WHO'S GOT THE B.E.A.T.? SPECIAL TREATMENT FOR CERTAIN EXPENSES AND INDUSTRIES

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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 21%. 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 is the second of a two-part series that explains how the proposed regulations identify taxpayers affected by the B.E.A.T. and how the rules are apply to those taxpayers. It focuses on the details affecting certain expenses and certain industries. For a practical outline of effected entities and payments, see "Who's Got the B.E.A.T.? A Playbook for Determining Applicable Taxpayers and Payments."

BASE EROSION TAX BENEFITS

In General

Generally, a base erosion tax benefit is the amount of any deduction relating to a base erosion payment that is allowed under the Code for the taxable year.[1] If full 30% withholding tax is collected by the U.S. entity on payments to related parties outside the U.S., the base erosion payment has a base erosion tax benefit of zero for purposes of calculating a taxpayer's modified taxable income. If an income tax treaty reduces the amount of withholding imposed on the base erosion payment, the base erosion payment is treated as a base erosion tax benefit to the extent of that reduction. Rules similar to those in Code §163(j)(5)(B) as in effect prior to the T.C.J.A. are applied in making the computation.

Coordination with Code §163(j) Limitation

Code §163(j) applies to limit the amount of a taxpayer's business interest expense that is deductible in the taxable year. The proposed B.E.A.T. regulations coordinate with Code §163(j) to determine how much of a taxpayer's interest expense deduction is limited under the B.E.A.T. and how much is limited under Code §163(j).[2] Under these rules, the interest expense disallowed under Code §163(j) is allocated first to interest expense on loans from unrelated parties. Any disallowed interest expense remaining is allocated to loans from related parties. Interest paid or accrued to related parties that is not disallowed under Code §163(j) is taken into account when applying Code §59A. If some related-party lenders are U.S. persons and others are foreign, the interest expense payments are divided between U.S. and non-U.S. persons on a proportional basis. In a similar way, any disallowed business

1 Prop. Treas. Reg. §1.59A-3(c).

2 Prop. Treas. Reg. §1.59A-3(c)(4).

interest expense carryforward is treated first as business interest paid to unrelated parties. The remainder is treated as business interest expense paid to related parties. Again, where lenders are a mix of U.S. and non-U.S. persons, apportionment is required.

MODIFIED TAXABLE INCOME

Method of Computation

For any taxable year, Code §59A imposes a tax on each applicable taxpayer equal to the base erosion minimum tax amount for that year. The base erosion minimum tax amount is determined based on an applicable taxpayer's modified taxable income for the taxable year. The computation of modified taxable income and the computation of the base erosion minimum tax amount are made on a taxpayer-by-taxpayer basis.

The computation of modified taxable income is made on an add-back basis. The computation starts with taxable income (or taxable loss) of the taxpayer, as computed for regular tax purposes, and adds (i) the gross amount of base erosion tax benefits for the taxable year and (ii) the base erosion percentage of any net operating loss ("N.O.L.") deduction under Code §172 for the taxable year.

If a taxpayer has an excess of deductions allowed by Chapter 1 over gross income, computed without regard to the N.O.L. deduction, the taxpayer has negative taxable income for the taxable year. Generally, the proposed regulations provide that a negative amount is the starting point for computing modified taxable income when there is no N.O.L. deduction from net operating loss carryovers and carrybacks.

If an N.O.L. deduction is carried to the taxable year and that N.O.L. deduction exceeds the amount of positive taxable income, the excess amount of the N.O.L. deduction does not reduce taxable income below zero for determining the starting point for computing modified taxable income.

Base Erosion Percentage of N.O.L. Deductions

Code §59A(c)(1)(B) provides that modified taxable income includes the base erosion percentage of any N.O.L. deduction allowed under Code §172 for the taxable year. The proposed regulations apply the base erosion percentage of the year in which the loss arose, or a vintage year, because the base erosion percentage of the vintage year reflects the portion of base eroding payments reflected in the net operating loss carryover.[3] In addition, because the vintage-year base erosion percentage is a fixed percentage, taxpayers will have greater certainty as to the amount of the future add-back to modified taxable income (as compared to using the utilization-year base erosion percentage).

Based on this approach, the proposed regulations also provide that in the case of net operating losses that arose in taxable years beginning before January 1, 2018, and that are deducted as carryovers in taxable years beginning after December 31, 2017, the base erosion percentage is zero because Code §59A applies only to base erosion payments that are paid or accrued in taxable years beginning after December 31, 2017.

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[3] Prop. Treas. Reg. §1.59A-4(b)(2)(ii).

Base Erosion Minimum Tax Amount

An applicable taxpayer computes its base erosion minimum tax amount ("B.E.M.T.A.") for the taxable year to determine its liability under Code §59A(a).[4] The taxpayer's B.E.M.T.A. is the amount by which (i) the applicable tax rate for the taxable year ("B.E.A.T. rate") multiplied by the taxpayer's modified taxable income for the taxable year exceeds (ii) the taxpayer's adjusted regular tax liability for that year.

In determining the taxpayer's adjusted regular tax liability for the taxable year, credits (including the foreign tax credit) are generally subtracted from the regular tax liability amount. To prevent an inappropriate understatement of a taxpayer's adjusted regular tax liability – thereby leading to excessive B.E.M.T.A., credits for overpayment of taxes and for taxes withheld at source are not subtracted from the taxpayer's regular tax liability because these credits relate to Federal income tax paid for the current or previous year.

"The base erosion percentage threshold for certain banks and registered securities dealers is lowered from 3% or more to 2% or more."

Application of Code §59A to Partnerships

A partnership is not an "applicable taxpayer." Only a corporation can be an applicable taxpayer. However, a partnership is treated as an aggregate of the partners in determining whether payments to or payments from a partnership are base erosion payments. Consequently, when determining whether a corporate partner that is an applicable taxpayer has made a base erosion payment, amounts paid or accrued by a partnership of which it is a member are treated as if they were paid by each partner to the extent an item of expense is allocated to the partner under Code §704.

Partners with certain small ownership interests are excluded from this aggregate approach for purposes of determining base erosion tax benefits from the partnership. This small ownership interest exclusion generally applies to partnership interests that represent less than 10% of the capital and profits of the partnership and less than ten percent of each item of income, gain, loss, deduction, and credit; and that have a fair market value of less than $25 million.[5]

Rules Relating to Banks and Dealers

Code §59A modifies two general rules in the case of certain banks or registered securities dealers:

- The base erosion percentage threshold for certain banks and registered securities dealers is lowered from 3% or more to 2% or more.
- The B.E.A.T. rate is one point higher for those banks or registered securities dealers.

The statutory definition of the term "bank" is not modified by the proposed regulations. Consequently, the definition in Code §581 applies. Therefore, an entity that is a bank or trust company incorporated and doing business under the laws of U.S. or any state and the District of Columbia is a bank. A foreign corporation licensed to conduct a banking business in the U.S. and subject to U.S. tax on effectively connected income is not.

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[4] Prop. Treas. Reg. §1.59A-5(b).

[5] Prop. Treas. Reg. §1.59A-7(b)(4).

The term “registered securities dealer” is limited to a dealer as defined in section 3(a)(5) of the Securities Exchange Act of 1934 that is registered, or required to be registered, under section 15 of the Securities Exchange Act of 1934.

The proposed regulations also confirm that the operative rules that lower the base erosion percentage threshold and increase the B.E.A.T. rate apply only to a taxpayer that is a member of an affiliated group, as defined in Code §1504(a)(1). They do not apply if the taxpayer is not affiliated with another includible corporation or is not itself an includible.

The lower threshold applies if any member of the aggregate group is a member of an affiliated group that includes a bank or registered securities dealer, as defined. A limited exception applies where the bank or registered securities dealer’s activities are *de minimis* within the affiliated group

Rules Relating to Insurance Companies

The definition of a “base erosion payment” includes any premiums or other consideration paid or accrued to a foreign related party for any reinsurance. Gross income for a life insurance company is defined in Code §803 to include the gross amount of premiums and other consideration on insurance and annuity contracts, less return premiums and premiums and other consideration arising out of indemnity reinsurance. For an insurance company other than a life insurance company, Code §832(b) provides that gross income generally includes underwriting income, which is comprised of premiums earned during the taxable year, less losses and expenses incurred.

This poses a practical problem as certain reinsurance agreements provide that amounts paid to and from a reinsurer are settled on a net basis or netted under the terms of the agreement. A similar practice applies to other commercial agreements where reciprocal payments may be settled on a net basis or netted under the terms of those agreements. The proposed regulations do not provide a rule permitting netting in any of these circumstances.

ANTI-ABUSE AND RECHARACTERIZATION RULES

Certain transactions with a principal purpose of avoiding Code §59A will be disregarded or deemed to result in a base erosion payment. This proposed anti-abuse rule addresses the following types of transactions:

- Transactions involving an intermediary acting as a conduit to avoid a base erosion payment
- Transactions entered into to reduce the base erosion percentage
- Transactions among related parties designed to avoid application of rules regarding banks and registered securities dealers[6]

Consolidated Groups as Taxpayers

Affiliated groups of domestic corporations electing to file a consolidated income tax return generally compute income tax liability on a “single-entity” basis. Following

[6] Prop. Treas. Reg. §1.59A-9(b).

that path, the tax under Code §59A is determined at the consolidated group level. This is designed to eliminate distortions based on the location of deductions within the group.

Coordinating Consolidated Group Rules for Code §§59A(c)(3) and 163(j)

As with individual subsidiaries operating in the U.S., the proposed regulations coordinate the application of Code §§59A and 163(j) when U.S. operations are conducted by an affiliated group in the U.S. Where both sections apply to interest expense, the taxpayer is required to treat all disallowed business interest as allocable first to interest paid or accrued to persons who are not related parties and then to related parties.

The proposed regulations mandate that an affiliated group must identify which interest deductions are allocable to domestic related party payments, foreign related party payments, and unrelated party payments on a consolidated basis.[7]

CODE §6038A REPORTING & RECORDKEEPING REQUIREMENTS

Code §6038A imposes reporting and recordkeeping requirements on domestic corporations that are 25% foreign-owned. Code §6038C imposes the same reporting and recordkeeping requirements on certain foreign corporations engaged in a U.S. trade or business. These corporations are collectively known as "reporting corporations."

Reporting corporations are required to file an annual return on Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Under Sections 6038A and 6038C of the Internal Revenue Code)*, with respect to each related party with which the reporting corporation has had any "reportable transactions."[8] Reporting corporations are also subject to specific requirements under Code §§6038A and 6038C to maintain and make available the permanent books of account or records that are sufficient to establish the accuracy of the Federal income tax return, including information, documents, or records to the extent they may be relevant to determine the correct U.S. tax treatment of transactions with related parties.[9]

Code §6038A(b)(2) was added under T.C.J.A. and applies to taxable years beginning after December 31, 2017. It authorizes regulations requiring information from a reporting corporation that is also a Code §59A "applicable taxpayer" for purposes of administering Code §59A.

To facilitate I.R.S. screening for noncompliance with Code §59A at the return filing stage, the I.R.S. is authorized to require by form or instructions the following information reporting:

- Relationships with related parties in regard to which a Form 5472
- Transactions within certain categories on a more detailed basis

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[7] Prop. Treas. Reg. §1.59A-3(c)(4).

[8] Treas. Reg. §1.6038A-2.

[9] Treas. Reg. §1.6038A-3.

- The manner used to determine the amount of particular reportable transactions and items
- A summary of reportable transactions and items with all foreign related parties on a schedule attached to Form 5472

CONCLUSION

The B.E.A.T. rules add significant complexity to foreign-owned U.S. corporations. This series of articles is intended to explain the scope of obligations imposed on affected corporations. For those corporate executives tasked with responsibility for preparing U.S. tax returns, the I.R.S. has posted draft forms.

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