NOVOGRADAC & COMPANY LLP®
CERTIFIED PUBLIC ACCOUNTANTS

CLIENT ALERT

BEAT: Who is affected? How calculated? Implications to tax credit communities?

Michael Novogradac, CPA, Nicolo Pinoli, CPA, Charles A. Rhuda III, CPA and Peter Lawrence

The corporate alternative minimum tax (AMT) was repealed by H.R. 1, the tax cut legislation signed into law Dec. 22, 2017. But, a similar parallel taxation system, the Base Erosion and Anti-Abuse Tax (BEAT), was introduced for international corporations. Similar to the AMT, the BEAT requires that international corporations calculate their tax liability two ways: first, under the regular tax system, and second, under the BEAT system. If the BEAT calculations yield a higher tax amount, then corporate taxpayers must pay the higher amount.

BEAT is the logical extension of the U.S. move to a territorial tax system, wherein corporations generally pay tax only on U.S. source taxable income. BEAT is intended to impose a minimum tax on international corporations that deduct for U.S. tax purposes payments to foreign subsidiaries and related parties. From a broad public policy perspective, the BEAT's purpose is to prevent the erosion of the U.S. corporate tax base by international corporations who attempt to minimize their US tax liability through mechanisms that shift U.S. source taxable income to foreign jurisdictions.

BEAT: Who is affected?

Not all corporations are subject to the BEAT. Regulated investment companies, real estate investment trusts and S corporations are specifically exempted from the BEAT. In addition, only very large international corporations that exceed a minimum threshold of base erosion tax benefits are subject to the BEAT. To be subject to the BEAT, a corporation must have at least $500 million in average annual gross receipts for the last three years. Additionally, a corporation must also have a base erosion percentage of at least 3 percent, with 2 percent being used in the case of banks and registered securities dealers. This 3 percent or 2 percent threshold is a de minimis test. If a company is below the threshold, it is not subject to the tax. The base erosion percentage is a ratio of the aggregate base erosion tax benefits of a corporation for a taxable year over the aggregate amount of deductions for the same year. The base erosion tax benefits for a corporation equal the deductions associated with base erosion payments, deductions for depreciation for property acquired with respect to a base erosion payment, and reductions in gross income associated with base erosion payments. Finally, a base erosion payment is generally any amount paid or accrued by a corporation to a foreign related party, although derivative payments are excluded from base erosion payments.

BEAT: How calculated?

For a corporation subject to the BEAT, the first step is to calculate modified taxable income. Modified taxable income is taxable income calculated under the regular tax regime, with two adjustments. First, the corporation must add back any base erosion tax benefit with respect to any base erosion payment. Second, the corporation must add back the base erosion percentage of any net operating loss deduction. This modified taxable income is then multiplied by the BEAT rate to calculate the tentative BEAT. The following table outlines the BEAT rate for three periods of time, and for two categories of corporations.

Taxable Year	Non-bank corporations	Bank/securities corporations
2018	5%	6%
2019-2025	10%	11%
2026 and thereafter	12.5%	13.5%

This is where the calculation gets particularly interesting. A corporation is subject to the BEAT if its tentative BEAT exceeds its regular tax, after its regular tax is reduced for certain tax credits. If a tax credit reduces regular tax for this calculation, the potential for the tentative BEAT to exceed the corporate regular tax rises.

Of particular interest to the tax credit community is how various tax credits are treated in this calculation. Research and development (R&D) tax credits, low-income housing tax credits (LIHTCs), and renewable energy production and investment tax credits (RETCs) receive special favorable treatment, but only until the end of 2025. Historic tax credits (HTCs) and new markets tax credits (NMTCs) do not receive special treatment.

Until the end of 2025, regular tax is <u>not</u> reduced for 100 percent of R&D tax credits, and not reduced for any more than 80 percent of LIHTCs and RETCs. Through a complex calculation that we won't get into here, as much as 20 percent of LIHTCs and RETCs may reduce regular tax. HTCs and NMTCs do reduce regular tax. After 2025, all tax credits reduce regular tax.

The net result is, essentially, that through the end of 2025, corporations may find that up to 20 percent of their LIHTCs and RETCs do not reduce their BEAT liability. After 2025, corporations may find that as much as 100 percent of their LIHTCs and RETCs do not reduce their BEAT liability. For HTCs and NMTCs, starting in 2018, corporations may find that as much as 100 percent of their HTCs and NMTCs do not reduce their BEAT liability.

Because the new law does not include any provision for carrying forward any tax credits that do not reduce the BEAT, such credits are permanently lost and no tax benefit is received.

For corporations that pay the BEAT, the value of some or all of their tax losses from tax credit investments is also reduced. This reduction results from the change in marginal tax rates applicable to those losses, which would normally be assessed at the regular marginal tax rate of 21 percent, but would fall to the much lower marginal BEAT rates referenced in the table above. For any given year, for an investor subject to the BEAT, the value of the losses would be reduced by as much as 76 percent in 2018, and about 35 to 52 percent thereafter.

BEAT: Implications to tax credit communities?

The implications of this potential loss of credits and tax loss benefits due to the operation of the BEAT is forcing international corporations to carefully evaluate and manage their exposure to the BEAT, to minimize the potential loss of tax benefits. In situations where tax credit investors find that their tentative BEAT is projected to exceed their regular tax liability, they may choose to adjust their plans for future tax credit investments, and may also elect to adjust their current investments by selling some portion of their existing portfolios.

APPENDIX

Simplified BEAT Example

Assumptions

Regular Taxable Income	$1,000
Base erosion tax benefit w/r/t base erosion pymt.	$500
Base erosion percentage of NOL	$100
R&D Tax Credit	$25
Applicable Section 38 Credits	$50
Nonapplicable Section 38 Credits	$50

General International Corporation	2018	2019-2025	Post 2025
Regular taxable income	$1,000	$1,000	$1,000
ADD BACK			
Base erosion tax benefit w/r/t base erosion pymt.	+ $500	+ $500	+ $500
Base erosion percentage of NOL	+ $100	+ $100	+ $100
Modified Taxable Income	$1600	$1600	$1600
BEAT Rate	x 5.0%	x 10.0%	x 12.5%
Tentative BEAT	$80	$160	$200
Regular taxable income	$1,000	$1,000	$1,000
Corporate Tax Rate	21.0%	21.0%	21.0%
Regular Tax Liability (Section 26(b))	210	210	210
Credits Allowed Under this Chapter	- $125	- $125	- $125
R&D Tax Credit	$25	$25	
Lesser of:			
80% of Applicable Section 38 credits:			
(42(a), 45(a) & 48 energy credit)	$50	$50	
80% Limit	x 80%	x 80%	
80% of Applicable Section 38 Credits	$40	$40	
80% of Base Erosion Minimum Tax Amount			
Tentative BEAT	$80	$160	
Regular Tax Liability (Section 26(b))	+ $210	+ $210	
All credits	- $125	- $125	
R&D add back	+ $25	+ $25	
Adjusted Reg Tax	$110	$110	
Adjusted Base Erosion Minimum Tax Amt	$ -	$50	
80% Limit	x 80%	x 80%	
80% of Base Erosion Minimum Tax Amount	$ -	$40	
Lesser Amount	$ -	$40	
Addback R&D and Applicable Credits:	$25	$65	
Adjusted Regular Tax Liability	$110	$150	$85
Base Erosion Minimum Tax Amount	**$ -**	**$10**	**$115**
Total Taxes Paid:			
Regular tax liability	$210	$210	$210
Tax Credits	- $125	- $125	- $125
Base Erosion Minimum Tax Amount	$ -	$10	$115
Total	$85	$95	$200
Credits Lost		$10	$115
Percentage of Credits Lost		-8%	-92%