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Base Erosion and Profit Shifting

Base Erosion Measures After Tax Reform: A Primer

By Isabel Gottlieb

The new tax reform law's anti-base erosion measures are aimed at helping to move the U.S. to a territorial system and to capture a greater share of tax revenue.

The corporate provisions of the law (Pub. L. No. 115-97), signed by President Donald Trump on Dec. 22, in addition to cutting the corporate tax rate to 21 percent from 35 percent, take aim at base erosion—the shifting of profits to low- or no-tax jurisdictions.

Here is an overview of some of the anti-base-erosion measures.

New Definition of Intangibles

In 1982, the Tax Equity and Fiscal Responsibility Act defined intangible property through a list of specific types of property—including intellectual property like patents, copyrights, trademarks, and items like franchises and licenses or technical data. The specificity of the list allowed taxpayers to argue that anything not included in the list wasn't intangible property, and therefore wasn't subject to tax.

The new language greatly expands the definition of intangible assets: “Workforce in place, goodwill (both foreign and domestic), and going concern value are intangible property within the meaning of section 936(h)(3)(B), as is the residual category of ‘any similar item’ the value of which is not attributable to tangible property or the services of an individual,” the Dec. 18 conference report said.

“Basically, if it's not tangible, it's intangible,” Jeffrey S. Korenblatt, a partner at Reed Smith LLP, told Bloomberg Tax.

The new law also assigns a standard 10 percent return on tangible assets at a tax threshold above which anti-deferral measures take effect. Any returns on intangible assets above the assumed 10 percent return on tangibles is subject to the “carrot and stick” provisions of foreign-derived intangible income and global intangible low-taxed income.

One thing this change in definition does is make transfer of branches or other foreign operations to foreign companies more expensive by eliminating tax-deferred options for those transfers, said Bruce Reynolds of Bloomberg Tax, a managing editor specializing in international taxation.

The ‘Carrot’: Foreign-Derived Intangible Income Deduction

The law offers a special deduction on income that U.S. companies earn from foreign activities, resulting in a rate of about 13 percent on income that is deemed intangible and foreign, compared with the 21 percent corporate income tax rate.

The law defines foreign-derived intangible income (FDII) as the portion of a U.S. corporation's intangible income derived from serving foreign markets.

Companies can take a deduction of 37.5 percent of their FDII, so the resulting effective tax rate is 13.125 percent, according to a Dec. 20 Baker McKenzie report.

The FDII deductions are phased: the rate is 37.5 percent of FDII for 2018 to 2025, then drops to 21.875 percent for 2026 and beyond.

The ‘Stick’: Global Intangible Low-Taxed Income

If the FDII deduction is a carrot, the so-called GILTI tax—on global intangible low-taxed income—is the stick.

The GILTI tax applies to both U.S. and foreign companies' foreign high returns, while the FDII incentive applies only to U.S.-based companies with foreign activities.

The GILTI tax targets the same type of income as the FDII—intangible income derived outside the U.S.

"The effect of a GILTI provision would be to subject a US shareholder to tax (at a reduced rate in the case of US corporations) on its CFCs' combined net income above a routine equity return on tangible depreciable business assets that is not otherwise subject to US tax or to foreign tax at a minimum rate or is not otherwise specifically excluded," PricewaterhouseCoopers LLP said in a Dec. 20 report.

GILTI operates like an added layer to Subpart F, Korenblatt said. "If you have a foreign corporation that earns income, and it's not passive such that it's been picked up under Subpart F and included in the return of U.S. shareholders, then the GILTI rules come in," he said.

That means that the ability to defer U.S. tax on this GILTI income until it is distributed goes away, Reynolds said.

The GILTI tax, like the FDII deduction, will be phased.

The 'Blanket Tax': Base Erosion Anti-Abuse Tax

The base erosion anti-abuse tax (BEAT) imposes a blanket tax on any payment by a large corporation deemed a "base-eroding payment."

The BEAT is an additional tax on corporations with average annual gross receipts for the last three years of more than $500 million that make "base-eroding payments to related foreign persons" of 3 percent or more of their deductible expenses, or 2 percent for certain banks and securities dealers.

The base erosion tax was the Senate's answer to the House's proposed 20 percent excise tax, which European Union finance ministers had said violated World Trade Organization rules and could lead to double taxation.

But the BEAT still might present a conflict with some U.S. tax treaties, the PwC report said, because it "restricts tax benefits based on the nationality of the recipient of the payment."

If the FDII is an incentive to bring business here—"Come to the U.S. for a nice low rate, we're competitive," and GILTI is a disincentive against taking it away—"Do you want to go out and get your rate low? Fine, but we're going to take a certain portion of that income and tax it," Korenblatt said, the base erosion tax seems to serve primarily as a way for the U.S. to increase its tax revenue. "I see it almost like a soak-up tax," Korenblatt said.

The BEAT is also a phased tax: After 2025, 10 percent of tax liability will increase to 12.5 percent, and there will be a reduction, but not to below zero, of the regular tax liability by the aggregate amount of credits against regular tax liability rather than against the excess.

The 'Holy Grail' in Planning

Tax reform may change some multinationals' transfer pricing planning, though the basic goal hasn't changed, John P. Warner, a shareholder with Buchanan Ingersoll & Rooney PC, told Bloomberg Tax. "The holy grail is to reduce the worldwide rate."

Provisions like FDII and GILTI, combined with the lower overall corporate rate, may incentivize taxpayers to shift more income to the U.S. to do that, Warner said.

But some tax practitioners said the new law's provisions might not be enough to encourage companies to relocate to the U.S.

For example, GILTI might favor a company that holds more tangible assets offshore: The 10 percent assumed return rate on tangible assets would be a larger figure, allowing for more of the company's intangible income to go untaxed.

"The GILTI rules create a surprising and unexpected incentive for U.S. multinationals to increase the amount of tangible assets held by their" controlled foreign corporations, "which in most circumstances will presumably be situated outside the United States," the Baker McKenzie report said.

It isn't clear whether the FDII will encourage U.S. multinationals to locate or relocate to the U.S., the report said.

“It is not clear that the statute will ultimately achieve its ostensible purpose of encouraging U.S. multinationals to locate (or re-locate) property in the United States,” the Baker McKenzie report said. “Simply put, the FDII deduction mechanics incentivizes domestic corporations to minimize the amount of tangible property (whether located in the United States or outside the United States) on their balance sheets, whereas the mechanics of the GILTI regime incentivizes groups to maximize the amount of tangible property owned by CFCs, which in most cases will presumably be outside of the United States.”

Another way to avoid or reduce the GILTI tax would be to invest in tangible property abroad. “The territorial system coupled with the generous pre-GILTI amount of return you can get without being taxed on offshore income, may in a perverse way incentivize U.S. multinationals to invest even more abroad,” Warner said.

The law won't alter transfer pricing rules like the arm's-length standard, but companies should be prepared for the possibility of more transfer pricing disputes, the Baker McKenzie report said.

“Regardless of the potential direction of impact, it is reasonable to expect an uptick in non-US driven TP disputes related to these intercompany transactions. Specifically, companies can expect further scrutiny around the valuation of intangibles, potential exit charges, and other challenges driven by the BEPS guidance,” it said.

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