The Great BEAT Debate

ABA 2019 Mid-Year Tax Meeting
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What’s not up for Debate?

Which issues were “resolved” in the proposed regulations?
Issues Addressed in the Prop. Regs.

- ‘Payment’ is broadly defined to capture a variety of non-recognition transactions
- Clarifies the services cost method (SCM) exception
- NOLs are subject to the base erosion tax percentage in the ‘vintage year’ and do not reduce modified taxable income below zero
- Clarifies scope of anti-abuse rule
- Adopts the add-back method rather than a recomputation method
- Reverses approach in Notice 2018-28 (i.e., Section 163(j))
Treaty Override

Does the unfavorable treatment of foreign tax credits for BEAT purposes apply in a treaty context?
• Supremacy Clause of the U.S. Constitution provides that federal statutes and treaties are the Supreme Law of the Land. U.S. Const. art. VI, cl. 2.

• When a treaty and a statute relate to the same subject, “the courts will always endeavor to construe them so as to give effect to both, if that can be done without violating the language of either . . .” Whitney v. Robertson, 124 U.S. 190, 194 (1888).

• But if a treaty and a statute are inconsistent, the more recent legal pronouncement controls (“last-in-time” rule). Whitney v. Robertson, 124 U.S. 190, 194 (1888); Kappus v. Comm’r, 337 F.3d 1053, 1057 (D.C. Cir. 2003).
BEAT & Tax Treaties – Background

• Relief from Double Taxation—“In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a resident or citizen of the United States as a credit against the United States tax on income applicable to residents and citizens” a foreign tax credit for income tax paid or accrued to the treaty partner. See 2016 U.S. Model Income Tax Convention, Art. 23(2).

• Non-Discrimination—“[I]nterest, royalties, and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned Contracting State.” See 2016 U.S. Model Income Tax Convention, Art. 24(4).

• Tax treaties generally have a saving clause that preserves the right of each country to tax its own residents as if no tax treaty were in effect. But Articles 23 and 24 are exceptions to the saving clause. See 2016 U.S. Model Income Tax Convention, Art. 1(4)–(5).
BEAT & Tax Treaties – Background

• The BEAT is generally computed as the excess of 10% (5% for 2018 and 12.5% after 2025) of MTI over the taxpayer’s regular tax liability reduced by certain credits, including the foreign tax credit. § 59A(b)(1)–(2).
  • Violation of Article 23?

• MTI is taxable income without regard to tax benefits from deductible payments to foreign related persons, depreciation and amortization deductions with respect to property acquired from foreign related persons, reinsurance payments to foreign related persons, NOL deductions reflecting the foregoing payments, and certain payments to related expatriated entities. § 59A(c)–(d).
  • Violation of Article 24?
Does the BEAT conflict with any provisions in U.S. tax treaties?

Yes

The BEAT is a treaty override

When calculating the BEAT, deductions for otherwise deductible payments to foreign related persons in treaty countries and FTCs for foreign taxes paid to treaty countries should **not** be allowed.

No

The BEAT is not a treaty override

When calculating the BEAT, deductions for otherwise deductible payments to foreign related persons in treaty countries and FTCs for foreign taxes paid to treaty countries should be allowed as if the BEAT did not exist.

No issue
The BEAT is not a treaty override

• Courts are generally disinclined to find conflicts between a statute and a treaty and would be unlikely to find a statutory override of negotiated treaty provisions absent clear congressional intent in the statute or legislative history to override the treaties.
  • Cook v. United States, 288 U.S. 102, 120 (1933) (“A treaty will not be deemed to have been abrogated or modified by a later statute unless such purpose on the part of Congress has been clearly expressed.”).
The BEAT is not a treaty override

- There is nothing in § 59A suggesting that the BEAT was intended as a treaty override and the legislative history does not suggest otherwise.
  - Tom Barthold, Chief of Staff of the Joint Committee on Taxation, has stated that the BEAT is not a treaty override. See Open Executive Session to Consider an Original Bill Entitled the “Tax Cuts and Jobs Act”: Hearing on H.R. 1 Before the S. Comm. on Finance, 115th Cong. 163–64 (2017).

- § 59A(c)(2)(B) allows deductions for BEAT purposes for otherwise “base erosion payments” if payments are subject to tax at source under §§ 871 or 881 and for which tax is withheld under §§ 1441 or 1442, except to the extent of any rate reduction under a bilateral income tax treaty.
  - This provision does not suggest a manifestation of congressional intent that the BEAT override treaties in their entirety.
  - It references only one (reduced withholding rates) of many treaty provisions.
  - By addressing only one treaty issue while remaining otherwise silent on the broader question of a treaty override, this might actually reflect an intent not to override treaties.
The BEAT is a treaty override

- Where a conflict exists between an earlier treaty and a later enacted statute, the statute is a treaty override. See, e.g., Reid v. Covert, 354 U.S. 1, 18 (1957); Whitney v. Robertson, 124 U.S. 190, 194–95 (1888); S. Rep. No. 100-445, at 317 (1988).
- This is true even if the statute or its legislative history do not explicitly indicate that a treaty override was intended. See S. Rep. No. 100-445, at 321–28 (1988), explaining treaty–statute interactions in the context of technical corrections to the Tax Reform Act of 1986:
  - “The committee is concerned that there are some who assert that treaties receive preferential treatment in their interaction with statutes . . . For example, before original introduction of this technical corrections legislation, the [IRS] announced that new Code section 367(e)(2) . . . would not apply where it ‘would violate a treaty non-discrimination provision’ . . . [later withdrawn] The committee is concerned that the language used in the original notice may have suggested an erroneous inference that, had section 367(e)(2) actually created a conflict in a particular case, it would have been given no effect under the terms of the original Notice. Normal application of the later-in-time rule would not permit this result.” Id. at 324.
  - “The committee believes it would be erroneous to assert that the absence of legislative history mentioning a treaty was sufficient to reach the result in Cook.” Id.
  - “In view of what the committee believes is the correct treatment of treaty–statute interactions, then, the committee finds it disturbing that some assert that a treaty prevails over later enacted conflicting legislation in the absence of an explicit statement of congressional intent to override the treaty; that it is treaties, not legislation, which will prevail in the event of a conflict absent an explicit and specific legislative override.” Id. at 325.
The BEAT is a treaty override

• If U.S. tax treaties were allowed to overcome the BEAT, the purpose of the statute to protect the U.S. tax base would be frustrated.
  • Taxpayers could potentially restructure their intercompany transactions so that payments subject to the BEAT would be made to related parties in treaty countries.
• Interpreting the law around treaty–statute interactions to require an explicit congressional intent in the statute or legislative history to override treaties would require Congress to predict and address, at the time a bill is passed, all potential treaty conflict issues raised by that bill.
Netting

When does netting apply and does this approach work?
Overview of Netting

• How do we determine the amount of a Base Erosion Payment?
  • Net-payment basis
  • Gross-payment basis

• In the proposed regulations, there is no general netting of base erosion payments (prop. reg. section 1.59A-3(b)(2)(ii)). If the application of general tax permits netting to produce the deductible amount, the proposed regulation do not affect that result.
BEAT Exceptions Provide Relief

- **Base erosion payments (interest, royalties, service fees (not SCM), margin on SCM fees)**
- Exceptions (COGS (with embedded royalties under 263A), SCM fees (costs only), qualified derivative payments, ECI, TLAC)

Diagram:

- U.S. Corporation
- Foreign Related Party
Eliminate BEAT Payments when Buying from 3rd Party

Eliminate BEAT Payments when Selling to $3^{rd}$ Party

See, for example,:*The Seven-Up Company, Petitioner, v. Commissioner of Internal Revenue, Respondent,* 14 T.C. 965 (1950).
BEAT Netting???

U.S. Corporation

Offsetting Inbound Payments?

Foreign Related Party

Base erosion payments (interest, royalties, service fees (not SCM), margin on SCM fees)
Propose regulations clarify base erosion payments are generally determined on a gross basis . . . but

• Prop. reg. section 1.59A-3(b)(2)(ii): “Except for [amounts paid or accrued with respect to mark-to-market position] or as permitted by the Internal Revenue Code or the regulations, the amount of any base erosion payment is determined on a gross basis, regardless of any contractual or legal right to make or receive payments on a net basis.”

• Preamble: “[I]f there are situations where an application of otherwise generally applicable tax law would provide that a deduction is computed on a net basis (because an item received reduces the item of deduction rather than increasing gross income), the Proposed Regulations do not change that result.”
Netting in transfer pricing regulations: Required in Cost Sharing Arrangements
Treas. Reg. 1.482-7(j)(3) Example 3.

• Rather than each participant receiving (gross) royalty for contribution and paying (gross) royalty for benefits received cost sharing regulations require netting of payments (either positive or negative) for each participant.

US Corp bills $125 for the services but does not charge FRP for the rental.

Actual Payment: $125 for Services

Arm's Length Rental Charge $25

Arm's Length Service Charge $100

1.482-1(g)(4)(iii) [paraphrase]: No allocation need be made with respect to the undercharge for rental. Excess amount charged for services was equal to an arm's length rental. Taxable income and income tax liabilities of US Corp are not distorted, and documentation requirements are met.
What if Ex. 1 of 1.482-1(g)(4) Modified for Netting?

U.S. Corporation Provides Architectural Services

Foreign Related Party Provide Engineering Services

Actual Payment: $75 for Engineering Services

Arm’s Length Payment for Architectural Services $25

Arm’s Length Payment for Engineering Services $100

U.S. Corp pay $75 for engineering services but does not charge FRP for the rental.

1.482-1(g)(4)(iii) [paraphrase OK?]: No allocation need be made with respect to the undercharge for architectural services. Undercharge for engineering services was equal to an arm’s length payment for architectural services and the taxable income and income tax liabilities of US Corp are not distorted, and documentation requirements are met.
Profit Split: Net or Gross?

U.S. service provider and related foreign service provider each provide to 3rd parties equal amounts of services. U.S provides trade name worth $80 annually to each party and foreign related party provides patented software worth $100 annually to each party. Under current regulations, does U.S. pay royalty (gross) 100 or (net) 20 to foreign related party? Is base erosion payment $100 or $20?
Should you be GILTI & then get BEAT?
Interaction of GILTI & BEAT

- BEAT penalizes taxpayers that pay substantial foreign tax, almost regardless of their base-eroding payments.
- The effective tax rate on GILTI can increase when the source of a controlled foreign corporation’s GILTI is a base erosion payment from its U.S. parent that is subject to the BEAT.
  - FTC received on GILTI income impacts BEAT
- The BEAT can apply to subpart F income already subject to regular U.S. corporate income tax at the full 21 percent rate.
  - Base Erosion payment can also be CFC income
When Does BEAT Apply?
Assuming Taxable Income = $100

Base erosion tax benefits, the base erosion percentage, and tax credits not large enough in green areas for BEAT To apply, assuming taxable income = $100.
**BEAT & GILTI Interaction**

### Facts
- Assume USP has taxable income from other sources of $100 and USP makes a deductible payment to CFC
- CFC has no expenses, no QBAI, and its income is subject to 10% CIT

### Computation

<table>
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<tr>
<th>Description</th>
<th>Amount</th>
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<tbody>
<tr>
<td>USP’s taxable income from other sources</td>
<td>100</td>
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<tr>
<td>Less: Fee paid to CFC</td>
<td>-100</td>
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<tr>
<td>Plus: GILTI</td>
<td>90</td>
</tr>
<tr>
<td>Plus: Sec. 78 gross-up on GILTI</td>
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<td>Less: Sec. 250 deduction</td>
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<td>Taxable income</td>
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<tr>
<td>Less: FTC</td>
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<td>Regular tax liability, after FTC</td>
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<td>BEAT</td>
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<td>Total US tax burden</td>
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<td>Regular CIT</td>
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<tr>
<td>Total foreign tax burden</td>
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### Analysis
- The $100 base eroding payment causes USP to pay BEAT. The 20% haircut for GILTI FTCs means USP pays $2.5 of US tax on the $100 payment (=21% of $90 GILTI plus $10 sec. 78 gross up less $50 sec. 250 deduction, offset by $8 of FTC).
- Total tax burden for the group ($25) is greater than if USP did not make the $100 payment to the CFC ($21).
- Conclusion depends on facts and circumstances of USP’s tax posture and other activities and attributes.
### GILTI & BEAT “Boomerang”

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<td>BEAT Payments</td>
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<td>U.S. Tax (21%)</td>
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<td>FTCs</td>
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<td>U.S. Tax Liability</td>
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<td>BEAT Liability</td>
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For Which a Deduction Is Allowed

Can (and should) an APA provide certainty as to the characterization of a payment for BEAT purposes?
Does APMA have authority to determine proper characterization of payments for BEAT purposes in APAs?

- APMA established to oversee “APA program and to act as the representative office of the U.S. competent authority responsible for handling competent authority cases arising under the business profits and associated enterprises articles of U.S. tax treaties. APMA also has shared responsibility for cases arising under the permanent establishment articles of U.S. tax treaties.” Rev. Proc. 2015-41, § 2.02(1).

- “APMA’s APA program provides a voluntary process whereby the IRS and taxpayers may resolve transfer pricing issues and issues for which transfer pricing principles may be relevant in a principled and cooperative manner on a prospective basis.” Rev. Proc. 2015-41, § 2.02(2).

- “Coverable issues” eligible to be covered by an APA: (1) issues arising under section 482 of the Code, (2) other issues for whose resolution transfer pricing principles are relevant, which in a particular case could include (a) issues arising under section 367(d) of the Code, (b) competent authority issues arising under the business profits and associated enterprises articles of U.S. tax treaties, and (c) the determination of the income effectively connected with the conduct of a trade or business within the United States, and (3) ancillary issues. Rev. Proc. 2015-41, § 1.04.
Does APMA have authority to determine proper characterization of payments for BEAT purposes in APAs?

Possibly

• It is within APMA’s competence and authority to determine the characterization of payments (e.g., as COGS or services eligible for the SCM) in negotiating an APA
• APMA is permitted to essentially “turn off” domestic law to reach resolution of an issue in other circumstances. See Rev. Proc. 2015-41, § 6.03 (permitting an APA to provide that a platform contribution transaction “will not be treated as a Trigger PCT” [per the § 482 regulations] for purposes of making periodic adjustments, during or after the APA term, under Treas. Reg. § 1.482-7(i)(6).”).

 Probably Not

• Authority under APA program is limited to resolving transfer pricing issues
• Whether related-party payments to foreign affiliates are “base erosion payments” is a matter of interpreting domestic law
• Whether a payment is subject to the BEAT is unrelated to whether that payment is made at arm’s length
Should APMA determine proper characterization of payments for BEAT purposes?

Yes

• APAs provide certainty and are a more efficient use of the resources of tax authorities.
• If a bilateral APA does not provide certainty as to the characterization of a payment for BEAT purposes, taxpayers’ incentives to pursue APAs would be greatly diminished.
• In the bilateral APA context, the U.S. competent authority negotiates with the foreign competent authority to reach a resolution (to which the taxpayer agrees). In this setting, payments subject to an APA are not base eroding payments and thus outside the objective of the BEAT.
• “APMA endeavors to administer the programs within its jurisdiction in a manner that is consistent with U.S. tax treaty obligations and that secures the appropriate tax bases of the United States and its treaty partners, prevents fiscal evasion, promotes consistency and reasonableness in outcomes . . .” Rev. Proc. 2015-41, § 2.02(1) (emphasis added).
Yes

The APA determines the appropriate arm’s-length return on intercompany transactions on a pre-tax basis. The tax treatment of the payments are not relevant to the arm’s-length nature of the payments.

The taxpayers’ incentives to pursue an APA are neither enhanced nor diminished by the failure to include § 59A within the purview of the APMA team.

While it might be argued that by applying broader OECD transfer pricing principles in reaching bilateral agreement with treaty partners APMA is already varying from the strict guidance of the Code, the characterization of certain payments as subject to the BEAT (or not) goes well beyond an exercise of applying slightly different formulations of the arm’s-length standard than are explicitly recognized in the U.S. regulations.
Other Considerations

• What should happen to intercompany payments to foreign affiliates that are subject to a current bilateral APA?

• Can existing APAs be modified or canceled because of the BEAT?
  • An APA may be revised by agreement of the parties. Rev. Proc. 2015-41, § 7.05(1).
  • “Unless the parties agree to revise the APA, APMA will cancel an APA in the event of . . . a material change in governing case law, statute, regulation, or applicable treaty.” Rev. Proc. 2015-41, § 7.06(3). [QUERY: is this a material change in a “governing statute”]
  • “If controlling U.S. case law, statutes, regulations, or treaties change the federal income tax treatment of any matter covered by the APA, the new case law, statute, regulation, or treaty provision supersedes any inconsistent terms and conditions of the APA.” Rev. Proc. 2015-41, § 7.07.
  • As a practical matter, it is not clear how many existing APAs would be affected by the BEAT, since such agreements often establish ranges of entity-level results, and each case would need to be examined at a transactional level to determine whether or how the application of the BEAT to particular intercompany payments would change the agreed results.
What’s still up for Debate?

1. The BEAT imposes tax on transactions when associated profits are already subject to tax at or above the full U.S. tax rate.
2. The BEAT taxes payments into a high-tax country more than it does payments into a low-tax country.
3. The BEAT is readily avoided by arranging payments that otherwise would be characterized as interest and royalties to be embedded in payments for COGS.
4. Many large- and medium-size businesses that could be engaged in significant amounts of abusive base erosion are exempt from the tax.
5. As a minimum tax, the BEAT provides a significant buffer that could allow taxpayers with large amounts of abusive base erosion payments to escape it.
6. The BEAT is not neutral.
7. The BEAT encourages potentially costly and nonstandard restructuring of arrangements with third parties.
8. The 3 percent threshold is a cliff.
9. The BEAT ignores profit shifting that can occur through adjustment of inbound payments from foreign related parties.
Questions?