WHO'S GOT THE B.E.A.T.? A PLAYBOOK FOR DETERMINING APPLICABLE TAXPAYERS AND PAYMENTS

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INTRODUCTION

Code §59A was enacted to impose tax on U.S. corporations with substantial gross receipts when base erosion payments to related entities significantly reduced regular corporate income tax imposed at a 21% rate. The tax is known as the base erosion and anti-abuse tax (the "B.E.A.T."). In late December, the I.R.S. proposed regulations that will provide guidance for affected taxpayers.

This article is the first in a series that will explain how the proposed regulations identify the taxpayers affected by the B.E.A.T. and the ways those taxpayer will be affected.

APPLICABLE TAXPAYERS

According to Prop. Treas. Reg. §1.59A-2, the B.E.A.T. applies only to a corporation, other than a R.I.C., R.E.I.T., or S-corporation, that satisfies the gross receipts test and the base erosion percentage test. For this purpose, related corporations within a "controlled group," per Code §52(a), generally are treated as a single taxpayer. The controlled group includes domestic and foreign corporations. For the latter, only gross receipts that generate effectively connected income ("E.C.I.") subject to tax under Code §882(a) are taken into account.

The Aggregate Group Concept

The regulations use the term "Aggregate Group" to refer to members within the controlled group that are taken into account as part of a single taxpayer.

The proposed regulations limit the Aggregate Group to corporations that benefit from deductions – and for that reason may have base erosion tax benefits. They exclude foreign corporations that are not subject to net U.S. income tax. Thus, foreign corporations that generate U.S.-source income taxable under Code §881 on a gross basis, only, are excluded. If a foreign corporation has both E.C.I. taxed under Code §882 and fixed and determinable annual and periodic income taxed under Code §881, only the former is included. If a foreign corporation determines its net taxable income under an applicable income tax treaty, so that part of its E.C.I. is not attributable to a permanent establishment in the U.S. and therefore not taxed, the foreign corporation is a member of the Aggregate Group only with regard to gross receipts attributable to the permanent establishment, which are taxed as business profits.

The proposed regulations generally provide that payments between members of the Aggregate Group are not included in the gross receipts of the Aggregate Group or in the numerator or the denominator used to calculate the base erosion percentage. This approach is consistent with the single entity concept of Code §59a(e)(3).

“One payment by a domestic corporation to a foreign corporation may not be taken into account in determining whether an Aggregate Group is an applicable taxpayer, while another payment between the same parties is taken into account.”

Payments between the Aggregate Group and any outside foreign corporation are taken into account in applying both the gross receipts test and the base erosion percentage test. On the other hand, payments to a foreign corporation from within the Aggregate Group that are subject to net income tax in the U.S. are not taken into account in applying the gross receipts test and the base erosion percentage test. It follows that one payment by a domestic corporation to a foreign corporation may not be taken into account in determining whether an Aggregate Group is an applicable taxpayer, while another payment between the same parties is taken into account.

The I.R.S. has requested comments on the proposed Aggregate Group concept.

Gross Receipts Test

A taxpayer satisfies the gross receipts test if the taxpayer or the Aggregate Group has $500 million or more of average annual gross receipts during the three prior taxable years. In the case of a foreign corporation, gross receipts are taken into account only if subject to net income tax under both U.S. domestic law and an applicable income tax treaty.

The taxpayer’s Aggregate Group is determined as of the end of its taxable year for which B.E.A.T. liability is being computed, and the calculation includes the gross receipts of those Aggregate Group members during the prior three-year period. The proposed regulations include specific rules for corporations that have been in existence for fewer than three years or have short years. The rules are generally consistent with Code §§448(c)(3)(B) through (D). The proposed regulations also clarify how gross receipts are determined when members of the Aggregate Group have differing taxable years.

In addition, if a member of an Aggregate Group owns an interest in a partnership, the proposed regulations provide that the group must include the member’s distributive share of items of gross income from the partnership.

Base Erosion Percentage Test

The base erosion percentage for a taxable year is computed by dividing (i) the aggregate amount of base erosion tax benefits (the “numerator”) by (ii) the sum of the aggregate amount of deductions plus certain other base erosion tax benefits (the “denominator”). The B.E.A.T. applies only when the numerator exceeds 3% of the denominator – or 2% if the applicable taxpayer or a member of its Aggregate Group is a domestic bank or registered securities dealer.

The numerator of the base erosion percentage excludes deductions for the following:

- Amounts paid or accrued to foreign related parties for services qualifying for the services cost method (“S.C.M.”) exception in Prop. Treas. Reg. §1.59A-3(b)(3)(i)
- Payments covered by the qualified derivatives payments (“Q.D.P.”) exception in Prop. Treas. Reg. §1.59A-3(b)(3)(ii)
- Amounts excluded pursuant to the total loss-absorbing capacity (“T.L.A.C.”) exception in Prop. Treas. Reg. §1.59A-3(b)(3)(v)[1]

[1] The Federal Reserve requires that certain global systemically important banking organizations (“G.S.I.B.’s”) issue T.L.A.C. securities as part of a global

In certain circumstances, an applicable taxpayer may make a payment to a foreign related party that is not a member of the Aggregate Group. This would occur if the recipient of the payment is a 25% owner[2] of the applicable taxpayer but does not own more than 50%. If that payment qualifies for the S.C.M., the Q.D.P., or the T.L.A.C. exception and is properly characterized as E.C.I.,[3] the payment will be included in the denominator of the fraction when computing the base erosion percentage. On the other hand, if the excluded payments are not properly treated as E.C.I., they are removed from the denominator of the fraction in addition to the numerator.

Code §988 addresses currency gains and losses derived in connection with certain debt obligations, accrued but unpaid expenses, and certain forward or futures transactions. Such losses are removed from the numerator and the denominator in determining the base erosion percentage.

The numerator of the base erosion percentage only takes into account base erosion tax benefits for which a deduction is allowed under the Code in the taxable year. Similarly, the denominator of the base erosion percentage takes into account only deductions allowed under the Code. Disallowed deductions are excluded. Therefore, since a deduction allowed under Code §965(c) to a U.S. Shareholder of a deferred foreign income corporation is not specifically excluded, that deduction is included in the denominator.

A base erosion tax benefit is not included in the numerator when the payment is subject to tax under Code §871 or Code §881 and 30% withholding tax has been collected and paid over to the I.R.S. If the payment is subject to a reduced rate of withholding tax under an income tax treaty, the actual payment is treated as two separate payments. One such deemed payment is treated as subject to 30% withholding. The other such payment is treated as fully exempt. To determine the taxable portion, the withholding tax rate under the applicable treaty is divided by the 20% rate provided by domestic law. As a result, if the withholding tax rate in the treaty is 10%, one-third of the total payment is deemed to be fully taxed (10% ÷ 30% = 33.33%). The remaining two-thirds of the payment is treated as fully exempt. This computation uses rules similar to those in Code §163(j)(5)(B), as in effect before the T.C.J.A.

The base erosion percentage also takes into account (i) certain premiums or other considerations paid to a foreign related party for reinsurance and (ii) amounts paid or accrued by the taxpayer to certain surrogate foreign corporations that result in a reduction in gross receipts for the taxpayer.

Taxpayers in an Aggregate Group with Different Taxable Years

A corporation is determined to be an applicable taxpayer based on the gross receipts and base erosion payments of each member of the Aggregate Group. However, each member must compute the Aggregate Group amount of gross receipts and base erosion payments based on its own taxable year and based on those corporations that are members of the Aggregate Group at the end of such taxable year.

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framework intended to minimize the risk of insolvency. A full discussion of the T.L.A.C. rules is beyond the scope of this article.

2 Prop. Treas. Reg. §1.59A-1(b)(17).

3 Prop. Treas. Reg. §1.59A-3(b)(3)(iii).

In general, the proposed regulations provide that each taxpayer determines its gross receipts and base erosion percentage by reference to its own taxable year, taking into account the results of other members of its Aggregate Group during that taxable year.[4] As a result, two related taxpayers with different taxable years will compute their applicable gross receipts and base erosion percentage by reference to different periods.

The fact pattern where this rule applies is broad. It can involve two or more separate chains of U.S. corporations in separate business segments where each chain separately files a consolidated tax return or brother-sister corporations having the same foreign corporation as a shareholder.

The following example illustrates the rule:

> **Facts.** The foreign parent ("F.P.") is a foreign corporation that owns all of the stock of a domestic corporation that uses a calendar year ("DC1") and a domestic corporation that uses a fiscal year ending on January 31 ("DC2"). F.P. does not have income effectively connected with the conduct of a trade or business within the U.S. DC2 is a member of DC1's Aggregate Group, and DC1 is a member of DC2's Aggregate Group.
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> **Analysis.** For DC1's tax return for the calendar year ending December 31, 2026, DC1 determines its gross receipts based on the gross receipts of DC1 and DC2 for the calendar years ending December 31, 2023, December 31, 2024, and December 31, 2025. Further, DC1 determines its base erosion percentage for the calendar year ending December 31, 2026, on the basis of transactions of DC1 and DC2 for the calendar year ending December 31, 2026.
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> For DC2's tax return for the fiscal year ending January 31, 2027, DC2 determines its gross receipts based on the gross receipts of DC2 and DC1 for the fiscal years ending January 31, 2024, January 31, 2025, and January 31, 2026. Further, DC2 determines its base erosion percentage for the fiscal year ending January 31, 2027, on the basis of transactions of DC2 and DC1 for the fiscal year ending January 31, 2027.[5]

When determining the base erosion percentage for a taxpayer in this fact pattern, the effective date for Code §59A applies by reference to the taxpayer making the return. Code §59A applies only to base erosion payments paid or accrued in taxable years beginning after December 31, 2017. Where one taxpayer reports on a calendar year basis and the other on a fiscal year basis ending on January 31, the calendar year taxpayer will take into account transactions of the fiscal year taxpayer beginning on January 1, whereas the fiscal year taxpayer takes into account transactions of the calendar year taxpayer beginning February 1.

B.E.A.T CALCULATIONS

Base Erosion Payments

The proposed regulations define a base erosion payment as a payment or accrual by the taxpayer to a foreign related party that falls into one of four categories:

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[4] Prop. Treas. Reg. §1.59A-2(e)(3)(vii).

[5] Prop. Treas. Reg. §1.59A-2(f)(2), example 2.

- A payment with respect to which a deduction is allowable
- A payment made in connection with the acquisition of depreciable or amortizable property
- A payment of premiums or other consideration for reinsurance that is taken into account under Code §§803(a)(1)(B) or 832(b)(4)(A)
- A payment that reduces the gross receipts of the taxpayer that is made with respect to certain surrogate foreign corporations or related foreign persons

Payments or Accruals that Consist of Non-Cash Consideration

A payment or accrual by a taxpayer may be a base erosion payment whether made in cash or in any form of non-cash consideration.[6] There may be situations where a taxpayer makes a non-cash transfer to a foreign related party. The transaction is subject to the B.E.A.T. as long as it meets one of the above definitions of a base erosion payment. It does not matter whether the transaction qualifies under certain nonrecognition provisions of the Code.[7]

Neither the nonrecognition of gain or loss to the transferor nor the absence of a step-up in basis to the transferee establishes a basis to exclude the payment from the definition of a base erosion payment. The statutory definition of base erosion payment is based on the amount of imported basis in the asset. In comparison, where a corporate taxpayer receives depreciable property from a foreign related party as an in-kind distribution subject to tax as a dividend under Code §301, there is no base erosion payment because there is no consideration provided by the taxpayer to the foreign related party in exchange for the property.

In addition, a base erosion payment also includes a payment to a foreign related party resulting in a recognized loss.

The proposed regulations do not include any specific exceptions for these types of transactions even though (i) the transferor of the assets acquired by the domestic corporation may not recognize gain or loss, (ii) the acquiring domestic corporation may take a carryover basis in the depreciable or amortizable assets, and (iii) the importation of depreciable or amortizable assets into the U.S. in these transactions may increase the regular income tax base as compared to the non-importation of those assets.

Interest Expense Allocable to a Foreign Corporation's E.C.I.

The B.E.A.T. applies to foreign corporations that have E.C.I., taking into account any applicable U.S. income tax treaty. A foreign corporation that has interest expense allocable under Code §882(c) to E.C.I. will have a base erosion payment to the extent the interest expense is paid to a foreign related party. The amount of interest that will be treated as a base erosion payment depends on the calculation method applied under Treas. Reg. §1.882-5.

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6 Prop. Treas. Reg. §1.59A-3(b)(2)(i).

7 Examples of such transactions include a domestic corporation's acquisition of depreciable assets from a foreign related party in an exchange described in Code §351, a liquidation described in Code §332, and a reorganization described in Code §368.

If a foreign corporation uses the method described in Treas. Reg. §§1.882-5(b) through (d), interest on direct allocations and on U.S.-booked liabilities paid or accrued to a foreign related party will be base erosion payments. If U.S.-booked liabilities exceed U.S.-connected liabilities, a foreign corporation computing its interest expense under this method must apply the scaling ratio to all of its interest expense on a *pro-rata* basis to determine the amount that is a base erosion payment. Interest on excess U.S.-connected liabilities also may be a base erosion payment if the foreign corporation has liabilities with a foreign related party.

Other Deductions Allowed with Respect to E.C.I.

Like excess interest expense, the proposed regulations provide that the amount of a foreign corporation's other deductions properly allocated and apportioned to effectively connected gross income under Treas. Reg. §1.882-4 are base erosion payments to the extent that those deductions are paid or accrued to a foreign related party. Accordingly, the regulations identify base erosion payments by tracing each item of deduction and determining whether the deduction arises from a payment to a foreign related party.

If a foreign corporation engaged in a trade or business within the U.S. acquires property of a character subject to the allowance for depreciation from a foreign related party, the amount paid or accrued by the taxpayer is a base erosion payment to the extent the property is used, or held for use, in the conduct of a trade or business within the U.S.

Income Tax Treaties

Certain U.S. income tax treaties provide alternative approaches for the allocation or attribution of business profits from an enterprise of one contracting state to its permanent establishment in the other contracting state on the basis of assets used, risks assumed, and functions performed by the permanent establishment. The use of a treaty-based expense allocation or attribution method does not, in and of itself, create legal obligations between the U.S. permanent establishment and the rest of the enterprise. Nonetheless, the proposed regulations recognize that treaty-based expense allocation or attribution income may arise from internal transactions (known as internal dealings). The proposed regulations require that these deductions be treated as base erosion payments.

In the first instance, the allocation and apportionment of expenses of the enterprise to the branch or permanent establishment is not itself a base erosion payment because the allocation represents a division of the expenses of the enterprise, rather than a payment between the branch or permanent establishment and the rest of the enterprise.

In the second instance, internal dealings are not mere divisions of enterprise expenses but rather are priced on the basis of assets used, risks assumed, and functions performed by the permanent establishment in a manner consistent with the arm's length principle.

The approach in the proposed regulations creates parity between deductions for (i) actual regarded payments between two separate corporations and (ii) internal dealings.

EXCLUDED PAYMENTS

Certain Services

The S.C.M. exception provides that Code §59A(d)(1) does not apply to any amount paid or accrued by a taxpayer for services if (i) the services are eligible for the services cost method under Code §482 and (ii) the amount constitutes the total services cost with no markup component. The I.R.S. interprets the key components as follows:

- The term "S.C.M." refers to the services cost method described in Treas. Reg. §1.482-9(b).
- The requirement regarding "fundamental risks of business success or failure" refers to the test in Treas. Reg. §1.482-9(b)(5), commonly called the business judgment rule.
- The term "total services cost" refers to the definition of "total services costs" in Treas. Reg. §1.482-9(j).

The preamble to the proposed regulations explains that Code §59A(d)(5) is ambiguous as to whether the S.C.M. exception applies when an amount paid for services exceeds the total services cost but the payment otherwise meets the other requirements for the S.C.M. exception. Under a literal interpretation, the S.C.M. exception does not apply to any portion of a payment that includes any mark-up component. Under another interpretation based on a set of legislative questions and answers known as a "soliloquy," the S.C.M. exception is available if there is a markup – but only to the extent of the total services costs. Under the latter approach, the services cost would continue to qualify for the S.C.M. exception provided the other requirements of the S.C.M. exception are met. The latter approach to the S.C.M. exception is more expansive because it does not limit qualification to payments made exactly at cost.

"The S.C.M. exception is available if there is a markup (and if other requirements are satisfied), but the portion of any payment that exceeds the total cost of services is not eligible."

The proposed regulations provide that the S.C.M. exception is available if there is a markup (and if other requirements are satisfied), but the portion of any payment that exceeds the total cost of services is not eligible for the S.C.M. exception and is a base erosion payment.

To be eligible for the S.C.M. exception, all of the requirements of Treas. Reg. §1.482-9(b) must be satisfied, except as modified in these regulations. Therefore, a taxpayer's determination that a service qualifies for the S.C.M. exception is subject to review under the requirements of Treas. Reg. §§1.482-9(b)(3) and (b)(4), and its determination of the amount of total services cost and allocation and apportionment of costs to a particular service is subject to review under the rules of Treas. Reg. §§1.482-9(j) and 1.482-9(k).

Although the proposed regulations do not require a taxpayer to maintain separate accounts to bifurcate the cost and markup components of its services charges to qualify for the S.C.M. exception, the proposed regulations do require that taxpayers maintain books and records adequate to permit verification of, among other things, the amount paid for services, the total services cost incurred by the renderer, and the allocation and apportionment of costs to services in accordance with Treas. Reg. §1.482-9(k).

Certain services are not eligible for the method due to the business judgment rule or for other reasons. Nonetheless, payments for those services are eligible for the S.C.M. exception.

The proposed regulations also clarify that the reference to the business judgment rule in the parenthetical, *i.e.*, "(determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure)," causes the entire requirement set forth in Treas. Reg. §1.482-9(b)(5) to be disregarded solely for purposes of Code §59A(d)(5).

Qualified Derivative Payments

A Q.D.P. exception can apply to any payment made by a taxpayer to a foreign related party pursuant to a derivative for which the following is true:

- The taxpayer recognizes gain or loss on the derivative on a mark-to-market basis.
- The gain or loss is ordinary.
- Any gain, loss, income, or deduction is also treated as ordinary.

The Q.D.P. exception applies only if the taxpayer satisfies reporting requirements that appear in Prop. Treas. Reg. §1.6038A-2(b)(7)(ix). If a taxpayer satisfies the reporting requirements for some Q.D.P.'s, but not all, only the payments for which the taxpayer fails to satisfy the reporting requirements will be ineligible for the Q.D.P. exception. The reporting requirement will first apply to taxable years beginning after final regulations are published. Until then, taxpayers may satisfy the reporting requirements by reporting the aggregate amount of Q.D.P.'s on Form 8991, *Tax on Base Erosion Payments of Taxpayers with Substantial Gross Receipts*.

Recipients Subject to U.S. Tax

For a payment to be treated as a base erosion payment, the recipient must be a foreign person. Code §6038A(c)(3) defines "foreign person" as any person that is not a U.S. person within the meaning of Code §7701(a)(30). However, for the B.E.A.T., the term "U.S. person" does not include any individual who is a citizen of any U.S. territory and is not otherwise a citizen or resident of the U.S.[8]

The proposed regulations include an exception from the definition of base erosion payment for amounts considered to be E.C.I.. If a foreign recipient determines its net taxable income under an applicable income tax treaty, the exception applies to payments that are considered to be business profits attributable to a permanent establishment or real property income, both of which are subject to net rates of tax under general treaty concepts.

Base Erosion Payments Occurring Before the Effective Date and Pre-2018 Disallowed Business Interest

As previously mentioned, the B.E.A.T. applies only to base erosion payments paid or accrued in taxable years beginning after December 31, 2017. Payments made prior to a taxable year beginning before January 1, 2018, are not subject to the B.E.A.T.

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8 Prop. Treas. Reg. §1.59A-1(b)(10).

To illustrate, assume that in 2015, a calendar year taxpayer made a payment to a foreign related party to acquire depreciable property. The taxpayer's depreciation deduction allowed in 2018 with respect to this property is not a base erosion tax benefit. Similarly, if in 2016, a taxpayer with a calendar year accrued interest on an obligation to a foreign related party, but the interest was not until paid under Code §267(a), the taxpayer's payment of the interest in 2018 is not a base erosion tax benefit.

The proposed regulations reverse a position stated in Notice 2018-28 regarding interest expense for which a deduction was not allowed as a by reason of Code §163(j). The notice concluded that business interest carried forward from a taxable year beginning before January 1, 2018, would be treated in the same manner as interest paid or accrued in a taxable year beginning after December 31, 2017, for purposes of Code §59A. This position has been abandoned. Any deferred interest that is carried forward from a taxable year beginning before January 1, 2018, is not a base erosion payment.

CONCLUSION

Proposed regulations on the B.E.A.T. provide a road map for understanding the focus of the I.R.S. in implementing the tax. In a second installment, we will focus on more of the detail affecting certain expenses and certain industries.