Back to Basis:

Basis and Cost Recovery in the International Provisions of the 2017 Tax Act

April 13, 2018
Young Tax Lawyers Symposium

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Agenda

- Background: evolution of taxing international intangible income
- Basis and cost recovery 101
- Introduction to new international tax provisions
- Basis and tangible/intangible value
  - GILTI
  - FDII
  - BEAT

Evolution of Taxing International Intangible Income

Pre-2017 International Tax System

World-wide Tax System with Deferral

- Income earned through foreign corporations was not subject to US tax until distributed to US parent (repatriated)
- Limited anti-deferral regimes:
  - Subpart F income, includes passive income, certain foreign base company income
  - Passive foreign investment company (PFIC) regime
- Bifurcated system for outbound transfers
  - Gain recognized on outbound transfer of stock and tangible property, subject to specified exceptions
  - Outbound transfer of intangible property triggered deemed royalties

Pre-2017 International Tax System (cont'd)

Challenges

- Corporate Tax rate (35%) disparity with low tax countries 0/10/15%
- Determination of "arm's length price" for transfers of, and returns to, hard to value intangible assets
- Allocation of value between tangible and intangible assets
- Enforcement of related party transactions

Past Proposals to Reform International Tax System

- Obama Administration 2011 “Green Book” Proposal/ Camp Option A
  - Subpart F income expanded to include “excess returns” related to transferred intangible assets
- Camp Option B
  - All foreign profits subject to Subpart F regime, with 2 exceptions:
    - Home country exception
    - Exception for income subject to 10% effective rate of foreign tax
- Camp Modified Option C: Foreign Base Company Intangible Income
  - Excess of the corporation’s adjusted gross income over 10 percent of the corporation’s qualified business asset investment
  - Qualified business asset investment is the aggregate of the corporation’s adjusted bases in depreciable tangible property used in a trade or business

Past Proposals to Reform International Tax System

- Obama Administration 2016 "Green Book" Proposal
  - Per-country minimum tax added to Subpart F
  - Earnings of a CFC or foreign branch subject to current US taxation at a rate of 19 percent, less 85 percent of the per-country foreign effective tax rate (the "residual minimum tax rate")
  - Foreign earnings subject to minimum tax (*i.e.*, "the tentative minimum tax base") would be reduced by an allowance for corporate equity ("ACE")
  - ACE allowance would provide a risk-free return on equity invested in active assets (generally assets that do not generate foreign personal holding company income)

2017 Tax Act's Key International Intangible Provisions

- Global Low-Taxed Intangible Income (GILTI)
- Foreign Derived Intangible Income (FDII)
- Base Erosion Anti-Abuse Tax (BEAT)
- Modification (clarification?) of definition of compensable intangible assets
- Repeal of active trade or business exception to gain recognition on the outbound transfer of tangible assets

Adapting to New Intangible Regime

Conceptual Questions

- New GILTI and FDII provisions require the calculation of returns on tangible asset basis, treat residual income as return on intangible assets
  - Use of residual method requires no actual intangible property
- Income from inventory sales vs. income from services, rents, royalties

Practical Questions

- Preferred location of tangible assets?
- Preferred location of intangible assets?
- Preferred location of active sales/services revenue?
- Impact on transfer pricing?

Basis and Cost Recovery

Cost Recovery 101

- The Code uses various cost recovery provisions to accomplish two competing goals:
  - Matching the economic cost of property with the periods during which it contributes to the taxpayer's income
  - Providing incentives for taxpayers to invest in productive capacity

Cost basis & Capitalization

- Cost Basis: §§ 1012, 1011, 1016
  - Taxpayers generally hold property with a cost basis
- Capitalization: § 263
  - Additional costs incurred to modify or otherwise improve depreciable property are generally capitalized, increasing a taxpayer's basis in its property
- UNICAP: § 263A
  - Direct costs, and the allocable share of certain indirect costs must also be capitalized into both inventory and non-inventory property
  - Indirect costs include royalties, certain indirect labor and employee compensation costs, and costs relating to purchasing, handling and storage

Cost Recovery

- Depreciation – §§ 167, 168
  - MACRS
    - General depreciation system ("GDS"): shorter recovery period, accelerated methods
    - Alternative depreciation system ("ADS"): longer recovery period, straight-line method
  - Bonus/expensing
    - Under § 168(k), as amended by the 2017 Tax Act, qualified property acquired and placed into service after September 27, 2017 and before January 1, 2023 may be fully expensed in the year acquired
- Amortization – § 197
  - Cost of acquired intangible property recovered ratably over 15 years

E&P Considerations

- § 312 provides adjustments to earnings and profits ("E&P"), the code's primary measure of a corporation's economic earnings
- E&P is determined using ADS.
- CFCs also generally compute E&P using ADS
  - Prior to the 2017 Tax Act, many taxpayers only kept their CFCs' tax books for E&P purposes

Introduction to GILTI, FDII & BEAT

GILTI

- **§ 951A(a)**: Each person who is a US shareholder of any CFC for any tax year shall include in gross income such shareholder's GILTI
- **GILTI**: excess of the US shareholder's net CFC tested income over the US shareholder's net deemed tangible income return for the tax year
- **Net CFC tested income**: aggregate of the US shareholder's pro rata share of each CFC's tested income less aggregate of its pro rata share of each CFC's tested loss
  - Tested income: excess (if any) of CFC's gross income excluding ECI, subpart F income, income excluded from subpart F income by reason of the high-tax exception, dividends from related persons, and foreign oil and gas extraction income; over allocable deductions
  - Tested loss: excess (if any) of allocable deductions over gross income over than the excluded categories

GILTI

- **Net deemed tangible income return**:
    - 10 percent of the aggregate of the shareholder's pro rata share of the each CFC's qualified business asset investment ("QBAI"), less
    - Interest expense taken into account in determining its net CFC tested income that exceeds properly allocable interest income that is taken into account in determining its net CFC tested income

GILTI
§ 250 deduction

- A **deduction** is allowed equal to 50% of the sum of
  - the amount of GILTI included in the US shareholder's gross income for the tax year and
  - the related § 78 gross-up
- Deduction percentage reduced to 37.5% for tax years beginning after December 31, 2025
- The deduction is subject to a **taxable income limitation**. If—
  - the sum of (i) FDII and (ii) GILTI otherwise taken into account by the US shareholder, exceeds
  - the taxable income of such US shareholder (determined without regard to the § 250 deductions),

  then the amount of FDII and GILTI eligible for the respective deductions is reduced proportionally.

GILTI
Foreign tax credit

- § 960(d) provides deemed paid FTCs equal to 80% of:
  - o the US shareholder's inclusion percentage, multiplied by
  - o the aggregate tested foreign income taxes of its CFCs
- **Inclusion percentage** is equal to:
  - o the US shareholder's GILTI amount, divided by
  - o the US shareholder's aggregate pro rata share of the tested income of each CFC
- **Tested foreign income taxes**: foreign income taxes paid or accrued by a CFC that are properly attributable to its tested gross income
- GILTI is a separate category for purposes of § 904

FDII

- Domestic corporation may **deduct** the lesser of
  - the sum of 37.5% of its foreign-derived intangible income plus 50% of its GILTI that is included in its gross income, or
  - its taxable income
- Deduction percentage reduced to 21.875% for tax years beginning after December 31, 2025
- **Foreign-derived intangible income**:

$$\text{Deemed intangible income} \times \frac{\text{Foreign-derived deduction eligible income}}{\text{Deduction eligible income}}$$

FDII

- **Deduction eligible income**:
  - Gross income excluding:
    - Subpart F income
    - GILTI
    - any financial services income (see § 904(d)(2)(D))
    - any dividend received from a CFC by its US shareholder
    - any domestic oil and gas income of the corporation and
    - any foreign branch income (see § 904(d)(2)(J))
  - Less properly allocable deductions.
- **Deemed intangible income**:
  - Deduction eligible income less deemed tangible income return.
- **Deemed tangible income return**:
  - 10 percent of the domestic corporation's QBAI

FDII

- **Foreign-derived deduction eligible income**:
  - Any deduction eligible income derived in connection with
    - Property
      - sold to a person other than a US. person, and
      - which the taxpayer establishes to the satisfaction of the Secretary is for foreign use; and
    - Services which the taxpayer establishes to the satisfaction of the Secretary are provided to any person, or with respect to property, not located within the United States
- **Foreign use**: use, consumption, or disposition which is not within the United States
- **Sold**: includes any lease, license, exchange, or other disposition

BEAT

- **BEAT:** 10% minimum tax (5% for tax years beginning in 2018, and 12.5% for tax years beginning in or after 2026) of modified taxable income, plus the base erosion percentage of any NOL allowed for the tax year
- **Modified taxable income**: taxable income, plus base erosion tax benefits arising from base erosion payments
- **Base erosion payment**:
  - Any amount paid or accrued to a related foreign person for which a deduction is allowed under Chapter 1
  - Any amount paid or accrued to a related foreign person in connection with the acquisition of depreciable or amortizable property
  - Any amount paid or accrued to a surrogate foreign corporation or member of the surrogate foreign corporation's expanded affiliated group that reduces the taxpayer's gross receipts
  - Certain reinsurance payments

BEAT

- **Base erosion tax benefit**:
  - Deductions for deductible payments made to foreign related persons
  - Depreciation or amortization deductions with respect to property acquired from foreign related persons
  - The reduction to gross receipts from base erosion payments for non-deductible payments to a surrogate foreign corporation or member of the surrogate foreign corporation's expanded affiliated group
  - Certain reductions to gross income and deductions available to insurance companies
- **Base Erosion Percentage**: For any tax year—
  - The sum of base erosion tax benefits for the year, divided by
  - The sum of deductions allowable to the taxpayer under Chapter 1, plus all base erosion tax benefits that are not deductions

BEAT

- BEAT is imposed only on **applicable taxpayers**:
  - A corporation other than a RIC, a REIT, or an S corporation
  - With average annual gross receipts of at least $500 million for the three tax-year periods ending with the preceding tax year and
  - Which has a base erosion percentage of 3% or higher (2% for banks or registered securities dealers)

BEAT
Services Exception

- A <u>payment for services</u> is not treated as a base erosion payment if—
  - The services meet the requirements of the services cost method under § 482 (determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure) and
  - such amount constitutes the total services cost with no markup component
- Otherwise, deductible payments for services are all base erosion payments

Basis and Tangible/Intangible Value in GILTI, FDII, and BEAT

GILTI & FDII
QBAI

- **QBAI**: the average of a CFC's aggregate adjusted bases, determined as of the close of each quarter of the tax year, in specified tangible property used in its trade or business and of a type with respect to which a deduction is generally allowable under § 167
    - The adjusted basis in any property must be determined using the ADS under current § 168(g)
    - Depreciation is ratably allocated on a daily basis to specified tangible property in the tax year to which the depreciation relates
- **Specified tangible property**: Property used in the production of tested income/ deduction eligible income
- **Dual Use Property**: A proportionate share of property used both in the production of tested/ deduction eligible income and other income is treated as specified tangible property, based on the gross income produced by the property

GILTI & FDII
Questions

- Can taxpayers transfer and lease tangible property across borders as they have historically transferred and licensed intangible property?
- Does the location of tangible or intangible property better correlate to the situs of economic activity?
- Together, do GILTI and FDII incentivize offshoring of tangible property?

BEAT
Questions

- Why does BEAT treat COGS differently than deductible payments?
    - Appears to look to the character of the taxpayer's income
    - Consider exception for expatriated entities
- Consider when capitalization is treated as an accounting method