The Impact of the New US Base Erosion and Anti-abuse Tax on the Global Cross-border Services Sector

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As the service sector of the global economy continues to grow rapidly, technological advances have enabled businesses to provide services from almost any location in the world to almost any other location in the world.

Broadly speaking, there are two elements of the services sector. First, multinational corporate groups provide a broad range of intra-group services from one or only a few central locations, thus improving efficiency. Second, an increasing number of businesses have outsourced many of their services to third-party providers and frequently personnel of the service providers' affiliates located outside, as well as within, the customer's home country.

Both elements of the cross-border services sector must confront the new base erosion and anti-abuse tax (BEAT), adopted by the US Congress in 2017 as part of the Tax Cuts and Jobs Act (TCJA) to restructure the provisions of the US Internal Revenue Code (the Code) governing international taxation. The BEAT appears to have been designed to curtail the base erosion strategies of multinational corporate groups, which base their headquarters outside the US, to reduce the US tax burdens on their US affiliates below those generally applicable to their US-based competitors. These strategies were implemented by means of tax-deductible payments, such as interest and royalties, made from the non-US affiliate to its non-US affiliates. This practice had particular impacts on US corporations with US headquarters and no operations outside the US. As noted below, the BEAT may also have a broader application. Congressional representatives have described the BEAT as a form of minimum tax on the US affiliates of large corporate groups that make substantial amounts of tax-deductible outbound payments to their non-US affiliates, a secondary legislative purpose that may well affect how the BEAT is interpreted and administered.

BEAT took effect for many corporate groups on January 1 2018, but substantial uncertainties still exist as to whether BEAT applies in many common situations and, if so, how it applies. Business groups and their advisors are hopeful that proposed regulations expected to be issued by the US Treasury and Internal Revenue Service (IRS) later this year will resolve many of these uncertainties and ambiguities. Moreover, BEAT continues to be controversial at the policy level. On the eve of its enactment in 2017, the finance ministers of the UK and several European countries informed US tax policymakers that the BEAT was likely, and in their view inappropriately, to reach "genuine commercial arrangements involving payments to foreign companies that are taxed at equivalent or higher rates than the US".Some have asserted that the BEAT will, in certain cases, result in double taxation by the US and could even be subject to challenge under the non-discrimination clauses of many bilateral tax treaties to which the US is a party. Following a brief and selective summary of the provisions of BEAT, this article will look at the treatment of cross-border services payments under BEAT. The application of the BEAT to services raises both questions of statutory interpretation and tax policy questions, including those related to intra-group services and, as discussed below, the possibly disparate treatment of US corporations that sell tangible goods and those who provide services to customers.

BEAT in a Nutshell

BEAT functions as a form of minimum tax (imposed at a rate ultimately reaching 12.5% rate for most corporations when fully effective in 2026). It applies to U.S. corporations that are not taxed on a flow-through basis and that have average gross receipts over a moving three-year base period of at least USD 500 million and then only if the corporation's "base erosion percentage" exceeds three per cent (two per cent for certain banks and securities dealers). A corporation's base erosion percentage is generally determined by dividing its "base erosion tax benefits" for the year (i.e., base erosion payments that generate a tax benefit in that year) by its total allowable tax deductions for that year. For any year, the BEAT is applied to the corporation's hypothetical taxable income (ie determined by adding back its base erosion payments to its actual taxable income) and, to the extent the BEAT tax on that hypothetical taxable income exceeds the corporation's regular income tax on its actual taxable income, the excess tax is due and payable. The effective whole or partial disallowance of many of the tax credits can increase the impact of the BEAT, including investment credits and the foreign tax credit that are often taken into determining the corporation's regular income tax liability. Certain of these computations (eg that for gross receipts) are to be made on a consolidated basis by treating the relevant affiliates as a single corporation.

Although directed at US corporate affiliates of groups headquartered outside the US, it is also applicable to foreign corporations that engage in a US business through an unincorporated branch as well as to US-headquartered groups whose US members make base erosion payments to one or more non-US affiliates.

BEAT and the Cross-border Services Sector

As a general proposition, a base erosion payment includes any amount paid or incurred by a US corporation to a related non-US party (as determined under special attribution rules) if a US tax deduction (including a deduction resulting from depreciation or amortization) is allowable.

There are a series of exceptions to this general rule of inclusion. One of these exceptions is for the cost of certain services and another encompasses payments taken into account as a reduction in gross receipts, such as cost of goods sold (COGS), in computing gross income rather than as a deduction from gross income in computing taxable income. The scope of the services exception is currently in dispute, this expected to be addressed in the regulations, and the COGS exception, which is generally believed to be limited to tangible products, may create a disparity between corporations whose business involves providing tangible goods to customers and corporations whose business is providing services to customers.

Statutory Exception for Cross-border Services

As noted above, virtually every member of a modern-day multinational corporate group engages in a wide variety of services transactions with other members of the group. These common transactions can increase a global enterprise's exposure to BEAT. In such a case, the question is whether and to what extent tax-deductible payments by a US member of such a group to a non-US affiliate for services provided counts as a base erosion payment. The BEAT statutory exception for services only exempts amounts paid or incurred for services that: (1) qualify for use of the "services cost method" under the transfer pricing rules of section 482 of the Code (applied without regard to the requirement in those rules that, in the business judgment of the relevant corporation the services in question "not contribute significantly to the fundamental risks of success or failure of the business"); and (2) the amount "constitutes the total services cost with no markup component".

The services cost method is generally applicable for transfer pricing rules only for "specified" services (and certain other services) that do not contribute significantly to the fundamental risks of success or failure of the business involved. The explicit elimination of the "significant contribution" limitation under the BEAT has led some to conclude that the exception was intended to encompass at least some categories of these "significant" services even if many countries require that they generally include a profit component for transfer pricing purposes. The BEAT's "no markup component" limitation has led others to conclude that, as a matter of statutory interpretation, the exception does not apply even where such a markup is required under the transfer pricing rules of the recipient's home country and/or has been approved in an IRS advance pricing agreement.

This apparent statutory inconsistency could be resolved in the forthcoming proposed regulations. One possibility, but not necessarily the only one, is that, where there is indeed a markup component, the BEAT exclusion for service costs nevertheless would be applicable, but only to the cost element of the payment. This would be consistent with a Senate colloquy on the scope of a prior and somewhat different version of BEAT during the 2017 legislative process.

But there are those who take the position that, under the specific terms of the final legislation, no portion of the "total services cost" (including the cost portion) of an amount that includes a markup component should be eligible for the exclusion.

Businesses Where the 'Product' Is Itself a Service

The COGS exception to "base erosion payment" classification in effect exempts from BEAT amounts paid or incurred by a US corporation to its non-US affiliates for raw materials or other components incorporated into finished goods sold to customers by the US affiliate. It also applies to the purchase of finished goods. Some have questioned, however, whether a limitation applies according to the proposed regulations for that portion of a payment for finished goods, etc. purchased from non-US affiliates that is attributable to intangibles embedded in the purchased property.

This exception provides relief for many US corporations with international supply chain structures, but some third-party service providers may find themselves in a comparatively less advantageous tax posture. For example, in some circumstances where services or intangibles provided to unrelated US customers by personnel employed by members of the group based outside the US, care must be taken in restructuring the underlying substantive economic relationship with the customer to avoid creating an unnecessary, and potentially taxable, stream of base erosion payments.

Some participants in the services industry may take the position for the purposes of calculating the BEAT that service payments (such as for production) are essentially equivalent to COGS as an adjustment to gross receipts, particularly if reported as such on their tax returns. In addition, some have urged the US Treasury and IRS to provide an explicit regulatory "cost of services" exception, comparable to COGS, in the forthcoming proposed regulations. The US Treasury and IRS may conclude that this is a policy issue requiring congressional action even if any regulatory relief were limited to cases not presenting abusive situations (ie where the relevant tax authorities have given advance approval for the transfer prices used for the services). Until either Congress or the US Treasury acts, however, the dichotomy between two critical sectors of the economy will remain.

Next Steps

The US Treasury and IRS have practiced very broad statutory discretion with respect to the BEAT regulations and key members of the tax-writing committees have expressed an interest in revisiting certain aspects of the provision. Participants in both elements of the service sector should be alert for further interpretations and changes.

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