DUFF & PHELPS

Protect, Restore and Maximize Value

Coming to Terms with BEAT: Unique Challenges for Asset Managers

The impact of the new Base Erosion and Anti-Abuse Tax (BEAT) implemented under the Tax Cuts and Jobs Act (TCJA) in 2018 is coming into focus for asset management firms that just closed out their first tax year under these new U.S. tax rules. Proposed regulations were issued on December 13, 2018[1], and companies now have more information to determine how their global transfer pricing policies may be triggering the new tax.

The BEAT generally applies to taxpayers meeting the following criteria:

- Total average annual gross receipts for the affiliated group exceed $500 million over the prior three-year period[2]; and
- Deductions in the U.S. for intercompany payments for services, interest, certain property/assets and royalties are greater than 3% of total deductions.
    - For banks and registered securities dealers, the threshold is 2%.

The BEAT is in addition to the taxpayer's regular tax liability. If the above criteria are met, an additional 10% tax (previously 5% in 2018) is applied to the excess of a taxpayer's modified taxable income over its regular tax liability, where modified taxable income is defined by the disallowance for deductions for base erosion payments.

In general, the BEAT penalizes large companies that have significant outbound payments to foreign related parties and targets payments for items such as services, royalties and interest rather than product purchases or other Cost of Goods Sold (COGS)-related items.

Asset management firms tend to run their global business in a highly integrated manner and can be significantly penalized by BEAT as a result of the intercompany transactions that come with integrated structures. For example, portfolio managers may draw upon research performed around the world to make product decisions, and customer relationships may be located in countries different from where trading and execution take place. In addition, many asset management firms have portions of their business that cause them to fall under rules specific to banks and registered securities dealers, which subject them to harsher consequences. Such companies have lower thresholds for triggering the BEAT in the first place (2% instead of 3%) and their "BEAT-able" transactions attract more tax (e.g., they pay 11% instead of 10% in 2019).

Another challenge relates to tracking and estimation. Many companies have difficulty estimating their BEAT-able payments because they may not have needed to track transactions in the way that the BEAT rules now require. However, complexity of related party transactions for asset management firms has arguably made the task more difficult for this industry. For example, companies that have implemented global profit splits to accommodate their highly integrated business do not yet have certainty within the proposed regulations about how their profit split allocations will be treated under the BEAT. This can be a material issue when a company uses a U.S. entity as the "header" for executing profit split allocations. Should such allocations be treated as outbound payments for services and therefore BEAT-able? Or should they be treated as allocations of income and not subject to the BEAT? The New York State Bar Association released a report[3] that highlights this issue, and requests more guidance on profit split allocations.

Finally, navigating certain exemptions from BEAT may be more challenging for asset managers than for other companies. The proposed BEAT regulations issued in December of 2018 were

1. https://www.irs.gov/newsroom/irs-issues-proposed-regulations-on-key-new-international-provision-the-base-erosion-and-anti-abuse-tax
2. The relevant three-year period is that which immediately precedes the current year.
3. http://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Section_Reports_2019/1409_Report.html

helpful in that they provided detailed guidance on certain exempt outbound payments. One category of exempted payments is for services that may qualify for the services cost method (SCM) under 1.482-9(b)[4]. In order to qualify for the SCM exemption, one of the following criteria need to be met:

- The activity is a specified covered service listed on Rev. Proc. 2007-13.
- The service is a low margin covered service where the median markup on total services costs for comparable service providers is less than or equal to 7%.

Asset management firms may have not paid much attention to which services were eligible for the SCM method before BEAT if the election to charge a service at cost was immaterial to them. However, under BEAT, eligibility for the SCM may become much more important. Tracking such services will be a tedious exercise for many asset management firms. In addition, the SCM exemption cannot be met where the service is an "excluded activity," per 1.482-9(b). Certain items on the list of excluded activities may be hard to interpret for asset management firms. For example, one excluded activity is "research, development or experimentation." Does this include equity research? Another item is "reselling, distribution, acting as a sales or purchasing agent, or acting under a commission or other similar arrangement." Some asset management firms may apply the label "distribution" to a broad set of activities, including marketing. Should such services be excluded? The item "financial transactions" has similar issues.

For any asset manager considering its BEAT exposure and eligibility for the SCM exemption, a detailed functional analysis should be considered. Intercompany and third-party contracts should also be reviewed to understand how the company has categorized its transactions and to ensure consistency.

In general, asset management companies can benefit from a transfer pricing review in 2019 to ensure their global policies are meeting all of their objectives including with regard to BEAT. The rate increase from 5% in 2018 to 10% in 2019 is likely to prove consequential, so efforts this year will be well placed to have significant impacts in the near future.

CONTACT

Michelle Johnson
Managing Director
+1 312 697 4680
michelle.johnson@duffandphelps.com

Michael Berbari
Vice President
+1 212 523 0591
michael.berbari@duffandphelps.com

4. The business judgment rule in 1.482-9(b)(5) is ignored for purposes of the BEAT exemption.