On December 13, 2018, the Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) issued proposed regulations under section 59A of the Internal Revenue Code of 1986, as amended, commonly referred to as the base-erosion and anti-abuse tax (BEAT).

Notably, the proposed regulations provide that:

- General federal tax principles apply in determining whether a payment is a deductible payment with respect to an “applicable taxpayer”;
- The services cost method exception to the treatment of certain payments as base erosion payments applies to eligible payments that include a mark-up, just not to the extent of the mark-up;
- Payments made to a foreign corporation are not treated as base erosion payments to the extent they are included in the calculation of the corporation’s effectively connected income or income allocable to a permanent establishment;
- Amounts accrued prior to the effective date of section 59A, but deductible after such date, are not considered to be base erosion payments;
- The base erosion percentage of any net operating loss (NOL) is determined by reference to the year in which the NOL arose, not the year in which it is used; and
- Specific anti-abuse rules apply to:
  - treat certain payments made through conduit entities as subject to the BEAT rules,
  - disregard certain transactions that are undertaken for a principal purpose of increasing the denominator in the base erosion percentage calculation and
  - disregard certain related-party transactions undertaken to avoid the lower base erosion percentage threshold and higher BEAT tax rate applicable to banks and registered securities dealers.

The BEAT functions as a minimum tax on corporations that have annual average gross receipts over a three-year period ending with the prior taxable year of at least $500 million, and have a “base erosion percentage” of at least 3% (or 2% in the case of banks and registered securities dealers). A corporation meeting the above thresholds is considered to be an “applicable taxpayer.”
Whether an “applicable taxpayer” is subject to the BEAT is determined by comparing its "modified taxable income" multiplied by the applicable BEAT tax rate for the taxable year to the taxpayer’s regular tax liability for the taxable year without taking into account certain credits. The applicable BEAT tax rate is 5% for tax years beginning in 2018, 10% for tax years beginning after 2018 and before 2025, and 12.5% for tax years beginning after 2025 (or 6%, 11% and 13.5%, respectively, in the case of banks and registered securities dealers). If a taxpayer’s regular tax liability exceeds the modified taxable income multiplied by the applicable BEAT tax rate, no tax is imposed under section 59A.

The discussion below highlights some of the key takeaways from the proposed regulations.

**Determination of Status as an Applicable Taxpayer**

Only “applicable taxpayers” are subject to the BEAT. An applicable taxpayer is a corporation, other than a regulated investment company, a real estate investment trust or a subchapter S corporation, that meets the gross receipts test and has a “base erosion percentage” over the applicable threshold.

Under the statute, the application of the gross receipts and base erosion percentage tests is on an aggregate basis, including all corporations within a section 52(a) controlled group (using 50% instead of 80%). Although this technically would include foreign corporations, the proposed regulations clarify that for purposes of applying the gross receipts and base erosion percentage tests, the aggregate group includes only domestic corporations and foreign corporations to the extent of income that is effectively connected (ECI) with a US trade or business (and not exempt from tax under a treaty). The preamble explains that this limitation ensures that only entities that otherwise may benefit from US tax deductions are taken into account.

The proposed regulations clarify that payments between members of the aggregate group are not taken into account in applying the gross receipts test or determining the base erosion percentage. For example, payments by a domestic corporation to a foreign corporation that are ECI are not taken into account. But, payments by a domestic corporation to the same foreign corporation would be taken into account if they were not included in the foreign corporation’s ECI. Special rules are also provided to address situations where payments may be deemed to be made between the US trade or business of a foreign corporation and the non-US home office.

The proposed regulations also include rules for purposes of applying the gross receipts test and determining the base erosion percentage where members of the controlled group have differing tax year ends. Generally, the determination is made by reference to payments during the tax year of the taxpayer for which the potential BEAT liability is being calculated, meaning that the period considered with respect to members of the aggregate group that have different tax year
ends will not correspond to their own taxable years.

In general terms, the base erosion percentage is the amount of the base erosion payments for the taxable year, divided by the taxpayer’s total deductible payments for the tax year. The proposed regulations clarify that section 965(c) deductions are to be included in the denominator of this fraction. In addition, the proposed regulations clarify that amounts that are excluded from treatment as a base erosion payment, such as qualified derivative payments or the portion of a services payment that is eligible for the services cost method exception, are not included in the denominator in calculating the base erosion percentage.

**Base Erosion Payments and Application of the Services Cost Method Exception**

The statute broadly defines base erosion payments to include the following payments made to related foreign parties:

- Payments made with respect to which a deduction is allowable;
- Payments made in connection with the acquisition of depreciable or amortizable property;
- Premiums or other consideration paid for reinsurance; or
- Payments resulting in a reduction of gross receipts of the taxpayer made to certain surrogate foreign corporations or related foreign persons.

An exception to the above rules applies under the statute in the case of an amount paid or accrued by the taxpayer for services if such services are eligible for the services cost method under the section 482 regulations, determined without regard to the requirement that the services not contribute substantially to fundamental risks of business success or failure, and such amount constitutes the total services cost with no mark-up. The proposed regulations clarify that this exception applies to a services payment that otherwise qualifies for the services cost method, as modified for purposes of section 59A, even if the payment includes a mark-up—only the mark-up component is treated as a base erosion payment. There is no requirement to separately state the components in the invoice, but the taxpayer is required to maintain appropriate books and records from which the mark-up component can be determined.

More generally, the proposed regulations clarify that the determination of whether a payment falls into one of the aforementioned categories is made under the general principles of US federal income tax law. By way of example, whether a royalty payment is deductible under section 162 or is an inventory cost included in cost of goods sold is not determined under the proposed regulations. Instead, that determination is made under general tax principles. Similarly, existing beneficial ownership principles apply, such as principal-agent, reimbursement doctrine, conduit principles and assignment of income, in
determining the taxpayer that is entitled to a deduction for purposes of applying section 59A.

Other clarifications made in the proposed regulations regarding the determination of whether an amount is treated as a base erosion payment include:

- **Payments in cash or any form of non-cash consideration may be treated as base erosion payments.** A taxpayer may acquire depreciable assets from a related foreign person in a tax-free transaction, such as a section 351 contribution or a reorganization under section 368. The proposed regulations provide that the amortization or depreciation with respect to the acquired assets is a base erosion payment, notwithstanding that no cash consideration was paid for such assets. Treasury and the IRS determined that neither the non-recognition of gain or loss to the transferor nor the absence of a stepped-up basis to the transferee establish a basis to create a separate exclusion from the definition of base erosion payments.

- **Exchange loss from a section 988 transaction is not treated as a base erosion payment.** Although recognized losses are considered to be base erosion payments, the proposed regulations exclude exchange losses related to section 988 transactions from treatment as base erosion payments. Such losses are excluded from both the numerator and the denominator for purposes of calculating the base erosion percentage. The proposed regulations specifically request comments on whether exchange losses should be included in the denominator.

- **Only amounts accrued in tax years beginning after December 31, 2017, are treated as base erosion payments.** The proposed regulations clarify that amounts that accrue in years prior to the effective date of section 59A are not base erosion payments, even if the amount is deducted in a tax year after the effective date of the statute. This is significant for disallowed interest expense that was carried forward under section 163(j), amounts subject to deferral under section 267, and for NOL carryforwards.

**Coordination with the Deduction Limitations of Section 163(j)**

The Tax Cuts and Jobs Act also made amendments to section 163(j), which limits deductions for interest expense paid by corporations. The limitations of section 163(j), as amended, apply to all interest expense, not just related-party interest expense. The proposed regulations include ordering rules for purposes of determining whether any amounts that are subject to deferral under section 163(j) are attributable to interest expense paid to a foreign related person. Generally, the rules treat any amounts subject to deferral under section 163(j) as attributable first to interest expense paid to third parties. If the amount of interest expense deferred under section 163(j) exceeds the total interest paid to third parties, the amount of deferral is allocated between foreign and domestic related lenders on a pro-rata basis. When deferred amounts are carried forward,
deductions within each annual layer are treated first as attributable to related-party interest on a proportionate basis, and then to unrelated-party interest.

**Clarifications Regarding the Modified Taxable Income Calculation**

As discussed above, whether the BEAT applies requires comparing the taxpayer’s base erosion minimum tax amount, based on its modified taxable income, to its adjusted regular tax liability. Modified taxable income is generally the regular taxable income of the taxpayer, plus the amount of the base erosion tax benefit and the base erosion percentage of any NOL deduction in the taxable year. The proposed regulations include helpful clarifications regarding the calculation of modified taxable income, including:

- Although the gross receipts test and base erosion percentage are determined on an aggregate basis, the computation of modified taxable income and the imposition of the BEAT minimum tax is made on a taxpayer-by-taxpayer basis.

- A group of corporations that file a consolidated tax return are treated as a single taxpayer for purposes of applying the rules. The regulations include specific rules for allocating any liability among the members of the group.

- NOL carryforwards do not reduce taxable income below zero for purposes of determining the starting point for modified taxable income. Some commentators observed that as a technical matter the entire net operating loss is carried forward and deducted each year. The proposed regulations clarify the intent is only to take into account the NOL carryforward that is actually used in a given year.

- In addition, in determining the base erosion percentage applicable to any NOL that is used in a taxable year, the proposed regulations refer to the base erosion percentage in the year the NOL arose, not the year when the loss is taken into account. This simplifies administration and provides increased predictability for taxpayers with NOL carryforwards.

- All US branches of a foreign corporation will be treated as single taxpayers for purposes of calculating modified taxable income and determining the amount of any BEAT liability. As a result, under the proposed regulations, US branches of foreign banks (that are not registered securities dealers) are not subject to the higher BEAT rate that is imposed on US banks and registered securities dealers.

**Proposed Anti-Abuse Rules**

The statute provides the Treasury and the IRS with broad regulatory authority to issue regulations addressing perceived abuses of the statute, including through the use of conduit entities and transactions or arrangements designed to cause payments that would be subject to section 59A to be excluded from the
application of section 59A. In line with the grant of authority, the proposed regulations provide rules for disregarding certain conduit entities and transactions. The proposed rules also allow the IRS to disregard transactions that artificially increase the denominator for purposes of determining the base erosion percentage, and certain transactions that are designed to avoid the application of the more restrictive rules for banks and registered securities dealers.

**Application to Partnerships**

A partnership is not an “applicable taxpayer” subject to the BEAT; only a corporation can be an applicable taxpayer. For purposes of the BEAT, including for purposes of evaluating whether a corporation is an applicable taxpayer and in determining whether the corporation has made a base erosion payment, the proposed regulations generally apply an aggregate approach to partnership taxation, pursuant to which the partnership is treated as an aggregate of its owners, rather than a separate entity.

Consistent with the aggregate approach, the proposed regulations generally provide that payments by a corporation to a partnership are treated as payments by the corporation to the partners of the partnership and that payments by a partnership to a corporation are treated as payments by the partners of the partnership to the corporation. Moreover, a corporate partner of a partnership generally must apply the BEAT by taking into account its distributive share of the partnership’s income, gain, deduction and loss, and its share of the partnership’s assets.

The proposed regulations include an exception to the aggregate approach whereby a partner does not take into account its distributive share of any partnership amount of base erosion tax benefits for a taxable year if the partner owns less than 10% of the capital and profits of the partnership at all times during the year, the partner is allocated less than 10% of each partnership item for the taxable year, and the 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.

**Special Rules Relating to Insurance Companies**

The proposed regulations provide limited guidance for insurance companies and request further comments. Most notably:

- Amounts paid under a reinsurance contract between an applicable taxpayer and a related foreign party are not netted but are included on a gross basis regardless of whether or not the reinsurance contract is settled on a net basis. However, the proposed regulations appear to indicate that return premiums reduce premium and are therefore not subject to the BEAT.

- If a domestic reinsurance company makes claim payments to a foreign
related ceding company pursuant to a reinsurance contract, such amounts may be subject to the BEAT. However, payments that are treated as reductions to gross income under section 832(b)(3)—which might be the case for a non-life insurance company—may not be subject to the BEAT. The Preamble notes the potential difference between the treatment of claim payments by life and by non-life domestic reinsurance companies and has requested comments on this issue.

- Payments made or accrued to a foreign insurance company that has made an election to be treated as a domestic company under section 953(d), as well as payments made to a US branch, are not subject to the BEAT. A payment made by a section 953(d) company, or a US branch, to a foreign related corporation could potentially be subject to the BEAT.

- Insurance companies must calculate their gross receipts and base erosion percentage disregarding payments between members of their aggregate group, including payments treated as ECI of a foreign member of the aggregate group.

**Special Rules Relating to Banks and Registered Securities Dealers**

As noted above, banks and registered securities dealers are subject to the BEAT if their base erosion percentage is 2% (rather than 3%), and the BEAT tax rate applied to such taxpayers is higher than the generally applicable BEAT tax rate. The proposed regulations provide that the aggregate group is not subject to the lower base erosion percentage trigger of 2% if the gross receipts attributable to the registered securities dealer or bank are less than 2% of the aggregate group’s gross revenue. Notably, if the 3% base erosion percentage trigger is met (as well as the gross revenue trigger), there is no exception for the application of the higher BEAT tax rate applicable to a single taxpayer that includes a bank or registered securities dealer. Under the proposed regulations, brokers who are not also registered securities dealers are not subject to the lower base erosion percentage threshold and higher BEAT tax rate applicable to banks and regulated securities dealers.

*If you have any questions about this legal alert, please feel free to contact any of the attorneys listed under ‘Related People/Contributors’ or the Eversheds Sutherland attorney with whom you regularly work.*