



Tax Planning During a Recession

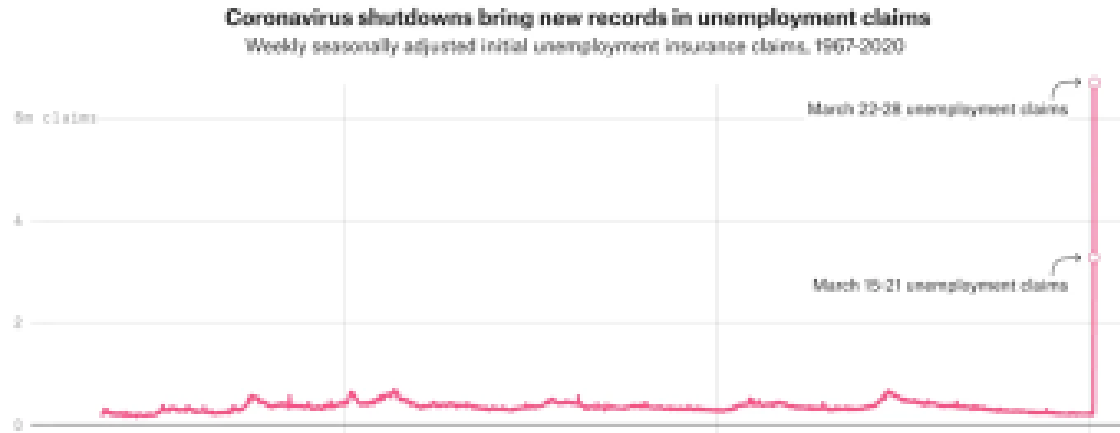
April 9, 2020



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The Recession of 2020

How Severe is the Recession of 2020?



APR. 3, 2020, AT 9:12 AM

This Jobs Report Was Bad. The Next One Will Be Worse.

Coronavirus: Recession? This is deeper and more challenging



Douglas Fraser
Business/economy editor, Scotland

Coronavirus Recession Looms, Its Course 'Unrecognizable'

The U.S. economic outlook darkens daily, with millions being unemployed and businesses in a steep decline.

Why the Global Recession Could Last a Long Time

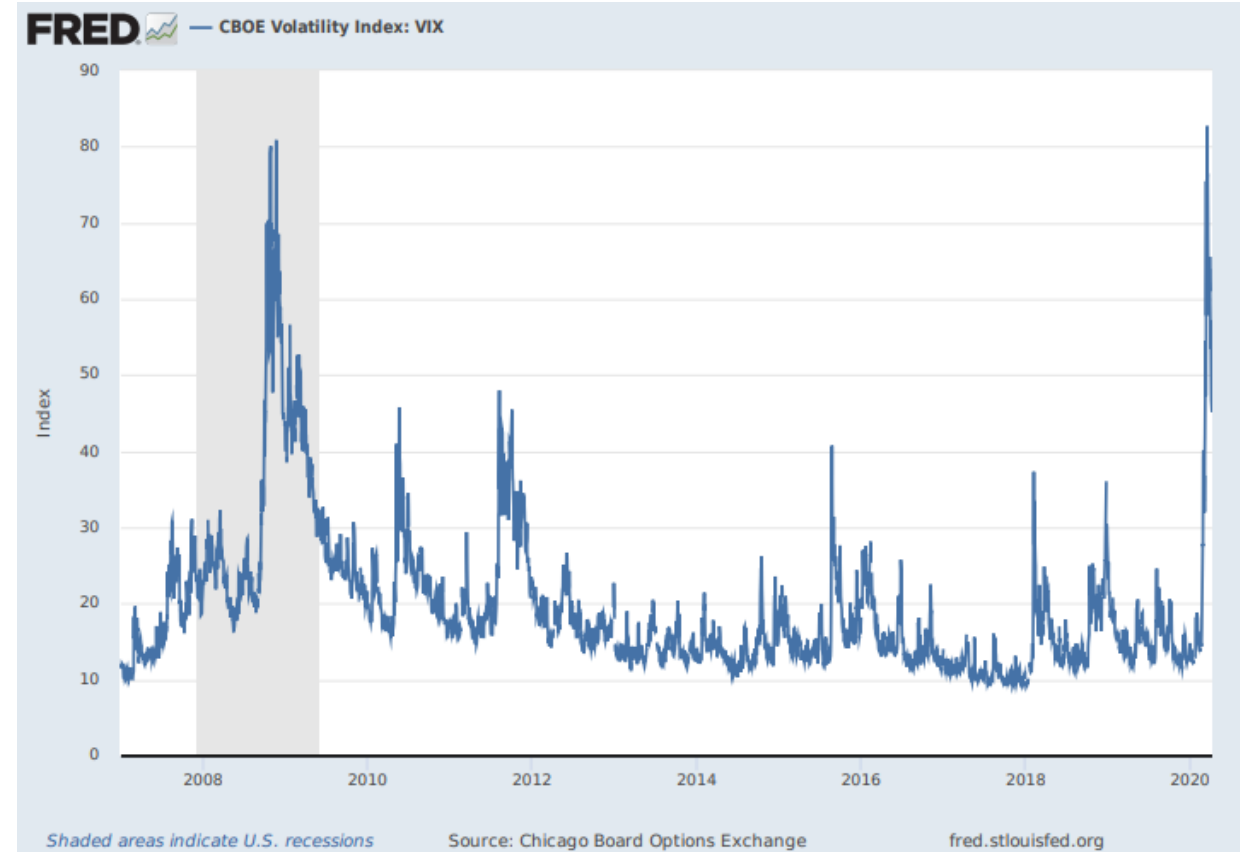
Times are growing that the worldwide economic downturn could be especially deep and long, with recovery limited by a confused society.

Recession? We're already in something much deeper and more challenging.

Start-Ups Are Pummeled in the 'Great Unwinding'
Dozens have laid off thousands, slashed costs and changed their businesses to try to survive the pandemic. All that may not work.

US Stock Market Returns & Volatility

As of April 7, 2020



Stock Market Returns by Region & Sector

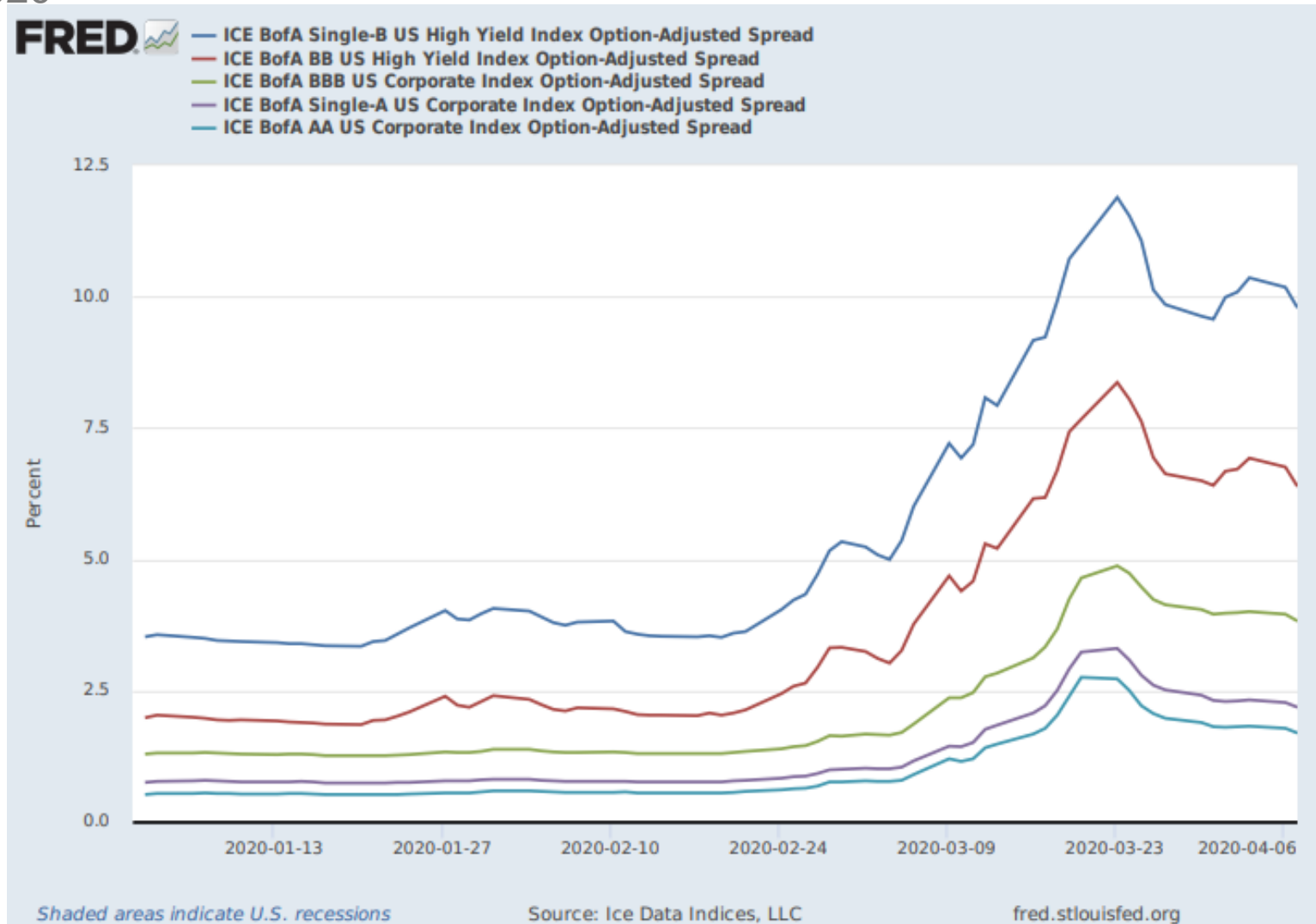
Source: Aswath Damodaran, April 8, 2020

	Market Cap (2/14/20) \$T	Market Cap (4/3/20) \$T	% Change
Africa	0.58	0.35	-38.8%
Australia/NZ	1.62	1.04	-35.8%
Canada	2.28	1.54	-32.2%
China	14.03	12.65	-9.8%
EU Region	13.68	9.90	-27.6%
Russia/East Europe	0.82	0.57	-31.1%
India	2.21	1.41	-36.2%
Japan	6.05	4.75	-21.5%
Latin America	2.39	1.40	-41.2%
Middle East	3.10	2.72	-12.1%
Other Asia	5.10	3.77	-26.0%
UK	3.07	2.05	-33.1%
US	<u>35.75</u>	<u>25.63</u>	<u>-28.3%</u>
Global	\$90.66	\$67.79	-25.2%

	Market Cap (2/14/20) \$T	Market Cap (4/3/20) \$T	% Change
Communication Services	7.39	5.77	-21.8%
Consumer Discretionary	10.17	7.31	-28.1%
Consumer Staples	7.13	6.11	-14.4%
Energy	5.94	4.34	-26.9%
Financials	14.99	10.12	-32.5%
Health Care	8.98	7.59	-15.5%
Industrials	10.19	7.16	-29.7%
Information Technology	13.64	10.35	-24.1%
Materials	4.99	3.74	-25.1%
Real Estate	4.05	2.86	-29.5%
Utilities	<u>3.21</u>	<u>2.45</u>	<u>-23.6%</u>
Global	\$90.66	\$67.79	-25.2%

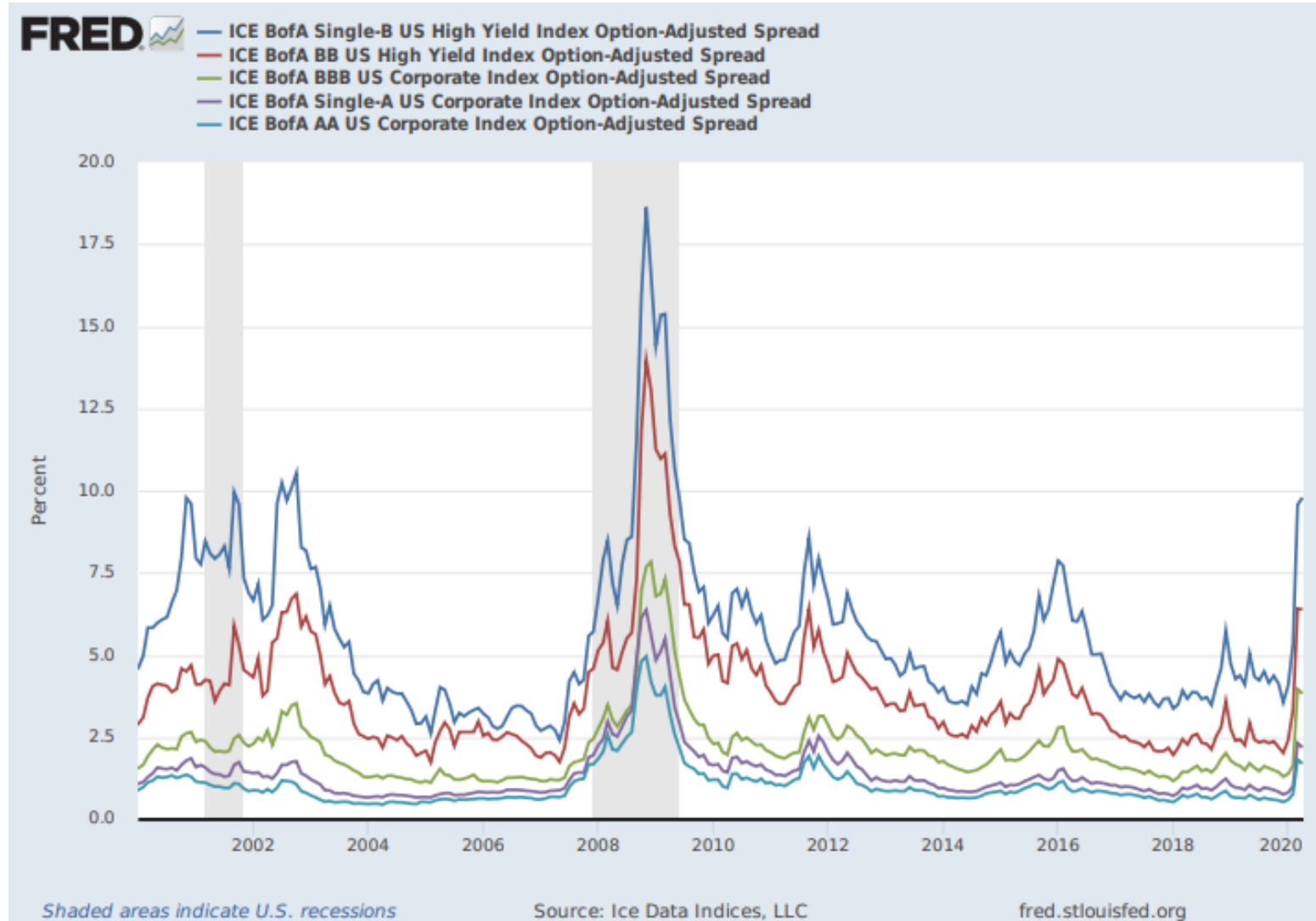
Interest Rates and Credit Spreads Have Spiked

As of April 7, 2020



Rising Credit Spreads & Severity of Recent Recessions

As of April 6, 2020



Transfer Pricing Planning Ideas In a Recession

Lessons Learned from the 2008 Recession

Transfer Pricing Regulations & Guidelines are premised on allocation of profit among related parties

- Presumes profitability throughout the value chain
- Poor times/losses are dealt with great difficulty

Issues for Taxpayers

- Lower compensation for 'routine' functions – how to deal with losses?
- Potential Impact on IP/Royalty Structures/cost sharing arrangements
- Impact on intercompany financing
- Impact transfer of entities or assets (increase in discount rates)
- Operational challenges
- Documentation challenges

Recession Planning Transfer Pricing Map

Now

- Consider asset/entity transfers
- Consider impact of rising interest rates on financing
- Ensure proper wording in intercompany agreements for adjustments
- Begin documenting impact of pandemic on business to support any adjustments
- Develop operational capabilities to change pricing policy
- Begin legal review jurisdictional requirements

2020

- Monitor to assess impact of recession on transfer pricing
- Consider adjustments
 - Lower distribution returns
 - Lower manufacturing returns
 - Lower service & management fees
 - Adjust stewardship
 - Adjust licensing rates
 - Loan guarantees
 - Market support payments
 - Adjust PCT payments
- Develop economic support
- Develop legal support

Longer Term

- Finalize Legal support
- Finalize economic support, include in documentation
- Consider adjusting cost share agreements
- Consider adjusting APA positions
- Consider profit split/loss sharing

Impact on Routine Returns

Lessons from 2008 Recession

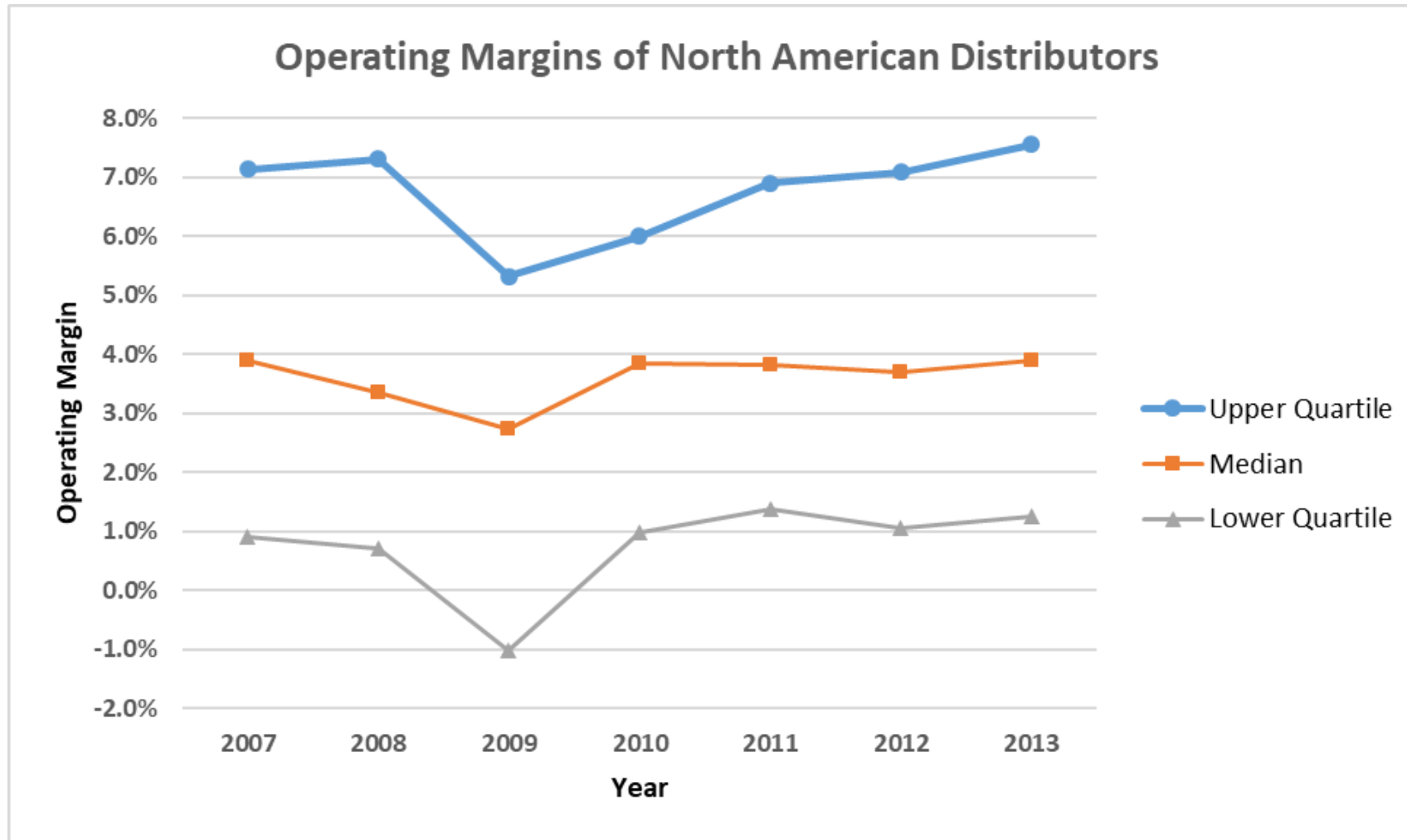
- Manufacturing Returns Tend to Be Strongly Cyclical
 - Capital-intensive
 - Industry-specific comparable sets
- Distribution Returns Tend to be Modestly Cyclical
 - Lower asset intensity
 - Cross-industry comparable sets
- Service Returns Were not Cyclical
 - Comparability often weak

Prepare for Adjustment

Consider Adjustment

Adjust if Exceptional Conditions

Distribution Returns During Last Recession



Three Approaches for Adjusting Routine Ranges

Adjust Distributor to Comparables

Business Cycle:^a Compare distributor and comparable long-run operating profits over business cycle

Adjust Comparables to Distributor

Range Adjustment:^b Adjust comparables operating profit to reflect distributor's declining business performance

Adjust Both Comparables & Distributor

Competitive Cost:^c Adjust distributor cost/capital structure during the period to the long-run competitive cost/capital base of the comparables

Notes:

a §1.482-1(f)(2)(iii)

b §1.482-5(c)(iii)

c §1.482-5(c)(2)(iii-iv)

Impact on Intercompany Financing

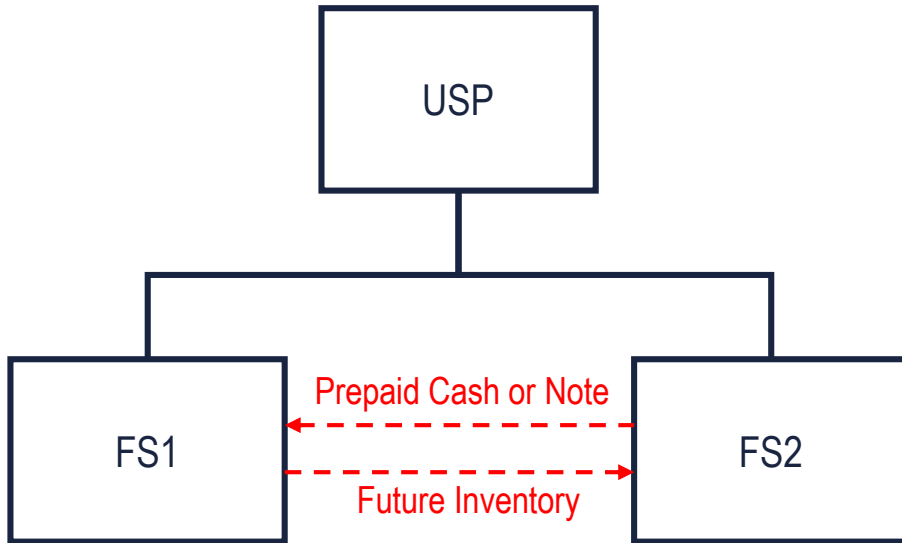
- Sharp rise in corporate yields and lower expected earnings will put pressure on the 30% interest deductibility cap
- Lower entity values may impact ability to meet thin cap requirements
- Remember, not only have entity values fallen, the value of intercompany debt has also fallen
- Refinancing intercompany debt is more expensive, though there are ways to mitigate
- Historical credit ratings may be of little use going forward.

International Tax Planning Ideas

Key Recession Planning Traps & Opportunities (GILTI)

- Though all of the U.S. – international tax provisions present unique considerations, the GILTI regime appears to cause taxpayers the most consternation at the moment
- QBAI and FTCs attributable to CFCs with tested losses are excluded from US shareholder's GILTI calculation
- Separate loss limitation rule impacts
- Fiscal year CFCs may end up with high FTCs (imposed on 2019 income) but tested losses due to economic downturn in 2020
 - Lack of carryforwards for losses and FTCs creates permanent cash and book losses

Accelerate Tested Income



FS1 (FY 2020)

Prepayment Income:	15*
Other Income:	55
Expense:	(65)
Net Income / (Loss):	5

*Without prepayment, tested losses (10) are forgone, and FS1 would have 10 of additional income in later year(s)

Generate tested income to be absorbed by tested losses, by selling IP or other assets, prepayments, etc.

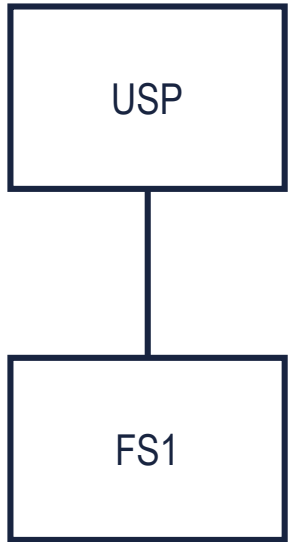
- Tested losses would otherwise go unutilized, so effectively minimal U.S. federal income tax consequences from accelerated income
- May create basis in IP or tangible assets to mitigate GILTI in later years

Key considerations:

- For prepayments, must be non-refundable
- Local country tax & customs considerations
- Operational / management considerations

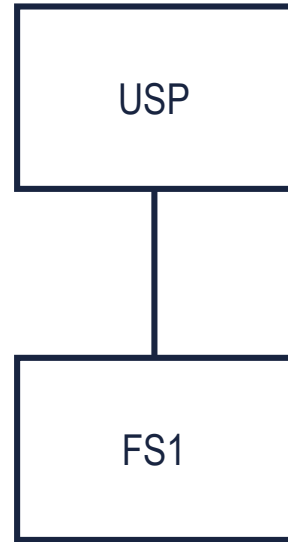
Defer Deductions: Sec. 59(e) Election

Alt 1:
No Section 59(e)
Election



<u>FS1 (FY 2020)</u>	
Income:	10
R&E Expense:	<u>(90)</u>
Tested Loss:	<u>(80)*</u>

Alt 2:
Section 59(e)
Election



<u>FS1 (FY 2020)</u>	
Income:	10
R&E Expense:	<u>(9)</u>
Tested Income:	<u>1</u>

*No carryforward

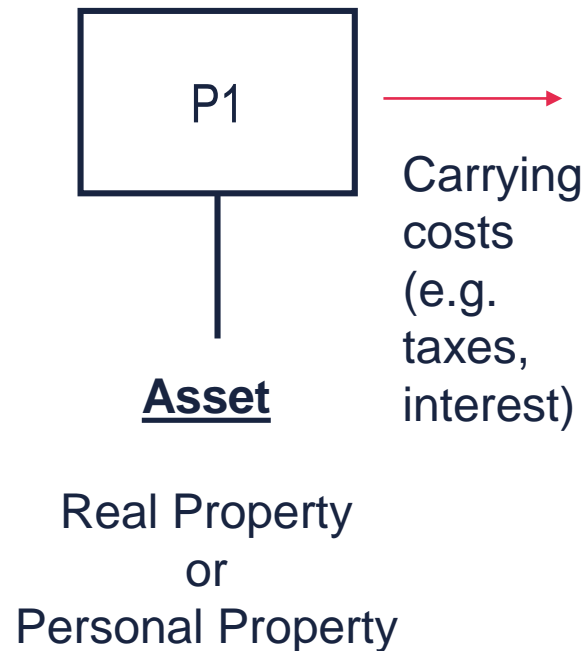
Under sec. 59(e), capitalize and amortize Qualified Expenditures over 10 years

- Defers deductions to later years—
 - CFCs expected to have tested income
 - Greater BEAT threshold headroom

Key considerations:

- Scope of “Qualified Expenditures”
- Benefits of rigid 10 year recognition period versus more flexible alternatives such as sec. 174(b) election
- For years beginning after Dec. 31, 2021, sec. 174(a) requires amortization over 5 years

Defer Deductions: Sec. 266 Election (Capitalize Interest)



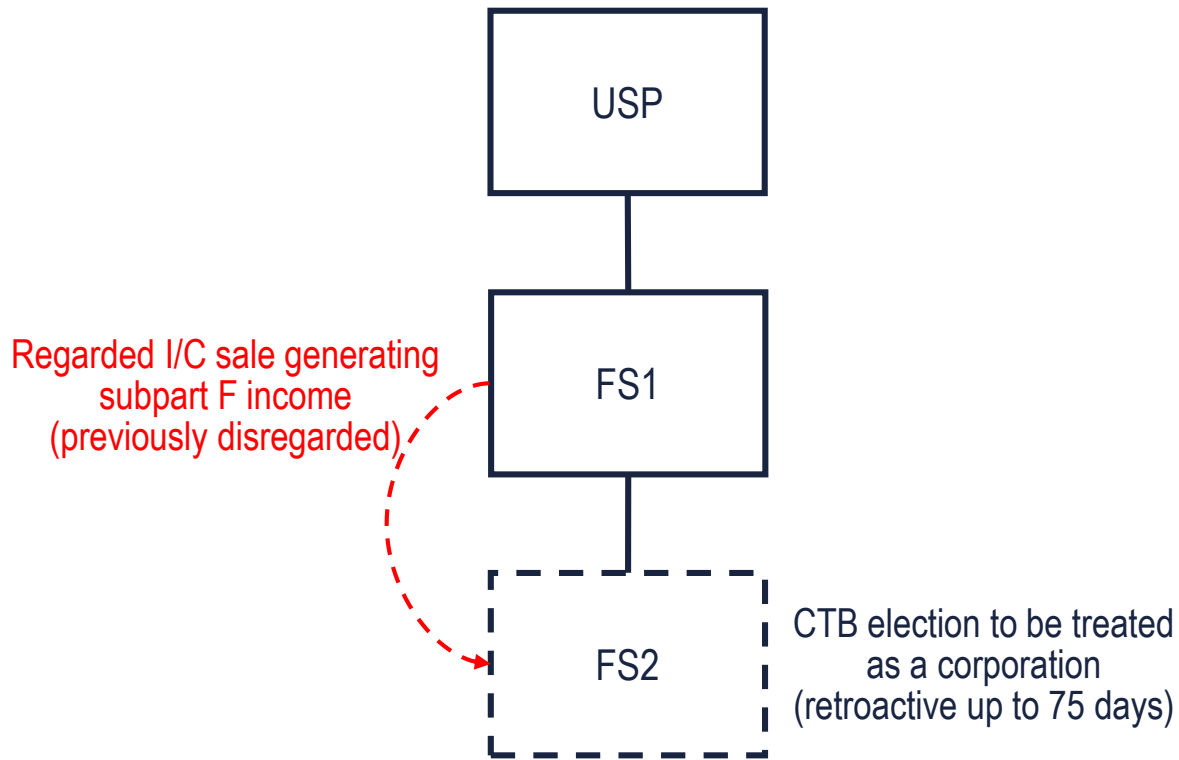
Section 266 allows taxpayers to capitalize interest on a loan to purchase personal property into such property's basis; also available for other carrying charges that would normally be deductible.

- Defers current interest deductions into amortizable/ depreciable basis that is recovered over several years
- Reduces interest expense to be allocated to foreign source income, thus increasing ability to use GILTI FTCs
- Allows taxpayers that would otherwise be driven into US NOL position from interest deductions to claim FDII benefits
- Increases 163(j) capacity by decreasing currently deductible interest

Key considerations:

- Scope of the term “purchase”
- Whether “personal property” includes intangible property

Convert Tested Losses to Qualified Deficits



Convert GILTI tested losses to qualified deficits, which may be used to offset subpart F income in later years

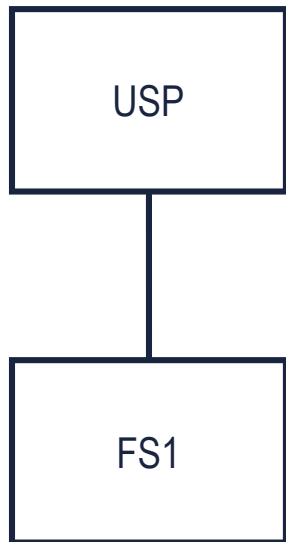
- Retroactive check-the-box elections to regard intercompany transactions, generating qualified deficits within subpart F categories rather than tested losses

Key considerations:

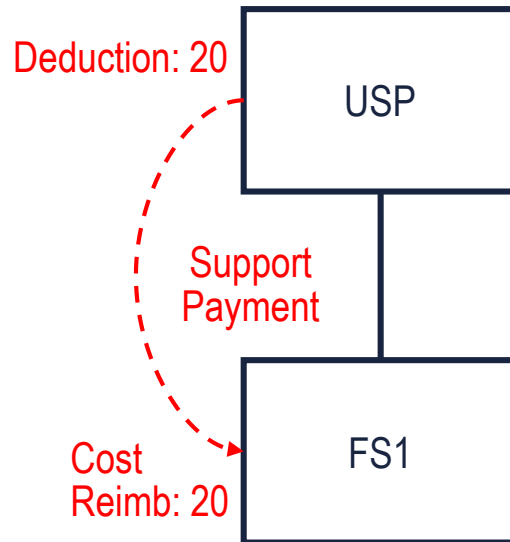
- Availability/timing of entity classification elections
- To the extent existing subpart F defense position is abandoned, consistency issues with prior year tax reporting unless facts are materially changed (i.e., certain positions may not be elective)

Support Foreign Affiliate Losses

Alt 1:
No Support
Payment



Alt 2:
With Support
Payment



FS1 (FY 2020)

Income:	50
Expense:	(65)
Net Income / (Loss):	(15)

FS1 (FY 2020)

Income:	50
Expense:	(65)
Support Payment:	20
Net Income / (Loss):	5

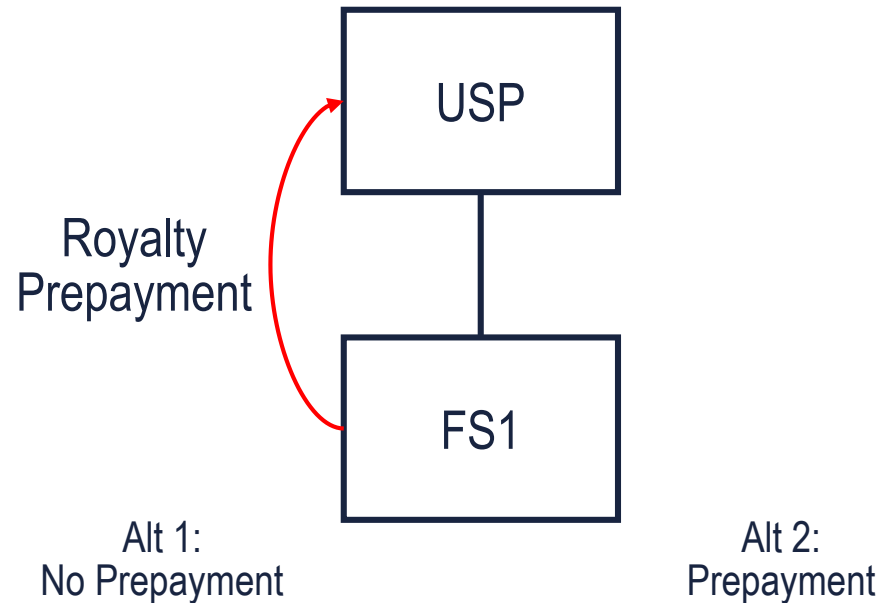
USP makes support payments to affiliates to mitigate losses (or reduced profits) imposed headquarters decisions, such as store or facility closures

- USP may preserve and monetize losses more efficiently
- Provided in US and OECD regulations
- In many cases, consistent with third-party behavior

Key considerations:

- Acceptability in foreign affiliate country
- Amendments to transfer pricing, intercompany agreement(s), documentation, etc.
- Even routine service entities with “guaranteed return” may experience extraordinary losses for which a support payment may be appropriate

CFC Royalty Prepayment or IP Migration of Non-US Rights



<u>USP (FY 2020)</u>	
US Source Loss:	(100)
Net GILTI (after § 250):	<u>150</u>
Net Income / (Loss):	0*

*GILTI FTCs forgone

<u>USP (FY 2020)</u>	
US Source Loss:	(100)
Prepayment:	100
Net GILTI (after § 250):	<u>50</u>
Net Income / (Loss):	50**

**GILTI FTCs not foregone

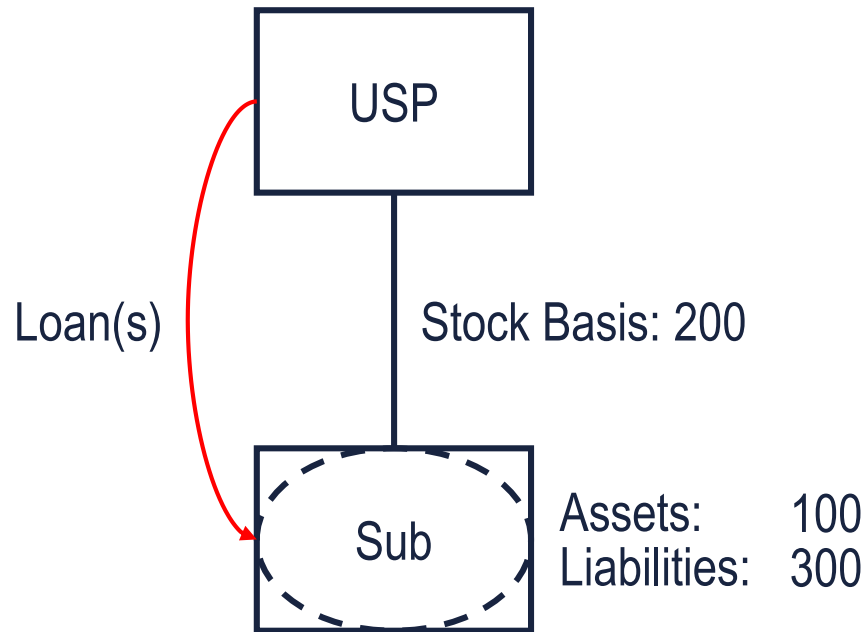
CFC prepays royalties to create foreign source income in section 904 general category partially absorbs US source losses that would otherwise limit GILTI FTCs

- May include USP outbound IP migration of non-US rights followed by section 367(d) prepayment
- GILTI FTCs otherwise forgone may be monetized
- Overall Domestic Loss (“ODL”) in future years may provide flexibility by enhancing section 904 general limitation

Key considerations:

- Confirm application of ODL recapture rules
- Review projected general basket FTCs in future years for ability to utilize increased section 904 general basket limitation

Worthless Stock and Bad Debt Deductions



US parent may time claim a loss for worthless shares of investments of wholly-owned subsidiaries or a deduction upon writing off debt from insolvent subsidiary

- Deteriorating economic conditions may have caused marginally solvent subsidiaries to become insolvent

Key considerations:

- Consider section 165 limitations for worthless subsidiaries
- Documenting timing of worthlessness / identifiable event for which insolvent company has a lack of future potential value
- CTB respected as an identifiable event
- Character of losses

Other U.S. – International Planning Traps & Opportunities

- Subpart F

- Consider availability of earnings in sec. 904 subcategories (note restrictions on cross-crediting)
- For CFCs that anticipated a “full inclusion” (>70% or more of gross income is FBCI), evaluate whether changing economic conditions may cause gross FBCI to fall below the 70% threshold

- BEAT

- Revised budgets/expenditures may reduce total of all deductible payments, causing related party payments to exceed 3% threshold
- Interplay between NOLs and BEAT

- NOLs

- Section 250 deduction issues - taxpayers must generally fully utilize deductible NOLs before section 250 deduction benefit

- Worthless Stock Loss & Bad Debt Deductions

- Employee Compensation

- Because COVID-19 has been declared a national emergency, “qualified disaster payments” within the meaning of section 139 may be made to employees without payroll tax to employer (while still being deductible), and without being taxable income to employee.

Legislative Action to Address the Downturn

Cash Needs: Legislative Relief for Repatriation

- Proposals range from modest to sweeping/broad-based, and include the following:
 - Temporary flexibility to basket FTCs from cash distributions (e.g. WHT) as chosen by taxpayer;
 - Guidance clarifying that all PTEP may be repatriated, irrespective of open questions on section 961 basis between lower-tier CFCs;
 - Temporary waiver of rules related to hybrid deduction accounts or “donut hole” E&P to facilitate access to cash in such entities or entities below;
 - Ability to repatriate cash in an amount equal to total PTEP in the group, creating a “PTEP account” method to account for such repatriation;
 - Temporary relief to set aside Section 301(c) to access cash irrespective of sub C attributes of distributing CFC;
 - Temporary relaxation of Section 956; and,
 - Temporary waiver of Section 965 annual tax payment;

GILTI: Legislative Relief for Effects of Downturn

- Temporary ability to carry forward or back test losses;
- Temporary ability to use “pooling” for GILTI FTCs and carry them forward rather than sacrifice them at the end of the year;
- Temporary relaxation or suspension of the expense allocation and apportionment rules of Section 861; and,
- Temporary election into subpart F.

BEATen Up by the BEAT: Requests for Legislative Relief

- Temporarily increase the current 3 percent threshold;
- Temporarily carve out outbound R&D expenses from the definition of base erosion payment;
- Introduce “subject to tax” condition;
- Provide relief for temporary shifting of work to foreign affiliates to minimize supply chain disruptions;
- Temporary relief for availing of cash from foreign affiliates— exempting outbound interest payments from the BEAT.

Thank you

Any questions?



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