New Section 59A: Base Erosion and Anti-Abuse Tax (the "BEAT")

WEDNESDAY, JUNE 6, 2018, 1:00-2:30 pm Eastern

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THE NEW BASE EROSION AND ANTI-ABUSE Tax (BEAT) RULES – WHAT WE KNOW SO FAR

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Background – Efforts to Prevent Shifting Income Away from US Tax Net

US Base Erosion And Anti-Abuse Tax (BEAT) – Background

- **Congress believed that base erosion structures enabled US corporations and US branches to strip earnings from the US tax net to lower tax jurisdictions**
  - **Common deductions included interest, royalties, management fees and derivative payments**
  - **Funding US sub (or branch) with debt vs. funding US sub with equity**
- **Pre-2018 US rules did not prevent base erosion structures to the satisfaction of the US Congress**
  - **IRC § 163(j) (only applicable to interest)**
  - **§ 163(j) allows netting of interest before limitation applies**
  - **US has been reluctant to sign on to European BEPS initiatives**

US Base Erosion And Anti-Abuse Tax (BEAT) – Who's Affected?

- **Taxpayer must be taxable as a corporation in the US**
  - **All banks & insurance companies are taxable as corporations (including those operating through US branches)**
- **Average annual gross receipts for prior 3 years must exceed $500 million**
  - **US branch: Gross receipts test only looks to US branch transactions**
  - **All income of US subs is counted (even if not earned within the US)**
  - **Each company is attributed the gross receipts of its affiliates**
- **Base erosion percentage must exceed 2% (3% for non-financial business)**
  - **Percentage generally means the ratio between the base erosion payment deductions and the taxpayer's total deductions (including base erosion payments)**
  - **Not clear whether intercompany transactions must be considered on a gross or net basis**

Base Erosion & Anti-Abuse Tax – Operation and Issues

Base Erosion and Anti-Abuse Tax Overview

- Is the BEAT the new corporate AMT or an anti-base erosion tax?
- BEAT compares taxpayers' modified taxable income (MTI) to their ordinary income tax liability (reduced by certain tax credits)
  - MTI is the taxpayer's taxable income determined without regard to (i) certain deductible "base erosion payments" and (ii) the "base erosion percentage" of any NOL deduction
- If the taxpayer's tax liability on MTI (computed at 10% rate) is greater than its ordinary income tax liability, the excess represents an additional tax (BEAT). Rate is 5% for 2018 only (6% for banks & B/Ds).
  - 12.5% beginning in 2026
- BEAT tax rate is 6% for financial institutions in 2018, 11% thereafter
  - 13.5% beginning in 2026

Steps in Computing BEAT Tax

- **Determine if BEAT applies for the year, if so:**
- **Determine “modified taxable income” by adding back base erosion payments for such year, and base erosion payments in NOLs being used in such year.**
- **Modified taxable income means taxable income before credits without regard to (i) any base erosion tax benefit with respect to any base erosion payment or (ii) the base erosion percentage of any NOL deduction for the taxable year**
- **Multiply modified taxable income by 10%**
  - **Rate is 5% in 2018, 12.5% after 2025**
- **Subtract regular tax liability from the result**
  - **Regular tax liability is pre-credit tax liability reduced (but not below zero) by credits other than R&D credits and 80% of certain other Section 38 credits (only), until 2026**

Base Erosion Payments Must Exceed Threshold

- **Base Erosion Percentage must be 3% or higher (2% for banks and securities dealers)**
- **Base erosion percentage is equal to (i) the aggregate amount of base erosion tax benefits of the taxpayer for the taxable year divided by (ii) the taxpayer's tax deductions for the taxable year, not including deductions for NOLs, participation exemption on foreign dividends, GILTI, FDII, certain payments with respect to services, and deductions for certain qualified derivative payments**
- **How are related party transactions taken into account? Statute would disregard all payments to foreign related parties.**
- **How are swaps and other derivatives treated?**
  - **Is a swap book grossed out so that every transaction is separately considered or is netting taken into account?**
  - **Peter Merkel of the IRS is reported to be interested in taxpayer comments on netting issue.**
  - **When a swap book is grossed out, it becomes less likely for a dealer that it will exceed base erosion percentage.**

Base Erosion Payments

Determining a taxpayer's MTI – "Base Erosion Payments:"

- **"Base erosion payment" generally means any amount paid or accrued to a related foreign party that generates a deduction or is used to acquire depreciable/amortizable property (including also premiums and reinsurance payments)**

- **Payments that qualify as FDAP income and are subject to 30% WHT in the US are excepted. But if the WHT rate is lower because of a tax treaty, then only a corresponding portion of the payment is excluded from the MTI calculation.**

- **A significant risk exists that payments by a US sub to a US branch be treated as a base erosion payment, even if the branch picks up the payment as US income.**

- **Payments by one US branch to another could be base erosion payments if they are respected for federal income tax purposes**
  - **Treaty Method vs. Treas. Reg. § 1.882-5 Method (interbranch payments not recognized)**

Base Erosion Payments - CFC

- **Double taxation arises also for CFCs**
  - **Assume a US shareholder makes a payment for services to a CFC that renders services outside the country of incorporation**
  - **Payment for services is included as subpart F income of the US shareholder**
  - **The payment for services is a base erosion payment, and the deduction could be denied under § 59A**
  - **Additionally, tax credits could be lost under the BEAT**

More on Base Erosion Payments

- Payments for the purchase of depreciable property
  - Add back depreciation as it accrues, not all at once in year of purchase
  - How will the rules apply to property acquired by contribution and in related party reorganizations?
- Certain reinsurance payments by insurance companies
- Certain payments to inverted corporations and their affiliates
- Base erosion component of an NOL (including pre-effective date NOLs?)
- Payments for certain services provided at cost
- Interest subject to § 163(j) limitation
  - Amount deductible after § 163(j) can be a base erosion payment
  - Treat interest disallowed by § 163(j) as unrelated party interest to the extent possible

More on Base Erosion Payments

- **Exceptions to base erosion payments**
  - **Services cost method exception under Treas. Reg. § 1.482-9, as amended by § 59A**
  - **Cost of goods sold (except for certain inverted companies)**
  - **Qualified derivative payments**
- **Issues to be clarified by guidance, including:**
  - **Payments covered by an APA or by MAP**
  - **Third party payments**

Excess Interest Payments by Branches

Taxpayers that operate through branches do not determine their interest expense solely be reference to US booked liabilities.

Branch interest expense is determined by the amount of US assets, using a 3-part calculation that determines US connected liabilities.

US connected liabilities are notional and the notional liabilities can give rise to notional interest deductions. The notional interest deduction can be subject to US withholding tax under Code § 884(f). Under Code § 884(f), the notional interest is considered to be paid to a non-US parent for purposes of Code § 881.

Treasury and the IRS should issue guidance that the notional interest is not a base erosion payment.

Qualified Derivative Payment Exception

Determining a taxpayer's MTI – "Base Erosion Payments:"

- **Qualified derivative payments (QDP) made by the US branch or US subs are not treated as base erosion payments**
  - **QDP (i) must be accounted for on the mark-to-market method of accounting, (ii) must result in ordinary gain or loss, and (iii) all items in connection with the payment must be treated as ordinary. QDP do not include any non-derivative component**
  - **Unclear how mark-to-market transactions (IRC § 475) work under the exception since payments are not deductible in mark-to-market accounting**
  - **Time value of money element inherent in any QDP must be stripped out and treated as base erosion payment**
  - **Does this rule require imputing a cost of funds on all amounts funded by non-US branches and non-US affiliates?**

The BEAT Eats Most Tax Credits

Base Erosion Minimum Tax Amount =

10% of Modified Taxable Income

–

Regular Tax Liability
(21% of Taxable Income)

–

Chapter 1 Credits
(includes Research Credit*, WOTC foreign tax credits, etc.)

–

Research Credit* + 80% of Applicable Sec. 38 Credits

***While regular tax liability is decreased by all Chapter 1 credits, only the Research Credit and specified Sec. 38 credits (low-income housing credit, renewable electricity production credit, and investment credits allocable to the energy credit) are added back in such that they do not reduce the regular tax liability. All other credits are lost, including foreign tax credits.**

Foreign Related Parties

A foreign related party can include US branches of non-US taxpayers, but this does not seem to be a base erosion payment situation.

Similarly, a foreign related party can include a controlled foreign corporation (a CFC) even if the US owner is including the payment as subpart F income. Again, this does not seem to be a base erosion payment situation.

Generally, a foreign related party includes:

- **Any 25% owner (by vote or value) (with modified § 318 attribution)**
- **Any person related to the taxpayer or a 25% owner, within the meaning of § 267(b) or § 707(b)(1) (with modified § 318 attribution)**
- **Any person related to the taxpayer for purposes of § 482**

Authority for Additional Guidance

- **Authority to issue guidance that is necessary or appropriate to carry out the provisions of § 59A**
- **Authority to address:**
  - **Use of unrelated persons, conduit transactions or other intermediaries**
  - **Transactions designed to change character of payments to avoid the BEAT**
  - **Substitution of payments not subject to the BEAT for base erosion payments**
- **Treasury and IRS to publish proposed regulations in Q4 2018**

Information Reporting on BEAT

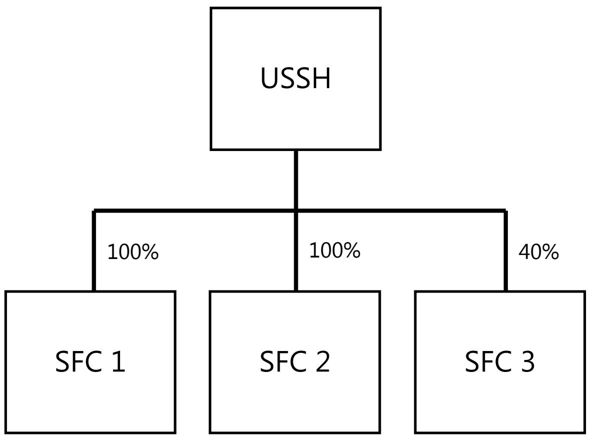
- **Treasury authority to require specific information reporting related to BEAT in connection with Form 5472**
- **Penalty for failure to furnish any Form 5472 information increased from $10,000 to $25,000**

A Base Erosion & Anti-Abuse Tax Example

Step-by-Step Guide to BEAT Calculation

Base Facts

USSH COMPANY PROFILE	
Gross Receipts	1,000,000,000
Total Deductions	800,000,000
Taxable Income Before NOLs	200,000,000
NOL Carryforward Applied	(50,000,000)
Taxable Income After NOLs	150,000,000
Regular Tax	31,500,000
Section 38 Credit	(1,000,000)
R&D Tax Credit	(2,000,000)
Foreign Tax Credit	(10,000,000)
Net Regular Tax	18,500,000
Non-COGS payments to related foreign parties	100,000,000
GILTI Deductions	5,000,000



Step-by-Step Guide to BEAT Calculation

Step 1: Calculate the Base Erosion Percentage

Base erosion tax benefit	100,000,000	[A]
Total Deductions	800,000,000	
Less: GILTI Deductions	5,000,000	
Eligible Deductions	795,000,000	[B]
Base erosion percentage	12.58%	[A] / [B]

- Determine the base erosion tax benefit
- Determine the Company's total deductions
- Subtract any disallowed deductions (e.g., deductions related to GILTI) to arrive at eligible deductions
- Divide the base erosion tax benefit by the total eligible deductions to arrive at the base erosion percentage

Step-by-Step Guide to BEAT Calculation

Step 2: Calculate Modified Taxable Income

NOL carryforwards utilized	50,000,000
Base erosion percentage (assumes constant)	12.58%
Base erosion percentage of NOL carryforwards utilized	6,289,308
Taxable Income after NOLs	150,000,000
Base erosion tax benefit	100,000,000
Base erosion percentage of NOL carryforwards utilized	6,289,308
Modified Taxable Income	**256,289,308**

- Apply the base erosion percentage to arrive at the base erosion percentage of NOL carryforwards utilized
- Add to Taxable Income the base erosion percentage of NOL carryforwards utilized and base erosion tax benefit, to calculate modified taxable income

Step-by-Step Guide to BEAT Calculation

Step 3: Calculate base erosion tax liability

Modified Taxable Income	256,289,308
Multiplier (5% for 2018; 10% or 12.5% for later years)	10.00%
Percentage of modified taxable income	25,628,931
Less: regular tax liability after applicable credits	21,300,000
Base erosion tax liability	**4,328,931**
Regular tax liability	31,500,000
Excess of all credits over R&D and 80% Sec. 38	(10,200,000)
Regular tax liability after applicable credits	21,300,000
All Credits over	13,000,000
R&D & 80% of Section 38 Credits	2,800,000
Excess of all credits over R&D & 80% Sec. 38	10,200,000

- Multiply the modified taxable income by 10% (for years after 2018) or 5% for 2018
- Compare result to pre-credit tax liability, reduced by credits other than R&D credits & 80% of certain Sec. 38 credits