Final and proposed BEAT regulations: Additional analysis

December 19, 2019

In brief

Treasury and the IRS on December 2 released 343 pages of Final Regulations (the Final Regulations) and 59 pages of Proposed Regulations (the 2019 Proposed Regulations) for the Base Erosion and Anti-Abuse Tax (BEAT) under Section 59A as enacted by the 2017 tax reform legislation (the Act). The BEAT rules require certain corporations to pay a minimum tax on taxable income as computed without certain deductions for certain payments to foreign related parties.

The Final Regulations incorporate with modifications the rules described in prior Proposed Regulations (the 2018 Proposed Regulations) under Section 59A and provide guidance related to the mechanics of determining, among other things, the applicable taxpayer status, a taxpayer's base erosion percentage, and a taxpayer's modified taxable income (MTI). The Final Regulations also address the application of Section 59A to certain partnerships, banks, registered securities dealers, insurance companies, and consolidated groups.

The 2019 Proposed Regulations provide additional guidance on determining the aggregate group, allow taxpayers an election to waive deductions for purposes of calculating their base erosion percentage, and provide certain rules applicable to partnerships.

Taxpayers subject to the BEAT rules should immediately review the Final Regulations and 2019 Proposed Regulations to determine the impact, if any, on their Section 59A tax liability.

In detail

Background

As addressed in previous PwC Insights, the BEAT, enacted as Section 59A, is intended to subject both US corporations and non-US corporations doing business within the United States to a minimum tax if deductions arising from 'base erosion payments' exceed a threshold percentage of total deductions in any tax year with certain limitations. A base erosion payment generally is a payment to a non-US related party that results in a deduction, either currently or in the future (e.g., depreciation or amortization deductions resulting from purchased assets).

The BEAT is imposed to the extent that 10% (or other applicable rates described below) of the taxpayer's MTI exceeds the taxpayer's regular tax liability, reduced by certain credits. MTI is taxable income determined without regard to any base erosion tax benefits (generally, the amount of allowable deductions attributable to base erosion payments) plus the base erosion percentage of the net operating loss (NOL) deduction for the tax year.

The BEAT rate is 5% for tax years beginning in calendar year 2018; 10% for tax years beginning in 2019 through 2025; and 12.5% for tax years beginning after December 31, 2025. The applicable rates are one percentage point higher for a group that includes a bank or securities dealer. The BEAT is effective for base erosion payments paid or accrued in tax years beginning after 2017.

The BEAT applies to an 'applicable taxpayer' with average annual gross receipts of at least $500 million (Gross Receipts Test) and a base erosion percentage of 3% or higher (2% for a bank or securities dealer) (Base Erosion Percentage Test).

For purposes of determining a taxpayer's gross receipts and base erosion percentage, pursuant to Section 59A(e)(3), all persons treated as a single employer under Section 52(a) are treated as a single taxpayer. In applying Section 1563 for purposes of Section 52, the exception for foreign corporations under Section 1563(b)(2)(C) is disregarded.

Final Regulations

Provisions retained from 2018 Proposed Regulations

While the Final Regulations reflect taxpayer comments on the 2018 Proposed Regulations, many provisions were finalized without revision. Notably, the Final Regulations do not provide exceptions from 'base erosion payments' for payments giving rise to subpart F, GILTI, or PFIC inclusions. The Final Regulations do not alter the general interaction of Section 163(j) and BEAT. The Final Regulations do not adopt taxpayer recommendations that MTI should be recalculated without taking into account base erosion payments; instead, the Final Regulations retain the add-back approach in calculating MTI.

The Final Regulations also retain the approach in the 2018 Proposed Regulations with respect to the Services Cost Method (SCM) exception without any further expansion of the exception, with additional detail on the documentation required to satisfy the SCM exception. The Final Regulations also maintain the 'internal dealings' framework in the 2018 Proposed Regulations, which treats notional amounts used in computing the business profits of a US permanent establishment under a treaty as base erosion payments (with additional guidance regarding interest expense determined in accordance with a treaty).

In addition, the Final Regulations retain the approach in the 2018 Proposed Regulations under which the proper characterization of payments for BEAT purposes is made under general tax principles. Thus, the preamble to the Final Regulations reconfirms that the amount of a base erosion payment generally is determined on a gross basis, except as otherwise provided in the Code or regulations. The preamble to the Final Regulations specifically discusses why the Final Regulations provide no exceptions or other guidance for 'middle-man' or 'pass-through' payments, payments priced using profit split or similar transfer pricing methods under Section 482, global dealing operations within the meaning of proposed Treas. Reg. sec. 1.482-8(a)(2)(i), hedging transactions, notional principal contracts, and cost sharing transaction payments under Treas. Reg. sec. 1.482-7(j)(3)(i).

Although the Treasury and IRS declined to provide specific guidance on when netting is permitted under current law, the preamble explains that Treasury and the IRS recognize that Section 59A may place more significance on some provisions of the Code than was the case before Section 59A's enactment, and expresses an intent to study the effect of the various provisions on the BEAT and whether changes should be made to the regulations thereunder to better take into account new considerations under the BEAT.

'With-or-Within' method

In general, the 2018 Proposed Regulations would have required each taxpayer to determine its gross receipts and base erosion percentage in reference to its own tax year, without regard to the tax years of other members of the aggregate group.

The Final Regulations provide that the determination of gross receipts and the base erosion percentage of a taxpayer's aggregate group are made on the basis of the taxpayer's tax year and the tax year of each member of its aggregate group that ends with or within the applicable taxpayer's tax year (the 'With-or-Within' method). The With-or-Within method only applies in determining whether a taxpayer is an applicable taxpayer under Section 59A(e). It does not impact the calculation of base erosion payments or base erosion tax benefits of the taxpayer.

Observation: While the preamble to the Final Regulations states that the With-or-Within method was provided to reduce the compliance burden of taxpayers with respect to the BEAT, taxpayers that adopted the 2018 Proposed Regulations method for determining gross receipts and base erosion percentage of their aggregate group will need to recalculate both amounts taking into account the With-and-Within method. Further, the 2019 Proposed BEAT Regulations provide guidance on how to apply the With-and-Within method in certain situations (discussed below).

Tax years beginning before January 1, 2018

In regards to the aggregate group rules for calculating base erosion percentage, the 2018 Proposed Regulations would have required the inclusion of a member's base erosion tax benefits and deductions even when its taxable year begins before January 1, 2018. Comments pointed out, and Treasury and the IRS agreed, that the inclusion of benefits and deductions attributable to a taxable year that begins before Section 59A's effective date was inappropriate. Thus, the Final Regulations exclude the base erosion tax benefits and deductions attributable to an aggregate group member's taxable year that begins before January 1, 2018.

BEAT netting rule for mark-to-market deductions

For a mark-to-market position, the 2018 Proposed Regulations and Final Regulations require taxpayers to combine all items of income, gain, loss, or deduction arising with respect to the position for the entire year in determining the amount of deduction for purposes of the base erosion percentage test (the 'BEAT Netting Rule'). Commentors requested that the Final Regulations exempt stocks, bonds, repurchase agreements, and securities lending transactions from the BEAT Netting Rule. This suggestion was rejected.

AMT credit

In determining a taxpayer's BEAT liability, Section 59A(b)(1)(B) requires an applicable taxpayer to reduce its regular tax liability by various credits allowed under Chapter 1 of the Code. However, certain credits, including credits for overpayment of taxes and for taxes withheld at source, are excluded from the list of credits that reduce regular tax liability. The Final Regulations provide that the alternative minimum tax (AMT) credit, like the research and experimentation credit, credits associated with the overpayment of taxes and taxes, withheld at source (i.e, credits allowed under Section 33 and 37), and applicable Section 38 credits do not reduce the regular tax liability in calculating the amount of base erosion minimum tax (BEMTA).

Observation: While the addition of the AMT credit to the list of credits that do not reduce the regular tax liability is a welcome addition for many taxpayers, the Final Regulations do not adopt recommendations to add foreign tax credits to such list. As a result, taxpayers that utilize foreign tax credits will have an increased risk of a BEAT liability as their adjusted tax liability, which is compared to the regular tax liability net of the credits listed above, will be lower.

Interest expense

Adopting the Section 163(j) coordination rule provided in the 2018 Proposed Regulations, the Final Regulations provide that interest expense is treated first as the interest expense paid to related parties, proportionately between foreign and domestic related parties, and then as interest expense paid to unrelated parties. The ordering rule is applied separately to disallowed interest expense carried forward from each prior tax year. The Final Regulations treat interest expense determined in accordance with a US tax treaty (including interest expense determined by internal dealings) in a manner consistent with the treatment of interest expense determined under Treas. Reg. sec. 1.882-5, to the extent of the hypothetical amount of interest expense that would have been allocated to the permanent establishment under Treas. Reg. sec. 1.882-5.

The 2018 Proposed Regulations generally provided that a foreign corporation that has interest expense allocable to effectively connected income (ECI) has a base erosion payment to the extent the interest expense results from a payment to a foreign related party. The amount of interest that is treated as a base erosion payment depends on the method used under Treas. Reg. sec. 1.882-5. If a foreign corporation uses the three-step method described in Treas. Reg. secs.

1.882-5(b) through (d), the 2018 Proposed Regulations would have provided that interest on direct allocations and on US-booked liabilities that is paid or accrued to a foreign related party is a base erosion payment.

Comments expressed a concern that the use of different methods under Treas. Reg. sec. 1.882-5 may produce meaningfully different amounts of base erosion payments and urged adoption of a consistent approach. In response, the Final Regulations provide that the amount of US branch interest expense treated as paid to a foreign related party is the sum of: (i) the directly allocated interest expense that is paid or accrued to a foreign related party, (ii) the interest expense on US booked liabilities that is paid or accrued to a foreign related party, and (iii) the interest expense on US-connected liabilities in excess of interest expense on US-booked liabilities multiplied by the ratio of average foreign related-party interest over average total interest (excluding from this ratio interest expense on US booked liabilities and interest expense directly allocated).

The Final Regulations provide that the same ratio applies to determine whether the interest expense on US-connected liabilities is paid to a foreign related party regardless of whether a taxpayer applies the method described in Treas. Reg. secs. 1.882-5(b) through (d) or Treas. Reg. sec. 1.882-5(e). For this purpose, the Final Regulations adopt certain simplifying elections (e.g., the use of a worldwide ratio of interest expense determined based on applicable financial statements).

The method set forth in the Final Regulations also applies to interest expense determined under a US income tax treaty by calculating the amount of interest that would have been allocated to ECI if the foreign corporation determined its interest expense under Treas. Reg. sec. 1.882-5.

Observation: Under the single-method approach, taxpayers would need to compute the amount of expense allocable to a US branch that is treated as a base erosion payment for purposes of Section 59A separately from the determination of allocable expenses under Section 882 or a US income tax treaty.

Internal dealings

For purposes of the interest expense calculations relating to internal dealings, the hypothetical Treas. Reg. sec. 1.882-5 interest expense cannot exceed the amount of interest expense determined under the US tax treaty. Interest expense in excess of the hypothetical Treas. Reg. sec. 1.882-5 interest expense is treated as interest expense paid by the permanent establishment to the home office or another branch of the foreign corporation, and therefore is treated as a base erosion payment.

Exception for groups with de minimis banking and securities dealer activities

The 2018 Proposed Regulations provided a *de minimis* exception from the 2% base erosion percentage threshold for a taxpayer that is a member of an aggregate group that includes a domestic bank or registered securities dealer if the total gross receipts of the aggregate group attributable to the bank or the registered securities dealer represent less than two percent of the total gross receipts of the aggregate group. However, under the 2018 Proposed Regulations, even if a taxpayer qualified for the *de minimis* exception to the lower base erosion percentage test threshold, there was no corresponding exception from the 1% BEAT rate step-up, as required under Section 59A(b)(3). In order to ensure that non-financial members of an affiliated group (where their base erosion percentage exceeds three percent) are not subject to the stepped-up rate when the gross receipts of the financial members are insignificant relative to the non-financial members, the Final Regulations retain the *de minimis* standard and provide that a taxpayer that is part of an affiliated group with *de minimis* banking and securities dealer activities is not subject to the 1% BEAT rate step-up.

Section 988 Losses

The Final Regulations preserve the exclusion of Section 988 losses realized with respect to transactions with a related foreign party from the base erosion percentage numerator and denominator, but update the application of such rules to unrelated party foreign currency losses. Related-party Section 988 losses, while excluded in a manner similar to qualified derivative payments (QDPs), are not subject to QDP reporting. In contrast, Section 988 losses that are recognized with respect to transactions with unrelated parties are included in the denominator.

Observation: This can be a significant BEAT denominator item for any taxpayer, and therefore is a welcome development.

Qualified derivative payments (QDPs)

Section 59A(h) provides that any QDP is not treated as a base erosion payment. To qualify as a QDP, a payment must be made by a taxpayer pursuant to a derivative with respect to which the taxpayer (1) marks the derivative to market under the Code or its method of accounting, (2) treats any gain or loss recognized as ordinary, and (3) treats the character of all items of income, deduction, gain, or loss with respect to a payment pursuant to the derivative as ordinary. In addition, Section 59A(h)(2) provides that no payments will be treated as QDPs for any tax year unless the taxpayer includes in the information required to be reported under Section 6038A(b)(2) with respect to such tax year such information as is necessary to identify the payments to be treated as QDP.

The Final Regulations do not adopt suggestions made by some commentators to further expand the scope of the QDP exception to include certain hedging transactions that are marked-to-market. For example, commentators pointed out that in certain industries (such as oil and gas), taxpayers commonly hedge risk with derivatives entered into with affiliates, but do not necessarily mark such derivatives to market. The preamble explains that because the mark-to-market requirement is statutory, such a departure from the statutory text would not be appropriate.

The 2018 Proposed Regulations provided guidance to implement the QDP exception. The 2018 Proposed Regulations narrowed the scope of the QDP exception by providing that it would not apply to a payment that would be treated as a base erosion payment if it were not made pursuant to a derivative, and specifically providing that a derivative does not include sale-repurchase transactions or securities lending transactions.

The Final Regulations make several modifications to the QDP rules in the 2018 Proposed Regulations.

- They retain the rule that sale-repurchase transactions are not treated as derivatives (and therefore payments pursuant to a sale-repurchase transaction may be base erosion payments).
- Securities lending transactions are no longer expressly excluded from the QDP rules.
- However, the Final Regulations treat payments made by a securities lender with respect to cash collateral (i.e., a ‘rebate fee’) as potentially excluded from the QDP exception (in addition to payments made pursuant to sale repurchase agreements)
- As a result, ‘in-lieu of payments’ and ‘borrow fees’ made by a borrower of securities may qualify for the QDP exception.

This rule is subject to an ‘anti-abuse’ rule that is intended to address concerns about securities lending transactions that have a significant financing component. This anti-abuse rule applies if the securities lending transaction (or substantially similar transaction) provides the taxpayer with the economic equivalent of a substantially unsecured cash borrowing and where the transaction is part of an arrangement that has been entered into with a principal purpose of avoiding the treatment of any payment with respect to the transaction as a base erosion payment.

Application of BEAT to partnerships

The Final Regulations adopt the 2018 Proposed Regulations proposal to treat partnerships as an aggregate for purposes of determining whether a payment made or received by a partnership qualifies as a base erosion payment.

Treasury and the IRS considered taxpayer comments to the Proposed Regulations that partnership interests issued to partners in connection with Section 721(a) nonrecognition contributions and partnership distributions of assets in connection with Section 731 nonrecognition distributions should be excluded as consideration which could be considered a BEAT payment. However, the Treasury and the IRS do not believe that such exclusions would be consistent with an aggregate treatment of partnerships. Rather, a contribution to a partnership (or distribution from a partnership) is treated as if the partners exchanged assets with each other.

In practice, this will require partners to determine their respective shares of partnership property immediately before and immediately after each nonrecognition transaction to determine whether, and to what extent, there has been a shift in the ownership of the partnership assets that could result in a BEAT payment. The determination of whether there has been a shift is made on a property-by-property basis.

If there is a single payment but the base erosion tax benefits span multiple years (e.g, issuance of a partnership interest in exchange for depreciable or amortizable property in a Section 721(a) contribution to the partnership), the amount of the

BEAT payment is determined at the date of the payment based on any shift in the ownership of the partnership assets. However, the amount of the base erosion tax benefits to each partner is determined on an annual basis and depends on the partnership allocations (including any allocations made pursuant to Section 704(c)).

Observation: In practice, compliance with the single payment spanning multiple tax years rule will require (i) an understanding of the partnership economics among the partners and (ii) application of the Section 704(c) rules and methods governing allocations of built-in gain assets, because both could have an impact on the base erosion tax benefit calculation. For example, a partnership's allocation of income or deduction to its partners could change from year to year due to a preferred partnership interest that is dependent on partnership income or loss. Similarly, remedial deductions allocated to a US partner under Section 704(c) from property contributed by a related foreign partner are considered base erosion tax benefits.

Increases to the basis of partnership property also can result in BEAT payments and corresponding base erosion tax benefits. If a distribution of property from a partnership to a partner results in an increase in basis to the distributed property or an increase in basis to the remaining partnership property, the increased basis attributable to a foreign related party is treated as newly purchased property by the existing partners from the foreign related partner. For example, if a partnership distribution to a foreign related party results in an increase to the basis of the remaining partnership property pursuant to Section 734(b), the increased basis is treated as newly purchased property. Similarly, if a distribution is made to a US partner and the basis of the distributed property is increased pursuant to Section 732(b), the increased basis is treated as newly purchased property based on the proportionate ownership of the foreign related party's share of the distributed property immediately before the distribution.

Similar rules apply for Section 743(b) basis adjustments to partnership assets resulting from the transfer of a partnership interest whereby a foreign related partner's interest in the underlying partnership assets is decreased as a result of the transfer.

Pass-through payments

Despite commenters' requests, the Final Regulations do not provide specific rules or safe harbors regarding the determination of whether payments made by a US entity as an agent or conduit, or under a cost-reimbursement or revenue; share arrangement (pass-through payments), to a foreign related party are excludable from the BEAT. The Final Regulations instead reiterate the 2018 Proposed Regulations by providing that a taxpayer determines the proper treatment of a payment as a deductible or pass-through payment under general US income tax law.

Observation: Taxpayers are left in largely the same position under the Final Regulations as under the 2018 Proposed Regulations with respect to pass-through payments. The determination as to whether a payment is a pass-through payment is based on a large and complex body of case law. Taxpayers that make payments to foreign related parties under a conduit or agency arrangement, or under a cost-reimbursement or revenue-sharing arrangement, should evaluate their internal and external agreements to determine whether such payments may qualify as pass-through payments.

Specified nonrecognition transactions

The preamble to the 2018 Proposed Regulations stated that a non-cash payment (e.g., stock) by a taxpayer to a foreign related party may be a base erosion payment notwithstanding that it was incurred in a nonrecognition transaction. The preamble gave an example of a domestic corporation's acquisition of depreciable assets from a foreign related party in a Section 351 exchange, a Section 332 liquidation, or a Section 368 reorganization.

The Final Regulations generally exclude from the definition of base erosion payment amounts transferred to, or exchanged with, a foreign related party in a 'specified nonrecognition transaction' (i.e., transactions described in Sections 332, 351, 355, or 368). However, Treasury and the IRS - expressing concern that the exclusion of nonrecognition transactions from the definition of base erosion payment could, in certain instances, lead to inappropriate results - added an 'anti-abuse' rule in the Final Regulations with respect to specified nonrecognition transactions, providing that if a transaction has a principal purpose of increasing the adjusted basis of property that a taxpayer acquires in the nonrecognition transaction, then the exception from treatment as a base erosion payment with respect to specified nonrecognition transactions does not apply to the specified nonrecognition transaction. Moreover, if a transaction between related parties increases the adjusted basis of property within the six-month period before the taxpayer acquires the property in a specified nonrecognition transaction, the transaction is deemed to have a principal purpose of increasing the adjusted basis of property that a taxpayer acquires in a nonrecognition transaction (i.e., taxpayers are not allowed to

rebut the presumption that the transaction was undertaken with the principal purpose of increasing the tax basis of the property).

Further, if a taxpayer transfers 'other property' to a foreign related party pursuant to a Section 351, 355, or 368 nonrecognition transaction, the other property is treated as a base erosion payment regardless of whether gain is recognized on the transaction. The term 'other property' generally has the same meaning as the phrase 'other property or money' as used in Sections 351(b), 356(b)(1), and 361(b) as applicable, plus the amount of liabilities assumed by the taxpayer in the nonrecognition transaction (but only the extent of the amount of gain recognized under Section 357(c)). However, other property does not include the sum of any money and the fair market value of any property to which Section 361(b)(3) applies.

Observation: The exclusion from the definition of base erosion payment of amounts transferred to, or exchanged with, a foreign related party in a specified nonrecognition transaction is a welcome exception for many taxpayers. However, taxpayers will need to analyze the anti-abuse rule in Treas. Reg. sec. 1.59A-9(b)(4) to determine whether the specified nonrecognition transaction qualifies for the exclusion.

Treatment of distributions

The 2018 Proposed Regulations provided that an in-kind distribution under Section 301 does not give rise to a base erosion payment because there is no consideration provided by the taxpayer and, thus, no payment or accrual. The Final Regulations provide additional guidance regarding the treatment of distributions, including deemed distributions.

The Final Regulations provide that a distribution with respect to stock for which there is no consideration (what Treasury calls a 'pure distribution') is not treated as an exchange; accordingly, such a distribution is not treated as a payment or accrual. Such distributions include distributions under Section 301.

However, the Final Regulations provide that a redemption of stock by a corporation within the meaning of Section 317(b) (such as a redemption described in Sections 302(a) and (d) or Section 306(a)(2)), or an exchange of stock described in Section 304 or 331, is an amount paid or accrued by the shareholder to the corporation (or by the acquiring corporation to the transferor in a Section 304 transaction). Treasury stated that, unlike a 'pure distribution,' a redemption of stock in exchange for property constitutes an exchange.

Observation: The effect of this rule is that certain exchanges that are treated for tax purposes as distributions under Sections 301 are not treated like a straight distribution of property to a shareholder for purposes of determining if there is payment or accrual for BEAT purposes, despite generally having the same treatment for other tax purposes. Because the exchange of stock is treated as a payment or accrual, such exchange may give rise to a base erosion payment, while a 'pure distribution' does not give rise to such a payment.

Loss transactions

The 2018 Proposed Regulations provided that in defining base erosion payment, 'an amount paid or accrued' included an amount paid or accrued using any form of consideration (e.g., cash, property, stock). The preamble to the 2018 Proposed Regulations stated that "a base erosion payment also includes a payment to a foreign related party resulting in a recognized loss; for example, a loss recognized on the transfer of property to a foreign related party."

The Final Regulations clarify that a loss recognized from the sale or transfer of property (e.g., stock or receivables) to a foreign related party is not itself a base erosion payment primarily because that built-in-loss is unrelated to the payment made to the foreign related party. However, if the taxpayer uses the property to make a payment to a foreign related party and the payment otherwise meets the definition of a base erosion payment, the portion of the payment that is deductible will continue to be a base erosion payment. The Final Regulations clarify that the amount of the base erosion payment in that case is limited to the fair market value of the property transferred.

Section 15

Section 59A(b)(1)(A) provides that the BEAT generally is equal to 10% of a taxpayer's modified taxable income over its regular tax liability. However, for tax years beginning in 2018, Section 59A(b)(1)(A) provides for a reduced BEAT rate of 5%. The 2018 Proposed Regulations provided that Section 15, requiring a blended tax rate for tax years that include a rate change, applies to fiscal tax years that include January 1, 2019. Following this proposed rule, an applicable taxpayer

with a tax year beginning July 1, 2018 and ending June 30, 2019 would be required to apply a blended rate between 5 and 10 percent in determining its BEAT liability for FY 2019.

Commenters noted that the application of Section 15 to fiscal tax years beginning after January 1, 2018 is contrary to the plain language of the statue. The Final Regulations modify the Proposed Regulations by providing that that Section 15 does not apply to any tax year that includes January 1, 2019. However, the Final Regulations continue to provide that the Section 15 blended rate applies to the change in the BEAT rate from 10% to 12.5% that is effective for tax years beginning after December 31, 2025.

Observation: The reversal of the requirement to apply Section 15 to tax years that include January 1, 2019 is welcome news for fiscal-year taxpayers that otherwise would be required to apply a higher rate to their fiscal tax year that begins in 2018.

Cost of Goods Sold

The Conference Report to the Act provides that base erosion payments generally do not include amounts that constitute reductions in gross receipts, including payments for cost of goods sold. However, neither the statute nor the 2018 Proposed Regulations expressly provide that payments constituting reductions in gross income are excluded from the definition of base erosion payments. In order to provide more certainty to taxpayers, the Final Regulations provide that an amount that reduces gross income under Section 61, including an amount properly treated as cost of goods sold under the Code generally is not a base erosion payment.

General rules applicable to consolidated groups

The 2018 Proposed Regulations provided that the BEAT is computed and imposed at the consolidated group level. This is consistent with the general approach of computing and imposing the regular tax liability of the members of an affiliated group that file a consolidated return on a single-entity basis. The Final Regulations retain this approach.

Also consistent with single-entity treatment, the 2018 Proposed Regulations provided that items from intercompany transactions are not taken into account for purposes of computing the group's base erosion percentage and BEMTA. The Final Regulations clarify what it means for intercompany transactions to be disregarded in making the required computations under Section 59A, by providing that items resulting from intercompany transactions are not taken into account in computing the group's base erosion percentage and BEMTA. For example, the group's base erosion percentage does not take into account additional depreciation of a member that results from an intercompany transaction between two members of a consolidated group (in computing the consolidated taxable income of the group, such depreciation deductions would have been offset by deferred gain recognized by the seller).

In general, the Final Regulations conform to the framework provided by the 2018 Proposed Regulations regarding the application to consolidated groups of the stacking rule in Section 59A(c)(3), to consolidated groups, which implement rules that identify which interest deductions are allocable to domestic related-party payments, foreign related-party payments, and unrelated-party payments based on specified allocation ratios, which are based on the entire group's business interest expense paid. If the current-year business interest expense (BIE) cannot be fully deducted, then the Section 163(j) carryforwards are allocated a status as either a domestic-related carryforward, foreign-related carryforward, or an unrelated carryforward. This status is taken into account for BEAT purposes in future years whether or not the member remains in the consolidated group.

However, the Final Regulations provide two new rules addressing situations when a member deconsolidates from the original consolidated group with a Section 163(j) carryforward. The first rule provides an exception if the gross receipts test was not met in the year the BIE was incurred, and permits the departing member (or the acquiring consolidated group) to apply the classification rules on a separate-entity basis to determine the status of the deconsolidating member's Section 163(j) disallowed BIE carryforward as a payment or accrual to a domestic-related, foreign-related, or unrelated party. The second rule requires that the Section 163(j) carryforward from the original group be treated as a foreign-related party payment if the departing member (or the acquiring consolidated group) failed to substantiate the status of the Section 163(j) carryforward from the original group.

Modification to existing consolidated group regulations

The 2018 Proposed Regulations revised Treas. Reg. sec. 1.1502-2 to include the tax imposed by Section 59A in the computation of consolidated tax liability. In addition, Treas. Reg. sec. 1.1502-4 was proposed to be revised to exclude

BEAT from the Section 904(a) limiting fraction for the purpose of calculating consolidated group foreign tax credits. The Final Regulations are unchanged on these points from the 2018 Proposed Regulations.

Applicability dates

The Final Regulations generally are applicable for tax years ending on or after December 17, 2018. However, taxpayers may rely on the Final Regulations in their entirety for tax years ending before December 17, 2018, but must do so consistently and cannot selectively choose which particular provisions to apply.

2019 Proposed Regulations

Waiver of deductions

Concurrent with the Final Regulations, the IRS and Treasury released new Proposed Regulations under Section 59A (REG-112607-19). The 2019 Proposed Regulations provide an election for taxpayers to waive allowed deductions in order to reduce their BEAT liability. A taxpayer that makes this election will not treat the waived deduction as a base erosion tax benefit and will not include the waived deduction in its base erosion percentage calculation.

A taxpayer may make the election to waive any portion of a deduction associated with a particular cost or expense. The election may be made on an originally filed or amended federal income tax return. A taxpayer also may make the election during the course of an examination of the taxpayer's tax return by following procedures provided by the Commissioner.

A taxpayer may increase the amount of any waived deductions on an amended return (or during the course of an examination of the taxpayer's tax return); however, a taxpayer may not later revoke or decrease the amount of previously waived deductions.

Until the 2019 Proposed Regulations are finalized, a taxpayer choosing to rely on the Proposed Regulations makes the election to waive deductions by including the following information on a statement attached to Form 8991, *Tax on Base Erosion Payments of Taxpayers With Substantial Gross Receipts*:

- Description of the item to which the deduction relates;
- Date on which the taxpayer paid or accrued the waived deduction;
- Provision of the Code and regulations that allows the deduction for the item;
- The amount of the deduction the taxpayer is claiming for the tax year;
- The amount of the deduction the taxpayer is waiving;
- A description of where the taxpayer will (or would) reflect the deduction on the return; and
- The name, EIN, and country of the foreign related party receiving the payment.

The election to waive a deduction is made on an annual basis and does not require IRS consent. Further, the election is not considered a method of accounting; thus, a taxpayer may separately choose to make the election to all or a portion of its allowed deductions each year.

The Proposed Regulations provide special rules to ensure that taxpayers do not later benefit from any waived deductions. For example, if a taxpayer waives a deduction with respect to an item and later requests a change in method of accounting with respect to that item, the previously waived portion is not taken into account in determining the amount of the taxpayer's Section 481(a) adjustment. Additionally, the taxpayer disregards the election for purposes of determining its earnings and profits as well as for purposes of determining basis adjustments to property as required under Section 1016 (e.g., for allowed or allowable depreciation). The waiver of a deduction also is disregarded for purposes of determining the price of a controlled transaction under Section 482.

Observation: The election to waive all or a portion of an allowed deduction is flexible, however, taxpayers should consider the need to track any waived amounts for purposes of later adjustments that may implicate the waived deduction.

Observation: A taxpayer that elects to waive all or a portion of an allowed deduction under the Proposed Regulations must, under the Final Regulations, exclude the waived amount from both the numerator and the denominator of the

taxpayer's base erosion percentage. The rule in the Final Regulations that excludes waived deductions from the denominator of the base erosion percentage appears to be inconsistent with the statutory language of Section 59A, which does not require a taxpayer to remove waived deductions from the denominator. Accordingly, taxpayers should consider the impact that waiving a deduction may have in lowering the taxpayer's base erosion percentage.

Observation: It is unclear how a waived deduction is to be computed for an interest expense deduction of a foreign corporation calculated under Treas. Reg. sec. 1.882-5 because of a requirement to compute the waived amount prior to any allocation or apportionment under the Section 861 regulations. The interaction of these waiver amounts with the deferral of interest expense deductions from partnerships under Section 163(j) becomes uncertain as a result of these rules.

Observation: It also is unclear to what extent waived deductions must be reported on Forms 5472. Draft instructions to new Forms 5472 for 2019 indicate that interest expense that is not deductible under Section 163(j) need not be treated as reportable transactions, however, the election to waive all or a portion of an allowed deduction is not addressed in draft instructions to Forms 5472 as either an amount required or not required to be reported.

With-or-Within method

The Final Regulations adopted the With-or-Within method for taking into account aggregate group members' gross receipts and base erosion percentage. The 2019 Proposed Regulations provide guidance on how to apply the With-or-Within method in certain scenarios.

Short tax year

The 2019 Proposed Regulations provide that if a taxpayer's tax year is fewer than 12 months, annual gross receipts should be extrapolated by multiplying the gross receipts for the period by 365 over the number of days in the short period. For determining the gross receipts and base erosion percentage of aggregate group for a short period, the taxpayer must use a reasonable approach (i.e., an approach that does not over-count nor under-count gross receipts, base erosion tax benefits, and deductions). The IRS has requested additional comments on whether more specific guidance is needed.

Members leaving and joining the aggregated group

To determine the gross receipts and the base erosion percentage of a taxpayer with respect to its aggregate group for purposes of Section 59A, the 2019 Proposed Regulations take into account only items of members that occur during the period that they were members of the taxpayer's aggregate group. A corporation is treated as having a deemed tax year-end when the corporation joins or leaves an aggregate group of a taxpayer. The taxpayer may determine items attributable to this deemed short tax year by either deeming a close of the corporation's books or, in the case of items other than extraordinary items, making a pro-rata allocation.

Application of BEAT to partnerships

The 2019 Proposed Regulations include a proposal to address special allocations and two proposals in the form of partnership 'anti-abuse' rules.

First, the 2019 Proposed Regulations provide that to the extent a partnership makes special allocations among its partners that do not impact the economics between the partners, the special allocation is effectively disregarded. ***Observation:*** It is not clear why this special rule is proposed because such an allocation generally would be expected to be subject to the Section 704(b) economic effect rules.

Second, there are proposed anti-abuse rules aimed at (1) derivatives on partnership interests that are entered into with a principal purpose of avoiding BEAT, and (2) special allocations made to a taxpayer not acting in a partner capacity on amounts paid to or accrued by a partnership that do not impact the economics between the partners.

Additionally, the Treasury Department and the IRS request comments on the treatment of foreign partner contributions to a partnership engaged in a US trade or business and provide guidance on the partner and partnership information reporting requirements with respect to BEAT.

Consolidated groups

The Treasury Department and the IRS request comments on the proper treatment of gross receipts when members join or deconsolidate from a consolidated group. In particular, they are focused on whether it is appropriate to continue to

eliminate gross receipts resulting from intercompany transactions when members deconsolidate and join a different aggregate group.

Predecessors

Given that the aggregate groups of a taxpayer and its predecessor may overlap and thus might result in double counting of gross receipts of corporations that are members of both, the 2019 Proposed Regulations provide that gross receipts of corporations that are predecessors of the taxpayer or the taxpayer's aggregate group should not be double counted. Treasury and the IRS have requested comments on how to reasonably prevent double counting with respect to predecessors of a taxpayer or the taxpayer's aggregate group.

Applicability date

The 2019 Proposed Regulations generally are applicable to tax years beginning on or after the date the regulations are filed as Final Regulations in the Federal Register. However, the rules in Prop. Reg. sec. 1.59A-7(c)(5)(v) (regarding a partnership's allocation of income in lieu of deductions), Prop. Reg. sec. (g)(2)(x) (an example illustrating curative allocations), and Prop. Reg. secs. 1.59A-9(b)(5) and (6) (regarding transactions involving derivatives on a partnership interest and partnership allocations to eliminate or reduce a base erosion payment) apply to tax years ending on or after December 2, 2019. Taxpayers may rely on the 2019 Proposed Regulations in their entirety for tax years beginning after December 31, 2017 and before the Final Regulations are finalized but must do so consistently and cannot selectively choose which particular provisions to apply.

Accounting considerations

Tax law changes or interpretations are accounted for in the period in which the law is enacted or the guidance is issued, and these changes generally would be included in income from continuing operations from an intraperiod allocation perspective. Final and temporary regulations have the weight of law and, therefore, should be accounted for in the period in which they are issued. On the other hand, while Proposed Regulations are not yet enforceable, they can be indicative of current thinking by Treasury and the IRS and provide insight to positions expected to be taken during examination of tax returns and could then have an impact on the assessment of tax positions. Companies will have to make a technical assessment of the sustainability of their tax positions and apply the guidance under ASC 740 to determine the impact on financial reporting.

The takeaway

The Final Regulations provide additional guidance related to the mechanics of determining a taxpayer's BEAT liability, and clarify the application of Section 59A to partnerships, banks, registered security dealers, and US consolidated groups. The Final Regulations also provide an anti-abuse rule that generally disregards certain transactions undertaken with a principal purpose of avoiding Section 59A. Taxpayers should review and assess the impact of the provisions in the Final and Proposed Regulations.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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