BEAT Implementation Proposals Related to Global Services Operations

I. BEAT Issues Presented by U.S.-Based Global Services Operations

Global services operations managed in the United States may inappropriately be treated as making base erosion payments for BEAT purposes. In this Part I we describe two common business models for such operations, explain why these business models should not present BEAT concerns yet may fall within the literal scope of the rules, and summarize why self-help restructuring of existing arrangements would not be a practical solution. We then turn in Part II to a suggested implementation approach that would resolve the issues described here without creating opportunities for abuse, while Part III addresses the regulatory authority for the suggested approach.

A. Two Common Business Models for U.S.-Based Global Services

Many U.S. businesses that provides services to customers around the world use a U.S. company, for example the group's parent company, as the customer-facing entity that handles the primary marketing and management functions of the global business. Typically customers will contract with that company, which will in turn subcontract with its affiliates around the world, where the relevant services are provided based on customer locations, supplier locations, and other business considerations.

In a second common scenario, a U.S.-based manufacturer may provide maintenance and repair services to purchasers as an integral part of its business operations. The provision of such services by an "original equipment manufacturer" ("OEM") often serves a central role in the OEM's marketing and sales strategy. OEM-provided services can also provide significant additional revenues for the group. As in the first scenario, customers typically enter into service contracts with a member of the U.S. manufacturer's group, which then subcontracts with affiliates around the world to provide the agreed services.

The two scenarios have distinct features, but from a U.S. tax standpoint they are very similar. In both scenarios, a U.S. headquarters/manufacturing entity enables a global network of service-provider affiliates to access a global customer base. The customer revenues arising from the provision of services by non-U.S. affiliates effectively passes through the U.S. group to those affiliates, and thus historically such arrangements were largely neutral in terms of their net U.S. tax effects. While customer revenues initially flowed to U.S. group members, and were then paid out to the foreign affiliates providing customer services, the arrangements could alternatively have been structured with the service-providing affiliates having the primary contractual relationship with the customer, and limiting the U.S. affiliate's role to that of an agent or service provider.

Under either potential structuring of the legal relationship with the customer, both the U.S. and non-U.S. affiliates would earn an appropriate profit on their respective functions and risks. Further, the choice between these alternative ways of structuring legal relationships with customers has generally been driven by business considerations, not tax planning. Specifically, where U.S. companies maintain the primary contractual relationships with the group's customers around the world, this practice stems from the concentration of worldwide marketing and management functions in the United States, as well as the preference of many customers to

contract with one of the more substantial entities in a group, which for a U.S.-based group will ordinarily be the U.S. parent or other substantial U.S. affiliate.

B. U.S.-Based Global Services Should Not Present BEAT Concerns

The U.S.-based global services operations described above do not present the tax-reduction concerns that BEAT seeks to address. In the arrangements targeted by the BEAT rules, rather than building and sustaining a global customer base, a U.S. enterprise sought to reduce its own U.S. tax base by making payments to foreign affiliates for intragroup costs such as interest expense, royalties, management fees, or fees for other internal services. In most such scenarios, the claimed expenses were for services provided to the U.S. enterprise itself in relation to its U.S. activities, not for services provided outside the United States directly to customers. Thus, while no reduction of the U.S. tax base occurs when global customer revenues from non-U.S. services are paid to non-U.S. affiliates, by contrast the type of base erosion targeted by BEAT arose when a U.S. enterprise reduced the revenues from its U.S. activities through intragroup payments. The proof of the difference is that in the latter scenario, the arrangement could not have been alternatively structured with the service-providing affiliates having the primary contractual relationships with the customers, because the payments were for intragroup transactions that were invisible to customers.

Accordingly, to the extent that a U.S. headquarters or manufacturing entity enables a global network of service-provider affiliates to access a global customer base, the intermediary function of the U.S. group should not be treated as giving rise to U.S. base erosion, or other inappropriate reduction of U.S. taxable income. The U.S. tax base of the headquarters/manufacturing company is the appropriate return to its global management functions and/or its manufacturing and sales activities, and that return is not reduced by the entity's intermediary function in relation to the foreign-based services that its affiliates provide to the global customers of the enterprise.[1] In sum, the income earned by non-U.S. affiliates by providing services outside the United States was never part of the U.S. tax base that needed protection from erosion, and the intermediary role of a U.S. entity doesn't alter that fact.

In addition to the intermediary nature of the U.S. operations described above, the provision of maintenance and repair services to the customers of an equipment-manufacturing business should be viewed as well outside the scope of the BEAT tax for an additional reason, related to the exclusion of the cost of goods sold ("COGS") from that tax. The legislative history is clear that base erosion payments giving rising to a BEAT tax do not include payments for COGS.[2] Thus, if a U.S. manufacturer pays its foreign affiliates for component parts they produced, no BEAT issue would arise because the payments would be treated as part of the U.S. parent's COGS that are excluded from BEAT. Yet the maintenance services addressed here are in many regards precisely equivalent to COGS payments; they are not only payments that are integral to the manufacturer's ability to sell its products to customers, but the services provided are in a real sense an extension of the group's manufacturing activities.

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[1] Indeed, the U.S. headquarters' management and marketing functions in relation to its foreign customer-service affiliates give rise to additional revenues that are subject to U.S. tax, and that would not arise if those functions were conducted elsewhere.

[2] Conf. Report, at 532 (payments that reduce gross income, including payments for COGS, are not base erosion payments).

Thus, a foreign affiliate that provides maintenance and repair services is closely comparable to a foreign affiliate that sells component parts. Further, the maintenance services in question, in the case of heavy equipment, often involve many of the same activities as the original manufacture of the equipment; as just one example, the maintenance requirements for a commercial aircraft engine regularly require the engine to be disassembled and rebuilt. Indeed, that maintenance activity may literally include the "remanufacturing" of parts in a process that involves such significant reconditioning of the parts that it can fairly be described as manufacturing. Thus, the similarity to COGS of maintenance and repair services that are integral to a business that manufactures heavy equipment would make it particularly anomalous to subject payments for such services to taxation under the BEAT regime.

Nevertheless, absent clarifying guidance both of these global services scenario are likely to generate exposure to the BEAT rules; depending on the nature of the contractual relationships, the U.S. participant may be treated as earning the gross amount of customer revenue and then making a deductible payment to the ultimate provider of non-U.S. services, arguably falling within the scope of a base erosion payment, despite the absence of an inappropriate reduction of U.S. tax. Further, while existing contractual relationships could in theory be restructured to eliminate the U.S. participant's intermediary role, such "self-help" solutions will in many cases present significant drawbacks, as discussed immediately below. Accordingly, a more workable solution will be to implement BEAT's definition of base-erosion payments in a manner that recognizes that not every related-party payment is a base erosion payment within the intendment of the rule, as discussed in Part II below.

C. Restructuring Existing Customer Relationships Would be Disruptive and Anticompetitive

As noted above, any BEAT issue in these structures could in principle be sidestepped simply by having the U.S. entity cease to perform its intermediary function, such that the primary contractual relationships would flow directly between customers and non-U.S. service providers, for example, through a "consortium" style contract between the U.S. group and its global customers. This ability to remove the U.S. entities from the payment stream for non-U.S. services underlines the fact that the foreign affiliates are in substance providing services to the group's unrelated customers, not to the U.S. members of the group that serve an intermediary function. But forcing such a restructuring of long-established legal relationships with customers would make the tax tail wag the business dog, causing business disruptions with serious anticompetitive effects:

- First, being forced to renegotiate longstanding customer arrangements would be disruptive to a company's business operations and customer relationships.

- Second, forcing such restructurings would provide a competitive advantage to foreign competitors who do not need to restructure and thus will not face any negative effects on their customer relationships from having to restructure.

- Third, because the extent of such disruptions would largely depend on the terms of existing arrangements, such restructurings will produce disparate effects on similarly-situated taxpayers, by imposing different impacts in different industries (disproportionately hurting taxpayers in industries with longer duration agreements, compare a single transaction arrangement like shipping a package v. a multi-year maintenance agreement, requiring more renegotiation of existing agreements), as well as inconsistent effects on taxpayers within a single industry, based on differences in

existing contractual structures thus producing the greatest disruptions and anticompetitive impacts on businesses that historically located their headquarters and marketing functions (and related jobs) in the United States.

- Fourth, as a consequence, forcing such restructurings would impose a disproportionate impact on U.S.-based multinational companies, which presumably were not the principal target of the BEAT rules in the first instance (although admittedly within their scope).

Thus, in the absence of clarifying guidance, U.S.-based OEMs and other U.S. companies that maintain global service networks will face a dilemma between a crippling increase in the U.S. tax burden imposed on their global operations, including unrelieved double taxation arising from BEAT's denial of foreign tax credits, on the one hand; or on the other hand suffering the business disruptions and anticompetitive effects of being forced to restructure their global services operations by moving their primary contractual relationships with customers to their foreign affiliates, and/or moving the headquarters and marketing functions for such operations outside of the United States. While the latter alternatives will be damaging and disruptive, they will in the long run be less damaging than endemic double taxation under the BEAT regime, and thus represent the likely long-term outcome for many companies.

While such a restructuring path could be viewed as a self-help solution to the problems described here, it is not a solution that makes sense for the U.S. tax system or the U.S. economy. That is, the potential availability of such a solution does not justify a wooden implementation of the statute that ignores its problematic impact on U.S.-based global services operations, because forcing such restructurings could well lead to a net loss of U.S. tax revenue; the resulting restructurings would both limit the additional revenues collected under the BEAT, and reduce the U.S. tax that is currently paid on the return to the headquarters and marketing functions conducted in the United States on behalf of global service operations, if in the future such functions are increasingly conducted elsewhere to avoid double taxation under the BEAT regime.

Accordingly, to avoid the business inefficiencies and long-term revenue loss that would arise if U.S.-based global services companies were forced to restructure to avoid double taxation under an inappropriate application of the BEAT regime, we urge the development of regulations that implement the statutory definition of a base erosion payment in a manner that takes into account whether such payments actually result in base erosion, in the manner outlined below.

II. Recommended Regulatory Treatment of Global Services Operations

We suggest that the term base erosion payment be defined to exclude payments related to a U.S.-based global services operation in the two scenarios described below.

A. Treatment of Global Services Company Payments by U.S. Headquarters for Customer Services Performed Outside the United States

This proposed rule would define the term base erosion payment to exclude payments for services provided directly to customers by a non-U.S. affiliate, when such services are performed outside the United States (the "OUS services rule"). By applying this rule only to services that are provided directly to customers, and only to services that are provided outside the United States, the OUS services rule would be targeted to the global services scenarios described above. A short mock-up of a potential regulatory drafting approach suggests that such a rule could be drafted in a straightforward manner:

> (a) *Treatment of Payments for Services to Unrelated Customers*—(1) *In general.* A payment to a related foreign person shall not be treated as a base erosion payment if:
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> > (i) The payment is for services provided by the related foreign person directly to or for the benefit of an unrelated customer; and
> >
> > (ii) Such services are performed outside the United States.
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> (2) *Location of Services.* Services shall generally be treated as performed outside the United States if they are performed by employees who are located outside the United States.

Further, the OUS services rule could be tailored to exclude certain incidental services such as call-center type operations that a U.S. business maintains for its own convenience outside the United States, but whose non-U.S. location is unrelated to the needs of its customers. In such a scenario, the location of the call center outside the United States would not be covered by the rule. These circumstances could be addressed with an exception along the lines of the following:

> (3) *Exclusion of Incidental Services.* This exception shall not apply to services that are incidental to the principal or primary nature of the relationship between the unrelated customer and the multinational group (e.g., an offshore call center established by a finance company to respond to routine customer inquiries related to bill payments or similar matters).

Because existing transfer pricing rules already require the U.S. participant to include in its U.S. taxable income an appropriate return to its U.S. functions and risks in relation to the global services business, no separate rules should be needed to address that requirement, which should ordinarily leave a level of U.S. profit over and above the amounts paid out to related-party service providers.

The OUS services rule would principally operate to prevent the inappropriate application of the BEAT tax to a U.S.-headquartered global services company. However, it could also potentially apply to a non-U.S. headquartered company, to the extent that its related party payments met the customer and non-U.S. performance requirements of the rule. However, while the existing subpart F rules ensure that the transactions covered by the rule are ordinary-course commercial dealings rather than tax-motivated attempts to shift income, consideration could be given to limiting the exception in the case of payments to a member of a non-U.S. multinational group that would have given rise to base company services income in the hands of the recipient if it were a CFC, and thus provide a more level playing field for U.S. and non-U.S. parented multinational groups.

B. Treatment of Integrated Maintenance Services

This proposed rule would exclude from treatment as a base erosion payment any related-party payment for the provision of maintenance services that are integrated with the taxpayer's manufacture and sale of property. Such "integrated maintenance services" ("IMS") would be defined as maintenance services that are directly related to the manufacture and sale of equipment or other property by the payor (or a U.S. affiliate). This rule would effectively give parity of treatment to COGS and to the manufacturer's costs of providing services that are directly related to its manufacturing operations.

The IMS rule would principally operate to prevent the inappropriate application of the BEAT tax to a U.S. manufacturer that provides IMS to its global customers. However, it could

also potentially apply to a non-U.S. headquartered group, to the extent that the group conducted original equipment manufacturing in the United States and made payments to global affiliates that qualified as payments for IMS. As above, to ensure that the transactions covered by the rule are ordinary-course commercial dealings rather than tax-motivated attempts to shift income, consideration could be given to limiting the exception in the case of payments to an affiliate of a non-U.S. multinational that would have given rise to base company services income in the hands of the recipient if it were a CFC, and thus provide a more level playing field for U.S. and non-U.S. parented multinationals.

III. Regulatory Authority

Both of the suggested rules would be issued under the section 59A(i) authority to issue regulations "necessary or appropriate to carry out the provisions of this section." That grant of authority is just as much a part of the statute as its specific rules; and in determining the scope of an appropriate exercise of that authority, it would be anomalous to view the authority as limited by the specific rules set forth in the statute, or as limited by the scope of what Congress specified that authority as "including." The point of such a grant is to give Treasury authority to address circumstances not contemplated by the statute itself. While such authority does not, of course, permit the drafting of a regulation that is fundamentally at odds with the statute, it must include the authority to implement the statute in a manner that is fully consistent with its policy goals.

The OUS services rule would appropriately be issued under the statute's "necessary or appropriate" regulatory authority because it implements the statutory definition of the term "base erosion payment" in a manner that excludes related-party services payments that effectively were never part of the U.S. tax base. The U.S. tax base is eroded when the income from U.S. economic activity is shifted to another jurisdiction through the use of a deductible payment, whereas the OUS services rule would be designed to ensure that any payment subject to the rule relates to economic activity conducted outside the United States (i.e., the non-U.S. services provided to the global customers of the business). While the statutory definition of base erosion payments is admittedly broad, the point of a general grant of regulatory authority is to refine such broad statutory rules whenever it is "necessary or appropriate" to do so in relation to matters of detail that were not considered or addressed by the statute.[3]

Similarly, the IMS rule would appropriately be issued under the "necessary or appropriate" regulatory authority of section 59A(i) because it likewise implements the statutory definition of the term "base erosion payment" in a manner consistent with the treatment of COGS by excluding payments for maintenance services that are integrated with the company's manufacturing and sale of equipment.

Providing appropriate treatment of the intermediary role served by a U.S. enterprise that facilitates access to its affiliates' provision of non-U.S. services would also be consistent with

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[3] An example of a similar exercise of regulatory authority to provide a sensible implementation of a broadly-worded statutory definition is provided by the conduit financing rule in Treasury regulation section 1.956-2(c)(4), implementing the rule of section 956(d) that generally treats a CFC's pledge or guarantee of a U.S. person's debt obligation as an investment in U.S. property ("under regulations"). Under the implementing regulations, a CFC's pledge or guarantee of a U.S. person's debt obligation is not treated as an investment in U.S. property if the U.S. debtor is "a mere conduit in a financing arrangement."

section 59A(i)'s call for "necessary or appropriate" regulations as "including" rules that address potential "avoidance of the purposes of this section, including through" the use of conduit transactions. Congressional guidance as to the topics that could appropriately be included in regulations obviously does not limit the scope of the general grant of authority to write "necessary or appropriate" regulations. Moreover, Congressional awareness that conduit arrangements could potentially result in avoidance of the statute's purposes is fully consistent with a parallel recognition that such arrangements, under an overly literal reading of the statute, could similarly result in defeating the statute's purposes by inappropriately triggering its application to cases in which it shouldn't apply—as in the case of the intermediary functions of U.S. group members described here.