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INSIGHT: Unbundling Your Way out of BEAT—Can Cost Allocations Make a Difference?




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As companies close their first tax year following the Tax Cuts and Jobs Act (TCJA), many multinational firms are planning around new provisions that will impact their intercompany transactions.

One area that is attracting significant attention is the new BEAT (Base Erosion and Anti-Abuse Tax) provision and how the identification and classification of intercompany expenses can minimize its potential effects.

This article will summarize the BEAT provision and discuss tax and transfer pricing considerations when determining the appropriate allocation of intercompany expenses.

BEAT—What is it And Who Has to Pay?

U.S. taxpayers must meet two requirements in order to be subject to the BEAT provision.

First, they must have a three-year average of gross receipts greater than $500 million dollars. The scope of applicable taxpayers for BEAT is defined to exclude regulated investment companies, REITs, or S-Corps.

Second, the U.S. taxpayer's deductions for intercompany payments for services, interest, certain property / assets, and royalties must be greater than 3 percent of its total deductions allowed. Certain alternative thresholds are named for banks and special entities.

If a U.S. taxpayer meets these two thresholds, they will be assessed an additional 10 percent tax on the modified taxable income once it has been adjusted for BEAT payments. The tax under the BEAT provision is equal to 10 percent of the taxpayer's "modified taxable income" (5 percent for 2018; 12.5 percent after 2025), less a portion of some tax credits.

Importantly, there are certain intercompany payments to foreign affiliates that are exempt from BEAT considerations. One exception includes payments classified as reductions to gross receipts, such as Cost of Good Sold (COGS), instead of deductions, which are usually recorded as operating expenses.

Another exception is made for service payments to foreign affiliates that are eligible under the Services Cost Method (SCM). The Services Cost Method is intended to preserve the salutary aspects of the cost safe harbor by allowing certain routine back-office and other low-value services to continue to be charged out at cost.

Taxpayers who are examining their potential BEAT liabilities are quickly realizing how these exceptions are placing a whole new level of importance on companies' ability to appropriately identify and classify intercompany expenses.

Companies should thoroughly examine their transfer pricing policies to determine whether methodologies need to be changed or modified in light of potential BEAT exposure. Whereas in the past it may have mattered less whether transactions and value were bundled or unbundled as long as resulting profits were in the right jurisdictions, the way costs and transactions are grouped may now result in material cash tax differences. This is especially the case where allocations are made on subjective factors or estimates. In the following paragraphs, we discuss two areas that companies may want to evaluate closely in a post-BEAT world: COGS/263A allocations and SCM costs.

Cost of Goods Sold and 263A Considerations

Intercompany payments that are classified under operating expenses are subject to BEAT, but payments under COGS are generally not. For U.S. taxpayers that maintain inventories, the COGS amount is not considered a base erosion payment according to the Conference Committee Report to HR1 that preceded the TCJA. COGS is considered under the IRS tax regulations as the costs assigned to inventory that has been sold, in this case to a foreign affiliate. Therefore, any expense that is either paid or accrued to a foreign affiliate that is captured in the COGS amount will not be subject to BEAT.

It is important to understand the build-up of the COGS to evaluate whether it is appropriate to add costs to minimize future BEAT implications. COGS is determined by aggregating (1) the inventory amount at the beginning of the fiscal year, (2) the inventory purchases, (3) cost of labor, (4) Section 263A costs, and (4) other costs associated with inventory.

IRC Section 263A details the uniform capitalization rules that require certain costs normally expensed be capitalized as part of inventory for tax purposes.

The sum of these costs is then reduced by the inventory amount at the end of the fiscal year. It is the Section 263A costs, specifically, that U.S. taxpayers may want to review in order to ensure they are not inadvertently subjecting themselves to excess BEAT.

Although taxpayers are required to calculate 263A costs routinely as a part of preparing any accurate tax financial statement, companies are given flexibility in the methodologies used for estimating such costs. In practice, and absent other reasons for doing so, the granularity of analyses used to develop such costs vary. Many companies may be applying broad allocation metrics to allocate indirect costs that are classified as operating expenses instead of COGS. BEAT may now incentivize companies to take a closer look at such allocations to ensure that costs are not being inadvertently missed.

For example, expenses including both sales-based royalties and management fees can be considered as capitalizable costs and included in the COGS amount.

For royalties, the underlying intangible property must be associated with the purchase, manufacturing, warehousing, and logistics of inventory to be considered under Section 263A and capitalized with other inventory costs. See Regs. Sec. 1.263A-1(e)(3)(ii)(U). Manufacturing know-how may fall into this category.

Intangible property related to sales and marketing or activities like trademark and trade name royalties are normally expensed and would likely not be eligible for inclusion as a Section 263A cost. See Regs. Secs. 1.263A1(e)(3)(iii)(A).

Similarly, management fees may also be capitalized as a Section 263A costs when these services are directly tied to the purchase, manufacturing, warehousing, and logistics functions. See Regs. Secs. 1.263A1(f)(1).

The diagram below presents the eligible expenses that can be re-categorized from operating expenses into COGS:

Reviewing Intercompany Royalty and Services Allocation under 263A:

Transfer Pricing Considerations for 263A Costs

After U.S. taxpayers have appropriately classified their inventory related expenses into COGS, they will need to consider how to properly analyze these expenses in accordance with the U.S. transfer pricing regulations. Any material changes in the what is included in a profit level indicator may impact how a transaction should be tested for documentation purposes, and how such transactions are compared to third party data for documentation purposes.

U.S. taxpayers have flexibility in whether they test services and royalties separately from other tangible or service transactions or together as a part of a bundled transaction. U.S. transfer pricing regulations allow for aggregating transactions under appropriate circumstances. Section 1-482-f(2)(i) states, ''aggregation of transactions can be considered if they are interrelated and analyzing them in aggregate leads to a reliable arm's length result.'' It is often difficult to benchmark service and royalty payments separately from other transactions. There may be synergies between the services and IP received from foreign affiliates and other services and tangible goods transactions that cannot be appropriately benchmarked by testing these transactions separately.

Illustration of Bundling IP with Tangible Good Transactions

Increasing COGS using Section 263A allocable costs may limit taxpayers' exposure to BEAT. However, taxpayers should note that costs related to Section 263A must be capitalized and can only be deducted for tax purposes when the relevant inventory is sold. This might create certain timing issues when costs can be expensed, but the downsides of capitalizing expenses under Section 263A might be significantly outweighed for some taxpayers by the removing these costs from BEAT considerations.

Intercompany Services and SCM Considerations

Another way to minimize the BEAT exposure is to utilize the SCM where it can be appropriately applied. According to the TCJA, amounts paid or accrued by a taxpayer to a related party for services that meet the requirements for using the SCM under Section 1.482-9 are excluded from the definition of the base erosion payment. To meet the exception, such services must be charged at amounts equal to ''total services costs'', as defined in U.S. transfer pricing rules 1.482-9, plus no mark-up. Also, the TCJA clarifies that the exception is to be made without regard for the SCM's business judgment rule.

The SCM has been traditionally used as a transfer pricing safe harbor to allow certain services to be provided between a U.S. corporation and its foreign related parties at cost without a markup. In the context of the

COGS
Inventory at beginning of year
Purchases less cost of items withdrawn for personal use
Labor costs (depreciation, salaries, warehouse and bottling/packaging labor)
Materials and supplies
Other costs (containers, freight-in, overhead expenses)
Inventory at the end of the year
Inventory at the beginning of the year

Operating Expenses
R&D Expenses
Warranty and product liability costs
Business Equipment qualifying under Section 179 (depreciable business assets, computer software acquired for active business)
Marketing, advertising
Office-related expenses
Losses under Section 165 including losses incurred in a trade or business, losses incurred in any transaction entered into for profit etc.

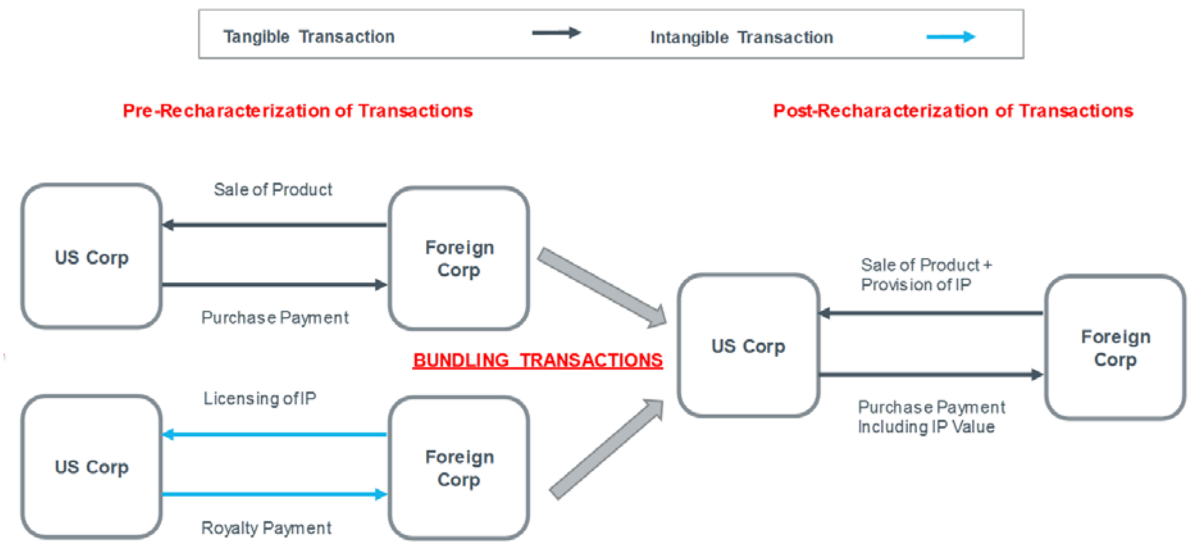
Allocable costs under § 263A

Operating expenses that are directly related to inventory and can be capitalized under § 263A can be classified under COGS to reduce net receipts.

Foreign costs to segment into inventory and non-inventory costs

Royalty expenses: Manufacturing Know-how; Services and Logistics Processes

Services costs: Quality and Control Expenses; Application Engineering Expenses; Purchasing and Handling Costs



US Corp's Income Statement	In Millions of USD
Sales	500
Cost of Goods Sold	350
Gross Profit	150
SG&A	50
Royalty Payment	50
Operating Profit	50
Subject to BEAT	50

US Corp's P&L's Income Statement	In Millions of USD
Sales	500
Cost of Goods Sold	400
Gross Profit	100
SG&A	50
Operating Profit	50
Subject to BEAT	0

BEAT, companies need to identify whether the SCM can be applied to services provided by foreign related parties to the U.S. taxpayer.

For a service to qualify for SCM exception, the following conditions must apply: (1) Services are not included in the list of excluded services such as R&D and manufacturing; and (2) Services are either (a) included in the list of specified covered services or (b) are determined to be a low margin covered service, which has a median comparable arm's length markup on total service costs of less than or equal to seven percent. The amount excluded from BEAT under this exception would be equal to the total services cost with no markup component.

In order to utilize the SCM exemption under the BEAT, a taxpayer should determine whether there are opportunities to classify services as SCM eligible, even if the company has previously decided not to elect this method for transfer pricing purposes. It may be optimal to ''unbundle'' transactions where a hybrid classification might apply (i.e., carve out services related to administration and coordination which could qualify for the SCM from marketing services which, in this example, would not). Specifically, taxpayers should review the list of 101 specified covered services in the revenue procedure (Rev. Proc. 2007-13) which include common back-office and administrative services such as human resources, information technology, accounting, general administration, treasury, legal, etc. Further, the TCJA indicated, in the context of the BEAT, that the SCM eligibility is determined without regard to the business judgement test. This allows a U.S. taxpayer to exclude certain services that are key to the business operations (such as finance and management services) and treat those services as ''low margin services'' that qualify for the SCM where appropriate.

Reviewing Intercompany Services under Services Cost Method:

Further, it is expected that the future guidance will be provided by Treasury to clarify whether the BEAT applies to solely the markup component of the service payment or to both the markup and cost component of the services payment.

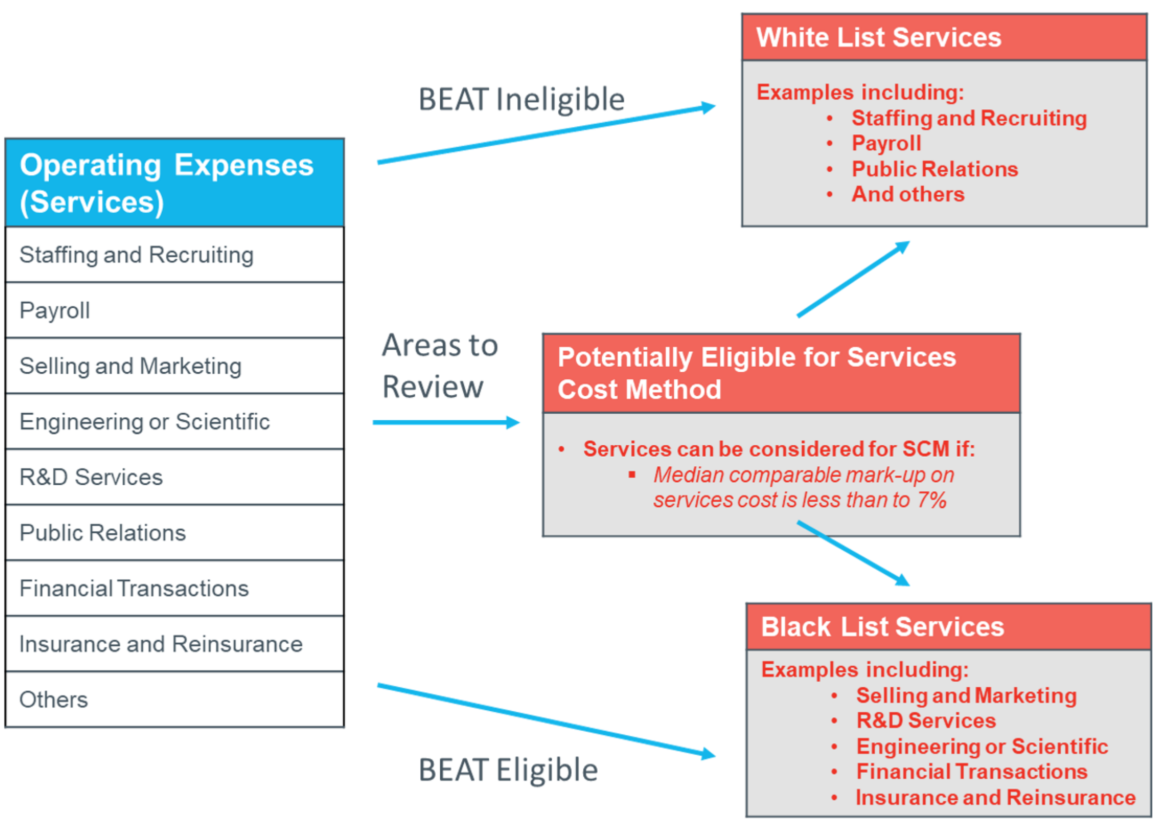
The diagrams below illustrate how recharacterizing transactions (bundling or unbundling intercompany transactions) have an impact on a taxpayer's BEAT obligations:

Illustration of Unbundling Services Transactions

These examples are simplified and for illustration purposes only.

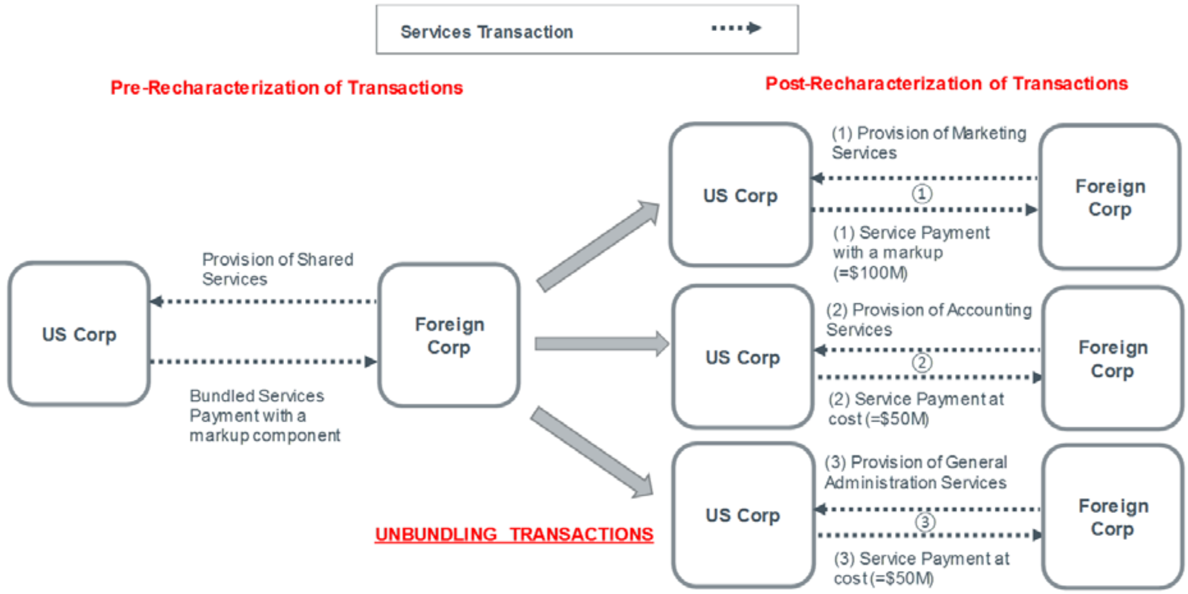
Transfer Pricing Considerations for Intercompany Services

As illustrated above, there are various ways to recharacterize the transactions or flows of payments to reduce BEAT exposure. When considering potential strategies, taxpayers should be sure to evaluate any potential challenges that may be imposed by tax authorities.



From a foreign related party's perspective, certain back office / support services that are qualified under the SCM may require a markup, which can result in double taxation for the markup component if the company chooses to implement a cost-only pricing policy. However, the markup component represents a small portion of the overall charge and therefore, the SCM exemption should be explored in these instances as well.

For example, it is common for taxpayers to collapse certain transactions into fewer transactions which are priced on a net basis. For example, a foreign party which manufactures tangible goods and sells those goods to related parties in the United States while also providing services to those parties may, for administrative convenience, not charge separate service fees and tangible goods prices, but rather let the value of the ser-



US Corp's Income Statement	In Millions of USD
Sales	500
SG&A	200
Services Payment	200
Operating Profit	100
Subject to BEAT	200

US Corp's P&L's Income Statement	In Millions of USD
Sales	500
SG&A	200
SCM Non-Qualified Services Payment (1)	100
SCM Qualified Services Payment (2) + (3)	100
Operating Profit	100
Subject to BEAT	100

vices be captured in the tangible goods prices. The IRS may be motivated to try to unbundle these two transactions, forcing recognition of a service payment subject to BEAT distinct from the tangible goods purchase (which is not). Taxpayers should be careful to evaluate any risks associated with any bundled transactions that might have implications for BEAT to ensure that they aren't subject to any unpleasant BEAT-related outcomes upon audit.

Conclusion

In summary, a taxpayer should evaluate its cost segregation processes to ensure such processes are performed with sufficient rigor given potential risks of material BEAT consequences. Once a U.S. taxpayer has correctly segmented its expenses, it will need to reconsider its transfer pricing policies to ensure that any changes have been reliably accounted for when such transactions are tested for documentation purposes. Given the large dollars at stake and lingering uncertainties in the BEAT provisions, IRS guidance is highly anticipated and needed by the corporate tax community.

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