35th Annual TEI-SJSU High Tech Tax Institute
IP Planning and Structuring for Intangibles:

"Is IP Planning Dead?"
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SJSU | LUCAS GRADUATE SCHOOL OF BUSINESS

TAX EXECUTIVES INSTITUTE, INC.
Silicon Valley Chapter

Your Panel

Greg Hartker, Partner – Morgan Lewis & Bockius LLP

Ken Harvey, Partner – Moss Adams LLP

Peter Rock – Western Region Territory Manager - Internal Revenue Service

Matthew Sapowith, Partner – MGO

Simon Webber, Managing Director – Duff & Phelps

IP Planning and Structuring for Intangibles

Agenda:

- Historical Overview
- EU Pushback – BEPS
- US Tax Reform
- Current State of Uncertainty; IP Planning for:
    - Start Up Companies
    - Mature Tech Companies
    - Asset Heavy Companies
    - Inbound
- IP Valuation Issues
- Where do we go from here?

IP Planning and Structuring for Intangibles

Historical Overview – The "30 Year Consensus" for IP Planning

- Planning focused on minimizing buy-in, managing PE risk (old OECD rules), avoiding Subpart F
- Planning arbitrage can potentially reduce tax on foreign profits from 35% + to as low as zero
- Planning proved "a little too effective" in the digital age

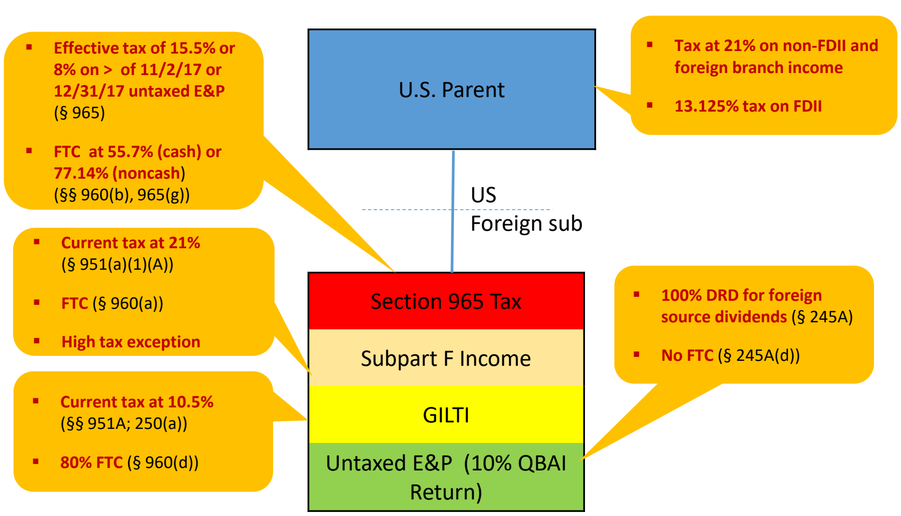
Pushback from the EU, OECD & US

- BEPS/DEMPE
- EU's ATAD (Anti-Tax Avoidance Directives) (e.g., exit tax)
- Digital Taxation (e.g. France's digital services tax)
- The US response
    - Realistic alternative, investor model, and limited use of RPSM
    - Tax Reform (GILTI/FDII)

IP Planning and Structuring for Intangibles-Tax Reform

Provision	Impact
• **Transition Tax**	• One-time tax on US shareholder's share of post-1986 earnings of foreign corporations in which it owns at least 10% (CFCs and 10/50 companies); tax rate is 15.5% (to extent of cash) or 8% (non-cash).
• **GILTI** *Global Intangible Low-Taxed Income*	• US shareholder must include share of CFC income (with certain exclusions) in excess of 10% of CFC's basis in depreciable tangible property (=GILTI). For taxable years beginning after 2017, the highest effective tax rate on GILTI for corporations is 10.5%, but increases to 13.125% for taxable years beginning after 2025
• **FDII** *Foreign derived intangible income*	• FDII is taxed at 13.125% and 16.406% for taxable years before and after 2026, respectively
• **BEAT** *Base Erosion and Anti-Abuse Tax*	• Potential tax of 10%/12.5% (before/after 2026) applies to base erosion (e.g., interest, royalties) payments by certain US companies (gross receipts $500m and deductible related party payments of 3%/2% for nonbanks/banks)
• **Limitation on interest expense**	• Interest expense that exceeds 30% of adjusted taxable income is not deductible
• **New CFC Attribution Rules**	• US corporations now deemed to own shares owned by their non-US shareholders. "US shareholder" definition now based on vote <u>**or**</u> value

IP Planning and Structuring for Intangibles-Tax Reform



IP Planning and Structuring for Intangibles

Tax Reform

- US adopts what is intended to operate as a global minimum tax disguised as a territorial system, barring unusual circumstances, foreign effective tax rate for US multinationals unlikely to go below 10.5%
- Since "full" US Federal rate now 21%, potential for tax arbitrage reduced
- Concurrently, FDII incentive provides a potential 13.125% rate

US Tax Reform – a Global Minimum Tax Approach

- The GILTI and FDII provisions together create a theoretical worldwide minimum tax on "deemed intangible income" intended to reduce incentives for companies to move their IP and the related profits offshore.
- US multinational corporations serving foreign markets should theoretically pay approximately the same effective tax rate on its intangible type income regardless of where it is located:
  - IP Offshore serving foreign customers – subject to GILTI (between 10.5% and 13.125%)
  - IP in the US serving foreign customers – eligible for FDII (21% US corporate tax rate reduced to 13.125%)
- Needless to say, it won't always work that way in practice.

FDII Planning

- Current rate is 13.125%. This rate will increase to 16.406% for tax years beginning after December 31, 2025.
- Potential challenges to the deduction (e.g., WTO) add uncertainty to structuring for FDII.
- A foreign person is generally a person that is not a US person under Section 7701(a)(30), including a foreign partnership and a foreign government.
- Foreign use means any use, consumption, or disposition that is not in the US.
- Documentation is an important aspect of FDII. Both the status of a buyer as a foreign person and the foreign use of the intangible property must be documented.

FDII Planning

- Intangible property is considered sold for a foreign use in proportion to the revenue generated by the property from exploitation outside the US.
  - It is possible to have a partial foreign use of intangible property.
  - A sale to an unrelated person for further manufacturing or modification in the US does not qualify.
  - Bundled transactions that include both sales and service factors are classified according to their predominant character.
- For intangible property used in the manufacture, development, sale or distribution of a product, the intangible property is treated as exploited at the location of the end user when the product is sold to that end user.
- For sales in exchange for a lump-sum payment, foreign use is determined based on the NPV (net present value) of the projected revenue.

US Tax Reform – Other Considerations – Subpart F

- Planning is generally advisable to obtain the lower GILTI effective tax rate (often 10.5% for US corporate shareholders) rather than the higher Subpart F tax rate of 21%.
  - However, consider that the foreign tax credit relating to Subpart F carries forward, while any unused GILTI foreign tax credit is lost.
  - Also consider that high tax kick out currently only applies to Subpart F income. Proposed regulations (not currently in effect) would expand the high tax kick out to GILTI.
  - The sale of IP by a CFC generally would qualify as either Subpart F income or as GILTI depending on the prior usage of the IP.

US Tax Reform – Other Considerations – R&D

- There will be mandatory amortization of R&D costs beginning in tax years after December 31, 2021.
  - Research conducted in the US – 5 year amortization period
  - Research conducted outside the US – 15 year Amortization Period
  - This change will affect the desirability of the R&D credit and whether non-core R&D costs are deducted under IRC §174 or another code section.
- Qualification for a patent box regime may also affect decision making. However, note that when the effective tax rate drops below 10.5%, GILTI may eradicate the tax saving.

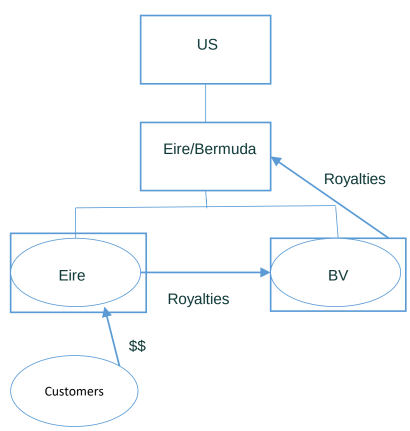
US Tax Reform – Other Considerations – States

- State adoption of TCJA changes has been inconsistent and has led to varying conformity to Section 965, GILTI, and FDII.
  - Fixed Conformity vs. Rolling Conformity
- Trends in state apportionment (single sales factor) and sourcing of sales (market-based sourcing) have also had an affect on IP placement.

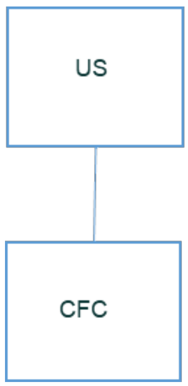
Pre-2017 US Intangibles Planning

The famous Double Dutch Irish Structure:

- Irish/Bermuda IP Holdco
- Dutch licensing
- Irish principal
- Result: lots of low tax profits, and
- France and Germany not happy



US Corporate Tax – After 2017

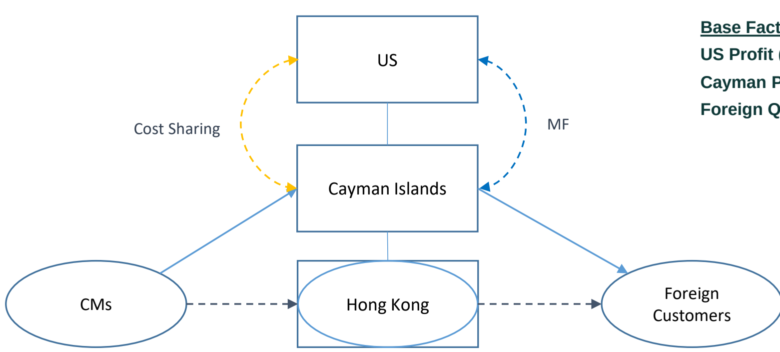


Unified tax rate of ≥ 13.125% (except for QBAI)

- CFC subject to tax in home country
- US parent subject to 21% tax on current year CFC earnings, but potentially mitigated by: i) 50% Section 250 deduction, and 80% Section 960 foreign tax credit and theoretical 901 credit; "QBAI" safe harbor
- No US tax on dividend (regardless of whether the income was subject to GILTI)
- 960 FTC one time "use it or lose it" for GILTI: no excess credit carryover
- FDII export incentive: target tax rate of 13.125%
- Individuals do not get the 13.125% FDII rate. To get a reduced GILTI rate, individuals must make a Section 962 election.

Life After US Tax Reform – "Old School" Tech Example

Example: Fabless Chip Company



Base Facts
US Profit (MF) = 100x
Cayman Profit = 1000x
Foreign QBAI = 0x

IP Planning and Structuring for Intangibles

GILTI Results:

US Profit*	100x
GILTI (Gross Inclusion)	1,000x
Section 250(a)(1)(B) Reduction	(500x)
Taxable Income	600x
US Federal Income Tax (21%)	126x
Global Effective Tax Rate (126x/1100x)	**11.45%**

* Available for FDII Section 250 deduction

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FDII Alternative: Cayman Royalty Structure

US Profit*	100x
Royalty Income (Max)	1,000x
Less: Section 250 Deduction	(375x)
Taxable Income	725x
US Federal Income Tax (21%)	152x
Global Tax Rate (152x/1100x)	**13.82%**

* Available for FDII Section 250 deduction

IP Planning and Structuring for Intangibles

- Onshore and offshore QBAI (tax reform confuses the definition of intangibles with the arbitrary FDII/GILTI definition)
- Changes to IRC 482/367(d) rules and repeal of former 367(a)(3)
- Consequently, offshoring IP looks compelling on paper
- Counterintuitive results: incentive for US companies manufacture and sell offshore?
- BEPS meanwhile is essentially increasing local country tax risk and uncertainty
- DEMPE functionality-increase in uncertainty or opportunity?
- Foreign to foreign basis step-ups (Uber ?)

IP Planning and Structuring for Intangibles

Uncertainty: the uncertain global tax and political environment makes any tax rate projections speculative. In such an environment many taxpayers will prefer to ‘wait and see’.

What issues should be considered when planning for a:

- Startup company

- Post-revenue but pre-profit enterprise

- Mature global company

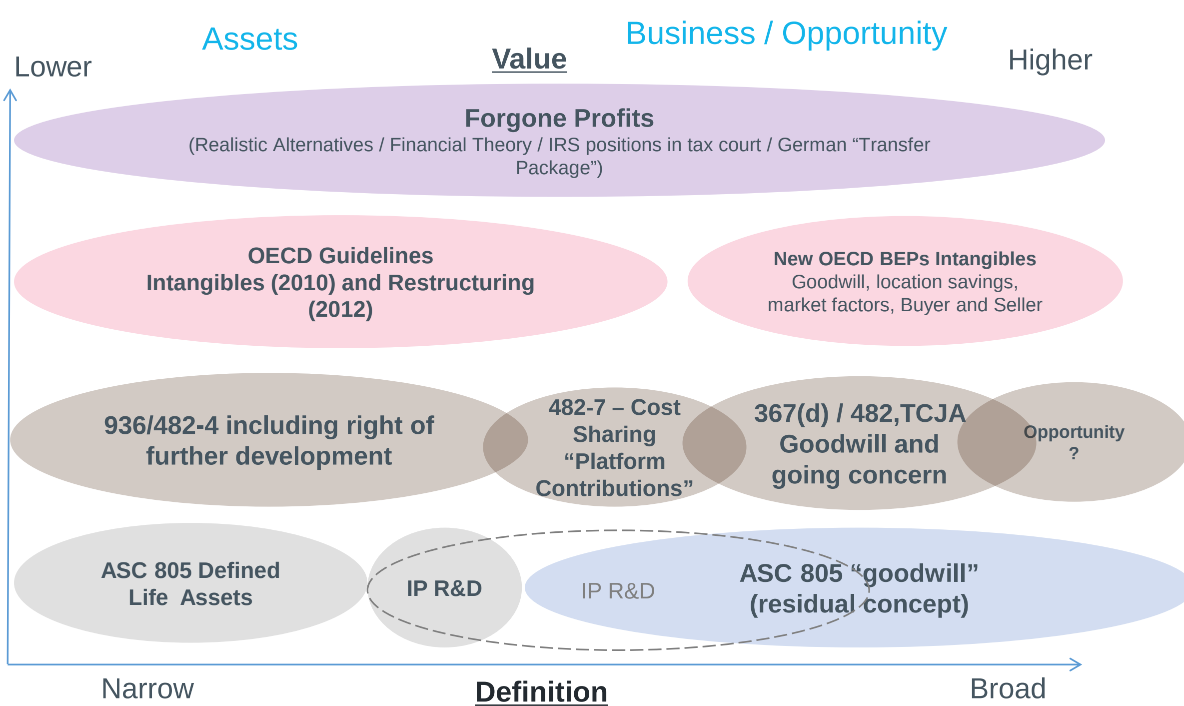
- Inbound (foreign-based) company vs outbound

Is there a preferred approach? What does the IRS think? Note that in some global situations, IRS/Treasury are now the allies of multinationals. US rules still place a higher emphasis on “floating intangibles” while EU rules are attempting to tie profits to so-called DEMPE functions.

Navigating Valuation Issues

Asymmetry abounds:

- Definitions of compensable intangibles
- What profits are you migrating
- Applicable rules
- Value definitions
- Gains and tax amortization basis
- Projections and CWI/HTVI



Key Valuation Questions: What profits are you migrating?

Forecasts

- Reliability of Company projections
- Probability weighted expected outcomes
- Organic or acquisitive growth

Several key questions still remain if onshoring to a foreign principal company

- Is onshoring of IP to principal company (with respectable substance) plus CSA with parent good enough?
- How much DEMPE is enough?
- Is contract R&D business as usual (albeit with higher mark-ups)?
- Data, the new "Market" intangible on the block?
- Market returns (BEPS 2.0)?

Key Valuation Questions: Applicable Rules

Mechanisms

- Transfers
- Contributions
- Dividends
- Exchanges
- Redomiciling
- Dual incorporation
- Licensing

Example

Applicable Rules

- Transfer pricing rules (ALS)
- Financial reporting rules
- Local specific tax valuation rules
- Capital Gains Tax rules
- Other
  - §367(d) super royalty

Key Valuation Questions: Value Definitions

Realistic alternatives

- Buyer perspective vs Seller's perspective
- Highest and best use vs actual use
- Range for transaction "clearing" price

Pre-tax vs post tax

- Tax assumptions
- Tax amortization benefits
- Tax gross up

Cash flow vs operating profits

- Capex, working capital, tax rules
- Different business models can generate very different cash flows
- TCJA impacts on cash flows (capex incentives, timing of deductions and taxation)

Limitations on Amortization: Tax Amortization Benefits

US IRC §197 amortization and the anti-churning rules:

- August 10, 1993 §197 amortization rules changed to allow amortization of indefinite lived assets
- Indefinite lived assets existing before August 10, 1993 are not eligible for §197 amortization

Non-amortizable assets

- Depends on local rules

Tax vs Financial Reporting Definitions

- Asset purchase vs Business combination

Limitations on Amortization: Tax Amortization Benefits

FOR ILLUSTRATION ONLY- DO NOT RELY ON THIS TABLE - CAPITAL ALLOWANCE AND AMORTIZATION RULES ARE COMPLEX								
Intangible Tax Amortization Benefit Period for Selected Countries (years)								
Country	Valuation Standard[7]	Patents	Software/ copyrights	Other Technology[1]	Trademarks	Customers / Relationships	Goodwill	Last Updated
United States	ALS or FMV	15	15	15	15[2]	15	15[2]	2019
Canada[6]	ALS or FMV	RUL or Elect 25% reducing bal	1 year or RUL	RUL	15~20[5]	15~20[5]	15~20[5]	2019
Ireland[4]	FMV or FV	RUL[3] or Elect 15	RUL[3] or Elect 15	RUL[3] or Elect 15	RUL[3] or Elect 15	No TAB	No TAB	2019
Netherlands	ALS or FMV	Greater of RUL or 5 years	Greater of RUL or 5 years	Greater of RUL or 5 years	Greater of RUL or 5 years	Greater of RUL or 5 years	10 years or longer	2019
United Kingdom[8]	FMV or FV	RUL or Elect 25	RUL or Elect 25	RUL or Elect 25	RUL or Elect 25	6.5% pa (15.4 years)	6.5% pa[9] (15.4 years)	2019
Australia[10]		20	5	5	No TAB	No TAB	No TAB	2016
Singapore	"Open Market Price" similar to FV	Irrevocable election for 5, 10 or 15 years	Irrevocable election for 5, 10 or 15 years	Irrevocable election for 5, 10 or 15 years	Irrevocable election for 5, 10 or 15 years	No TAB	No TAB	2019
Hong Kong		1	1	1	5	No TAB	No TAB	2016
China		RUL or Elect 10	RUL or Elect 10	RUL or Elect 10	RUL or Elect 10	RUL or Elect 10	No TAB	2016
Malaysia		5	2.5	2.5	5	No TAB	No TAB	2016

Income Approach: Projections and Tax Rates

Impact of TCJA

- Important to have a discrete forecast period in the DCF extend to ***2027 or later*** to account for some of the tax policy implications that are temporary
- Expected impact on tax savings in initial years likely leads to an ***increase in operating cash flow***. This may not always translate to ***Free Cash Flow***.
- Capex and R&D rule changes mean that ***mid-term cash flows may reduce significantly***.

How should valuations take into account tax uncertainty?

- Will there be challenges to FDII at the WTO?
- Some concern in the tax community about potential reversals of tax rates by subsequent administrations.
- What's the impact of digital taxes on international tax developments?

Valuations should only include expectations of events that are known or knowable

Best Practice: probability weighted expected outcomes based on different scenarios…if you've got the time

Projections: US Commensurate with Income / OECD Hard to Value Intangibles

- Similarities between US CWI and OECD HTVI
  - Deal with asymmetry of information between taxpayer and tax authorities
- Differences between US CWI and OECD HTVI
  - Replacement vs recalculation
  - Special rules (US CSA's and US intangibles)
- Mitigation (if desirable):
  - Have probability weighted outcome scenarios with sufficient breadth.
  - Contingent consideration
  - Built in adjustment trigger clauses