

# Locating Intangibles - 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

3

## Changing Landscape of International Tax & Transfer Pricing

### US Tax Reform

- ▶ Significant reduction in corporate tax rate to 21%
- ▶ Foreign Derived Intangible Income benefit - potential to further reduce rate to 13.125%
- ▶ Global Intangible Low Taxed Income - effectively creates global minimum tax rate

4

## 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?

5

## 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 transferring to foreign jurisdiction
- ▶ Uncertainty remains due to changing political environments

6

# Foreign Derived Intangible Income ("FDII") - Overview and Practical Calculation

7

## 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 Production Activities Deduction (DPAD), which was repealed by the TCJA, and the great-grandchild of the DSS, FSC, EIE regimes
- ▶ The new regime allows a domestic corporation to take an additional deduction based on the amount of such corporation's "foreign-derived intangible income"
  - ▶ 37.5% of FDII for tax years beginning 2018 through 2025
  - ▶ 21.875% of FDII for tax years beginning after 2025
- ▶ Effective Tax Rate on FDII
  - ▶ 13.125% for tax years beginning 2018 through 2025
  - ▶ 16.406% for tax years beginning after 2025

8

## The Calculation - Practical Approach

- ▶ Starting Point for the Calculation
  - ▶ Deduction Eligible Income (DEI) - per the statute
    - ▶ All of the domestic corporation's income other than
      - ▶ Subpart F income
      - ▶ GILTI income
      - ▶ Foreign branch income
      - ▶ Domestic oil and gas extraction income
      - ▶ Dividends from a CFC (generally subject to new Participation Exemption)
    - ▶ Properly Allocable Deductions
  - ▶ Practical considerations
    - ▶ Taxable Income or Book Income - what's the basis for your provision calculation?
    - ▶ How do I determine what are "properly allocable deductions"?

9

## 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 Intangible Income Return
  - ▶ Same definition as for GILTI except it looks at the US balance sheet
  - ▶ Depreciable Assets - key factor
    - ▶ Average based on quarter-end amounts
    - ▶ Only looking at property that is used in the trade or business
      - ▶ Since depreciation under Section 167 also includes assets held for the production of income, QBAI may not include the entire fixed asset ledger used for depreciation
  - ▶ When determining the basis of your depreciable assets, depreciation should be re-computed using the alternative depreciation system (ADS)
    - ▶ Straight-line method
    - ▶ Pre-determined recovery period (class life)

10

## The Calculation - Practical Approach

- ▶ Foreign-Derived Deduction Eligible Income (FDDEI)
  - ▶ Carve this out from DEI or build up separately
    - ▶ Direct Foreign Sales/Services
    - ▶ Related Party Sales/Services
  - ▶ Do not include foreign branch sales
  - ▶ Do not forget to allocate deductions to your FDDEI
    - ▶ Allocation & Apportionment methodology
  - ▶ Additional detail about how to determine foreign sales/services will be discussed *infra*

11

## The Calculation - Practical Approach

- ▶ How much is my deduction before limitation?
  - ▶  $\text{DEI less (10\%x QBAI) = Deemed Intangible Income}$
- ▶ Foreign Derived Intangible Income Percentage =
 
$$\frac{\text{FDDEI (e.g, Foreign Sales/Services Income)}}{\text{DEI (All income less exclusions)}}$$
- ▶  $\text{FDII Percentage} * \text{Deemed Intangible Income} = \text{FDII}$
- ▶  $\text{FDII} * .375 \text{ (pre-2026 years)} = \text{Your deduction}$

12

# The Calculation - Practical Approach

- ▶ The Limitation
  - ▶ Taxable Income Threshold imposed on the FDII Deduction
    - ▶ FDII deduction is reduced before GILTI deduction
    - ▶ Need to consider current year loss and C/F NOL usage
  - ▶ US Taxable Income (includes GILTI & 78 Gross-up) (US TI)
    - ▶ Does not include the deductions for GILTI and FDII
  - ▶ Sum of your FDII, GILTI & 78 Gross-up (SUM)
  - ▶  $SUM - US\ TI = Excess$
  - ▶ If no Excess, then no limitation
  - ▶ If Excess, then reduce FDII by the Reduction Ratio
    - ▶ Reduction ratio =  $FDII/SUM$

13

## Generating and Maximizing FDII

14

## 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.<sup>15</sup>

## Sale of Tangible Property

- ▶ Sourcing rule analogies for the “use, consumption, or disposition” of tangible property can be found in the DISC rules and Foreign Base Company Sales Income (FBCSI) rules:
  - ▶ DISC Rules - Property must be sent outside U.S. and must ultimately be used outside the U.S. In addition, supporting documentation is required to substantiate. (Section 993(c)(1), Treas. Reg. 1.993-3(d))
    - ▶ Includes a 3 year lookback anti-abuse rule to ensure that ultimate use was outside the US.
    - ▶ Acceptable documentation includes customs documentation and certificate of carrier.
  - ▶ FBCSI Rules - Use, consumption, or disposition of property is presumed to be in country of destination, unless taxpayer knew or should have known that another country was where the property was used, consumed, or disposed of. (Section 954(d)(1)(B), Treas. Reg. 1.954-3(a)(3)(ii))
  - ▶ Consider complications due to the use of a carrier or freight forwarder.
- ▶ Inventory is not the only tangible property that would qualify for FDII. Treasury has stated that mobile property used in the business offshore may qualify.



## Sale of Tangible Property (continued)

- ▶ Components Rule - For purposes of the related party sale rule, a sale of property shall be treated as the sale of each of its components.
  - ▶ This may involve tracing of components.
- ▶ Potential presumption: In JCT Explanation n. 1522, “if property is sold by a taxpayer to a person who is not a U.S. person, and after such sale the property is subject to manufacture, assembly, or other processing (including the incorporation of such property, as a component, into a second product by means of production, manufacture, or assembly) outside the United States by such person, then the property is for a foreign use.”
  - ▶ Consider the FBCSI determination of manufacturing activity in Treas. Reg. 1.954-3(a)(4).
  - ▶ An anti-abuse rule may be created to prevent roundtripping through the use of a foreign contract manufacturer.

17

## 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.

18

## 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 is for the use or the privilege of using the property outside the United States. (Section 862(a)(4))
  - ▶ FPHCI Rules - Rental and royalty income is sourced based on where the expenses associated with the exploitation of the intangible property are incurred. (Treas. Reg. 1.954-2(b)(4)(vii)(A))
- ▶ Consider whether the platform contribution transaction (PCT) payments in cost sharing arrangements would qualify.
- ▶ If a foreign related party is used as an intermediary, consider whether there are any Subpart F implications resulting from sales from the foreign related party. Subpart F could increase the effective tax rate for the chain of transactions up to 21%.

19

## Foreign Use - Services

- ▶ Sourcing rule analogies for services are not readily available in U.S. federal income tax law, since the provision appears to look towards the location where the service recipient enjoys the commercial benefit of the service.
- ▶ This appears to be similar to market-based sourcing rules in state & local tax law. These generally provide tiers (e.g., customer billing address) for determining where benefits are received.
- ▶ The OECD International VAT/GST Guidelines are another analogy for the sourcing of services:
  - ▶ On-the-spot business-to-consumer services - Determined by reference to place of physical performance.
  - ▶ Remotely performed business-to-consumer services - Determined by reference to customer address.
  - ▶ Business-to-business services - Determined by reference to the customer's place of business (identified by analyzing business agreements)

20

## Foreign Use - Services (continued)

- ▶ Transportation services - Due to the specific challenges in the sourcing of these services, several potential approaches have been proposed:
  - ▶ All of the income from a trip that has either an origin or a destination outside of the U.S. is foreign use.
  - ▶ Predominant location method (based on mileage) similar to the FPHCI rules in Treas. Reg. 1.954-2(c)(2)(v).
- ▶ Substantially Similar Anti-Abuse Rule - If a service is provided to a related party who is not located in the United States, such service shall not be treated as FDII unless the taxpayer established to the satisfaction of the Secretary that such service is not substantially similar to services provided by such related party to persons located within the United States.
  - ▶ Appears to be an attempt to prevent back-to-back services.
  - ▶ Consider how “substantially similar” may be defined.
  - ▶ Consider sourcing issues if sourcing based on customer location (e.g., customer uses service while traveling to U.S.)
  - ▶ Is this a cliff or will there be a de minimis threshold?

21

## 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.

22

## 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.

23

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

24

## 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

25

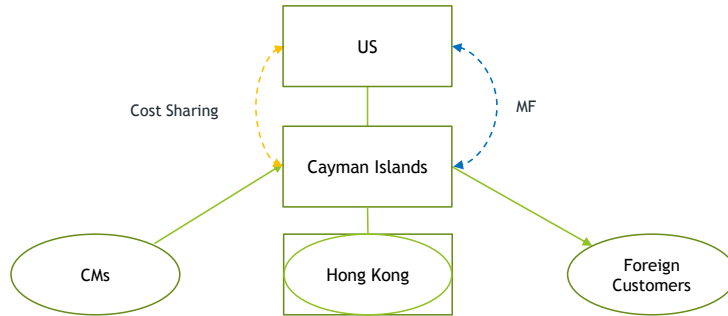
## FDII - Context with GILTI

- ▶ 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 - eligible for FDII (21% US corporate tax rate reduced to 13.125%)
- ▶ Needless to say, it won't always work that way in practice.

26

# FDII v. GILTI - "Old School" Tech Example

Example: Fabless Chip Company



**Base Facts**  
 US Profit (MF) = 100x  
 Cayman Profit = 1000x  
 Foreign QBAL = 0x

27

## FDII - Fabless Chip Company

Results:

US Profit*	100x
GILTI (Gross Inclusion)	1,000x
Section 250(a)(1)(B) Reduction	<u>(500x)</u>
Taxable Income	500x
US Federal Income Tax (21%)	126x
<b>Global Effective Tax Rate (126x/1100x)</b>	<b>11.45%</b>

\* Available for FDII Section 250 deduction

28

## FDII vs. GILTI: Fabless Chip Company

### FDII Alternative #1: Cayman Royalty Structure

US Profit*	100x
Royalty Income (Max)	1,000x
Less: Section 250 Deduction	<u>(375x)</u>
Taxable Income	725x
US Federal Income Tax (21%)	152x
<b>Global Tax Rate (152x/1100x)</b>	<b>13.82%</b>

\* Available for FDII Section 250 deduction

29

## FDII vs. GILTI: Fabless Chip Company

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

Total Taxable Income	1,100x
Less: Section 250 Deduction	<u>(413x)</u>
Taxable Income	687x
US Federal Income Tax (21%)	144x
<b>Global Tax Rate (144x/1,100x)</b>	<b>13.10%</b>

- ▶ 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.

30

## FDII vs. GILTI: Chip Company with Fabs/OEM (even more old-school)

### Base Facts:

US Profit	100x
Foreign Profit - IP	1,000x
Manufacturing (“Tangible”) Profit	1,000x
Foreign QBAI	10,000x

- ▶ Two foreign tax options: tangible assets are taxed 10% or 30% (roughly). Intangible profit is taxed at zero in the foreign jurisdiction (possibly not a sustainable result given BEPs and global populism).

31

## FDII vs. GILTI: Chip Company with Fabs/OEM

### Results:

Foreign Tax Rate:	10%	30%
US Profit	100x	100x
GILTI (IP Profit)	1,000x	1,000x
Section 78 Gross Up (est.)	50x	150x
Section 250(a)(1)(B)	<u>(500x)</u>	<u>(500x)</u>
US Taxable Income	650x	750x
US Federal Income Tax	137x	158x
FTC (next slide)	<u>(40x)</u>	<u>(120x)</u>
New US FIT	97x	38x
Global Effective Tax Rate	$(97x+100x)/2,100x=9.38\%$	$(38x+300x)/2,100x=16.10\%$



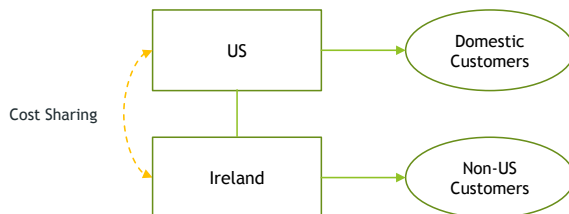
# FDII vs. GILTI: Fabless Chip Company

Foreign Tax Rate:	10%	30%
GILTI (IP Profit)	1,000x	1,000x
DTIR	1,000x	1,000x
GILTI Inclusion (%)	50%	50%
Foreign Taxes	100x	300x
FTC Potential	$(100x \times 50\% \times 80\%) = 40x$	$(300x \times 50\% \times 80\%) = 120x$

33

# 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:**

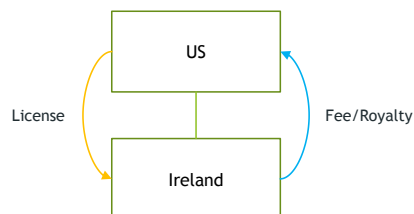
GILTI (w/ Sec. 78 GU)	1,000x
Section 250 Deduction (FDII)	<u>(500x)</u>
Net	500x
US Income	<u>1,000x</u>
Total US Taxable	1,500x
Federal Income Tax (21%)	315x
80% FTC	<u>(100x)</u>
Net US FIT	215x

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

34

# FDII v. GILTI - SaaS Example w/Limited Risk Distributor

Minimize Foreign Profit / LRD Model



**Base Facts:**

US Profit =	1,000x
Initial License Fee =	900x
Irish Profit =	100x

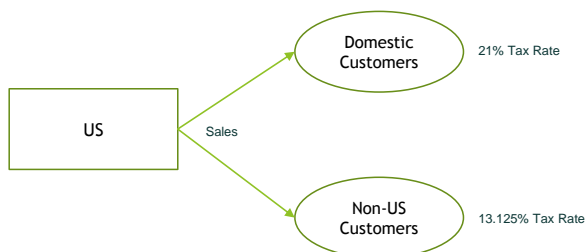
**Tax Computation:**

GILTI (w/ Sec. 78 GU)	100x
Section 250 (FDII)	<u>(50x)</u>
Net	50x
FDDEI	900x
Section 250 Deduction (FDII)	(337.5x)
US Profit	<u>1,000x</u>
Taxable Income	1,612.5x
US Federal Income Tax (21%)	339x
80% FTC	<u>(10x)</u>
Net US FIT	329x

Global ETR = (329x+12.5x)/2,000x = 17.1%

35

# FDII v. GILTI - Distribution/e-Commerce



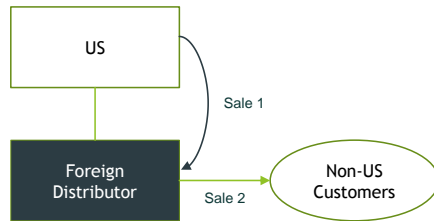
**B2C Platform**

- Safe to presume foreign buyers qualify as “foreign use?”
- Does not seem to matter whether product is produced in the US.
- What about BEPS?

36

# 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 "foreign use"
- Easier proving foreign use with third-party distributor?

37

## FDII - Extra Credit

- ▶ Limitation of FDII: the Section 250 deduction is (apparently) available only for C-corporations
- ▶ Same with the GILTI Section 250 deduction
- ▶ Should we all become C-corporations now?
- ▶ Consider three exporters:

	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 Tax (Residual)	0x	103x	206.75x
<b>Total</b>	<b>279x (27.9%)</b>	<b>287.5x (28.8%)</b>	<b>338x (33.8%)</b>

\*Note that to qualify for IC-DISC benefits, the product must be US-produced.

## 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

39

# QUESTIONS?

40

## Presenters

### **Sanjay Agarwal JD, LLM**

MGO LLP

Partner

(415) 963-3764

sagarwal@mgocpa.com

### **Ken Harvey**

Moss Adams LLP

Partner

(415) 677-8272

ken.harvey@mossadams.com

### **Lisa Askenazy Felix**

Armanino LLP

Director, Tax

(669) 800-6800

lisa.felix@armaninollp.com

### **Allan Smith**

Grant Thornton LLP

Partner

(408) 216-8540

allan.smith@us.gt.com