Understanding the **Transfer Pricing Implications** of Tax Reform
On December 22, 2017, President Donald Trump signed the Tax Cuts and Jobs Act (TCJA) into law. As the most significant changes to the U.S. Internal Revenue Code since 1986, the TCJA also includes substantial changes to international tax rules affecting most multinational enterprises. For many organizations, this results in the adjustment of global tax strategies, particularly when it comes to transfer pricing arrangements.

Let’s take a look at four provisions of the new tax law and the implications for transfer pricing.

1. The Implications of BEAT

The Base Erosion & Anti-Abuse Tax (BEAT) represents a tax on income after the limitation of certain intercompany deductions taken by U.S. affiliates that represent intercompany payments for a variety of transaction types including royalties, lease payments, and service charges. If the U.S. affiliate has sales in excess of $500 million per year, BEAT may increase the tax obligations of this affiliate depending on how it applies to the affiliate. As an illustration, consider a U.S. affiliate that buys products from third-party suppliers designed by a foreign parent. The U.S. affiliate incurs a variety of expenses including:

- The cost of the products
- Its own operating expenses
- Various intercompany payments including royalty payments for the use of foreign-owned intangible assets, as well as payments for certain services provided by foreign affiliates

While a standard approach to transfer pricing documentation is to compare the operating margin of the U.S. affiliate to the operating margin of third-party distributors, such applications of the Comparable Profits Method (CPM) may be insufficient. Financial auditors of multinationals during their ASC 740-10 review often ask for the details of what represents the intercompany deductions, including royalties and service charges. ASC 740-10 includes both a recognition standard as well as a measurement standard. The recognition standard asks whether the deduction would even be allowed, while the measurement standard asks whether the deduction is too high from the perspective of the IRS.

How would BEAT affect the evaluation of intercompany service charges and royalties for design intangibles? If BEAT imposes a complete disallowance of such intercompany service payments to foreign affiliates, this disallowance would represent an extreme and absurd result. If BEAT, however, allowed for the allocated costs to be charged without a profit element, then at least these allocated costs would be recognized as an appropriate intercompany deduction.

Similar considerations exist for royalties. The representatives of the taxpayer would likely argue for the use of a CPM approach for the evaluation of the intercompany royalty rate on the premise that the foreign affiliate owns all of the valuable intangible assets. The IRS might counter that a Residual Profit Split approach should grant the U.S. affiliate a portion of residual profits, alleging that the distribution affiliate both owned marketing intangibles and incurred additional commercial risk by using a valuable design owned by the Irish affiliate. One could envision the IRS arguing for a royalty rate closely to 8% using this logic. If BEAT, on the other hand, limited the deduction to design costs only, the result would be that the U.S. distribution affiliate would capture all residual profits. We should note that this extreme result appears to be inconsistent with arm’s length pricing.

Multinationals can plan around the BEAT provisions given the fact that cost of goods sold would remain deductible. Imagine a change in the flow of transactions where a foreign affiliate purchased shoes from third-party suppliers and took the responsibility of paying for the various intercompany services provided by other foreign affiliates. The foreign affiliate would then charge a higher intercompany price for goods such that the U.S. affiliate receives only its original CPM return. While BEAT would no longer apply, the IRS could still review whether the intercompany price is arm’s length.
The new law legislates a position that the IRS has been unsuccessfully pushing in several litigations over intercompany royalties involving medical device manufacturers.

2. Intercompany Interest Rate Considerations

Edward Kleinbard coined the term “stateless income” to capture the shift of profits away from operating affiliates to tax havens through three types of intercompany charges: interest, royalties, and rents. BEPS Action 4 proposed two types of limitations on intercompany interest deductions:

- Limits to intercompany debt where an affiliate’s debt to asset ratio mirrors the overall third-party debt to asset ratio of the multinational
- Limitations to the ratio of interest expenses relative to operating profits such as a 30% limitation

Under the old U.S. tax law, section 163(j) limited the ratio of interest expenses to operating profits before depreciation (EBITDA) to 50%, which could be seen as a generous upper bound in an era of low interest rates. The new tax law will reduce this limit to 30% and eventually use as the denominator operating profits after depreciation (EBIT).

As you’re trying to comply with the law, think about reducing interest expenses in one of two ways: interest rate and intercompany debt. Multinationals should not rush to reduce intercompany debt to be in compliance with the new provision of section 163(n) until they have done their analysis of what interest rate would be supportable under the arm’s length standard as expressed under section 1.482-2(a).

For more information on this topic, including a mock audit, see Determine Whether Your Intercompany Interest Rates Are Arm’s Length As You Comply With Section 163(n).

How ONESOURCE can help:

- **ONESOURCE Transfer Pricing Documenter** helps with arm’s length analysis of tangible, intangible, and service transactions. You can:
  - Search multiple databases simultaneously and export your data for analysis to Microsoft® Excel or Word
  - Increase accuracy and save time by eliminating manual processes
  - Get up-to-date regulatory information on revenue authorities located around the world, including the IRS’s transfer pricing accounting regulations and the OECD Guidelines

3. FDII as a Legislation Imposition of the IRS View on Intercompany Royalties

The new tax law will impose an effective tax rate of 13.125% on Foreign Deemed Intangible Income (FDII), which is defined as any profits above a routine return on sales of products abroad. The intercompany structure envisioned by FDII is a foreign affiliate licensee paying royalties to the U.S. parent as owner of intangible assets.

The FDII base is supposed to reflect what transfer pricing economists dub “residual profits” as it proposes a deduction for what is often called routine profits.

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FDII and Global Intangible Low-Taxed Income (GILTI) are defined as any foreign affiliate’s extraordinary income which is its income in excess of deemed tangible income defined as 10% of its return on its qualified business asset investment. In principle, qualified business asset investment represents the value of the foreign affiliate’s tangible assets.

The new law legislates a position that the IRS has been unsuccessfully pushing in several litigations over intercompany royalties involving medical device manufacturers. This legislated approach is likely to overestimate the arm’s length royalty rate for two fundamental reasons:

• 10% of the book value of tangible assets may underestimate the appropriate routine return and hence overestimate residual profits
• Licensees generally would retain a portion of residual profits both because third-party licensees take significant commercial risk when licensing a valuable intangible asset and because licensees often own a portion of the valuable intangible assets utilized

Section 1.482-6 recognizes the potential role played by licensees owning some of the valuable intangible assets but fails to account for the role of commercial risk incurred by the licensee.

U.S. corporations that export a significant amount of goods and/or perform IP-intensive services overseas should evaluate whether their critical IP should reside in the U.S. to take advantage of the tax benefits FDII offers.

4. GILTI and the Battle Over Intangible Profits

The introduction of the Global Intangible Low-Taxed Income (GILTI) tax is similar to BEAT in that it was created to curb the erosion of the U.S. tax base; however, GILTI is only applicable to U.S. multinationals with controlled foreign corporations.

One of the hopes of U.S. tax policy makers was that the low effective tax rate under FDII would encourage more U.S. parent corporations to keep their intangible assets owned domestically rather than migrated to foreign affiliates. The tax rate under GILTI, however, is only 10.5% if the tax haven affiliate is zero.

The Double Irish Dutch Sandwich (DIDS) that is quite popular for multinationals that have transferred their intangible assets to the DIDS has its own unique features as a portion of the Irish profits end up in Bermuda affiliates. Ireland, however, does retain a portion of these profits and taxes them at 12.5%. GILTI allows for a partial relief from double taxation so how much the multinational pays in taxes to the U.S. and to Ireland depends on the percentage of profits that Ireland retains under the DIDS structure and this partial double tax relief under GILTI. Even if Ireland abolished the DIDS structure and taxed all income at 12.5%, the total taxes under GILTI would be only 13%. The effective tax rate under GILTI would be equal to or less than 13.125% under the new tax law. As such, the incentive would remain to locate intangible assets abroad.

The representatives of these multinationals argue for a limited level of profits for the other European affiliates based on CPM logic. European tax authorities are challenging such transfer pricing arrangements on several grounds. A licensee bears significant commercial risk when utilizing valuable intangible assets owned by another entity.

The other potential issue is what represents the valuable intangible assets and which legal entity owns them. The initial establishment of what is often referred to as Cost Sharing Arrangements (CSA) is accompanied by an intercompany fee paid to the U.S. parent for pre-existing intangibles. These payments are often quite low relative to at least the initial value of the multinational’s business. One justification for these low valuations is that the intangible assets were not very valuable when the CSA was formed but grew in value through the intangible development efforts paid for by the cost sharing partner.

European tax authorities often disagree with the extreme views of the IRS with respect to the alleged U.S. ownership of all intangible assets as well as the CPM approach for the evaluation of intercompany royalty rates. The FDII/GILTI provisions of the new U.S. tax law appear to embed such extreme IRS views into U.S. tax law. How the potential prospect of double taxation from disagreements between the foreign tax authorities and the position taken under the new U.S. tax law will be resolved should be an interesting question over time.
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How multinationals adjust their tax structures and transfer pricing arrangements in reaction to these new provisions will be an interesting development to watch on a going-forward basis. U.S.-based corporations with offshore intellectual property should assess whether retaining it offshore or migrating it to the U.S. yields a better tax result. Because the GILTI tax also affects controlled foreign corporations that do not employ significant tangible assets, considerations should also be made to avoid or mitigate the GILTI tax, like investing in significant tangible assets offshore.

How ONESOURCE can help:

- **ONESOURCE Operational Transfer Pricing** helps you manage your intercompany transactions confidently, strategically, and accurately.
  - Compare any relevant business activity’s financials to the 10% return on tangible asset metric for defining routine return v. residual profit
  - Proactively review and adjust prices to remain in compliance with your transfer pricing policy year round
  - Centralize data sources at levels required for transfer pricing review, resulting in greater control and visibility over your transfer pricing process
- **ONESOURCE Transfer Pricing Documenter** helps with arm’s length analysis of tangible, intangible, and service transactions.
  - Examine the actual return to assets for third-party companies that could be seen as comparable to the routine activities of their relevant business activity
  - Get up-to-date regulatory information on revenue authorities located around the world, including the IRS’s transfer pricing accounting regulations and the OECD Guidelines
- **ONESOURCE BEPS Action Manager** offers research, data management, entity charting, document storage, reporting, and analytics combined into a single solution, enabling multinational enterprises to achieve worldwide compliance and multidisciplinary collaboration in a post-BEPS era.

Competing Amid Uncertainty

Each of these provisions addresses certain features of the debate over base erosion and profit shifting but do so in rather unique, if not controversial, ways. How multinationals adjust their tax structures and transfer pricing arrangements in reaction to these new provisions will be an interesting development to watch on a going-forward basis. Another interesting item to watch is how foreign tax authorities respond to the features of the new U.S. tax law that appear to be inconsistent with the arm’s length principle.

With so much uncertainty, it’s clear that corporate tax departments need a solution that enables transparency, consistency, agility, and of course, global compliance.

**ONESOURCE Transfer Pricing** helps you automate data collection from various global systems and compile foreign transaction information and supporting documents in a centralized location.

With access to more than 1.6 million private and public company records, ONESOURCE also has the comparables you need to establish and defend your transfer price. Our data suite gives you access to high quality public, private, and intangibles data for transfer pricing analysis. Our transfer pricing software helps you evaluate your existing pricing and policies against the latest data as you create, implement, and track new policies and manage and communicate policies across your business.

Let ONESOURCE Transfer Pricing software help you set a standard that allows you to reduce out-of-period adjustments, review intercompany policy compliance, and make timely adjustments throughout the year. Plan next year’s prices more accurately and make keeping up with comparables an automatic part of your workflow with clear documentation. Our software can help you establish a new level of accuracy and create a detailed audit trail for each step of the transfer pricing accounting process.

Lower compliance costs, mitigate tax risk, and achieve better results with ONESOURCE Transfer Pricing.
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