

BEAT Proposed Regulations Provide Important Guidance

Tax Alert

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Overview of Proposed Regulations

Determinations of Whether Payments Constitute Base Erosion Payments Made Under General U.S. Federal Tax Law

Treatment of Non-Cash Payments as Base Erosion Payments

Services Cost Method Exception

Exception for Payments Treated as Effectively Connected Income

TLAC Exception

Consistent Treatment of NOLs and Other Pre-Effective Date Items

Anti-Abuse and Recharacterization Rules

Conclusion

On December 13, 2018, the Department of Treasury (Treasury) and the Internal Revenue Service (IRS) issued proposed regulations (Proposed Regulations) under section 59A, the base erosion and anti-abuse tax (BEAT) added by the 2017 Tax Cuts and Jobs Act.¹ The BEAT targets deductible payments by large U.S. corporate taxpayers to foreign related parties. In practice, the BEAT can produce surprising and arbitrary results. The Proposed Regulations are applicable to tax years beginning after December 31, 2017.² Taxpayers are permitted to rely on the Proposed Regulations for all tax years that end before the regulations are finalized, so long as the taxpayer and all related parties consistently apply the Proposed Regulations for all such tax years.

The BEAT generally applies to corporations (other than regulated investment companies, real estate investment trusts, and S corporations) that have average annual gross receipts of at least \$500 million for the last three tax years and whose base erosion percentage is three percent or higher.³ Both the gross receipts and the base erosion percentage are computed by applying the aggregation rules provided in the statute and clarified in the Proposed Regulations.⁴ Taxpayers subject to the BEAT calculate their BEAT liability as the excess of (i) the applicable tax rate⁵ times modified taxable income for the tax year, over (ii) the taxpayer's regular tax liability reduced by certain credits (including foreign tax credits).⁶ Modified taxable income is generally computed by adding back to the taxpayer's regular taxable income any gross base erosion tax benefits and the base erosion percentage of any net operating loss (NOL) deduction allowed under section 172 for the tax year.⁷ The base erosion percentage is determined using a fraction; the numerator is the aggregate amount of the taxpayer's base erosion tax benefits, and the denominator is the aggregate amount of the taxpayer's allowable deductions, with certain modifications.⁸

Overview of Proposed Regulations

The Proposed Regulations are divided into 10 sections covering several definitional, computational, and other issues under the BEAT, including when a taxpayer is subject to the BEAT and the computation of base erosion payments and associated base erosion tax benefits, modified taxable income, and the base erosion minimum tax. The Proposed Regulations also include guidance specific to qualified derivative payments (which are generally not treated as base erosion payments), partnerships, banks and registered securities dealers, and insurance companies. Finally, the Proposed Regulations establish anti-abuse rules targeting three types of transactions to prevent the avoidance of the purposes of section 59A.

The Preamble includes over 20 requests for comments, which must be submitted within 60 days after the date of publication in the Federal Register, which is scheduled to occur December 21, 2018. (Requests for a public hearing are subject to the same deadline.) Select issues under the Proposed Regulations are discussed below in more detail.

Determinations of Whether Payments Constitute Base Erosion Payments Made Under General U.S. Federal Tax Law

A base erosion payment is defined as any amount paid or accrued by the taxpayer to a foreign related party that is described in one of four categories: (1) a payment with respect to which a deduction is allowable; (2) a payment in connection with the acquisition of depreciable or amortizable property; (3) a premium or other consideration for reinsurance; and (4) in the case of certain inverted companies, a payment that reduces gross receipts.⁹ The Preamble states that except where provided by the Proposed Regulations, the determination of whether a payment or accrual is described in one of those four categories "is made under general U.S. federal income tax law."¹⁰ Accordingly, in general there is no BEAT-specific overlay that applies in determining whether a payment is made to a foreign related party or not, or whether a payment is classified as a cost includible in inventory (and therefore recovered as a reduction of gross receipts) or as a deductible amount. These determinations must be made under general U.S. federal income tax principles, including judicial principles such as principal-agent, reimbursement doctrine, conduit, and assignment of income. The application of these principles depends on the facts and circumstances of the arrangement under review, and should be carefully considered when making determinations under the BEAT.

The application of U.S. federal tax law principles extends to determining the amount of a base erosion payment (or base erosion tax benefit) in cases where there are reciprocal or offsetting payment obligations. The Proposed Regulations generally provide that "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," except as otherwise provided in the Proposed Regulations or in the Code or the regulations thereunder.¹¹ One example of regulations that permit or require netting of offsetting obligations is Treas. Reg. § 1.482-7, addressing the treatment of payment obligations arising in the context of cost sharing arrangements for the development of intangible property.¹² Another example is Treas. Reg. § 1.482-1(g)(4), which provides for a setoff against a section 482 allocation based on other non-arm's-length transactions between the same controlled taxpayers during the same tax year.¹³ Treasury and IRS have requested comments on addressing whether a distinction should be made between reinsurance contracts and other commercial contracts that provide for netting of items payable between counterparties.

The Proposed Regulations include anti-abuse rules, discussed below, that have the effect of overriding general U.S. federal tax law principles for purposes of applying the BEAT provisions. In general, these anti-abuse rules are targeted and apply only with respect to transactions that have a principal purpose of avoiding section 59A.

Treatment of Non-Cash Payments as Base Erosion Payments

The Proposed Regulations broadly define the statutory term "amount paid or accrued" as "an amount paid or accrued using any form of consideration, including cash, property, stock, or the assumption of a liability."¹⁴ As defined, stock issued to or exchanged with a foreign related party in a nonrecognition transaction may constitute a base erosion payment under the Proposed Regulations. The Preamble provides that a base erosion payment may result from "a domestic corporation's acquisition of depreciable assets from a foreign related party in an exchange described in section 351, a liquidation described in section 332, and a reorganization described in section 368."¹⁵

Treating nonrecognition transactions as giving rise to base erosion payments is a surprising result. In nonrecognition transactions, the domestic corporation may take a carryover basis in the depreciable property and the importation of depreciable property into the U.S. may enhance, rather than erode, the regular income tax base. The Treasury and IRS acknowledge these points in the Preamble but nonetheless declined to exclude these types of transactions from the definition of a base erosion payment.¹⁶

In contrast to the treatment of nonrecognition transactions, the Preamble states that an acquisition of depreciable property from a

foreign related party as an in-kind distribution subject to section 301 does not give rise to a base erosion payment because there is "no consideration provided by the taxpayer" and therefore "no payment or accrual."¹⁷ The Proposed Regulations do not address stock redemptions, but the logic expressed in the Preamble suggests that the treatment of a stock redemption may depend on whether the redemption is treated as a sale or exchange under section 302(a) or a section 301 distribution under section 302(d).

The Preamble states that a payment to a foreign related party where a loss is recognized is a base erosion payment, under the general definition of a base erosion payment.¹⁸ The Proposed Regulations do provide an exception, however, for foreign exchange losses from section 988 transactions.¹⁹ Although this exception for section 988 losses may be helpful in reducing a taxpayer's base erosion payments, section 988 losses are also excluded from the denominator of the base erosion percentage and therefore may make it more likely that a taxpayer exceeds the three percent threshold in the statute.²⁰

Treasury and IRS have requested comments on the treatment of payments or accruals that consist of non-cash consideration.

Services Cost Method Exception

The Proposed Regulations settle, in a taxpayer-favorable way, the issue of whether the payment of a markup for services eligible for the services cost method (SCM) in the section 482 regulations, as modified by section 59A, affects the treatment of the cost component of the service fee under the exception in section 59A(d)(5) for "certain amounts with respect to services" (the SCM exception).²¹ Section 59A(d)(5) provides that "any amount paid or accrued by a taxpayer for services" is not a base erosion payment if (1) the "services . . . 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 (2) "such amount constitutes the total services cost with no markup component."²²

An open issue under the BEAT, due to a perceived ambiguity in the statutory language, had been whether the SCM exception applied if the amount paid or accrued included a markup. The Proposed Regulations provide that the payment of a markup does not disqualify the entire payment from the SCM exception – the exception is available for the amount of total services cost (as defined in Treas. Reg. § 1.482-9(j)) and anything above that amount (*i.e.*, the markup) is a base erosion payment.²³ We believe this interpretation is consistent with the statute and the policies underlying the BEAT.

To be eligible for the SCM exception, in general the requirements for use of the SCM per the section 482 regulations²⁴ must be met, without regard to the so-called business judgment rule in Treas. Reg. § 1.482-9(b)(5).²⁵ Further, the Proposed Regulations specify the record-keeping requirements for purposes of qualifying for the SCM exception. Consistent with the books and records that must be kept under the section 482 regulations, the taxpayer must maintain books and records adequate to permit verification of the total services costs incurred by the service provider, including a description of the services in question, identification of the provider and recipient of the services, and sufficient documentation to allow verification of the methods used to allocate and apportion the costs to the services in question in accordance with Treas. Reg. § 1.482-9(k).²⁶ Under the Proposed Regulations, the taxpayer's books and records must also include adequate documentation of the amount charged for the services and the calculation of the amount of profit markup, if any, paid for the services.²⁷ Unlike the section 482 regulations, the Proposed Regulations do not require the taxpayer to maintain a statement evidencing the taxpayer's intention to apply the SCM to evaluate the arm's length charge for such services.²⁸ This apparent liberalization of the books and records requirement in the section 482 regulations is sensible given that the SCM exception is available even if the taxpayer does not apply the SCM. The Preamble clarifies that taxpayers are not required to maintain separate accounts to bifurcate the cost and markup components of its service charges to qualify for the SCM exception.²⁹

We believe the Proposed Regulations' resolution of the markup issue is sensible. Allowing the SCM exception up to the cost component of a payment for services that includes a markup is supported by the statutory language, which excepts from the definition of a base erosion payment "any amount paid or accrued" for services eligible for the SCM without regard to the business judgment rule. The use of "any amount" suggests that a payment for services may be bifurcated into two components – cost and markup components – and per section 59A(d)(5)(B), the exception applies to the extent of the cost component.³⁰ In addition, the

statute only requires the services to be eligible for the SCM and does not require the taxpayer to use the SCM. The statute suspends application of the business judgment rule in Treas. Reg. § 1.482-9(b)(5), meaning that it expressly covers situations where the taxpayer, for transfer pricing purposes, cannot ordinarily charge the services at cost. If the Proposed Regulations had adopted the "all-or-nothing approach" to the SCM exception by disqualifying the entire payment if a markup was paid, they would have rendered some of the statutory language a nullity.³¹ By only excluding the markup from the SCM exception, the Proposed Regulations avoided creating situations where a small difference in charged costs could result in "dramatically different tax effects."³²

Treasury and IRS have requested comments on the interpretation of the SCM exception in the Proposed Regulations.

Exception for Payments Treated as Effectively Connected Income

The Proposed Regulations exclude amounts paid or accrued to a foreign related party from the definition of base erosion payments to the extent such amounts are subject to U.S. federal income tax as effectively connected income.³³ The exception is available only if the taxpayer receives a withholding certificate providing for an exemption from withholding under sections 1441 or 1442 because the amounts are effectively connected income.³⁴ A similar exception applies to payments to a foreign related party where a treaty applies in determining net taxable income under the treaty.³⁵

As explained in the Preamble, income that is effectively connected with the conduct of a trade or business in the U.S. is subject to tax in the hands of the foreign recipient under sections 871(b) and 882(a) on a net basis, as if the foreign recipient were a domestic person.³⁶ As such, the approach in the Proposed Regulations to exclude from the BEAT amounts already subject to U.S. federal income tax is reasonable, is consistent with the policies underlying section 59A, and avoids double taxation on such amounts.

No similar exception from the definition of a base erosion payment is provided for amounts paid or accrued to controlled foreign corporations (CFCs) that are subject to U.S. federal income tax as Subpart F income or global intangible low-taxed income (GILTI) of a U.S. shareholder. As a result, a domestic corporation may be subject to double taxation with respect to a deductible payment it makes to a CFC: it must take the payment into account in determining its income inclusion under Subpart F or GILTI, and it must also include the payment in its modified taxable income under the BEAT. There is little evidence that Congress intended these regimes to operate in this manner.

TLAC Exception

The Proposed Regulations add an exception from base erosion payments for amounts paid or accrued to foreign related parties with respect to total loss-absorbing capacity (TLAC) securities.³⁷ This exception is available only to the extent of the amount of TLAC securities required by the Federal Reserve under U.S. law.³⁸ This exception recognizes that certain global systematically important banking organizations are required by the Federal Reserve to issue a certain amount of TLAC securities "as part of a global framework for bank capital that has sought to minimize the risk of insolvency."³⁹ Given the "special status" of TLAC securities and precise limits imposed on them by Federal Reserve regulations, Treasury and the IRS deemed it sensible to include this exception from base erosion payments in the Proposed Regulations.⁴⁰

The TLAC exception in the Proposed Regulations applies only to TLAC securities required by the Federal Reserve and thus, it does not generally apply to securities issued by foreign corporations engaged in a U.S. trade or business. The Preamble recognizes that foreign regulators may impose requirements on the financial institutions they regulate similar to those imposed by the Federal Reserve under U.S. law.⁴¹ Treasury and the IRS have requested comments regarding a similar exception for foreign corporations that are subject to solvency requirements similar to those applicable to U.S. corporations.

While the TLAC exception applies only to a narrow set of taxpayers, it demonstrates the willingness of Treasury and the IRS to use their authority to craft a regulatory exception to the BEAT in a case where that exception is consistent with the broad underlying policies of the BEAT. This is a welcome development.

Consistent Treatment of NOLs and Other Pre-Effective Date Items

The Proposed Regulations bring clarity to the treatment of NOLs for purposes of the BEAT. Section 59A(c)(1)(B) provides that the base erosion percentage of a NOL deduction allowed for the tax year is added back to taxable income to compute modified taxable income. Under the statute, there was uncertainty as to whether the base erosion percentage was computed in the year the NOL arose (*i.e.*, the vintage year), or rather the year in which the taxpayer takes the NOL deduction. Prop. Treas. Reg. § 1.59A-4(b)(2)(ii) provides that the base erosion percentage for the vintage year is used to determine modified taxable income. Furthermore, the Proposed Regulations clarify that the base erosion percentage for NOLs that arose in tax years prior to the effective date of the BEAT is zero, and therefore there is no add-back of such NOL deductions in determining modified taxable income for the tax year when they are allowed.⁴²

The Proposed Regulations treat other amounts incurred prior to the effective date of the BEAT consistently with the treatment of NOL carryforwards from pre-effective date years. Significantly, the Treasury and IRS reversed the position previously expressed in Notice 2018-28⁴³ with regard to section 163(j) interest expense carryforwards from pre-effective date years. Under Prop. Treas. Reg. § 1.59A-3(b)(3)(vii), any disallowed interest that is carried forward from a tax year beginning before January 1, 2018 is not a base erosion payment. In addition, Prop. Treas. Reg. § 1.59A-3(b)(3)(vi) provides that any amount paid or accrued in tax years beginning before January 1, 2018 is not a base erosion payment. The Preamble makes clear that as a result of this rule, a payment or accrual made in 2015 to a foreign related party to acquire depreciable property is not a base erosion payment, and the taxpayer's depreciation deduction in 2018 with respect to this property is not a base erosion tax benefit.⁴⁴

Anti-Abuse and Recharacterization Rules

Section 59A(i) provides broad authority to prescribe regulations as necessary to prevent the avoidance of the purposes of section 59A, including through the use of intermediaries or transactions designed to convert payments subject to the BEAT into payments that are not so subject. The Proposed Regulations exercise this authority in a targeted manner to address three types of transactions.

First, the participation of an intermediary is disregarded where the intermediary is inserted within a payment flow between a U.S. taxpayer and a foreign related party, a payment directly between the U.S. taxpayer and the foreign related party would have been a base erosion payment, and the transaction has as a principal purpose avoiding a base erosion payment.⁴⁵ Several examples of this rule are provided; in general, these examples demonstrate that the rule is limited to cases where an intermediary is placed between a U.S. taxpayer and a foreign related party, and does not extend to cases where the U.S. taxpayer simply chooses to restructure a transaction with a different counterparty to avoid the application of section 59A (for example, by entering into a transaction with third parties rather than with a foreign related party).⁴⁶ Second, transactions that have a principal purpose of increasing the denominator of the base erosion percentage computation are disregarded for that purpose.⁴⁷ An example is provided involving a U.S. taxpayer that takes offsetting positions with respect to a financial asset with a principal purpose of increasing the denominator of the base erosion percentage computation.⁴⁸ Third, transactions occurring among related parties that have a principal purpose of avoiding the rules applicable to certain banks and registered securities dealers are not taken into account for purposes of applying those rules.⁴⁹ These anti-abuse rules disregard or recharacterize transactions only for purposes of applying section 59A, and not for other purposes.

Conclusion

Section 59A is a problematic statute that can cause surprising results. The Proposed Regulations provide important guidance on definitional, computational, and other issues under section 59A, some of which improve the operation of the statute, and others of which raise new issues. Taxpayers and other commentators should review the rules carefully and determine areas that merit comment.

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¹REG-104259-18 (Dec. 13, 2018). All "section" references are to the Internal Revenue Code of 1986 (the Code), as amended and currently in effect.

²Prop. Treas. Reg. § 1.59A-10.

³Section 59A(e); Prop. Treas. Reg. § 1.59A-2(b)-(e). A taxpayer that is a member of an affiliated group that includes a bank or registered securities dealer satisfies the base erosion percentage test if its base erosion percentage is two percent or higher. Section 59A(e)(1)(C); Prop. Treas. Reg. § 1.59A-2(e)(2).

⁴See Section 59A(e)(3); Prop. Treas. Reg. §§ 1.59A-1(b)(1), -2(c).

⁵The applicable tax rate is five percent for tax years beginning in calendar year 2018, 10 percent for tax years beginning after December 31, 2018, through tax years beginning before January 1, 2026, and 12.5 percent thereafter. Section 59A(b)(1)(A), (b)(2)(A); Prop. Treas. Reg. § 1.59A-5(c).

⁶Section 59A(b); Prop. Treas. Reg. § 1.59A-5.

⁷Section 59A(c); Prop. Treas. Reg. § 1.59A-4.

⁸Section 59A(c)(4); Prop. Treas. Reg. §§ 1.59A-2(e)(3), -4(b)(2)(ii).

⁹Section 59A(d); Prop. Treas. Reg. § 1.59A-3(b)(1).

¹⁰REG-104259-18 at 18.

¹¹Prop. Treas. Reg. § 1.59A-3(b)(2)(ii).

¹²See Treas. Reg. § 1.482-7(j)(3).

¹³Treas. Reg. § 1.482-1(g)(4).

¹⁴Prop. Treas. Reg. § 1.59A-3(b)(2)(i).

¹⁵REG-104259-18 at 20.

¹⁶REG-104259-18 at 20.

¹⁷REG-104259-18 at 21.

¹⁸REG-104259-18 at 21.

¹⁹Prop. Treas. Reg. § 1.59A-3(b)(3)(iv).

²⁰Prop. Treas. Reg. § 1.59A-2(e)(3)(ii)(D).

²¹See Section 59A(d)(5).

²²Section 59A(d)(5).

²³Prop. Treas. Reg. § 1.59A-3(b)(3)(i).

²⁴See Treas. Reg. § 1.482-9(b).

²⁵Section 59A(d)(5)(A); Prop. Treas. Reg. § 1.59A-3(b)(3)(i)(B)(1).

²⁶Prop. Treas. Reg. § 1.59A-3(b)(3)(i)(B)(2), (C); Treas. Reg. § 1.482-9(b)(6).

²⁷Prop. Treas. Reg. § 1.59A-3(b)(3)(i)(C).

²⁸See Treas. Reg. § 1.482-9(b)(6).

²⁹REG-104259-18 at 29.

³⁰REG-104259-18 at 28-29. Bifurcation of the payment into cost and markup components and application of the SCM exception up to the cost component was an interpretation advanced in a Senate floor colloquy between Senator Portman and Senator Hatch prior to enactment of the bill. See 163 Cong. Rec. S7697 (Dec. 1, 2017).

³¹REG-104259-18 at 29.

³²REG-104259-18 at 27.

³³Prop. Treas. Reg. § 1.59A-3(b)(3)(iii)(A).

³⁴Prop. Treas. Reg. § 1.59A-3(b)(3)(iii)(A).

³⁵Prop. Treas. Reg. § 1.59A-3(b)(3)(iii)(B).

³⁶REG-104259-18 at 33–34.

³⁷Prop. Treas. Reg. § 1.59A-3(b)(3)(v).

³⁸REG-104259-18 at 36; *see* Prop. Treas. Reg. § 1.59A-3(b)(3)(v)(B).

³⁹REG-104259-18 at 35.

⁴⁰REG-104259-18 at 35–36.

⁴¹REG-104259-18 at 36.

⁴²Prop. Treas. Reg. § 1.59A-4(b)(2)(ii).

⁴³2018-16 I.R.B. 492.

⁴⁴REG-104259-18 at 37.

⁴⁵Prop. Treas. Reg. § 1.59A-9(b)(1).

⁴⁶*See* Prop. Treas. Reg. § 1.59A-9(c).

⁴⁷Prop. Treas. Reg. § 1.59A-9(b)(2).

⁴⁸Prop. Treas. Reg. § 1.59A-9(c)(5).

⁴⁹Prop. Treas. Reg. § 1.59A-9(b)(3).

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