Introduction to the BEAT (Base Erosion Anti-Abuse Tax) for investors in tax credit projects

By Forrest D. Milder

This alert discusses how the new Base Erosion Anti-Abuse Tax, or BEAT, a minimum tax adopted as new Section 59A of the Internal Revenue Code (the Code) by Public Law 115-97 (often, but unofficially, referred to as the "Tax Cuts and Jobs Act of 2017") may affect investments in tax credit projects. As discussed below, the BEAT only applies to certain taxpayers. Unfortunately, many of those taxpayers are also investors in projects that rely on tax credits, and the BEAT is computed in a way that may squander these credits, depending on the taxpayer's particular situation.

Overview

In an effort to minimize their tax liability, some American corporations with foreign affiliates (1) incur deductible fees to these affiliates and/or (2) direct gross income to these affiliates. These are referred to as "base erosion tax benefits." Using these tax benefits, these corporations reduce their American taxable income and their overall tax liability. The BEAT is intended to assure that companies that take advantage of this strategy still pay a minimum U.S. tax.

Here's how the new tax works:

The BEAT applies to "Applicable Taxpayers." These are corporations (other than regulated investment companies, REITS and S corporations) that have average annual gross receipts of at least $500 million for the most-recent three-year period and a "base erosion percentage" (more on this below) of 3 percent (2 percent for certain banks and securities dealers, including members of their affiliated groups) or more for that taxable year.

The base erosion percentage is computed by determining the company's base erosion tax benefits, and then dividing this amount by most of the corporation's other allowable deductions. The foreign affiliates taken into account are those that own at least 25 percent of the stock of the applicable taxpayer (by vote or value) or which satisfy a broad range of direct, indirect and constructive ownership tests.

Of course, this is a great oversimplification of how the math is done—there are complex definitions, rules and exceptions for doing these computations—but simply stated, the BEAT applies to corporations that (i) average mid-nine-figure revenues and (ii) have at least a small amount of deductions from, and/or shifting revenues to, certain affiliated foreign companies. On the other hand, corporations with smaller amounts of revenue, or which do not have foreign affiliates, can stop reading.

The Computations

From here, the computation of the BEAT is truly tortured, and features a maze of computations, on the order of "*compute the excess of A over B after reduction by a percentage of C*." I'll do my best to explain in as straight forward a way as possible. Please note that my defined terms are not taken from the Code; they are simply designed to make things easier to follow:

> **The Percentage Computation**. First, an applicable taxpayer computes its normal taxable income, but without claiming the deductions associated with otherwise-deductible payments to related foreign affiliates. It multiplies that amount by 5 percent for 2018, 10 percent for 2019 through 2024 and 12.5 percent in 2025 and later years; these percentages are increased to 6, 11 and 13.5 percent for certain banks and securities dealers. We'll call this amount the "Percentage Computation."
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> **Conventional Tax Liability.** The corporation also computes its conventional tax liability using the conventional tax system, including ***all of*** the effect of the tax credits (if any) found in Section 38 of the Code, which defines the "general business credit." This includes the research credit (R&D, found in Section 41), low-income (LIHTC, Section 42), renewable energy (RETC, including both the Section 48 investment tax credit and the Section 45 production tax credit), historic (HTC, Section 47) and new markets (NMTC, Section 45D) tax credits, as well as many others. We'll call this the corporation's "Conventional Tax Liability."
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> **Adjusted Conventional Tax Liability**. The corporation then adds back 100 percent of its R&D credits and 80 percent of its LIHTCs and RETCs, but none of any other Section 38 credits (e.g., it does not add back the HTC or NMTC) to its Conventional Tax Liability. We'll call this its "Adjusted Conventional Tax Liability." **Important note**: These percentage adjustments for certain tax credits go to zero starting with tax years that begin after 2025.
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> **The BEAT**. Next, the corporation subtracts its Adjusted Conventional Tax Liability from its Percentage Computation. If this is a positive number, it is the BEAT. If it is negative or zero, then the Corporation does not owe any BEAT.
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> **Total Tax Liability.** Finally, the corporation adds its Conventional Tax Liability to its BEAT to determine its total tax liability.

It can be hard to see at first, but the BEAT will likely have the effect of making certain credits more valuable for those affected taxpayers who are reducing their tax liability through deductions and reduced income associated with their foreign affiliates. Specifically, when you make your way through all the algebra, you'll see that 100 percent of an affected taxpayer's R&D credits can be used to offset its BEAT, as well as 80 percent of its low-income (LIHTC) and renewable energy (RETC) credits. However, ***none*** of its other Section 38 business credits, including the historic (HTC) and new markets (NMTC) tax credits, can be so used. As a result, the LIHTC and RETC have lost some of their effectiveness for these taxpayers, and the HTC and NMTC and other business credits have lost even more, possibly making them a less desirable investment for Applicable Taxpayers, depending on whether they are subject to the BEAT.

Three Illustrations

Here are a few illustrations of how the BEAT computation interacts with tax credits:

> **LIHTC or RETC Computation.** Assume that Corporation A is an Applicable Taxpayer and it is subject to the 21 percent regular tax rate and the 10 percent BEAT rate that applies to most corporations in 2019. Suppose that it has $20,000 of income, less $10,000 of deductions not attributable to base erosion, as well as a deductible payment to a foreign affiliate of $5,500 that is considered a base erosion tax benefit. Further presume that it has an LIHTC or RETC of $100. On these facts, A's Conventional Tax Liability is $20,000 of income less $15,500 of all deductions (including the ones attributable to its foreign affiliate), multiplied by the 21 percent corporate tax rate, or $945 of tax, further reduced by its $100 of LIHTC or RETC to $845.
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> Now, let's compute the BEAT. First, the Percentage Computation is as follows: $20,000 of income less $10,000 of non-base-erosion deductions multiplied by 10 percent, or $1,000. Note that the $5,500 of deductions attributable to its foreign affiliate is not part of this computation. Next, we compute the corporation's Adjusted Conventional Tax Liability. We start with its Conventional Tax Liability of $845, and add back 80 percent of its LIHTC or RETC, or $80, to get $925. We now subtract this Adjusted Conventional Tax Liability ($925) from the Percentage Computation ($1,000), yielding the corporation's BEAT of $75. And finally, we get to the corporation's total tax liability, namely its Conventional Tax Liability of $845 (note that this takes tax credits into account) plus the BEAT of $75, or a total of $920.
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> **NMTC or HTC Computation.** Assume the same facts as before, ***except*** that A had $100 of NMTC or HTC, and no other tax credits. A's Conventional Tax Liability would be as before: $945 less $100 of NMTC or HTC, or $845. The Percentage Computation would also stay the same, i.e., $1,000, as described above. However, its Adjusted Conventional Tax Liability would be different from the last example, because unlike the LIHTC or RETC, where 80 percent of the credit is added back, ***none*** of the NMTC or HTC is added back. So, this time, the corporation's Adjusted Conventional Tax Liability would be the same as its Conventional Tax Liability, or $845. Accordingly, the BEAT would be the Percentage Computation, $1,000 less A's Adjusted Conventional Tax Liability, $845, or $155. Note that this is $80 higher than it was when A had a $100 LIHTC or RETC. Finally, A's total tax liability—$845 of conventional tax liability plus $155 of BEAT, would total $1,000. This, too, is $80 higher than in the LIHTC/RETC example.
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> **No Tax Credits**. Finally, assume that A had no tax credits. This time, A's Conventional Tax Liability would be $945, because there are no tax credits to affect A's tax liability. The Percentage Computation would still be $1,000, as described above. And with no tax credits, A's Adjusted Conventional Tax Liability would be the same as its Conventional Tax Liability, or $945. So, the BEAT would be the Percentage Computation, $1,000 less A's Adjusted Conventional Tax Liability, $945, or $55. And, A's total tax liability—$945 of conventional tax liability plus $55 of BEAT—totals $1,000, just as it did with the NMTC or HTC.

To summarize, in computing its BEAT, corporation A got $80 of benefit from its $100 of LIHTC or RETC (total tax bill of $920), but it didn't get ***any*** benefit from its $100 of NMTC or HTC (total tax bill of $1,000 with or without the NMTC/HTC).

Takeaways

A few important observations about the BEAT:

— First, the BEAT can be ***retroactive***. It can apply to tax credits generated by previously closed transactions for which the tax credit accrues after the BEAT became law. For example, if a corporation invested in an LIHTC transaction in 2016, with a ten-year credit period running from 2017 through 2026, then starting in 2018, the computation of the BEAT might make the LIHTC worth less, even though the investment was made before the BEAT even existed. Indeed, in 2026, when the BEAT adjustment for the LIHTC falls to zero, the LIHTC ***might*** not be worth anything. There can be similar consequences if the corporation invested in a 10-year wind PTC transaction or a seven-year NMTC transaction before the BEAT was adopted.

— Second, it is hard to calculate how the BEAT will affect any particular applicable taxpayer, because the computation depends on whether the BEAT is larger than the corporation's conventional tax liability, and this comparison can vary greatly from year-to-year. For example, assume that a taxpayer's Percentage Computation is $1,000, but its Conventional Tax Liability is $2,000, and it has $200 of tax credits. On those facts, the corporation's Conventional Tax Liability, even after allowing for its tax credits, is $1,800, and this is already larger than the Percentage Computation. Accordingly, the BEAT will not affect this corporation's tax liability or its ability to use the credits. On the other hand, another corporation might have facts like those in my first illustration, and its tax credits would be worthless.

— Finally, don't forget the floors and minimums. Corporations with less than $500 million of average annual revenue, or a base erosion percentage that is less than 3 percent (2 percent for certain banks and securities dealers) won't be subject to the BEAT, and can stop thinking about it.

For more information on the new tax law and its application to tax credits, please contact your Nixon Peabody attorney or:

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