Trade Update: The Impact of U.S. Tax Reform

2018 U.S. Cross-Border Tax Conference

May 15 – 17, 2018

kpmg.com
Notices

The following information is not intended to be “written advice concerning one or more Federal tax matters” subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230.

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 U.S. Trade and Tax Reform Overview
02 General Customs Considerations
03 What do FDII and BEAT mean for me?
04 Looking Ahead
05 Q&A
Today’s presenters

Luis (Lou) Abad  
Principal, Trade and Customs,  
KPMG WNT  
T: 212-954-3094  
E: labad@kpmg.com

Brian Cody  
Principal, Economic and Valuation Services, KPMG WNT  
T: 214-840-2080  
E: bcody@kpmg.com

#KPMGXB
U.S. trade & tax reform overview
Emerging areas of trade disruption

Trade policy trends that could significantly impact your trade and business strategy

Protectionist Pivot

- Campaign rhetoric to impose high tariffs on Mexico and China
- Withdrawal from TPP
- Withdrawal from Paris climate accord
- Threatened withdrawal from NAFTA and KORUS
- Executive Orders on trade matters
- G20 dropped endorsement of free trade / fighting protectionism
- Tax Reform

New Tariffs on U.S. Imports

- Section 201 safeguard tariffs (solar panels and washing machines)
- Section 232 national security tariffs (steel and aluminum)
- Section 301 potential unfair trade tariffs (proposed on 1,300 products)
- 20% tariffs (Canadian softwood lumber)
- 102 AD/CVD investigations from 1/20/17 through 4/4/18 (96% increase from prior period)
- First government-initiated AD/CVD action in 25 years

Potential Retaliatory Measures

- WTO Challenges
- Chinese tariffs on U.S. goods
- Trade War?

New Trade Laws and Increased Enforcement

- TFTEA 2015
- Sanctions (Iran, Korea and Russia)
- Expanded liability net

© 2018 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved.
Overview of new international tax framework

**BEAT**
- Imposes minimum tax
- Imposes 10% tax on certain payments to foreign related persons

**163(j) Limit on interest deduction**
- Related and unrelated party debt
- 30% of EBITDA (EBIT in 2026)

**FDII – 13.125%**
- Income from sale, leases, licenses, and dispositions of property to foreign person for foreign use
- Income from services to person outside the U.S.

**Distributions**
- Mandatory Repatriation
- Participation Exemption
- 0% on Previously Taxed Income

**GILTI – 10.5% (13.125%)**
- CFC income that is not exempt or sub F
- Current inclusion with 50% deduction
- 80% FTC
- Separate basket
- No FTC carryforward

**Sub F – 21%**
- Current inclusion at 21%
- General and passive baskets
- 10 year FTC carryforward

**Exempt Income – 0%**
- 10% QBAI
- High Tax sub F income (elective)

**Branch Income – 21%**
- Current inclusion
- Separate basket
- 10 year carryforward
- Cannot get FDII

**Other Income – 21%**
- U.S. and Foreign source income that is not FDII or GILTI or eligible for DRDs

© 2018 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved.
Key transfer pricing considerations for BEAT

BEAT functions as an alternative minimum tax (i.e., it’s a parallel tax system)

BEAT could lead to significant supply chain rationalizations
— Different treatment for payments to domestic related parties vs. foreign related parties
— Different treatment for payments to third party vs. related parties
— Different treatment for reduction in gross receipts vs. deductions – COGS not subject to BEAT

BEAT SCM services exception is critical for many taxpayers
— The statutory language providing for the BEAT SCM exception contemplates that marked-up services can qualify for that exception
— Robust transfer pricing documentation is critical
  - White list analysis; and
  - Low margin covered services analysis

Emerging trends and patterns
— Agency arguments
— Disaggregation of SCM services from non-SCM services
FDII, transfer pricing implications

The FDII regime generally creates a preferential rate for export activities thus incentivizing companies to keep production activities and intangible property in the U.S. or potentially migrate production activities and intangible property back to the U.S.

Similar to the GILTI regime, the FDII regime uses blunt mechanics to compute “intangible income” i.e., “intangible income” is equal to certain profit in excess of a 10% return on QBAI (depreciable tangible property). Thus, the FDII incentive regime extends well beyond income associated with actual intangibles.

In theory, the combined effect of FDII and GILTI is to equalize the tax treatment of “intangible income” earned domestically and offshore. However, in practice such equalization will not always be the case due to various factors such as:

— A taxpayer may not have a GILTI inclusion thus can continue to pursue an offshore tax rate that is lower than the U.S. tax rate.
— GILTI and FDII deduction is limited by a taxpayer’s taxable income (determined without regard to the deduction)
— Expense allocations for FTC purposes

The FDII regime has been highly criticized by U.S. trading partners as an export subsidy, and there is some uncertainty regarding the sustainability of the regime.
General trade and customs considerations
Groups seeking to establish the United States as an export hub, should strategically plan to allow for an efficient and cost effective import and export platform

— Consider mechanisms and strategies available to minimize customs duties and related costs when importing products that may be later exported (e.g., drawback and foreign trade zones)
  - Note the interplay (and sometimes the conflict) with U.S. transfer pricing
  - Also must consider compliance with strict U.S. export laws (with extra-territorial reach)

— U.S. manufacturing may be the practical answer for products subject to special trade remedies (e.g., anti-dumping, countervailing, section 201, 232 and 301 duties etc), which can be substantial and retroactive

— Customs duties are generally based on costs related to imported goods (i.e., COGS); thus must ensure that BEAT planning takes customs into account
What is an FTZ?

— Area that is physically located in the U.S. (i.e., warehouse/3PL/manufacturing site)
— Area is considered outside U.S. Customs Territory
— Operates as public utilities
— Encourages activity in U.S. through use of U.S. labor and increase in capital investment

Main FTZ Economic Benefits

— Direct Delivery
— Enhancing cash flow / duty deferral
— Weekly entry (reduced customs fees)
— Duty elimination on exports
— Reduced or eliminated customs duties on products kitted/ assembled /manufactured in the FTZ through “inverted tariff” mechanism
— Potential reduction or exemption on local ad-valorem taxes on inventory
What do FDII and BEAT mean for me?
FDII - Opportunities to explore and issues to consider

Overview
— U.S.-parented corporation (“USP”) is a multinational consumer goods company. USP is the global IP owner.
— The group relies on a manufacturer in China (China Co).
— The group has distributors (“Foreign Distributor”) in each major foreign market which purchase products from China Co at cost plus 5% and sell the products to local third party customers at a market price.
— Foreign Distributors license the IP from USP in exchange for royalty

Opportunities
— Establish the U.S. as the global principal company (buy-sell) to maximize FDII deduction (see next slide)
Overview

— U.S.-parented corporation ("USP") is a multinational consumer goods company. USP is the global IP owner.
— The group relies on a manufacturer in China (China Co).
— The group has distributors ("Foreign Distributor") in each major foreign market which purchase products from China Co at cost plus 5% and sell the products to local third party customers at a market price.
— Foreign Distributors license the IP from USP in exchange for royalty

Opportunities

— Establish the U.S. as the global principal company (buy-sell) to maximize FDII deduction

Trade and Customs Considerations

— Potentially dutiable royalty becomes certainly dutiable payment as part of the price of imported goods to foreign the foreign distributor / importer
— Previously “unrelated” import transaction becomes a related party import transaction for the foreign distributor / importer
— Potential new export compliance obligations on USP
— Export compliance / FTZ?
Base Erosion and Anti-Abuse Tax (BEAT)

If companies do not adjust business practice to account for the new legislation, BEAT may raise dutiable customs value for imported products, increasing duty exposure and heightening compliance risk in the area of product valuation.

— Restructure supply chain to aggregate the supply of goods with services currently provided by a related party; “BEATable” costs can be included from the COGS for imported goods
— Restructure intercompany arrangements to characterize (and bundle, if appropriate) “BEATable” license or service costs as included in the COGS for imported goods
— Restructure intercompany arrangements or supply chain to unbundle excludable 3rd party service costs (e.g., 3rd party tolling/assembly services) from intercompany payments for imported goods

U.S. Customs Considerations:
— Understanding net financial impact of adjusting valuation / payment arrangements;
— Duty increase may be mitigated (e.g. First Sale rule);
— Adjustments could belie past “non-dutiable” customs positon;
— New arrangement must comply with customs regulations (e.g. bona fide buying agent);
— Changes may preclude transaction value (including First Sale), triggering alternative, more onerous customs value methods.
Inbound structure: BEAT issues

Overview
— Foreign-parented multinational corporation (“FP”) is a multinational manufacturer.
— FP operates in the U.S. market via a licensed distributor (“U.S. Co”)
— U.S. Co pays a royalty of 5% of sales to FP for access to the IP owned by FP.
— U.S. Co purchases goods at cost plus 5% from a foreign manufacturing affiliate (“China Co”).

ID of Potential BEAT Issues
— U.S. Co payment of a royalty to FP would be considered a base erosion payment (assuming the royalty is treated as deduction and not a reduction in gross receipts for tax accounting purposes) and potentially subject to BEAT.
— In many cases the royalty would be treated as allocable to inventory and hence would be treated a reduction in gross receipts. AMCS should be consulted.

Trade and Customs Considerations
— Understand the customs duty impact and net financial impact of the alternative arrangement
— Understand the customs reporting and compliance requirements. Non-compliance could be costly from both a customs and tax perspective (e.g., IRC section 1059A)
IRC § 1059A

Overview

Generally, imported property subject to § 1059A if both:
— Subject to ad valorem customs duties (based on value); and
— From related person (under § 482)

§ 1059A limits (a) costs for Income Tax basis or inventory cost to (b) costs taken into account for Customs Value (with specified additions)
IRC § 1059A - BEAT solution? At what cost?

**Pre-Tax Reform**
Inventory Cost Basis / COGS (price of goods) $100M
Customs Liquidated Value $100M
Additional non-dutiable payment $ 20M

**Post-Tax Reform**
Inventory Cost Basis / COGS (price of goods) $100M (no BEAT)
Inventory Cost Basis / COGS (royalty) $ 20M (no BEAT)
Potentially Deductible $120M
Customs Liquidated Value $100M
Difference (Undeclared customs value): $ 20M

Duty Rate 10%

Additional Duty Liability (Scenario 1): $2M
Tax Rate 21%

Potential Tax Benefit of Royalty Deduction (Scenario 2): $4.2M
Potential Customs Penalty (negligence – 2x duties): $4M

The importer cannot take full benefit of its COGS ($120M)
Tax benefit only for $100M liquidated customs value (as adjusted)
Potential additional tax liability is $4.2M if the full COGS ($120M) is reflected on the income tax return

Example:
- Royalties,
- License fees
- Buying commissions

Scenarios:
1. Treat as dutiable thereby increasing duties; or
2. Incur additional potential tax liability under §1059A (and potential customs penalties)
BEAT – Alternative to explore and issues to consider

Overview
— Foreign-parented multinational corporation ("FP") is a multinational manufacturer.
— FP operates in the U.S. market via a licensed distributor ("U.S. Co")
— U.S. Co pays a royalty of 5% of sales to FP for access to the IP owned by FP.
— U.S. Co purchases goods at cost plus 5% from a foreign manufacturing affiliate ("China Co").

Potential Alternative Structure
— Establish FP as a global principal company whereby U.S. Co would purchase all its finished goods from FP.
— Establish U.S. Co as a limited risk distributor (as opposed to a licensed distributor). This would have the effect of eliminating the separate royalty. (Note, merely being an “LRD” does not automatically turn off BEAT).

Further Considerations
— Transfer pricing - Conversion costs for U.S. Co?
— Trade and customs - Higher customs costs as a result of higher finished goods price under the new supply chain arrangement?
— Trade and customs - Can we mitigate the higher customs cost with "first sale" customs valuation? If not, does the new transfer price between FP and U.S. Co satisfy customs arm’s length requirements?
— Chinese origin goods – Sec. 232 or 301 tariffs?
First sale for export

**China Co. Manufacturer**

First Sale (Invoice 1)

- Ex-Manufacturer Price – $8,000
- Duty – $1,600

**FP (Principal) Middleman**

- FOB/FCA Price – $9,600
- Duty – $1,920

**U.S. Co. Distributor**

Second Sale (Invoice 2)

Merchandise Generally Shipped Directly from Manufacturer to Company in the United States

**First Sale Value**

- Includes:
  - Labor
  - Manufacturer Overhead
  - Manufacturer Margin
  - Raw Materials

Assuming a 20% markup and 20% Duty Rate

**Second Sale (Traditional Customs Value)**

- Includes:
  - First Sale Value, plus –
  - Middleman Mark-up
  - Foreign Inland Freight
  - Intellectual Property Rights
  - Administration

© 2018 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved.
Procurement structure: BEAT issues

Overview

— U.S.-parented multinational corporation (“USP”) is a multinational apparel company.
— USP relies on third party manufacturers in China.
— USP utilizes a foreign affiliated procurement company (“Hong Kong Co”) to source goods from the third party manufacturers in China.
— USP pays Hong Kong Co a procurement fee / buying agency fee based upon the volume of goods Hong Kong Co procures.

ID of Potential BEAT Issues

— USP’s procurement fee to Hong Kong Co could potentially be considered a base erosion payment (assuming the procurement fee is treated as deduction and not a reduction in gross receipts for tax accounting purposes) and subject to BEAT.
— In many cases the procurement fee would be treated as allocable to inventory and hence would be treated as reduction in gross receipts. AMCS should be consulted.
Procurement structure: Alternatives

Overview

- U.S.-parented multinational corporation (“USP”) is a multinational apparel company.
- USP relies on third party manufacturers in China.
- USP utilizes a foreign affiliated procurement company (“Hong Kong Co”) to source goods from the third party manufacturers in China.
- USP pays Hong Kong Co a procurement fee based upon the volume of goods Hong Kong Co procures.

Potential Alternative Structure

- Establish Hong Kong Co as a buy-sell procurement company rather than a fee based procurement company. This would have the effect of transforming a BEAT payment (deduction) into a non-BEAT payment for inventory (reduction in gross receipts).

Further Considerations

- **Transfer pricing** - Would the U.S. require compensation for giving up a contract?
- **Trade and customs** – Will buying and importing goods from Hong Kong Co (related party) results in more customs costs than buying and importing directly from third party manufacturers in China? Was the sourcing commission included in dutiable value originally?
- **Trade and customs** - Can we mitigate the higher customs cost with “first sale” customs valuation? If not, does the new transfer price between FP and U.S. Co satisfy customs arm’s length?
- Chinese origin goods – Sec. 232 or 301 tariffs?

© 2018 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.
Looking Ahead
### Trade considerations should be a part of strategic tax planning discussions

#### 21% and FDII
- Tax incentives ("Carrots") to establish the U.S. as an export hub or IP center

**Trade considerations:**
- Royalties paid by foreign affiliates / distributors – dutiable?
- Previously unrelated transactions become related party import transactions – arm’s length?
- U.S. export control compliance?
- Considered the impact of higher tariffs?
- Duty drawback and FTZ benefits?

#### BEAT
- Minimum tax ("Stick") on certain payments to foreign affiliates

**Trade considerations:**
- Restructured transactional arrangements and supply chains (increasing COGS) - increase customs duty costs?
- Mitigation strategies (first sale)?
- Import transactions – arm’s length?
- Customs reporting requirements?
- IRC § 1059A
Conclusion

Have you thought of the customs costs to your tax reform strategy?

Trade and customs professionals should be involved in strategic tax planning discussions.

The trade point of view can be helpful to:
— assess feasibility and calculate customs duty and indirect tax costs;
— ensure the net financial benefit of any new arrangement is understood before implementation;
— mitigate or reduce additional duty costs where possible (e.g., through First Sale, FTZs, etc.);
— address any import or export regulatory compliance risks (and exposures) that may arise; and
— recommend tailored trade compliance programs or global trade management systems (automation) to facilitate trade operations.

Companies should also continue to monitor United States trade policies and remedies that could potentially offer additional “carrots” or “sticks” concerning the supply chain (e.g., restructure or move existing operations) or could potentially necessitate a transfer pricing adjustment:
— Section 201 safeguard tariffs
— Section 232 national security tariffs
— Section 301 unfair trade tariffs
— NAFTA 2.0 or potential withdrawal
Thank you
The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.