

# **30<sup>th</sup> Annual Institute on Current Issues in International Taxation**

## **Hot Topics in Supply Chain Planning**

November 30, 2017

# Panel

## Chair

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## Panelists

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# AGENDA

- U.S. Tax Reform: Supply Chain & IP Impacts
- Procurement Structure Issues: Sales or Services Income?
- Technology: Disrupting Supply Chains & the Tax Law
- Branch Rule Issues

# U.S. Tax Reform: Supply Chain & IP Impacts

# Foreign High Return Amount (FHRA) and Global Intangible Low-Taxed Income (GILTI)

Element	FHRA	GILTI <sup>1</sup>
U.S. Shareholder Inclusion	50% of U.S. shareholder's <b>net CFC tested income</b> less the excess of (1) a <b>benchmark return</b> on its CFCs' <b>bases in tangible depreciable assets</b> used to derive tested income/loss over (2) interest expense taken into account in determining net CFC tested income	Similar, but— ▪ no adjustment to benchmark return for interest expense ▪ 100% inclusion <b>reduced to 50% for corps</b> after deduction <sup>2</sup>
Net CFC Tested Income	U.S. shareholder's pro rata share of aggregate <b>CFC tested income</b> minus aggregate <b>CFC tested loss</b> CFC tested income: CFC gross income (without regard to <b>Exclusions</b> ) less allocable deductions	Same
Exclusions	<ul style="list-style-type: none"> <li>▪ ECI, subpart F income, high-taxed amounts under §954(b)(4), and related-party dividends</li> <li>▪ Look-thru amounts under §954(c)(6), active financing, insurance, or dealer exceptions</li> <li>▪ Income from CFC-produced commodities</li> </ul>	<ul style="list-style-type: none"> <li>▪ Same</li> <li>▪ Foreign oil and gas extraction and foreign oil-related income</li> </ul>
Basis in CFC Property	Adjusted bases of depreciable tangible property determined as of year-end	Same, using average of quarter-end bases
Benchmark Return	Short-term AFR + 7%	10%
Foreign Tax Credit	<ul style="list-style-type: none"> <li>▪ <b>80%</b> of taxes on tested income; <b>100%</b> §78 gross-up of FHRA</li> <li>▪ Separate §904 basket; no carryforward</li> </ul>	Same
Observations	<ul style="list-style-type: none"> <li>▪ Corps can eliminate U.S. residual tax via FTCs if foreign ETR on tested income is <b>12.5%+</b></li> <li>▪ Maximum U.S. tax rate is half of the U.S. rate (e.g., <b>10%</b> for corps)</li> <li>▪ As the foreign ETR falls below 12.5%, it is not entirely replaced by an equal amount of U.S. tax on the FHRA</li> <li>▪ Consider pulling high-tax income out of FHRA into sub F income if pool sufficiently high taxed.</li> <li>▪ Ensure appropriate mix of high-tax and low-tax CFCs under a U.S. shareholder because FHRA is not determined on a consolidated group basis</li> <li>▪ Individuals and REITs treated differently—because <b>deemed paid</b> taxes eliminate this tax, individuals, trusts, and REIT shareholders are always taxable on half of their FHRA</li> </ul>	<ul style="list-style-type: none"> <li>▪ Same</li> <li>▪ Individuals much worse under GILTI because no deduction<sup>2</sup></li> </ul>

<sup>1</sup> Certain proposed changes to GILTI that apply post-2025 are not reflected here

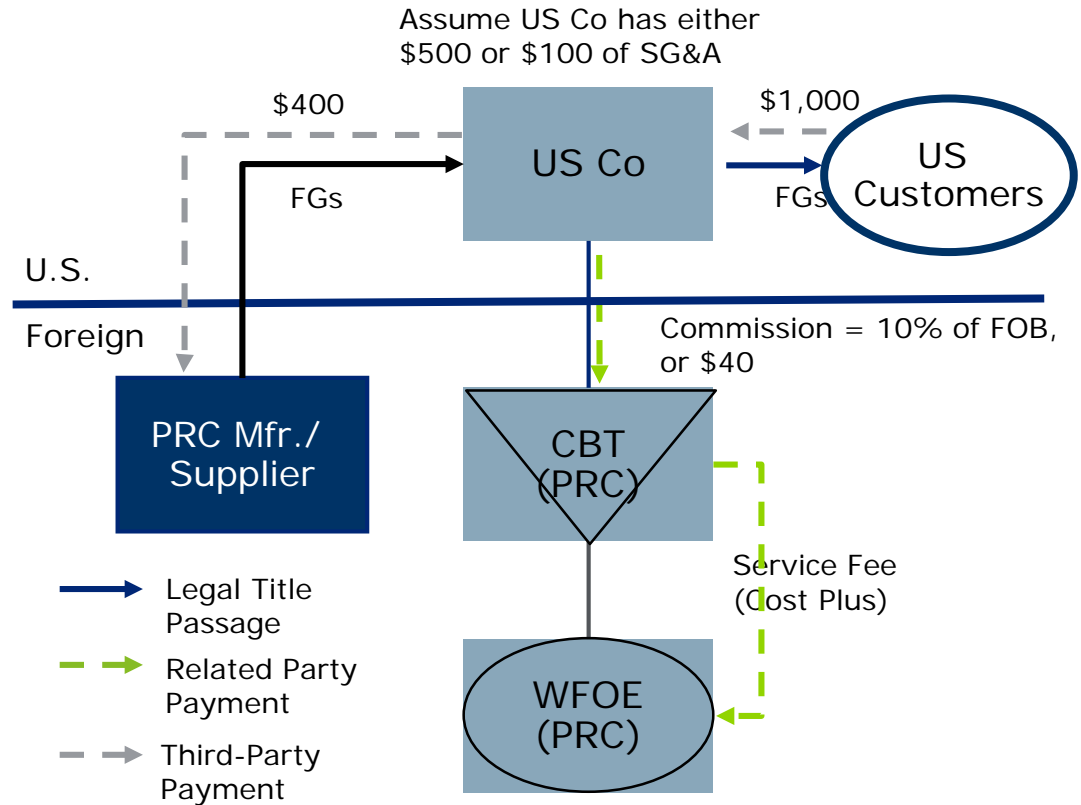
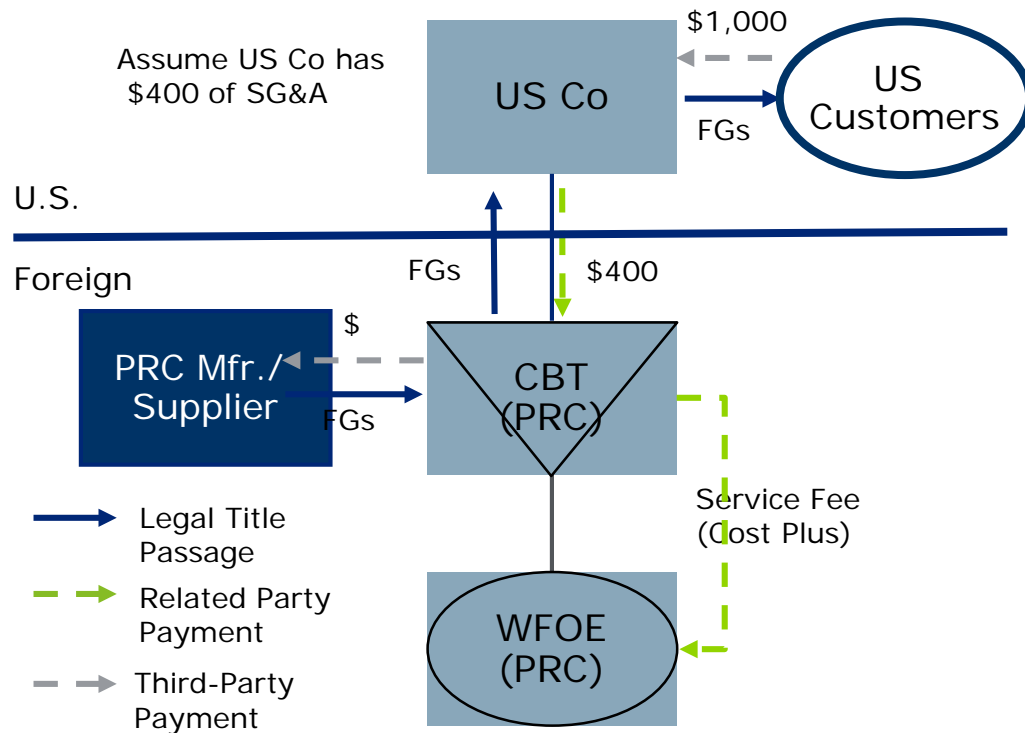
<sup>2</sup> See slide 9 for additional discussion of deduction for foreign-derived intangible income

# Excise Tax Overview

Element	Excise Tax
Rule / Rate of Tax	<b>Excise tax on Specified Amounts (SAs):</b> <b>20%</b> tax imposed on <b>SAs</b> paid or incurred by a domestic corporation to a related foreign corporation
Applicable Taxpayer	Domestic corporations in an <b>international financial reporting group (IFRG)</b> (group of entities that prepares consolidated financial statements)
Taxable Base	<b>Specified Amount:</b> Any amount allowable to the payor as a <b>deduction</b> or includible in the payor's <b>COGS, inventory</b> , or the <b>basis</b> of a depreciable or amortizable asset, <b>except—</b> <ul style="list-style-type: none"> <li>▪ Interest</li> <li>▪ Acquisition of a security or commodity defined in §475(c)(2) and (e)(2), respectively</li> <li>▪ U.S.-source FDAP income, to the extent taxed at 30% under section 881(a)</li> <li>▪ No-markup services, if payor elected to use the services cost method</li> <li>▪ ECI</li> </ul> <b>ECI election:</b> Related foreign corporation may <b>elect</b> —revocable only with consent—to treat SAs paid or accrued as ECI. Only <b>Deemed Expenses</b> are allowed as a deduction against SAs treated as ECI under §882(g).
Deemed Expenses	Amount of expenses such that the <b>net income ratio</b> (EBIT divided by revenue) of the foreign corporation with respect to the SA (taking into account only the SA and deemed expenses) is equal to the <b>net income ratio</b> of the IFRG determined with respect to the product line to which the SA relates
Safe Harbor	IFRG with 3-year average annual aggregate SAs of no more than \$100 million
Foreign Tax Credit	For deemed ECI election, <b>80%</b> of the amount of taxes paid or accrued is creditable
Observations	<ul style="list-style-type: none"> <li>▪ <b>Safe Harbor</b> based only on <b>SAs</b></li> <li>▪ <b>Cost-sharing payments</b> appear to be within scope of a specified amount</li> <li>▪ <b>Interest</b> payments excluded</li> <li>▪ Query interaction with <b>tax treaties</b></li> <li>▪ FHRA Interaction: SAs that give rise to <b>ECI</b> (even if deemed) are excluded from FHRA</li> <li>▪ JCT description indicates the branch profits tax is implicated in the case of an ECI election</li> <li>▪ Determine proper <b>U.S. GAAP</b> treatment (i.e. above or below-the-line deduction)</li> </ul>

# Supply Chain Planning

## CBT – Convert Buy-Sell to Commission



### Tax Reform Considerations

- The commission structure subjects a smaller specified amount to the excise tax (\$40 instead of \$400)
- The commission structure is less likely to result in an IFRG that would be subject to the excise tax (by staying below the \$100M specified amount threshold)
- Note: COGS are not considered a deduction under the Senate version of the provision (other than for inverted companies)

# Base Erosion Anti-Abuse Tax (BEAT) Overview

Element	BEAT <sup>1</sup>
U.S. Tax	<p><b>Applicable Taxpayer</b> pays <b>Base Erosion Minimum Tax Amount</b> (BEMTA) if:</p> <ul style="list-style-type: none"> <li>▪ <b>10%</b> of its <b>modified taxable income</b> exceeds</li> <li>▪ its regular tax liability (reduced by credits other than §41(a) research credits)</li> </ul>
Applicable Taxpayer	Corporations (excluding RICs, REITs, and S corps)
Taxable Base	<p><b>Modified Taxable Income:</b>  <b>Taxable income</b> determined without regard to—</p> <ul style="list-style-type: none"> <li>▪ <b>Base erosion tax benefits</b> with respect to <b>base erosion payments</b> <ul style="list-style-type: none"> <li>○ Amounts paid or accrued to a foreign related party (generally, 25% “relatedness”), including in connection with the acquisition of depreciable/amortizable property</li> <li>○ Amounts constituting a reduction in gross receipts paid or accrued to a related <b>surrogate foreign corporation</b> or a foreign member of the surrogate foreign corporation’s expanded affiliated group</li> <li>○ <b>Excludes—</b> <ul style="list-style-type: none"> <li>– Base erosion payments taxed at 30% under §§871 or 881</li> <li>– No-markup services, if certain requirements in §482 met</li> </ul> </li> </ul> </li> <li>▪ Base erosion percentage of any NOL</li> </ul>
Safe Harbor	<ul style="list-style-type: none"> <li>• 3-year average annual gross receipts (including those of related domestic corporations and ECI of foreign corporations) of \$500 million or less</li> <li>• Base erosion percentage (ratio of base erosion tax benefits to all deductions excluding deductions allowable under §§172, 245A, and 250) of <b>less than 4%</b> for the taxable year</li> </ul>
Foreign Tax Credit	N/A
Observations	<ul style="list-style-type: none"> <li>▪ <b>Interaction</b> with GILTI and ECI under §882 could give rise to double <b>U.S.-taxed payments</b></li> <li>▪ <b>Financial transactions</b> (swaps, forwards, etc.) <i>could</i> qualify as base erosion payments</li> <li>▪ If taxpayer’s regular tax liability is reduced more than <b>50% by credits</b> or if taxpayer’s taxable income is reduced more than <b>50% by base erosion payments</b>, BEAT may impose additional tax</li> <li>▪ COGS not included in base erosion payments</li> <li>▪ Application to taxpayers with large NOLs</li> </ul>

<sup>1</sup> Certain proposed changes to GILTI provision post-2025 are not reflected here



## Tax on Base Erosion Payments

- The Senate proposal imposes a minimum tax equal to the **base erosion minimum tax amount** ("BEMTA") of an **applicable taxpayer** for a taxable year.

$$\text{Applicable Taxpayer's BEMTA} = 10\% \times \text{modified taxable income} - \text{regular tax liability less tax credits (excluding §41(a) research credits)}$$

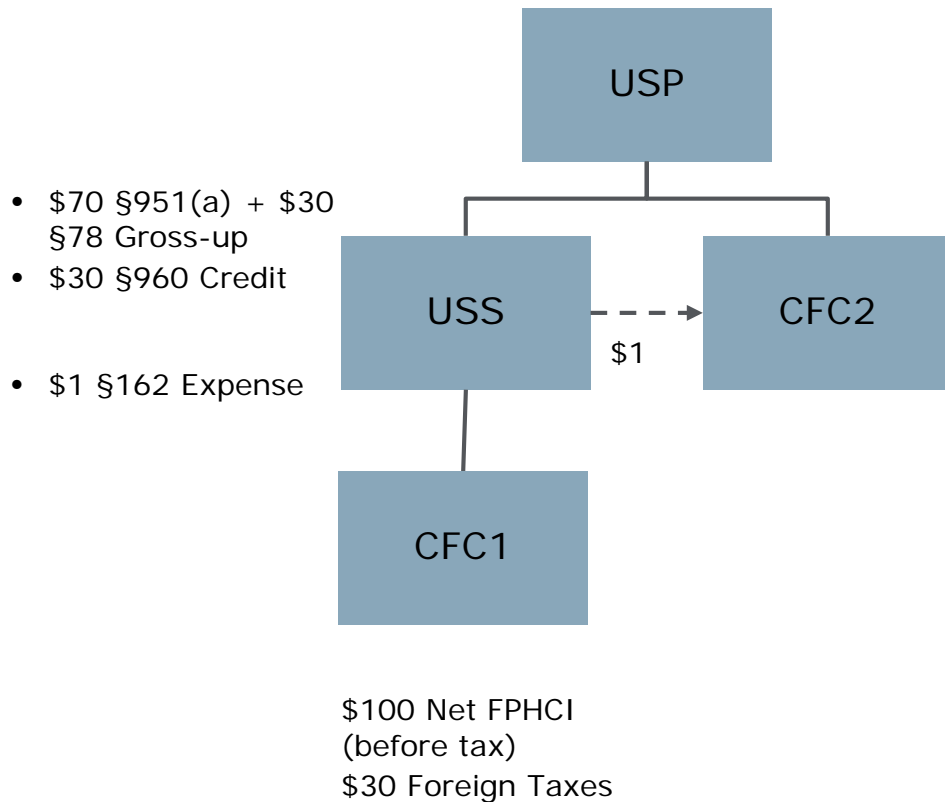
- An **Applicable Taxpayer** is generally any corporation other than a REIT, RIC, or S corporation.
  - An applicable taxpayer only includes corporations that have average annual gross receipts greater than \$500 million for the previous 3 taxable years (taking into account related U.S. corporations' gross receipts, and in the case of a foreign taxpayer, gross receipts attributable to ECI).
  - 4% Safe Harbor**: There exists a safe harbor for corporations that have a **base erosion percentage** of less than 4 percent for the taxable year.
- Modified taxable income** ("MTI"):
  - The applicable taxpayer's Chapter 1 taxable income in a taxable year determined without regard to a **base erosion tax benefit** (a **deduction allowed** in the taxable year with respect to a **base erosion payment**).
  - A base erosion tax benefit does not include deductions attributable to base erosion payments that are taxed under sections 871 or 881 and withheld upon under sections 1441 or 1442. If such payments are subject to a reduced rate of tax, this exclusion only applies to the proportion of such reduction.

# Tax on Base Erosion Payments

- Modified taxable income (cont.)
  - Modified taxable income also includes a **percentage of NOLs equal to the NOL's base erosion percentage** (defined on the next slide).
  - A **base erosion payment** is defined broadly to include any amount paid or accrued by a taxpayer to a related foreign person **with respect to which a deduction is allowable**.
    - A base erosion payment also includes a payment to a related foreign person in connection with the acquisition of property subject to depreciation or amortization deductions and a payment that reduces a taxpayer's gross receipts made to related surrogate foreign corporations defined in section 7874(a)(2) or a foreign member of a related surrogate foreign corporation's EAG.
  - A taxpayer's **base erosion percentage** is equal to the ratio of:
    - the taxpayer's aggregate deductions with respect to base eroding payments, over
    - the taxpayer's total amount of Chapter 1 deductions (including deductions with respect to base erosion payments) other than deductions allowed under §§172 (NOLs), 245A (relating to the bill's 100% DRD), and 250.<sup>1</sup>
- **Regular tax liability** (RTL) is given the same meaning as in section 26(b), and is generally defined as a taxpayer's tax liability under Chapter 1, excluding certain excise and U.S. source taxes (e.g., gross basis tax on FDAP income under sections 871 and 882 and branch profits tax under section 884).

<sup>1</sup> It is assumed that §250 provides the new deduction for foreign-derived intangible income

# Interplay Between Credits and BEAT



\* For purposes of the BEAT computation, assume that USS qualifies as an Applicable Taxpayer

## BEAT

- Base Erosion Payment: \$1
- 4% Safe Harbor: Does not qualify
  - USCo Base Erosion Percentage: 100%  
 $\$1 / \$1 = 1$  or 100%
- **BEMTA** =  $\text{MTI} \times 10\% - (\text{RTL} - \text{Non-R\&E Credits})$ 
  - **MTI**: \$100  
 $\$100$  Taxable Income  
 $- \underline{\$0}$  Deductions (without regard to BEPs)  
 $\$100$
  - **RTL**: 19.8  
 $\$100$  Taxable Income  
 $- \underline{\$1}$  Deductions  
 $\$99$   
 $\times \underline{20\%}$  Corporate Rate  
 $\$19.8$
- **FTC**: \$19.8

### Residual U.S. Tax

- $\$100 \times 10\% = \$10$
- Less RTL = \$0
- BEAT = \$10

### Key Takeaways

- \$1 of §162 deduction prevented taxpayer from utilizing §960 FTCs to reduce U.S. ETR below 10%, resulting in double U.S. tax on CFC1's income
- Either eliminating the base eroding payment or generating non-base erosion payment deductions to qualify for the 4% safe harbor could prevent application of the BEMTA provisions

# Deduction for Foreign-Derived Intangible Income (FDII)

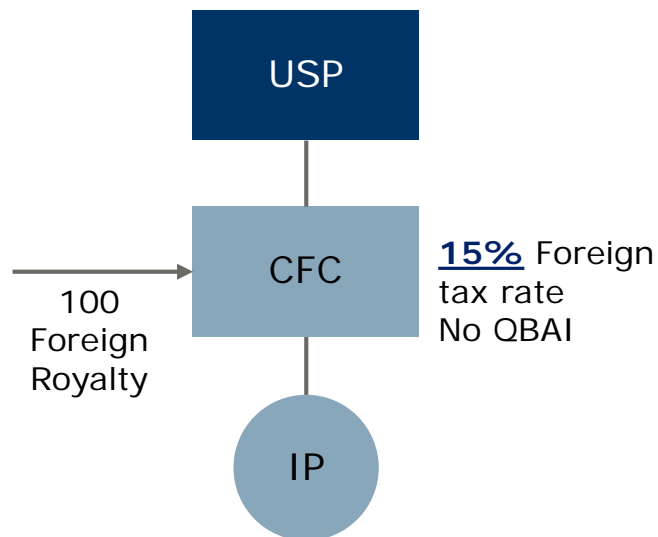
Element	Senate Deduction for Foreign-Derived Intangible Income (FDII)
Amount of Deduction	<b>37.5%</b> of the lesser of: (1) The sum of <b>foreign-derived intangible income (FDII)</b> plus GILTI; or (2) Taxable income determined without regard to the deduction for FDII.
Applicability	Applies annually to domestic corporations for taxable years beginning after December 31, 2017, and before January 1, 2026. The <b>deduction for FDEII is reduced from 37.5% to 21.875% for taxable years beginning after December 31, 2025.</b>
Amounts Eligible for Deduction	<p><b><u>FDII</u></b> = Deemed Intangible Income (DII) x [Foreign-Derived Deduction Eligible Income (FDDEI) / Deduction Eligible Income (DEI)]</p> <p><b><u>DEI</u></b>: Gross income determined without regard to: (1) subpart F income; (2) GILTI; (3) CFC dividends; (4) domestic oil and gas income; and (5) any foreign branch income under §904(d)(2)(J)), less allocable deductions (including taxes).</p> <p><b><u>FDDEI</u></b>: DEI that is generally derived in connection with sales of property intended for foreign use, and services provided to any person, or with respect to property, not located within the United States.  <i>*Special rules apply to sales/services to related parties.</i></p> <p><b><u>DII</u></b> = Excess of DEI over <b>deemed tangible income return (DTIR)</b>.</p> <p><b><u>DTIR</u></b> = 10% x <b>Qualified Business Asset Investment (QBAI)</b>  <i>*QBAI is generally defined the same as in the GILTI provisions.</i></p>
Observations	<ul style="list-style-type: none"> <li>• A <b>37.5% deduction</b> results in a <b>12.5% U.S. effective rate</b> on the FDII. A <b>21.875% deduction</b> results in a <b>15.625% U.S. effective rate</b> on the FDII.</li> <li>• Query whether royalty income falls within the definition of FDDEI. The JCT explanation provides that the terms “sold,” “sells,” and “sale” include any lease, exchange, or other disposition, but does not specifically reference “license.”</li> </ul>

# Special Rules Domestication of U.S. Shareholders

Element	Senate Special Rules for Transfers of IP from CFC to U.S. Shareholders
Rule	For certain distributions of intangible property ("IP") by a CFC, the fair market value (FMV) of the IP is treated as <u>not</u> exceeding the adjusted basis (AB) of the property immediately before the distribution.
Applicability / Effective Date	Applies to <b>distributions by a CFC to its U.S. shareholder</b> that are <b>made before the last day of the third taxable year of the CFC beginning after December 31, 2017.</b>
Definition of IP	IP described in section 936(h)(3)(B) (including workforce in place, foreign and domestic goodwill, and going concern value), as well computer software described in section 197(e)(3)(B).
Basis Adjustments	<p>If the distribution is <u>not</u> a dividend, U.S. shareholder's AB in its CFC stock is increased by the amount of the distribution that would, but for this proposal, be includible in gross income.</p> <p>The AB of the IP immediately after the distribution is the AB of the property immediately before the distribution, reduced by the amount of the increase (if any) described above.</p>
Observations	<ul style="list-style-type: none"> <li>• <b>CFC presumably recognizes no gain under section 311(b)</b> if the IP has a FMV &gt; AB.</li> <li>• To the extent that the distribution constitutes a dividend, <b>100% DRD is apparently available.</b></li> <li>• <b>U.S. shareholder generally receives carryover basis in the IP</b> (as opposed to a fair market value basis under section 301(d)), subject to the potential basis adjustments described above.</li> </ul>

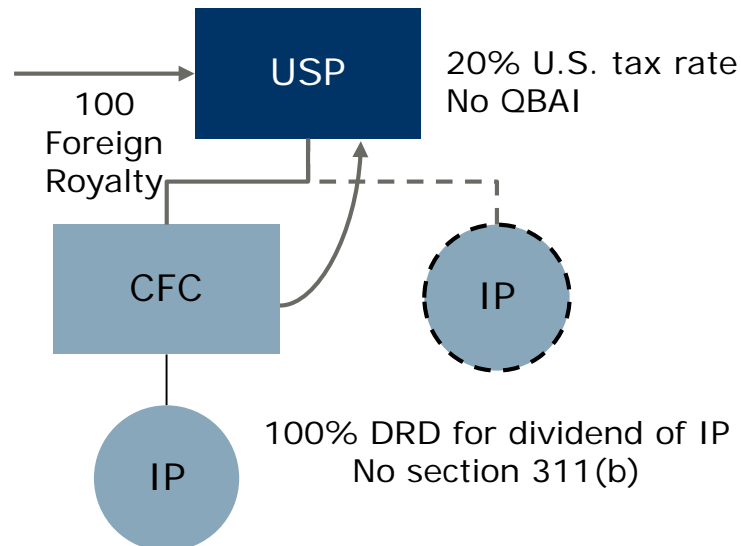
# To Onshore or not to Onshore?

## Offshore IP



Pre-tax Income	100
Foreign Taxes	(15)
Net CFC Tested Income	85
Less: Deemed Tangible Return (QBAI*10%)	-
GILTI	85
Sec. 78 Gross-up	15
Sec. 951A Inclusion (GILTI + Sec. 78 Gross-up)	100
Less: 50% Deduction for GILTI	(50)
Taxable Income	50
US Tax @ 20%	10
Less: Foreign Tax Credit	(10)
Residual U.S. Tax	-
<b>ETR</b>	<b>15%</b>

## Onshore IP



Deduction Eligible Income (DEI)	100
Less: Deemed Tangible Income Return (QBAI*10%)	-
Deemed Intangible Income (DII)	100
Percentage of Foreign-Derived Deduction Eligible Income (FDDEI) to Deduction Eligible Income (DEI)	100%
Foreign-Derived Intangible Income (FDII)*	100
Less: 37.5% Deduction for FDII	(37.50)
Taxable Income	62.50
US Tax @ 20%	12.50
<b>ETR</b>	<b>12.5%</b>

\*Assumes foreign-source royalty income meets the definition of foreign-derived deduction eligible income

## Observations:

### Offshore IP

- **With 50% deduction for GILTI:** 12.5% U.S. residual tax threshold and 10% U.S. minimum tax
- **With 37.5% deduction for GILTI:** 15.625% U.S. residual tax threshold and 12.5% minimum U.S. tax

### Onshore IP

- **With 37.5% deduction for FDII:** 12.5% U.S. effective rate
- **With 21.875% deduction for FDII:** 15.625% U.S. effective rate
- Consider impact of QBAI on the deduction for FDII (more QBAI generally = less deduction for FDII but more deduction for depreciation)
- Consider impact on the basis of USP's CFC stock and USP's basis in IP if the distribution is not a dividend
- Contrast distribution of the IP with a sale of the IP to USP

# Procurement Structure Issues: Sales or Services Income?

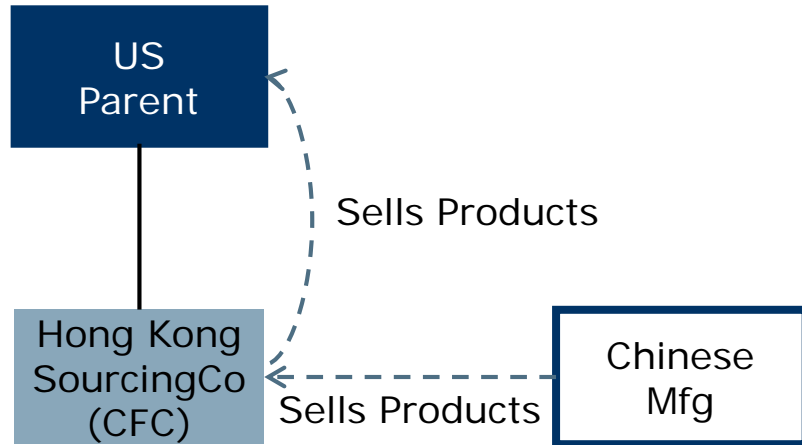
## Foreign Base Company Sales Income

- Income derived by a CFC from the purchase and sale of property that it purchased from, or sold to, a related person, and
- The property is both manufactured and sold for use outside CFC's country of organization.

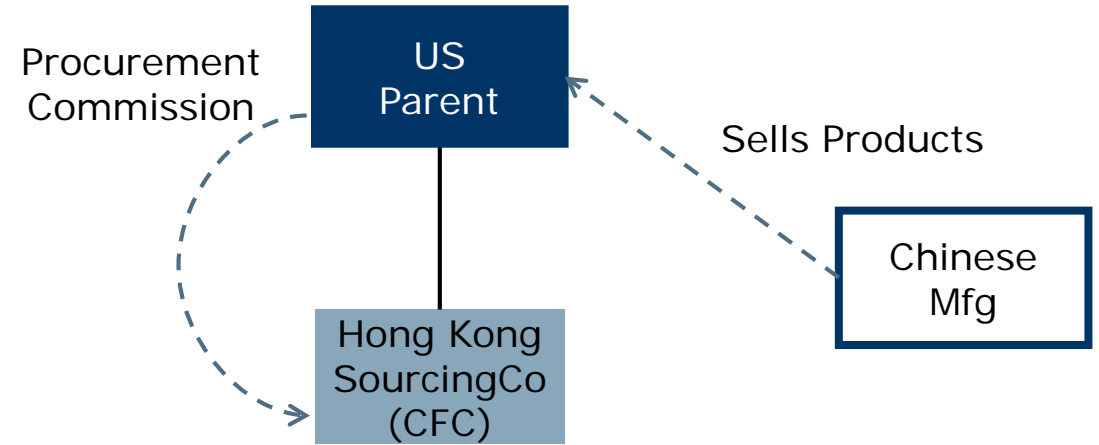


# Procurement Arrangements

## Buy-Sell



## Commission



## Unique FBCI Characterization Rule

- Commissions (or fees) derived by a CFC from
  - (1) purchasing products on behalf of a related person, or
  - (2) selling products on behalf of a related person,are analyzed under section 954(d)—Foreign base company sales income
- Such income is characterized as services income for other purpose of the Code and thus generally would be analyzed under section 954(e)—Foreign base company services income

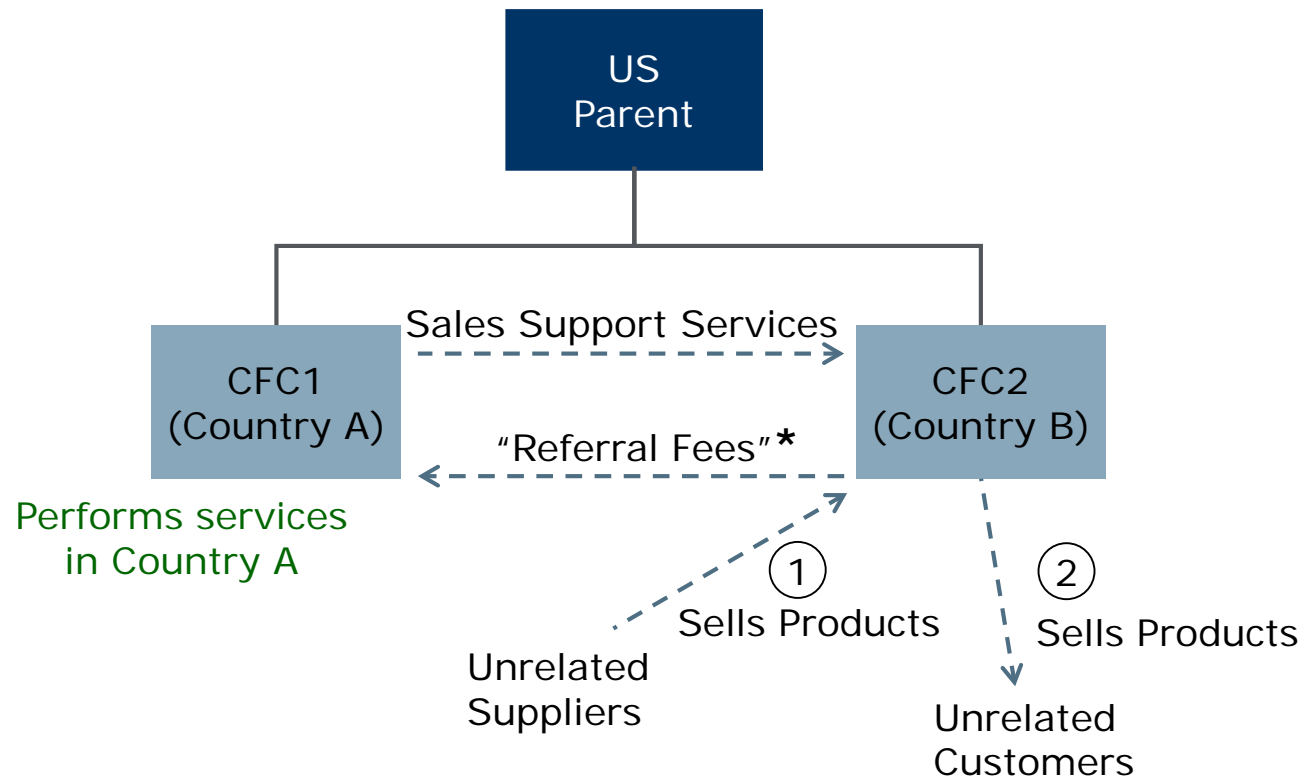
## Fees Subject to Section 954(d) Analysis

- The CFC performs the same “purchasing” or “selling” activities as if it were actually purchasing or selling the property (except taking title)
- Such activities generally include soliciting sales or contacting suppliers, negotiating the terms of the sale or purchase transactions, and entering into the contracts on behalf of a seller or buyer

## Distinction is Significant

- Section 954(d) exceptions:
  - (1) CFC organized in same country where products are manufactured or sold for use, or
  - (2) products are manufactured by CFC
- Section 954(e) exception: CFC organized in same country where services are performed

## FAA 20153301F: Services Income Treated as Sales Income



IRS: CFC1's fee income is analyzed as sales income because "CFC2 is selling on behalf of CFC1" (confusing?)

Taxpayer: Bifurcate fees between pre-sale functions (sales/Sub F) vs. post-sale functions (services/non-Sub F)

IRS: Can't bifurcate

\* 6% of gross selling price of orders solicited by CFC1

## FAA 20153301F: Bifurcation of Commission?

- When a single transaction gives rise to items of income that fall within the definition of more than one FBCI category, the separate items of income generally are to be analyzed separately
- If separate items of income arising from a single transaction cannot be determined, the income is characterized based on its predominant character
- Treas. Reg. §1.954-1(e).

## **Pre-Sale**

- Maintain customer relationship
- Solicit sales
- Arrange for delivery to customers

## **Post-Sale**

- Responding to shortages, quality and product damages
- Handling billing disputes and settlements
- Credit management, tracking invoices, and collection
- Providing customers with market information

## FAA 20153301F: IRS Conclusion

- IRS did not expressly reject a bifurcation approach, but did not find that the facts supported it
- Predominant character of referral fee was sales income
  - Taxpayer did not substantiate that any amount of referral fees were for post-sale services
  - Post-sale functions all “incident to the sales function”; “but for the sale, there would be no post-sale activities”
  - Fees based on gross margins (sales-based)



## Coordination Rule

- Fees and commissions within the meaning of section 954(d) are subject to analysis under that section (priority over section 954(e))
- Such fees and commissions are subject to analysis only under section 954(d) (and not under section 954(e))
  - This is the case even if the fees or commissions qualify for an exception under section 954(d)
  - See RR 86-155; PLR 201325005; PLR 201332007; TAM 8536007; *Brown Group*, 77 F.3d 217 (8th Cir. 1996)

# Technology: Disrupting Supply Chains & the Tax Law

# Tax Impacts of Technology-Enabled Supply Chains and the Digital Economy

## **Physical supply chain**

- Impacts of technology on manufacturing

## **Digital economy**

- Digital marketing
- E-commerce- physical product
- E-commerce- digital product/services

# Technology-Enabled Manufacturing

**Manufacturing is being partially brought back to be closer to a company's customer base. Emerging technologies, such as 3D printing/additive manufacturing, have the potential to transform current manufacturing models.**

Network footprints are changing and IP is reducing the cost of manufacturing, thereby shifting value from physical processes to the underlying IP

Manufacturing location becomes fluid and mis-alignment of people, assets and risks creates BEPS and Subpart F (substantial contribution) risks

# Technology-Enabled Manufacturing

## Key Tax Implications

- What is a substantial contribution to 3D printing?
- What is the characterization of income related to 3D printing?
  - Is IP provided as a service? Software license?
- What happens when your distributor starts printing parts?
- What are factors for determining nexus?

# Digital Economy Perspectives

## Issues and Considerations

- Digital economy policy trends (of which BEPS Action 1 is only a part or only the beginning of the discussion)
- Digital economy taxation trends (e.g., 2014-2015 IRS priority guidance plan, legislation around the globe)
- Withholding tax, nexus, and indirect taxation considerations
- Compliance vs. planning (tax rulings, nexus/PEs, inherent “costs” of risk and tax increases, evolving landscape)

# US Court Cases

## ***Piedras Negras Broadcasting***

- Mexican radio station did not have a PE in the U.S. because the situs of its income producing services was in Mexico

## ***Albert J. Miller***

- Service payment by a US partnership to its HK partner (corp) is considered foreign source even though the HK partner subcontracted certain services to its US subsidiary.

## ***Container Corporation***

- No withholding tax on payment by U.S. sub to its Mexican parent for parent's guaranty of sub's debts to U.S. lenders

## Notice 2007-13

- Addresses concern by Treasury and the IRS of the ability of a U.S. person to shift profits offshore to CFCs organized in low tax jurisdictions, in cases where the U.S. person provides so much assistance to the CFC that the CFC cannot be said to be providing services on its own account
- Amends the substantial assistance regs for foreign base company services income and applies to services performed by a CFC that receives substantial assistance from a U.S. related person or persons
- Objective cost test – assistance furnished by U.S person(s) equals or exceeds 80% of the total cost to the CFC of performing services, or the cost of the services provided by the CFC itself is more than 20% of the total cost to the CFC of performing services.
- Eliminates the subjective principal element test
- Assistance includes direction, supervision, services, know-how, financial assistance, and equipment, material or supplies
- Costs determined after taking into account Sec. 482 adjustments and should have a direct and contemporaneous connection between the assistance provided by a related party and the CFC's performance of services under a particular service contract(s)
- Potential application to IP spend (e.g. R&D costs, PCT payment, etc...)



# Ecommerce – Physical Product

## **Transfer pricing:**

- Centralized business models, mix of intangibles and distribution network
- OECD intangibles report:
  - Alignment of ownership and people functions
  - What would unrelated parties have agreed vs. what is legally agreed
- OECD BEPS report: focus on digital economy
- Conclusion of current project on intangibles

## Ecommerce – Physical Product (cont'd)

### Transfer pricing:

- Documentation requirements – full value chain disclosure?
- Broader reflection on transfer pricing principles – “do not throw away the baby with the bath water”
- Emerging markets: United Nations transfer pricing manual
  - Focus on customer location as source of profit
  - Large populations with high market potential
  - Implications for the future?
- Where is the value (technology vs. marketing intangibles)?
  - Hardware or software (patents, copyrights and know-how)
  - Brand or relationships (trademarks and customer lists)
  - Customer data

## Ecommerce – Digital Product or Service

What is the most reliable method to price the transaction?

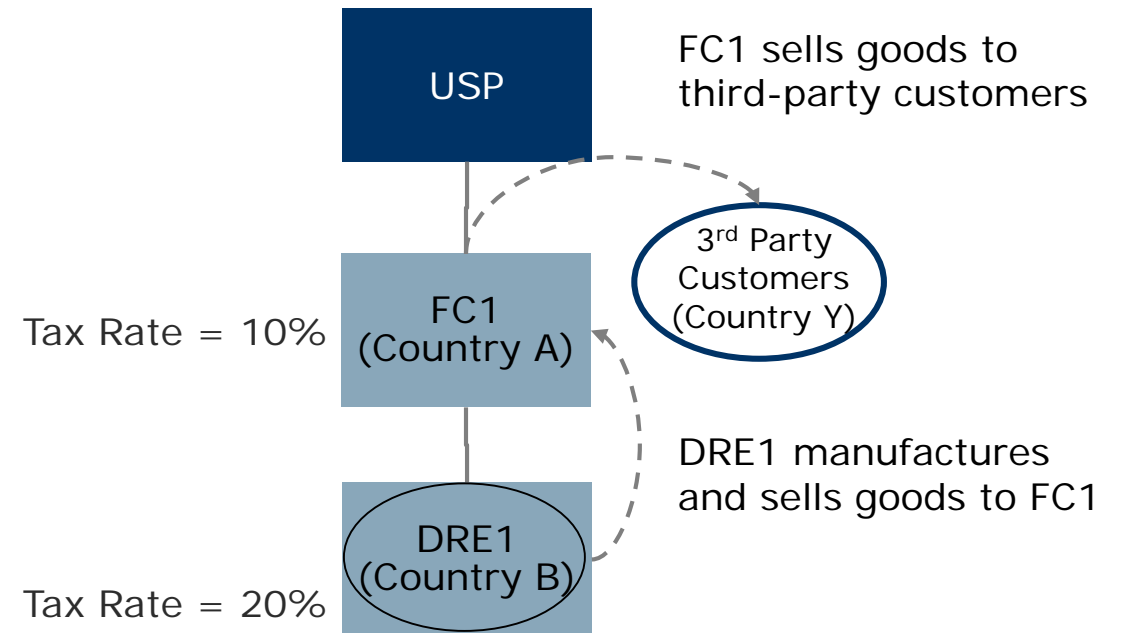
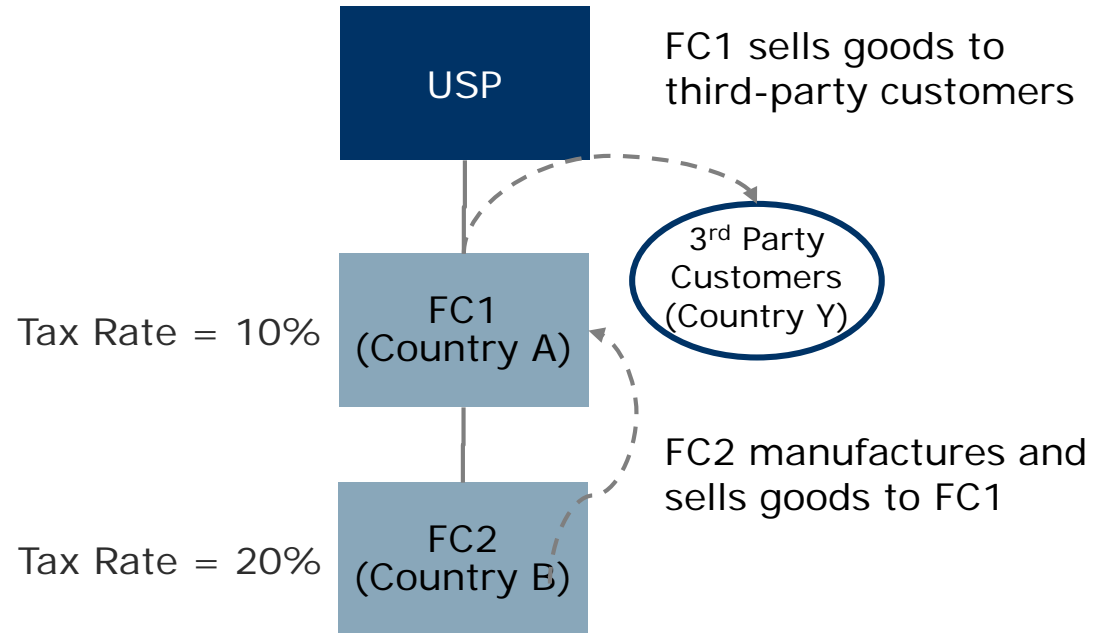
- If it is the delivery of a digital product, has anything really changed from previous models?
- If the transaction is a service, then other methods may well apply
  - Tax authorities in the location of the customer prefer the profit-split method, which allocates more than just the routine profit to their jurisdiction.
  - Or, should the activities in country be priced using a cost plus method?
  - Or under US services rules, can you use the services cost method and price the service at cost?
  - Under what circumstance might this method be most reliable?
  - Profit split requires dual ownership of intangibles, which heightens importance of identifying intangibles and determining who owns them.

# Branch Rule Issues

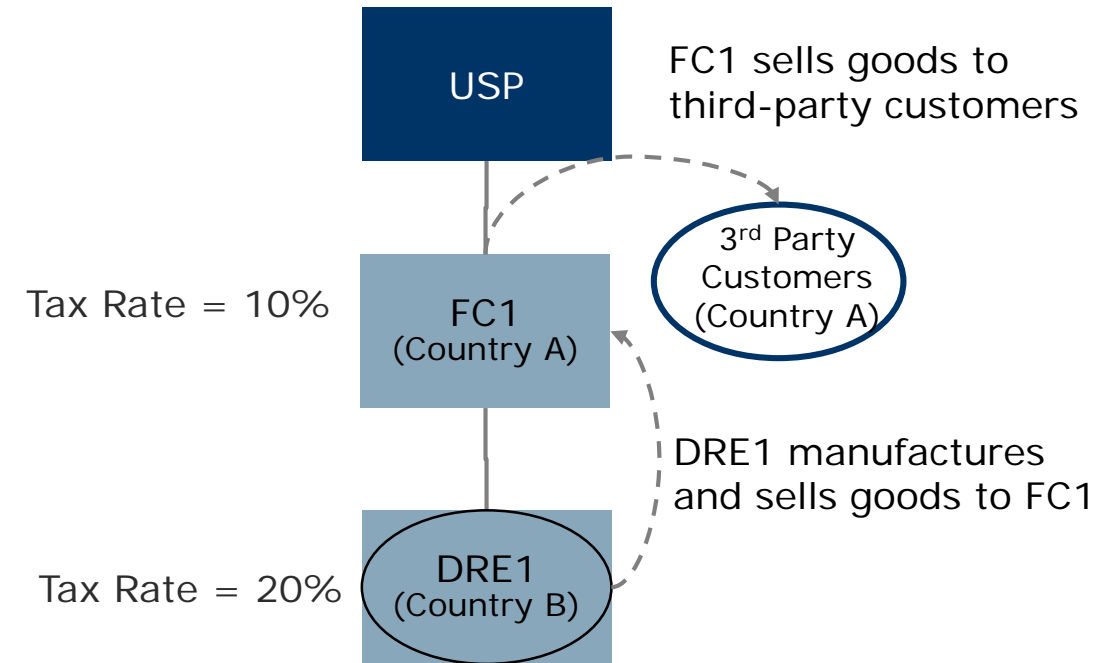
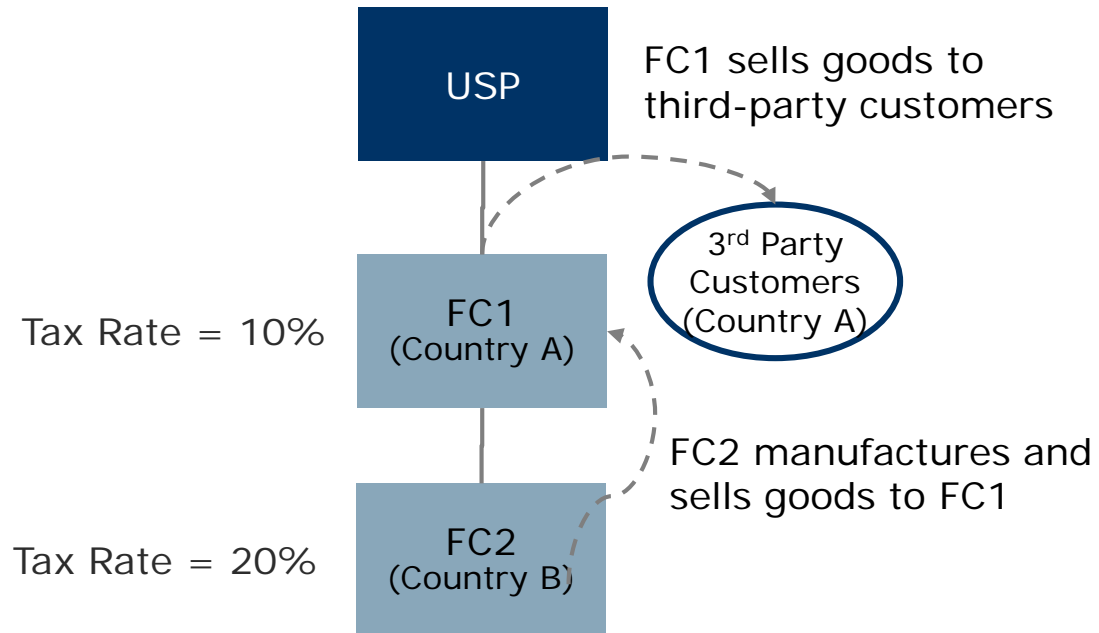
## Branch Rule – General Background

- **Purpose** – Prevent avoidance of foreign base company sales income rules through the use of branches that allow the separation of manufacturing and sales activities, with the sales activities subject to a low rate of foreign tax.
- **General Rule** – a branch of a CFC is treated as a separate CFC for FBCSI purposes if:
  - The CFC engages in purchasing, selling or manufacturing activities through a branch that is located outside the CFC's country of incorporation AND
  - The carrying on of such activities has "substantially the same tax effect as if the branch . . . Were a wholly owned subsidiary corporation of such CFC"
- **Tax Rate Disparity Test**
  - Branch Rule applies if there is an impermissible "tax rate disparity" between the CFC and the branch
  - Rate of tax on branch/CFC income is (i) <90% of and (ii) 5 percentage points lower than CFC/branch income

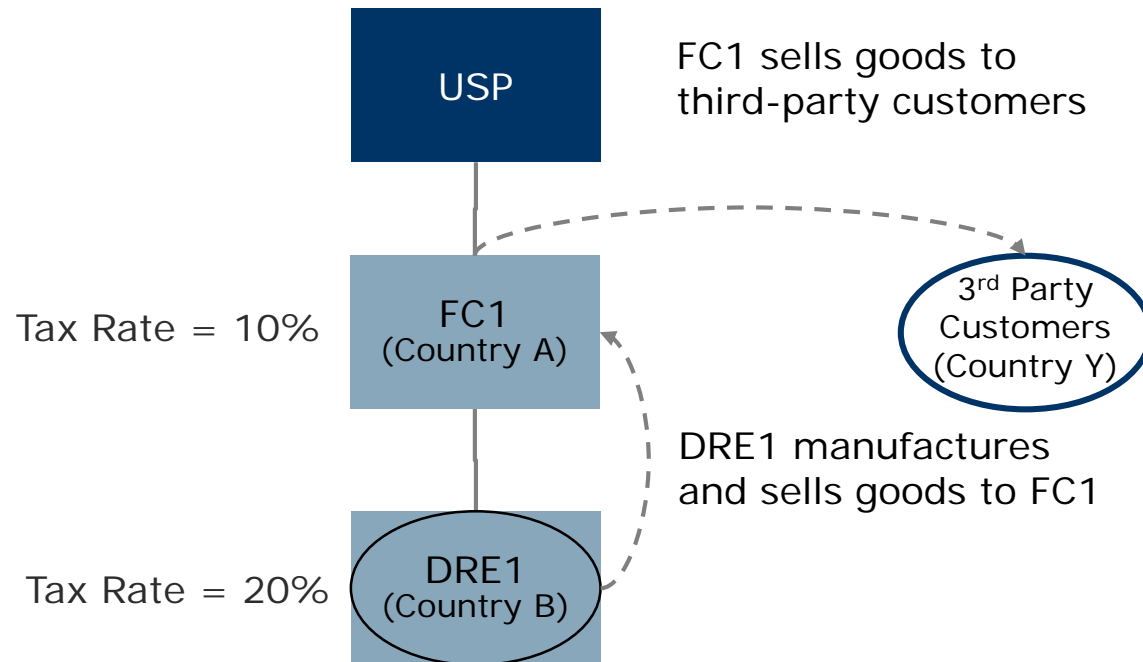
## Branch Rule – Classic Example



## Branch Rule – Same Country Sales Exception



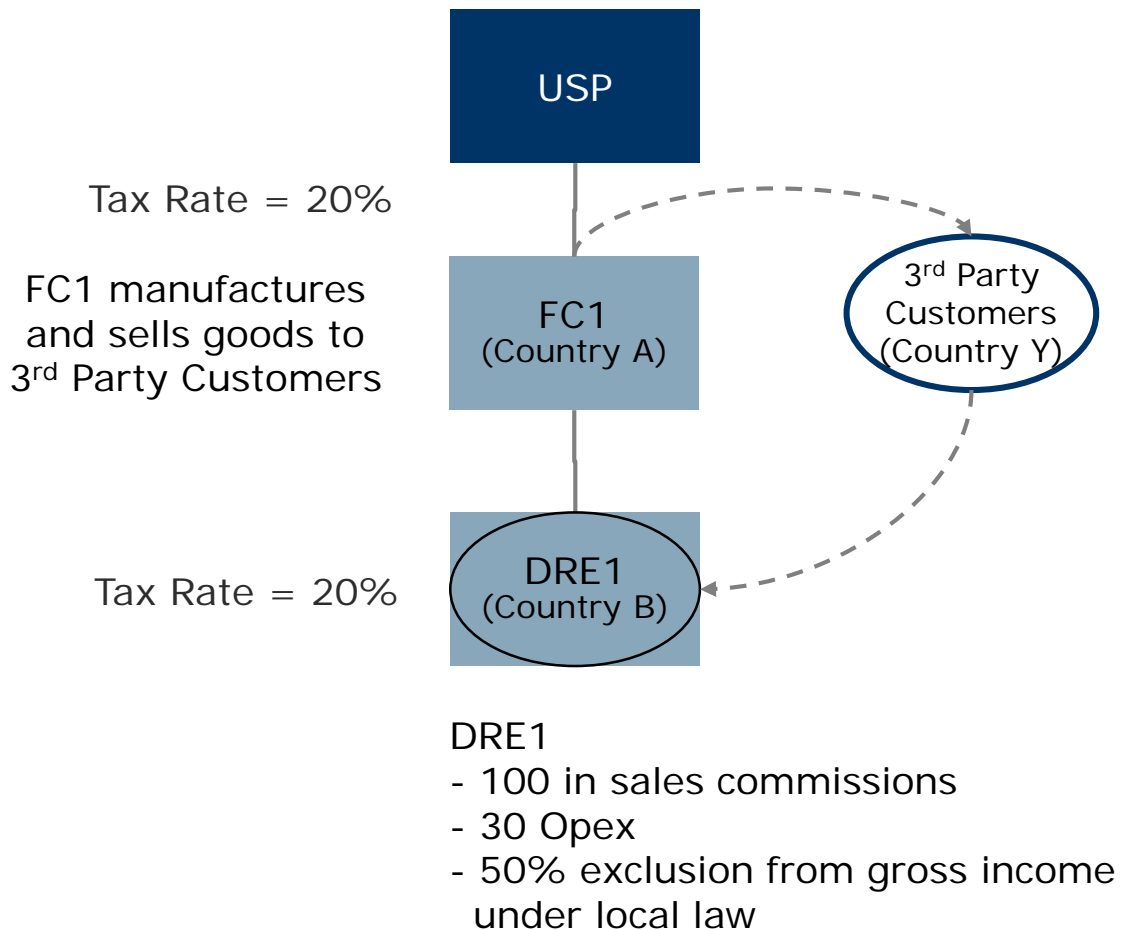
## Branch Rule – Tax Rate Disparity Test



- TRD requires comparison of Actual ETR on branch income vs. Hypothetical ETR on branch income
- Actual ETR =  $\text{Actual Taxes Paid} / \text{Tax Base}$
- Hypothetical ETR =  $\text{Hypo Taxes} / \text{Hypo Tax Base}$
- Key question – What is the Tax Base in the two formulas?
- IRS provided guidance in AM 2015-002

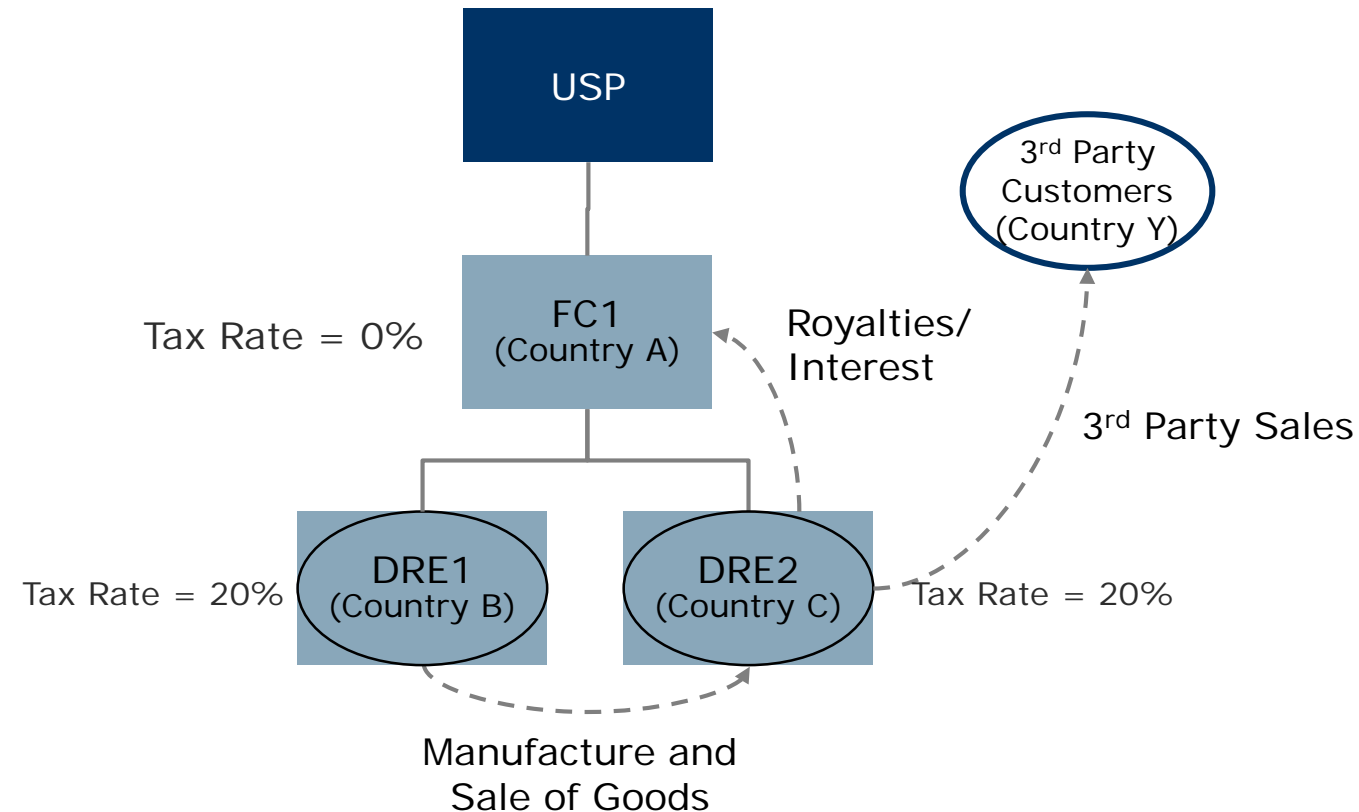


## Branch Rule – Tax Rate Disparity Test – AM 2015-002



- Both Country A and Country B have the same statutory tax rate
- But Country B excludes 50% of gross income from out-of-country sales.
- As a result DRE incurs 4 of tax ( $.2 * (100 - 50 - 30)$ )
- Question – What tax base to use? Tax Base under Country A or Country B's laws?
- AM 2015-002 effectively concludes you use the hypothetical Country A tax base
- “For the comparison to be meaningful, an appropriate common tax base must be used to calculate the actual ETR and the hypothetical ETR”
- Under AM 2015-002
  - Actual ETR =  $4/70 = 5.7\%$
  - Hypo ETR =  $14/70 = 20\%$

## Branch Rule – Disregarded Transactions

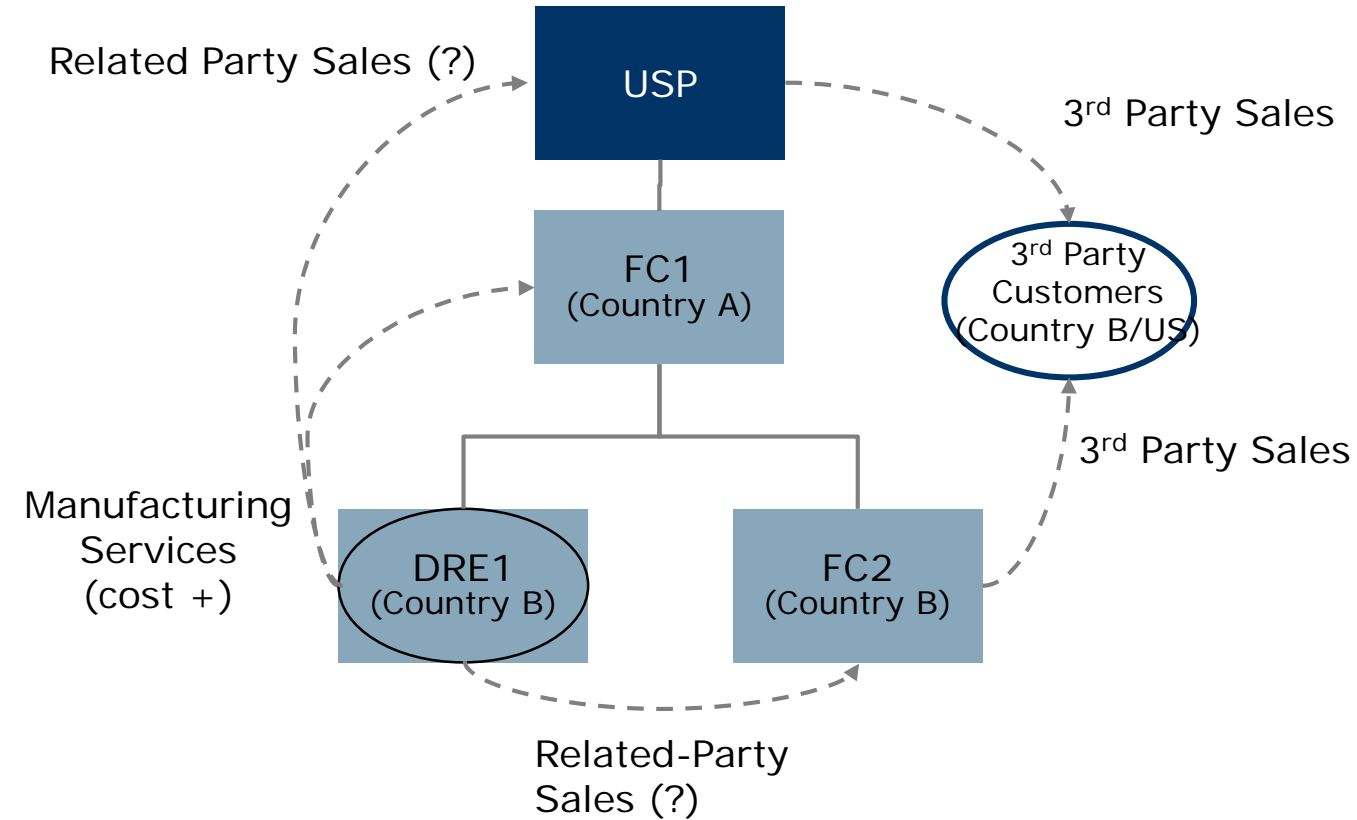


- Application of TRD to Disregarded Payments
  - Whose law determines treatment of royalties paid by DRE2 to FC1
- PLR 200942034
  - In determining ETR of a branch, you DO take into account an allocable portion of the branch's (disregarded) interest expense

## Branch Rule – Income Allocations

- If Branch Rule applies, need to determine allocation of income between/among branches and CFC to determine FBCSI.
  - Otherwise disregarded payments now become relevant
- 1.954-3(b)(3) – If the Branch Rule applies, the branch is treated as a separate corporation it is “solely for purposes of determining the foreign base company sales income of each such corporation.”
- AM 2015-002
  - “Once it has been concluded that tax rate disparity exists, additional steps must be performed to determine the correct amount of net income under U.S. tax principles attributable to the branch and to determine whether any exceptions to FBCSI apply.”

## Branch Rule – Pending Tax Court Case



- FC1 enters into manufacturing supply agreements with each of USP and FC2.
  - FC1 purchases raw materials and owns all WIP until sale to USP and FC2
- FC1 enters into a manufacturing services agreement with DRE1.
- On a tolling basis, DRE1 conducts manufacturing activities in Country B.
- Issue: Is FC1's income FBCSI?

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