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Skipping a BEAT: Skipping a BEAT: To NOL, or Not to NOL, That Is the Question!

As often characterized, the base erosion anti-abuse tax ("BEAT") functions as a minimum tax that applies to the extent that a taxpayer’s BEAT liability, calculated based on modified taxable income ("MTI") multiplied by the 10% BEAT rate,\(^1\) exceeds the taxpayer’s regular tax liability. MTI is a taxpayer’s regular taxable income, excluding deductions for:

1. Base erosion tax benefits ("BETBs") with respect to any base erosion payment; and
2. The base erosion percentage of any net operating loss ("NOL") deduction allowed for the taxable year.

In this installment of our "Skipping a BEAT" series, we take a closer look at the impact of the Proposed Regulations\(^2\) on the compliance burden for taxpayers with NOL carryovers, as well as, a punitive impact of utilizing NOLs.

\(^1\) Such rate is 5 percent for taxable years beginning in calendar year 2018 and 12.5 percent for taxable years beginning after December 31, 2025. Sections 59A(b)(1)(A) and (b)(2)(A).
Compliance with BEAT Rules

The BEAT rules may appear at first glance to have a limited effect on a taxpayer’s recordkeeping responsibilities with respect to NOLs. That is because, unlike the former corporate alternative minimum tax, the calculation of MTI does not require a separate determination of when NOL carryovers may be utilized. However, taxpayers must now track the base erosion percentage of each NOL that is available to be carried forward and maintain that information for a (potentially) longer period of time than under pre-TCJA law due to the indefinite carryforward of post-2017 NOLs. The foregoing may represent a significant compliance burden for some corporate taxpayers that must already apply multiple provisions of the federal income tax law to calculate their NOL deductions each year.

As noted above, taxpayers must calculate MTI by adding back to regular taxable income the base erosion percentage of NOL deductions allowed in a given year (to give the effect of excluding a portion of the deduction). The statute provides rules for calculating the base erosion percentage in general, but does not specify whether the base erosion percentage to be used for the addback is that of the year in which the NOL arose or the year to which the NOL is carried. The Proposed Regulations clarify that:

1. The base erosion percentage of an NOL deduction is the percentage in the year the NOL arose; and
2. The base erosion percentages for NOLs sustained in a taxable year beginning before January 1, 2018 is zero.

Thus, for all years beginning in 2018 or later, taxpayers must continue to track the base erosion percentage of their NOLs until they are fully utilized.

For inbound groups, which often have more than one US consolidated group, the “aggregate group” rules add another layer of complexity to the tracking requirements described above. Though section 59A(c)(4) defines the base erosion percentage by reference to the BETBs and other deductions of a “taxpayer,” multiple related US consolidated groups are combined for this purpose under the aggregation rules of section 59A(e)(3). It follows that NOLs sustained by one US consolidated group may become “tainted” by the base erosion payments of a related US consolidated group owned by the same foreign parent, even if the former has never made any base erosion payments. The timing of recognition of items of income and deduction by one domestic subsidiary (which affect the aggregate group’s base erosion percentage) may therefore affect the ability of another domestic subsidiary to benefit from NOL carryovers.

The foregoing considerations also extend to the acquisition of a US Target from an unrelated seller. Consider a situation where a US Target was historically below the $500 million revenue threshold under section 59A(e)(1)(B) and has significant NOL carryovers from post-2017 years. Such US Target is unlikely to keep track of its base erosion percentage. However, post-acquisition, when combined with the US activities of the buyer, the threshold requirements of section 59A(e)(1)(B) are likely to be met, such that US Target comes into the purview of the BEAT rules. Going forward, taxpayers must track the base erosion percentage of NOL deductions allowed in a given year (to give the effect of excluding a portion of the deduction).

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3 A separate NOL deduction was a feature of the corporate alternative minimum tax (“AMT”) prior to its repeal by section 12001 of the 2017 Tax Cuts and Jobs Act “TCJA”. See sections 55 through 59 prior to amendment by the TCJA.
4 See section 172. Prior to its amendment by the TCJA, section 172(b)(1)(A) only permitted a 20-year carryforward for NOLs.
5 For example, all taxpayers must track NOLs by the year sustained and by the taxpayer (e.g., a single domestic corporation or consolidated group) that sustained them. Taxpayers that are acquisitive must keep track of the information required to apply sections 382 and 384 when acquiring domestic corporations. Further, taxpayers filing consolidated US federal income tax returns must apply the complicated consolidated return rules to track NOLs that are brought into their consolidated groups by joining members and that may leave the group when members depart.
6 Section 59(c)(1)(B).
7 It is unclear from the plain language of the statute whether the rule refers to the base erosion percentage for the year in which a NOL is sustained or the year in which the resulting NOL carryover is deducted. See section 59A(c)(4).
9 Generally, the base erosion percentage calculated as a taxpayer’s BETBs, divided by the taxpayer’s total deductions (with certain exceptions, e.g., for NOL deductions) for the year. See section 59A(c)(4) and Prop. Reg. § 1.59A-2(e)(3).
10 Section 59(e)(3) provides that “All persons treated as a single employer under subsection (a) of section 52 shall be treated as 1 person for purposes of this subsection and subsection (c)(4).” Subsection (c)(4) provides rules for calculating a taxpayer’s base erosion percentage. See the prior installment of the Skipping a BEAT series, “Skipping a BEAT: Members Only,” published in June 2019 for additional discussion related to qualification of applicable taxpayers.
forward, when utilizing US Target’s NOLs, its base erosion percentage needs to be determined for relevant historical years and applied in the computation of its MTI. This puts pressure on the due diligence process by the buyer in ensuring that there is sufficient data to determine the base erosion percentage of the US Target for the post-2017 years in which the NOLs were incurred.

### Importance of Timing of Income and Deductions

As noted above, the base erosion percentage of a taxpayer’s NOL carryover is permanently excluded as a deduction for MTI purposes. Thus, it should be important to most corporate taxpayers to enhance the portions of their NOL carryovers that can offset both regular taxable income and MTI. This consideration is of particular importance in the M&A context, where transactions often affect the timing of income and deductions (e.g., due to qualification of acquired assets for 100% expensing under section 168(k), section 382 limitations on the use of NOL carryovers, etc.).

To illustrate the importance of the timing of income and deductions as it affects the value of post-2017 NOL carryovers in the context of an acquisition, let’s assume that FP, a foreign corporation that is not engaged in a US trade or business, wholly owns two US corporations, US1 and US2, each of which is a calendar year taxpayer. Further suppose that FP formed US2 for purposes of acquiring a business from an unrelated party in an asset acquisition, and US2 completes that acquisition in 2019. US1 and US2 have the following income and deductions in 2019 and 2020:

<table>
<thead>
<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income</td>
<td>$200x</td>
<td>$200x</td>
<td>$50x</td>
<td>$62.5x</td>
</tr>
<tr>
<td>Deductions</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Royalty to FP (BETB)</td>
<td>(100x)</td>
<td>(100x)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation of acquired property (includes 100% expensing)</td>
<td>(100x)</td>
<td>(100x)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>NOL carryover (deduction)</td>
<td></td>
<td></td>
<td>(50x)</td>
<td></td>
</tr>
<tr>
<td>Regular taxable income</td>
<td>100x</td>
<td>100x</td>
<td>(50x)</td>
<td>12.5x</td>
</tr>
<tr>
<td>Regular tax liability (At 21%)</td>
<td>21x</td>
<td>21x</td>
<td>-</td>
<td>2.63x</td>
</tr>
</tbody>
</table>

US1 and US2 are both wholly owned by a common parent corporation and must therefore compute their base erosion percentages on an aggregate group basis. Accordingly, the aggregate group’s 2019 base erosion percentage is 50% [$100x BETB (royalty) / ($100x royalty + $100x depreciation)]. US2’s 2019 and 2020 BEAT calculations are therefore as follows:

<table>
<thead>
<tr>
<th></th>
<th>US2 2019</th>
<th>US2 2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income</td>
<td>(50x)</td>
<td>12.5x</td>
</tr>
<tr>
<td>Items excluded from MTI</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Royalty to FP (BETB)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Base erosion percentage of NOL (50% of $50 NOL)</td>
<td>-</td>
<td>25x</td>
</tr>
<tr>
<td>Modified taxable income</td>
<td>(50x)</td>
<td>37.5x</td>
</tr>
<tr>
<td>BEAT Rate</td>
<td>-</td>
<td>10%</td>
</tr>
<tr>
<td>BEAT Rate * MTI</td>
<td>-</td>
<td>3.75x</td>
</tr>
<tr>
<td>Regular tax liability</td>
<td>-</td>
<td>2.63x</td>
</tr>
<tr>
<td>Base erosion minimum tax amount</td>
<td>-</td>
<td>1.12x</td>
</tr>
</tbody>
</table>

US2’s $50x NOL carryover has a base erosion percentage of 50%, and US2 will only be able to deduct $25x of the NOL for purposes of its 2020 MTI calculation. Other things equal, the loss of $25x of NOL deduction for BEAT purposes results in a permanent additional cash tax cost of $1.12x.

Now, let’s assume the same facts as the foregoing example, except that in this case, the US2 elects not to apply the 100% expensing provision for certain business assets. Assume that with the foregoing election, US2 will deduct $50x

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11 See section 168(k).
12 Supra note Error! Bookmark not defined..
13 See section 168(k)(7).
of depreciation from its business assets in each of the two years. In this scenario, US2 will have no taxable income in 2019, and no NOL carryover to be partially added back in the calculation of MTI when utilized, resulting in no additional BEAT liability in 2020. Thus, US2 should be able to deduct its entire $100x cost basis in the depreciable property it acquired in 2019 without the $1.12x BEAT (i.e., cash tax) cost that arose above.

The importance of timing also extends to pre-2018 NOLs. For example, consider a taxpayer that utilizes a pre-2018 NOL that fully offsets regular taxable income in a given year. The Proposed Regulations do not allow the use of NOL carryovers to reduce taxable income below zero for purposes of calculating MTI.14 Therefore, to the extent that taxpayer has a single dollar of BETBs when pre-2018 NOL carryovers are equal to or exceed regular taxable income, the taxpayer’s use of its NOL carryover guarantees that the taxpayer will pay BEAT. In this situation, accelerating income into the year of NOL utilization or deferring deductions into a subsequent year can prevent such taxpayer from incurring a permanent cash tax cost under BEAT.

The interactions between the various provisions of the TCJA can be quite complex. At first glance, the interaction between the BEAT and the NOL rules may appear only to represent an additional compliance cost. However, as illustrated above, a portion of the anticipated tax benefit of an NOL may be permanently lost in certain situations due to the mechanics of the BEAT rules. The effects of when items of income and expense are recognized should therefore no longer be viewed as simply a timing issue following the enactment of the TCJA. Taxpayers should consider modeling the effects of significant transactions on loss generation and utilization before such transactions are undertaken in order to plan for potential opportunities to enhance the value of their NOL carryovers for BEAT purposes.

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If you can’t BEAT ‘em, accrue ‘em: Tax Accounting Implications of BEAT

Basic Erosion Anti-Abuse Tax

For tax years beginning after December 31, 2017, a corporation is potentially subject to tax under the BEAT provision if the controlled group of which it is a part has sufficient gross receipts and derives a sufficient level of “base erosion tax benefits.”

Under the BEAT, a corporation must pay a base erosion minimum tax amount (BEMTA) in addition to its regular tax liability after credits. The BEMTA is generally equal to the excess of (1) a fixed percentage of a corporation’s modified taxable income (taxable income determined without regard to any base erosion tax benefit related to any base erosion payment, and without regard to a portion of its NOL deduction) over (2) its regular tax liability (reduced by certain credits). The fixed percentage is generally 5 percent for taxable years beginning in 2018, 10 percent for years beginning after 2018 and before 2026, and 12.5 percent for years after 2025. However, the fixed percentage is 1 percentage point higher in certain cases involving banks and securities dealers (i.e., 6, 11, and 13.5 percent, respectively).

Tax accounting implications

Tax Rate to Apply: BEAT operates much like an AMT system. ASC 740 notes that when alternate tax systems like the AMT exist, deferred taxes should still be measured at the regular tax rate. Because the BEAT provisions are designed to be an “incremental tax,” an entity can never pay less than its statutory tax rate of 21 percent. Like AMT preference items, related-party payments made in the year of the BEMTA are generally the BEMTA’s driving factor. The AMT system and the BEAT system were both designed to limit the tax benefit of such “preference items.” Further, as was the case under the AMT system, an entity may not know whether it will always be subject to the BEAT tax. Accordingly, while there is no credit as the one that existed under the AMT regime, the similarities between the two

systems are sufficient to allow BEAT taxpayers to apply the existing AMT guidance in ASC 740 and measure deferred
taxes at the 21 percent statutory tax rate.

In January 2018, the Financial Accounting Standards Board (FASB) staff issued Staff Q&A No. 4, which states that
companies should measure deferred taxes without regard to BEAT (i.e., should continue to measure deferred taxes at
the regular tax rate), with any payment of incremental BEAT reflected as a period expense (i.e. recorded in current tax
expense in the period incurred).

**Impact of BEAT on Realizability Assessment of Certain DTAs**

In the calculation of the BEMTA, certain credits and NOLs may not be available to reduce the BEMTA. Consequently,
the actual economic benefit received from utilizing a credit loss or NOL may be less than the DTA (before reduction for
any valuation allowance) for that particular tax attribute and, in some cases, may result in no cash tax savings at all
because, without the attribute, the entity would have paid more regular tax and less BEMTA.

FASB staff Q&A No. 4, which addresses the broader accounting implications of BEAT, states that an entity “would not
need to evaluate the effect of potentially paying BEAT in future years on the realization of [DTAs].” The DTAs are
measured in accordance with the regular tax system, and any utilization of NOLs or tax credits would reduce the
regular tax liability even if additional BEMTA is owed.

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**Calendars to watch**

Each edition, be sure to mark your calendars for some of the more important events (recent and upcoming) as well as
tax developments making in impact on businesses investing into the United States.

**Recent and upcoming activities**

<table>
<thead>
<tr>
<th>Date</th>
<th>Location</th>
<th>Event Description</th>
<th>Register now URL</th>
</tr>
</thead>
</table>
September 24
2:00 p.m. ET
Dbriefs archive: Quarterly accounting roundup: Q3 2019 update on important developments
Watch

September 25
2:00 p.m. ET
Dbriefs archive: Year-end updates, new developments, and recent hot topics
Watch

October 6
1:00 p.m. ET
Dbriefs archive: Update: Advanced pricing agreements and mutual agreement procedures
Watch

October 15
1:00 p.m. ET
Dbriefs archive: Recent developments in state legislation and the US Supreme Court
Watch

October 17
1:00 p.m. ET
Dbriefs archive: Data wrangling: The new frontier in tax department automation
Watch

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