IP in the New International Tax Landscape

ABA Fall Tax Meeting
October 4, 2019

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Agenda

• Overview of Key Rules
  – New US Rules
    • GILTI
    • FDII
    • BEAT
    • Section 367(d) Transfers of Intangibles
    • Transfer Pricing
  – New BEPS and EU Rules
    • ATAD
    • Digital Taxation
    • Other BEPS
• Case Studies
  – Moving IP out of the US
  – Moving IP into the US
  – Moving IP between two foreign jurisdictions
• Overview of the new software regs
OVERVIEW OF KEY RULES: NEW US RULES
GILTI Inclusion - § 951A

Each person who is a United States shareholder of any controlled foreign corporation for any taxable year of such United States shareholder shall include in gross income such shareholder's global intangible low-taxed income for such taxable year.

$$\text{GILTI} = \text{Net Tested Income} - [(10\% \times \text{QBAI}) - \text{Interest Expense}]$$

Generally, an amount of income currently includable in income deemed derived from CFCs of which a US person is a direct or indirect 10% shareholder
FDII Deduction - § 250

Permits a domestic corporation a deduction for 37.5% of the foreign-derived intangible income of such corporation for the taxable year

\[
\text{FDII} = \text{Deemed Intangible Income} \times (\text{Foreign-Derived Deduction Eligible Income}/\text{Deduction Eligible Income})
\]

*Generally, income derived from the sale of property to non-US person for foreign use or services to a person or property outside the US. Roughly comparable to an export incentive or patent box.*
Annual tax imposed on applicable taxpayers equal to the base erosion minimum tax amount for the taxable year. Such tax is in addition to any other tax imposed by this subtitle.

\[ \text{BEMTA} = 10\% \times \text{Modified Taxable Income} - (\text{Adjusted Regular Tax Liability}) \]

Generally, a new minimum tax imposed on large corporations with material outbound related-party payments and/or foreign tax credits, based on taxable income as modified to add back most tax credits and certain “base eroding” tax benefits
Outbound Transfers - § 367

367(d) – Generally, treats § 351 or § 361 exchange of IP by US transferor to a foreign transferee as if the US transferor sold the IP for an amount contingent on the productivity/use of such property and subject to a deemed annual royalty over the IP’s useful life.

Former 376(a)(3) repealed. No more “active trade or business” exception for outbound transfers.
Intangible Property - § 367(d)(4)

- (A) patent, invention, formula, process, design, pattern, or know-how,
- (B) copyright, literary, musical, or artistic composition,
- (C) trademark, trade name, or brand name,
- (D) franchise, license, or contract,
- (E) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data,
- (F) goodwill, going concern value, or workforce in place (including its composition and terms and conditions (contractual or otherwise) of its employment), or
- (G) other item the value or potential value of which is not attributable to tangible property or the services of any individual.
Transfer Pricing - § 482

- Generally, IRS can impose an “arm’s-length” standard to reallocate income/expenses among related parties to clearly reflect income or prevent tax evasion.
- Amended to expressly use new § 367(d)(4) definition of “intangible property”.
- Transfers may be sales, loans, licenses, or other conveyances making the intangible property available to related parties.
- “For purposes of [482], 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.”
EU ATAD

• EU Council has adopted the Anti-Tax Avoidance Directive ("ATAD") from the European Commission’s proposals to strengthen rules against tax avoidance

• This requires EU member states to adopt, among other things, new rules relating to exit taxes, CFCs, and digital taxation
EU ATAD: Exit Taxes

• Generally, an exit tax applies when a taxpayer relocates certain assets from one tax jurisdiction to another

• Example: Hungarian proposal
  – Triggered when relocate assets out of Hungary
  – Paid in five annual payments of 20% per year
  – Deferral of payments discontinued and tax debt due for certain triggers
  – If assets will return within 12 months, no exit tax
EU ATAD: CFC Rules

- Regime of current taxation by reference to the income of an EU shareholder’s CFC

- For CFCs in another EU member state, generally creates an exception if such CFCs perform substantive economic activity

- For CFCs in nonmember states, ATAD provides a choice between the same exception or an exception for income not derived from arrangements put into place to obtain tax benefits
OECD BEPS: Transfer Pricing

• Current guidance on transfer pricing focuses on economic substance: Does the ownership and movement of intangibles actually involve the development, enhancement, maintenance, protection, and exploitation (“DEMPE”) of those intangibles?

• Current guidance requires patent box & other preferential regimes follow the “modified nexus approach” to be consistent with the substantial activity principle
BEPS: Substance Requirements

• Many countries now require economic substance
  – Example: Bermuda’s new minimum economic substance requirements for local companies, LLCs, and pure equity holdings entities

• Increasingly less viable to have a pure IP holding company with no employees, operations, other assets, etc.
  – OECD transfer pricing guidelines also require income allocations to follow DEMPE (substance)
BEPS: Patent Boxes

• BEPS requires patent box regimes to meet certain minimum standards
  – Preferential treatment for IP holding may only be granted to income derived from substantial activities effectively carried out by the taxpayer obtaining the benefit
  – “Nexus approach” for substantial activities: examine proportion of expenditures directly related to development activities that demonstrate real value added by taxpayer

• Formerly tax-favorable IP holding regimes in many countries have now been tightened, including across the EU
BEPS: Digital Taxation

• Taxation of “digital economy”
  – Essentially, the transformation of all sectors by information and communication technology, requiring a reframing of many aspects of domestic and international taxation
  – Multiple measures under consideration
• Being studied as part of OECD BEPS project, with guidance expected by the end of 2020
• In July 2019, France enacted a “digital services tax” on turnover from online advertising, the sale of consumer data for advertising purposes, and the fees derived from connecting buyers and sellers online
  – Other nations (in and outside of Europe) are considering/expected to enact similar measures
OVERVIEW OF SOFTWARE REGS
Characterizing Digital Transactions

• Current software revenue characterization regulations (Treas. Reg. §1.861-18)

• Proposed revisions to software revenue characterization regulations

• New proposed regulations on cloud transactions (Prop. Treas. Reg. §1.861-19)
Treas. Reg. § 1.861-18

• Transfer of a computer program
• Copyright right vs copyrighted article
  – make copies for distribution to the public
  – prepare derivative computer programs
  – public performance
  – public display
• Sale vs lease or license
• Limited services and know-how categories
Prop. Treas. Reg. § 1.861-18

• Expanded to cover all “digital content” = content that is or was protected by copyright
• Applies to new TCJA provisions (59A, 245A, 250, 267A)
• Performance or display to advertise the digital content is not a copyright right
• Electronic sale of copyrighted article deemed to occur “at the location of download or installation onto the end-user’s device”
• “Cloud transaction” = on-demand network access to computer hardware, digital content … or other similar resources
• Classify solely as lease or service
• But separate classification for non-de minimis transactions in a single arrangement
• Factors drawn from §7701(e) and case law
• Examples of line between -18 and -19
Service vs Lease

- physical possession
- control of property
- significant economic or possessory interest
- economic risk in case of nonperformance
- concurrent use
- price substantially exceeds rental value
- right to select and replace property
- component of an integrated operation
- fee based on work not mere passage of time
EXAMPLE: MOVING IP OUT OF US
US to Foreign IP Ownership – Base Case

US Parent

Owns and Exploits Worldwide IP

Foreign OpCos

Intercompany Services / Buy-Sell Arrangement

Average Foreign Tax Rate = 20%
Base Case – Post-TCJA

- **Tax Rate:** US Parent pays 21% corporate tax, with possible FDII benefit on foreign sales (13.125%)

- **Valuation / Transfer Pricing Issues:** N/A

- **Local country issues:** Low. US Parent likely transacts directly with third parties

- **Foreign Tax Credit considerations:** Cannot cross-credit Foreign OpCo taxes in excess of GILTI rate against US tax on FDII.

- **Other considerations:** BEAT on service fees to Foreign OpCos.
US to Foreign IP Ownership – Licensing Structure

US Parent

- Owns Worldwide IP

Foreign Principal
- Foreign Tax Rate = 8%
- Exploits foreign IP
- Intercompany Services / Buy-Sell Payments

Foreign OpCos
- Average Foreign Tax Rate = 20%

License of Foreign IP
Licensing Structure – Post-TCJA

- **Tax Rate**: US Parent pays 21% corporate tax, with possible FDII benefit on foreign royalties (13.125%). Licensing Co profit taxed as GILTI.

- **Valuation / Transfer Pricing Issues**: Determining arm’s length royalty rate

- **Local country issues**: Low to medium. Foreign Principal’s profits are more likely aligned with in-country substance.

- **Foreign Tax Credit considerations**: Cross-crediting of Foreign Principal’s and Foreign OpCo’s taxes.

- **Other considerations**: Foreign Principal can bear intercompany fees for sales related functions, alleviating BEAT.
US to Foreign IP Ownership – IP Migration

US Parent

- Owns US IP Only

Foreign Principal & IP Co

- Sale / Contribution of Foreign IP
- Exploits IP
- Owns further developments

Intercompany Services / Buy-Sell Payments
Contract R&D

Foreign OpCos

Average Foreign Tax Rate = 20%

Foreign Tax Rate = 8%
IP Migration – Post-TCJA

• **Tax Rate:** US Parent pays 10.5% GILTI rate on foreign profits

• **Valuation / Transfer Pricing Issues:** Likely application of income method under Reg. 1.482-7, or amended Sec. 367(d)(4) / Section 482

• **Local country issues:** More significant pressure on Foreign Principal’s substance including development related functions in DEMPE

• **Foreign Tax Credit considerations:** Full cross-crediting in GILTI basket.

• **Other considerations:** Foreign Principal can bear R&D and sales-related fees, alleviating BEAT. Possible hedge against future rate increases.
EXAMPLE: MOVING IP INTO US
Current Status

• USP’s IP held in an Irish Entity

• USP has decided to move its IP out of Ireland because...
  – Payments from USP’s US Consolidated group to Ireland constitute BEAT payments
  – Ireland has insufficient economic substance
  – Amortization impacts the GILTI Inclusion
Alternative Facts

• USP’s IP is being held in US LLC owned by an Irish Entity

• USP has decided to move its IP out of Ireland and back to the US

• USP currently pays a 367(d) royalty – no provision to remove royalty upon repatriation to US
Alternative Facts

- As Irish CFC pays a 367(d) royalty to USP, if the IP is exploited elsewhere in Europe, does this qualify for an FDII benefit?
• As a result of the proposed transactions, (1) IP transferred from FSub2 to Controlled and (2) Controlled joins USP’s consolidated group.

• As a result of the proposed transactions, USP continues to receive the deemed royalties and Controlled is treated as the “transferee foreign corporation.” Temp. Treas. Reg. § 1.367(d)-1T(f)(3).

• IRS ruled that, under the Consolidated Regulations:
  – Deemed Royalty from FSub2 to USP will be excluded from the parent’s gross income for the remaining useful life of the IP
  – USP’s intercompany item from the receipt of the Deemed Royalty will not be considered taxable or tax-exempt income
  – Controlled’s corresponding item from the deemed payment of the Deemed Royalty will not be taken into account for purposes of E&P

* FSub2 pays USP a deemed royalty as the result of a prior transaction whereby USP transferred the IP to FSub2 in a transaction subject to section 367(d).
EXAMPLE: MOVING IP BETWEEN TWO FOREIGN JURISDICTIONS
Current Status

USP has decided to move its IP out of Bermuda because…

- BermudaCo has no meaningful “DEMPE” under new OECD guidance
- BermudaCo has insufficient economic substance under new Bermuda rules
- USP has become sensitive to public response to such arrangements
Options

• Move IP to US?

• Add substance to Bermuda?

• Move IP to a low- or mid-tax rate country?
Move IP to US?

USP could repatriate IP, but:

– USP has robust foreign operations and sales
– USP is not confident that FDII will remain in effect to create a favorable rate
– USP appreciates that new § 367 & § 482 rules will likely make it harder (more expensive) for USP to move IP back offshore later

... Moving IP to US is not an ideal option
Add Substance to Bermuda?

USP could add substance to Bermuda operations, but:

– USP thinks this is not possible for business reasons
  • Difficult to move physical assets
  • Difficult to find employees to hire/relocate
  • Difficult to sell change to investors

..: Adding substance to Bermuda is not an ideal option
Move to Low-/Mid-Tax Country?

Consider current & emerging common options:
  Ireland
  Netherlands
  Luxemburg
  Switzerland
  Singapore
  United Kingdom
Move to Low-/Mid-Tax Country

Transfer by Sale

– Must be arm’s length
– Consider basis step-up & amortization deductions
– Consider GILTI (and possibly Subpart F) gains
– tax on gain by other non-US countries with related DEMPE?
– Will the old holding jurisdiction impose exit tax?

Transfer by Contribution / Distribution

– Consider US tax implications
– Consider local (foreign) tax implications
– Consider whether should or can be tax-free in both US and relevant foreign jurisdictions
– Will the old holding jurisdiction impose exit tax?
Move to Low-/Mid-Tax Country

Consider impacts after the transfer:

• Income rate comparison
• Effect on USP’s GILTI
• Relevant royalty withholding regimes
• If US IP included (rather than only ROW IP), BEAT on royalty stream