B.E.A.T.-ING BASE EROSION: U.S. SUBJECTS LARGE CORPORATIONS TO ANTI-ABUSE TAX

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The Tax Cuts and Jobs Act ("T.C.J.A.") introduced Code §59A, which imposes a new Base Erosion and Anti-Abuse Tax ("B.E.A.T.") on large corporations that significantly reduce their U.S. tax liability through the use of cross-border payments to related persons. The provision is viewed to be an act against inbound base erosion as well as another form of the now-repealed corporate Alternative Minimum Tax.

B.E.A.T. HITS BIG BUSINESS

The B.E.A.T. generally applies to corporate taxpayers that have average annual gross receipts of $500 million or more during the testing period (the "gross receipts test") and whose deductible payments to related parties ("base erosion payments") equal or exceed 3% of their total allowed deductions (2% for certain banks and securities dealers). The provision does not apply to S-corporations, regulated investment companies ("R.I.C.'s") or real estate investment trusts ("R.E.I.T.'s").

The B.E.A.T. is not limited to U.S. corporations but can apply to foreign corporations as well with respect to income that is effectively connected with the conduct of a U.S. trade or business. However, for purposes of determining whether the foreign corporation meets the gross receipts test, gross receipts are only included if they are taken into account when calculating the taxpayer's U.S. effectively connected income.

If the base erosion payments reduce the taxpayer's U.S. tax liability to less than 10% of its U.S. (modified) taxable income, the B.E.A.T. applies. The definition of base erosion payment is open ended and includes, *inter alia*, payments for services, interest, rents, and royalties.

CALCULATING THE TAX LIABILITY

If applicable, the amount of the B.E.A.T. is determined by a formula that compares 10% of the modified gross income with the actual tax paid by the taxpayer. A positive result is the B.E.A.T. amount. Modified gross income is generally arrived at by adding back to the taxable income (i) any deductions allocated to base erosion payments or (ii) depreciation and amortization related to property whose purchase was treated as a base erosion payment, as well as (iii) a certain portion of the deducted net operating loss.

In 2018 the calculation of the B.E.A.T. takes into account a 5% rate of tax. After 2025, the calculation takes into account a 12.5% rate of tax. These rates are 1% higher for certain banks and securities dealers.

The "add-back" deductions are those attributable to base erosion payments, which generally mean deducted amounts paid or accrued by the taxpayer to a related foreign person. For these purposes, a foreign person is related to the taxpayer if the person is (i) treated as owning at least 25% of the shares entitled to the vote or the value in the taxpayer, (ii) related to the taxpayer or to a 25% owner within the meaning of Code §267, or (iii) treated as related under principles applicable to the transfer pricing rules of Code §482. For purposes of determining the relationship, constructive ownership rules apply.

Certain payments are excluded. These include the following:

- Payments that reduce the taxpayer's gross receipts, such as payments for the cost of goods sold (except for certain expatriated corporations)
- Payments for services that are eligible for the application of the services cost method under the transfer pricing regulations
- Payments subject to U.S. withholding tax under the rules applicable to fixed determinable annual or periodic ("F.D.A.P.") payments[1]

If interest deductions are limited by Code §163(j), the reduction in the deduction amount is allocable first to interest on loans from unrelated parties. When comparing the calculated amount of tax to the actual tax liability, certain general and industry specific business credits are added back, increasing the likelihood that the B.E.A.T. will apply.

PLANNING ISSUES AND OPPORTUNITIES

Deductible F.D.A.P. payments that are actually subject to U.S. withholding tax are generally excluded from the calculation of the B.E.A.T. amount. However, the provision does not address other payments that are subject to U.S. tax (*e.g.*, payments to related controlled foreign corporations that may be treated as Subpart F that are included in the U.S. shareholder's taxable income and payments to U.S. branches outside the U.S.). In this respect, a Treasury official, speaking at an International Tax Institute meeting in N.Y., stated that the provision was intended not only as an anti-base erosion provision but also as a minimum tax provision. It is therefore possible that further guidance will not amend this seeming omission. However, we are to await and see.

Following the enactment of this provision, large corporations should analyze the deductible payments made to related foreign persons and determine if the B.E.A.T. is a concern. While potential restructuring of payments can be explored, the Treasury has been granted broad regulatory authority to issue regulations to prevent the avoidance of the B.E.A.T., including the use of unrelated persons. According to the Treasury official, regulations should be published by June 2019 and will apply retroactively to January 1, 2018.

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[1] Code §871 imposes tax on F.D.A.P. income received by nonresident individuals; Code §881 imposes tax on F.D.A.P. income received by foreign corporations; Code §§1441 and 1442 provide for the withholding of the tax imposed under the aforementioned provisions.