to align transfer pricing outcomes with value creation (Actions 8-10).
- An entity's entitlement to residual return from intangibles focuses on entity's performance of "DEMPE" functions instead of ownership of intangibles.

Tax Reform and Transfer Pricing –

Section 482 & Intangibles: New Definition, Realistic Alternatives, and Aggregation

IRC Section 482 After Tax Reform

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible. For purposes of this section, the Secretary shall require the valuation of transfers of intangible property (including intangible property transferred with other property or services) on an aggregate basis or the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers.

Definition of Intangible Property Under Prior § 936(h)(3)(B)

The term "intangible property" (IP) means any:

- Patent, invention, formula, process, design, pattern, or know-how;
- Copyright, literary, musical, or artistic composition;
- Trademark, trade name, or brand name;
- Franchise, license, or contract;
- Method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or
- Any similar item.

Definition of Intangible Property

- Section 482 formerly referenced § 936(h)(3)(B) for the definition of IP.
- The 2017 Tax Cuts and Jobs Act (P.L. 115-97) amended § 936(h)(3)(B) and the definition of IP.
- After the 2017 amendments, for purposes of § 482, the definition of IP was changed to include goodwill, going concern value, or workforce in place, or any other item the value of which is not attributable to tangible property or the services of any individual.
- The "any other item" category replaces the "any similar item" category in former § 936(h)(3)(B)(vi).
- The amendments to § 936(h)(3)(B) applied to transfers in taxable years beginning after December 31, 2017.
- On March 23, 2018, the Consolidated Appropriations Act, 2018, was enacted. The definition of IP was moved from § 936(h)(3)(B) to § 367(d)(4) and the old cross reference in § 482 was updated to reference § 367(d)(4).

Case Law Interpreting § 936(h)(3)(B)

- *Veritas Software Corporation v. Commissioner,* 133 T.C. 297 (2009)

- *Amazon.com, Inc. v. Commissioner*, 148 T.C. No. 8 (2017)

Veritas Software Corporation v. Commissioner

- In November 1999, Veritas US assigned all of its existing sales agreements with European-based sales subsidiaries to Veritas Ireland.
- Simultaneously, Veritas US entered into a Cost Sharing Arrangement ("CSA") with Veritas Ireland.
  - Veritas US gave Veritas Ireland the exclusive and perpetual right to manufacture products utilizing "covered intangibles" within its territory and the nonexclusive and perpetual right to do so worldwide.
  - In exchange, Veritas Ireland agreed to pay Veritas US royalties through a buy-in payment.
- In 2000, Veritas Ireland paid Veritas US a $166 Million lump-sum buy-in payment.
  - This payment was adjusted by the taxpayer to $118 Million in 2002.
  - Veritas US' 2000 amended tax return disclosed this buy-in payment.
- In 2006, the Service determined the buy-in payment amount did not "clearly reflect" Veritas US' income under § 482 and issued the taxpayer a notice of deficiency.

Veritas Software Corporation v. Commissioner

The Service's Position:

- Initially, the Service determined the appropriate buy-in payment to be $2.5 Billion using the market capitalization method as the transfer pricing method ("TPM").
  - At trial, the Service amended this lump-sum payment to $1.675 Billion using an income method rather the market capitalization method.
  - The Service used an aggregate valuation rather than individually valuing items transferred from Veritas US to Veritas Ireland.
- The Service argued Veritas US' acquisition of other software companies were comparable to the CSA with Veritas Ireland and argued the CSA was thus "akin to a sale or geographic spinoff."
- Veritas' Position:
  - Veritas utilized the Comparable Uncontrolled Transaction ("CUT") Method and argued it was the most reliable method because it compared a transaction involving substantially similar IP.
  - Veritas argued the Service's allocation was arbitrary, capricious, and unreasonable.
  - Veritas contended the Service's determination accounted for items that had insignificant value and items that were not transferred between the parent company and subsidiary

Veritas Software Corporation v. Commissioner

The United States Tax Court's Opinion:

- The Service's § 482 allocation was arbitrary, capricious, and unreasonable.
  - The Service's $1.675 billion determination was insufficiently supported when limited to preexisting intangible as required by Treas. Reg. § 1.482-7(g)(2).
  - The Service incorrectly calculated the useful life of the Veritas products and the discount rate.
  - The Service cited regulations that were announced 10 years after the disputed transaction.
  - The Service's interpretation of the definition of IP that is compensable under § 482 is overly broad.
- The CUT method utilized by Veritas, with some adjustments, was the best method for determining the buy-in payment.

Amazon.com Inc. v. Commissioner

- In 2005 and 2006, Amazon US transferred IP required to operate its European websites businesses to its Controlled Foreign Corporation in Luxembourg (“Amazon Luxembourg”).
- Amazon US also entered into a Cost Sharing Arrangement (“CSA”) with Amazon Luxembourg.
  - Amazon Luxembourg’s territory was Europe, the Middle East, and Africa.
  - Amazon US’ territory was the rest of the world.
- The Service designated the original cost-sharing buy-in issue for litigation.

Amazon.com Inc. v. Commissioner

Amazon's Position:

- Amazon determined the value of the transferred IP required Amazon Luxembourg to pay a buy-in amount of $254.5 million.
- Amazon's litigating position was that under the TPM the value of the transferred IP required Amazon Luxembourg to pay a buy-in amount of $284 million to $433 million.
- Amazon's TPM at trial was to use three separate CUTs for the value of 1) technology, 2) marketing IP, and 3) customer information.

The Service's Position:

- The Service's audit position was that the value of the transferred IP required Amazon Luxembourg to pay a buy-in amount of $3.6 billion.
- The Service's litigating position reduced the buy-in amount to $3.468 billion based on a DCF.
- As a corroborating method, the Service used the CUT method to determine that the different species of IP required the following buy-in payments from Amazon Luxembourg.
  - Technology - $3.3 billion
  - Marketing IP - $3.1 billion
  - Customer Info - $215 million
- The Service argued the transferred property has an indeterminate useful life and thus had to be valued in the aggregate rather than in three separate groups.

Amazon.com Inc. v. Commissioner

The United States Tax Court's Opinion:

- Decided under the 1995 cost sharing regulations which were in effect when the transaction occurred.
  - The CUT used by Amazon was one of four acceptable transfer pricing methods.
- Citing Veritas, ruled the buy-in payment must only include "pre-existing intangible property."
  - Roughly 58% of the Service's determination was based on cash flows beginning in 2012 and continuing in perpetuity.
- The Service incorrectly applied the "akin to a sale" theory rather than valuing specific assets and failed to effectively apply the "realistic alternatives" theory.
- The Court declined to overturn Veritas.

Realistic Alternatives and Aggregation

Realistic Alternatives & Aggregation

- The 1995 regulations include Treas. Reg. § 1.482-1(f)(2)(ii)(A), which states that the IRS "may consider the alternatives available to the taxpayer in determining whether the terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances."

- Further, those regulations include Treas. Reg. § 1.482-1(f)(2)(i)(A), which states "the combined effect of two or more separate transactions may be considered, if such transactions, taken as a whole, are so interrelated that consideration of multiple transactions is the most reliable means of determining arm's length consideration…."

Realistic Alternatives & Aggregation

- The temporary cost-sharing regulations issued in 2009, and the final cost-sharing regulations issued in 2011, further developed the realistic alternatives and aggregation principles.
  - Treas. Reg. § 1.482-7(g)(2)(iii)(a) states: "The relative reliability of an application of a method also depends on the degree of consistency of the analysis with the assumption that uncontrolled taxpayers dealing at arm's length would have evaluated the terms of the transaction, and only entered into such transaction, if no alternative is preferable."
  - Treas. Reg. § 1.482-7(g)(2)(iv) states, "…it may be that the multiple transactions are reasonably anticipated, as of the date of the PCT(s), to be so interrelated that the method that provides the most reliable measure of an arm's length charge is a method under this section applied on an aggregate basis for the PCT(s) and other transactions…."

Realistic Alternatives & Aggregation

- In 2015, Treas. Reg. § 1.482-1T(f)(2)(i)(B) regarding aggregation was promulgated, stating the following:
  - The combined effect of two or more separate transactions (whether before, during, or after the year under review), including for purposes of an analysis under multiple provisions of the Code or regulations, may be considered if the transactions, taken as a whole, are so interrelated that an aggregate analysis of the transactions provides the most reliable measure of an arm's length result determined under the best method rule of section 1.482-1(c). Whether two or more transactions are evaluated separately or in the aggregate depends on the extent to which the transactions are economically interrelated and on the relative reliability of the measure of an arm's length result provided by an aggregate analysis of the transactions as compared to a separate analysis of each transaction. For example, consideration of the combined effect of two or more transactions may be appropriate to determine whether the overall compensation in the transactions is consistent with the value provided, including any synergies among items and services provided.
- This temporary regulation expired on September 14, 2018.

Realistic Alternatives & Aggregation

- The IRS tried, and failed, to argue its position in Amazon by citing to both the realistic alternatives principle and the aggregation principle. The Tax Court found the IRS's argument unpersuasive for "many reasons," including (1) that the realistic alternatives principle should not be applied if the taxpayer's actual structure has economic substance; and (2) a business enterprise valuation approach aggregates compensable IP with non-compensable IP (under § 936(h)(3)(B)) such as workforce in place.
- The TCJA codified the realistic alternatives and aggregation principles, adding the following language to § 482:
  - "For purposes of this section, the Secretary shall require the valuation of transfers of intangible property (including intangible property transferred with other property or services) on an aggregate basis or the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers."

Global Intangible Low-Taxed Income & Foreign Derived Intangible Income

Global Intangible Low-Taxed Income ("GILTI")

- GILTI is a new stand-alone anti-deferral regime
  - Applies in addition to subpart F
  - Applies only to CFCs
  - Applies to most non-subpart F income
- Applicable rate is 10.5 percent based on a 50 percent deduction

GILTI Definition

- In principle, the tax applies to CFC income that exceeds a formulaic return on tangible assets.
- CFC income calculated at the U.S. shareholder level by netting results of income and loss CFCs (“tested income” and “tested loss”).
  – Includes almost all non-subpart F income
  – Main exception is oil and gas extraction income
- Resulting “net CFC tested income” is reduced by “net deemed tangible income return” – 10 percent of the qualified business asset investment (QBAI) of each CFC, reduced by deductible interest expense.
- Result is the GILTI subject to tax.

Structural Implications of GILTI

- Bottom line: GILTI generally limits the scope of the TCJA territorial tax exemption for CFCs to a deemed 10 percent return on tangible assets.
- GILTI does not eliminate the broad structural incentives to locate international business operations in CFCs.
  - Locating hard assets in a CFC remains beneficial, as income is exempt from U.S. tax to the extent of a deemed 10 percent return on QBAI.
  - To the extent GILTI does apply, favorable 10.5 percent rate compared to 21 percent for income from U.S. assets.
- Nor does GILTI foreclose the use of CFCs as intangible holding companies.
  - GILTI tax rate generally comparable to concessionary 13.125 percent tax rate for foreign derived intangible income under § 250.

Foreign Derived Intangible Income ("FDII")

- New Code § 250 generally provides a 37.5 percent deduction for FDII, in addition to providing the 50 percent GILTI deduction.
  - Result: an adjusted tax rate of 13.125 percent on income from foreign-use intangibles held by U.S. taxpayers.
- This rate was intended to be comparable to GILTI rate that would apply if the same intangibles were held by a CFC.
  - *In theory*: If foreign effective rate is lower than 13.125%, then GILTI is taxed at a nominal 10.5 percent rate; if foreign effective rate is at least 13.125%, then no GILTI.
- In practice, the choice between IP held by a CFC subject to GILTI and a US corporation with FDII benefits may or may not be a close call:
  - Need to factor in many variables, for example:
    - The impact of expense allocation on effective GILTI rate
    - Accessing FTCs, including the 20% GILTI "haircut"
    - Exit taxes
    - Long-term viability of FDII (WTO prohibited export subsidy?)
    - Collateral implications of any restructuring
    - (re-)pricing updated royalties and other affected intercompany transactions

Base Erosion and Anti-Abuse

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

- BEAT targets: interest, royalties, and service payments to foreign related parties that could be used to shift profits outside of the U.S.
- BEAT is a new alternative minimum tax: 10 percent multiplied by the taxpayer's modified taxable income.
- The excess of this result over the taxpayer's regular tax (less credit adjustment), if any, is the BEAT liability.
- Modified taxable income: taxable income plus "base erosion tax benefits."
    - <u>Base erosion tax benefits</u>: benefits allowed by the Code for the taxable year with respect to base erosion payments.
    - <u>Base erosion payments</u>: amounts paid or accrued to a foreign affiliate with respect to which a deduction is allowable either immediately or eventually (e.g., as depreciation).

Overview – Base Erosion and Anti-Abuse Tax (“BEAT”)

- BEAT generally requires “applicable taxpayers” to pay a minimum tax at an applicable BEAT rate of 10 percent in 2019 and 12.5 percent beginning in 2026.
- To whom does BEAT apply?
  - The BEAT applies to an “applicable taxpayer”
  - **Applicable taxpayer** means:
    1. A corporation (other than a regulated investment company, real estate investment trust, or S corporation);
    2. That has average annual gross receipts of at least $500 million for the three-year period ending with the preceding taxable year; and
    3. That has a **base erosion percentage** (“BEP”) of 3 percent or higher for that taxable year.
        - The BEP threshold is only 2 percent for banks and securities dealers

What are Base Erosion Payments?

- IRC section 59A(d)-

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)
- 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
- Any amount paid or accrued to a related surrogate foreign corporation ("SFC") (only if the SFC first became an SFC after 9 November 2017) or a foreign member of the same expanded affiliated group ("EAG") as the SFC that reduces the taxpayer's gross receipts

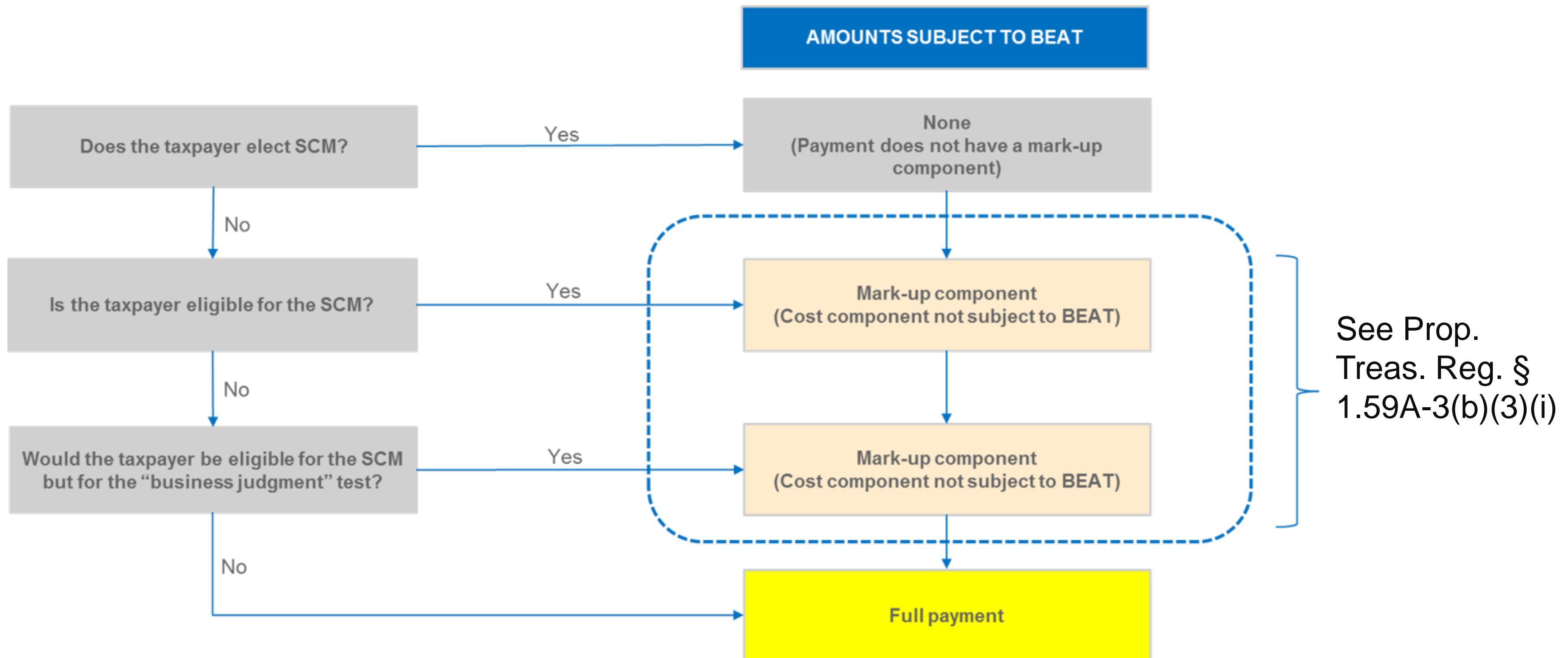
Base erosion payments exclude:

- **Cost of goods sold ("COGS"):** generally excluded *unless* paid to a related SFC (that first became an SFC after 9 November 2017) or a foreign EAG member of the SFC that reduces the taxpayer's gross receipts
- 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

Service Cost Method ("SCM") Exception

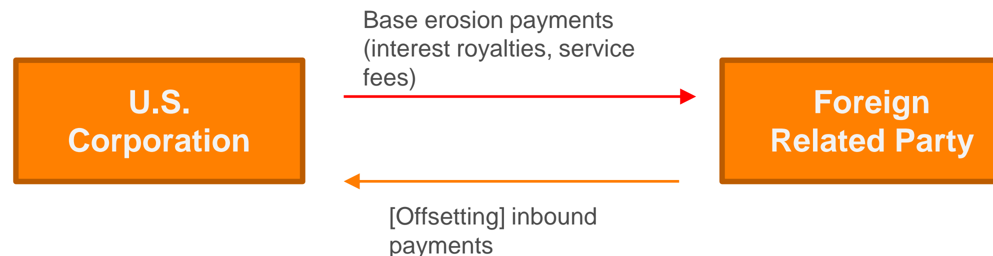
- IRC section 59A(d)(5) provides that a base erosion payment does not include any amount paid or accrued by the taxpayer for services if:
  - The services are eligible for use of the SCM under section 482, without regard to the requirement that the services not contribute significantly to the fundamental risks or business success or failure; and
  - Such amount 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. section 1.482-9(b)(4); and
  - Are specified covered services as identified by Rev. Proc. 2007-13, or are low margin covered services.
    - Low margin covered services are controlled services transactions for which the comparable mark-up on total services costs is 7 percent or less.

SCM Eligibility for the BEAT



BEAT (con't)

- Netting issues:
  - How to determine the amount of a base erosion payment?
  - The proposed regulations do not provide for the general netting of base erosion payments.
  - If the application of general tax principles permits netting to produce the deductible amount, the proposed regulations do not affect that result.



BEAT (con't)

- Proposed regulations provide that base erosion payments are generally determined on a gross basis:
  - "***Except*** for [amounts paid or accrued with respect to mark-to-market position] or ***as permitted by the Internal Revenue Code or the regulations***, the amount of any base erosion payment is determined on a ***gross basis***, regardless of any contractual or legal right to make or receive payments on net basis." Prop. Treas. Reg. § 1.59A-3(b)(2)(ii).
- However:
  - Preamble: "[I]f there are situations where ***an application of otherwise generally applicable tax law*** would provide that a deduction is computed on a net basis (because an item received reduces the item of deduction rather than increasing gross income), the Proposed Regulations do not change that result."

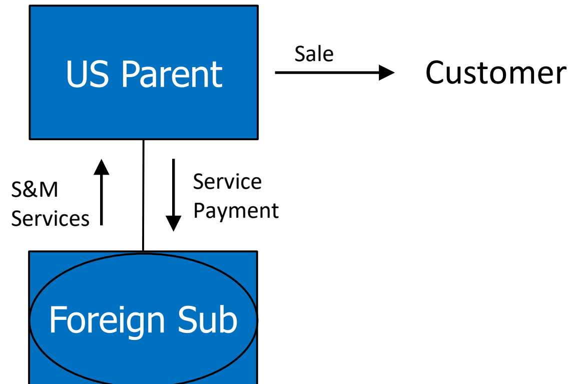
BEAT (cont'd)

- Netting in transfer pricing regulations:
  - Rather than each participant receiving (gross) royalty for contribution and paying (gross) royalty for benefits received, cost sharing regulations expressly contemplate netting of payments (either positive or negative) for each participant. Treas. Reg. § 1.482-7(j)(3), *Ex.* 3.
  - Treas. Reg. § 1.482-1(g)(4) also expressly permits set-offs, provided they do not change the characterization or source or otherwise distort taxable income in such a manner as to affect US taxable income.

BEAT (cont'd)

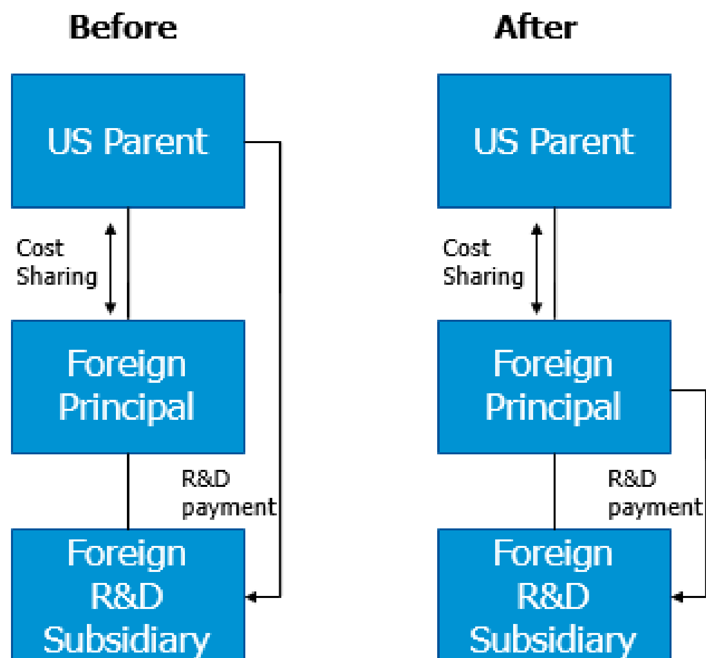
- APA issues:
  - Does APMA have authority to determine proper characterization of payments for BEAT purposes in APAs?
  - *Should* APMA determine proper characterization of payments for BEAT purposes?
  - Can existing APAs be modified or canceled because of the BEAT?
    - An APA may generally be revised by agreement of the parties.
    - *QUERY*: Is the enactment of BEAT a material change in applicable law?
      - "If controlling U.S. case law, statute, regulations, or treaties change the federal income tax treatment of any matter covered by the APA, the new case law, statute, regulations, or treaty provision supersedes any inconsistent terms and conditions of the APA." Rev. Proc. 2015-41, § 7.07.
    - If BEAT constitutes a material change in law, each case would need to be examined to determine whether or how the application of the BEAT to particular intercompany payments may change the agreed results.

Planning: CTB Election?



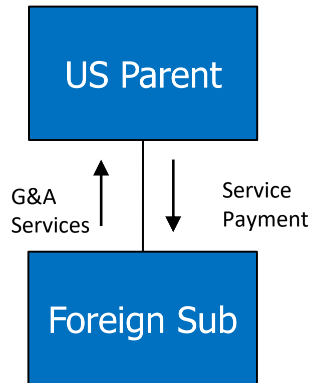
- An outbound payment for services (e.g. R&D or S&M) can be a base eroding payment
- Does a check-the-box ("CTB") election for a foreign affiliate make sense?
  - Now the outbound payment is a disregarded transaction
  - This is a low-impact approach from a legal and operational perspective
- Of course, CTB elections have other tax consequences (e.g. inbound liquidation, foreign branch income and foreign tax credit management)

Planning: Cost Sharing



- An outbound payment for R&D services can be a base eroding payment
- Under a cost sharing, the R&D contract can be moved to the foreign principal
- The payment from the foreign principal to the foreign R&D service provider is not a base eroding payment
- The US parent and the other cost sharing participant end up in the same place economically, since under either approach the R&D costs are added to the cost pool regardless of which entity makes the payment to the R&D subsidiary

Planning: Eligibility for SCM Exception



- An outbound payment for G&A services may be a base eroding payment
- A base erosion payment does not include any amount paid or accrued by the taxpayer for services if the service is eligible for SCM
- Taxpayers should revisit their outbound service payments for potential eligibility for SCM

BEAT Considerations in Transfer Pricing

- Taxpayers should evaluate whether their outbound payments to foreign related parties qualify for the SCM exception so as to avoid BEAT exposure.
  - If a payment is eligible for SCM but a markup is required for foreign tax purposes, only the markup component is considered a BEAT payment.
- BEAT should be taken into consideration in planning and structuring (or re-structuring) cross-border payments, including payments made pursuant to an APA.
  - Taxpayers are restructuring to avoid becoming subject to BEAT – and the affected transfer pricing arrangements must be reviewed and updated.
  - Arm's length determinations to be made annually.
- Pursuant to the newly proposed regulations, BEAT generally applies on a gross basis and netting may not be available, including in the transfer pricing context.
  - Not always clear when netting is permitted in the BEAT context.
- BEAT and APAs:
  - Can an APA expressly address the characterization of a payment for BEAT purposes?
  - Would an APA's characterization of payments in a covered transaction be respected for BEAT purposes?

Section 267A

- Section 267A is modeled generally after BEPS Action 2.
- It denies deductions for interest and royalty payments between related parties made to, or by, a hybrid entity or with respect to a hybrid instrument.
  - In this context, "related" generally means more than 50 percent ownership by vote or value, though constructive ownership rules apply.
- Treasury recently promulgated very broad proposed regulations implementing this new rule.
  - Applies in certain situations even where a payment is fully included in income in the recipient's foreign jurisdiction.
  - May apply even if a royalty/interest payment is made to an unrelated recipient if (i) hybrid mismatch is priced into the terms of the arrangement, or (ii) hybrid mismatch is a principal purpose of the arrangement.

Section 267A

- Even if a royalty or interest payment is arm's-length, and covered by an APA, a deduction may be disallowed under § 267A.

Restructuring Considerations

Should Existing Structures Be Unwound?

- ***Pros*** to unwinding existing structures
  - Although calculations need to be made on case-by-case basis, in some cases (e.g., significant BEAT or non-C corporation shareholder of CFC not entitled to GILTI deduction) there may be a net tax benefit to unwinding existing offshore structures.
  - Even if the existing structure continues to produce net tax benefits, such benefits may be reduced to the point that the tax rate arbitrage benefit is now outweighed by countervailing considerations, such as IRS defense and administrative costs.
- ***Cons*** to unwinding existing structures
  - Existing offshore structures may provide indispensable non-tax benefits (e.g., an Irish CFC may be better able to serve EU customers than the U.S. parent group for commercial and regulatory reasons) that may justify their continued existence.
  - Although unwinding might reduce IRS audit risk in the long-term, the restructuring transaction (particularly if it involves transfers of IP) may be heavily scrutinized by the IRS and non-U.S. tax authorities.
  - There can be tax costs to moving operations, such as an exit tax.
  - The tax law may change again in a way that may contra-indicate restructuring now.

Restructuring Considerations

- ***Pros*** to restructuring
  - In some cases, post-Tax Reform business and tax strategies may align.
    - Locating capital-intensive manufacturing in a CFC in a low cost, low tax jurisdiction may improve pre-tax cash flows (by reducing costs) and reduce the group's effective tax rate ("ETR").
- ***Cons*** to restructuring
  - New potential structures to maximize post-Tax Reform benefits may not always align with business realities.
    - For example, manufacturing goods and providing services for non-U.S. markets from the U.S. to maximize FDII may increase costs more than any potential tax savings.
    - Making capital investments in CFCs to minimize GILTI and deferring investments in the U.S. to maximize FDII may not make business sense.
  - New structures may create new foreign transfer pricing exposures even if respected by the IRS.
    - If intercompany transactions are determined to be not commercially rational or reflective of the actual substance of the relationship between related parties, as required by BEPS Actions 8-10, they could be re-characterized.

Update on OECD Working Party 6 Developments and Considerations for Taxpayers' Intercompany Transactions

Moving Beyond Arm's-length?

- Current Anti-BEPS measures do not necessarily address certain tax issues, including how to address the digital economy.
- OECD released a public consultation document February 2019 proposing solutions to these issues.
  - One of the proposals is to allocate taxing rights to jurisdictions based on "user participation" and "marketing intangibles" under the assumption that users/marketing create value (curtailing "physical presence" shortfalls).
  - This is intended to address the concerns of emerging and developing markets that argue the rules unfairly allocate too large a share to residence countries.
  - This proposal would likely necessitate at least some revision of existing transfer pricing rules (e.g., allocating more value to marketing intangibles).
- OECD timeline aims to provide final solutions in 2020.