Base Erosion and Anti-Abuse Tax: Proposed Regulations Do Not Concede Much

December 17, 2018

Treasury and the IRS have issued Proposed Regulations on the base erosion and anti-abuse tax (BEAT) introduced in last year's tax reform legislation. The Proposed Regulations include some changes that will be helpful to taxpayers, but by and large, they apply the BEAT rules in an inflexible way that can result in a surprisingly broad application of the BEAT to many transactions.

The BEAT rules impose a 10% minimum tax system that applies if a US company makes a deductible "base erosion payment" to a foreign affiliate (a 5% rate applies in 2018 only; the 10% rate rises to 12.5% in 2026). Payments subject to the BEAT include interest, purchases of depreciable assets and certain reinsurance payments that reduce gross income. There are exceptions for qualifying derivative payments, services provided at cost and payments subject to US withholding tax.

The BEAT applies to a US corporation if average annual gross receipts (tested on a group basis taking into account US affiliates and US branches of foreign affiliates) exceed $500M for the prior three years, and if base erosion payments to non-US affiliates are at least 3% of total deductions (2% for groups that include a bank or registered securities dealer).

Our summary below highlights important aspects of the Proposed Regulations. The regulations will not be effective until issued in final form, but once finalized, they will apply for taxable years beginning after December 31, 2017. In the meantime, taxpayers may rely on the Proposed Regulations but only if the taxpayer and all related parties apply the regulations consistently.

PROPOSED REGULATIONS

Base Erosion Payments

- The Proposed Regulations broadly define "base erosion payments" to include amounts paid or accrued to a foreign related party using cash or **any other form of consideration**, including property, stock or the assumption of a liability. These rules cover acquisitions by a US corporation of depreciable property even in transactions where no gain or loss is recognized, and sales of property at a loss.

Comment: These provisions would apply, for example, if a domestic corporation were to acquire depreciable property from a foreign related party in a tax-free contribution in exchange for the US corporation's stock.

- A US branch of a foreign corporation is subject to the BEAT rules, and the Proposed Regulations provide rules for allocating to the US branch interest and other expenses **that a foreign corporation pays or accrues to another foreign affiliate**. The interest rules are based on an existing formula rule that can allocate interest to a US branch (and result in BEAT tax) even if the interest is not reflected on the books of the branch.

- The Proposed Regulations clarify that the **exception** for certain payments to a foreign related party for services provided at cost **(services cost method) is available even if a mark-up is charged** on those services. The mark-up, however, will not be eligible for the exception.

- The Proposed Regulations provide a **new exception** for payments made to US branches of foreign corporations if the payments are subject to US income tax as income that is **effectively connected with a US trade or business** (ECI).

Comment: The ECI exception provides relief to taxpayers in a situation where there is no base erosion because the payment to the related foreign corporation is subject to US income tax. However, payments to an affiliate that is a controlled foreign corporation (CFC) are not excluded from the BEAT even if they cause tax for US 10% shareholders.

- The Proposed Regulations provide a **new exception** for interest paid or accrued on TLAC securities issued by globally systemically important banking organizations under applicable Federal Reserve regulations.

- The Proposed Regulations also provide a **new exception** from base erosion payments for losses from **foreign currency transactions**.

- The Proposed Regulations say that the exception from the BEAT for payments on qualified derivatives **does not include a securities lending transaction, sale-repurchase transaction** or any substantially similar transaction.

No Netting Rule, Including for Reinsurance Transactions

- The Proposed Regulations provide that if a contract requires netting of payments to and from a foreign related party, including **netting reinsurance premium payments against claims payments from the foreign related party or against reserve adjustments**, the BEAT will be imposed on the **gross outbound payment** (unless netting is otherwise prescribed by the tax rules).

Comment: The absence of a specific netting rule means that the BEAT is imposed without regard to the actual amount of profits being shifted offshore in these transactions. Reinsurance by US insurers to non-US affiliates may be taxed very harshly under the BEAT rules (potentially in excess of the net profits from the transaction), leading some insurance groups to bring reinsurance structures onshore or to explore alternatives to conventional reinsurance.

- The IRS **declined to create a general exception for the BEAT for claims payments by a US reinsurer to a non-US affiliate insurer**, but noted that property and casualty companies may not be subject to the BEAT on these payments because they technically treat the payments as a **reduction to gross income** rather than a deduction.

Comment: Imposing the BEAT on outbound claims payments arguably runs contrary to the purpose of the BEAT because reinsurance of profitable business by US insurers increases the US tax base. However, unprofitable business does erode the base.

$500 Million Gross Receipts and Base Erosion Percentage Tests

- Taxpayers measure the gross receipts and base erosion percentage tests by looking to an **aggregate group** of related corporations as of the last day of their taxable year. Foreign corporations may be included in the aggregate group, but only to the extent of their ECI.

Comment: When considering an acquisition or disposition of a domestic corporation or foreign corporation with ECI, it will be important to model the effect on the acquiring and selling groups of the target's gross receipts and BEAT payments (and whether the buyer has a bank or broker-dealer affiliate), in order to ensure that the change does not inadvertently cause either group to fail to qualify for the *de minimis* tests. Only including foreign corporations with respect to ECI is a sensible rule that avoids distorting the tests with items that do not affect the US tax system.

- The Proposed Regulations generally provide that the lower base erosion percentage threshold of 2% applies to any aggregate group that includes a bank or registered securities dealer~~.~~ However, a *de minimis* rule excludes any bank or securities dealer whose gross receipts are less than 2% of the gross receipts of the group

Comment: The *de minimis* rule is welcome and prevents a "cliff effect" scenario such as a financial services group with a *de minimis* broker-dealer affiliate and a 2.5% base erosion percentage being thrown into the BEAT on all of its outbound payments.

NOLs

- The BEAT starts with a taxpayer's regular taxable income and adds back base erosion tax benefits to determine the base on which the minimum tax is assessed. Taxpayers with current-year deductions in excess of current-year income will use **a negative taxable income number** as the starting point for the BEAT calculation. However, **NOL carryforwards are not available** to drive otherwise positive taxable income below zero, **resulting in a BEAT tax** once the base erosion payments are added back from zero.

Comment: There is no separate tracking of NOLs for BEAT and regular income tax purposes. As a result, if an NOL is used to reduce income in a year where the BEAT is imposed at a 10% rate, it is lost for purposes of offsetting future 21% taxable income.

Interest Ordering Rules

- The tax rules limit a taxpayer's ability to reduce taxable income by "excessive" interest deductions. For purposes of the BEAT, **ordering rules** are required in the case of a taxpayer that incurs interest expense to both related and unrelated persons. The Proposed Regulations contain an ordering rule that is unfavorable for taxpayers, namely that for purposes of the BEAT, current-year deductions in respect of related persons come first, meaning that **allowed interest is considered first to be related-party interest and therefore potentially subject to the BEAT**.

Anti-Abuse Rules

- The Proposed Regulations include broad anti-abuse rules, designed to prevent taxpayers from avoiding the BEAT. In particular, the Proposed Regulations disregard **unrelated intermediaries**, if there is a plan or arrangement **a principal purpose of which is the avoidance** of a base erosion payment. The Proposed Regulations also disregard transactions designed to **increase the denominator of the base erosion percentage** and transactions a principal purpose of which is to take advantage of the more favorable 3% *de minimis* rule available to groups that do not include **banks and securities dealers**.

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Please do not hesitate to contact us with any questions.

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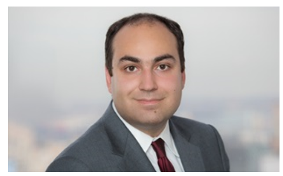

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