Shedding Light on the BEAT

Panelists:

• Joseph Calianno, Partner, BDO USA LLP, Washington, DC (Moderator)

• Amie Colwell Breslow, PwC, Washington, DC

• Lucas Giardelli, Mayer Brown LLP, New York, NY

ABA Tax Section Meeting
January 18, 2019
Base Erosion and Anti-Abuse Tax (BEAT)

- The Base Erosion and Anti-Abuse Tax or BEAT requires certain corporations to pay additional corporate tax in situations where such corporations have certain “base erosion payments” to foreign related parties and certain thresholds and conditions are satisfied (complicated formula for determining the tax)

- Can impact a number of corporations in different industries and with different organizational structures (e.g., U.S. parented groups and foreign parented groups) that make “base erosion payments” when such corporations are “applicable taxpayers”

- Often viewed as an inbound rule but applies outbound as well

- Applies to base erosion payments paid or accrued in taxable years beginning after December 31, 2017
Applicable Taxpayer - Section 59A(e)

- Very generally, an applicable taxpayer:
  - Is a corporation (other than a RIC, REIT or S corporation);
  - Has average annual gross receipts for the prior 3-taxable year period ending with the preceding taxable year of at least $500 million; and
  - Has a “base erosion percentage” of 3% or more for the tax year (2% where a bank or securities dealer is part of the affiliated group)
Aggregation Rule - Section 59A(e)

- Certain aggregation rules apply for purposes of these threshold tests (Section 59A(e)(3))
  - All persons treated as a single employer under Section 52(a) are treated as 1 person for purposes of Section 59A(e) and Section 59A(c)(4) (base erosion percentage), except that in applying Section 1563 for purposes of Section 52, the exception for foreign corporations under Section 1563(b)(2)(C) shall be disregarded.
In the case of a foreign person, only gross receipts which are taken into account in determining income which is effectively connected with the conduct of a trade or business within the U.S. are taken into account. In the case of a taxpayer which is a foreign person, the preceding sentence shall not apply to the gross receipts of any U.S. person which are aggregated with the taxpayer's gross receipts by reason of Section 59A(e)(3).

Rules similar to the rules of Section 448(c)(3)(B), (C) and (D) apply in determining gross receipts.
Applicable Taxpayer
(Selected Issues)
Proposed Regulations-Applicable Taxpayer

- For purposes of section 59A, a taxpayer is an applicable taxpayer with respect to any taxable year if the taxpayer—
  - Is a corporation, but not a RIC, REIT or S corporation;
  - Satisfies the gross receipts test of Prop. Reg. 1.59A-2(d) (Gross Receipts Test); and
  - Satisfies the base erosion percentage test of Prop. Reg. 1.59A-2(e)

- See Prop. Reg. 1.59A-2(b)
Aggregation Rule
(Selected Issues)
Proposed Regulations-Aggregation Rule

• The term aggregate group means the group of corporations determined by
  • Identifying a controlled group of corporations as defined in Section 1563(a), except that the phrase “more than 50 percent” is substituted for “at least 80 percent” each place it appears in Section 1563(a)(1) and the determination is made without regard to Sections 1563(a)(4) and (e)(3)(C), and
  • Once the controlled group of corporations is determined, excluding foreign corporations except with regard to income that is, or is treated as, effectively connected with the conduct of a trade or business in the United States
    • Notwithstanding the foregoing, if a foreign corporation determines its net taxable income under an applicable income tax treaty of the United States, it is excluded from the controlled group of corporations except with regard to income taken into account in determining its net taxable income
• See Prop. Reg. 1.59A-1(b)(1)
Proposed Regulations-Aggregation Rule

- A taxpayer that is a member of an aggregate group determines its gross receipts and its base erosion percentage on the basis of the aggregate group as of the end of the taxpayer's taxable year.

- For these purposes, transactions that occur between members of the taxpayer's aggregate group that were members of the aggregate group as of the time of the transaction are not taken into account.

- In the case of a foreign corporation that is a member of an aggregate group, only transactions that relate to income effectively connected with, or treated as effectively connected with, the conduct of a trade or business in the United States are disregarded for this purpose. In the case of a foreign corporation that is a member of an aggregate group and that determines its net taxable income under an applicable income tax treaty of the United States, only transactions that are taken into account in determining its net taxable income are disregarded for this purpose.

- See Prop. Reg. 1.59A-2(c)
Proposed Regulations-Aggregation Rule

- Dual treatment of certain foreign corporations

  - It may be the case that a payment by a domestic corporation to a foreign corporation is not taken into account in determining applicable taxpayer status because the payee is subject to net income tax in the United States on that payment, while another payment by the same domestic corporation to the same foreign corporation is taken into account in determining applicable taxpayer status because the payee is not subject to net income tax in the United States on that payment.
Proposed Regulations-Aggregation Rule

- The Proposed Regulations provide rules for determining whether the gross receipts test and base erosion percentage test are satisfied with respect to a specific taxpayer when other members of its aggregate group have different taxable years.

- In general, the Proposed Regulations provide that each taxpayer determines its gross receipts and base erosion percentage by reference to its own taxable year, taking into account the results of other members of its aggregate group during that taxable year.

  - For purposes of determining the gross receipts, base erosion tax benefits, and deductions of the aggregate group, the taxpayer must include those amounts that occur during the course of the taxpayer's own taxable year, not another member of the aggregate group's taxable year, if different.
Proposed Regulations-Aggregation Rule

- The preamble states that taxpayers may use a reasonable method to determine the gross receipts and base erosion percentage information for the time period of the member of the aggregate group with a different taxable year.

- The Proposed Regulations also provide that when determining the base erosion percentage for a taxpayer that is a member of an aggregate group with other members that have a different taxable year, the effective date in Section 14401(e) of the TCJA, as it applies to the taxpayer making the return, controls whether that taxpayer takes into account transactions of other members of its aggregate group.

  - Section 14401(e) of the TCJA provides that Section 59A applies only to base erosion payments paid or accrued in taxable years beginning after December 31, 2017.

- See Prop. Regs. 1.59A-2(d)(2) and -2(e)(3) for further details.
Proposed Regulations-Aggregation Rule

- **Facts:** Foreign Parent (FP) is a foreign corporation that owns all of the stock of a domestic corporation that uses a calendar year (DC1) and a domestic corporation that uses a fiscal year ending on January 31 (DC2). FP does not have income effectively connected with the conduct of a trade or business within the United States. DC2 is a member of DC1’s aggregate group, and DC1 is a member of DC2’s aggregate group.
Proposed Regulations-Aggregation Rule

• **Analysis:** For DC1’s tax return filed for the calendar year ending December 31, 2026, DC1 determines its gross receipts based on gross receipts of DC1 and DC2 for the calendar years ending December 31, 2023, December 31, 2024, and December 31, 2025. Further, DC1 determines its base erosion percentage for the calendar year ending December 31, 2026, on the basis of transactions of DC1 and DC2 for the calendar year ending December 31, 2026.

• For DC2’s tax return filed for the fiscal year ending January 31, 2027, DC2 determines its gross receipts based on gross receipts of DC2 and DC1 for the fiscal years ending January 31, 2024, January 31, 2025, and January 31, 2026. Further, DC2 determines its base erosion percentage for the fiscal year ending January 31, 2027, on the basis of transactions of DC2 and DC1 for the fiscal year ending January 31, 2027.
Gross Receipts Test
(Selected Issues)
Proposed Regulations-Gross Receipts Test


- A taxpayer, or the aggregate group of which the taxpayer is a member, satisfies the gross receipts test if it has average annual gross receipts of at least $500,000,000 for the three-taxable-year period ending with the preceding taxable year.

- In the case of a foreign corporation, the gross receipts test only takes into account gross receipts that are taken into account in determining income that is subject to net income tax as income effectively connected with the conduct of a trade or business within the United States, or taken into account in determining net taxable income under an applicable U.S. income tax treaty.

- If a member of an aggregate group owns an interest in a partnership, the Proposed Regulations provide that the group includes its share of the gross receipts of the partnership in its gross receipts computation (aggregate approach to partnerships).
Proposed Regulations-Gross Receipts Test

- The gross receipts of a consolidated group are determined by aggregating the gross receipts of all of the members of the consolidated group.

- If a taxpayer was not in existence for the entire three-year period referred to in Prop. Reg. 1.59A-2(d)(1), the taxpayer determines a gross receipts average for the period that it was in existence, taking into account Prop. Reg. 1.59A-2(d)(7) (dealing with a short year discussed below).

- If a taxpayer has a taxable year of fewer than 12 months (a short year), gross receipts are annualized by multiplying the gross receipts for the short period by 365 and dividing the result by the number of days in the short year.

- Gross receipts for any taxable year are reduced by returns and allowances made during that taxable year.

- Other rules provided in Proposed Regulations (predecessors, insurance companies, etc.)

- See Prop. Reg. 1.59A-2(d) for further details on this test.
Base Erosion Percentage
(Selected Issues)
Base Erosion Percentage Section 59A(c)(4)

Base Erosion Percentage* = Total Deductions Allowable** for the Year + Certain Base Erosion Tax Benefits***

Aggregate Amount of Base Erosion Tax Benefits for the Year

* For this purpose, a controlled group of corporations is treated as a single corporation

** Includes base erosion tax benefits deductions included in Section 59A(c)(2)(A)(i) and (ii) but doesn’t include Sections 172 (NOL), 245A (DRD), 250 (FDII/GILTI) deductions, deductions for amounts paid or accrued for services to which the services cost method (SCM) exception in Section 59A(d)(5) applies, and any deduction for qualified derivative payments (QDP) which are not treated as a base erosion payment by reason of Section 59A(h)

***Base erosion tax benefits described in Section 59A(c)(2)(A)(iii) and (iv)
Proposed Regulations-Base Erosion Percentage (Prop. Reg. 1.59A-2(e)(3))

- The taxpayer's base erosion percentage for any taxable year is determined by dividing—
  - The aggregate amount of the taxpayer's (or in the case of a taxpayer that is a member of an aggregate group, the aggregate group's) base erosion tax benefits (as defined in Prop. Reg. 1.59A-3(c)(1)) for the taxable year \( \text{(the numerator)} \), by
  - The sum of—
    - The aggregate amount of the deductions (including deductions for base erosion tax benefits described in Prop. Reg. 1.59A-3(c)(1)(i) and base erosion tax benefits described in Prop. Reg. 1.59A-3(c)(1)(ii)) allowable to the taxpayer (or in the case of a taxpayer that is a member of an aggregate group, any member of the aggregate group)
    - The base erosion tax benefits described in Prop. Reg. 1.59A-3(c)(1)(iii) with respect to any premiums or other consideration paid or accrued by the taxpayer (or in the case of a taxpayer that is a member of an aggregate group, any member of the aggregate group) to a foreign related party for any reinsurance payment taken into account under Sections 803(a)(1)(B) or 832(b)(4)(A) for the taxable year and
    - Any amount paid or accrued by the taxpayer (or in the case of a taxpayer that is a member of an aggregate group, any member of the aggregate group) resulting in a reduction of gross receipts described in Prop. Reg. 1.59A-3(c)(1)(iv) for the taxable year \( \text{(the denominator)} \)
  - The denominator is reduced by the items on the following slide
Proposed Regulations-Base Erosion Percentage

- Except as provided in Prop. Reg. 1.59A-2(e)(3)(viii) (relating to certain payments that qualify for the ECI exception and another base erosion payment exception), the following items are not taken into account in the denominator:
  - Any deduction allowed under Section 172, 245A, or 250 for the taxable year
  - Any deduction for amounts paid or accrued for services to which the SCM exception described in Prop. Reg. 1.59A-3(b)(3)(i) applies;
  - Any deduction for QDPs that are not treated as base erosion payments by reason of Prop. Reg. 1.59A-3(b)(3)(ii)
  - Any exchange loss within the meaning of Reg. 1.988-2 from a Section 988 transaction as described in Reg. §1.988-1(a)(1)
  - Any deduction for amounts paid or accrued to foreign related parties with respect to total loss absorbing capacity (TLAC) securities that are not treated as base erosion payments by reason of Prop. Reg. 1.59A-3(b)(3)(v) and
  - Any deduction not allowed in determining taxable income from the taxable year

- Other factors that may impact the base erosion percentage (treaties, amounts paid or accrued between members of a consolidated group (Prop. Reg. 1.1502-59A(b)), deductions and base erosion tax benefits from partnerships (Prop. Reg. 1.59A-7(b)), mark to market positions, certain payments that qualify for the effectively connected income exception and another base erosion payment exception, etc.) See Prop. Reg. 1.59A-2 for additional details.
Proposed Regulations-Base Erosion Percentage ( Highlights)

- Prop. Reg. 1.59A-2 and preamble provide details on the calculation of the base erosion percentage. Some of the highlights include:

  - A taxpayer, or the aggregate group of which the taxpayer is a member, satisfies the base erosion percentage test if its base erosion percentage is three percent or higher (two percent or higher rate if taxpayer or member of taxpayer’s aggregate group is a member of an affiliated group that includes a domestic bank or registered securities dealer—lower rate n/a in the case of aggregate group or consolidated group that has de minimis (as provided in the Proposed Regulations) bank or registered securities dealer activities)
Proposed Regulations-Base Erosion Percentage (Highlights)

- Base erosion tax benefits are generally the deductions or reductions in gross income that result from base erosion payments.

- The numerator of the base erosion percentage only takes into account base erosion tax benefits, which generally are base erosion payments for which a deduction is allowed under the Code for a taxable year.

- Similarly, the Proposed Regulations ensure that the denominator of the base erosion percentage only takes into account deductions allowed under the Code by providing that the denominator of the base erosion percentage does not include deductions that are not allowed in determining taxable income for the taxable year.
Proposed Regulations-Base Erosion Percentage (Highlights)

- The numerator of the base erosion percentage excludes deductions for:
  - Amounts paid or accrued to foreign related parties for services qualifying for the SCM exception in Prop. Reg. 1.59A-3(b)(3)(i)
  - Payments covered by the QDP exception in Prop. Reg. 1.59A-3(b)(3)(ii), and
  - Amounts excluded pursuant to the TLAC exception in Prop. Reg. 1.59A-3(b)(3)(v)
  - Generally, these deductions are also excluded from the denominator of the base erosion percentage
  - Section 988 losses are excluded from the numerator and the denominator in determining the base erosion percentage
- A base erosion tax benefit is not included in the numerator when the payment was subject to tax under Section 871 or 881 and that tax has been deducted and withheld under Section 1441 or 1442.
- For any base erosion payment subject to a reduced rate of withholding tax under an income tax treaty, the associated amount of base erosion tax benefits eliminated from the numerator of the base erosion percentage calculation is determined using proration rules similar to those in Section 163(j)(5)(B) as in effect before the TCJA.
The base erosion percentage also takes into account the two categories of base erosion tax benefits that result from reductions in gross income rather than deductions allowed under the Code:

- Certain premium or other consideration paid to a foreign related party for reinsurance, and
- Amounts paid or accrued by the taxpayer to certain surrogate foreign corporations that result in a reduction in gross receipts to the taxpayer.

Section 59A(c)(4)(A)(ii)(II) provides that those base erosion tax benefits that result from reductions in gross income are included in the both the numerator and the denominator in the same amount. Other payments that reduce gross income but that are not base erosion payments are not included in the denominator of the base erosion percentage.
An applicable taxpayer may make a payment to a foreign related party that is not a member of the aggregate group, and that payment may qualify for the ECI exception (discussed below). If so, and if that payment also qualifies for either the SCM exception, the QDP exception, or the TLAC exception, the payment will be included in the denominator for purposes of the base erosion percentage.

For example, if an applicable taxpayer makes a deductible payment to a foreign related person who is a 25-percent owner and that payment is both a QDP and subject to federal income taxation as income that is, or is treated as, effectively connected with the conduct of a trade or business in the United States under an applicable provision of the Internal Revenue Code or regulations, that deductible payment is included in the denominator of the base erosion percentage.

However, if the applicable taxpayer makes a deductible payment to a foreign related person and that payment is a QDP, but not otherwise subject to federal income taxation, that deductible payment is excluded from the denominator of the base erosion percentage.

For additional details on the computation of the base erosion percentage (and what is included or excluded from the numerator or denominator), See Prop. Reg. 1.59A-2(e)(3)
Base Erosion Payments and Base Erosion Tax Benefits (Selected Issues)
Overview of Prop. Reg. 1.59A-3 - General Definition

- Consistent with Section 59A(d), a base erosion payment is defined as a payment or accrual by the taxpayer to a foreign related party that is described in one of four categories:
  - a payment or accrual with respect to which a deduction is allowable
  - a payment or accrual made in connection with the acquisition of depreciable or amortizable property
  - premiums or other consideration paid or accrued for reinsurance that is taken into account under Section 803(a)(1)(B) or 832(b)(4)(A) or
  - a payment or accrual resulting in a reduction of the gross receipts of the taxpayer that is with respect to certain surrogate foreign corporations or related foreign persons
- To the extent all or a portion of a payment or accrual is described in more than one of these categories, the amount is only taken into account once as a base erosion payment
- The amount of any base erosion payment is generally determined on a gross basis, regardless of any contractual or legal right to make or receive payments on a net basis
Facts:

- FP is a foreign corporation that owns all of the stock of FC, a foreign corporation, and DC, a domestic corporation. DC owns FDE, a foreign disregarded entity.
- FP has a trade or business in the United States with effectively connected income (USTB).
- DC pays interest to FDE and FC.
- FDE pays interest to USTB. All interest paid by DC to FC and by FDE to USTB is deductible by DC in the current year for regular income tax purposes.
- FDE also acquires depreciable property from FP during the taxable year.
- FP’s income from the sale of the depreciable property is not effectively connected with the conduct of FP’s trade or business in the United States. DC and FP (based only on the activities of USTB) are applicable taxpayers under Prop. Reg. 1.59A-2(b).
Determining a Base Erosion Payment

Analysis:

- The payment of interest by DC to FC is a base erosion payment because the payment is made to a foreign related party and the interest payment is deductible. To the extent DC has interest expense disallowed under Section 163(j), the disallowed expense is first allocable to interest paid to unrelated parties.

- The payment of interest by DC to FDE is not a base erosion payment because the transaction is not a payment to a foreign person and the transaction is not a deductible payment.

- With respect to the payment of interest by FDE to USTB, if FP’s USTB treats the payment of interest by FDE to USTB as income that is effectively connected with the conduct of a trade or business in the United States pursuant to Section 864 or as profits attributable to a U.S. permanent establishment of a tax treaty resident, and if DC receives a withholding certificate from FP with respect to the payment (i.e., W-8ECI), then the ECI exception applies. Accordingly, the payment from DC, through FDE, to USTB is not a base erosion payment even though the payment is to the USTB of FP, a foreign related party.

- The acquisition of depreciable property by DC, through FDE, is a base erosion payment because there is a payment to a foreign related party in connection with the acquisition by the taxpayer of property of a character subject to the allowance for depreciation and the ECI exception does not apply because FP’s income from the sale of the depreciable property is not effectively connected with the conduct of FP’s trade or business in the United States. See Prop. Reg. 1.59A-2 for the application of the aggregation rule with respect to DC and FP’s USTB.
The determination of whether a payment or accrual is described in one of the four categories previously discussed is made under general U.S. federal income tax law.

- For example, the Proposed Regulations do not explicitly address the classification of a royalty payment as either a deductible expense or an amount includible in inventory costs (ultimately reflected as COGS) under sections 471 and 263A.

Pursuant to the preamble, the Proposed Regulations defer to generally applicable tax principles for determining whether a payment is treated as a deductible payment, including existing tax law dealing with the beneficial ownership of income or assets:

- principal-agent principles
- reimbursement doctrine
- case law conduit principles
- assignment of income or
- other principles of generally applicable tax law
Overview of Prop. Reg. 1.59A-3
Non-Recognition Transactions

- A non-cash payment (e.g., stock) by a taxpayer to a foreign related party may be a base erosion payment notwithstanding that it is incurred in a nonrecognition transaction.

- For example, a domestic corporation’s acquisition of depreciable assets from a foreign related party in a Section 351 exchange, a Section 332 liquidation, or a reorganization defined in Section 368 could qualify as a base erosion payment.

- However, the Proposed Regulations provide that an in-kind distribution under Section 301 does not give rise to a base erosion payment because there is no consideration provided by the taxpayer and thus no payment or accrual.
Other Types of Base Erosion Payments

- Interest and Other Deductions Allocable to ECI

  - A foreign corporation with interest expense allocable under Section 882(c) or other deductions properly allocable and apportioned under Treas. Reg. 1.882-4 will have a base erosion payment to the extent the interest expense or deductions results from a payment or accrual to a foreign related party.

  - The amount of interest that will be treated as a base erosion payment depends on the method used under Treas. Reg. sec. 1.882-5.

  - If a foreign corporation engaged in a U.S. trade or business acquires depreciable or amortizable property from a foreign related party, the amount paid or accrued by the taxpayer to the foreign related party can be a base erosion payment to the extent the property is used or held for use in the conduct of a U.S. trade or business.
Other Types of Base Erosion Payments

- **Income tax treaties / Permanent Establishment (Internal Dealings)**

  - A deduction attributable to any amount paid or accrued (or treated as paid or accrued) by a PE to the FC’s home office or another branch of the FC, may be a base erosion payment, notwithstanding that the payment is generally disregarded under aggregate / single-entity treatment.

  - Occurs when the FC determines the profits attributable to a permanent establishment (PE) by applying transfer pricing principles by analogy (pursuant to an applicable income tax treaty).
Overview of Prop. Reg. 1.59A-3
Base Erosion Tax Benefits

- Base Erosion Tax Benefit is the amount of any deduction relating to a base erosion payment described in Prop. Reg. 1.59A-3(b) such as a deductible expense, depreciation/amortization, certain insurance payments, and reduction in gross receipts attributable to payments to certain surrogate foreign corporations.

- The amount is an input in the computation of the base erosion percentage and the determination of modified taxable income.

- Base erosion benefit associated with deductible payments made to a foreign related party is reduced to zero when full withholding (reduced base erosion benefit if partial withholding).

- Proposed Regulations address treatment of interest payments when Section 163(j) applies.
Exceptions to Base Erosion Payments
(Selected Issues)
QDP Exception - Section 59A(h)

A QDP is generally not treated as a base erosion payment

- Excluded from both the numerator and denominator of the base erosion percentage

QDP Requirements:

1. Payment made pursuant to a “derivative”

2. Taxpayer marks the derivative to market and recognizes ordinary gain/loss with respect to it

3. Payment is not a base erosion payment on a standalone basis and is not allocable to a non-derivative component and

4. Reporting requirements are satisfied
QDP Exception - Definition of “derivative”

• A “derivative” is any contract the value of which, or payment with respect to which, is determined by reference to any stock, debt, actively traded commodity, currency or any rate, price, index, etc.

• Prop. Reg. 1.59A-6(d)(2)(iii) provides that a sale-repurchase transaction (“repo”), a securities lending transaction or any substantially similar transaction are not considered derivatives. According to the Preamble, this exclusion results from their characterization as secured loans for tax purposes, but:
  - What about a securities lending transaction that is not treated as a loan under Section 1058?
  - What about repos that are not treated as loans for tax purposes?
  - Even in a repo treated as a loan, are substitute payments and borrowing fees excluded from the QDP exception?
QDP Exception - Reporting Requirement

• The detailed reporting of QDPs is only applicable for tax years beginning after the final regulations are published. In the meantime, taxpayers satisfy the reporting requirement by reporting the aggregate amount of QDPs on Form 8991 (the “BEAT Form”)

• Under Prop. Reg. 1.59A-6(b)(2)(ii), if a taxpayer satisfies the reporting requirements for some QDPs, but not all, only the payments for which the taxpayer failed to satisfy the reporting requirements will be ineligible for the QDP exception (no cliff effect)
SCM Exception - Section 59A(d)(5)

- SCM exception—Section 59A(d)(1) does not apply to any amount paid or accrued by a taxpayer for services if—

  - Such services are services which meet the requirements for eligibility for use of the services cost method under Section 482 (determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure), and

  - Such amount constitutes the total services cost with no markup component
Proposed Regulations – SCM Exception

- Treasury rejects all or nothing approach to “no markup” language
- The Proposed Regulations provide that the SCM exception is available if there is a markup (and if other requirements are satisfied), but that the portion of any payment that exceeds the total cost of services is not eligible for the SCM exception and is a base erosion payment
- To be eligible for the SCM exception, all of the requirements of Treas. Reg. 1.482-9(b) must be satisfied, except as modified by the Proposed Regulations
  - Therefore, a taxpayer’s determination that a service qualifies for the SCM exception is subject to review under the requirements of Treas. Reg. 1.482-9(b)(3) and (b)(4), and its determination of the amount of total services cost and allocation and apportionment of costs to a particular service is subject to review under the rules of Treas. Regs. 1.482-9(j) and 1.482-9(k), respectively.
The Proposed Regulations do not require a taxpayer to maintain separate accounts to bifurcate the cost and markup components of its services charges to qualify for the SCM exception.

- The Proposed Regulations do require that taxpayers maintain books and records adequate to permit verification of, among other things, the amount paid for services, the total services cost incurred by the renderer, and the allocation and apportionment of costs to services in accordance with Treas. Reg. 1.482-9(k).
• The Proposed Regulations do not require that taxpayers “include a statement evidencing [their] intention to apply the services cost method to evaluate the arm's length charge for such services,” but the Proposed Regulations do require that taxpayers include a calculation of the amount of profit mark-up (if any) paid for the services.

- For purposes of qualifying for the SCM exception under Section 59A(d)(5), taxpayers are required to comply with the books and records requirements under the Proposed Regulations but not Treas. Reg. 1.482-9(b)(6).

• The Proposed Regulations clarify that the parenthetical reference in Section 59A(d)(5) to the business judgment rule prerequisite for applicability of the SCM -- “(determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure)” -- disregards the entire requirement set forth in Treas. Reg. 1.482-9(b)(5) solely for purposes of Section 59A(d)(5).
SCM Exception - Illustration

- Assume that total cost for services is $100x with a $10x mark up (total payment made by USP to RFC is $110x).

- Assume payment satisfies requirements for the SCM exception in the Proposed Regulations.

- The base erosion payment would be $10x (not $110x).
Exception to Base Erosion Payment Status for Payments the Recipient of which is Subject to U.S. Tax

- The Proposed Regulations take into account the US tax treatment of the foreign recipient for defining base erosion payments.

  - In particular, payments to a foreign related party that are subject to net-based tax as ECI or a similar standard under a US income tax treaty are excluded from the definition of base erosion payments.

- However, the Proposed Regulations do not provide for an exception when a payment is made to a CFC and the payment is included in the income of a US shareholder (e.g., under subpart F or GILTI).
Exception for Section 988 Losses

• Prop. Reg. 1.59A-3(b)(3)(iv) provides that Section 988 exchange losses are not base erosion payments and, thus, are excluded from the numerator of the base erosion percentage

• Prop. Reg. 1.59A-2(e)(3)(ii)(D) also excludes Sections 988 exchange losses from the denominator of the base erosion percentage, even if the loss results from a payment to an unrelated party

• But Section 988 exchange gains are included as “gross receipts” for purposes of the gross receipts test
TLAC Exception

- The Federal Reserve requires that certain global systemically important banking organizations issue TLAC instruments:
  - Under these rules, US subsidiaries of foreign banks are often required to issue “internal” TLACs in the form of long-term debt to foreign affiliates in the amount and terms prescribed by the Federal Reserve
  - The foreign parent would typically issue a corresponding amount of “external” TLAC to the public

- Prop. Reg. 1.59A-3(b)(3)(v) provides an exception for payments made on the amount of TLAC long-term debt required by the Federal Reserve (excluded from the numerator and denominator of the base erosion percentage)
  - The TLAC exception does not apply to securities issued by a foreign bank with a US branch given that foreign banks are not subject to the Federal Reserve TLAC requirement (even though they may be subject to similar requirements of non-US regulators)
Base Erosion Payments Occurring Before the Effective Date and Pre-2018 Disallowed Business Interest

- The Proposed Regulations confirm the exclusion of a deduction described in Section 59A(c)(2)(A)(i) (deduction allowed under Chapter 1 for the taxable year with respect to any base erosion payment) or Section 59A(c)(2)(A)(ii) (deduction allowed under Chapter 1 for the taxable year for depreciation or amortization with respect to any property acquired with such payment) that is allowed in a taxable year beginning after December 31, 2017, if it relates to a base erosion payment that occurred in a taxable year beginning before January 1, 2018.

- The Proposed Regulations reverse course on position taken in Notice 2018-28 taken w/r/t disallowed interest under Section 163(j) and BEAT payments:
  - The Proposed Regulations provide that any disallowed disqualified interest under Section 163(j) that resulted from a payment or accrual to a foreign related party and that is carried forward from a taxable year beginning before January 1, 2018, is not a base erosion payment.
  - The Proposed Regulations also clarify that any disallowed business interest carryforward under Section 163(j) that resulted from a payment or accrual to a foreign related party is treated as a base erosion payment in the year that the interest was paid or accrued even though the interest may be deemed to be paid or accrued again in the year in which it is actually deducted.
Modified Taxable Income
(Selected Issues)
Modified Taxable Income - Add-Back Approach

• Section 59A(c)(1) defines “modified taxable income” as the taxable income of the taxpayer determined without regard to (a) base erosion tax benefits and (b) the base erosion percentage of any NOL deduction

  - Modified taxable income is determined on a taxpayer-by-taxpayer basis (a US consolidated group is treated as a single taxpayer)

• Under the Proposed Regulations, the computation of “modified taxable income” follows a static “add-back approach,” i.e., simply adds back (a) and (b) to taxable income

  - The Proposed Regulations rejected a dynamic “recomputation approach,” i.e., the disallowance of deductions under BEAT will not result in an increased NOL utilization or an increased Section 163(j) “adjusted taxable income” for BEAT purposes
Modified Taxable Income - Negative Taxable Income

- The Proposed Regulations generally provide that if a taxpayer has a current year loss (i.e., excess of deductions over gross income), the taxpayer will be considered to have negative taxable income for the year as the starting point for the “modified taxable income” calculation.

- But if there is an NOL carryover to the taxable year and the NOL deduction exceeds the amount of positive taxable income before that deduction, the excess amount of NOL deduction does not reduce taxable income below zero for purposes of the “modified taxable income” calculation.

- Taxpayer had pre-2018 $100 NOL. In 2018, Taxpayer had $5 of taxable income before taking into account the NOL carryforward.

- The starting point for computing the 2018 modified taxable income is $0 (rather than negative $95).
NOL Base Erosion Percentage - “Vintage Year” Approach

• Modified taxable income includes an add back for the base erosion percentage of any NOL deduction allowed for the taxable year. The statute is ambiguous as to whether this means the base erosion percentage in the year that the NOL arose (the “vintage year”) or the year in which the taxpayer takes the NOL deduction (the “utilization year”)

• Prop. Reg. 1.59A-4(b)(2)(ii) applies the base erosion percentage of the vintage year
  - For NOLs arising in pre-2018 tax years, the base erosion percentage is always zero

• The relevant base erosion percentage is the percentage for the aggregate group

• NOL from a year when taxpayer was not subject to BEAT: is the base erosion percentage always zero?

• See Prop. Reg. 1.59A-4 for additional details on modified taxable income
Base Erosion Minimum Tax Amount
(Selected Issues)
Base Erosion Minimum Tax Amount

• The Base Erosion Minimum Tax Amount (“BEMTA”) equals the excess of (1) the BEAT rate for the tax year multiplied by the taxpayer’s modified taxable income for the tax year over (2) the taxpayer’s “adjusted regular tax liability” for that year.

• In determining the taxpayer’s adjusted regular tax liability, credits (including foreign tax credits) are subtracted from the regular tax liability amount, thus increasing the amount of the BEMTA.
  • The following credits do not reduce the adjusted regular tax liability:
    - Credits for overpayment of taxes and for taxes withheld at source
    - Only for tax years beginning before 1/1/2026, the Section 41(a) research credit and a portion of applicable Section 38 credits (i.e., low-income housing credit, renewable energy production credit and energy credits).

• See Prop. Reg. 1.59A-5 for additional details on calculation.
Application of Section 59A to Partnerships (Selected Issues)
Overview of Prop. Reg. 1.59A-7

- A partnership is not an “applicable taxpayer” under Section 59A(e)(1); only corporations can be applicable taxpayers

- The Proposed Regulations apply an aggregate approach to partnerships for purposes of:
  - applying the gross receipts test to determine if a corporate partner is an applicable taxpayer; and
  - determining if payments to or from the partnership are base erosion payments

  *Example:* A corporate partner is treated as receiving amounts received by or accrued to the partnership to the extent the item of income or gain is allocated to the partner under Section 704.

- Related party determinations under Section 59A(g) are made at the partner level as well

- Look through to ultimate non-partnership partner, if the partner of a partnership is a partnership
Overview of Prop. Reg. 1.59A-7

- De minimis exception: The aggregate approach will not apply to a corporate partner that owns less than 10%, directly or indirectly, of the capital and profits and less than 10%, directly or indirectly, of each item of income, gain, loss, deduction, and credit, and where such partner’s interest has a fair market value of less than $25 million.

- Deductions attributable to property acquired by a partnership from a foreign related party of a corporate partner in a recognition or non-recognition transaction are generally treated as base erosion tax benefits.
  - Example: when a partnership acquires property from a foreign person that is related to a domestic corporate partner, the related depreciation deductions allocated to the partner are generally treated as base erosion tax benefits.
  - Similar results if the property is transferred in an otherwise qualifying Section 721 transaction.
  - Consistent with approach taken to acquisitions of property by a subchapter C corporation.
Special Rules for Banks and Registered Security Dealers
(Selected Issues)
Special Rules for Banks and Registered Securities Dealers

• Certain banks and registered securities dealers are subject to two special rules: (1) base erosion percentage threshold lowered from 3% to 2% and (2) BEAT rate is 1% higher

• Prop. Reg. 1.59A-1(b)(4) defines “bank” as a bank or trust company incorporated under the laws of the US or of any US state. A foreign bank with a US branch, even if licensed to conduct business in the US, will not be subject to the special rules

• The special rules apply if any member of the aggregate group is a member of an affiliated group that includes a bank or registered securities dealer

- For purposes of the lower base erosion percentage threshold, Prop. Reg. 1.59A-2(e)(2)(iii) includes a de minimis exception if gross receipts attributable to the bank or registered dealer are less than 2% of the aggregate group’s total gross revenue for the tax year

Do the special rules apply if a bank/securities dealer is a member at any time during the tax year?
Anti-Abuse and Recharacterization Rules
(Selected Issues)
Section 59A(i)—Broad Regulatory Authority and Reporting

- Broad authority under Section 59A(i) to draft regulations or other guidance as may be “necessary to carry out the provisions of Section 59A” including:
  - providing for such adjustments to the application of Section 59A as are necessary to prevent the avoidance of the purposes of Section 59A, including through-
    - the use of unrelated persons, conduit transactions, or other intermediaries or
    - transactions or arrangements designed, in whole or in part,-
      - to characterize payments otherwise subject to Section 59A as payments not subject to Section 59A or
      - to substitute payments not subject to Section 59A for payments otherwise subject to Section 59A and
  - for the application of Section 59A(g) (related party), including rules to prevent the avoidance of the exceptions under Section 59A(g)(3)
  - Section 6038A permits the IRS to implement expanded reporting relating to BEAT
Section 59A(i)—Proposed Regulations

• This proposed anti-abuse rule addresses the following types of transactions:
  • Transactions involving intermediaries acting as a conduit to avoid a base erosion payment;
  • Transactions entered into to increase the deductions taken into account in the denominator of the base erosion percentage; and
  • Transactions among related parties entered into to avoid the application of rules applicable to banks and registered securities dealers (for example, causing a bank or registered securities dealer to disaffiliate from an affiliated group so as to avoid the requirement that it be a member of such a group).
• The Proposed Regulations also create reporting and recordkeeping requirements pursuant to Section 6038A
• See Prop. Reg. 1.59A-9 for additional details.
Consolidated Groups
(Selected Issues)
Overview of Prop. Reg. 1.1502-59A
Application of Section 59A to Consolidated Groups

- The Proposed Regulations clarify that the BEAT is computed and imposed at the consolidated group level
  - This is consistent with the general approach of computing and imposing regular tax liability of the members of an affiliated group that file a consolidated return on a single-entity basis
- Consistent with the single-entity approach, intercompany transactions are not taken into account for purposes of calculating the BEMTA
- The Proposed Regulations also provide rules regarding the application of the stacking rule Section 59A(c)(3) to consolidated groups
  - A classification approach is applied to identify which interest deductions are allocable to domestic related party payments, foreign related party payments, and unrelated payments
  - The Proposed Regulations also provide for apportionment of the domestic related party status and foreign related party status of Section 163(j) carryforwards among members of the group
Example 1

Facts:
- Foreign corporation (FP) wholly owns domestic corporation (P), which in turn wholly owns S1 and S2. P, S1, and S2 are members of a consolidated group. The consolidated group is a calendar year taxpayer.
- The members have never engaged in intercompany transactions.
- For the 2019 taxable year, P, S1, and S2 were permitted the following amounts of deductions (within the meaning of Section 59A(c)(4)), $2,400x, $1,000x, and $2,600x; those deductions include base erosion tax benefits of $180x, $370x, and $230x.
- The group’s consolidated taxable income for the year is $150x. In addition, the group satisfies the gross receipts test in Prop. Reg. 1.59A-2(d).

Analysis:
- The receipts and deductions of P, S1, and S2 are aggregated for purposes of making the computations under Section 59A. The group’s base erosion percentage is 13%.
- The consolidated group is an applicable taxpayer under Prop. Reg. 1.59A-2(b) because the group satisfies the gross receipts test and the group’s base erosion percentage (13%) is higher than 3%.
- The consolidated group’s modified taxable income is computed by adding back the members’ base erosion tax benefits (and, when the consolidated group has consolidated net operating loss available for deduction, the consolidated net operating loss allowed times base erosion percentage) to the consolidated taxable income, $930x.
- The group’s base erosion minimum tax amount is then computed as 10% of the modified taxable income less the regular tax liability, $61.5x.

Group base erosion percentage:
\[
\frac{(180x + 370x + 230x)}{(2,400x + 1,000x + 2,600x)} = 13\%
\]

Group’s modified consolidated taxable income:
\[
150x + 180x + 370x + 230x = 930x
\]

Group base erosion minimum tax:
\[
930x \times 10\% - 150x \times 21\% = 61.5x
\]
Example 2

Facts:
- The facts are the same as Example 1, except that S1 sold various inventory items to S2 during 2019. Such items are depreciable in the hands of S2 (but would not have been depreciable in the hands of S1) and continued to be owned by S2 during 2019.

Analysis:
- The result is the same as Example 1. Pursuant to Prop. Reg. 1.1502-59A(b)(2), items resulting from the intercompany sale (for example, gross receipts, depreciation deductions) are not taken into account in computing the group’s excess gross receipts under Prop. Reg. 1.59A-2(d) and base erosion percentage under Prop. Reg. 1.59A-2(e)(3).

Deductions:
- S1: $1,000x
- S2: $2,600x

Base erosion tax benefit:
- S1: $370x
- S2: $230x

Group base erosion percentage:
\[
\frac{(180x + 370x + 230x)}{(2,400x + 1,000x + 2,600x)} = 13\%
\]

Group’s modified consolidated taxable income:
\[
150x + 180x + 370x + 230x = 930x
\]

Group base erosion minimum tax:
\[
930x \times 10\% - 150x \times 21\% = 61.5x
\]
Applicability Date
Proposed Applicability Date

• The Proposed Regulations (other than the proposed reporting requirements for QDPs in Prop. Reg. 1.6038A-2(b)(7)) are proposed to apply to taxable years beginning after December 31, 2017
  • Until finalization, a taxpayer may rely on the Proposed Regulations for taxable years beginning after December 31, 2017, provided the taxpayer and all related parties of the taxpayer (as defined in Prop. Reg. 1.59A-1(b)(17)) consistently apply the Proposed Regulations for all those taxable years that end before the finalization date

• With respect to the reporting requirements for QDPs, Prop. Reg. 1.6038A-2(b)(7)(ix) applies to taxable years beginning one year after final regulations are published in the Federal Register, although simplified QDP reporting requirements provided in 1.6038A-2(g) are also proposed to apply to taxable years beginning after December 31, 2017
  • If any provision is finalized after June 22, 2019, the Treasury and the IRS generally expect that such provision will apply only to taxable years ending on or after December 17, 2018. See section 7805(b)(1)(B)
  • See Prop. Reg. 1.59A-10 for applicability dates
This document is not written tax advice directed at the particular facts and circumstances of any person. This document is for general information purposes only, and should not be used as a substitute for consultation with professional advisors. If you are interested in the subject of this document we encourage you to contact an independent tax advisor to discuss the potential application to your particular situation.