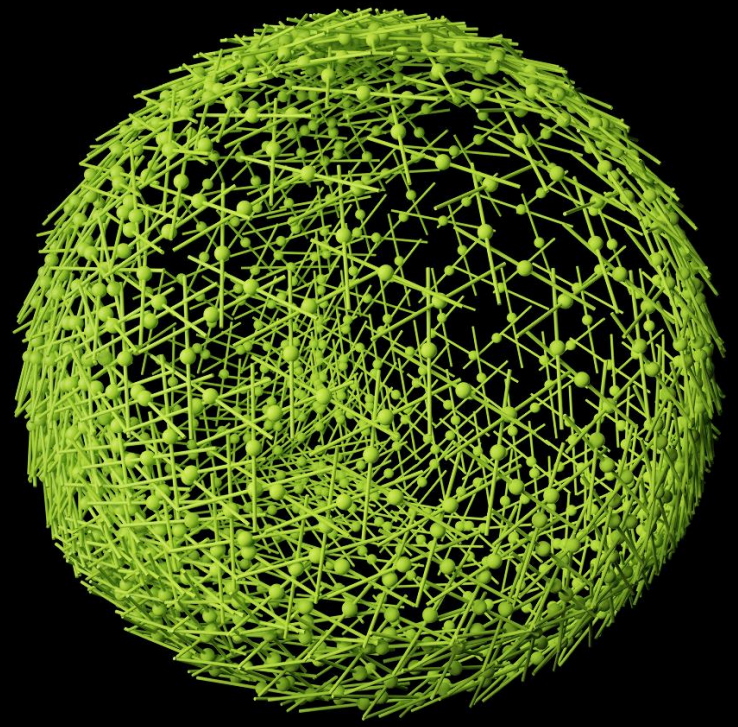
Deloitte.



Recent changes in the US taxation laws

25 April 2024

Notable Aspects of Section 174 Applicable to Tax Years beginning after December 31, 2021

- For tax years beginning after December 31, 2021, taxpayers are not able to currently deduct R&E expenditures; rather, taxpayers must capitalize and amortize R&E expenditures over a period of 5 or 15 years, depending on the location of the activities resulting in the R&E expenditures (5 years for U.S.-based and 15 years for foreign-based activities).
  - Amortisation begins at the midpoint of the taxable year in which such R&E expenditures are incurred and generally ends at the midpoint of the final year of amortization (meaning costs are effectively recovered either over 6 or 16 years for domestic or foreign research, respectively).

Proposed section 174 legislation

Proposed amendments to section 174 including the follow highlights:

- Suspends mandatory capitalization under section 174 for U.S. research to taxable years beginning after December 31, 2025
- In the interim, taxpayers would be permitted to:
  - Currently expense R&E expenditures as a deduction during the taxable year paid or incurred
  - Elect to defer certain types of R&E expenditures over a period of no less than 60 months
  - Elect to capitalize R&E expenditures
- Transition rules would allow taxpayers additional options for effecting the retroactive change in law (i.e. instead of amended prior year tax returns)

Notice 2023-63 Background

- On September 8, 2023, Treasury and IRS issued Notice 2023-63 providing interim guidance on:
  - The requirement to capitalize and amortize specified research or experimental (SRE) expenditures under section 174
  - Treatment of SRE expenditures for percentage of completion method under section 460
  - Cost sharing arrangements involving SRE expenditures under section 482
- On December 22, 2023, the government issued **Notice 2024-12** clarifying and modifying certain provisions of Notice 2023-63, and **Rev. Proc. 2024-9,** which provides automatic consent accounting method change procedures to apply certain of the provisions of Notice 2023-63, as modified by Notice 2024-12.

Notice 2023-63 Contract Research

- Notice 2023-63 provides if a Research Provider **does not bear financial risk** under the terms of the contract **AND does not have the right to use any resulting SRE product** in its trade or business or otherwise exploit any resulting SRE Product through sale, lease, or license ("SRE product right"), then research costs paid or incurred by the Research Provider pursuant to the contract are **not** SRE expenditures.
- Notice 2024-12 clarifies that if a Research Provider that **does not bear financial risk** under the terms of the contract with the Research Recipient **obtains an "excluded SRE product right,"** but does not obtain any other SRE product right under the terms of such contract, then the research costs paid or incurred by the Research Provider pursuant to the contract are **not** SRE expenditures.
  - An **"excluded SRE product right"** is an SRE product right that:
    - Is separately bargained for (i.e., an SRE product right that arose from consideration other than the cost paid or incurred by the research provider to perform SRE activities under that contract), or
    - Was acquired for the limited purpose of performing SRE activities under that contract or another contract with the Research Recipient.
- Consider potential collateral impacts of U.S. Research Provider costs falling outside of the scope of section 174

Notice 2024-12

Removal of Consistency Requirement in Notice 2023-63 and Clarification on Rev. Proc. 2000-50

- Removal of consistency requirement in Notice 2023-63.
  - Permits taxpayers to apply some, but not all provisions of Notice 2023-63.
  - Taxpayers may not rely on the disposition rules for SRE expenditures paid or incurred with respect to property that is contributed to, distributed from, or transferred from a partnership.
- Clarification of obsolescence of Rev. Proc. 2000-50.
  - Taxpayers may continue to rely on Rev. Proc. 2000-50 for software development costs paid or incurred in taxable years beginning on or before December 31, 2021.

Rev. Proc. 2024-9

Section 7.02 of Rev. Proc. 2023-24: Change in Method of Accounting for SRE Expenditures

- Taxpayers may benefit from a “gap” analysis to determine the extent to which the methodology employed to determine section 174 expenditures in 2022 differed from the methodology prescribed by Notice 2023-63. In addition to contract research guidance was also provided on many areas of uncertainty, notably:
  - **Meaning of “Software Development”**
  - **Type of indirect costs to be included as section 174 expenditures**
  - **Limitations on basis recovery upon the sale of property resulting from research**
- Procedural guidance provide taxpayers administrative options for adopting the Notice (even if a different approach was applied on the 2022 return)

Simplified US Tax Computation: BEAT

Section 61 gross income and inclusions (GILTI, Subpart F, gross-up, etc.) (less) deductions (incl. section 163(j), NOL, 245A DRD, 250 deduction)

= Taxable income

* 21%

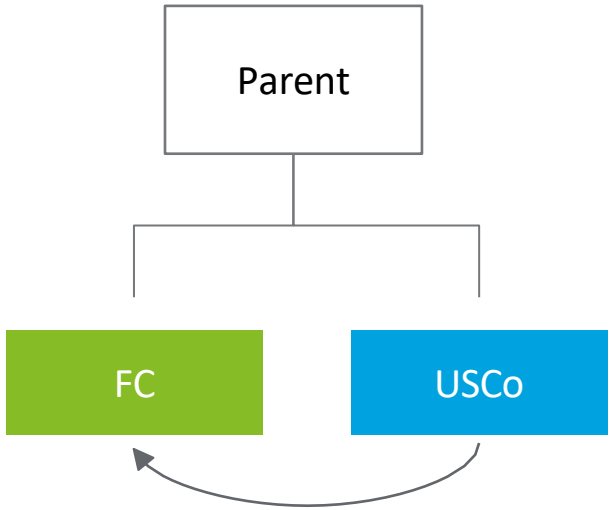
= Regular income tax liability (RTL) (less) FTCs and other credits

+ BEAT liability (base erosion minimum tax amount)

= Total tax

BEAT overview—Section 59A

- Section 59A was enacted by the Tax Cuts and Jobs Act ("TCJA") in part to mitigate the erosion of the U.S. tax base through deductible payments made to foreign related parties.
- BEAT is a minimum tax computation for corporations. If applicable, BEAT imposes an additional corporate minimum tax on the taxpayer and can apply in a tax year in which the taxpayer has no regular taxable income or a net operating loss.



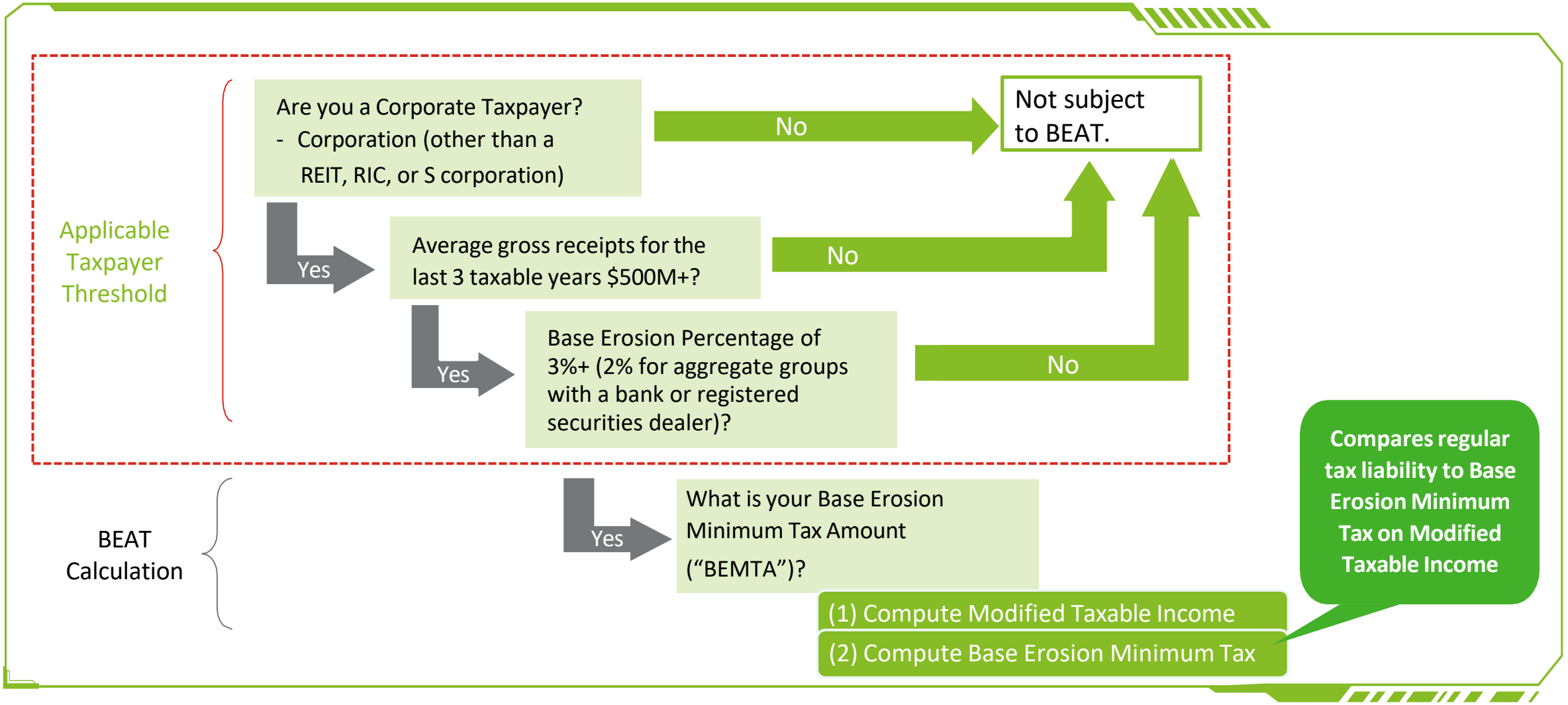
$200 base erosion payment (not subject to WHT)

USCo:

	$500	Gross Income
-	$200	Allowed Deduction for payment to FC
=	$300	Taxable Income
x	21%	Corporate rate
=	$ 63	US federal income tax

$500	Taxable Income (w/o deduction)
$105	US federal income tax (w/o deduction)
$ 42	**"Lost" US tax revenue**

The BEAT decision tree



Base erosion minimum tax amount

Where BEMTA is greater than zero, an applicable taxpayer must pay BEMTA as well as its tax liability imposed under section 11 of the Code

Applicable Taxpayer's **BEMTA**	=	**BEAT Rate**	X	**Modified Taxable Income**	–	**Regular Tax Liability** less Tax Credits (excluding—until 2026—section 41(a) research credit and up to 80% of " applicable section 38 credits")

BEAT Rate

- 10% for tax years beginning after 2018 and before December 31, 2025
- 12.5% for tax years beginning after December 31, 2025
- Rates are increased by 1% for a taxpayer that is a member of an affiliated group which includes certain banks or registered securities dealers. *See* section 59A(b)(3)

Modified Taxable Income

- Taxable income, determined without regard to
  - BETBs (i.e., BETBs are "added back" to taxable income); and
  - BE % of NOL utilized (determined by applying BE % of the "vintage year" in which the NOL arose)

Regular Tax Liability

- Generally, the tax imposed by section 11 pre-credit (see section 26(b))
- Any credits under sections 33, 37, and 53 do not reduce regular tax liability
- Applicable section 38 credits:
  - Section 42(a) low-income housing credit
  - Section 45(a) renewable electricity production credit
  - Section 46 investment credit allocable to section 48 energy credit

Applicable taxpayer

Section 59A(e)(1) provides that an applicable taxpayer subject to BEAT must be a taxpayer* that satisfies ALL of the following requirements:

1. Corporation	**Taxpayer must be corporation** (other than a REIT, RIC, or S corporation).
2. Average annual gross receipts of at least $500 million (gross receipts test)	Taxpayer's **average annual gross receipts are at least $500 million for the previous 3 taxable years** [taking into account related US corporations' gross receipts, and in the case of a foreign taxpayer, gross receipts attributable to effectively connected income (ECI)].
3. Base erosion percentage is at least 3% (BE % test)	Taxpayer's **base erosion percentage** (*i.e.*, BETBs, divided by total deductions) **is at least 3%** (2% in the case of member of affiliated group that includes a bank or registered securities dealers).

***Aggregation Rule:**
Whether a taxpayer is an applicable taxpayer is determined by treating **all persons treated as a single employer under section 52(a) as a single taxpayer.**

****Gross Receipts: p**ursuant to Treas. Reg. §1.59A-1(b)(13), the term "gross receipts" has the meaning provided in Treas. Reg. §1. 448- 1T(f)(2)(iv), which provides that gross receipts include receipts properly recognized under the taxpayer's accounting method used in that taxable year for U.S. federal income tax purposes.

- Gross Receipts include total sales (net of returns and allowances) and all amounts received for services
- Gross Receipts also include any income from investments, and from incidental or outside sources, including interest income.

Applicable taxpayer (cont.)

Other Considerations:	
1. Short years	Generally, any taxpayer with a taxable year of less than 12 months must **annualize its gross receipts from the short taxable year (annualization rule).**
2. Corporations not in existence for the entire 3-year period	If a taxpayer was not in existence for the entire three-year period referred to in the gross receipts test, the taxpayer determines a gross receipts average for the period that it was in existence (which includes gross receipts in the current year). *See* Treas. Reg. § 1.59A-2(d)(2).
3. Members leaving/joining aggregate group	Generally, the tax year of a member joining/leaving a taxpayer's aggregate group is deemed to end immediately before joining/leaving such group. Thus, items of a member that occur **before such member joins the taxpayer's aggregate group are not taken into account** for purposes of determining gross receipts and BE% of taxpayer's aggregate groups. However, gross receipts of the aggregate group are **not reduced as result of a member leaving the taxable group.**
4. Predecessors	**Any reference to a taxpayer includes any predecessor of the taxpayer for purposes of the gross receipts test.** Predecessors expressly include the distributor or transferor corporation in a section 381(a) transaction in which the taxpayer is the acquiring corporation.

Base erosion percentage (BE %)

Base Erosion Percentage = $\dfrac{\text{Aggregate amount of Base Erosion Tax Benefits (BETBs)}}{\text{Aggregate amount of allowable deductions (including BETBs)} + \text{other BETBs that are reductions to gross receipts} - \text{Deductions allowed under sections 172, 245A, or 250} - \text{Deductions excluded from BEPS under: section59A(d)(5) SCM exception; section 59A(h) QDP exception; Treas. Reg. § 1.59A-3(b)(3)(iv) exchange loss exception}}$

Common BETBs include:

- Deducted amounts paid or accrued to a foreign related party (generally, 25% “relatedness” test).
- Depreciation/amortization deductions in connection with the acquisition of property from a foreign related party in a recognition transaction.
- Mark-up portion of payments eligible for services cost method described in Treas. Reg. § 1.482-9

Common BETBs do not include:

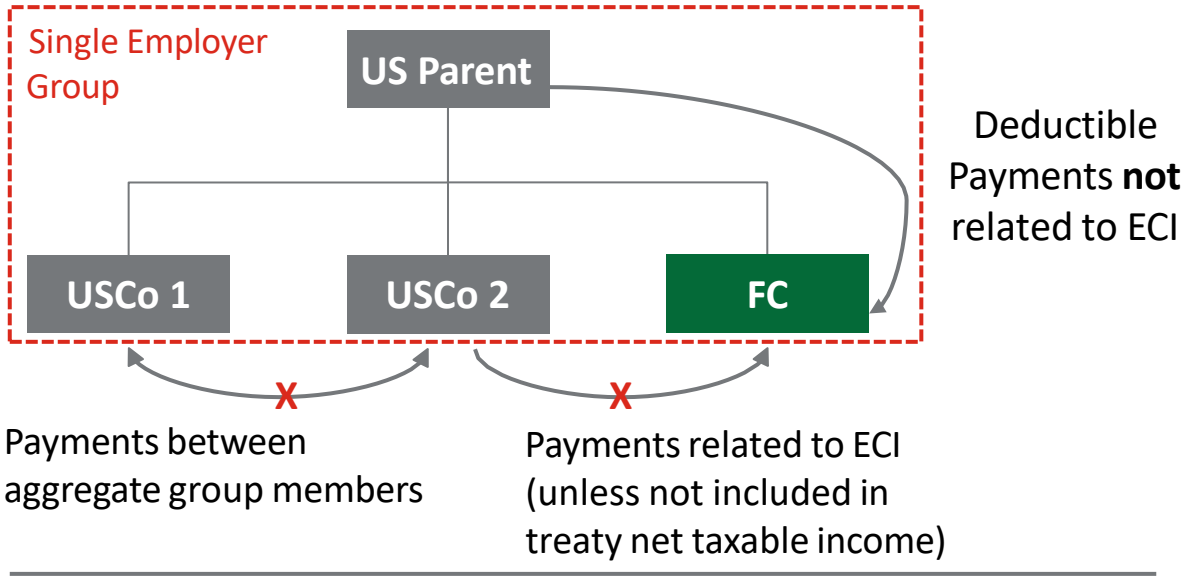
- Deductions for BEPs taxed at 30% under sections 871 or 881 and sections 1441 or 1442.
- Generally, reductions in gross profit for costs of goods sold.
- At-cost portion of payments for the costs of services that qualify for the BEAT SCM exception under section 59A(d)(5).
- Deductions for “Qualified derivative payments" (“QDPs”) under 59A(h).
- Amounts for which deductions are not claimed (*e.g.*, deductions waived under Treas. Reg. § 1.59A-3(c)(6), interest disallowed under section 163(j)).

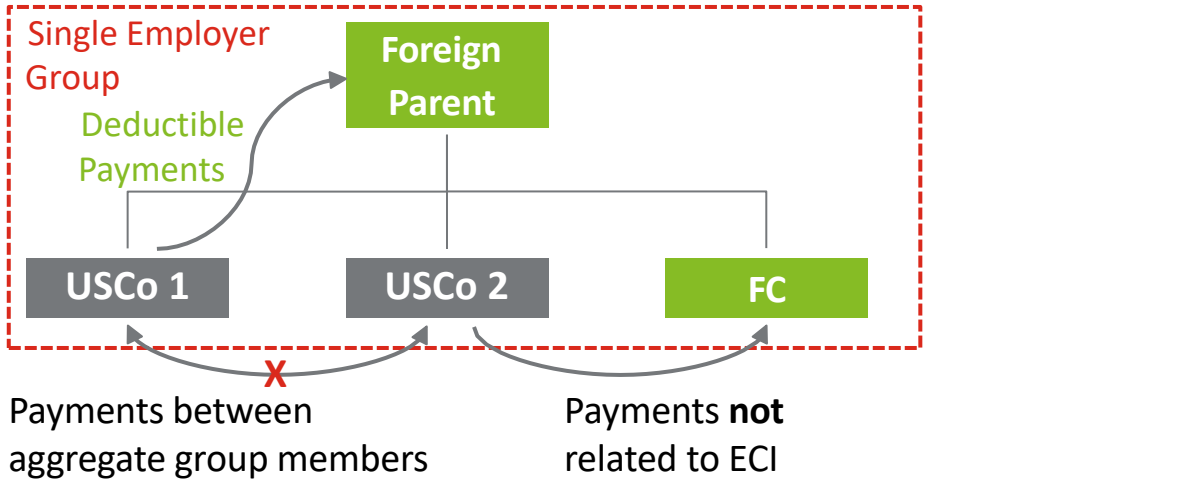
Aggregation rule—Single employer

Section 59A(e)(3) treats all persons that are treated as a single employer under section 52(a) (with certain modifications discussed below) as one person for purposes of applying the gross receipts test and BE % test.

1. Single employer under section 52(a)	Generally, all corporations that are members of the **same controlled group of corporations** are treated as a single employer. Controlled group of corporations is defined by reference to section 1563(a), **except the ownership threshold is reduced from at least 80% to more than 50% vote or value.**
2. Inclusion of foreign corporations	Foreign corporations can be members of the aggregate group. However, foreign corporations are outside the aggregate group to the extent their operations do not generate income taxable (after applying treaty, if any) under section 11. As a result, payment by taxpayer to foreign aggregate group member that bears net- basis US tax on the payment is not a BEP.

Applicable taxpayer—Aggregation rule





- **Aggregate Group:** Generally, taxpayers treated as a single employer under section 52(a) are treated as single taxpayer for purposes of:
  - BE % and BE % Test; and
  - Gross Receipts Test

  Disregard payments labeled **X**
- Generally, transactions between aggregate group members are **not taken into account**.
- If aggregate group member is a **foreign corporation**, intercompany transactions related to ECI or computation of net taxable income under a treaty are disregarded.
- For aggregate group members with different tax year-ends, special rules apply.

SCM under section 482

What?

Under section 59A(d)(5) and Treas. Reg. § 1.59A-3(b)(3(i), the at-cost portion of payments for services that qualify for the section 482 SCM in accordance with Treas. Reg. § 1.482-9, are not treated as BEPs.

Impact?

Reduce BEAT impact:

- Certain costs used to calculate services fees are excepted
- Only the mark-up is treated as a BEP.

Conditions?

- SCM rules specifically exclude some services from the exception and purposely allow some services to be excepted.
- Low margin covered services that are not explicitly listed in either list (for which the median comparable markup does not exceed 7%) may be eligible for only the mark-up to be considered a BEP.
- Business judgement test in SCM does not apply to determination of whether a payment is considered a BEP.
- Permanent books of account and records must be maintained for as long as the costs with respect to the services are incurred by the renderer. The books and records must be adequate to permit verification by the Commissioner of the amount charged for the services and the total services costs incurred by the renderer.

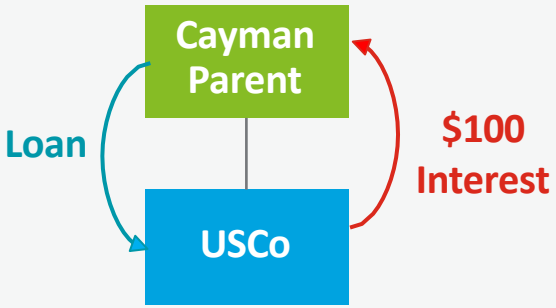
ECI exception – Example

- A BEP does not include an amount paid or accrued to a foreign related party subject to tax as ECI, provided taxpayer receives a withholding certificate on which the foreign related party claims an exemption from withholding under sections 1441 or 1442 because the amounts are ECI (e.g., W8-ECI). See Treas. Reg. § 1.59A-3(b)(3)(iii).
- – Requires a Form W-8ECI withholding certificate.

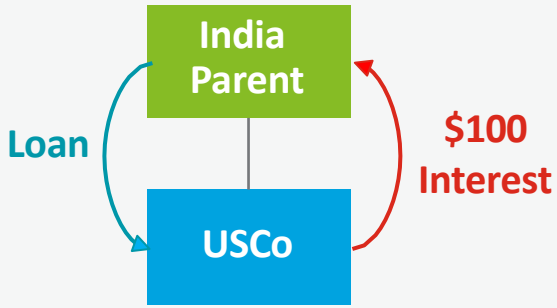
Payments subject to WHT

Reduction to Base Erosion Payments where subject to withholding tax ("WHT")x	
Section 881	Imposes a tax of 30% on the amount received by a foreign corporation as US-sourced fixed, determinable, annual, and periodic ("FDAP") income, which includes: • Dividends • Interest • Rents • Royalties
Sections 1441 and 1442	Imposes a requirement on all persons having control, receipt, custody, etc. of such payments **to deduct and withhold 30% from payments**. However, the 30% WHT rate can be reduced under an applicable tax treaty.
Section 59A(c)(2)(B)	Provides that if tax is imposed by section 871 or 881 and that tax has been deducted and withheld under sections 1441 or 1442 on a BEP, the **BETB attributable to the BEP is <u>not</u> treated as a BETB for purposes of calculating a taxpayer's modified taxable income (MTI).** If the amount of withholding imposed on the base erosion payment is **reduced under an income tax treaty, the BEP is treated as a BETB to the extent of the reduction in withholding.**
Treas. Reg. § 1.59A-3(c)(3)	If any tax treaty between the US and a foreign country reduces the US WHT rate, then the **amount of base erosion tax benefit that is not taken into account** in calculating both MTI and BE% equals: $\text{BETB not taken into account} = \text{BETB before reduction} \times \frac{\text{WHT rate imposed (30\%)} - \text{WHT rate imposed under tax treaty}}{\text{WHT rate imposed without regard to tax treaty (30\%)}}$

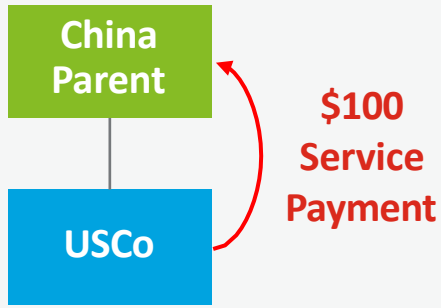
Payments subject to WHT (cont.)



- No U.S.-Cayman tax treaty
- WHT: $100 x 30% = $30
- No BETB associated with the interest payment



- WHT rate reduced to 15% under U.S.-India tax treaty
- WHT: $100 x 15% = $15
- BETB: $100 x (30% - 15%) / 30% = $50



- Services are **not** subject to WHT, so the entire amount is includible in the calculations of MTI and BE%
- BETB: $100 (assuming services do not qualify for SCM exception)

Thank you!

Kindly spare a minute to help us with your valuable feedback for today’s session…

For any queries, please feel free to write to us at intax@deloitte.com

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