Tuesday, February 19, 2019

Internal Revenue Service
CC:PA:LPD:PR (REG-104259-18)
Room 5203, PO Box 7604
Ben Franklin Station
Washington, DC 20044

Via Federal eRulemaking Portal

Re: Comments on proposed regulations implementing IRC section 59A (IRS REG-104259-18)

Dear Sir/Madam:

The Association of Clinical Research Organizations (ACRO) respectfully submits this letter in response to the Notice of Proposed Rulemaking under section 59A (commonly referred to as the "**Base Erosion and Anti-Abuse Tax**" or "**BEAT**")[1] published by the Department of the Treasury ("**Treasury**") and the Internal Revenue Service ("**IRS**") in the Federal Register on December 21, 2018 (the "**Proposed BEAT Regulations**").[2]

ACRO represents the world's leading clinical research and technology organizations. Our member companies provide a wide range of specialized services across the entire spectrum of development for new drugs, biologics and medical devices, from pre-clinical, proof of concept and first-in-man studies through post-approval and pharmacovigilance research. Clinical research organizations (CROs) provide these services to the pharmaceutical, biotechnology and medical device industries (referred to herein as "Sponsors"), which are increasingly outsourcing their clinical development activities to CROs to enable them to bring new life-saving drugs, treatments, therapies, and medical devices through the development and approval process as safely and efficiently as possible.

In 2018, ACRO member companies managed or otherwise supported a majority of all FDA-regulated clinical investigations worldwide, with more than 130,000 employees engaged in research activities in 114 countries. CRO industry revenue for 2017 was in excess of $35 billion and is expected to grow 12 percent year-on-year through 2021. ACRO is dedicated to bringing efficiency, innovation and value to the clinical research process and to highlight the

[1] Unless otherwise indicated, all "section" references are to the Internal Revenue Code of 1986, as amended; and to the Treasury Regulations ("**Treas. Reg.**") promulgated thereunder.

[2] *See* 83 Fed. Reg. 65956 (Dec. 21, 2018). The Proposed Regulations were first made available for public inspection on December 13, 2018, and later published in the Federal Register on December 21, 2018.

important contribution CROs make as partners in the development of new medicines and new treatments that benefit millions of patients worldwide.

We recognize and commend the extraordinary efforts of Treasury and IRS staff in issuing TCJA guidance in a timely and comprehensive manner. To that end, this letter will raise the following comments and recommendations below for your consideration:

A. Pass-through Payments - The definition for a base erosion payment under Proposed Regulation §1.59A-3(b)(1)(i) should not include payments made by a US taxpayer to reimburse a foreign related party at cost and without a markup for amounts it paid to third parties on behalf of a customer.

B. Revenue Sharing Payments - The definition of a base erosion payments under Proposed Regulation §1.59A-3(b)(1)(i) should not include payments made by a US taxpayer to share revenue received from a customer with a foreign related party.

C. Netting – The operating rules under Proposed Regulation §1.59A-3(b)(2)(ii) for base erosion payments should not include payments when there is a contractual relationship between the US taxpayer and a foreign related party which allows the parties to make or receive payments on a net basis.

D. Bifurcated Year – The base erosion minimum tax amount under Proposed Regulation §1.59A-5(c)(3) should be modified so that section 15 does not apply to taxable years beginning in calendar year 2018.

I. BACKGROUND

A. Overview of the BEAT

The Tax Cuts and Jobs Act, Pub. L. 115-97 (2017) ("TCJA"), enacted on December 22, 2017, added section 59A to the Code. Section 59A imposes on each applicable taxpayer a tax equal to the base erosion minimum tax amount for the taxable year (the "base erosion and anti-abuse tax" or "BEAT").

In general, a taxpayer is subject to the BEAT if it is a corporation (other than a regulated investment company, a real estate investment trust, or an S corporation), has average annual gross receipts for the prior three-year period of $500 million or more, and has a base erosion percentage for the tax year of 3 percent or more.[3]

The BEAT is equal to the excess of (1) the BEAT applicable rate for the tax year multiplied by the taxpayer's modified taxable income over (2) the taxpayer's regular tax liability reduced by certain credits. The BEAT applicable rate is 5 percent for tax years beginning in 2018, 10 percent for tax years beginning on or before December 31, 2025, and 12.5 percent for tax

[3] Section 59A(e)(1).

years beginning after December 31, 2025 (one percentage point higher for banks and securities dealers).

Modified taxable income (MTI) is taxable income determined without regard to (1) the base erosion tax benefit with respect to any base erosion payment, or (2) the base erosion percentage of the allowed net operating loss deduction for the tax year.[4]

Base erosion tax benefits generally are deductions allowed with respect to a base erosion payment. A base erosion payment generally is an amount a taxpayer pays or accrues to a foreign related person for which a deduction is allowable. The base erosion percentage generally is determined by dividing the amount of all base erosion tax benefits for the tax year by the sum of allowable deductions and certain allowable base erosion tax benefits for the tax year.[5] As such, a taxpayer subject to BEAT generally will be limited from realizing the full tax deduction for amounts paid or accrued to a foreign related party.

The Proposed BEAT Regulations do not provide any specific rules regarding the application of general tax principles relating to how netting rules, the reimbursement doctrine, principal-agent principles, and case law conduit principles apply in determining whether an amount paid to a foreign related party is a base erosion payment. Instead, the Proposed BEAT Regulations defer to the tax characterization of the relevant items as determined under generally applicable federal income tax principles.

B. Overview of CRO Operations

To understand the potential impact the BEAT may have on CROs, it is important to understand a representative operating model through which global clinical trials often are conducted. Generally speaking, to conduct global clinical trials, a CRO often arranges their business through one or more major hubs that serve as the primary contracting party to global contracts. Below is an example to illustrate certain relevant facts in this operating model.

> Example: CRO X operates through two "hubs" - one formed and operating in the United States ("the US Hub") and one formed and operating in a non-US jurisdiction ("the Non-US Hub"). CRO X primarily contracts with Sponsors by entering into a Master Services Agreement ("MSA"), wherein either the US Hub or the Non-US Hub is the signatory to the MSA and subsequently enters into Statements of Work ("SOWs") for each clinical trial pursuant to the MSA. The signing party is referred to as the Prime Contractor[6].
>
> A SOW may require services to be performed in multiple jurisdictions all over the world. In these instances, the US Hub and Non-US Hub typically engage its foreign

[4] Section 59A(c)(1).
[5] Section 59A(c)(4).
[6] In certain cases, both the US Hub and Non-US Hub may be signatories to an MSA and/or related SOWs. In this case, one party is still designated as the Prime Contractor in order for the Sponsors to have one invoicing party. The Sponsors are generally unwilling to engage in a global contract where multiple parties would invoice for portions of the overall Direct or Indirect Costs.

affiliates to perform the required services in their respective jurisdictions. Thus, CRO X's use of hubs generally is necessary to avoid Sponsors having to contract separately with many (and possibly hundreds) of foreign affiliates.

The fees paid by the Sponsor to CRO X are made up of two main components: (1) "Direct Costs," which represent service fees the sponsor has agreed to pay CRO X for services performed by CRO X's employees and (2) "Indirect Costs," which represent reimbursement for expenses paid to third parties incurred in the course of providing services that are not direct costs.

Direct Costs are typically fees for services that are earned, in some part, by each of the US Hub and Non-US Hub. The proportion of revenues from Direct Costs that accrue to each of the US Hub and Non-US Hub generally is based on the proportion of the work to be completed in certain relevant jurisdictions[7]. To simplify the cash flow between the Sponsor and CRO X, the Sponsor makes these cash payments directly to the Prime Contractor and the Prime Contractor further distributes the cash to the appropriate parties. Where the US Hub is the Prime Contractor, cash is collected by the US Hub for all Direct Costs and then transferred to the Non-US Hub for the portion of the global revenue to which they are entitled.

Indirect Costs generally are borne by CRO X or its affiliate (e.g., a controlled foreign corporation (CFC), referred to as the "Local Entity") and are costs that the Sponsor has agreed to reimburse. As with the Direct Costs discussed above, to simplify the cash flow between the Sponsor and CRO X, the Sponsor makes these cash payments directly to the Prime Contractor and the Prime Contractor further distributes the cash to the appropriate parties. Notably, where the US Hub is the Prime Contractor, cash is collected by the US Hub for Indirect Costs incurred by the Local Entity and then transferred to the Local Entity in reimbursement of its third-party payments for Indirect Costs.

Often, a distinction is made between two components of Indirect Costs: (1) "Investigator Grants" and (2) all other expenses or pass-through costs. Investigators are qualified doctors or nurses who are engaged by CRO X or its affiliates to conduct a clinical investigation. Grant payments are made to investigators in exchange for their participation in a particular study. All other pass-through costs include, but are not limited to, service-related travel expenses and third-party vendor fees for printing, laboratory fees, and shipping costs. All Indirect Costs are billed to the Sponsor at the cost incurred by CRO X (directly or indirectly through its subsidiaries) without mark-up.

II. COMMENTS RELATING TO CERTAIN ASPECTS OF PROPOSED SECTION 59A REGULATIONS

A. INDIRECT COSTS/PASS-THROUGH PAYMENTS

[7] Often the US Hub is responsible for performing services in North America (and possibly Latin America) and the non-US Hub is responsible for performing services in the Rest of World.

Proposed Regulation

Proposed Regulation §1.59A-3 provides definitions and related rules regarding base erosion payments and base erosion tax benefits. Specifically, Proposed Regulation §1.59A-3(b)(1)(i) define a base erosion payment, in relevant part, as "any amount paid or accrued by the taxpayer to a foreign related party of the taxpayer and with respect to which a deduction is allowable under chapter 1 of subtitle A of the Internal Revenue Code."

The proposed regulations do not contain any specific provisions with respect to the treatment of payments made by a US taxpayer to reimburse a foreign related party without a markup for amounts it paid to third parties on behalf of a customer ("pass-through payments").

However, the Explanation of Provisions provides that:

> "In general, the treatment of a payment as deductible, or as other than deductible, such as an amount that reduces gross income or is excluded from gross income because it is beneficially owned by another person, generally will have federal income tax consequences that will affect the application of section 59A and will also have consequences for other provisions of the Code. In light of existing tax law dealing with identifying who is the beneficial owner of income, who owns an asset, and the related tax consequences (including under principal-agent principles, reimbursement doctrine, case law conduit principles, assignment of income or other principles of generally applicable tax law), the proposed regulations do not establish any specific rules for purposes of section 59A for determining whether a payment is treated as a deductible payment or, when viewed as part of a series of transactions, should be characterized in a different manner."

ACRO Recommendation

ACRO recommends the final regulations contain a specific provision that confirms pass-through payments based on a contract or agreement that are received as reimbursements for third party costs paid by CROs without a markup are not base erosion payments.

Explanation for ACRO's Recommendation

We recognize the government's intent based on the language in the preamble for general tax principles to apply to determine the treatment of pass-through payments. However, due to the significance of the issue to the CRO industry and to avoid any uncertainty, ACRO recommends the final regulations make clear that pass-through payments are not base erosion payments where the relevant agreement provides certain third-party costs will be reimbursed without markup.

We believe this conclusion is consistent with general tax principles where an entity that is just facilitating a payment, and has no rights or obligations with respect to the payment, would be treated as a mere conduit, as outlined in more detail below.

That is, it is a well-settled principle of tax law that a taxpayer does not experience an accession to wealth within the meaning of section 61 when a taxpayer receives funds that, at the time of receipt, are subject to an obligation to be repaid. These authorities have held that in general, if funds received by a taxpayer are subject to an obligation to repay there is no accession to wealth upon the receipt of such funds, notwithstanding the fact the taxpayer may have "complete dominion" over the funds. This general principle arises in a number of contexts including reimbursed expenditures,[8] conduit arrangements,[9] and agency relationships.[10]

Particularly relevant for CROs' pass-through costs is the concept of conduit arrangements, where a taxpayer receives an amount with an offsetting obligation to make a payment and thus has no accession to wealth. In these instances, the courts have ruled "it is well settled that a taxpayer need not include in income amounts which are not received under a claim of right and which are required to be transmitted to someone else."[11]

The following facts have been relevant in cases that rely on a conduit arrangement to exclude an amount received from income:

- The taxpayer did not have claim of right to the income or the absence of an enforceable obligation to pay the money to someone else[12];
- The taxpayer received no benefit from additional amounts that were paid to it and remitted to the related party[13];
- The taxpayer merely served to provide a bank account through which funds could be funneled to a related party[14];
- The amounts collected were not used in the company's business and were never claimed by the company as anything other than money to which someone else was entitled[15];

[8] See e.g., *Boston Elevated Railway Co v. Comm'r*, 37 BTA 494 (1938) (it is well settled that when a taxpayer makes expenditures under an agreement that he will be reimbursed for, such expenditures are in the nature of advancements and are not deductible as business expenses. By parity of reasoning, payments so conditioned would not be income to the recipient.) and *Glendinning, McLeish & Co. v. Comm'r*, 24 B.T.A. 518 (1931) (it is well settled by the decisions of this Board that, where the taxpayer makes expenditures under an agreement that he will be reimbursed for, such expenditures are in the nature of loans or advancements and are not deductible as business expenses.).
[9] See e.g., *Seven-Up Co. v. Comm'r*, 14 TC 965, 978 (1950); *Affiliated Foods Inc. v. Comm'r*, 154 F.3d 527 (1998).
[10] See e.g., *National Carbide*, 366 U.S. 422 (1949), *Bollinger*, 485 U.S. 340 (1988).
[11] See e.g., *Brown v. C.I.R.*, T.C. Memo 1977-100 (1977), *Lashells' Estate v. C.I.R.*, 208 F.2d 430 (6th Circuit, 1953), *Seven-Up Company v. C.I.R.*, 14 T.C. 965 (1950).
[12] See *Lashells' Estate v. C.I.R.*, 208 F.2d 430 (6th Circuit, 1953).
[13] See *Brown v. C.I.R.*, T.C. Memo 1977-100 (1977).
[14] Id.
[15] See *Lashells' Estate v. C.I.R.*, 208 F.2d 430 (6th Circuit, 1953).

- The company did not have any intention of making a profit from the pass-through transaction[16];
- The payments were not for services rendered or to be rendered by the taxpayer[17]; and
- The parties intended for the taxpayer to be a mere conduit for passing on payments[18].

With respect to pass-through payments made by CROs, the taxpayers generally are similarly situated in that they have no claim of right to, and receive no benefit from, amounts received from Sponsors that are required to be transmitted to foreign related parties to cover Indirect Costs paid to third parties. Moreover, the CROs generally do not use the pass-through payments collected in their business and do not claim the amounts as anything other than money to reimburse the foreign related party for Indirect Costs on behalf of the Sponsor. Significantly, the CROs do not intend to make a profit from the pass-through payments as the Indirect Costs are reimbursed by the Sponsor without a markup. Finally, the pass-through payments are not for services rendered or to be rendered, as the payment for Direct Costs is intended to fully compensate the CROs for their services. Thus, it is reasonable to believe the CROs act as a mere conduit, and have no accession to wealth within the meaning of section 61, with respect to pass-through payments.

As such, we believe it is reasonable to conclude that pass-through payments received by a CRO would not give rise to income or deductions, and thus would not result in base erosion payments. As a result, it seems unlikely that Congressional intent would have been for these pass-through payments to be treated as base-erosion payments and, thus, be subject to the BEAT.

However, due to significance of the issue and to avoid any potential controversy, ACRO recommends the final regulations make clear that pass-through payments are not base erosion payments where the relevant agreement provides certain third-party costs will be reimbursed without markup. This clarification is necessary to avoid the potential for similarly situated taxpayers to be taxed differently, such as where Non-US hubs receive pass-through payments to be paid to US related parties and are not subject to the BEAT. Moreover, including a specific provision in the regulations will prevent a trap for the unwary where unsophisticated taxpayers that are not aware of the applicable case law may treat their pass-through costs as base erosion payments. Further, absent this clarification, CROs may be forced to change their business practices (e.g., revise their contracting models or move their hubs outside the US) to gain certainty that amounts passing through them will not give rise to base erosion payments. Such changes to a CRO's business practices likely would significantly increase complexity and costs and make CROs less competitive with Non-US CROs.

B. Direct Costs/Revenue Sharing Payments

---

[16] Id.
[17] See *Seven-Up Co. v. Comm'r*, 14 TC 965, 978 (1950).
[18] See *Seven-Up Co. v. Comm'r*, 14 TC 965, 978 (1950); *Affiliated Foods Inc. v. Comm'r*, 154 F.3d 527 (1998).

Proposed Regulation

As noted above, Proposed Regulation §1.59A-3 provides definitions and related rules regarding base erosion payments and base erosion tax benefits. Specifically, Proposed Regulation §1.59A-3(b)(1)(i) defines a base erosion payment, in relevant part, as "any amount paid or accrued by the taxpayer to a foreign related party of the taxpayer and with respect to which a deduction is allowable under chapter 1 of subtitle A of the Internal Revenue Code."

The proposed regulations do not contain any specific provisions with respect to the treatment of payments made by a US taxpayer to share revenue received from a customer with a foreign related party ("revenue sharing payments").

However, the Explanation of Provisions provides that:

> "In general, the treatment of a payment as deductible, or as other than deductible, such as an amount that reduces gross income or is excluded from gross income because it is beneficially owned by another person, generally will have federal income tax consequences that will affect the application of section 59A and will also have consequences for other provisions of the Code. In light of existing tax law dealing with identifying who is the beneficial owner of income, who owns an asset, and the related tax consequences (including under principal-agent principles, reimbursement doctrine, case law conduit principles, assignment of income or other principles of generally applicable tax law), the proposed regulations do not establish any specific rules for purposes of section 59A for determining whether a payment is treated as a deductible payment or, when viewed as part of a series of transactions, should be characterized in a different manner."

ACRO Recommendation

ACRO recommends that the final regulations acknowledge that revenue sharing payments are not base erosion payments to the extent they are paid pursuant to a valid agency or revenue sharing agreement, and provide factors or safe harbors to determine whether the agency or revenue sharing agreement is valid.

Explanation for ACRO's Recommendation

We recognize the government's intent based on the language in the preamble for general tax principles also to apply to determine the treatment of revenue sharing payments. However, due to the significance of the issue to the CRO industry and to avoid any uncertainty, ACRO recommends the final regulations make clear that revenue sharing payments paid pursuant to a valid agency or revenue sharing arrangement are not base erosion payments.

As noted in the Example in Section IB above, to simplify the contracting and cash flow between the Sponsor and CRO X, a Sponsor typically makes cash payments for both Direct

Costs and Indirect Costs directly to the Prime Contractor and the Prime Contractor further distributes the cash to the appropriate parties on behalf of the Sponsor. Where the US Hub is the Prime Contractor, cash is collected by the US Hub for all Direct Costs and then transferred to Non-US Hub for distribution to foreign affiliates for the portion of the global revenue to which each is entitled for the services each provides.

To the extent the payments for Direct Costs received by a US Hub and remitted to foreign related parties are considered income and deductions of the US Hub, then the US Hub would have a potentially nondeductible base erosion payment. In contrast, to the extent the payments for Direct Costs are received by the US Hub as an agent or a revenue sharing partner for which it has an offsetting obligation to pay that amount to the foreign affiliate, the payments would not give rise to income or a corresponding deduction, and thus would not be subject to BEAT. Thus, it is critical to analyze the rights and obligations under a CRO's contracts to determine the treatment of revenue sharing payments.

Typically, CROs may have two contracting scenarios that would require a separate analysis. In Scenario 1, CRO X executes a bi-party contract between the Prime Contractor and the Sponsor for Direct and Indirect Costs (the "Bi-Party Model"); and under Scenario 2, CRO X executes a tri-party contract among the US Hub, the Non-US Hub and the Sponsor for Direct and Indirect Costs, regardless of who is designated as the Prime Contractor (the "Tri-Party Model"). In either the Bi-Party or Tri-Party Model, an intercompany agreement would exist to set forth the mechanism for determining the revenue to be shared by each of the US Hub and Non-US Hub.

As noted above, it is a well-settled principle of tax law that a taxpayer does not experience an accession to wealth within the meaning of section 61 when a taxpayer receives funds that, at the time of receipt, are subject to an obligation to be repaid. For example, a taxpayer generally does not have a claim of right to income received when it has a requirement to transmit the amount to someone else in a valid agency or revenue sharing arrangement.

First, with respect to agency, the application of agency principles has been developed through case law. In particular, the Supreme Court examined the issue of whether a corporate entity was in substance an agent and therefore not taxable on duties it performed for a related principal in three notable cases: *Moline Properties, Inc. v. Commissioner, National Carbide Corp. v. Commissioner,* and *Commissioner v Bollinger*.[19] In *National Carbide*, the Court outlined four "relevant considerations" in determining whether a true agency arrangement exists, including (1) whether the agent operates in the name of and for the account of the principal, (2) whether the agent binds the principal by its actions, (3) whether the agent transmits money received to the principal, and (4) whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal. The Court further determined that, if a corporation is a true agent, (5) its

[19] *Moline Properties, Inc. v. Commissioner,* 319 U.S. 436 (1943); *National Carbide Corp. v. Commissioner*, 336 U.S. 433 (1949); *Commissioner v. Bollinger*, 485 U.S. 340 (1988).

relations with its principal must not be dependent upon the fact that it is owned by the principal, if such is the case, and (6) its business purpose must be the carrying on of the normal duties of an agent.

Subsequently, in *Bollinger*, the Court reasoned that it is reasonable for the Commissioner to demand "unequivocal evidence of genuineness [of agency] in the corporation-shareholder context in order to prevent evasion of *Moline*." The Court concluded that, "The genuineness of the agency relationship is adequately assured, and tax-avoiding manipulation adequately avoided, when the fact that the corporation is acting as agent for its shareholders with respect to a particular asset is set forth in a written agreement at the time the asset is acquired, the corporation functions as agent and not principal with respect to the asset for all purposes, and the corporation is held out as an agent and not principal in all dealings with third parties relating to the asset."[20]

Thus, under agency principles, in order to support a position that US Hub is an agent for the foreign related parties, it is critical that the US Hub be disclosed as an agent with respect to any services performed by a foreign related party, all dealings of the US Hub with respect to services provided by a foreign related party be on behalf of the principal, and the rights and obligations under the contract with respect to services provided by a foreign related party be with that foreign related party, among other factors. If the US Hub is an agent, then amounts collected from the Sponsor for Direct Costs and transmitted to Non-US Hub would not be treated as income or deductions of the US Hub under either a Bi-Party or Tri-Party Model.

Similarly, under revenue sharing principles developed by the courts, a taxpayer generally does not have a claim of right to income received when it has a requirement to transmit the amount to someone else in a valid revenue sharing arrangement. That is, when there is an agreement to share revenue earned from a venture, the taxpayer does not have a claim of right to the income and is not required to recognize income. As a corollary, the taxpayer would not take a deduction for amounts remitted to the other party.

The following facts have been relevant in cases that rely on a revenue share arrangement to exclude an amount received from income:

- Each of the parties uses their assets and/or their employees to perform.[21]
- A bona fide arrangement exists pursuant to which the funds are to be shared.[22][23]

[20] *Id.* at 349-350.
[21] See e.g., *Mill v. C.I.R.*, 5 T.C. 691 (1945); *Clark v. C.I.R.*, 19 T.C. 48 (1952); *Lashells' Estate v. C.I.R.*, 208 F.2d 430 (6 th Cir., 1953); *Steven's Brothers and the Miller-Hutchinson Company, Inc. v. C.I.R.*, 24 T.C. No. 953, 24 T.C. No.106 (1955); *Manchester Music Co. v. U.S.*, 733 F.Supp 473 (New Hampshire District Court, 1990).
[22] Note the law is in consistent as to whether this arrangement needs to be in writing (Compare *Mill, Clark, Lashell's Estate, Shaara* with *Illinois Power Co, Stevens, Mount Vernon Gardens*) and whether the customer must know about the arrangement (Compare *Lashell's Estate* with *Johnson, Basye*).
[23] See e.g., *Manchester Music Co. v. U.S.*, 733 F.Supp 473 (New Hampshire District Court, 1990); *DJB Holding Corporation v C.I.R.*, 803 F.3d 1014 (CA9, 2015); *Mill v. C.I.R.*, 5 T.C. 691 (1945); *Brown v. C.I.R.*, T.C. Memo 1977-100 (1977); *Steven's Brothers and the Miller-Hutchinson Company, Inc. v. C.I.R.*, 24 T.C. No. 953, 24 T.C. No.106 (1955); *Déjà Vu-Lynnwood, Inc. v. U.S.*, 88 AFTR 2d 2001-6876 (CA9, 2001); *Taylor Blvd.*

- The taxpayer does not claim the amount as anything other than money owed to another[24], does not have control over or unrestricted use of the funds[25], and does not use the funds in his business[26].
- The taxpayer receives no benefit from the amounts he collects and remits to another for their performance[27], and the taxpayer does not earn/intend to earn a profit on such amounts[28].
- Each party is at risk for their respective portion of the performance[29].

Thus, under revenue sharing principles, a US Hub arguably would not have income for amounts it receives from a Sponsor related to a bona fide arrangement to share revenue where each of the parties has the rights and obligations with respect to their performance and the parties perform using their assets and their employees, among other considerations. If the US Hub and the Non-US Hub have a valid revenue sharing arrangement, then amounts collected from the Sponsor for Direct Costs and transmitted to Non-US Hub would not be treated as income or deductions of the US Hub under either a Bi-Party or Tri-Party Model.

Despite the existence of case law that could support a position to exclude certain revenue sharing payments from income, ACRO recommends that the regulations including a specific provision with respect to agency and revenue sharing arrangements. Including a specific rule in the regulations will prevent a trap for the unwary where unsophisticated taxpayers that are not aware of the applicable case law may treat their revenue sharing payments improperly as base erosion payments. Further, given the CRO operating model, it is critical that revenue sharing payments be received pursuant to a valid agency or cost sharing arrangements. A different result would substantially change the economics of the transactions, and thus many CROs are faced with the need to restructure their operations and/or contracting models to avoid the US being taxed on the foreign affiliate's share of the revenue. As such, it is critical for CROs to understand the relevant rules and considerations to properly analyze and potentially restructure their agreements to be a valid agency or

Theatre, Inc. v. U.S., 82 AFTR 2d 98-5102 (Kentucky District Court, 1998); *Acme Music Co., Inc. v. IRS*, 80 AFTR 2d 97-7574 (Pennsylvania District Court, 1997).

[24] See e.g., *Diamond v. C.I.R.*, 50 T.C. 530 (1971); *Lashells' Estate v. C.I.R.*, 208 F.2d 430 (6 th Cir., 1953).

[25] See e.g., *Vandenbosch v. C.I.R.*, T.C. Memo 2016-29 (2016); *Manchester Music Co. v. U.S.*, 733 F.Supp 473 (New Hampshire District Court, 1990); *J&J Cab Service, Inc. v. U.S.*, 81 AFTR 2d 98-1656 (North Carolina District Court, 1998); *Howard's Yellow Cabs, Inc. v. U.S.*, 81 AFTR 2d 98-1417 (North Carolina District Court, 1998); *Acme Music Co., Inc. v. IRS*, 80 AFTR 2d 97-7574 (Pennsylvania District Court, 1997); *Shaara*, T.C. Memo 1980-247; *Jolar Cinema, Inc.*, T.C. Memo 1983-403; *In Re: Rodriguez*, 101 AFTER 2d 2008-1876, 387 B.R. 76 (Bkcty Ct NY, 2008).

[26] See e.g., *Lashells' Estate v. C.I.R.*, 208 F.2d 430 (6 th Cir., 1953); *Brown v. C.I.R.*, T.C. Memo 1977-100 (1977); *Clark v. C.I.R.*, 19 T.C. 48 (1952).

[27] See e.g., *Brown v. C.I.R.*, T.C. Memo 1977-100 (1977); *Clark v. C.I.R.*, 19 T.C. 48 (1952); *Lashells' Estate v. C.I.R.*, 208 F.2d 430 (6 th Cir., 1953); *Mill v. C.I.R.*, 5 T.C. 691 (1945); *Shaara*, T.C. Memo 1980-247; *In Re: Rodriguez*, 101 AFTER 2d 2008-1876, 387 B.R. 76 (Bkcty Ct NY, 2008)

[28] See e.g., *Lashells' Estate v. C.I.R.*, 208 F.2d 430 (6 th Cir., 1953); *Clark v. C.I.R.*, 19 T.C. 48 (1952); *Ball*, T.C. Memo 1984-218.

[29] See e.g., *DJB Holding Corporation v C.I.R.*, 803 F.3d 1014 (CA9, 2015); *Clark v. C.I.R.*, 19 T.C. 48 (1952).

revenue sharing arrangement such that only retained revenue (i.e., total Direct Costs revenue less amount of Direct Costs revenue paid to the non-US Hub) is subject to US tax.

For these reasons, ACRO recommends that the final regulations provide that revenue sharing payments are not base erosion payments to the extent they are paid pursuant to a valid agency or revenue sharing agreement, and include factors such as those outlined above to determine whether an agency or revenue sharing agreement is valid. Alternatively, the final regulations could provide safe harbors that can be relied on to conclude an arrangement is a valid agency or revenue sharing arrangement.

C. NETTING

Proposed Regulation

The Proposed Regulation § 1.59A-3(b)(2)(ii) address the operating rules for transactions providing for net payments. In general, the amount of any base erosion payment is determined "on a gross basis, regardless of any contractual or legal right to make or receive payments on a net basis. For this purpose, a right to make or receive payments on a net basis permits the parties to a transaction or series of transactions to settle obligations by offsetting any amounts to be paid by one party against amounts owed by that party to the other party." Regardless if an agreement exists between the parties in a transaction or series of transactions that allows payments on a net basis, the proposed regulations provide that base erosion payments are calculated on a gross basis.

In the preamble to the proposed regulations, Treasury and the IRS explain that netting is not permitted because "the BEAT statutory framework is based on including the gross amount of deductible and certain other payments (base erosion payments) in the BEAT's expanded modified taxable income base without regard to reciprocal obligations or payments that are taken into account in the regular income tax base, but not the BEAT's modified taxable income base."[30] Treasury and the IRS requested comments on distinctions regarding commercial contracts entered into by an applicable taxpayer and a foreign related party that provide for netting of items payable by one party against items payable by the other party in determining that net amount to be paid between the parties. The preamble does address situations where generally applicable tax law would provide that a deduction is computed on a net basis (because an item received reduces the item of deduction rather than increasing gross income). The proposed regulations do not change that result.

ACRO notes that the netting of related party transactions for BEAT purposes would be a consistent treatment with the special rules with respect to services provided to related parties under section 250. Respectively, section 250(C)(ii) requires taxpayers to aggregate related party services provided to and received from related parties that are substantially similar in nature for purposes of determining allowance of a deduction. In addition, viewing interrelated transactions "on an aggregate basis" is consistent with section 482, as amended by the 2017 tax reform, and legislative history. Therefore, intercompany payments that

[30] 83 Fed. Reg. 65956, 65968 (Dec. 21, 2018).

relate to the same business activity, product or service, should be treated in the aggregate, on a net basis for the purposes of applying section 59A.

ACRO Recommendation

ACRO recommends that gross payments made and received by a taxpayer may be netted and accounted for consistently to the extent that the payments are connected with or to the same business activity, product or service. Specifically, ACRO recommends Proposed Regulation § 1.59A-3(b) be modified such that taxpayers receiving and making gross payments may be permitted to consistently account for payments on a net basis within the same business activity, product, or service. Under this recommendation, only a net outbound amount paid or accrued to a foreign related party will be considered as the amount of the base erosion payment.

Explanation for ACRO's Recommendation

Because clinical trial protocols require measurement of safety and efficacy of a therapy on a specific number of patients over a specific period of time, large scale clinical trials typically are conducted in various countries to maximize the possibility of achieving the required amount of trial patients within targeted time-frames. This strategy allows a potential therapy to more quickly reach the market and help patients, and to do so in a competitive global market. Rather than contracting with Pharma-industry customers separately for each foreign component of a global clinical trial, outsourced clinical trial organizations typically enter into global service agreements with those customers and utilize a recharge process whereby the US collects fees from customers as a general contractor, and then reimburses subcontractors in other countries for services performed. Similarly, foreign affiliates may operate as the general contracting entity and subcontract for services to be provided in the U.S. When payments are both received and due for services provided between foreign related parties and the U.S. Company, common administrative practice is to report the net amount. In addition, reporting the net amount reduces wire transfers and the administrative burden of reconciling intercompany balances and charges between the U.S. and foreign affiliates. Accounting for the related party transactions on a gross payment basis would result in a significant BEAT liability where, economically, there is no base erosion and from a tax policy perspective, should result in no BEAT liability.

For the aforementioned reasons, ACRO recommends modifications to Proposed Regulation § 1.59A-3(b) to specify that gross payments made and received by a taxpayer may be netted provided that the accounting is consistent and related to the same business activity, product or service. As a result, only a net outbound payment from the U.S. will be treated as a base erosion payment. For a multinational company, the netting of such payments is recommended to better reflect the economics of related party transactions and should be permitted when determining base erosion payments.

D. BIFURCATED REPORTING YEAR

Proposed Regulation

For BEAT purposes, section 59A(b)(1)(A) defines the statutory rate to be "an amount equal to 10 percent (5 percent in the case of taxable years beginning in calendar year 2018)." The language in the statute clearly defines the applicable BEAT rate is 5 percent for taxable years beginning in calendar year 2018 and 10 percent for taxable years beginning in calendar year 2019.

The Proposed Regulation § 1.59A-5(c)(3) provides that "Section 15 applies to any taxable year beginning after January 1, 2018," which could subject a fiscal-year taxpayer to section 15 and apply a blended rate of tax between 5 and 10 percent with respect to its taxable year beginning in calendar year 2018. This interpretation is not consistent with the statute in section 59A(b)(1) and the legislative history under this provision that plainly states a 5 percent rate applies for the entire taxable year beginning in calendar year 2018.

When there is a change in tax rate during the middle of a taxable year, section 15 provides rules for taxpayers to determine the effective date of a change in tax rate. Under section 15(a), tax is computed using a blended tax rate "if any rate of tax imposed by this chapter changes, and if the taxable year includes the effective date of the change (unless that date is the first day of the taxable year)."

Section 15(c)(1) states that if the rate changes for taxable years "beginning after" or "ending after" a certain date, the following day is the effective date of the change. Similarly, section 15(c)(2) provides that if the rate changes for taxable years "beginning on or after" a certain date, that date is considered the effective date of the change. The terms utilized in section 59A(b)(1) are dissimilar to those prescribed in Section 15(c). Precisely, Section 59A specifies the rate for taxable years "beginning in" whereas section 15(c) determines the effective date for a rate change by reference to taxable years "beginning after", "ending after," or "beginning on or after".

Applying section 15 to taxable years beginning in calendar year 2018 conflicts with the statute and legislative history. Congress clearly intended to provide a one year transition period to adopt the new provision, and the statute clearly provides for a 5 percent rate to be applied for taxable years beginning in calendar year 2018. In addition, in the Conference Committee Report to Accompany the Act Congress explains that the 5 percent "applies for one year for base erosion payments paid or accrued in taxable years beginning after December 31, 2017."

Section 59A(b)(2) addresses modifications for taxable years beginning after 2025 when the rate changes from 10 percent to 12.5 percent and appears to fall under the language of section 15(c)(1). Accordingly, January 1, 2026, would be considered the effective date of the change as it is the following day. This effective date will not be the first day of a fiscal taxable year. As a result, it seems a reasonable interpretation of the statute to apply section 15 to a taxable year that begins before and ends after January 1, 2026.

ACRO Recommendation

ACRO

ASSOCIATION OF CLINICAL RESEARCH ORGANIZATIONS

ACRO recommends that Proposed Regulation § 1.59A-5(c)(3) be modified to provide that section 15 does not apply to taxable years beginning in calendar year 2018.

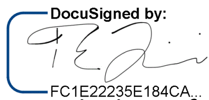
Explanation for ACRO's Recommendation

The statutory language in section 59A(b)(1)(A) is clear for both calendar and fiscal year taxpayers that the prescribed rate is effective on the first day of a taxable year. For example, if a taxpayer's taxable year begins on July 1, 2018, then the taxpayer applies 5 percent to its modified taxable income for the year to calculate BEAT. Likewise, for its taxable year beginning on July 1, 2019, the taxpayer applies 10 percent to its modified taxable income for BEAT purposes. On the first day of the respective taxable year, the tax rate takes effect and the exception under section 15(a) should apply. Applying section 15 to the taxable year beginning on July 1, 2018, would result in an approximate BEAT rate of 7.5 percent for that year, which would be in direct conflict with the 5 percent rate prescribed by section 59A(b)(1)(A). Modifying the proposed regulations so that section 15 does not apply to taxable years beginning in calendar year 2018 provides a one-year transition period to apply the new tax provision, consistent with the statute and legislative intent.

III. CONCLUSION

We understand that a number of details would need to be addressed if Treasury and the IRS accept the recommendations set forth above. ACRO representatives would welcome the opportunity to meet with Treasury and the IRS to discuss any of the above recommendations.

Yours sincerely,



Association of Clinical Research Organizations
Thomas E. Zajkowski
Treasurer

cc: L. G. "Chip" Harter, Deputy Assistant Secretary (International Tax Affairs), U.S. Treasury Department
Harvey Mogenson, U.S. Treasury Department
Brenda Zent, Special Advisor, U.S. Treasury Department
Leni Perkins, Attorney-Advisor, Branch 8, ACC(I), Internal Revenue Service
Shelia Ramaswamy, Attorney-Advisor, ACC(I), Internal Revenue Service
Karen Walney, Attorney-Advisor, ACC(I), Internal Revenue Service
Julie Wang, Attorney-Advisor, Internal Revenue Service
John P. Stemwedel, Attorney-Advisor, Internal Revenue Service