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Transfer Pricing and the Base Erosion Anti-Abuse Tax: BEATing the Aggregation Principle … Let the BEAT Go On

By Leo Parmegiani, CPA, Partner and Per H. Jorgensen, Transfer Pricing Economist

As companies deliberate the closing of their calendar fiscal year-end (FYE) financial records, transfer pricing issues are often given prominent consideration for optimizing on potential opportunities and minimizing risks of tax exposure (*October 2019 issue of International Tax Insights*). This has become even more paramount with the conclusion of the final Base Erosion and Anti-Abuse Tax (BEAT) [or Section 59A of the Internal Revenue Code (IRC)] and the U.S. Treasury Regulations (Treas Regs) promulgated thereunder. These rules were enacted by the Tax Cuts and Jobs Creation Act (TCJA) of December 22, 2017, effective for taxable years ending on or after December 17, 2018.

As middle-market companies are looking for near-term ways to minimize their potential BEAT liabilities – and are completing their 2020 financial forecasts for the coming year of operations – a company's management may not consider that the recently finalized BEAT regulations would apply to its business operations since the rules have a de minimis gross receipts threshold of $500 million, and a company would have made a base erosion payment of three percent or more of all deductible expenses, with certain exceptions. However, here is how the "aggregation principle" of the BEAT regulations "snares you in" and how you can mitigate its potential impact on your business operations

Broadly speaking, base erosion payments do not include cost of sales incurred from purchases of tangible products from foreign affiliated parties, intercompany services accounted for under the Services Cost Method (SCM), or other intercompany transactions determined to be arm's length. Nonetheless, the BEAT regulations are of particular importance to companies that are part of multinational enterprises with U.S. inbound intercompany transactions which make deductible payments for tangible products, intangible property, financial arrangements, management services, or cost-sharing contributions, as components of each of these intercompany transactions could be determined to have been conducted at a non-arm's-length price and, consequently, subject to the imposition of the BEAT.

Aggregation Principle

An aggregate group of company members encompasses affiliated entities within a commonly controlled group of companies – applying a 50 percent rather than an 80 percent ownership threshold – inclusive of a multinational corporation's (MNC) non-U.S. operations. Hence, even if the U.S. operations of a multinational conglomerate may be small, but the payments made to a foreign affiliated entity with aggregated three-year average gross revenues exceeding a $500 million threshold, the U.S. company can be scrutinized under the BEAT regulations, if a base erosion payment exceeds more than three percent of all deductible expenses. Conversely, if a MNC's gross revenue base falls below the $500 million threshold, the BEAT will not "beat" a U.S. company engaged in outbound intercompany transactions with a foreign affiliated party.

Netting Provisions

The base erosion payment is generally determined on a gross payment basis (i.e., there are no offsets). Although the regulations do not provide any further guidance with respect to cost-sharing arrangement payments, or those conducted under a profit-split arrangement, the BEAT regulations acknowledge that there are certain "global-dealing financial trading positions" that may be co-owned and would, henceforth, be excluded from BEAT consideration. The BEAT regulations, however, do not make exceptions for pass-through payments, unless these are determined to include a U.S. base erosion component. These non-conclusory ambiguities of the regulations, upon which the preamble did not provide any further guidance, are in need of further review.

Services Cost Method (SCM) Exemption

The more things change, the more they stay the same, as the final BEAT regulations still exempt payments made for intercompany services that qualify under the Services Cost Method which enable companies to charge for the provision of intercompany services at "actual cost" (i.e., management, technical, marketing, legal, etc.) as opposed to employing a cost plus profit markup methodology if the following criteria are met:

1. The service is a “specified covered service” which represents common support services among taxpayers that do not generally exceed a profit markup significantly greater than a “median” markup on total service costs;

2. The services are a “low margin covered service” for which the median markup does not exceed seven percent, using an interquartile range principle to calculate the profit markup. It should be noted that any BEAT would apply explicitly only to the profit markup and not to the total transaction charge for intercompany services provided.

Only the cost amount of the payment is exempt; any markup amount would still be treated as a base erosion payment if it otherwise qualifies.

The SCM, however, cannot include the following excluded activities:

- Manufacturing or production,
- Extraction, exploration, or processing of natural resources (e.g., oil, gas, minerals),
- Construction,
- Reselling, distribution, or sales, purchase, commission agency,
- Research and development or experimentation,
- Engineering or scientific,
- Financial transactions or guarantees, and
- Insurance or reinsurance.

Lastly, regulations state that the SCM cannot be applied “at cost” if the provision of intercompany services contributes “significantly” to the fundamental risks of a business’ success or failure. However, this rule does not apply in determining whether payments otherwise eligible for the SCM method are exempt from treatment as a base erosion payment.

Documentation Requirements

In order to mitigate a potential BEAT assessment and to allow for the verification that the SCM is applicable, the books and records evidencing the taxpayer’s intention to employ the SCM must be maintained, specifically stating that this transfer pricing methodology is applied, including a description of the services rendered and the intended recipient thereof. Since the only component of an intercompany service that may be subject to the BEAT charge is the profit markup, certification that there is none will support a taxpayer’s position to avoid an imposition of BEAT by the U.S. Internal Revenue Service.

PKF O’Connor Davies Recommendation

Taxpayers should begin reviewing their intercompany transactions to identify their intercompany tangible products transactions and potentially “unbundle” the transfer prices for these, to the extent that they embody discernable arm’s-length product cost, imbedded value of intangible property or services, which can be more accurately determined to be arm’s length and, hence, would not be subject to the potential imposition of BEAT; documentation of intercompany transactions that meet the arm’s-length standard is still the pillar on which to avoid getting BEAT!

Treasury Releases Final BEAT Regulations

By Christopher Migliaccio, Senior Manager

The Treasury released final regulations implementing the Base Erosion and Anti-Abuse Tax (BEAT) on December 6, 2019, along with new proposed regulations. The final regulations, in particular, provide welcome guidance for taxpayers by including changes from the 2018 proposed regulations which are taxpayer-friendly.

Enacted as part of the Tax Cuts and Jobs Act (TCJA), the BEAT targets corporate taxpayers that make significant deductible payments to foreign related parties. If a corporation has a base erosion percentage

(base erosion payments over total deductions) of over 3% (2% for banks and securities dealers) and $500 million in average annual gross receipts over a three-year period, they are subject to the BEAT.

The changes from the 2018 proposed regulations are numerous. The following are the most important headlines for taxpayers from the final and new proposed regulations.

Transfers in Non-Recognition Transactions Not Base Erosion Payments

The final regulations exempt transfers of property in non-recognition transactions (such as tax-free reorganizations and liquidations) from treatment as base erosion payments. The proposed regulations did not; thus, transfers of depreciable property in such transactions would have been treated as base erosion payments.

Taxpayers Can Forego Deduction

The new proposed regulations would allow a taxpayer to forego a deduction in order to get below the base erosion percentage threshold for the tax year. The taxpayer must forego the deduction for all federal income tax purposes. ***PKFOD Observation:*** This should lessen concerns for taxpayers who find themselves near the threshold.

No Blended Rate for First Year

The final regulations clarify that taxpayers use a 5% rate on modified taxable income to determine their base erosion minimum tax amount for all tax years beginning in 2018, not just those coinciding with the calendar year. The 2018 proposed regulations would have provided for a blended rate for non-calendar year taxpayers in 2018, mixing the 5% rate applicable for 2018 and the 10% rate applicable for 2019.

Transfers of Built-In Loss Property Not Base Erosion Payments

The final regulations clarify that a sale or transfer of property to a related party resulting in a deductible loss does not create a base erosion payment. Treatment of such transactions was unclear in the 2018 proposed regulations.

Simplified Application to Aggregate Groups

The base erosion percentage and gross receipts tests for whether the BEAT applies to a corporation are determined at an aggregate group level, so a taxpayer must include the gross receipts and deductions of other corporations that are at least 50% related in its calculation. The final regulations require the taxpayer to take into account the gross receipts and deductions of group members' tax years ending with or within that of the taxpayer. ***PKFOD Observation:*** This is a welcome change from the 2018 proposed regulations which would have required a much more complicated method and which would have caused a significant compliance burden.

Action Item

Companies who've determined that they are at risk of being subject to the BEAT need to consider how the new regulations affect their calculations. In most cases, the new final and proposed regulations should provide better results than the 2018 proposed regulations.

German Federal Council Approves Research Allowance Act

By Ralf Ruedenburg, Principal, Head of German Desk

For the first time, Germany will offer a tax credit for certain R&D projects. The Research Allowance Act will become effective on January 1, 2020 and will be available for certain R&D activities such as basic research, industrial research, and experimental development. Pure product development is not eligible. The R&D activities must meet the Organisation for Economic Co-operation and Development (OECD) standards for such activities.

Companies, regardless of size and industry sector, can take a credit of up to €500,000 per year for R&D projects starting on January 1, 2020.

The credit amount will be

- Credited against tax liability, or
- Paid in cash if the tax credit exceeds the tax liability.

Funding is open for three types of R&D projects:

- A company's own R&D projects,
- Cooperative projects (for example, with a university), and
- Contract research. Note that a credit for contract research is only available to the payor on the contract, and only if the R&D contractor is based in the EU/EEA.

Companies need to apply for a certificate to make sure that the R&D activities qualify for the tax credit. Details regarding the certification process are planned to be published by the end of 2019.

The amount of the credit is 25% of direct R&D personnel costs, plus the employer's social security contributions, up to €2,000,000 (for a maximum credit of €500,000). For contract research, the credit is 25% on 60% of the contract value

The credit limitation of €500,000 per company and year applies to corporate groups, as defined in the German corporate law. The new instrument allows an ex-post application for funding and improved predictability due to legal entitlement to the R&D tax credit.

PKF O'Connor Davies Recommendation

Businesses with existing or planned R&D activities in Germany need to investigate which of their activities are potentially eligible for the tax credit. They also need to make sure that the proper documentation is prepared and maintained to prove tax credit eligibility to the German tax authorities. Receiving the tax credit in cash is especially interesting for start-up companies that usually do not pay tax in the first years.

Contact Us

We can discuss your particular facts and circumstances to ascertain how we may be able to assist you and/or your company with respect to any of the matters discussed in this publication. Please contact the partner in charge of your account or any of the following:

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About PKF O'Connor Davies

PKF O'Connor Davies, LLP is a full-service certified public accounting and advisory firm with a long history of serving clients both domestically and internationally. With roots tracing to 1891, eleven offices in New York, New Jersey, Connecticut, Maryland and Rhode Island, and more than 800 professionals, the Firm provides a complete range of accounting, auditing, tax and management advisory services. PKF O'Connor Davies is ranked 29th on *Accounting Today'*s 2019 "Top 100 Firms" list and is recognized as one of the "Top 10 Fastest-Growing Firms." PKF O'Connor Davies is also recognized as a "Leader in Audit and Accounting" and is ranked among the "Top Firms in the Mid-Atlantic," by *Accounting Today.* In 2019, PKF O'Connor Davies was named one of the 50 best accounting employers to work for in North America, by *Vault*.

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