Intangibles Planning under the Tax Cuts and Jobs Act

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Welcome to the New World. The Tax Cuts and Jobs Act (“Act”) just made holding intangible property (“IP”) in the United States a lot more attractive, and holding IP outside the United States a lot less so. Doing so, it provides important benefits for U.S. domestic manufacturers that own IP in the United States, particularly those that export, and that did not heretofore own and develop IP through affiliates in low-tax jurisdictions. The Act also requires us as tax practitioners and economists to rethink fundamentally our approaches to transfer pricing planning for intangibles and to develop a whole new set of skills and knowledge. Many have likened the adjustment to that following the Tax Reform Act of 1986.

Intangible Income

The first step in intangibles planning under this new regime is understanding the definition of intangible income under the Act. Intangible income is deemed to be that income which exceeds a 10-percent return on qualified business asset investment (“QBAI”) less allocable interest expense. QBAI is the quarterly average for each taxable year of the adjusted bases in any tangible property used in the production of the tested income. The 10-percent return on QBAI is known as deemed tangible income return. Reducing it by interest expense appropriately allocable to tested income results in net deemed tangible income return.

As economists we have traditionally considered routine profit to be that profit which can be benchmarked and residual profit to be the remaining profit. For example, a certain markup on costs or return on operating assets based on comparables might be used for determining a routine return for manufacturing (it might even be 10 percent of QBAI). But income attributable to intangibles could also be considered routine if it could be reliably benchmarked, for example, by a fixed royalty rate. Residual profit could also be attributable to things other than intangibles such as risk. This viewpoint will continue to be valid but in the application of certain important provisions of the Act, it is turned on its head. For those provisions, the only routine profit is 10 percent of QBAI and all residual profit is attributable to intangibles.

Therefore, for any U.S.-owned multinational enterprise to assess the impact of the Act it will need to measure its intangible income and where it is being earned. For those corporations earning foreign-related intangible only income in the United States, the Act provides an unequivocal benefit. Those corporations earning intangible income outside of the United States could face additional taxes due to a minimum tax on those earnings as described further below. So much for territoriality under the new participation exemption system.

Foreign-Derived Intangible Income

What makes holding IP so attractive in the United States is the deduction for foreign-derived intangible income (“FDII”). The benefit depends, of course, on the level of residual profit
related to foreign sales. FDII is that intangible income related to sales of property, where sales are defined to include any lease, license, exchange, or other disposition; by a U.S. corporation to non-U.S. person for foreign use or services provided by a U.S. corporation to a non-U.S. person or with respect to property not located in the United States. The Act provides a deduction on FDII of 37.5 percent. With the new flat corporate tax rate of 21 percent, the effective rate on FDII is 13.125 percent. That benefit, however, is reduced for taxable years after 2025 when the deduction changes to 21.875 percent, yielding an effective rate on FDII of roughly 16.4 percent.

Global Intangible Low-Taxed Income

Where U.S. multinational enterprises may see additional U.S. tax resulting from foreign-earned intangible income is the inclusion in the gross income of a U.S. shareholder of any controlled foreign corporation (“CFC”) its global intangible low-taxed income (“GILTI”). GILTI is the aggregate foreign intangible income, or that income which exceeds 10 percent of QBAI, less interest expense. GILTI will have a deduction of 50 percent, resulting in an effective rate of 10.5 percent. Foreign tax credits are allowed for foreign taxes paid with respect to GILTI but those credits will be limited to 80 percent of the taxes paid. Thus, any GILTI taxed at less than 13.125 percent (10.5%/0.80) would be subject to current U.S. tax. That rate (13.125 percent) is identical to the effective rate on FDII.

In addition, for taxable years beginning after 2025, the deduction for GILTI is decreased to 37.5 percent, resulting in an effective rate of 13.125 percent. The haircut of 20 percent on foreign tax credits, however, means that any GILTI taxed at less than 13.125 percent (13.125%/0.80) would be subject to current U.S. tax. Again, the rate is identical to that for FDII after 2025.

Implication

In sum, the Act defines intangible income to be all income that exceeds 10 percent of QBAI less allocable interest expense, and it taxes any foreign-related intangible income at 13.125 percent through 2025 and at 16.4 percent thereafter whether it is earned in the United States or abroad.

Planning

In planning for intangibles under the Act, it may be useful to consider three different categories of U.S.-owned multinational enterprises:

1. Those that own and develop IP in the United States only;
2. Those that own and develop IP in the United States and abroad and that have considerable substance with respect to their international IP-holding structures; and
3. Those that own and develop IP in the United States and abroad and that do not have considerable substance with respect to their international IP-holding structures.
Category 1

These companies likely have little need to consider tax planning with respect to intangibles. They will enjoy a preferential rate on their foreign-derived intangible income under their current structures. Additionally, shifting IP outside of the United States may be prohibitively expensive as the Act has also defined intangible asset to include any goodwill, going concern value, or workforce in place. For these companies, Christmas came three days early when the President signed the legislation on December 22.

Category 2

These companies may likely wish to continue with their existing intangible ownership and development strategies. While the tax-rate differential with respect to intangible income (as defined by the Act) may have been eliminated, these structures have been set up with important business purposes and considerable investment. There might not be any benefit from making changes. Still, if there is a perceived benefit for centralizing global intangible ownership and development, then the United States would likely be a good jurisdiction for them.

Category 3

These companies may seriously wish to consider centralizing IP ownership in the United States. Efforts by the Organisation for Economic Co-operation and Development (“OECD”) to combat base erosion and profit shifting (“BEPS”) are placing strain on IP-ownership structures with little substance. An important part of the OECD’s Action Plan on BEPS is aligning transfer pricing outcomes with value creation. The items reported on the OECD’s Country-by-Country Report suggests that value creation is related to capital, headcount, and tangible assets. These companies also tend to hold IP in very low-tax jurisdictions so taxes associated with an outbound transfer of IP from those jurisdictions might not be great.

But there are risks associated with onshoring IP in the United States due to uncertainty as discussed below.

Risks

A vitally important consideration in intangibles planning under the Act is: how permanent is any of this? For one, the deduction on FDII may, and likely will be, challenged as an illegal export subsidy under the rules of the World Trade Organization (“WTO”). The WTO previously ruled against previous Foreign Sales Corporation and Extraterritorial Income Exclusion provisions.

Additionally, the entire Act itself may be at risk depending on future control of Congress and the White House. The Republican strategy of bringing the legislation to a rapid vote was a success. But it did not afford Republicans the opportunity to persuade thoroughly the American public or any of their Democratic colleagues in the House and Senate.
The Tax Reform Act of 1986, by contrast, was forged through extensive vetting and bipartisan consensus. President Ronald Reagan and Secretary of the Treasury James Baker worked with House Speaker Thomas (“Tip”) O’Neill and Ways and Means Committee Chairman Daniel Rostenkowski of the Democratic-controlled House as well as Senator William Bradley and Representative Richard Gephardt, who had their own tax-reform bill. The current Act passed by a simple majority in the Senate.

Summary

The Act provides considerable benefits to U.S. corporations that earn their foreign-related intangible income in the United States. Its effect is more ambiguous on companies that own and develop IP in multiple jurisdictions where they have established considerable substance, and in some cases may actually result in an increased tax burden. It likely results in a detriment to those companies that own IP in low-tax jurisdictions with little or no substance but provides an opportunity for them to onshore their IP in the United States and still benefit from a preferential rate.

But caution is prudent before making any changes in one’s IP ownership and development strategies. Once IP has been shifted back to the United States it will be expensive to move it out. The inclusion of goodwill and going concern value in the definition of intangible asset will make any IP value more akin to an enterprise value. Planning for IP under the Act will depend critically on a company’s subjective probability assigned to survival of the Act’s provisions related to intangible income and the corporate income tax rate.

Finally, I am responsible for the views expressed in this Transfer Pricing Update and they are not necessarily those of my colleagues at Economics Partners, LLC.