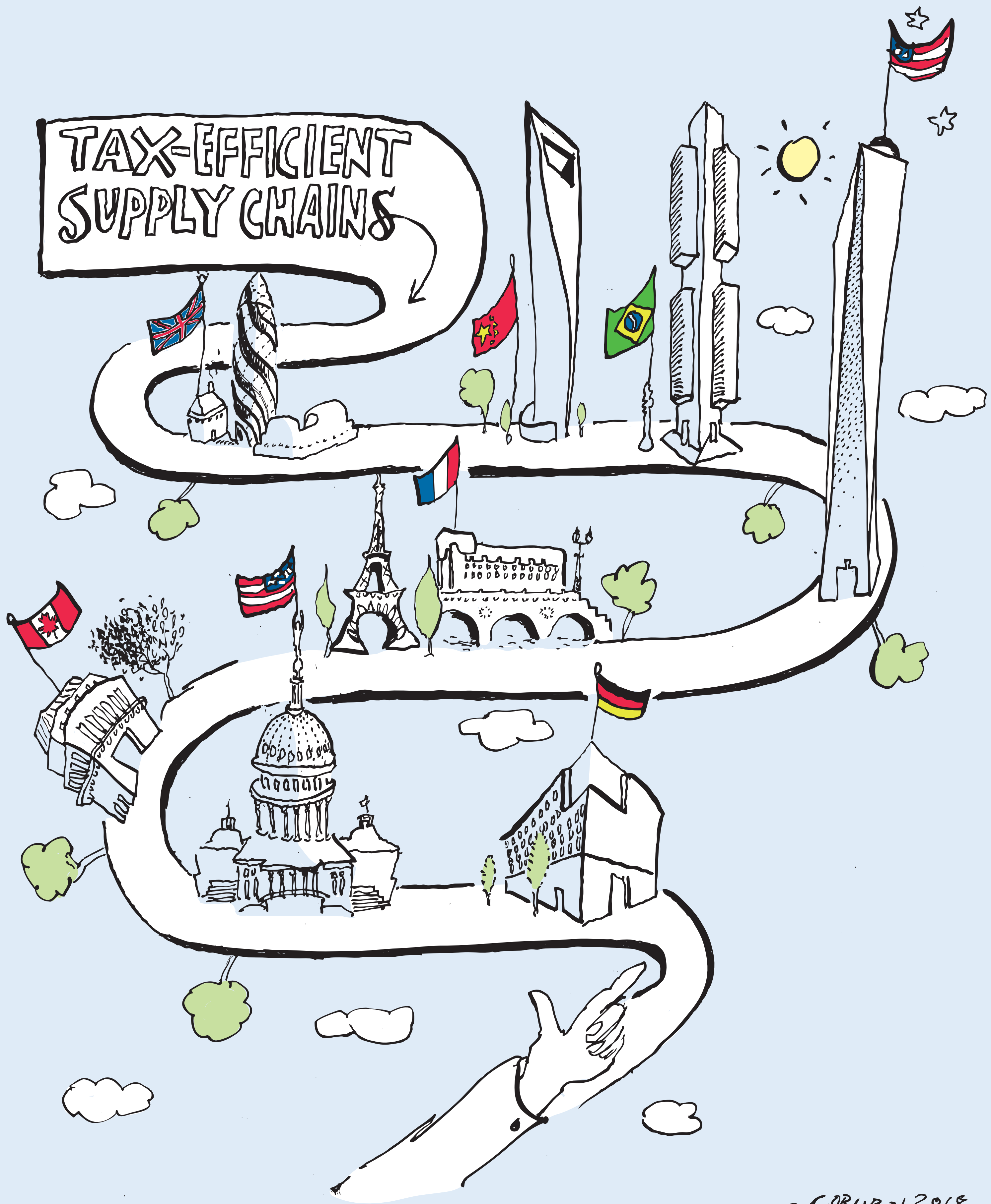
TAX-EFFICIENT SUPPLY CHAINS
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Tax-Efficient Supply Chain in Shadow of Tax Reform

GILTI, FDII, and BEAT: they're not just acronyms—they require reassessing tax consequences of existing supply chain structures

By Moshe Spinowitz

For the past quarter century the same legal framework and economic incentives have driven how multinational corporations structure their supply chains. Relatively high U.S. corporate rates incentivized companies to locate valuable assets and operations in lower-taxed jurisdictions; the United States' worldwide tax regime incentivized retaining and reinvesting those earnings outside the United States; and the anti-deferral regime of Subpart F of the Internal Revenue Code mandated compliance with its rules to avoid the generally adverse consequences of immediate, full U.S. taxation.

Then came December 22, 2017. Several core features of the tax reform legislation enacted that date (whose full name I have relegated to the endnotes)[1] should prompt multinational corporations to reevaluate their supply chain structures. First and foremost, the reduction in the U.S. corporate tax rate from 35 percent to 21 percent significantly shrinks the gap between the U.S. tax rate and foreign tax rates. When coupled with the foreign tax implications of the Organisation for Economic Co-operation and Development's BEPS project, that gap maybe be smaller yet.

Second, the replacement of the prior international taxation regime—in which foreign subsidiary income was generally not taxed in the United States until it was repatriated—with a new regime in which foreign subsidiary income is either taxed in the United States currently (albeit at potentially differential rates) or not at all alters the basic rules governing the taxation and repatriation of foreign earnings.

Finally—and derived from the prior point—the adoption of a bevy of new regimes (with their attendant acronyms) governing the taxation of cross-border activities—GILTI, FDII, and BEAT—requires a reassessment of the tax consequences of existing supply chain

structures and their continuing tax and business efficiency under these new regimes. And with these rules already in effect, time is of the essence.

Below, I briefly summarize the key aspects of the new GILTI, FDII, and BEAT regimes. These summaries are by their nature general overviews and do not attempt to address every nuance or ambiguity of these new rules or their sometimes unexpected interactions. After those brief summaries, I discuss aspects of the landscape that have and have not changed, and the implications those changes might pose for multinational supply chain planning after tax reform.

Impact of Key International Aspects of Tax Reform on Supply Chain Planning

GILTI

Although some have described the new international tax system as a "territorial" system, that is at best a misnomer. The new regime is in fact one in which a far broader swath of foreign subsidiary income is subject to current U.S. taxation. And the main culprit is the new GILTI regime.[2] GILTI—or global intangible low-taxed income—is in some ways a new category of Subpart F income that subjects controlled foreign corporation (CFC) income in excess of a certain threshold (described below) to current taxation in the United States, at potentially reduced tax rates (only "potentially" because the deduction mechanism through which the reduced tax rate is achieved may not in fact yield a reduced rate of tax in all circumstances).

Broadly speaking, under the GILTI regime, a U.S. shareholder calculates its net CFC income (excluding for these purposes certain specified categories of income such as "regular" Subpart F income and netting for these purposes income and losses across CFCs) that is in excess of a 10 percent return on the CFC's basis in depreciable tangible property.[3] That "excess" net income is deemed to be intangible income that is included on a current basis in the taxable income of the CFC's U.S. shareholders. Corporate U.S. shareholders of the CFC are then entitled to claim a deduction (subject to certain limitations) equal to 50 percent (and falling to 37.5 percent after 2025) of the GILTI, yielding an effective tax rate of 10.5 percent (or 13.12 percent starting in 2026).[4] The U.S. shareholder may then claim a foreign tax credit in respect of 80 percent of the foreign taxes paid with respect to the GILTI.[5] In a simple scenario, foreign income that is taxed at a rate of 13.125 percent (16.4 percent starting in 2026) or greater would result in no U.S. residual tax, since 80 percent of the credits associated with 13.125-percent-taxed income would fully offset the 10.5 percent U.S. tax that would otherwise be levied on that income. But the devil is in the details, and the availability of the deduction and the ability to use the associated foreign tax credits can cause the effective tax rate on such foreign income to vary significantly.

FDII

As a complement to the new GILTI regime, the new legislation introduced a somewhat similar reduced-tax regime for foreign "intangible income" earned directly by domestic corporations that parallels the reduced rate of tax that applies to such income earned by foreign subsidiaries. Under that regime, a domestic corporation is entitled to a 37.5 percent deduction (falling to 21.875 percent after 2025) in respect of its foreign-derived intangible income, or FDII, earned with respect to the sale of goods or provision of services to foreign persons.[6] The deduction is generally available for income derived from the sale of goods or provision of services to unrelated foreign persons as well as sales or services to related foreign persons, provided that the property sold to the related foreign person is either resold or used in the sale of other property to an unrelated foreign person or that, in the case of services, the related party does not provide substantially similar services to persons in the United States.[7] For these purposes, the lease or license of property constitutes a sale.[8] Like GILTI, FDII is calculated formulaically based on income earned in excess of a 10 percent return on depreciable tangible property. In effect, where the deduction is fully available, the provision yields a reduced 13.125 percent (16.4 percent after 2025) rate of tax on such foreign-derived income. FDII is thus essentially designed to place on an even footing "foreign-derived income" earned directly by a domestic corporation with similar income that is earned by a foreign subsidiary of a domestic corporation.

BEAT

Finally, whereas GILTI and FDII generally address "outbound transactions"—i.e., foreign income earned by domestic corporations and their foreign subsidiaries—the new BEAT (Base Erosion and Anti-Abuse Tax) regime addresses inbound transactions, i.e., the treatment of expenses incurred by domestic corporations with respect to payments to foreign persons.[10] The BEAT is effectively a new alternative minimum tax that applies a reduced rate of tax (10 percent currently, climbing to 12.5 percent after 2025) to a larger tax base (so-called "modified taxable income"). The larger tax base is calculated by disallowing deductions in respect of deductible payments made by domestic corporations to related foreign persons (provided those deductions are above a certain threshold). And generally speaking, tax credits (including foreign tax credits, but excluding R&D credits) cannot be used

to reduce a taxpayer's BEAT liability. The net result is that domestic corporations that make significant deductible payments to foreign affiliates and/or that rely on tax credits (e.g., foreign tax credits) to reduce their "regular" U.S. tax liability may well feel the bite of the BEAT.

What Hasn't Changed: Old-Fashioned Subpart F Is Still With Us

SAME RULES . . .

Before discussing those aspects of international tax reform that have changed the tax and supply-chain landscape, it is worth noting what *has not* changed—most notably "old-fashioned" Subpart F income.

Notwithstanding the significant changes to the international tax regime enacted by the TCJA, the basic rules regarding what constituted Subpart F income pre-reform remain in effect. Relevant to supply chain planning in particular, the rules regarding foreign base company sales and services income remain unchanged. Multinational corporations thus will continue to need to monitor their CFC operations to determine whether sales and services income earned by their CFCs remains outside the scope of the Subpart F rules of Sections 954(d) and 954(e). Questions that existed before tax reform—for example, what constitutes manufacturing (both physical manufacturing and substantial contribution to manufacturing) for purposes of Section 954(d); where services are considered performed for purposes of Section 954(e); how to distinguish between sales and services for purposes of those two provisions; how to apply the branch rules of Section 954(d); and how new technologies may alter the answers to any or all of these questions—remain issues that must be faced by U.S. multinational corporations with foreign operations.

. . . BUT POTENTIALLY DIFFERENT RESULTS

While the legal framework for analyzing and applying the foreign base company sales and services rules have remained unchanged, the broader changes in the international tax regime have dramatically transformed the relevant economic considerations. As a result, taxpayers may well need to reassess the general assumptions that "more foreign subsidiary income is good" and "Subpart F income is bad" that have driven so much of supply chain planning for the past several decades.

First, the significant reduction in the U.S. federal income tax rate—from 35 percent to 21 percent—has significantly reduced the cost of earning Subpart F income. And given that a tax credit is still available for foreign taxes paid with respect to Subpart F income, the residual U.S. tax incurred due to earning Subpart F income may be significantly reduced or eliminated as a result of the reduction in the U.S. corporate income tax rate. For example, whereas previously a CFC's Subpart F income taxed at 20 percent in the relevant local jurisdiction would face a 15 percent residual U.S. tax, today the U.S. residual tax on such income would be a mere one percent.

In addition, the new GILTI regime (described above) causes a far broader swath of CFC income to be subject to current U.S. tax. In essence, all CFC income in excess of a threshold return on tangible assets will now be subject to current taxation in the United States. Thus, non-Subpart F income that was previously exempt from current taxation in the United States is now currently includible under the GILTI regime. For taxpayers that can fully utilize the GILTI-associated deduction, the reduced rate of taxation on that income—10.5 percent versus 21 percent—would still make it preferable to earn CFC income as "GILTI" and not as foreign base company sales or services income. But there may well be scenarios where there is little difference, or even a benefit in earning such income as foreign base company income. In particular, where much of the GILTI deduction cannot be claimed (e.g., the taxpayer's U.S. losses), and the GILTI credits cannot be used (nor can they be carried forward or back under the new regime), it may, ironically, be advantageous to earn foreign base company income so as to be able to claim the associated credits, and carry them forward or back under the rules of Section 904(c).

> Although some have described the new international tax system as a "territorial" system, that is a misnomer at best.

Conversely, the adoption of a dividend-exemption regime with respect to dividends from foreign subsidiaries may mean that companies that previously chose not to comply with the foreign base company sales and services rules in light of repatriation needs (and related U.S. taxes) may wish to rethink that decision. Previously, for a U.S. multinational planning to taxably repatriate its foreign earnings, there was no tax deferral benefit to complying with the Subpart F rules—in all events, the income would be subject to full, current U.S. taxation. Under the new dividend exemption system, that is no longer the case. Because U.S. taxation of CFC income no longer depends on whether those earnings are repatriated to the United States, under the new regime, foreign base company sales and services income (taxed at the full 21 percent

rate) may in fact be more costly than non-Subpart F GILTI that enjoys a reduced rate of tax. There thus may be a permanent benefit to ensuring that CFC income is not foreign base company sales or service income, without regard to any planned repatriation of those earnings.

Finally, the new FDII regime may, in fact, make it more desirable for domestic corporations to earn income from foreign sales and services directly, rather than through foreign subsidiaries. Under prior law, the choice was generally to earn income directly in the United States and pay 35 percent tax on such income, or to earn income in a foreign subsidiary (generally at lower rates) and at least have the possibility of deferring U.S. tax on such income. With the new FDII regime, the choice may instead be: earn income directly in the United States and enjoy a reduced rate of tax (potentially as low as 13.125 percent) on such income, or earn income in a foreign subsidiary and potentially face a higher (21 percent) rate of tax on such income under the Subpart F regime. In other words, earning income in a foreign subsidiary may no longer be the "nothing ventured, nothing gained" proposition it once was.

The essential point is that when viewed in isolation, the rules governing Subpart F income generally—and foreign base company sales and service income in particular—remain unchanged, the collateral consequences of the tectonic shift in U.S. tax law cannot be ignored. The reduction in the U.S. tax rate, adoption of a dividend-exemption system, and introduction of the new categories of GILTI and of FDII mean that past tax savings are no indication of future results, and an overall, individualized reassessment of the tax (and nontax) costs and savings of complying with the foreign base company sales and services income rules is warranted.

As with FDII, the BEAT may generate similarly adverse and perhaps unexpected tax consequences as a result of related-party services.

Beware Quirks of FDII and BEAT

While we are still in the early days of our new tax regime, some notable, quirky, and perhaps unexpected features of the FDII and BEAT regimes have already become apparent and are worth noting as multinational corporations consider the impact of these new regimes on their supply chain structures. The delineation of the features of these regimes highlighted below is certainly not an attempt at a comprehensive list of the relevant considerations. Nor is it an attempt to show the full, and often unexpected, interaction of these intersecting regimes (e.g., how might the tax credit disallowance of the BEAT regime influence the effective residual tax under the GILTI regime?). But it is a start.

FDII

As noted above, the FDII regime potentially yields a reduced rate of tax on "foreign-related" income earned directly by domestic corporations. The income eligible for that reduced rate includes a wide range of income—including income from selling goods, providing services, or licensing intangible property—earned directly from unrelated foreign persons. But it also includes income from related-party transactions—including related-party services income and related-party royalties—where the related foreign person either resells the property for foreign use or uses the property in selling other goods for foreign use or providing services to unrelated foreign persons. Thus the sale of goods, the provision of services, and the license of intangible property to related foreign persons may yield FDII-eligible income.

But a noteworthy caveat arises in the case of services provided to related parties. In that case, the services income earned by the domestic corporation from the foreign affiliate is *not* FDII if the foreign affiliate provides "substantially similar . . . services . . . to persons located within the United States."[11] While in concept the provision appears to operate as an anti-conduit provision of sorts (preventing a domestic corporation from earning FDII from a CFC whose income in turn arises from U.S.-destined services), by its terms the provision appears to deny FDII treatment to *all* services income earned from a CFC if that CFC provides *any* substantially similar services to U.S.-based customers. The provision thus introduces a cliff effect whereby a small amount of U.S.-destined CFC services income can disqualify a far greater amount of otherwise FDII-eligible income. Services-focused multinational corporations will thus need to carefully evaluate their services supply chains to maximize FDII-eligible income, by providing more foreign services directly to third-party consumers or by eliminating the "substantially similar services" provided to U.S.-based customers by foreign affiliates, or both.

BEAT

As with FDII, the BEAT may generate similarly adverse and perhaps unexpected tax consequences as a result of related-party services. In calculating "modified taxable income" so

as to determine the alternative "base erosion minimum tax amount," deductible payments to related foreign persons, including those for services, are generally disregarded, thereby yielding a larger tax base. Although there is an exception for the cost-reimbursement component of services eligible for the services cost method under Section 482, there is no similar exception for services that fall outside the scope of the services cost method. In that case, the full amount of the services payment—both the cost-reimbursement component and the profit margin—is disallowed. For example, if a CFC incurs costs of $1,000 in providing services to its U.S. affiliate, and the U.S. affiliate pays $1,100 for those services, the CFC has $100 of taxable income, but the U.S. affiliate loses $1,100 of deductions. As a result, CFC-provided services that otherwise generate little profit may yield significant additional U.S. tax under the BEAT. Multinational, services-oriented corporations with integrated services supply chains may as a result need to reevaluate those supply chains and consider restructuring their contractual arrangements—both related-party and third-party—to prevent these adverse consequences.

Unlike FDII, however, the BEAT treats related-party deductible payments quite differently from related-party purchases of goods. Whereas the FDII regime, as discussed above, generally treats the sale of goods and the licensing of IP for foreign use equivalently, the BEAT regime draws a sharp distinction between related-party purchases of goods on the one hand and related-party licenses on the other. While the cost-of-goods-sold expenses associated with the former are *not* disregarded in computing modified table income for the BEAT (i.e., they do not give rise to an increased tax base), the royalties associated with the latter are. As a result, U.S. corporations that purchase goods from foreign affiliates may fare far better than those who in-license IP from their foreign affiliates. Thus, domestic corporations with significant related-party royalty payments may need to reevaluate the underlying supply chain to shift more of those transactions from royalty payments to purchases of goods.

Conclusion

Multinational corporations have designed their supply chain structures in the shadow of a U.S. tax landscape that has not fundamentally changed in over a quarter of a century. With the enactment of tax reform at the end of 2017—and its going into effect almost immediately—multinational corporations will need to reevaluate their supply chains in light of the generally changed tax landscape (i.e., the significantly reduced U.S. corporate tax rate) and in light of the radically revised international tax regime—both the holdover components from the old regime and the alphabet soup of new provisions. The interaction of these components can yield unexpected, and sometimes counterintuitive, results and may require a rethinking of existing supply chains.

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Endnotes

1 An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, Public Law 115-97 (2017) (hereinafter the Tax Cuts and Jobs Act or TCJA).

2 Section 14201 of the TCJA; Internal Revenue Code Section 951A.

3 IRC Section 951A(b), (c).

4 IRC Section 250(a)(1)(B), (a)(3).

5 IRC Section 951A(d).

6 Section 14202 of the TCJA; new Section 250 of the Code.

7 IRC Section 250(b)(4), (5).

8 IRC Section 250(b)(5)(E).

9 IRC Section 250(b)(2).

10 Section 14401 of the TCJA; IRC Section 59A.

11 IRC Section 250(b)(5)(C)(ii).