Bloomberg Tax

Daily Tax Report®

Reproduced with permission from Daily Tax Report, 53 DTR 16, 3/19/18. Copyright © 2018 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

Transfer Pricing

INSIGHT: BEAT Strikes the Wrong Note

Elizabeth Stevens and Peter Barnes of Caplin & Drysdale discuss the potential unintended consequences of the base-erosion and anti-abuse tax (BEAT) enacted under the 2017 tax act. The authors write that formerly routine payments by U.S. companies to foreign related parties may now be penalized by the BEAT and create incentives to move U.S. manufacturing jobs offshore.

ELIZABETH J. STEVENS AND PETER A. BARNES

The primary theme of the Tax Cuts and Jobs Act of 2017 can be stated in only four words: *Corporate tax rate cuts*. But the second and third most prominent features of the legislation are acronyms and confusion. The BEAT tax leads in both categories, featuring a catchy acronym and provoking deep confusion about what the provision is intended to do and how it will achieve its goal.

The Base-Erosion and Anti-abuse Tax (ergo, ''BEAT'' tax) imposes additional income tax on companies that make significant payments to foreign related parties, even if the payments are arm's-length, and even though such payments lie at the core of many sensible business models. By treating these payments (and business models) as somehow abusive, the tax will drive companies to abandon reasonable—and otherwise fully tax compliant—practices, reducing their competitiveness and, in some cases, reducing U.S. jobs. These results cannot possibly be what Congress had in mind.

Elizabeth Stevens is an associate with Caplin & Drysdale. Her practice centers on international tax planning and advocacy for corporate clients. Ms. Stevens joined Caplin & Drysdale after her clerkship with Judge Robert A. Wherry, Jr., of the U.S. Tax Court.

Peter Barnes is of counsel with Caplin & Drysdale. Before joining the firm, Mr. Barnes was senior international tax counsel for General Electric Co. His over 30 years of experience in the international tax arena help Mr. Barnes bring a wealth of knowledge to the firm and its clients.

How the BEAT Works

In very simple terms, the BEAT tax operates like an alternative minimum tax system. Multinational companies calculate their regular tax. Then, these same companies calculate their taxable income again, but with add-backs for many payments made by U.S. companies to related foreign companies. The BEAT tax is calculated by multiplying this new, higher taxable income by an alternative tax rate of 5 percent to 13.5 percent, depending on the taxable year. (Banks and securities dealers face incrementally higher rates than other taxpayers, and all taxpayers benefit from relatively lower, introductory rates in 2018. Otherwise, the varying rates appear designed to meet Congressional revenue scoring targets rather than to reflect any tax policy purpose.) If the BEAT tax is higher than the company's tax under the regular corporate tax system, then the company's tax liability is increased to the higher amount.

The principal add-backs in calculating the BEAT tax are payments of interest, payments of royalties, and certain payments for services. For tangible property acquired from a foreign affiliate, any depreciation/amortization deductions are added back, but payments for such property are exempted if they would be treated for tax and accounting purposes as ''cost of goods sold'' (COGS). Thus, if a U.S. company buys widgets from its foreign affiliate, its payments to the foreign affiliate generally are not ''bad'' payments for the BEAT tax.

Keep that point in mind, because the distinction creates perverse incentives for legislation with ''Jobs'' in the title.

There is a skirmish going on regarding how payments for routine services will be handled under the BEAT tax: Will the full payment from the U.S. company to its related foreign service provider be added back, or only the profit portion of the payment? (Keep that point in mind too, because an answer that the entire payment is treated as a ''bad'' payment will absolutely destroy certain business models.) The language of the legislation and Conference Report and what many people believe is Congressional intent do not agree on this point. In any event, some portion of payments to foreign related parties for services are included in the BEAT calculation.

What is the BEAT Tax Intended to Do?

What is the BEAT tax intended to do? Good question.

The tax purports to be a means by which the U.S. can ''protect'' its tax base. The Conference Report states that ''[a] base erosion payment means any amount paid or accrued by a taxpayer to a foreign person that is a related party of the taxpayer and with respect to which a deduction is allowable.'' But the not-so-hidden message in this construct of the tax is that the U.S. government lacks confidence that it can police transfer pricing. Only foreign related party payments are subject to the add-back. Payments to unrelated parties of interest, royalties and services fees apparently do not erode the U.S. tax base.

Similarly, the BEAT tax can be viewed as a minimum tax on U.S. activity. But, a minimum tax generally would not distinguish between payments to related parties and payments to unrelated parties.

The only sustainable argument for the BEAT tax is that U.S. transfer pricing enforcement is so wholly ineffectual that it must be backstopped by an automatic penalty on most cross-border related party payments, as both a deterrent to related party transactions and a crude proxy for an arm's length price. The U.S. is not nearly so impotent, however, and Congress certainly did not premise the BEAT tax on any such finding. Moreover, as a fail-safe mechanism for the transfer pricing rules, the tax is hugely overbroad, since by its terms it would apply even to payments that the IRS has agreed are arm's length in an Advance Pricing Agreement or Closing Agreement.

Consequences of the BEAT Tax

Ambiguity, or even confusion, regarding the purpose of the BEAT tax would be tolerable if the consequences of the tax were not so terrible. But the consequences are terrible—and completely foreseeable.

Examples:

1. A U.S.-headquartered multinational company provides global installation and repair services for power generation, aircraft engines, or other heavy equipment. Customers—which are generally large multinationals as well—sign global contracts to acquire services in more than one country. The U.S. multinational and its affiliates make many cross-border payments for services, royalties and other elements of the contracts. The goal of these intercompany payments is to match taxable revenue with the relevant expenses for services, research and development, training, management, and all other costs. If all such payments from the U.S. parent to its global affiliates are now considered ''base erosion'' payments and subject to the BEAT tax, the business model quickly breaks down. And for what purpose, since the payments are already subject to scrutiny by each country under transfer pricing rules? The BEAT tax encourages the adoption of less efficient business models.

2. A U.S. company pays royalties to a foreign affiliate (which may be a foreign parent of the U.S. company, or a foreign subsidiary if the taxpayer is a U.S.-headquartered company.) The U.S. company uses the intellectual property to manufacture goods in the U.S. (which, significantly, provides U.S. jobs). If the U.S. company cannot include the royalty payment in COGS, the payment will be subject to the BEAT tax, but no BEAT tax applies if the foreign affiliate performs the manufacturing and the U.S. company purchases the finished goods. The BEAT tax thus puts enhanced pressure on the tax accounting rules and creates a significant financial incentive to push manufacturing to foreign affiliates.

3. Ironically, the BEAT tax also increases the likelihood of audit controversies when a U.S. company buys tangible property from a foreign manufacturing affiliate. Consider the challenge of applying the provision when a U.S. company pays a foreign affiliate for tangible goods that include embedded software or other intellectual property. Must the price for the goods be divided into a price for the tangible property and a separate price for the software? If the U.S. company resells the goods, the purchase price from the software may constitute an embedded royalty not includible in the U.S. company's COGS. Whether a sale of goods is a sale solely of tangible property or a sale of both tangible property and embedded software has long been an issue in foreign audits, and U.S. law on this point is not unambiguous. The BEAT tax greatly increases the stakes.

4. Consider the allocation of headquarters costs by a multinational company to its global affiliates. For the past three decades, charges by U.S. multinationals of headquarters costs to their foreign affiliates have sparked more foreign tax audits (and foreign tax disallowances) than perhaps any other type of transaction. The basic rules, under U.S. law and global tax norms, are well understood: a company determines what costs are ''stewardship'' expenses (for the benefit of the parent shareholder) and then allocates other costs (such as expenses for global, regional and country teams to deliver financial, legal, human resources, information technology, and other services) to all the benefiting affiliates. Foreign governments routinely disallow these expenses as ''duplicative'' or ''unnecessary''; furthermore, governments often seek to apply withholding taxes to these reimbursements of expenses, even if there is no profit element in the charge. U.S. taxpayers fight, with some success, to argue that no foreign withholding tax should apply to mere reimbursements. By potentially reducing the benefit of deductions for headquarters costs allocated to U.S. affiliates of foreign companies, the BEAT tax will make that fight much harder, especially if the provision is eventually interpreted to apply to the full amount of payments for routine services, and not just the profit element.

 COPYRIGHT © 2018 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 0092-6884

5. All U.S. companies at risk of paying the BEAT tax will have an incentive to engage in transactions with unrelated parties, rather than related parties. These alternative arrangements will often be more costly and less efficient from a purely commercial perspective, before taking the BEAT tax into account. Significantly, large multinationals will always be worrying about the BEAT tax, because any year in which regular corporate taxable income is low the BEAT tax is likely to apply. The BEAT tax will influence commercial arrangements and distort business incentives—counterintuitive outcomes in the prevailing deregulatory environment.

6. And, finally, the BEAT tax will likely be challenged by tax treaty partners. The tax effectively operates to disallow deductions for foreign related party payments, applies more harshly to taxpayers that earn substantial high-tax foreign-source income, and cannot be offset by foreign tax credits. It could also deter taxpayers facing foreign audit adjustments from seeking double tax relief under a treaty. The BEAT tax presages years of disputes and uncertainty.

What Next?

Because the BEAT tax applies solely to foreign related party payments, its effect is to penalize transactions that are already under scrutiny for transfer pricing compliance. The argument that the BEAT tax can be defended as a minimum tax is not convincing. And the provision may prompt a retreat from unobjectionable business models and create incentives that reduce U.S. jobs, not increase them.

In a sensible world, the BEAT tax would be withdrawn. If Congress believes the Internal Revenue Service needs additional tools to ensure transfer pricing compliance, Congress should give the IRS the funding and other resources it needs to effectively enforce the existing rules, not a blunt instrument that strikes the wrong note.