

Don't Get Beat by the BEAT

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BEAT Overview

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BEAT Overview

- Potential addition to regular tax liability
BEAT = Modified TI X 10% - Regular tax (minus credits)
- Targets taxpayers making deductible payments to related parties that are foreign persons
- BEAT Applies when:
 - There is an Applicable Taxpayer; And,
 - To the extent the BEAT tax liability > regular tax liability
- *The results:* In effect a reversal of certain deductions attributable to payments to foreign related parties and certain tax credit (Modified TI is the 'regular' taxable income without 'base erosion tax benefits')
- *The Rationale:* Making US corporations more internationally competitive (e.g., reducing base erosion opportunities that have previously allowed foreign-controlled US Corp. to operate in the US at a lower ETR than their US based competitors)

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BEAT Overview (Cont.) – Basic terms

“Base Erosion Tax Benefit”

- Any deduction which is allowed with respect to a base erosion payment to a related foreign person
- Deduction for amortization and depreciation allowed with respect to property acquired from a related foreign person
- Reduction in premiums/deduction for certain reinsurance premiums or other consideration paid to a related foreign party
- Reduction in gross receipts for payments to inverted companies that reduce gross receipts

Section 59A(c)(2).

“Base Erosion Tax Payments”

- Amount paid or accrued to a related foreign person with respect to which a deduction is allowable
- Amortization and depreciation with respect to property acquired from a related foreign person
- Certain reinsurance premiums or other consideration paid to a related foreign person
- Payments to related surrogate foreign corporations under section 7874 (i.e., inverted companies) that reduce gross receipts

Section 59A(d).

Related generally = 25% ownership or person under common control

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Applicable Taxpayer

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Applicable Taxpayer

- The BEAT is imposed on “**applicable taxpayers**,” defined as any corporation (other than a RIC, REIT or S corporation) with \$500 million of “**gross receipts**” on average for the three prior taxable years and a “**base erosion percentage**” of at least 3%, reduced to 2% in the case of a taxpayer that is a member of an affiliated group that includes a bank or registered securities dealer.
 - In the case of a foreign corporation, only ECI gross receipts are taken into account for purposes of the gross receipts threshold.
- The term “**gross receipts**” is not defined precisely, but it appears to encompass gross revenue from sales of merchandise and/or services, reduced by the cost of the merchandise (“**COGs**”), and in the case of merchandise, reduced by returns and allowances. That is because the BEAT statute cross-references the special rules that apply to the determination of whether a corporation is eligible for the cash method of accounting, including:
 - Annualizing gross receipts for any taxable year of less than 12 months
 - In the case of gross receipts from sales of merchandise, netting of returns and allowances; and
 - Inclusion of the gross receipts of a predecessor entity in determining the gross receipts of a corporation for the taxable year.

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Applicable Taxpayer – Gross Receipts

- Commentators including the ABA and NYSBA have requested Treasury and the IRS to clarify the definition of **gross receipts** in a manner that will result in fairness to all taxpayer types. Issues of concern include:
 - Should gross receipts of taxpayers in a lending business include only interest or also repayments of principal?
 - Should taxpayers that incur substantial tax deductible expenses (i.e., non-COGs expenses) be entitled to some sort of offset in computing gross receipts?
- Based on the legislative history of the BEAT, Congress didn't believe that brick and mortar businesses pose the same base erosion risk as capital or services-intensive businesses which tend to be highly portable, so it is not clear that Treasury and the IRS have the authority to issue regulations that would provide for the fairness requested by commentators.

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Applicable Taxpayer – Base Erosion Percentage

- In addition to the gross receipts threshold, a corporation must make a threshold amount of deductible payments to foreign persons that are “**related parties**” to be subject to BEAT (“**base erosion tax benefits**”). Base erosion benefits must represent 2 percent of overall deductions for corporations that are members of an affiliated group that includes a bank and or registered securities dealer and 3 percent for all others (the “**base erosion percentage**”).
 - The \$500 million average gross receipts and 3 percent base erosion percentage thresholds create a so-called “cliff effect.” Once these threshold tests are met, a single extra dollar of base erosion tax benefit causes the BEAT to apply to all base erosion payments.
 - Base erosion tax benefits include deductible payments of interest, royalties, management fees, etc. made to foreign persons that are “**related parties**”, as well as depreciation/amortization on assets purchased from same in tax years beginning after Dec. 31, 2017
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Applicable Taxpayer – Base Erosion Percentage

- Base erosion tax benefits exclude **COGS** (but not if payee is “**surrogate foreign corporation**”). Other payments excluded from the definition of base erosion tax benefits include:
 - Payments subject to US withholding tax (except that withholding reduced by treaty may be treated as base-eroding payment on pro-rata basis, to extent of treaty-based reduction); service payments eligible for reimbursement at cost under a section 482 safe harbor; and “qualified derivative payments.”
 - Even if payments generate ECI to payees or generate Subpart F inclusions to US owners of payee, such payments still generally count as “bad” payments for BEAT purposes.

 - COGS exclusion creates incentive to characterize various types of intergroup payments as COGS/finished products
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Applicable Taxpayer – Related Party

- A “related party” is:
 - A 25 percent owner of the taxpayer,
 - Any person who is related (within the meaning of § 267(b) or § 707(b)(1)) to the taxpayer or any 25 percent owner of the taxpayer
 - includes a member of the same § 1563 controlled group as the taxpayer or any 25 percent owner of the taxpayer and a partnership 50% of the capital or profits interests of which are owned by the taxpayer or any 25 percent owner of the taxpayer, and
 - Any other person related to the taxpayer within the meaning of § 482. Notably, § 482 imports subjectivity into the determination of “related party” as it includes “*persons acting in concert.*”

 - A 25 percent owner of a corporation is defined as any person who owns at least 25 percent of the total voting power or value of the stock of the corporation. For purposes of the overall definition of a related party and the definition of a 25 percent owner, the constructive ownership rules of § 318 apply, with certain modifications.
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Applicable Taxpayer - Base Erosion Percentage

$$\text{Base Erosions Percentage} = \frac{\text{The aggregate amount of base erosion tax benefits of the taxpayer for the taxable year}}{\text{The aggregate amount of the deductions (including deductions described in § 59A(c)(2)(A)(i)-(iv)) allowable to the taxpayer under this chapter for the taxable year}}$$

❖ Essentially the percent of the applicable taxpayer's worldwide deductions that arose from base erosion payments

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Applicable Taxpayer - the Aggregation Rules

- Aggregation rules apply to the determination of a taxpayer's **gross receipts** and **base erosion percentage** for purposes of determining whether such taxpayer is an "**applicable taxpayer.**" Under these rules, the "**controlled group**" of which a taxpayer is a member is the relevant unit for measuring the taxpayer's average gross receipts and base erosion percentage.
- A **controlled group** includes the following relationships:
 - A chain of corporations connected through stock ownership with a common parent corporation where: (i) one or more of the corporations owns stock that possesses more than 50 percent of the vote or value of the stock of each corporation (except the common parent corporation); and(ii) the common parent corporation owns stock possessing more than 50 percent of the vote or value of the stock of at least one of the other corporations (a "**parent-subsidiary group**")
 - Two or more corporations, if fewer than five shareholders that are individuals, estates, or trusts together own (1) at least 80 percent of the total vote or value of each corporation and (2) more than 50 percent of the vote or value of each of the corporations, taking into account a shareholder's stock ownership only to the extent the ownership in each corporation is identical (a "**brother-sister group**"); and

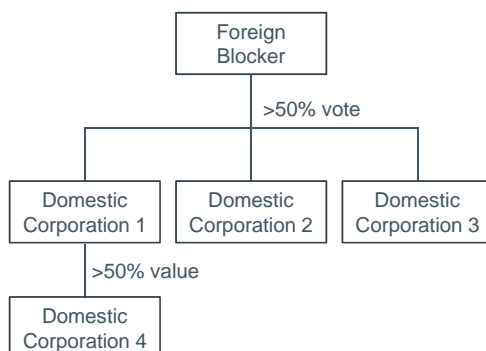
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Applicable Taxpayer - the Aggregation Rules

- **Controlled group** *cont'd*:
 - Three or more corporations where each is a member of a parent-subsidary controlled group or a brother-sister controlled group, and one of the corporations is (i) a common parent corporation included in a parent-subsidary controlled group, and also (ii) included in a brother-sister controlled group (a “**combined group**”).
- Both directly and constructively owned stock is taken into account in determining whether a corporation is a member of a controlled group. Under the constructive ownership rules, stock is attributed from:
 - A partnership to its partners having a five percent or greater interest in the capital or profits of the partnership in proportion to their interest in the partnership’s capital or profits, whichever is greater; and
 - A corporation to its shareholders that own five percent or more of the value of its stock in proportion to the value of their stock in relation to the value of all stock of the corporation.

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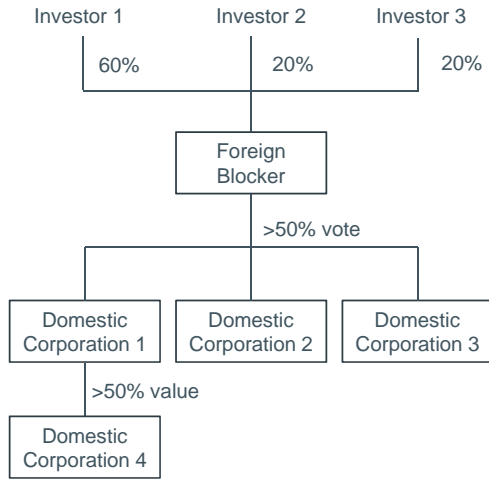
Aggregation Rules – Example 1



- Foreign Blocker and Domestic Corporations 1-4 are members of a controlled group under the parent-subsidary group test, because they are connected by >50% ownership
- Thus, the gross receipts of Domestic Corporations 1-4, as well as effectively connected gross receipts of Foreign Blocker, are aggregated for purposes of determining whether the \$500M threshold has been exceeded
- Deductible payments from the Domestic Corporations to Foreign Blocker (e.g., interest not subject to withholding tax) may be treated as giving rise to base erosion tax benefits because Foreign Blocker is a related person

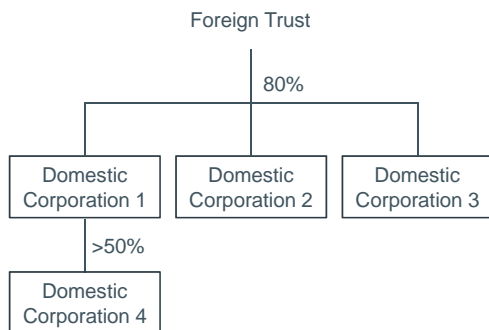
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Aggregation Rules – Example 2



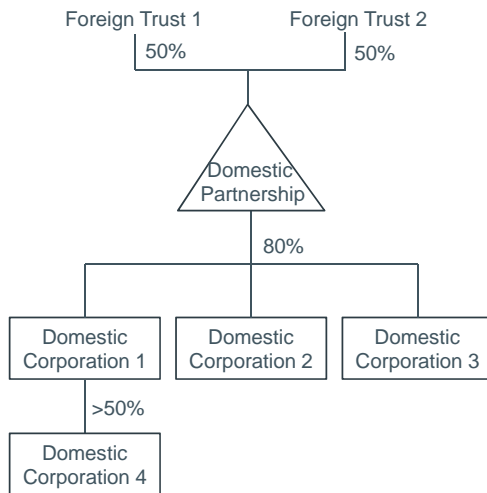
- Foreign Blocker and Domestic Corporations 1-4 are members of a controlled group under the parent-subsidary group test, so the gross receipts of Domestic Corporations 1-4, as well as effectively connected gross receipts of Foreign Blocker, are aggregated for purposes of determining whether the \$500M threshold has been exceeded
- Deductible payments from the Domestic Corporations to Foreign Blocker and Investor 1 may be treated as giving rise to base erosion tax benefits because Foreign Blocker and Investor 1 are related parties
- Investors 2 and Investor 3 could be treated as related parties under § 482

Aggregation Rules – Example 3



- Domestic Corporations 1-4 will be a controlled group under the combined group rule: Domestic Corporations 1-3 will be a brother-sister group, while Domestic Corporation 1 and 4 will be a parent-subsidary group
- Thus, the gross receipts of Domestic Corporations 1-4 will be aggregated for purposes of determining whether the \$500M threshold has been exceeded
- Deductible payments made by Domestic Corporations 1-4 to Foreign Trust may be treated as giving rise to base eroding tax benefits, but payments to unrelated minority shareholders will not because such minority shareholders will not be related parties

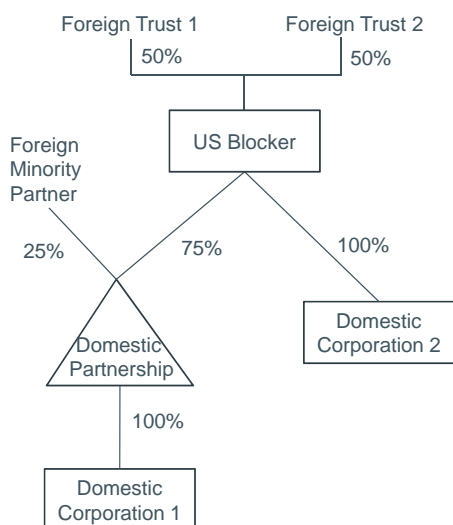
Aggregation Rules – Example 4



- Foreign Trust 1 and 2 will each be considered to own 40% of Domestic Corporations 1-3 under the constructive ownership rules of Section 318(a) – each of Trust 1 and 2 own at least 5% of the capital or profits interests of Domestic Partnership
- So Domestic Corporations 1-4 will be a controlled group under the combined group rule: Domestic Corporations 1-3 will be a brother-sister group, while Domestic Corporation 1 and 4 will be a parent-subsidary group
- Absent regulations or guidance to the contrary, deductible payments made to Domestic Partnership will not be treated as giving rise to base eroding tax benefits, because Domestic Partnership is not a foreign person

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Aggregation Rules – Example 5



- US Blocker will be considered to own >50% of Domestic Corporation 1 under the constructive ownership rules of Section 318(a)
- So US Blocker, Domestic Corporation 1, and Domestic Corporation 2 will be a controlled group under the parent-subsidary group rule
- Deductible payments made by Domestic Corporation 2 to Foreign Minority Partner will be considered to give rise to base eroding tax benefits, even though Foreign Minority Partner is uninvolved in the investment in Domestic Corporation 2

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BEAT treatment of “COGS”

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BEAT treatment of “COGS”

Section 59A(c)(2)(A): In general, the term “base erosion tax benefit” means –
Any deduction described in subsection (d)(1) which is allowed...with respect to any base erosion payment

- COGS is a reduction of gross income, not a deduction per se (Reg. § 1.61-3(a))
See also Sec. 59A(c)(2)(A)(iv): payment to a related expat/inverted entity which results in a reduction of the gross receipts of the taxpayer is a “Base Erosion Benefit”
- The same exception does Not apply to cost of services or the cost of leasing (“below the line” deductions)
 - Therefore, first question is whether the taxpayer is engaged in **a sales transactions**
 - If the commercial arrangement involves multiple transactions, they must be bifurcated and examined separately

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BEAT treatment of “COGS” (cont.)

Types of Costs required to be capitalized under Sec. 263A (the UNICAP rules)

- *Direct Costs*
 - **Producers:** Direct materials and direct labor costs
 - **Resellers:** Acquisition costs of property acquired for resale (including intangibles)

- *Indirect Costs*
 - “Directly benefits or incurred by reason of” the performance of production or resale activities
 - Treas. Reg. § 1.263A-1(e)(3)(ii) lists 23 types of indirect costs that are subject to capitalization
 - Example of costs which are Not capitalized:
 - Selling and Distribution Costs; Warranty and Product Liability; On-Site Storage Costs; Deductible Service Costs

- **Section 174 costs are excluded from Sec. 263A** (they also don’t qualify for the SCM exception)

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BEAT treatment of “COGS” (cont.)

The COGS exclusion applies to Manufacturing and Distribution businesses. To what extent royalties are treated as COGS and thus excluded?

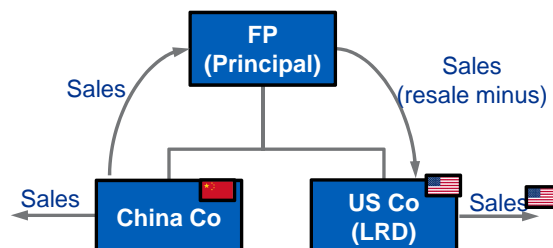
- » Key question is whether the royalty is a cost of producing goods which are *being sold*.
 - Production-related royalties are capitalized (and may be COGS) even if they are not imposed until the goods are actually sold (*i.e., the contingency on the sale to occur doesn’t preclude them from being treated as COGS*)
 - Royalties that do not have any connection to production (e.g. marketing/advertising rights) however, are not COGS
- » Royalties may be bundled: price allocation may be required if the price of each component is not separately stated
- » Royalties might be subject to US withholding tax (exclusion or partial exclusion)
- » Could the regulatory authority per Sec. 59A(i) (anti avoidance) be used to limit taxpayer’s ability to capitalize such type of payments?
- » A change of accounting method could have other indirect effects (Form 3115)
 - Can change timing of recovery of cost (depending on whether a portion must be capitalized into ending inventory)
 - Consider interaction with trade & customs rules

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BEAT treatment of “COGS” & Royalties (cont.)

Current structure:

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



Alternative structure

- FP becomes a global principal whereby US Co purchases all its finished goods from FP
- US Co becomes an LRD (as opposed to a licensed distributor). This would have the effect of eliminating the separate royalty

Consideration

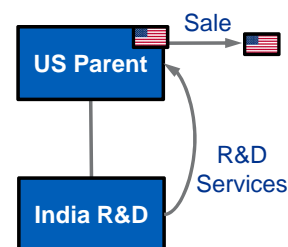
- Transfer pricing (conversion costs for U.S. Co?)
- Trade and customs (higher customs costs as a result of higher finished goods price? Is the royalty dutiable in original structure?)
- Tax accounting (could prior royalty be treated as a reduction in gross receipts such that a restructuring is not required?)
- Legal (amend legal agreements?)
- IT systems (can IT system host tri-party invoicing?)
- Anti-avoidance regulations

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BEAT treatment of “COGS” & R&D services (cont.)

Current structure (example)

- US parent sells to 3rd parties
- Indian CFC provides R&D services to US parent
- Section 174 costs are excluded from Sec. 263A

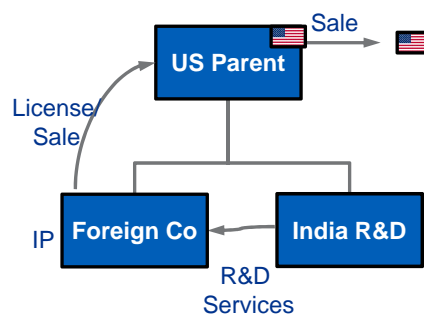


Alternative structure

- Use another CFC to own IP and contract with the Indian R&D CFC
- Dutch Co can licensee or sell to USP

Consideration

- Transfer pricing
- Trade and customs
- Legal
- IT systems
- Anti-avoidance regulations



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BEAT and Partnerships

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BEAT & Partnerships

- The aggregation rules applicable to the determination of the gross receipts threshold provide for the attribution of ownership, proportionately, from a partnership to partners who each own 5% or greater interest in the capital or profits interests of the partnership.
- Otherwise no statutory rule as to the treatment of partnerships for purposes of base erosion payments. Thus, not clear whether aggregate or entity theory of partnership is to be applied to payments by partnerships or to partnerships.
- Except in the context of the anti-avoidance rule, not clear that Treasury has regulatory authority to address open questions in this area.

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BEAT and the Services Cost Method (SCM) Exception

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BEAT and the Services Cost Method (SCM) Exception

With regards to the BEAT, Services which meet the requirements for eligibility for the services cost method under § 1.482-9 (determined without regard to the business judgment rule) will not be treated as Base Erosion Payments.

The services must be a covered service as defined in the regulations. A covered service falls into one of the following two categories:

- Specified Covered Services: Listed in Rev Proc 2007-13
- Low Margin Covered Services: Services for which the median comparable markup is 7% or less.

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BEAT and the Services Cost Method (SCM) Exception

§ 1.482-9 also includes a list of excluded activities which are not eligible for use with the SCM, a list of activities often referred to by tax practitioners as the black list. The activities on this list consist of the following:

- Manufacturing
- Production
- Extraction, exploration, or processing of natural resources
- Construction
- Reselling, distribution and similar activities
- Research and development
- Engineering or scientific activities
- Financial transactions
- Insurance or reinsurance

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BEAT and the Services Cost Method (SCM) Exception

Business Judgment Rule: The business judgment rule under § 1.482-9. states that for a service to be considered a covered service under the SCM the taxpayer must reasonably conclude that the service does not contribute significantly to key competitive advantages, core capabilities, or fundamental risk of success or failure in a trade or business of the taxpayer.

However, for services to qualify for the SCM with regards to the BEAT provision the business judgment rule does not need to be considered.

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BEAT and the Services Cost Method (SCM) Exception

At a high level the language indicates that payments eligible for the Services Cost Method (irregardless of the business judgment rule) should not be treated as base erosion payments.

However, uncertainty remains regarding how these payments will be treated if they contain a markup.

The TCJA language reads that the SCM exception applies when the “amount constitutes the total services cost with no markup component”.

What was intended by this language:

- Does this mean any services charge which includes a markup is subject to the BEAT?
- Or is only the markup portion subject to the BEAT?

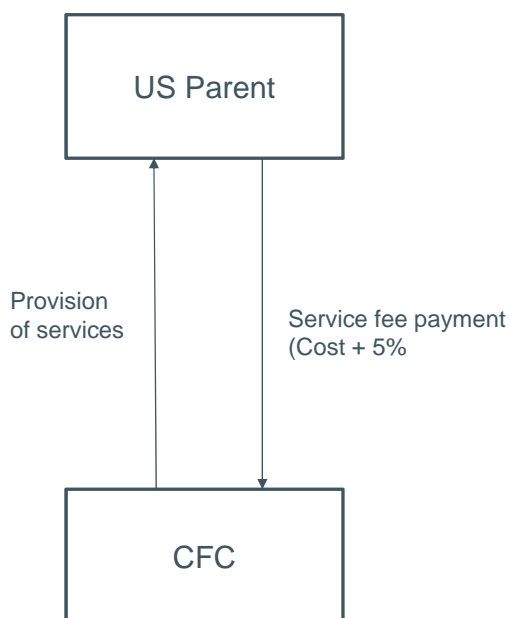
Possible treatment option:

- Segmenting the payment into two components:
 - One component for the service charge
 - One component for the markup

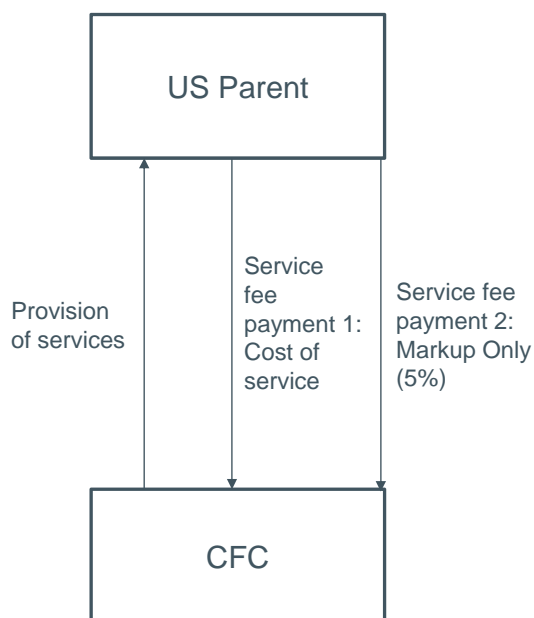
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BEAT and the Services Cost Method (SCM) Exception

Combined Payment (could all be subject to BEAT due to markup)



Bifurcate payment (potentially only markup payment subject to BEAT)



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BEAT and Agency Relationships

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BEAT and Agency Relationships

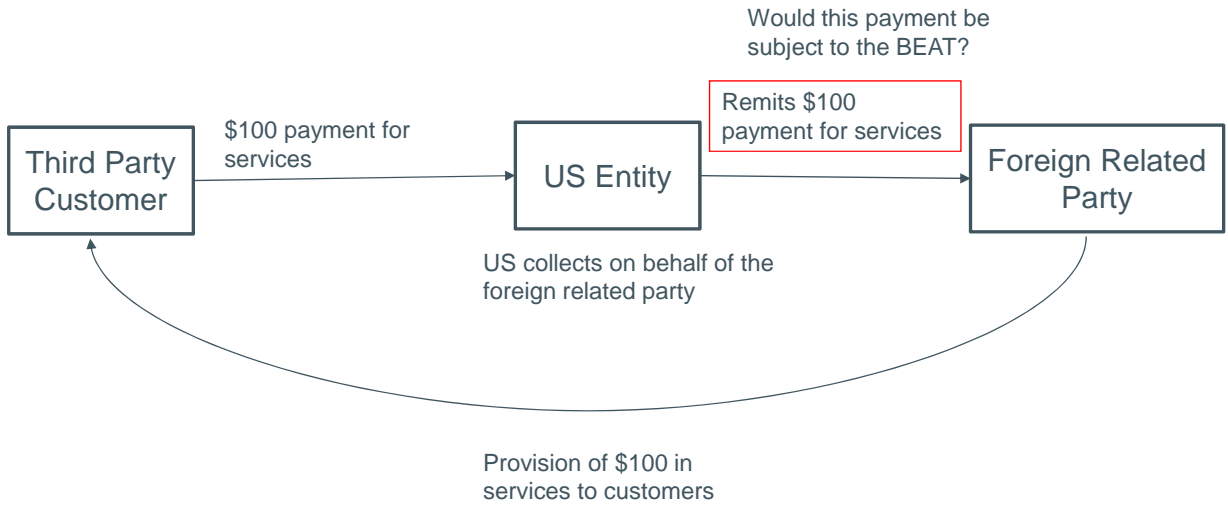
How would agency relationships be treated under the BEAT?

Currently the treatment is unclear.

- If a US entity collects funds on behalf of a foreign related party and then remits the funds to that related foreign party would this be treated as a base erosion payment?
- If a US entity makes a payment to a foreign related party on behalf of another foreign related party would this be treated as a base erosion payment?

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BEAT and Agency Relationships: Example



BEAT and the Aggregation / Disaggregation of Payments

Aggregation and Disaggregation of Payments

A key ambiguity in the BEAT is the treatment of the netting of payments between related entities:

- It is common for a US entity and foreign entity to net payments for services and only make the “net” payment due
- Under the BEAT do payments need to be disaggregated and the full outbound payment be treated as a base erosion payment?
 - » Would the treatment depend on the similarity of the services?
 - Netting of US performed G&A and foreign performed G&A
 - Netting of US performed G&A and foreign performed sales and marketing
 - » Implications for cost sharing:
 - Netting of PCT payments
 - Netting of ongoing R&D payments

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Aggregation and Disaggregation of Payments Example 1: G&A Example*

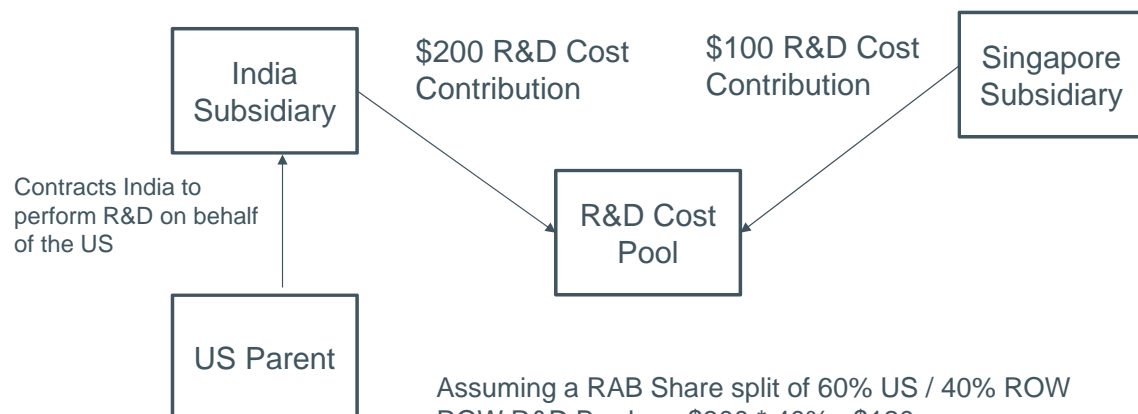


Should the full payment of \$100 be treated as a base erosion payment or only the \$10 net payment?

*Assume not subject to SCM Exception

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Aggregation and Disaggregation of Payments Example 2: Cost Sharing Example



Assuming a RAB Share split of 60% US / 40% ROW

ROW R&D Burden= $\$300 * 40\% = \120

US R&D Burden= $\$300 * 60\% = \180

US funded R&D allocated to Singapore: $\$200 - \$180 = \$20$

Would this \$20 in US R&D expense ultimately funded by Singapore be treated as a US base erosion payment?

Handling the BEAT

Handling the BEAT: Restructuring related party payments with external party payments

One approach is to potentially lower base erosion payments is to replace related party transactions with third party transactions.

Potential transactions to switch to third parties:

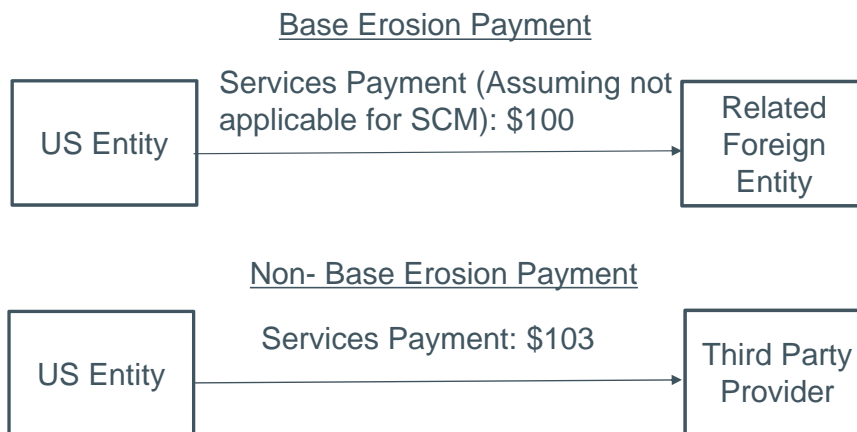
- Services transactions (assuming not subject to the SCM exception)
- Loans / interest transactions (assuming not subject to 163j limitations)

Benefit could be enjoyed as long as third party costs are less than costs if provided by related party + BEAT tax

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Handling the BEAT: Restructuring related party payments with external party payments

Replacing related party transactions with third party transactions.



If the \$100 services payment increases 2017 modified taxable income by \$100, the BEAT tax impact would be \$5 ($\$100 * 5\%$).

Therefore, they would be better off making the \$103 services payment to a third party provider than the \$100 related party payment.

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Handling the BEAT: Restructuring to include additional components into COGS

Another approach to lowering base erosion payments is to bundle additional expenses into COGS payments.

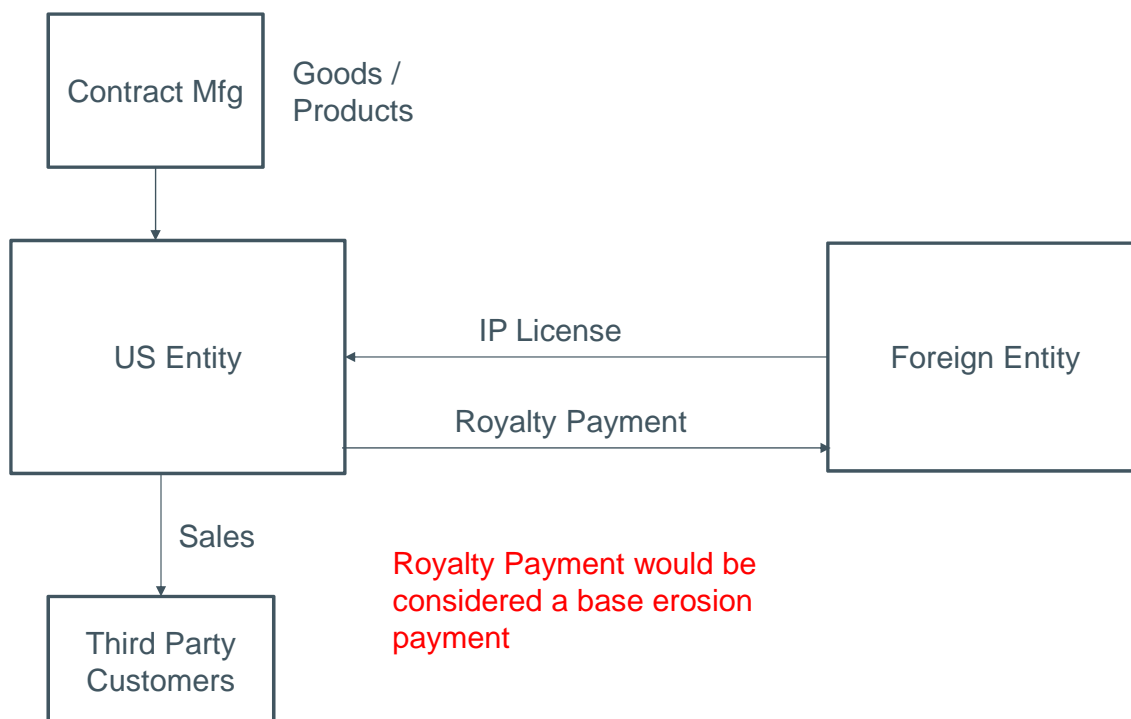
Examples of potential expenses to bundle with COGS include:

- Royalty payments for the licensing of IP
- Management fees

There is uncertainty regarding how the IRS will treat the bundling of payments and the extent to which they will “unbundle” payments.

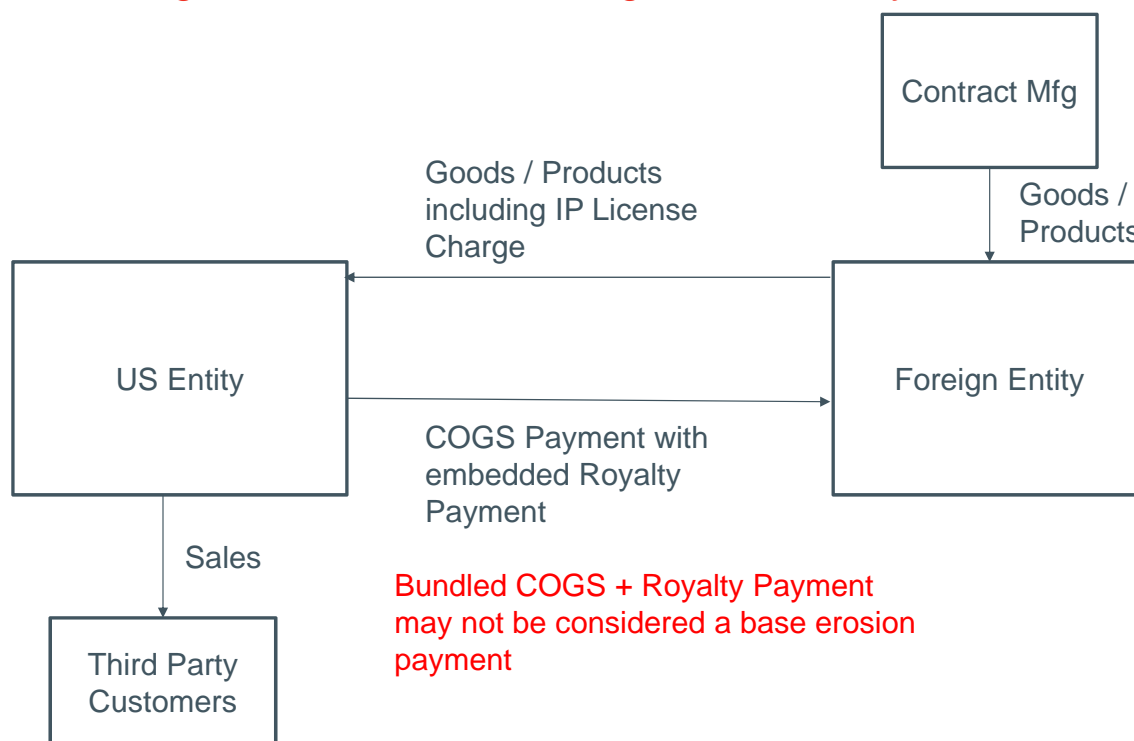
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Handling the BEAT: Restructuring to Bundle Royalties into COGS



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Handling the BEAT: Restructuring to Bundle Royalties into COGS



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Handling the BEAT: Monitoring the BEAT Threshold

The \$500 million average gross receipts and 3 percent base erosion percentage thresholds create a so-called “cliff effect.”

Once these threshold tests are met, a single extra dollar of base erosion tax benefit causes the BEAT to apply to all base erosion payments.

Therefore, taxpayers near the limit of either of these thresholds should take extra care in accelerating or deferring income or deductions to manage the threshold.

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BEAT Threshold Example

Consider a hypothetical tax payer with the following gross receipts. If they could defer recognition of \$3 million in the most recent taxable year they would be below the threshold and not be subject to the BEAT as shown in Scenario 2.

| | | Year N-2 | Year N-1 | Most Recent Year (N) | Average |
|-------------------|----------------------------------|----------|----------|-------------------------|----------|
| <u>Scenario 1</u> | Gross Receipts (Millions USD) | \$ 502.0 | \$ 499.0 | \$ 501.0 | \$ 500.7 |
| <u>Scenario 2</u> | Gross Receipts (Millions USD) | \$ 502.0 | \$ 499.0 | \$ 498.0 | \$ 499.7 |

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Handling the BEAT: CTB election to treat foreign sub as a DRE

Assume US parent makes payments to its CFC for services which do not qualify for the SCM exception:

- If US Parent's payment to Foreign Subsidiary for R&D or back office functions creates BEAT exposure and if terminating the intercompany payment is not an option, then a check-the-box election may be effective
- A check-the-box election would result in the CFC becoming a branch of US Parent effectively eliminating the base erosion payment

Potential adverse results of making such CTB election

1. Separate basket for foreign tax credits tax credit
2. Dual consolidated losses
3. Section 367 upon liquidation of the CFC, and Sec. 367 and sec. 91 if the DRE/QBU is later on reincorporated or transferred to another CFC
4. May be treated as a hybrid entity by another relevant jurisdiction

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Calculating the BEAT

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The BEAT Calculation: “MTI” and NOL deduction

Section 59A(c)(1) defines Modified Taxable Income (“MTI”):

“ The term 'modified taxable income' means the **taxable income** of the taxpayer computed under this chapter for the taxable year, ***determined without regard to—***

- A. Any base erosion tax benefit with respect to any base erosion payment, or
- B. The base erosion percentage of any net operating loss deduction allowed under section 172 for the taxable year”

Therefore: “Base erosion tax benefit” and Sec. 172 NOLs deduction (times BE%) are added back to the ‘regular’ taxable income. Questions:

1. What is the starting point? (i.e., the “taxable income” amount)?
2. The “base erosion percentage” of which year should be used in adding back the Sec. 172 NOL?
3. What does taxable income “Without regard to” mean? Should the taxable income be ‘hypothetically’ recalculated for MDI purposes simultaneously with adding back the above items?

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The BEAT Calculation: “MTI” and NOL deduction

Example

- Gross income: \$800
- Base erosion tax benefits: \$100
- Other deductions: \$300
- **NOL** carryover from pre-2018 years: **\$1000**

BEAT Results

1. The Base erosion percentage = $\$100/\$400 = 25\%$
2. Should the taxable income (i.e., the starting point be \$600 of a loss? In which case the “add backs” are $\$100 + 25\% \times \100 (NOLs) = \$250 net loss for BEAT purposes (i.e., no positive MTI and thus no BEAT liability);
3. Alternatively, if the ‘regular’ taxable income is zero (assuming ‘taxable income’ cannot be negative) then: $\$0 + \$100 + 25\% \times (\$400 \text{ the ‘effective’ NOL deduction amount}) = \200 MTI for BEAT purposes

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The BEAT Calculation: “MTI” and NOL deduction

The first alternative seems justified

- The pre-reform version of Sec. 172 provide (still relevant for C/O these losses) that “net operating loss deduction” amount allowed for a taxable year is the aggregate of the NOL carryovers and carrybacks
- Nothing in the I.R.C. is saying that taxable income cannot be negative, and the existence of other provisions that explicitly state that taxable income is floored at zero for limited purposes suggests that where such explicit limits are not applicable, taxable income can be negative

However,

- Alt. 1 allows NOL carryovers to be turned into cascading deductions of the total carryover year after year, reduced only by the amount absorbed by positive pre-NOL taxable income in each year
- But while Approach #1 effectively allows a portion of NOL carryovers to be used to offset modified taxable income, NOL carryovers are still consumed only by regular taxable income.
- So in the previous example, the \$100 of BETBs and \$100 of BE% of NOLs that is eliminated by NOLs appear to still be available in the following year as a carryover against both regular taxable income and MTI. “Evergreen” NOLs seem unlikely to have been intended by the drafters.

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The BEAT Calculation: “MTI” and NOL deduction

“ . . . taxable income . . . determined without regard to . . . the **base erosion percentage** of any net operating loss deduction allowed under section 172 for the **taxable year**”

What does Base Erosion % of the NOL for the taxable year mean? The year in which the NOL was created or the year in which it is utilized?

Ex 1: Year 1: \$100 Loss. No related party payments;
Year 2: \$100 of NI before Sec. 172 NOL deduction. BE% is 50%

Ex. 2: Same as Ex. 1 but BE% in Year 1 is 50% and 0% in Year 2

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The BEAT calculation: Should taxable income be recalculated?

“ The term 'modified taxable income' means the **taxable income** of the taxpayer computed under this chapter for the taxable year, determined **without regard to . . .**”

What does taxable income “Without regard to” mean? Should the taxable income be ‘hypothetically’ recalculated for MDI purposes simultaneously with adding back the above items?

“**Top Up**” approach: BEAT deductions are added back (simpler method)

“**Recalculation**” approach: Recalculate TI as if BEAT deductions never existed

This approach allows other non BEAT deductions to be utilized once the TI is recalculated without the BEAT deductions (this includes interest deduction, NOLs and charitable donations). Meaning, recalculating TI without BEAT deductions frees up NOLs and Sec. 163(j) interest deductions

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BEAT Challenges

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BEAT Challenges: Double Taxation

- Potential of double taxation due to the BEAT
 - BEAT imposes a minimum tax designed to limit a large, multinational corporation's ability to reduce its normal U.S. taxes through payments to foreign related parties.
 - Although BEAT is styled as a minimum tax, it is applied to an income base that excludes certain payments to foreign related parties and ignores certain tax credits, potentially increasing the effective tax rate to much more than the statutory rate of 21%.

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BEAT Challenges: Legal Challenges

- Potential legal challenges against the BEAT
 - The BEAT may constitute a prohibited subsidy under World Trade Organization rules.
 - Deductions that can trigger BEAT include amounts paid or accrued by a taxpayer to a foreign related person for depreciable or amortizable property and, in the case of inverted companies, for the cost of goods. Because of the potentially higher rate of tax on these payments, BEAT could be viewed as an import charge, creating an implicit subsidy contingent upon the use of domestic over imported goods, potentially a “prohibited subsidy” under the WTO’s Agreement on Subsidies and Countervailing Measures.
 - Alternatively, BEAT could be viewed as an unscheduled tariff on imported goods in violation of 1994 General Agreement on Tariffs and Trade, Part II.1(b).

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BEAT/ FDII Considerations when inbounding IP

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BEAT/FDII considerations when inbounding IP

The BEAT and the FDII regime may, in certain circumstances, incentivize U.S. multinational groups to “inbound” IP and other economically productive activity. Note that branch income is not eligible for the deduction under FDII, so fully benefitting from the FDII regime may require an actual movement of assets and employees.

By inbounding property such as IP, it reduces the instances in which deductible payments may otherwise need to be made (e.g., royalties)

Four viable methods for inbounding IP (and other related assets)

- Sale Method (e.g., U.S. Parent buys the IP from its CFCs for cash)
- Distribution Method (e.g., CFC distributes the IP to U.S. Parent)
- Liquidation Method (e.g., CFC liquidates into U.S. Parent) (can be done through an election to be a DRE of U.S. Parent, but note the branch income limitation to FDII)
- Reorganization Method (e.g., CFC undergoes an asset reorganization into U.S. Parent (or another U.S. corporation)).

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BEAT/FDII considerations when inbounding IP

1. The Sale Method: Any gain recognized by the CFC may be Subpart F income or GILTI (gain should be limited if a § 338 election has been made). The U.S. Parent’s depreciation/amortization deductions with respect to such property give rise to Base Erosion Tax Benefits
2. Distribution Method: Any § 311(b) gain recognized by the CFC may be Subpart F income or GILTI (limited if a § 338 election has been made). Since the U.S. Parent does not make any payment for the property, U.S. Parent’s depreciation/amortization deductions with respect to such property do not give rise to Base Erosion Tax Benefits
3. Liquidation/Reorganization Method: The CFC generally does not recognize gain or loss (hence, limited Subpart F/GILTI exposure).
 - I. The U.S. Parent’s “surrender” of stock in the CFC under the Liquidation Method may not be viewed as a payment for the property; as such, U.S. Parent’s depreciation/amortization deductions with respect to such property would not give rise to Base Erosion Tax Benefits
 - II. In a reorganization scenario, the CFC would be deemed to transfer its assets to the acquiring corporation for stock of the acquiring corporation. Can this be viewed as a “payment” for BEAP purposes?

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What is next for the BEAT?

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What is next for the BEAT?

- BEAT Tax form (8991) released on September 5, 2018
 - Form is DRAFT / Not for Filing
- Tax form 8991 instructions released on October 17, 2018
 - Instructions in DRAFT form
- Proposed Regulations
 - Release date is unclear, generally expected for November 2018

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Questions



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