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Tax News and Developments
North America

Client Alert
January 17, 2019

Treasury and IRS Release Proposed BEAT Regulations

Introduction

On December 13, 2018, the Treasury Department and the Internal Revenue Service (the "Service") issued proposed regulations (the "Proposed Regulations") providing guidance on the base erosion and anti-avoidance tax (the "BEAT") under section 59A. Congress enacted section 59A as part of the Tax Cuts and Jobs Act (the "TCJA"), requiring certain corporations to pay a minimum tax associated with deductible and certain other payments to foreign related parties.

This client alert provides a high level overview of the BEAT and the Proposed Regulations. This alert also provides a more detailed discussion of select issues which taxpayers have been concerned about since Congress enacted section 59A, including how the BEAT might apply in non-recognition transactions, netting rules, how the services cost method ("SCM") exception to the BEAT applies, the potential for double or triple taxation under the BEAT, how the BEAT applies to partnerships, and potential ways to "beat" the BEAT.

Who is Subject to the BEAT

The BEAT applies only to an "applicable taxpayer." Generally, an applicable taxpayer is a corporate taxpayer which is a member of an "aggregate group" that (i) has $500 million or more of average annual gross receipts during the three prior taxable years; and (ii) has a "base erosion percentage" of three percent or more. *See* section 59A(e)(1). The BEAT applies to taxable years beginning after December 31, 2017.

Aggregation Rules

The Proposed Regulations define the aggregate group generally as corporations which are members of the same controlled group of corporations as defined by section 1563(a), with certain modifications. The aggregate group excludes foreign corporations except to the extent that the foreign corporation has effectively connected income of a US trade or business ("ECI") that is subject to tax under section 882. *See* Prop. Treas. Reg. § 1.59A-1(b)(1). In addition, members of a consolidated group (as defined in Treas. Reg. § 1.1502-1(h)) are treated as a single corporation for purposes of the aggregation rules. *See* Prop. Treas. Reg. § 1.1502-59A(b)(2).

The Proposed Regulations clarify that taxpayers should disregard payments between members of the aggregate group in calculating the group's gross receipts or base erosion percentage. *See* Prop. Treas. Reg. § 1.59A-2(c); Prop. Treas. Reg. § 1.59A-3(d), Example (7) (FP, a foreign corporation, owns all the stock of two domestic corporations, DC1 and DC2; FP sells depreciable property

to DC1; DC1 later sells the same depreciable property to DC2; DC2's payment for the property is disregarded, but DC2's depreciation deductions are treated as both base erosion tax benefits and base erosion payments to FP, presumably to the extent DC2's basis in the property does not exceed DC1's basis in the property).

Whereas the threshold tests apply to the aggregate group, each corporation that is an applicable taxpayer computes its modified taxable income (“MTI”) and base erosion minimum tax amount (“BEMTA”) on a separate taxpayer basis. Recognizing that different members of the aggregate group might have different taxable years, the Proposed Regulations provide that each applicable taxpayer applies the threshold test to the relevant amounts of other members of the aggregate group that occur during the applicable taxpayer’s own taxable year. The taxpayer may use any reasonable method of proration for this purpose. *See* Prop. Treas. Reg. § 1.59A-2(e)(3)(vii); Prop. Treas. Reg. § 1.59A-2(f)(2), Example (2).

Base Erosion Percentage

In general, the aggregate group calculates its base erosion percentage each year by dividing (1) the aggregate amount of base erosion tax benefits allowed for the year (the “numerator”), by (2) the sum of the aggregate amount of all its deductions allowed for the year plus certain other base erosion tax benefits allowed for the year (the “denominator”). *See* Prop. Treas. Reg. § 1.59A-2(e)(3).

As we explain below, base erosion tax benefits are generally deductions or reductions in gross income that result from base erosion payments, but generally do not include payments that increase the cost of goods sold. Thus, the numerator does not include deductions which the taxpayer enjoys with respect to payments that fall within an exception to base erosion payments. The numerator also does not include base erosion payments which do not give rise to base erosion tax benefits because of some other exceptions.

The denominator consists of the sum of all deductions the taxpayer is entitled to take under other parts of the Code and other base erosion tax benefits, with certain exceptions. *See* Prop. Treas. Reg. § 1.59A-2(e)(3)(i)(B). The Proposed Regulations generally exclude from the denominator deductions which the taxpayer enjoys with respect to payments that fall within an exception to base erosion payments. *See* Prop. Treas. Reg. § 1.59A-2(e)(3)(ii). Yet, if the payment qualifies for either the SCM exception, the qualified derivatives payments exception, or the total loss absorbing capacity exception, there are instances where the payment might nonetheless be included in the denominator. More specifically, if the payment also qualifies for the ECI exception (described below) such that it is excluded from the numerator, and is a payment to a foreign related party that is not a member of the taxpayer’s aggregate group, then the Proposed Regulations exclude the payment from the denominator. *See* Prop. Treas. Reg. § 1.59A-2(e)(3)(viii). At the same time, the Proposed Regulations do not exclude from the denominator deductions which the taxpayer enjoys with respect to base erosion payments which do not give rise to base erosion tax benefits, for

example, where the payment is subject to withholding tax under section 1441 or 1442.

The Proposed Regulations also exclude from the denominator deductions under section 172 (net operating loss (“NOL”) carryover deductions), section 245A (deductions for the foreign source portion of dividends received by domestic corporations from specified 10-percent owned foreign corporations), and section 250 (deductions with respect to foreign-derived intangible income and global intangible low-taxed income). *See* Prop. Treas. Reg. § 1.59A-2(e)(3)(ii)(A).

Base Erosion Payments

Base erosion tax benefits are generally the amounts of deductions a taxpayer claims or reductions in gross income with respect to base erosion payments, generally excluding increases in cost of goods sold. Thus, to determine a base erosion benefit, the taxpayer must determine whether there is a payment or accrual to a foreign related party that gives rise to a base erosion payment. A foreign related party is a person who is not a United States person (as defined by section 7701(a)(30), with modifications), that is either a 25 percent owner of the taxpayer, related to the taxpayer or any 25 percent owner of the taxpayer within the meaning of section 267(b) or section 707(b), or a controlled taxpayer within the meaning of Treas. Reg. § 1.482-1(i)(5). Section 59A(g)(3) applies the constructive ownership rules of section 318 in determining stock ownership, subject to certain modifications.

A base erosion payment arises when an applicable taxpayer pays or accrues an amount in a transaction with a foreign related party if the transaction is within one of the following four categories:

1. The taxpayer is entitled to deduct the payment;
2. The taxpayer is entitled to amortize or depreciate the property it acquires as a result of the payment;
3. The taxpayer pays or accrues a premium or other consideration for reinsurance that is taken into account under section 803(a)(1)(B) or 832(b)(4)(A); or
4. The taxpayer makes a payment to certain expatriated entities or related foreign person that reduces the taxpayer's gross receipts. *See* Prop. Treas. Reg. § 1.59A-3(b)(1).

The first two categories are most likely to affect taxpayers. In the second category, the payment itself does not give rise to BEAT exposure. Rather, the depreciation or amortization deduction in each year that results from the payment gives rise to BEAT exposure for that year. The third category is limited to reinsurance, and the fourth category is limited to certain affiliated groups that have inverted within the meaning of section 7874. The fourth category is the only case in which an addition to cost of goods sold can give rise to a base erosion payment and base erosion tax benefit.

The definition of base erosion payments in section 59A(d) generally does not include payments that reduce the taxpayer's gross income but are not treated as deductions, such as cost of goods sold, except for payments to certain expatriated entities. The Proposed Regulations reserve a section for rules in relation to certain expatriated entities. Pending further guidance, one would certainly question whether the provision in the statute on its face might run afoul of authorities that provide that a taxpayer must always be allowed to subtract the cost of goods sold from gross receipts in computing its gross income that is subject to tax under the Sixteenth Amendment. *See, e.g., Scales v. Commissioner,* 18 T.C. 1263 (1952).

For foreign corporations that are subject to the BEAT because they have ECI, the Proposed Regulations provide that deductions that are allocable and apportionable to ECI are base erosion payments to the extent the deduction results from a payment or accrual to a foreign related party. The Proposed Regulations generally follow allocation and apportionment rules in the section 882 regulations, with certain modifications. *See* Prop. Treas. Reg. § 1.59A-3(b)(4)(ii).

Consistent with the effective date of section 59A, the Proposed Regulations clarify that amounts that a taxpayer pays or accrues in taxable years beginning before January 1, 2018, do not constitute base erosion payments. *See* Prop. Treas. Reg. § 1.59A-3(b)(3)(vi). Thus, an amortization or depreciation deduction that arises in a taxable year beginning after December 31, 2017, does not constitute a base erosion tax benefit if it relates to a payment for an asset that occurred in a taxable year beginning before January 1, 2018. The Proposed Regulations also clarify that disallowed business interest expense that a taxpayer carries forward from a taxable year beginning before January 1, 2018, does not give rise to a base erosion tax benefit, contrary to the approach Treasury took in Notice 2018-28. *See* Prop. Treas. Reg. § 1.59A-3(b)(3)(vii).

Application of General US Federal Income Tax Law Principles

As explained in more detail below, general US federal income tax law principles determine whether an amount is paid, accrued or deductible. 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 a series of transactions, should be characterized in a different manner.

As an exception, the Proposed Regulations provide that where a US tax treaty allows a taxpayer to take into account amounts equivalent to deductible payments in computing its business profits with respect to transactions with its permanent establishments, these amounts, which the Proposed Regulations refer to as "internal dealings," constitute base erosion payments. *See* Prop. Treas. Reg. § 1.59A-3(b)(4)(v)(B). Treasury believes that this creates parity between deductions for actual regarded payments subject to section 482 and internal dealings which are subject to comparable OECD Transfer Pricing Guidelines. *See* Preamble to Proposed Regs. at 27.

As discussed further below, the preamble to the Proposed Regulations (the “Preamble”) strongly supports the conclusion that a payment to a foreign affiliate that does not gives rise to a deduction for US tax purposes, and does not otherwise fall into categories 2 - 4 above, does not implicate the BEAT. The clearest example of this conclusion is in the principal-agent context. Assume that a multinational group performs certain services for unrelated parties. For commercial reasons, the US parent of the group enters into contracts with the unrelated parties as an agent for the whole group. Both the US parent and the foreign affiliates are thus parties to the contract and both perform services for the unrelated parties. The US parent, still acting as an agent, receives gross proceeds from the contracts from the unrelated parties. The US parent then remits to each foreign affiliate the share of the proceeds that reflects the activities that the affiliate performs for the unrelated parties. The foreign affiliates are all CFCs or disregarded subsidiaries of regarded CFCs. To reduce the risk of a US PE, the affiliates expressly grant the US parent the authority to negotiate and conclude contracts in advance of each potential arrangement with a third party. *See* Treas. Reg. § 1.864-7(d)(1)(ii).

The Tax Court has consistently held that an agent does not treat as income amounts that the agent has no right to retain and must transmit to another person. *See*, *e.g.*, *Ancira v. Commissioner* 119 T.C. 135 (2002); *Seven-Up Co. v. Commissioner*, 14 T.C. 965 (1950). As the US parent does not recognize income in an amount equal to the foreign affiliates’ share of the revenue, the parent also does not have a deductible expense that reduces its income when the parent remits the relevant amounts to the foreign affiliates. Moreover, the US parent is not paying the affiliates for services or property. Instead, the affiliates are performing services directly for the unrelated parties with which they have a direct contractual relationship.

The analysis is generally similar in the context of profit-split or profit-sharing arrangements. *See*, *e.g.*, *Mill v. Commissioner*, 5 T.C. 691 (1945). In this context, if properly structured, the affiliates once again have a direct relationship with the unrelated party, and the US parent is again acting as an agent for its affiliates. In those cases as well, if a US parent receives gross proceeds and remits to a foreign affiliate the affiliate’s share of the profit, the payment is not a deductible expense and therefore does not implicate the BEAT.

Non-Cash Consideration

Notably, Prop. Treas. Reg. § 1.59A-3(b)(2) provides that a base erosion payment may result from any form of consideration, including "cash, property, stock, or the assumption of liability." The Preamble provides that these transactions include a domestic corporation's acquisition of depreciable assets from a foreign related party in a tax-free exchange described in section 351, a reorganization described in section 368, and a liquidation described in section 332. *See* Preamble to Proposed Regs. at 21.

Treasury and the Service believe that a risk to the US tax base can arise as a result of an outbound payment for depreciable or amortizable property without regard to whether (i) the transaction is a recognition or a non-recognition

transaction, (ii) the transferor of the assets acquired by the domestic corporation recognizes gain or loss, (iii) the acquiring domestic corporation takes a step-up or a carryover basis in the depreciable or amortizable assets, or (iv) importing depreciable or amortizable assets into the United States increases the regular income tax base of the taxpayer as compared to the non-importation of such assets. The Treasury, therefore, did not include any specific exceptions for these types of transactions.

In contrast, Treasury explained that for transactions in which a taxpayer that owns stock in a foreign related party receives depreciable property from the foreign related party as an in-kind distribution subject to section 301, there is no base erosion payment because the taxpayer does not provide any consideration to the foreign related party in exchange for the property. Importantly, this conclusion extends to situations in which the US distributee recognizes capital gain under section 301(c)(3) because the distribution exceeds the distributing company's E&P and the distributee's tax basis in the company's stock. In this case as well, the distributee does not make a payment for the property that the distributee receives, and the transaction therefore falls outside the scope of the BEAT.

The analysis is equally clear in the context of distributions that give rise to gain under section 311(b). Under section 311(b), the distributing corporation recognizes gain "as if" it had sold the property. The statute imposes this construct solely for purposes of the determining the gain that results from the distribution. The statute does not deem the distributing corporation to have sold the property, or the distributee to have made a payment in exchange for the property. Accordingly, a distribution that gives rise to gain under section 311(b) also falls outside the scope of the BEAT.

It is not entirely clear whether tax-free transactions, pursuant to which no stock is provided in exchange for depreciable or amortizable property, should be subject to BEAT rules. For instance, a transaction may be considered an exchange of property for stock that qualifies as a section 351 exchange or a section 368 reorganization under the meaningless gesture doctrine, even if no stock consideration is provided. *See, e.g.*, *Lessinger v. Commissioner,* 85 T.C. 824 (1985), *rev'd on other grounds*, 872 F2d 519 (2d Cir. 1989); *James Armour, Inc. v. Commissioner*, 43 T.C. 295 (1964); *Commissioner v. Morgan*, 288 F.2d 676 (3d Cir. 1961), *cert denied*, 368 US 836 (1962); *King v. United States*, 79 F.2d 453 (4th Cir. 1935), *aff'g* 10 F. Supp. 206 (D. Md. 1935); Treas. Reg. § 1.368-2(l)(2)(i); Rev. Rul. 64-155, 1964-1 C.B. 138.

Prop. Treas. Reg. § 1.59A-3(b)(2) appears to require some sort of cash or non-cash consideration for a base erosion payment to exist. However, the Preamble also provides that taxpayers must determine whether a payment or accrual described in categories 1 - 4 is made under the general US federal income tax principles. Accordingly, in cases in which the transferor of property to the applicable taxpayer owns all the stock of the applicable taxpayer, the meaningless gesture doctrine could deem the acquiring company to issue stock in exchange for the property, and that stock could be treated as a payment for

BEAT purposes. From a policy perspective, an inbound transfer of, for example, depreciable or amortizable property to an applicable taxpayer in a tax-free transaction in which there is no actual outbound transfer of cash or other property that reduces the applicable taxpayer's assets should not result in a payment for BEAT purposes under the meaningless gesture doctrine because the transaction results in a net increase in the applicable taxpayer's assets. By increasing the applicable taxpayer's net assets the transaction achieves the overarching purpose of the TCJA to relocate property to the United States.

A similar question arises with respect to certain transactions where cash or non-cash consideration is received but that are treated as section 301 distributions. *See, e.g.*, sections 304 and 302. If a transaction that involves a payment in form is treated as a distribution in substance for US federal income tax purposes, the better view would seem to be that the transaction falls outside the scope of the BEAT.

Treating inbound tax-free transactions as base eroding payments to the extent a depreciable or an amortizable asset is received is surprising for various reasons. First, it seems contrary to the general thrust of the TCJA, which is intended to encourage taxpayers to relocate business functions, assets, and intellectual property to the United States, and to expand business activities within the United States. The foreign-derived intangible income (“FDII”) provisions in section 250, the global intangible low-taxed income (“GILTI”) provisions in section 951A, and the BEAT provisions all provide incentives for taxpayers to migrate business activities, assets, and ultimately jobs to the United States. Before Treasury issued the Proposed Regulations, many companies considered onshoring their intangible assets to the United States pursuant to a reorganization under section 368(a)(1)(F) or a deemed liquidation under section 332 (i.e. check-the-box election). The Proposed Regulations disincentivize taxpayers to undertake such transactions.

It seems anomalous to treat inbound section 301 distributions of property as not constituting base erosion payments while viewing inbound reorganizations and section 332 liquidations as resulting in base erosion payments in cases in which the foreign related party's existence terminates and its successor is the applicable taxpayer. For example, USP, a domestic corporation, owns all the stock of CFC, a foreign corporation. If CFC distributes depreciable or amortizable property to USP under section 301, the Preamble states there is no base erosion payment for the property because, by definition, nothing is paid or accrued in a section 301 distribution. In contrast, CFC could completely liquidate into USP under section 332. One could take the position, and Treasury apparently has, that USP has made a base erosion payment to the CFC for the CFC's depreciable or amortizable property because USP returns its CFC stock to CFC and that stock is cancelled in liquidation. Similarly, pursuant to a plan of reorganization described in section 368(a)(1)(F), CFC could transfer all its assets to US Newco, a domestic corporation, solely in exchange for all the stock of US Newco, after which CFC dissolves, distributing the US Newco stock to USP. Treasury has apparently taken the position that US Newco has made a base erosion payment to CFC for the CFC's depreciable or amortizable property

because it has exchanged its CFC stock for stock in US Newco. In the case of each of the latter 2 transactions, it is difficult to see any policy reason for treating either exchange as a base erosion payment in light of the fact that nothing originating in the United States is moving outside the United States. To the contrary, (i) all of the assets of the foreign related party become assets of the applicable taxpayer with the applicable taxpayer succeeding to all the foreign related party's tax attributes, including asset basis and holding periods, and (ii) the foreign related party's existence terminates in the transaction. Although the applicable taxpayer acquires depreciable or amortizable property from a foreign related party in these cases, the foreign related party's existence terminates and the very asset that the applicable taxpayer is deemed to have paid ceases to exist in the transaction. Moreover, in an F reorganization, because the target corporation and the acquiring corporation are the same person for US federal income tax purposes, to find a payment at all one has to treat the acquiring corporation to be making a payment in effect to itself. Thus, notwithstanding the language in the Preamble, the better view in these cases is that the applicable taxpayer did not make a base erosion payment within the meaning of section 59A(d)(2).

In addition, tax-free incorporation, liquidation, and reorganization transactions are not equivalent to purchase transactions where cash or other property is exchanged. Instead, these tax-free transactions represent capital transactions (i.e. contribution, return of capital, or readjustment of corporate form to which the US taxpayer provided capital) rather than true outbound deductible payments (whether cash or non-cash). In fact, section 59A(d) specifically uses the term "base erosion *payment*" [emphasis added] and, with respect to the acquisition of the depreciable property, section 59A(d)(2), which is titled as a "*purchase* of depreciable property" provides that the term "base erosion payment" means "any amount *paid or accrued* […] in connection with the acquisition […] of property of a character subject to the allowance for depreciation (or amortization in lieu of depreciation)." [Emphasis added]. The term purchase is generally used in conjunction with taxable sale or exchange transactions, in which the transferor recognizes gain or loss and the purchaser receives cost basis in the purchased property under section 1012. These transactions are treated differently under the Code than tax-free transactions under sections 351, 332, and 368, pursuant to which the transferee obtains a carryover basis in the assets that it acquires (*See*, *e.g.*, sections 334(b) and 362). The BEAT provisions are intended to prevent applicable taxpayers from shifting profits overseas through large deductible outbound *payments* (whether cash or non-cash), thereby eroding the US taxable base. An acquisition of property in a tax-free transaction, whether or not the acquiring corporation issues stock, should not be viewed as a payment or purchase that Congress intended to capture by the BEAT provisions. Indeed, in many other contexts, the Code and/or the courts distinguish tax-free, carryover basis transactions from a taxable purchase. *See*, *e.g.*, *Rosenthal v. Commissioner*, T.C. Memo 1965-254 (distinguishing a sale or exchange from a 351 exchange); *In Re Drage*, 42 A.F.T.R. 2d 78-5869 (M.D. Fl 1978) (again distinguishing a 351 from a taxable exchange); TAM 9731002 (similar); section 338(h)(3)(A) (defining a “purchase” of stock as “any acquisition of stock, but only

if…the stock is not acquired in an exchange to which section 351, 354, 355 or 356 applies.”); section 305(e)(6) (defining a “purchase” of stock as “any acquisition of stock where the basis of the stock is not determined in whole or in part by reference to the adjusted basis of such stock in the hands of the person from whom acquired.”).

It should be no surprise that, in anticipation of push back from taxpayers, the Treasury Department and the Service have requested comments on the treatment of payments and accruals that consist of non-cash consideration.

Netting Generally

One important question is whether taxpayers will be able to net payments for BEAT purposes. Take for example the case of a US parent that pays royalties of $10 million a quarter to a CFC for technology and receives royalties of $2 million a quarter for royalties with respect to related technology. Assume further that both royalties relate to different elements of the same product, are required under the same cross license, and that the cross license agreement explicitly allows the parties to net payments. As a result, the US parent only pays royalties of $8 million. Does the US parent take into account a gross BEAT payment of $10 million or can it make its BEAT calculations on the basis of a net payment of $8 million? The Code itself merely provides that "the term 'base erosion payment' means any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer and with respect to which a deduction is allowable under this chapter." *See* section 59A(d)(1). The legislative history for section 59A does not provide additional guidance.

The Proposed Regulations fortunately do address netting. The Preamble addresses this question early on when it addresses the four types of payments that can be treated as BEAT payments. The Preamble provides that general US tax principles determine whether a payment is characterized as a BEAT payment. Illustrating this rule, the Preamble explains that the Proposed Regulations do not address whether a royalty is a deductible expense under section 162 or a cost includible in inventory under sections 471 and 263A that reduces gross income under section 61. Instead, general tax principles govern. The Preamble goes on to provide:

> 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. *See* Preamble to Proposed Regs. at 19-20.

Somewhat oddly, the Preamble addresses this question again in section IX, which provides rules relating to insurance companies. The Preamble acknowledges that the Treasury Department and the Service are aware that certain reinsurance agreements provide that amounts paid to and from a reinsurer are settled on a net basis or netted under the terms of the agreement. The Treasury Department and the Service also acknowledge that other commercial agreements between related parties have reciprocal payments that the parties may settle on a net basis or that the parties may net under the terms of those agreements. Explaining that the Proposed Regulations do not provide a general rule allowing netting in these circumstances, the Preamble provides:

> The proposed regulations do not provide a rule permitting netting in any of these circumstances 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. Generally, the amounts of income and deduction are determined on a gross basis under the Code; however, as discussed in Part III of this Explanation of Provisions section, if there are situations where an application of otherwise 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. *See* Preamble to Proposed Regs. at 60.

The Preamble goes on to request comments on whether related party insurance agreements should be treated differently than other agreements for this purpose.

Importantly, the Preamble indicates that taxpayers may net in cases where general tax principles provide for taxpayers to compute deductions on a net basis. Thus, where general tax principles provide that a receipt reduces a deduction, rather than generating income, the general rules compute the deduction on a net basis.

The Proposed Regulations implement this approach by generally prohibiting netting. *See* Prop. Treas. Reg. § 1.59A-3(b)(2)(ii). The Proposed Regulations specifically 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." Returning to the reinsurance context, the Proposed Regulations go on to illustrate the rule by explaining that a taxpayer may not reduce or net premiums or any other consideration paid to a foreign related party for reinsurance by other amounts the taxpayer receives from the foreign related party or by reserve adjustments or other returns. Apart from situations in which general US tax principles provide netting, the only explicit exception allowing

netting in the context of the BEAT is for mark-to-market transactions. For any position with respect to which the taxpayer applies a mark-to-market method of accounting for US federal income tax purposes, the taxpayer determines its gain or loss with respect to that position for any taxable year by combining all items of income, gain, loss, or deduction arising with respect to the position during the taxable year. Although this rule allows netting of gains and losses over the course of a year, since it relates to a single position the rule does not apply to cross-payments on related transactions, much less unrelated transactions. Interestingly, the Proposed Regulations do not directly address the favorable portion of the rule, which allows taxpayers to net where general tax principles incorporate netting principles.

Implications of the Netting Rules

Many taxpayers aggregate a variety of different payments through a US member of the affiliated group, which then charges the expenses out to other members of the group. Consider, for instance, the case of a taxpayer that provides general IT support for all members of the group in three locations: the United States, India and Ireland. Rather than having the subsidiaries in India and Ireland charge the other affiliates directly, each charges its entire expense, with an appropriate uplift, to the US service provider, which then bills the other affiliates on a net basis. Assume further that these services do not qualify for the exception to BEAT treatment for payments that fit within the SCM exception. This approach might ease administration and it might put the taxpayer in a better position in the event that the Indian or Irish tax authorities challenge the transfer pricing for the services. Among other things, this approach facilitates access to US competent authority in the case of a transfer pricing dispute. Unfortunately, this approach maximizes the amount of the BEAT payments under the Proposed Regulations. Given the significant risk that these structures would be treated as giving rise to BEAT payments on a gross basis, many taxpayers began moving away from this approach, or at least planning to do so, shortly after the President signed the BEAT into law along with the rest of tax reform. The Proposed Regulations confirm that these structures maximize the amount of the BEAT payments and thus will often be unfavorable.

The more interesting cases relate to payments for which US federal income tax principles allow taxpayers to net. A couple of important examples arise in the context of cost-sharing. To begin with, there are the cost-sharing payments the controlled participants in a cost-sharing arrangement make to each other to share the costs of developing cost-shared intangibles. The cost-sharing regulations treat the party making such a cost-sharing payment as paying its own costs of developing intangibles at the location where the development takes place. *See* Treas. Reg. § 1.482-7(j)(3)(i). Accordingly, the payment increases the payor's deductible development expense and reduces the recipient's deductible development expense. To the extent that there is any ambiguity about whether this rule allows netting, Treas. Reg. § 1.482-7(j)(3)(iii), Example 1 confirms that taxpayers may net payments to develop cost-shared intangibles. This rule fits comfortably within the exception for netting in the Proposed Regulations. As discussed above, those rules allow for netting in "situations where an application

of otherwise 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*)." Preamble to Proposed Regs. at 60 [emphasis added]. As required under this exception allowing netting, a payment of cost-shared expenses a participant receives reduces its deductible expense, rather than increasing the recipient's income. Accordingly, taxpayers should be able to net cost-sharing payments for BEAT purposes.

A similar issue arises in the cost-sharing context with respect to platform contribution transaction ("PCT") payments (formerly known as "buy-in payments"). The cost-sharing regulations provide that a controlled participant's PCT payment "is deemed reduced to the extent of any payments owed" to the controlled participant from another controlled participant. *See* Treas. Reg. § 1.482-7(j)(3)(ii). To the extent that there is any ambiguity about whether this rule allows netting, Treas. Reg. § 1.482-7(j)(3)(iii), Example 3, which involves four cost-sharing participants, confirms that taxpayers may net PCT payments. Again, this rule fits comfortably within the exception for netting in the Proposed Regulations.

One particularly interesting issue is how the common law reimbursement doctrine interacts with the cost-sharing rules in the context of the definition of a base erosion payment. Assume that a US parent and a foreign affiliate are in cost-sharing, and that the parties' reasonably anticipated benefits ("RAB") share for a given year is 60 (US)/40 (foreign). Assume further that the US parent makes a payment of 100 to a second foreign affiliate for contract research and development ("R&D"). The foreign cost-sharing participant bears 40 of that 100 and pays a cost-share of 40 to the US parent. Does the US parent make a base erosion payment of 100 or 60? Under longstanding judicial and administrative guidance, a company that incurs an expense on behalf of an affiliate is not entitled to deduct that expense. *See*, *e.g.*, *Glendinning, McLeish & Co. v. Commissioner*, 24 B.T.A. 518 (1931); Rev. Rul. 84-138, 1984-2 C.B. 123. The company also does not recognize income when the affiliate reimburses the company for the payment. Treas. Reg. § 1.482-7(j)(3) states that each participant's cost-sharing payments are treated as payments of the participant's own costs. Cost-sharing payments thus are akin to reimbursement payments under the regulations. Accordingly, the there is a strong argument that the US parent only makes a base erosion payment of 60. The 40 represents an expense that the parent incurs on behalf of the affiliate, which the parent is not entitled to deduct.

As a practical matter, the safer response to the issue above is to move the contract with the R&D service provider to the foreign cost-sharing participant. In that case, the parties can much more confidently limit the US participant's BEAT exposure to the participant's outbound cost-sharing payments. Specifically, using the RAB share in the example above, if the foreign cost-sharing participant makes a payment of 100 to a foreign affiliate that performs contract R&D, the US parent makes a cost-sharing payment of 60 to the foreign participant. That 60 represents the US parent's own cost under Treas. Reg. § 1.482-7(j)(3). Thus, the US parent is treated as paying the 60 directly to the foreign affiliate providing the services. As a result, US parent has made a 60 payment for R&D services to a

foreign related party, which likely makes the cost-sharing payment a BEAT payment. Although this approach, as a technical matter, is much safer, the company is arguably no better off from a BEAT exposure standpoint than under the approach where the contract is with the US parent. In both cases, the better view is that the US parent makes a BEAT payment of 60. Yet, this approach provides the company with greater certainty about the extent of the company's BEAT exposure, since there is no material risk that the foreign affiliate's share of the payment to a foreign contract R&D provider can be considered a BEAT payment.

At the same time, the analysis above suggests that recontracting may not be necessary. That conclusion could be welcome if there are good commercial, operational, systems, legal, or other reasons to preserve the contract with the US parent. In this case, a company might be willing to accept some uncertainty on the tax side for the benefit of not disturbing the status quo from a commercial, operational, or other standpoint.

There is another looming issue for taxpayers engaged in cost-sharing that have material amounts of stock-based compensation. The cost-sharing regulations specifically require taxpayers to share this expense. Most taxpayers have chosen to comply with the regulations. As a result, many non-US cost-sharing participants have made significant cost-sharing payments to compensate the US participant for stock-based compensation expense within the cost-sharing pool. Taxpayers have long argued that Treasury cannot require taxpayers to include stock-based compensation within the cost-sharing pool because taxpayers at arm's length are not unwilling to pay for stock-based compensation for a variety of reasons. Thus far, the case law has generally supported this approach. *See Xilinx v. Commissioner*, 125 T.C. 37 (2005), *aff'd*, 598 F.3d 1191 (9th Cir. 2010); *Altera Corp. v. Commissioner*, 145 T.C. 91 (2015).

The validity of the current regulation requiring taxpayers to share this expense is currently before the Ninth Circuit. *See*, *Altera Corp. v. Commissioner*, 2018 US App. LEXIS 20542 (9th Cir. July 24, 2018), *rev'g,* 145 T.C. 91 (2015), *withdrawn by* 898 F.3d 1266, 2018 US App. LEXIS 21925 (9th Cir., Aug. 7, 2018). In the event that the Ninth Circuit invalidates the current regulation, many taxpayers will have contractual rights within their cost-sharing agreements requiring the US cost-sharing participant to refund stock-based compensation expense that the non-US cost-sharing participant paid solely because the taxpayer wished to comply with the current regulations. In many cases, these refunds could be very large. Assuming the US participant can deduct the refund in the current year, although the taxpayer could probably net the refund against the cost-sharing payment the foreign participant owes for the current year, the refund could still be very large and could result in a material payment under the Proposed Regulations. Foreign cost-sharing participants with PCT liabilities within the year might possibly be able to argue that they can net these payments as well by analogy to the current cost-sharing regulations. Even then, the net refund could result in a material BEAT payment. To further complicate matters, it is unclear whether the contractual provisions requiring a refund control the timing of the deduction for US federal income tax purposes.

To avoid this BEAT exposure, taxpayers might wish to argue that they are required to deduct the refund in the years to which it relates for the arrangement to be arm's length. This approach would require taxpayers to amend their returns for the relevant years in which the stock-based compensation was incurred. Assuming most of the compensation occurred in pre-BEAT years, which is likely, this approach would largely eliminate the BEAT exposure. Unfortunately, Treas. Reg. § 1.482-1(a)(3) provides that taxpayers cannot amend returns to reflect transfer pricing adjustments that reduce US tax liability. Case law suggests that taxpayers may nevertheless be able to amend, provided that the Service has already proposed a transfer pricing adjustment and the regulations specifically allow for setoffs. These issues are complex, and their resolution depends on each taxpayer's individual facts and circumstances, and the results in cases that remain undecided. For taxpayers with this issue, some advanced planning to consider the options, of which there are many, and how to address them will be important.

Exceptions to Base Erosion Payments

Section 59A and the Proposed Regulations exclude from the definition of base erosion payments various deductible payments an applicable taxpayer makes to a foreign related party. These exceptions include payments that are eligible for the SCM under section 482 with modifications, qualified derivative payments, payments that are treated as ECI in the hands of the recipient, and section 988 losses with respect to payments to a foreign related party. This client alert discusses only select exceptions which are of interest.

Services Cost Method Exception

Section 59A(d)(5) and Prop. Treas. Reg. § 1.59A-3(b)(3) exclude from the definition of “base erosion payment” the cost component of amounts that a taxpayer pays or accrues for services that could qualify for the SCM “without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure.” Thus, the Proposed Regulations allow a taxpayer to make cost-plus payments to foreign affiliates for certain services that are core to the taxpayer’s business and limit the taxpayer’s BEAT exposure to the amount of the uplift. Under Treas. Reg. § 1.482-9(b)(3), the services must either fall on one of the Service’s “white lists” or be services for which the median comparable markup on “total services costs” as defined in Treas. Reg. § 1.482-9(j) is less than or equal to seven percent. Under Treas. Reg. § 1.482-9(b)(4), the services cannot involve certain excluded activities. For most taxpayers, the relevant excluded activities are manufacturing or production, sales or distribution, R&D, and financial transactions.

As the Preamble acknowledges, in the months after Congress enacted the TCJA into law, there was some uncertainty as to whether the SCM exception applied only to payments for services at cost. *See* Preamble to Proposed Regs. at 29. The reason for this uncertainty lay in the fact that section 59A(d)(5)(B) states that the exception applies where the amount the taxpayer pays or accrues “constitutes the total services cost with no markup component.” By its terms, the

SCM allows the taxpayer to charge out services that qualify for the SCM at cost, with no markup. Thus, the words, “with no markup component,” raised concerns that Congress was trying to mirror the SCM in section 59A(d)(5)(B) and limit the exception to services that the taxpayer did in fact charge out at cost.

Initial comfort came in the form of a colloquy between Senators Rob Portman and Orrin Hatch on the Senate version of the BEAT. In that colloquy, Senator Portman asked Senator Hatch whether a taxpayer could reflect the cost component of a payment in one account and the markup component of the payment in another account and exclude the cost component from the BEAT. Senator Hatch observed that the taxpayer could do so. Further comfort came as taxpayers and practitioners recognized that this colloquy reflected the only reasonable interpretation of the statute. By turning off the requirement that the services to which section 59A(d)(5) applies “not contribute significantly to fundamental risks of business success or failure,” Congress allowed section 59A(d)(5) to apply to services that could not in fact qualify for the SCM because they represent services that are core to the taxpayer’s business. Paying for these services at cost typically would not be arm’s length. If section 59A(d)(5) were to require a taxpayer to charge out such services at cost, section 59A(d)(5) would require the taxpayer to take a position that is not arm’s length for US tax purposes. This construction of section 59A(d)(5) would be inconsistent with the principle that a statute - here, the Internal Revenue Code - should be read as a “harmonious whole.” *See*, *e.g.*, *FDA v. Brown & Williamson Tobacco Corp.*, 529 US 120 (2000).

Alternatively, if section 59A(d)(5) were interpreted to mean that it only applies to payments for non-core services that do not “contribute significantly to fundamental risks of business success or failure,” a portion of section 59A(d)(5) would be superfluous. This construction of section 59A(d)(5) also would be untenable. Congress included all the elements of section 59A(d)(5) for a reason, and this interpretation would essentially read one of those elements out of the statute. One fundamental rule of interpretation is that every word of a statute should be given effect, where possible. *See*, *e.g.*, *United States v. Menasche*, 348 US 528 (1955).

Treasury expressly agreed with this second point. In the Preamble, Treasury observed that limiting the application of the exception in section 59A(d)(5) to services that could in fact qualify for the SCM “would render the parenthetical reference in section 59A(d)(5)(A) a nullity.” *See* Preamble to Proposed Regs. at 30.

The treatment of the SCM exception in the Proposed Regulations therefore represents a welcome development for taxpayers. First, the SCM exception restores in part a measure of parity between services businesses and manufacturers or distributors by allowing taxpayers that rely on services as inputs to their business to exclude the cost component of at least some of those inputs, just like a manufacturer or distributor may exclude its costs for inventory property. Second, the SCM exception provides taxpayers with another tool to manage their BEAT exposure by excluding the cost component of payments for

qualifying services from both the numerator and the denominator of the base erosion percentage calculation.

In an improvement to the approach that Senator Portman suggested in his colloquy with Senator Hatch, the Proposed Regulations do not require taxpayers to maintain separate accounts for cost and uplift components of a payment that qualifies for the SCM exception. Similarly, the Proposed Regulations do not require taxpayers to invoice the cost and uplift components separately. The Proposed Regulations require the taxpayer only to maintain "adequate books and records" to allow the Service to verify the cost and uplift components and the nature of the services in question. *See* Prop. Treas. Reg. § 1.59A-3(b)(3)(i)(C).

For taxpayers that previously did not consider the nature of certain services because the services were core to the taxpayer's business and did not qualify for the SCM under Treas. Reg. § 1.482-9, the BEAT's SCM exception provides a reason to revisit these services. For example, a taxpayer that views sales and marketing or brokerage services that foreign affiliates perform as core to its business might consider more carefully whether these services constitute sales activities or financial transactions, respectively, that fall on the list of excluded activities in Treas. Reg. § 1.482-9(b)(4). If the taxpayer believes that the services fall outside the scope of the excluded activities in Treas. Reg. § 1.482-9(b)(4), the taxpayer will want to develop the facts to support a distinction between, for example, the demand generation activities that foreign affiliate personnel perform and high touch solicitation or negotiation that in substance rises to the level of sales.

The ECI Exception

Treasury and the Service created the ECI exception to base erosion payment status for payments the recipient of which is subject to US tax. *See* Prop. Treas. Reg. § 1.59A-3(b)(3)(iii). A payment from a US corporation to a US branch of a foreign corporation is not a base erosion payment to the extent the payment is ECI. Treasury explained its justification for creating this exception in the Preamble as follows:

> The Treasury Department and the IRS have determined that it is appropriate in defining a base erosion payment to consider the US tax treatment of the foreign recipient. In particular, the Treasury Department and the IRS have determined that a payment to a foreign person should not be taxed as a base erosion payment to the extent that payments to the foreign related party are effectively connected income. Those amounts are subject to tax under sections 871(b) and 882(a) on a net basis in substantially the same manner as amounts paid to a United States citizen or resident or a domestic corporation. Accordingly, the proposed regulations include an exception from the definition of base erosion payment for amounts that are subject to tax as income effectively connected with the conduct of a US trade or business. *See* Preamble to Proposed Regs. at 35-36.

In other words, Treasury concluded that payments that give rise to ECI do not give rise to the base erosion concerns that motivated Congress to enact the BEAT in the first place. Thus, it would be inconsistent with Congressional intent to treat these payments as BEAT payments.

This exception is very helpful to foreign banks that have operations in the United States. Many foreign banks form a corporation in the US that interacts with a US branch of a foreign corporation. The ECI Exception provides relief for payments a US corporation makes to the US branch for services, interest, and other payments that give rise to a deduction in the United States.

The Exception for Section 988 Losses

Section 988 and Treas. Reg. § 1.988-1(a) provide for the treatment of the sale of nonfunctional currencies or transactions denominated in nonfunctional currencies (e.g., debt instruments, payables, receivables, forward contracts, futures contracts, option contracts, and other similar financial instruments). The Proposed Regulations provide that exchange losses from these transactions are not base erosion payments. *See* Prop. Treas. Reg. § 1.59A-3(b)(3)(iv). These losses are excluded from the numerator and denominator in computing the base erosion percentage. The administration requested comments on the treatment of section 988 losses under the BEAT, including whether the elimination of section 988 losses from the base erosion percentage denominator should be limited to transactions with foreign related parties. *See* Preamble to Proposed Regs. at 37.

Treasury and the Service "determined that these losses do not present the same base erosion concerns as other types of losses that arise in connection with payments to a foreign related party." *See* Preamble to Proposed Regs. at 36. The Preamble does not provide an analysis underlying this conclusion. Moreover, the Preamble does not define "base erosion concerns." Should a payment from the United States to a higher tax jurisdiction (e.g., Japan) present "base erosion concerns?" There are numerous other transactions that could satisfy this standard. Treasury should use its general authority to further exclude payments that do not present the same base erosion concerns as other types of payments.

There is No Exception for Subpart F or GILTI Income

Unlike the other exceptions described above, oddly, Treasury did not provide an exception for payments that give rise to subpart F income or GILTI. BEAT payments that give rise subpart F income or GILTI can potentially result in to double or triple taxation. Consider the case, for example, of a US corporation ("US Corp") that owns a controlled foreign corporation ("CFC1"), which is incorporated in the UK. Third party customers pay US Corp fees to perform services around the globe. US Corp performs some of the services in the United State, and US Corp recognizes income for the services it performs. US Corp pays CFC1 an amount to perform some of the services. US Corp also deducts the amount paid to CFC1 for the services CFC1 provided. CFC1 does not perform the service in the United States or in the UK. US Corp deducts the amount it pays CFC1. CFC1's income from providing services is foreign base company services income under section 954(e) because it does not perform the

services in its country of incorporation, or in the United States for that matter. In computing its ordinary income, US Corp includes its taxable income for the services it provided. In addition, US Corp includes in its taxable income CFC1's subpart F income. US Corp also receives a foreign tax credit associated with the subpart F income under section 960. For BEAT purposes, the payment US Corp makes to CFC1 is a base erosion payment and is added back to compute MTI. Including the payment in MTI can result in double taxation because the amount is included again as subpart F income. To make matters worse, US Corp may lose the benefit of some or all of the foreign tax credits associated with the subpart F income, resulting in triple taxation on the same stream of income.

Former Senator Jeff Flake filed an amendment on the floor of the Senate during the consideration of the Senate version of the TCJA that would have partially fixed this issue. It is unclear why the Senate did not take up the amendment or why it was not included in the manager's bill.

Treasury could have created an exception for subpart F or GILTI income, even though Congress did not take up Senator Flake's amendment that would have addressed the issue at least in part. Given that Treasury, adhering to Congressional intent, created exceptions for other payments, it is unclear why Treasury did not create a similar exception for subpart F or GILTI income. As discussed above, in the case of section 988 losses, for example, Treasury considered the issues that caused Congress to enact the BEAT and what Congress intended to accomplish with the BEAT. Treasury concluded that section 988 losses do not "present the same base erosion concerns as other types of losses that arise in connection with payments to a foreign related party." *See* Preamble to Proposed Regs. at 36. Treasury could easily extend the same logic to subpart F or GILTI payments that give rise to double and triple taxation, as the subpart F or GILTI income is already taxed once and does not give rise to base erosion concerns.

Treasury's reasoning with respect to section 988 losses echoes its analysis of payments that give rise to ECI. As discussed above, payments that give rise to ECI are not BEAT payments because these payments have been taxed on a "net basis in substantially the same manner as amounts paid to a United States citizen or resident or a domestic corporation." *See* Preamble to Proposed Regs. at 35-36. Amounts that give rise to subpart F income are also taxed on a net basis in substantially the same manner as amounts paid to a United States citizen or resident or a domestic corporation. The only difference is that, instead of the foreign corporation filing the corporate return in the United States, it is the US shareholder that includes the net taxable subpart F income. This distinction is not relevant for BEAT purposes. Congress was concerned about payments that eroded the US tax base because they were deductible in the United States and the recipient did not recognize income in the United States.

This approach to subpart F and GILTI income is harsh and we hope it will be revisited.

Partnership Issues

For purposes of the BEAT, such as determining whether a corporation is an applicable taxpayer and whether a corporation incurred a base erosion payment, the Proposed Regulations generally apply an aggregate approach to partnerships. Thus, when determining whether a corporate partner that is an applicable taxpayer has made a base erosion payment, amounts that a partnership pays or accrues are treated as paid by each partner to the extent an item of expense is allocated to the partner under section 704. Similarly, any amounts that a partnership receives or accrues are treated as received by each partner to the extent the item of income or gain is allocated to each partner under section 704. *See* Prop. Treas. Reg. § 1.59A-7(b). In the interest of clarity, Prop. Treas. Reg. § 1.59A-7(b)(5)(i) provides that, for purposes of section 59A:

> [E]ach partner is treated as owning its share of the partnership items determined under section 704, including the assets of the partnership, using a reasonable method with respect to the assets. For items that are allocated to the partners, the partner is treated as owning its distributive share (including of deductions and base erosion tax benefits). For items that are not allocated to the partners, the partner is treated as owning an interest proportionate with the partner's distributive share of partnership income.

The rules and exceptions for base erosion payments and base erosion tax benefits then apply accordingly on an aggregate basis. This approach prevents an applicable taxpayer from (a) paying a domestic partnership that is owned by foreign related parties, rather than paying those foreign partners directly, to circumvent the BEAT and (b) causing a partnership in which an applicable taxpayer is a partner to make a payment to a foreign related party, rather than paying that foreign related party directly.

To avoid undue burden on taxpayers, the Proposed Regulations provide a limited exception for small partnership interests, pursuant to which the partner does not look through its partnership interest to determine the base erosion tax benefit. *See* Prop. Treas. Reg. § 1.59A-7(b)(4)(i).

Consistent with the approach Treasury took with respect to subchapter C transactions, the Proposed Regulations do not provide for special treatment of base erosion tax benefits attributable to a partnership or to partnership nonrecognition transactions. For example, if a partnership acquires property from a foreign related party of a taxpayer that is a partner in the partnership, deductions for depreciation of the property allocated to the taxpayer generally are base erosion tax benefits. Similarly, if a foreign related party and a taxpayer form a partnership, and the foreign related party contributes depreciable property, deductions for depreciation of the property generally are base erosion tax benefits, in part, because the partnership is treated as acquiring the property in exchange for an interest in the partnership under section 721.

The Proposed Regulations leave many questions open, including but not limited to, whether the following give rise a base erosion benefit:

1. When an applicable taxpayer partner contributes property to the partnership that results in additional depreciation deductions being allocated to the partner with respect to depreciable property that was previously contributed to the partnership by the foreign related partner, its is not clear whether the contribution by the applicable taxpayer partner should be treated as a base erosion payment to the foreign partner to the extent of the additional depreciation deductions. If Treasury and the Service intended for section 721 contributions to be treated in a similar manner as the section 351 contributions under the Proposed Regulations, then issuing the partnership interest to the foreign related partner in exchange for the contributed depreciable property should be the only event treated as a base erosion payment. However, the regulations are not clear. A similar question arises with respect to additional depreciation deductions that are allocated to the applicable taxpayer partner as a result of an event that occurs in a taxable year after December 31, 2017 (*i.e.* contribution by the applicable taxpayer), with respect to property that was contributed to the partnership by the foreign related partner prior to January 1, 2018.

2. The Proposed Regulations do not currently consider the fact that the applicable taxpayer partner is also giving up some depreciation deductions by contributing depreciable property to the partnership to the extent the depreciation deductions are allocated to the foreign related partner.

3. The treatment of remedial allocations under section 704(c) is also unclear. For instance, a partnership may allocate remedial items of depreciation deductions to an applicable taxpayer partner under section 704(c) with respect to a built-in gain property contributed by a foreign related partner to the partnership, which may be treated as base erosion payments. In addition, the partnership may allocate additional remedial items of depreciation deductions to an applicable taxpayer partner as a result of an increase in a property's book basis in a revaluation. If the property was contributed by a foreign related partner to the partnership, it is not clear whether the revaluation event results in a base erosion payment.

Base Erosion Tax Benefits

Base erosion tax benefits are generally the amounts a taxpayer may deduct or subtract from gross income with respect to base erosion payments. The Proposed Regulations provide four categories of base erosion tax benefits that correspond to the four categories of base erosion payments.

Yet, a base erosion payment does not have a base erosion tax benefit where tax is imposed by sections 871 (tax on certain income of nonresident aliens) or 881 (tax on income of foreign corporations not connected with a US trade or business), and where the tax is deducted and withheld at 30 percent under sections 1441 or 1442. *See* Prop. Treas. Reg. § 1.59A-3(c)(1)(iv).

To the extent a treaty reduced or eliminated withholding, then the payment has a base erosion tax benefit. The base erosion tax benefit is computed by multiplying the base erosion tax benefit assuming no treaty by the fraction of the rate imposed without regard to the treaty, reduced by the rate of tax imposed by the treaty, over the full 30 percent withholding rate. For example, if a payment is characterized as a royalty and was subject to 10 percent withholding under an applicable income tax treaty, then ((30-10)/30) or 2/3 of the payment is treated as a base erosion tax benefit.

Section 59A(c)(3) provides an ordering rule that applies where section 163(j) disallows interest deductions. In determining the amount of interest a taxpayer may deduct for BEAT purposes, section 59A(c)(3) deems section 163(j) to disallow interests the taxpayer pays to unrelated parties first, before disallowing interests the taxpayer pays to related parties. The Proposed Regulations provide further guidance relating to business interest expenses. *See* Prop. Treas. Reg. § 1.59A-3(c)(4). The Proposed Regulations require first that the taxpayer classify its business interest expense as foreign related business interest expense, domestic related business interest expense, or unrelated business interest expense in the year that the taxpayer pays or accrues the interest. To the extent section 163(j) does not apply to an interest deduction, the Proposed Regulations treat the deduction first as foreign related business interest expense and domestic related business interest expense on a pro rata basis, then as unrelated business interest expense. Where an interest deduction is attributable to disallowed business interest expense carried forward from prior taxable years, the above allocation rules apply separately to the carried forward amounts, in a way that follows the same year by year convention set forth in Treas. Reg. § 1.163(j)-5(b)(2).

Modified Taxable Income

Each applicable taxpayer calculates its own MTI, separate from that of other members of the aggregate group. To arrive at its MTI, the taxpayer first determines its taxable income under section 63(a), except that a NOL carryforward or carryback under section 172 cannot reduce this starting point to below zero. Then, the taxpayer adds back (1) the gross amount of its base erosion tax benefits for the taxable year, and (2) the base erosion percentage of the amount of NOL deductions taken into account in calculating the starting point. *See* Prop. Treas. Reg. § 1.59A-4(b).

The Proposed Regulations clarify that in adding back the base erosion percentage of NOL deductions to MTI, the taxpayer should use the base erosion percentage for the year in which the NOL arose, also referred to as the vintage year. *See* Prop. Treas. Reg. § 1.59A-4(b)(2)(ii).

Base Erosion Minimum Tax Amount

The BEMTA is the excess, if any, of (i) the BEAT tax rate multiplied by the taxpayer’s MTI, over (ii) the taxpayer’s regular tax liability reduced by various credits discussed below. *See* Prop. Treas. Reg. § 1.59A-5(b). For most corporations, the BEAT tax rate is 5 percent for taxable years beginning in the calendar year 2018, 10 percent for taxable years beginning after December 31, 2018, through January 1, 2026, and 12.5 percent for taxable years beginning after December 31, 2025. *See* Prop. Treas. Reg. § 1.59A-5(c).

Buried deep in the proposed regulations and not discussed in the Preamble is an increase in the BEAT rate for fiscal year taxpayers. In years in which the BEAT rate increases starting January 1 for calendar year taxpayers - e.g., from 5 percent to 10 percent, or 10 percent to 12.5 percent - the Proposed Regulations require fiscal year taxpayers to apply a blended rate for the fiscal year that ends in that year. *See* Prop. Treas. Reg. § 1.59A-5(c)(3). Taxpayers achieve this blending by applying the old rate to the portion of the year that falls before January 1 and the new rate to the portion of the year that falls after January 1. Thus, for example, a fiscal year taxpayer with a June 30 year will pay the BEAT at an effective rate of 7.5 percent for the fiscal year ending June 30, 2019 - 5 percent for the first six months, and 10 percent for the next six month. This result is a nasty surprise for fiscal year taxpayers who believed that the BEAT tax rate was 5 percent for their first fiscal year. We expect taxpayers to comment that this position is contrary to the statute and legislative intent.

Tax Credits

The BEAT is very unkind to most, but not all, tax credits. In calculating regular tax liability for purposes of the BEAT, a taxpayer loses the benefits of tax credits, other than the R&D tax credit under section 41 and 80 percent of applicable section 38 credits. The section 38 credits include the low income housing tax credit, the renewable electricity production credit, and the investment credit to the extent allocable to the energy credit. *See* section 59A(b)(1)(B). For taxable years beginning on or after January 1, 2026, all credits, including the R&D tax credit, are excluded when calculating a taxpayer's BEAT liability and can create BEAT liability. Given the fact the United States, like most other countries, has historically taken the view that providing an incentive for R&D is a high priority from a policy perspective, we find it hard to believe that the rule requiring taxpayers to calculate their BEAT liability without the benefit of the R&D tax credit will ever go into effect. Despite our expectation that Congress will change the rule, at least for now, taxpayers have to plan for the fact that it is in effect.

Mechanically, a taxpayer computes its regular tax liability and reduces this liability with its tax credits, other than the R&D credit and 80 percent of applicable section 38 credits. The Proposed Regulations provide that credits for overpayment of taxes and for taxes withheld at source are not subtracted from the taxpayer’s regular tax. *See* Prop. Treas. Reg. § 1.59A-5(b); Preamble to Proposed Reg. at 52.

The Proposed Regulations contain a small surprise. The Proposed Regulations follow section 26(a) which provides for the use of foreign tax credits before other tax credits. Accordingly, a taxpayer must first use its foreign tax credits for purposes of calculating regular tax liability. If foreign tax credits reduce to zero or near zero the regular tax liability, then R&D tax credits and applicable section 38 credits cannot be used to offset BEMTA. *See* Preamble to Proposed Regs. at 52-53.

Many of the problems that the interaction of tax credits and the BEAT create are embedded in the statute. A US corporation, for example, may have BEAT liability solely due to foreign tax credits from a high tax jurisdiction. To be more specific, the taxpayer may have little or no regular tax liability as a result of foreign tax credits, or other US tax credits for that matter. Assuming the taxpayer is an applicable taxpayer, the taxpayer is subject to the BEAT and may owe additional tax solely from the application of foreign tax credits. In this context, the taxpayer should not be viewed as trying to erode the US tax base since the taxpayer is not subject to the material amount of US tax. The BEAT effectively serves as a minimum tax, rather than a tax on base erosion payments. Moreover, if the taxpayer migrates the activities that generate foreign tax credits to a low or no tax jurisdiction, then the US corporation may not have any BEAT tax liability, even though the potential for base erosion remains. Thus, the architecture of the BEAT encourages taxpayers to migrate activities to low or no tax jurisdictions to minimize BEAT liability, which again is contrary to a regime ostensibly targeted at eliminating base erosion.

Another oddity is that certain credits addressing similar activities have disparate treatment. For example, the R&D credit is focused on increasing research and development in the United States. Similarly, the orphan drug tax credit ("ODTC") is designed to encourage businesses to research and test pharmaceuticals. The R&D credit can be fully utilized against the BEAT (taking into account section 26(a)), while a US corporation could have BEAT liability due to the ODTC. This result seems directly contrary to Congress's policy choice to retain the ODTC. The House version of the TCJA would have repealed the ODTC. Based on compromises with the Senate, Congress chose to have the ODTC apply at a modified, but reduced, level. Despite this apparent desire to retain the benefit of the ODTC, the BEAT effectively eliminates the benefit of the ODTC for many taxpayers. Viewing these sections together, one wonders whether the left hand knew what the right hand was doing.

Although the R&D credit and applicable section 38 credits can offset the BEAT through taxable years beginning before January 1, 2026, the cliff effect can impact new investments. Many projects require significant time and investment. Research for a new medication can exceed ten years, and the average low income housing project that claims the credit has a seven to ten year investment horizon. As a result, the cliff created in 2026 is affecting investment decisions made in 2019. Hopefully, Congress will extend or eliminate the cliff effect for R&D credits, applicable section 38 credits, and all other credits.

Anti-Abuse Rules

The Proposed Regulations contain three targeted anti-abuse rules. The first rule in Prop. Treas. Reg. § 1.59A-9(b)(1) disregards a transaction involving intermediaries or conduits if the principal purpose of the arrangement is to avoid, or reduce the amount of, a base erosion payment. The second rule in Prop. Treas. Reg. § 1.59A-9(b)(2) disregards a transaction, plan, or arrangement that has a principal purpose of increasing the deductions in the base erosion percentage calculation denominator. The third rule in Prop. Treas. Reg. § 1.59A-9(b)(3) disregards a transaction, plan, or arrangement that has a principal purpose of avoiding the rules that apply to certain banks and registered securities dealers.

The BEAT anti-abuse rules appear to leave intact some of the more significant approaches to addressing the BEAT. For instance, many taxpayers historically entered into global deals for the entire group through a US counterparty. The US counterparty then outsourced activities to its foreign affiliates. When Congress enacted the BEAT, these arrangements suddenly gave rise to BEAT exposure. To mitigate this exposure, some of these taxpayers began changing the commercial flows in the deals by having the foreign affiliate enter into the contracts and then outsource activities to a member of the US group. This approach does not appear to raise concerns under the BEAT anti-abuse rules.

Some taxpayers also chose to mitigate BEAT exposure by electing to treat some or all of their CFCs as disregarded entities for US tax purposes. From a US tax perspective, this approach eliminated regarded base erosion payments. Eliminating base erosion payments reduces both the numerator and the denominator of the base erosion percentage calculation. Yet, Prop. Treas. Reg. § 1.59A-9(b)(2) focuses exclusively on transactions, etc., that *increase* this denominator. Thus, this approach also does not appear to raise concerns under the BEAT anti-abuse rules.

The anti-abuse rules appear to be similarly silent on other common BEAT mitigation strategies, such as capitalizing R&D expense under section 59A(e) to fall under the relevant base erosion percentage for a given year.

Consolidated Return Rules

Applicable Taxpayer

Prop. Treas. Reg. § 1.1502-59A(b)(1) generally treats a consolidated group, as defined in Treas. Reg. § 1.1502-1(h), as a single corporation for purposes of section 59A, and Prop. Treas. Reg. § 1.1502-59A(b)(2) clarifies that a consolidated group is treated as a single corporation for purposes of the aggregation rules of Prop. Treas. Reg. § 1.59A-2(c). In particular, a consolidated group is a single taxpayer for purposes of determining whether it is an "applicable taxpayer" (at least $500 million of average annual gross receipts over the prior 3 tax years, plus a base erosion percentage of at least 3% for the current tax year). Items from intercompany transactions are disregarded for purposes of making the calculations that section 59A requires, including the gross receipts and base

erosion percentage computations. Finally, if a person is a related party with respect to any member of a consolidated group, the person is a related party with respect to the group and each of the other members of the group. *See* Prop. Treas. Reg. § 1.1502-59A(b)(3).

To illustrate the foregoing, in Prop. Treas. Reg. §1.1502-59A(f), *Example (1)(ii)*, S sells equipment to B that is inventory in the hands of S but a section 1231 asset in the hands of B. Under these facts, all of B's corresponding items (depreciation deductions) and S's intercompany items (gross income from the intercompany sale) are disregarded. Suppose the equipment were also depreciable by S, which has a $100x basis in the equipment, and S sells the equipment to B for $200x. For Year 1, B is entitled to a $70x depreciation deduction, $30x of which is determined by reference to S's basis and method under section 168(i)(7). In that case, only the $40x additional B depreciation deduction and S's resulting $40x income inclusion under Treas. Reg. § 1.1502-13(c)(2)(ii) should be disregarded for purposes of the gross receipts and base erosion percentage tests. *See* Prop. Treas. Reg. § 1.1502-59A(b)(1).

Consolidated MTI

In determining a consolidated group's consolidated modified taxable income ("CMTI"), the calculation starts with the consolidated group's consolidated taxable income ("CTI") for the tax year under consideration. The Proposed Regulations require taxpayers to adjust CTI by:

1. Eliminating intercompany items and offsetting corresponding items attributable to intercompany transactions, to the extent such items are taken into account in the tax year under consideration;
2. Adding each member's base erosion tax benefits as defined in Prop. Treas. Reg. § 1.59A-3(c) taken into account in the tax year under consideration; and
3. Making any other additions required by Prop. Treas. Reg. § 1.59A-4(b)(2) for the tax year under consideration. For instance, CTI is increased by the group's base erosion percentage for any consolidated net operating loss carryover ("CNOLC") to the tax year under consideration, with the base erosion percentage for the CNOLC being determined as of the tax year in which the NOL was incurred, which is zero if the NOL was incurred in a tax year beginning before January 1, 2018.

To illustrate the foregoing, P is the common parent of a calendar year consolidated group that includes two other members, S1 and S2, each of which is wholly owned by P. For 2019, 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 CTI for the year is $150x ($6,150x of

gross income minus $6,000 of aggregate deductions). The consolidated group's CMTI is computed by adding back the members' base erosion tax benefits (and, when the consolidated group has CNOLC available for deduction, the CNOLC allowed as a deduction in 2019 times the group's base erosion percentage) to the group's CTI, resulting in CMTI of $930x ($150x + $180x + $370x + $230x). The group's consolidated base erosion minimum tax amount is then computed as 10 percent of its CMTI less the regular tax liability, or $61.5x ($930x × 10% - $150x × 21%). *See* Prop. Treas. Reg. §1.1502-59A(f), *Example (1)(i)*.

Coordination with Section 163(j)

Prop. Treas. Reg. § 1.1502-59A(c) contains rules coordinating the BEAT with business interest expense of a consolidated group that is subject to potential deferral under section 163(j). The rules are somewhat complex, primarily because there is a single-entity rule for determining the extent to which the group's current business interest expense ("BIE") is a base erosion payment, and a separate-entity rule for determining the extent to which the group's disallowed BIE carryforwards are base erosion payments. To the extent BIE is permitted as a deduction under section 163(j)(1) in a tax year of a consolidated group with related party debt, the deduction is classified first as from BIE paid or accrued to foreign and domestic related parties on a pro-rata basis. Any remaining deduction is treated as from BIE paid or accrued to an unrelated party. *See* Prop. Treas. Reg. § 1.1502-59A(c)(3)(i). This classification rule is applied by treating the group as a single corporation for current year BIE deductions, but by treating each member as a separate corporation for each disallowed BIE carryforward deducted in the current year. Once a BIE deduction is classified as a foreign related party, domestic related party, or unrelated BIE deduction, the BIE deduction is allocated among all members incurring deductible BIE for the tax year in question based on their respective amounts of BIE deductions for the year. *See* Prop. Treas. Reg. § 1.1502-59A(c)(4). This could result in a member incurring only domestic related party or unrelated BIE being allocated a portion of foreign related party BIE deductions. If a group's aggregate current year BIE exceeds its consolidated section 163(j) deduction, the rules of Prop. Treas. Reg. § 1.1502-59A(c)(5) allocate each category of carryforward among the members of the group. The amount of each category allocated to a member retains its status as one or more of foreign related party, domestic related party, or unrelated disallowed BIE carryforwards in the event that the member deconsolidates or is acquired in a section 381(a) transaction in which the successor succeeds to the carryforward under section 381(c)(20).

To illustrate the foregoing, FP is a foreign corporation owning all the stock of P. P is the common parent of a calendar year consolidated group that includes two other members, S1 and S2, each of which is wholly owned by P. Each of S1 and S2 owns a 40 percent capital and profits interest in PRS, a domestic partnership. For 2019, (i) P incurs BIE of $100x, all of which is owed to a third party bank; (ii) S1 incurs BIE of $45x, all of which is owed to PRS; (iii) S2 incurs $60x of BIE, all of which is owed to FP; and (iv) the P group's consolidated section 163(j) limitation, as determined under Prop. Treas. Reg. §§ 1.163(j)-4(d) and 1.163(j)-

5(b)(3), is $80x. On November 30, 2019, P sells all the stock of S2 to X, an unrelated buyer, resulting in S2 leaving the P consolidated group.

> Under Treas. Reg. § 1.1502-76(b), $55x ($60x x 335/365) of S2's $60x of 2019 interest expense owed to FP is allocated to its short period as a member of the P group, the last day of which is November 30. Consequently, the aggregate BIE of the P group for 2019 is $200x ($100x unrelated + $45x domestic related + $55x foreign related), which exceeds the consolidated section 163(j) limitation ($80x) by $120x.
>
> Under Prop. Treas. Reg. § 1.1502-59A(c)(3), the $80x of deductible BIE is first allocated, pro rata, to the related party BIE incurred by S1 and S2 (i.e., $36x [$80x x $45x/$100x] is domestic related party BIE, and $44x [$80x x $55x/$100x] is foreign related party BIE). This means that $44x of the P group's $80x of 2019 deductible BIE is a base erosion tax benefit.
>
> Also, because there is no limitation left for the $100x of unrelated BIE, none of the 2019 BIE deduction is categorized as unrelated BIE. Thus, the P group's consolidated disallowed BIE carryforward of $120x consists of $100x of unrelated BIE, $9x of domestic related party BIE, and $11x of foreign related party BIE.
>
> Finally, $11x of disallowed BIE carryforward is carried by S2 out of the P group. Under Prop. Treas. Reg. § 1.1502-59A(c)(5), S2's carryforward has the following characteristics: (i) $0.825x ($9x x $11x/$120x) is a disallowed domestic related party BIE carryforward; (ii) $1.008x ($11x x $11x/120x) is a disallowed foreign related party BIE carryforward; and (iii) $9.167x ($100x x $11x/120x) is a disallowed unrelated BIE carryforward. This leaves the P group (now consisting of P and S1) with a $109x disallowed BIE carryforward to 2020, of which $9.992x is foreign related party, $8.175x is domestic related party, and $90.833x is unrelated.

Note in the preceding example that the status of S2's disallowed BIE carryforwards is retained following S2's departure even though the section 59A(g) relationship between S2 and the payee of the interest, FP, is severed when S2 leaves the P consolidated group. For example, if X is the common parent of a different consolidated group and is able to absorb S2's $11x disallowed BIE carryover in 2020, $1.008x of the absorbed carryover will be treated as a base erosion tax benefit. *See* Prop. Treas. Reg. § 1.1502-59A(c)(7).

How to Beat the BEAT

To avoid the application of BEAT provisions, many companies aim to stay below the 3 percent base erosion percentage threshold. To reduce the amount of base erosion payments in the numerator, companies may wish to restructure their operations to avoid outbound payments between related parties, revise operating agreements, recharacterize outbound remittances as something other than

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deductible payments, and ensure that certain payments can qualify for the SCM exception. For instance, understanding and characterizing transactions as cost of goods sold or revenue sharing payments may help taxpayers minimize their BEAT exposure. While taxpayers may have considered inbound reorganizations or other tax-free transactions in the past to avoid the application of BEAT provisions, the Proposed Regulations now treat any depreciation or amortization deductions that arise from the acquisition of depreciable or amortizable assets pursuant to such transactions as base erosion tax benefits to the extent the transactions occur in taxable years beginning after December 31, 2017.

Other Special Rules

There are various rules that apply only to specific types of entities. For example, there are special rules that apply to payments to a domestic trust, a regulated investment company, or a real estate investment trust. *See*, *e.g.*, Prop. Treas. Reg. § 1.59A-3(b)(2)(v). There are various rules that apply only to taxpayers in select industries. For example, the threshold for the BEAT to apply is lower and the BEAT tax rate is higher if the aggregate group includes a bank or a registered securities dealer. *See* section 59A(b)(3). There are also special rules that apply only to insurance companies.

Reporting and Recordkeeping Requirements

The Proposed Regulations impose various reporting requirements under section 6038A. In addition, the Proposed Regulations impose record keeping requirements which taxpayers would have to satisfy before they could qualify for the SCM exception, and reporting requirements which taxpayers would have to satisfy before they could qualify for the qualified derivatives payment exception.

A material portion of the information contained herein will be published in the March 2018 edition of TAXES - The Tax Magazine, a monthly journal published by Wolters Kluwer.

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