9 December 2019

Global Tax Alert

US final and proposed BEAT regulations provide some relief for taxpayers

EY Tax News Update: Global Edition

EY's Tax News Update: Global Edition is a free, personalized email subscription service that allows you to receive EY Global Tax Alerts, newsletters, events, and thought leadership published across all areas of tax. Access more information about the tool and registration here.

Also available is our EY Global Tax Alert Library on ey.com.

Executive summary

The United States (US) Treasury Department (Treasury) and the Internal Revenue Service (IRS) have issued final and proposed regulations on the base erosion anti-abuse tax (BEAT) under Internal Revenue Code[1] Section 59A (the final BEAT regulations and the 2019 proposed regulations, respectively). Both sets of regulations were published in the Federal Register on 6 December 2019.

The final BEAT regulations are largely consistent with the proposed BEAT regulations released on 13 December 2018 (the 2018 proposed regulations) but adopt several significant changes. Most notably, the final BEAT regulations generally exclude from the base erosion payment definition amounts transferred to a foreign-related party in certain specified nonrecognition transactions. The 2019 proposed regulations would also allow taxpayers to elect to forego a deduction so that it is not taken into account as a base erosion tax benefit so long as the deduction is waived for all US income tax purposes.

This Tax Alert describes significant changes in the final regulations compared to the 2018 proposed regulations and provides an overview of the 2019 proposed regulations.

Detailed discussion

Overview of BEAT

The BEAT generally applies to a corporation that: (i) is subject to US net income tax; (ii) has average annual gross receipts of at least US$500 million for the prior three years (the gross receipts test); and (iii) a "base erosion percentage" of 3% or more (2% or more for a taxpayer that is a member of an affiliated group with a domestic bank or registered securities dealer) (the base erosion percentage test). A corporation subject to the BEAT is an "applicable taxpayer." An aggregation rule applies to treat the taxpayer and certain affiliated corporations as one person for purposes of applying the gross receipts and base erosion tests to determine whether the taxpayer is an applicable taxpayer.

In addition to any other income tax, an applicable taxpayer must pay a "base erosion minimum tax amount" equal to the excess (if any) of 10% (5% for tax years beginning in calendar-year 2018) of its "modified taxable income" over an adjusted regular tax liability amount for the tax year. An applicable taxpayer's modified taxable income equals its taxable income for the year, determined without regard to (i) any deductions allowed (or certain reductions to gross receipts) (a base erosion tax benefit) with respect to a "base erosion payment," and (ii) the base erosion percentage of any net operating loss deduction allowed under Section 172.

Base erosion payments principally consist of (i) any amount paid or accrued by the taxpayer to a "foreign related party" and for which a deduction is allowed; and (ii) any amount paid or accrued by the taxpayer to a foreign related party in connection with the acquisition of depreciable (or amortizable) property. Base erosion tax benefits, in turn, are defined by reference to base erosion payments. For example, base erosion tax benefits include (i) a deduction allowed for any amount paid or accrued to a foreign related party (e.g., an amount of interest deductible under Section 163); and (ii) a depreciation (or amortization) deduction allowed for the acquired depreciable (or amortizable) property. The base erosion percentage for any tax year is generally the aggregate amount of base erosion tax benefits for the year (the numerator) divided by the aggregate deductions for the year (including base erosion tax benefits) but excluding deductions allowed under Sections 172, 245A or 250, and certain other deductions that are not base eroding payments.

The final regulations

Rules relating to the determination of base erosion payments

Exclusion for corporate nonrecognition transactions

An important and taxpayer-favorable change made by the final BEAT regulations is to generally exclude from base erosion payments amounts transferred to, or exchanged with, a foreign related party pursuant to a nonrecognition transaction under Sections 332, 351, 355, or 368 (specified nonrecognition transaction). Thus, a US subsidiary that receives depreciable or amortizable property from a foreign parent in a Section 351 exchange for stock of the US subsidiary will not be treated as making a base erosion payment to acquire that property, and the subsequent depreciation or amortization deductions will not be treated as base erosion tax benefits. The same result would apply to a US parent obtaining depreciable or amortizable property from a foreign subsidiary in a Section 332 liquidation of the foreign subsidiary. The exclusion does not apply to the transfer of other property or money (boot) by the taxpayer as a part of the specified nonrecognition transaction.

Equally important (and less taxpayer-favorable) is the addition of specific anti-abuse rules that address the Government's concern that a foreign related party may engage in a transaction that results in a basis step-up of amortizable or depreciable property immediately before transferring the property to a taxpayer in a specified nonrecognition transaction.

The general anti-abuse rule denies the nonrecognition exclusion when there is a transaction (or series of transactions), plan or arrangement with a principal purpose of increasing the adjusted basis of property that a taxpayer acquires in a specified nonrecognition transaction.

Additionally, a per se anti-abuse rule denies the exception when a transaction (or series of transactions), plan or arrangement between related parties increases the adjusted basis of property within the six months preceding the taxpayer's acquisition of the property in a specified nonrecognition transaction. While the per se rule is limited to basis step-up transactions occurring between related parties, the general rule appears to apply to basis step-up transactions occurring between related and unrelated parties. Neither of the rules clarify the status of the parties to the transaction as foreign or domestic.

Treatment of transfers or exchanges of built-in-loss property

The final BEAT regulations also provide favorable treatment of transfers or exchanges of built-in-loss property. Under the 2018 proposed regulations, it was not clear whether the transfer of built-in-loss property to a foreign related party that results in a deductible loss would on its own be considered a base erosion payment, with the loss treated as a base erosion tax benefit. The final BEAT regulations specify that a loss recognized on a sale or transfer of property to a foreign related person is not a deduction that would cause the payment to be treated as a base erosion payment. Thus, for example, a US company that recognizes a loss on machinery sold to a foreign related party in exchange for cash is not treated as making a base erosion payment (in the form of the machinery) that results in the loss being a base erosion tax benefit. In contrast, built-in-loss property that serves as payment to a foreign related person that is otherwise allowed a deduction or is for the acquisition of depreciable (or amortizable) property will be treated as a base erosion payment to the extent of its fair market value.

Simplifying conventions — Treas. Reg 1.882-5

Under the 2018 proposed regulations, the amount of interest on "excess effectively connected liabilities" that is a base erosion payment is determined by multiplying the interest by a ratio of related-party liabilities over total liabilities. "Effectively connected liabilities" are liabilities that are not recorded on the books of a US branch but are recorded on the books of the home office or another foreign branch and are allocated to the US branch under the three-step formula in Treas. Reg. Section 1.882-5. To the extent the allocated liabilities exceed US booked liabilities, they are excess effectively connected liabilities.

The final regulations modify this rule so that the amount of interest on excess effectively connected liabilities that is a base erosion payment is now determined by multiplying the interest by a ratio of the average worldwide related party interest expense over the average total worldwide interest expense accrued by the foreign corporation.

The final regulations also introduce a new rule allowing US branches to elect to compute their worldwide interest ratio using their applicable financial statements under Section 451(b)(3). The branch must use the applicable stand-alone financial statement of the foreign corporation of which it is a branch and may not use consolidated statements. The election is made on Form 8991 or a successor form.

Internal dealings

For BEAT purposes, the final regulations continue to treat certain deemed deductions determined under "internal dealings" like deductions determined under the Code and regulations. Under certain treaties, foreign corporations determine the business profits attributable to a permanent establishment (PE) based on the assets used, risks assumed and functions performed by the PE. In general, internal dealings refer to this treaty-based expense allocation or attribution method whereby amounts equivalent to deductible payments may be allowed in computing the business profits of an enterprise with respect to transactions between the PE and the home office or other branches of the foreign corporation (Treaty Method).

Under the proposed 2018 regulations, if a foreign corporation elects to use the Treaty Method, then all deductible deemed payments of the branch for internal dealings would be treated as BEAT payments. The final regulations continue to treat royalties and most other notional payments between the US branch and home office as base erosion payments. However, they provide a new and complex rule for interest payments under the Treaty Method.

First, the branch must determine its interest expense under Treas. Reg. Section 1.882-5 without application of the Treaty Method (the hypothetical 1.882-5 interest expense) using the new interest ratio. If the interest expense computed under the Treaty Method exceeds the hypothetical 1.882-5 interest expense, then the excess is a base erosion payment. Thus, to the extent that the Treaty Method is used to determine the interest expense allocable to a US branch, the BEAT payment may include two components: first, the related-party amount determined by applying the hypothetical 1.882-5 interest expense calculation, and second, the amount in excess of the hypothetical 1.882-5 interest expense.

Other deductions allowed under Treas. Reg. Section 1.882-4 for amounts paid or accrued by a US branch to a foreign related party (including a deductible amount apportioned to effectively connected income and non-effectively connected income) may also be base erosion payments.

Rules for determining an applicable taxpayer

The final BEAT regulations do not retain the rule under the 2018 proposed regulations that a taxpayer that is an aggregate group member determines its gross receipts and base erosion percentage on the basis of the aggregate group at the end of the taxpayer's tax year. Instead, the final BEAT regulations now require a taxpayer that applies the gross receipts and base erosion tests at the aggregate group level to include a member that is part of its aggregate group at any point during the taxpayer's tax year. The 2019 proposed regulations (discussed later) provide additional rules on how departing or incoming members are taken into account in determining a taxpayer's aggregate group.

The final BEAT regulations also simplify the way the gross receipts and base erosion percentage tests apply to an aggregate group that includes members with different tax years. The 2018 proposed regulations would have required a taxpayer that is in an aggregate group with a member having a different tax year to apply the gross receipts and base erosion percentage tests at the aggregate group level by reference to its own tax year end.

The final BEAT regulations adopt a simplifying rule for determining the gross receipts and base erosion percentage of a taxpayer's aggregate group based on the gross receipts, base erosion tax benefits, and deductions of the taxpayer for its tax year, and these same amounts of the other members of the aggregate group for their respective tax years that end with or within the taxpayer's tax year. The final BEAT regulations further exclude the base erosion tax benefits and deductions for a member's tax year that begins before 1 January 2018, for purposes of applying the base erosion percentage test at the aggregate group level.

The final BEAT regulations do not include rules on predecessors or short tax years. Instead, rules on these situations have been re-proposed in the 2019 proposed regulations.

The Preamble clarifies that a taxpayer's aggregate group can include a regulated investment companies (RIC) or real estate investment trusts (REIT), even though a RIC or REIT is not itself subject to BEAT. It can also include a controlled entity treated as a corporation under Section 892.

Rules affecting the computation of the base erosion minimum tax amount (BEMTA)

The final BEAT regulations provide that Section 15 does not apply to blend the BEAT rate of 5% and 10% for the tax year of a fiscal-year taxpayer beginning in calendar year 2018 (i.e., the first tax year that a fiscal-year taxpayer could have been subject to BEAT). Accordingly, both calendar-year and fiscal-year taxpayers can apply the 5% BEAT rate for the first tax year each would be subject to BEAT.

The final BEAT regulations also provide favorable treatment of AMT credits for determining an applicable taxpayer's adjusted regular tax liability in calculating the amount of BEMTA owed. The adjusted regular tax liability amount is generally the applicable taxpayer's regular tax liability amount reduced (but not below zero) by all credits (including foreign tax credits) other than the research credit and 80% of certain other Section 38 credits. The 2018 proposed regulations included credits for overpayment of taxes and for taxes withheld at source as credits that are not subtracted from the taxpayer's regular tax liability because they relate to US income tax paid for the current or prior tax year. Because AMT credits similarly relate to US income tax paid in a prior tax year, the final BEAT regulations provide that AMT credits do not reduce the adjusted regular tax liability of an applicable taxpayer for purposes of computing BEMTA.

In the 2018 proposed regulations, the lower 2% threshold for the base erosion percentage test for taxpayers that are members of an affiliated group with a domestic bank or registered securities dealer did not apply if the total gross receipts of the aggregate group attributable to the bank or registered securities dealer represented less than 2% of the total gross receipts of the aggregate group (de minimis exception). The final BEAT regulations retain the requirements for the de minimis exception but extend it to also preclude the higher BEAT rate otherwise applicable to taxpayers that are members of an affiliated group with a bank or registered securities dealer.

Transfer pricing related provisions

Exception related to services and the services cost method (SCM)

The final BEAT regulations are practically identical to the 2018 proposed regulations in providing an exception from the definition of base erosion payments for amounts eligible for the SCM under Treas. Reg. Section 1.482-9 (without regard to the business judgment rule). This means that, whether or not the taxpayer elected to apply the SCM, the cost portion (but not the markup) of an eligible service would not be considered a base erosion payment.

The final BEAT regulations describe minimum documentation requirements that must be met to establish that the applicable service is SCM-eligible for purposes of Section 59A. These documentation requirements are more stringent than those imposed for transfer pricing purposes.

No additional exceptions related to netting

The 2018 proposed regulations would have determined base erosion payments on a gross basis (notwithstanding a contractual or legal right to receive payments on a net basis) unless netting is permitted by the Code or applicable regulations (including positions properly subject to mark-to-market methods of accounting). Numerous comments recommended that the final BEAT regulations permit netting in a broader range of circumstances. These recommendations were not accepted. However, the Preamble notes that "the Treasury Department and the IRS are cognizant that [IRC Section] 59A may place more significance on some sections of the Code than was the case before [the *Tax Cuts and Jobs Act*]," and that they intend to further study regulations dealing with netting under notional principal contracts and cost sharing payments under Treas. Reg. Section 1.482-7(j)(3).

Additional comments recommended netting payments when the parties adopted a profit split method to determine arm's-length price under Section 482. Other comments requested not to treat payments made under a global dealing operation as base erosion payments. The final BEAT regulations do not adopt these recommendations. However, the Preamble notes that global dealing operations (or similar arrangements) may not give rise to base erosion payments in certain cases when parties may co-own trading positions; in that case, payments between them may not be deductible under general tax law principles. When the US participant compensates foreign participants for services performed, however, the Preamble further notes that the arrangement may be more properly characterized as trading income to the US participant and a deductible payment to the foreign participant for purposes of Section 59A.

Rules applicable to certain financial transactions

The final BEAT regulations include several new rules that are taxpayer favorable from a financial transactions perspective. First, the final BEAT regulations alter the treatment of foreign currency losses realized under Section 988 in computing the base erosion percentage. The 2018 proposed regulations would have excluded all foreign currency losses from the denominator in computing the base erosion percentage. Under the final BEAT regulations, Section 988 losses are included in the denominator, unless those losses arose from transactions with foreign related parties and were excluded from the numerator of the base erosion percentage.

Second, the final BEAT regulations remove the per se exclusion of securities lending transactions from the exception for "qualified derivatives payments" (QDP) and, instead, only exclude payments made with respect to the cash borrowing component of the securities lending transaction. As such, payments attributable to the borrowed security can qualify for the QDP exception. However, under an anti-abuse rule, those payments will not qualify for the QDP exception if the securities lending transaction is economically similar to an uncollateralized loan.

Third, the final BEAT regulations expand the exception for interest paid on total loss-absorbing capacity (TLAC) securities issued by "globally systemically important banking organizations" (GSIBs) in two ways. First, the exception is expanded to include internal securities issued by GSIBs under the laws of a foreign country that are comparable to the rules established by the Federal Reserve Board (provided those securities are treated as debt for US federal income tax purposes). Second, commentators had pointed out that GSIBs issue more than the minimum amount of TLAC securities, so they do not fall below the minimum amount if their balance sheet changes. In response to this comment, the final BEAT regulations expand the exclusion to cover interest paid on TLAC securities representing up to 115% of the specified minimum amount of TLAC securities the GSIB is required to issue.

Application of BEAT to partnerships

The final BEAT regulations provide a more detailed explanation of how the aggregate approach in the proposed regulations operates, including the treatment of partnership contributions and transfers of partnership interests. The 2018 proposed regulations generally would have applied an aggregate (i.e., look-through) approach in determining whether payments to or from a partnership, whether domestic or foreign, are base erosion payments. That is, any amount paid or accrued by a partnership would be treated as paid or accrued by each partner based on the partner's distributive share of items of deduction (or other amounts that could be base erosion tax benefits) with respect to that amount (as determined under Section 704). The final BEAT regulations elaborate on the application of the aggregate approach to certain partnership transactions and include nine examples to illustrate the mechanics. They also clarify that, if a transaction is not specifically described in Treas. Reg. Section 1.59A-7, whether it gives rise to a base erosion payment or base erosion tax benefit will be determined in accordance with the principles of Treas. Reg. Section 1.59A-7 and the purposes of Section 59A.

Contributions to partnerships

As previously discussed, the final BEAT regulations provide a favorable exclusion for certain corporate nonrecognition transactions. The Preamble explains that a similar nonrecognition exclusion for a partner's Section 721 contribution to a partnership is purposely not adopted due to the flow-through nature of partnership taxation and Treasury's intent to apply an aggregate approach to partnership transactions.

Partnership interest transfers

The expanded explanation of the aggregate rule in determining whether a BEAT payment has been made appears to encompass almost all transactions involving partners and partnerships. The BEAT regulations treat a taxpayer's acquisition of an interest in a partnership asset as a base erosion payment if (i) the partnership holds depreciable property and has a foreign related party as a partner; (ii) the acquisition reduces the foreign partner's interest in the asset. The acquisition is a base erosion payment because the regulations treat the property as acquired by the taxpayer.

The final BEAT regulations define "partnership interest transfer" to include an increase or decrease in a partner's proportionate share of a partnership asset, regardless of whether the transfer is by a partner or the partnership (including via a deemed or actual sale or a capital shift). This increase or decrease may result from:

- A contribution of property or services to a partnership
- A distribution
- A redemption

Or

- Any other transfer of a proportionate share of a partnership asset (other than a partnership's transfer of a partnership asset that is not a partnership interest to a person not acting in a partner capacity)

The broad definition of partnership interest transfers will require taxpayers to carefully consider whether any contributions to or any distributions from a partnership constitute a base erosion payment. The aggregate approach greatly increases the complexity in applying BEAT to partnerships with both domestic and foreign related partners.

Base erosion tax benefit definition

The final BEAT regulations provide a specific definition of base erosion tax benefit for a partner in a partnership that includes a partner's distributive share of any deduction or reduction in gross receipts attributable to a base erosion payment (including as a result of Sections 704(b) and (c), 707(a) and (c), 732(b) and (d), 734(b) and (d), 737, 743(b) and (d), and 751(b)). The expanded definition appears to align with the intent of the final BEAT regulations to apply an aggregate approach to partnerships, whereby all transactions between a partner and the partnership need to be considered under BEAT.

Application of BEAT to insurance companies

The final BEAT regulations include an exception for claims payments by domestic reinsurance companies (claims exception). The claims exception excludes from the definition of base erosion payment amounts paid or accrued to a foreign related party for losses incurred (as defined in Section 832(b)(5)) and claims and benefits (as defined in Section 805(a)(1)).

To qualify for the claims exception, the taxpayer must be taxable under subchapter L, and the foreign related party must be a regulated foreign insurance company (which is defined in the final BEAT regulations as an insurance company meeting certain licensing, regulatory and other requirements). Amounts covered by the claims exception must be paid or accrued under a reinsurance contract between the taxpayer and foreign regulated insurance company, and properly allocable to amounts required to be paid by the regulated foreign insurance company (or indirectly through another regulated foreign insurance company) under an insurance, annuity or reinsurance contract to a person other than a related party.

The final BEAT regulations exclude amounts covered under the claims exception from the denominator of the base erosion percentage. The final BEAT regulations clarify that all other amounts paid or accrued for losses incurred (as defined in Section 832(b)(5)) and claims and benefits (as defined in Section 805(a)(1)) are included in the denominator of the base erosion percentage.

Application of BEAT to consolidated groups

Similar to the 2018 proposed regulations, the final regulations generally apply a single-entity approach to the treatment of consolidated groups, with some specific separate entity rules that apply to the carryforward of disallowed business interest expense under Section 163(j). As related to consolidated groups, the final regulations focus on the interactions between Sections 59A and 163(j), and as described later, do not provide guidance covering certain common transactions.

For determining whether a consolidated group is an applicable taxpayer and the amount of tax due under Section 59A, members of a consolidated group are treated as a single taxpayer. For example, deductions of members are aggregated to calculate the base erosion percentage (e.g., if one member has $50 of deductions that are base erosion tax benefits and the only other member has $150 of deductions that are not base erosion tax benefits, the base erosion percentage of the group is 25%).

Items from intercompany transactions (transactions between corporations that are members immediately after the transaction) are not taken into account in determining the base erosion percentage or the BEMTA. For example, additional depreciation resulting from the intercompany sale of depreciable property for one member to another member is excluded from the denominator of the base erosion percentage. In a noticeable omission, the final regulations do not explicitly address the effect on the calculation of the base erosion percentage or modified taxable income when the acceleration rule of Treas. Reg. Section 1.1502-13(d) applies. For example, if member S sells property at a gain or loss to member B, and then parent member P sells the stock of S or B outside of the consolidated group, S's gain or loss from the intercompany transaction is accelerated. Read literally, the final regulations appear to disregard S's item, even though it is an actual item that affects the consolidated group's regular tax liability. The Preamble to the 2019 proposed regulations acknowledges some uncertainty for acceleration-rule transactions in the context of calculating gross receipts, but Treasury does not appear to acknowledge this issue for purposes of calculating the base erosion percentage or modified taxable income.

Regarding Section 163(j), the final regulations provide a single-entity classification rule for deduction of business interest expense, and a separate-entity rule for the group's disallowed business interest carryforwards. Domestic related-party business interest expense and foreign related-party business interest expense that are allowed under Section 163(j) are deemed to have been incurred pro-rata by all members of the group that incurred business interest expense in the year, regardless of which members in fact paid or accrued interest to foreign related or domestic related parties. Then, domestic related-party and foreign related-party business interest expenses of the group are allocated to each member in proportion to each member's business interest expense. Disallowed business interest expense is assigned a status under a similar proportionate calculation and retains the original assigned status when it is allowed in a future year (whether the member that carries forward the business interest expense stays in the group or not).

General BEAT anti-abuse rules

The 2018 proposed regulations included three general anti-abuse rules to address: (1) transactions involving intermediaries, including related parties, if there was a principal purpose of avoiding a base erosion payment (or reducing the amount of a base erosion payment); (2) transactions with a principal purpose of increasing the deductions taken into account in the denominator of the base erosion percentage; and (3) transactions among related parties entered into with a principal purpose of avoiding the application of the lower base erosion percentage threshold and higher BEAT rate to groups with banks or registered securities dealers. The final BEAT regulations adopt these general anti-abuse rules without change and incorporate some additional examples in response to requests for more clarity about what would constitute "a principal purpose."

One example covers the addition of intermediaries into a supply chain with a principal purpose of avoiding base erosion payments involving transfers of depreciable or amortizable property. A domestic corporation (DC1) that ordinarily acquires depreciable property from a related foreign party inserts into its supply chain another domestic corporation (DC2) that is a property dealer that capitalizes its purchases into inventory and recovers the amount through cost of goods sold. The facts in the example explain that, "with a principal purpose of avoiding a base erosion payment," DC2 purchases the equipment from the foreign related party and then resells it to DC1. The example concludes that the purchase price paid by DC1 to DC2 is deemed to result in a base erosion payment because it would have been a base erosion payment if it had been paid directly to the foreign related party, and DC2 makes a corresponding payment to the foreign related party "as part of a series of transactions, plan or arrangement that has a principal purpose of avoiding a base erosion payment" from DC1 to the foreign related party. Like several other anti-abuse examples, this example does not clarify the meaning of "a principal purpose" because the existence of an avoidance plan is included as one of the facts in the example.

Treasury and the IRS declined to accept most requests for exceptions to the anti-abuse rules for intermediaries. Moreover, comments requesting a change that would have allowed domestic corporate captive finance subsidiaries that purchase business equipment from a foreign related party and lease the property to unrelated third-party end user to treat the depreciation deductions attributable to the leased property as COGS for purposes of the BEAT were not accepted. The Preamble explains that a deduction allowed for depreciation for property acquired from a foreign related party is a base erosion tax benefit, notwithstanding that the property acquired by the taxpayer is used in an income-generating business in the US, such as the leasing of the business equipment to unrelated third-party lessees of the property.

Other suggested changes that were not adopted

No exception for amounts paid or accrued to a CFC that results in a subpart F or GILTI inclusion

Although numerous comments recommended an exception from the definition of a base erosion payment for payments made by a domestic corporation to a CFC that result in a GILTI or subpart F income inclusion, these suggestions were not adopted.

Pass-through payments

Comments suggested the definition of a "base erosion payment" exclude arrangements in which a taxpayer serves as a "middleman" for a payment to a foreign related party or makes a pass-through payment to a foreign related party as part of a global service arrangement. These suggestions were not adopted.

Effective dates of the final regulations

In general, the final BEAT regulations under Section 59A apply to tax years ending on or after 17 December 2018. However, taxpayers may apply the final BEAT regulations in their entirety for tax years ending before 17 December 2018. Taxpayers may also apply the 2018 proposed regulations in their entirety for all tax years ending on or before 6 December 2019. Taxpayers choosing to apply the proposed 2018 regulations must apply them consistently and cannot selectively choose which particular provisions to apply.

The 2019 proposed regulations

Rules for determining an applicable taxpayer

As previously discussed, the final BEAT regulations do not retain the rule under the 2018 proposed regulations that a taxpayer that is a member of an aggregate group determines its gross receipts and base erosion percentage on the basis of the aggregate group at the end of the taxpayer's tax year. The 2019 proposed regulations provide additional rules that address how departing or incoming members are taken into account in determining a taxpayer's aggregate group. To determine the gross receipts and base erosion percentage of its aggregate group under these proposed rules, a taxpayer would take into account only the portion of another corporation's tax year during which that corporation is a member of the taxpayer's aggregate group.

The 2019 proposed regulations also include re-proposed rules on predecessors or short tax years. Until these rules are finalized, taxpayers must take a reasonable approach consistent with Section 59A(e)(2)(B) to determine gross receipts and base erosion benefits in these situations.

Proposed election to waive allowable deductions

In response to comments, the 2019 proposed regulations would allow a taxpayer to elect to forego claiming all or part of an otherwise allowable deduction. Subject to the exceptions identified below, an election to waive deductions would be operative for all US federal income tax purposes.

A taxpayer would elect to waive an allowable deduction (or multiple deductions) on an original filed federal income tax return or an amended return (if filed within three years of the original filing date, provided the amended return does not decrease or revoke a prior waived deduction). The election would not be considered a method of accounting under Section 446; accordingly, IRS consent is not required, and taxpayers may choose whether to make the election on a year-by-year basis. To prevent taxpayers from waiving a deduction in one year and recouping the amount in a subsequent year, the 2019 proposed regulations would disregard the election for certain purposes, including for determining:

- The taxpayer's overall method of accounting or a method for any material item
- The amount of depreciation/amortization allowable or other basis adjustments
- The amount of a taxpayer's E&P
- The price of a controlled transaction under Section 482
- Whether there is a change in method of accounting
- The amount of a Section 481(a) adjustment

Also included is a general anti-abuse rule that would disregard items as necessary to prevent taxpayers from receiving the benefit of a waived deduction.

A special ordering rule would require the taxpayer to treat the waiver of an allowable deduction as occurring before the expense allocation and apportionment rules under Treas. Reg. Sections 1.861-8 through -14T and 1.861-17. As a result, if a taxpayer waived a significant amount of deductions, the pools of deductions subject to these rules could also be significantly reduced, which could negatively affect the taxpayer's foreign tax credit (FTC) position.

Also notable is an exception for directly allocable interest expenses (directly allocable to income produced by a particular asset). If a taxpayer waived deductions for these amounts, it would still have to reduce the value of the appropriate asset(s) by the waived amount. The Preamble explains that this exception is intended to mitigate the possibility that a taxpayer could inappropriately allocate additional interest expense to particular assets.

Application of BEAT to partnerships

The 2019 proposed regulations include a rule on allocating income in lieu of deductions. In general, the final BEAT regulations treat deductions allocated by the partnership to an applicable taxpayer resulting from a base erosion payment as a base erosion tax benefit. Cognizant that a partner in a partnership can obtain a similar economic result if the partnership allocates income items away from the partner instead of allocating a deduction to the partner through curative allocations, the 2019 proposed regulations provide that the partner is similarly treated as having a base erosion tax benefit to the extent of that substitute allocation.

The 2019 proposed regulations also include anti-abuse rules to prevent partnerships from allocating items of income with a principal purpose of eliminating or reducing base erosion payments in certain situations that do not change the economic arrangement of the partners. One rule would generally treat a taxpayer as having a direct interest in a partnership interest or asset if the taxpayer acquires a derivative on a partnership interest (or partnership asset) with a principal purpose of eliminating or reducing a base erosion payment. The other would generally apply when a partnership receives (or accrues) income from a person not acting in a partner capacity and allocates that income to its partners with a principal purpose of eliminating or reducing a base erosion payment. In addition, the Preamble contemplates adding an example on the Section 704(c) traditional method and curative allocations, indicating that a shift in the allocation of gross income items could be treated as a base erosion tax benefit.

Effective dates of the 2019 proposed regulations

The 2019 proposed regulations generally would apply to tax years beginning on or after the date that regulations finalizing those rules are published. However, the following proposed provisions would apply retroactively when the regulations are finalized: the proposed rules on determining the applicable taxpayer and waiving deductions would apply to tax years beginning on or after 6 December 2019, and the proposed rules on partnerships would apply to tax years ending on or after 2 December 2019. However, taxpayers may rely on the 2019 proposed regulations in their entirety for tax years beginning after 31 December 2017, and before the regulations are finalized.

Implications

The final and 2019 proposed regulations provide some helpful rules for taxpayers. In particular, the exception in the final BEAT regulations for specified nonrecognition transactions should generally allow for more transactions to occur without triggering BEAT, though careful consideration of the new guidance is warranted, including the new anti-abuse rules.

The final regulations also add some taxpayer-favorable rules for financial transactions. For example, taxpayers with a large number of Section 988 transactions, such as banks, will benefit from the inclusion of Section 988 losses from third-party transactions in the denominator when computing the base erosion percentage. On the other hand, many taxpayers will likely be disappointed that the IRS and Treasury rejected commentators' suggestion to expand the QDP exception to include transactions that are not subject to the mark-to-market method of accounting (e.g., certain hedging transactions).

While it may be helpful to forgo a deduction, electing to waive a deduction will likely mean weighing the benefit of a BEAT exemption (i.e., if the waived deduction results in the taxpayer's base erosion percentage falling below the required threshold to qualify as an applicable taxpayer) against the possible disadvantages stemming from the waived deduction, including potential increased tax cost, and the risk of unforeseen collateral effects on the taxpayer's tax filing position. Modeling will be key to evaluating the implications of making the election.

The final BEAT regulations continue to treat notional payments as base erosion payments when business profits attributable to a PE are determined under certain treaties. Taxpayers should carefully consider the implications of these rules. In addition, the documentation requirements needed to verify that services are eligible for the SCM exception should be considered so that adequate books and records are maintained.

Finally, the aggregate approach adopted for transactions involving partners and partnerships creates significant complexity in determining a partner's base erosion tax benefit for partnerships with both domestic and related foreign partners. The partnership allocation anti-abuse rule contemplated by the 2019 proposed regulations would continue expanding the application of the aggregate approach and require taxpayers to consider whether certain allocations of gross income items could be treated as creating base erosion tax benefits to applicable partners.

Endnotes

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.

For additional information with respect to this Alert, please contact the following:

Ernst & Young LLP, International Tax and Transaction Services

- Craig Hillier, *Boston* craig.hillier@ey.com
- José Murillo, *Washington, DC* jose.murillo@ey.com
- Arlene Fitzpatrick, *Washington, DC* arlene.fitzpatrick@ey.com
- Leo Naughton, *New York* leo.naughton@ey.com
- Julia Tonkovich, *Washington, DC* julia.m.tonkovich@ey.com
- Stephen Peng, *Washington, DC* stephen.peng@ey.com
- Tanza Olyfveldt, *Washington, DC* tanza.olyfveldt@ey.com

Ernst & Young LLP, Transfer Pricing

- Tracee Fultz, *New York* tracee.fultz@ey.com
- Kenneth Christman, *Washington, DC* kenneth.christmanjr@ey.com
- Thomas Vidano, *Washington, DC* thomas.vidano@ey.com
- Carlos Mallo, *Washington, DC* carlos.mallo@ey.com
- Heather Gorman, *Washington, DC* heather.gorman@ey.com

Ernst & Young LLP, Capital Markets

- Lee Holt, *New York* lee.holt@ey.com
- David Peppelman, *Washington, DC* david.peppelman@ey.com

Ernst & Young LLP, Partnerships

- Mark Opper, *Washington, DC* mark.opper@ey.com
- Ashley Lu, *Washington, DC* ashley.lu@ey.com

Ernst & Young LLP, Accounting Periods, Methods & Credits

- Kenneth Beck, *Washington, DC* kenneth.beck@ey.com
- Susan Grais, *Washington, DC* susan.grais@ey.com
- Scott Mackay, *Washington, DC* scott.mackay@ey.com

Ernst & Young LLP, National M&A Group

- Andy Dubroff, *Washington, DC* andrew.dubroff@ey.com
- Andrew Herman, *Washington, DC* andrew.herman1@ey.com

Ernst & Young LLP, Financial Services Organization

- Chris Ocasal, *Washington, DC* chris.ocasal@ey.com
- John Owsley, *Washington, DC* john.owsley@ey.com

International Tax and Transaction Services

Global ITTS Leader, **Jeffrey Michalak,** *Detroit*

ITTS Director, Americas, **Craig Hillier,** *Boston*

ITTS Markets Leader, Americas, **Laynie Pavio,** *San Jose, CA*

ITTS NTD Leader, **Jose Murillo,** *Washington, DC*

ITTS Regional Contacts, Ernst & Young LLP (US)

West
Sadler Nelson, *San Jose*

East
Colleen O'Neill, *New York*

Central
Aaron Topol, *Atlanta*

Financial Services
Chris J Housman, *New York*

Canada – Ernst & Young LLP (Canada)
Warren Pashkowich, *Calgary*

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

EYG no. 005622-19Gbl

1508-1600216 NY
ED None

ey.com