Taxpayers may be able to reduce BEAT liability by increasing cost of goods sold

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In brief

The base erosion and anti-abuse tax (BEAT), enacted as Section 59A by the 2017 tax reform legislation (the Act), imposes a tax on base erosion payments, which include amounts a taxpayer pays or accrues to a related foreign person that the taxpayer may deduct. Costs recovered through cost of goods sold (COGS) are subtracted from gross receipts and are not deductions. Thus, a payment to a related foreign person that is included in COGS generally is not a base erosion payment subject to BEAT. Accordingly, a taxpayer may be able to reduce its BEAT liability by increasing COGS, particularly by using the uniform capitalization (UNICAP) rules under Section 263A.

In detail

BEAT

The BEAT applies to base erosion payments by an applicable taxpayer in tax years beginning after December 31, 2017. A base erosion payment generally is an amount a taxpayer pays or accrues to a related foreign person (1) for which a deduction is allowable, (2) in connection with the acquisition of property subject to depreciation or amortization, or (3) for certain reinsurance payments. A base erosion payment also includes an amount paid or accrued to an entity that became a surrogate foreign corporation (SFC) after November 9, 2017, or a member of an SFC’s expanded affiliated group, if the payment reduces the taxpayer’s gross receipts.

An applicable taxpayer is a corporation (other than a RIC, REIT, or S corporation) with average annual gross receipts for the three preceding tax years of at least $500 million and a base erosion percentage of at least 3% (2% in the case of certain banks and registered securities dealers). The base erosion percentage is determined, in general, by dividing the amount of all base erosion tax benefits by the sum of most deductions and certain base erosion tax payments.

The BEAT is equal to the excess of (1) the BEAT applicable rate for the tax year multiplied by the taxpayer’s modified taxable income over (2) the taxpayer’s regular tax liability.

- The BEAT applicable rate is 5% for tax years beginning in 2018, 10% for tax years beginning on or before December 31, 2025, and 12.5% for tax years beginning after December 31, 2025. The applicable rate for banks and security dealers is one percentage point higher (6% for tax years beginning in 2018, 11% for...
tax years beginning on or before December 31, 2025, and 13.5% for tax years beginning after December 31, 2025).

- Modified taxable income is the taxpayer's taxable income without regard to (1) the tax benefits resulting from base erosion payments and (2) the net operating loss deduction allowed for the tax year multiplied by the base erosion percentage.

- In the BEAT computation in tax years beginning on or before December 31, 2025, regular tax liability is reduced by credits, with certain addbacks (for example, the Section 41 research credit). For tax years beginning after 2025, regular tax liability is reduced by all credits.

See PwC's Tax reform readiness: Base erosion and anti-abuse tax for more detail on BEAT.

**COGS**

**Overview**

COGS is the means by which a taxpayer that maintains inventories recovers the costs allocated to inventory that has been sold. COGS is equal to (1) the sum of (a) the value of inventory held by the taxpayer at the beginning of the tax year, (b) the amount of inventory purchases, (c) the cost of labor, (d) additional Section 263A costs, and (e) other costs allocable to the inventory, less (2) the value of inventory on hand at the end of the tax year.

For a taxpayer that maintains inventories, gross income is gross receipts less COGS. As noted in the Conference Report on the Act, “base erosion payments do not include... payments for cost of goods sold.” H. Rpt 115-466, p. 657. Thus, amounts paid or accrued to a related foreign person and recovered through COGS are treated favorably under the BEAT and generally are not base erosion payments subject to the BEAT.

**Increasing COGS by capitalizing costs under Section 263A (UNICAP)**

Section 263A specifies that direct and allocable indirect costs of property that a taxpayer produces or acquires for resale must be capitalized to inventory. Sales-based royalties and management fees are two types of costs that may be capitalizable under Section 263A. However, taxpayers often improperly omit these costs from COGS and instead take these costs as a “below-the-line” deduction that is not part of COGS.

Sales-based royalties are the licensing fees, payments, and royalty costs related to the use of intellectual property that become due upon the sale of property produced or acquired for resale. Sales-based royalties related directly or indirectly to purchasing, production, storage, or handling of inventory are capitalizable under Section 263A. Regulations under Section 263A permit taxpayers to allocate capitalizable sales-based royalties entirely to property that has been sold. A taxpayer generally may recover these costs in the year paid or accrued as part of its COGS.

Accordingly, capitalizable sales-based royalties paid to a related foreign party are excluded from the taxpayer's base erosion payments if the costs are properly capitalized and included in COGS under Section 263A. However, sales-based royalties attributable solely to deductible activities, such as sales and marketing, are not capitalizable under Section 263A and may be base erosion payments subject to the BEAT if paid to a related foreign party.

Management fees may be capitalizable under Section 263A to the extent the services relate directly or indirectly to purchasing, production, storage, or handling of inventory. Thus, a management fee paid to a related foreign person for assistance with the sourcing of raw materials is capitalizable under Section 263A. A management fee for assistance with human resources, accounting, or information systems is a mixed service cost, a portion of which may be capitalizable under Section 263A. In either case, the amounts capitalized under Section 263A and recovered as COGS are not subject to the BEAT. However, management fees attributable solely to deductible activities, such as sales and marketing, are not capitalizable under Section 263A and may be base erosion payments subject to the BEAT if paid to a related foreign party.

**Observation:** A taxpayer that currently is not capitalizing sales-based royalties, management fees, or other costs under UNICAP may request a change in method of accounting by filing Form 3115, Application for Change in Accounting Method. Whether a change to a taxpayer's method for capitalizing costs under Section 263A must be filed under the automatic method change procedures or the non-automatic method change procedures depends on the taxpayer’s facts and circumstances. Most changes under Section 263A qualify for the automatic method change procedures.

**The takeaway**

Taxpayers may want to review their costs to identify amounts paid or accrued to related foreign persons that may be capitalizable to inventory and recovered through COGS, which may reduce their BEAT exposure.
Let’s talk
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