SQUIRE PATTON BOGGS

And the BEAT Goes On: Proposed Regulations Address Numerous Issues

On December 13, 2018, the Treasury Department and the Internal Revenue Service (IRS) issued proposed regulations to implement Section 59A of the Internal Revenue Code, the Base Erosion and Anti-Abuse Tax (BEAT), which applies with respect to certain outbound related party payments, as explained below.

The proposed regulations deal with the mechanics of the BEAT and clarify a number of important issues. Notably, the proposed regulations provide for taxpayer-favorable treatment of payments to offshore affiliates for services where the services cost method (SCM) could be used under Section 482, even if the payments include a markup over cost. The proposed regulations also contain a de minimis exception for groups that include a bank or registered securities dealer that accounts for only a small part of the overall group's business.

Overview of the BEAT

The BEAT was enacted in 2017 as part of the Tax Cuts and Jobs Act. Estimated to raise nearly US$150 billion over 10 years, the BEAT was intended to protect the US federal corporate income tax base from being eroded by tax-deductible payments made by certain large US corporate taxpayers to foreign affiliates by imposing a minimum tax regime.

An "applicable taxpayer" will have a BEAT liability for any excess of (1) the "base erosion minimum tax amount," determined by applying the BEAT tax rate[1] to the applicable taxpayer's "modified taxable income," over (2) the taxpayer's regular tax liability, as reduced by most credits (including the foreign tax credit). Modified taxable income is derived by adding back deductions for "base erosion payments" to non-resident affiliates and the rules further provide for limited use of net operating losses (NOLs) to the extent attributable to base erosion payments.

The BEAT does not allow credits other than the R&D tax credit and 80% of the low-income housing tax credit, the electricity production tax credit, and other energy tax credits, for years before 2026. No credits at all are allowed in later years in calculating the base erosion minimum tax amount. Thus, the BEAT will effectively dilute the value of many tax credits to those otherwise eligible to claim them.

Applicable Taxpayers

The BEAT applies only to corporate taxpayers with average annual domestic gross receipts of at least US$500 million over the preceding three years.

This figure is calculated for a given corporation by aggregating the domestic gross receipts of all commonly controlled corporations (both domestic and foreign, with only effectively connected income being taken into account in the case of a foreign corporation) and excludes intra-group transactions. Moreover, the BEAT applies only if the controlled group has a "base erosion percentage" of 3% or more (2% for banks and securities dealers). This is determined by reference to whether the group's deductions for payments to related foreign parties equal or exceed 3% (or 2%, if applicable) of the group's total deductions for the year.

Base Erosion Payments

Base erosion payments are payments made to a related foreign party (as defined) that generate a tax deduction (including a depreciation or amortization deduction), except:

- Payments that reduce gross receipts, such as payments included in the cost of goods sold
- Payments for services that are eligible for the SCM under Section 482
- Qualified derivatives payments
- Payments subject to US withholding tax when paid (except to the extent the withholding tax is reduced under a treaty)

Reinsurance premiums paid to an offshore affiliate are also base erosion payments.

BEAT Issues and the Proposed Regulations

The BEAT is controversial in several respects. First, it imposes US tax on amounts that may also be taxed as income by the home country of the related recipient, with no relief from double taxation. In addition, in some cases, the BEAT is imposed on amounts that are separately included in the US tax base as subpart F or GILTI inclusions, and again no relief is available for such double taxation. Finally, the BEAT arguably violates the non-discrimination provisions of US tax treaties by denying deductions for payments to residents of treaty countries that would be deductible if paid to a US taxpayer.

The proposed regulations do not deal with these issues, as Treasury and the IRS have concluded that they lack the authority to address them. Rather, the proposed regulations explain how the BEAT is calculated and clarify certain issues created by the statutory language. In addition, Treasury and the IRS exercised their interpretive authority to create some new rules, some of which are taxpayer-favorable, but some of which are not.

[1] 5% in 2018, 10% in 2019-2025, and 12.5% in 2026 and later years.

SCM Exception for Service Fees

Section 59A carves out from the definition of "base erosion payment" any amount paid for services that meet the requirements for eligibility for use of the SCM under Section 482 (other than the requirement that the services do not contribute significantly to fundamental risks of business success or failure). The carve-out only applies if "such amount constitutes the total services cost with no markup component." This statutory language created uncertainty as to whether the entire amount of an SCM-qualified payment would be treated as a base erosion payment for BEAT purposes or if just the markup component would be so treated.

The proposed regulations provide a welcome clarification, stating that an SCM-qualified payment that includes a markup component will not be a base erosion payment to the extent of the cost portion. Therefore, only the markup portion will be treated as a base erosion payment.

TLAC Exception for GSIBs

In response to policy arguments made by large banks, Treasury and the IRS provided in the proposed regulations that the term "base erosion payment" does not include a payment of interest made by a global systemically important bank (GSIB) on hybrid securities issued to meet total loss-absorbing capacity (TLAC) capital requirements of financial regulators. Specifically, the Federal Reserve Board requires US intermediate holding companies in foreign-owned GSIBs to issue TLAC securities to the foreign parent company, thereby creating a significant amount of interest payments that would be base erosion payments if not for the exception in the proposed regulations.

De Minimis Rule for Groups With a Bank or Registered Securities Dealer

To provide relief for non-financial groups that may include a company meeting the formal definition of a bank or registered securities dealer, the proposed regulations provide a *de minimis* rule, under which the base erosion percentage test for a controlled group containing a bank or registered securities dealer will be 3%, rather than 2%, if the gross receipts attributable to the bank or securities dealer are less than 2% of the group's total gross revenue.

Payments Included in US Effectively Connected Income

Treasury and the IRS also exercised their authority to provide that deductible payments subject to US tax as effectively connected income of a foreign person who is a US taxpayer will not be treated as base erosion payments.

Non-cash Case Erosion Payments: Basis Importation

In a less taxpayer-friendly fashion, Treasury and the IRS included provisions in the proposed regulations to treat non-cash payments or accruals as base erosion payments if they involve a related foreign party and result in deductions for US tax purposes. For example, if a US corporation were to issue stock to a related foreign party in exchange for depreciable property, this would be treated as a purchase of depreciable property for BEAT purposes, even though no gain or loss is recognized on the exchange under Section 351.

BEAT Mechanics

The proposed regulations explain in some detail how the BEAT is applied. For example, the statutory language is not entirely clear as to whether the controlled group that is the applicable taxpayer for purposes of the gross-receipts test and the base erosion percentage test is also the taxpayer for purposes of determining modified taxable income and the base erosion minimum tax amount. The proposed regulations clarify that this is not the case; rather, modified taxable income and the base erosion minimum tax amount must be computed separately for each US corporate taxpayer in the group (whether such taxpayer is a consolidated group or a standalone corporation, such as a foreign corporation with a US branch).

In addition, the proposed regulations provide for modified taxable income to be computed on an addback basis, rather than by way of recomputations of items in the taxpayer's regular tax computation. The rules also clarify that taxable income will be calculated as it is for "regular tax purposes." This means that the starting point for the BEAT addback could be taxable income or a taxable loss. The starting point of a taxable loss, however, may not include any NOL deduction arising from a loss carryover or carryback.

The proposed regulations also contain a number of provisions dealing with timing differences and the allocation of interest expense for BEAT purposes (e.g., between payments to unrelated parties and payments to related parties).

Once modified taxable income is calculated, the use of NOLs is limited. The proposed limitations clarify two items related to this usage. First, only post-2017 losses will be subject to the limitation, since 2018 is the first year in which a BEAT percentage would be calculated (the "vintage-year approach"). Second, and consistent with the first point, only losses arising in a year in which there is a BEAT addback will be limited under the rules (the "alternative utilization year approach"). Taxpayers should be pleased with this matching principle that applies the NOL limitation to the same year in which a base erosion percentage is calculated.

Anti-abuse Rule

The proposed regulations also contain provisions to implement the statutory provision intended to reach transactions (e.g., the use of intermediaries as conduits to avoid "base erosion payment" classification) that have a principal purpose of avoiding the BEAT.

Issues Not Addressed

The proposed regulations do not address all issues that taxpayers will encounter in applying the BEAT and, in some instances, simply direct taxpayers to apply general US tax principles (e.g., whether netting principles will be applicable in determining the amount of a taxpayer's base erosion payments to related parties).

Conclusion

The BEAT proposed regulations should be very helpful to corporate groups that are potentially within the scope of the BEAT and may previously have had difficulty in determining whether the BEAT would apply to them. The clarification of the SCM exception and the provision of the *de minimis* rule for groups with a bank or registered securities dealer are particularly welcome, as is the TLAC exception for large banking groups.

Comments on the proposed regulations will be accepted up to 60 days after the regulations are published in the Federal Register. Given the number of taxpayer-friendly provisions in the proposed regulations, it may be beneficial for some taxpayers to submit comments noting the provisions they find helpful, as well as ones they find too onerous.

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32908/12/18