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International Tax ADVISORY ■

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The BEAT (Still) Goes On – New Final and Proposed BEAT Regulations

To the elation of taxpayers and practitioners alike, on December 2, 2019, Treasury and the IRS released final and proposed regulations under Section 59A (commonly referred to as the base erosion and anti-abuse tax, or BEAT). Within the hundreds of pages of final and proposed regulations, including the extensive discussion in the preamble, taxpayers can find some much-needed clarifications as well as interesting planning opportunities.

Background

As its name suggests, the BEAT of Section 59A introduced by the Tax Cuts and Jobs Act is meant to combat base erosion. It applies to corporate taxpayers (other than REITs, RICs, and S corporations) with annual gross receipts over $500 million for the prior three years and whose base erosion percentage is 3% or higher (2% for banks). Generally, the BEAT operates as a minimum tax (5% for 2018, 10% for 2019 through 2025, and 12.5% for years after 2025) on payments to foreign related parties. The BEAT is calculated on the excess of modified taxable income over a taxpayer's regular tax liability, reduced by certain types of credits.

Key Takeaways

The new final regulations are very similar to the December 21, 2018 proposed regulations, with a few important changes. The new proposed regulations provide additional clarification on determining a taxpayer's aggregate group and how the BEAT applies to partnerships. The 2019 Proposed Regulations also provide a potentially helpful election to waive deductions. The Final Regulations generally apply to tax years ending on or after December 17, 2018, but taxpayers may elect to apply the Final Regulations in their entirety for tax years ending before December 17, 2018. Taxpayers may also apply the 2018 Proposed Regulations in their entirety for all tax years ending on or before December 6, 2019. Taxpayers can rely on the 2019 Proposed Regulations for tax years beginning after December 31, 2017 and subsequent years so long as such rules are also applied in their entirety.

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Clarifications about base erosion payments

Commenters requested numerous changes to the definition of base erosion payments, including the treatment of middleman payments, agency arrangements, reimbursements, global services contracts, profit-split arrangements, services performed in connection with manufacturing, payments mandated by regulation, etc. They also asked that a general netting rule be included to offset payments. The Final Regulations do not adopt many of the changes requested, but they do include some favorable modifications and retain helpful provisions from the proposed regulations (e.g., services cost method exception).

For example, the Final Regulations include a specific reference that items in cost of goods sold are not base erosion payments, and they state, in the regulatory text, that general U.S. federal income tax law applies to determining if a payment is a base erosion payment. In addition, the Final Regulations do not add restrictions to what is includible in cost of goods sold. Companies are carefully evaluating whether certain payments that might otherwise be base erosion payments can be excluded by applying principles of generally applicable tax law and modifying the applicable legal agreements and transactions accordingly.

For reinsurance, the Final Regulations provide that base erosion payments do not include a deductible payment to related foreign insurers for losses incurred and claims and benefits under a reinsurance contract if the payment is allocated to a contract with an unrelated insured. In addition, base erosion payments do not include depreciation on assets acquired from a foreign related party in a tax-free transaction.

Clarifications about aggregate groups

Section 59A determines the status of a corporation as an "applicable taxpayer" (meaning a taxpayer subject to the BEAT) by measuring gross receipts and the base erosion percentage by reference to the corporation's "aggregate group." This can get tricky when members of a taxpayer's aggregate group have different taxable years. Under the 2018 Proposed Regulations, the gross receipts, base erosion tax benefits, and deductions of the aggregate group for a tax year are determined by reference to the taxpayer's own tax year, ignoring the tax year of the other member. This would have required each tested group member to construct annualized gross receipts for all affiliates with different tax years to match its own tax year. Commenters decried this proposal due to the potential administrative headaches involved in treating all group members as having the same taxable year. In response to these comments, the Final Regulations provide a more streamlined rule. The determination of gross receipts and the base erosion percentage of a taxpayer's aggregate group is made on the basis of the taxpayer's tax year and the tax year of each member of its aggregate group that ends with or within the applicable taxpayer's tax year (referred to as the "with-or-within method").

The Final Regulations also clarify that a transaction between parties is disregarded when determining the gross receipts and base erosion percentage of an aggregate group for purposes of the BEAT if both parties were members of the aggregate group at the time of the transaction. This is true regardless of whether the parties were members of the aggregate group on the last day of the taxpayer's year.

The 2019 Proposed Regulations provide guidance on the application of the aggregate group rules for purposes of the with-or-within method in situations involving group members with short taxable years, members who leave or join the group, and predecessor entities. If an aggregate group member has a short taxable year, the gross receipts of that taxpayer should be annualized by multiplying the gross receipts for the short taxable year by 365 and dividing the result by the number of days in the short taxable year. Additionally, taxpayers must use a "reasonable approach" to determine the base erosion percentage of the aggregate group and whether the taxpayer or its aggregate group satisfies the gross receipts test and base erosion percentage when a group member has a short taxable year.

No guidance is given for what exactly a reasonable approach would look like. If a member leaves or joins an aggregate group, only items of members that occur during the period that they were members of the taxpayer's aggregate group should be taken into account. In cases involving predecessor entities, if the aggregate group of the taxpayer and its predecessor overlap, the gross receipts of those corporations included in both aggregate groups are not double counted. The preamble to the 2019 Proposed Regulations notes that Treasury and the IRS are studying whether it is appropriate to continue to eliminate gross receipts resulting from intercompany transactions when members deconsolidate and join a different aggregate group.

Election to waive deductions

The 2019 Proposed Regulations offer taxpayers the option to elect to waive deductions that could be treated as base erosion payments. By default, all deductions that could be properly claimed by a taxpayer for the taxable year (even if not actually claimed) are treated as allowed deductions unless a taxpayer elects to waive them. If the election is made, the waived deduction is excluded from the computation of the base erosion percentage and is not added back when determining modified taxable income. This provides taxpayers with an opportunity to reduce their base erosion percentage below the 3% threshold, allowing them to escape the BEAT. This election is one of the most notable and taxpayer-favorable inclusions in the recent BEAT guidance.

Taxpayers should keep in mind that deductions waived for purposes of the BEAT are waived for almost all U.S. federal income tax purposes. This means that a cost-benefit analysis should be performed before deciding whether to make the election. Thankfully, the 2019 Proposed Regulations offer some flexibility to taxpayers making this election. A taxpayer is able to make the election to waive deductions on its original filed federal income tax return, by an amended return, or even during the course of an audit. Additionally, the election is only made annually, and IRS consent is not needed if the taxpayer does not make the election in a subsequent taxable year. Although the 2019 Proposed Regulations state that a taxpayer can only increase the amount of its waiver (e.g., on an amended return or upon audit to remain below the 3% threshold), recent statements suggest that Treasury is considering allowing decreases as well.

As noted above, the waiver of deductions is disregarded only for certain U.S. federal income tax purposes set out in the 2019 Proposed Regulations. One instance where the waiver is disregarded is if the waived deduction was for depreciation or amortization. In that case, the basis in the relevant asset must still be reduced by the waived amount. The waiver is also disregarded for certain transfer pricing purposes. The waiver is disregarded for purposes of determining the price of a controlled transaction under Section 482. In addition, if a taxpayer applies a transfer pricing method that uses costs or expenses as an input, the costs or expenses associated with waived deductions continue to be treated as "costs" or "expenses" for purposes of the Section 482 regulations. As a catchall category of sorts, the 2019 Proposed Regulations also provide that the waiver of deductions is disregarded for "any other item as necessary to prevent a taxpayer from receiving the benefit of a waived deduction."

Next Steps

Companies should consider how the newly issued Final Regulations and 2019 Proposed Regulations will impact them and evaluate whether they are better off applying the Final Regulations or the 2018 Proposed Regulations for prior tax years. Steps to minimize or avoid the BEAT may require modifications to legal agreements, systems, transaction flows, etc., and timely planning is critical. Additionally, companies should analyze any potential benefits from the election to waive deductions. Treasury and the IRS have requested comments from the public on all aspects of the 2019 Proposed Regulations, which must be submitted by February 4, 2020.

For more information, please contact Richard Slowinski at 202.239.3231 or Stefanie Kavanagh at 202.239.3914.

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