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IRS Issues Final and Proposed Regulations on BEAT

The Final Regulations Retain the General Framework of the 2018 Proposed Regulations with Important Clarifications. New Proposed Regulations Add an Election to Waive Deductions to Avoid the Threshold for BEAT Application.

SUMMARY

On December 2, 2019, the Internal Revenue Service (the "IRS") and the Treasury Department ("Treasury") issued final regulations (the "Final Regulations") and proposed regulations (the "New Proposed Regulations") on the base erosion and anti-abuse tax ("BEAT"). As discussed below, the Final Regulations adopt the general framework and many of the provisions set forth in proposed regulations that were published on December 21, 2018 in the Federal Register (the "2018 Proposed Regulations"), with certain modifications. The New Proposed Regulations propose a few additional modifications including, most significantly, an election to waive deductions for all tax purposes to avoid the threshold for BEAT application.

The Final Regulations generally apply to taxable years ending on or after December 17, 2018. Taxpayers may apply the Final Regulations in their entirety for taxable years beginning after December 31, 2017 and ending before December 17, 2018. If finalized, the New Proposed Regulations would generally apply to taxable years beginning after the date that final regulations are published in the Federal Register. Until finalization, taxpayers may rely on the New Proposed Regulations in their entirety for taxable years beginning after December 31, 2017.

Set out immediately below is an overview of the most important changes, for readers generally familiar with BEAT. The overview is followed by relevant background and a more detailed description of provisions.

OVERVIEW

GENERAL TAX PRINCIPLES

The Final Regulations confirm the significance of financial structuring in determining whether transactions give rise to Base Erosion Tax Benefits (as defined under "*Background*", below). The preamble to the Final Regulations (the "Preamble") reiterates the fact that the existence *vel non* of deductions for payments made to related foreign persons (and the characterization of transactions where relevant—*e.g.*, as derivatives) is determined by the application of general principles of federal income taxation to all of the relevant facts and circumstances,[1] including agency principles.[2] The IRS has declined to provide special characterization rules solely for purposes of applying BEAT in light of purported Congressional objectives. Moreover, except in limited specified cases (*e.g.*, the insertion of a conduit into what would otherwise be a Base Erosion Payment (as defined under "*Background*", below)), the Preamble suggests that taxpayers are free to structure their transactions in a manner that minimizes deductions for payments made to related foreign persons, as compared with other economically similar alternatives.

ELECTION TO WAIVE DEDUCTIONS

In addition, the New Proposed Regulations offer taxpayers an election to forgo (on an item-by-item basis) deductions that are otherwise allowable for Base Erosion Payments as necessary to ensure that taxpayers will not exceed the relevant Base Erosion Percentage threshold (as defined under "*Background*", below) and will therefore not be subject to BEAT.[3] This election is proposed to be available on a retroactive basis (*i.e.*, by filing an amended return).[4] As a result, a taxpayer's maximum exposure to BEAT tax liability may in effect be limited to regular tax on additional net income in an amount equal to its deductions for Base Erosion Payments that exceed the Base Erosion Percentage threshold. *See* Part E.1, below.

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1 Treas. Regs. § 1.59A-3(b)(2)(i); *see also* Preamble at 24 ("[B]ecause existing tax law generally applies, the amounts of income and deduction for purposes of section 59A are generally determined on a gross basis under the Code and regulations."); Preamble at 31 ("To the extent that an amount is treated under general U.S. federal income tax law as received by a U.S. person as an agent for, and is remitted to, a foreign related party, see also Part IV.A (How Base Erosion Payments are Determined in General) of this Summary of Comments and Explanation of Revisions, which discusses the addition of §1.59A-3(b)(2)(i) to clarify that the determination of whether a payment or accrual by the taxpayer to a foreign related party is described in one of four categories of a base erosion payment is made under general U.S. federal income tax law, including agency principles."); Preamble at 65 ("[T]he Treasury Department and the IRS believe that whether an amount constitutes a reduction to determine gross income or COGS must be determined under established principles of U.S. federal income tax law.").

2 *See* Preamble at 23, 31.

3 *See* Prop. Treas. Regs. § 1.59A-3(c)(6).

4 Prop. Treas. Regs. § 1.59A-3(c)(6)(iii).

NETTING

As an example of the above, the Final Regulations make it clear that the only "netting rule" that applies to deductible payments running in opposite directions between a U.S. and foreign affiliate is one based on the fact that such payments simply do not exist under general U.S. tax principles.[5] Thus, if a foreign affiliate lends money to a U.S. affiliate in exchange for fixed payments of interest, and the U.S. affiliate simultaneously lends money to the foreign affiliate in exchange for floating payments of interest, the U.S. affiliate's deductions for interest paid to the foreign affiliate are Base Erosion Tax Benefits in their entirety.[6] But if these two transactions are part of an interest rate swap that nets the payments within the four corners of a single transaction document, the taxpayer might reasonably conclude that a deductible payment from the U.S. affiliate to the foreign affiliate only exists to the extent of the excess, if any, of the fixed rate over the floating rate.

HEDGING TRANSACTIONS

Similarly, the Final Regulations make it clear that if a U.S. taxpayer enters into a hedging transaction with a foreign affiliate, the U.S. taxpayer's deductions for payments on the hedge may be Base Erosion Payments notwithstanding that the foreign affiliate enters into an identical hedge in the market with an unrelated party. There is no "look-through" for this purpose.[7] But it would presumably not be "abusive" for the taxpayer to ask the foreign affiliate to instead act as an agent of the U.S. affiliate in placing the U.S. affiliate into a hedging transaction directly with the unrelated party. The taxpayer would have to ensure, however, that the relevant facts and circumstances allowed it to conclude that the foreign affiliate was acting as an agent, rather than as a principal, under relevant U.S. tax principles.[8]

GLOBAL TRADING AND DEALING

Likewise, the Preamble expressly states that "a global dealing operation in which participants manage a single book of assets, bear risk, and share in trading profits may be viewed as co-ownership of the trading

[5] *See* Preamble at 31; Preamble at 172 ("[A]mounts of income and deduction are generally determined on a gross basis under the Code, and unless a rule permits netting (so that there is no deduction or the deduction is a reduced amount, as opposed to a deduction offset by an item of income), no netting is permitted.").

[6] Preamble at 33 ("[W]hether the amount of income or deductions with respect to financial contracts that provide for offsetting payments is taken into account on a gross or net basis is determined under generally applicable federal income tax law.").

[7] Preamble at 36–37 ("The final regulations do not provide for a netting rule for related-party hedging transactions.").

[8] Likewise, the Final Regulations clarify that unlike the case where a U.S. affiliate buys goods from a foreign affiliate and sells them to unrelated U.S. parties (a transaction that does not give rise to any deductible payment to which BEAT could apply, under the so-called "cost of goods sold exception"), a U.S. affiliate that buys goods from a foreign affiliate and leases them to unrelated parties will be required to treat its deductions for depreciation of the purchased property as Base Erosion Tax Benefits. *See* Preamble at 65–66. But under the right set of facts, nothing would prevent that U.S. affiliate from properly characterizing its leases as sales for U.S. tax purposes.

positions or similar arrangement, with no deductible payments made by the participants for purposes of section 59A."[9] In other words, in receiving and then remitting a share of such profits to a related foreign person, a U.S. taxpayer is in effect acting as an agent and therefore does not have either income or offsetting deduction. The Final Regulations clearly do not view as abusive the taxpayer's decision to conduct and characterize its operations in this manner.

Whether that is in fact what is happening for U.S. tax purposes, however, is determined by all the relevant facts and circumstances, including not merely the relevant documentation, but also the economic substance of the relationship. If, for example, a foreign affiliate receives fixed amounts from a U.S. affiliate that do not vary with the relevant trading profits but rather increase directly in proportion to the amount of services that the foreign affiliate performs or provides, it is conceivable that the taxpayer's characterization of the payments as a "share" of relevant trading profits might be recharacterized as a deductible payment made in exchange for services under general U.S. tax principles.

QUALIFIED DERIVATIVE PAYMENTS

Likewise, the Final Regulations condition the availability of an exception for "qualified derivative payments" (as defined in Part B.5, below) on characterization of a financial transaction as a derivative under general U.S. tax principles. In this regard, the Preamble expressly states that when a U.S. taxpayer "repos in" stock or securities from a related foreign person, the related foreign person continues to own those stock and securities under general U.S. tax principles (because the U.S. taxpayer is treated as merely holding security for a loan of cash to the related foreign person); it follows that the U.S. taxpayer's remittance to the related foreign person of dividends or interest on the underlying stock or securities does not give rise to income and offsetting deduction in the hands of the U.S. taxpayer (with the latter constituting a Base Erosion Tax Benefit).[10] Rather, such remittance gives rise to neither, because the U.S. taxpayer is in effect acting as an agent for the related foreign person's receipt of interest income.[11]

By contrast, when a U.S. taxpayer "borrows" the same stock or securities from a related foreign person, the related foreign person ceases to own the property under general U.S. tax principles. Importantly, and unlike the 2018 Proposed Regulations, the Final Regulations concede that in such a case, the U.S. taxpayer's remittance of "substitute" dividends, interest or borrowing fees to the related foreign person is made in respect of a derivative relationship, and the associated deduction can therefore meet the requirements of the exception for deductions for qualified derivative payments.[12]

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9 Preamble at 30–31.

10 Preamble at 127 ("[I]n the sale-repurchase transaction, the remittances on the collateral by the nominal buyer to the nominal seller are treated as a payment from the issuer of the security to the nominal seller for U.S. federal income tax purposes.").

11 *See* Treas. Regs. §. 1.59A-6(d)(2); Preamble at 125, 129.

12 *See* Preamble at 129, 188.

Whether the transaction is in fact a repo or a securities borrowing, however, is based on general U.S. tax principles. Thus, where a U.S. taxpayer purportedly repos in stocks or securities from a related foreign person but then sells them in the market to cover a short position, the transaction may in fact be a derivative (*i.e.*, a stock or securities borrowing) under general U.S. tax principles, regardless of what documentation is used.[13] Conversely, where a U.S. taxpayer purports to borrow stock or securities from a related foreign person but then fails to sell them to anyone else, the transaction may in fact be a mere repo under general U.S. tax principles.[14]

The Final Regulations further clarify that in either case, deductions for interest paid in respect of cash received from a related foreign person in respect of such transactions (*i.e.*, where a U.S. taxpayer repos or lends *out* stocks or securities to a related foreign person and receives cash in exchange) are Base Erosion Tax Benefits.[15] Moreover, the Final Regulations provide an anti-abuse rule that treats transactions as unsecured cash borrowings, rather than as derivatives, if that is their economic substance and they are entered into with a principal purpose of avoiding the treatment of payments as Base Erosion Payments.[16] *See* Part B.5, below.

LOSSES

The Preamble states that in the view of Treasury and the IRS, deductions for losses arising from changes in the value of a U.S. taxpayer's property or financial positions are not "allowed with respect to" a payment to a related foreign person (*i.e.*, are not Base Erosion Tax Benefits) merely because a related foreign person is involved in the transaction whereby the taxpayer realizes the loss.[17] As a technical matter, the Final Regulations themselves (unlike the Preamble) do not provide more on this point than that transferring built-in loss property to a related foreign person does not give rise to a Base Erosion Payment (a conclusion that may be of limited significance, because the deduction for any loss arising from such a transfer would normally be deferred or disallowed under Section 267 of the Code).[18] However, similar logic would arguably apply to losses arising from changes in the value of derivative financial contracts (*e.g.*, equity, interest rate

13 *See*, *e.g.*, *Provost v. United States*, 269 U.S. 443, 455–57 (1926).

14 *See* Treas. Regs. §. 1.59A-6(d)(2)(iii)(A) (expressly providing that a derivative does not include "a securities lending transaction . . . that is treated as a secured loan for Federal tax purposes.").

15 *See* Treas. Regs. § 1.59A-6(c)(1).

16 *See* Treas. Regs. § 1.59A-6(d)(2)(iii)(C).

17 *See*, *e.g.*, Preamble at 39–40 ("That is, the term 'base erosion payment' does not include the amount of built-in-loss because that built-in-loss is unrelated to the payment made to the foreign related party.").

18 *See* Treas. Regs. § 1.59A-3(b)(2)(ix).

or commodity swaps, options, and forward contracts)[19] notwithstanding that the contracts are entered into with related foreign persons and notwithstanding that they are settled in cash.[20] *See* Part B.3, below.

FOREIGN CURRENCY LOSSES

Unlike the 2018 Proposed Regulations, the Final Regulations do not generally exclude deductions for foreign currency losses from the denominator of the taxpayer's Base Erosion Percentage for purposes of determining whether BEAT applies to the taxpayer.[21] However, the anti-abuse rule of the 2018 Proposed Regulations continues to apply to disregard transactions (including particularly economically offsetting transactions) the principal purpose of which is to inflate the denominator of the fraction.[22] *See* Part B.5, below.

TAX-FREE REORGANIZATIONS

Unlike the 2018 Proposed Regulations, the Final Regulations do not generally treat payments made pursuant to tax-free reorganizations and other non-recognitions transactions (*e.g.*, transactions under Sections 332, 351 and 368 of the Code) as Base Erosion Payments. (The concern under the Proposed Regulations was that as a result of such treatment, deductions for the depreciation of property acquired in such transactions might have been treated as Base Erosion Tax Benefits.)[23] However, any portion of such payments that arises from a taxable portion of an applicable transaction—*e.g.*, on account of rules dealing with "boot", excess liabilities or a taxable liquidation under Section 331—may be treated as Base Erosion Payments.[24] *See* Part B.2, below.

EFFECTIVELY CONNECTED DEDUCTIONS OF U.S. BRANCHES

The Final Regulations broadly follow the rules of the 2018 Proposed Regulations for determining when deductions for interest deemed paid by the U.S. branch of a foreign financial institution give rise to Base

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19 *See* Preamble at 21 ("[M]ark-to-market loss arising from a deemed sale or disposition of a third-party security held by a taxpayer is not within the general definition of a base erosion payment because the loss is not attributable to any payment made to a foreign related party.").

20 As the Preamble notes, such contracts may in many cases be eligible regardless for the "qualified derivative payments" exception referenced above, but the distinction may nevertheless be relevant both for purposes of determining whether such losses are excluded from the denominator of the Base Erosion Percentage fraction and also for purposes of qualified derivative payment reporting. *See* Preamble at 21.

21 *See* Preamble at 75.

22 *See* Preamble at 156; Treas. Regs. § 1.59A-9(b)(2). The Regulations do exclude from the denominator deductions for losses from foreign currency transactions that are excluded from the numerator. Preamble at 75; Treas. Regs. § 1.59A-2(e)(3)(ii)(D). As discussed above, however, it is not clear that such transactions are ever "excluded" from the numerator, as opposed to not belonging in the numerator to begin with because they are not allowed "with respect to" payments made to foreign related persons.

23 *See* preamble to the 2018 Proposed Regulations, 83 FR 65956, 65960.

24 Preamble at 44–46.

Erosion Tax Benefits.[25] The Final Regulations contain a number of simplifying technical rules, however.[26] *See* Part B.6, below. The Final Regulations also extend the exception for interest paid on U.S. government-mandated TLAC ("total loss-absorbing capacity") securities to interest paid on similar indebtedness incurred by foreign corporations pursuant to foreign regulatory law and deemed paid in part by a U.S. branch under U.S. tax regulations.[27] *See* Part B.5, below.

QUALIFIED DERIVATIVES REPORTING

The Final Regulations likewise include further guidance on the required reporting of deductions for qualified derivative payments and extend a good faith safe harbor for such reporting to all taxable years beginning before June 7, 2021. However, as noted above, there may be continuing uncertainty regarding how to deal with payments that may or may not be excluded by reason of the derivatives exception (as opposed to payments excluded for some other reason) and how to deal with the limited ability of systems to distinguish among payments on the basis of technical tax distinctions. *See* Part B.5, below.

PARTNERS AND PARTNERSHIPS

The Final Regulations continue the "aggregate approach" of the 2018 Proposed Regulations for purposes of characterizing deductions as Base Erosion Tax Benefits in the hands of partners of a partnership. The Final Regulations provide some additional guidance, however, on how the aggregate approach operates in practice. *See* Part C.1, below. The Final Regulations decline, in this regard, to provide consistency with the treatment of corporate nonrecognition transactions. *See* Part C.2, below.

The New Proposed Regulations contain anti-abuse rules designed to deal with the ability of partnerships to specially allocate items of income and deduction, including to allocate deductions for Base Erosion Payments away from partners that are subject to BEAT. It is not clear how these rules would interact with current general rules of partnership tax law requiring such special allocations to have "substantial economic effect". Similarly, the New Proposed Regulations contain an anti-abuse rule to deal with the interposition of a financial institution that effectively converts shares of partnership income into payments on a derivative. It is not clear how this rule would interact with the general anti-abuse rule for interposition of a "conduit" that is contained in the Final Regulations. *See* Part E.3, below.

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25 *See* Preamble at 52–54.

26 *See* Preamble at 52–56.

27 *See* Preamble at 77–78; Treas. Regs. § 1.59A-3(b)(3)(v).

BACKGROUND

Section 59A of the Internal Revenue Code of 1986, as amended,[28] added by the comprehensive tax reform legislation commonly known as the Tax Cuts and Jobs Act of 2017, introduced the concept of BEAT. Conceptually, BEAT imposes a minimum tax on an alternatively computed tax base of certain taxpayers (both U.S. and non-U.S.) intended, as its name suggests, to reduce the incentive for such taxpayers to make deductible payments to related foreign persons that would reduce the U.S. tax base.

The actual imposition of BEAT works generally in a mechanical manner, requiring the determination of several BEAT-specific items. First, the Applicable Taxpayer (as defined below) must identify all payments to a non-U.S. person deemed to be related to the Applicable Taxpayer under special attribution rules (such payment, a "Base Erosion Payment") and the tax benefits with respect to such Base Erosion Payments (such tax benefit, the "Base Erosion Tax Benefit"). Next, the Applicable Taxpayer must divide the aggregate amount of Base Erosion Tax Benefits for the taxable year by the total amount of deductions and any other tax benefits treated as a Base Erosion Tax Benefit for the taxable year (such quotient, the "Base Erosion Percentage"). If the Base Erosion Percentage exceeds 3% (2% in the case of a member of an affiliated group that includes certain financial institutions) (the "Base Erosion Percentage Test"), the Applicable Taxpayer must determine its "modified taxable income," which is the taxpayer's regular taxable income determined without regard to any "Base Erosion Tax Benefit" and the "Base Erosion Percentage" of any net operating loss deduction allowed under Section 172 for the taxable year.

Once such BEAT-specific items are determined, the amount of tax imposed by the BEAT on the Applicable Taxpayer equals the excess (if any) of (i) the "BEAT Rate"[29] multiplied by modified taxable income over (ii) the regular tax liability of the taxpayer reduced by certain credits.

Only a corporate taxpayer that meets the following conditions is subject to BEAT (such taxpayer, an "Applicable Taxpayer"): (i) it is not a regulated investment company, real estate investment trust or S corporation; (ii) it has average annual gross receipts of at least $500 million for the 3-taxable-year-period ending with the preceding taxable year (the "Gross Receipts Test"); and (iii) it meets the Base Erosion Percentage Test. For purposes of the Gross Receipts Test and Base Erosion Percentage Test, special aggregation rules apply to treat a group of corporations under common control as one person (such aggregated corporations, the "Aggregate Group").

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[28] References herein to a "Section" are to sections of the Code and the Treasury regulations ("Treasury Regulations" or "Treas. Regs.") promulgated thereunder.

[29] The BEAT Rate is 5% for taxable years beginning in 2018, 10% for taxable years thereafter until 2025, and 12.5% for taxable years beginning after December 31, 2025. Treas. Regs. § 1.59A-5(c)(1). In addition, each of the percentages mentioned in the preceding sentence is increased by 1% for a member of an affiliated group that includes a bank or a registered securities dealer (*i.e.*, 6% in 2018, 11% until 2025, and 13.5% thereafter). Treas. Regs. § 1.59A-5(c)(2).

DISCUSSION

The Final Regulations generally adopt the 2018 Proposed Regulations, subject to some noteworthy modifications. The discussion below addresses some of the most important modifications of the 2018 Proposed Regulations contained in the Final Regulations as well as the key provisions of the New Proposed Regulations.

A. AGGREGATE GROUPS

1. Taxable years of members of an Aggregate Group (new "with-or-within" approach)

The Final Regulations adopt the rule contained in the 2018 Proposed Regulations that a corporation determines whether it meets the Gross Receipts Test and the Base Erosion Percentage Test by taking into account the gross receipts and the Base Erosion Tax Benefits of an Aggregate Group that includes the corporation, where applicable.[30] For purposes of applying the Gross Receipts Test and the Base Erosion Percentage Test to a corporation's Aggregate Group, the Final Regulations provide that the gross receipts, Base Erosion Tax Benefits, and deductions of members of an Aggregate Group are measured for the taxable year of each such member that ends with or within the taxable year of the corporation.[31] This convention represents a simplified approach compared to the definition in the 2018 Proposed Regulations, which would have required that the Gross Receipts Test and the Base Erosion Percentage Test be applied on the basis of the taxable year of the corporation being tested, notwithstanding that other members of the corporation's Aggregate Group might have different taxable years from such corporation and might not maintain adequate records to accurately reflect activity that occurred during the corporation's taxable year.[32] By contrast, under the Final Regulations, all deductions, gross receipts and Base Erosion Tax Benefits of an Aggregate Group member for such member's entire taxable year that ends with or within the taxable year of the corporation being tested are taken into account, reducing the burden associated with the approach of the 2018 Proposed Regulations.

2. Payments between Aggregate Group members

The Final Regulations adopt the rule of the 2018 Proposed Regulations that generally provides that payments between members of an Aggregate Group are (i) not included in the gross receipts of the Aggregate Group for purposes of applying the Gross Receipts Test and (ii) not taken into account for purposes of determining the numerator or the denominator in the Base Erosion Percentage calculation.[33] The Final Regulations clarify that a transaction between parties is disregarded for these purposes if both

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30 Treas. Regs. § 1.59A-2(c)(1), Treas. Regs. § 1.59A-2(d)(1).

31 Treas. Regs. § 1.59A-2(c)(3).

32 *See* Preamble at 13.

33 Treas. Regs. § 1.59A-2(c)(1).

parties are members of the same Aggregate Group at the time a transaction occurs, regardless of whether the parties are members of the same Aggregate Group on the last day of the taxable year.[34]

B. BASE EROSION PAYMENT

1. Application of general tax law principles to determine Base Erosion Payments

The Final Regulations generally retain the definition of Base Erosion Payment contained in the 2018 Proposed Regulations, defining the term as an amount paid or accrued by a taxpayer to a related foreign person (taking into account special attribution rules) that is described in one of four specific categories: (1) a payment with respect to which a deduction is allowable; (2) a payment made in connection with the acquisition of depreciable or amortizable property; (3) certain premiums or other consideration paid or accrued for reinsurance; or (4) a payment resulting in a reduction of the gross receipts of the taxpayer that is with respect to certain surrogate foreign corporations or related foreign persons.[35] The Preamble explains that the IRS rejected comments requesting that a rule provide that the amount of a Base Erosion Payment be determined by reducing the amount of a payment by the amount of another corresponding obligation.[36]

2. Nonrecognition transactions

The Final Regulations retain the rule stated in the 2018 Proposed Regulations clarifying that payments or accruals of both cash and non-cash consideration (such as stock or assumption of liability) may be Base Erosion Payments.[37] However, the Final Regulations depart from the 2018 Proposed Regulations by providing that in general, an amount transferred to or exchanged with a related foreign person pursuant to an exchange described in Section 351, a liquidation described in Section 332, a distribution described in Section 355 or a reorganization described in Section 368, does not result in a Base Erosion Payment.[38] The Preamble highlights comments to the 2018 Proposed Regulations that pointed out that such nonrecognition transactions often do not give rise to stepped-up basis in the assets transferred to a U.S. person and often do not "erode" the U.S. tax base at all.[39] However, the exclusion added in the Final Regulations does not extend to certain "other property" transferred to or received from a related foreign person pursuant to an applicable nonrecognition transaction. For example, the transfer of property other than stock of the issuer by a domestic corporation to a foreign person pursuant to a Section 351 exchange,

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34 *Id.*

35 Treas. Regs. § 1.59A-3(b)(1).

36 Preamble at 32–33.

37 Treas. Regs. § 1.59A-3(b)(2)(ii).

38 Treas. Regs. § 1.59A-3(b)(3)(viii)(A).

39 Preamble at 42–43.

or the transfer of property other than stock or securities pursuant to a reorganization described in Section 368, may constitute a Base Erosion Payment under the Final Regulations.[40]

The Final Regulations add an anti-abuse rule that provides that the general exclusion of amounts paid pursuant to certain nonrecognition transactions from the definition of Base Erosion Payment also does not apply if a transaction or series of transactions, plan or arrangement has a principal purpose of increasing the adjusted basis of property that a taxpayer acquired in any such nonrecognition transaction.[41] The Preamble explains that in the absence of such an anti-abuse rule, the general exclusion for nonrecognition transactions could encourage a domestic corporation to transfer its own stock in exchange for property with a stepped-up basis, giving rise to higher depreciation or amortization deductions for a U.S. taxpayer without a Base Erosion Payment having been made.[42]

3. Loss transactions

The preamble to the 2018 Proposed Regulations stated that a payment to a related foreign person resulting in losses recognized by the taxpayer could be a Base Erosion Payment.[43] Commenters objected that when a U.S. taxpayer sells property to a related foreign person for cash and accordingly recognizes a loss, no "payment or accrual" by the U.S. taxpayer occurs, and even if such a payment or accrual does occur, the U.S. taxpayer's deduction for the recognized loss is attributable to the U.S. taxpayer's built-in loss in the property, rather than the payment or accrual.[44] The Final Regulations thus provide that a loss recognized on the sale or transfer of property to a related foreign person is not a deduction that causes the transfer of property to be treated as a Base Erosion Payment.[45] However, the Final Regulations further provide that if a taxpayer uses property to make a deductible payment to a related foreign person, such use may give rise to a Base Erosion Payment equal to the fair market value of the property at the time of the transfer.[46]

4. Distributions

The Final Regulations provide that a distribution by a corporation with respect to its stock not in exchange for consideration does not give rise to a Base Erosion Payment by the shareholder, but a redemption of stock by a corporation in exchange for property generally is treated as an amount paid or accrued by the

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40 Treas. Regs. § 1.59A-3(b)(3)(viii)(B)–(E).

41 Treas. Regs. § 1.59A-9(b)(4).

42 Preamble at 48.

43 Preamble to the 2018 Proposed Regulations, 83 FR at 65960.

44 Preamble at 38–40.

45 Treas. Regs. § 1.59A-3(b)(2)(ix).

46 *Id.*

shareholder to the corporation and thus may give rise to a Base Erosion Payment by the shareholder.[47] The latter rule also applies to a liquidation of a corporation described in Section 331.[48]

5. Exceptions to Base Erosion Payments

The 2018 Proposed Regulations contained several exceptions to the definition of Base Erosion Payment. The Final Regulations generally retain these exceptions, subject to certain revisions.

Qualified derivative payments exception. The statute provides that a qualified derivative payment ("QDP") will not be treated as a Base Erosion Payment. A QDP is defined as any payment made by a taxpayer to a related foreign person pursuant to a "derivative" for which (i) the taxpayer recognizes gain or loss on a "mark-to-market" basis, (ii) the gain or loss is ordinary, and (iii) any gain, loss, income or deduction on a payment made pursuant to the derivative is also treated as ordinary.[49] A derivative is defined as a contract the value of which is determined by reference to (but the derivative itself cannot be) stock in a corporation, debt, any actively traded commodity, any currency or any rate, price, amount, index, formula, or algorithm, but excludes certain insurance contracts.[50]

The 2018 Proposed Regulations provided that "a securities lending transaction, a sale-repurchase transaction, or any substantially similar transaction" would not be a derivative under the 2018 Proposed Regulations and thus payments pursuant to such a transaction could give rise to Base Erosion Payments.[51] Responding to comments, the IRS revised this rule in the Final Regulations to provide that a securities lending transaction is no longer excluded from the definition of "derivative," but the "cash leg" of such a transaction is so excluded.[52] The Preamble explains that commenters noted that the loan of a security represents a contract the value of which, or any payment or other transfer with respect to which, is directly or indirectly determined by reference to a share of stock in a corporation, and thus the loan should be treated as a derivative; whereas cash transferred to the securities lender pursuant to a securities loan is essentially a cash borrowing rather than a derivative.[53] Accordingly, the Preamble states that payments made with respect to the securities leg of a securities lending transaction, such as a borrowing fee or a substitute payment, may qualify as a QDP.[54]

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[47] Treas. Regs. § 1.59A-3(b)(2)(ii).

[48] *Id.*

[49] Section 59A(h)(2).

[50] Section 59A(h)(4).

[51] Fmr. Prop. Treas. Regs. § 1.59A-6(d)(2)(iii).

[52] Preamble at 129; § 1.59A-6(d)(2)(iii).

[53] Preamble at 127.

[54] Preamble at 129, 188.

The Final Regulations also add an anti-abuse rule that provides that a securities lending transaction or substantially similar transaction that is part of an arrangement entered into with a principal purpose of avoiding the treatment of any payment with respect to that transaction as a Base Erosion Payment and that provides the taxpayer with the economic equivalent of a substantially unsecured cash borrowing is not treated as a "derivative" for purposes of the QDP exception.[55]

Qualified derivative payment reporting. The statute provides that the QDP exception applies only if certain reporting requirements are met.[56] The Final Regulations provide that these requirements apply to all taxpayers.[57] For purposes of determining the aggregate QDP amount that must be reported on IRS Form 8991, the Final Regulations provide that taxpayers may use the net amount with respect to each derivative transaction, excluding for this purpose any payment made with respect to a derivative that is excluded from QDP status or otherwise treated as a type of payment that is not a derivative payment.[58] The Final Regulations also provide that for taxable years beginning prior to June 7, 2021, the QDP reporting requirements will be treated as satisfied to the extent that a taxpayer reports the aggregate amount of qualified derivative payments on IRS Form 8991 in good faith.[59]

Total loss-absorbing capacity ("TLAC") securities exception. Consistent with the 2018 Proposed Regulations, the Final Regulations provide that amounts paid or accrued to related foreign persons with respect to TLAC securities are not Base Erosion Payments. The Final Regulations also add a similar rule with respect to "foreign TLAC securities".[60]

TLAC securities are debt securities issued by certain global systemically important banking organizations (GSIBs) intended to absorb losses and minimize the risk of insolvency and are required to be issued by GSIBs under the regulations issued by the Board of Governors of the Federal Reserve.[61] The Final Regulations define "foreign TLAC security" to mean a debt security issued under a bank regulatory requirement imposed under the laws or regulations of a foreign country that are comparable to the provisions of U.S. law that require issuance of TLAC securities.[62] For purposes of determining the amount of payments with respect to foreign TLAC securities that a U.S. trade or business or permanent establishment is permitted to exclude from treatment as a Base Erosion Payment, the amount of TLAC debt required by foreign law to be put into place is treated as equal to the lower of (1) the amount of TLAC

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55 Treas. Regs. § 1.59A-6(d)(2)(iii)(C).

56 Section 59A(h)(2)(B).

57 Treas. Regs. § 1.59A-6(b)(2)(i).

58 Preamble at 133; Treas. Regs. § 1.59A-6(b)(2)(iii); Treas. Regs. § 1.59A-6(b)(3)(ii).

59 Treas. Regs. § 1.59A-3(b)(2)(iv).

60 Treas. Regs. § 1.59A-3(b)(3)(v)(A).

61 Treas. Regs. § 1.59A-1(b)(20), citing 12 C.F.R. § 252.161.

62 Treas. Regs. § 1.59A-3(b)(3)(v)(F)(4).

debt that would be required to be put into place by a U.S. trade or business or permanent establishment pursuant to rules established by the Federal Reserve Board for TLAC if the trade or business or permanent establishment were a domestic subsidiary that is subject to Federal Reserve Board requirements and (2) the minimum amount, if any, of TLAC debt that is specified by the bank regulatory requirements of the applicable foreign country that are comparable to the requirements established by the Federal Reserve Board.[63]

Exchange loss exception. Consistent with the 2018 Proposed Regulations, the Final Regulations provide that exchange losses from certain transactions involving nonfunctional currency ("Section 988 losses") are not Base Erosion Payments.[64] However, the Final Regulations exclude Section 988 losses from the denominator of the Base Erosion Percentage only to the extent that any such losses are excluded from the numerator by reason of the exclusion for Section 988 losses.[65] As noted in "Overview—Losses", above, however, it is not clear that deductions for Section 988 losses are excluded from the numerator on that basis, as opposed to simply not relating to payments to foreign related persons.

6. Interest expense and other deduction allocations in the case of ECI

BEAT applies to foreign corporations that have income subject to U.S. net income taxation as "effectively connected income" ("ECI"), taking into account any applicable income tax treaty. The Final Regulations modify the approach that the 2018 Proposed Regulations took with respect to allocating U.S. branch interest expense to payments or accruals to related foreign persons, which approach applied different sets of rules to taxpayers depending on their method of allocating such interest expense for U.S. tax purposes. The Final Regulations instead apply a uniform methodology to all applicable taxpayers, providing that interest expense that is allocable to ECI constitutes Base Erosion Payments equal to the sum of (1) the amount of interest expense that is directly allocated to liabilities paid or accrued to a related foreign person, (2) the amount of interest expense allocated to "U.S.-booked liabilities" paid or accrued to a related foreign person, and (3) the amount of interest expense allocated to "U.S.-connected liabilities" to the extent in excess of the amount allocated to U.S.-booked liabilities, multiplied the ratio of all interest paid to related foreign persons over worldwide interest expense.[66]

In addition to applying uniformly to the allocation of interest expense by U.S. branches of foreign corporations irrespective of the methodology used by the foreign corporation to allocate interest expense under Treasury Regulations Section 1.882-5, the allocation methodology set forth above also is subject to additional simplifying conventions that were adopted in response to comments to the 2018 Proposed Regulations. The use of a ratio of worldwide interest expense, as described in clause (3), above, is a

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63 Treas. Regs. § 1.59A-3(b)(3)(v)(F)(2)–(3).

64 Treas. Regs. § 1.59A-3(b)(3)(iv).

65 Preamble at 75; Treas. Regs. § 1.59A-2(e)(3)(ii)(D).

66 Treas. Regs. § 1.59A-3(b)(4)(i).

departure from the 2018 Proposed Regulations, which would have required the use of a ratio of liabilities incurred to related foreign persons over worldwide liabilities for purposes of allocating interest expense on U.S.-connected liabilities.[67] This change was made in response to comments to the 2018 Proposed Regulations indicating that U.S. branches of foreign banks may not have access to information necessary to determine the worldwide liabilities of the foreign bank. In addition, in response to comments indicating that it may be difficult for foreign entities that do not ordinarily classify payments as interest in accordance with U.S. tax principles to do so for BEAT purposes, the Final Regulations permit taxpayers to rely on financial statements for purposes of determining the worldwide interest ratio.[68]

7. Internal dealings

The 2018 Proposed Regulations provided special rules for determining the extent to which interest expense should be allocated to ECI pursuant to the business profits provision of an income tax treaty. The 2018 Proposed Regulations generally required that where a foreign corporation determines the profits attributable to a permanent establishment based on the assets used, risks assumed and functions performed by the permanent establishment, transactions between the permanent establishment and the home office or other branches of the foreign corporation ("Internal Dealings") would be treated as being actually paid or accrued for purposes of determining whether there is a Base Erosion Payment.[69] However, in part in response to comments that suggested that interest expense allowed to a permanent establishment as internal dealings may often represent interest expense on back-to-back loans among the permanent establishment, the home office, and another entity, the IRS revised its approach to Internal Dealings, such that the Final Regulations provide that interest expense determined in accordance with an income tax treaty is determined in a manner generally consistent with the treatment of interest expense as determined under the rules of Treasury Regulations Section 1.882-5, which is the provision pursuant to which interest expense is allocated to ECI outside the context of an income tax treaty.[70] The Final Regulations require the determination of a hypothetical allocation under that provision of the Treasury Regulations, notwithstanding that different rules may apply for non-BEAT purposes.[71] Interest expense determined in accordance with a tax treaty that is in excess of the hypothetical determination under Treasury Regulations Section 1.882-5 is entirely treated as interest expense paid by the permanent establishment to the home office or another branch of the applicable foreign corporation (and thus generally constitutes a Base Erosion Payment),[72] because, according to the Preamble, internal dealing permits a permanent establishment to replace external borrowing with internal dealing, such that any interest expense allocated to the permanent

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[67] Preamble at 55.

[68] Preamble at 55–56; Treas. Regs. § 1.59A-3(b)(4)(i)(D).

[69] Fmr. Prop. Treas. Regs. § 1.59A-3(b)(4)(v)(B).

[70] Treas. Regs. § 1.59A-3(b)(4)(v).

[71] Treas. Regs. § 1.59A-3(b)(4)(i)(E).

[72] Treas. Regs. § 1.59A-3(b)(4)(i)(E)(1).

establishment in excess of what would be allocated under Treasury Regulations Section 1.882-5 should be treated as an internal payment.[73]

C. APPLICATION OF BEAT TO PARTNERSHIPS

1. Treatment as aggregates

The 2018 Proposed Regulations generally applied the aggregate theory of partnerships by treating payments to and from a partnership as payments made to and from each partner (in an amount equal to such partner's distributive share).[74]

The Final Regulations provide more detailed rules than the 2018 Proposed Regulations for purposes of applying the aggregate theory to partnerships in the context of BEAT. The Final Regulations provide that if depreciable or amortizable property is contributed to a partnership, each partner in the partnership is treated as receiving a proportionate share of the property for purposes of determining whether a Base Erosion Payment was made in connection with the contribution.[75] Similarly, if a partnership transfers property to a partner, each partner is treated as transferring its proportionate interest in the property, and if an interest in a partnership is transferred, the transferor is treated as transferring a proportionate share of the partnership's assets.[76] If a taxpayer acquires an interest in an asset of a partnership from a partnership that has a foreign person that is related to the taxpayer as a partner, the transaction generally will be treated as giving rise to a Base Erosion Payment.[77] The Final Regulations also provide that if a distribution of property from a partnership gives rise to an increase in the basis of property held by the partnership or the property distributed to the partner, any such increase in basis that is attributable to a related foreign person is treated as newly purchased property by the taxpayer from the related foreign person for purposes of determining whether the taxpayer is treated as making a Base Erosion Payment.[78]

2. Nonrecognition transactions

Notwithstanding the rule in the Final Regulations that a transaction described in Section 351 generally does not give rise to a Base Erosion Payment by a domestic corporation that transfers its own stock, the Preamble expressly declines to extend a similar rule to partnerships and instead states that where a domestic corporation contributes depreciable property to a partnership in which a related foreign person is

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73 Preamble at 61–62.

74 Fmr. Prop. Treas. Regs. § 1.59A-7(b).

75 *See* Treas. Regs. § 1.59A-7(c)(1).

76 *See* Treas. Regs. § 1.59A-7(c)(2)–(3).

77 *See* Treas. Regs. § 1.59A-7(c); Preamble at 148. This rule applies only to acquisitions of such property on or after January 1, 2018 and applies regardless of whether the partnership has a Section 754 election in effect.

78 *See* Treas. Regs. § 1.59A-7(c)(4); Preamble at 149.

also a partner, the transaction is treated as a partner-to-partner exchange that could give rise to a Base Erosion Payment.[79]

D. OTHER SPECIAL RULES

1. Insurance companies

The preamble to the 2018 Proposed Regulations noted that there could be a disparity in the treatment of domestic life insurance companies and non-life insurance companies that may lead to asymmetric outcomes for BEAT purposes, because certain payments incurred by domestic insurance companies that provide reinsurance to related foreign insurance companies are (i) deductible payments that would potentially be a Base Erosion Payment, in the case of a domestic life insurance company, or (ii) payments that reduce gross income that would not be a Base Erosion Payment, in the case of a domestic non-life insurance company.[80] In response to comments with respect to this issue, the Final Regulations provide an exception from the definition of Base Erosion Payment for deductible amounts for losses incurred (as defined in Section 832(b)(5)) and claims and benefits (as defined in Section 805(a)) pursuant to reinsurance contracts, to the extent that the amounts paid or accrued to a related foreign insurance company are allocable to amounts required to be paid by such company pursuant to an insurance, annuity or reinsurance contract to a person other than a related person.[81] Any amounts that are so excluded from the definition of Base Erosion Payment are excluded from both the numerator and the denominator of the Base Erosion Percentage.[82]

2. Anti-abuse rules

Both the 2018 Proposed Regulations and the Final Regulations contain multiple anti-abuse rules targeting specific transactions. Two of the more broadly applicable anti-abuse rules apply if (1) a taxpayer pays or accrues an amount to an intermediary who then makes a corresponding payment to a related foreign person (of the taxpayer) in a plan that has a principal purpose of avoiding or reducing a Base Erosion Payment, or (2) a transaction, plan or arrangement that has a principal purpose of increasing deductions included in the denominator of the Base Erosion Percentage is disregarded.[83]

The Final Regulations add multiple examples that are intended to elucidate the "principal purpose" standard applied by these rules. In one of the added examples, a domestic affiliate of a foreign corporation purchases equipment from the foreign corporation and then resells the equipment to another domestic affiliate of the foreign corporation. Although the first domestic affiliate capitalizes its purchases into inventory and cost of

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79 Preamble at 138.

80 Preamble to the 2018 Proposed Regulations, 83 FR at 65968.

81 *See* Treas. Regs. § 1.59A-3(b)(3)(ix).

82 Treas. Regs. § 1.59A-2(e)(3)(ii)(F).

83 Treas. Regs. § 1.59A-9(b)(1)–(2).

goods sold (and thus did not purchase depreciable property from the foreign corporation so as to give rise to a Base Erosion Payment), the second domestic affiliate is treated as having made a Base Erosion Payment to purchase the equipment from the foreign corporation, in part because the example states that the transactions were organized with a principal purpose of avoiding a Base Erosion Payment.[84]

In another example added by the Final Regulations, even though a domestic financial institution enters into both a long position and a short position with different unrelated counterparties on the same day with respect to stock in the same issuer, the fact that the financial institution did not enter into these transactions with a principal purpose of increasing deductions taken into account for purposes of calculating the denominator of the Base Erosion Percentage is sufficient to prevent the anti-abuse rule from applying.[85]

3. Initial year tax rate for fiscal year taxpayers

Under the statute, the BEAT Rate is generally 10 percent but is "5 percent in the case of taxable years beginning in calendar year 2018."[86] The 2018 Proposed Regulations provided that Section 15 would apply to any taxable year beginning after (but not including) January 1, 2018, such that a taxpayer using such a taxable year would be subject to a blended tax rate that would be a blend of the 5 percent rate and the 10 percent rate for such taxable year.[87] However, the Final Regulations have revised this rule and provide that Section 15 does not apply to taxable years beginning in calendar year 2018, such that the BEAT Rate with respect to such taxable years is 5 percent.[88] However, the Final Regulations provide that the change in the BEAT Rate from 10 percent to 12.5 percent that is scheduled to occur for taxable years beginning after December 31, 2025 will be subject to a blended rate in an applicable transition year under Section 15.[89]

E. THE NEW PROPOSED REGULATIONS

1. Election to waive deductions

The New Proposed Regulations provide that a taxpayer may elect to "waive" certain deductions (a "Waiver Election") on an item-by-item basis, such that for purposes of the definition of Base Erosion Tax Benefit, any waived deductions would reduce the amount of "allowed deductions" of the taxpayer.[90] The effect of a Waiver Election would be that the applicable deduction would be treated as being waived for all purposes of the Code and Treasury Regulations.[91] The taxpayer would be permitted to make a Waiver Election on

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84 Treas. Regs. § 1.59A-9(c)(6).

85 Treas. Regs. § 1.59A-9(c)(8).

86 Section 59A(b)(1).

87 Fmr. Prop. Treas. Regs. § 1.59A-5(c)(1).

88 Preamble at 121; Treas. Regs. § 1.59A-5(c)(1).

89 Preamble at 121; Treas. Regs. § 1.59A-5(c)(1).

90 *See* Prop. Treas. Regs. § 1.59A-3(c)(6).

91 Prop. Treas. Regs. § 1.59A-3(c)(6)(ii)(A).

an original filed federal income tax return, on an amended return, or during the course of an examination with respect to a return, but a taxpayer would not be permitted to decrease the amount of deductions waived pursuant to a Waiver Election or otherwise revoke a Waiver Election on an amended return or during the course of an examination.[92] The Waiver Election would be made on an annual basis on IRS Form 8991 and would require a detailed description of the item to which the applicable deduction relates.[93]

The preamble to the New Proposed Regulations notes that the IRS and Treasury are concerned that in the absence of procedural safeguards, taxpayers making a Waiver Election could reduce their amount of Base Erosion Tax Benefits while using some or all of the forgone deductions in a subsequent taxable year.[94] Accordingly, the New Proposed Regulations provide that if a taxpayer waives a deduction and subsequently makes an accounting method change, the waived portion of the applicable item would not be taken into account in determining the amount of the adjustment resulting from the accounting method change.[95] The New Proposed Regulations also provide that a Waiver Election would be disregarded for purposes of determining any item as necessary to prevent a taxpayer from receiving the benefit of a waived deduction.[96]

2. Determination of a taxpayer's Aggregate Group

The New Proposed Regulations propose additional rules that would apply in connection with the "with-or-within" rule that was added by the Final Regulations for purposes of applying the Gross Receipts Test and Base Erosion Percentage Test to Aggregate Groups. *See* Part A.1, above. The New Proposed Regulations would provide that in the case of a taxpayer with a short taxable year, the taxpayer must use a reasonable approach to avoid over-counting or under-counting deductions, gross receipts, and Base Erosion Tax Benefits,[97] in part in order to avoid distortions that could arise from the convention that gross receipts are annualized and apportioned ratably for purposes of allocating gross receipts to a short taxable year.[98]

In addition, the New Proposed Regulations would provide that for purposes of applying the Gross Receipts Test and the Base Erosion Percentage Test to an Aggregate Group one of whose members joins or leaves the Aggregate Group, only items of members that occur during the period that they are members of the Aggregate Group are taken into account by the applicable taxpayer, on the basis of a deemed ending of the taxable year of a member at the time that it joins or leaves an Aggregate Group.[99]

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92 Prop. Treas. Regs. § 1.59A-3(c)(6)(iii).

93 Prop. Treas. Regs. § 1.59A-3(c)(6)(i).

94 Preamble to the New Proposed Regulations at 12.

95 Prop. Treas. Regs. § 1.59A-3(c)(6)(ii)(D).

96 Prop. Treas. Regs. § 1.59A-3(c)(6)(ii)(B)(7).

97 Prop. Treas. Regs. § 1.59A-2(c)(5).

98 Preamble to the New Proposed Regulations at 6–8.

99 Prop. Treas. Regs. § 1.59A-2(c)(4).

3. Anti-abuse rules applicable to partnerships

The New Proposed Regulations would add two additional BEAT anti-abuse rules: one such rule would provide that a taxpayer is treated as having a direct interest in a partnership if the taxpayer instead acquires a derivative on the partnership as part of a transaction, plan or arrangement that has a principal purpose of avoiding a Base Erosion Payment and the partnership interest (or partnership assets) would have resulted in a Base Erosion Payment had the taxpayer acquired the interest or asset directly.[100] The second proposed anti-abuse rule would provide that if a partnership receives or accrues income from a person not acting in a partner capacity and allocates such income to partners in a manner that does not change the economic arrangement of the partners but with a principal purpose of avoiding a Base Erosion Payment or reducing the amount of a Base Erosion Payment, then the taxpayer transacting with the partnership would determine its Base Erosion Payment as if the allocations had not been made and the items of income had been allocated proportionately.[101]

F. EFFECTIVE DATES AND COMMENT PERIOD

The Final Regulations generally apply to taxable years ending on or after December 17, 2018. Taxpayers may apply the Final Regulations in their entirety for taxable years beginning after December 31, 2017 and ending before December 17, 2018.[102]

If finalized, the New Proposed Regulations would generally apply to taxable years beginning after the date that final regulations are published in the Federal Register.[103] Until finalization, taxpayers may rely on the New Proposed Regulations in their entirety for taxable years beginning after December 31, 2017.

The IRS requests comments on the New Proposed Regulations. Written or electronic comments to the New Proposed Regulations must be received by the IRS by February 4, 2020.

Questions regarding the Final Regulations and the New Proposed Regulations may be directed to any member of the Tax Group.

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100 Prop. Treas. Regs. § 1.59A-9(b)(5).

101 Prop. Treas. Regs. § 1.59A-9(b)(6).

102 Treas. Regs. § 1.59A-10.

103 Preamble to the New Proposed Regulations at 21.

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