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IRS Issues New Final and Proposed Regulations Under the U.S. Base Erosion and Anti-Abuse Tax

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Summary

The IRS released final and proposed regulations providing further guidance and addressing certain open issues under the base erosion and anti-abuse tax (BEAT). The final regulations, based partly on the IRS's response to comments received, clarify previously proposed regulations, such as providing that certain amounts transferred in connection with a nonrecognition transaction are not base erosion payments. The newly proposed regulations would create a mechanism to reduce or eliminate application of the BEAT rules by permitting an electable waiver of tax deductions in order to reduce base erosion payments.

Background

The *Tax Cuts and Jobs Act of 2017* (Act) added the new BEAT regime under section 59A, which targets deductible amounts paid or accrued by "applicable taxpayers" to foreign related parties (base erosion payments).[1]

An applicable taxpayer is a U.S. corporation or a non-U.S. corporation doing business in the United States if (i) average annual gross receipts for the previous three years are at least US$500 million (the gross receipts test) and (ii) the ratio of the corporation's base erosion payments to its total deductions for the taxable year (the base erosion percentage) is at least 3% (2% for certain banks and registered securities dealers [base erosion percentage test]). For purposes of the gross receipts test and base erosion percentage test, all persons treated as part of the same "aggregate group" (generally based on common ownership greater than 50%) are treated as a single taxpayer. Regulated investment companies (RICs), real estate investment trusts (REITs) and S corporations are excluded from the definition of applicable taxpayer; therefore, such entities are not themselves subject to the BEAT.

An applicable taxpayer subject to the BEAT pays an additional tax equal to the excess of 10% (increasing to 12.5% in 2026) of the applicable taxpayer's "modified taxable income" over its regular federal income tax liability (as reduced by certain tax credits).[2] Modified taxable income for this purpose is the applicable taxpayer's regular taxable income for the year increased by (i) the base erosion payments for such year and (ii) the base erosion percentage of net operating losses (NOLs) used during such year against regular taxable income (provided that for these purposes regular taxable income is not treated as reduced below zero as a result of any NOL deduction).[3]

On December 21, 2018, the IRS issued proposed regulations providing guidance regarding (i) which taxpayers will be subject to the BEAT rules, (ii) the determination of base erosion payments and (iii) the calculation of the BEAT (2018 Proposed Regulations).

On December 2, 2019, the IRS provided additional guidance under the BEAT rules by issuing (i) a set of final regulations (2019 Final Regulations) that implemented (with some modifications) the 2018 Proposed Regulations and (ii) new proposed regulations (2019 Proposed Regulations).

2019 Final Regulations

Some of the key takeaways from the 2019 Final Regulations are as follows:

Gross Receipts and Base Erosion Percentage Tests. As noted above, RICs and REITs are excluded from the definition of "applicable taxpayer"; therefore, these entities are not themselves subject to the BEAT. In light of this exclusion, the comments received requested regulations to provide that RICs and REITs be excluded from an applicable taxpayer's aggregate group for purposes of the gross receipts test and the base erosion percentage test. The 2019 Final Regulations rejected this request, noting that as with partnerships whose income and deductions flow through to an applicable taxpayer for purposes of these tests, so too should the income and deductions of RICs and REITs that are members of an aggregate group flow through to the applicable taxpayer. Moreover, as with RICs and REITs, certain controlled entities under section 892 can also be included in an applicable taxpayer's aggregate group.

Overlap with Anti-Deferral Regimes. The 2019 Final Regulations finalized the provisions of the 2018 Proposed Regulations providing that payments to a foreign related party will not be treated as base erosion payments to the extent that such payments are treated as effectively connected income (ECI) to the recipient. In response to the 2018 Proposed Regulations, commentators requested that the ECI exception be expanded to cover certain payments to foreign related parties that are controlled foreign corporations or passive foreign investment companies (PFICs) to the extent that such payments are included in income of a U.S. person under the U.S. anti-deferral regimes (i.e., the subpart F income, GILTI or PFIC regimes). The 2019 Final Regulations declined to extend the ECI exception to cover such payments.

Base Erosion Payments. The 2019 Final Regulations, in response to comments received on the 2018 Proposed Regulations, exclude from the definition of base erosion payment amounts transferred to or exchanged from a foreign related party in a "specified nonrecognition transaction" (i.e., transactions described in sections 332, 351, 355 or 368); provided, however, that any "boot" transferred to a foreign related party in such a specified nonrecognition transaction may be treated as a base erosion payment (without regard to whether gain is recognized in such transaction).

2019 Proposed Regulations

Some of the key takeaways from the 2019 Proposed Regulations are as follows:

Election to Waive Deductions. Notwithstanding the general rule that all deductions that can be claimed by an applicable taxpayer are treated as allowed deductions for purposes of the base erosion percentage test, the 2019 Proposed Regulations provide that an applicable taxpayer may elect to waive, on an annual basis, certain tax deductions, which shall not be taken into account for purposes of the base erosion percentage test. By electing to waive tax deductions and reducing base erosion payments, an applicable taxpayer may be able to avoid triggering the BEAT in a particular year. As the base erosion percentage is determined on an aggregate group basis, it may be necessary for an applicable taxpayer's affiliates to waive deductions if the applicable taxpayer intends to reduce its base erosion percentage under this rule. If the election is made, the deductions are treated as waived for all U.S. federal income tax purposes. Prior to such time that the 2019 Proposed Regulations are finalized, an applicable taxpayer can make such election by attaching a statement with the required information to its IRS Form 8991, *Tax on Base Erosion Payments of Taxpayers with Substantial Gross Receipts*.

Partnerships. The 2018 Proposed Regulations generally provided for the use of an aggregate approach to partnerships, treating payments both to and from a partnership with corporate partners as having been received or made by the partners for BEAT purposes. Consequently, if an applicable taxpayer is a partner in a partnership, deductions allocated from the partnership to such applicable taxpayer resulting from a base erosion payment are treated as a base erosion payment of the applicable taxpayer. In order to prevent an applicable taxpayer from achieving a similar economic result through curative partnership allocations (i.e., in lieu of allocating deductions to an applicable tax payer, allocate income that is otherwise allocable to the applicable tax payer for book purposes to other partners of the partnership) without triggering the BEAT rules, the 2019 Proposed Regulations provide that use of such allocations in lieu of deductions will be treated as a base erosion payment if such allocations cause the applicable taxpayer to be in an economically equivalent position of having been allocated a base erosion payment.

Effective Date

The 2019 Final Regulations became effective December 6, 2019. The 2019 Proposed Regulations generally apply to tax years beginning on or after the date that these regulations are finalized; however, certain provisions of the Proposed Regulations (e.g., the partnership provision described above regarding allocation of income in lieu of deductions) apply to tax years ending on or after December 2, 2019.

Moreover, taxpayers can rely on the 2019 Proposed Regulations in their entirety for tax years beginning after December 31, 2017, until finalized.

[1] For the purposes of the BEAT, a related party is (i) any person that owns at least 25% of the vote or value of the taxpayer corporation's stock (a 25% owner); (ii) any person related to the taxpayer or a 25% owner under sections 267(b) or 707(b)(1); and (iii) any other person related to the taxpayer under section 482. The stock ownership attribution rules of section 318 apply, with certain modifications. References to sections refer to sections of the Internal Revenue Code of 1986, as amended.

[2] The BEAT is not reduced for foreign tax credits.

[3] Various commentators have requested that regulations provide a mechanism to ensure that pre-2018 vintage NOLs are not devalued as a result of, *inter alia*, a reduction in the corporate tax rate to 21%, from 35%, under the Act. These comments were not adopted in the regulations.

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