

Latest BEAT Regulations Finalize Rules for Waiving Deductions

Tax Alert

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On September 1, 2020, Treasury and the IRS released additional guidance under section 59A, the base erosion and anti-abuse tax (BEAT) added by the 2017 Tax Cuts and Jobs Act.¹ These final regulations finalize December 2019 proposed regulations, which, among other things, proposed a rule giving taxpayers the option to waive deductions (and therefore potentially avoid being subject to the BEAT).² Because the regulations provide that the decision to waive deductions is essentially irrevocable, taxpayers will have to consider carefully the advisability, content, and timing of such a waiver together with other tools for managing their BEAT exposure.

The newly issued final regulations generally apply to tax years ending on or after the date the regulations are published in the Federal Register, but taxpayers may apply these regulations in their entirety for tax years beginning after December 31, 2017, provided that, once applied, taxpayers must continue to apply them in their entirety for all subsequent tax years.³ Alternatively, taxpayers have the option of applying only Treas. Reg. § 1.59A-3(c)(5) and (6) (relating to the BEAT waiver election, discussed below) for tax years beginning after December 31, 2017, if those provisions are applied in their entirety for all subsequent tax years.⁴ Treas. Reg. §§ 1.59A-7(c)(5)(v) and -9(b)(5)-(6) (which relate to the application of the BEAT to partnerships) apply to tax years ending on or after December 2, 2019, but taxpayers may similarly apply them back to 2018 as provided above.⁵

The BEAT generally applies to C corporations that have average annual gross receipts of at least \$500 million for the last three tax years and whose base erosion percentage (which is intended to measure the percentage of the taxpayer's aggregate deductions that is made up of "base erosion tax benefits") is three percent or higher.⁶ Both gross receipts and the base erosion percentage are computed by applying the aggregation rules provided in the statute and attendant regulations.⁷ Taxpayers subject to the BEAT calculate their BEAT liability as the excess of (i) the applicable tax rate (currently 10 percent) times "modified taxable income" for the tax year, over (ii) the taxpayer's regular tax liability reduced by certain credits (including foreign tax credits).⁸ A taxpayer's "modified taxable income" means taxable income computed without regard to any base erosion tax benefits and without regard to a portion of net operating losses.⁹ Base erosion tax benefits are generally the deductions allowed "for the taxable year with respect to any base erosion payment," and a "base erosion payment" in general includes any amount paid or accrued by a taxpayer to a related foreign person with respect to which a deduction is allowable.¹⁰

Election to Waive Deductions for Purposes of the BEAT

The applicability and magnitude of the BEAT depend in large part on the amount of a taxpayer's base erosion payments and corresponding deductions (or base erosion tax benefits). The greater the amount of base erosion tax benefits, the greater the numerator of the taxpayer's base erosion percentage and thus the likelier that the taxpayer would pass the three percent threshold and be subject to the BEAT. And a greater amount of base erosion payments would generally result in a greater amount of base erosion tax benefits and thus a higher BEAT liability. Accordingly, one tool at taxpayers' disposal to manage their BEAT exposure is managing the deductions claimed with respect to base erosion payments or otherwise.

For example, taxpayers could evaluate whether they are properly applying the rules in section 263A (which provide for the capitalization and inclusion in inventory costs of certain costs),¹¹ could consider deferring certain deductions (e.g., items eligible for the section 59(e)(4) election),¹² or could consider restructuring payment flows to eliminate unnecessary deductible payments to foreign related parties. More generally, deferring deductions (or accelerating income) can minimize exposure under the BEAT by increasing regular tax liability, converting a permanent item into a temporary item. The proposed regulations released in December 2019 included another potential tool taxpayers could employ to manage their BEAT exposure at the margin—an election to permanently waive deductions. The final regulations adopt in substantially the same form the proposed rules with respect to the BEAT waiver election.

The regulations provide that for purposes of determining a taxpayer's "base erosion tax benefits," all deductions that could be properly claimed by a taxpayer for the tax year (determined after giving effect to the taxpayer's method of accounting and any elections the taxpayer made (*e.g.*, with respect to capitalization or depreciation deductions)) are treated as "allowed deductions."¹³ Such allowed deductions are considered base erosion tax benefits that factor into the computation of the taxpayer's base erosion percentage and modified taxable income.

However, taxpayers have the option under the regulations to waive deductions in whole or in part.¹⁴ A deduction waived under the BEAT regulations is treated as having been waived for all federal tax purposes (subject to some exceptions enumerated in the regulations).¹⁵ The final regulations clarify that this election is available only to taxpayers that, absent the election, would be an "applicable taxpayer" subject to the BEAT.¹⁶ In summary, the procedures in the regulations for making the BEAT waiver election are as follows:

- The election is made annually, and IRS consent is not necessary if a taxpayer chooses not to make the election in a subsequent tax year.
- The election may be made on an original or amended tax return or during an IRS examination. The taxpayer may also *increase* the amount of waived deductions on an amended tax return or during an examination. According to the preamble, the procedures that apply to affirmative tax return changes during an examination, as set forth in the Internal Revenue Manual, apply to the BEAT waiver election.¹⁷
- To make the election, a taxpayer must complete the appropriate part of Form 8991, *Tax on Base Erosion Payments of Taxpayers With Substantial Gross Receipts*, including the information required by Treas. Reg. § 1.59A-3(c)(6)(ii)(B).¹⁸

Importantly, the regulations do not permit a taxpayer to revoke a prior election or *decrease* the amount of waived deductions on an amended tax return or during examination.¹⁹ Comments had requested this additional flexibility, noting, among other things, that there are no apparent policy reasons for allowing taxpayers to increase (but not to decrease) the amount of waived deductions on an amended return or during an audit and that no additional administrative burdens would result from providing taxpayers this option.²⁰

Treasury and the IRS disagreed, noting in the preamble that the ability to decrease the amount of waived deductions on an amended return or during an audit would not further one of the policy goals behind the BEAT waiver election: "to address taxpayer concerns that, due to the cliff effect of applicable taxpayer status, a marginal amount of base erosion tax benefits could have a greater effect on overall tax liability."²¹ In addition, Treasury and the IRS explain that the regulations provide "significant flexibility" regarding the BEAT waiver election and "that expanding taxpayer electivity to permit the reduction of waived amounts will increase uncertainty to the IRS as it assesses tax return positions."²²

Given the regulatory rules, taxpayers will have to weigh the benefits of waiving deductions for purposes of the BEAT on an original tax return against the risk of potentially waiving too many deductions and not having an option under the regulations to later claim those deductions. Taxpayers will need to consider these questions together with other tools for managing their BEAT exposure, as well as other uncertain positions that could affect regular tax liability or other inputs to determining the liability for BEAT.

Additional Guidance in the Final BEAT Regulations

The final regulations also provide guidance regarding the computation of gross receipts and the base erosion percentage of a taxpayer's aggregate group in certain circumstances.²³ For example, in cases where the taxpayer has a short tax year, the regulations retain the proposed rule permitting the use of a "reasonable approach" to determine the aggregate group's gross receipts and base erosion percentage (and provide additional guidance with respect to short tax years).²⁴ The regulations also address complexities in computations involving the taxpayer's aggregate group arising from members leaving or joining the aggregate group²⁵ and the treatment of predecessors to the taxpayer.²⁶

In response to comments, the final regulations narrow the scope of the anti-abuse rule in Treas. Reg. § 1.59A-9(b)(4) relating to the exception to the definition of base erosion payments for "specified nonrecognition transactions" by providing that the anti-abuse rule applies only to the extent of the amount of stepped-up basis of property acquired in a nonrecognition transaction that is subject to the anti-abuse rule.²⁷ Finally, the regulations also provide additional guidance on the application of the BEAT to partnerships.²⁸

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¹T.D. 9910. All "section" references are to the Internal Revenue Code of 1986, as amended and currently in effect.

²84 Fed. Reg. 67046 (Dec. 6, 2019).

³Treas. Reg. § 1.59A-10(b).

⁴Treas. Reg. § 1.59A-10(b).

⁵Treas. Reg. § 1.59A-10(b).

⁶Section 59A(e).

⁷See section 59A(e)(3); Treas. Reg. § 1.59A-2(c).

⁸Section 59A(b).

⁹Section 59A(c)(1).

¹⁰Section 59A(c)(2)(A), (d).

¹¹Under section 263A, capitalized costs are generally accounted for as cost of goods sold. In general, amounts properly treated as cost of goods sold are not base erosion payments. Treas. Reg. § 1.59A-3(b)(2)(viii).

¹²Comments had requested that Treasury and the IRS provide some relief for taxpayers that had made elections under section 59(e)(4) to defer over a ten-year period certain costs (instead of taking a deduction currently) or elected not to claim bonus depreciation before the proposed regulations providing taxpayers the option to waive deductions were released at the end of 2019. Another comment requested that Treasury and the IRS allow taxpayers to retroactively make section 59(e)(4) elections or not claim bonus depreciation. The final regulations released in early September do not provide relief in this regard. See T.D. 9910, at 24–26.

¹³Treas. Reg. § 1.59A-3(c)(5).

¹⁴Treas. Reg. § 1.59A-3(c)(6)(i). The final regulations clarify that the BEAT waiver election is also available for insurance-related base erosion payments (see section 59A(d)(3)) even though such payments may be accounted for as reductions to gross premiums instead of "deductions." See Treas. Reg. § 1.59A-3(c)(6)(v). Further, the final regulations permit a corporate partner in a partnership to make a BEAT waiver election with respect to partnership items. See Treas. Reg. § 1.59A-3(c)(6)(iv). The preamble to the final regulations clarifies that "the BEAT waiver election should not affect any existing law addressing 'waiver' outside of the specific situation covered by the BEAT waiver (electing not to claim a deduction in order to avoid applicable taxpayer status)." T.D. 9910, at 20.

¹⁵See Treas. Reg. § 1.59A-3(c)(6)(iii)(A).

¹⁶Treas. Reg. § 1.59A-3(c)(6)(i); see T.D. 9910, at 19.

¹⁷T.D. 9910, at 28.

¹⁸Treas. Reg. § 1.59A-3(c)(6)(ii)(A).

¹⁹Treas. Reg. § 1.59A-3(c)(6)(ii)(A).

²⁰See T.D. 9910, at 21-22.

²¹*Id.* at 22.

²²*Id.*

²³See Treas. Reg. § 1.59A-2(c)(1) (providing that 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); Treas. Reg. § 1.59A-1(b)(1) (defining "aggregate group").

²⁴See Treas. Reg. § 1.59A-2(c)(5).

²⁵See Treas. Reg. § 1.59A-2(c)(4).

²⁶See Treas. Reg. § 1.59A-2(c)(6).

²⁷A base erosion payment includes an amount paid or accrued using any form of consideration (e.g., stock) to a foreign related party for the acquisition of depreciable or amortizable property. Section 59A(d)(2); Treas. Reg. § 1.59A-3(b)(2)(ii). But there is a regulatory exception to the definition of base erosion payments for certain types of transactions, including "specified nonrecognition transactions" (sections 332, 351, 355, and 368 transactions). See Treas. Reg. § 1.59A-3(b)(3)(viii). That exception was adopted in the regulations released in December 2019 and was accompanied by an anti-abuse rule.

²⁸See Treas. Reg. § 1.59A-7. Other sections of the regulations provide additional guidance relating to partnerships. See, e.g., Treas. Reg. § 1.59A-3(c)(6)(iv) (application of the BEAT waiver election to partners and partnerships); Treas. Reg. § 1.59A-3(b)(3)(iii)(C) (application of the exception to the definition of base erosion payments for effectively connected income to partnerships).

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