

DECEMBER 18, 2018

IRS Proposes Regulations Under the Base Erosion and Anti-Abuse Tax

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The *Tax Cuts and Jobs Act* replaced the U.S. federal corporate alternative minimum tax with the base erosion and anti-abuse tax (BEAT), which targets deductible payments made after 2017 by certain large corporations to foreign related parties.¹ This week, the IRS issued proposed regulations to provide guidance on application of the BEAT provisions.

In order to be subject to the BEAT, a corporation's average annual gross receipts for the previous three years must be at least US\$500 million and the ratio of the corporation's "base erosion payments" to its total deductions for the taxable year (the base erosion percentage) must be at least 3%.² The BEAT does not apply to RICs, REITs or S corporations.

A base erosion payment is a payment to a foreign related party if the payment is deductible or is used to acquire depreciable or amortizable property. Base erosion payments do not include payments for services that are generally eligible for the "services cost method" under section 482 or certain payments with respect to derivatives that are marked to market. In addition, costs of goods sold (COGS) are not base erosion payments, thereby giving taxpayers an incentive to restructure payments as COGS that would otherwise be treated as base erosion payments.³

If the BEAT applies, the amount of the BEAT is the excess of 10%⁴ of the corporation's "modified taxable income" over its federal income tax liability computed without regard to the BEAT, reduced by certain tax credits.⁵ Modified taxable income for this purpose is the corporation's taxable income with the base erosion payments added back. In addition, the base erosion percentage of the corporation's net operating loss carryovers (NOLCs) is added back. Accordingly, income used to pay interest to a related foreign party will be subject to tax of at least 10% if the payor corporation is subject to the BEAT.

Among the more notable provisions in the proposed regulations are the following:

Base Erosion Payments. The proposed regulations detail covered payments as determined by using U.S. federal income tax principles. The proposed regulations provide that the acquisition of depreciable property in a non-recognition transaction can result in a covered payment, whereas a distribution of depreciable property from a foreign related party under section 301 will not (because there is no consideration paid).

Effectively Connected Income. The proposed regulations provide that a foreign corporation's interest payments can be base erosion payments if they reduce effectively connected income (ECI). Conversely, payments to a foreign related party are not base erosion payments if those payments constitute ECI to the recipient and are taxable under an applicable tax treaty.

The proposed regulations recognize that payments may be made between a foreign corporation's permanent establishment in the United States (as determined under a tax treaty) and a home office of that foreign corporation. Rules are provided for allocating and attributing expenses to these internal transactions for the purposes of the BEAT.

Service Cost Method Exception. Payments that are eligible for the service cost method under section 482 are not base erosion payments. The proposed regulations permit exclusion of the cost component of the payments even if a profit margin is charged and impose recordkeeping requirements.

Timing Issues. The proposed regulations clarify that deductions that relate to payments in years before the effective date of the *Tax Cuts and Jobs Act* are not taken into account under the BEAT. For example, if a corporation purchased depreciable property from a foreign related party in 2015, depreciation deductions with respect to that property taken after January 1, 2018, are not base erosion payments. Similarly, NOLCs that arose before January 1, 2018, are not subject to the BEAT.⁶

Coordination with Section 163(j). The statute provides that payments for business interest that are disallowed under section 163(j) are not base erosion payments for the purposes of the BEAT, but disallowed interest is treated as coming from unrelated parties first, which maximizes the amount of interest subject to the BEAT. The proposed regulations provide further coordinating rules.

Partnerships. The proposed regulations generally use 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. These rules have a "small ownership interest" exception for partnership interests representing less than 10% of capital and profits of the partnership and with a fair market value of less than US\$25 million.

Consolidated Returns. Members of an affiliated group that file a consolidated return are treated as a single taxpayer for the purposes of the BEAT.

Withholding Taxes. The proposed regulations provide that a base erosion payment is treated as having a base erosion tax benefit of zero if the full 30% withholding tax is paid under section 1441 or 1442 with respect to the payment. If the payment is eligible for a reduced rate of withholding under a tax treaty, the payment is treated as a base erosion tax benefit in proportion to the reduction in withholding tax.

Tax Credits. The BEAT is reduced by the R&D tax credit until the end of 2025, but, as noted above, not by foreign tax credits.

Anti-Abuse Rule. Certain transactions with a principal purpose of avoiding the BEAT will be disregarded or deemed to result in a base erosion payment. These transactions include (i) transactions involving intermediaries acting as a conduit; (ii) transactions entered into in order to increase the amount of deductions in the denominator of the base erosion percentage; and (iii) transactions among related parties entered into in order to avoid application of the BEAT to banks and registered securities dealers.

Effective Date

The proposed regulations are generally proposed to apply to taxable years beginning after December 31, 2017. Until the proposed regulations are made final, a taxpayer may rely on them as long as the taxpayer and its related parties apply the rules consistently.

¹ Section 59A. 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-Percent Owner); (ii) any person related to the taxpayer or a 25-Percent 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" are to sections of the Internal Revenue Code of 1986, as amended.

² For banks and registered securities dealers, this threshold is reduced to 2%.

³ An exception applies to inverted companies.

⁴ The BEAT rate is only 5% in 2018, increasing to 10% at the beginning of 2019 and further increasing to 12.5% at the beginning of 2026.

⁵ The BEAT is not reduced for foreign tax credits.

⁶ The proposed regulations are more favourable to taxpayers than prior guidance on this issue in Notice 2018-28, which was partially revoked by the proposed regulations.

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