SHIFTING INCOME AND BUSINESS OPERATIONS

Authors
Stanley C. Ruchelman
Kenneth Lobo

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INTRODUCTION

Multinational groups ("M.N.G.'s") engage in foreign direct investment as they acquire or create assets abroad to manufacture or sell the corporation's goods and services. There are many business reasons to make outbound foreign direct investments. Building a plant abroad may be the most cost efficient way for a U.S.-based M.N.G. to gain access to a foreign market. Trade barriers or transportation costs could make it prohibitively costly to serve the foreign market via direct export from a U.S. location. Foreign direct investment may put the U.S.-based M.N.G. physically closer to its customers, allowing better customer service and providing a better understanding of the foreign market. A U.S. multinational corporation may make an outbound foreign direct investment to lower operating costs by exploiting less expensive, or more skilled, foreign labor and less expensive access to raw materials or components from suppliers, or to permit operation in a less burdensome regulatory environment. Foreign direct investment may provide access to technology developed abroad.

Another factor that may motivate foreign direct investment is the tax burden placed upon a U.S.-based M.N.G.'s. The phrase "to shift income" is used in the J.C.T. Report to refer to the broad range of tax-planning techniques that minimize tax liability by migrating income or items of income from a high-tax jurisdiction to a jurisdiction with a low- or zero-tax rate. Such migration may be achieved through the restructuring of a business and its supply chain, the transfer or sharing of ownership rights to intangible property ("I.P."), and use of the asymmetries between U.S. law and that of another jurisdiction in order to avoid income recognition under Subpart F and ensure deferral.

VALUE CHAIN PLANNING

While it is generally not possible to avoid high-tax jurisdictions entirely, an integrated value chain may be structured in a way that achieves both business and tax objectives. These structures often follow what has come to be known as the principal model, which limits the functions and contractual risk of M.N.G. members in high-tax countries allowing the profit attributable to risk-taking and high value functions to be allocated to a member in a low-tax country. To illustrate, a group member in a low-tax country would act as principal. It would own I.P. rights and would retain the contractual responsibility for high value functions associated with that property, such as the continued development of I.P., as well as the general management and control of business operations. In comparison, lower value functions, such as contract manufacturing or limited risk distributor functions, would be performed in locations dictated by non-tax business needs or historical reasons. Examples include proximity to suppliers and ultimate customers and an experienced workforce.

Those functions would be performed by a related contract manufacturer or other limited-risk contractor that recognizes positive taxable income limited to a routine return reflecting the absence entrepreneurial risk.

In the past, the O.E.C.D. recognized the importance of risk-taking and the contribution efficient value chain structures made to lower the barrier to entry in new markets. However, there exist concerns that some allocations of risk may be mere formalities. This underlies several action items within the ongoing Base Erosion and Profit Shifting Initiative ("B.E.P.S.").

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Commentators have expressed concern that traditional transfer pricing principles are ignored by the O.E.C.D. recommendations, which, if adopted, would make it difficult for a corporation to know whether its structures and risk allocations will continue to be respected.

Evidence exists that there is increasing awareness of these concerns, which may lead to more cautious tax-planning. This can play out in two behavioral changes. One is the avoidance of the principal model where possible. The other is the creation of substance in the principal model so that risks and functions are accompanied by head count and facilities. Both are evidence of a "good citizen" approach, but the latter leads to loss of high-value functions now performed in the United States on a contract basis by a related party.

EXPLOITATION OF I.P. RIGHTS

The taxation of income attributable to I.P. is a particularly difficult area for policymakers. The location of I.P. and related profit is highly sensitive to tax rates and may account for a significant share of shifting profit to low-tax jurisdictions.

A U.S. person may transfer I.P. or a right to use the property to a related foreign person in one of four ways: (i) an outright transfer of all substantial rights in the I.P., either by sale or through a non-recognition transaction such as a tax-free capital contribution; (ii) the provision of services by a member of the U.S. M.N.G. where the use of the I.P. enhances the value of services; (iii) a license of the I.P.; and (iv) a qualified cost-sharing arrangement.

All licenses or sales of I.P., and provision of services that use I.P., are generally required to be conducted on an arm's length basis. A cost-sharing arrangement is a cross-border transfer through the sharing of I.P. rights. Again, it must be carried out on an arm's length basis and significant controversy exists regarding the "buy-in," which is an upfront cost for the right to share, and the indirect costs that must be shared. Direct costs are not controversial, but equity-based compensation is a flashpoint at the present time. As a result of the arrangement, the foreign affiliate owns some or all of the rights to the new technology developed under the arrangement for use within its designated geographic area of operation.

If a transfer of I.P. to a foreign affiliate occurs in connection with certain corporate transactions, the transferor must recognize imputed income as if it sold the intangible for payments that are contingent on the use, productivity, or disposition of the transferred property. The payments continue over the useful life of the property or its period of ownership, up to 20 years.