Can’t Touch This

THE BASICS OF INTANGIBLES

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Topics

Identifying Intangibles

Valuing Intangibles Pre-TCJA

Valuing Intangibles Post-TCJA

International Responses to Taxing Intangibles and the Digital Economy

Alternative US Methods for Taxing Intangibles
  - GILTI
  - FDII
Identification Pre-TCJA

• In general, an intangible asset is a right or privilege that is of some value to an individual or business, but that has no physical substance, unlike tangible property, plant, and equipment.

• Former section 936(h)(3)(B) defined “intangible property” (IP) as any:
  (i) patent, invention, formula, process, design, pattern, or know-how;
  (ii) copyright, literary, musical, or artistic composition;
  (iii) trademark, trade name, or brand name;
  (iv) franchise, license, or contract;
  (v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or
  (vi) any similar item,
  which has substantial value independent of the services of any individual.

• Pre-existing regulations and other Code sections continue to use section 936(h)(3)(B) as a reference for the definition of intangibles. See, e.g., Treas. Reg. § 1.367(a)-1 (regarding transfers to foreign corporations), Treas. Reg. § 1.954-2 (defining “foreign personal holding company income”), §197 & regulations thereunder (regarding amortization of goodwill and certain other intangibles).

• OECD Guidelines, Chapter VI & BEPS Actions 8-10: Marketing intangibles v. trade intangibles
Identification Post-TCJA

• The Tax Cuts and Jobs Act (TCJA), P.L. 115-97, amended section 936(h)(3)(B). Subsequently, the Consolidated Appropriations Act of 2018, P.L. 115-141, repealed section 936 and copied the modified definition of IP that had been in section 936(h)(3)(B) to new section 367(d)(4).

• After tax reform, IP means any—
  (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.
Value Pre-TCJA

Former section 482:

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.
Value Pre-TCJA

Arm’s length standard
- “A controlled transaction meets the arm’s length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same [or comparable] transaction under the same [or comparable] circumstances (arm’s length result).” Treas. Reg. § 1.482-1(b)(1).

Best method rule
- “The arm’s length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm’s length result.” Treas. Reg. § 1.482-1(c)(1).

Available methods for transfers of intangibles (see Treas. Reg. § 1.482-4)
- CUT
- CPM
- Profit split
- Unspecified methods

Specific regulations on cost-sharing arrangements (see Treas. Reg. § 1.482-7)
Value Pre-TCJA

Aggregation & realistic alternatives

- In determining the true taxable income of a controlled taxpayer, “the Commissioner 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.” Treas. Reg. § 1.482-1(f)(2)(ii)(A).

- The comparability factors that must be considered include economic conditions, such as the alternatives realistically available to the buyer and seller. Treas. Reg. § 1.482-1(d)(3)(iv)(H).

- Application of a method to value transfers of IP “should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it.” Treas. Reg. § 1.482-4(d)(1).

- “[T]he combined effect of two or more separate transactions (whether before, during, or after the year under review) 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 ….”” Treas. Reg. § 1.482-1(f)(2)(i)(A).

- See also Treas. Reg. § 1.482-7(g)(2)(iii) and (iv) (aggregation and realistic alternatives concepts applied to cost-sharing arrangements).
Value Pre-TCJA

Aggregation & realistic alternatives in section 482 temporary regulations
- “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 §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.” Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(B).

Intended to “clarify” Treas. Reg. § 1.482-1(f)(2)(i)(A)

The temporary regulation was not finalized and expired on September 15, 2018
Value Pre-TCJA

*Veritas Software Corp. v. Commissioner,* 133 T.C. 297 (2009), non-acq., IRB 2010-49 (Dec. 6, 2010).

- Veritas US and Veritas Ireland entered into a cost-sharing arrangement (CSA)
  - CSA participants agreed to pool their resources and R&D efforts related to software products and software manufacturing processes and share the costs and risks of the R&D
  - Veritas US licensed to Veritas Ireland the right to use certain “covered intangibles” in existence as of the effective date of the CSA as well as the right to use Veritas US’s trademarks, trade names, and service marks in certain geographies
  - Veritas Ireland agreed to pay Veritas US a lump-sum buy-in payment and royalties
  - Lump-sum buy-in payment = $166 million (later adjusted by the taxpayer to $118 million)
Value Pre-TCJA

Veritas Software Corp. v. Commissioner

- IRS challenged the lump-sum buy-in payment under section 482
  - In its notice of deficiency, IRS valued the buy-in payment at $2.5 billion based on several economic analyses.
  - At trial, IRS reduced its valuation of the buy-in payment to $1.675 billion based on an income method using a Discounted Cash Flow (DCF) model.
  - IRS economic expert employed an “akin to a sale theory” and aggregate valuation approach.
  - IRS economic expert’s analysis assumed the pre-existing intangibles had indefinite useful life.
- Veritas used the CUT method.
Value Pre-TCJA

*Veritas Software Corp. v. Commissioner*

- Tax Court’s decision
  - IRS’s determination was arbitrary, capricious, and unreasonable
  - Rejected the IRS’s “akin to a sale” and aggregation theory
  - IRS’s interpretation of the definition of intangible property compensable under section 482 was overly broad
    - “For the years in issue, however, there was no explicit authorization of respondent’s ‘akin’ to a sale theory or its inclusion of workforce in place, goodwill, or going-concern value. Taxpayers are merely required to be compliant, not prescient.” 133 T.C. at 316.
  - IRS’s allocation improperly took into account subsequently developed intangibles
  - IRS employed the wrong useful life, discount rate, and growth rate
  - Adopted Veritas’s CUT method, with some adjustments, as the best method
Value Pre-TCJA


- Amazon US entered into a CSA with Amazon Europe Holding Technologies SCS (AEHT), a Luxembourg subsidiary
- Amazon US granted AEHT the right to use certain pre-existing intangible assets required to operate Amazon’s European website business in exchange for a buy-in payment
- Buy-in payment: $255 million
- Three sets of intangibles at issue:
  - Technology intangibles
  - Marketing intangibles
  - Customer information
## Value Pre-TCJA

*Amazon.com, Inc. v. Commissioner*

<table>
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<tr>
<th>IRS</th>
<th>Amazon</th>
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| • Method: DCF to determine the value of the entire bundle of IP (used CUT as corroborating method)  
• Indefinite useful lives for the IP  
• Buy-in payment: $3.5 billion | • Method: CUTs to value the specific IP transferred under the CSA  
• Determined useful lives for IP at issue  
• Buy-in payment: $284 million - $413 million |
Value Pre-TCJA

Amazon.com, Inc. v. Commissioner

- Tax Court’s decision
  - Followed Veritas—“One does not need a Ph.D. in economics to appreciate the essential similarity between the DCF methodology that Dr. Hatch employed in Veritas and the DCF methodology that Dr. Frisch employed here.” 148 T.C. at 155.
  - Ruled that the buy-in payment represents compensation solely for the use of “pre-existing intangible property,” which included only specifically enumerated property based on the definition of IP in effect at the time
  - IRS argued that Amazon US had the “realistic alternative” of continued ownership of all the IP in the US, which the Court found unpersuasive
    - Even where a realistic alternative exists, the IRS will not restructure the transaction if the taxpayer’s actual structure has economic substance
  - Decided under the 1995 cost-sharing regulations that were in effect when the transaction occurred
    - CUT used by Amazon was one of four acceptable methods to determine the arm’s length charge for the pre-existing IP
    - Had the case been governed by the 2009 cost-sharing regulations, it may have been decided differently
Value Pre-TCJA

Amazon.com, Inc. v. Commissioner

- Ninth Circuit’s decision
  - Affirmed the Tax Court’s decision
  - “The case turns on whether, as the Commissioner argues, the regulatory definition is broad enough to include all intangible assets of value, even the more nebulous ones that the Commissioner refers to as ‘residual-business assets’ (i.e., Amazon’s culture of innovation, the value of workforce in place, going concern value, goodwill, and growth options).”
  - “Although the language of the definition [of an intangible] is ambiguous, the drafting history of the regulations shows that ‘intangible’ was understood to be limited to *independently transferrable assets.*” (emphasis added)
- Rejected the IRS’s argument that its interpretation of the regulations at issue was entitled to *Auer* deference
  - The regulatory definition of “intangible” was not “genuinely ambiguous”
  - Even if it was, the agency’s interpretation was not entitled to deference because of the lack of any warning to taxpayers of the IRS's interpretation of “intangible” in the relevant regulations
Value Post-TCJA

Current section 482:
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 367(d)(4)), 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.
Value Post-TCJA

Definition of “intangible property”

- The TCJA modified the definition of IP in section 936(h)(3)(B) and the Consolidated Appropriations Act of 2018 moved the definition from section 936(h)(3)(B) to section 367(d)(4) and updated the cross-reference in section 482.

- After tax reform, “intangible property” specifically includes:
  - Workforce in place
  - Goodwill (both foreign and domestic)
  - Going concern value
  - Other item the value or potential value of which is not attributable to tangible property or the services of any individual (similar to the “any similar item” included in the definition of intangible property in former section 936(h)(3)(B))

- Modification of the definition of IP was intended to “address[] recurring definitional and methodological issues that have arisen in controversies [Veritas and Amazon] in transfers of intangible property for purposes of section[] ... 482 ... [The provision] does not modify the basic approach of the existing transfer pricing rules with regard to income from intangible property.” H.R. Rep. No. 115-466, at 661 (2017) (Conf. Rep.).
Value Post-TCJA

Aggregation & realistic alternatives

- New sentence added to section 482 codifying the aggregation and realistic alternatives principles
- Conference Report explains that “the [aggregation] provision is consistent with the position that the additional value that results from the interrelation of intangible assets can be properly attributed to the underlying intangible assets in the aggregate, where doing so yields a more reliable result.” H.R. Rep. No. 115-466, at 661-62.
  - Supports this approach with case law outside the section 482 context. See id. at 662 n.1554.
- The IRS’s decision to use either aggregation or realistic alternatives remains subject to judicial review
  - The use of aggregation or realistic alternatives permitted only where it will achieve the most reliable result
- Query how this addition to section 482 will affect the interpretation or application of the transfer pricing rules since these concepts have been in the regulations for decades
International Responses

Base Erosion and Profit Shifting (BEPS) (2013): Double non-taxation
- Developed 15 actions to equip governments with rules to address tax avoidance
- Action 1: Tax Challenges Arising from Digitalization
- Actions 8-10: Transfer Pricing
  ◦ (DEMPE): development, enhancement, maintenance, protection, and exploitation

Addressing the Tax Challenges of the Digitalisation of the Economy and Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy (2019):
- Review the impact of digitalization on nexus and profit allocation rules

IMF Policy Paper: Corporate Taxation in the Global Economy
International Responses

Addressing the Tax Challenges of the Digitalisation of the Economy and Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy (2019)

◦ Pillar One:
  ◦ User participation and Marketing intangibles:
    ◦ Change permanent establishment rules? (nexus)
    ◦ Valued under ALS still? (profit allocation)
  ◦ Significant economic presence:
    ◦ Fractional apportionment method (based on sales, assets, and employees)?

◦ Pillar Two:
  ◦ Income inclusion rule: Taxed if income was subject to low tax rate abroad
  ◦ Tax on base eroding payments: Deny deduction for certain payments
TCJA’s FDII and GILTI Regimes

- TCJA established a participation exemption system under which certain earnings of a foreign corporation can be repatriated to a corporate U.S. shareholder without U.S. tax.

- TCJA added section 951A in order to subject intangible income earned by a CFC to U.S. tax on a current basis, similar to the treatment of a CFC’s subpart F income.

- TCJA also added section 250, which allows domestic corporations for taxable years beginning after December 31, 2017, and before January 1, 2026, a 37.5% deduction for foreign-derived intangible income ("FDII") and a 50% deduction for global intangible low-taxed income ("GILTI"). As a result, the effective U.S. tax rate on FDII is 13.125% and the effective tax rate on GILTI is 10.5%.
GILTI

GILTI Formula

• GILTI inclusion amount = Net CFC Tested Income – Net Deemed Tangible Income Return (“NDTIR”)

• Net CFC Tested Income = Aggregate pro rata share of tested income of all CFCs – Aggregate pro rata share of tested loss of all CFCs

• NDTIR = 10% x Qualified Business Asset Investment (“QBAI”) – Specified Interest Expense
GILTI

Tested Income and Tested Loss

• Tested income and tested loss are CFC-level items, the pro rata shares of which flow up to the US shareholder.

• Tested income is not limited to the CFC’s current E&P.

• CFC tested income (or loss) is calculated according to US taxable income principles (see Treas. Reg. §1.952-2)
GILTI
Tested Income and Tested Loss

• Gross tested income is gross income less the following excluded items:
  • US source income effectively connected with the conduct of a trade or business by the CFC in the US (“ECI”);
  • Gross income taken into account in determining the CFC’s subpart F income;
  • Gross income excluded from the CFC’s foreign base company income (“FBCI”) and insurance income by reason of the high-tax exception in § 954(b)(4);
  • Dividends received from a related person; and
  • Foreign oil and gas extraction income (“FOGEI”).
• Deductions (including taxes) properly allocable to gross tested income are determined similar to the rules of § 954(b)(5).
• Tested loss is the excess of allocable deductions over gross tested income, i.e., when Gross Tested Income – Allocable Deductions < 0.
GILTI

QBAI and Specified Interest Expense

• QBAI is a CFC-level attribute.
• QBAI is the average of the CFC’s aggregate adjusted bases at the end of each quarter in depreciable specified tangible property that is used in a trade or business.
• Specified tangible property is tangible property used in the production of tested income.
• Tangible property is used in the production of gross tested income if some/all of its depreciation is allocated/apportioned to gross tested income (or capitalized to inventory/property held for sale, where some/all of the income/loss from the sale is included in tested income).
• A tested loss CFC does not have QBAI.
• Specified interest expense reduces QBAI.
GILTI

GILTI Inclusion

• A US shareholder of a CFC that owns stock of the CFC within the meaning of § 958(a) must include in gross income its GILTI for the taxable year. See § 951A(a).

• A US shareholder’s GILTI inclusion under § 951A is treated as an amount included under § 951(a)(1)(A) for other purposes of the Code, including:
  • Previously-taxed earnings and profits ("PTEP") See § 959
  • Basis adjustments See § 961
  • § 962 Elections
  • § 1248(b)(1) and (d)(1), and
  • The six-year statute of limitations See § 6501(e)(1)(C)

• There is authority to extend treatment to other Code sections by regulation under § 951A(f)(1)(B).
GILTI

Allocation of GILTI Among CFCs and Consolidated Groups

• US shareholder’s GILTI is allocated among CFCs with respect to which the shareholder is a US shareholder.

• Final regulations generally adopt a “single US entity” approach for consolidated groups.
GILTI

USC’s GILTI Inclusion:
1) USC’s pro rata share of F1, F2, and F4 net tested income: $600 (F2 tested income) + $1,000 (F4 tested income) - $200 (F1 tested loss) = $1,400 (F3’s income is not included due to subpart F inclusion)
2) USC’s pro rata share of deemed tangible income return: 10% x ($100 +$10,000) = $1,010 (F1’s tangible assets are not included because it has a tested loss), see IRC § 951A(d)(2)(A)
3) USC’s GILTI inclusion: $1,400 - $1,010 = $390
4) Foreign tax credits: $390/$1,600 = 24.4% (inclusion percentage); 24.4% x $40 (aggregate tested taxes) = $9.76; 80% x $9.76 = $7.8, see IRC § 960(d)(1)
5) U.S. tax after FTC: $390 + $9.76 ($78 gross-up) = $399.76 x 50% (§ 250 deduction) = $199.88 x 21% = $42 - $7.8 = $34.2
FDII

Foreign-Derived Intangible Income

• Similar to GILTI, doesn’t actually identify intangible income, but rather uses a complex formula to identify “deemed” intangible income.

• Unlike GILTI, targets income earned directly by the US.

• FDII = (FDDEI/DEI) x DII
  ◦ DEI = gross income less certain enumerated items (largely income inclusions from CFCs, financial services income, DOGEI, and foreign branch income) and properly allocable deductions
  ◦ DII = DEI – (10% x QBAI) – QBAI good for GILTI, bad for FDII. Note no reduction for interest expense.
  ◦ FDDEI = DEI derived in connection with:
    ◦ Sale to foreign person for foreign use or
    ◦ Service provided to person, or with respect to property, located outside the US

• Proposed Regulations expand dramatically on what sales/services constitute FDDEI
FDII

FDDEI Sales

• Sales must be:
  ◦ To a foreign person (special rule for property sold to US government for FMS)
  ◦ For a foreign use

• Under the statute, there is no differentiation between sales of different types of property.

• Under proposed regulations, foreign use depends on whether the sale is of (i) general property or (ii) intangible property.
FDDEI Sales

• General property is sold for a foreign use if either:
  ◦ (i) no domestic use within three years of delivery or
  ◦ (ii) subject to manufacture, assembly, or other processing outside the US prior to domestic use.
    ◦ Subject to further manufacture if either:
      ◦ Physical and material change to the property (facts and circumstances) or
      ◦ The property is incorporated as a component (less than 20% value) into a second product.
  ◦ Special rule for transportation property.
  ◦ Related-party rules apply for sales of general property to related foreign parties.

• Intangible property is sold for a foreign use to the extent revenue is earned from exploiting the intangible property outside the United States.

• Complex documentation rules required (“reasonable documentation” required for taxable years beginning before issuance of proposed regulations). Seller must also not know or have reason to know the documentation is inaccurate as of filing date.
FDII

FDDEI Services.

- Services must be provided to persons, or with respect to property, located outside the United States
  - Statute not entirely clear whether focus was on person or property.

  - Under proposed regulations, focus is on location of service or person depends on which type of service is being provided.
    - Transportation service
    - Proximate service
    - Property service
    - General service
      - To business recipient
      - To consumer

- Complex documentation requirements but only for general services to business recipients.
FDII

**USC “C” Corp**

$150 Goods Related

$200 Goods Unrelated

**Foreign Related**

**Foreign Unrelated**

Assume USC has:

- Gross income: $1000
- GILTI: $200
- Subpart F: $150
- Sales to US: $500
- Sales OUS: $150
- Tangible assets: $1000

DEI = $650 (GILTI and Subpart F not included)

DII = $650 – (10% x $1000) = $650 – $100 = $550

FDDEI = $150 (assuming foreign use/doc met)

FDII = $150/$650 = X/$550; X = $127

FDII Deduction = $127 x .375 = $48

**US**

USC transports individual from US to UK for $500

Assume USC has:

- Gross income: $1000
- GILTI: $0
- Subpart F: $0
- Flights in US only: $500
- Flights one-leg in US: $500
- Tangible assets: $5000

DEI = $1000

DII = $1000 – (10% x $5000) = $1000 – $500 = $500

FDDEI = $250 (only 50% DEI because only one leg in US)

FDII = $250/$1000 = X/$500; X = $250

FDII Deduction = $250 x .375 = $94