

Don't Get Beat by the BEAT

Yaron Katz, Partner – KPMG
Frank Mugabi, Partner – DLA Piper
Robert Bachmann, Director – Duff & Phelps

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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
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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

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

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- 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,
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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 - Base Erosion Percentage

Base
Erosions
Percentage

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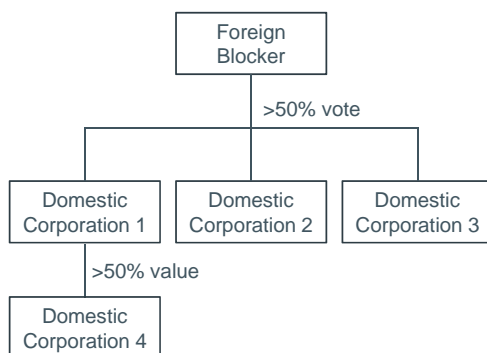
Applicable Taxpayer - the Aggregation Rules

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
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Aggregation Rules – Example 1

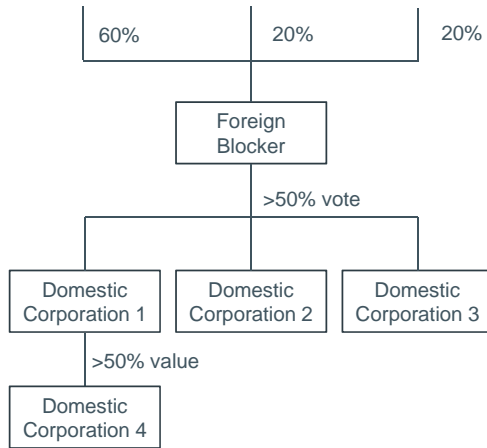


Foreign Blocker and Domestic Corporations 1-4 are members of a controlled group under the parent-subidiary group test, because they are connected by >50% ownership

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

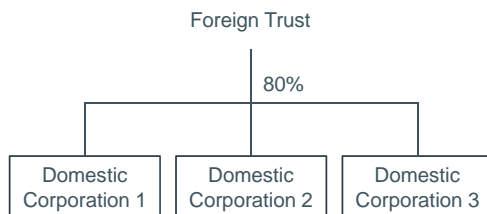
Deductible payments from the Domestic Corporations to Foreign Blocker (e.g., interest not subject to withholding tax) may be treated as giving rise to base erosion tax benefits because Foreign Blocker is a related person

Aggregation Rules – Example 2



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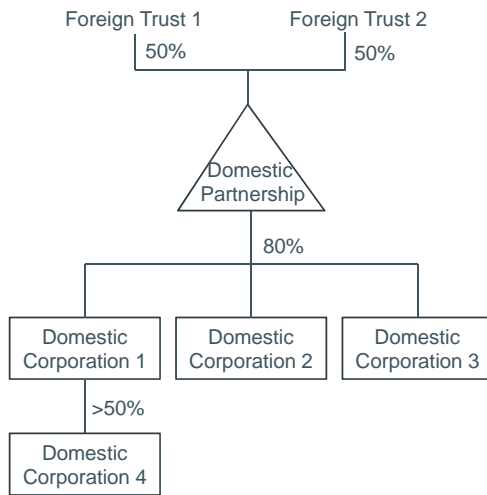
Aggregation Rules – Example 3



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-subsidiary group

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Aggregation Rules – Example 4



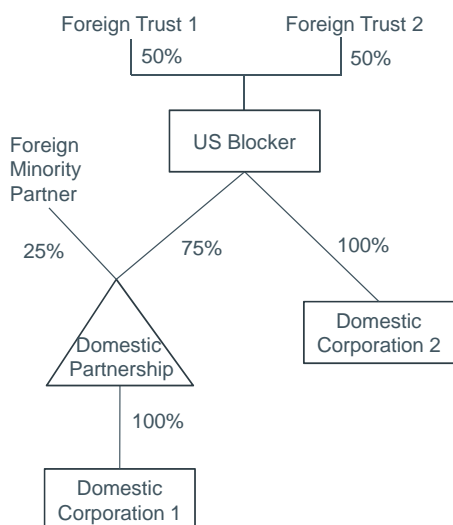
Foreign Trust 1 and 2 will each be considered to own 40% of Domestic Corporations 1-3 under the constructive ownership rules of Section 318(a) – each of Trust 1 and 2 own at least 5% of the capital or profits interests of Domestic Partnership

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**
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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)

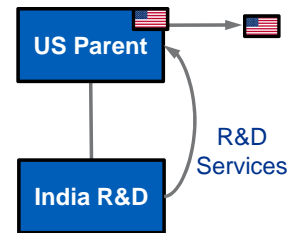
BEAT treatment of "COGS" & Royalties (cont.)

Current structure:

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

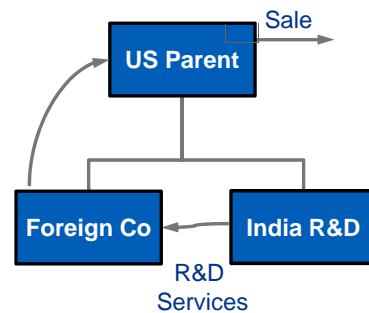
Current structure (example)

- 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

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

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.

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.

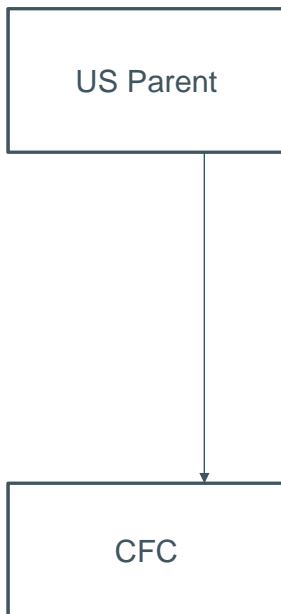
However, for services to qualify for the SCM with regards to the BEAT provision the business judgment rule does not need to be considered.

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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

BEAT and the Services Cost Method (SCM) Exception



BEAT and Agency Relationships

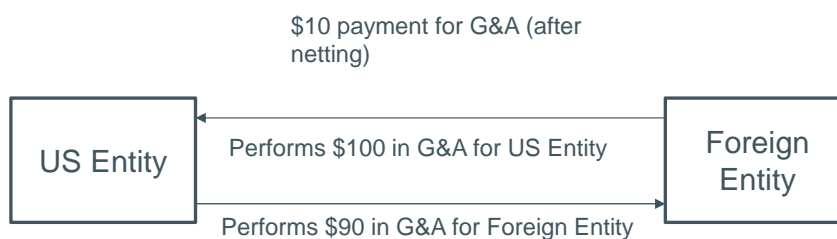
BEAT and the Aggregation / Disaggregation of Payments

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

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?

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Aggregation and Disaggregation of Payments Example 2: Cost Sharing Example

Singapore
Subsidiary

US Parent

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?

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Handling the BEAT

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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)

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

Replacing related party transactions with third party transactions.

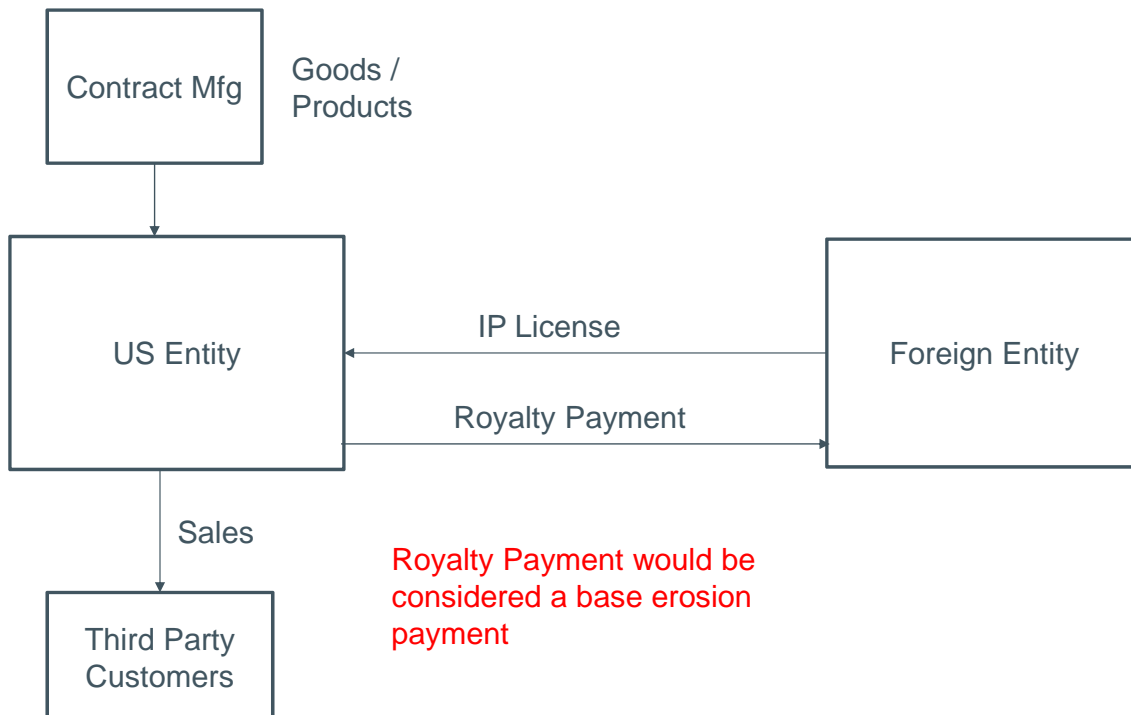


Handling the BEAT: Restructuring to include additional components into COGS

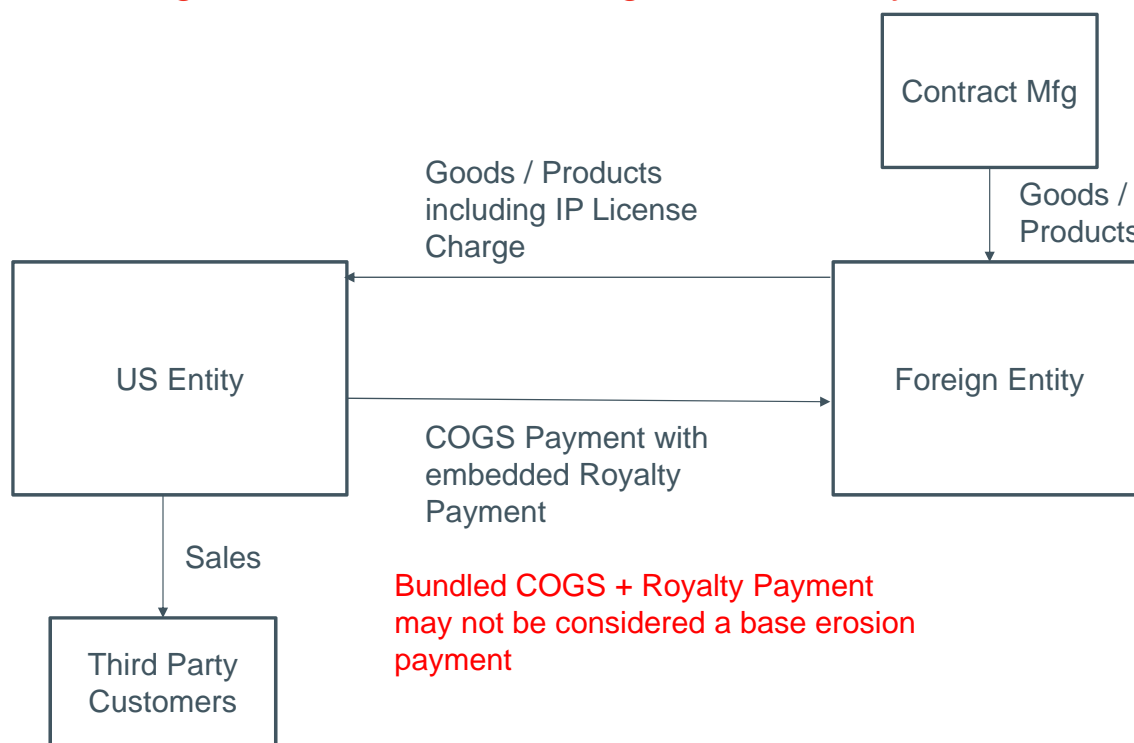
Another approach to lowering base erosion payments is to bundle additional expenses into COGS payments.

Examples of potential expense C..7(.3(e)9)3.6(o)2.2(f)-2.4()9.8(p)1.7(o)1.7(t).9(cn

Handling the BEAT: Restructuring to Bundle Royalties into COGS



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



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:

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**

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 - 1.8(25\%) = \450)

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.

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

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, such as interest, dividends, and capital gains.¹

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

**BEAT/ FDII Considerations when
inbounding IP**

BEAT/FDII considerations when inbounding IP

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 tu3e
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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

Your Presenters

Yaron Katz
Partner