TAXES - The Tax Magazine (2006 to Present), INTERNATIONAL TAX WATCH—The Final and Proposed BEAT Regulations: A Favorable Turn, (Feb. 6, 2020)

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By Stewart Lipeles, Jeff Maydew, Julia Skubis Weber, Joshua Odintz, Alexandra Minkovich, and Katie Rimpfel

Stewart Lipeles, **Jeff Maydew**, **Julia Skubis Weber** and **Joshua Odintz** are Partners at Baker McKenzie. **Alexandra Minkovich** is a Partner and **Katie Rimpfel** is an Associate at Baker McKenzie.

I. Introduction

The Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") issued the highly anticipated final regulations (the "Final Regulations") implementing the base erosion and anti-avoidance tax (the "BEAT") on December 2, 2019. [1] Treasury and the IRS simultaneously issued proposed regulations [2] (the "Proposed Regulations" and with the Final Regulations, the "Regulations"). The Regulations resolve several areas of uncertainty in the statute in a taxpayer-favorable manner.

This column focuses on certain important changes Treasury and the IRS made to the proposed BEAT regulations introduced December 13, 2018 [3] (the "2018 Proposed Regulations"), and provides some updates to our column [4] on the 2018 Proposed Regulations. This column also notes some key requests that Treasury and the Service did not adopt. Among other items, we will cover:

- Clarifications to the Aggregation Rules;
- Treasury's refusal to exempt certain "pass-through," middleman, or global services payments;
- Modifications to the rules with respect to tax free transactions;
- The interaction between the BEAT, ECI, Subpart F and GILTI; and
- The proposed election to forgo deductions.

II. BEAT Overview

Code Sec. 59A imposes a minimum tax on certain U.S. taxpayers who, broadly speaking, make deductible payments to foreign affiliates. [5] In particular, if a U.S. taxpayer is an "applicable taxpayer," [6] Code Sec. 59A imposes a "base erosion minimum tax amount" in addition to the U.S. taxpayer's regular tax liability. [7] A U.S. taxpayer is an "applicable taxpayer" if the U.S. taxpayer is a corporation that is a member of an "aggregate group" that (i) has average annual gross receipts over the three preceding taxable years of at least $500 million, and (ii) has a "base erosion percentage" equal to or exceeding 3 percent. [8] A taxpayer's "base erosion percentage" is the ratio between the taxpayer's "base erosion tax benefits" and the taxpayer's total deductions. [9]

III. The Final Regulations

A. Aggregation Rules

The 2018 Proposed Regulations define the aggregate group generally as corporations that are members of the same controlled group of corporations as defined by Code Sec. 1563(a), with certain modifications. The Final

Regulations clarify and simplify rules for determining which entities are members of the aggregate group. The Final Regulations provide that, for purposes of determining gross receipts and the base erosion percentages for the group, a taxpayer must make the determination on the basis of the taxpayer's gross receipts, base erosion tax benefits, and deductions for the taxable year, as well as the gross receipts, base erosion tax benefits and deductions of each member of the aggregate group for the taxable year of each member that ends with or within the taxpayer's taxable year. [10]

The 2018 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. The Final Regulations explain how to apply this rule when members leave the group. The Final Regulations disregard transactions between parties if both parties are members of the aggregate group at the time of the transaction, even if the parties are no longer members of the group when the taxpayer's taxable year ends. [11]

For purposes of determining the base erosion percentage of an aggregate group, the final regulations exclude base erosion tax benefits and deductions attributable to the taxable year of a member of the aggregate group that begins before January 1, 2018. [12]

B. Passthrough or Middleman Payments

The Preamble to the 2018 Proposed Regulations stated that, in general, the determination of whether a payment or accrual by a taxpayer to a foreign related party falls within one of the enumerated categories of "base erosion payments" [13] is determined "under general U.S. federal income tax law." [14] The Preamble stated:

> 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. [15]

Taxpayers had requested that the Final Regulations clarify this statement in the Preamble to the 2018 Proposed Regulations by adding a rule providing that base erosion payments do not include payments made pursuant to a contract where a "domestic corporation makes a deductible payment to a foreign related party, and that foreign related party in turn makes corresponding payments to unrelated third parties." [16] The Preamble refers to these payments as "passthrough" or "middleman" payments.

The Final Regulations did not adopt this recommendation. Treasury and the IRS declined to provide "a general exception to the definition of a base erosion payment in situations when the foreign related payee also makes payments to unrelated parties." [17] The Preamble explains that Treasury declined to adopt a general exception to the definition of a base erosion payment in situations when the foreign related payee also makes payments to unrelated persons because:

> This recommended exception is inconsistent with the statutory framework of the BEAT. If traced to the ultimate recipient, most expenses of a taxpayer could be linked to a payment to an unrelated party, through direct tracing or otherwise, leaving a residual of profit associated with the payment.

> Accordingly, adopting such an exception would have the effect of eliminating a significant portion of service payments to foreign related parties from the BEAT because it would impose the BEAT on the net rather than the gross amount of the payment. The only net income based concept included in the BEAT statute is the treatment of payments covered by the services cost method ("SCM") exception. [18]

This explanation reinforces Treasury's original statement in the 2018 Proposed Regulations that U.S. federal income tax principles apply for purposes of determining whether a payment is a deductible payment. The explanation specifically responded to requests from taxpayers that Treasury create an exception for *deductible* payments to foreign related parties if the foreign related party subsequently makes a payment to an unrelated party. Treasury declined to create an exception for payments that give rise to a deduction, demonstrating that Treasury did not wish to create an exception that exceeded the scope of the result under general U.S. federal income tax principles.

By contrast, this explanation confirms that payments which do not give rise to a deduction (*e.g.* through application of the agency and reimbursement doctrines) are excepted from the definition of "base erosion payment." The Final Regulations did adopt recommendations to include language in the text of the regulations formalizing the advice given in the Preamble to the 2018 Proposed Regulations. The Final Regulations include a new Reg. §1.59A-3(b)(2)(i), which provides that "the determination of the amount paid or accrued, and the identity of the payor and recipient of any amount paid or accrued, is made under general U.S. federal income tax law." As the Preamble to the Final Regulations explains, "[t]o the extent that an amount is treated under general U.S. federal income tax law principles as received by a U.S. person as agent for, and is remitted to, a foreign related party … the determination of whether the payment or accrual by the taxpayer to a foreign related party is described in one of the four categories of a base erosion payment is made under general U.S. federal income tax law, including agency principles." [19] Thus, Treasury's decision not to create an exception for passthrough payments should not affect payments which otherwise fall under the general agency or reimbursement principles. [20] At conferences and in other public statements made since the Final Regulations were released, Treasury officials have suggested as much, noting that the fundamental rule in implementing the BEAT is that general tax principles apply to determine the appropriate treatment of a payment, which requires taxpayers to carefully understand and apply general agency and reimbursement principles.

C. Global Services

Taxpayers also asked Treasury to include an exception from the term "base erosion payment" for revenue-sharing payments or arrangements associated with global dealing. Some comments went as far as suggesting that an amount should not be treated as a base erosion payment if the parties have adopted a profit split as their method for allocating profits under Code Sec. 482 for transfer pricing purposes. The Final Regulations do not adopt these recommendations. [21] In Treasury's view, it is the contractual relationship between the parties that controls, and not the transfer pricing methodology. Similarly, the Final Regulations do not provide a general exemption for global dealing operations because the result should depend on the underlying facts. [22] In public statements, Treasury has noted that commenters identified a variety of different common fact patterns in global dealing operations. Treasury noted that it would be difficult to draft an exception for global dealing operations with the appropriate parameters and stated that they ultimately concluded that the most administrable approach for taxpayers and the government would be to apply general tax principles. Nevertheless, the Preamble acknowledges that under general tax principles, "a global dealing operation in which participants manage a single book of assets, bear risk, and share in trading profits may be viewed as co-ownership of the trading positions or similar arrangement." [23] Accordingly, transfers between the parties in such a case should not be treated as deductible payments under general tax principles or, more importantly, for purposes of Code Sec. 59A. Under this approach, well advised taxpayers that enter into appropriate intercompany agreements will be able to eliminate payments subject to the BEAT. Unfortunately, taxpayers that do not have similar resources will end up walking into traps for the unwary.

D. Loss Transactions

The Preamble to the 2018 Proposed Regulations provided that a base erosion payment included a payment to a foreign party in which the payor recognized a loss. A loss could arise, for example, on the transfer of property with a built-in loss to a foreign related party. [24] Commenters reasonably argued that under the plain language of the statute, the BEAT depended on the amount paid to a foreign related party, and not on whether the payment gives rise to a deductible loss. Thus, taxpayers recommended tying the amount of the base erosion payment to the fair market value of the payment. Adopting this recommendation, the Final Regulations clarify that a loss the taxpayer realizes due to the form of consideration it provides to the foreign related party is not itself a base erosion payment. Basically, Treasury accepted the argument that a built-in loss is unrelated to the amount of the payment made to the foreign related party. Accordingly, the amount of the base erosion payment is limited to the fair market value of the property. [25]

E. Netting

The Final Regulations retain the approach that the 2018 Proposed Regulations took with respect to netting. [26] As a general matter, the Final Regulations provide that base erosion payments are determined on a gross basis. Thus, the regulations generally do not permit netting unless netting is otherwise permitted by the Code or regulations. While there are cases such as cost sharing where the Code or the regulations permit netting, that is the exception and not the general rule. Nonetheless, as discussed above, general tax principles apply for purposes of determining whether there is a payment in the first instance. Accordingly, appropriate contract flows that establish an agency arrangement, for instance, do not give rise to a base erosion payment and there is no need to rely on netting principles.

F. Tax Free Transactions

As we discussed in our prior article, Proposed Reg. §1.59A-3(b)(2) provided that a base erosion payment may result from any form of consideration, including “cash, property, stock, or the assumption of liability.” The Preamble to the 2018 Proposed Regulations provided that these transactions include a domestic corporation’s acquisition of depreciable assets from a foreign related party in a tax-free exchange described in Code Sec. 351, a reorganization described in Code Sec. 368, and a liquidation described in Code Sec. 332. [27] We argued, as many others did, that these “payments,” which are often deemed, should not be treated as base erosion payments based on the language of Code Sec. 59A and the policy behind it. In our view, for instance, the conclusion that a deemed payment is actually a payment is highly questionable. In addition, in these cases, when the dust settles, there is no foreign party that holds the consideration that the applicable taxpayer paid or was deemed to pay. Moreover, the approach of the 2018 Proposed Regulations was directly contrary to the policy of the TCJA, which was to encourage taxpayers to repatriate assets and activities to the United States.

We were pleased to see that, in the Final Regulations, Treasury took these arguments into account and accepted the recommendations that we, and other commenters, made. The Final Regulations generally exclude amounts transferred to, or exchanged with, a foreign related party in a transaction under Code Secs. 332, 351, 355, and 368 (a “Specified Nonrecognition Transaction”) from the category of base erosion payments. [28] This result is not especially surprising given that Treasury specifically asked for comments in the Preamble to the 2018 Proposed Regulations on whether its approach was appropriate. It appears that Treasury was taking a “conservative” approach in the 2018 Proposed Regulations, knowing that it could relax the rule if taxpayers made compelling arguments. This change shows that Treasury is serious when it asks for comments and that taxpayers can positively affect the outcome when they participate in the rule making process. Treasury should be commended for making this change, and should not be criticized for the approach it took in the 2018

Proposed Regulations now that it has changed course. However, taxpayers should be mindful that Treasury has determined that this rule should not extend to transfers of “other property” (*i.e.*, boot). [29]

A Specified Nonrecognition Transaction is, not surprisingly, limited to certain tax free transactions. The fact that the taxpayer pays with stock, for instance, is not sufficient. Thus, the Final Regulations also provide that a redemption of stock by a corporation under Code Sec. 317(b) or an exchange of stock pursuant to Code Sec. 304 or Code Sec. 331, does give rise to an amount paid or accrued for BEAT purposes. [30] On the other hand, the Final Regulations provide that a distribution that a corporation makes to a shareholder with respect to its stock under Code Sec. 301 is not an amount paid or accrued to the shareholder and does not give rise to a base erosion payment. [31]

From a planning perspective, this change will provide a path for corporations to repatriate assets, including intellectual property, and the related functions without incurring additional BEAT. A U.S. multinational now can liquidate a foreign subsidiary into the United States under Code Sec. 332 or domesticate a foreign subsidiary in an F reorganization without the transaction itself giving rise to BEAT exposure. Given Code Sec. 245A, except in unusual cases, [32] the deemed dividend inclusion under Code Sec. 367(b), [33] generally will not give rise to net taxable income. Thus, the transaction itself is generally neutral from a U.S. tax perspective.

Although this change is welcome, U.S. tax policy is still out of step with international norms. Most other countries actually provide taxpayers with an incentive to repatriate assets and functions. In addition to allowing taxpayers to repatriate assets and functions without tax, most other countries grant taxpayers a basis step up, which gives rise to amortization expense, to encourage taxpayers to onshore assets. Although Congress considered certain options to allow even broader avenues for repatriating assets tax free in the TCJA, it never considered granting taxpayers a tax free basis step up in connection with onshoring.

G. Interaction of Code Sec. 59A with Code Sec. 163(j)

The Final Regulations retain the general approach to Code Sec. 163(j) that the 2018 Proposed Regulations took with respect to this section. Thus, the Final Regulations provide that the amount of allowed business interest expense is treated first as an expense paid to a related party. In other words, the BEAT rules apply first and an amount of interest paid to a related foreign party may be treated as a base erosion payment, even though it is subsequently disallowed pursuant to Code Sec. 163(j). On the other hand, the amount of disallowed business interest expense carried forward is treated as a business expense paid to unrelated parties, and thus generally is not treated as a base erosion payment. [34]

H. ECI, Subpart F and GILTI

Numerous commentators requested an exception for payments that give rise to subpart F or GILTI. They persuasively argued that these payments do not give rise to base erosion concerns because the “U.S. Shareholder” [35] recognizes deemed income in connection with these payments. For example, a U.S. corporation makes payments to a 100-percent-owned controlled foreign corporation (“CFC”). The payment gives rise to subpart F income (*e.g.*, foreign base company services income). The U.S. corporation includes the income as subpart F income. Due to the BEAT, the U.S. corporation loses the deduction for the payment, as well as the foreign tax credit related to the subpart F income. The result is triple taxation on the income.

Treasury refused to provide an exception for these payments. Some commentators (including Baker McKenzie) argued that, like Code Sec. 988 losses, payments giving rise to subpart F and GILTI do not present base erosion concerns because the income is subject to U.S. corporate income tax. Treasury responded that Code Sec. 988 losses are different because “the losses did not present the same base erosion concerns as other types of losses that arise in connection with payments to a foreign related party.” [36] Treasury did not articulate the criteria for base erosion concerns in the proposed or final regulations. Moreover, the legislative history for Code Sec. 59A does not define base erosion or otherwise provide examples of base erosion concerns. Treasury also noted that the inclusion of a subpart F exception in Code Sec. 267A reflects Congressional intent to not provide a similar exception in the final BEAT regulations. [37] Finally, commentators argued that Treasury should provide an exception to subpart F and GILTI because Treasury provided an exception for ECI. Commentators argued that, like subpart F and GILTI, ECI results in current tax and thus they should all be treated the same. Treasury rejected this rationale because a taxpayer with ECI is directly subject to U.S. tax, while a CFC is not. [38] To the authors, this is a meaningless distinction, as the income is subject to immediate U.S. federal income tax.

There may be other factors that informed Treasury's decision. First, then Senator Flake introduced an amendment while the TCJA was under consideration that would have treated a payment giving rise to subpart F income as exempt from the BEAT. [39] The Senate did not debate or vote on the Flake amendment. Perhaps Treasury believed the introduction of an amendment tied Treasury's hands.

Alternatively, perhaps Treasury did not want to provide an exemption for payments that give rise to GILTI because it felt that would basically read the rule out of the Code or violate the nondiscrimination clauses of various U.S. tax treaties. Once it reached that conclusion, Treasury may have felt it had to treat subpart F the same. Nonetheless, Treasury had other reasonable alternatives. First, it could have adopted the comments that it received and provided an exemption for payments that give rise to GILTI because that is simply the right thing to do. Payments subject to GILTI are subject to U.S. tax. The fact that the rate is lower is irrelevant because Congress selected the GILTI rate and must believe that it is appropriate. If Treasury was hesitant to do that, then Treasury should have at least carved out subpart F and taken the position that GILTI is different because (i) it is not subject to the full U.S. tax rate, and (ii) providing an exemption for GILTI would arguably gut the BEAT.

Regardless of the reasons, the Final Regulations preserve Congress' erroneous decision to double or triple tax certain payments under the BEAT. It is now up to Congress to fix a decision that lacks any policy rationale.

I. BEAT Rate for Fiscal Year 2018

The 2018 Proposed Regulations contained a surprise that was not discussed in the Preamble. Specifically, Code Sec. 59A provided for an introductory tax rate for tax years beginning in 2018 of 5 percent, before jumping to 10 percent in subsequent years. [40] The 2018 Proposed Regulations applied section 15 to fiscal years that began in 2018, requiring a blending of the introductory rate and the 10-percent rate. For many taxpayers, this approach largely eliminated or at least significantly reduced the benefit of the introductory rate. Taxpayers essentially argued that this approach took away a benefit that Congress intended them to have and was not a technically correct application of section 15. Treasury and the Service responded to the comments, and the Final Regulations apply the introductory rate to all tax years that begin in 2018. This change will, at a minimum, reduce the BEAT for tax year 2018 for many fiscal year taxpayers. For some taxpayers, this change in the Final Regulations may eliminate the BEAT (such taxpayers would need to file an amended return to claim a refund).

J. Effective Dates

The Final Regulations generally apply to taxable years ending on or after December 17, 2018. *In lieu* of applying the Final Regulations, taxpayers may rely on the 2018 Proposed Regulations in their entirety for all taxable years ending on or before December 6, 2019. [41]

II. The Proposed Regulations

The Proposed Regulations propose three general rules: (1) rules permitting taxpayers to forgo deductions to get below the 3-percent threshold, (2) special rules describing how the aggregation rules operate during short taxable years and when an entity enters or exits the group mid-year, and (3) partnership anti-abuse rules. Comments are due on the Proposed Regulations by February 4, 2020. Of these rules, the ability to forgo deductions is, by far, the most important rule and has the greatest potential impact on taxpayers. It is discussed in detail below.

A. Forgoing Deductions

The Proposed Regulations provide that a taxpayer may forgo a deduction. To the extent a taxpayer elects to forgo a deduction, that amount will not be treated as a base erosion payment, provided that the taxpayer waives the deduction for all U.S. federal income tax purposes. In the event a taxpayer waives a deduction for purposes of Code Sec. 59A, the Proposed Regulations provide that the taxpayer cannot claim the deduction for any other purposes of the code or regulations, except as otherwise provided under the Proposed Regulations. [42]

The rules for when a taxpayer may waive a deduction are quite generous. A taxpayer may elect to waive a deduction on its original U.S. federal income tax return or in an amended return. In addition, a taxpayer may elect to waive a deduction in the course of an audit of the taxpayer's income tax return for the relevant year. A deduction may be waived in whole or in part. The election to waive a deduction is made on an annual basis and is irrevocable. [43] Nonetheless, if a taxpayer chooses to waive a particular deduction in one year, the taxpayer is not required to waive that deduction again in the next year or years. Moreover, if a taxpayer chooses to waive the deduction again, it is not required to waive the same amount in the subsequent year. Until Treasury finalizes the Proposed Regulations, a taxpayer may rely on the Proposed Regulations and elect to forgo a deduction by attaching a statement to Form 8991, *Tax on Base Erosion Payments of Taxpayers with Substantial Gross Receipts*, and including the information required under the Proposed Regulations. [44]

The Proposed Regulations provide that the election to waive a deduction is disregarded for certain purposes. To begin with, the election to waive a deduction is disregarded for purposes of determining the taxpayer's overall method of accounting or the taxpayer's method of accounting for any particular item. Similarly, the taxpayer's election to waive a deduction is disregarded in determining whether there has been a change in the taxpayer's overall plan of accounting or the taxpayer's treatment of a material item is a change in method of accounting under Code Sec. 446(e) and the regulations thereunder. A taxpayer's election to waive a deduction is also disregarded for purposes of determining the amount allowable for depreciation or amortization for purposes of Code Sec. 167(c) and Code Sec. 1016(a)(2) or (3) and any other adjustment to basis under Code Sec. 1016(a). In other words, a taxpayer's election to forgo a deduction is disregarded for purposes of determining a taxpayer's basis in the assets. [45]

The Proposed Regulations contain a special rule to ensure that a taxpayer is not able to reduce the amount of its base erosion tax benefits by waving a deduction in a prior year, and then recover the waived deduction in a subsequent year by making an accounting method change. More specifically, the Proposed Regulations provide that by electing to waive a deduction, the taxpayer agrees that if it changes its method of accounting with respect to the item it has waived, the portion of the item that it previously waived is not taken into account in determining the amount of the adjustment under Code Sec. 481(a). [46]

B. Impact of Forgoing Deductions on the Foreign Tax Credit

The Proposed Regulations provide that the election to waive deductions should be treated as occurring before the allocation and apportionment of deductions. [47] That means that the deductions do not exist when it comes time to allocate and apportion deductions, which means that waived expenses do not reduce foreign source income for purposes of calculating a taxpayer's foreign tax credit limitation under Code Sec. 904.

The taxpayer's election to forgo an interest deduction that is directly allocable to income a particular asset produces does not result in additional interest expense being allocated to that asset. Thus, the Proposed Regulations provide that, to the extent a taxpayer waives a deduction for certain interest expense that would have been directly allocated and would have reduced the value of an asset for purposes of allocating and apportioning expenses, the asset value is still reduced as if the taxpayer had not waived the deduction.

The taxpayer's decision to forgo a deduction is also disregarded for purposes of applying the exclusive apportionment rule for research and experimentation expense ("R&E" expense) in Reg. §1.861-17(b). [48]

For taxpayers using the sales method for allocating R&E expense, the exclusive apportionment rule in Reg. §1.861-17(b) exclusively apportions 50 percent of the R&E expense to the geographic location where more than 50 percent of the R&E expense arose. [49] Given that most U.S. multinationals conduct most of their R&E in the United States, this rule has the beneficial effect of generally allocating 50 percent of a taxpayers R&E expense to domestic source income. As a result, this portion of the R&E expense does not burden foreign income for purposes of calculating a taxpayer's foreign tax credit limitation under section 904. The proposal to disregard a taxpayer's decision to forgo a deduction for purposes of applying Reg. §1.861-17(b) means that taxpayers should retain the entire benefit of the exclusive apportionment rule.

C. Impact on Code Sec. 482

The taxpayer's decision to waive a deduction is also disregarded for purposes of determining the price of a controlled transaction under Code Sec. 482. [50] Thus, in determining whether a deduction that a taxpayer takes on its U.S. federal income tax return with respect to a controlled transaction clearly reflects a taxpayer's income, the IRS will consider the amount waived as if it were actually deducted. In addition, if a taxpayer applies a transfer pricing method that uses costs or expenses as an input, the costs or expenses associated with the waived deductions are still treated as costs or expenses for purposes of Code Sec. 482 because the decision to waive the deduction only has an impact on the amount the taxpayer can deduct, and should not have an impact on the underlying cost or expense for purposes of determining the transfer pricing.

D. Ability to Forgo Expenses Offsets the Sting of the 3-percent Threshold

As noted above, the BEAT only applies if base erosion tax benefits exceed 3 percent of all deductible expenses. This threshold may be the scariest and most troubling aspect of the BEAT. There is a very dramatic difference between being above the 3-percent threshold or under the 3-percent threshold. If a taxpayer is under the 3-percent threshold, the taxpayer simply is not subject to the BEAT at all. If the taxpayer is over the 3-percent threshold, even by $1, the taxpayer is fully subject to the BEAT. Except for the BEAT, a taxpayer might not have any U.S. federal tax liability due to its NOLs or its foreign tax credits. Once the taxpayer goes over the 3-percent threshold, the taxpayer can be subject to a very material U.S. federal tax liability. The taxpayer may, as a practical matter, lose the benefit of its NOLs or foreign tax credits once it goes over this threshold. In addition to being highly concerning for taxpayers, from a policy perspective, it is extremely difficult, if not impossible, to justify such dramatically different results based on a dollar of expense.

As a result, a large part of BEAT planning is ensuring that the taxpayer is under the 3-percent threshold. Prior to the Proposed Regulations, it may be imperative for a taxpayer to know with a great deal of certainty whether it is under the 3-percent threshold. As a result, the taxpayer might build in a lot of cushion into its calculations or otherwise take extreme measures to make sure it is under the 3-percent threshold. The ability to waive a deduction very significantly reduces the sting of this rule. In particular, the ability to waive a deduction at the audit level significantly protects taxpayers that did not give themselves a sufficient "cushion" to avoid the BEAT when they filed their tax returns, as well as those taxpayers for whom the IRS identifies additional BEAT payments during audit. To the extent that a small deduction pushes the taxpayer over the 3-percent threshold, the taxpayer can waive the expense. As a result, this rule is highly beneficial. Given that it is nearly impossible to justify the dramatically different results that may arise from going $1 over the threshold, the rule is also simply good policy. [51]

E. Planning Implications

The fact that taxpayers can waive expenses for all purposes of the code is a powerful planning device. It allows taxpayers to accelerate income, which can produce all sorts of benefits. [52] A taxpayer can, for instance, waive expenses for BEAT purposes, which accelerates income, and then use NOLs that would otherwise expire to offset the additional income. Thus, the taxpayer can effectively waive refresh NOLs by waiving expenses.

The taxpayer could also waive expenses for purposes of increasing U.S. taxable income that is eligible for the deduction under Code Sec. 250 for foreign derived intangible income (*i.e.*, “FDII”). Similarly, the taxpayer could recalculate its Code Sec. 163(j) expense. [53]

F. Effective Dates for the Proposed Regulations

The Proposed Regulations generally apply to taxable years beginning on or after the date the final regulations are filed in the Federal Register. In addition, taxpayers may rely on the rules in the Proposed Regulations in their entirety for taxable years beginning after December 31, 2017 and before the final regulations apply. [54]

III. Impact on Cross-Border Tax Controversies

Treasury did not address the impact of the BEAT on cross-border tax disputes in the Regulations. A taxpayer may be negotiating a bilateral advanced pricing agreement or have filed a request for relief under a tax treaty’s mutual assistance program article. Is a deemed payment pursuant to a foreign entity pursuant to a corollary adjustment a base erosion payment? Can the U.S. Competent Authority provide relief from the BEAT? Before Treasury issued the Proposed Regulations, a few commentators raised these questions and others along the same lines. Unfortunately, the Preamble is silent on the topic. Unless Treasury intends to address these questions repeatedly on a case-by-case basis (which could result in different results for otherwise similarly-situated taxpayers), Treasury will have to address these issues in subsequent guidance, perhaps in Internal Revenue Bulletin guidance in the form of a Revenue Procedure.

IV. Conclusion

The Final Regulations and the Proposed Regulations are substantially more taxpayer favorable than the 2018 Proposed Regulations and they do an excellent job of implementing the BEAT. Treasury and the IRS are to be congratulated on a fine work product.

Footnotes

1 T.D. 9885, IRB 2019-52, Dec. 2, 2019, 84 FR 66968 (Dec. 6, 2019).

2 REG-112607-19, 84 FR 67046 (Dec. 6, 2019).

3 REG-104529-18, 83 FR 65956 (Dec. 21, 2018).

4 Tatyana Johnson, Ethan Kroll, Stewart Lipeles, Joshua Odintz and Katie Fung, *The Proposed BEAT Regulations: Topics of Interest*, 97 TAXES 3 (March 2019).

5 An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, H.R. 1, P.L. 115-97 (2017) (the “Tax Cuts and Jobs Act” or “TCJA”), §14401(e).

6 Code Sec. 59A(e)(1).

7 Code Sec. 59A(a).

8 Code Sec. 59A(e)(1). The base erosion percentage is reduced to two percent for banks and registered securities dealers.

9 Code Sec. 59A(c)(4).

10 Reg. §1.59A-2(c)(3).

11 Reg. §1.59A-2(c)(1).

12 Reg. §1.59A-2(c)(8).

13 The four categories of base erosion payments are: “(1) a payment with respect to which a deduction is allowable; (2) a payment made in connection with the acquisition of depreciable or amortizable property; (3) premiums or other consideration paid or accrued for reinsurance that is taken into account under section

803(a)(1)(B) or 832(b)(4)(A); or (4) a payment resulting in a reduction of the gross receipts of the taxpayer that is with respect to certain surrogate foreign corporations or related foreign persons."

14 83 FR 65,969 (Dec. 21, 2018).

15 *Id.* at 65,959 (emphasis added).

16 84 FR 66973 (Dec. 6, 2019).

17 *Id.*

18 *Id.* at 66973.

19 *Id.* at 66974.

20 The Final Regulations strengthen our conviction, as previously expressed in this publication, that amounts transferred pursuant to agency or reimbursement arrangements can fall outside of the BEAT if properly structured. *See* Tatyana Johnson, Ethan Kroll, Stewart Lipeles, Joshua Odintz and Katie Fung, *The Proposed BEAT Regulations: Topics of Interest*, 97 TAXES 3 (March 2019).

21 84 FR 66974 (Dec. 6, 2019).

22 84 FR 66973-4 (Dec. 6, 2019).

23 84 FR 66974 (Dec. 6, 2019).

24 83 FR 65956 (Dec. 21, 2018).

25 84 FR 66976 (Dec. 6, 2019).

26 84 FR 66975-6 (Dec. 6, 2019).

27 83 FR 65960 (Dec. 21, 2018).

28 Reg. §1.59A-3(b)(3)(viii).

29 Reg. §1.59A-3(b)(3)(viii)(B).

30 84 FR 66978 (Dec. 6, 2019).

31 *Id.*

32 There are times when Code Sec. 245A will not provide relief. A taxpayer, for instance, may not satisfy the holding period requirement in Code Sec. 246(c), may hold hybrid shares within the meaning of Code Sec. 245(e), or the earnings might be domestic source.

33 Certain inbound transactions, including Code Sec. 332 liquidation and inbound F reorganizations, can trigger an inclusion of the all earnings and profits amount (the "All E&P Amount"). *See* Code Sec. 367(b); *see also* Reg. §§1.367(b)-2(d) & -3(b)(3). The All E&P Amount should include the untaxed earnings and profits of the foreign corporation, but not any previously taxed income (*e.g.*, previously taxed income arising from inclusions under Code Sec. 965). Reg. §1.367(b)-2(d).

34 Reg. §1.59A-3(c)(4).

35 A "U.S. Shareholder" in a CFC is U.S. person that owns or is treated as owning 10% of the voting power or 10% of the value in the CFC. See Code Sec. 951(b).

36 84 FR 66984 (Dec. 6, 2019).

37 *Id.*

38 *Id.*

39 Senate Amendment 1686, to Senate Amendment 1618 (Amending H.R. 1, An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018), 163 CONG. REC. S7588 (Nov. 30, 2017).

40 See Code Sec. 59A(b)(1)(A). The rate is scheduled to rise to 12.5% in taxable years beginning after December 31, 2025. Code Sec. 59A(b)(2)(A).

41 Reg. §1.59A-10.

42 Proposed Reg. §1.59A-3(c)(6)(ii).

43 Proposed Reg. §1.59A-3(c)(6)(iii).

44 *Id.*

45 Proposed Reg. §1.59A-3(c)(6)(ii)(3).

46 Proposed Reg. §1.59A-3(c)(6)(iii).

47 Proposed Reg. §1.59A-3(c)(6)(ii)(A)(2).

48 *Id.*

49 Reg. §1.861-17(b)(1)(i).

50 Proposed Reg. §1.59A-3(c)(6)(ii)(B)(5).

51 Interestingly, Treasury is open to allowing taxpayers to reduce the amount of the deductions waived on audit. *See* Andrew Velarde, *Limitation on BEAT Waiver Reduction About Administrative Burden*, TAX NOTES FEDERAL (Jan. 14, 2020). Apparently, Treasury decided taxpayers should only be allowed to increase the amount of the deductions waived to make the rule more administrable. On reflection, Treasury acknowledged that allowing taxpayers to reduce the amount waived on audit may not make the rule any more difficult to administer and expressed a willingness to consider allowing taxpayers to reduce the amount waived during audit. More importantly, the whole point of the rule is to insure that a dollar of expense does not give rise to a tax liability wholly and completely out of proportion to the expense. Allowing taxpayers flexibility to avoid that result without unnecessarily forgoing deductions thus seems appropriate.

52 Note, it is well settled that taxpayers can in many situations accelerate income, provided that they take the appropriate steps to do so. In *Estate of Stranahan*, CA-6, 73-1 USTC ¶9203, 472 F2d 867, *rev'g*, 30 TCM 1078, Dec. 31,008(M), TC Memo. 1971-250, the taxpayer intentionally accelerated income by selling his son the right to receive certain future dividends. The taxpayer's only reason for executing the sale was to accelerate income into the current taxable year so that he could utilize a large deduction. The Sixth Circuit respected the dividend assignment as a sale and not a loan, concluding that the transaction had been for good and sufficient consideration and that the son bore the risk that dividends would not be paid. *Compare Mapco, Inc.*, CtCls, 77-2 USTC ¶9476, 556 F2d 1107. Taxpayer, for instance, commonly used prepayments to accelerate income. *M.E. Schlude*, SCt, 63-1 USTC ¶9284, 372 US 128, 83 SCt 601; *American Automobile Association*, SCt, 61-2 USTC ¶9517, 367 US 687, 81 SCt 1727; *Automobile Club of Michigan*, SCt, 57-1 USTC ¶9593, 353 US 180, 77 SCt 707. *See also Perfumers Manufacturing Corp.*, 33 TC 532, Dec. 23,892 (1959), *acq.* 1960-2 CB 6.

53 *See* Andrew Velarde, *IRS Offers Clarification on BEAT Deduction Waiver*, TAX NOTES FEDERAL (Dec. 23, 2019).

54 Proposed Reg. §1.59A-10.