Comparison of Key Anti-Base Erosion Rules in the Tax Reform Act of 2017 and under UK Tax Law

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Inbound and Outbound Base Erosion

UK: Diverted Profits Tax (DPT)

US: Base Erosion Anti-Abuse Tax (BEAT)

Diverted profits tax

- Applies (after consultation) from 1 April 2015, to profits diverted from the UK, as a freestanding tax separate from corporation tax. Its focus is on contrived arrangements designed to erode the UK tax base
- The DPT rate is 25%, and has to be paid upfront (cf corporation tax that's in dispute)
- It targets:
  1. intra-group arrangements that lack economic substance (eg a large tax-deductible payment to a minimal function tax haven affiliate)
  2. the avoidance of a UK taxable presence (so essentially the avoidance of the creation of a permanent establishment)

Diverted profits tax (cont'd)

- In recharacterisation cases (the former)
  - the triggers are an effective tax rate mismatch (80% of what would have been paid) and insufficient economic substance (which weighs the tax benefit against any economic benefit)
  - quantification is by reference to the "just and reasonable alternative provision“
- In PE cases (the latter)
  - if one of the main purposes is to avoid a PE, then a PE is deemed and the profits attributable to it calculated;
  - if there is an effective tax rate mismatch, you recharacterise
- Does not apply to SMEs, to loan transactions or within a de minimis threshold
- Provides a level playing field between UK- and foreign-based MNEs. It applies entity by entity, as is generally the case in the UK
- No tax treaty override, to ensure compliance with the UK's international obligations

Inbound and Outbound Base Erosion (US)

Base Erosion and Anti-Abuse Tax (BEAT)

- BEAT is an add-on minimum tax applicable to US corps. with over $500 million of average annual gross receipts over the prior 3-year period and with "base erosion tax benefits" over 3% of total deductions (with adjustments).*
- "Base erosion tax benefits" are:
  1. Deductions from gross income allowed with respect to payments to related foreign persons,
  2. Depreciation or amortization allowed with respect to property purchased from related foreign persons,
  3. Insurance-related payments to related foreign persons, and
  4. Payments to related expatriated entities that reduce gross receipts.

  Note: No exclusion for payments to high-tax countries or subject to US tax.
- Special rules:
  - Base erosion tax benefits are reduced to the extent withholding tax applies.
  - It is unclear if cost component of low-value services may be excluded.
  - Qualified derivative payments are not treated as base erosion payments.

*For banks and security dealers, a 2% (vs. 3%) threshold applies.

Inbound and Outbound Base Erosion (US)

Base Erosion and Anti-Abuse Tax (cont'd)

- The BEAT rate is 5% for the first tax year beginning after 12/31/17, 10% for the 7 tax years beginning after 12/31/18, and 12.5% for tax years beginning after 12/31/25.*
- BEAT tax liability is the excess of :
  - BEAT rate times "minimum taxable income," over
  - Regular tax plus
    - For tax years beginning *before* 1/1/26, the research credit and a capped amount of certain other general business credits
    - Note: Foreign tax credits are not added back
- "Minimum taxable income" is regular taxable income plus:
  - Base eroding tax benefits, and
  - Base erosion percentage of NOLs
- It is unclear whether BEAT applies on a consolidated basis.

*For banks and security dealers, the BEAT rates are 1% point higher.

Example of Base Erosion Anti-Abuse Tax (BEAT)

Item	Formula	US Parent
1 Gross income of US corporation		$1,000
2 Deductions allowable to US corporation		$800
3 Taxable income of US Corporation	L1-L2	$200
4 US source		$150
5 Foreign source (GILTI, subpart F, branches)		$50
6 US tax before credits	21%*L3	$42
7 Foreign tax credit		$10
8 R&E credit		$5
9 Regular US tax after credits	L6-L7-L8	$27
10 Base erosion tax benefit wrt base erosion payments[1]		$200
11 Modified taxable income	L3+L10	$400
12 10% of modified taxable income[4]	10%*L11	$40
13 Regular US tax less credits other than R&E credit[3]	L8+L9	$32
14 BEAT	Max(0,L12-L13)	$8

[1]Base erosion payments are payments to related foreign persons that result in a US tax deduction. COGS are not treated as base erosion payment except where foreign person is a surrogate foreign corporation (or related foreign person).

[2]BEAT generally does not apply if average annual gross receipts for the prior 3 years are less than $500M or base erosion tax benefit is less than 3% of deductions allowable to US corp.

[3]Research credit and capped amount of certain other general business credits are not added back to regular tax for tax years beginning after 12/31/25.

[4]The BEAT rate generally is 5% for the first tax year beginning after 12/31/17, then increases to 10% for the next 7 years, and increases again to 12.5% of tax years beginning after 12/31/25.

Outbound Base Erosion

UK: Controlled Foreign Corporation (CFC) Rules

US: Global Intangible Low-Taxed Income (GILTI)

UK CFC rules

- Original rules introduced in 1984 reflected the UK's then worldwide corporate tax regime.
- The new rules effective from 1 January 2013 are more limited in their aim and more effective in countering abuse, reflecting:
  - the move to a territorial corporate tax regime with a foreign dividend and a foreign branch exemption
  - the ECJ decision in the Cadbury Schweppes case, which limited the scope of EU Member States' CFC regimes, to ensure compliance with the EU fundamental freedoms
- The new rules focus on preventing the diversion of UK profits (effectively profits arising from UK activities). Where such diversion arises, the profits are imputed to shareholders of the CFC (as with Subpart F) for conformity with the UK's tax treaties
- There is no differentiation between normal and superprofits. So, for example, high profits made outside the UK are not subject to the CFC rules if they've not been diverted from the UK

Outbound Base Erosion (US)

Global Intangible Low-Taxed Income (GILTI)

- GILTI is includible in the US shareholder's income, with a 50% deduction (for corporate shareholders) in tax years beginning after 12/21/17 and before 1/1/26, and a 37.5% deduction in tax years beginning after 12/31/25.
  - At the 21% corporate rate, this is a 10.5% rate initially and then a 13.125% rate
- GILTI is the excess of <u>net</u> "tested income" over "deemed tangible income" for all CFCs.
  - Tested income *excludes* subpart F income, related-party dividends, income connected with the US, and foreign oil and gas extraction income (FOGEI)
  - Deemed tangible income is 10% of the adjusted basis of tangible property (determined using ADS depreciation) less certain interest expense* for CFCs with positive tested income.
- 80% of foreign taxes attributable to GILTI income are creditable
  - A separate foreign tax credit limitation applies to GILTI
  - No carryovers of excess credits are permitted
  - US interest, stewardship, and R&D expenses are allocable against GILTI for purposes of the foreign tax credit limitation
- Assuming all foreign taxes are creditable, US residual tax is due on GILTI if the foreign tax rate is less than 13.125% (16.4% after 2025).
  - Due to expense allocation, US tax may be due even if foreign tax on GILTI exceeds 21%

*Interest expense allocated to tested income to the extent associated interest income is excluded from tested income.

Example of Calculation of US Tax on GILTI

	Item	Formula	CFC1	CFC2	US Parent	
					No exp. Alloc.	With exp. Alloc.
1	Tested Income[1]		$200	$200	$400	$400
2	Tested Loss		$0	$0	$0	$0
3	Net CFC Tested Income				$400	$400
4	Tested Foreign Income Taxes		$25	$35.43	$60	$60
	Foreign effective tax rate on tested income	L4/(L1+L4)	*11.1%*	*15.0%*	*13.125%*	*13.125%*
5	Qualified Business Asset Investment[2]		$1,400	$200	$1,600	$1,600
5a	Int. exp. related to int. not included in tested inc.				$20	$20
6	Net deemed tangible income	(10%*L5)-L5a			$140	$140
7	GILTI	Max(0,L3-L6)			$260	$260
8	Inclusion percentage	L7/L3			65%	65%
9	Deemed Paid Credit before 20% haircut	L8*L4			$39	$39
10	Deemed Paid Credit after 20% haircut	80%*L9			$31	$31
11	Grossed up GILTI	L7+L9			$299	$299
12	50% Deduction[4]	50%*L11			$150	$150
13	Taxable income before expense alloc.	L11-L12			$150	$150
14	Expenses allocated to GILTI basket[5]				-	$50
15	GILTI for FTC limitation	L13 - L14			$150	$100
16	FTC limitation[6]	21%*L15			$31	$21
17	US tax before credit	21%*L13			$31	$31
18	Foreign tax credit[3]	Min(L10,L16,L17)			$31	$21
19	US Tax on High Return Amount	L17-L18			**$0**	**$11**

[1]Gross income reduced by ECI, subpart F income, income that would be subpart F but for high-tax exception, and FOGEI, less allocable deductions.

[2]Average of end-of-quarter adjusted bases in tangible depreciable property that generates tested income or loss, determined under ADS.

[3] A separate foreign tax credit limitation applies to GILTI income, with no carryforward or carryback of excess credits.

[4] The deduction is reduced to 37.5% for tax years beginning after 12/31/25.

[5] Interest, stewardship and research expenses allocable to income in the GILTI basket.

[6] Assumes US parent tax before credits is 21% of US parent taxable income.

Domestic Incentives for IP Ownership

UK: Patent Box

US: Foreign Derived Intangible Income (FDII)

Patent box

- Applies 10% of corporation tax to profits earned from patented inventions. Phased in from 1 April 2013, rate fully in place from 1 April 2017
- Only covers patented IP, so not things like trade marks or brands. UK patent law (like Germany, cf the US, France) follows an "apply, examine, grant" approach
    - Inevitably quite complex rules to determine the profits earned from patented inventions
    - rules are blind to whether the profits come from sales to UK customers or not
    - simplified rules for SMEs
    - more complex for MNEs

Patent box (cont’d)

- Changes made effective 1 July 2016 (with grandfathering to 2021)
  - ties eligible profits more closely to R&D expenditure input
  - reflects Germany-UK agreement and the BEPS report
  - compliant with the BEPS nexus approach, and so certified "not harmful" by the OECD after peer review
- Complies with the UK's international obligations, particularly the agreed BEPS output and the EU fundamental freedoms

Incentives for Ownership of IP (US)

Foreign Derived Intangible Income (FDII)

- FDII of a US corp. is eligible for a 37.5% deduction for tax years beginning after 12/31/17 and before 1/1/26, and a 21.875% deduction for tax years beginning after 12/31/25.
  - At a 21% corporate rate, this is a 13.125% rate initially and then a 16.4% rate.
- FDII is the "foreign percentage" of "Deemed Intangible Income" (DII).
- DII is the excess of deduction-eligible (tested) income over "deemed tangible income."
- Deduction-eligible (tested) income is the excess of gross income, excluding:
  - Foreign income subject to US tax (i.e., GILTI, subpart F, foreign branch income),
  - Financial services income, and
  - Domestic oil and gas extraction income,

  over allocable deductions (including taxes)
- "Deemed tangible income" is 10% of the adjusted basis in tangible property (determined using ADS depreciation)
- The "foreign percentage" of DII is the foreign-derived share of deduction-eligible income
  - Foreign-derived deduction-eligible income is deduction-eligible income from:
    - Property sold to a foreign person for foreign use
    - Services provided to a foreign person or with respect to foreign property

Example of US Tax on Foreign-Derived Intangible Income

Item		Formula	US Parent
1	Deduction eligible income (tested income)[1]		$100
2	Qualified Business Asset Investment[2]		$0
3	Net deemed tangible income	10%*L2	$0
4	Deemed intangible income	Max(0,L1-L3)	$100
5	Foreign-derived deduction eligible income[3]		$100
6	Foreign percentage	L5/L1	100%
7	FDII	L4*L6	$100
8	37.5% of foreign-derived intangible income[4]	37.5%*L7	$38
9	Taxable income attributable to deduction eligible income	L1-L8	$63
10	US tax	21%*L9	$13.13
11	**Tax benefit from foreign-derived intangible income**	21%*L7	**$7.88**

[1]Gross income of US corp. determined without regard to: subpart F income, GILTI, dividends from CFCs, domestic oil & gas extraction income, and foreign branch income.

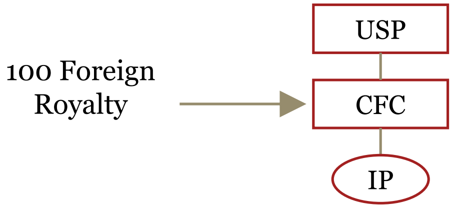
[2]Average of end-of-quarter adjusted bases in tangible depreciable property that generates tested income or loss, determined under alternative depreciation system.

[3]Property sold to a foreign person for use, consumption, or disposition outside the US and services provide to a person or with respect to property located outside the US. "Sale" includes lease, exchange or other disposition.

[4]The dedcution for FDII is reduced to 21.875% for tax years beginning after 12/31/25.

FDII vs. GILTI: Hold IP in US or Offshore?

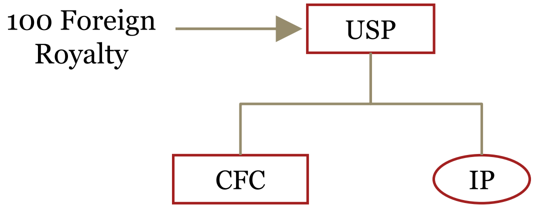
Offshore IP



Scenario

	A	B	C
Pre-tax Income	100	100	100
Foreign Taxes	0	13.125	15
Net CFC Tested Income	100	86.875	85
Less: Net Deemed Tangible Income Return (QBAI*10%)	-	-	-
GILTI	100	86.875	85
Sec. 78 Gross-up		13.125	15
Sec. 951A Inclusion (GILTI + Sec. 78 Gross-up)	100	100	100
Less: 50% Deduction for GILTI	(50)	(50)	(50)
Taxable Income	50	50	50
US Tax @ 21%	10.5	10.5	10.5
Less: Foreign Tax Credit	(0)	(10.5)	(10.5)
Residual US Tax	10.5	-	-
ETR	**10.5%**	**13.125%**	**15%**

Onshore IP



Deduction Eligible Income (DEI)	100
Less: Deemed Tangible Income Return (QBAI*10%)	-
Deemed Intangible Income (DII)	100
Percentage of Foreign-Derived Deduction Eligible Income (FDDEI) to Deduction Eligible Income (DEI)	100%
Foreign-Derived Intangible Income (FDII)	100
Less: 37.5% Deduction for FDII	(37.50)
Taxable Income	62.50
US Tax @ 21%	13.125
ETR	**13.125%**

Note: Based on FDII and GILTI rates applicable before 2026 and does not account for expense allocation.

Anti-Hybrid Rules

UK: Rules Compliant with BEPS Action 4

US: Tax Reform Act of 2017

Hybrids

- Rules introduced applicable from 1 January 2017, reflecting the agreed BEPS output under Action 4.
- The rules cover hybrid instruments (eg something that one country sees as debt while another regards it as equity), hybrid entities (such as one regarded as opaque by one country - like a limited company in the UK - but transparent by another), companies with PEs and dual resident companies (because they effectively have a "foot in two camps").
- The rules target cases where there's a deduction but no inclusion of income, double deductions and imported mismatches (where the effects of a hybrid mismatch arrangement are imported into the UK).
- The prime counteraction is to deny relief for the deduction claimed. Where that doesn't happen (because, for example, the deduction is in another country that doesn't have hybrid rules), the UK will charge the mismatch amount to UK tax (and so charge UK tax on an amount that wouldn't otherwise be taxed.

Anti-Hybrid Rules (US)

Tax Reform Act of 2017

- Tax Reform Act of 2017 denies deduction for interest or royalties where:
  - Paid to a related party,
  - Payment is excluded from gross income (or is deductible) under the tax law of the related party's country of residence (unless included in GILTI), and
  - The payment is part of a "hybrid transaction" or is paid by, or to, a "hybrid entity."
- A "hybrid transaction" is a transaction where one or more payments are treated as interest or royalties by the US but not under the tax law of a recipient's country of residence.
- A "hybrid entity" is one where the US treats the entity as fiscally transparent and the country where the entity is resident does not, and vice versa.
- Broad regulatory authority granted to Treasury, including to address: conduit arrangements, branches of US entities, structured transactions, tax preference regimes, hybrid dividends, and dual resident entities.

Questions?