Client Alert
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IRS BEATs on Partnerships with Final Section 59A Regulations

On December 2, 2019, the Treasury Department ("Treasury") and the Internal Revenue Service (the "IRS") issued final regulations (the "Final Regulations") as well as new proposed regulations (the "Proposed Regulations" and, together with the Final Regulations, the "BEAT Regulations") under section 59A, implementing the "base erosion and anti-avoidance tax" (the "BEAT"). The Final Regulations finalize proposed regulations that were introduced on December 13, 2018 (the "Prior Proposed Regulations") with some important changes. This client alert discusses key aspects of the aggregate approach to partnership transactions taken by the BEAT Regulations and its application, which represents a material expansion of the treatment set forth in the Prior Proposed Regulations, and analyzes various situations in which common partnership transactions can have material BEAT consequences to U.S. partners.

Overview of the BEAT

As detailed in our January 17, 2019, Client Alert, "*Treasury and IRS Release Proposed BEAT Regulations*," Congress enacted section 59A as part of the Tax Cuts and Jobs Act to impose a minimum tax on certain corporations if their regular U.S. corporate income tax liability is reduced below an acceptable threshold because of certain payments made to foreign related parties. The BEAT tax is imposed on "applicable taxpayers" and is in addition to such taxpayers' regular tax liability. For any taxable year, the BEAT tax is equal to the amount, if any, by which 10% (12.5% for taxable years beginning in 2026 and thereafter) of the "modified taxable income" of an "applicable taxpayer" exceeds the taxpayer's regular tax liability for such taxable year, without taking into accounts certain tax credits which reduce such regular tax liability.

An "applicable taxpayer" is a domestic corporation that has (i) $500 million or more of average annual gross receipts during the three prior taxable years (taking into account certain aggregation rules that impute the consolidated gross receipts of an "aggregate group" of related corporations to all corporations within such group) and (ii) has a "base erosion percentage" of three percent or more. Note that banks, registered securities dealers and certain expatriated corporations are subject to the BEAT if their "base erosion percentage" is 2 percent or more. The "base erosion percentage" is calculated each year by dividing (1) the aggregate amount of the taxpayer's "base erosion tax benefits" for the year, by (2) the sum of the aggregate amount of all deductions allowed for the year plus any other "base erosion tax benefits" for the year that are not deductions. "Base erosion tax benefits" are generally deductions or reductions in gross income that a taxpayer claims with respect to "base erosion payments" (but generally excluding increases in cost of goods sold). A "base erosion payment" is a payment made or deemed to be made by a taxpayer to a foreign related party in the following four types of transactions: (1) a transaction that gives rise to a deduction; (2) the acquisition of a property by the taxpayer from a foreign related party if the property is subject to the allowance for depreciation or amortization; (3) a transaction involving reinsurance premium or other consideration that is taken into account under section 803(a)(1)(B) or 832(b)(4)(A); or (4) a transaction involving a taxpayer who makes a payment to certain expatriated entities or related foreign persons that causes the reduction of the taxpayer's gross receipts.

A taxpayer's "modified taxable income" for a taxable year is the taxable income of the taxpayer for such year computed without regard to any "base erosion tax benefits" or to the portion of any net operating losses from prior years that is attributable to "base erosion tax benefits."

Final Regulations

Treasury's Aggregate Treatment of Partnerships For Purposes of Section 59A

The BEAT Regulations follow the general approach taken in the Prior Proposed Regulations by treating partnerships as aggregates of their partners for purposes of applying the BEAT. A corporate partner is treated as directly deriving a share of partnership items for purposes of applying the BEAT rules, for example when determining whether a corporate partner meets the gross receipts threshold to be an "applicable taxpayer" who could be liable for the BEAT tax.

The Previous Proposed Regulations simply provided that any amount paid or accrued by a partnership would be treated as paid or accrued by each partner in accordance the partners' proportionate share of the particular partnership item associated with payment. The Final Regulations flesh out this rule, by essentially disregarding the partnership and treating any partner as directly engaging in transactions in which the partnership engages with others and as directly engaging in transactions with the other partner when it engages in transactions with the partnership (rather than engaging in transactions with the partnership as a separate entity).

For purposes of the BEAT, taxpayers must treat a portion of each payment made to or by a partnership as having been made to or by each partner and must treat the assets and liabilities of the partnership as assets and liabilities of each partner (the "Look-Through Rule"). For example, if the partnership makes a payment, that payment will be treated as having been made by the partners to the recipient. Such a payment can take the form of cash, property, stock or the assumption of liability. If the payment is made to a person that is a foreign related person with respect to a partner that is an "applicable taxpayer" then that payment will be treated as a base erosion payment with respect to that partner. If the payment is deductible, the partner's "base erosion tax benefit" is the taxpayer's allocable share of the partnership's deductions associated with the payment. If the payment is to acquire depreciable property from a foreign related person with respect to the partner, the partner's "base erosion tax benefit" will be the partner's allocable share of the partnership's depreciation deductions that are attributable to such property.

Similarly, if a partner makes a payment to the partnership (whether in the form of cash, property or the assumption of a liability), the partner will be treated as having made a payment to the other partners in the partnership, and, if any of the other partners are foreign related parties with respect to such partner, that payment could be a "base erosion payment" that results in "base erosion tax benefits" to the payor partner. If the payment is deductible by the payor partner, the "base erosion tax benefits" will be any deduction attributable to the portion of the payment that is deemed to have been made to the other partners in the partnership pursuant to the Look-Through Rule. If the payment is made in exchange for the acquisition of depreciable property by the payor partner from another partner after applying the Look-Through Rule (whether the payor partner acquires such property from the partnership or is deemed to indirectly acquire an additional share of partnership property by acquiring an additional interest in the partnership), the "base erosion tax benefits" will be the depreciation deductions attributable to the portion of such property that the payor partner is deemed to have acquired from any other partners who are foreign related parties.

It should be noted that "base erosion tax benefits" are determined separately with respect to each partnership payment or accrual, and with respect to each partnership property. "Base erosion tax benefits" are not netted against any other items derived by the applicable partner through the partnership. Below is a more detailed discussion of how the Look-Through Rule applies to partners in various instances for purposes of determining the partner's BEAT liability, using illustrative examples where appropriate.

Small Partner Exception

The Final Regulations exempt certain "small partners" from having to take partnership items into account using the Look-Through Rule for purposes of their BEAT computations. The exemption applies to a U.S. corporate partner in a partnership if the following requirements are met: (1) the U.S. corporate partner's interest in the partnership represents less than 10 percent of the capital and profits of the partnerships at all times during the taxable year; (2) the U.S. corporate partner is allocated less than 10 percent of each partnership item of income, gain, loss, deduction and credit for the taxable year; and (3) the U.S. corporate partner's interest in the partnership has a fair market value of less than $25 million on the last day of the partner's taxable year, determined using a reasonable method.

Contributions to Partnerships

When a related foreign person makes a section 351 contribution to an "applicable taxpayer," the BEAT Regulations except the "applicable taxpayer" stock received by the contributing related foreign person from being treated as a "base erosion payment." However, there is no corresponding exception for section 721 contributions to partnerships. Instead, under the Look-Through Rule, the partnership contribution transaction is recast as an exchange occurring directly between the partners. Moreover, because of the inability to net the amount of "base erosion tax benefits" arising from a partnership transaction against an equivalent amount of tax benefits foregone by the taxpayer in the same transaction, a partnership transaction can result in additional "base erosion tax benefits" to a U.S. partner even though the aggregate net amount of the partner's tax deductions remains unchanged. The example below illustrates these concepts.

Example A:

DC (a U.S. corporate partner) and FC (a foreign related partner) each contribute depreciable property, Property A and Property B, respectively, to form PRS, a 50-50 partnership. The tax basis and fair market value of each property is $100 and each property generates $20 of depreciation deductions. In the absence of the partnership, DC would have $20 of annual depreciation deductions from Property A. As a result of the formation of the partnership, applying the Look-Through Rule, DC is treated as transferring a 50% interest in Property A to FC, a foreign related party, in exchange for FC's 50% interest in Property B. The 50% interest in Property A that shifts over from DC to FC when applying the Look-Through Rule to PRS is treated as a "base erosion payment" made by DC to acquire a 50% interest in Property B, a depreciable property, from FC. As a result, the $10 of depreciation deduction attributable to Property B that are allocated to DC by PRS each year are treated as a "base erosion tax benefit" with respect to DC. Although the aggregate amount of DC's depreciation deductions would be the same absent the partnership transaction (DC would have had $20 of annual depreciation deductions from Property A absent the transaction, while it will be allocated $10 of depreciation deductions from Property A and $10 from Property B by PRS each year), DC still has a "base erosion tax benefit" for purposes of the BEAT computation as a result of entering into the transaction, because it is not allowed to net the $10 of depreciation deductions attributable to Property A that it foregoes against the $10 of depreciation deductions attributable to Property B which are treated as a "base erosion tax benefit."

It should be noted that all depreciation deductions attributable to partnership property that an "applicable taxpayer" is deemed to acquire in exchange for a "base erosion payment" when applying the Look-Through Rule, including any remedial items of deduction allocated to the "applicable taxpayer" with respect to such property by a partnership that used the "remedial method" for purposes of section 704(c), are treated as "base erosion tax benefits." In the example above, if FC has zero basis in Property B at the time of its contribution to PRS and PRS uses the "remedial method" with respect thereto, the $10 remedial item of depreciation deduction that would be allocated to DC by PRS each year in respect of Property B would be treated as a "base erosion tax benefit" by DC.

Allocations of Deductions In Excess of A Partner's Proportionate Share of the Property

The BEAT Regulations warn that "a partner's base erosion tax benefit may be more than the partner's base erosion payment." This essentially means that the aggregate amount of a partner's "base erosion tax benefits" includes any deductions allocated to that partner with respect to any partnership asset that the partner is deemed to have acquired from a related foreign party in exchange for a "base erosion payment" when applying the Look-Through Rule, even if the aggregate amount of such deductions exceeds the partner's "proportionate share" of the asset (i.e. the partner's ownership percentage in the asset). A partner's allocable share of any item of income or deduction of the partnership is determined under sections 704(b) and (c) and takes into account amounts determined under other provisions of Subchapter K, including but not limited to sections 707(a) and (c), 732 (b) and (d), 734(b) and (d), 737, 743(b) and (d), 751(d) and 482. To illustrate this, the BEAT Regulations provide that if a partnership makes a payment to a foreign related party of its domestic partner to acquire a depreciable asset, and the partnership specially allocates more depreciation deductions to that partner than its proportionate share of the asset, the partner's base erosion tax benefit includes that specially allocated depreciation deduction even if the total allocated deduction exceeds the partner's share of the base erosion payment made to acquire the asset.

To illustrate this concept, assume that in *Example A* above, PRS allocates 70% of the depreciation deductions attributable to Property B (the property contributed by FC) to DC and 70% of the depreciation deductions attributable to Property A to FC, rather than 50% of the depreciation deductions attributable to each property being allocated to each partner. In that instance, the aggregate amount of DC "base erosion tax benefits" would be $70, the total amount of depreciation deduction attributable to Property B that are allocated to it by PRS, even though DC only made a $50 "base erosion payment" to FC to acquire an indirect interest in Property B through PRS.

Partnership Distributions

As mentioned above, the BEAT Regulations provide an exemption for corporate non-recognition transactions in which an "applicable taxpayer" acquires property from a related foreign party, including a distribution of assets from a foreign subsidiary to a U.S. corporate parent in a section 332 liquidation. These types of transaction are deemed not to involve a "base erosion payment" from the "applicable taxpayer" and not to result in any "base erosion tax benefits" even if depreciable property acquired from the foreign related party.

A corporate partner also does not generally recognize gain or loss as a result of a partnership distribution unless any money distributed exceeds such partner's adjusted basis in its partnership interest immediately before the distribution. For purposes of the BEAT, however, the Final Regulations treat a distribution that reduces a partner's interest in the distributing partnership as an exchange of property between the distributee partner and the other partners. The distributee partner is deemed to exchange (i) any portion of the partnership's property attributable to it immediately before the distribution under the Look-Through Rule for (ii) a portion of the property distributed to it by the partnership that was attributable to the other partners immediately before the distribution under the Look-Through Rule. This exchange can result in "base erosion tax benefits" (i) to the distributee partner if it is an "applicable taxpayer" to the extent of the portion of the distributed property that was attributable to any foreign related partner immediately prior to the distribution, or (ii) to any non-distributee partner if it is an "applicable taxpayer" that is related to a foreign distributee partner to the extent the former is deemed to have acquired additional depreciable property from the latter as a result of the distribution when applying the Look-Through Rule. The following example illustrates this concept.

Example B:

A partnership has three equal partners, DC (a U.S. partner), FC (a foreign related partner), and UC (an unrelated domestic partner), and owns two assets, $180 of cash and Property A, a depreciable property with a fair market value of $90 and a tax basis of $60. Each partner's interest in the partnership has a fair market value of $90 and a tax basis of $80. A liquidating distribution of $90 of cash is made to FC, resulting in a gain of $10 (the excess of the $90 cash liquidating distribution over FC's $80 tax basis in its partnership interest) under section 731(a)(1). No section 754 election is in effect. Prior to the liquidating distribution, each partner is treated as owning one third of Property A under the Look-Through Rule. Immediately after the distribution, each of DC and UC are treated as owning one half of Property A under the Look-Through Rule. Thus, DC will be treated has having made a "base erosion payment" equal to $15 (its $60 one-third share of the partnership's $180 of cash immediately prior to the distribution minus its $45 one-half share of the partnership's $90 of cash immediately thereafter) to acquire a $15 one-sixth interest in Property A from FC, a foreign related person, which will result in "base erosion tax benefit" to DC. DC's "base erosion tax benefit" is the excess of (i) DC's one-half share of the partnership's depreciation deductions attributable to Property A's $60 tax basis that are allocated to it by the partnership after the distribution over (ii) its one-third share of the partnership's depreciation deductions attributable to Property A's $60 tax basis that would have been allocated to it by the partnership prior to the distribution.

The requirement to treat each partnership liquidating distribution as an exchange of partnership property between the partners for purposes of the BEAT can lead to some strange results, as illustrated in the following example.

Example C:

A partnership with equal partners, DC (a U.S. corporation) and a FC (a foreign related partner) who previously contributed depreciable Property A and depreciable Property B, respectively, liquidates by distributing Property A to FC and Property B to DC. DC is treated as having exchanged a one-half interest in Property A for a one-half interest in Property B with FC, a foreign related party. Thus, DC would treat one half of the depreciation deductions attributable to Property B as "base erosion tax benefits" for purposes of the BEAT after the liquidation. Note that, if the partnership were to distribute Property A back to DC (who originally contributed Property A to the partnership) in the liquidation, DC would still be treated as having exchanged one half of Property B for one half of Property A with FC and would treat one half of the depreciation deductions attributable to Property A as "base erosion tax benefits" after the liquidation. Thus, even if the liquidation returns to DC the property that was originally owned by it prior to the formation of the partnership, it would still result in an adverse BEAT impact.

Basis Acquisitions

The Final Regulations treat any step up in the tax basis of partnership property resulting from a partnership distribution, for example, pursuant to section 732 or section 734(b), as newly-acquired property. To the extent such property is deemed to be acquired from a foreign related party in exchange for a "base erosion payment," then any depreciation deductions attributable thereto will be treated as "base erosion tax benefits."

To illustrate, assume that the partnership in *Example B* above has an election under section 754 in effect. The $10 of taxable gain recognized by FC on the $90 liquidating distribution of cash to it would result in a $10 adjustment to the partnership's basis in Property A under section 734(b), from $60 to $70. That $10 of additional basis will be treated as newly-acquired depreciable property, half of which will be treated as having been acquired by DC from FC, a foreign related party. Therefore, one half of the depreciation deductions attributable to the $10 basis step-up allocated by the partnership to DC after the liquidating distribution will be treated as "base erosion tax benefits" by DC, in addition to the depreciation deductions attributable to Property A's existing $60 tax basis that are allocated to DC in excess of its current share thereof.

Sale of A Partnership Interest

The sale of a partnership interest will also have BEAT consequences to any partner who is an "applicable taxpayer." Under the Look-Through Rule, the sale is considered a transfer by the selling partner of its proportionate share of partnership property, including depreciable assets, as described in the following example.

Example D:

A U.S. corporation (DC) purchases 50% of a related foreign corporation's (FC's) interest in a partnership PRS, which is owned equally by a FC and an unrelated domestic unrelated corporation (UC). PRS owns one depreciable asset (Property A) with a fair market value of $200 and a tax basis of $120. The partnership has no election under section 754. Property A will generate $24 of annual tax deductions for the next five years. After the purchase, these depreciation deductions will be allocated $12 to UC and $6 to both FC and DC each year. Under the Look-Through Rule, FC is treated as selling to DC a 25-percent interest in Property A, resulting in an annual "base erosion tax benefit" to DC of $6, namely the amount of depreciation deductions attributable to Property A that are allocated to DC each year.

Note that if a section 754 election was in effect in the above example, there would be a step-up in the basis of Property A with respect to DC under section 743(b). That basis step-up would be treated as a separate property that is newly-acquired by DC from FC for purposes of the BEAT and would generate additional "base erosion tax benefits" equal to the DC's depreciation deductions that are attributable to such basis step-up.

Sale of A Partnership's Depreciable Property

A sale of a partnership's depreciable property to a U.S. corporation could give rise to a base erosion payment and thus a potential BEAT liability. If an existing partner is a foreign related party, when analyzed under the Look-Through Rule, the transaction will cause the foreign related party to be treated as selling its portion of the partnership property to the U.S. corporation. The Final Regulations provide that the "base erosion tax benefit" in this case would be the amount of the U.S. corporation's depreciation deductions that are attributable to the foreign related party's proportionate share of the depreciable property (through the partnership) immediately prior to the sale.

Proposed Regulations

In conjunction with the Final Regulations, Treasury issued the Proposed Regulations and requested comments from taxpayers on such Proposed Regulations. Below are some key features of the Proposed Regulations that relate to the application of the BEAT to partnership transactions.

Income Allocation and Curative Method

The Final Regulations generally limit "base erosion tax benefits" to deductions allocated by the partnership to an "applicable taxpayer." However, a partnership can provide a partner with an economic benefit that is equivalent to a deduction by making a "curative allocation" of income away from that partner for purposes of section 704(c) under the "traditional method with curative allocations." Accordingly, Treasury has proposed a new rule that treats a section 704(c) "curative allocation" of income to a foreign affiliate partner who contributed an appreciated property as a "base erosion tax benefit" to the U.S. noncontributing corporate partner. The theory is that the curative allocation of income away from the U.S. partner is economically equivalent to the base erosion tax benefit that occurs with a curative allocation of depreciation deductions to the U.S. corporate partner.

Effectively Connected Income

The Final Regulations did not except from the definition of a "base erosion tax benefit" allocations of income from a partnership that are taxable as effectively connected income to a foreign related party as a result of a contribution of depreciable property by a foreign related partner to a partnership with a U.S. partner or a distribution of depreciable or amortizable property by a partnership with a foreign related partner to a U.S. partner. Treasury is considering additional guidance on the subject, however, and requested comments on this issue.

Anti-Abuse Rules

The Proposed Regulations set forth two anti-abuse rules to address partnership transactions designed to avoid a BEAT liability. The first rule concerns transactions involving derivatives on a partnership interest. If a taxpayer acquires a derivative on a partnership interest as part of a transaction, plan or arrangement that has a principal purpose of avoiding BEAT liability; and the acquisition of the partnership interest by the taxpayer would have resulted in "base erosion tax benefits," then the taxpayer is treated as having a direct interest in the partnership instead of the derivative interest for purposes of applying the BEAT rules. A derivative interest in a partnership includes any contract, including any financial instrument, the value of which, or any payment or other transfer with which, is (directly or indirectly) determined in whole or in part by reference to the partnership, including the amount of partnership distributions, the value of partnership assets, or the results of partnership operations.

The second anti-abuse rule prevents a partnership from allocating items of income with a principal purpose of eliminating or reducing base erosion payments to a taxpayer not acting in a partner capacity on amounts paid or accrued by a partnership that do not change the economic arrangement of the

Baker McKenzie

www.bakermckenzie.com

For additional information please contact the authors of this Client Alert or any member of Baker McKenzie's North America Tax Practice Group.

Steven Schneider
+1 202 452 7006
steven.schneider@bakermckenzie.com

Maher Haddad
+1 312 861 2666
maher.haddad@bakermckenzie.com

Dinh Tran
+1 202 835 6226
dinh.tran@bakermckenzie.com

partners. The preamble of the Proposed Regulations offers an example involving a domestic corporation and a third party who each pay equal amounts to a partnership with a foreign related partner and an unrelated partner for services. If the partnership allocates the income it receives from the domestic corporation to the unrelated partner while allocating an equivalent amount of income from the third party to the foreign related partner with the principal purpose of eliminating the domestic corporation's "base erosion tax benefits," the domestic corporation must determine its "base erosion tax benefits" as if the allocation had not been made and the partners shared the income proportionately. Thus, half of the domestic corporation's payment would be a "base erosion payment" and half of the deduction attributable to that payment would be a "base erosion tax benefit."

Updated Partnership Forms

The Proposed Regulations note that Form 1065, Schedule K, and Schedule K-1 will be updated so that a U.S. partnership and a foreign partnership with a U.S. filing obligation would be able to provide the information to partners who are each responsible for reporting separately their BEAT liability on Form 8991. With respect to a foreign partnership that has no U.S. filing obligation, the proposed regulations place the reporting burden on the U.S. partners.

Conclusion

Under the BEAT Regulations, the BEAT regime looks through partnerships to impose tax on U.S. corporate partners or, in certain circumstances, U.S. corporations generally based on the interactions between that corporation and its foreign affiliates. In analyzing partnership transactions under the BEAT regime, Subchapter K concepts are revamped to align with BEAT concepts of direct and proportionate property ownership and tax benefits derived from certain payments. Baker McKenzie would be delighted to help you navigate this complex and somewhat daunting BEAT regime.