COVID-19 Disruption: International Tax and Transfer Pricing Issues

Companies are facing supply chain, consumer demand, and cash flow issues arising from the COVID-19 pandemic.

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Over the past several years, multinational companies have been experiencing rapid change on a number of fronts. On the tax front, companies have spent quite a bit of time and energy coming to terms with the new realities introduced by the Tax Cuts and Jobs Act (“TCJA” or, more broadly, “Tax Reform”), Pub L. No. 115-97. And now, with the dust still not quite settled on Tax Reform, companies are facing supply chain, consumer demand, and cash flow issues arising from the COVID-19 pandemic. To cope, many companies are ramping up short term R&D in response to supply chain disruption or, depending on their products or services, intense shifts in consumer demand. Others are tapping preexisting reserves of inventory and supplies, or reviewing cash management plans as revenue fluctuates. All are managing social distancing and workforce-in-place issues.

While tax implications are of course secondary considerations, they are nonetheless very relevant – and numerous – pieces of the puzzle. In this article, we will focus on some of the significant international tax and transfer pricing issues arising from companies' disruption activities. First, we will discuss the tax implications of cash flow planning, with a primary focus on the interaction of certain provisions in the newly-enacted Coronavirus Aid, Relief, and Economic Security Act (“CARES Act”), Pub. L. No. 116-136, and the TCJA. We will next discuss common international tax and transfer pricing issues related to R&D, supply chain, and remote workforce responses to the COVID-19 pandemic.

**Cash Flow Considerations**

While cash flow is always a paramount consideration, in the context of a pandemic, accessing cash quickly and inexpensively can be critical for a company. The CARES Act includes a number of provisions that are meant to provide businesses with greater liquidity. Any useful discussion of the CARES Act starts with highlights of the TCJA, which introduced several significant restrictions on taxpayers' ability to take deductions, a limited participation exemption (along with a one-time, mandatory repatriation of then-
untaxed foreign earnings), new constraints on the deferral of income earned through foreign subsidiaries, and tax benefits for certain export activities.

Let's start with restrictions on deductions. First, with respect to net operating losses (“NOLs”) generated in taxable years beginning after December 31, 2017 (“post-TCJA NOLs”), the TCJA capped deductions at 80 percent of taxable income in the absorption year. Excess NOLs may be carried forward indefinitely (an expansion from the pre-TCJA 20-year carryforward period), but cannot be carried back to a prior year.

In addition, the TCJA modified section 163(j), by expanding its application to all of a corporation's business interest expense (subject to limited exceptions for certain trades or businesses) and reducing the interest expense limitation. As relevant here, taxpayers' net business interest deductions are disallowed – and carried forward indefinitely – to the extent they exceed 30 percent of adjusted taxable income (more specifically, EBITD A). The limitation is further reduced to EBIT for taxable years beginning after December 31, 2021.

Finally, the TCJA introduced the Base Erosion and Anti-abuse Tax (the “BEAT”). The BEAT, which is an addition to regular federal income tax, is imposed on large taxpayers that make significant deductible payments to foreign related persons. The BEAT operates as a minimum tax. A taxpayer's BEAT liability is equal to the excess of the BEAT tax rate (currently 10 percent for most taxpayers, and 11 percent for certain financial institutions) multiplied by modified taxable income (“MTI”), over regular tax liability before the application of certain tax credits. At a high level, MTI is taxable income with “BEAT-able” deductions added back, including interest deductions not otherwise disallowed by section 163(j) and a portion of post-TCJA NOLs that are absorbed in that taxable year (if any).

In addition, the TCJA added a limited participation exemption regime, to allow tax-free repatriation of certain earnings generated through foreign subsidiaries. New section 245A provides a 100-percent dividends received deduction for U.S. corporate shareholders, with respect to the foreign source portion of any dividends received from a specified foreign corporation (an “SFC,” generally a foreign corporation that is not a passive foreign investment company and has a 10-percent domestic corporate shareholder). As a transition mechanism, U.S. shareholders were subject to a one-time tax on a deemed repatriation of
all then-untaxed SFC earnings, under section 965. Section 965 liability was imposed at 15.5 percent rate to the extent of cash or cash equivalents held through a foreign corporation, or 8 percent to the extent of non-cash assets held through a foreign corporation. Taxpayers were entitled to make several elections with respect to their section 965 inclusions, including an election to pay the resulting section 965 liability in installments over a period of 8 years, and an election to prevent NOLs that would otherwise offset income at a rate of 21 percent, from offsetting the section 965 inclusion at rate that would generally not exceed 15.5 percent.

Finally, the TCJA imposed current taxation on certain income earned by controlled foreign corporations that is not otherwise currently taxed under section 951, et seq., or eligible for participation exemption (the global intangible low-taxed income, or “GILTI” rules), and provided benefits for income from qualifying export activities (the foreign derived intangible income, or “FDII” rules). In both cases, tax is imposed at a reduced corporate tax rate, via a deduction from in-scope income. The deduction is currently equal to 37.5 percent of FDII income and 50 percent of GILTI. Notably, these deductions are, in the aggregate, subject to a taxable income limitation. There is no carryforward of disallowed deductions, or of excess limitation.

Not surprisingly, Tax Reform planning has occupied many taxpayers in the last several years, causing them to revisit intercompany arrangements and reconsider their accounting methods, particularly with respect to the timing of income and deductions. Between the interactive nature of the Tax Reform provisions and the particular sensitivity of these provisions to NOLs, Tax Reform planning was a complicated exercise even before the CARES Act. The CARES Act relieves some of the restrictive provisions of the TCJA, but only on a temporary basis. Taxpayers are challenged with modifying their tax plans just enough to meet their short-term needs, without compromising their longer-term objectives.

Significantly, the CARES Act temporarily loosens the restrictions on NOL deductions, by permitting taxpayers to deduct 100 percent of their NOLs generated in taxable years beginning after December 31, 2017, and beginning before January 1, 2021 (“qualifying NOLs”). Perhaps even more importantly, qualifying NOLs may be carried back five taxable years, including years during which the 35 percent corporate tax rate was in effect – giving loss-making taxpayers a much needed source of cash.¹ Taxpayers may elect to
waive either the entire five-year carryback period, or only section 965 inclusion years (generally 2017 and 2018 taxable years, on an “all or nothing” basis). While a carryback into a 35 percent rate environment is generally favorable, taxpayers may elect to forego the benefit for a number of reasons, e.g., if taking the NOL carryback would result in foreign tax credits going unused. Even if qualifying NOLs are carried back to a year in which the taxpayer had a section 965 inclusion (a “section 965 inclusion year”), the taxpayer is automatically treated as if it had made a section 965(n) election. This prevents qualifying NOLs from offsetting the taxpayer's section 965 inclusion (the “wall-off rule”). Consequently, taxpayers have a significant amount of flexibility in terms of NOL planning – full carryback (subject to wall-off rule), zero carryback, or carryback only to non-section 965 inclusion years.

In addition, with respect to taxable years beginning in 2019 and 2020, the CARES Act increases the section 163(j) limitation, from 30 percent to 50 percent of a taxpayer's adjusted taxable income. A taxpayer may elect to use 2019 adjusted taxable income, rather than 2020 adjusted taxable income, for purposes of computing their 2020 interest limitation. This affords taxpayers that are facing reduced income in 2020 increased ability to deduct their net (possibly significantly increased) financing costs.

Taxpayers should be taking a holistic look at the benefits of the CARES Act provisions, within the broader picture of their post-TCJA profile, to determine their “all-in” tax and cash flow implications. Taxpayers that carryback NOLs to pre-TCJA taxable years may avoid the general downsides of having and absorbing NOLs in post-TCJA taxable years. The trade-off between an NOL carried back into a 35 percent year (and the resulting refund check) versus a potential, go-forward 10 percent BEAT liability is undeniably attractive. And the possibility of accelerating deductions to increase a qualifying NOL is also tempting.

However, taxpayers should also understand the potential costs of NOL absorption that is split between pre-TCJA and post-TCJA taxable years. For example, taxpayers that are subject to (or on the cusp of being subject to) the BEAT may increase their (or create) BEAT liability by offsetting taxable income with NOLs. Consider a simple example: FP, is a foreign corporation that owns USP, the parent of a U.S. consolidated group. In 2019, USP earns gross income of $600 and has $100 of interest deductions with respect to a loan
from FP. As a result, USP has 2019 federal income tax liability of $105 (21 percent × $500). In this case, USP does not have a 2019 BEAT liability because the minimum tax amount (10 percent of its modified taxable income, or $60 (10 percent × $600)) does not exceed its regular tax liability of $105. However, if USP carries back a $500 NOL to its 2019 taxable year, it will pay $0 of regular tax liability and therefore generate a BEAT liability of at least $10. (MTI may also be increased to reflect the base erosion percentage of the absorbed NOL carryback.)

Taxpayers that have BEAT exposure should also consider the impact of the increased interest deductions under modified section 163(j) (and, in particular, the BEAT/section 163(j) “stacking” rules), in cases when the interest payments are made to foreign related persons.

In addition to the BEAT impact, many U.S. multinational companies should think about the interaction of NOL carrybacks and any section 250 deduction. Taxpayers that significantly benefitted from FDII, i.e., qualified for a reduced tax rate on their export sales, licenses, or services income, could face a reduction of benefits as a result of the taxable income limitation. U.S. multinational companies with GILTI inclusions should likewise consider the impact of the loss of the section 250 deduction when carrying back NOLs into post-TCJA years. In particular, taxpayers must weigh the benefit of using NOLs that would offset income that is subject to U.S. tax at a rate of 21 percent to instead offset FDII or GILTI that would be subject to tax at a reduced U.S. effective rate of tax of 13.125 percent or 10.5 percent, respectively. Further, in the case of GILTI, taxpayers may also lose the benefit of any foreign tax credits that may offset U.S. tax imposed on GILTI inclusions, since those foreign taxes are not eligible for carryforward.

As discussed above, taxpayers also face a potential cost when carrying qualifying NOLs back to a section 965 inclusion year. While the qualifying NOL cannot offset the section 965 inclusion amount, the reduction of other taxable income that same year may have adverse results, e.g., soaking up income, the liability for which would otherwise be offset by expiring foreign tax credits. In addition, if the qualifying NOL is carried back to a section 965 inclusion year and the taxpayer has an outstanding section 965 liability (i.e., resulting from an election to satisfy the liability in installments), any overpayment is credited first against the remaining section 965 liability; only the excess is refunded to the
taxpayer. In this case, a cash-needy taxpayer may elect to skip the section 965 inclusion year from its carryback period.

As many taxpayers have learned from the TCJA, U.S. income tax results are no longer intuitive as all aspects of the tax law are highly interrelated. The CARES Act only adds to the complexity created by the TCJA. While tax will not be the paramount issue here, it is a significant factor for determining the ultimate U.S. tax effect of any decisions available under the CARES Act. Modeling elections, projections, and alternative scenarios will be essential.

Beyond the CARES Act, companies are thinking about mechanisms for moving available cash within their organizations, such as factoring receivables. U.S.-based multinationals factoring to offshore related entities face the challenge of section 864(d), which treats the new holder as earning interest and consequently creates subpart F income if the holder qualifies as a controlled foreign corporation.

Factoring U.S. receivables looks more favorable for foreign-based multinationals that may be able to transfer receivables from the U.S. operating companies to a brother-sister foreign entity – assuming there are no direct or indirect U.S. shareholders with subpart F concerns. Still, there are several issues that should be carefully analyzed, including the appropriate amount of discount and factoring commission, the treatment and timing of the U.S. operating company's loss under BEAT and section 267, and the U.S. permanent establishment risk to the foreign factoring entity.

**Coping with Disruption — International Tax and Transfer Pricing Considerations**

As companies have shifted their business operations to deal with supply chain and workforce disruption issues caused by the COVID-19 pandemic, there may be a number of collateral international and transfer pricing issues that arise.

**R&D Considerations**
One trend is that companies are increasing their R&D activities merely by responding to the economic crisis. For example, a company that had relied on one or two jurisdictions as the focal point(s) of its production or warehousing, or is facing constrained supplies or materials for production, may be creating intangible property through its plans to shift or retrofit its supply chain. Other companies may be enhancing their remote working or e-commerce capabilities in response to shelter-in-place requirements. As companies increase their R&D activities and related spend in these unconventional ways, they should consider the tax effect of R&D deductions on a go-forward basis.

Importantly, R&D expense is not capitalized into COGS and is a “blacklisted” activity that would not qualify for the section 482 Services Cost Method, which would generally allow a zero markup on the pricing of the intercompany service. As a result, increased R&D spending potentially increases or creates a BEAT liability, if R&D payments are made to foreign related persons. Helpfully, several provisions provide flexibility with respect to the timing of R&D deductions, e.g., the section 59(e) election to capitalize R&D deductions, or amortization under section 174(b). Taxpayers should also consider the implications of increased R&D credits on their BEAT liability for post-2025 taxable years when those credits can increase a taxpayer's BEAT liability.

Once companies have had a chance to regroup, they may find that their “all hands on deck” efforts to rework products, supply chains, and workplaces in response to the pandemic resulted in the creation of IP in unexpected (and potentially unfavorable) locations. Companies should assess the desirability of a clean-up exercise, to identify and (re-)rationalize IP ownership and location throughout their organization. Such a clean-up exercise could involve various sorts of intangible property transactions, including cost sharing arrangements, ongoing license arrangements, sales of intangible property and business restructurings, among others. Any controlled transaction involving intangible property will need to be transfer priced – which, notably, should appropriately account for the impact of the increased economic uncertainty arising from COVID-19. In particular, before executing any move, companies should understand the current valuation of their IP, which may have fluctuated – maybe significantly – given the current times. Moreover, companies should consider the extent to which the tax consequences of an IP transfer rely on current valuation, e.g., whether the transfer looks at snapshot value (e.g., for section 311 purposes) or value over time (e.g., under section 367(d)).
Supply Chain Considerations

Another area in which questions are frequently arising is in response to supply chain disruptions (and consequential modifications). These disruptions are causing companies to look at supply chain functions and assets differently, and considering whether it makes sense commercially to rebalance roles and operations within the organization. A potential consequence of any such rebalancing of roles and operations is the creation of new intercompany transactions or the restructuring of existing ones, which will require the determination of transfer prices consistent with the arm's length standard.

Importantly, even without a concerted rebalancing of roles and operations within the organization, economic disruptions are leading companies to take a fresh look at their transfer pricing policies. One of the most fundamental questions facing companies in this regard is whether transfer pricing policies that were appropriate under normal business conditions still work under the abnormal economic conditions we are experiencing now. Companies are evaluating contractual terms, functions and risks of the parties involved and third party behavior to determine whether any adjustment to historical pricing is warranted during the downturn to continue conformity with the arm's length standard.

Finally, beyond the reassessment of transfer prices of tangible and intangible property, some companies are assessing the benefits of increasing or decreasing risk in given jurisdictions. A critical initial step is gaining a better understanding of the appropriate scope of an entity's risk, given its role in the group's supply chain. It is also important to keep in mind that the impact of any reallocation of risk between controlled entities on transfer prices and profit allocation is likely to outlast the current economic downturn.

For example, under normal economic conditions it is uncommon for limited risk distributors to experience losses. While it is conceivable for a limited risk distributor to make losses under certain circumstances in a severe economic downturn and to revert back to normal profitability once the economic stress is alleviated without effectuating a reallocation of risk, the reversion to a limited risk distributor return without potentially an adjustment in the expected level of profitability may well be harder once a reallocation of risk between the low risk distributor and the principal company has been implemented.
Remote Workforce Considerations

Finally, companies are evaluating the collateral impact of the various social distancing policies being implemented within their workforce. As employees are working from home or executive business travel is restricted, companies are facing the possibility of creating instances of unanticipated tax nexus. For example, a company may have commonly required executives to conclude contracts or make business decisions for particular entities in specified jurisdictions, to control permanent establishment ("PE") risk. If the same executives are now “grounded” and are concluding contracts from their homes, they may have created an unanticipated PE in their home country(ies).

Query whether various jurisdictions will overlook inadvertent PE creation given the widespread adoption of stay-at-home orders. The Organisation for Economic Cooperation and Development ("OECD") recently released guidance discussing the tax consequences of temporary workforce changes related to COVID-19. In particular, the OECD has recommended that countries might overlook the potential creation of a PE as a result of shelter-in-place orders, e.g., in the case of an employee that concludes contracts while working from a home office during the COVID-19 pandemic, even though the same activities may give rise to a PE in normal circumstances. At the time of this writing, several countries – including, e.g., the United Kingdom, Australia, and Singapore – have issued guidance consistent with this recommendation. Companies should keep an eye out for country-specific developments, as their plans for returning to the normal workplace crystallize.

Absent explicit guidance from a jurisdiction, a company will be faced with a strategic decision as to whether to declare a PE (and focus instead, e.g., on limiting the scope of attributable business profits). Companies should also consider the impact on their value chains of any longer term changes in workforce location that are put in motion by COVID-19. For example, changes in the location of employees making decisions on the development, enhancement, maintenance, protection or exploitation ("DEMPE") of intangibles that survive the temporary “grounding” due to COVID-19 could have longer term implications for the location of intangible property ownership.

Conclusion
Constant change seems to be a new norm in the tax world. Regardless of the catalyst – i.e., whether the source of change is legislative or commercial – tax professionals need to consider ongoing developments holistically. Modeling will be critical to the analysis to ensure integration of old, new, and newer provisions from the federal, state and local, and even foreign perspectives. Companies will also need to consider whether their response to conditions like COVID-19 will be reactive and temporary, or whether they will be long-term modifications, and adjust their tax planning accordingly.

1 At the time of this writing, we note that the U.S. House of Representatives passed (mostly along party lines) the Health and Economic Recovery Omnibus Emergency Solutions Act, H.R. 6800 (the “HEROES Act”). As relevant here, the HEROES Act would eliminate the carryback of NOLs incurred in post-TCJA, to offset income in pre-TJCA tax years (i.e., in taxable years during which the 35 percent corporate tax rate was in effect). The outlook for this bill in the U.S. Senate is uncertain. Taxpayers considering the benefits of the CARES Act will need to keep an eye on further developments.