Expense Allocation – Post Tax Reform
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The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.
Agenda

01 Expense allocation – Overview

02 R&E expense allocation

03 Interest expense allocation

04 Stewardship expense allocation

05 Allocation of expenses to foreign branches
Today’s presenters

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<tr>
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<th>Title</th>
<th>Firm/Company Name</th>
<th>Email</th>
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## Why does expense allocation matter?

### Tax Reform Changes
1. Decrease in corporate rate
2. Expansion of earnings s/to current U.S. tax
3. More baskets
4. No carrybacks / carryforwards of GILTI FTCs

### Taxpayer Impact
1. Increased reliance on FTCs
2. Excess FTCs (especially in GILTI and foreign branch baskets)
3. Expense allocation more painful

### Go-Forward Considerations
1. More attention on FTC calculations, especially expense allocation
2. Strategic assessment of FTC utilization, including expense allocation considerations

### Addition of FDII regime
1. Beneficial rate for net FDDEI (determined after allocation of expenses)

### Need to balance expense allocation planning for FTC and FDII purposes
# Common expense allocation mistakes

<table>
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<th>Expense</th>
<th>Incorrect Method</th>
<th>Taxpayer Impact</th>
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<td><strong>Research &amp; Experimentation</strong></td>
<td>Incorrect pool of R&amp;E expenses – extrapolating from section 41 credit study rather than section 174 deduction</td>
<td>Potential over-allocation to foreign source income (FSI) and audit risk</td>
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<td></td>
<td>Double-counting intercompany sales under sales method</td>
<td>Potential over-allocation to foreign source income and audit risk</td>
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<td>Allocation of R&amp;E expenses to CFC distributors that don’t license IP</td>
<td>Potential over-allocation to foreign source income</td>
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<td>Improper treatment of intercompany services and royalties under sales method, especially for FDII</td>
<td>Potential over-allocation to FDDEI and audit risk</td>
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<td><strong>Stewardship</strong></td>
<td>Incorrect pool of expenses – pooling all expenses other than interest and R&amp;E under header SG&amp;A</td>
<td>Potential over-allocation to foreign source income and potential transfer pricing and audit risk</td>
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<td></td>
<td>Allocation of stewardship expense using gross income method</td>
<td>Potential over-allocation to GILTI</td>
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<tr>
<td></td>
<td>Not charging out controlled services transactions</td>
<td>Potential over-allocation to GILTI; audit risk</td>
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R&E expense allocation
Section 174 v. Section 41 categories of expenses

Section 174
- Cost recovery
- Patent Fees
- Overhead
- Research outside of the US

Section 41
- Direct wages
- Supplies
- Contract Research
- Research services for foreign affiliates?
Allocation and apportionment – Overview

Income derived from successful R&D should bear the cost of unsuccessful R&D
— Accomplished by dividing R&D expenditures between the product categories to which they relate, generally by reference to three digit SIC codes.

Step 1: Allocation
Allocate to all items of gross income as a class (including income from sales, royalties, and dividends) related to such product category (or categories).

Exception for certain legally mandate research

Step 2: Apportionment
Apportion among the statutory and residual groupings within the product categories.
— FTC purposes: statutory groupings include general limitation, foreign branch, GILTI, and possibly passive basket income.
— FDII purposes: statutory groupings are gross FDDEI and gross non-FDDEI, and amounts excluded from DEI are in the residual grouping.
Step 2: Apportionment – Overview

<table>
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<tr>
<th>Sales Method</th>
<th>Gross Income Method</th>
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<tbody>
<tr>
<td><strong>Geographic Exclusive Apportionment</strong></td>
<td><strong>Geographic Exclusive Apportionment</strong></td>
</tr>
<tr>
<td>— 50% of R&amp;D expenditures</td>
<td>— 25% of R&amp;D expenditures</td>
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**Apportionment of Remainder**
- Apportioned among groupings “in the same proportions that the amount of sales from the product category (or categories) that resulted in such gross income [within the groupings] bear, respectively, to the total amount of sales from the product category (or categories).”

**Sales Method**
- But not for FDII!

**Gross Income Method**
- 5-year binding election but free choice for 1st TYBA 12/31/17
- Subject to “collar” based on application of sales method
- Apportioned among groupings on the basis of gross income of the taxpayer in the various groupings

But not for FDII!
Common issues under the sales method

Characterization of sales as GILTI
— Are sales characterized based on character of gross income at CFC level (general basket) vs shareholder level (GILTI)?

Treatment of royalties
— Royalties are not themselves a “sale”
— Can CFC sales be characterized (all or in part) by reference to a royalty?

Treatment of limited risk distributors (that do not license IP)

Application of section 864(e)(3) to CFC sales? If so, how?
Common issues under the gross income method

Treatment of subpart F / GILTI / dividends from CFCs
— Treatment of cost sharing participants
— Treatment of limited risk distributors (that do not license IP)
Other considerations

Proposed regulations promised by end of 2019

Does Reg. § 1.861-17 apply to amortization of amounts capitalized under section 59(e)?

Treatment of intercompany services fees paid by CFCs

— Treated as a sale under sales method
  - Should CFC sales be reduced under the no double-counting rule?
— In the case of intercompany research services, who has 174 deduction? The affiliate that funds and owns the R&E, the affiliate performing the R&E, or both?
— In many cases, management fees and R&E service fees will not be in the same SIC code as customer revenue
  - Which SIC code attracts R&E expense?
Interest expense allocation
Interest expense allocation – Overview

Asset Values & Stock Characterization
— Interest expense of a U.S. corporation is required to be apportioned on the basis of asset values
— Asset values are determined under the Tax Book Value (TBV) Method or the Alternative TBV Method (Alternative TBV)
— Assets must then be characterized in the various section 904 baskets. CFC stock is characterized based on the method used for apportioning interest expense at the CFC level, using either the Asset Method or the Modified Gross Income Method (MGI)

Pre-tax reform taxpayers had less reason to care about the allocation of their interest expense for a number of reasons (already discussed), plus
— All foreign source income and foreign taxes were in the general income category
Determining your asset ratios

U.S. Assets to Foreign Assets
(U.S. to Foreign Ratio)

U.S. Assets

Foreign Assets

- General Basket
- Passive Basket
- GILTI Basket
- Foreign Branch Basket

Assets in Each 904(d) Basket
(Basket Ratio)
U.S. to foreign ratio planning – Reduction of CFC stock value

TBV = Average Non-PTEP Stock Basis

Potential TBV reduction planning
— Return of basis distributions
— Top-tier CFC liquidations

Potential E&P reduction planning
— First-tier cash / note distributions
— Distributions of loss property
— Taxable liquidations (e.g., Granite Trust)
Basket ratio planning – Ex. 1: Tested loss planning

**Background**
- USP is excess credit in the GILTI basket.
- CFC FinCo makes a loan to CFC HoldCo.

**U.S. tax considerations**
- Interest expense of CFC HoldCo is allocated to tested income under the asset method and creates a tested loss; tested loss reduces “inclusion percentage”.
  - Note Prop. Reg. § 1.861-9(j)(2)(ii)
- The lower inclusion percentage results in less of the first-tier stock being attributed to GILTI and more being attributed to the section 245A subgroup.

**Potential tax benefit**
- Reduction in interest expense apportioned to GILTI basket
  - Consider impact of loss on any QBAI/foreign taxes at CFC HoldCo
  - Consider impact of lower inclusion percentage on taxes of other CFCs
Basket ratio planning – Ex 2: CFC stock value blending

**USP**

- **US Asset Basis:** $400
- **Interest Expense:** $100

**CFC1**

- **Contributed Stock:** $200 AB + $100 E&P
- **US Asset Basis:** $200
- **Interest Expense:** $50
- **USP:** $200 AB + $100 E&P

**CFC2**

- **Contributed Stock:** $200 AB + $100 E&P
- **US Asset Basis:** $200
- **Interest Expense:** $50
- **USP:** $200 AB + $100 E&P

**Holdco**

- **USP:** $200 AB + $200 E&P

**CFC1**

- **Tested Income:** $100

**CFC2**

- **Tested Income:** $100

**GILTI 245A Apportionment**

<table>
<thead>
<tr>
<th>U.S.</th>
<th>Foreign</th>
</tr>
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<tbody>
<tr>
<td>GILTI</td>
<td>37.5%</td>
</tr>
<tr>
<td>245A</td>
<td>12.5%</td>
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**GILTI 245A Apportionment**

<table>
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<tr>
<th>U.S.</th>
<th>Foreign</th>
</tr>
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<tbody>
<tr>
<td>GILTI</td>
<td>50%</td>
</tr>
<tr>
<td>245A</td>
<td>25%</td>
</tr>
<tr>
<td>25%</td>
<td>25%</td>
</tr>
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Potential pitfall – CFC netting

2019: UK Tax Rate @ 19%

- CFC Loan $1,000 @ 5%
- 3rd Party Loan $1,000 @ 5%
- Change in UK Corporate Tax Rate

2020: UK Tax Rate @ 17%

- CFC Loan $1,000 @ 5%
- 3rd Party Loan $1,000 @ 5%

—if CFC netting rules apply, there could be a direct apportionment of the third party interest expense
Stewardship expense allocation
Three categories of expenses that are often confused and misidentified:

— Controlled services: services that provide a direct and proximate benefit to a subsidiary, for which there should be a charge-out as prescribed by Reg. § 1.482-9(l)

— Stewardship activities: narrowly defined by regulations as duplicative (Reg. § 1.482-9(l)(3)(iii)) & shareholder activities (Reg. § 1.482-9(l)(3)(iv))

— Other SG&A/Supportive: the residual category of expenses, which consist of neither controlled services nor stewardship

Post tax reform, there is a premium on taxpayers correctly categorizing these items because of their different impact on expense allocation to GILTI.
Identifying stewardship expense

All SG&A Expenses at the U.S. Shareholder Level

Costs Required to be Charged Out

Costs Not Required to be Charged Out

Stewardship

Duplicative Activities

SH Activities

Benefit is too indirect / remote
Stewardship expense allocation

Stewardship is allocable to the class of gross income consisting solely of dividends. Reg. § 1.861-8(e)(4)(ii). KPMG believes there are more likely than not positions that “dividends” includes

- Section 245A eligible dividends and the section 78 gross up attributable to Subpart F and GILTI inclusions, **but not the inclusions themselves**; or
- Section 245A eligible dividends and the section 78 gross up attributable to Subpart F and GILTI inclusions **and the inclusions themselves**.

Query whether dividends should be interpreted to include subpart F and GILTI inclusions; there is authority that “dividends” means only actual dividends.

Further query whether its actual dividends or dividend-paying capacity.

Future guidance may clarify this ambiguity.
Stewardship expense apportionment

Reg. § 1.861-8(e)(4)(ii) provides a number of possible apportionment factors (time spent by employees (weighted by compensation); comparisons of gross receipts, gross income, unit sales volume

— Reg. § 1.861-8T(g) indicates that dividends actually paid to the U.S. shareholder is generally not an appropriate apportionment factor because subsidiaries will have different dividend paying policies. Therefore, apportionment should look to gross income or receipts at the subsidiary level.

— Whether one apportions based on all gross receipts at the subsidiary level or just those receipts that could support a section 245A eligible dividend depends on which of the above more likely than not position that the taxpayer is taking.
Allocation of expenses to foreign branches
Disregarded reallocation transactions ("DRTs")

Disregarded payments between a branch and its branch owner (or between foreign branches) that would be deductible or capitalized if recognized for U.S. federal income tax purposes may cause adjustments to foreign branch income:

- Foreign branch basket income increased by amount of disregarded payments from branch owner to the branch that would be (if regarded) allocated and apportioned to general limitation income of the branch owner.

- Foreign branch basket income is decreased by amount of disregarded payments from the branch that would be (if regarded) allocated and apportioned to income on the branch’s books and records that is not passive.

- Reallocated income retains its character (e.g., services, royalties) and source (e.g., U.S. or foreign):
  - U.S. source general limitation income may become U.S. source branch basket income.
  - Could reduce amount of branch owner’s FDII.

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Example: Effect of DRT on expense allocation

**Background**

— USP earns U.S. source and foreign source income from sales and pays a fee for research services to Foreign Sub

— To mitigate BEAT, USP elected to treat Foreign Sub as a disregarded entity
  - U.S. tax considerations

— USP’s payment to Foreign Sub is a DRT

— As a result, USP reallocates a portion of its sales income from the general category to the foreign branch category based on the manner in which the service fee would be allocated if it were regarded

— How should Foreign Sub’s R&E expense be allocated for FTC purposes?

— Similarly, how should Foreign Sub’s assets be characterized for purposes of expense allocation (i.e., pre- or post-DRT)?
Questions
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