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# Tax reform readiness: Base erosion and anti-abuse tax

February 2, 2018

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## In brief

The [2017 tax reform reconciliation act](#) (the Act) — the largest overhaul of the US tax code (the Code) in 31 years — targets US tax-base erosion by imposing an additional tax liability on certain corporations that make ‘base-erosion payments’ to related foreign persons.

The new base erosion and anti-abuse tax (BEAT) essentially is a minimum tax calculated on a base equal to the taxpayer’s taxable income determined without regard to (1) the tax benefits arising from base erosion payments and (2) the base erosion percentage of any net operating loss (NOL) allowed for the tax year. The BEAT rate is five percent for tax years beginning in calendar year 2018, 10 percent for tax years beginning in 2019 through 2025, and 12.5 percent for tax years beginning after December 31, 2025. Those BEAT rates increase by one percent for certain banks and securities dealers.

This Insight reviews the basics of the new BEAT provisions. PwC on January 31 hosted a webcast featuring PwC specialists who provided in-depth analysis of, and insight into, the BEAT provision. [Watch](#) the webcast replay and register for future webcasts in PwC’s Tax Reform Readiness webcast series, in which PwC specialists will discuss additional key provisions of the Act and the latest administrative guidance under those provisions. The next webcast, ‘Tax reform readiness: Tax reform’s impact and opportunities for US taxpayers,’ will take place February 7, 2018, from 2:00 PM - 3:00 PM (EST).

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## In detail

### **The BEAT: the basics**

With the introduction of the BEAT, the Act targets US tax-base erosion by imposing an additional tax liability on corporations (other than RICs, REITs, or S corporations) that, together with their affiliates under the BEAT aggregation rule, (1) have average annual gross receipts for the three-year period ending with the preceding tax year of at least \$500 million and (2) make certain base erosion

payments to related foreign persons during the tax year of three percent (two percent for certain banks and securities dealers) or more of all their deductible expenses and base erosion tax benefits, apart from certain exceptions.

These exceptions are the NOL deduction, the new dividends received deduction for foreign-source dividends, the new deduction for foreign-derived intangible income (FDII), the new deduction

relating to global intangible low-taxed income (GILTI), qualified derivative payments that are not base erosion payments, and certain payments for services.

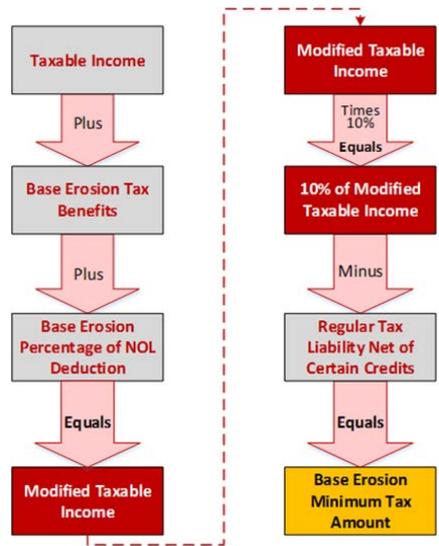
The BEAT equals 10 percent (five percent for the 2018 calendar year) of the taxpayer’s ‘modified taxable income’ — generally, US taxable income determined without regard to any base erosion tax benefit or the

base erosion percentage of the NOL deduction — over the taxpayer’s regular tax liability net of most tax credits. (See flowchart below.)

A base erosion payments generally is any amount paid or accrued by the taxpayer to a related foreign person (i) for which a deduction is allowable, (ii) for the purchase or acquisition of property subject to depreciation or amortization, and (iii) for certain reinsurance payments. Certain qualified derivative payments and certain payments for services are two main exceptions from base erosion payments.

Base erosion payments include any amount paid or accrued by the taxpayer to a related foreign person that is an ‘expatriated entity’ (or a member of a group that includes an expatriated entity) under the anti-inversion rules of Section 7874, and that results in a reduction in gross receipts of the taxpayer. This provision applies only if the foreign person became an expatriated entity after November 9, 2017. Except with respect to payments to ‘expatriated entities,’ payments that appropriately are accounted for as cost of goods sold do not constitute base erosion payments.

The BEAT is effective for base erosion payments paid or accrued in tax years beginning after December 31, 2017. For tax years beginning after December 31, 2025, (1) the percentage of modified taxable income that is compared against the regular tax liability increases to 12.5 percent and (2) the US corporation’s regular tax liability will be net of all credits (as opposed to most credits). Special rules apply for banks, insurance companies, and ‘expatriated entities.’



For a ‘deeper dive’ into the BEAT and other international provisions of the Act, see PwC Insight, [Republican tax bill will significantly impact US international tax rules](#), December 21, 2017.

**Issues to consider**

*Impact of NOLs*

In calculating ‘modified taxable income,’ the taxpayer adds back ‘the base erosion percentage of any net operating loss deduction allowed under Section 172 for the taxable year.’ This provision raises a number of issues, such as:

- possible increased exposure as a result of using NOL carryforwards
- whether the NOL deduction and the base erosion percentage are determined by reference to the current year in which the NOL is being used or the year in which the NOL was created.

*Interaction of BEAT with other new provisions*

Taxpayers should consider how the BEAT mechanism interacts with other new provisions of the Act that also require extensive calculations, including:

- the GILTI provisions (new Section 951A)
- the new interest expense deduction limitations (amended Section 163(j)).

Taxpayers should model the scenarios to understand the effects with respect to BEAT resulting from application of the interest expense limitation or the GILTI tax.

*Other gray areas*

The BEAT raises numerous other issues that taxpayers will need to consider as they determine their BEAT liability, including the following:

- The characterization of payments, especially with respect to transactions involving bundled services and goods, can affect whether a payment is within the scope of the BEAT provision. Tax accounting rules in particular will be extremely important in this regard, especially for a taxpayer that is considering a change to categorizing certain payments as inventoriable items.
- Taxpayers that have transfer pricing arrangements with an overall routine return should examine how to unbundle these payments for purposes of BEAT characterization. For example, taxpayers should consider what part of a payment represents compensation for a royalty versus services, and whether there are any embedded cost of goods sold (COGS).
- The scope of the services cost method (SCM) exception under Section 59A(d)(5) for services that meet the eligibility requirements for use of the SCM under Section 482 should be analyzed. In

particular, it is unclear whether inclusion of a markup (or any profit element) in a service payment to a foreign related party makes the entire payment ineligible for the SCM exception.

- Taxpayers should consider the treatment of payments to or from certain partnerships and whether BEAT should be applied under an 'aggregate' or 'entity' theory.
- Application of the BEAT to foreign corporations engaged in a US trade or business but not taxable with respect to business profits under an applicable US income tax treaty should be considered.

- Application and scope of the anti-abuse rule in Section 59(A)(i) is unclear without further guidance. Taxpayers should be mindful of this provision as they seek to mitigate their exposure to BEAT.

### **The takeaway**

The BEAT raises many issues that will require taxpayers to make reasoned interpretations of the law pending Treasury and IRS guidance. We expect guidance on the BEAT later this year.

Taxpayers should consider taking the following actions:

- identifying transactions that could be subject to the BEAT
- performing detailed computational modeling of the BEAT and other provisions of the Act
- evaluating operating models and business practices such as arrangements set up for the convenience of a client or customer to determine whether, in accordance with the business purpose and substance principles, BEAT exposure could be reduced.

### **Let's talk**

If you would like to discuss any of the issues raised by the new BEAT, please contact:

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