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Legal Update
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The Tax Act Changes the Game for Transfer Pricing

The "Tax Cuts and Jobs Act" (the "Tax Act"),[1] signed into law by President Donald Trump on December 22, 2017, fundamentally changes the US international tax system. Consequently, the Tax Act is a game changer for transfer pricing and international tax planning for both US- and foreign-parented multinational enterprises ("MNEs"). Although the Tax Act significantly reduces the corporate income tax rate from 35% to 21% and enacts a number of measures intended to discourage MNEs from holding intangible property ("IP") and attributing profits outside the United States through transfer pricing, significant planning opportunities remain.

This Legal Update provides an overview of some of the provisions of the Tax Act most relevant to international structuring and transfer pricing-related decisions, as well as some general considerations and takeaways for both US- and foreign-parented MNEs regarding the Tax Act's impact on common intercompany transactions and potential planning opportunities and pitfalls.

Rate Reduction and Territoriality

The Tax Act permanently reduces the corporate tax rate from 35% to 21% effective for tax years beginning after December 31, 2017, and allows an effective corporate rate of 13.125% for foreign derived intangibles income ("FDII"), defined broadly and generally as certain income from sales, licenses and services for ultimate foreign use or consumption.

The Tax Act enacts a "participation exemption," which through new section 245A,[2] allows a 100% dividends-received deduction for foreign-sourced dividends received by most domestic C corporations from 10% or greater foreign subsidiaries.[3] The effect of the participation exemption is to transition the United States from a worldwide to a "modified territorial" tax system in which the future income of US MNEs properly attributed to foreign subsidiaries is generally permanently exempt from US tax and, thus, can be repatriated at any time without incurring an additional US liability.[4] However, as discussed above, US-parented MNEs may be subject to significant current US taxation (albeit at a reduced rate) under the new global intangible low-taxed income ("GILTI") regime discussed below.

In connection with the transition to a modified territorial tax system, the Tax Act also imposes a one-time tax (i.e., a "deemed repatriation" or "toll charge") on the non-previously taxed post-1986 earnings of foreign subsidiaries. Under revised Section 965, the tax applies to US shareholders (corporate and non-corporate) that own 10% or more of the voting power or value in (i) a controlled foreign corporation ("CFC") or (ii) a foreign corporation in which at least one domestic corporation owns 10% or more of the voting power or value. The effective tax rate for the toll charge is 15.5% for foreign earnings attributable to cash and other liquid assets and 8% for the remainder. The toll charge is calculated based on foreign earnings as of November 2, 2017 or as of December 31, 2017, whichever is greater.

CONSIDERATIONS AND TAKEAWAYS:

The combination of the rate reduction and the institution of a modified territorial tax system creates countervailing considerations for US-based MNEs with respect to international tax and transfer pricing planning. On the one hand, the US rate reduction, particularly in combination with the GILTI and FDII regimes discussed below, may substantially reduce the potential for tax rate arbitrage as compared with pre-2018 years. But on the other hand, for US MNEs, the participation exemption provides certainty that the benefit of any tax rate arbitrage will be permanent, meaning each percentage point of tax rate arbitrage is potentially more valuable than before.

Furthermore, the toll charge may be an important consideration for US-parented MNEs with pending or potential US or foreign transfer pricing controversies affecting pre-2018 years. To the extent that section 965 is interpreted to require redeterminations of the toll charge amount in the event of a subsequent tax adjustment that affects the relevant foreign earnings amount as of November 2 or December 31, 2017, the resolution of a US transfer pricing dispute could give rise to a reduction in the toll charge, while the resolution of a foreign transfer pricing dispute could give rise to an increase in the toll charge. This could potentially reduce the net tax cost of resolving US transfer pricing disputes while increasing the net tax cost of resolving foreign transfer pricing disputes. Whether the Treasury Department will issue guidance to clarify the impact of subsequent transfer pricing or other tax adjustments on the toll charge is uncertain.

Moreover, the impact of the future rate reduction may also be an important strategic consideration for resolving pre-2018 controversies, to the extent that the pre-2018 resolution or settlement sets at least "soft precedent" for future years. For example, a settlement for pre-2018 years that increases tax in a CFC in a jurisdiction with a 30% corporate tax rate may initially result in a slight reduction in total taxes paid to the extent full double tax relief in the United States is obtained (because the US refund calculated at the 35% rate would be larger than the assessment paid to the CFC's taxing authority at the 30% rate). The settlement may nonetheless be undesirable if the settlement sets an expectation with the CFC's taxing authority regarding the transfer pricing method to be applied in 2018 and subsequent years when the US tax rate falls below the CFC's rate.

GILTI and FDII

The new GILTI tax and the new deduction for FDII do not themselves affect the transfer pricing rules but nevertheless significantly affect incentives for US MNEs to allocate income through transfer pricing to the US consolidated group rather than to CFCs (and vice versa).

Notably, while the GILTI tax is the primary means through which the Tax Act seeks to discourage US MNEs from holding IP in and attributing IP-related income to CFCs, its maximum rate (through 2025) of 10.5% in combination with a relatively low foreign tax rate environment will produce an effective tax rate materially less than the new US 21% corporate rate. And, moreover, CFC income that is not subject to current tax under either the new GILTI or existing subpart F regimes will now be permanently exempt from US taxation under the new participation exemption.

Mechanically, the new GILTI tax is calculated as follows. New section 951A provides that a 10% or more US shareholder of any CFC will currently include in income (and be subject to US tax on) its GILTI. The amount of a US shareholder's GILTI in a given taxable year equals the excess, if any, of (i) the US shareholder's "net CFC tested income" over (ii) a "net deemed tangible income return" (i.e., a "routine return"). The US shareholder's net CFC tested income is the excess of (i) the aggregate of its pro rata share of its CFC's "tested income" over (ii) the aggregate of its pro rata share of its CFC's "tested loss." A CFC's tested income equals the excess of (x) the CFC's gross income without regard for certain items (including, but not limited to, items of Subpart F

income and effectively connected income) over (y) the CFC's deductions properly allocable to such tested income—if, instead, (y) exceeds (x), the CFC will be considered to have a "tested loss." The net deeemed tangible income return equals 10% of the shareholder's pro rata share of the aggregate adjusted bases of the CFCs' tangible depreciable business property minus the amount of interest expense taken into account in determining the net tested income. Thus, most or nearly all of a CFC's income could be taxed in the United States if the CFC owns primarily intangible assets or highly depreciated tangible property, as the routine return would be minimal.

GILTI of a US corporate shareholder is taxed at the new corporate rate of 21%. However, because a domestic corporation may annually deduct 50% of its GILTI amount (plus the corresponding section 78 gross-up amount) for 2018 through 2025, and 37.5% of its GILTI amount (and section 78 gross-up amount) beginning in 2026, the effective US tax rate on GILTI for domestic corporations is 10.5% for 2018 through 2025, and 13.125% after 2025.[5] Furthermore, US corporate shareholders will be permitted to claim a credit for their proportionate share of 80% of the foreign taxes paid by the CFC with respect to the GILTI. Based on the 80% foreign tax credit, GILTI subject to foreign tax at a rate of at least 13.125% would not incur any additional US tax liability during 2018 through 2025.

The flipside of the new GILTI tax is the new section 250 deduction for FDII. Under the new section 250, domestic corporations may deduct 37.5% of FDII in taxable years 2018 through 2025, which results in a 13.125% effective rate. In taxable years after 2025, the FDII deduction is 21.875% which, assuming a 21% corporate tax rate, brings the effective rate to 16.406%.

FDII is conceptually similar to GILTI: like GILTI, FDII is a *deemed, not an actual* intangibles return calculated mechanically by reference to taxable income *in excess* of the deemed 10% routine return. However, whereas GILTI applies to income earned by CFCs, FDII generally applies to income earned by a domestic corporation from the performance of services or sales, leases or licenses of property to customers outside the United States. To the extent such income exceeds the applicable routine return, the excess is 37.5% deductible (21.875% after 2025). Thus, while GILTI is a "stick" that provides some—albeit limited—discentives for US MNEs to attribute intangibles-related income to CFCs in low tax jurisdictions, FDII is a "carrot" that incentivizes US MNEs and US subsidiaries of foreign MNEs to attribute intangibles-related income to the United States, at least to the extent it relates to foreign exploitation.

The FDII deduction is available for sales, leases or licenses of property to unrelated foreign parties for foreign consumption, as well as sales to foreign related parties, provided that "such property is ultimately sold by a related party, or used by a related party in connection with property which is sold or the provision of services, to another person who is an unrelated party who is not a United States person," and "the taxpayer establishes to the satisfaction of the Secretary that such property is for a foreign use . . . ." Thus, it would appear that income from many common intercompany transactions, including sales of manufactured property to foreign related distributors for resale in foreign markets, as well as royalty income from licenses of intellectual property for use in foreign jurisdictions, could potentially qualify. The deduction is also available for income from services provided to foreign related parties, provided that the taxpayer establishes that the service "is not substantially similar to services provided by such related party to persons located within the United States."

CONSIDERATIONS AND TAKEAWAYS:

Determining a US MNE's liability for GILTI tax and ability to benefit from the FDII deduction under existing structures is a complex inquiry. Likewise, determining whether and how the MNE's effective tax rate can be reduced by restructuring to minimize GILTI and maximize

FDII needs to be analyzed and quantitatively modeled on a case-by-case basis. Nevertheless, a few general observations can be offered:

- It bears emphasizing that both GILTI and FDII are *deemed*, not actual intangibles returns, the application of which is not in any way conditioned on IP being owned or R&D activities being performed in any particular jurisdiction. Thus, a US MNE could conceivably be subject to GILTI from activities conducted through CFCs with no IP, if the CFCs' activities are sufficiently high-margin and/or involve few tangible assets (or tangible assets that are fully depreciated) so as to produce income in excess of the applicable tangible assets-based routine return. By the same token, a domestic corporation that licenses IP developed and owned outside the United States may be able to benefit from the FDII deduction if it uses that IP to manufacture property for export (although in this case, the royalties paid by the domestic corporation could potentially be subject to the BEAT, as discussed below).
- Because the GILTI tax applies mechanically, increasing the functions or "substance" of CFCs (e.g., the number of employees and their business decision-making capabilities) will not eliminate or even reduce the GILTI. The *only* way to reduce the GILTI of a CFC is to increase its level of depreciable, tangible assets. Consider a US MNE with a CFC in a low tax jurisdiction housing a "center of excellence" with thousands of employees but owning comparatively few depreciable tangible assets and a US MNE with a true "cash box" CFC with no employees. While the two hypothetical CFCs are at opposite ends of the spectrum on traditional markers of "substance," both would be treated similarly—and unfavorably—under the GILTI regime.[6]
- The GILTI tax is calculated on an aggregated basis at the shareholder level, taking into account the income and tangible, depreciable assets of all CFCs. As a result, US MNEs should be able to manage GILTI tax liability by effectively offsetting the potential GILTI income of high margin, non-capital intensive activities of some CFCs (e.g., IP holding companies) with routine returns on tangible, depreciable business assets held by other more capital intensive CFCs (e.g., manufacturing and operating companies).
- While the GILTI regime incentivizes capital investments in CFCs (since such investments would increase the routine return on the CFCs' tangible, depreciable business assets that is not subject to the GILTI tax), the FDII regime has precisely the opposite effect of discouraging such investments in the United States (since such investments would increase the US group's routine return that is not eligible for the FDII deduction).
- Whether or not US MNEs can achieve a lower effective tax rate by holding IP and/or increasing business activities in CFCs, which would increase both the GILTI tax and partly creditable (up to 80%) foreign tax, or holding IP and/or increasing business activities in the United States, which may increase FDII, depends on numerous factors, including but not limited to (i) the tangible asset-intensity of both foreign and US operations, (ii) applicable foreign income tax and withholding tax rates, (iii) transfer pricing allocations of income between the US group and the CFCs, and (iv) the impact of other provisions of the Tax Act, including the BEAT discussed below. Needless to say, with respect to income from sales of products, licenses of IP, or performance of services for ultimate foreign use or consumption, and assuming a relatively low foreign tax rate (and low or no withholding tax), the decision may in some cases be a close call given the relatively close convergence of the effective GILTI (10.5%) and FDII (13.125%) tax rates.
- However, with respect to income from sales of products or services for US consumption, it may actually be comparatively more advantageous for US MNEs to increase foreign

operations and hold the relevant US market IP rights through CFCs. In the case of US market sales or services, the 13.125% FDII effective rate is not available, so any income properly allocated through transfer pricing to CFCs with respect to such sales or services (e.g., income from the sale of tangible products manufactured by the CFC for resale in the United States) may result in a tax savings to the extent the applicable foreign tax rate is less than the new regular 21% corporate income tax rate. For example, due to the 80% credit mechanism, the GILTI tax combined with the Irish rate of 12.5% would produce a combined rate of 13% for an Irish CFC, which is still materially lower than the US rate of 21%. And, as noted, under the participation exemption system, all arbitrage is now permanent.

- Although FDII appears designed to act as a counterpart to the GILTI tax—which applies only to US-parented MNEs or other domestic corporations with CFCs—the FDII deduction is nonetheless available to *all* domestic corporations, including, presumably, US subsidiaries of foreign-parented MNEs. Thus, in some cases it may be advantageous for foreign-parented MNEs to consider expanding their US subsidiaries' operations to include direct or indirect sales (including leases or licenses) or services for ultimate consumption in non-US markets.

BEAT

The base erosion and anti-abuse tax ("BEAT") of new section 59A is an add-on minimum tax regime, calculated using a modified taxable base that adds back deductions for "base erosion payments." The BEAT equals the excess of (i) 10% (or 5% for a taxable year beginning in 2018, and 12.5% in a taxable year beginning after 2025) of the taxpayer's "modified taxable income" for the tax year over (ii) the regular tax liability for the year reduced by the excess of certain tax credits over the research credit and certain other credits (beginning in 2026, reduced by all credits).[7] In effect, the BEAT rules compare 10% of the corporation's income without taking deductible payments to foreign affiliates into account with the corporation's regular tax liability determined by taking such deductions as well as credits into account. If the 10% amount is larger, then BEAT is owed.

The BEAT applies only to large corporate taxpayers that have average annual gross receipts of at least $500 million for the three years preceding the year at issue and a "base erosion percentage" of 3% or higher.[8] Foreign corporations engaged in a US trade or business are also subject to the BEAT if their US-related gross receipts meet the $500 million threshold. The base erosion percentage is generally equal to the amount of "base erosion tax benefits," divided by the aggregate amount of deductions allowable to the corporation for the taxable year.

Base erosion tax benefits generally include payments made by the corporation to a related foreign person if the payments are either deductible or includable in the basis of a depreciable or amortizable asset, such as payments for interest, royalty or services.[9] A related foreign person includes any foreign shareholder owning 25% or more of the voting power or value of the corporation's stock, as well as other foreign persons related to either the 25% shareholder or the corporation under other related party provisions in the Internal Revenue Code (i.e., sections 267(b), 707(b)(1), and 482). Base erosion tax benefits do not include (i) any payments that are included in cost of goods sold (the "COGS Exception"),[10] (ii) certain "qualified derivative payments," (iii) payments subject to withholding tax, and (iv) payments for services that are provided at cost and that meet the eligibility requirements for use of the section 482 services cost method (determined without regard to the "business judgment test" requirement that the services "not contribute significantly to fundamental risks of business success or failure") (the "SCM Exception").[11]

CONSIDERATIONS AND TAKEAWAYS:

While the BEAT is complex and may be unavoidable in some cases, both US- and foreign-parented MNEs may wish to consider the following in order to minimize exposure to the BEAT:

- First, MNEs may wish to revisit their transfer pricing policies for transactions involving payments from domestic corporations to foreign related parties. For example, a US subsidiary may trigger BEAT by paying royalties and interest to its foreign parent as calculated under its existing transfer pricing policy. If the transfer pricing were changed to reduce the royalty and interest payments (which can be as simple as moving the royalty or interest rates from the current target to another lower, but still arm's length, point within the applicable range), this may eliminate BEAT liability by either reducing the subsidiary's base erosion percentage below 3% and/or by reducing the amount of the BEAT add-on below the corporation's regular tax liability. However, any MNE contemplating transfer pricing changes to reduce BEAT exposure should take into account whether the change would likely be acceptable to tax administration in the foreign related payee's jurisdiction, and document upfront the arm's length nature of the change.
- Second, MNEs should consider whether their transactions involving payments from domestic corporations to foreign related parties are optimized to obtain the best use of the COGS Exception, the applicability of which appears form-driven in many cases. For example, consider a US subsidiary that licenses IP from its foreign parent, then engages a related contract manufacturer to manufacture products using the same IP. In that case, the royalties paid to the foreign parent are subject to BEAT. However, if instead of licensing its IP, the foreign parent engaged the foreign related contract manufacturer directly, and the US subsidiary purchased manufactured products for resale directly from the contract manufacturer, no BEAT would be incurred because the purchases would be included in the US subsidiary's cost of goods sold.
- Third, MNEs may be able to manage the BEAT by having domestic corporations within the group transact with third parties rather than foreign related parties wherever feasible. For example, if a domestic corporation's BEAT liability is driven by interest payments, the BEAT might be reduced or eliminated by borrowing directly from third-party banks instead of from foreign related parties because third-party payments are not subject to the BEAT. Even if the foreign parent guaranteed the third-party loan, the guarantee fee payment that the US subsidiary would need to pay its parent would be smaller on a given amount of principal and thus give rise to a lower BEAT liability than paying related party interest.
- Fourth, MNEs may want to closely evaluate the applicability of the SCM Exception. Although currently unclear, there is a possibility that the SCM Exception can apply to the *cost portion* of service charges that qualify for the SCM but are nevertheless marked-up (e.g., because the relevant foreign tax authority requires that a markup be charged).[12] If this interpretation is upheld in subsequent guidance, it could potentially make the SCM Exception quite broad. In any event, domestic corporations paying for services performed by foreign related parties may wish to closely consider and document which of such services qualify for the SCM because they constitute or are similar to one or more of the various back-office type services listed in Revenue Procedure 2007-13 as generally eligible for the SCM (such as IT or HR). For other services that are neither listed in Revenue Procedure 2007-13 nor explicitly listed by the section 482 regulations as excluded from SCM eligibility (e.g., manufacturing and R&D), domestic corporations may wish to evaluate such services' eligibility for the SCM as "low margin covered services," generally defined as services

with a median markup less than or equal to 7%. While a comparability analysis and benchmarking study would be required, it would appear that a wide range of common business services (e.g., management) could potentially qualify as "low margin covered services" eligible for the SCM Exception. This is true *even if* the services are key value drivers for the business because the "business judgment test" does not apply for purposes of the SCM Exception.

Changes to Sections 367 and 482

In addition to the provisions intended to change transfer pricing incentives (e.g., GILTI, FDII and BEAT), the Tax Act also contains two direct changes to the US transfer pricing regime. First, the Tax Act amends section 936(h)(3)(B) to include the following items in the definition of an "intangible asset" for purposes of section 367(d) and 482:

- Goodwill, going concern value and workforce in place; and
- "any other item the value or potential value of which is not attributable to tangible property or the services of any individual . . ."

Second, the Tax Act amends both sections 482 and 367(d)(2) to allow the IRS to value IP on an aggregate basis or by comparison to realistic alternatives, "if the Secretary determines that such basis is the most reliable means of valuation of such transfers." Furthermore, the Tax Act also repeals the longstanding exception to gain recognition under section 367(a) for transfers to a foreign corporation of property that is used in the active conduct of a trade or business outside the United States.

CONSIDERATIONS AND TAKEAWAYS:

Although the Conference Report suggests these changes were intended in part to facilitate the use by the IRS of income-based valuation methods, they do not on their face mandate use of any particular valuation approach or method. And while the new expanded definition of "intangible assets" may mean that goodwill, going concern value and workforce in place must be compensated at arm's length if transferred, whether such items are in fact transferred, and whether they have any value, remains a question of fact. Similarly, aggregation and valuation by reference to realistic alternatives are still only appropriate to the extent they are the "most reliable" approaches. For example, if the facts establish that the taxpayer's actual transaction is a license of certain identified, discrete items of IP, the most reliable method of valuation (i.e., the "best method") will not be one that values the license by reference to a putative "realistic alternative" of a sale of an entire business on an aggregated basis. This was true before and after the statutory change. Nevertheless, because the expanded IP definition, aggregation, and the realistic alternatives principle are now enshrined in statute, robust upfront analysis and documentation will be more important than ever before to support a different approach.

All this said, US and foreign MNEs may in some cases want to embrace the valuation approaches now enshrined in the statute. For example, a US parent licensing IP to a CFC in exchange for royalties eligible for the FDII deduction (thus subject to the effective 13.125% rate) may find it advantageous to use an income-based valuation method that produces a higher value than other potentially applicable methods, provided that the income-based method is acceptable to the tax authority in the CFC's jurisdiction. It is also worth keeping in mind that income-based valuation methods are very sensitive to input parameters and assumptions, and as such, may not in all cases produce a higher value than other methods. Needless to say, robust upfront analysis and documentation will also be important for taxpayers that choose to embrace income-based valuation of IP in deference to the statutory changes. Such taxpayers can likely expect scrutiny by the IRS of projections, discount rates and other input parameters and assumptions that drive

value under income-based approaches, as well as potential challenges by foreign tax authorities.

Should MNEs Restructure Now?

Whether MNEs should restructure or implement transfer pricing changes now in light of the many changes of the Tax Act is a very complex inquiry that can only be addressed in light of the facts and circumstances of each individual case. On the one hand, there may be some cases where the combination of the Tax Act changes (e.g., rate reduction, GILTI, FDII, BEAT) make existing pre-tax reform structures tax inefficient in absolute terms or may reduce the tax savings to the point where the benefits are now outweighed by administrative and audit defense costs. On the flipside, there may be instances where clearly identified, discrete changes in structure or pricing could substantially improve results going forward. Nevertheless, structure or transfer pricing changes to maximize benefits from the Tax Act may not always make business sense. For example, manufacturing products in the United States for export to non-US markets may be tax efficient if the FDII effective rate of 13.125% is lower than the applicable rate in the relevant foreign jurisdictions, but this approach may also be cost inefficient and run contrary to a business strategy of manufacturing products close to the end customer.

Furthermore, MNEs making structure or transfer pricing changes prompted by the Tax Act should be cognizant of the inherent risks associated with relying only on the plain language of the new statutes and the limited legislative history. Indeed, many of the key provisions of the Tax Act explicitly or implicitly assume that regulations will be issued to interpret the new laws, and until and unless this happens, there will be substantial uncertainty as to how such provisions will be interpreted by the IRS on audit. Given the lack of key guidance, taxpayers taking positions based on interpretations of the Tax Act should document the facts and rationale for their position upfront and be prepared to defend their position on audit. Such taxpayers should also consider making their concerns regarding the need for guidance known to the Treasury Department as soon as possible and to participate in the public comment process once notices of proposed rulemaking are issued. Finally, before implementing any changes motivated in whole or in part by the Tax Act, MNEs should fully consider the foreign tax consequences of the change in all relevant jurisdictions, bearing in mind that the Tax Act's international provisions are unilateral measures that may be at odds with the applicable rules outside the United States, as well as the risk that certain provisions (particularly the FDII deduction) may be subject to challenge by other jurisdictions in the World Trade Organization (WTO).

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Endnotes

[1] Pub. L. 115-97, 131 Stat. 2054 (2017).

[2] All section references are to the Internal Revenue Code of 1986, as amended by the Tax Act and other prior amendments, or to Treasury Regulations promulgated thereunder.

[3] The dividends received deduction is not available for "hybrid dividends," defined generally as dividends for which the paying CFC received a deduction.

[4] We refer to the new system as a "modified territorial" tax system because the United States still retains the right to tax income of foreign branches or disregarded entities of domestic corporations, as well as the subpart F income (under the existing regime that remains largely unchanged) and GILTI of certain foreign subsidiaries of US taxpayers. And, of course, the changes described in the text do not extend to individuals, partnerships or S corporations, and exclude RICs and REITs.

[5] Because the 50% deduction is available only to "domestic *corporations*," non-C corporation shareholders would be subject to GILTI tax at the normally applicable income tax rate (up to the top 37% individual rate). For the same reason, non-C corporation taxpayers would be ineligible for the FDII deduction.

[6] In this regard, there appears to be a tension between the Tax Act, which relies on mechanical rules such as GILTI to combat perceived instances of inappropriate profit shifting to low tax jurisdictions, and the recent revisions to the OECD Transfer Pricing Guidelines resulting from Actions 8-10 of the OECD's Base Erosion and Profit Shifting ("BEPS") Action Plan, which instead rely primarily on strengthened rules and expectations regarding substance.

[7] Taxpayers that are members of an affiliated group that includes a bank or a registered securities dealer will be subject to an 11% rate (6% for 2018) when calculating their BEAT.

[8] The applicable base erosion percentage is 2% for taxpayers that are members of an affiliated group that includes a bank or a registered securities dealer.

[9] Related party royalty and interest payments paid or accrued to hybrid entities or in hybrid transactions (and thus, are not subject to tax in the foreign payee's jurisdiction) are also subject to new section 267A, which disallows deductions for such amounts.

[10] The COGS Exception is not specifically enumerated in the statute but is confirmed by the Conference Report, which states that payments included in COGS are not subject to BEAT because they are reductions to income not deductions. Furthermore, the COGS Exception explicitly does not apply to payments to certain foreign related parties or group members that expatriated (inverted) after November 9, 2017.

[11] Under Treas. Reg. §1.482-9(b), services eligible for the SCM include "specified covered services" specifically listed in Revenue Procedure 2007-13 (which includes most common back office services) or are otherwise low-margin services with an arm's length median markup of 7% or less ("low margin covered services"). However, the regulation also provides a list of "excluded services" ineligible for the SCM in all events, which include manufacturing; production; extraction, exploration or processing of natural resources; construction; reselling, distribution, acting as a sales or purchasing agent, or acting under a commission or similar arrangement; research, development or experimentation; engineering or scientific; financial transactions, including guarantees; and insurance or reinsurance. Furthermore, the SCM requires otherwise qualifying services to pass a certain subjective "business judgment test" (which can disqualify certain otherwise qualifying services based on subjective considerations of the services' importance to the business), but the Tax Act allows the business judgment test to be ignored for purposes of applying the SCM Exception to the BEAT.

[12] A Senate Floor colloquy between Senate Finance Committee Chairman Orrin Hatch and Senator Robert Portman on December 1, 2017 suggests that the *cost portion* of charges for SCM eligible services could be bifurcated and excluded from the base erosion tax benefits subject to the BEAT *even if* a markup is actually charged for transfer pricing purposes (although the markup portion would be subject to the BEAT). See 163 Cong. Rec. S7697 (Dec. 1, 2017). Unfortunately, the subsequently issued Conference Report seems to support the opposite interpretation, explaining that the exception applies "only if the payments are made for services that have no markup component." Jt. Explanatory Statement of the Comm. of Conf. to H.R. 1 at 533. Notwithstanding the Conference Report, the fact that the business judgment test may be ignored in determining eligibility for the SCM Exception implicitly supports the interpretation of the Senate Floor colloquy, since under Treas. Reg. §1.482-9(b), services that fail the business judgment test generally *cannot* be charged at cost-plus no markup. Whether the Treasury Department will issue regulations to clarify the SCM Exception, and if so, which interpretation will be reflected, is currently uncertain.

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